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"There is now no doubt about the breadth of tipper-tippee liability and … the government will be justifiably emboldened in bringing more cases."

Supreme Court Sides with Prosecutors in Insider Trading Case

The U.S. Supreme Court on December 6 gave Justice Department and SEC prosecutors an early holiday gift: it unanimously rejected a challenge to a lower court ruling on an insider trading case. In doing so, the Supreme Court returned one of the standards by which insider trading cases are judged to approximately where it was prior to 2014.

In *United States v. Salman*, the Supreme Court supported a ruling by the U.S. Court of Appeals for the Ninth Circuit. That ruling, written by Justice **Samuel Alito**, stated that a tipper's gift of confidential information to a trading relative is, by itself, suf-

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Protect Your Firm from Investment Performance Scrutiny

The SEC has made no secret about its focus on how advisers and their sub-advisers represent investment performance. Recent agency settlements with advisory firms highlight the need for advisers to take necessary steps so they do not find themselves in the crosshairs.

Enhanced due diligence of third-party performance, appropriate disclosures, books and records that support performance claims, and internal controls are among the necessary steps that chief compliance officers should look into before resting easy that their firms are on safe ground. **ACA Performance Services** managing director

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Guidance Clarifies Reliance on Predecessor Registrations

Five questions, five relatively clear answers. That's what the SEC Division of Investment Management provides in its latest guidance on when and how investment advisers may rely on predecessor registrations. Attorneys and consultants providing counsel to investment advisory firms would be wise to use the guidance.

"The staff of the Division of Investment Management has received numerous inquiries over the years concerning when, and under what circumstances, an entity may be able to rely on a predecessor's registration as an investment adviser with the [SEC]," the guidance states. The November 2016 document provides relatively plain-English answers to questions related to the following instances when reliance on a predeces-

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Supreme Court

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ficient evidence of a personal benefit to the tipper. The ruling upheld a lower court verdict that convicted **Bassam Salman**, an extended family member of a former **Citigroup** investment banker, of allegedly receiving material nonpublic information that was passed on to him from the Citigroup employee's brother.

The Supreme Court agreed with the Ninth Circuit's reasoning to rest its decision on a 1983 Supreme Court decision, *Dirks v. SEC*. The Ninth Circuit chose not to rely on a controversial 2014 ruling from the U.S. Court of Appeals for the Second Circuit in an unrelated case, *United States v. Newman*. In that case, the Second Circuit said that for a personal benefit to be construed to a tipper, there would need to be proof of a meaningful relationship between the tipper and tippee "that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."

But the Ninth Circuit, and now the Supreme Court, did not buy into the Second Circuit's reasoning. "To the extent that the Second Circuit in *Newman* held that the tipper must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift (*such as an insider trading tip - Editor*) to a trading relative, that rule is inconsistent with *Dirks*," the Supreme Court said. *Dirks*, in other words, remains the final word – or at least until the Supreme Court says otherwise in a future case.

Not only did the ruling uphold the *Dirks* definition of a personal benefit to a tipper, it was the first ruling by the Supreme Court involving insider trading in the approximately 20 years since *Dirks*.

The Second Circuit ruling

The Second Circuit's original ruling in *Newman* reached near-landmark decision status almost immediately after it was released (*ACA Insight*, 1/26/15). It not only reversed the convictions and threw out the indictments of two hedge fund portfolio managers accused of insider trading, but, according to legal scholars and practicing attorneys at the time, appeared to rewrite insider trading case law. The ruling, in fact, was cited by defense attorneys arguing for their clients, as well as judges in making rulings.

That is now likely to change.

"The Second Circuit in *Newman* clearly got it wrong and the Supreme Court in *Salman* clearly got it right," said **University of North Carolina at Chapel Hill** law professor **Thomas Lee Hazen**. "I think the *Salman* decision is especially noteworthy since the Court, which is sharply divided on most issues that come before it, was unanimous in repudiating *Newman*. There is now no doubt about the breadth of tipper-tippee liability and I imagine the government will be justifiably emboldened in bringing more cases."

