THE LAW OF INSIDER TRADING: LEGAL THEORIES, COMMON DEFENSES, AND BEST PRACTICES FOR ENSURING COMPLIANCE

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The authors wish to thank and acknowledge their colleagues Glen P. Barrentine, Robert Zwirb, and Sharon Rose and friend Michael Wheatley for their valuable assistance with this piece.

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I.
INTRODUCTION

The government's 2011 prosecution of hedge fund manager Raj Rajaratnam and the various investigations into the use of expert networks by hedge funds and other institutional investors have prompted questions about the law of insider trading, permissible methods of gathering information, general defenses to allegations of insider trading, and the ways in which firms can reduce risks of liability.[1] As a first line of de-

1. The term "expert network" is used to refer to firms that are in the business of connecting clients, principally institutional investors, with per-

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fense, investment firms should ensure that robust and comprehensive compliance programs are in place to reduce the risk of potential insider trading.[2] Regardless of the quality of their compliance procedures, however, institutional investors and financial services personnel may be suspected of, or even face criminal and civil charges for insider trading. To assist firms and individuals in considering and weighing possible defenses against actions brought by the Department of Justice ("DOJ") or the Securities and Exchange Commission ("SEC"), this Article (1) provides an overview of the relevant law regarding insider trading, (2) discusses some of the general legal and factual defenses that may be raised, depending on the facts and circumstances of the case, and (3) provides guidelines for establishing and maintaining an effective compliance program to minimize the risks of insider trading liability.

Any firm that becomes the subject of an insider trading investigation should be mindful that the law of insider trading is nuanced and highly dependent upon the facts and circumstances of a particular case. This Article analyzes the current law of insider trading and describes some of the key defenses that may be raised in consultation with counsel.

II.
LEGAL OVERVIEW

A. *Background on Insider Trading*

In general terms, insider trading laws prohibit trading a security on the basis of material nonpublic information, where the trader has breached a duty of trust or confidence owed to either an issuer, the issuer's shareholders, or the source of the information, and where the trader is aware of the breach.[3] Im-

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sons who are deemed to have special expertise in the client's area of interest. Experts can include academics, scientists, engineers, doctors, lawyers, suppliers, and professional participants in the relevant industry, including in some cases even former employees of the company of interest. These networks can save investors the time, cost, and uncertainty associated with obtaining specialized knowledge on their own. If used properly, expert networks can be a valuable and legitimate research tool that facilitates efficient access by clients to persons with specialized and valued expertise.

2. *Id.*

3. *See* 17 C.F.R. § 240.10b5-1, -2 (2010). If trading relates to a planned or existing tender offer, Rule 14e-3 makes trading unlawful without regard to whether any fiduciary duty exists. *See* 17 C.F.R. § 240.14e-3 (2010).

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plicit in its name, the law of insider *trading* prohibits actual *trading* in a security while in possession of material nonpublic information; the law does not prohibit refraining from trading while in possession of such information.[4]

The *sine qua non* of any insider trading claim is material nonpublic information. As a general matter, information that is "public" cannot form the basis of an insider trading claim. This encompasses not only publicly distributed information, but also information that an investor personally developed from independent observation of the public world. For example, watching trucks on a public road as they leave a warehouse (as a means to help ascertain the level of demand for a product) cannot form the basis of an insider trading claim. Likewise, to adequately state a cause of action for insider trading, the information at issue must be "material." The Supreme Court has said that information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision.[5] This standard requires a showing that there is a substantial likelihood that the fact "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[6]

The materiality of particular information often becomes a central question in an insider trading case involving an institutional investor. In general, an investor that assembles multiple pieces of *non-material* information to reach a material conclusion has not violated insider trading laws, regardless of whether the information obtained was nonpublic.[7] Indeed, institutional investors, such as hedge funds, often piece together

4. *Cf.* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (holding only purchasers and sellers of securities have standing to sue for damages under 10b-5).

5. *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (articulating materiality standard in shareholder voting context); Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1988) (expressly adopting the standard of materiality from *TSC Industries*, 426 U.S. 438 (1976), for the context of Rule 10b-5).

6. *TSC Indus.*, 426 U.S. at 449.

