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ASCENDANT INVESTMENT ADVISER COMPLIANCE CONFERENCE

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# Insider Trading: Creating a Safe Environment (SEC Top Risk)

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# Insider Trading and Tipping

- Defined
- Consequences
- Elements for Liability
- Tippees
- Misappropriators
- Tender Offers
- Regulation FD
- Nonpublic Information on Portfolio Transactions
- Wrap up and tips

# Insider Trading in the News

- Galleon Criminal Investigation
  - To date, 20 fund managers and corporate executives have been charged
  - The investigation ongoing
- Mark Cuban Civil Case
  - Federal court in Texas dismissed SEC complaint
  - SEC appealing
- Investigation of SEC Staff Trading
  - In May 2009, trading by two enforcement attorneys was referred to the Justice Department

# Obligations of Investment Advisers

- Exchange Act – Avoiding Securities Fraud
  - Prohibits fraud in connection with the purchase or sale of a security
- Advisers Act – Mandatory Procedures
  - All registered advisers must establish policies reasonably designed to prevent the misuse of inside information
  - Deficient procedures **alone** can trigger enforcement actions (and do)

# Insider Trading and Tipping

- “Insider trading” refers to the practice of
  - Buying or selling shares of stock (or options)
  - While in knowing possession of material nonpublic information about the issuer or the market for its stock
  - In breach of some obligation with respect to the information
- “Tipping” refers to the practice of
  - Communicating such material nonpublic information to another who then purchases or sells the stock (or options)
    - *By communicating such information, the tipper seeks to do indirectly (i.e., through tipping) that which he or she cannot do directly (i.e., engage in insider trading)*

# Consequences

- Expose the wrongdoers and their “controlling persons” (including employers) to
  - SEC enforcement investigations, administrative proceedings, and lawsuits
  - Unwanted publicity, embarrassment, and bars from serving as a director or officer of a public company
  - Lawsuits brought by private plaintiffs, under both express and implied private rights of action, seeking damages
  - Civil fines of up to three times the profit gained or loss avoided by the wrongdoers (or, in the case of “controlling persons,” the greater of \$1 million or three times the profit gained or loss avoided by the wrongdoers)
  - Criminal investigations, convictions, and sanctions, including substantial criminal fines and (in the case of individuals) prison sentences

# Elements for Liability under Rule 10b-5

- Untrue Statement or Failure To State Fact Necessary To Render Other Statements Made Not Misleading
- Intent – and Possession versus Use
- Materiality
- Nonpublic

# Overcoming Silence

- “Boot-Strapping” from State “Common Law” Principles
- The Value of Information
  - Fiduciary and Other Duties
  - Misappropriation

# The Corporation and Corporate Insiders

- The Corporation Itself
- Directors and Officers
- Employees
- Controlling Shareholders
- “Temporary” Insiders

# Tippees

- Distinguished From “Temporary” Insiders
- Standard for Liability -- Tippee liability requires proof that:
  - The insider/tipper breached a fiduciary or other duty by disclosing the confidential information to the tippee for an improper purpose
    - *The test is “whether the insider personally will benefit, directly or indirectly, from his disclosure”*
    - *Personal benefit includes reputational and “ego” benefits as well*
  - The tippee knew or should have known that the tipper’s communication constituted such a breach
    - *Does not mean that the tippee must have formed a legal judgment*
    - *Enough that the tippee was aware that the information was confidential and was given to him without apparent corporate justification*

# Misappropriators

- One who
  - Misappropriates someone else's information
  - Converts it to his or her own personal use
  - Trades while in possession of that information
    - *Or communicates it to others who trade*

# Tender Offers

- Rule 14e-3's Prohibitions
  - Bar on trading while in possession of material nonpublic information
  - Bar on communicating the material nonpublic information to others

# Issuer's Duty to Disclose

- Mere Possession of Material Nonpublic Information Does Not Give Rise to a Disclosure Duty
- Selective Disclosure Triggers Disclosure Duty under SEC Regulation FD

# Regulation FD

- Regulation FD prohibits issuers and certain persons acting on their behalf from selectively disseminating material nonpublic information to securities industry professionals, institutional investors, and certain other persons who would reasonably be expected to trade or provide trading advice based on the information
- Intentional disclosure of material nonpublic information to such persons must be done in a way that ensures simultaneous public dissemination
- Any unintentional disclosure must be remedied within 24 hours or the next business day (unless the recipient has agreed to keep the information confidential)

# Limits on Regulation FD

- Regulation FD only applies to communications by an issuer's
  - Senior management
  - Investor relations professionals
  - Others who regularly communicate with securities market professionals and security holders
- Regulation FD applies only to an issuer's communications with
  - Securities market professionals
  - Holders of the issuer's securities where it is reasonably foreseeable they will trade based on the information
- Regulation FD does not apply to issuer
  - Communications with the press and rating agencies
  - Ordinary-course business communications with customers and suppliers

# Affect of Regulation FD on Analysts

- Regulation FD was not intended to undermine the role of the analyst
- Because the materiality of information disclosed turns on a reasonable shareholder would view the information as such, issuers can provide analysts with nonpublic information that may be significant to a knowledgeable analyst but would not be viewed as material by the average shareholder

# Affect of Regulation FD on Analysts

- Key SEC statements:
  - “An issuer is not prohibited from disclosing a non-material piece of information to an analyst, even if, unbeknownst to the issuer, that piece helps the analyst complete a ‘mosaic’ of information that, taken together, is material”
  - Regulation FD is not focused on “whether an analyst, through some combination of persistence, knowledge, and insight, regards as material [any] information whose significance is not apparent to the reasonable investor”
  - “If an analyst sought to ferret out information about an issuer’s business by quizzing a store manager on how business was going, the store manager’s response ordinarily would not trigger any Regulation FD obligations”

# Analyst Liability for Reg FD Violations?

- While in theory this could happen, it's not likely
- Analyst cannot control what words a company official ultimately utters
- But, analysts could face aiding and abetting liability where the analyst “conspires” with the company to obtain material nonpublic information or tries to coerce the company into making selective disclosure

# Current Issues

- Nonpublic Information on Portfolio Transactions
  - State Street
  - Evergreen
- “Value added” clients and investors
- Use of consultants
- Access to MNPI on deal systems (e.g., Intralinx)
- SEC focus on procedures

# Wrap up and tips

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