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To Tell or Not to Tell: Best Practices for Managers Considering Whether to Self-Report Legal or Regulatory Violations

As a result of regulatory requirements and investor demands, hedge fund managers have, by necessity, become more transparent about business practices, conflicts of interest and problems that may arise. Determining when to self-report to authorities regulatory and compliance violations uncovered can be a thornier matter, though. Absent a specific legal obligation to self-report—and there are none—managers must conduct an analysis of the facts and circumstances surrounding a potential violation in order to weigh the potential benefits of self-reporting, any credit regulators may give and any censure or civil penalties ordered, against the likelihood that regulators will independently discover potential violations, and the firm will incur even harsher censure and civil penalties. This article discusses the factors that contribute to an investment manager's analysis of whether to self-report, the advantages and disadvantages of self-reporting, recordkeeping requirements if issues are uncovered and reported to regulators, and when and how investors should be notified of issues self-reported to regulators.

What Issues Should be Self-Reported?

There is no hard and fast rule on what should and should not be self-reported. Generally, violations of securities laws or any criminal conduct should be reported to regulators as soon as possible. However, violations of firm compliance rules or general policies and procedures may not rise to a level that necessitates a self-report.

According to David Tang, counsel at Seward and Kissel, "With certain issues, such as fraud or insider trading, the stakes are a lot higher, so the calculus of whether to self-report is different. The severity of the infraction is certainly a factor in the decision to self-report."

Determining Whether to Self-Report

The decision whether to self-report an issue to regulators should be made on a case-by-case basis, and a facts and circumstances analysis should be applied to each issue uncovered to determine if the manager should self-report.

Joshua Newville, a partner at Proskauer Rose explained, "The decision to self-report is really a case-by-case analysis. There is a continuum of issues that may be internal violations of policy or technical compliance violations up to the types of matters where you could potentially have fraudulent conduct and potential harm to investors in the fund. Once you get to the point where you're looking at potential violations of securities laws or criminal laws that might have a material detrimental effect on investors, that's when you think harder about self-reporting. Self-reporting minor violations is not realistic."

Tang agreed and noted, "At the end of the day, self-reporting is a facts and circumstances decision. There is no baseline of 'if you report, then you will receive credit and how much.' You have to weigh the severity of the misconduct, consider any credit you may be given, the potential consequences of not reporting and make your decision."

Added Richard Marshall, a partner at Katten Muchin Rosenman, "Whether to self-report is a judgment call. It's a tactical decision to make. With respect to that judgment, what you have to weigh is the likelihood that a regulator will discover the problem without the self-report. You also have to weigh what credit you would get for self-reporting. That's a very difficult judgment call and it depends on how good a story you have to tell. If you've been an exemplary manager and in this case you are an innocent victim of someone else's misconduct, and you acted quickly, promptly and efficiently, then you may get more credit for self-reporting."

If regulators are likely to find out about a problem on their own, then the decision to self-report should be an easy one for managers. Additionally, if third parties, such as an administrator or accountant, know about an issue, then the likelihood that regulators will independently discover the violation is higher, and the decision to self-report is more straightforwardly weighted towards the affirmative.

According to Marc Powers, a partner and National Leader of BH Securities Litigation, Regulatory Enforcement and Hedge Fund practices at BakerHostetler, "Part of the analysis is whether the uncovered, non-public issue or wrongdoing is going to get out publicly anyway. In that instance, you may want to be ahead of the curve, self-report the issue to the SEC, and gain some cooperation credit."

"The decision to self-report depends on the underlying conduct," said Terence Rozier-Byrd, a partner at Baker Botts. "If you're talking about a potential breach of fiduciary duty, or there is some type of criminal activity that has taken place in an isolated occurrence, the best thing to do is to make that known so you can attempt to mitigate the harm to the firm or to the investors."