7. To be sure, if all the non-material information was obtained through improper means (*i.e.*, with knowledge of the breach of a duty to the source of the information), a court may view the information in the aggregate as a "material" whole and thus hold that the conduct constitutes insider trading, assuming all of the other elements are met. This may be particularly true

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bits of public and nonpublic, *non-material* information to understand the broader position of a particular company. This practice is commonly referred to as the "mosaic" theory of investing and it can serve as the basis of a defense to insider trading charges, particularly where the SEC asserts that an investor, who may have inadvertently obtained information from a tipper who breached his fiduciary duty, traded on that information.[8]

B. *Liability for the Fund or Firm Based on Conduct of Employees*

Although the law of insider trading is focused on the actions of individuals, a fund or financial services firm may face criminal and civil liability if firm management explicitly or implicitly consents to an individual's conduct such that the acts of the wrongdoer-employee are deemed to have occurred within the scope of employment.[9] For example, under Section 21A of the Securities Exchange Act of 1934 (the "Exchange Act"), a fund or financial services firm that employs a tipper (i.e., an employee who shares information with someone outside the firm) or tippee (i.e., an employee who receives the material nonpublic information and then trades) may be liable for a civil penalty of up to the greater of either three times the direct profits of the trade or $1,000,000.[10] An employer's

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when all of the improperly obtained non-material nonpublic information derives from a single source.

8. *See, e.g.*, State Teachers Ret. Bd. v. Fluor Corp., 654 F.2d 843, 854 (2d Cir. 1981) (citation omitted); *see also* Andrew Ross Sorkin, *Collecting Tidbits, and Trouble*, N.Y. TIMES, Nov. 30, 2010, at B1 (discussing mosaic theory as a defense employed by Raj Rajaratnam, founder of the Galleon Group).

9. *See, e.g.*, SEC v. Mgmt. Dynamics, Inc., 515 F.2d 801, 812-13 (2d Cir. 1975) (holding stock brokerage firm civilly liable for its employees' insider trading on grounds that it placed the traders in a position to engage in insider trading); *see also* RESTATEMENT (SECOND) OF AGENCY § 219(1) (1958) ("A master is subject to liability for the torts of his servants committed while acting in the scope of their employment."). However, for purposes of vicarious tort liability, most courts have taken the view that insider trading is not within the scope of employment. *See, e.g.*, Energy Factors, Inc. v. Nuevo Energy Co., No. 91 Civ. 4273, 1992 U.S. Dist. LEXIS 10208, at *18 (S.D.N.Y. July 7, 1992) (holding that an employee who trades on or tips material, nonpublic information "must normally be viewed as on a frolic of his own" (quoting O'Connor & Assoc. v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179, 1194 (S.D.N.Y. 1981))).

10. Securities Exchange Act of 1934 § 21A, 15 U.S.C. § 78u-1(a)(3) (2006).

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liability may be established if it "knew or recklessly disregarded the fact that such [employee] was likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent such act or acts before they occurred."[11] The employer-firm may also be liable if it "knowingly or recklessly failed to establish, maintain, or enforce any policy or procedure required under Section 15(f) [for registered broker-dealers] or Section 204 of the Investment Advisers Act of 1940 [for registered investment advisers]," and the failure is found to have substantially contributed to, or permitted the occurrence of, the act or acts constituting the violation.[12]

C. *Theories of Insider Trading*

The crux of criminal and civil insider trading law derives from Section 10(b) of the Exchange Act (although criminal authorities often utilize additional laws to prosecute insider trading such as conspiracy and aiding and abetting). According to case law, insider trading violates Section 10(b), which makes it unlawful to "use or employ, in connection with the purchase or sale of any security. . . any manipulative or deceptive device or contrivance in contravention of" rules promulgated by the SEC.[13] Rule 10b-5 under the Exchange Act, adopted pursuant to the SEC's authority under Section 10(b), makes it unlawful to "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."[14]

Based upon these provisions, the Supreme Court has long recognized three general theories of insider trading liability, commonly referred to as: (1) the "classical" theory, (2) the

11. Securities Exchange Act of 1934 § 21A, 15 U.S.C. § 78u-1(b)(1)(A)) (2006).

12. The legislative history of the liability penalty provision of Section 21A(b)(1) of the Securities Exchange Act of 1934 (codified at 15 U.S.C. § 78u-1(b)(1) (2006)) implies that a firm's failure to adopt prophylactic policies and procedures may result in the firm being deemed reckless and therefore liable for the conduct of employees. H.R. Rep. No. 100-910, at 18 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6062. For a description of compliance considerations with respect to interaction with expert networks, *see* Cadwalader, Wickersham & Taft LLP, *supra* note 1.

