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Affordable Care Act, Changing Demographics, Consolidation All Fueling Health Care Law

Think habanero chili pepper hot. Death Valley hot. Right-off-the-grill hot. *Fifty Shades of Gray* smoking, steamy hot.

That's how hot health care law is right now. In his annual report, *What's Hot and What's Not in the Legal Profession*, consultant Robert Denney calls health care law in 2013 "red hot." He's right—and that should come as no surprise given the nation's focus on all things health care-related.

Of course, the passage of the Patient Protection and Affordable Care Act and the Supreme Court ruling to uphold the law have generated and continue to produce a lot of work for lawyers in this field, as does the health industry consolidation craze currently taking place and, more generally, the aging Baby Boomer demographics. The recent rise in the government enforcement efforts of fraud and abuse laws, which started before passage of the Affordable Care Act and will certainly increase now, is also driving health care legal work.

"We've seen a significant uptick in activity," says Mark Gallant, chair of the health care practice group at Philadelphia's Cozen O'Connor. "Health care has always been heavily regulated and anything that steps up

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Private Fund Advisers:

SEC Enforcement Priorities and Compliance Opportunities

Because numerous factors dictate the future enforcement priorities of the Securities and Exchange Commission (SEC), efforts to predict the next enforcement wave are not always successful. Nevertheless, all signs indicate that the SEC will continue to closely scrutinize advisers to private funds (*i.e.*, hedge funds and private equity funds) for the foreseeable future.

Over 1,500 investment advisers to private funds have newly registered with the SEC under the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, as reported by the SEC on October 19, 2012 (Release No. 2012-214). As a result, the SEC now regulates over 4,000 private fund advisers. The SEC has already prepared for routine examinations of the new registrants. As these examinations progress, and as the SEC otherwise analyzes its enforcement leads (*e.g.*, through its whistleblower program), we can expect to see an increasing number of enforcement actions involving private fund advisers.

Four primary areas of enforcement risk, discussed below, have emerged from the SEC's public statements and prior enforcement actions. Private fund advisers should proactively address these issues as soon as possible. In addition to mitigating potential liability, firms that comprehensively address these enforcement risks in advance may also find themselves with a distinct competitive advantage over their peers.

Conflicts of Interest

Managing capital is a fiduciary responsibility and the SEC expects private fund advisers and their personnel to adhere to their obligations faithfully. In the SEC's view, creating or ignoring conflicts of interest are antithetical to the appropriate functioning of the fiduciary relationship. Numerous types of conflicts can arise among advisers, their personnel, their funds, and their investors. The SEC expects private fund advisers to identify and address potential risks before they harm investors.

Conflicts created by economic incentives are particularly important to the SEC. The SEC will likely continue to focus on how private fund advisory fees are calculated and charged, and how they are described to investors.

Indeed, the agency has already taken enforcement action against alleged deception about private fund fees. In an October 2012 complaint (Release No. 2012-206), the SEC alleged that hedge fund investors were not told that the fund and its managers had taken over $140,000 in excessive fees and capital withdrawals, which they collected partly by changing the method of calculating fees without telling investors.

The SEC may also ask private fund advisers about compensation of the firm's personnel, transactions with affiliated parties, individuals' outside business activities, use of third parties (such as placement agents), and personal investments by adviser personnel.

The SEC will likely also continue to focus on how private fund advisers allocate limited investment opportunities among an adviser's multiple funds, or among the funds and an adviser's personnel. The SEC has already acted on this issue in the private equity context. In August 2012 (Release No. 67761),

the SEC announced that it had settled an administrative proceeding against the former partner of a private fund adviser. (Full disclosure: I helped litigate this case on behalf of the SEC.) The SEC's order found, among other things, that the respondent had usurped a lucrative investment opportunity from the private equity funds for which he worked, and allocated the opportunity to a private investment vehicle that he had formed with a friend.

Similarly, the SEC may take action based on insufficient disclosures to investors about any benefits that an adviser receives for an allocation. For example, the SEC announced in May 2012 (Release No. 3412) that it had instituted an administrative proceeding against a private fund adviser and its principal, alleging, among other things, that the respondents chose investments to sell to clients without fully disclosing the respondents' personal interests in the investments.

