2023 Investment Adviser Compliance Conference /

Effective Strategies & Best Practices

March 12-14, 2023

Marriott Marquis, Washington, D.C.

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1

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Prevention of Misuse of MNPI and Insider Trading: Alternative Data and Expert Networks

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2

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Agenda

- Key Terms
- Why use Alternative Data and Expert Networks?
- Laws/Rules Specific to Investment Advisers and MNPI
- The SEC's Perspective
- Policies and Procedures: How to Prevent Receipt and Misuse of MNPI in the Context of Alternative Data and Expert Networks
- Questions?

3

Key Terms

MNPI (material nonpublic information)

- Information is "material" if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision (e.g., information that could affect a company's share price once made public).
  - In the context of speculative or contingent events such as mergers, materiality depends on balancing both the probability that the event will occur and the anticipated magnitude of the event (e.g., a low probability merger that would have a significant impact on a small company is probably material).
- Information is "nonpublic" if it is generally not available to the investing public.
- Insider trading involves (1) trading or facilitating trading in a company's stock (2) while in possession of MNPI (3) in breach of a fiduciary duty or other relationship of trust and confidence owed to the company, its shareholders, or the source of information (4) where the trader is aware of the breach.
- Anyone who either trades on MNPI or passes it on to someone who trades on it can be liable for insider trading.

4

Key Terms

Alternative Data

- "Alternative data" refers to nontraditional types of data used in financial analysis.
- Examples include:
  - information from satellite and drone images;
  - GPS data from consumers' mobile phones;
  - social media and internet search data and product reviews; and
  - analyses of aggregate credit card transactions.
- Not all alternative data contains MNPI, but use of it presents a higher risk of encountering MNPI.
- Receipt and use of alternative data also raises privacy concerns, questions of ownership, data validation, and other issues that are not typically present with respect to use of expert networks.
- Most alternative data leveraged by investment advisers is purchased from third-party vendors who source, process, and sell datasets to buyside purchasers via subscription services.

5

Key Terms

Expert Networks

- "Expert networks" refers to groups of professionals – such as academics, scientists, engineers, doctors, lawyers, suppliers, and former employees of a company – who are paid for their specialized information and research services.
- Clients of expert networks pay to gain insight into certain industries or sectors through consultations, written reports, and market studies.

6

Why Use Alternative Data and Expert Networks?

- Investment advisers are constantly looking for untapped sources of information to give them an edge over their competitors.
- Investors continually look for new signals on how to invest.
- Risk management: non-traditional data and data sources can help limit loss in the face of risky transactions or a volatile market.

7

Laws/Rules Specific to Investment Advisers and MNPI

Section 204A of the Advisers Act (Policies re Insider Trading)

- Requires investment advisers to establish, maintain, and enforce written policies and procedures that are reasonably designed, taking into consideration the nature of the adviser's business, to prevent the misuse of MNPI by the adviser or any person associated with the adviser.

Rule 206(4)-7 of the Advisers Act (Compliance Rule)

- Requires investment advisers to (1) adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and associated rules by the adviser and its supervised persons, and (2) review, at least annually, the adequacy of their policies and procedures and the effectiveness of their implementation.
- Compliance programs must be designed to:
  - Prevent violations from occurring;
  - Detect violations that are occurring or have occurred; and
  - Correct violations

8

Laws/Rules Specific to Investment Advisers and MNPI

Words of Caution:

- Avoid "off the shelf" compliance policies and procedures which are not specifically tailored to the adviser's business practices.
- An adviser may be sanctioned for the absence of proper procedures even if the inadequacy has not resulted in an occurrence of insider trading.

9

The SEC's Perspective

Expert Networks – Cases and SEC Enforcement Actions

- *SEC v. CR Intrinsic Investors, LLC*
- *2011 SEC Charges*

10

The SEC's Perspective

In 2011, a speech by Carlo di Florio, former director of the SEC's Office of Compliance Inspections and Examinations, signaled the SEC's approval of the use of expert networks, provided that appropriate front-end and back-end controls were put into place.

- Front-end controls could include:
  - Reviewing the terms of agreements with expert network firms;
  - Requiring employees to read and acknowledge the adviser's insider trading policies;
  - Preapproving every conversation with an expert and periodically conducting "chaperoned" conversations (i.e., including a compliance person as a silent listener to the conversation between the expert and the adviser's analyst or portfolio manager);
  - Conducting an evaluation of the expert network's compliance program and internal controls; and
  - Either prohibiting the use of experts who are employees of a public company or having extra controls in place.
- Back-end controls could include:
  - Obtaining certifications from employees who use expert networks that they are not trading on MPNI; and
  - Monitoring and testing of employee trading, particularly trades effected after the expert conversation occurs and trades in specific companies relative to press releases, earnings announcements, and SEC filings.

