PROTECTING AGAINST INSIDER TRADING: EXPERT NETWORKS AND BEST PRACTICES FOR FOSTERING COMPLIANCE AND REDUCING LEGAL RISKS

DECEMBER 16, 2010
AGENDA

OPENING AND COMPLIANCE11 OVERVIEW
Tracey Straub

REMARKS
Cadwalader Panel

SOLUTION OVERVIEW
Tracey Straub

Q & A
## Our Products

### Personal Trading
- Employee Trading
- Pre-clearance
- Electronic Feeds
- Insider Trading
- Restricted List
- Business Rules

### Affirmations and Disclosures
- Policy Acknowledgements
- Quarterly Reporting
- U4 Updates
- Annual Compliance Questionnaire
- New Hire Paperwork
- Outside Business Activities

### Gifts, Entertainment and Contributions
- Gift Giving/Receiving
- Political Contributions
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### Case Management
- Advertising
- Arbitration/Litigation
- Client Complaints
- Continuing Education
- Marketing Review
- New Hire Tracking
- Registrations
- Regulatory Inquiries
- Trading Exceptions
Glen P. Barrentine

Glen Barrentine’s practice focuses broadly on legal and regulatory matters affecting broker-dealers, investment advisers, and other financial entities. Glen frequently advises on regulatory inspections, examinations and inquiries, internal investigations and compliance reviews. Areas of particular focus include trading related issues and supervisory and compliance processes and procedures. Significant ongoing client representations include a high frequency trading firm, an institutional clearing firm and an NYSE/Amex designated market maker.

Glen was formerly the Chief Regulatory Officer of the American Stock Exchange where he supervised its enforcement, options, and equities surveillance and other regulatory programs. Before joining the Amex, Glen was an Assistant General Counsel with Bank of America, where he was the principal attorney for compliance and regulatory issues affecting the bank’s institutional brokerage firm, Banc of America Securities. He also previously served at the U.S. Securities and Exchange Commission as an Assistant Director with the Commission’s Office of Compliance Inspections and Examinations, and before that with the Division of Market Regulation.


Glen earned his J.D., magna cum laude, from Boston University School of Law and his B.A. from St. John’s College in New Mexico.
Bradley J. Bondi is a partner in the Business Fraud and Complex Litigation practice, resident in the Washington, D.C. and New York offices. He represents companies and individuals at trial and on appeal in a wide range of complex civil and criminal matters, including regulatory proceedings, SEC enforcement actions, insider trading probes, securities and financial litigation, grand jury and congressional investigations, and internal reviews. He also counsels boards of directors and senior management of companies and financial services firms on matters of corporate governance, securities law, compliance, and crisis management. Brad defends clients in enforcement actions and investigations initiated by the SEC, DOJ, United States Attorneys, FDIC, OCC, FINRA, OFAC, FTC, and various other federal and state regulators.

Prior to joining Cadwalader, Brad served as counsel for enforcement actions and regulatory rulemaking to SEC Commissioners Troy Paredes and Paul Atkins. While at the SEC, Brad was detailed to the Financial Crisis Inquiry Commission ("FCIC"), a bipartisan commission established by Congress to investigate the causes of the financial crisis, where he served as Deputy General Counsel. Brad also served briefly as a Special Assistant United States Attorney for the Eastern District of Virginia. Prior to his government service, Brad was a litigation partner at Kirkland and Ellis LLP and an associate at Williams and Connolly LLP.

Brad teaches securities law as an adjunct professor at Georgetown University Law Center and George Mason University School of Law. A frequent speaker at business and legal conferences, Brad is also a prolific author of articles on securities law, insider trading, criminal law, and corporate governance.

Brad earned his LL.M (with distinction) in securities and financial regulation from Georgetown University Law Center, where he achieved a perfect grade point average and earned seven book awards. He earned his J.D. (with high honors, Order of the Coif, Intramural Best Trial Advocate), M.B.A. (Finance and Management), and B.S. (with highest honors, Outstanding Male Graduate) from the University of Florida. Following law school, he clerked for Judge Edward E. Carnes of the United States Court of Appeals for the Eleventh Circuit.
Jonathan Hoff is a securities and business litigator who has experience in the fields of securities and corporate litigation, mergers and acquisitions, and corporate governance. Jon’s practice focuses on the representation of public companies and financial institutions. He represents clients in corporate and securities litigation, including shareholder class action and derivative suits, merger and acquisition transactions, accounting- and finance-related litigations, and corporate- and securities-related government and internal investigations, as well as disputes involving subprime mortgages, real estate securitizations, CDOs, derivatives, and other structured products.

