Should hedge funds self-report?

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Hedge fund managers often struggle with the determination of whether to self-report a legal or compliance violation uncovered during a routine compliance examination or other actions.

The decision whether, or when, to self-report a legal or compliance violation will be based on the specific facts and circumstances of the issue, as well as an analysis of the benefits and drawbacks of bringing the issue to the attention of regulators.

HFMCompliance spoke with hedge fund lawyers, general counsel and CCOs about whether or when hedge fund managers should self-report issues, and whether and how investors should be notified of issues that were self-reported to regulators.

Determining whether to self-report

The decision to self-report is a case-by-case analysis of each issue uncovered to determine whether it would be beneficial to self-report any legal or regulatory violations discovered. As to what issues should be self-reported, generally, violations of securities laws or any criminal conduct should be reported while violations of a firm's compliance policies and procedures would not need to be self-reported, says Richard Heller, a partner at Thompson Hine.

A decision to self-report sets in motion a complex and unpredictable process that could have enormous legal and business consequences for a firm.

"If it's a simple trading mistake then I don't think that rises to the level of self-reporting. If it's something like an ongoing fraud then it should be reported; you don't want to be considered an accomplice after the fact because then you could be faced with criminal penalties as a result."

The GC/CCO of a global macro fund manager agreed that the evaluation comes down to the specific facts and circumstances of the issue. She notes that self-reporting may make more sense in instances of a rogue employee doing something the manager does not condone. "Then you would report the issue along with how you discovered the problem and what you did, or are doing, to rectify the problem."

Daniel Zwirn, founder of defunct hedge fund D.B. Zwirn and now chief investment officer of Arena Investors, a credit-focused investment firm, says he decided to self-report a compliance issue because it was the right thing to do. "I operated under the standard that every decision should pass the 'New York Times Test,' and that clients' interests should always come first."

Another part of the analysis to self-report may be the potential to reduce or eliminate any punishment for the issue, making the decision whether to self-report a violation a "tricky" one because this is not always the case, the global macro CCO explains.

If a manager decides to self-report an issue, it's important to show that the firm's compliance process identified the issue that was in violation of the firm's policies and procedures and/or the law, and that the firm dealt with the issue.

The global macro GC/CCO suggests managers' reports focus less on the problem and more on the solution.
"Give more detail around the positive resolution of the issue rather than the facts around the issue itself. You want to show the positive action steps that demonstrate your compliance programme is working, that you're identifying when there are issues and you're doing something about them."

If you decide not to self-report, the GC/COO at a $6bn equity hedge fund advises: "If you're going the self-correct route, you better be sure you get it right." He says regulators who examine a firm and find an issue that was corrected but not reported will be sceptical of the corrective action and likely ask many more questions about the issue.

Benefits and drawbacks of self-reporting

When deciding whether to self-report an issue, managers must also weigh the benefits and drawbacks of doing so. The main benefit of self-reporting is that it may result in some degree of credit from a regulator or other authority. Regulators and authorities encourage self-reporting and say credit will be given to those who voluntarily bring issues to their attention.

The US Department of Justice's criminal division in March expanded its self-reporting programme beyond violations of the Foreign Corrupt Practices Act (FCPA) to include all non-corruption criminal cases. In 2016, the SEC's division of enforcement began its Cooperation Program and offers deferred prosecution and non-prosecution agreements to firms that self-report issues.

According to Heller: "By self-reporting, you are showing regulators and investigators that your firm takes compliance very seriously and that goes a long way with regulators, who may decide to reduce or eliminate penalties against the self-reporting firm."

However, the promise of reduced or deferred prosecution is not enough of an inducement to self-report, notes the $6bn equity hedge fund GC/COO.

"To me, it doesn't seem that it's worth it to self-report. People are not getting enough meaningful, tangible credit for self-reporting. Also, it's not clear to anyone exactly what credit exactly will be given because there doesn't seem to be a clear standard or approach."