Managers should also have a plan in place to deal with issues once they are uncovered. Rozier-Byrd advised, "The first step in determining whether to self-report issues is to establish a chain of command internally. You want to make sure you have clear lines of communication with your chief compliance officer to notify him or her of any potential compliance issues. From there, you should contact your outside counsel to figure out whether the conduct is serious enough to give rise to self-reporting."

Norm Champ, a partner at Kirkland & Ellis, cautioned managers, "Don't think about self-reporting unless you talk it over carefully with your lawyers. Self-reporting is a serious decision, and it's one you really need to consider carefully with your lawyers and other advisors."

Waiving of Privilege When Self-Reporting

Involving attorneys in investigating a potential violation and deciding whether to self-report may, however, pose issues related to preservation of attorney-client privilege. As Powers noted, "You need to be sensitive to the issue, and when and how you disclose information to the SEC. Otherwise, the client may find in a subsequent non-governmental proceeding an argument of waiver of the fruits of an internal investigation. On the other hand, if you go to the government, you should consider the benefits of waiving the privilege to be deemed to have fully cooperated. So initially, at least, seek to only provide to the SEC underlying pre-existing company documents that don't reflect your work product."

On the issue of attorney-client privilege, Newville added, "Anything you tell regulators is generally non-privileged the moment you self-report, as a function of disclosure to an outside party. With any internal communications, it's important for both internal and external counsel to make clear to people they are speaking to at the firm that they represent the firm and any privilege is the firm's privilege—in short, to use Upjohn warnings."

Marshall noted that managers have to consider situations where they have discussions with counsel prior to the self-report and whether that discussion will ultimately be helpful or harmful. "You need to decide if you waive your privilege with those discussions. You have to weigh that into your decision to self-report and if you want to preserve your privilege."

Internally Investigating Issues

Investigating an issue thoroughly, and ascertaining all pertinent facts to understand the scope of a potential regulatory or compliance violation, can help a managers decide whether to self-report to regulators.

According to Champ, "The first thing you should do would be to investigate the issue to determine what happened and if you have a violation of law. If you think you have violated federal securities laws, you have to take a hard look at self-reporting. You have to have all of the facts before you can self-report anything to regulators."

Tang agreed that a full internal investigation of the issue is necessary before a decision to self-report can be made. "You need to make a determination of whether or not you have an issue in the first place. You can't assume that you know all of the facts surrounding an issue, and you can't assume that you know exactly what the issue is or who is responsible. I recommend asking outside counsel to help with the investigation so you can have an unbiased fact-finding process with anyone that may be involved. Using outside counsel has the added benefit of attorney-client privilege. Privilege is important because you may come out of the investigation and determine you don't really have a problem. Still, you will have a report with a lot of facts and interview notes on your compliance program and firm practices that could be discoverable in a regulatory action or litigation."

Tang continued, "An internal investigation helps you decide the right disciplinary action against those responsible for the misconduct and evaluate the adequacy and effectiveness of your policies and procedures. An internal investigation will also help you understand if any investors were harmed, which is of utmost importance to regulators. To the extent there were any illicit gains, you need to determine the amount. As a fiduciary, you are not allowed to keep any illicit gains. You need to do an assessment of what the reimbursement amount would be to the client, how you allocate that reimbursement among clients and a plan to actually reimburse clients—including those who may have since redeemed."

An internal investigation will also furnish managers with all the information necessary to make a full reporting to regulators, Newville observed. "You need to have enough information on the front end to make sure that the issue is something that rises to the level of being reportable. That requires a decent amount of investigation on the front end. The manager needs to make a determination whether the information is reportable to LPs, which I think is a decision that should be made before a report is made to a regulator."

Weighing the Advantages and Disadvantages of Self-Reporting

Regulators encourage self-reporting and aver that credit will be given to managers who voluntarily bring issues to their attention. In fact, in an effort to encourage what Director Andrew Ceresney called the "significant and tangible" benefits of self-reporting, in January 2016, the SEC's Division of Enforcement announced that self-reporting would be a precondition to a firm's eligibility for deferred prosecution or non-prosecution agreements.

