

SEC Warns Public Pension Funds and Other Unregistered Investment Advisers on Insider Trading

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Last Thursday, the SEC warned public pension funds and other unregistered investment advisers on the need for vigilance and adoption of policies and procedures to address potential insider trading issues. The same topic was recently addressed in a February 27, 2008 conference sponsored by Morgan Lewis on advanced topics in hedge fund practices. During the Hedge Fund Enforcement and Litigation Round-Up session, Morgan Lewis partners and former SEC enforcement lawyers Anne Flannery and Ivan Harris expressed our view that insider trading likely will remain a hot enforcement topic and that the SEC staff likely will focus on registered investment advisers' compliance with Section 204A of the Investment Advisers Act of 1940, which requires firms to "establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such investment adviser's business, to prevent the misuse . . . of material, non-public information by such investment adviser or any person associated with such investment adviser."

During the presentation, Anne and Ivan suggested that even firms that are not registered as investment advisers should consider the concept behind Section 204A and institute procedures to detect and prevent insider trading activity. Although unregistered investment advisers are not subject to Section 204A, they remain subject to liability for insider trading under the federal securities laws. Therefore, even though an unregistered adviser has no affirmative duties under Section 204A, creating a framework consistent with its business model that evidences its good-faith efforts to detect and prevent insider trading would aid a firm in demonstrating to the SEC an absence of scienter in the event that the firm or any of its investment professionals is investigated for possible insider trading.

Last Thursday, the SEC issued an investigative report pursuant to Section 21(a) of the Securities Exchange Act of 1934 (Section 21(a) Report) reminding public pension funds of their responsibilities under the federal securities laws and warning them of the risks that they take if they do not have adequate compliance policies, procedures, and training. The Section 21(a) Report can be accessed via the following link: <http://sec.gov/litigation/investreport/34-57446.htm>. Notably, the Section 21(a) Report reminded firms that are exempt from the requirements of the Investment Company Act of 1940 and the Investment Advisers Act of 1940 that they and their employees nevertheless remain subject to liability under the general antifraud provisions of the federal securities laws, including Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder. The Section 21(a) Report was released following an SEC Division of Enforcement investigation, in which Enforcement concluded that the Retirement Systems of Alabama (RSA) traded while in possession of

material, nonpublic information. The Section 21(a) Report noted that RSA had no policies, procedures, or training to ensure that its money managers understood and complied with the federal securities laws in general and regarding insider trading specifically. The Section 21(a) Report concluded that the improper trading could have been avoided if RSA had had adequate policies and procedures and had trained their investment professionals on the duties and implications of coming into possession of material, nonpublic information.

Over the past 20 years, Morgan Lewis has helped many firms develop and implement policies and procedures relating to insider trading. In addition, we have extensive experience in presenting training sessions for investment professionals that could be adapted to your business model. Please let us know if you would like any assistance in developing policies, procedures, or training in this area.

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