



► Compliance Corner

— By Paul M. Miller*



Insider Trading and Corresponding Compliance Policies and Procedures of Investment Advisers

The recent insider trading cases involving investment advisory firms and their portfolio management personnel demonstrate a renewed SEC focus on insider trading and the insider trading policies and procedures maintained by investment advisory firms. Section 204A of the Investment Advisers Act of 1940 has for sometime required investment advisers to establish, maintain and enforce written policies and procedures reasonably designed, taking into consideration the nature of the adviser's business, to prevent the misuse of material, non-public information by the adviser and any its associated persons.

This article discusses insider trading and describes relationships that potentially present heightened insider trading risks for investment advisory firms and their personnel. It also considers how an advisory firm may implement a more effective insider trading policy, one that is designed to address the firm's current insider trading risks.

Insider Trading and Material, Non-Public Information

In general, insider trading by investors refers to engaging in any one of the following activities while in possession of material, non-public information about a public issuer of securities that was obtained in breach of a duty of trust or confidence owed to the source of that information: (i) trading on the basis of such information; (ii) providing such information to others (*i.e.*, tipping); (iii) recommending the purchase or sale of securities on the basis of such

information; or (iv) providing substantial assistance to someone who is engaged in any one of the foregoing activities. In addition, the SEC has adopted a rule that expressly prohibits trading while in possession of material information about a prospective tender offer before it is publicly announced.

Insider trading may be conducted where the information was disclosed to the investor in violation of an insider's duty to keep the information confidential (*i.e.*, where the information was misappropriated for use as a basis for trading). Insiders include officers, directors and employees of the issuer. Insiders may also include persons who have confidential relationships with the issuer and who are given access to material, non-public information about the issuer (*e.g.*, attorneys, accountants, consultants).

Violations for insider trading arise if the information on which trading occurred was both material and non-public. Information is considered to be material if there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision, or if the information is reasonably certain to have a substantial effect on the price of the security. Examples of material information include information:

- regarding significant acquisitions, divestitures or business combinations;
- affecting financial results of an issuer, including significant changes in earnings or earnings projections;
- regarding significant changes in directors or senior management;

- regarding the issuer's securities (*e.g.*, stock splits); and
- about new products or discoveries or developments regarding customers or suppliers.

Information about an issuer is generally non-public until it has been communicated to the market place. For example, information is considered to have been communicated to the market place if the information is accessible in a public court docket or is contained in a report filed on the SEC's EDGAR system or if the information appears on Bloomberg or in the *Wall Street Journal*.

Insider Trading and Investment Advisory Firms

Investment advisory firms are in the information gathering business. They regularly seek information about issuers, securities and markets, and use such information to make investment decisions for their clients. Any informational advantage with respect to an issuer or security, no matter how small, could result in positive returns for clients. Obtaining an informational advantage can, however, place an advisory firm in the insider trading cross hairs; often there is a fine line between obtaining a legitimate informational advantage and obtaining an informational advantage as a result of a trader, or a source of information, having breached his or her duty of trust or confidence.

It is, therefore, critical that an investment advisory firm understand the

Continued on page 13

sources of its investment information and the business activities and relationships from which such information is obtained. Certain relationships present, for example, heightened risks for access to material, non-public information. These relationships may result from ownership of various securities of an issuer or from obligations to other persons. Examples include the following:

- Service as a director or officer of publicly-traded company
- Participation on creditor committees
- Family or personal relationships with insiders or others in the financial services industry
- Brokerage relationships providing access to "PIPE" transactions
- Ownership of debt and equity securities of the same issuer
- Clients (including private fund investors) who are corporate insiders

An effective insider trading policy identifies the sources of the firm's investment information and those business activities and relationships that may expose the firm and its personnel to material, non-public information.

Insider Trading Policies and Procedures

In many respects, implementing effective insider trading policies and procedures involves the same process as developing and implementing any effective compliance policy and procedure. The process should involve:

- (i) Identifying and assessing current insider trading risks;
- (ii) Drafting a new insider trading policy or amending the current policy to address the risks identified by the risk assessment;
- (iii) Distributing the policy as necessary and educating and training advisory personnel with respect to the policy; and

- (iv) Reviewing and updating periodically the policy, in response to changes in the law and to the firm's advisory business, sources of investment information, relationships and risks.

