KIRKLAND & ELLIS LLP

KIRKLAND**PEN**
Private Equity Newsletter

November 17, 2009

Increase in Insider Trading Enforcement Affecting Private Funds

PENpoints

In light of today's emboldened enforcement environment and recent media attention garnered by high-profile insider trading cases, it is increasingly important for private equity firms and hedge funds to implement strong compliance programs.

Recent enforcement activities by the U.S. Securities and Exchange Commission (SEC), the Department of Justice (DOJ) and the Federal Bureau of Investigation (FBI) reflect a renewed, more systematic and aggressive approach by federal authorities to investigating and prosecuting alleged insider trading, in particular by persons associated with private investment funds.[1] Recent examples include:

- Indicting at least 20 individuals and firms, including several hedge funds, in some of the most sweeping insider-trading cases ever brought by federal regulators;
- Using undercover techniques, including informants, front businesses and, for the first time ever, court-authorized wiretaps to target insider trading on Wall Street;
- Developing and applying new technological tools to track and analyze securities trading, including a data-mining project to uncover clusters of correlated trades;
- Expanding the SEC's enforcement activities beyond traditional equity securities, focusing on swaps and other non-equity securities; and
- Pursuing expanded theories of insider-trading liability.

In addition, today virtually every SEC civil insider-trading investigation carries substantial risk of a parallel criminal investigation and prosecution.

When the government pursues charges of insider trading (or other illegal activity) by a private fund's employee, a private fund that has adopted — and followed — good insider trading/compliance policies and procedures and cooperates with law enforcement should in most cases incur reduced or no penalties. For example, in a recent enforcement action involving a CFO's alleged selective disclosures violating Regulation FD, the SEC did not charge the employer where (1) the employer cultivated an environment of compliance with training, policies and controls; (2) the CFO was alleged to have acted alone and in violation of company policies and controls; (3) the employer immediately self-reported the conduct to the SEC and cooperated with the investigation, and (4) the employer adopted remedial measures and additional controls.

While a private fund manager's approach will vary depending on the nature and complexity of its business, all such firms should consider the following:

- *Written Insider Trading Policies*. A firm with no written policy[2] should promptly adopt and implement written policies and procedures designed to identify, contain and prevent the intentional or inadvertent misuse of non-public information in its possession. Examples include requiring all personnel to (1) check a "restricted list" of public companies about which the firm has confidential information before making personal or firm-related securities trades, or (2) pre-clear with the firm's chief compliance officer (or person with similar authority) a personal securities trade.

  A firm with a written policy should review and, if necessary, revise its policies and procedures, taking into account (among other things) whether the firm has added new lines of business, investment products or strategies presenting potential compliance issues not covered in existing policies and procedures.

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- *Application of Policies and Procedures*. A firm should also assess how its insider trading/compliance policies/procedures are operating in practice. For example: Do firm personnel comply with specific contractual obligations relating to the handling of confidential information, such as written confidentiality agreements? If the firm maintains a "restricted list," is it being updated and properly utilized? Has the firm taken appropriate steps in cases of any discovered violations? Does the firm have regular compliance training for and annual certifications of compliance by all firm personnel?
- *Third Party Sources of Information*. A firm using third parties such as "information brokers" or similar consulting organizations as part of its research efforts should analyze the type of information conveyed by such sources and whether to adopt specific policies and procedures relating to these resources.
- *Information Technology*. A firm should evaluate the costs and benefits of using technology to aid in detecting and preventing insider trading, such as compliance software that identifies and prevents a firm from trading in any security on a restricted list. In addition, a firm should evaluate its information security procedures, including safeguards limiting physical and electronic access to information, as well as policies relating to use of various communications protocols, such as e-mail, voicemail, telephone, instant messaging and cell phone, many of which have provided valuable information to investigators in recent enforcement actions.
- *Tone at the Top*. One of the most important steps a firm can take is setting an ethical "tone at the top" by encouraging awareness of and compliance with all legal and regulatory obligations, and good faith reporting of misconduct.

The possibility of insider trading by rogue employees of private equity and hedge funds has always existed, but the legal and business risks and liabilities for those firms are greater in today's emboldened enforcement environment. Media attention generated by recent high-profile insider trading cases, and the adverse consequences that can result from the mere allegation of insider trading, demonstrate the benefits of strong compliance programs.

