Prevention of the Misuse of Material Nonpublic Information by Investment Advisers

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While there is much discussion about potential changes to the regulatory landscape as a result of the recent presidential election in the United States, one area that is likely to remain a high priority with the Securities and Exchange Commission ("SEC") and the Department of Justice is the enforcement of insider trading laws.[1] There is probably no better indication of this than Mr. Preet Bharara's acceptance of the president-elect's invitation to continue as U.S. Attorney for the Southern District of New York.[2]

Investment advisers are obligated to enact anti-insider trading policies and procedures pursuant to Section 204A of the Investment Advisers Act of 1940 ("Advisers Act"). Under Section 204A, every registered investment adviser "shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such investment adviser's business, to prevent the misuse in violation of this Act or the Securities Exchange Act of 1934, or the rules or regulations thereunder, of material, nonpublic information by such investment adviser or any person associated with such investment adviser."

What exactly does Section 204A mean for each investment adviser and its chief compliance officer ("CCO") in regards to enacting appropriate anti-insider trading policies and procedures? Each investment adviser (whether it manages hedge funds or private equity funds) and CCO must approach this question with an open mind on at least an annual basis and perhaps more frequently as changes to the adviser's business occur. We do know that because of allegations related to insider trading, firms like Visium Asset

[1] The principal source of law for insider trading in the United States is Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") as well as Rule 10b-5 thereunder. Other sources include Section 17(a) of the Securities Act of 1933 ("Securities Act") as well as Exchange Act Section 14(e) and Rule 14e-3 thereunder. Prosecutors will also use mail and wire fraud statutes such as 18 U.S.C. Sections 1341 and 1343. Each of these statutory provisions and rules has been the subject of many significant judicial interpretations.

[2] *See* Benjamin Weiser & Nick Corasaniti, *Preet Bharara Says He Will Stay On as U.S. Attorney Under Trump*, N.Y. TIMES (Nov. 30, 2016), http://www.nytimes.com/2016/11/30/nyregion/preet-bharara-says-he-will-stay-on-as-us-attorney-under-trump.html?_r=0.

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Management (which had had approximately $7.8 billion under management as of January 1, 2016) are today out of business.[3] We also know that the SEC issued a press release[4] on June 15, 2016 summarizing three complaints against: (i) Sanjay Valvani and Gordon Johnston[5]; (ii) Christopher Plaford[6]; and (iii) Stefan Lumiere.[7] Complaints (i) and (ii) cite, among other things, the failure of a registered investment adviser to meet the requirements of Section 204A.

Gordon Johnston used to work at the Food and Drug Administration ("FDA") and became a paid consultant to Sanjay Valvani, a portfolio manager ("PM") that invested in health care companies. Johnston maintained a friendship with people that continued to work at the FDA. These FDA officials regularly briefed Johnston about the approval process of certain generic drugs. In violation of his duty of confidentiality, Johnston provided material nonpublic information ("MNPI") to Valvani about impending approvals of certain generic drugs. Valvani traded based on this MNPI and also tipped Plaford who also traded on this information. Plaford and Lumiere also created bogus valuations and consequently inflated the monthly net asset value and performance[8] of several funds and took more management and performance fee than they would otherwise be entitled to.

Valvani also had close personal relationships with executives of public companies in which he traded on behalf of his investment adviser. By way of example, Valvani was friends with the Chief Executive Officer ("CEO") and other senior management of a pharmaceutical company ("Pharma Company"). Valvani would obtain advance notice of earnings announcements prior to public release.

Valvani's complaint states that "Investment Adviser did little to prevent Valvani from violating its written policies against insider trading. No one at Investment Adviser monitored Investment Adviser's or Valvani's relationship with Johnston or, at a minimum, questioned the lawful nature of the information that Valvani had obtained from Johnston. Further, no one at Investment Adviser monitored Valvani's

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[3] *See* Rachael Levy, *Wall Street Has Been Rocked by an $8 Billion Hedge Fund's Implosion*, BUS. INSIDER (June 18, 2016, 11:02 AM), http://www.businessinsider.com/visium-asset-management-closure-rocks-wall-street-2016-6; Rachael Levy, *A Big-Name Hedge Fund Manager at Visium Has Turned Himself in to the Feds*, BUS. INSIDER (June 15, 2016, 12:12 PM), http://www.businessinsider.com/a-big-name-hedge-fund-manager-at-visium-has-turned-himself-in-2016-6.

