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EXPERT NETWORKS

# Are You Listening? Whether Hedge Fund Managers Should Chaperone Primary Research Calls (Part One of Three)

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Insider trading and the potential for misuse of confidential information should be top-of-mind for investment professionals. With the prevalence of insider trading cases brought over the last five years, the government's initiative to stamp the practice out has been persistent, aggressive and fruitful. And the government's fervor to bring insider trading actions seems to persist even after the Second Circuit dealt the government a setback in *U. S. v. Newman*. See "The *Newman/Chiasson* Decision Continues to Have Implications for Insider Trading Compliance," The Hedge Fund Law Report, Vol. 8, No. 17 (Apr. 30, 2015).

Nonetheless, it appears the temptations and incentives to find an edge in a highly competitive trading environment remain as strong as ever. For instance, a recent study contends that insider trading is associated with approximately 25% of mergers and acquisitions.[1] Another recent study (looking at pre-December 2013 data) suggests that insider trading around corporate divestitures or spinoffs is similarly pervasive, which is notable when one considers there were a record number of spinoffs in the last year.[2] Further, the U.K. Financial Conduct Authority has seen a significant uptick in suspected insider trading.[3] Finally, and more generally, a recent survey of more than 1,200 U.S. and U.K. financial services professionals seems to confirm that ethical issues persist in the financial services industry.[4]

Against this backdrop, with the DOJ and SEC as determined as ever to continue to bring insider trading charges and fight for a broad interpretation of existing insider trading law; and investment managers subject to intense scrutiny from outside diligence teams, the demands on, and obligations of, compliance departments to monitor information inflows have become all the more critical.

While compliance officers have many arrows in their quivers to help them meet these obligations, Eugene Ingoglia, Partner at Morvillo; Laurence Herman, General Counsel and Managing Director at Gerson Lehrman Group (GLG); and Patrick Gordon, Senior Counsel at GLG, focus on one in particular in this guest article: chaperoning primary research calls. This first article in a three-part series provides background on chaperoning, including a discussion of the statutory landscape, primary research and SEC guidance. The second article will address the potential scope of a chaperoning policy, as well as offer practical guidance in implementing that policy. The third article will cover specific challenges to chaperoning. For more on chaperoning, see "RCA Symposium Offers Perspectives from Regulators and Industry Experts on 2014 Examination and Enforcement Priorities, Fund Distribution Challenges, Conducting Risk Assessments, Compliance Best Practices and Administrator Shadowing (Part Three of Three)," The Hedge Fund Law Report, Vol. 7, No. 1 (Jan. 9, 2014).

*Introduction to Chaperoning*

For some, the word "chaperone" conjures up notions of a high school date, with a watchful parent tagging along to ensure the propriety of everyone's behavior. In many ways, chaperoning in the primary research arena is not so different. It involves two individuals having a discussion and exchanging ideas, with a discerning compliance officer listening in, hanging on every word. And as awkward, time consuming and perhaps invasive as it may seem, based on the authors' experience, chaperoning is no longer a rare exception.

While differently situated, all of the authors work with investment firms that are looking for best practices to detect and prevent insider trading. They have all been privy to, and even helped craft, the policies and procedures investment firms have developed to manage their primary research, whether through expert networks, informal connections or direct consulting relationships. Needless to say, these policies have evolved considerably over the years.

Some policies have become pretty standard among firms that perform primary research (with slight tweaks to account for the size, strategy and investment methods of the firm). For example, many firms require consultants to acknowledge an attestation prior to interacting with analysts; prohibit employees from consulting with current, or recent, public company employees; and limit the frequency of interactions between analysts and a specific consultant.

One advantage of such policies is that, assuming firms are working with a reputable provider, they are fairly low maintenance. Compliance officers set the policy in motion (preferably, by embedding it in their expert network platform's software), and it then becomes self-enforcing – in other words, pursuant to the policy, a consultant is either permitted or prohibited to consult with a firm's user, or the information elicited automatically moves the consultant into a holding pen, requiring approval from the compliance officer before a consultation can take place.

Chaperoning is very different in this regard. It is not at all self-enforcing, and it is certainly not low maintenance. Rather, making the decision to chaperone requires compliance officers to contemplate a host of additional questions. This is why investment firms frequently have questions about chaperoning best practices.

Unfortunately, there is no singular "standard" chaperoning program. This article series will address various issues around chaperoning calls, including a refresher on adviser obligations; where the concept of chaperoning originated; and provide investment firms and compliance officers with some best practices and factors they should consider when putting together their chaperoning program.

