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ACA Insight

The weekly news source for investment management legal and compliance professionals

"It will take a couple of years before we can say whether *Newman* will have had a profound impact of the law, or was instead just part of its ebb and flow."

Inside Insights

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Insider Trading: High Court's Refusal to Review Leaves Uncharted Path Forward

The U.S. Supreme Court's refusal to review a lower court ruling that redefined insider trading creates an uncertain legal world. Defense attorneys and their clients may take comfort from the higher hurdles some prosecutors may now have to jump over to bring such cases, but all parties will need to get used to a new playing field as practice takes hold.

The Supreme Court on October 5 chose, without comment, not to review the December 2014 decision by the U.S. Court of Appeals for the Second Circuit that tossed out the insider trading convictions of two hedge fund managers, **Todd Newman** and

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Dissent: Backtesting Requirements Should Not Be Set by Commission Opinion

How do you define performance backtesting in advertising? Not through a Commission Opinion on an enforcement appeal, according SEC commissioners **Michael Piwowar** and **Daniel Gallagher**.

The two commissioners on October 2 dissented from a September 3 Commission Opinion that upheld an administrative law judge's ruling against an adviser accused of providing fraudulent misrepresentations to prospective clients. Gallagher and Piwowar found much of the Opinion acceptable, but apparently saw red when

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Personal Trading: Take Steps to Detect and Prevent

Chief compliance officers need to monitor personal trading. It can be difficult to do, but it can be done.

Improper personal trading typically occurs in the context of either insider trading, when an employee trades based on material non-public information, or when an employee uses client information to trade to his or her benefit.

Personal trading is covered by Advisers Act Rule 204A-1, the Code of Ethics Rule. Among other things, the rule requires that registered advisers establish, maintain

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Insider Trading

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Anthony Chiasson. The Department of Justice this past July had filed an appeal with the top court, asking that the lower court decision be reversed – but the Supreme Court's refusal to take up the request means that Justice Department prosecutors will need to live within the confines of the Second Circuit ruling.

"My suspicion is that it will take a couple of years before we can say whether *Newman* will have had a profound impact of the law, or was instead just part of its ebb and flow," said **Georgetown University** law professor **Donald Langevoort**. Investment advisers, he suggested, "should by no means take this to suggest that inside edges can be extracted with impunity."

Nor is this necessarily the end of the road. "It may just be a refusal to review right now," said **University of Michigan** law professor **Adam Pritchard**. "There will be plenty of opportunities down the road, and the Court may want to see how things develop in those cases."

The Second Circuit ruling, in addition to overturning the convictions of Newman and Chiasson, changed the definition of what constitutes insider trading in two critical ways:

- **What constitutes a benefit**. Under the Second Circuit ruling, a benefit received by a tipper would need to be quite tangible – more than simply friendship – for it to be considered a benefit given in return for material, non-public information. Previously, based on the landmark 1983 Supreme Court case of *Dirks v. SEC*, an insider providing inside information to a trading friend or relative without an expectation of something tangible in return was nonetheless considered to be receiving a benefit. That interpretation was at the heart of the Justice Department's appeal to the Supreme Court.
- **What a tippee knows**. The Second Circuit also ruled that there must be evidence to prove that a tippee knew he or she was trading on information obtained from an insider in violation of the insider's fiduciary duty. The Department of Justice did not challenge this part of the ruling, however.

"Many things will now happen," Langevoort said. "Courts of appeal outside of the Second Circuit will continue to offer their own opinions about the meaning of personal benefit and the standard for tipper-tippee liability. Even inside the Second Circuit, courts will have to address whether the standards for liability vary when the case is brought as a civil action by the SEC rather than by criminal prosecutors."

Zaccaro Morgan partner **Nicolas Morgan** said there is some uncertainty as to whether the *Newman* standard applies in civil SEC cases. "One indication that *Newman* does apply in SEC cases came earlier this year from one of the SEC's own administrative law judges when he concluded that the standard did apply," he said. "That said, the SEC Division of Enforcement has appealed that ALJ's decision and may take the opposite view in cases filed in federal court, so the issue may remain unsettled for some time until courts bring greater clarity."