"I suspect it will be full steam ahead for insider trading cases," said **Willkie Farr** partner and former SEC deputy chief of staff **James Burns**. "The Supreme Court ruling really reopens the ability for the Commission to bring cases."

Others took a different view. "The *Salman* decision is neither surprising nor all that remarkable when viewed in the broader context of insider trading law," said **Morgan Lewis** partner **Andrew Southerling**. The Supreme Court in *Salman* simply followed what it said nearly three decades ago in *Dirks*; the facts in *Salman* squared entirely with the gift giving principle articulated in *Dirks*. In fact, the gift giving conduct among family members in Salman was precisely the kind of conduct the *Dirks* ruling prohibited."

"The *Salman* decision also does not undo *Newman* entirely," he said. "In *Newman*, the Second Circuit held that for a downstream tippee to be guilty of insider trading, the tippee must know that the information was confidential and divulged by the tipper for a personal benefit. The *Newman* Court found that the downstream tippees in that case knew nothing about the insider/tippers and nothing about any personal benefit they received in exchange for the inside information. In *Salman*, the Supreme Court found that the tipper, the brother-in-law of Salman, gifted inside information to his brother for the specific purpose of trading on that information. The brother, in turn, tipped Salman, who then traded on the confidential information with full knowledge that it had been improperly disclosed by a family member for the purpose of trading." Therefore, *Salman* is consistent with *Newman* in this important respect.

Remaining questions

Yet despite the Supreme Court's ruling being welcome news to the government, some legal experts noted that the ruling limited itself to the facts of *Salman* and appeared to avoid any broader statements.

"While *Salman* says fairly strongly that the Court regards the structure of insider trading law as we have known it for the past thirty years, at least in the tipper-tippee context, as sound and amply satisfactory in terms of clarity and notice, it avoids saying much beyond the facts of this particular case, and recognizes that harder factual cases will have to be resolved with sensitivity to both the goals of the prohibition and the demands of due process," said **Georgetown University School of Law** professor **Donald Langevoort**.

"The *Salman* ruling is very narrow," said **University of Michigan** law professor **Adam Pritchard**. "Essentially, 'We meant what we said in *Dirks*.' The decision rejects the broadest language in *Newman*, but it also rejects the very broad argument that the government was advancing (i.e., any disclosure of material non-public information should be presumed to be a gift)."

"It doesn't answer the question of the quantum of friendship required to make a disclosure a gift," he said. "All we know is that telling your brother is sufficient. Also undisturbed is the requirement that the ultimate tippee know that the information was disclosed as a gift. That's going to be a hotly litigated issue in cases going forward."

Protect Your Firm

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Karen Foley and **K&L Gates** partner **Michael McGrath** addressed these topics in a recent ACA webinar, "The SEC's Focus on Investment Performance."

"This is clearly a topic that is on the top of most folks' minds and understandably so," said Foley, noting the lack of SEC guidance addressing the subject.

The SEC focus

If anyone is in doubt of the SEC's scrutiny of third-party performance advertising, he or she need only consider the 15 advisory firms that have settled with the SEC since 2015. In each case, according to the agency, these firms relied on the same sub-adviser while failing to perform proper due diligence into the sub-adviser's performance claims.

The SEC on August 25 of this year fined 13 investment advisory firms that the agency said repeated false claims made by their sub-adviser, investment management firm **F-Squared Investments**, about F-Squared's flagship product without first obtaining sufficient documentation to support those claims. The fines ranged from $100,000 to $500,000. That settlement followed up on two earlier settlements that made similar claims (*ACA Insight*, 2/29/16).

F-Squared itself in December 2014 agreed to pay $35 million in disgorgement and penalties, as well as admit wrongdoing, to settle charges that it defrauded investors through false performance advertising (*ACA Insight*, 1/5/15). The case, and most of the later cases, centered around the veracity of F-Squared's advertising performance claims of its index product, the investments of which could be rebalanced periodically based on buy-sell signals from an algorithm.

"F-Squared falsely advertised a successful seven-year track record for the investment strategy based on the actual performance of real investments for real clients," the SEC said at the time of its settlement with F-Squared. "In reality, the algorithm was not even in existence during the seven years of purported performance success."

