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A legal update from Dechert's Financial Services Group

Massachusetts Securities Division Regulates the Use of Consultants and Expert Network Services by Investment Advisers

The Massachusetts Securities Division of the Office of the Secretary of the Commonwealth (the "Division") adopted a final version of a regulation (the "Rule") imposing certain requirements on advisers who use consultants and expert network firms. Although, as discussed below, the regulation defines the term "adviser" broadly, the Division has recognized that preemption principles apply, assuring that federally-registered advisers are not subject to the Rule.[1] The Division has so far declined to clarify the reach of the Rule to advisers not registered with either the Securities and Exchange Commission (the "Commission") or Massachusetts.

In adopting the Rule, Massachusetts became the first state to regulate the use of these parties by investment advisers. The Rule, effective December 1, 2011, requires investment advisers using consultants or expert network firms to receive certification from the consultants involved that the consultants will not disclose confidential information. The Rule comes on the heels of a broad, ongoing federal insider trading probe, as well as a similar Massachusetts proceeding. The public aspect of the federal probe began with the October 2009 arrest of Raj Rajaratnam, manager of the Galleon Group hedge fund, and ultimately led to at least 17 cases against expert network firm employees and portfolio managers using their services.

What Are "Expert Network" Firms and Why Are They the Focus of the Rule?

For a fee, expert network firms act as matchmakers between consultants and investment firms seeking information on products, trends and companies. These parties may provide investment managers with a helpful and useful information advantage by providing unproblematic information concerning such matters as the efficacy of certain new drugs, the application of certain technologies or other matters. Some of these services, however, have allegedly provided material nonpublic information about specific companies to paying customers and/or linked clients with experts they knew would provide such information.

In March 2011, the Enforcement Section of the Division filed an administrative complaint against Massachusetts-registered investment adviser Risk Reward Capital Management Corp., its investment adviser representative, and a small affiliated hedge fund and its manager (together, "Risk Reward").[2] The

[1] Massachusetts Securities Division of the Office of the Secretary of the Commonwealth, *Adopting Release: Use of Expert Network Services – 950 CMR 12.205(9)(c)(16); Performance Based Fees – 950 CMR 12.205(9)(c)(17); and Other Technical Changes and Corrections* ("Adopting Release"), August 8, 2011. http://www.sec.state.ma.us/sct/sctnewregs/description_of_changes_to_proposed_regs.pdf. Although the Division declined to explicitly carve-out federally registered advisers in response to comments by the Investment Company Institute and others, the Division acknowledged that the Rule is preempted by the National Securities Markets Improvement Act of 1996 ("NSMIA") from applying to advisers registered with the Commission.

[2] *In the Matter of Risk Reward Capital Management Corp., RRC Management LLC, RRC BioFund LP, and James Silverman*, Massachusetts Securities Division Docket No. E-2010-057.

complaint alleges that Risk Reward traded on material nonpublic information acquired through a New York expert network firm and then attempted to hide its conduct by destroying evidence and altering documents filed with the Division.

The Commission and the U.S. Department of Justice have also recently brought insider trading charges against expert network consultants and employees for allegedly passing material nonpublic information to hedge funds and other investors.[3]

The federal crackdown on insider trading has created uncertainty about issues such as materiality and channel checking (*i.e.*, a method of stock analysis based on information supplied by parties other than the company being analyzed). As a result, the Managed Funds Association asked the Commission for guidance on the use of expert network firms.[4] To date, no such guidance has been issued.

To What Advisers Does the Rule Apply?

The Rule adds a new subdivision of Rule 2.205(9)(c). That rule purports to apply to any "adviser," which term is defined as "any person, including persons registered or excluded from registration under M.G.L. c. 110A, who receives any consideration from another person primarily for advising the other person as to the value of securities or their purchase and sale, whether through the issuance of analyses or reports or otherwise."[5] The rule goes on to provide that "[i]t is a rebuttable presumption that such term includes all investment advisers and investment adviser representatives, as well as other persons who charge fees based on assets under management or portfolio performance for rendering investment advice," but does not indicate how the presumption may be rebutted.

