Reducing Insider Trading Risk at Hedge Fund Advisers

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Andrew Vollmer, a partner in the WilmerHale Securities Litigation and Enforcement Group, recently published an article entitled "How hedge fund advisers can reduce insider trading risk" in the *Journal of Securities Law, Regulation & Compliance*, Vol. 3, No. 2, page 106 (2010). Vollmer was Deputy General Counsel of the Securities and Exchange Commission from 2006 until early 2009.

The article discusses some of the approaches that hedge fund managers use to prevent insider trading violations. They include avoiding agreements to keep information confidential and giving heightened attention to business communications between hedge fund personnel and close family members or personal friends. The article also describes the many legitimate reasons that analysts at money managers have to communicate in private with senior management of public companies and ways hedge fund advisers can police the insider trading risks associated with those communications.

In this excerpt, the article describes a common situation that could mistakenly create a record that an adviser agreed to keep information confidential (footnotes omitted):

> Third parties often seek to interest hedge funds in securities transactions that have not been publicly announced. Examples include a private investment in public equity (PIPE), an offering of convertible bonds, or a debt restructuring. Information about the transaction is often material and could have a non-trivial effect on the market price of related securities if publicly disclosed.
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> Agents for the potential offeror, usually a broker-dealer, need to check the market for interest in the transaction. One appropriate way for them to do that is to obtain a confidentiality agreement from the hedge fund before revealing key information that could be material, but some broker-dealers are not as careful as they should be. Before obtaining a confidentiality agreement, they can reveal too much information, such as the name of the issuer, the type of transaction, or even preliminary price terms.
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> Broker-dealers also sometimes take an additional step before a hedge fund agrees to

confidentiality. They send an uninvited email with information about the transaction and an attachment containing details. The broker-dealer might feel safe in doing so because the detailed attached documents typically say the information is confidential, the information is to be used solely to evaluate the proposed transaction, and the recipient agrees to these terms.

This pattern of events can put the careful hedge fund manager at risk and force a decision on whether trading should be restricted. The hedge fund possibly has material, non-public information, and it has documents labelling the information as confidential and stating that the recipient agreed to keep the information confidential.

On the other hand, in the manager's mind, the hedge fund has deliberately not agreed to keep any information confidential. The manager should not be found to have a duty by agreement because one person may not unilaterally impose a confidentiality agreement on another. Volitional acceptance is needed. Equally, the disclosure should not be seen as a tip. The broker-dealer is not, and in the typical case does not appear to be, breaching a duty when communicating about the possible transaction with the hedge fund – just the opposite. The broker-dealer is doing its job to identify interest in the transaction and possible buyers. The communications are authorised and encouraged by the issuer and, absent unusual facts, do not indicate otherwise.

The difficulty is that evidence about the broker-dealer's first call or email to the adviser's employee might be lost, ambiguous, or self-serving. A law enforcement agency might suspect an express or implied agreement, and a court might infer an agreement. One prominent insider trading case turns in part on whether a large shareholder, during the course of one telephone call, orally agreed to keep information about a PIPE confidential.

The article then discusses several methods to reduce these risks. They include periodically notifying potential counterparties and their agents that the adviser does not want to receive unsolicited information about possible deals and, when feasible, creating a procedure within the adviser to direct all communications about possible investment opportunities to a person in an area walled off from trading decisions.

Read the full text of the article, How hedge fund advisers can reduce insider trading risk.