One drawback for hedge fund managers is that they are notifying regulators of something that, upon a more thorough examination, may not be a material issue, says Mark Goldstein, special counsel at Katten Muchin Rosenman.

Another downside is the potential negative of regulators investigating a self-reported issue, notes Michael Saarinen, a partner with Alston & Bird. "A decision to self-report sets in motion a complex and unpredictable process that could have enormous legal and business consequences for a firm."

Saarinen adds firms are often concerned that self-reporting could create detrimental business consequences even if the SEC never brings charges. "For example, a non-routine investigation by the SEC could precipitate widespread redemption requests for a hedge fund."

To highlight the unforeseen negative fallout of a self-report, sources who spoke with *HFMCompliance* pointed to the case of D.B. Zwirn, a hedge fund started by Zwirn, once managing $12bn in assets, which was liquidated after it discovered, voluntarily self-reported to the SEC, and remedied a series of improper fund transfers that were directed solely by the firm's CFO.

Looking back on the fallout, Zwirn said he did not anticipate that keeping to his ethical standards would have unfolded the way it did. "In hindsight, I would do so again as it was the only ethical and correct path to take."

Legal obligations to self-report

There is no legal obligation for hedge fund managers to self-report issues to regulators or authorities. However, hedge fund managers will have to disclose certain conduct in various regulatory filings. For example, Form ADV includes disciplinary disclosures in Part 1 and Part 2, which effectively requires disclosure of certain bad acts, Goldstein explains.

Goldstein says that hedge fund managers with an affiliated broker-dealer registered with FINRA will have to report an issues when "the firm or an associated person of the firm has violated any securities, insurance, commodities, financial or investment-related laws, rules, regulations or standards of conduct of any domestic or foreign regulatory body or self-regulatory organisation."

When dually registered with the SEC and FINRA, Goldstein adds that managers who self-report issues to FINRA may trigger additional reporting to the SEC.

Managers who uncover compliance or legal violations should, and often do, seek advice of outside counsel. However, having attorneys involved in the investigation of an issue and the decision to self-report presents issues relating to preserving attorney-client privilege.

Saarinen says that although waiving attorney-client privilege may not be required, it may be necessary. "Although the SEC has asserted that privilege waivers are not necessary to receive cooperation credit, some commentators suggest that a company is more likely to be considered 'cooperative' if its personnel waive attorney-privilege."

Investigate and remediate

Managers also have to decide when to make a self-report. The $6bn equity hedge fund GC/COO said it would be best for managers to investigate the issue, to understand all relevant facts of the situation and, preferably, to remedy the issue before going to authorities.

“By investigating the issue, you first determine whether or not you have something serious enough to go to regulators with,” the $6bn equity hedge fund GC/COO notes. “You also have a change to correct the issue and, if necessary, take disciplinary action against those who committed the offence. Finally, the investigation helps you figure out if you need to make any changes to your compliance policies and procedures. This is all important information to have before you self-report.”

The global macro GC adds that because self-reporting is so fraught with factual questions and nuances, in order to get as positive an outcome for the firm as possible, managers would be wise to investigate before self-reporting.

“You don’t want to go to regulators with only some of the details of what happened. That doesn’t instill confidence in you or your compliance programme and will make the regulators more likely to come in for their own investigation rather than letting you have control over the situation and the narrative to investors.”

Notifying investors

Hedge fund managers have become more transparent about their operations and investments, particularly as many investors demand more information as a condition of investment. Because self-reported issues will be investigated, managers need to consider whether to disclose an issue to investors.

The decision to notify investors will also depend on the materiality question, Goldstein says. “You want to disclose to your investors and service providers and anyone else who was impacted by the issue as to what happened and what you did to remediate the issue and make sure it doesn’t happen again.”

Finally, the $6bn equity hedge fund GC/CCO says: “If you have an agreement with investors to tell them of all regulatory investigations or legal actions, I would say you have to tell them about an issue you self-reported. If it’s something that could end up in the press, you definitely want to tell your investors first. The last thing you want is to have your investors read about an issue in the paper.

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