*The Statutory Landscape*

When contemplating chaperoning best practices, the analysis begins with the statutory obligation of investment advisers to develop procedures reasonably designed to detect and prevent insider trading, as set forth in the Investment Advisers Act of 1940 (Advisers Act), and the rule promulgated thereunder.[5] Rule 204A of the Advisers Act requires investment advisers to "establish, maintain, and enforce written policies and procedures reasonably designed . . . to prevent the misuse . . . of material, nonpublic information by such investment adviser or any person associated with such investment adviser."[6] Similarly, Rule 38-1 of the Investment Company Act requires registered advisers to: (1) adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws; (2) review those policies and procedures annually for their adequacy and the effectiveness of their implementation; and (3) designate a chief compliance officer to be responsible for administering the policies and procedures.[7]

The Advisers Act has been interpreted to impose a continuing obligation on advisers to supervise all persons acting on its behalf. Indeed, the SEC has stated that "the 'delicate fiduciary relationship' between an investment adviser and a client imposes an obligation on an adviser to review and to monitor its activities and the activities of its employees." The following are several SEC orders addressing such supervisory responsibilities:

- *Shearson Lehman Brothers, Inc. and Stein Roe & Farnham*, Exchange Act Release No. 23640 (Sept. 24, 1986). See also *Patrick J. Vaughan*, Advisers Act Rel. No. 2842A (Feb. 10, 2009) (director of retail sales at adviser/broker-dealer failed to reasonably supervise employee by failing to respond to red flags regarding his misconduct and lack of supervision);
- *Fanam Capital Management, Richard J. Ennis and Seth Morgulas*, Advisers Act Rel. No. 2316 (Oct. 29, 2004) (executive VP failed to take reasonable supervisory action and relied on trader spreadsheets without independently verifying their accuracy, thereby facilitating the fraudulent activity);
- *In the Matter of Robert T. Littell and Wilfred Meckel*, Advisers Act Rel. No. 2203 (Dec. 15, 2003) (hedge fund principal's failure to reasonably supervise investment manager, with a view to preventing violations of the federal securities law, enabled employee to communicate materially inaccurate information to potential investors);
- *Oechsle International Advisors, L.L.C.*, Advisers Act Rel. No. 1966 (Aug. 10, 2001) (adviser failed to supervise portfolio manager who had manipulated the closing price of certain securities held in advisory accounts).

As was acknowledged in *In re Rhumbline Advisers*, Release No. 1765 (Sept. 29, 1998), "the Commission has repeatedly emphasized that the duty to supervise is a critical component of the federal regulatory scheme."[8] And, the Commission is more than willing to bring cases against advisers that, in the Commission's view, do not reasonably supervise associated persons with an eye towards preventing violations of the federal securities law.[9]

What kind of procedures would be considered reasonable to fulfill that obligation? Most would agree – and the SEC proceedings confirm – that it is not enough simply to create an internal rule that prohibits investment professionals from trading on the basis of material nonpublic information, even if such a rule is combined with some periodic training. Therefore, responsible investment managers develop procedures and allocate professionals to monitor what their employees are doing at certain key risk points. Information flow in and out of a firm is among these key risk points.

*Primary Research*

Primary research has long been a tool for industry analysts. Years before expert platforms came into being, analysts reached out directly to contacts in their industries of interest to gain insight. These efforts included attending industry conferences, cold-calling industry experts, visiting retailers of interest to speak with managers, chatting up attendees at relevant industry conferences and leveraging personal networks. In fact, as far back as the 1950's, Phil Fisher touted his "scuttlebutt" research efforts in a book that was critically acclaimed when written and has been in print ever since.[10] Primary research always has been, and will continue to be, invaluable in the industry and elemental to investment managers in their efforts to make better-informed decisions.

While this informal research was undoubtedly vital, it was time consuming and virtually impossible to monitor. The advent of expert networks changed all that. Suddenly, it became easier for investment managers to arrange primary research interactions, and those interactions were of greater quality.

From the perspective of compliance officers, the interactions were now auditable and came with the benefit that consultants or experts were now subject to training and formal agreements. For the first time, compliance officers were able to readily monitor primary research interactions and keep tabs on what their users were doing, as well as know and document that the individuals their users were interacting with were aware of their obligations. This was a huge step forward.

Those benefits notwithstanding, primary research has also been used as a tool for insider trading. In addition to many incidences in which insiders informally provided material nonpublic information, leading to insider trading charges, there was also a firm that, in the words of U.S. Attorney Preet Bharara, "converted a legitimate enterprise into an illegal racket" by providing inside information in the guise of expert advice, in order to enable insider trading by prominent funds. The series of sensational (and ultimately successful) cases brought by the SDNY beginning in 2010 left fund managers uncertain about the best practices for managing primary research by their analysts. Managers knew primary research was an essential part of their research process and necessary to generate alpha. But how could they manage their analysts' conduct of primary research while remaining on the (far) right side of the law?