Jon has been recognized as one of the leading securities litigation attorneys by Chambers USA; one of the “100 Lawyers You Need to Know in Securities Litigation” by Law Dragon; in New York Super Lawyers; and in Who’s Who in American Law. Jon is a frequent speaker and author on securities and corporate litigation and counseling, current developments in mergers and acquisitions, the business judgment rule, and shareholder litigation. Jon is a co-author of the treatise, Public Companies, which provides a comprehensive treatment of the responsibilities and functions of publicly traded corporations and their directors, officers, and general counsel. In addition, Jon is a member of the editorial board of the Securities Litigation Report.

Jon received his undergraduate degree from the University of California at Berkeley and his law degree from UCLA, where he served as Comment Editor for the Law Review. He is admitted to practice in New York and California, as well as before the U.S. Supreme Court; the U.S. Courts of Appeals for the Second, Fourth, Fifth, Seventh, Ninth, and Tenth Circuits; and the U.S. District Courts for the Southern and Eastern Districts of New York and the Northern and Central Districts of California.
Steven Lofchie, Co-Chairman of the Financial Services Department, concentrates his practice in advising financial institutions on regulatory issues and on derivatives and other financial instruments. He is the author of Lofchie’s Guide to Broker-Dealer Regulation (3d ed. 2005), considered the leading treatise in the field. Chambers USA ranked Steve in its first band for both financial services regulation and derivatives.

Steve counsels broker-dealers, banks, securities exchanges, private funds and registered investment companies regarding regulatory and transactional issues. His regulatory practice addresses virtually all the securities-law related statutory and regulatory requirements applicable to broker-dealers, other regulated institutions and their affiliates. He advises on registration requirements and exemptions, employee issues; cash market, sales, and trading; the development of compliance and supervisory procedures; satisfaction of margin, capital and recordkeeping requirements; the rules of the financial industry self-regulatory organizations; anti-money laundering; privacy; procedures for cross-border transactions; and insider trading issues.

Steve has been very active in developing web-based compliance tools, including his Guide to Broker Dealer Regulation, online compliance manuals, research tools and document analysis systems.

Steve received his M.B.A. from Columbia Business School, where he was a General Motors Fellow. He received his J.D. from Yale Law School, where he was a member of the Yale Law Journal.

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Glen P. Barrentine
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Roadmap

1. Background and Theories of Liability
2. Insider Trading and Institutional Investors
3. Insider Trading and Expert Networks
4. Best Practices for Compliance
Theories of Liability Under 10b-5

1. Classical Theory

Elements of the Classical Theory:

1) Corporate Insider (e.g., board member, executive, or employee);
2) Trades in the corporation’s securities (or of a potential deal partner);
3) On the basis of material, nonpublic information; and
4) Obtained by reason of the insider’s position.
2. Misappropriation Theory

Elements of the Misappropriation Theory (*U.S. v. O’Hagan*):

1) Person trades in securities;
2) Misappropriates material and confidential information;
3) In breach of a duty owed to the source of the information; and
4) Person traded in securities on the basis of that information.

Note: Duty of loyalty or confidence arises between a recipient of material, nonpublic information and the source when:

(1) recipient agrees to maintain the information in confidence, or
(2) recipient and source have a “history, pattern, or practice” of sharing confidential information where recipient knew or should have known to maintain confidentiality; or
(3) where the source is the parent, spouse, or sibling of the recipient. Rule 10b5-2.
Theories of Liability Under 10b-5

3. Tipper/Tippee Theory

- Elements of the Tipper/Tippee Theory (*Dirks v. SEC*):

  1) The tipper provided material, nonpublic information to the tippee;

  2) The tipper breached a duty owed to the owner of the misappropriated information;

  3) The tippee knew or had reason to know that the tipper breached that duty; and

  4) The tipper received “a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings” or “makes a gift of confidential information to a trading relative or friend.”
Traditional Types of SEC Enforcement Actions Involving Institutional Investors

- Security professional (e.g., analyst) provides material, nonpublic information to fund. *SEC v. Guttenberg* (Mar. 2007)
- Broker-dealer tips fund about anticipated trade (*i.e.*, front running).
- Insider at a public company provides material, nonpublic information regarding upcoming merger, acquisition, or announcement. *SEC v. Sebbag & Hoxie* (May 2010)
Traditional Types of SEC Enforcement Actions Involving Institutional Investors (cont’d)

• Fund provides material, nonpublic information to another fund as quid pro quo for information to flow in opposite direction. SEC v. Tang (Oct. 2009)

