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Wells Fargo Prime Services Business Consulting

# Industry and Regulatory Updates

## Highlights





## Industry Trends

### Current Trends in Management Fee Negotiations for Hedge and Credit Funds

*By: David Nissenbaum, Partner, and Jina Choi, Associate, Schulte Roth & Zabel LLP*

*Fee structures continue to evolve as investors increasingly leverage their bargaining power to negotiate terms that better align their interests with those of managers. The overarching trend in management fees highlights relationship-driven negotiations that reflect growing demand for lower fees and greater transparency around costs.*

An increasing number of hedge and credit fund managers are offering or asked to provide customized fee breaks based on the timing, size or continuity of investments.

*Size-based discounts; Co-Investments*: Among the most commonly negotiated fee breaks are discounts based on the size of an investor's investment, which some managers calculate by including an investor's investments across all of the manager's products. In addition to discounts for large investments, these investors may also request access to co-investment opportunities at low or no management fees as a way to lower their overall fees. It is not uncommon for a manager with significant assets under management to have multiple side letters with a variety of size-based fee discounts. Particular care needs to be taken to think through and harmonize most favored nation provisions to ensure that a manager does not inadvertently give fee breaks due to differing MFN terms.

*Loyalty discounts*: As an incentive to retain assets or to remain competitive, some managers have offered fee breaks to investors who have continuously maintained investment in the manager's fund for a specified period of time. Loyalty discounts have been suggested more often in the last few years but are not a widespread trend.

*"1-or-30"*: The "1-or-30" fee alternative achieved some popularity in 2017 and 2018 when numerous investors and managers adopted some version of it. In its suggested form, the manager is paid the greater of a 1% management fee to cover operational costs, or 30% of overall profits if performance surpasses an agreed-upon benchmark. As often as not, an investor or manager will accept a variation, such as no benchmark or a "1-or-20" fee alternative. It remains to be seen if the popularity of this fee model will continue.

*Founders' Classes*: While more popular in the years immediately after the financial crisis, some managers still offer "founders' classes" with discounted fees to entice early investing. In exchange, investors often agree to lock-up periods during which redemptions are prohibited or subject to a redemption charge. Founders' classes terms - which are generally disclosed in offering materials - vary widely, but managers usually retain flexibility to extend the period during which new or existing investors of the founders' class can purchase interests on its terms.

Investors continue to scrutinize a fund's costs relative to its performance, and managers must be prepared to engage in significant negotiations surrounding the scope of their operational costs.

*Fee offsets*: Credit funds which engage in negotiated transactions and lead deals follow the private equity practice of offering dollar-for-dollar offsets of transaction fees they earn against management fees. The amount offset is often negotiated at a fund's launch and will vary depending on type of fund. Even more common in credit is to have transaction-related fees paid to the fund (rather than the manager), and the manager effectively earns incentive compensation on that income.

*Management versus fund expenses*: Investors are requesting more information about a fund's expenses and overhead. This is a companion to the trend towards increasing the scope of fund expenses as management fee rates have declined. Investors tend to be understanding of investment-related costs and fund operational expenses, but expect transparency. Managers need to be mindful that they provide uniform access to expense information, and thorough disclosure in their fund offering documents. Managers intent on successfully raising funds now and into the future must prepare to leverage existing and burgeoning relationships with investors. To maintain the flexibility required for competitive negotiations, managers should set a reasonable "rack rate" that will cover costs and stand up to scrutiny while still being attractive to the average investor, and use this rate as a guide for bespoke arrangements with individual investors.

## Hedge Fund Seeding Activity in Emerging Managers

*By: Jaclyn M. Greco, Senior Manager, Business Development, Seward & Kissel*

According to the Seward & Kissel LLP 2014-2018 Seed Transactions Deal Points Study, 2018 was an active year for seeding activity, and seeding appears to be gaining momentum in 2019. The primary driver of this activity appears to be the reemergence of institutional seeders – including private equity funds and other non-traditional seeders, as well as new institutional investors raising private funds to allocate seed capital. There has also been observed an increase in the ticket size of a seed investment as compared against recent years. Additionally, the environment for managers seeking seed capital is one of the most favorable in recent history, with institutional investors' willingness to provide operating capital becoming more prevalent. The current seed environment represents the most alignment of interests that we have observed between seeders and managers in more than a decade.

The benefit to an emerging manager receiving seed capital, beyond having "sticky" investment capital, is the credibility that a seed arrangement provides in the marketplace when fundraising from prospective investors.

Key considerations when negotiating seed deals are (a) structure of the investment, (b) lock-up terms, and (c) duration/termination economics.

*Structure*: Typically, the first consideration when negotiating a seed deal is deciding whether to structure the seeder's interest as a top-line revenue share or as an equity interest. In 2018, by a far margin, most seed deals were structured as a top-line revenue share, where the seeder receives an agreed-upon percentage of the top-line revenue of the manager (i.e., management and/or incentive fees). An equity interest arrangement, where the seeder would receive an interest in the management entity, entitles the seeder to a share of the manager's net profits. In 2018, it is estimated that equity interest arrangements comprised less than 10% of all seed deal structures.

*Lock-up Terms*: A significant benefit of a seed deal to the fund manager, beyond the seed capital to jumpstart their business, is the comfort of long-term investment capital for the fund, providing the manager a runway for their launch and the ability to scale. Overwhelmingly over the past three years (2016 – 2018), anywhere from 66-79% of seed deals included a two-year lock-up provision on the seed capital. Most of the time, managers preferred a "hard" lock-up, wherein the capital cannot be redeemed for a set period of time. However, deals that include a combination of "hard" and "soft" lock-up periods for the duration of the overall lock-up period were increasingly observed in the data set. A "soft" lock-up period allows the investor to redeem its seed capital during that period of time, subject to the payment of an early redemption charge.

In addition to the normal restrictions on liquidity for seed capital, seeders typically require lock-up "releases," whereby the seeder is able to redeem its investment regardless of the lock-up provisions after triggering events that can adversely affect the manager's performance – including, certain levels of investment losses, "bad boy" behavior, regulatory or legal matters or "key man" matters.

*Duration/Termination Economics*: Giving away a piece of one's business is always a difficult thing as an entrepreneur. Common questions regarding seed deals include: "how long will the seeder be involved in my business?" and "how long will the seeder receive its economics?"

The structure of the exit aspects of a seed deal can vary greatly. Customarily, seed economics remain intact in perpetuity. Alternative structures include a buyout, step-down, sunset or termination of the seeder's equity interest/revenue-share arrangement. Specifically:

- In 2018, buyout provisions were at the lowest level that the study observed since 2014, representing approximately 40% of seed deals studied. Buyout rights typically become exercisable after an agreed-upon number of years post lock-up. When negotiating buyout provisions in a seed deal, there are several ways to price a buyout feature, such as a revenue multiple or percentage of AUM.
- A less common approach is a sunset provision, where the percentage of revenue share ownership decreases to zero over a fixed period. In 2018, 15% of the observed seed deals we handled included sunset provisions.
- The least common form of termination is where the seeder's equity interest/revenue share ends after an agreed upon period. This type of termination provision was only represented in 6% of seed deal transactions that were included in the study.

