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ACA COMPLIANCE GROUP

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The weekly news source for investment management legal and compliance professionals

"The Enforcement staff does not shy away from litigating in district court, where we have had great success … and we will continue to take tough cases to trial in both forums."

SEC Explains How It Chooses Between Administrative Hearings and Courts

If you ever wanted to know the criteria the SEC's Division of Enforcement uses in deciding to try a case in an administrative hearing or in federal court, your wait may be over.

The SEC staff on May 8 issued guidance on how it decides the venue in which to try a case – although the document reads more like an explanation of how the Division makes its choices, rather than guidelines it wants prosecutors and other Division officials to follow.

"The guidance outlines a number of factors the Enforcement Division considers in

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Chief Compliance Officers: Best Practices for Self-Protection

Protect yourself from a chief compliance officer's ultimate nightmare.

That nightmare, which has some variants, goes something like this: The CCO discovers wrongdoing at his firm. He reports the problem up the chain, ultimately reaching the chief executive officer. The CEO chooses to either ignore the issue or simply does not agree with the CCO's assessment or proposed actions. The problems continue and are ultimately discovered by the SEC, which brings charges against the firm, as well as the CCO, since he failed to stop the problem. Both the firm and the CCO are

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Misallocation of CEO Compensation Adds Penalty to Adviser's Ledger

One dollar here, one dollar there; one dollar here, one dollar there; one dollar here, 75 cents ther – oops.

The name of the game is allocation. If the charges in an SEC settlement are to be believed, an adviser and its chief financial officer/chief compliance officer attempted to deceive the board of directors of a fund series by misallocating the adviser CEO's salary in an attempt to make profits look consistent. Now it is paying the costs of a settlement instead.

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tive hearing. "When seeking such remedies it is often a more efficient and effective use of limited agency resources to seek those remedies directly in an administrative proceeding rather than first commencing a district court action, seeking and obtaining a district court injunction, and instituting a separate administrative proceeding seeking the remedies based on the injunction."

- **Costs, resources and time-effectiveness.** Speed is a consideration, as the guidance says that "in general, hearings are held more quickly in contested administrative actions than in contested federal court actions. This may allow the Division to use the Commission's limited resources more effectively." Resources are also used more efficiently when the SEC can seek and obtain relief in a single proceeding, something that may be possible in certain cases heard in district court, as well as in certain cases heard in an administrative forum. There are also "efficiencies" in either forum in other aspects of a case, such as a motion for summary judgment in federal court or a motion for summary disposition in an administrative proceeding, according to the guidance. Finally, the Division noted that the "time and types of pre-trial discovery available in federal court may entail both costs and benefits, which should be weighed on the facts and circumstances of a case."
- **Fair, consistent and effective resolutions.** The guidance takes the position that administrative law judges and the SEC know their subject matter. They "develop extensive knowledge and experience concerning the federal securities laws and complex or technical securities industry practices or products." The guidance suggests that "if a contested matter is likely to raises unsettled and complex legal issues under the federal securities laws, or interpretation of the Commission's rules, consideration should be given to whether, in light of the Commission's expertise concerning those matters, obtaining a Commission decision on such issues, subject to appellate review in the federal courts, may facilitate development of the law." When state laws or specialized areas of federal law are critical, "district court may be more appropriate," it says.

Chief Compliance Officers

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censured, barred from the securities business, forced to pay a steep financial penalty, receive lots of bad press, and lose their credibility.

Don't let this happen to you.

Problems typically occur when there is an issue that the CCO and the firm see differently, said **Stradley Ronon** partner **Lawrence Stadulis**. "The CCO may think a certain action is a violation, but upper management may think there is legal wiggle room to do so. Or the parties agree that something wrong happened but differ on how to address and paper trail it," such as both agreeing that there was a compliance policy violation but only the CCO seeing the violation as a material one that, with respect to mutual fund managers, must be reported to the board under Rule 38a-1, he said. "There understandably is a tension between the parties under these circumstances. They both want to do the right thing but genuinely disagree on how to handle the situation."

Of course, as some SEC cases have shown, there are situations where firms have done the wrong thing and been charged for doing so – and the CCO was either charged as a participant, or charged with not following through on compliance policies and procedures, or with having inadequate policies and procedures.

Ultimately, of course, a CCO can self-report to the SEC, but this should be a last step after attempts to report up the chain have failed, said **Eaton & Van Winkle** partner **Paul Lieberman**. The agency's recent whistleblower awards to two compliance professionals, as well as its action against a firm that retaliated against a whistleblower, may make this a somewhat more attractive option to CCOs frustrated by a lack of response from upper management.

Steps to take

Consider the following:

- **Report up.** There should be a clear reporting roadmap so that the CCO does not have difficulty with reporting issues. "There should be no need to struggle over decisions, such as, should I report to the CEO, the CFO or go straight to the SEC," said Stadulis. Don't skip a rung or go to someone not designated in the reporting chain. "That is likely to cause resentment and confusion, and could also irreparably damage the whole reporting process down the road." Lieberman noted that there is a degree of self-protection in reporting up. By doing so, he said, "the CEO cannot come back later and ask, 'How did you let this happen?'"