A. Identifying and Assessing Current Insider Trading Risks.

The compliance officer or person responsible for conducting the insider trading risk assessment should identify sources of investment information and those business activities and relationships in which the adviser and its personnel have, or are likely to have, material, non-public information. The compliance officer may interview advisory personnel or disseminate a questionnaire to advisory personnel in which they are required to respond to questions concerning sources of investment information and their business activities, family relationships and other relationships. At a minimum, the interview or questionnaire should elicit responses to the following questions:

- Do you communicate with management or insiders of publicly traded issuers? If so, how often? Please describe the types of information that you typically obtain from management or insiders. Do you take any precautions to ensure that the information communicated or provided to you by management or insiders does not involve material, non-public information (e.g., confirm information provided is publicly available, remind management to limit information provided to you to that which has been made publicly available)? If so, please describe the precautions.
- Do you communicate with analysts, unaffiliated portfolio managers and other investment professionals about publicly traded issuers? If so, how often? Please describe information that you obtain from such persons. Do

you take any precautions to ensure that such information communicated or provided to you by such persons does not involve material, non-public information?

Do you interact with third-party service providers of publicly traded issuers (e.g., brokerage firms, printing firms, banks) from which you may obtain information about the issuer? If so, how often? Please describe the types of information that you may obtain.

Are you aware of any confidentiality agreements to which the adviser is a party and pursuant to which it has obtained or may obtain material, non-public information? If so, please describe the agreements or provide a copy of the agreement to the compliance officer. Also, please describe the information that has been obtained or may be obtained in connection with the agreement.

Do you use or access expert networks? If so, please describe the network and your access to or use of the network.

Do you serve as an officer or director of a publicly traded issuer? Are you aware of any such service by an employee of the adviser?

Are you aware of any circumstance in which the adviser or its personnel may serve on the creditor committee of an issuer?

Are you aware of any situation in which the adviser or its personnel has been provided information concerning the existence of a PIPE transaction? For example, has a broker-dealer used by the adviser contacted you and inquired about your possible participation in a PIPE transaction? If so, please describe the situation and the brokers from whom such information may be received.

Continued on page 14

Are you aware of any situation in which the adviser beneficially owns debt securities and equity securities of the same issuer? If so, please describe the situation and any precautions that have been taken to limit access to material, non-public information about the issuer.

Are you aware of any client (including any investor in a private fund) that is a corporate insider? If so, please identify the client (or investor).

Are you aware of any family member that is an officer or director of an issuer in which clients invest? If so, please identify.

Are you aware of any other situation or arrangement, including situations and arrangements involving other adviser employees, in which non-public information about securities is communicated? If so, please describe.

Do you provide information about client trading or client portfolio holdings to third parties? If so, please describe to whom you provide the information and the information provided. Are such persons subject to a confidentiality agreement with the adviser or otherwise subject to a duty to the adviser regarding the use or dissemination of the information?

Based on responses to these and other questions, the compliance officer can identify sources of investment in-

formation and those business activities and relationships in which the adviser and its personnel have, or are likely to be exposed to, material, non-public information. The compliance officer can also assess the frequency with which the adviser may be subject to the risks and tailor the insider trading policy and procedures to address the risks.

B. Insider Trading Policies and Procedures.

Any insider trading policy should contain a general policy statement regarding the goal of the policy. Most policies contain a general policy statement that it is the adviser's policy to prohibit trading by the adviser and its personnel while in possession of material, non-public information.

In addition to the general policy statement, the insider trading policy should include a concise, non-technical definition of material, non-public information and provide examples of such information. The policy should also require advisory personnel who suspect that they may have obtained material non-public information to not trade in the securities to which that information relates, to not tip the information to others, to not recommend the purchase or sale of securities on the basis of that information, and to inform the firm's compliance officer promptly concerning the information. The policy should further require the compliance officer to investigate any such claim

and document the results of the investigation and actions taken in the event the compliance officer has reached a conclusion that the claim involved material, non-public information. In addition, the policy should outline the potentially severe consequences of insider trading (e.g., civil and criminal

penalties).

