

## SEC Charges Adviser for Failing to Monitor Consultants

***The action underscores the need for investment advisers and broker-dealers to maintain robust policies and controls when utilizing third-party contractors.***

On May 27, 2016, the Securities and Exchange Commission (SEC) announced a settlement with Federated Global Investment Management Corp. (FGIMC), a registered investment adviser, for failing to establish written policies and procedures reasonably designed to prevent the misuse of material, non-public information (MNPI) in FGIMC's use of outside consultants.<sup>1</sup> Specifically, the SEC found that FGIMC used a third-party consultant who — unbeknownst to FGIMC's senior management and compliance department — also served on the boards of four public companies and at times had access to MNPI regarding those companies, as well as information about the holdings of funds FGIMC advised. While FGIMC did have written policies regarding the use of MNPI, none indicated a mechanism to identify potential conflicts among consultants, which, according to the SEC, resulted in a gap in FGIMC's compliance program. As detailed below, the FGIMC Order highlights the SEC's continued focus on ensuring investment advisers and other SEC-registered entities maintain appropriate policies and procedures to protect MNPI.

### FGIMC Settlement

The FGIMC settlement concerned an investment adviser's policies and procedures geared toward preventing the misuse of MNPI. Notably, the SEC charged FGIMC for policy gaps and lapses, but did not charge anyone with insider trading.

FGIMC acted as sub-adviser to certain funds, and from time to time utilized third-party consultants and research professionals. The FGIMC Order notes that FGIMC maintained written policies and procedures on MNPI, as well as the personal trading activities of individuals who had access to confidential information regarding the funds.<sup>2</sup> However, according to the SEC, FGIMC did not establish policies for identifying outside consultants who — based on their functional roles and whether they had access to confidential information regarding the funds — should have been subject to oversight and controls carried out by FGIMC's compliance department.<sup>3</sup> And because FGIMC did not establish or maintain policies for identifying whether outside consultants should be subject to its policies or procedures, including its code of ethics for access persons, the SEC found that FGIMC was unable to enforce its code of ethics and other written policies and procedures as to outside consultants.<sup>4</sup>

With respect to one particular consultant, the SEC alleged that FGIMC was unaware that:

- The consultant was also a member of the boards of directors of a number of publicly traded biotechnology companies, and possessed MNPI regarding those companies

- The Funds held and traded the securities of four companies of which the consultant was a board member
- The consultant had access to non-public information regarding the funds, including some of the funds' holdings and FGIMC investment management personnel opinions regarding securities that the funds held or were considering purchasing
- The consultant purchased and sold in his personal brokerage accounts, the securities of the same pharmaceutical and biotechnology companies that the funds held, sometimes in close proximity to the funds' trades<sup>5</sup>

The SEC concluded that FGIMC violated Section 204A of the Advisers Act, which requires investment advisers registered with the SEC to establish, maintain and enforce written policies and procedures reasonably designed — considering the nature of the investment adviser's business — to prevent the misuse of MNPI by the investment adviser or *any person associated with* the investment adviser.<sup>6</sup> FGIMC, without admitting or denying the SEC's findings, agreed to a cease and desist order, censure, and a US\$ 1.5 million fine.<sup>7</sup>

The FGIMC action highlights that the SEC can charge an investment adviser with policies and procedures violations even if the agency cannot prove that anyone engaged in insider trading. In October 2015, the agency brought similar charges against Wolverine Trading LLC and Wolverine Asset Management LLC (together, Wolverine), which are affiliated investment adviser and broker-dealer entities, alleging deficiencies in Wolverine's MNPI policies and procedures.<sup>8</sup> As in the FGIMC action, the SEC brought the Wolverine action without alleging any insider trading.

The requirement to maintain and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI applies to broker-dealers as well. The relevant portions of Section 15(g) of the Securities Exchange Act of 1934 are formulated substantially similarly to Section 204A of the Advisers Act, and require broker-dealers to maintain policies and procedures reasonably designed, taking into consideration the nature of such broker's or dealer's business, to prevent the misuse of MNPI by such broker or dealer or any person associated with such broker or dealer. Accordingly, the findings in the FGIMC order may have potential implications beyond the investment adviser context.

## Conclusion

In light of the FGIMC Order, investment advisers and broker-dealers should assess their compliance policies and procedures on utilizing third-party consultants, and whether any portions of the policies and procedures should be applied to such consultants.

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**Endnotes**

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<sup>1</sup> In re Federated Global Investment Management Corp., Administrative Proceeding File No. 3-17264 (May 27, 2016), available at: <https://www.sec.gov/litigation/admin/2016/ia-4401.pdf> (the FGIMC Order).

<sup>2</sup> *Id.* at p. 4.

<sup>3</sup> *Id.* at p. 5.

<sup>4</sup> *Id.* at p. 6.

<sup>5</sup> *Id.* at pp. 6-9.

<sup>6</sup> *Id.* at p. 10.

<sup>7</sup> *Id.* at p. 12.

<sup>8</sup> In re Wolverine Trading, LLC and Wolverine Asset Management, LLC, Administrative Proceeding No. 3-16890 (Oct. 8, 2015), available at: <https://www.sec.gov/litigation/admin/2015/34-76109.pdf>