To address the risks of potential enforcement action involving alleged conflicts of interest, private fund advisers should implement rigorous policies, procedures, and controls. The written policies should explicitly address the specific conflicts raised by the business. Frequent training, monitoring, auditing, and updating are essential.

Known conflicts should be fully disclosed to investors. Investors additionally should be told the adviser's process for identifying and resolving potential future conflicts (*e.g.*, the process for allocating investments among funds or the process by which employees disclose their personal investments).

Advertising and Performance

Part of the SEC's core mission includes ensuring that investors receive accurate information about private fund investments. The SEC will therefore carefully scrutinize private fund advisers' advertisements. (*See, e.g.,* October 9, 2012 letter to industry regarding presence examinations at *http://www.sec.gov/about/offices/ocie/letter-presence-exams.pdf.*)

In particular, advisers who overstate their experience (*e.g.*, taking credit for investments made by a predecessor or third-party entity), or that selectively highlight only successes (*e.g.*, presenting an overall misleading picture of prior performance), are at risk for enforcement action. Particular attention should be paid to the use of performance models, since they could run the risk of being viewed as incomplete or misleading. Private fund advisers should also ensure that they present an accurate picture of their firm's liquidity and size (*e.g.*, assets under management).

Case in point: in July 2012 (Release No. 9333), the SEC announced that it had settled an administrative proceeding against a private fund adviser and its principal for, among other things, misrepresenting the principal's experience, the firm's assets under management, and the entity's due diligence processes to attract capital to the funds.

The SEC also analyzes private funds' reported returns through its Aberrational Performance Inquiry (API). By using risk analytics to identify suspicious returns, the SEC already has brought seven API cases alleging that inflated returns were reported to investors. (*See* SEC Release No. 2012-209, Oct. 17, 2012, and Release No. 2011-252, Dec. 1, 2011.) The SEC shows every sign of continuing to use, and perhaps expanding the use of the API program.

To ensure that advertisements are completely truthful, private fund advisers should adopt controls requiring compliance officers to oversee and approve public statements. Private fund advisers must in general maintain accurate and detailed books and records for their business, which will also help ensure that accurate performance is reported to investors.

Valuing and Safeguarding Assets

The SEC's concern about the accuracy of private fund advisers' reported valuations is already well-known, as is the SEC's active investigation of private fund advisers' valuation

practices. (*See Wall Street Journal*, Feb. 24, 2012, "Private-Equity Fund in Valuation Inquiry.") Private fund advisers face particular challenges here because investments often are not freely traded on a public market. The SEC will nevertheless carefully scrutinize advisers' valuation practices, the role that valuation plays in advisers' fundraising or in determining compensation/fees, and advisers' disclosures about their methodologies.

For example, in an October 2012 complaint (Release No. 2012-209), the SEC alleged that a private fund advisory firm and two of its executives enticed institutional investors to the fund and collected excessive fees by ignoring the firm's stated valuation procedures to inflate the value of certain holdings. The SEC has likewise alleged in other cases that private fund advisers publicized falsely inflated investment valuations. (*See, e.g.,* Release No. 2011-252, Dec. 1, 2011, summarizing additional cases brought under the API program; SEC Release No. 3412, May 30, 2012, in which the respondent allegedly applied a multiple, and separately applied a premium, when determining valuations; and SEC Release No. 2012-238, Nov. 20, 2012, in which the respondent allegedly overstated assets under management to SEC examiners.)

Furthermore, as fiduciaries, private fund advisers must protect client assets from misuse. The SEC has a well-known record of pursuing private fund advisers for making Ponzi-like payments, or for otherwise misusing investor funds. Recent comments attributed to an SEC commissioner about examinations of newly-registered private equity fund advisers likewise reinforced the need for advisers to take steps to ensure that their practices regarding uses of client assets are consistent with their representations to clients, and with their fiduciary duties. (*See Bloomberg Securities Regulation & Law Report* at 44 SRLR 2227 (Dec. 10, 2012).)

