

HEDGE FUNDS: BEST PRACTICES FOR HANDLING GOVERNMENT INVESTIGATIONS

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HEDGE FUND VALUATION APPROACH

- Define “Fair Value” using generally accepted accounting principles (GAAP). Include all accruals, interest, dividends, fees, expenses, discounts and all payables. Recognize the impact of unrealized gains and losses based on the valuation date. Document sources of information not contained within the books and records.
- Adopt standards and measurement tools from the beginning and apply them consistently and fairly period to period of valuation. Document the standards and tools used.
- Maintain either verifiable paper or electronic trails to support recurring valuation measures.

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HEDGE FUND VALUATION APPROACH

- Use reliable and recognized pricing sources. Disclose where estimates are used to determine “difficult to value” positions (Smirlock case). Establish policies for the use of multi-sources for pricing.
- Separate the use of pricing sources from those also providing transaction or consulting services to the Fund.
- Re-evaluate all valuation policies frequently, including all fee and expense accruals. Set up a valid checks and balances system to maintain integrity.

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REPORTING RESPONSIBILITIES

- Formally adopt Standards of Conduct to identify legal responsibilities to the client who have invested and to those that regulate the reporting to the client. The compliance department should identify “covered employees”, establish the applicable federal securities laws (Advisors Act, Securities Act of 1933, Securities Exchange Act of 1934 etc.).
- Promptly disclose any changes to performance expectations previously communicated to the investor group for suitability and other purposes or any changes to the investment vehicles or strategies previously communicated.

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REPORTING RESPONSIBILITIES

- Establish and document a long-term internal reporting and compliance manual identifying reporting measurements and reports to minimize conflicts with fee structures, service providers and use of soft dollar arrangements.
- With general counsel, identify risks early on for timely disclosure including liquidity issues (margin calls, leverage), loss of key personnel, perceived or real conflicts of interest and subscription and redemption activity.
- Engage well- respected professionals, especially qualified auditors and complete the audits and tax returns on a timely basis without subsequent amendments.

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PRESERVING & MANAGING INFORMATION

- Scope of Preservation
- Employees' Duty
- Designate Point People for Employees' Questions
- Separate Communication With IT Professionals
- Follow Up With Key Information Custodians
- Confidentiality and Instructions Memo
- Consider 3rd Party Providers (e.g. Prime Brokers)
- Follow Up Frequently

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COMMUNICATING WITH THE GOVERNMENT

- Set Reasonable Timetables
- Prioritize Information Sources
- Disclose Plan for Gathering & Producing Information
- Gain Government's Confidence
- Inform Investigators of Delays or Problems
- Get "Out in Front of" Bad Information
- Keep Them Informed & Part of the Process
- Test Messages & Responses



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RESPONDING TO THE GOVERNMENT

Depends on Numerous Factors

- Multi-Regulatory Inquiry
- Civil and Criminal Exposure
- “Witness” or “Target”
- Wrongdoing is Isolated or Systemic
- Issues involve Industry Practice or only your Company
- Related Private Lawsuits

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RESPONDING TO THE GOVERNMENT

Get to the Bottom First

- Consider own Internal Inquiry
- Consider in-House v. Outside/Special Counsel
- Determine who to Involve
- Corporate Governance Issues
- Consider Media/Reputation Issues
- Consider Advising Insurance Carrier
- Understand Applicable Law and Potential Theories of Liability

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Strategies for Investigative Testimony

Before

- SEC/SRO Fifth Amendment Consequences
- Delay until fully understand Facts
- Know what the Regulators Know
- Review all Relevant Documents
- Coordinate with Defense counsel

During

- Control the record
- Get Proffer letters
- Resolve Privilege Issues
- Ask Clarifying Questions
- Take Regular Breaks
- Speak Truth, or Remain Silent

After

- Review Transcript
- Communicate with Other Counsel
- Arrange Conversation with Staff

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DEALING WITH POTENTIAL PROSECUTION

- Flush Out “Wells” Notice
- Coordinate With Defense Counsel
- Consider Oral v. Written Response
- Let Staff Know You Will Litigate

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FORENSIC ACCOUNTING FOR HEDGE FUNDS

- Approach in two general phases:
 - A. Gather an understanding of the entire operation of the fund for the purpose of identifying the fund's strengths and weaknesses and to focus Phase II on specific forensic procedures to be applied and communicate approach to the client that has engaged the forensic audit

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FORENSIC ACCOUNTING FOR HEDGE FUNDS

- B. Identify whether the forensic procedures will focus on financial misappropriations and/or weaknesses in the internal controls of the fund that allowed violations of fiduciary responsibilities or applicable federal securities acts. If the former, consider the ability of potential guilty parties to provide restitution and the reporting responsibility to the Board, investors and regulators. If the latter, determine the same including disclosure to the media and the impact on the going concern of the Fund.
- In A. above the following must be documented in detail for the purpose of identifying forensic procedures to be utilized.

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FORENSIC ACCOUNTING FOR HEDGE FUNDS

- Formal organization structure
- Due diligence performed on key personnel and other representatives of the fund
- Management controls – checks and balances
- Internal trading controls – checks and balances and paper trail documentation
- All contractual agreements
- All board and committee minutes
- Divergences from targeted risk profiles, approvals and monitoring

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FORENSIC ACCOUNTING FOR HEDGE FUNDS

- Implementation and timing of internal reporting processes
- Compliance with risk levels and trading strategies-portfolio managers and others with either financial or reporting responsibilities including third party service providers
- Legal compliance and retention policies

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SEC HOT BUTTONS

- PIPES Transactions: Insider Trading
- Misappropriation of Assets
- Misrepresentations in Valuation/Investment Strategy/Returns
- Ponzi Schemes
- Conflicts: Undisclosed Interest and Affiliated Broker-Dealers

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