

Adviser Duties, Diligence, Documentation and Disclosure After Madoff and Bayou Funds: Lessons from *Hennessee Group LLC* and *Charles J. Gradante*

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Introduction and Overview.

“Trust me” might previously have been an accepted response to questions posed by an adviser’s clients and regulators. Questions about portfolio management, valuation of assets, the security of client funds, and the adviser’s use and reliance on third party custodians and sub-advisers were not typically raised. The recent Madoff and Bayou Funds scandals, among others, have dramatically changed clients’ and regulators’ expectations as to how a fiduciary executes its standard of care.

This note highlights the rigorous review and documentation of adviser activities that clients and regulators are coming to expect. These points are illustrated in a recent enforcement action brought and settled by the Securities Exchange Commission (the “SEC”) against Hennessee Group LLC and Charles J. Gradante,¹ which is discussed below. This note concludes by proposing that advisers take the needed steps to assure they can demonstrate that (1) they are performing their own duties appropriately, (2) they have engaged in appropriate diligence and oversight with respect to sub-advisers and third parties, and (3) their disclosures to clients are accurate and consistent.

The SEC Settlement in *Hennessee Group*.

Hennessee Group imposed significant sanctions against investment adviser/hedge fund consulting firm Hennessee Group and its managing principal² in connection with settled findings that the adviser’s disclosures

about its diligence and monitoring efforts operated as a fraud – given that Hennessee Group sent investor funds off to the Bayou Funds, which looted them.³ In support of the sanctions, the SEC identified significant disparities between what Hennessee Group’s investors were told about the adviser’s due diligence practices and what Hennessee Group in fact did to assess the Bayou hedge funds, which it recommended to its investors beginning in 2002. According to the SEC’s settled allegations, by the time Hennessee Group first recommended the Bayou funds, Bayou and its principals had spent years fabricating the funds’ performance, concealing trading losses, and manufacturing “independent” audited financial statements. (The Bayou fraud unraveled in August 2005, after Bayou issued worthless redemption checks to certain investors from overdrawn bank accounts and began shutting down its operations.)

The SEC alleged that, when Hennessee Group evaluated Bayou, it failed to perform two levels of what Hennessee Group touted was its five-level initial diligence process. The SEC also alleged that Hennessee Group disregarded certain red flags during its due diligence review and subsequent monitoring of Bayou. When taken together, these failings, according to the SEC, amounted to conduct that operated as a fraud on Hennessee Group’s clients and prospective clients and thereby violated Section 206(2) of the Advisers Act, a fraud statute that does not require evidence of bad faith or even reckless conduct but instead encompasses an adviser’s

¹ *Hennessee Group LLC and Charles J. Gradante*, SEC Rel. No. IA-2871 (Apr. 22, 2009).

² The order settled SEC administrative and cease-and-desist proceedings based on the respondents’ agreement to (1) censures, (2) orders to cease and desist from violations and further violations, (3) pay over \$700,000 in disgorgement and prejudgment interest, and \$100,000 in a civil money penalty, (4) distribute the SEC’s settlement order to existing clients and to each new client for two years after the date of the order, and (5) adopt policies and procedures in a written manual that ensure adequate oral and written disclosures regarding the Group’s process for evaluating, selecting, and monitoring hedge funds.

³ SEC Charges Investment Adviser That Recommended Bayou Hedge Fund to Clients, Press Rel. 2009-86 (Apr. 22, 2009), available at <http://sec.gov/news/press/2009/2009-86.htm>.

Memorandum

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negligent course of conduct that operates as a fraud on the adviser's clients.

Three Strategies to Meet Client and Regulator Expectations.

The facts of *Hennessee Group* may be egregious but advisers should not allow that to obscure its message. That message is that an adviser must not only effectively discharge its fiduciary responsibilities in its own work for clients and in overseeing the efforts of sub-advisers and third parties, but must also be in a position to demonstrate in its compliance documentation its diligence and follow-up on red flags. An adviser, further, must assure that it accurately and fairly conveys its practices in the adviser's disclosures. Here are three strategies for accomplishing these goals.

1. *Standardize and memorialize diligence and oversight efforts.* All advisers utilize, to one degree or another, the services of others in discharging their fiduciary duties to their investors. The *Hennessee Group* order speaks to the value of having a robust, auditable process for documenting that the adviser is relying appropriately on others to assist it in carrying out its duties to investors. It also speaks to the value of standardizing and memorializing that process in the adviser's written policies and procedures and reflecting the adviser's efforts in compliance documentation. Notably, Hennessee Group formally undertook to develop written policies and procedures (related specifically to disclosure of its selection, evaluation, and oversight practices), as a condition to settling the SEC's fraud claim against it.

2. *Adopt a methodical approach to pursuit of red flags and follow-up and document the conclusions reached.* *Hennessee Group* also reflects that is critical that an adviser thoughtfully consider, and then document, its conclusions with respect to (1) any sub-adviser or other third-party provider's refusal to provide requested documentation during due diligence or monitoring efforts, and (2) any information that comes to the adviser's attention during such processes that can be characterized as a "red flag." Among the facts marshaled in *Hennessee Group* were that when the adviser sought prime brokerage reports from Bayou

in order to conduct a portfolio/trading analysis, but was refused, the adviser simply proceeded to the next phases of due diligence. Further, problematic information about Bayou that came to the adviser's attention was not pursued, and certainly was not disclosed to the adviser's investors. It may be that information that a sub-adviser offers in lieu of what the adviser has requested is more than sufficient for the adviser's diligence or monitoring purposes. It also may be that information that may appear at first to raise an issue for the adviser proves benign, when run to ground. But an adviser that does not have in place a process that requires it to consider these matters in a methodical fashion, consistent with the adviser's duties to its investors, and once the matters are considered, to document the adviser's conclusions with respect to them, leaves the adviser vulnerable to claims of negligent inattention, at the least.

3. *Adopt a disciplined approach to disclosure that focuses on accuracy and consistency.* Finally, *Hennessee Group* starkly illustrates what can happen when an adviser does not have in place effective procedures for ongoing review of, and assessment for continuing accuracy of and consistency across, its oral and written disclosures to clients and prospective clients about its diligence and monitoring efforts. Assuring that such procedures are included in the adviser's written policies and procedures, and that they are routinely followed, is a prudent course.

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