

Hedge Fund Lending Practices May Draw Increased Government Scrutiny into Insider Trading Compliance

August 27, 2010

New research may spark increased SEC attention into potential insider trading violations at hedge funds. In a paper to be published in the *Journal of Financial Economics*, four academics found that insider trading appears to occur with much greater frequency in connection with syndicated lending by hedge funds than by commercial banks.¹ Specifically, the authors found "evidence consistent with the short-selling of the equity of the hedge fund borrowers *prior* to public announcements of both loan originations and loan amendments." The authors also found that stock prices frequently drop after the announcement of new hedge fund loans whereas the market frequently reacts positively to new bank loan announcements.

Based on a sample of equity short-selling data from the period of January 2, 2005 to July 6, 2007 – the only period during which such data was available under Regulation SHO – the authors tracked the trading of 105 U.S. companies that borrowed from hedge funds and 255 companies that borrowed from commercial banks. Hedge fund borrowers on average saw a 74.8 percent increase in the volume of short sales during the 5 day period prior to announcement of the new loans as compared to the volume 60 days before announcement. In contrast, commercial bank borrowers saw little difference in the volume of short sales between those two periods.

Similarly, prior to the announcement of amendments to existing loans from hedge funds, short selling increased by 28.4 percent, whereas short selling dropped by 17.4 percent prior to the announcement of amendments for bank loans.

Insider Trading Standards

These trading patterns raise serious insider trading concerns. In general, insider trading occurs when a person trades in a corporation's stock on the basis of material non-public information in breach of a duty owed either to a corporation's shareholders (the "classical theory") or to the source of the information (the "misappropriation theory").² Under the "classical theory," shareholders may be owed a duty either by corporate insiders, such as corporate officers, directors,

¹ The paper, titled "Do Hedge Funds Trade on Private Information? Evidence from Syndicated Lending and Short-Selling," has been co-authored by four academics: Nadia Massoud, Debarshi Nandy, and Keke Song of York University's Schulich School of Business in Toronto, and Anthony Saunders of New York University's Stern School of Business.

² See *United States v. Chiarella*, 445 U.S. 222, 228 (1980); *United States v. O'Hagan*, 521 U.S. 642, 650 (1997).

and employees, or by temporary insiders, such as underwriters, accountants, lawyers or consultants who "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."³ Under the "misappropriation theory," the duty to the source of the information contemplates a duty of trust and confidence.⁴

Determining whether a hedge fund falls under the classical or misappropriation theory (or neither) requires a fact specific case-by-case analysis; although the misappropriation theory would be the most likely to apply. Under either theory, however, a court would need to find a relationship beyond that of an arms-length transaction with a borrower.⁵ The SEC would argue that a confidentiality agreement between a hedge fund and borrower would suffice for purposes of the misappropriation theory, and even though that argument may not prevail, the SEC would likely still pursue an insider trading action in that scenario. See e.g., *SEC v. Cuban*, 634 F. Supp. 2d 713, 725 (N.D. Tex. 2009) (finding that an alleged oral agreement to maintain information about a PIPE offering as confidential was not sufficient under the misappropriation theory as there was not also an alleged agreement "not to trade on or otherwise use" the information), *on appeal*, No. 09-10996 (5th Cir.)⁶; *SEC v. Northern*, 598 F. Supp. 2d 167, 176 (D. Mass. 2009) (finding that a mere confidentiality agreement is sufficient under the misappropriation theory); *United States v. Kim*, 184 F. Supp. 2d 1006, 1010-11 (N.D. Cal. 2002) (finding that, if the "outsider" does not owe a fiduciary duty to the source of the information, then the relationship must bear all the hallmarks of a fiduciary duty such as superiority, dominance or control). The type of duty required under the misappropriation theory is a developing area of insider trading law.

Materiality is also a case specific determination. Non-public information is material "if there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision.⁷ In applying this standard, courts have looked to "the importance attached to the [non-public information] by those who knew about it," which may be determined by the timing of stock purchases or unusual types of purchases.⁸ Courts have also looked to the effect that the disclosure of information has on stock prices.⁹

³ *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983).

⁴ See *O'Hagan*, 521 U.S. at 652.

⁵ See *Chiarella*, 445 U.S. at 228; *O'Hagan*, 521 U.S. at 652.

⁶ Dewey & LeBoeuf LLP has successfully represented defendant Mark Cuban in this case.

⁷ *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

⁸ *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 851 (2d Cir. 1968).

⁹ See *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1425 (3d Cir. 1997).

Compliance Best Practices

Although the SEC has not commented on any enforcement interest, an SEC spokesman told the Wall Street Journal that its division of risk, strategy and financial innovation is examining the issue of trading prior to the announcement of hedge fund loans and loan amendments.¹⁰ In the face of potential heightened scrutiny from regulators, it is important that hedge fund managers maintain strong compliance practices to prevent insider trading. Indeed, hedge fund managers need to be prepared to communicate how they have addressed these issues to regulators. The alternative is to risk exposure to serious penalties for insider trading or failing to supervise employees who commit insider trading. The potential sanctions include investment adviser bars and other suspensions, disgorgement, fines, injunctions, and revocation of securities licenses. Criminal charges, as in the Galleon Group case, are also a concern. Hedge fund managers would do well, therefore, to review the adequacy of their compliance programs. Experienced counsel can assist in ensuring that the program is properly tailored to the specific insider trading risks presented by a particular hedge fund's business. Some of the key issues that such a compliance review should encompass are set forth below.

