Recent Enforcement Actions by SEC's Asset Management Unit Highlight New Proactive, Analytical Approach

Several enforcement actions announced by the SEC over the past month appear to be the early fruits of several initiatives launched by the SEC Enforcement Division over the past year. On September 22, 2010, SEC Director of Enforcement Robert Khuzami testified before the Senate Judiciary Committee that the Enforcement Division was launching "a range of initiatives designed to increase its ability to identify hidden or emerging threats in the markets, and to stop that misconduct early." Such initiatives included the creation of new national specialized units, such as the Asset Management Unit. The recently announced enforcement actions suggest that under these new initiatives, even minor violations may receive significant attention in an effort to identify and undercut potentially fraudulent schemes at their earliest stages. Indeed, Mr. Khuzami has analogized the new initiatives to the "broken windows" policing strategy employed in New York City in the 1990s, which focused on aggressively policing and prosecuting small crimes in order to prevent more serious ones. As discussed in more detail below, these initiatives affect hedge funds, registered investment companies and their boards, and registered investment advisers, and will soon affect private equity funds and their advisers.

On December 1, 2011, the SEC announced four separate enforcement actions arising from a new initiative—the "Aberrational Performance Inquiry"—to combat fraud by identifying "abnormally" high-performing hedge funds and targeting them for greater scrutiny. The complaints alleged a range of securities violations, including inflating the value of fund holdings, purposefully concealing fund performance, and misrepresenting critical fund attributes such as liquidity, investment strategy, manager credentials, and conflicts of interest. Under the initiative, the Asset Management Unit uses proprietary risk analytics to monitor fund performance and to identify "outlier funds"—those regularly reporting above-market returns and unexpectedly low volatility. The Asset Management Unit may also scrutinize hedge funds with performance records that appear inconsistent with their stated investment strategies or other relevant benchmarks. Although little detail is available about the specific analytics being used, Mr. Khuzami has stated that the Asset Management Unit is focusing on hedge funds that purport to outperform market indexes by 3% or more on a regular basis.

On November 16, 2011, as part of a new initiative focusing on registered fund fee arrangements and the advisory contract renewal process, the SEC announced that it had brought an enforcement action against Morgan Stanley Investment Management (MSIM). The SEC alleged that MSIM arranged a subadvisory contract between The Malaysia Fund and a third-party, Malaysia-based subadviser for investment advice, research, and other services. The complaint alleged that those services were never actually provided, but the fund's board renewed the subadvisory contract each year based on MSIM's representations that those services were being provided, ultimately costing the fund's investors $1.845 million in fees improperly paid to the subadviser in addition to the advisory fees paid to MSIM. MSIM settled with the SEC for more than $3.3 million. The SEC also faulted MSIM for failing to maintain written procedures governing its oversight of subadvisers. In a speech on December 1, 2011, Mr. Khuzami explained that the Asset Management Unit is "focusing on analyzing databases to identify mutual funds that exhibit poor performance, have relatively high fee arrangements, and sub-advisers – all of which may suggest excessive fee arrangements."

On November 28, 2011, the SEC announced three enforcement actions stemming from an Asset Management Unit initiative to work with SEC examiners to ensure that investment advisers have viable compliance programs. In two of those actions, the adviser allegedly received and failed to respond to previous warnings from the SEC staff regarding compliance deficiencies. Mr. Khuzami explained that "[n]ot all compliance failures result in fraud, but many frauds take root in compliance deficiencies."

Although the enforcement actions described above alleged a range of offenses, from very technical violations to egregious displays of misbehavior, collectively they appear to be a harbinger for the Asset Management Unit's new, proactive methods. Accordingly, registered and unregistered funds and registered investment advisers should expect an increase in enforcement actions brought for lesser violations and should take care to avoid such problems, particularly by ensuring the accuracy of all public disclosures. The staff of the Asset Management Unit has stated that its new analytics-based approach is being applied "across the investment adviser space – beyond performance and beyond hedge funds." It noted that "[t]he [quantitative] review of private equity is in its earliest stages, but others, including mutuals, are pretty far along."

If you have any questions, please contact the Ropes & Gray attorney with whom you regularly work.