The advisers who relied on F-Squared's performance claims "took the position that they themselves were the victims of F-Squared," and that enforcement action should not have been brought against them, said McGrath. But the agency, he said, countered with two factors that advisers today would be wise to pay attention to:

1. The advisers failed to meet a "duty of care" to ensure that the information sent to clients and potential clients was accurate; and
2. The advisers did not meet their obligation to keep sufficient records, as required by Advisers Act Rule 204-2, the Books and Records Rule, to substantiate the performance claims they shared with clients.

Due diligence best practices

Advisers that want to avoid finding themselves charged with relying on faulty investment performance figures from sub-advisers or other third parties should make sure they perform necessary due diligence steps of the third party, Foley said. Those steps include:

- **Always seek to obtain books and records to substantiate performance.** This is true even if you perform a review onsite. While some advisers may find they are unable to get hold of books and records in all circumstances, "I think it is important for advisers to make the effort," she said. "Don't just assume a manager will never give it to you – ask for it." Obtain, if possible, records, such as attribution analyses and audited financials that will provide you with the best possible understanding of how the performance results were derived."
- **Inquire about returns that do not correlate with known factors associated with the strategy.** If these don't match up, "probe a little bit more," Foley said. "Get some insight as to what is causing these unexpected returns." One good check might be seeing how the performance of the investment strategy compares to that of a peer group.
- **Ensure there is a strong internal control environment and appropriate segregation of duties.** "Understand the investment performance process," she said. "Figure out where the data is coming from. Who is responsible for calculating performance? Is this person different from the person generating the performance, such as the portfolio manager?"
- **Determine GIPS status.** It's not enough just to be GIPS compliant. Firms should have their compliance verified, Foley said. "Who was the verifier? What period was examined? How frequently?" Firms that are not GIPS compliant should have their track records performance-certified, she said. Find out why they are not GIPS compliant, if it is relevant.
- **Make sure the due diligence team has sufficient knowledge about any complex strategies implemented.** This will help facilitate that the right questions are asked. "It would make no sense to send a due diligence team in to review a manager's performance of a strategy that they don't really understand, because they are not going to be able to ask the right questions," Foley said. "Would they be able to determine whether the responses they were getting back were reasonable or not?"
- **Ask about red flags.** Any of the following, she said, "should lead you to probe a little deeper:" use of third-party managers; multiple changes in auditors, prime brokers or verifiers; unfavorable results from background checks; undisclosed potential conflicts of interest; or inefficient operational infrastructure and inadequacy of compliance programs.
- **Review disclosures.** Identify any deviations from disclosures made to clients from actual practices. "In the eyes of a regulator, if it wasn't documented, it wasn't done," Foley said.
- **Compare performances.** Foley suggested matching performance results received from advisory firm managers to those provided to third-party databases.
- **Develop policies and procedures.** These should be "robust" and related to how third-party performance is evaluated and substantiated, she said. "Follow the procedures consistently."
- **Obtain documentation relating to your due diligence.** This documentation must show that appropriate and thorough due diligence was performed. Make sure you followed up on all unanswered questions, Foley suggested.
- **Maintain a professionally skeptical attitude.** Foley made the point that "professional skepticism is the expectation." The due diligence team should investigate "with the expectation that there is something

wrong and something to be found," she said. You want the approach to be that the third-party firm is "guilty until innocent." Look for enough evidence to support a stand that the track record is not fraudulent or misleading.

Hypothetical and backtested performance

Advisers need to be aware that the SEC scrutinizes claims that rely on either hypothetical or backtested performance results to see if they are in any way false or misleading, said McGrath. Advisers or sub-advisers using such results need to be certain that they are accompanied by clear disclosures as to what they represent and how they were derived.

Hypothetical results show performance that does not reflect the experience of actual client portfolios, said McGrath. The definition may be broader than some advisers expect. For example, the removal of some aspect of an investment strategy, such as a hedge, also may cause results to be viewed by regulators as hypothetical, he said.