Compliance Policies and Procedures

Hedge fund managers registered as investment advisers are required by Section 204A of the Investment Advisers Act of 1940 and Rule 204A-1 thereunder to maintain policies and procedures to prevent insider trading.¹¹ Moreover, under Section 21A of the Securities Exchange Act of 1934, the SEC may bring an action for civil penalties for control person liability against a registered investment adviser whose personnel committed insider trading, if the adviser "knowingly or recklessly failed to establish, maintain, or enforce" Section 204A policies and procedures if that "failure substantially contributed to or permitted" insider trading.¹²

Many unregistered investment advisers at hedge funds should also be concerned about the need for policies and procedures. Indeed, under the recently enacted Private Fund Investment Advisers Registration Act of 2010, many currently exempt investment advisers will be required to register with the SEC by July 21, 2011. A summary of the changes for investment advisers from this Act is available in our previous client alert,

http://www.deweyleboeuf.com/en/Ideas/ClientAlerts/2010/07/~/_media/Files/clientalerts/2010/20100723_DoddFrankPrivateFunds.ashx. In addition, regardless of registration status, all hedge funds and hedge

¹⁰ Gregory Zuckerman, *Hedge-Fund Lending Draws Scrutiny*, WALL STREET JOURNAL, July 3, 2010.

¹¹ See 15 U.S.C. § 80b-4a; 17 C.F.R. § 275.204A-1.

¹² 15 U.S.C. § 78u-1(b).

fund advisers are subject to Section 10(b) of the Exchange Act and Rule 10b-5.

Insider trading policies and procedures should in general (i) contain a summary of insider trading law, (ii) forbid employees from trading on material non-public information or communicating such information to others, (iii) require employees to disclose material non-public information that they receive to a compliance officer, (iv) require the compliance officer to act on the information by prohibiting trading in the security or reviewing employee personal trading accounts, and (v) provide that violation of the policies and procedures will result in suspension or other sanctions. The effectiveness of the policies and procedures should also be reviewed periodically by a compliance officer and reported to senior management.

Training

Employees and senior management should be provided with periodic training on the firm's insider trading policies and procedures, including a review of insider trading law in general. Each employee should also be required to sign an attestation of his or her knowledge of the firm's policies and procedures.

Firewalls

A firm's information or firewall should ensure that personnel who initiate lending are "walled off" from employees in the firm's sales or trading departments.¹³ Personnel who initiate lending should also have no sales or trading authority for the firm. Access to non-public information should also be restricted for employees who do not need it to perform their duties. The policies and procedures should include provisions for the physical separation of employees, the storage of non-public information, computer access privileges, and oversight for the distribution of internal communications. If a "walled off" employee needs to have an investment-related communication, approval by compliance or legal personnel should be required, and the communication should be monitored and documented.

Protection of Information from Outside Contractors

As with firm personnel, physical security should be provided for sensitive documents from outside contractors who have access to the firm's offices. If outside contractors are the equivalent of "temporary insiders" and require access to non-public information, they should receive training and be required to agree in writing to the firm's insider trading restrictions.

¹³ For smaller firm's, as it may be impractical to dedicate personnel solely to lending or trading, abstaining from trading is an alternative to a firewall. For example, lending personnel could be involved in trading if no trading is permitted with respect to borrowers.

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

Pursuant to US Treasury Department Circular 230, unless we expressly state otherwise, any tax advice contained in this communication (including any attachments) was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties or (ii) promoting, marketing or recommending to another party any matter(s) addressed herein.

No part of this publication may be reproduced, in whole or in part, in any form, without our prior written consent.

© 2010 Dewey & LeBoeuf LLP
All rights reserved.

For further information on Dewey & LeBoeuf, please visit www.dl.com

Trading Restrictions

The firm should maintain a restricted list for securities in which the firm has received material non-public information. All employees should be restricted from trading or recommending those securities until the information has been publicly announced. The firm itself should also not trade securities on the restricted list. The restricted list should be circulated periodically and the firm's employees should otherwise have ready access to it.

The firm should also maintain a "watch list" for securities in which the firm is likely to receive material non-public information. Access to the "watch list" should be highly restricted so that it does not in effect become a tip sheet for the securities of companies considering certain transactions such as loans, tender offers, public offerings, and divestitures. Unlike the restricted list, trading of securities on the "watch list" is generally not restricted. However, securities on the "watch list" should be monitored by compliance and/or legal personnel for suspicious trading by the firm or its employees.

Trading Surveillance

The firm should audit the trades of its employees in an effort to deter or identify insider trading. Under Rule 204A-1, registered investment advisers are required to establish reporting requirements for "access persons," which include the reporting of personal securities holdings and transactions.¹⁴ Investment advisers are further required to review those reports.¹⁵

In addition to the provisions of Rule 204A-1, firms should consider requirements that "access persons" provide duplicate trade confirmations and account statements, trade only through designated brokers, pre-clear personal securities transactions, and not engage in "short-swing" trading and market timing. Moreover, the audit program should also apply to personnel who do not fall under the definition of "access person," but who nonetheless are routinely exposed to non-public information.

For more information, please contact Christopher J. Clark at (212) 259-8555, Stephen A. Best at (202) 346-8735, Seth C. Farber at (212) 259-7227, Suzanne Jaffe Bloom at (212) 259 7362 or your Dewey & LeBoeuf relationship attorney.

¹⁴ "Access person" is defined by Rule 204A-1(e)(1) as "Any of your supervised persons: (A) Who has access to nonpublic information regarding any clients' purchase or sale of securities, or nonpublic information regarding the portfolio holdings of any reportable fund, or (B) Who is involved in making securities recommendations to clients, or who has access to such recommendations that are nonpublic."

¹⁵ See 17 C.F.R. § 275.204A-1(a)(3).