



# ► Compliance Corner

— By: Kerry S. Burke and Brandon K. Gay\*

## Expert Networks in the Crosshairs: A Prime Opportunity for Investment Advisers to Bolster Their Insider Trading Compliance Policies and Procedures

### Introduction

Recently, the Securities and Exchange Commission and U.S. Department of Justice have conducted a sweeping probe of investment managers for potential insider trading activities. As evidenced in the cases brought by the SEC against Galleon and former consultants of Primary Global Research,<sup>i</sup> a principal focus of these investigations is on the interactions between investment managers and expert networks. An “expert network” provides investment managers and others with access to various industry experts within a given field, such as physicians, academics and scientists. For instance, an investment manager investing in biotechnology companies may seek guidance from a doctor regarding the potential commercial success of a new drug as well as information on general industry trends. The expert network maintains a database of individuals who can provide this particular level of insight.

Generally, it is legal to obtain advice and analysis from the experts in the network.<sup>ii</sup> However, the practice can present thorny issues from an insider trading perspective, particularly if the experts are current or former employees of a publicly-traded company. As such, these experts may be in possession of material non-public information that they are obliged to keep confidential.

The increased focus by federal regulators on expert networks and the managers that use them provides ample reason for advisers to revisit their own

expert networking arrangements. In this article, we discuss the interplay between expert networking arrangements and the insider trading laws and provide some suggestions for minimizing the compliance risks associated with these arrangements.

### Overview of the Laws of Insider Trading

#### Bases for Liability

“Insider trading” is not defined in the federal securities laws, but is used broadly to refer to trading or recommending a trade while in the possession of material non-public information, in violation of a duty to keep the information confidential or a relationship of trust and confidence. Federal courts have developed two theories of liability for insider trading—the classic theory and the misappropriation theory. Under the classic theory, a corporate insider or a temporary insider (such as an accountant, lawyer or consultant), who obtains material non-public information by virtue of a professional relationship affording the agent access to the information, breaches a duty of trust and confidence owed to the corporation’s shareholders by trading in securities on the basis of the confidential information. Consequently, insiders have a duty to disclose the material non-public information to the counterparty or abstain from trading.

The misappropriation theory fills certain gaps left by the classic theory of

insider trading and is applicable when a corporate “outsider” trades on the basis of material non-public information, in violation of a duty of confidentiality owed by the outsider to the source of the information. For instance, in one case, a stockbroker and several employees of *The Wall Street Journal* were convicted of insider trading after the stockbroker traded on confidential information that was to be included in a column.<sup>iii</sup> Here, the court held that the publication’s employees had a fiduciary obligation to protect confidential information obtained during the course of their employment.<sup>iv</sup>

Both theories also apply to “tippees” (*i.e.*, individuals receiving material non-public information from a “tipper”). A tippee inherits the tipper’s duty and is subject to insider trading liability if (i) the tipper breached a duty by disclosing the information and (ii) the tippee knows or should have known of the breach by the tipper.

Additionally, Section 204A of the Investment Advisers Act of 1940, as amended, requires registered advisers to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material non-public information by the adviser and certain associated persons. Section 204A permits the SEC to sanction an adviser for failing to maintain effective insider trading policies without any underlying misuse of material nonpublic information or other wrong-doing.<sup>v</sup>

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## Material Non-Public Information

Irrespective of the theory of liability, a person only will be liable for insider trading if the information at issue is material and non-public. There is no bright-line test for assessing materiality. Information would be considered material if there is substantial likelihood that a reasonable investor would consider the information important in making his or her investment decision. The information does not need to cause a reasonable investor to change his or her investment decision to be material, but instead would need to be viewed by such investor as significantly altering the “total mix” of available information.<sup>vi</sup> Materiality does not only involve a quantitative determination; qualitative materiality assessments also must be made based on all available facts and circumstances. Among the factors an adviser could consider in making a materiality determination are (i) the specificity of the information, (ii) the significance attached to the information by those who knew it, (iii) whether the information diverges from analysts’ expectations, (iv) the probability that the events that are the subject of the information will occur and (v) the anticipated magnitude of such event in light of a company’s activity. Although not an exhaustive list, the following topics often concern material information: earnings; stock splits or dividends; mergers, acquisitions or disposition of assets or businesses; the discovery or development of a new product; and significant litigation.

Information is considered “non-public” if it has not been broadly disseminated to investors in the marketplace. Information would be considered public after it has become available to the general investing public through a press release, a public filing with the SEC, or by disclosure in *The Wall Street Journal* or some other financial publication and sufficient time has passed so that the information has been disseminated widely. Liability

for insider trading can attach where general information about the matter is public, if the information that is traded upon is more specific than that contained in the public sphere. Additionally, at least one court has held that the fact that information may be found publicly does not necessarily make the information “public” for securities trading purposes unless it is readily accessible or broadly disseminated.<sup>vii</sup>

## Penalties for Insider Trading Liability

Beyond reputational harm, the penalties associated with insider trading liability may be severe. The SEC may obtain injunctive relief, disgorgement of profits gained or losses avoided plus interest, or civil penalties of up to three times the amount of the illegal profits gained or losses avoided. The Department of Justice can seek criminal penalties for insider trading, including fines of up to \$5 million (\$25 million for entities) and imprisonment of up to 20 years.<sup>viii</sup>

## The Mosaic Theory

The mosaic theory, often a defense asserted by an expert network to an insider trading claim, recognizes the validity of investment professionals using publicly available information and immaterial information from private sources to inform the professionals’ investment activity.<sup>ix</sup> A skilled expert’s persistence, knowledge and insights regarding a particular company or industry may constitute valuable and lawful pieces of an adviser’s overall mosaic. The validity of the mosaic theory rests on each piece of the information provided by the expert being public or immaterial. In addition, the expert may not obtain such information in breach of a duty of trust. At times, the source of information furnished to an adviser by an expert network may not be entirely clear. Accordingly, an adviser may consider implementing the compliance controls described below to reduce the risk of

material non-public information being included in the adviser’s mosaic.