• Fund trades on material, nonpublic information obtained by virtue of evaluating a private investment in public equity (PIPE transactions). e.g., SEC v. Ladin (Oct. 2008); SEC v. Berlacher (Sept. 2007); SEC v. Mangan (Dec. 2006)

• Fund trades on material, nonpublic information obtained by virtue of being a lender to a public company.
Insider Trading and Institutional Investors

- Why the recent focus on institutional investors?
  - Voluminous trades
  - Nature of trading strategies
  - Success of institutional investors
  - Regulatory and political focus on hedge funds
  - SEC Enforcement focus on so-called “high-impact” cases
  - Establishment of specialized units in the SEC’s Enforcement Division

- In 2007, then-Chairman Christopher Cox: “[T]he SEC is targeting hedge fund insider trading as a top priority”

- In last two years under Chairman Schapiro, numerous high-profile, enforcement actions against institutional investors
  - e.g., SEC v. Galleon Management, LP; SEC v. Santarlas
Expert Networks

- Expert networks serve to connect clients (often institutional investors) with persons who are deemed to have special expertise in the client’s area of business.
- Expert networks gained prominence following the SEC’s enactment of Regulation Fair Disclosure in 2000.
- Reg FD prohibits corporate executives from selectively disclosing information to analysts, investment advisers, and institutional investors such as hedge funds.
- If used appropriately, expert networks can be valuable and legitimate research tools that foster compliance with insider trading laws and reduce legal risk.
- Alternatives to expert networks may pose more risks.
Recent FBI Probe of Expert Networks

- Reports that U.S. Attorney for the Southern District of New York is focused on expert networks and hedge funds.
- Section 32 of the Securities Exchange Act makes any “willful” violation of a securities law a crime.
- Likely allegation: Fund obtained material, nonpublic information through the use of an expert network or information consultant.
- Reports that more subpoenas and raids are looming.
- Focus on insider trading with regard to expert networks is not confined to U.S. regulators. UK regulators getting involved.
In November 2010, the FBI reportedly raided three hedge funds based on an alleged three-year insider-trading investigation.

On November 24, 2010, Bloomberg reported that an expert consultant to hedge funds, Don Ching Trang Chu, was charged with conspiracy to commit securities fraud and conspiracy to commit wire fraud. According to news reports, he allegedly arranged for insiders at publicly traded companies to provide information to clients of his firm.

Researcher in Oregon allegedly asked to wear a wire to secretly tape conversations with hedge fund.
Recent FBI Probe of Expert Networks (cont’d)

- Justice Department has tools the SEC does not have:
  - Search warrants, wiretaps, trap and trace devices, use of confidential informants, undercover operatives, and grand jury subpoenas.

- Justice Department has charges the SEC does not have:
  - Conspiracy (18 U.S.C. § 371) (e.g., Disney employee case), mail and wire fraud, false statements, perjury, and the relatively-unused section 807 of the Sarbanes-Oxley Act (18 U.S.C. § 1348) (used in the squawk box prosecutions).
  - Penalties are more severe.
  - Even if not charged with insider trading, may be charged with other crimes.
Recent FBI Probe of Expert Networks (cont’d)

Section 807 of SOX (18 U.S.C. § 1348) – “securities fraud”

- Makes it a crime to knowingly execute, or attempt to execute, a scheme or artifice that (1) defrauds any person in connection with any securities of a public company or (2) obtains, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of any security of a public company.
- Covers attempt.
- No requirement of purchase or sale, only “in connection” with a security.
- Perhaps a diluted duty requirement.
- Materiality may be judged by source company’s standpoint, not by that of a reasonable investor, i.e., “the misrepresentation or omission would naturally tend to lead . . . a reasonable employer to change its conduct [to avoid potential economic harm].” U.S. v. Mahaffy
Expert Networks and Insider Trading

Important Points

- Section 10(b) and Rule 10b-5 are applicable . . . at a minimum.
- A disclosure of information that is both material and nonpublic.
  - Public v. nonpublic information about a company (e.g., counting trucks leaving a warehouse versus obtaining nonpublic sales figures).
  - Material information: What if the investor aggregates several pieces of immaterial, nonpublic information to get a broader picture? (i.e., Mosaic Theory).
  - Breach of a fiduciary duty: For insider trading under existing law, liability can attach only if the investor knew or should have known that the expert (or his or her source) violated a fiduciary duty. No accidental liability, but not willful blindness.
Critical Questions

