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WEEKLY BRIEFING
COMPLIANCE NEWS, GUIDANCE BEST PRACTICES

INSIDE...

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Deviating from promised strategy costs HF manager in new SEC settlement

Investors in a hedge fund will be reimbursed nearly $3 million in losses suffered when they were misled about the fund's investment strategy and historical performance by an investment adviser and its hedge fund manager.

The **SEC**'s New York Regional Director **Andrew Calamari** delivered a clear message in announcing the Jan. 28 settlement—"investment advisers must be completely candid when disclosing two key features that investors rely upon when making investment decisions: investment strategy and historical performance."

Charged were **QED Benchmark Management** and its founder/owner **Peter Kuperman** who managed the QED Benchmark LP hedge fund. The SEC stated that Kuperman and QED Management marketed the hedge fund based on promises to follow a scientific stock selection strategy. The problem: Kuperman and QED Management repeatedly deviated from that stated strategy.

Delaying fraud discovery

The settlement details a laundry list of compliance violations, including marketing based on a misleading mixture of actual and hypothetical returns, undisclosed conflicts of interest, unsupported valuations and lying to investors about the fund's liquidity when they began requesting redemptions. "Through these deceptions, Kuperman delayed the discovery of his

(Disclosure Settlement, continued on page 5)

OCIE aims to add 100 examiners to focus on IA exams by October

New OCIE Director **Marc Wyatt** is putting his stamp on the IA exam program in a big way. Sources tell **IA Watch** that reports OCIE will encourage scores of B-D examiners to switch to inspecting IAs was an idea Wyatt hatched.

The *Wall Street Journal* first reported the idea Jan. 29th. **IA Watch** has confirmed the concept, which one **SEC** source described as a "plan."

The nagging need to increase the agency's number of IA exams explains the reason for the new concept. Sources say it's unrelated to SEC Chair **Mary Jo White**'s intention to push ahead a separate proposal to permit third-party exams of investment advisers (**IA Watch**, Jan. 2, 2015).

(More IA Examiners, continued on page 2)

Tips to fight the potentially long battle for vindication following an SEC charge

After four years of clashing with the **SEC** over fraud charges, **Nicholas Rowe**, the former president of the advisory firm **Focus Capital Wealth Management**, finally got his day in court this month. An ALJ hearing was set for Feb. 1 in his home state of New Hampshire.

With his RIA shuttered for four years, Rowe, who's now bankrupt, will be representing himself. "It's a terrible ordeal," he tells **IA Watch**. "You cannot imagine the sleepless nights."

The SEC charged Rowe with allegedly selecting investments unsuitable for his clients and for making misrepresentations about his fees. Rowe contends the case really stems from clients upset that they lost assets during the Great Recession.

"It's exhausting because they have unlimited funds and unlimited lawyers to mount their battle," says Rowe of the Commission. The SEC "called me this morning [seeking] a settlement," Rowe claimed last month. Rowe, who now works as a mechanic, declined, insisting he's innocent.

A CCO recently told **IA Watch** how an SEC enforcement action that he challenged bankrupted him as well.

(Gearing for Battle, continued on page 3)

FINRA Financials (Continued from page 2)

($870,000, down from $890,000 in 2013). According to the watchdog site **OpenSecrets.org**, the SRO dished out few contributions to politicians. Here's the list.

FINRA examiners

The 990 for the entity that conducts industry exams, called **FINRA Regulation**, saw its revenue less expenses balloon 160% to $253 million in 2014. Salaries dropped 8%; total expenses fell 9%. Total revenues spiked 13% to $852 million, thanks to $428 million in regulatory fees and $132 million in fines.

This unit imposed just shy of 1,400 disciplinary actions, expelled 18 firms and made hundreds of referrals to the **SEC**. Its 1,100 employee exam program conducted nearly 2,500 regular and branch office exams and more than 7,000 "targeted and sweep reviews and examinations."

FINRA arbiters

The third entity that makes up the SRO is **FINRA Dispute Resolution**. It handles the mediations and arbitrations arising from investor complaints. This unit's 990 shows dispute resolution fees brought in $37 million.

The highest paid arbiter was **Robert Herschman** of Bal Harbour, Fla., who hauled in $414,000. Overall, salaries totaled $19 million, a 16% dip compared with 2013. The unit's former leader, **Linda Fienberg**, witnessed her total compensation pass $2 million, including a $360,000 bonus.

A sizable loss

Total revenues in this unit went up nearly 4% to $38 million. However, net assets sustained a $14 million loss in 2014 compared with a $11.5 million net loss in 2013. ■

Gearing for Battle (Continued from page 1)

With CCO liability issues blazing red hot, it could pay to have a strategy – just in case.

"If I were a CCO, there are some cases in the last 12 months ... that would really frighten me," says **Ben Anderson**, principal with **Anderson PLC** in Minneapolis.

Richard Marshall, a partner with **Katten** in New York, tells of a client who recently challenged an SEC action all the way through the court of appeals and achieved total vindication. The client footed the bill himself. "To go through that process is very expensive," admits Marshall.

Most CCOs don't have the kind of money needed to defend themselves. Many advisers wave the white flag and opt to settle a case to turn off the legal price meter.

