SEC SANCTIONS INVESTMENT ADVISER FOR MISLEADING INVESTORS ABOUT THE QUALITY AND RIGOR OF ITS DUE DILIGENCE PROCESS FOR EVALUATING HEDGE FUND INVESTMENTS

On April 22, 2009, the United States Securities and Exchange Commission issued an administrative order imposing remedial sanctions against Hennessee Group LLC and Charles J. Gradante, Hennessee Group's co-founder, chief executive officer and chief investment officer, for willfully violating Section 206(2) of the Investment Advisers Act of 1940 (the "Act").[1] According to the order, Hennessee Group and Gradante breached their fiduciary duties to their investment advisory clients by misrepresenting the due diligence they undertook in recommending that their clients invest in Bayou Group LLC, a hedge fund that collapsed in 2005 amid revelations of widespread fraud for which its former head and co-founder is now serving a 20-year prison sentence.

Factual Background

Founded in 1997, Hennessee Group is an investment adviser registered with the Commission that recommends hedge funds to its clients for investment and monitors those investments on its clients' behalf. Hennessee Group and its principals held themselves out as "Pioneers in Hedge Fund Consulting" with years of experience helping clients achieve "higher investment returns with lower risk" by recommending "a customized portfolio of hedge funds, properly diversified and managed." Hennessee Group promoted its process for evaluating and selecting funds, telling clients and prospective clients that it would not recommend investment in hedge funds that did not satisfactorily complete all five levels of its "Five Level Due Diligence Process." By 2005, Hennessee Group had approximately 100 clients and $1.35 billion in client assets under management.

Hennessee Group began recommending Bayou to its clients in December 2002. By mid-2005, Hennessee Group had collected over $500,000 in advisory fees for referring to Bayou approximately 40 clients, who collectively invested over $56 million in the Bayou Funds. According to the Commission, however, Hennessee Group failed to perform two of the five elements of the due diligence process it told its clients and prospective clients that it would perform and did not inform clients that it had not adhered to its advertised due diligence practices. In particular, the SEC found that Hennessee Group did not conduct a portfolio/trading

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1 *In re Hennessee Group LLC and Charles J. Gradante*, Investment Advisers Act of 1940 Release No. 2871 (April 22, 2009) ("*Hennessee*").

analysis of the Bayou Funds, even though its promotional materials created the impression that the portfolio/trading analysis was Hennessee Group's specialty and a core element of its due diligence process. Instead, according to the Commission, after Bayou refused to produce its trading data, Hennessee Group decided to rely entirely on Bayou's uncorroborated representations and purported rates of return. The Commission likewise found that Hennessee Group failed to verify Bayou's relationship with two firms Bayou claimed had served as its independent auditors, one of which was a legitimate entity that Bayou never retained and the other of which was a nonexistent entity fabricated by one of Bayou's principals. According to the SEC, although Hennessee Group was unfamiliar with the two firms and despite the fact that none of the approximately 150 hedge funds it monitored on behalf of its clients used either firm as its auditors, Hennessee Group took no steps to confirm whether either firm had an audit relationship with Bayou beyond confirming that Bayou's financial statements contained an unqualified audit opinion letter. The Commission also found that Hennessee Group ignored several red flags suggesting that the identity of Bayou's outside auditors was in doubt, and failed to investigate fully rumors of potential conflicts of interest at Bayou raised by Hennessee Group's own clients.

Those failures, the Commission found, were inconsistent with the representations Hennessee Group had made to its clients regarding the quality and rigor of its due diligence. They also violated Section 206(2) of the Act, which prohibits any transaction, practice or course of business that operates as a fraud or deceit upon any client or prospective client, whether or not the adviser acts with scienter, or intent to defraud. The Commission ordered Hennessee Group to pay nearly $815,000 in disgorgement, civil penalties and prejudgment interest and to cease and desist from committing or causing further violations of the Act.

Implications

Hennessee Group's failure to comply with the unambiguous assurances it gave to its clients regarding the quality and rigor of its due diligence practices provided a ready basis for enforcement action by the SEC. But even in the absence of clear evidence of material departures from their advertised services, investment advisers can expect increased scrutiny of their due diligence practices. If an adviser has invested client moneys in a hedge fund that has engaged in fraud and lost clients' money, the adviser's initial and ongoing due diligence process will likely be the subject of close scrutiny by those clients and perhaps, as in this case, by the SEC. The *Hennessee* order is thus an important reminder that, when investments turn sour and recovery against the underlying fund is difficult or impossible, investment advisers that fail to follow reasonable diligence practices or deviate from the representations they made to investor clients about those practices may face vigorous enforcement action by the SEC and, potentially, civil litigation.

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If you have any questions about this alert, or would like a copy of the *Hennessee* order, please call or email Mary Eaton (212-728-8626, meaton@willkie.com), Rose F. DiMartino (212-728-8215, rdimartino@willkie.com), or the Willkie Farr & Gallagher attorney with whom you regularly work.

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