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Research

What Fund Managers Need to Know About Corporate Access: Six Front-End Controls to Manage the Risk of Inadvertently Receiving MNPI (Part Two of Three)

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By Kara Bingham, *Hedge Fund Law Report*

Fund managers have adopted stringent controls around their investment team members speaking with industry experts and political consultants, but when it comes to speaking directly with officers and executives of publicly traded companies – frequently referred to as "corporate access" – the consensus around best practices has been slower to develop.[1] This second article in our three-part series discusses how advisers can design policies to minimize the risks associated with these meetings, as well as six front-end controls that advisers should consider adopting. The first article provided an overview of the context in which meetings between fund managers and issuers arise; the goals of corporate access; the ways brokers are compensated for facilitating these meetings; and two key legal risks presented by this practice. The third article will analyze several testing mechanisms that managers can use to ensure compliance with their policies governing corporate access, as well as the SEC's expectations regarding an adviser's oversight, controls and procedures related to communications with executives at publicly traded companies.

See our two-part series on mitigating insider trading risks: "Relevant Laws and Regulations; Internal Controls; Restricted Lists; Confidentiality Agreements; Personal Trading; Testing; and Training" (Sep. 27, 2018); and "Expert Networks, Political Intelligence, Meetings With Management, Data Rooms, Information Barriers and Office Sharing" (Oct. 11, 2018).

Building Out Corporate Access Policies

When designing policies and procedures to prevent trading on inside information, fund managers should begin by identifying their potential sources of material nonpublic information (MNPI), explained Tom Hardin, founder of Tipper X Advisors LLC and a former long-short equity analyst focused on the technology sector. Corporate access involves communications between a fund manager's investment personnel and executives at publicly traded companies – including a company's chief executive officer, chief financial officer, investor relations personnel and other officers (collectively, Issuer Management) – and thus is a potential source of potential MNPI.

Advisers will next need to consider where to document those policies and procedures. Some advisers have elected to adopt standalone policies around corporate access, while others address it within their insider trading policies, explained Michael W. McGrath, partner at K&L Gates.

The policies and controls around corporate access should be designed to address the potential risk posed by the practice – namely, the disclosure of MNPI by Issuer Management to a member of the adviser's investment team. Advisers should adopt controls designed to prevent their investment personnel from inadvertently receiving MNPI during discussions with Issuer Management. Those policies will also need to clearly set forth the steps employees should take if they believe they have potentially been exposed to MNPI.

When building out compliance policies and procedures, an adviser should first consider its organizational culture, advised Beth Haddock, CEO and founder of Warburton Advisers. The adviser's chief compliance officer (CCO) will need to think long and hard about what policies will work for his or her organization. In most cases, simply prohibiting these types of meetings will not be a viable approach, as employees are likely to circumvent an absolute prohibition.

"It is also difficult to adopt a facts-and-circumstances approach to corporate access," Haddock continued. "Policies that require the CCO to decide on a case-by-case basis the controls to apply to each corporate access interaction are difficult to manage," she noted. Thus, CCOs will need to strike the right balance between which communications:

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1. are prohibited because they are too high-risk;
2. are subject to the procedures and controls set forth in the adviser's policies; and
3. require pre-approval by the firm's CCO.

Corporate Access Front-End Controls

"We are starting to see more controls being adopted by fund managers in this area," explained Danielle Joseph, director at ACA Compliance Group (ACA). In ACA's 2017 compliance survey, 40 percent of manager respondents indicated that they did not have controls in place for employees who speak directly to senior executives at public issuers, she observed. This figure dropped to 27 percent of respondents in ACA's 2018 compliance survey.

When deciding which controls should govern communications with Issuer Management, advisers often start by considering the controls that have developed around communications with expert networks, explained David I. Miller, partner at Morgan Lewis and former Assistant U.S. Attorney in the Southern District of New York. Four key controls that Miller often suggests to his fund manager clients in connection with expert networks include:

1. chaperoning at least some percentage of those calls;
2. requiring analysts to provide upfront warnings to the expert that they cannot receive MNPI;
3. encouraging analysts to take copious notes during the conversation and ultimately providing those notes to compliance or legal; and
4. providing the analysts with regular training on avoiding the receipt of MNPI.