Historically, seeders have had tremendous leverage to negotiate favorable terms in exchange for the seed capital. However, 2018 and the beginning of 2019 has showcased an environment where the interests of managers and seeders are more aligned than years' past, with managers and seeders seeking a mutually beneficial partnership for success and capital appreciation.

More and more, seeders are providing support to managers to help grow their businesses, which can include operating capital, middle- and back-office support, and general infrastructure assistance/guidance. It is expected that this environment will continue throughout 2019 as both managers and seeders are motivated to forge strong partnerships for success.

## Trends in Offshore Funds

*By: Ingrid Pierce, Global Managing Partner, Walkers Global*

### *Overview*

We have continued to see strong M&A activity with several take-private transactions involving our global funds group. Larger managers continue to consolidate their products, we have seen both mid-size and large managers offering increasingly tailored products for significant investors, leading to a rise in the number of funds of one. There has also been more creativity on fee levels, which has been much talked about, although we have only begun to see this taking root in the last few months.

The increasingly complex regulatory environment means that clients and their advisers have to think much more deeply about cross border regulatory issues. Our regulatory group has been engaged in advising fund clients on the recent regulations governing data protection, anti-money laundering and economic substance. We have also seen more restructuring of funds in the last six months, in particular to implement changes in redemptions terms.

### *Registration, restructuring & redemptions*

We have found that for the most part, open-ended funds of one are deciding to register with the Cayman Islands Monetary Authority (CIMA). This is typically investor-driven and frequently reflects the facts that: (i) the investor is itself regulated in other jurisdictions; and (ii) underlying investors expect some level of regulatory supervision or oversight wherever it operates.

Funds are trying to manage liquidity concerns, making changes to their regular redemption schedule, in many cases, to decrease the frequency of redemptions and/or increase the notice period. Some of the restructuring is aimed at better alignment of terms with underlying investments and in other cases it is building and managing an asset base with a longer horizon in mind.

The most common question is whether investor consent is required for these sorts of changes. The answer is usually 'yes' although much will depend on the terms of the fund documents. One place to start is to ask: is it clear from the fund documents that these sorts of changes could be made in the future with or without consent? To the extent that the fund has multiple classes and different changes are proposed with respect to redemptions for different classes, then consent on a class by class basis may be required. There is also the concept of 'negative consent', not a concept founded in Cayman law, although one which can be successfully deployed if investors subscribe on the express basis that under certain circumstances they will be deemed to have agreed to a certain course of action. Consent, whether positive or deemed, must be informed, which means that at some point prior to the issue of interests in the fund, the investor must agree to the process by which the fund may make changes of the type contemplated.

The risk-free way to proceed in these circumstances is usually to obtain express consent in accordance with the shareholder voting provisions (which may require the holding of an extraordinary general meeting of shareholders), although there may be easier and more commercial ways to achieve the same result.

### *Data Protection*

The Cayman Islands Data Protection law comes into force on 30th September, 2019. Most people will be broadly familiar with what this means as there are similar rules in other jurisdictions.

Cayman Islands financial sector entities will generally be "data controllers", "data processors" or both. As a general proposition, a data controller must comply with the eight data protection principles set out in the law when processing personal data. These principles are explained in detail in the DPL and appropriate advice should be taken on the interpretation and measures needed to comply. However, they are common sense principles, which essentially require that if you are processing personal data, you must do so in fair manner which meets certain conditions. Personal data should only be obtained for a specified lawful purpose and not be excessive in relation to the purpose for which it was collected. Unsurprisingly, data must be accurate, not kept for longer than necessary for the relevant purpose and must be processed in accordance with the rights of the data subjects. Importantly, if data is being transmitted to another country, that country must have an adequate level of protection for processing this data.

Cayman entities may need to take certain steps to ensure they are in compliance. We have found that many US clients have already undertaken significant work in this area, including by adopting procedures and training staff. As a result, their Cayman entities may only require minor changes to certain service agreements or additions to their existing investor privacy notices.

### *Economic Substance*

Most people will be aware that the OECD Inclusive Framework on Base Erosion and Profit Shifting (BEPS) requires geographically mobile activities to have "economic substance". Under BEPS Action 5, the European Union required legislation to be in place by 1 January 2019. Legislation has been enacted in the Cayman Islands, the British Virgin Islands, Bermuda, Guernsey, Jersey and other OECD-compliant jurisdictions.

Some entities are making this an opportunity to establish physical premises and locate staff in the relevant jurisdiction and see various opportunities in doing so. On the other hand, investment funds are generally not in scope of the new rules. Clearly there is a lot of detail and nuance as to how the new rules will work which we cannot cover in this brief publication (noting there are certain differences in each jurisdiction) and international standards are continuing to develop so further changes to the laws and guidance can be expected. Managers will need to consult their legal counsel in each relevant jurisdiction.

## Navigating Parental Leave

*By: Julie L. Werner, Partner and Lauren M. Hollender, Counsel, Lowenstein Sandler LLP*

Your employee has shared her good news - she is having a baby! She immediately wants to know how much time off she is allowed and how much of that time will be paid. At a minimum, your company must have a parental leave policy that complies with applicable law. A more generous leave policy will help your company attract and retain talent. Creating a parental leave policy that is right for your business is a complicated, yet important task.

### *What is Parental Leave?*

Parental leave has two parts: (i) pregnancy-related medical leave; and (ii) parental bonding leave. The first type is limited to women who give birth, while parental bonding leave must be offered to both men and women equally. Failing to provide sufficient leave time, or offering leave in a discriminatory manner, can result in a disgruntled employee filing a lawsuit.

### *What Laws Require Parental Leave?*

Companies who employ 50 or more employees within a 75-mile radius must comply with the federal Family Medical Leave Act ("FMLA"). To be eligible for FMLA leave, an employee must have worked for his or her employer for at least a year and a minimum of 1,250 hours. Under the FMLA, employees may take up to 12 weeks of unpaid leave for pregnancy-related incapacity or to care and bond with a new child. While up to 12 weeks of leave is allowed, pregnancy-related disability in the case of a healthy birth typically lasts only 6 to 8 weeks.

Employers also must comply with state laws which may offer benefits in addition to, or in the absence of, the FMLA. For example, New Jersey and New York both have state family leave laws. The New Jersey Family Leave Act ("NJFLA") and New York Paid Family Leave Act ("NYPFLA") provide 12 weeks and 10 weeks respectively of bonding leave, but neither provides pregnancy disability leave. For FMLA covered employers, the leave time a woman takes for her own condition will count under the FMLA only. Once FMLA leave is exhausted, she may then take time to bond with her baby under state law. This creates the possibility of up to 24 weeks of available parental leave time for female employees in New Jersey and up to 22 weeks of available parental leave time for female employees in New York. By contrast, a father's parental bonding leave runs concurrently under the FMLA and the New Jersey and New York statutes. It is capped at 12 weeks.

Smaller employers are not off the hook. The NJFLA (as of June 30, 2019) applies to companies with 30 or more employees, and the NYPFLA applies to private employers who have just one employee! Therefore, small employers in both states who are not bound by the FMLA must still provide state mandated leave.