You're probably aware of the case against former General Counsel **Ted Urban**, who was able to mount a successful fight against SEC charges because his firm's insurance paid his massive legal bills (**IA Watch**, June 10, 2013). Insurance is a sure route of protection, but there are other avenues to pursue.

Begin with your job description. "Make sure you're in agreement [with your firm] what your job actually consists of," counsels Anderson, who shares more protective steps [**IA Watch** has also produced a list of best practices] The job description should focus on your "core responsibilities" – developing compliance P&Ps, training and education, and testing and surveillance. "But don't go beyond that," he warns or risk being a supervisor in the SEC's eyes.

Company documents

Look also to your firm's bylaws. "It's frequently the

(Gearing for Battle, continued on page 4)

A comparison of numbers from FINRA's 990 reports, 2013-2014

FINRA	2013	2014	% diff
Program Service Revenue	$478,422,829	$568,641,919	18.9%
Investment Income	$65,607,553	$29,991,302	-54.3%
Other Revenue	$120,041,827	$108,750,667	-9.4%
Total Expenses	$783,423,547	$893,191,300	14.0%
Total Revenue	$664,072,209	$707,383,888	6.5%
Salaries	$235,429,316	$224,493,649	-4.6%
Revenue Less Expenses	$(119,351,338)	$(185,807,412)	35%
Net Assets/Fund Balances	$1,784,876,287	$1,900,469,657	6.5%

Source: The IRS Form 990 filing for the main **FINRA** group known as the **Financial Industry Regulatory Authority** (see story on page 2). ■

Gearing for Battle (Continued from page 3)

case that the company's bylaws will actually provide for the advancement of legal fees during the course of an investigation," says **Mark Pearlstein**, a partner with **McDermott Will & Emery** in Boston.

The wording may be found in the articles of incorporation, too. Eye if the language covers officers. Does it name the CCO as an officer? Watch carefully for whether the coverage is "mandatory or permissible." If it's the latter, "that's not a good position for the CCO to be in," says Anderson because it means the corporation can elect to provide the protection or not.

If your firm is a limited liability corporation, the key documents may be the certificate of formation or operating agreement. Partnership agreements would hold the protection for that type of entity, Anderson adds.

An ideal time to bring all this up is when you're considering taking the CCO job. "That's generally something that a forward-looking CCO should be talking about during the course of negotiations, especially this day and age," recommends Pearlstein.

Here's an example of protective language, courtesy of **Alan Sklover**, an attorney with **Sklover & Company** in New York:

> *The employer agrees that it will promptly reimburse the employee for the reasonable legal expense of legal counsel of the employee's choice to counsel and represent the employee before any regulatory or law enforcement or inquiry or hearing.*

The CCO must be able to select the attorney. Settling for the firm's attorney could create a conflict. Sklover tells of a firm lawyer who once admitted to him that the company wouldn't permit him to fully represent an employee.

"They've got to have separate counsel from the very beginning," states **Steven Salky**, a partner with **Zuckerman Spaeder** in Washington, D.C. He represented former **Wells Fargo** compliance officer **Judy Wolf**, who ultimately won her case last year (**IA Watch** 💻, Aug. 6, 2015).

Sklover says the protective language he shared above has to be documented but how is flexible. It could be captured on videotape, found in an e-mail or sustained in some other way.

Indemnification

Corporate indemnification can also serve you, but it could vary by where you live. "It's different in every state," says **Andrew Fotopulos**, senior VP at **Starkweather & Shepley Insurance** in Westwood, Mass.

The issue hit home for Fotopulos with a previous employer. Corporate officers were granted indemnification and, as an executive vice president, he assumed he was covered. He ultimately learned he was left out. "There was nothing ever in writing," he remembers. "Unless you're named in the bylaws of the corporation – by name or by position – you're not subject to indemnification," he warns.

A key word to look for in any of these venues is "advancement." This means your legal bills would be paid through to the end, says Marshall. Of course, some agreements contain clawbacks, meaning you could ultimately be on the hook for the fees if you don't prevail in the legal action.

It would be ideal if these issues were all contained within an employment agreement, but not all CCOs have these. "Ask for [legal coverage] on the way in," states Sklover, who specializes in employment law.

Insurance

When it comes to insurance, know that a firm's professional liability policy likely only covers the adviser and its employees for their primary professional role, e.g., giving investment advice – not for compliance duties, warns Fotopulos. "There may not be any coverage for them for their services as chief compliance officer," he adds.

The coverage can go by several names – corporate reimbursement, management liability, director's or officer's liability. "Every carrier has a different name for it," he says. There's even a CCO-specific product (**IA Watch** 💻, Aug. 20, 2015).

Don't be fooled if a policy offers $5 million in coverage. The real question is how much of that coverage remains when you need it. Expect to require seven figures in coverage for a drawn out enforcement action, adds Anderson. And Marshall reminds that none of this matters if the firm stops paying the premium.

Editor's Note: IA Watch's Feb. 24-26 IA compliance conference features a panel on CCO liability. Find out more and register here 💻. ■

Actions to avoid if you wish to cultivate a thriving compliance culture

FINRA has made clear it wants to see firms more committed to a culture of compliance in 2016 (**IA Watch** 💻, Jan. 7, 2016). Recently, we gave you tips to cultivate a

(Compliance Culture, continued on page 5)