13. 15 U.S.C. § 78j(b) (2006).

14. 17 C.F.R. § 240.10b-5 (2010).

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"tipper-tippee" theory, and (3) the "misappropriation" theory. Importantly, in order to fit within any of these three categories, a person (although not necessarily the person actually trading) must have violated a duty of trust or confidence. In addition, the Second Circuit has more recently recognized a fourth theory of insider trading, referred to as "outsider trading" or the "affirmative misrepresentation" theory, based on an affirmative misrepresentation that does not require a breach of a duty.

1. *"Classical" Theory.*

The "classical" theory of insider trading generally applies when an insider, in violation of a fiduciary duty to his or her company (or to another company to which the insider owed a duty), trades in the securities of the company on the basis of material nonpublic information obtained by reason of the insider's position.[15] As discussed below, the SEC has defined by rule the concept "on the basis of" to mean that the person merely was aware of the nonpublic information at the time of the trade.[16] The classical theory covers situations in which a company executive, board member, or agent, such as an investment banker, trades in the company's securities or in the securities of a potential deal partner prior to the release of news concerning a significant event, such as a tender offer, merger, or earnings announcement.

2. *"Tipper-Tippee" Theory.*

The "tipper-tippee" theory imposes liability when (1) the tipper "has breached his fiduciary duty to the shareholders by disclosing the [material nonpublic] information to the tippee", (2) the tippee "knows or should know that there has been a breach", (3) the tippee uses the information in connection with a securities transaction, and (4) the tipper receives some personal benefit in return.[17] The fourth element is satisfied when a tipper either receives "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

15. *See* Chiarella v. United States, 445 U.S. 222, 228 (1980).

16. *See* 17 C.F.R. § 240.10b5-1(b) (2010). For further discussion of the term "on the basis of," see *infra* Section II.D

17. Dirks v. SEC, 463 U.S. 646, 647 (1983).

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makes a "gift of confidential information to a trading relative or friend."[18]

3. *"Misappropriation" Theory.*

The "misappropriation" theory applies to situations in which a person, who is not an insider, lawfully comes into possession of material nonpublic information, but nevertheless breaches a duty of trust or confidence (as further discussed below) owed to the source of the information by trading on the basis of such information or by conveying the information to another person to trade.[19]

In sum, the legal framework surrounding insider trading is nuanced and comes from a multiplicity of legal sources. Moreover, different types of financial firms may be more likely to be charged under different theories. For example, an issuer or investment bank may be more commonly charged under the classical theory, while an institutional investor may more likely be charged under the tipper-tippee theory. In any case, the methods to prevent insider trading and the legal issues to consider in the event of any charge regarding insider trading require careful and detailed analysis of the particular facts.

4. *"Outsider Trading" or the "Affirmative Misrepresentation" Theory.*

In 2009, the Second Circuit recognized a novel form of insider trading – referred to by some commentators as the "outsider trading" or the "affirmative misrepresentation" theory – that does not require a breach of a fiduciary duty. In *SEC v. Dorozhko,* the Second Circuit held that neither Supreme Court nor Second Circuit precedent imposed a fiduciary duty requirement on the ordinary meaning of "deceptive" where the alleged fraud is an affirmative misrepresentation rather

18. *Id.* at 664. Courts take a broad view of factors that constitute a "personal benefit." Tippers have been found liable for, amongst other actions, providing material, nonpublic information in order to: maintain a solid working and personal relationship, *see* SEC v. Yun, 327 F.3d 1263, 1280 (11th Cir. 2003); maintain networking contacts, *see* SEC v. Sargent, 229 F.3d 68, 77 (1st Cir. 2000); or benefit another within the context of a close friendship, *see* SEC v. Maio, 51 F.3d 623, 632 (7th Cir. 1995).

19. United States v. O'Hagan, 521 U.S. 642, 652 (1997).

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than a non-disclosure.[20] This holding created controversy because it marked the first time a court had recognized insider trading without finding a breach of a fiduciary duty.[21] The case arose from an unusual set of facts that warrant reciting. Oleksandr Dorozhko allegedly hacked into Thomson Financial's secure computer system where he accessed the third-quarter earnings of IMS Health, Inc. ("IMS") before they were released to the public.[22] Dorozhko then purchased a substantial volume of put options expiring within two weeks.[23] When the financial results were finally publicized, Dorozhko profited by selling the put options of IMS he had purchased previously.[24]