Even when not required by those laws, employers may be required to provide leave as a reasonable accommodation under the Americans with Disabilities Act (ADA). Granting leave may still be advisable even if the ADA does not apply. Firing an employee right after she gives birth or applies for state-mandated benefits is almost never a good idea! Employers who deny leave altogether risk claims of pregnancy discrimination and/or retaliation under the anti-retaliation provisions of many state benefits laws.

### *Available Sources of Compensation During Parental Leave.*

Parental leave under the FMLA and many state laws is unpaid. While employees are usually eligible for state mandated temporary disability benefits and in some states, paid family leave insurance benefits, there usually remains a gap in pay. To fill that gap, companies often develop salary continuation policies in which the company agrees to "top off" or pay the difference between the employee's salary and available insurance benefits. Salary continuation benefits are best defined as the difference between the employee's weekly salary and the amount of benefits the employee is *eligible to receive* from other sources. The goal is to incentivize employees to apply for available benefits.

Salary continuation benefits should be defined separately for pregnancy-disability leave and parental bonding leave, although an employer may choose to cap the total amount it offers. For example, an employer can provide 8 weeks of salary continuation benefits for pregnancy-disability and 8 weeks for parental bonding, but limit the total combined number of salary continuation weeks to 12.

Companies must ensure their bonding leave benefits are gender neutral. Gone are the days when employers can offer bonding leave to mothers but not fathers. Some employers grant more weeks of bonding leave to primary versus secondary caregivers, but companies must be careful not to discriminate or make assumptions about caregiving based upon gender stereotypes.

The circumstances under which employers can require employees to use available sick or vacation time ("PTO") while on leave is becoming more limited. Employers can usually do so only during entirely unpaid portions of leaves. States that offer short-term disability benefits or paid family leave generally prohibit employers from requiring employees to exhaust PTO prior to or while receiving benefits. This means an employee may still have an available bank of PTO upon return from leave.

### *Conclusion*

Navigating the complex maze of laws that require parental leave and determining what benefits your company wishes to offer requires careful legal analysis and many choices. Companies should be proactive and craft a policy that is right for their business and complies with the law.

## Mitigating Reputational Risk: The Role of Notification and Communications Experts in Data Breach Response

*By: Leonardo Saraceni, Marketing, Cyber Risk and Legal Management Consulting, Kroll*

Whether your data breach involves 500 or 5 million records, affected consumers, employees, investors – and regulators – will expect to hear from you. What happened? Were you proactive in your security and ability to detect a breach? How will you make things right and prevent it from happening again?

Being prepared to communicate to an array of audiences is fundamental to a defensible cybersecurity strategy. Organizations that develop holistic crisis communications plans enable their incident response teams to begin restoring trust from the very first announcement. Critically, efforts must continue throughout all touchpoints until the incident is resolved.

Experts in breach notification and public relations play a vital role in these efforts, ultimately helping organizations:

- Reduce impact on customers, employees and partners
- Lessen risk of subsequent litigation
- Minimize damage to brand and bottom line
- Save time and money

(*Note*: Counsel should formally engage the breach notification partner and PR firm to ensure privilege extends to all activities and communications. Also be sure to document all efforts, which can support your organization's defense in the event of litigation.)

*The incident is just the beginning*

At the start of a crisis (and even weeks later), breach victims often don't have a complete picture of what has happened. Breaches can be made worse by misguided communication efforts that take too long, fail to come off as transparent or provide statements that must be corrected as the forensic investigation uncovers new details.

Added pressure comes from the fact that all 50 states, as well as many governments worldwide, have laws that impact the timing of notification.

*Pre-breach communications planning*

Crisis communications experts can help your organization better position itself for a potential breach by:

- Developing a crisis communications playbook, and updating it quarterly, that covers (at minimum):
    - Contact information for all response team members.
    - Comprehensive lists and contact information for all audiences (customers, media, etc.).
    - Incident response steps, including prerequisites for going public, action prompts for anticipated scenarios, etc.
    - Media policies and drafts of communications materials (notification letters, press releases, social media statements, etc.).
- Running a tabletop exercise with the full team.

*Responding to a breach*

Throughout the crisis, PR partners can provide support that includes:

- Helping you understand how the media landscape will impact coverage and audience response.
- Ensuring you keep up with media requests, not missing opportunities to tell your side of the story and preventing the spread of inaccurate information.
- Advising on using social media – e.g., solely as a tool for monitoring client sentiment or as a way to keep parties updated.

*Customized, compliant notifications and beyond*

In close coordination with your PR experts, your breach notification partner can counsel on how to communicate with affected individuals. They can also help ensure you leverage your organization's defensible narrative, as in the following example:

- When/Where did the theft/breach occur?
- What happened? What was lost or stolen?
- What is [CLIENT] doing about this?
  *[SAMPLE: Client immediately notified local law enforcement and is cooperating with them as they continue their investigation.]*
- What is [CLIENT] doing to prevent this from happening in the future?
  *[SAMPLE: [CLIENT] has examined and analyzed existing procedures and systems to ensure appropriate security measures are (reinforced/in place).]*
- Why wasn't I notified sooner?
  *[SAMPLE: [CLIENT] immediately notified local law enforcement officials and launched an investigation into the incident. The investigation included a review of internal security systems to confirm that procedures already in place are strengthened to further safeguard against a breach of data security in the future. Last, it was imperative that impacted individuals were identified and their contact information gathered into a consistent format for notification. This investigation was a time-consuming process, but Client believed it was necessary to ensure appropriate precautions and next steps were taken.]*

Your breach notification partner should be experienced in best practices relating to scrubbing data, checking databases, using first class mail, etc., to help optimize deliverability of notices while reducing costs. When appropriate, an email or customized website could serve as alternate forms of notification.

In selecting a breach notification partner, also consider their ability to quickly establish call center support that can function as a seamless extension of your company.

*Communicating and supporting, not "spinning"*

A crisis communications firm's role isn't to cover up a data breach or spin it into something it isn't. Rather, they will focus on managing the communications process in a way that will minimize reputational risk.

An experienced, full-service breach notification provider will have the resources and expertise to optimize all your outreach and remediation efforts. Working together with PR firms and legal counsel, they can help ensure your organization is in the best defensible position while also restoring your reputation, brand and relationship with stakeholders.

**This article is based on a webinar that was presented by Brian Lapidus, Global Leader of Kroll's Identity Theft and Breach Notification practice, and Zach Olsen, President, and Kelsey Eidbo, Senior Client Supervisor, of Infinite Global. For more insights on this topic, click here to listen to the webinar.*

## Organizational Leadership: Transforming the Employee Experience - Subtle Tools for Optimizing Your Team's Performance

*By: Gail Kreitzer, Consultant & Coach, Dashboarding Minds*

Within the financial sector, increasingly competitive and volatile global market forces often breed acutely demanding corporate cultures, which tend to obliterate work/life boundaries. Even the "best and brightest" employees suffer when work/life demands pile on at a faster pace than they can resolve.

