INVESTMENT MANAGEMENT UPDATE

Legal News℠

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A Compilation of Enforcement and Non-Enforcement Actions – January 2012

Enforcement Matters

Insider Trading Scheme by Hedge Fund Managers and Analysts Subject of Recent Charges by SEC

On January 18, 2012, the SEC, in connection with an alleged $78 million insider trading scheme, charged two large hedge fund investment advisory firms and several fund managers and analysts with violations of fraud in federal court. In addition, the U.S. Attorney for the Southern District of New York announced parallel criminal charges against the same individuals. The charges are the latest salvos by the SEC from its ongoing investigation into the trading activities of hedge funds.

In the SEC's complaint, it is alleged that several hedge fund managers at two Connecticut-based investment firms, Diamondback Capital Management LLC and Level Global Investors LP, illegally obtained corporate nonpublic information regarding Dell and Navidia Corporation from insiders resulting in insider trades on behalf of hedge funds managed by Diamondback and Level Global. According to the SEC's complaint, the gains in the Dell insider trading exceeded $62 million and the gains in the Navidia insider trading was $15.7 million.

According to the complaint, the insider nonpublic information was shared by the hedge fund managers with each other and with others who worked with firms located in New York and California. Those persons traded on the information, resulting in gains of approximately $1.4 million.

The SEC's complaint in this matter and previous actions against hedge fund managers demonstrates the SEC's intent to aggressively investigate insider trading by persons at hedge fund management firms who seek and obtain nonpublic information about publicly traded companies. The investigations uncover the uncanny ability of such advisers to obtain nonpublic information from corporate insiders, among others. The violations occur when the holders of such nonpublic information trade on that information.

The SEC's complaint charges each of the defendants with violations of the "anti-fraud" provisions under the Securities Act of 1933 and the Securities Exchange Act of 1934. The SEC is seeking a final judgment ordering the defendants to disgorge the ill-gotten gains with interest, pay financial penalties, and a permanent injunction from further violations of the anti-fraud provisions.

On January 23, 2012, it was announced by the SEC that Diamondback Capital Management LLC had agreed to pay more than $9 million to settle the insider trading charges brought by the SEC on January 18, 2012. The settlement offer by Diamondback still needs to be approved by the Court and includes a "non-prosecution" agreement with the U.S. Attorney's office for the Southern District of New York.

Non-Enforcement Matters

Recent SEC Enforcement Action Underscores Investment Adviser Responsibility for Fair Valuing Portfolio Securities of Mutual Funds It Advises

A recent SEC enforcement action against an investment adviser to mutual funds highlights the adviser's responsibility for fair valuing the funds' portfolio securities. The enforcement action makes it clear that one of the core delegated responsibilities of an investment adviser, on behalf of mutual funds it advises, is to price securities in the funds accurately. This responsibility remains on the shoulders of the adviser even if the funds use a pricing service.

According to the SEC's order, the investment adviser purchased, on behalf of the mutual funds, 54 complex fixed-income securities. The SEC's order finds that following the purchases, all but six of the securities were then valued at prices substantially in excess of the transaction prices, including many at least 100 percent higher. The valuations of the fixed-income securities were provided by pricing sources (broker-dealers or a third-party pricing service).

By using the valuations provided by broker-dealers or a third-party pricing service instead of the transaction prices, the investment adviser caused the mutual funds to not follow their own written valuation procedures. These procedures required the securities to be valued at the transaction price until the investment adviser received a response to a price challenge based on the discrepancy identified in the price tolerance report, or the investment adviser made a fair value determination. The procedures provided that the transaction price could be used for up to five business days until a decision needed to be made to determine the fair value.

As a result of the investment adviser failing to ensure the mutual funds implemented their procedures, the SEC found the adviser aided and abetted and caused the funds to violate Rule 38a-1 under the Investment Company Act. The SEC also found that the investment adviser aided and abetted and caused the mutual funds to violate Rule 22c-1 adopted pursuant to Section 22(c) of the Investment Company Act because the securities were not properly or timely priced at fair value, resulting in the mutual fund shares being sold, purchased, and redeemed based on inaccurately high net asset values.

The enforcement action highlights the need for investment advisers to mutual funds to carefully follow the funds' fair valuation policies and procedures, and highlights the need for such advisers to carefully oversee the fair valuation process, even if a pricing service is being used.