1 See remarks by the SEC's Director of Enforcement directed to investment advisers. (October 16, 2009, press conference by Robert Khuzami at http://www.sec.gov/news/speech/2009/spch101609rk.htm.)

2 An SEC registered private investment fund adviser is required to adopt procedures reasonably designed to deter insider trading and procedures to monitor and in certain cases pre-clear employee securities transactions.

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

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PENbriefs

Change of Control — Words, and Creativity, Matter

Much attention has been focused recently on the depressing impact on M&A activity of "change of control" and "anti-assignment" clauses (for ease of reference, referred to as "CoC provisions") in company agreements. In many cases, these contractual provisions are deemed insurmountable obstacles to achieving a deal. Two recent court decisions, however, highlight the importance of paying close attention to the words of a CoC provision and of employing creative structuring techniques to avoid or minimize its impact on a transaction.

To learn more about these decisions, please see our recent *M&A Update*.

Avoiding Liability Pitfalls in Financial Advisory Assignments

Recent case law on potential liability of investment bankers for advice given in connection with M&A advisory roles has focused on the contractual nature of the relationship between the adviser and the recipient of the advice. Courts have been generally unwilling to find an extracontractual duty owed to shareholders of a target, the likely harmed parties in the event of alleged faulty advice, particularly if the engagement letter and/or fairness opinion itself is clear as to whom advice is being offered and the nature of the relationship between the adviser and the recipient parties. As the case law has developed, standard language in engagement letters has evolved to further clarify the nature of the banker/company relationship, reduce the likelihood that extracontractual claims against an investment bank would survive court scrutiny and minimize the damages that may be asserted by aggrieved parties.

To learn more about why parties to banker engagement letters should sharpen their focus on the specific working of engagement letters as well as their conduct during the period in which advice is being offered, please see our recent *M&A Update*.

PENnotes

Kellogg School of Management's 2009 Real Estate Conference
Evanston, Illinois
November 18, 2009

The Kellogg School of Management's 2009 Real Estate Conference will review trends in the capital markets, the opportunities and pitfalls of distressed real estate investing in the current market and ongoing trends in restructuring. Kirkland partner Robert T. Buday will speak on "Distressed Investing Opportunities: Possibilities and Pitfalls."

PLI's "Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings" Conference
Chicago, Illinois - November 18-20, 2009

This PLI program will focus on the tax issues presented by the entire spectrum of modern major corporate transactions. Kirkland partners Jack S. Levin, P.C., will speak on "Structuring Buyouts/Venture Capital Deals," Todd F. Maynes, P.C., will discuss "Tax Strategies for Financially Troubled Businesses and Other Loss Companies" and Jeffrey T. Sheffield, P.C., will speak on "Current Issues in Divisive Strategies – Spin-Offs and Synthetic Spin-Offs."

PLI's "Drafting Corporate Agreements 2010"
New York, New York
January 6, 2010

This PLI seminar will focus on drafting complete, concise and enforceable agreements, key terms of standard transactional agreements, when and how to use letters of intent, confidentiality and standstill agreements, and the wide range of M&A agreements, both public and private. Kirkland partner Andres Mena will speak on "Credit/Indenture Agreements."

Columbia Business School's 16th Annual Private Equity and Venture Capital Conference
New York, New York
January 29, 2010

This year's Columbia Business School Private Equity and Venture Capital Conference will focus on the future of the private equity industry and the role firms will play in a changing economic environment. Kirkland partner Kirk Radke will participate in a panel entitled "The New World Order: Regulatory Practices and Private Equity Opportunities."

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Private Equity Practice at Kirkland & Ellis

Kirkland & Ellis LLP's nearly 400 private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 200 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. In 2009, Kirkland received the awards for Best Law Firm (Private Equity Deals) and Best Law Firm (Fund Formation) in North America from *Private Equity International*. Mergermarket has ranked Kirkland first by volume for Global and North American Buyouts in its "Global M&A Round-up for Year End 2008," and Pitchbook named Kirkland the most active law firm representing private equity firms in its "Private Equity Breakdown" for Q2 2009.

For the second year in a row, *The Lawyer* magazine recently recognized Kirkland as one of the "The Transatlantic Elite," noting that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent." In addition, Kirkland's London office was recently named the 2008 "Banking Team of the Year" at the Dow Jones Private Equity News Awards for Excellence in Advisory Services.

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