"The SEC and Department of Justice likely are going to try to narrow Newman as much as possible," said **University of North Carolina School of Law** professor **Thomas Lee Hazen**. "It is unclear whether the holding that friendship alone is not sufficient can be limited to criminal cases with the higher burden of proof. Also, even in criminal cases there may be an attempt to narrow *Newman* to its facts where there was a remote tippee and the friendship may not have been more casual than close. Perhaps a showing of a closer personal friendship might have led to a different result."

The Supreme Court's refusal to review must be particularly stinging to U.S. attorney for the Southern District of New York **Preet Bharara**, who has built his career as a prosecutor in part on pursuit of insider trading by hedge funds. The appeal to the Supreme Court was his second attempt at review. An April 2015 appeal for review to the full Second Circuit also went nowhere, when the Second Circuit, like the high court, chose not to review.

Defense reaction

Attorneys defending against insider trading prosecution welcomed the Supreme Court development.

"By declining to consider the Second Circuit's well-reasoned decision, the Supreme Court's action reinforces

the clarity the *Newman* decision provides for insider trading cases and places appropriate checks on the prosecution of tenuous insider trading cases by zealous prosecutors," said Morgan.

Brown Rudnick partner **Alex Lipman** said that the primary result of the Supreme Court's refusal to review is that prosecutors will need to "put on more evidence of bad intent" when bringing insider trading cases. Prior to the Second Circuit ruling, prosecutors routinely based their charging decisions on their subjective view of whether a set of facts constituted insider trading. "Now they will have to look primarily at the objective facts," he said. "The government will need to put on objective evidence to prove that the sharing of information was for a bad purpose."

As a result, "the government is going to have a harder time proving the cases on the margins," he said. But he also is of the opinion that this will not mean fewer insider trading cases, as both the Department of Justice and the SEC will simply focus on developing additional facts needed to meet the new standards.

Advisers take note

Should investment advisers be more lenient in terms of monitoring for insider trading in their firms as a result of the Supreme Court not reviewing the Second Circuit ruling? Better think twice before taking such a course.

"If an adviser is in possession of information that he or she knows is material, non-public information obtained directly or indirectly from an insider, it's hard to imagine a chief compliance officer advising anything other than extreme caution in trading on that information," said Morgan. "To conclude, based on *Newman*, that it's okay to trade because the person providing the information did not receive a pecuniary benefit would be very aggressive advice, to say the least. Just because a legal theory would make an excellent defense at trial, permitting conduct that comes anywhere close to an ill-defined legal line is not advisable."

Advisory firms "should not change a thing" in terms of how they monitor for and detect insider trading, Lipman said. "I wouldn't relax."

Dissent: Backtesting Requirements

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the majority of commissioners, in their view, went too far and used the Opinion to state what backtesting in advertising requires.

"The Commission majority has taken a relatively straightforward set of facts and needlessly engaged in 'rulemaking by opinion,'" Gallagher and Piwowar said. The dissent was one of the last acts taken by Gallagher, as October 2 was also his last day as a commissioner.

The Commission Opinion and the dissent revolve around an appeal of an ALJ ruling against adviser **Raymond J. Lucia Companies** (RJLC) and it owner, **Raymond Lucia**, Sr. The two were charged by the SEC with using slideshow presentations at multiple seminars in 2009 and 2010 to pitch an investment strategy in which they allegedly misrepresented performance in two backtests. The performance was misleading, the agency said, because, among other things, it used assumed inflation and real estate investment trust (REIT) rates "that did not reflect historical rates."

"The majority Opinion creates from whole cloth specific requirements for advertisements that include the word 'backtest,'" Gallagher and Piwowar said in their dissent. "Despite the lack of any statutory or regulatory definition of what constitutes a 'backtest,' the majority finds it fraudulent or deceptive practice if a backtest fails to use actual historical rates – even if the slideshow presentation specifically discloses the use of assumed rates for certain components."

An attorney representing RJLC and Lucia said that "While we are disappointed by the SEC's action, we take some comfort in the fact that several commissioners recognized that the Division of Enforcement's main argument simply does not hold up. Mr. Lucia looks forward to vindicating himself on appeal."

"This case illustrates the perils of using any form of hypothetical information, even if you make it clear that it doesn't represent actual trading results, as the respondents appear to have done," said **Sidley Austin** partner **Mark Borrelli**. "In the majority opinion, the SEC found that even though the respondents used disclaimers, the

materials that the respondents used created the false impression that they illustrated how the strategy would have performed under certain market conditions. According to the SEC, the materials did not correctly represent even this hypothetical standard."