Acknowledgement of a firm's cooperation is a key factor in the decision to self-report and an obvious benefit for doing so. According to Tang, "The main benefit of self-reporting is that it may result in some degree of credit from a regulator. The SEC has tried to encourage cooperation from market participants. However, you should know that the SEC and other regulators are not required to and may not necessarily give credit. Even when credit is given, there is no formula as to how much credit you get."

Added Newville, "The SEC will say the benefits include potential reduction in penalties, or no penalties, if they bring an enforcement action against the manager. It's hard for the industry to see those benefits because it's difficult to compare different matters, which depend on individual facts. That said, the benefits of self-reporting would be to increase cooperation with the SEC or whomever your primary regulator may be. There is the potential for a reduction in penalties or for regulators to view the issue as more of a compliance issue rather than an enforcement issue."

Once a manager self-reports an issue, there must be full cooperation. Managers cannot self-report a problem that was uncovered and then refuse to provide any information that could facilitate the regulator's investigation into the issue.

The very fact that a regulator will have actual knowledge of compliance and/or regulatory violations is a drawback to self-disclosure. As Marshall pointed out, "Regulators will absolutely know about a problem when you self-report, so then you have to try to figure out how much trouble you are in because of this issue."

"To the extent that you identify an issue and take corrective measures," Rozier-Byrd said, "that is likely to be viewed favorably by regulators. However, it doesn't get you off the hook completely. You can still be subject to an enforcement action or some type of inquiry even if you think you've appropriately resolved the matter internally."

Added Powers, "One of the drawbacks to self-reporting is that you may have given the regulators a case they may have never picked up and you were able to clean up fully privately. By self-reporting you could also hurt the client by putting it in the center of an SEC investigation."

Tang agreed putting an issue on regulators' radar is a concern, and added that it can unwittingly lead to discovery of other regulatory and compliance violations, even if the initial issue self-reported does not amount to a violation. "Another concern is you have not actually violated securities laws and you're reporting to regulators unnecessarily. Additionally, any self-reporting could lead regulators to come in, review the rest of your compliance, and uncover other issues."

Legal Obligations to Self-Report

For hedge fund managers, there are no direct legal obligations to self-report issues to regulators. However, certain conduct may cause managers to disclose issues in various regulatory filings. Powers explained, "Public companies have obligations to report promptly material issues that may affect their businesses, but there are no parallel obligations for investment managers under the federal securities laws."

Hedge fund managers do, however, have regulatory reporting obligations in relation to certain conduct. As Tang explained, "If you are registered as an investment adviser with the SEC, you'll have to complete and update Form ADV, which includes disciplinary disclosures in Part 1 and Part 2. This effectively requires disclosure of certain bad acts."

For hedge fund managers that also have a registered broker-dealer, FINRA Rule 4530 requires firms to report 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 organization."

The SEC, while it does not have a specific rule requiring self-reporting, established a cooperation program to encourage managers to report regulatory violations. Ceresney explained the impetus for the program, and that in the criminal context, "Cooperation is critical to building cases. Cooperators provide a bird's-eye view of the misconduct, often informed by their own participation in the scheme. Cooperators not only accept responsibility for their actions through pleas or other consequences, they also serve as a narrator for the story that the criminal authorities are presenting to a jury. In contrast, all too often, we at the SEC were left without such a narrator in our cases, facing nothing but hostile witnesses who have no incentive to tell the truth and no desire to assist us." The same can likely be said for incentives in civil cases as well.

Deciding Not to Self-Report

If a manager uncovers an issue or violation that it neither addresses internally nor self-reports, it could lead to significant disciplinary action if uncovered by regulators in an examination. On the other hand, if a manager internally addresses an issue discovered but does not self-disclose it, the issue may very well end there, without any sanctions.

