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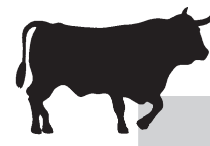

Increased Focus on Insider Trading

As highlighted by the highly publicized *Galleon* case, the United States Securities and Exchange Commission (the "SEC") has significantly increased its proficiency in prosecuting individuals and entities for engaging in insider trading. In an attempt to crack down on the disclosure and use of material non-public information, the SEC and federal prosecutors have utilized a variety of information-generating techniques such as working with cooperating witnesses, wire-tapping office phone and personal cell phone conversations and entering into no-prosecution agreements with cooperating firms. A significant portion of these insider trading actions have been filed against suppliers of confidential information and facilitators of the expert networks that use such information. However, insider trading actions are increasingly focused on the users of the information, including the hedge funds and investment firms that stand to profit from trading based on the inside information. Investment managers are understandably concerned about where this all came from and where it may lead. What is insider trading, really?

U.S. insider trading law was developed primarily by the courts over many years. The statute under which this law was developed is Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), which interestingly does not define or refer to insider trading. Rather, Section 10(b) of the Exchange Act speaks of the use of a manipulative or deceptive device or contrivance in contravention of "such rules and regulations as the SEC may prescribe as necessary or appropriate in the public interest or for the protection of investors." In turn, the SEC promulgated Rule 10b-5, which also did not define insider trading; rather, it prohibited generally the employment of any device or scheme to defraud, making untrue statements or omissions of fact or engaging in a practice that would operate as a fraud upon

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Conducting a Mock SEC Audit

In light of recent statutory and regulatory changes, a vast number of investment managers — previously exempt from registration with the SEC under the Investment Advisers Act of 1940 — have registered with, and are subject to the extensive regulation, oversight and monitoring activities of, the SEC. Because the SEC staff scrutinizes the compliance program of a registered adviser during its routine examinations, or audits, to which even newly registered advisers are subject, it is essential that registered investment managers ensure that their investment programs, compliance programs and business operations comply with the various laws, rules and regulations applicable to registered advisers. As such, in anticipation of an SEC staff examination, many investment managers (including those who are not yet registered advisers) hire legal counsel or other firms to test all or a portion of their compliance program — and effectively prepare for an SEC examination — by engaging in a so-called "mock audit." The various steps and objectives of a mock audit (e.g., reviewing existing policies and procedures, analyzing the implementation and effectiveness of such procedures, and identifying compliance weaknesses) provide investment managers with feedback with respect to its compliance programs and offer managers an opportunity to learn of significant omissions or concerns.

Mock Audit: Overall Process

Mock audits provide investment managers with an opportunity to complete a "dry run" of an actual SEC staff examination. While participating in a mock exam, investment managers and their personnel become familiar with the SEC examination process, and practice taking the requisite actions and preparing the materials necessary to

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any person. To be unlawful, such conduct had to be "in connection with the purchase or sale of any security."

From there, the law was developed through the courts, which, after a certain evolution resulted in the following definition of insider trading: insider trading occurs when (i) a purchase or sale of a security (including an option) is made while; (ii) one is aware of material non-public information; and (iii) in breach of a duty of trust or confidence owed, (a) directly or derivatively to the issuer of the security, or (b) to any other person who is the source of the non-public information. This general definition encompasses two theories of liability: classical or traditional, and misappropriation.

Classical or Traditional Theory: The classical or traditional theory focuses on situations where a corporate insider trades in his or her company's securities on the basis of material confidential information obtained by reason of his or her position. Under this theory, the corporate insider breaches duties owed to the company and the counterparty. The classical theory of insider trading liability derives principally from the Supreme Court's holdings in *Chiarella v. U.S.*, 445 U.S. 222 (1980), and *Dirks v. SEC*, 463 U.S. 646 (1983). The *Chiarella* opinion stated that a securities trader commits Rule 10b-5 fraud if he "fails to disclose material information prior to the consummation of a transaction... when he is under a duty to do so." The *Chiarella* opinion further delineated when a person possessing material non-public information owes such a duty - called "[t]he obligation to disclose or abstain" from trading. It held that the duty to disclose or abstain arises only from "a fiduciary or other similar relation of trust and confidence between [the parties to the transaction]."