Hypothetical results are also considered "backtested" when a particular investment strategy is applied to historical financial data in an attempt to show the performance that the strategy would have obtained if it had been implemented during the time period. McGrath said that the SEC views this practice with skepticism because such results are "created with the benefit of hindsight." The SEC and agency staff consider the use of backtesting "to be extremely dangerous" when used with unsophisticated investors, as, he said, such investors "may not recognize the inherent limitations of backtested performance."

What should be disclosed about the limitations of backtested performance? McGrath suggested the following list as a starting point:

- Prepared with the benefit of hindsight;
- All material economic and market factors that might have impacted the adviser's decision-making when using the model to manage actual client accounts;
- Whether the adviser was managing actual money during the period;
- Whether the strategy retroactively applied was not available during the periods represented;
- Assumptions with regard to scalability may not be valid;
- If applicable, does not take into account the costs of hedging or leverage;
- Not indicative of the skill of the adviser;
- Investor may experience loss;
- If applicable, the extent to which actual results during the same period were materially different; and
- All material facts relevant to any comparison between the backtested performance and its benchmark.

"Disclose all material aspects of the backtested model," he said. These would include how the strategy was applied to historical data, changes to the model or assumptions, and whether the backtested performance reflects the deduction of advisory fees, brokerage or other commissions, mutual fund exchange fees, and other expenses a client might pay."

Internal controls

Make sure your firm has written policies and procedures that address the entire investment performance process, said Foley. Include the systems used, calculation methodologies, use of third parties, roles and responsibilities, oversight, policies for data retention and retrieval, and policies for distribution and marketing. Review those policies and procedures "at least annually," she said.

In addition, she said, develop and implement controls "that demonstrate the firm's commitment to a strong control environment."

Guidance Clarifies

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sor registration may be an issue:

- A change of the state or territory in which a business is organized and/or a change in its form of organization,
- A change in control or a change in leadership at an

investment adviser,

- A change in ownership of an investment adviser,
- An acquisition of a portion of an investment advisory business, and
- An internal reorganization at an investment adviser.

Prior to the issuance of the guidance, advisers and their attorneys or consultants had only a 1992 interpretive statement to rely on, said **Mayer Brown** attorney **Adam Kanter**. That document, Registration of Successors to Broker-Dealers and Investment Advisers, provided much the same answers as the new guidance, but required more effort to understand, he said. "You had to parse the language."

"The main benefit of the new guidance is that you now have an easier, digestible, FAQ-like idea of what you are supposed to do," he said. "It's a good resource to have, reduces the head scratching."

The main beneficiary of the guidance will likely not be advisory firms, however, as any given firm rarely, if ever, uses a succession filing. Law firms, consultants and others with large numbers of advisers as clients, however, are likely to have the topic come up more frequently.

"This is one of the better IM guidance update documents to date," said **Stradley Ronon** partner **Lawrence Stadulis**. He pointed to three aspects of the guidance that stood out:

- **Timeliness.** "There's a lot of acquisitions and consolidation in the advisory industry right now, so these questions are coming up."
- **Connected with prior guidance.** "The SEC staff does not create any new law here. It does not drop an atom bomb."
- **Practical.** "It's clear, for the most part, and provides examples."

Two succession methods

Before getting to the Investment Management staff's answers to the five questions, it is important to know just how a successor application to rely on a predecessor registration works. Advisers typically must file such applications within 30 days after taking over a predecessor's business. There are two methods to do so, depending on the circumstances:

- **Succession by application.** This is used if the successor is an unregistered entity and is acquiring or assuming substantially all of the assets and liabilities of an SEC-registered adviser that is no longer conducting advisory activities. After filing the application, "the successor may rely on the registration of the acquired adviser until the SEC declares the successor's new registration effective."
- **Succession by amendment.** This is used if the successor is a new investment adviser "formed solely as a result of a change in form of organization, a reorganization, or a change in the composition of a partnership and there has been no 'practical' change in control or management," the guidance states. In such cases, the successor adviser may amend the earlier registration by filing an amended Form ADV.

Following are the staff's answers to the five questions it often receives on this topic.