While many of these controls have equal applicability in the corporate access context, some fund managers have elected to impose less stringent controls in connection with meetings with Issuer Management. This may be due in part to the fact that, historically, some managers have relied upon the fact that the issuer is subject to Regulation FD, Joseph noted. "The development of controls in the corporate access context will likely be more reactive," she observed, noting that "when we see the SEC come down harder on this issue, we will likely see controls in this area become more mainstream."

Additionally, applying some of the controls that have developed around expert networks to meetings between investment personnel and Issuer Management may prove logistically difficult or awkward. For example, some managers may feel strange bringing their CCOs along to chaperone meetings with Issuer Management, remarked Joseph.

Advisers typically adopt a combination of controls, largely dependent upon how acute they view the risk of receiving MNPI in the corporate access context, observed McGrath.

Some of the more common controls that managers should consider adopting are the following:

1) Tracking Communications With Issuer Management

"Most of the fund managers that I work with that communicate with Issuer Management are tracking those calls and meetings," Joseph explained. This is consistent with the 2018 ACA compliance survey results, which indicated that 41 percent of fund manager respondents that permit direct communications with senior executives of public companies formally track those meetings.

From an operational perspective, fund managers typically track this information either in spreadsheets, on centralized calendars or through software programs, Joseph explained. Regardless of what method is used, the manager's policies typically require the investment team member that is communicating with Issuer Management to log the communication. The CCO would then have access to that data so he or she can conduct testing around it, she added.

Basic data points that the manager should consider tracking include:

- the name of the employee who spoke with Issuer Management;
- the name of the member of Issuer Management with whom the analyst or portfolio manager is speaking;
- the name of the company that Issuer Management works for;
- the date and time of the communication; and
- whether the communication was facilitated by a sell-side broker and, if so, the name of that broker-dealer.

Other data points that CCOs may want to collect around these communications include: (1) whether the member of Issuer Management is routinely investor-facing; and (2) how long the member of Issuer Management has worked for the company, Hardin added. Experienced personnel who routinely interact with investors are more likely to be well trained in terms of complying with Regulation FD and avoiding the inadvertent disclosure of MNPI.

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While spreadsheets and calendars appear to be the most common methods used to track this data, there are some benefits to investing in a software program designed to document these interactions. Certain software programs allow not only employees of the fund manager to log their communications and meetings with Issuer Management but also permit sell-side brokers to enter information concerning the corporate access events that they facilitate for their buy-side clients, explained Adam J. Reback, partner and CCO at J. Goldman & Co., L.P.

Another consideration with which CCOs will need to grapple is whether to require analysts to report these communications and meetings in advance. By having this information ahead of time, CCOs can review the data for higher-risk communications, Hardin explained, which may warrant additional scrutiny and controls. One drawback, however, of requiring investment personnel to report this information in advance is that it could be viewed as disruptive to the research process.

2) Documenting Communications With Issuer Management

In addition to logging these communications, some fund managers have elected to go a step further and require their investment team members to document in writing the substance of their communications with Issuer Management, McGrath noted. From Miller's point of view, it is "essential that analysts document what they hear, take good notes and then ultimately provide those notes to the adviser's compliance and legal teams."

"Ideally, analysts upload their notes to the fund manager's research management system the same day that the communication occurred," Hardin suggested. He also emphasized that the substance of the notes is important, adding that analysts should not only accurately memorialize what was said by Issuer Management in those meetings but also the analysts' inferences from what was said.

In Joseph's experience, most fund managers do not require their analysts to document in writing the substance of these meetings, but she did note several key benefits to documenting the content of these discussions. First, notes taken contemporaneously with a meeting can be used to demonstrate the information that was provided during the meeting or call. Compliance officers can also review these notes after the fact in an attempt to determine if any MNPI was conveyed during the conversation, she added. Additionally, the SEC may ask advisers for information to substantiate their investment recommendations; thus, analysts' notes from corporate access meetings may be used to support investment recommendations. "If the investment team is taking notes that are instrumental to any investment decision, those notes need to be maintained as part of the research file," she concluded.