The SEC brought an action alleging that Dorozhko committed insider trading by affirmatively misrepresenting himself (i.e., hacking into the computer system) in order to gain access to material nonpublic information about IMS, which he used to trade.[25] The United States District Court for the Southern District of New York denied the SEC's motion for a preliminary injunction to freeze the proceeds of Dorozhko's transactions, holding that the SEC had not shown that it likely would succeed on the merits of a claimed violation of Section 10(b) of the Exchange Act.[26] Relying on insider trading law precedent, the district court determined that the "deceptive device" element of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder requires a breach of fiduciary duty.[27] Because Dorozhko, a hacker, did not owe a fiduciary duty either to the source of the information or to those persons with whom he had transacted in the market, the court determined that he was not liable under Section 10(b).[28]

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20. SEC v. Dorozhko, 574 F.3d 42, 49 (2d Cir. 2009).

21. See Michael D. Wheatley, Apologia for the Second Circuit's Opinion in SEC v. Dorozhko, 7 J.L. ECON. & POL'Y 25, 25 (2010).

22. SEC v. Dorozhko, 606 F. Supp. 2d 321, 325-26 (S.D.N.Y. 2008).

23. *Id.* at 326.

24. *Id.*

25. *Dorozhko,* 574 F.3d at 49.

26. *Dorozhko,* 606 F. Supp. 2d at 343.

27. *Dorozhko,* 574 F.3d at 49 (citing Chiarella v. United States, 445 U.S. 222, 235 (1980) (finding that "there can be no fraud absent a duty to speak") and United States v. O'Hagan, 521 U.S. 642, 653 (1997) (finding that defendant violated duty to law firm and its clients by misappropriating and trading based on material nonpublic information)).

28. *Dorozhko,* 606 F. Supp. 2d at 343.

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On appeal, the Second Circuit held that an affirmative misrepresentation in connection with the purchase or sale of a security is a "distinct species of fraud" that violates the securities laws regardless of the existence of a fiduciary duty.[29] Absent a fiduciary duty to disclose or abstain from trading, the defendant still had an affirmative obligation not to mislead someone.[30] The court stated, "misrepresenting one's identity in order to gain access to information that is otherwise off limits, and then stealing that information is plainly 'deceptive' within the ordinary meaning of the word . . . . [I]t seems to us entirely possible that computer hacking could be, by definition, a 'deceptive device or contrivance' that is prohibited by Section 10(b) and Rule 10b-5."[31] The case was remanded to the district court to resolve whether Dorozhko's hacking constituted a deceitful affirmative misrepresentation. On remand, the district court granted the SEC's unopposed motion for summary judgment. [32]

Questions remain as to whether the *Dorozhko* decision has any significance outside the computer hacking context. One can envision the "affirmative misrepresentation" concept extended to investment interactions where institutional investors are accused of tricking market participants into sharing material nonpublic information.[33]

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29. *Dorozhko*, 574 F.3d at 49.

30. *Id.* (distinguishing insider trading in abrogation of a duty to disclose or abstain from trading, from affirmative representations of those who are under no duty other than one not to mislead (citing Basic v. Levinson, 485 U.S. 224, 240 n.18 (1988))).

31. *Id.* at 51.

32. SEC v. Dorozhko, No. 07 Civ. 9606 (NRB) (S.D.N.Y. Mar. 24, 2010) (order of Judge Buchwald), *available at* http://law.du.edu/documents/corporate-governance/sec-and-governance/dorozhko/SEC-v-Dorozhko.pdf. In granting the motion for summary judgment, the district court directed Dorozhko to disgorge illegal gains of $286,456.59 and $6,903.94 in prejudgment interest; the court also barred him from future violations of federal securities laws. *Id.* Dorozhko's counsel, Charles A. Ross, had told the court that he was unable to contact his client and therefore did not oppose the motion. *See* Yin Wilczek, *Court Grants SEC Summary Judgment In Ukrainian Hacker Insider Trading Case*, 42 SEC. REG. & L. REP. (BNA) 584 (2010).

33. For instance, a counterparty in a private loan transaction might seek to obtain material, nonpublic information under false pretences to use in making an investment in public securities of the counterparty.

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D. *Rule 10b5-1: Definition of "on the basis of"*

In 2000, the SEC defined by rule the concept of trading "on the basis of" material nonpublic information. Under Rule 10b5-1, "a purchase or sale of a security of an issuer is 'on the basis of' material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale."[34] With a few exceptions, a trader's other motivations for making the trade are generally not a defense as long as he was aware of the material nonpublic information at the time of the trade.

