The SEC's Focus on Value-Added Investors

Private fund managers' controls with respect to MNPI

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Staff at the U.S. Securities and Exchange Commission ("SEC") have long been concerned about new ways that financial firms can become exposed to material nonpublic information ("MNPI"), which can lead to insider trading. Particularly with respect to investment advisers, regulators view contacts with other industry participants as potentially ripe for the transmission of MNPI. An investment adviser's contacts with experts from expert networks, officials at publicly traded companies, and counterparts at other buy-side firms (typically within the scope of an adviser's research and investment process), have long been within the SEC's focus.

Examination staff often request a copy of a fund manager's policies and procedures relating to value-added investors — what are they looking for and how can a manager be prepared? They also ask managers to identify their value-added investors. This article explains the genesis of the term and provides practical suggestions for meeting examination expectations and protecting your firm.

Before the government's attention turned to a series of high-profile insider trading cases against hedge fund managers using expert networks, examination staff began inquiring into firms' relationships with investors in their funds who were also affiliated with public companies. The examination staff labeled them as "value-added investors" ("VAI") because they viewed them as potentially providing a conduit for insider information to the fund managers who would then use such information for the benefit of client funds and their investors, including the insiders. After taking a back seat to expert networks, these types of investors have once again become a focus of regulators.

The term "value-added investors" is not defined under the Investment Advisers Act of 1940 ("Advisers Act") or elsewhere in the federal securities laws. Generally speaking, the term can be understood to cover those fund investors who are corporate officers or directors of public companies, private fund executives, or brokerage executives. Examination requests regarding VAI referto individual investors, not financial institution investors.

It is important to identify those investors who have invested in a fund because of their relationship with the portfolio manager or other investment professionals. Oftentimes these investors speak more frequently with the firm's portfolio managers than other investors, and exchange information. On the other hand, there are insiders who invest in a portfolio manager's fund for reasons unrelated to the identity of the portfolio manager and do not communicate with the firm's investment professionals outside of normal dialogue and reporting. However, the examination staff often do not seem to consider whether private fund managers actually derive additional value from such investors in determining whether additional controls in this area are warranted. There is oftentimes an assumption that private fund managers will have MNPI controls in place with respect to VAI regardless of whether they contact VAI as part of their research or investment process.

Section 204A of the Advisers Act requires that every investment adviser "establish, maintain, and enforce written policies and procedures reasonably designed" to prevent the misuse of MNPI. It is on that basis which examination staff will review the sufficiency of a private fund manager's compliance program with respect to VAI. At the start of an examination, the examination staff will typically request, among other documents and information, a list of investors in each fund along with their capital account values on different dates during the relevant period. The examination staff will also request a list of all VAI. The staff will compare the two lists and run searches on the individual investors who were not identified in the VAI list. To the degree they identify any investors they believe should have been included in the VAI list, they will send follow-up requests asking why such investors were excluded from the VAI list.

Examination staff also will review a private fund manager's Code of Ethics and Insider Trading Policies to see if they maintain a separate VAI policy and if such policy includes a periodic review of investors to determine if any changes occurred which would cause them to be categorized as VAI. Examiners will also review a private fund manager's electronic communications monitoring and fund-trading backtesting to confirm whether risks related to VAI are addressed by the private fund manager's compliance program. To the degree these policies or controls are not in place, the examination staff may include in a deficiency letter that such an adviser does not have reasonably designed policies and procedures to prevent and detect the misuse of MNPI under Section 204A of the Advisers Act.

There are several steps private fund managers can take to enhance their compliance programs with respect to VAI, and prepare for examination requests in this area:

- Maintain a VAI inventory. Keeping an accurate list of VAI is the first step in building compliance processes around this issue. Without a current list, any monitoring or testing will be incomplete. While fund subscription documents require investors to provide some background information with respect to such investors' ability to receive new issue securities, and certain disclosure about their financial industry ties, typically this information is not required to be updated if it has changed. Private fund managers can use subscription documents as a starting-off point to identify VAI, but augmenting a review of subscription documents with internet searches will likely give a private fund manager more insight into which of their investors are VAI. Private fund managers should also keep in mind that their investors' employment status and affiliations with public companies or financial firms are not static, and so refreshing their VAI list on annual or other periodic basis is warranted. Refreshing the VAI list should incorporate new internet searches about investors' financial industry or public company affiliations.

- Understand investment professional contacts with VAI. While it may not be a firm's standard practice to speak with investors as part of the research and investment process, many investment professionals do. Compliance teams should have periodic discussions with investment professionals to confirm whether and to what extent they have communicated with any VAI regarding the research or investment process. This will give compliance teams more information with which to conduct the electronic communications and trading reviews described below.
- Enhance electronic communications monitoring. Whenever the examination staff identifies a new risk, they expect advisers to enhance their electronic communications reviews with respect to that risk area. The perceived risk related to VAI is no exception. Private fund managers should consider incorporating as part of their electronic communications reviews, communications between investment professionals and identified VAI. Existing email reviews can be augmented to account for communications with VAI or separate thematic reviews related to VAI can be conducted to bolster existing electronic communications reviews. VAI-related electronic communications reviews should also, as described below, be conducted together with reviews of fund trading in securities of companies which are affiliated with VAI.
- Review fund trading and follow up appropriately. To the degree an adviser has any VAI in the funds it manages who are corporate officers or corporate insiders of public companies, advisers should review fund trading in the securities of those companies. Such reviews should reconcile fund trading with any relevant news, and electronic communications around the time of the trading with VAI. Documentation of such reviews, reconciliations and any follow-up actions should be maintained.

Increasingly, examination staff expect private fund managers to address VAI in their compliance program regardless of the degree to which investment professionals communicate with investors as part of their research or investment process. Private fund managers would be well served to understand and address the perceived risks of VAI. **THFJ**