Consider the plight of an employee who, in addition to managing a heavy and complicated workload, may be dealing with their child's serious illness, a contentious relationship, marriage, or divorce, a declining parent, or mounting financial pressures. More often than not, they find themselves operating in a highly reactive state, working harder, longer and faster in order to manage all of the things that are competing for their limited time and attention.

This type of response can lead to increased stress levels and can negatively impact the "Whole Employee", which simply refers to an individual's combined mental, physical and emotional well-being.

Left unchecked, pervasive employee stress and lack of support pose significant risks to a company and its stakeholders. First, it can render traditional approaches to optimizing performance ineffective. Second, the organization may lose valuable institutional knowledge and intellectual property if an employee decides to leave to seek a presumably less stressful environment. Finally, it may negatively impact a company's ability to attract new talent, especially from the Millennial and Gen-Z talent pools who tend to prioritize a more "fulfilling" work/life experience.

All of these potential outcomes will directly impact the bottom line. According to a 2017 poll conducted by the American Psychological Association, $300 billion in lost annual productivity can be attributed to workplace stress.

Today, large companies are re-evaluating nearly every aspect of an employee's work experience in order to cultivate a more "mindful" employee- someone who is better equipped to reflect on the implications of their choices, decisions, and actions. Yoga classes, meditation training, and employee relaxation rooms are becoming more of the rule as opposed to an exception. Additionally, mindfulness training is being incorporated into leadership development and team building exercises. According to market research firm IBISWorld, meditation and mindfulness is estimated to be a $1.1 billion dollar industry and growing rapidly.

### What else can Leaders do to optimize their team's performance, at a low cost?

An often overlooked, yet highly impactful mindfulness tactic is an employee's approach to mental organization. Specifically, how they classify, organize, store, and access tasks (and thoughts) in order to prioritize and execute across all areas of their lives. Often, employees utilize a piecemeal approach to their work/life organization, which leaves them feeling scattered and stressed.

If their overall approach is not helping them to actively and continuously distill the relentless onslaught of competing demands, their ability to prioritize and execute effectively will become greatly impaired. The result is a perpetual state of overload.

Instead, leaders can help their employees by providing their teams with an opportunity to evaluate and assess their approach to mental organization in order to determine if it is helping them develop their own performance and attain a balanced approach to the many demands on their time.

*Valuable questions to address include:*

Does an employee's approach to organization help them to pragmatically-

- Foster awareness of the bigger picture as well as the smaller details?
- Improve their ability to focus their attention?
- Minimize potential distractions?
- Operate less reactively and more intentionally?
- Clear their minds and identify potential stressors?
- Stay tightly connected to their professional and personal priorities?
- Efficiently pivot between the different areas of their lives?

In many instances, an employee may not have fully considered their own role in perpetuating their state of overload. Ultimately, the overarching question becomes, "Does the employee leverage an approach to mental organization that focuses primarily on maximizing small slivers of their output, or does it more appropriately focus on the Whole Employee and all of the demands the individual must meet?"

When Leaders make the effort to foster a more mindful and holistic approach to mental organization within their teams, they provide invaluable support that crosses the work/life divide. Their employees, in turn, can better meet the demands of a rapidly evolving work environment.

## Engaging with Expert Networking Firms

*By: Carmen J. Lawrence, Partner and Michelle R. Jacob, Senior Associate; King & Spalding*

Expert networking firms operate as "matchmakers" facilitating the exchange of information between subject matter experts in a particular industry with investment professionals seeking to gain an informational edge. These networking firms provide valuable services to aid investment professionals with relevant and specific industry knowledge.

Expert networking firms are on the rise. Over the past five years, the industry has grown 6.8% to reach revenue of $860 million in 2018, with growth attributed to improved reputation, likely resulting from increased regulatory scrutiny and corresponding compliance efforts.[1]

### *Risks of Expert Networking Firms*

Because many industry experts are corporate insiders or consultants with duties of confidentiality, these discussions risk disclosure of material non-public information. If MNPI is disclosed, and traded on or tipped to others who trade, such actions could violate federal securities laws, namely, insider trading. Indeed, expert networking firms have been scrutinized by the DOJ and SEC for facilitating the exchange of MNPI.[2] *United States v. Martoma*, hailed as the "most lucrative" insider trading scheme ever charged, involved an expert network tipper.[3] Martoma was convicted in 2014 of securities fraud and sentenced to nine years in prison and forfeited $9.3 million.[4] Martoma's employer, CR Intrinsic Investors, LLC, settled its case with the SEC, without admitting or denying the findings, for over $600 million.[5]

The SEC has successfully brought charges against investment firms for failing to maintain adequate policies and procedures to prevent insider trading when engaging with expert network firms. In October 2016, Artis Capital Management, L.P. and a senior research analyst settled charges with the SEC, without admitting or denying the findings, for failing to maintain adequate policies and procedures to prevent insider trading and failing to respond appropriately to red flags. The SEC found that an Artis employee had worked with an expert at a public company who provided MNPI on which that employee traded. Both the Artis employee and insider were charged by criminal authorities, received prison sentences, and settled charges with the SEC resulting in disgorgement, penalties, and a permanent securities industry bar and officer or director of a public company bar, respectively.[6] Artis disgorged illicit trading profits, interest, and penalties, totaling more than $8.8 million. The SEC Order found that the Artis supervisor had failed to reasonably supervise and imposed a $130,000 penalty and twelve-month suspension from the securities industry.

Artis had written policies and procedures that prohibited the receipt of MNPI but failed to adopt policies or procedures to address the particular risk of "frequent interaction with contacts at public companies in whose securities Artis traded." The SEC Order found that "Artis did not take steps to ensure that (i) its policies relating to insider trading were adequately enforced, and (ii) it had systems in place to ensure that Artis was not trading on the basis of material nonpublic information." The SEC further noted that Artis did not require the analyst to report interactions with employees of public companies and did not have policies to track or monitor these interactions.[7]

### *Guidance/Best Practices*

With these risks in mind, professionals seeking to use expert networks or corporate access to consult with insiders should exercise caution to ensure they are complying with the law. While expert firms often have their own compliance controls, many of those require the client investment professional to choose whether to opt-in and utilize them.[8] This underscores the need for investment professionals to implement policies, back-end testing procedures, and train employees annually on the use of these firms or other contact with corporate insiders.

Consistent with prior remarks from the SEC,[9] a robust compliance policy should require:

- Experts to sign a pre-engagement agreement that outlines best practices and certificate of compliance
- Employees to obtain pre-approval from compliance before scheduling a call with experts
- Discussions with experts to be taken on recorded lines
- Compliance to conduct periodic reviews of the recordings and/or have compliance "chaperone" some calls unannounced
- Employees to read a disclaimer at the beginning of calls stating no MNPI should be shared
- Employees to keep complete records of all expert consultations, including what securities or sectors were discussed
- A six-month prohibition for experts opining about their current business or have additional controls in place for discussions with current insiders, such as requiring compliance approval before making investments decisions or recommendations
- Emphasize consultation with legal and compliance if there is any question about whether certain expert intelligence could preclude trading in a security

Further, consistent with SEC remarks, investment firms should implement back-end procedural controls to ensure compliance with policies, including:[10]

- Compliance review of policies and controls in place at expert networks engaged by the firm
- Compliance review of agreement terms with experts
- Obtain certifications from employees who use expert networks that they are not trading on MNPI
- Periodic testing of trades made after expert conversations, including targeting higher profit trades or other risk-based criteria
- Periodic testing of trades in specific companies against press releases, earnings announcements, and 8-k filings

*Conclusion*

Expert engagement can provide valuable insight for investment professionals, but firms and individuals must exercise caution to ensure MNPI is not shared, and subsequently, traded on. A robust compliance infrastructure with some level of oversight of conversations and trading is recommended to ensure compliance with securities laws.