"The Commission seems to announce a per se rule against using anything other than actual historical rates for backtesting even if the use of hypothetical rates are disclosed to prospective and actual investors," said **Mayer Brown** partner **Matthew Rossi**. "This is problematic, first because, as the dissent of Gallagher and Piwowar points out, there is no statutory or regulatory definition of backtesting, nor is there any express prohibition on the use of hypothetical rates if disclosed to investors and prospective investors."

"Second," he said, "in some cases, it is not clear what constitutes the 'actual historical rate.' In this case, for example, the experts did not agree on the 'actual historical' inflation rates, and REIT rates were not available for part of the hypothetical period in question. Nonetheless, the Commission called the respondent's assumptions – which were disclosed – 'flawed,' and found their use to constitute a fraudulent or deceptive practice. The takeaway for investment advisers is to avoid using assumed rates in any hypothetical model that could be construed as a 'backtest,' and to be cautious about choosing historical rates."

Backtested performance

The ALJ found that RJLC violated Sections 206(1), (2) and (3) of the Advisers Act by "misleading prospective clients about its Buckets of Money retirement wealth management strategy," the Commission's Opinion said. Specifically, the ALJ found that at seminars that RJLC and Lucia conducted to pitch the strategy, they "misrepresented that they had performed two backtests (one from 1966 to 2003 and another from 1973 to 1994) proving that a model portfolio following the Buckets of Money strategy during difficult historical market periods would substantially increase in value while also providing annual retirement income," according to the Opinion.

But those backtests were misleading, the Commission noted in summarizing the ALJ's findings, because RJLC and Lucia did not inform the prospective clients that the backtests:

- Used assumed inflation and REIT rates that did not reflect historical rates,
- Did not deduct advisory fees, and
- Did not actually follow the Buckets of Money strategy by "rebucketizing," meaning reallocating assets between "buckets" of portfolio assets.

Had RJLC and Lucia conducted the backtests based on actual historical inflation and REIT rates, as opposed to assumed rates, prospective investors would have been shown "their model portfolio exhausting its assets before the end of the backtest periods rather than substantially increasing in value," the ALJ found, according to the Commission. Perhaps most importantly, the ALJ found that the adviser did not inform prospective clients that actual backtesting was not used – a point that RJLC and Lucia, as well as Gallagher and Piwowar in their dissent, challenged.

The other charges that the Opinion upheld, such as the improper miscalculation of investment returns under the backtested models and failure to deduct advisory fees, were not challenged by any of the commissioners. Had the Commission made their determination on the other charges, "the Opinion would have been easy to support," Gallagher and Piwowar said.

In upholding the ALJ's ruling, a civil money penalty of $250,000 was levied on RJLC, and $50,000 on Lucia. In addition, Lucia was barred from the securities business, and both RJLC and Lucia had their investment adviser registrations revoked.

The dissent

In addition to their argument that the requirements for backtesting should not be established in a Commission Opinion but through rulemaking, Gallagher and Piwowar noted that the slideshow presentation used in the seminars disclosed the use of assumed rates for certain components.

"The majority opinion emphasizes the testimony of

witnesses at the slideshow presentations who thought that the backtests used actual historical inflation rates," they noted. "But the test for materiality is an objective, not subjective, test of the reasonable investor. Given the clear disclosure of the inflation rates assumptions in the slideshow presentation, we find that a reasonable investor would not have believed that actual historical rates of inflation were used in the backtests."

Further, Gallagher and Piwowar said, "It is appropriate to use a consistent, assumed inflation rate when comparing the results among portfolios. Moreover, we find troubling the majority opinion's holding that, notwithstanding the disclosure that the scenarios were determined using assumed 3 percent inflation, the slideshow presentation was nevertheless fraudulent because a backtest must use historical inflation rates."

RJLC and Lucia argued in their appeal of the ALJ ruling to the full Commission "that they explicitly told seminar attendees, through both the slides and the actual words spoken by Lucia, that they were presenting hypothetical illustrations using hypothetical assumptions," the Opinion said. "Respondents claim that the slides themselves 'specifically and repeatedly explained that '[r]ates of return are hypothetical in nature and are for illustrative purposes only' and that '[t]his is a hypothetical illustration and is not representative of an actual investment.' And respondents claim that Lucia, in presenting the slides, 'expressly informed seminar attendees that he was using *hypothetical, pretend, assumed [*emphasis SEC] rates of return.'"