3) Warnings Against Receiving MNPI

Warnings against receiving MNPI are one of the most common controls adopted by fund managers, McGrath explained. These warnings are typically read from a script by the analyst at the beginning of the conversation and generally consist of an admonishment by the analyst that he or she does not want to receive MNPI, as well as an express request that the member of Issuer Management not disclose any MNPI during the communication.

Providing this admonition in the conference setting where a member of Issuer Management is addressing dozens, if not hundreds, of investors is often problematic, however. Miller noted that the provision of this admonition is more relevant in one-on-one or small-group meetings. "To the extent that executives from the issuer begin to talk about their own company, then the analyst should make every effort to express the caveat that he or she cannot receive MNPI," he noted.

Acknowledging that it may be awkward for an analyst to give this warning in a meeting, Miller explained that this is where the training provided by the fund manager becomes critical. "When analysts feel that the conversation is veering to an inappropriate place, they should have enough training to steer the conversation away from that information or clearly communicate to Issuer Management that they cannot receive MNPI," Miller added.

4) Chaperoning Communications With Issuer Management

"Although it is still fairly uncommon, we have observed some managers implement a chaperoning program in the corporate access context," Joseph explained. ACA's 2018 compliance survey also suggests that this practice is gaining momentum, with 24 percent of respondents reporting that they periodically chaperone corporate access calls and meetings, compared with just 17 percent of respondents identifying this as a control in the 2017 compliance survey.

One key factor preventing some managers from chaperoning corporate access communications is a lack of resources, Reback explained. About a decade ago, however, the notion of chaperoning calls with expert networks was also met with resistance, he noted. Nevertheless, the SEC expressed its view that communications with experts should be chaperoned; thus, many advisers conformed.[2] Notably, the SEC has not yet publicly advocated for chaperoning in the corporate access context.

Another challenge in chaperoning these communications is that it can be disruptive to the investment research process. Expert network meetings tend to be pre-planned, but in many cases, calls with Issuer Management are not, Reback explained. "In some instances, there is action in the market and the analyst wants to call the issuer and see what is going on. In order to chaperone these calls, the compliance officer would have to drop what he or she is doing to join," he remarked.

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One potential solution to this challenge would be to require analysts to submit their management call lists ahead of time, Hardin suggested, although this control would need to be flexible enough to account for material movements in markets and other extenuating circumstances. "One key benefit to compliance officers reviewing a call list in advance is that they can potentially identify higher-risk communications that they may want to chaperone," Hardin noted.

For managers that want to implement a chaperoning program, one option to consider would be a risk-based approach. There are several factors that may deem certain communications and meetings higher risk than others. For example, when corporate access communications are facilitated through sell-side brokers, the compliance departments of those brokers typically vet the members of Issuer Management with which their analysts are speaking and periodically attend those meetings to ensure that no MNPI is being conveyed, Reback explained. Thus, corporate access events facilitated through sell-side broker-dealers may be viewed as lower risk.

Another factor to consider is whether the member of Issuer Management routinely speaks with investors, as well as the seniority of that individual, noted Hardin. Experienced, investor-facing executives are more likely to be well trained on how to comply with Regulation FD, which prohibits companies from selectively disclosing material information.

Finally, larger meetings and conferences tend to present fewer risks for fund managers than smaller meetings, remarked Miller. Joseph agreed, noting that "one-on-one meetings appear to present the greatest risk of receiving MNPI, as opposed to meetings that occur in larger group settings." Thus, she has seen some managers apply more controls in the one-on-one context.

See our three-part series on chaperoning research calls: "Should Hedge Fund Managers Chaperone Primary Research Calls?" (Sep. 17, 2015); "Considerations in Implementing a Chaperoning Program" (Sep. 24, 2015); and "Challenges in Implementing a Chaperoning Program" (Oct. 1, 2015).