*SEC Guidance on Chaperoning*

The SEC first comprehensively discussed the use of expert networks in March 2011, in remarks by then director of the Office of Compliance Inspections and Examinations (OCIE), Carlo di Florio. Di Florio's remarks laid out what some contend is the playbook for proper and thoughtful use of primary research and gave advisers the guidance they had been seeking. [11]

While di Florio made clear that the Commission did not have any "inherent hostility" towards expert networks, he highlighted "the need for advisers to have reasonable policies to prevent insider trading."[12] According to di Florio, such reasonable policies included having a number of "front end" controls, including internal review of agreements with expert network firms; a policy requiring users to acknowledge the firm's insider trading policies; a pre-approval process for every conversation with an expert; an evaluation of the controls in place at expert networks with which the adviser does business; and an extra layer of controls with respect to experts employed at public companies, or an avoidance of such public company experts altogether.

At the time, the controls mentioned above were already fairly prevalent in the marketplace. But di Florio also mentioned chaperoning as a "front end" control that advisers should consider implementing: "[front end controls] might mean having, at least occasionally, 'chaperoned' conversations – that is, a compliance person is a silent listener to the conversations between the expert and adviser's money manager/analyst." By the authors' account, unlike the other front end controls mentioned by di Florio, chaperoning was uncommon in 2011.

Di Florio's suggestions were welcomed by many investment firms and noticed by many limited partnerships, allocation consultants and other industry influencers. His remarks were significant in that they represented the first explicit guidance from the SEC on primary research usage. Further, di Florio didn't issue unnecessarily broad edicts, but rather encouraged a reasonable, risk-based approach to managing primary research usage, leaving it to managers to develop practices and policies that were tailored to manage the risks specific to that firm.

Also, his suggestion of occasionally chaperoning these conversations made abundant sense. Four years later, it seems that occasional chaperoning has become an expectation. For instance, the authors understand that at least one OCIE office has asked about and, in at least one case, was troubled that a manager did not chaperone research calls under *any* circumstances. Many operational due diligence (ODD) teams and institutional investors now inquire about chaperoning practices on due diligence questionnaires. In the eyes of OCIE, allocation consultants, ODD professionals, institutional investors and maybe even regulators, the perception has become that the absence of any kind of chaperoning practice is an indicator of a less-than-rigorous compliance program.

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[1] Augustin, Patrick and Brenner, Menachem and Subrahmanyam, Marti G., *Informed Options Trading Prior to M&A Announcements: Insider Trading?* (May 24, 2014).
[2] August, Patrick, Brenner, Menachem, Jianfeng, Hu, Subrahmanyam, Marti G., *Are Corporate Spin-Offs Prone to Insider Trading?* (Feb. 24, 2015).
[3] See Laura Suter, *FCA Data Reveals Surge in Insider Trading Cases*, Fundweb (Mar. 23, 2015).
[4] Ann Tenbrunsel and Jordan Thomas, *The Street, The Bull and The Crisis: A Survey of the US and UK Financial Services Industry*, Univ. of Notre Dame (May 15, 2015).
[5] 15 U.S.C. § 80b (2000).
[6] Id.at § 80b-4a.
[7] 17 C.F.R. 270.38a-1 (2000). The Advisers Act was the last in a series of laws passed in the wake of the stock market crash of 1929 to "eliminate certain abuses in the securities industry." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963). The Advisers Act put in place a legal framework for monitoring the investment advisory business, including registration and disclosure requirements and prohibitions on "fraudulent, deceptive, or manipulative" practices. 15 U.S.C. §§ 80b-3, -5 and -6.
[8] See also *In re Western Asset Management Co.*, Release No. 1980 (Sept. 28, 2001) (stating that supervisors must "respond vigorously to indications of possible wrongdoing

[and] inquire into red flags and indications of irregularities and conduct adequate follow-up and review to detect and prevent future violations of federal securities law").

[9] See *In re Steven A. Cohen*, Release No. 3634 (July 19, 2013).

[10] Phillip A. Fisher, *Common Stocks and Uncommon Profits* (1958).

[11] Carlo di Florio's remarks came on the heels of a request by the Managed Funds Association for greater clarity as to what is expected of investment managers (specifically, MFA head Richard Baker stated, "Our industry would like to know where the sidelines are right now so that we can stay well within them. The trouble is the referees aren't quite clear where those lines are right now.").

[12] Carlo di Florio, Remarks at the IA Watch Annual IA Compliance Best Practices Seminar (Mar. 22, 2011).

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