In *Dirks*, the Court built on its holding in *Chiarella*. It examined when a person who receives material non-public information (a "tippee") inherits a fiduciary duty to the corporation's shareholders to disclose or refrain from trading. Noting the "derivative" nature of tippee liability, the Court held that tippee liability attaches when an "insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach."

Under certain circumstances, such as when corporate information is revealed to an underwriter, accountant, lawyer or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes.

Misappropriation Theory: The misappropriation theory focuses on situations where a person (not an "insider") uses material confidential information for trading purposes in breach of a duty owed to the source of the information. Under the misappropriation theory under Rule 10b-5, a person violates Rule 10b-5 when he or she misappropriates material non-public information in breach of a duty of trust and confidence and uses that information in a securities transaction. The duty does not have to run to the issuer. In *U.S. v. Chestman*, 947 F.2d 551, 556 (2d Cir. 1991), the Court noted that "[f]ocusing on the language "fraud or deceit upon *any* person" (emphasis added), we have held that the predicate act of fraud may be perpetrated on the source of the non-public information, even though the source may be unaffiliated with the buyer or seller of securities."

The SEC later adopted Rule 10b5-1 which defined a "manipulative or deceptive device". The "manipulative and deceptive devices" prohibited by Section 10(b) of the Exchange Act and Rule 10b-5 thereunder include, among other things: (i) the purchase or sale of a security of any issuer, (ii) on the basis of material non-public information about that security or the issuer, (iii) in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material non-public information. Note that "on the basis of" means "aware of." It does not mean that one has to "rely" on the information in making an investment decision.

As a result of the evolution of insider trading law and the increased focus on users of information, investment managers should carefully review their existing insider trading policies to determine if the manager's policies explain "material, non-public information", identify potential sources of such information, describe the procedures for handling such information (e.g., restricted lists) and require ongoing training and monitoring of employees. If you have any questions as you navigate the complexities of insider trading law, or if you wish to receive a description of recent enforcement actions brought by the SEC and other federal authorities, please contact an attorney in our Investment Management Group.

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respond effectively to the SEC staff's inquiries. An investment manager may elect to conduct a mock audit that replicates all or a portion of the steps routinely undertaken by the SEC including:

- Initial Request Letter – An initial request letter provided to the manager typically outlines the mock audit process and requests that the manager provide an array of basic documentation concerning the manager's advisory business, internal structure and any investment funds or accounts it manages prior to the commencement of the on-site portion of the mock audit. The letter will typically also request that the manager make additional information available during the on-site portion of the mock audit.
- On-Site Diligence and Personal Interviews with Senior Personnel – After the initial document production stage is completed, more in-depth diligence may be conducted on-site at the investment manager's offices. In connection with the on-site portion of the audit, the manager may be required to make available a broad-ranging set of documents and data. Areas of focus may include: (i) compliance programs, risk management and internal controls; (ii) Form ADV and conflict disclosures; (iii) advisory trading activities and investment positions; (iv) performance advertising and/or marketing; (v) brokerage and custody arrangements; (vi) fee arrangements; and (vii) solicitation arrangements.

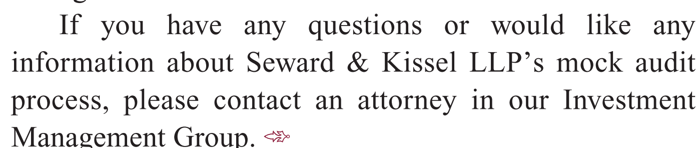
The on-site portion of the mock examination may also involve personal interviews with various members of the manager's senior staff, including the principal executives, financial and operating officers, chief compliance officer, and marketing officer.