Decisions Based Upon Aggregated Information

• Is any one piece of information “material” by even the most expansive definition?
• Was information artificially broken into pieces before being conveyed?
• Who owns the information and how was it obtained?
• Did someone breach a contractual, customary, or personal relationship in providing any information?
• Was an original source an insider, supplier, or affiliate?
Compliance Considerations

- Government investigations are expensive and can cause lasting damage to the reputation of the firm.
  - Legal analysis is often difficult and dependent on the facts.
  - Investigations may lead to other charges being made rather than those originally investigated.
- The best time to plan for a possible investigation is now, by ensuring that robust and comprehensive compliance programs are in place.
  - Such a program
    - signals that a firm actively addresses potential wrongdoing – i.e. that further government investigation is unlikely to reveal violations;
    - allows a firm to quickly respond when federal agents come calling; and
    - reduces the likelihood that employees engage in wrongdoing.
Compliance Best Practices

Selection of Expert Networks

- Use only established and well-regarded networks.
- Ensure that networks have appropriate compliance personnel and procedures in place and that they vet their experts.
- Confirm that experts are contractually forbidden by the network from obtaining material, nonpublic information and obtaining information in breach of a duty.
- Confirm that no expert is bound by any confidentiality agreement or obligation that would prohibit them from revealing information about a company at issue.
- Confirm that no expert could be deemed to be an insider of a company at issue.
Compliance Best Practices (cont’d)

Initiating Contact with a Specific Expert

• Conduct your own vetting of the expert.
• Understand how the expert obtains information and who the expert utilizes to gather information.
• Compliance personnel should interview each expert to confirm an understanding of, and compliance with, insider trading laws.
• The expert should sign a document agreeing to comply with insider trading laws and firm policies and procedures.
Initiating Contact with a Specific Expert (cont’d)

• Confirm that no information will originate from an insider.
• Confirm that no one will breach a contractual or fiduciary duty by providing the information.
Compliance Best Practices (cont’d)

Ongoing Contact with an Expert

• Contact with an expert should be made through established channels of communication (not text messages and/or instant messages).

• Designate personnel to interact with outside experts.

• Compliance personnel should be present for calls or meetings with experts or randomly monitor such communications as permitted by law (e.g., federal and state taping laws).

• Warnings should be given at the start and end of any telephone call or other communication to inform/remind participants of relevant legal requirements.

• Document any information provided by the expert.
Compliance Best Practices (cont’d)

Ongoing Contact with an Expert (cont’d)

- Any unusual behavior or information should be reported to the compliance department or in-house counsel immediately.
- Normal document retention policies should be applied.
Compliance Best Practices (cont’d)

Internal Compliance at the Institutional Investor

- Ensure robust compliance procedures are in place.
- Train and remind employees on substance of law, firm’s procedures, flagging problematic issues, and reporting to the compliance department.
- Establish internal monitoring procedures, especially with regard to significant trades/deals.
- Limit the use of social media, instant messages, and text messages for any work-related communications.
- Erect walls if material, nonpublic information is received through legitimate channels (e.g., lending).
- When possible, investment decisions should be centralized and documented.
- Trading resulting in an unusual gain or loss avoidance should trigger an internal review regarding possible use of inside information.
- Violations of policies and procedures concerning insider trading should not be tolerated.
Other Considerations

• Being proactive when a problem comes to light may benefit the firm.
  – For FINRA members, reporting may be required. FINRA Rule 4530 (old NYSE Rule 351).
  – Self-reporting and self-policing credit by the SEC (Seaboard Report) and Department of Justice (Chapter 8 of the Sentencing Guidelines).
Conclusion

- Insider trading is nuanced and depends on the facts and circumstances.
- A law enforcement investigation can be costly and can damage the reputation of a firm.
- Compliance is key to preventing a law enforcement investigation and reducing legal risks.
- Compliance must be extended to the use of expert networks.
- Now more than ever funds must be diligent when it comes to self-policing violations of the law and having robust internal procedures.
**INSIDER TRADING FUNCTIONALITY**

**Market Events**

Market events are gathered from multiple sources and enhanced with market data so you can filter out the noise.

The system will automatically generate exceptions for suspicious trades based on rules that you configure.

**Market Events Include:**

1. **News**: News for the U.S. financial markets from more than 60 authoritative sources.

2. **Press Releases**: Company press releases, including corporate and industry news, earnings announcements and projections, dividends, mergers and acquisitions, joint ventures, research analyst coverage, and more from: *BusinessWire / MarketWire / PRNewsWire*

3. **SEC Form 8-K Filings**: Company financial information filed with the SEC Form 8-K, which is used to report significant changes such as a merger and acquisition, bankruptcy, change of auditors or any other important information.
QUESTIONS

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