Hedge Fund Operational Due Diligence Education Series- Understanding Material Nonpublic Information in the United States

With the recent raids of the offices of three hedge fund managers by the Federal Bureau of Investigation and the on-going prosecution of Raj Rajaratnam's Galleon Group, cracking down on allegedly illegal insider trading is clearly on the forefront of the U.S. government's financial regulatory agenda. Traditionally, many investors have equated the use of material nonpublic information with boiler room insider trading rings and back room corporate tipsters. However, many investors may not realize the numerous ways in which perfectly legitimate hedge funds during the course of daily business may come into contact with, either directly or indirectly, data which could be potentially classified as material nonpublic information.

Hedge funds may receive material nonpublic information inadvertently (i.e. - an unsolicited fax comes into the firm with questionable insider information or a hedge fund receives an unsolicited email offering material nonpublic information[1]). Alternatively, a hedge fund manager may be directly exposed to such information during the course of otherwise perfectly legal investment research. This can sometimes happen when a hedge fund makes use of third-parties to provide research or perspective on a specific industry or company. In recent years, an industry has blossomed of so-called *expert networks* or *consultant networks* which effectively provide a matchmaker service between industry or company experts and hedge funds.

Expert networks often make the experts agree in advance that they will not disclose material nonpublic information. However, the firms which manage these expert networks themselves are rarely, if ever, on the call to ensure that the disclosure of material nonpublic information takes place. Indeed, even if such information was disclosed it may be difficult for someone without specific knowledge of an industry or company to detect what information is both *material* and *nonpublic* in the first place. It is within this nuanced legal gray area, between legal investment research and material nonpublic information, that the U.S. government, hedge fund managers and investors performing operational due diligence on hedge funds must navigate while at the same time balancing considerations of maintaining a hedge fund's competitive advantage versus blatant disregard for the law.

The United States has a long history of case law which provides guidance with regards to liability, particularly for those with fiduciary obligations, for trading on material nonpublic information.[2] In 2000, the SEC codified rules prohibiting the uses of material nonpublic information under SEC Rule 10b5-1 and Rule 10b5-2. Depending on a hedge fund's interaction with material nonpublic information a number of defenses may be invoked when allegations of wrongdoing are brought. These defensive include an affirmative defense for pre-planned trades (the so-called 10b5-1 loophole), use of mosaic theory, a lack of awareness that the hedge fund traded on material nonpublic information, use of information barriers, and the implementation of reasonable policies and procedures to prevent trading on material nonpublic information.

[1] *See*, Bonnie Hoxie's Hot Tips (http://hedgefundoperationalduediligence.com/bonnie-hoxies-hot-tips-disney-insiders-hedge-fund-secrets)

[2] *See, e.g.*, United States v. Carpenter, *484 U.S. 19* (1987); *United States v. O'Hagan*, 521 U.S. 642 (1997).

Investor Operational Due Diligence Considerations For Hedge Funds and Material Nonpublic Information

During the operational due diligence process investors should ask hedge fund managers a number of questions in order to diagnose both a fund's potential exposures to the risks associated with material nonpublic information, as well as what preventative measures, if any, a hedge fund may have taken to insulate themselves for the liability associated with receiving or trading on such information. Specifically, the types of questions which can be asked include:

Use of Expert Networks:

- Does your hedge fund make use of third-party expert networks?
- If Yes:
  - Which expert networks are utilized?
  - How frequently are they used?
  - Has the hedge fund vetted the procedures in place, if any, at the expert network to prevent the transmission of material nonpublic information?
  - Has the hedge fund proactively communicated that they do not wish to receive material nonpublic information to expert networks?
  - Is the hedge fund's internal compliance department involved in providing training to analysts with respect to what material nonpublic information is and associated relevant trading restrictions?
  - Is compliance involved in random audits of interaction between a hedge fund's analysts and experts?
  - Are any restrictions in place with regards to what kind of experts may be spoken to?
  - Does the firm have a system in place to track all interactions with such expert networks including which firm's and industries were discussed?

Other Third-Party Firms Which Provide Information:

- Does your hedge fund receive trading ideas or supplementary market intelligence from any other third-party sources such as smaller niche brokers?
- If Yes:
  - What types of information does your hedge fund receive from these sources?
  - In the case of smaller niche brokers, does the hedge fund typically steer certain trades through these brokers in exchange for deal flow?
  - What procedures are in place, if any, to ensure a broker does not transmit material nonpublic information?

Internal Hedge Fund Procedures:

- Does your hedge fund have any explicit policies with regards to material nonpublic information? (i.e. - in the compliance manual or code of ethics)
- Has the hedge fund performed any training for employees with respect to material nonpublic information?
- Does compliance perform any testing or historical trade analysis to track potential uses of material nonpublic information?
- In the event the hedge fund may come into contact with material nonpublic information does the firm maintain a clear procedure as to what employees should do? Sample action steps could include:
  - Procedures to report the source of information and nature of information to compliance;
  - Implementation of both a restricted list and blackout periods for trading in such information (perhaps both for the firm's fund's and personal account dealing)

A comprehensive operational due diligence review should provide investors with an understanding of a hedge fund's exposure to material nonpublic information. The Corgentum operational due diligence review process provides investors with a comprehensive review of the operational strengths and weaknesses associated with each hedge fund manager including exposure to the risks associated with material nonpublic information. Corgentum Consulting is the preeminent provider of the industry's most comprehensive hedge fund operational due diligence reviews for investors.

For More Information

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