Consideration should also be given to incorporating procedures addressing the following:

Periodic Reviews of Employee Correspondence and Email. Periodic reviews of advisory personnel correspondence and email are effective deterrents of prohibited conduct and are effective compliance tests of the policy. The reviews should focus on risks identified from response to the interviews or questionnaires. For example, if in response to the interview or questionnaire a portfolio manager indicated that he or she receives information about PIPE transactions periodically from a broker, the compliance officer should spot check the manager's email from that broker for PIPE transaction information.

Periodic Reviews of Client Trading and Employee Personal Trading. Periodic reviews of client trading and employee personal trading are also effective deterrents of prohibited conduct and are effective compliance tests of the policy. These reviews should focus on risks identified from responses to the interviews or questionnaires and look for patterns of conduct suggesting prohibited conduct.

Restricted List. A restricted list typically contains those securities for which the advisory firm or its personnel have material, non-public information. For example, if a portfolio manager of the firm serves as a director of a publicly traded issuer, the issuer's equity securities should be included on the restricted list during any blackout period identified by the issuer's code of ethics and to which the portfolio manager would be subject as a result of the directorship. Typically, the adviser and its personnel are prohibited from trading in securities on the restricted list. The prohibition applies to trading for client accounts as well as for

Continued on page 15



personnel accounts. Often, the securities on the restricted list are flagged on the firm's order management system so that no trade in the security may be processed through the order management system. The procedures should describe when securities are placed on the restricted list and when securities may be removed from the restricted list.

□ **Watch List.** A watch list typically contains those securities for which the advisory firm or its personnel are about to obtain material, non-public information. It may also consist of securities that are subject to information barriers, which are described below. Compliance officers use watch lists to monitor trades by the firm, its employees and clients. Unlike a restricted list, the compliance officer does not disclose the securities on a watch list to employees of the firm.

□ **Information Barriers.** Information barriers or "Chinese Walls" are designed to limit the distribution of material, non-public information within a firm, and can be asserted as a defense against an insider trading claim. In essence, an information barrier procedure "walls off" those individuals that have material, non-public information so that other advisory personnel do not have access to the information. The procedures require implementation of stringent physical and technological barriers to limit potential access to the material, non-public information. These procedures are typically used by larger

investment advisory and brokerage firms that have the necessary geographic and technological diversification to establish separation between personnel and back office operations, and may not be practical for smaller firms.

C. Distribution of Insider Trading Policy; Training and Ongoing Reviews of Insider Trading Risks and the Insider Trading Policy.

A compliance policy can only be effective if those advisory personnel subject to the policy understand it. To facilitate understanding, the insider trading policy should require its own periodic distribution as well as require advisory personnel to sign acknowledgements that the policy was read and understood and will be followed. The firm should also hold periodic training sessions with respect to the policy. These activities permit advisory personnel to clarify their understanding of the policy and their responsibilities. They also permit the compliance officer to highlight changes and stress the importance of compliance.

D. Periodically Review and Update the Insider Trading Policy.

The insider trading policy should require the compliance officer to update periodically the risk assessment and

other procedures of the policy. Because insider trading laws and the firm's advisory business and relationships change and evolve over time, the insider trading policy should provide a mechanism to respond promptly and effectively to these changes. An "adopt it and forget it" approach to insider trading compliance can lead to both non-compliance and related supervision failures.

Conclusion

Due to the prolific headlines surrounding insider trading, investment advisory firms should take a proactive approach to addressing compliance with insider trading laws and rules. A proactive approach requires implementing an insider trading policy based on your firm's insider trading risks, monitoring compliance with the policy, educating advisory personnel of their responsibilities under the policy and changing the policy in response to, among other things, changes in your firm's business and relationships.

** Paul M. Miller is a partner in the Washington, DC office of Seward & Kissel LLP. He can be reached by email at millerp@sewkis.com. The author would like to thank his colleagues Pat Poglinco, Rob Lustrin and Bibb Strench for their valuable insights and views on the subject matter. This article is intended to provide general information on the matters discussed. It should not be relied upon for legal advice on any matter. ■*

REGISTER NOW! for the IAA 2010 Annual Conference!



This month's IAA Newsletter includes a brochure providing details about the 2010 IAA Annual Conference. All member firms are strongly encouraged to attend this outstanding event. Registration and event details are in the brochure. Register now!

WHAT: 2010 IAA Annual Conference

WHERE: The Trump International Hotel and Tower in Chicago, Illinois
www.trumpchicago.com

WHEN: April 28-30, 2010 ■