- **Make a detailed written report.** While you can simply have a conversation with whoever you report up to, a written report may be more effective because it will provide particulars, Lieberman said. "Have all your evidence and supporting documents pulled together." But make sure that you know who will be reading the report. "Reporting violations to the portfolio managers or traders may not be the best initial step in those instances where they may be the most likely culprits. Moreover, the reporting chain should not end at the top of a subsidiary of another company," Stadulis said. CCOs would also be wise to "talk things out before putting them in writing. It is difficult taking back an email asserting that there was a violation and management took no action when this turns out not to be the case. Understand that not every compliance issue is the same. Fraud and misappropriation are very serious allegations that require immediate attention and careful scrutiny. The failure to comply with the technical aspect of a compliance policy on a one-time basis should not."
- **Create and keep written records.** These records should be of actions you took and conversations you had that addressed the problem. Emails, memorandums, written reports – keep copies of all of them, Lieberman said. "Not every record can be contemporaneous, but at some point the recordkeeping has to start." Without those records, you have no evidence, should you ever need it.
- **Consider your own qualifications.** This is particularly true at small firms, where the CCO may not have a background in the area where the problem is occurring. If that expertise is lacking, consider tapping third-party counsel or an outside consultant. "Do some preparatory work on the problem before reporting up, so you know what you are talking about and can answer all questions," Lieberman said. Large firms may have both compliance and legal departments. It helps if they take a unified position, so they can present a united plan of action, he said.
- **Open lines of communication.** These should be with others at the adviser who are committed to compliance. The more allies you have, the more effective you are likely to be. "Try to work things out collaboratively in a manner that is in everyone's best interests," said Stadulis.

Third-party counsel and self-reporting

Speaking with outside counsel can occur under a variety of circumstances. One is whether you are speaking with the firm's outside counsel or your own outside counsel. Let's look at several possibilities.

- **Help writing the report.** This may be the case when the CCO needs to tap the firm's outside counsel for expertise in a particular area, such as custody. Outside counsel would work with the CCO to create a detailed and thorough report that would later make its way up the firm's chain of command as directed by the firm's policies. Upper management should be told that outside counsel will be part of this process.
- **Help convincing upper management.** In situations where upper management or, in smaller firms, the owner does not agree there is a problem or simply refuses to deal with it, an outside attorney working in conjunction with the CCO can make a strong argument for action, perhaps in a conference call or in a personal meeting, Lieberman suggested.
- **Self-reporting.** If a CCO is convinced that he has tried every possible course of action to persuade upper management and is getting nowhere, he may consider self-reporting to the SEC. Given that this is a risky step, it probably would be wise to seek independent outside counsel, rather than rely on the firm's outside counsel. Those who do self-report usually "get some

credit" from the SEC for doing so, said Lieberman. The alternative, letting the problem remain, which would be a form of cover-up, "would be a disaster," he said.

But, hopefully, a CCO can effectively resolve compliance issues within the firm. "In my experience, 99 times out of 100, the parties work these things out amicably and satisfactorily, as long as there are open lines of communication and mutual respect," said Stadulis. "In fact, this is the hallmark of a good compliance program. A great CCO understands the importance of this and does not view himself or herself as a lone wolf in the wilderness."

Misallocation of CEO Compensation

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Kornitzer Capital Management, a Kansas-based advisory firm with approximately $11.3 billion in assets under management, on April 21 settled an administrative action brought against it by the SEC and paid a civil money penalty of $50,000. **Barry Koster**, the firm's chief financial officer and chief compliance officer, also settled and paid a civil money penalty of $25,000.

According to the administrative order instituting the settlement, Koster each year "adjusted the allocation of the compensation of [the firm's] chief executive officer to the funds in a manner designed, in part, to achieve consistency of [the fund's] reported profitability in managing the funds year over year. Koster did not disclose this information to the board."

"The SEC will scrutinize representations regarding the allocation of an adviser's expenses and pursue charges when there's a discrepancy between the representations and actual practice."

Kornitzer Capital was charged with violating Section 15(c) of the Investment Company Act, which makes it unlawful for a registered fund to enter into or renew any advisory contract unless the terms of the contract are approved by a majority of the fund's independent directors. The SEC makes it the duty of a fund adviser, in this regard, to furnish the directors with the information necessary for them to evaluate the terms of the advisory contract. By providing incorrect information about the CEO's compensation, the adviser failed in this duty, according to the administrative order. Koster was charged with having caused the firm's violation. The attorney representing both Kornitzer Capital and Koster, when reached by phone, chose not to comment.

The settlement "appears to be the latest episode in a broader effort by the SEC to scrutinize the advisory contract approval and renewal process for registered funds," said **Mayer Brown** partner **Matthew Rossi**. "From the SEC's perspective, there is little point in requiring directors to evaluate information provided by an adviser if the adviser's information is inaccurate or incomplete. In fact, the SEC likely views the provision of inaccurate information by investment advisers under these circumstances as threatening to undermine the entire contract approval and renewal process required by Section 15(c)."

"This case demonstrates the SEC's continued focus on transparency in an adviser's allocation of expenses to the funds it manages," said **Zaccaro Morgan** partner **Nicolas Morgan**. "While other cases involving expense allocation have criticized private equity or hedge fund managers for misrepresenting expense allocation in representations to investors or potential investors, this case extends that same principal to communications between an investment company fund adviser and its board."

"The enforcement action makes clear that the SEC is focused not only on ensuring accurate disclosures to fund investors but also to those charged with statutory obligations (here, under 15(c)) to protect investors by overseeing funds, such as the board in this case," said **Foley Hoag** partner **Daniel Marx**.

"The takeaway for fund advisers," Morgan said, "is the same in both contexts: the SEC will scrutinize representations regarding the allocation of an adviser's