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## Sky is Not the Limit for Business Interest Expense Deductions: The Impact of Post-Tax Reform Interest Deductibility Limits on Hedge Funds and Investors

*By: Amanda H. Nussbaum, Partner, and Sejin Park, Associate, Proskauer Rose LLP*

Tax reform, which passed at the end of 2017 and is commonly known as the "Tax Cut and Jobs Act" (the "TCJA"), introduced a new limit (in new section 163(j) of the Internal Revenue Code) on the extent to which taxpayers can deduct their net business interest expense. In November 2018, the Internal Revenue Service and the U.S. Department of the Treasury issued proposed regulations that provide guidance on the new limitation. The proposed regulations generally apply to taxable years ending after the date of their publication as final regulations, but taxpayers may generally rely on them for taxable years beginning on or after January 1, 2018 so long as the taxpayers and any related parties consistently apply the proposed regulations.

Passive investors of securities trading hedge funds that use leverage will be among the hardest hit. As a result of the new limitation, investors in these funds will lose a portion of their deduction on the interest paid by the funds. (Prior to the TCJA, these investors generally could deduct such interest in full.) Interest expense that is deductible under the new section 163(j) limitation will be allocated to investors who will also be subject to the pre-existing limitation on the deductibility of investment interest under section 163(d).

The following Q&As will consider this change in law and particularly its impact on hedge funds and their investors.

*How has the TCJA changed the deductibility of business interest expense?*

New section 163(j) and the proposed regulations generally disallow a deduction for net business interest expense that exceeds 30% of adjusted taxable income ("ATI") plus floor plan financing interest expense in the current taxable year (the "section 163(j) limitation"). "Business interest" includes any interest paid or accrued on indebtedness that is properly allocable to a trade or business. ATI generally approximates earnings before interest, taxes, depreciation, and amortization (EBITDA) for taxable years 2018 through 2021, and earnings before interest and taxes (EBIT) for taxable years 2022 and thereafter. Any deduction in excess of the section 163(j) limitation is carried forward and may be used in a subsequent year, subject to the limitation.

Certain small businesses whose gross receipts do not exceed $25 million on average in the prior three taxable years are exempted from the section 163(j) limitation. Additionally, certain trades or businesses such as real property businesses can elect out of the section 163(j) limitation at the cost of slower depreciation.

*How does this new limitation affect hedge funds?*

Partnerships and other pass-through entities are subject to special rules under section 163(j) and the proposed regulations. A common hedge fund structure consists of a "master" fund structure, which includes a master fund and a domestic feeder (each of which is typically treated as a partnership for federal income tax purposes), or a parallel fund structure, which includes a domestic fund (which is typically treated as a partnership for federal income tax purposes). If a hedge fund is treated as engaged in a trade or business for federal income tax purposes (often in the case of securities trading partnerships or "trader funds," as discussed below), the section 163(j) limitation applies first at the fund level. To the extent that the fund has business interest expense greater than the permitted deduction amount for a taxable year, the excess is not carried forward by the fund, but instead will be allocated to each partner as "excess business interest." The partner may deduct its share of the fund's excess business interest in any future year, but only against excess taxable income or excess business interest income allocated to the partner by the fund.

Not all hedge funds are affected by this limitation. Broadly speaking, hedge funds fall into two categories – investor funds and trader funds. Whether a fund is treated as an "investor" or a "trader" is not always clear and depends on a fund's trading activity, including the volume, regularity, continuity and frequency of trading. Generally, investor funds tend to buy and hold assets for longer-term appreciation, whereas trader funds have a much higher trading volume and seek to profit from short-term price movements. Due to this difference, trader funds, and not investor funds, are treated as engaged in the trade or business of trading securities for federal income tax purposes and, thus, are subject to the section 163(j) limitation with respect to their business interest expense. However, while only trader funds are subject to the section 163(j) limitation, individual and other non-corporate investors in trader funds can deduct management fees; individual and other non-corporate investors in investor funds cannot deduct management fees at all until 2026, and then they will be deductible, subject to the limitations on miscellaneous itemized deductions and application of the alternative minimum tax.

*Which fund investors will be affected by these changes?*

Under pre-existing section 163(d), individual and other non-corporate taxpayers cannot deduct investment interest expense in excess of their net investment income (including in the case of partners, their allocable share of any net investment income of a partnership) (the "section 163(d) limitation"). "Investment interest" generally means interest on indebtedness incurred to generate investment (i.e., non-business) income. For example, if an investor fund borrows money to make investments and pays interest on the debt, the fund will allocate this investment interest expense to its partners and report their allocable share on their schedules K-1. The partners then compute how much investment income they have earned that year and determine whether they can deduct the interest expense allocated to them. In the trader fund context, a non-corporate limited partner's distributive share of the interest expense is also treated as "investment interest" and subject to the section 163(d) limitation.

As discussed above, under the TCJA and the proposed regulations, trader funds will now be subject to the section 163(j) limitation. To the extent that a limited partner's share of the interest expense of a trader fund is subject to the section 163(j) limitation, but is allowable under section 163(j), the interest expense will also be subject to the section 163(d) investment interest limitation in the hands of the limited partner. The limited partner would need to have sufficient investment income in order to deduct the investment interest expense allocated to such limited partner. This interest expense "double whammy" is bad news for trader funds and their investors.

*How might hedge fund investors avoid the new section 163(j) interest expense deduction limitation?*

Investors in trader funds who can invest in the foreign feeders of those funds can entirely avoid the section 163(j) limitation but will then be subject to different tax issues. Foreign feeders are generally treated as passive foreign investment companies ("PFICs"), which are foreign corporations for U.S. federal income tax purposes that generate primarily passive income or hold primarily passive assets. If the foreign feeder is a PFIC, a U.S. investor must make a "qualifying electing fund" ("QEF") election to avoid certain penalty taxes. A QEF election requires the investor to report and include in gross income such investor's pro rata share of the PFIC's "earnings and profits" each year. Although the PFIC would technically be denied interest expense deductions in excess of the section 163(j) limitation, the earnings and profits of a PFIC are reduced by the entire amount of the interest expense (regardless of whether the interest expense is disallowed under section 163(j)). Therefore, investing through a PFIC entirely avoids sections 163(j) and 163(d). However, investors should be aware of the potential downsides of investing through a PFIC. Losses incurred at the master fund or foreign feeder level, as well as foreign tax credits (if any), will not pass through to shareholders of a PFIC (and will be deductible, if at all, only upon sale or redemption of the investor's interest in the foreign feeder). Furthermore, withholding may apply to any U.S.-source dividends received by the PFIC. A similar analysis would apply if the investor were a 10% U.S. shareholder in a foreign feeder that is treated as a controlled foreign corporation ("CFC") but there would be other tax considerations to take into account. A CFC is a foreign corporation in which U.S. shareholders, who each own at least 10% of the CFC's stock (by vote or value), together own more than 50% of the CFC's stock (by vote or value).