In Light of Recent SEC Guidance, Investment Advisers Should Evaluate and Update Their Social Media Policies

The SEC recently issued a National Examination Risk Alert on Investment Adviser Use of Social Media, in which it makes clear that the use of social media by investment advisers is on its radar. "Social media," for this purpose, includes blogs, wikis, and podcasts, as well as social networking sites such as Facebook and Twitter. In the alert, the SEC notes disapprovingly that many investment advisers have procedures that are unclear as to whether they address social media use, are not specific as to which types of social networking activity are permitted or prohibited, or do not address the use of social media by solicitors. Put more simply, it is time for investment advisers to evaluate and update (if desirable) their social media policies.

As investment advisers evaluate their social media policies, they should consider the non-exhaustive list of factors provided in the SEC's alert, summarized below. Advisers that allow the public to post messages or other content on their social media sites also should pay particular attention to how they handle such content. In this regard, the alert provides guidance on how third-party content interacts with the prohibition on testimonials found in Rule 206(4)-1, as the SEC believes that, depending on the facts and circumstances, the use of "social plug-ins" such as the "like" button could be a testimonial.

Rule 206(4)-1 forbids registered investment advisers from publishing or distributing advertisements that refer to testimonials. "Testimonial" is not defined, but the guidance interprets the term to include a statement of a client's experience with, or endorsement of, an investment adviser. This may include, for example, public use of a "like" button. The guidance states that some social media sites do not permit an investment adviser to disable the "like" or similar feature, which may require an investment adviser to develop a system to monitor and, if necessary, remove third-party postings.

The factors highlighted by the SEC in the alert are set forth below (the SEC cautioned that these factors and suggestions are neither exhaustive nor will they constitute a safe harbor nor a "checklist" for SEC examiners). The SEC also was careful to stress that investment advisers are ultimately responsible for their investment adviser representatives' or solicitors' use of social media.

- **Usage Guidelines.** Investment advisers should determine whether it is desirable to create firm usage guidelines that provide guidance to investment adviser representatives and solicitors on the appropriate and inappropriate use of social media.
- **Content Standards.** Investments advisers should consider the risk that content created by the firm or its investment adviser representatives or solicitors implicates its fiduciary duty or other regulatory issues (for example, such as content that contains investment recommendations or information on specific investment services or investment performance).
- **Monitoring.** Investment advisers should consider how to effectively monitor the firm's social media sites or firm use of third-party sites, taking into account that many third-party sites may not provide complete access to a supervisor or compliance personnel.
- **Frequency of Monitoring.** Investment advisers should consider the frequency with which they monitor investment adviser representatives or solicitor activity on a social media site.
- **Approval of Content.** Investment advisers should consider the appropriateness of pre-approval requirements (as opposed to after-the-fact review).
- **Firm Resources.** Investment advisers should consider whether they have dedicated sufficient compliance resources to adequately monitor investment adviser representative or solicitor activity on social media sites, including the ability to monitor the activity of numerous investment adviser representatives or solicitors.
- **Criteria for Approving Participation.** In analyzing the risk exposure for an investment adviser and its clients due to the use of a social networking site, the adviser's compliance procedures may consider, without limitation, the reputation of the site, the site's privacy policy, the ability to remove third-party posts, controls on anonymous posting, and the advertising practices of any social media site used by the firm, its investment adviser representatives, or solicitors to conduct business.
- **Training.** In establishing or reviewing any training requirements for its investment adviser representatives, investment advisers should consider implementing training related to social media that seeks to promote compliance and to prevent potential violations of the federal securities laws and the firm's internal policies.
- **Certification.** Investment advisers should consider whether to require a certification by investment adviser representatives and

advisory solicitors confirming that those individuals understand and are complying with the firm's social media policies and procedures.

- **Functionality.** Investment advisers consider the functionality of each social media site approved for use, including the continuing obligation to address any upgrades or modifications to the functionality that affect the risk exposure for the firm or its clients. Such consideration is particularly significant given the rapidly evolving nature of this new media.
- **Personal/Professional Sites.** Investment advisers should consider whether to adopt policies and procedures to address an investment adviser representative or solicitor conducting firm business on personal (non-business) or third-party social media sites. For example, a firm may choose to specify what types of firm communications or content are permitted on a site that is not operated, supervised, or sponsored by the firm.
- **Information Security.** Investment advisers should consider whether permitting their investment adviser representatives to have access to social media sites poses any information security risks. Protecting information and information systems from unauthorized access, use, disclosure, disruption, modification, perusal, inspection, recording, or destruction is an important risk faced by all firms. Although hacking and other breaches of information security can be posed in multiple ways, use of social media, especially third-party social media sites, may pose elevated risks.
- **EnterpriseWide Sites.** Investment advisers that are part of a larger financial services or other corporate enterprise may consider whether to create usage guidelines reasonably designed to prevent the advertising practices of a firm-wide social media site from violations of the Investment Advisers Act.

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