11

The SEC's Perspective

Alternative Data – Enforcement Action

- *In the Matter of App Annie Inc. and Bertrand Schmitt*

12

The SEC's Perspective

SEC's April 2022 Risk Alert: Investment Adviser MNPI Compliance Observations

- The staff observed what it considered to be inadequate or nonexistent policies and procedures by investment advisers using alternative data and expert networks.
- With respect to alternative data, investment advisers should:
  - Memorialize their diligence processes and follow them consistently;
  - Adopt policies and procedures regarding the assessment of the terms, conditions, and legal obligations relating to the collection or provision of the data, including when advisers become aware of red flags relating to the sources of data; and
  - Retain documentation to demonstrate that their policies and procedures have been consistently implemented.
- With respect to expert networks, investment advisers should:
  - Identify all expert networks used by the adviser;
  - Identify each individual expert used and track their relationships with potential sources of MNPI;
  - Track and log calls with experts, and keep "detailed notes" which can be reviewed by compliance; and
  - Monitor employee trading activity in the securities of publicly traded companies that are in similar industries as those discussed during calls with expert networks (referred to as "Shadow Trading"; see *SEC v. Penuwat* (2021)).

13

The SEC's Perspective

SEC's October 2022 Proposed Rule: Outsourcing by Investment Advisers

- New proposed Rule 206(4)-11 would require investment advisers to adhere to enhanced due diligence requirements before retaining a service provider to perform certain "covered functions."
  - A "covered function" is a function or service that: (1) is necessary to provide advisory services in compliance with the federal securities laws, and (2) if not performed or performed negligently, would be reasonably likely to cause a material negative impact on the adviser's clients or the adviser's ability to provide investment advisory services.
  - While not explicitly contemplated in the proposing release, and in most cases likely not a "covered function", services provided by non-traditional data sources, such as alternative data vendors and expert networks, could be implicated by this proposed rule, especially for those firms that rely heavily on these services for their trading activity.
  - Either way, the proposed rule outlines the type of diligence the SEC believes is necessary to ensure proper oversight of certain outsourced functions and, therefore, is useful to advisers in constructing their own oversight framework.

14

The SEC's Perspective

SEC's October 2022 Proposed Rule: Outsourcing by Investment Advisers

- Under the proposed rule, before outsourcing a "covered function," an investment adviser would be required to reasonably identify and determine through due diligence that outsourcing the function to that service provider would be appropriate by considering:
  - The nature and scope of the covered function;
  - Potential risks resulting from the service provider performing the covered function, including how to mitigate and manage such risks;
  - The service provider's competence, capacity, and resources necessary to perform the covered function;
  - The service provider's material subcontracting arrangements related to the covered function;
  - Coordination with the service provider for federal securities law compliance; and
  - The orderly termination of the performance of the covered function.
- The proposal also would require the adviser periodically to monitor the service provider's performance and to reassess the selection of the service provider under the due diligence requirements of the rule. Additionally, the adviser would have to make and keep books and records related to its due diligence and monitoring and report census-type information about these service providers on Form ADV.

15

The SEC's Perspective

Recent SEC Document Request List relating to MNPI Monitoring

Asking for:

- A list of all independent research providers (e.g., expert networks, consultants, political intelligence firms, and expert advisory panels) utilized by the adviser during the examination period;
- For all such service providers, the corresponding contract terms of use, fee schedule, amount paid during the examination period to the service providers or to individuals employed by the service providers, and method of payment (e.g., soft dollars);
- A log of all discussions with such service providers, detailing date, participants, topic, company that was being researched, whether the discussion was chaperoned, and whether the discussion was in person;
- Records of chaperoning or other compliance oversight of the communications with such service providers;
- All training materials provided to the adviser's personnel pertaining to receipt and control of MNPI; and
- All written policies and procedures pertaining to receipt and control of MNPI.

16

Policies and Procedures: How to Prevent Receipt and Misuse of MNPI in the Context of Alternative Data and Expert Networks

Before hiring a non-traditional data vendor (i.e., an expert network or alternative data provider)**:**

Conduct (and document) initial due diligence, including:

- Request references and a list of other firms using that vendor;
- Review the types of data provided, the sources of the data, and the availability of the data to others;
- Review vendor's compliance program, including internal controls to prevent the misuse of MNPI, and the vendor's legal rights to access, obtain, and provide the data; and
- Review vendor's disciplinary/regulatory/litigation history.

17

Policies and Procedures: How to Prevent Receipt and Misuse of MNPI in the Context of Alternative Data and Expert Networks

Before hiring a non-traditional data vendor (i.e., an expert network or alternative data provider)**:**

Ensure agreement with vendor:

- Prohibits vendor from conveying MNPI;
- Provides appropriate MNPI representations and representations regarding vendor's right to sell the data; and
- Requires vendor to notify adviser of changes in vendor's "terms of use," data collection methodologies/sources, disciplinary or regulatory actions, and litigation.