## Compliance Considerations

Considering the potential insider trading liability when engaging expert networks and the potential harm to an adviser if it is the subject of an insider trading investigation, it is prudent for advisers to implement compliance practices addressing their use of expert networks (or other research providers). Although any such procedures should be tailored closely to the advisers’ business, the following are general compliance measures that could serve to insulate advisers from the potential insider trading risks associated with using experts.

**Review of insider trading policies.** Advisers should review their insider trading policies no less than annually to ensure that they are sufficiently robust and address current developments in the law. Common elements of well-designed insider trading policies include information barriers, substantive supervision and control over communications by employees, a restricted list of securities, restrictions on and review of securities trading and education and training. The adviser’s employees should make annual certifications concerning their compliance with the adviser’s policies on insider trading.

**Due diligence.** Prior to the engagement, an adviser should conduct due diligence on an expert network, including an assessment of whether the network has an insider trading policy, the network’s processes for checking and approving experts and the representations of the network’s experts with respect to the use of material non-public information.

**Contractual protections.** An adviser’s contract with an expert network should include representations that the experts provided by the network will not disclose material non-public information to the adviser. An adviser should consider

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whether the network should indemnify it for any potential insider trading investigations and/or liability in connection with the provision of information through the network.

**Seek representations from particular experts.** Before engaging in discussions with an expert, an adviser should consider obtaining representations from such person that the expert (i) understands that the adviser should not be provided with material non-public information and (ii) is not violating the terms of any employment, confidentiality or other agreement or duty to refrain from providing the information. For current or former public company employee experts, an adviser could require the consent of the subject company in connection with the expert providing information.

**Outright ban on permissible types of experts.** An adviser could consider whether to restrict access to experts that present heightened risks of conveying material non-public information, such as current employees of a public company, or former employees who are less than one year removed from employment at the subject company.

**Pre-approved and supervised interactions.** An adviser's chief compliance officer should pre-approve any discussion between an adviser's employee and an expert. The chief compliance officer also should consider whether to chaperone interactions between employees and experts. The content of all supervised conversations should be documented and retained by the adviser. At a minimum, any discussions between an adviser's employee and an expert should not occur through informal channels, such as Twitter or text messages.

**Post-interaction controls.** The adviser may consider obtaining from all employees that interact with expert networks a certification that the employee will not trade on material non-public information. Further, the adviser's chief compliance officer should monitor trades by such employees and test such trades against the release of publicly available information, such as press releases and earnings announcements.

**Expert network-specific training.** An adviser should consider supplementing its insider trading training with a module on the appropriate use of expert networks.

## Conclusion

In light of the recent attention paid to expert networking arrangements, advisers should carefully consider the most optimal uses of such networks within their businesses. Increased scrutiny does not mean that advisers must immediately cease engaging expert networks. Instead, by understanding the contours of the insider trading laws and implementing appropriate front-and-back-end controls, advisers can both use experts and decrease the likelihood that they will end up on the front page of the newspaper as the subject of an investigation.

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<sup>i</sup> See, e.g., *SEC v. Galleon Management, LP, et al.*, 09-CV-8811 (S.D.N.Y.); *SEC v. Longoria et al.*, 10-CV-0753 (S.D.N.Y.).

<sup>ii</sup> See, e.g., February 8, 2011 comments of Preet Bharra, United States Attorney for the Southern District of New York ("Now let me begin by making something crystal clear. There is nothing inherently wrong with or bad about hedge funds or expert networking firms or aggressive market research for that matter. Nothing at all.").

<sup>iii</sup> *United States v. Carpenter*, 791 F.2d 1024 (2d. Cir. 1986).

<sup>iv</sup> See *id.* at 1034.

<sup>v</sup> See *In re Morgan Stanley & Co.*, SEC Release No. 54047 (June 27, 2006).

<sup>vi</sup> *Basic v. Levinson*, 485 U.S. 224, 231-32 (1988).

<sup>vii</sup> *United States v. Royer*, 549 F.3d 886 (2d. Cir. 2008).

<sup>viii</sup> In addition, there are implied private rights of action for insider trading violations found in Sections 10(b) of the Securities Exchange Act of 1934, as amended, and 14(e) and Rules 10b-5 and Rule 14e-3 thereunder and a limited express private right of action for contemporaneous traders under Section 20A of the Exchange Act.

<sup>ix</sup> See Speech by Carlo di Florio: Remarks at the IA Watch Annual IA Compliance Best Practices Seminar (March 21, 2011) ("I believe these cases do not represent some inherent hostility by the Commission toward expert networks, nor do they indicate that the Commission is seeking to undermine the mosaic theory").