- The Rule clearly applies to Massachusetts-registered advisers.
- Due to the preemption provisions of NSMIA, it clearly does not apply to federally-registered advisers. "Exempt reporting advisers" (*i.e.*, investment advisers relying on the venture capital fund adviser exemption of Section 203(l) of the Investment Advisers Act of 1940 (the "Advisers Act") or the small private fund adviser exemption of Section 203(m) of the Advisers Act) will not enjoy the benefit of preemption. On September 8, 2011, the Division issued a clarifying policy statement acknowledging that the Rule does not apply to federally-registered advisers.[6]
- Because of the sweeping language used, the application of the Rule to advisers that are not registered with either the Commission or Massachusetts is less clear. Despite reports that the Division has offered informal assurance that the Rule will only apply to advisers that are required to register in Massachusetts, Dechert has been unable to obtain any such assurance, formal or informal. The September 8 policy statement offers no guidance on this issue. As a practical matter, Massachusetts would face a constitutional impediment to enforcing the Rule against out-of-state advisers having few if any contacts with Massachusetts.[7]

The Rule

As noted, the Rule adds a new subdivision of Rule 12.205(9)(c), which provides a non-exclusive list of practices by an adviser that are deemed by the Division to be "dishonest and unethical practices in the securities business."[8] The Rule applies in connection with an adviser's procurement of consultation services to assist in making investment decisions for client accounts, whether the adviser pays the consultants directly or through firms that match consultants with investment advisers (*i.e.*, expert network firms). Thus, although the Rule was adopted in response to the role of expert

3 Amended Complaint, *SEC v. Longoria et al.*, No. 11-CV-0753 (S.D.N.Y. 2011).

4 Managed Funds Association, Letter to Robert Khuzami, Jan. 21, 2011. http://online.wsj.com/public/resources/documents/SEC_MFA.pdf.

5 950 CMR 12.205(9)(a).

6 Massachusetts Securities Division of the Office of the Secretary of the Commonwealth, *Policy Statement: Matching or Expert Services Regulation under 950 CMR 12.205(9)(c)(16) and Investment Advisers under SEC Authority*, September 8, 2011. http://www.sec.state.ma.us/sct/sctnewregs/RevisedPolicyonFedIAsFinal.pdf.

7 To the extent the Rule may be considered to require maintenance of a record (*e.g.*, the signed certification and/or the electronic signature), it may be preempted as to certain out-of-state advisers by virtue of Section 222(b) of the Advisers Act. In pertinent part, that section prohibits a state from enforcing any law or regulation that would require maintenance of books or records in addition to those required under the laws of a state in which such adviser maintains its principal place of business and is registered.

8 950 CMR 12.205(9)(c).

network firms in recent insider trading scandals, it applies to the use of paid investment consulting services regardless of whether the adviser engages the consultant directly or through an expert networking firm.

The Rule prohibits an adviser from retaining investment consulting services without first obtaining a written certification from the consultant that discloses all confidentiality restrictions which the consultant has or reasonably expects to have that are relevant to the potential consultation. The certification must be signed and dated by the consultant and must, regardless of the scope of the restrictions listed, affirmatively state that the consultant will not provide any confidential information to the adviser. The certification must also state that the information contained within it is accurate as of the date of the initial consultation, and any subsequent consultation. Advisers may procure an electronic dated signature for the certification, if they retain the electronic documents in compliance with general books and records requirements.[9] Receipt of the certification does not relieve the adviser of the duty not to trade on insider information received from the consultant.

"Insider trading" is generally considered to mean trading on the basis of, or tipping others regarding, material nonpublic information provided or obtained in violation of a duty by a covered person acting with fraudulent intent. In mandating the disclosure of confidentiality restrictions, the Division emphasized the confidentiality element of insider trading, as opposed to the materiality, nonpublic or fraudulent intent elements.[10] The Division also did not limit the scope of the Rule to information regarding publicly traded securities.

Take Aways

The Rule makes mandatory for advisers subject to the Rule a specific procedure that, as a practical matter, should be followed in some form as a "best practice" by all investment advisers that use such "expert" information services. As recently noted by Robert Khuzami, the Commission's Director of Enforcement, expert network firms and the consultants associated with them can "provide legitimate expertise and experience to assist investors in making investment decisions."[11] The use of "expert" consultants and expert network firms warrants caution, however, particularly in light of the widely publicized efforts of civil and criminal authorities to crack down on insider trading.