[4] *See* Press Release, U.S. Sec. & Exch. Comm'n, Hedge Fund Managers and Former Government Official Charged in $32 Million Insider Trading Scheme (June 15, 2016), *available at* https://www.sec.gov/news/pressrelease/2016-119.html.

[5] *See* Complaint, Sec. & Exch. Comm'n v. Valvani, No. 16 Civ. __ (S.D.N.Y. June 15, 2016), *available at* https://www.sec.gov/litigation/complaints/2016/comp-pr2016-119-valvani-johnston.pdf.

[6] *See* Complaint, Sec. & Exch. Comm'n v. Plaford, No. 16 Civ. __ (S.D.N.Y. June 15, 2016), *available at* https://www.sec.gov/litigation/complaints/2016/comp-pr2016-119-plaford.pdf.

[7] *See* Complaint, Sec. & Exch. Comm'n v. Lumiere, No. 16 Civ. __ (S.D.N.Y. June 15, 2016), *available at* https://www.sec.gov/litigation/complaints/2016/comp-pr2016-119-lumiere.pdf.

[8] Certain investment advisers are required to report performance numbers on Form PF. The SEC has indicated that it is monitoring these numbers in an effort to identify aberrational performance that might indicate fraud.

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relationship with Pharma Company's executive management. Reporting, or even questioning, the receipt of material nonpublic information from these executives was left to Valvani."[9]

To meet the requirements of Section 204A, the Adviser must have an effective compliance program in place. The basics of an effective compliance program include having a written Compliance Manual[10] and Code of Ethics[11] that are updated at least once per year. Rule 206(4)-7 of the Advisers Act (the "Compliance Rule")[12] also requires that each registered investment adviser review the adequacy and effectiveness of its policies and procedures on an annual basis.[13] All hands training should be conducted soon after the release of the updated Compliance Manual and Code of Ethics. This training should cover, among other things, details that each employee must know regarding the adviser's anti-insider trading policies and procedures and their responsibilities thereunder. The adviser's personnel should be trained on how to recognize MNPI and be encouraged to bring any concerns to senior management and the CCO. This is especially the case if a trader or PM thinks he or she might have been exposed to MNPI. When in doubt, traders and PMs should not make the call on their own about whether the information they have received constitutes MNPI. The CCO, together with outside counsel, should immediately analyze all of the facts and circumstances surrounding the trader's concern and may determine to put the relevant security on a "restricted list". There should be no trading in the adviser's client accounts or in any personal accounts with respect to such security until such determination is made or in any security on the restricted list.

Beyond the "basics," the CCO must have an attitude of professional skepticism: trust but verify. This can be difficult to achieve especially when the PMs are senior to the CCO and control the CCO's employment and compensation. Nevertheless, with this attitude firmly in place (and possibly with the assistance of independent third parties) the CCO should conduct an in depth enterprise risk assessment at least annually of the adviser and each client. This assessment should cover, among other things, the sourcing of investment ideas. Where do the analysts, traders and PMs get their trading ideas? Do they speak with industry experts, consultants or management at public companies? Who do they speak with? How frequently? Should these meetings and calls be catalogued, tracked and monitored? Should the CCO have the opportunity to "chaperone" and listen in on the calls?

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[9] Valvani, *supra* note 5, ¶¶ 90-91.

[10] Rule 206(4)-7 of the Advisers Act is known as the "Compliance Rule." See also, Advisers Act Release No. 2204, Investment Company Act Release No. 26299 (Dec. 17, 2003).

[11] Advisers Act Rule 204A-1 is the "Code of Ethics Rule." *See also* Investment Adviser Codes of Ethics, Advisers Act Release No. 2256, Investment Company Act Release No. 26492 (July 2, 2004).

[12] Advisers Act Rule 206(4)-7.