The Commission did not buy it. "We find that such statements did not change the overall impression that respondents had performed backtests showing how the Buckets of Money strategy would have performed during the two historical periods," it said, noting that, in addition to using the word "backtest," the slideshow included questions like, "What would have happened if you retired in 1966?"

"The argument by the dissenting commissioners that the SEC is engaging in 'rulemaking by opinion' raises a larger issue as to the Commission's authority to develop new law in its rulings on enforcement actions," said Borrelli. "In the majority opinion, the Commission denies that it is creating a new rule for all advertisements that include 'backtests,' which is what the dissenters claim. Instead it says that it is just evaluating the respondents' use of the word 'backtest.' Interestingly, though, in addressing one of the respondents' arguments the Commission defended its right to establish new principles in the context of an opinion in an enforcement proceeding."

Stradley Ronon partner **Lawrence Stadulis** suggested that the SEC, in its Opinion, may not have been seeking to impose a new regulatory obligation on advisers. "It simply meant to convey the obvious, namely, that it is false or misleading for advisers to state or imply that backtested performance calculated and presented based on assumed inflation rates or market returns is 'actual' backtested performance," he said. "It wants hypothetical performance to be clearly labeled as such."

However, he said, "the reasoning set forth in the Opinion relating to this issue is susceptible to industry confusion. Of particular concern is the statement that a backtest must be based on data from a specific historical period and therefore can never be based on return or other assumptions. This is not consistent with any accepted industry definition of that term. In fact, backtested performance frequently is based on certain non-historical assumptions, such as those pertaining to assumed commission rates and advisory fees. In some cases, reasonable returns are assumed in the absence of any available contemporaneous market data."

"The SEC or its staff should clarify that this type of hypothetical backtested performance, which has been around for decades, is not false or misleading," Stadulis said.

Definition of the term

Part of the Opinion addressed the question of whether a backtest, by definition or at least by the understanding of most potential investors, means that actual rates from a historic period must be used. The Division of Enforcement brought forth expert witnesses who said their understanding is that a backtest uses real historic data.

Nonetheless, RJLC and Lucia argued that there was no established definition of "backtest" that prohibits the use of assumed rates. "Respondents contend that to base liability here on 'a firm definition not found in the securities laws,' would violate due process" by denying them fair notice of what is required, the Opinion said, and that doing so would "be an abuse of discretion by imposing 'regulatory changes through litigation' rather than rulemaking" – pretty much the same point Gallagher and Piwowar argued in their dissent.

But the Commission rejected this argument. "In finding liability, we need not define 'backtest' in all contexts, we just need to assess its use by respondents here. That use was in conjunction with other statements that misled seminar attendees to believe that respondents had analyzed how a model portfolio would have performed had it implement the Buckets of Money strategy in the past." ☙

Personal Trading

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and enforce a written Code of Ethics requiring access persons to submit quarterly reports on certain personal securities transactions and annual reports of securities holdings. It is important to keep in mind that the definition of "access person" includes any employee who has access to non-public information; the definition is not limited to only those employees who actually obtain non-public information, said **Day Pitney** counsel **Eliza Sporn Fromberg**.

Whether you decide to limit personal trade reporting to access persons or extend it to a wider group, the requirements mean that CCOs, depending on the size of the firm "might receive a few hundred reports each quarter, and it may not be realistic, given all a CCO has to do, to go through every one," said **Mayer Brown** attorney **Adam Kanter**.

Best practices

Fortunately, there are ways to handle the work flow and do an effective job of monitoring personal trades. Consider the following:

- **Ensure that personal trades are reported electronically.** If you are not doing this already – many firms are – consider doing so. Ask your brokers if they provide electronic feeds, said Fromberg. However, brokers sometimes will not provide electronic surveillance directly to advisers, so many advisers engage a third-party service provider to assist with this. It makes the compliance department's surveillance of personal trading much easier when compliance officers can filter and sort data, as well as search by individual names.
- **Review for more than what is on your firm's restricted list.** Many firms maintain a list of securities or companies for which, because of sensitive trading or other issues, personal trading is not permitted. While you certainly want to monitor for employees transacting in restricted securities, go beyond that in your searches and look for patterns of unusual activity, said Kanter. "Look for outliers. Who is doing more trading than normal? Was there a substantial amount of trading in one month and none the next? Is the security currently owned by a client or being considered for purchase by a client?" Fromberg suggested that firms "look for matches between employee trades and client trades," which she said might be understandable with widely traded stocks like Apple, but would raise more concerns with thinly traded stocks.
- **Require pre-trade clearance.** Consider pre-trade clearance for any personal transactions involving securities that clients are also trading in or considering trading in, said Kanter. "For instance, if a firm's bread-and-butter trading is in biotech stocks, some firms may require that all personal trades in biotech stocks be pre-cleared." Doing so, he added, may have the practical effect of stopping all personal trades in the area, as employees may simply find the process of seeking pre-clearance time consuming and too much bother. Fromberg noted that Rule 204A-1 requires pre-approval only for access persons' investments in IPOs and private placements, but suggested that firms consider requiring pre-clearance for personal trades by all employees.

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- **Establish blackout periods.** These prevent employees from trading in a particular security for a defined period of time before and after a client transaction involving that security is made. It may not always be possible, of course, to know several days prior to a client trade just what transaction for the client will be conducted, but firms should usually be able to establish a post-trade blackout period. The advantage of time restrictions is that they might prevent employees from taking advantage of time-sensitive inside information or knowledge of client activity to engage in transactions they could improperly benefit from. "Set it for as long as you can without ruffling feathers, but at a minimum for as long as you think there could be an opportunity for inappropriate trading activity," Kanter said.
- **Assign a particular compliance officer to certain employees.** For instance, a specific compliance officer might be assigned to review a portfolio manager's trading for certain patterns, said Fromberg. Having one compliance officer tied to particular employees for a sustained period will allow that compliance officer to become familiar with the securities the employees trade in, as well as their trading patterns – and therefore make it easier to spot aberrations to those patterns.
- **Review employee email.** Despite warnings not to write sensitive information on company email, employees still do it, and it is quite conceivable that these emails might contain information on personal trading, said Fromberg.
- **Disclose.** Note in your firm's Form ADV, Part 2, Item 11C that your firm allows personal trading in certain securities that clients also trade in, and that you have compliance policies and procedures in place to prevent improper activity, said Kanter.
- **Remind employees regularly of your firm's policies.** For insider trading, that means those policies and procedures governing use of material non-public information, said Fromberg. Employees should also be reminded that they have a fiduciary duty not to put their own trades ahead of their clients.

The bottom line in monitoring personal trading is that it is a balancing act, said Kanter. "You don't want to be overly burdensome, but you don't want to open the door for something to happen."

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One SEC Deputy Chief of Staff Named as Another Departs

Michael Liftik was named a deputy chief of staff by the SEC on October 5. He replaces **Erica Williams**, whose departure was announced the same day.

Liftik, who will be one of two agency chiefs of staff – the other is **Nathaniel Stankard** – has been senior adviser to SEC chair **Mary Jo White** since April 2013, providing legal advice on enforcement policy matters and cases. He is also White's representative on the deputies committee of the Financial Stability Oversight Council.

As legal adviser, Liftik worked with SEC staff and officials from the Department of Treasury, Federal Reserve Board and other financial regulators to identify and address developments in the asset management industry, cybersecurity and macroeconomic trends.

Liftik began his SEC tenure in November 2007 as a Division of Enforcement staff attorney in San Francisco, where he investigated and litigated securities law violations, the agency said. Those cases included charges against private investment fund managers and others involving secondary market trading in pre-IPO companies, and an inquiry into potential Regulation FD violations involving the use of social media. From May 2012 to April 2013, he was counsel to the director of the Enforcement Division.

Prior to joining the agency, Liftik practiced securities litigation and white-collar crime at law firms in San Francisco and Boston. He holds a law degree from **Harvard Law School**.

Williams served as deputy chief of staff to three SEC chairs: White, **Elisse Walter** and **Mary Schapiro**. She first took on the position in May 2012, having joined the chair's staff as enforcement counsel in February 2011. She began her SEC career in February 2004 in the Enforcement Division's trial unit.

Prior to joining the agency, Williams was a commercial litigator. She holds a law degree from the **University of Virginia School of Law**.

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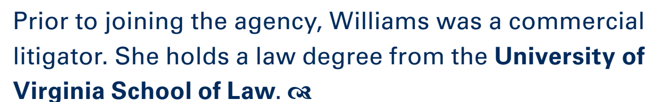

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