Alternatively, hedge funds may consider using synthetic debt instruments to avoid the interest expense deduction limitation. However, the proposed regulations define "interest" very broadly for purposes of applying the section 163(j) limitation to include items ranging from what is typically considered interest under federal income tax law to specified types of payments not typically considered interest under federal income tax law. An anti-abuse rule under the proposed regulations may also apply to treat amounts predominantly associated with the time value of money as interest. Accordingly, payments made under synthetic debt instruments may be recharacterized as interest and subject to the section 163(j) limitation.

## Recent case law impacts advisory clients' exposure to Section 13(d) and Section 16 reporting obligations and liability under the Exchange Act

*By: Arthur H. Kohn, Partner, Adam Fleisher, Partner, Marc Rotter, Senior Attorney, Cleary Gottlieb Steen & Hamilton LLP*

Advisers need to take Section 13(d) and Section 16 considerations into account when entering into agreements with clients and managing relationships to avoid exposing clients to reporting obligations and liability under the Securities Exchange Act of 1934 (the "Exchange Act"). Specifically, in the hedge fund and investment adviser context, questions may arise as to whether and when advisers and their clients may be deemed to form a "group."

The two key concepts used to determine if an investor is subject to reporting and liability under Sections 13(d) and Section 16 are "beneficial ownership" and "group."

"Insider" status under Section 16 is triggered by beneficial ownership of, or membership in a "group" that beneficially owns, more than 10% of a class of voting equity securities registered under Section 12 of the Exchange Act.[1] "Insiders" are subject to the reporting obligations of Section 16(a) and the short-swing profit rules of Section 16(b), which requires insiders to disgorge to the issuer deemed profits resulting from purchases and sales in any six-month period of equity securities (including related derivatives) of the relevant issuer in which the "insider" has a "pecuniary interest." Reporting obligations under Section 13(d) are triggered by beneficial ownership of, or membership in a "group" that beneficially owns, more than 5% of a class of securities described above.

An investor is the "beneficial owner" of a security if it has or shares the power to (i) vote (or direct the vote) or (ii) dispose (or direct the disposition) of the security, or if it has the right (not subject to a material contingency outside of its control) to acquire voting or dispositive power within 60 days.[2] A client of an investment adviser is the beneficial owner of securities managed by that adviser if it has the right to acquire voting or dispositive power on notice of 60 days or less (e.g., by terminating the advisory agreement).

A "group" is defined as two or more persons that have agreed "to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer." Several courts have held that a person cannot be a member of a "group" if that person does not "beneficially own" any securities of the issuer.

Two recent cases, *Rubenstein v. International Value Advisers, LLC*[3] and *Rubenstein v. Berkowitz*[4], have addressed when an advisory client will be deemed part of a "group" with an investment adviser. In both cases, the court held that a delegation of broad discretionary authority to acquire securities for the client's account does not create a "group" between the client and the investment adviser because it does not show any agreement was reached with respect to securities of a particular issuer. Similarly, in both cases the court rejected the argument that multiple clients of an investment adviser would be deemed a "group" solely because they use the same investment adviser. The courts also rejected the argument that "silent acquiescence" by a client to an adviser's use of securities for a control purpose is sufficient to evidence formation of a "group." However, the court in International Value Advisers indicated that an investment adviser and an advisory client may be deemed a "group" if the client invests knowing of an adviser's investment strategy regarding a particular issuer.

Earlier cases addressed related questions in the context of managed funds, similarly finding that funds and their adviser are not a "group" solely because the funds are managed by the adviser.[5] However, courts have found that a "group" may exist if the adviser is, or is under common control with, the general partner of the advised funds.[6]

By remaining cognizant of and educating professionals regarding, Section 13(d) and Section 16, advisers can avoid inadvertently exposing clients to reporting obligations and liability.

1 Directors, officers and entities that deputize individuals to serve as officers or directors are also "insiders." Additionally, Section 16 also applies to securities issued by closed-end funds registered under the Investment Company Act of 1940.
2 If the right to acquire beneficial ownership is acquired with the purpose or effect of changing or influencing the control of the issuer or in connection with or as a participant in any transaction having such purpose or effect, beneficial ownership of the underlying securities is imputed to the investor immediately upon acquisition.
3 363 F.Supp.3d 379 (S.D.N.Y. 2019).
4 2019 WL 1382766 (S.D.N.Y. 2019).
5 Brian B. Sand & Zachary B. Sand Joint Tr. v. Biotechnology Value Fund, L.P., 2017 WL 3142110 (N.D. Cal. 2017); Greenfield v. Criterion Capital Mgmt., LLC, 2016 WL 4425237 (N.D. Cal. 2016).
6 Sand v. Biotechnology Value Fund; Greenfield v. Cadian Capital Mgmt., LP, 213 F. Supp. 3d 509 (S.D.N.Y. 2016).

## Pay to Play

*By: Benson Cohen, Partner, Sidley Austin LLP*

The next national election is about 18 months away, and candidates for federal, state and local office are busy raising money. In total, billions will be raised and spent by November 3, 2020. The Securities and Exchange Commission (SEC) pay to play rule will be more than 10 years old by then, and most investment advisors understand the basics of the rule and have adopted compliance policies. While there has been no significant change in the SEC's pay to play rule, political fundraising has changed in significant ways creating new challenges for investment advisors. But first the basics of the pay to play rule.

Investment advisors may not accept compensation for two years from a "government entity" (broadly, any agency, authority, or instrumentality of the state or political subdivision, any pool established by the state or political subdivision or any agency, authority or instrumentality thereof, any plan or program of a government entity and officers, agents and employees of the State or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity) after the advisor or a "covered associate" (broadly, any general partner, managing member or executive office, any employee who solicits a government entity, any supervisor of such soliciting employee and any political action committee controlled by the advisor or any covered associate) makes a campaign contribution to an official of that government entity or to a candidate for, or holder of, an office that can directly or indirectly influence the hiring of an investment advisor or has the authority to appoint a person who can influence the hiring of an investment advisor. Investment advisors may not, directly or indirectly, pay any third person to solicit a government entity unless that person is a “regulated person” subject to pay to play rules adopted by the Financial Industry Regulatory Authority (FINRA) or the Municipal Securities Revenue Board (MSRB) and approved by the SEC.