Change in business organization

It is not uncommon for advisers to ask whether a change of the state or territory in which their business is organized, and/or a change in their form of organization (with no change in control) raises a succession issue. "Whether an adviser may rely on the succession rules depends on the particular facts and whether a new legal entity is created," the staff said.

An adviser that changes its form of organization, legal status, or composition of its partnership, without a change of control, would choose the "succession by amendment" method, the guidance states. The reason is that "a change of the place of incorporation from one state to another and/or a change in the form of business … results in the dissolution of the previous organization and the de facto creation of a new legal entity that has taken over the business of the previous organization."

This would also be the case in circumstances without clear guidance from the SEC, when "it is less clear whether an entity has dissolved and a new legal entity has been created," the staff said. In such situations, the question of dissolution would fall under state law; if state law deems that a dissolution has occurred, the "succession by amendment" would again be the way to go, assuming there is no practical change in control or management.

If, however, there has been both a dissolution and a practical change in control or management, the new legal entity would have to file a "succession by application."

Change in control

The guidance here addresses whether the transfer of a controlling block of a registered adviser's securities to a new owner or owners, or a change in leadership, raises succession concerns. The situations referred to in regard to this question do not involve an unregistered entity acquiring or assuming substantially all of the assets and liabilities of a registered adviser, nor do they involve changing the adviser's type of legal entity, such as a limited liability company.

A successor provision typically would not be needed in this situation, the guidance states. The adviser would simply need to amend its Form ADV to show the new ownership on Schedules A and B, and answer "no" to the succession question in Item 4. The staff also suggested that the adviser should consider providing an explanation in the miscellaneous section of Schedule D for the benefit of staff examiners, as well as for the adviser's clients.

However, if the new controlling party either causes an unregistered separate or new legal entity to acquire or assume substantially all of the registered adviser's assets and liabilities and continue the adviser's business, or changes the registered adviser's form of legal entity, then "the acquiring or resulting adviser must register and may do so by filing a 'succession by application,'" the guidance states.

Change in ownership

Do minor changes in control trigger succession concerns? The level-of-ownership change necessary to raise the question of whether predecessor registration issues must be addressed is what the IM staff attempts to answer here.

"A change in ownership of an adviser, by itself [emphasis SEC], does not implicate successor concerns, even if the change in ownership results in a change in control of the adviser," the guidance states. "Changes of ownership would need to be reported in an amendment to the adviser's Form ADV if the changes would alter the answers on Schedules A or B or other parts of the Form ADV."

Partial purchase

Can an adviser rely on the succession provisions if it purchases a portion, but not substantially all, of a registered adviser's business? This question comes up when a registered adviser's client list or a portion of the advisory business, but not its assets and liabilities, is purchased by an unregistered entity.

The IM staff's answer here is negative. "Despite continuity in advisory services to the clients of the prior adviser, the purchaser is not acquiring or assuming substantially all of the assets and liabilities of the registered adviser, and thus, the purchaser is not entitled to rely on the successor provisions. Instead, it must wait until its own registration with the SEC (or state, if applicable) becomes effective before engaging in business as an investment adviser."

Internal reorganization

Here the guidance addresses questions regarding a registered adviser that undergoes an internal reorganization or restructuring in which an unregistered entity acquires substantially all of the assets and liabilities of the registered adviser, which is owned by the same parent corporation.

If such an acquisition occurs, and if the unregistered entity continues the business of the registered adviser (and the registered adviser ceases its advisory activities), "the unregistered adviser may rely on 'succession by amendment' provided that the unregistered entity continues to be wholly owned by the same parent corporation," the guidance states.

The unregistered entity may not rely on "succession by amendment," the agency staff states,"if there has been a change in the control of the unregistered entity." Instead, the unregistered entity would be required to file its own registration application and may rely on the "succession by application" method.

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Published by:
ACA Compliance Group
(301) 495-7850
(301) 495-7857 (fax)
service@acainsight.com

Editor/Publisher:
Robert Sperber
(301) 502-8718
rsperber@acainsight.com

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subscribe@acainsight.com
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Customer Service:
(800) 508-4140
service@acainsight.com

On the Web:
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