[13] For a recent example of a registered investment adviser that failed to complete its annual compliance review for multiple years (despite the requirement to do so in its own compliance manual), *see* Dupree Financial Group, LLC, Advisers Act Release No. 4546 (Oct. 5, 2016), *available at* https://www.sec.gov/litigation/admin/2016/ia-4546.pdf.

What agreements are in place with experts and consultants[14]? Are they still employed by public companies? If not, how long have they been out of the industry? Are they periodically reminded by the adviser's traders and PMs that the adviser does not want MNPI? How often should the adviser's personnel have access to a given expert? What documentation should be maintained?

Based on a knowledge of (i) where investment ideas are coming from, (ii) who the trader's contacts are at public companies and (iii) the identity of industry experts or consultants (as well as the terms of their agreements and the extent of their training and the frequency of contact), the CCO can more intelligently assess the risk of an inadvertent disclosure of MNPI from these sources and the level of oversight and controls that should be put in place. Merely having a policy against insider trading is not enough. Similarly, a PM's, trader's or research analyst's "self-evaluation" of information they receive from people likely to possess MNPI is not enough to comply with Section 204A.

Other common sources of MNPI might come from outside business activities of adviser personnel. For example, you may have supervised persons that sit on the boards of directors of public companies.[15] You might have investors in your funds that are insiders to public companies, or that sit on public boards. Certain of your supervised persons may be married to or have relationships with public company insiders, lawyers that work on mergers and acquisitions or tender offers, or investment bankers that obtain MNPI about impending deals.

Each adviser is different and the habits and tendencies of its PMs and traders need to be analyzed and understood. Some like to attend conferences where representatives of public companies might attend. Others have friends at other hedge funds, private equity funds or broker dealers. You might have traders that like to participate in idea sharing forums. If you have prominent investors in your funds and they regularly speak with the PM, that too needs to be considered. Some advisers are also registered as broker dealers and need to ensure adequate information barriers are in place.[16] The potential sources of

[14] *See* Press Release, U.S. Sec. & Exch. Comm'n, Consultant to Chinese Private Equity Firms Settles Insider Trading Charges (June 9, 2016), *available at* https://www.sec.gov/news/pressrelease/2016-115.html, for an example of a consultant to several private equity firms that settled insider trading charges; *see also* Complaint, Sec. & Exch. Comm'n v. Ma, No. 5:16-cv-03131 (N.D. Cal. June 8, 2016), *available at* https://www.sec.gov/litigation/complaints/2016/comp-pr2016-115.pdf.

[15] Private equity firms whose PMs sit on the boards of private portfolio companies are still at risk of learning confidential information about public companies that the portfolio company does business with. Private equity funds also are at risk in "going private transactions" or with respect to portfolio companies that go public or any other investments in public companies. *See* Carlo V. di Florio, Director, Office of Compliance Inspections & Examinations, U.S. Sec. & Exch. Comm'n, Private Equity International's Private Fund Compliance (May 3, 2011), *available at* https://www.sec.gov/news/speech/2011/spch050311cvd.htm.

[16] Information barriers may also be appropriate for a number of different circumstances including where an adviser purchases syndicated loans based on nonpublic information but also purchases other securities in the borrower's capital structure. Smaller advisers may have a difficult time credibly establishing any form of barrier. In the absence

MNPI are numerous and varied. MNPI needs to be the subject of an ongoing dialogue between the investment professionals and the compliance function if suitable controls and monitoring are to be put in place.

In a recent case,[17] the SEC cited a registered investment adviser and a senior analyst for failing to supervise a research analyst that made trading recommendations based on MNPI he received from a public company a short time before significant public announcements were made by that company. The adviser also violated Advisers Act Section 204A for failure to adopt policies or procedures to address the risk presented by the research analyst's frequent communication with public companies. The adviser did not require its analysts to report their interactions with employees of public companies and it did not have policies to track or monitor these interactions.