Investment advisors may not solicit any person or political action committee (PAC) to make any campaign contribution to an official of a government entity to which the advisor is providing, or seeking to provide, advisory services nor any payment to a political party of a state or locality where the advisor is providing, or seeking to provide, advisory services to a government entity. Finally, an investment advisor and covered associates may not do anything indirectly which if done directly would result in a violation. In other words, circumvention of the pay to play is prohibited

Since the 2012 national election, Super PACs have become a major force. According to the Center for Responsive Politics almost $830 million was raised by Super PACs in 2012, $1.8 billion in 2016, and $1.6 billion in 2018 (a year in which there were no presidential elections). While most large Super PACs are established under state law, state Super PACs are becoming more common for candidates for mayor and governor. Because the national economy is strong and the stakes are high, 2020 promises to set new fund raising records for contributions to Super PACs.

Can advisors and covered associates contribute to Super PACs? The pay to play rule does not address this issue, but the staff’s commentary for the final rule strongly suggests that contributions to Super PACs are not subject to the pay to play rule. The staff has noted that “independent expenditures” are not subject to the pay to play rule, and Super PACS only make such expenditures and are prohibited from making contributions to candidates.

Also since the 2012 election, Victory Fund solicitations have become much more common for federal candidates. A Victory Fund is a joint fundraising agreement between political committees from the same political party. Senate and House candidates typically include a state party committee as part of the joint fundraiser. Presidential candidates frequently include many state party committees. The main challenge for advisors is to determine how the agreement to divide Victory Fund contributions will affect compliance with the prohibition on payments to state or local parties where the advisor is seeking or providing advisory services. Some states, such as New Jersey, also allow joint fundraising by candidates for the Legislature. Advisors should not allow covered associates to contribute to Victory Funds or state joint fundraisers without first analyzing the joint fundraising agreement to determine who will receive part of the funds and whether any part of the contribution will trigger the pay to play rule. This type of analysis can often be difficult and time consuming. Therefore, the better approach is to prohibit such donations.

Another recent political development is that many candidates and political committees are willing to provide a letter of assurance regarding how contributions of covered associates will be used. The SEC has not indicated whether or not an advisor may rely on such assurances. Most candidate campaign committees are temporary organizations with uncertain controls over their funds. Advisors should think long and hard over whether a covered associate’s proposed contribution should be allowed based on a written assurance letter when the advisor is receiving compensation from a government entity within the state where the contribution will go.

One way to resolve difficult contribution issues is to allow a covered associate to make a contribution subject to the de minimis exception. The pay to play rule exempts a contribution up to $350 as long as the contributor at the time of the contribution is entitled to vote for the candidate because the contributor has his or her principal residence in the locality where is seeking election. For contributors out side of that locality, a contribution of $150 is permitted.

Certain other campaign activities are not subject to the pay to play rule. For example, a covered associate may engage in volunteer activity on behalf of a candidate but may not serve on a fundraising committee. While the spouse of a covered associate may free to contribute, advisors should be careful to make sure that the covered associate and the spouse are not seeking to evade the pay to play rule. The challenge for the adviser is how to determine compliance. Generally under campaign finance law, the person who signs the check, even from a joint account, is the contributor. The SEC pay to play rule has not commented on whether spouse contributions from joint bank accounts are not covered by the rule.

Finally, the SEC pay-to-play rule is not the only relevant law. Some states and cities have restrictions that limit contracting by those who have made political contributions. For example, the New Jersey State Investment Council, prohibits contracts with an investment management firm for the benefit of the State Pension and Annuity Fund for two years after a contribution of more than $250 to a state political party including state legislative leadership committees, county committees and independent committees as defined in the regulations. In addition, the Treasurer may not enter into a contract with a financial services firm if the firm has made a contribution to a candidate for Treasurer within five years of the date of the contract.

## Compliance Hot Topics to Know

*By: David Tang, Counsel, Seward & Kissel Regulatory Compliance (SKRC)*

In this article, we highlight certain compliance hot topics that we at Seward & Kissel Regulatory Consulting (SKRC) have observed in the context of providing compliance consulting, conducting mock audits and advising clients on SEC exams. Below we take a closer look at the most important document in a registered investment adviser's ("adviser") compliance program, the compliance manual.

### *Compliance Manuals*

In 2018, approximately 17% of all SEC-registered advisers were examined by the SEC's Office of Compliance Inspections and Examinations ("OCIE"). OCIE examiners will typically review advisers' compliance with Rule 206(4)-7 of the Investment Advisers Act of 1940 ("Advisers Act"), which requires each adviser to adopt and implement compliance policies and procedures that are reasonably designed to address the adviser's risks and prevent violations of the Advisers Act and the rules thereunder. Additionally, OCIE examiners, as well as investors, often expect advisers to adopt optional policies and procedures that address a set of vaguely defined standards referred to as "best practices."

The compliance manual, therefore, is a document that is relied upon to address multiple concerns, including business and operational risks, legal and regulatory requirements, OCIE expectations and investor demands. Given the importance of the compliance manual, advisers should take care to avoid the following common but preventable deficiencies and red flags.

### *Template Manuals*

It is not unusual for new or newly-registered advisers to develop their compliance manual using a template from a law firm or consultant. However, as advisers and their compliance programs mature, their compliance manuals should be increasingly tailored to their businesses and operations. In a recent Risk Alert on Regulation S-P, the OCIE staff glaringly observed manuals with "written policies and procedures that contained numerous blank spaces designed to be filled in by registrants." A new compliance manual that years later continues to maintain the look and feel of a template will likely raise a red flag.

### *Vendor Names*

Similarly, compliance manuals (and annual compliance review reports) should not feature the name or logo of the law firm or compliance consultant that prepared it. When regulators see third-party vendor names on the cover page, header or footer of advisers' compliance documents, they question whether advisers have merely adopted templates or have truly customized their policies and procedures. For example, when a service provider's name is on the annual review report, OCIE examiners may question whether the vendor, rather than the adviser and its chief compliance officer, are ultimately responsible for administering the adviser's compliance program.

### *Best Practices*

Adding to the challenge, advisers may feel pressured to add optional policies and procedures to their compliance manuals under the rubric of best practices. While best practice is a worthy goal, these optional procedures add to the complexity and administrative burden of a compliance program. Advisers should only adopt best practice procedures that address an actual conflict or risk to their business. In the adopting release for Rule 206(4)-7 of the Advisers Act, the SEC said: "Each adviser, in designing its policies and procedures, should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks." For example, frequent periodic testing of trading for market manipulation activity may well be a best practice for advisers that engage in active short-term trading. The same testing, however, is not needed, and therefore should not be adopted, by advisers that employ long-term investment strategies that rarely trade.

### *Documentary Evidence*

OCIE examiners regularly request detailed evidence that advisers have satisfied the various obligations, procedures, and practices described in their compliance manuals. For example, if the compliance manual says an adviser will periodically compare the performance of similarly managed accounts or spot check expense allocations, the SEC staff will request documentation of these reviews. Advisers should take a full inventory of, and carefully document their compliance with, every commitment in their compliance manual. When creating compliance documentation, advisers should always keep in mind that these records may be subsequently subject to regulatory review.

