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November 2016

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SEC Requires Hedge Funds to Prevent Insider Trading Despite Unsettled Legal Definition

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On October 13, the SEC brought an enforcement action against Artis Capital Management ("Artis"), alleging that it did not have or enforce policies and procedures reasonably designed to prevent insider trading. Specifically, the SEC faulted the adviser for:

- Not appropriately supervising a research analyst or questioning the analyst about the source of his information despite purported "red flags"—such as the temporal proximity between the trade recommendation and acquisition news;
- Not asking the CCO to look into the matter despite the same "red flags"; and
- Not having and enforcing policies to track and monitor the analyst's interactions with employees of public companies.

The firm's research analyst allegedly recommended what turned out to be profitable trades based on tips from a friend employed at a public company in the absence of any supporting models, written reports, or research files. The SEC found Artis in violation of Section 203(e)(6) and 204A of the Advisers Act, and Artis paid $8.8 million in disgorgement and penalties to settle the case.

The SEC's aggressive focus on advisers' failure to adopt, maintain, and enforce anti-insider trading policies and procedures goes back to at least 2008 when the SEC issued a "warning" to the industry in the form of a Report of Investigation concerning its investigation of Retirement Systems of Alabama ("RSA") for insider trading. There, the CEO of RSA purportedly ordered his investment group to buy shares before public disclosure of an acquisition target where RSA was to finance the acquisition.

While the SEC did not bring any charges against RSA, the Commission sought to "emphasize the responsibilities of all investment professionals, and other public entities under the federal securities laws, and to highlight the risks they undertake when they operate without a compliance program." The SEC noted that RSA did not have a proper compliance program to ensure compliance with the federal securities laws, and concluded that had RSA had a proper compliance program, it would not have engaged in the alleged insider trading.

Against this backdrop, the SEC's recent targeting of an adviser for failing to prevent insider trading is unsurprising. However, the SEC's aggressive enforcement position is troubling for advisers, given the currently ill-defined and unsettled legal definition of insider trading.

That unsettled definition was on display earlier in October when the Supreme Court heard oral argument in a significant insider trading case—the first such case to be heard by the Supreme Court since 1997. A majority of the justices in that case, *Salman v. United States*, appeared poised to rule in the government's favor.

At issue in *Salman* is whether a person who provides an insider trading tip must receive a "tangible" or "pecuniary" gain in exchange for the tip, or whether a close family relationship between the tipper and tippee is sufficient to establish insider trading liability. Whichever way the Supreme Court rules, one thing is clear: the standard for what constitutes insider trading remains unclear. Despite decades of insider trading litigation and prosecution, judges, lawyers, and the general public disagree about and often misunderstand fundamental, definitional issues.

The SEC's requirement that investment advisers prevent such an unsettled legal issue obviously creates challenges when designing policies to appropriately guard against employee insider trading without prohibiting perfectly legal securities trading. Nevertheless, given the SEC's aggressive enforcement position, fund advisers should re-examine their policies in this area and err on the side of caution. To the extent not already addressed in existing policies, advisers may want to consider requiring the tracking and investigation of the source of outside information and the investigation of tips and trades that seem "too good to be true."

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