According to Tang, “If you choose not to self-report, and a regulator later identifies the violation, you don’t necessarily have a problem. It will depend on what the incident was and how you handled it. You will, of course, miss out on any credit you would have received for self-reporting. However, a regulator may credit a company for the effectiveness of its internal response, including the internal investigation, reimbursement, disciplinary actions and corrective steps taken.”

Documenting Issues that are Uncovered

As with any internal investigation and report, accurate and complete recordkeeping is necessary. Whether or not a report is made to regulators, managers need to create and maintain records describing what the issue was, how the firm investigated it and any steps taken to mitigate the problem and prevent future recurrences.

Rozier-Byrd explained, “Whatever the issue is, it should be provided in writing to the chief compliance officer. The CCO should then keep notes of his or her analysis, including consultation with internal and external counsel. There should also be documentation on how the matter was resolved and if regulators were notified so you have a record of the issues that were presented and how you analyzed and resolved them.”

Marshall added, “If you self-report to a regulator they are almost certainly going to follow up. You don’t want to be in a situation where you make a self-report which leaves too many questions unanswered. You need to prepare a well-thought-out presentation that gives the regulators a lot of information.”

Any information reported to regulators needs to be complete and accurate, Newville said. “When you’re making a self-report, there are three steps to focus on. First, your report should focus on your investigation and what you learned about the issue. Second, you need to include your response, and any action internally that needed to be taken, and what you did, if anything. The third point is messaging, mainly to people inside the firm, then LPs, and then regulators. You want to be able to present to regulators a coherent summary of where the firm is on these three points.”

How to Self-Report to Regulators

How a manager self-reports an issue can vary and range from a phone call to a written submission or in-person presentation.

“In terms of process, it is helpful to have a policy which says that to the extent the manager is aware of a violation of either the policies and procedures of the firm or federal securities laws, the CCO or another member of senior management should be notified,” Tang said. “That person will then determine the necessary actions to take, including whether to notifying a regulator.”

Which regulator(s) a manager reports to—the SEC, CFTC, state regulators or some other entity— will largely depend on the manager and the nature of the violation uncovered. Which division within the regulator the manager reports to will also depend on the manager, which office it contacts and whether examiners have previous knowledge or experience with the firm.

If going to the SEC, Champ noted, “Who you talk to at the SEC when you self-report is going to depend on what you uncover. You could go to someone in the Division of Investment Management, if there is something that can be done through a no-action relief or guidance. Managers could go to examiners to let them know about issues or to Enforcement.”

Disclosing Self-Reported Issues to Investors

As a general matter, before an issue is self-reported to regulators, it may be best to disclose the issue, and the actions taken to correct it, to the fund's investors. The last thing an investor wants to do is learn about an issue by reading about it in a newspaper or learning about it from an enforcement action.

As Powers advised, "You tell investors when you're comfortable that you've gotten to the bottom of the facts and issues, or never, depending on whether it needs to be disclosed for legal or business reasons."

According to Rozier-Byrd, "You should tell investors when you self-report. Part of your fiduciary duty as a manager is to fully and fairly disclose all material facts that would be relevant to someone in making an investment decision."

Disclosing self-reported issues to investors is not, however, required in most cases. According to Marshall, "You don't have to let investors know when you self-report. The advantage of telling investors is that you anticipate a problem, so you're letting them know so they aren't caught by surprise and you lose credibility with them. You can also control how the report is made and the timing if you notify investors on your own."

Side letter agreements may, however, play into a manager's decision to self-report. If the manager has a side letter agreeing to notify an investor about the discovery of some anomaly, that could play into the manager's decision to notify all investors, since it is more likely that one of them could tell the government before the manager does. On this point, Rozier-Byrd advised, "Irrespective of whether a manager has these notice provisions in side letters, I think it's just best practice to tell your investors."

Depending on the nature of an issue or potential violation, managers may be required to disclose certain acts to investors through regulatory filings. As Tang explained, "In terms of disclosure to investors, the bad actor disqualification requirements of Rule 506 and, in some cases, investor due diligence questionnaires will require disclosure of certain misconduct."