### *SKRC Observations*

Advisers can avoid the above-mentioned deficiencies and red flags by conducting a thorough review of their compliance manual. Template policies and procedures should be customized. Names and logos of outside counsel and consultants should be deleted. Topics, policies and procedures that do not apply should be eliminated and others tailored to address the specific conflicts and risks that apply. Best practices should only be adopted if they meet an actual risk, and the adviser has determined that timely and consistent implementation is achievable.
The impression presented to regulators and investors should reflect the reality that advisers have intentionally and thoughtfully prepared compliance manuals that are reasonably designed to address their unique conflicts, risks and regulatory concerns.

## Due diligence failure and delays in providing compliance resources results in SEC actions

*By: John Mrakovcic, Principal Consultant, ACA Compliance Group*

### *Overview*

On November 6, 2018, the SEC reached two separate settlements ("the Settlements") with a former investment advisory firm, Pennant Management, Inc. ("PMI"), and its founder and CEO, Mark Elste ("Elste")[1], over allegations that it denied PMI's CCO adequate resources to properly implement a compliance program and failed to perform adequate due diligence and oversight of one of PMI's counterparties, contrary to representations made to prospective and current clients in its Form ADV and marketing materials.

In the PMI settlement, the SEC alleged that from May 2013 to September 2014, PMI advised clients to purchase interest in repurchase agreements ("repos") originated by First Farmers Financial ("First Farmers"), notwithstanding concerns regarding the legitimacy of these investments, concerns over First Farmers' CEO and inadequate counterparty oversight due to a lack of compliance resources.

By the end of 2013, clients had invested a total of approximately $800 million in the repo program. By September 2014, PMI determined that First Farmers had forged paperwork and that all of the repos were fraudulent. PMI was ordered to pay a civil monetary penalty of $400,000.

In the Elste settlement, the SEC alleged that Mr. Elste was aware that PMI's compliance program lacked sufficient resources but failed to timely address this deficiency, which substantially contributed to PMI's Rule 206(4)-7 violations. Mr. Elste was ordered to pay a civil monetary penalty of $45,000.

### *Due Diligence Oversight*

First Farmers sought to use PMI to finance what it claimed to be U.S. Department of Agriculture ("USDA") guaranteed loans. PMI tasked certain employees to begin to gather information for the initial due diligence. As part of the process, PMI received unaudited 2012 financial statements and an unaudited balance sheet as of February 2013. Additionally, PMI hired a private investigation firm to conduct a background check on First Farmers and its principals. The investigation revealed several red flags with respect to First Farmers' CEO, namely that he never graduated from college, as he represented to PMI, pleaded no contest to assaulting a police officer, was convicted of two DUIs and had been sued multiple times for breach of contract. Other than the two DUIs, PMI's Investment Committee and senior management were not made aware of the adverse findings resulting from the CEO's background check.

Despite not receiving audited financials, as required by the Master Repurchase Agreement ("MRA"), as disclosed in PMI's Part 2A of Form ADV and as represented in marketing materials, on May 9, 2013, PMI's Investment Committee approved a repo facility with First Farmers with a limit of $75 million. Shortly thereafter, PMI started to advise its clients to invest in the facility. In April 2014, PMI received First Farmers' 2013 audited financials, purportedly by a new auditor, the existence of which could not be confirmed by PMI or by a third-party investigation firm. Regardless of these concerns, PMI's Investment Committee continued to increase the limit on the facility throughout 2014.

Based on concerns expressed to Mr. Elste from an on-site visit by a new PMI employee in July 2014, further due diligence conducted by a third-party private investigation firm revealed that the firm could not locate the underlying borrowers for several of the First Farmers loans. At that time, PMI also learned that First Farmers had not provided USDA Certificates of Incumbency, as required by the MRA, which intended to affirm the authority of the USDA officer executing a guarantee. At the direction of Mr. Elste, PMI contacted the USDA and law enforcement personnel and began consulting an outside law firm. In order to maintain confidentiality, only a limited number of employees were aware of PMI's investigation of First Farmers. As a result, PMI did not disclose what it was learning about First Farmers to clients invested in its repo program, which included a new private fund which received investments of $24 million during September 2014.

On September 25, 2014, the USDA confirmed to PMI that a representative sample of loans purchased from First Farmers were fraudulent and it would not honor the guarantees. On September 30, 2014, the FBI arrested First Farmers' CEO and PMI informed its clients about the fraud.

### *Compliance Resources*

In January 2012, PMI appointed one of its portfolio managers as interim CCO. The CCO had no compliance experience, but accepted contingent upon having access to outside counsel and compliance consultants as needed. After reviewing PMI's policies and procedures, the CCO concluded that the firm's compliance program was deficient and advised PMI's CEO, in a March 2012 email, of the immediate need for an outside resource to evaluate the status of the compliance program, including the policies and procedures within the compliance manual. PMI, however, did not retain additional resources at that time.

In December 2012, PMI's CCO and President gave PMI's CEO a list of compliance priorities and requested additional resources. However, the request for additional resources was denied. Instead, the CCO was asked to utilize existing staff to assist with compliance efforts.
In February 2013, as part of its 2012 annual report to the PMI Board of Directors, which included the PMI CEO, the CCO stated that, in his "professional opinion, there is a risk that a compliance issue may go unnoticed due to limited resources available for testing and auditing of numerous areas of the firm's compliance program." On multiple occasions in 2013, the PMI CEO denied requests from the CCO for additional resources.

In its 2013 annual report to PMI's Board of Directors, the CCO noted that "[s]ince the [compliance] program was recently updated and because of limited resources and increased demands on my time, the review of Pennant's compliance program was not as in-depth in 2013 as it was in 2012." As in the 2012 report, the CCO's 2013 report reiterated his concerns about risk resulting from insufficient resources. In June and July 2014, PMI hired a compliance analyst and engaged an outside consultant to evaluate its compliance program.

### *Takeaways*

The findings in the Settlements serve as a reminder of the importance of a well-resourced compliance program. The CEO's refusal to provide timely and adequate compliance resources requested by the CCO is an important lesson learned. Senior executives can be held accountable for looking the other way on compliance. CCOs should not be afraid to speak up and request resources, as applicable. It is possible that the actions of the CCO, along with maintaining associated evidence of such actions, helped keep the CCO from being included in the charges brought by the SEC.

1 Administrative Proceeding File No. 3-18884, In the Matter of Pennant Management, Inc., Respondent
Administrative Proceeding File No. 3-18885, In the Matter of Mark A. Elste, Respondent

# About Wells Fargo Prime Services and Contacts

## *About Wells Fargo Prime Services*

Wells Fargo Prime Services offers comprehensive prime brokerage services and solutions for alternative asset managers. Through our multi-asset class platform, we help managers with their operational and financial goals through our service offerings including:

- Integrated financing solutions
- Technology and operational solutions
- Capital Introduction
- Business consulting services
- Risk management solutions

## *About the Business Consulting group*

Business Consulting services include: business development (from launch to franchise management), best practices, peer analysis and benchmarking, and thought leadership. By leveraging our knowledge of industry service providers we aim to facilitate key introductions and discussions with the goal of achieving the right operational fit for our customers' businesses. We help hedge funds think through strategic business decisions at launch and throughout their life cycle based on a customized approach to meet a client's specific needs.

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