5) Require Employees to Report Receipt of MNPI

It is standard practice for insider trading policies to require employees to report to the fund manager's CCO – or his or her designee – if they think they have potentially been exposed to MNPI, McGrath explained.

It is important to note, however, that this control – *i.e.*, the duty for employees to self-report the receipt of MNPI – in and of itself, is not likely to be viewed as sufficient by the SEC to meet the adviser's obligation under Section 204A of the Investment Advisers Act of 1940 (Advisers Act). Section 204A requires advisers 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, nonpublic information by such investment adviser or any person associated with such investment adviser."

In a 2016 enforcement action brought against Artis Capital Management, L.P. (Artis), the SEC alleged that respondent Artis and one of its senior analysts failed to supervise an analyst who provided them with MNPI. The SEC noted that if the nature of a particular "investment adviser's business exposes employees to persons in possession of material nonpublic information on a regular basis, a general policy that those employees self-evaluate information they receive is insufficient to comply with . . . Section 204A of the Advisers Act." Thus, requiring employees to self-report the receipt of MNPI is a good control to have, but it cannot be the adviser's only control when it comes to policies and procedures designed to prevent insider trading.

See "General Insider Trading Policies and Procedures May Be Insufficient for Hedge Fund Managers to Avert SEC Enforcement Action" (Nov. 3, 2016).

6) Training

Training is critical to prepare members of the investment team for the various scenarios they may encounter when communicating with Issuer Management. When developing their training materials, Reback recommended that CCOs consider reviewing with investment personnel red flags that may arise during communications with Issuer Management that should cause them concern.

"Realistic hypotheticals are one of the best tools available to CCOs to train their investment personnel," Hardin noted. For CCOs that are unable to develop examples to which their analysts and portfolio managers can relate, he suggested that the CCO collaborate with a member of the investment team that is supportive of the compliance function to develop hypotheticals that mimic real-life events.

Training also provides compliance officers with a key opportunity to remind the investment team of the types of communications and meetings that fall within the adviser's policies and procedures governing corporate access, explained McGrath. For example, an analyst may attend a social event and meet an executive from an issuer that proceeds to discuss his or her business. Given that this interaction arose in a social context, the analyst may not remember to report this meeting to compliance, but the analyst may very well receive the same information that he or she would otherwise have received in an organized meeting.

"Training provides the CCO with an opportunity to remind the adviser's personnel that situations may arise where it may not be possible to implement the adviser's formal corporate access procedures, yet employees still have an obligation to understand the fundamental issues and risks associated with potentially receiving MNPI," remarked McGrath. He also noted that appropriate lines of communication between investment personnel and compliance need to remain open so that when an inadvertent encounter does arise, the analyst or portfolio manager feels comfortable discussing the issue to compliance.

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Finally, Haddock explained that people engage in insider trading because they think that "everyone else is doing it and this is how you get your edge. They don't think of it as illegal behavior because they don't see a victim." Thus, training is the best way to address those rationalizations.

For more on training, see "What Fund Managers Can Learn From 'Tipper X': Best Practices for Preventing and Detecting Insider Trading (Part One of Two)" (Jul. 13, 2017).

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[1] For purposes of this article series, unless the context suggests otherwise, the term "corporate access" will broadly encompass the practice of meetings between Issuer Management and investment personnel facilitated by sell-side brokers, as well as communications between those two groups that are initiated directly by a member of the fund manager's investment personnel.

[2] *See* "Remarks at the IA Watch Annual IA Compliance Best Practices Seminar," Carlo V. di Florio (Mar. 21, 2011) (stating that "I am not suggesting that advisers must avoid using expert networks, but that they should address any increase to their compliance risks that expert networks may pose, and build appropriate controls around information obtained from expert networks, at both the front end and the back end. . . . It might mean having, at least occasionally, 'chaperoned' conversations -- that is, a compliance person is a silent listener to the conversation between the expert and the adviser's money manager/analyst.").

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