- Summary of Findings and Feedback – After assessing the information garnered during the mock audit, the mock examiner may prepare a "comment letter" or "deficiency" letter, which is a routine aspect of an actual SEC audit. Although the results of the mock audit would only be protected by attorney-client privilege if an attorney is retained to conduct the mock audit, the mock examiner's findings can be presented in a variety of forms (including an oral presentation) and in varying degrees of depth depending on an investment manager's preferences.

Mock Audit: Purpose and Benefit

As discussed above, engaging in a mock audit provides a unique opportunity for an investment manager — whether seasoned and familiar with SEC oversight, or completely unfamiliar with the regulatory regime — to "practice" going through all or a portion of the steps of an actual SEC audit and gain significant knowledge that may help avert or otherwise address issues that may have otherwise arisen during an actual audit.

If you have any questions or would like any information about Seward & Kissel LLP's mock audit process, please contact an attorney in our Investment Management Group.



Legislative, Regulatory and Other Snapshots

SEC Proposes Rule 506(c) in Connection with "JOBS" Act. On April 5, 2012, President Obama signed the "Jumpstart Our Business Startups Act" (the "JOBS Act") into law. The JOBS Act seeks to make it easier for smaller companies to raise capital in the U.S. public and private capital markets in part by (i) amending Section 12(g) of the Exchange Act to raise the number of holders of record of a company that triggers public company reporting from 500 to 2,000 and (ii) directing the SEC to remove the general solicitation and advertising prohibitions that currently apply to private offerings made pursuant to Rule 506 of Regulation D under the Securities Act of 1933, so long as all purchasers who actually buy securities are "accredited investors". The change to Section 12(g) to raise the number of holders of record triggering public company reporting is already effective. The SEC has issued proposed new rule 506(c), expected to be adopted in the near future, to remove the

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current prohibition on general solicitation and advertising under Rule 506. Rule 506(c) will allow private funds to engage in general solicitation and advertising, provided that the following conditions are met:

- the private fund takes reasonable steps to verify that the purchasers of its securities are accredited investors;
- all purchasers of the securities are accredited investors; and
- all terms and conditions of existing Rule 501 (definitions) and Rules 502(a) (integration restrictions) and 502(d) (resale limitations) are fulfilled.

To review our memorandum identifying certain business, regulatory and compliance issues that advisers to private funds should consider and address prior to pursuing new marketing opportunities, please visit our website (www.sewkis.com) under the Investment Management Practice heading, "Publications."

CFTC Rescinds 4.13(a)(4) Exemption and Finalizes Definition of Swap, Security-Based Swap and Other Key Terms. In connection with the rescission by the Commodity Futures Trading Commission (the "CFTC") of the exemption from commodity pool operator ("CPO") registration in CFTC Regulation 4.13(a)(4), managers currently relying on the exemption will be required to either (i) rely on a different exemption or (ii) register with the CFTC as a CPO, by December 31, 2012. For many fund managers, the most likely alternative exemption will be under Rule 4.13(a)(3), which provides a full exemption from registration as a CPO for a manager of a fund that meets certain trading limits.

The CFTC and the SEC have also issued final rules and interpretations that define the terms "swap" and "security-based swap" and provide guidance as to whether a particular swap instrument is regulated by the CFTC or the SEC. The final definitions are of significant importance to advisers as they analyze whether they will be eligible to rely on the 4.13(a)(3) exemption or be required to register with the CFTC as a CPO.

The CFTC has jurisdiction over swaps, which are considered commodity interests and count towards the thresholds in Rule 4.13(a)(3). The term "swap" includes foreign currency options; commodity options; non-deliverable forwards in foreign exchange; cross-currency swaps; forward rate agreements; contracts for differences; options to enter into swaps; forward swaps; interest rate and other monetary rate swaps; total return swaps on a broad-based security index or on two or more loans; credit default swaps on a group of obligations constituting a broad-based security index; and swaps on futures (other than security futures). The Department of the Treasury issued a final determination that exempts foreign exchange forwards and foreign exchange swaps from the definition of swap under the Commodity Exchange Act.

