A NEW PARADIGM FOR INSIDER TRADING PROSECUTION

Regulatory Compliance Association
PracticeEdge Series
September 19, 2013

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Federal Insider Trading Laws

Understanding the Basics – Where is the basic prohibition of insider trading derived from?

• The basic prohibition under federal securities law is derived from Rule 10b-5, promulgated pursuant to Section 10(b) of the Exchange Act.

• Section 10(b) and Rule 10b-5 are general antifraud provisions that broadly prohibit “manipulative or deceptive devices” in connection with the purchase or sale of any security.

• There are no specific references to or definitions of insiders or insider trading.

• The courts have developed the law of insider trading on a case-by-case basis.
Why is Insider Trading Against the Law? Is anybody really hurt?

• Fundamental unfairness of trading securities on information that is not available to others.

• Erosion of investor confidence in the markets that inhibits market participation.

• Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law. An investor's informational disadvantage vis-à-vis a misappropriator with material, nonpublic information stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill [United States v. O'Hagan, 521 U.S. 642, 658-659, 117 S. Ct. 2199, 138 L. Ed. 2d 724 (1997)].
What is illegal insider trading?

• Purchasing or selling securities while in possession of material non-public information concerning such securities or the issuer of such securities, or tipping such information, where the trader (the person who purchases or sells the stock or options) or tipper breaches a fiduciary duty or a duty arising out of a relationship of trust or confidence.

• When is information “nonpublic”?
  • Information is “nonpublic” when it is not available generally to investors in the marketplace
  • Under Regulation FD, information is not deemed publicly disclosed unless it is reported on a Form 8-K filed with the SEC or disseminated “through another method (or combination of methods) of disclosure reasonably designed to provide broad, non-exclusionary distribution of the information to the public.”
What is illegal insider trading?

• Establishing materiality
  • Information is deemed “material” where there is a substantial likelihood that a reasonable shareholder would consider the information important in deciding whether to buy or sell the securities in question, or where the information, if disclosed, would be viewed by a reasonable investor as having significantly altered the “total mix” of information available.

• Looking to Regulation FD for guidance. Non-exhaustive list of likely material events:
  • sales and earnings information
  • mergers, acquisitions, tender offers
  • new products or discoveries, or developments regarding customers or suppliers (e.g., the acquisition or loss of a contract)
  • change in auditors or auditor notification that the issuer may no longer rely on an auditor’s audit report;
  • changes in control or management
  • events regarding the issuer’s securities – e.g., defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, etc.
Theories of Insider Trading

• Classical Theory
  • applies to insiders who learn the subject material nonpublic information in the course of their employment and who owe a fiduciary duty to the issuer not to use the subject information for their personal benefit.
  • under the classical theory, the government must prove that a corporate insider, or his tippee, traded in the securities of the insider’s company on the basis of material nonpublic information obtained by reason of the insider’s position with the company

• Who is an “insider”?  
  • any person who, by reason of a fiduciary or confidential relationship to an issuer of securities, has access to non-public material information about that company.
  • the issuing corporation itself, its directors, officers and employees, or major security holders.
  • outside professional advisors, including lawyers, accountants, brokers, dealers, financial and investment advisors as well as engineers.
  • business associates, including suppliers, customers, business partners, and parties to a proposed acquisition, divestiture or other transaction; or
  • financial analysts and institutional investors.
  • The SEC typically takes an expansive view of the definition of an insider, and has found that a large variety of persons can be insiders, including, in addition to the list above, bankers and lenders, corporate trustees, finders, investment bankers, management consultants, marketing advisers and market makers.
Theories of Insider Trading

• Misappropriation Theory
  • Applies to outsiders (non-employees of issuer whose securities are subject of the insider trading) who learn the subject material nonpublic information in the course of their employment and who owe a fiduciary duty to someone other than the issuer not to use the information for their personal benefit. [See the O'Hagan case]
  • [a] company’s confidential information ... qualifies as property to which the company has right of exclusive use.” Accordingly, a person who acquires confidential information by virtue of an agency, fiduciary, or other relationship of trust and confidence with another is not free to misappropriate such information.
  • Where a person owes no duty to the shareholders of a corporation as a traditional insider, “temporary” insider, or tippee, he may nonetheless be liable for insider trading or tipping under the so-called “misappropriation” theory appropriate that information by converting it to his or her own personal gain.
How does the SEC Investigate and Establish the Occurrence of Illegal Insider Trading Techniques

• Sources of Cases
  • Informants (Anonymous calls, market professionals, disgruntled employees, competitors)

• Market Surveillance
  • SRO suspicious trading reports
  • SEC review of market trading
    • Analysis of market trading records
How does the SEC Investigate and Establish the Occurrence of Illegal Insider Trading Techniques

• Inquires and audits of investment managers and traders
• What are the goals of SEC interviews with portfolio managers, traders, compliance personnel
  • The SEC will obtain chronologies, itineraries and other documents
  • The SEC will analyze monthly account statements and telephone records
  • Connecting the dots - understanding counterparty relationships and sources of investment ideas helps to establish relationships between insiders & traders
• Follow the money
How does the SEC Investigate and Establish the Occurrence of Illegal Insider Trading Techniques

- Use of circumstantial evidence.
  - Telephone records frequently provide this circumstantial evidence in “tipping” cases
  - Evidence bearing on credibility of defendant who denies (e.g., false exculpatory statements by a defendant in the course of the investigation)
- Blue collar tactics
  - Use wire-tapping
  - Witness-flipping and promises of leniency for cooperators
Objectives of Insider Trading Investigations

• It is not enough for the SEC simply to identify suspicious trading and ask a jury to infer that it was the product of insider trading.

• Identifying suspicious trades
  • Large trades
  • Timely trades
  • Trades with disproportionate impact
  • Counter to trading or investing process (aberrant trades)
  • Aberrational performance
Objectives of Insider Trading Investigations

• Identifying insiders and traders
• Establishing possession of material, non-public information (connect insiders and traders)
• Establishing scienter (show perjury, profit sharing, payoffs, similar acts, use of nominee accounts)
  • In the insider trading context, it is unclear whether the scienter requirement of Rule 10b-5 requires proof that the defendant traded on the basis of material nonpublic information;
  • As the SEC has long asserted, it may be sufficient that the defendant traded while in knowing possession of material nonpublic information which he did not disclose.
• Mosaique Theory
• Establishing a duty (employment contracts, confidentiality agreements, etc.)
Advisers Act Issues

• Statutory obligation Section 204A
  • Requires an investment adviser to “establish, maintain and enforce written policies and procedures reasonably designed” to prevent the misuse of material, non-public information by the adviser or any person associated with the adviser.

• Implementing Effective Controls Within An Investment Adviser’s Compliance Program
  • The Role of the Chief Compliance Officer
  • Developing effective educational and training materials
  • Identifying high risk and unusual circumstances
Advisers Act Issues

- Use of third party experts
- Meetings with company management
- Serving on creditor committees
- Higher risk strategies and investment techniques
- Complex organizations/multiple trading teams and strategies
Advisers Act Issues

• Thoughts on effective surveillance and monitoring
  • Aberrational performance reports
  • Aberrant trade recommendations
  • Monitoring outside business relationships
  • E-mail, instant messaging and other communication tools
  • Monitoring trading with the Street and counterparty relationships
  • Interviewing new candidates