Prepare for the magnifying glass: SEC hikes scrutiny of asset managers - 4 steps to consider

Securities Litigation Alert

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By:

Earlier this month, the Wall Street Journal reported that the Securities and Exchange Commission is in the process of preparing new rules to increase the monitoring and oversight of various asset funds, including hedge funds and alternative mutual funds.

Importantly, the SEC’s proposed rules are being promulgated at the same time the SEC is conducting what it has coined a “national sweep exam” of alternative mutual funds to examine in greater detail how alternative funds value the “illiquid assets” held by the fund, among other things.

The SEC’s potential regulatory action is in response to apparent increasing concern that the multitrillion-dollar asset management industry could create substantial instability to the financial system with the occurrence of a significant event, such as a sudden change in interest rates or widespread investor redemptions. This move by the SEC follows an announcement made last year by the Financial Stability Oversight Council that it was reviewing the activities of asset management firms and related businesses to determine whether those firms should be subject to additional scrutiny under the Dodd-Frank Act.

It has been suggested that the proposed sweep of alternative mutual funds is part of a larger strategy by the SEC to bring the alternative mutual funds, and similarly situated entities such as asset managers and hedge funds,
under the same regulatory umbrella imposed upon large banks and similarly situated financial institutions in response to the 2008 recession. Those regulations were adopted to address the purported risk that the failure of one or more large financial institutions could potentially debilitate the national economy. The combined import of the SEC’s announced “sweep” and the potential regulations reported by the *Journal* is that alternative mutual funds are now on the SEC’s radar, and additional oversight and regulatory scrutiny are all but assured in the near future. These developments further solidify the SEC’s pattern of instituting regulations and audits of investment strategies that become increasingly popular in the financial industry.

This news should concern managers of alternative mutual funds. The SEC’s suggestion of pursuing new regulations raises the stakes for the information that could be gleaned from the SEC’s sweep of alternative mutual funds. The SEC has said that the sweep will focus on liquidity, leverage and board oversight. From the sweep, the SEC hopes to gain “insight into how alternative mutual funds attempt to generate yield and how much risk they undertake, in addition to how well boards are carrying out their oversight duties” as well as to identify areas where it believes “fund managers may need additional guidance.”

In addition, the SEC may, on the basis of the sweep, draw conclusions and share observations regarding industry practice that could influence its rulemaking. For example, earlier this year, after conducting “presence exams” of private equity firms, SEC staff famously shared their observations regarding the industry, including “real and significant” conflicts and “violations of law or material weaknesses” in more than half the firms examined.

The SEC’s findings regarding the alternative mutual fund industry’s valuation of its illiquid assets and/or fund liquidity could potentially cause the SEC to pursue additional regulations or seek to conduct additional oversight of the alternative mutual fund space. In other words, there is a great deal of uncertainty and unpredictability in what the SEC may do next once the national sweep exam has been completed - the SEC’s reaction to the national sweep could bring with it a substantial amount of additional scrutiny, oversight and regulation in the future. As a result, alternative mutual funds should prepare themselves for the magnifying glass of the SEC.

Four steps to take

Knowing that increasing SEC scrutiny, such as inquiries and subpoenas, may be just around the corner, what precautionary measures can you, as an alternative mutual fund manager, take to protect your interests?

- **Preliminary considerations** should include consulting with counsel that is experienced in this area, who, in turn, will engage an independent valuation consultant and, among other things, determine whether the fund’s valuations are appropriate (and, relatedly, whether the fund’s valuation policies and methodologies are appropriate and consistent with the fund’s disclosures).

- It is important for your counsel to be the one to engage the consultant, *in order to create and safeguard attorney-client privilege* (which could be waived if you engage the independent valuation consultant directly).

- You should also **work with your counsel to ensure that you maintain robust internal controls** for preserving electronic information relating to the assets held in the funds, and to ensure that any examinations are seamless and do not cause additional regulatory oversight.

- Particularly if and when you receive a formal and more focused SEC inquiry or subpoena, you need hedge fund counsel who are highly experienced in responding to these inquiries, in order to **develop a manageable discovery plan** that won’t unduly consume and distract you and your fund, personally and economically.

Preparation will go a long way in dealing with what appears to be a developing mine field of new regulations, and potential enforcement actions, from the federal government.

Find out more about this closer scrutiny from the SEC by contacting the authors.