The SEC has jurisdiction over security-based swaps and these instruments will not count towards the thresholds in Rule 4.13(a)(3). The term "security-based swap" includes total return swaps on a single security, loan or narrow-based security index; credit default swaps based on a single reference obligation or a group of obligations constituting a narrow-based security index; derivatives on yields (where "yield" is a proxy for the price or value of a debt security, loan or narrow-based security index), except in the case of certain exempted securities; and derivatives based on security futures (other than futures on certain foreign government debt securities).

For further information regarding these matters, including the definition of "security-based swap agreement" and regulations regarding "mixed swaps", as well as no-action relief provided for family offices and CPOs of funds-of-funds, please visit our website (www.sewkis.com) under the Investment Management Practice heading, "Publications."

Tax Developments. There have been a number of developments in the past year which we are monitoring.

In early 2012, the IRS issued proposed regulations interpreting the Foreign Account Tax Compliance Act ("FATCA"). The IRS expects to issue final regulations by the end of 2012. The proposed regulations provide significant guidance to private investment funds on the steps they will need to take to identify direct or indirect U.S.

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investors in their offshore funds.

In September 2011, the IRS issued proposed regulations addressing the tax treatment of notional principal contracts, including credit default swaps and bullet swaps. These regulations are expected to be finalized in late 2012 or early 2013.

In January 2012, the Department of the Treasury released proposed Treasury Regulations that greatly expand the potential for a 30% U.S. withholding tax to be imposed on dividend equivalent payments made to foreign persons (including offshore private investment funds) on certain equity swaps (and similar transactions) on U.S. securities. Managers of offshore private investment funds that enter into equity swaps (or similar transactions) with respect to U.S. securities should be aware of these proposed regulations when entering into transactions where payments could be made on or after January 1, 2014. The Department of the Treasury has also issued temporary Treasury regulations which provide that the current rules with respect to withholding on equity swaps will continue to apply with respect to payments made before January 1, 2014.

Looking forward, federal income tax rates are scheduled to rise to a maximum of 39.6% for ordinary income and 20% for long-term capital gains on January 1, 2013 from current rates of 35% and 15%, respectively. In addition, the preferential tax rate of 15% for "qualified dividend income" is also scheduled to expire on January 1, 2013. The Obama Administration has proposed to allow the lower tax rates to expire for high income taxpayers, but no agreement has been reached with Congress. In addition, the new 3.8% Medicare tax on investment income is scheduled to take effect on January 1, 2013.

Investment Management Group News

Seward & Kissel LLP announced that the firm's hedge fund and asset management practice has entered into an alliance with London-based law firm Simmons & Simmons for hedge fund and asset management work. The alliance is non-exclusive and both firms continue to work with other referral firms. The alliance gives both firms the opportunity to provide clients with seamless global representation in the hedge fund and asset management space across the U.S., Europe and Asia.

Seward & Kissel LLP hosted a seminar entitled "Coping with the Current SEC and DOJ Enforcement Environment: Advice for Investment Managers". Participants in the presentation included Investment Management partners **Rob Van Grover** and **Pat Poglinco**, as well as the partner co-heads of Seward & Kissel LLP's newly established Government Enforcement and Internal Investigations group, **Rita Glavin** and **Mike Considine**. To view the seminar, please visit our website (www.sewkis.com) under the Investment Management Practice heading, "Events."

Sharon M. Davison joined the Investment Management Group as Counsel in August 2012. Sharon has over 20 years of experience dealing with regulatory and compliance issues of broker-dealers, as well as investment managers and investment funds.

Seward & Kissel LLP provides legal advice to its investment management clients on structure, business planning, regulatory, compliance, corporate finance, asset securitization, capital markets, business transactions, derivatives, bankruptcy/distressed debt, tax, ERISA, litigation, trademark, employment, trusts & estates and real estate matters.

Publications. Prior editions of the Private Funds Report may be found on the web at www.sewkis.com under the Investment Management Practice heading, "Publications."

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If you have any questions regarding The Private Funds Report, please contact any of the attorneys in our Investment Management Group specializing in private investment funds via telephone at (212) 574-1200 or e-mail generally by typing in the attorney's last name **@sewkis.com**

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