To address these risks, private fund advisers should establish detailed portfolio valuation methodologies. The procedures should be consistently followed and clearly communicated to investors. As necessary, independent third-party valuation experts should be consulted. Private fund advisers should also establish and follow detailed custody controls to ensure that client funds are protected from potential misuse.

Fraud *du Jour*

The SEC's enforcement efforts occasionally seem focused entirely on the current "fraud du jour." Private fund advisers should therefore keep an eye on the SEC's overall enforcement efforts, and consider any potential impacts on their firms. Three current trends warrant mention.

First, enforcement of the Foreign Corrupt Practices Act (FCPA) has undergone a recent resurgence. Although private funds have not been highlighted in the press, they have not escaped scrutiny. In April 2012 (Release No. 2012-78), the SEC filed a complaint against the former managing director of a private equity fund adviser, alleging that the individual bribed a Chinese official in exchange for investment opportunities. (Akin to the previously-mentioned case that I helped litigate, the defendant in this April 2012 case also allegedly usurped investment opportunities from his firm's fund, for himself and the Chinese official.)

The SEC's FCPA scrutiny is not likely to subside any time soon, particularly since private fund advisers face multiple liability risks. Private fund advisers face potential FCPA issues both at the "fund level" (*i.e.*, involving their investments) and at the "firm level" (*i.e.*, involving the finding of investors and investment opportunities). Additionally, other countries have their own anti-corruption statutes, and some (like the UK Bribery Act of 2010) apply even more broadly than the FCPA. To address the corruption risks, private fund advisers should adopt detailed and specific anti-bribery compliance procedures; conduct appropriately-scoped due diligence of investors, investments, acquisitions, and

third parties; and take appropriate responsive actions.

Second, insider trading continues to be a top enforcement priority. The SEC has filed more insider trading actions in the past three years than ever before in the agency's history. (*See* SEC Release No. 2012-227, Nov. 14, 2012.) Many of these efforts have focused on private fund advisers, particularly on hedge funds. (*See* summary at *http://www.sec.gov/spotlight/insidertrading/cases.shtml*.) This trend is not surprising as private fund advisers regularly receive material non-public information in the course of their work. Yet trading or tipping based on that information can, of course, subject both individuals and firms to significant liability.

The safeguard against these risks is statutorily specified: Section 204A of the Investment Advisers Act of 1940 requires investment advisers to adopt written policies and procedures reasonably designed to prevent the misuse, in violation of insider trading law, of material non-public information by the adviser or its personnel.

Third, anti-money laundering (AML) enforcement is poised to emerge as one of the government's next enforcement trends. The government is increasingly investigating banks, broker-dealers, and other financial institutions to determine whether compliance deficiencies resulted in failures to catch allegedly illegal money flows.

Detailed rules about advisers' obligations to adopt and enforce AML policies are currently lacking but may be forthcoming soon. In the meantime, however, private fund advisers and their personnel are not immune from AML investigations or prosecutions if they are complicit in wrongdoing, or if they transact with designated countries, entities, or individuals that are blocked by existing U.S. laws. Also, entities that currently maintain AML policies may require private fund advisers with whom they do business to adopt policies as well.

Private fund advisers should therefore consider proactively adopting and enforcing AML policies that include learning about investors and the sources of their funds, as well as any requisite diligence and monitoring. Note that gathering information about investors and their finances for AML purposes could overlap with existing efforts to verify the status of investors as qualified purchasers/accredited investors.

Private fund advisers face a host of regulatory risks, and scrutiny related to those risks will likely increase over time. Navigating the waters can be tricky, but the benefits of adopting and enforcing comprehensive policies and controls are manifest. Proactive compliance efforts help advisers and their personnel limit their potential liability risks.

Because comprehensive compliance efforts help protect investor funds from misuse, fraud, and the costs of enforcement action, private fund advisers may find that significant efforts will provide yet another competitive advantage. The potential enforcement risks to private fund advisers are coupled with equally salient compliance, and business, opportunities. ■

—Brian Neil Hoffman

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