Investment advisers should also consider independent diligence on the expert utilized and the information provided. If an expert is a current employee of a company to be discussed or was recently an employee (*i.e.*, within the past six months),[12] advisers should think twice about proceeding with the engagement at all. If the information provided appears material and specific to a company or companies and cannot be "sourced" in the public domain, advisers should inquire of the consultant concerning its source and determine for itself whether the explanation points to a lawful source and appears credible. Advisers should also consider a range of other protective measures regarding the use of expert network firms, including collecting information regarding precautions taken by expert network firms in connection with their consultants, revising expert network contracts to prohibit the provision of inside information and updating insider trading policies to specifically address the use of consultants and expert network firms.

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9 See Adopting Release.

10 While the Commission has indicated that the "duty of trust or confidence" referred to in Rule 12b5-2 could be a duty of confidentiality, defense lawyers have disagreed. For example, in *SEC v. Mark Cuban*, 620 F.3d 551 (5th Cir. 2010), the lower court dismissed the Commission's suit based on the defendant's arguments that, in a "misappropriation theory" insider trading case, liability requires an agreement not to trade and not simply an agreement to keep information confidential. The U.S. Court of Appeals for the Fifth Circuit reversed the District Court's dismissal without reaching the issue, concluding that there was a plausible basis to find that the defendant agreed not to trade. Although there is still an open issue of whether insider trading liability requires an agreement not to trade, it is prudent for advisers to assume that it does not.

11 Robert Khuzami, Speech Before the U.S. Attorney's Office for the Southern District of New York, Feb. 8, 2011. http://www.sec.gov/news/speech/2011/spch020811rk.htm.

12 For a more detailed discussion of the federal crackdown on expert network firms allegedly involved in insider trading, please refer to our February 2011 *DechertOnPoint*, "Risky Business: Trafficking in Insider Information About Customers." http://www.dechert.com/files/Publication/8a49266c-3ce8-4cd8-a880-2bdbdf0ac5a3/Presentation/PublicationAttachment/b46c9462-7704-4785-9e26-31ba2ac269b4/FS_WCSL_SA_02-11_Risky_Business.pdf.

Other Massachusetts Regulatory Developments

At the same time that it adopted the Rule, the Division also adopted a number of additional amendments to the Code of Massachusetts Regulations (the "Code"). In response to the Commission's recent increase of the client net worth and assets under management requirements applicable to federally-registered advisers that rely on Rule 205-3 under the Advisers Act,[13] the Division added to Rule 12.205(9)(c) a subdivision prohibiting the collection of performance-based fees that are not received in compliance with Rule 205-3.[14] The Division also made various changes throughout the Code to reflect industry changes. For example, references to the National Association of Securities Dealers (NASD) have been replaced with references to the Financial Industry Regulatory Authority (FINRA).

The Division has yet to adopt other proposed changes to the Code. These proposals include an amendment to the definition of an "institutional buyer" under 950 CMR 12.205(1)(a)(6). M.G.L. c. 110A, § 401(m)(1)(E) exempts from the definition of "investment adviser" persons whose only clients are "institutional buyers" or other designated entities. Such persons are thus exempt from the investment adviser registration requirement of M.G.L. c. 110A, § 201(c). The proposed amendment would remove accredited investors from the definition of "institutional buyers" such that investment advisers would not be able to rely on the exemption, for new investors that are accredited investors or additional funds contributed by existing accredited investors. The exemption would remain available, however, for business that existed prior to the implementation date of the amendment. If the proposal is adopted, private fund advisers that both rely on the exemption, and are required to register with the Commission by March 30, 2012, may be subject to Massachusetts registration requirements (and thus the Rule) during the interim between the effective date of the amendment and the time that such advisers register with the Commission.

Conclusion

Investment advisers subject to the Rule are encouraged to review the Rule and to prepare new policies and procedures or update existing ones as necessary well in advance of the December 1 effective date. Investment advisers should also monitor for any similar regulatory developments in other states and, if they have not done so already, adopt appropriate procedures to govern the use of experts.

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[13] For a more detailed discussion of the Commission's recent amendments to Rule 205-3, please refer to our July 2011 *DechertOnPoint*, "The SEC Raises Performance Fee Requirements for U.S. Advisers." http://www.dechert.com/files/Publication/d30f1627-1dde-4df2-bd9f-2c250f7440e0/Presentation/PublicationAttachment/347020e5-db03-4c79-9097-35dea1c49bd9/FS_16_07-11_The_SEC_Raises_Performance_Fee_Requirements.pdf.

[14] Adopting Release.

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