In addition to tracking sources of MNPI, forensic email and instant message ("IM") reviews can be a powerful compliance tool. The reviews can be targeted and specific. They can also be driven by portfolio profit and loss attribution compared with a review of public company announcements. Armed with an understanding of the investment idea generation process, prominent fund investors as well as a list of relevant public company executives, consultants and industry experts, we recommend conducting email and IM reviews on a frequent basis. If a trader comes from a firm that has a history of regulatory problems then the CCO may consider adding enhanced monitoring procedures.[18]

The investment adviser should also be looking at trading patterns: size of trades, frequency of trades. This supervisory activity should be able to detect an aberration in the pattern of a PM's trading activity. Why does this PM suddenly seem to have so much conviction, for example? Larger organizations may have a risk officer performing this review. In one prominent insider trading case, supervisory personnel were able to identify that traders were obtaining advance notice of and trading on the contents of the Wall Street Journal's *Heard On The Street* Column.[19]

Lastly, a regular analysis of who are the supervised persons[20] and access persons[21] of an investment adviser is an important exercise. An example of the failure to conduct this analysis would be the Federated Global Investment Management case.[22] In some cases, consultants assist the PM with some

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of an effective barrier, MNPI possessed by a supervised person can be attributed to all—hence the need for a restricted list.

[17] Artis Capital Management, L.P., Advisers Act Release No. 4550 (Oct. 13, 2016), *available at* https://www.sec.gov/litigation/admin/2016/ia-4550.pdf.

[18] The National Futures Association ("NFA") has published Interpretive Notice 9021 on Enhanced Supervisory Requirements. Many SEC registered investment advisers are also NFA members.

[19] *Carpenter v. United States*, 484 U.S. 19 (1987).

[20] Supervised Person is defined in Advisers Act Section 202(a)(25).

[21] Access Person is defined in Advisers Act Rule 204A-1.

[22] *See* Federated Global Investment Management Corp., Advisers Act Release No. 4401 (May 27, 2016), *available at* https://www.sec.gov/litigation/admin/2016/ia-4401.pdf. The SEC sanctioned Federated Global Investment

aspect of the investment or monitoring function. The consultants in some cases might be supervised persons and access persons. In other cases they may be covered with a consultant's employment agreement that covers MNPI and confidentiality. In other cases, an adviser might have an investment advisory or similar board whose members have a role in the adviser's investment process. The point is that MNPI can be introduced into the investment process at many points along the way. The CCO needs to be aware of and consider each of these points and also be fully aware of who he or she should be supervising. Having a well thought out and documented access person analysis is a smart move.

Eternal vigilance is the price of an effective compliance program. The CCO needs to lead and be a resource but everyone at the firm need to do his or her part. As we have seen, merely enacting anti-insider trading policies and procedures is often not enough to meet the requirements of Section 204A. We have tried to illustrate some of the many sources of MNPI that your supervised persons may be exposed to. Each change to the facts, however, whether it involves a new supervised person, industry expert or consultant, security type, business line or board seat, requires that the CCO and the adviser analyze this issue anew to ensure that proper controls, training and procedures are in place to ensure that MNPI is not misused on your watch.

If you have any questions about this article please contact:

Management, a registered investment adviser (the "Adviser") for failing to identify a third party consultant ("Consultant") as a person that should have been subject to the Adviser's Compliance Manual ("Manual") and Code of Ethics ("Code"), including prohibitions on outside business activities, conflicts and the misuse of material nonpublic information. Specifically, the Adviser failed to adopt and implement policies and procedures for identifying an outside consultant who, based on his functional role "similar to a part-time employee" and access to confidential information regarding the Adviser's investment transactions, should be viewed as a "supervised person" and an "access person" subject to the Adviser's policies and procedures, including its Manual and Code. Consultant provided the Adviser with research, analysis and investment recommendations. At times, Consultant organized and attended in person meetings with the Adviser and pharmaceutical and biotechnology company executives. By virtue of his role with the Adviser, Consultant had access to nonpublic information regarding client portfolio holdings and Adviser's portfolio recommendations. Consultant also sat on the boards of directors of a number of publicly traded biotechnology companies. Consequently, Consultant possessed MNPI about these companies. Adviser traded securities of companies for which Consultant was a board member. Adviser was not monitoring or pre-clearing Consultant's personal trading which included securities traded by Adviser.

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