18

Policies and Procedures: How to Prevent Receipt and Misuse of MNPI in the Context of Alternative Data and Expert Networks

Once a non-traditional data vendor is hired:

- Re-perform due diligence (at least annually).
  - Reassess data vendors and data sets for compliance with the most recent regulatory guidance.
  - Identify "triggers" for an immediate or enhanced review outside of normal due diligence (e.g., changes in vendor's "terms of use").
- Request periodic evidence or certifications regarding vendor's policies and procedures to prevent disclosure or misuse of MNPI.
- Create an inventory of data providers and data sets in use, including:
  - Description of information provided;
  - Source of information;
  - Date information was received;
  - Limitations on the use of the data imposed by the vendor (i.e., "terms of use"); and
  - Special procedures implemented by the adviser to prevent transmission of, or trading in, MNPI (e.g., restricted lists, physical and technology information barriers, etc.).

19

Policies and Procedures: How to Prevent Receipt and Misuse of MNPI in the Context of Alternative Data and Expert Networks

Once a non-traditional data vendor is hired:

- Implement ongoing monitoring of the vendor and the data provided.
  - Procedures must be tailored to the type of data, how it is used by the adviser, and its risks (e.g., high value data sets, which are likely to attract greater scrutiny from regulators, may warrant additional diligence).
  - Document all interactions with vendor.
  - Establish data approval controls (e.g., the person responsible for confirming the data's reliability for portfolio management purposes may need to be different from the person who assesses MNPI risk).

20

Policies and Procedures: How to Prevent Receipt and Misuse of MNPI in the Context of Alternative Data and Expert Networks

Once a non-traditional data vendor is hired:

- Train employees to recognize MNPI and what to do in the event it is received.
  - Obtain periodic certifications from employees who use alternative data and expert networks to confirm that they understand their obligations and have not and will not trade on MNPI.
- Monitor employee activity.
  - Review employee trading, including lookbacks and pattern surveillance.
  - Review employee communications (e.g., emails, instant messages, etc.).
- Keep accurate records – show your work!

21

Policies and Procedures: How to Prevent Receipt and Misuse of MNPI in the Context of Alternative Data and Expert Networks

Special considerations for use of alternative data:

- Document who the original owner of the data is and whether ownership rights were properly conferred.
- Document how the data was collected.
- Ensure that data provided is aggregated and anonymized.
- Confirm the adviser's intended use of the data is consistent with the vendor's "terms of use."

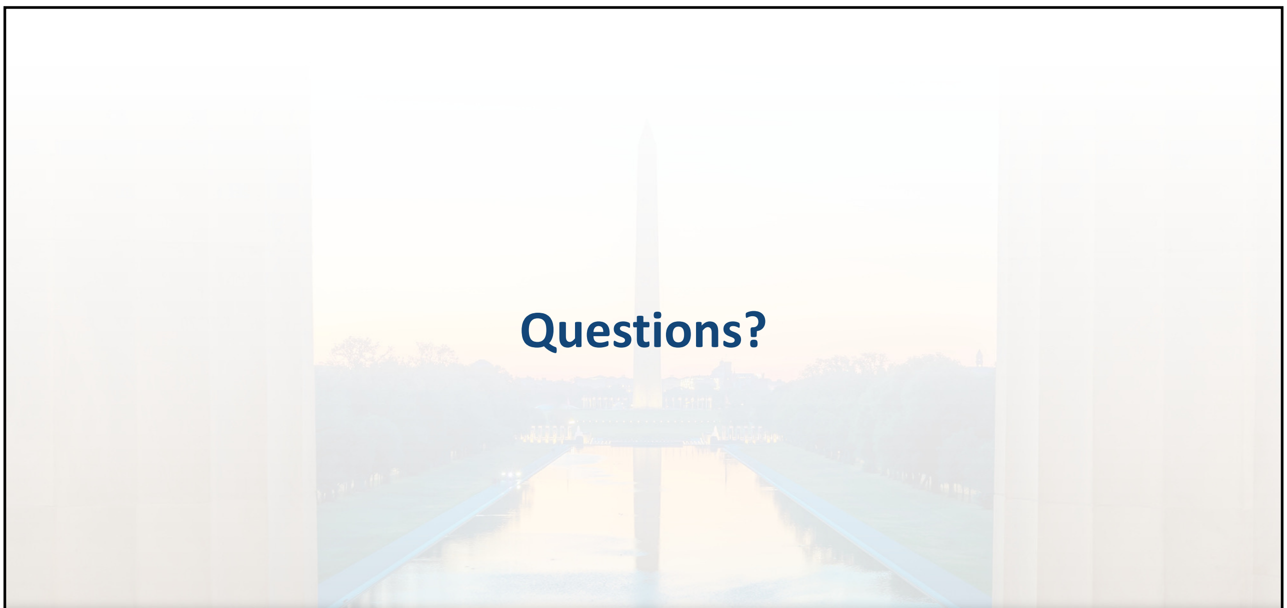
22

Policies and Procedures: How to Prevent Receipt and Misuse of MNPI in the Context of Alternative Data and Expert Networks

Special considerations for use of expert networks:

- Consider prohibiting the use of a vendor who:
  - is, or has been in the prior 6 months, a consultant or employee of the research target; or
  - is, or has been in the prior 12 months, an executive officer or director of the research target.
- Consider chaperoning calls with experts and/or requiring all discussions to begin with a script in which vendor agrees that investment adviser does not wish to receive MNPI.

23



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24