Importantly, Rule 10b5-1 expressly provides three affirmatives defenses. The trader has not traded "on the basis of" material nonpublic information if he demonstrates that "[b]efore becoming aware of the information," he (1) entered into a binding contract to purchase or sell the security, (2) instructed another person to purchase or sell the security for the instructing person's account, or (3) adopted a written plan for trading securities (a so-called "10b5-1 plan").[35] These affirmative defenses turn on the trader's ability to show that he already had plans to execute the trade *before* learning of the material nonpublic information.[36]

With respect to 10b5-1 plans, insider trading occurs, as the name suggests, where there has been "trading." It is not a violation for a person to halt or suspend a plan *to avoid* trading,[37] although repeatedly stopping and restarting a 10b5-1 plan would be viewed with skepticism by the SEC.[38]

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34. 17 C.F.R. § 240.10b5-1(b) (2010).

35. 17 C.F.R. § 240.10b5-1(a)(1)(i)(A) (2010).

36. *See* Press Release, SEC, Former Countrywide CEO Angelo Mozilo to Pay SEC's Largest-Ever Financial Penalty Against a Public Company's Senior Executive (Oct. 15, 2010), *available at* http://www.sec.gov/news/press/2010/2010-197.htm (describing SEC settlement of an insider trading suit against former Countrywide CEO Angelo Mozilo, who established four 10b5-1 plans to sell options in Countrywide's stock while aware of material, nonpublic information about increasing risk due to the poor performance of loans Countrywide originated).

37. *See Exchange Act Rules: Questions and Answers of General Applicability, Question 120.17*, SEC (last updated Feb. 11, 2011), http://www.sec.gov/divisions/corpfin/guidance/exchangeactrules-interps.htm.

38. *See, e.g.*, Linda Chatman Thomsen, Dir., Div. of Enforcement, SEC, Opening Remarks Before the 15th Annual NASPP Conference (Oct. 10, 2007), *available at* http://www.sec.gov/news/speech/2007/spch101007lct.

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E. *Rule 10b5-2: Definition of Duty of Trust or Confidence*

In 2000, the SEC defined by rule a non-exhaustive list of the relationships that would establish a duty of trust or confidence for purposes of the misappropriation theory.[39] Under Rule 10b5-2, a duty of trust or confidence arises between a recipient of material nonpublic information and the source when: (1) the recipient "agrees to maintain the information in confidence"; (2) the source and recipient "have a history, pattern, or practice of sharing confidences," such that the recipient knew or reasonably should have known the source expected the information to be kept in confidence; or (3) where the source is the "spouse, parent, child, or sibling" of the recipient.[40] Although the validity of this rule was called into question by the Fifth Circuit in *SEC v. Cuban*,[41] the rule remains valid in other circuits. Therefore, it is prudent for an institutional investor when designing its compliance procedures to continue to view the duty of trust or confidence through the lens of Rule 10b5-2.

F. *Potential Criminal Charges Associated with Insider Trading*

Section 32 of the Exchange Act makes it a crime to willfully violate any provision of the Exchange Act or rule enacted thereunder, including Rule 10b-5.[42] Thus, the DOJ, as well as the SEC, can pursue an insider trading violation.

In addition to charges for insider trading, the DOJ has the option to bring charges that the SEC cannot. These charges include conspiracy, mail and wire fraud, false statements to in-

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htm (stating generally that the SEC is scrutinizing 10b5-1 plans to identify potential abuses where executives may be trading on inside information by using such plans for cover); Linda Chatman Thomsen, Dir., Div. of Enforcement, SEC, Remarks at the 2007 Corporate Counsel Institute (Mar. 8, 2007), *available at* http://www.sec.gov/news/speech/2007/spch030807lct2.htm (same).

39. *See* Selective Disclosure and Insider Trading, Exchange Act Release No. 33-7881, 65 Fed. Reg. 51,716 (Aug. 24, 2000) (adopting, among other things, Regulation FD and Exchange Act Rule 10b5-2), *available at* http://www.sec.gov/rules/final/33-7881.htm.

40. 17 C.F.R. § 240.10b5-2(b)(1)-(3) (2010).

41. 620 F.3d 551, 555-58 (5th Cir. 2010) (noting, but leaving open, the question of whether Rule 10b5-2 goes beyond the scope of Section 10(b) of the Exchange Act).

42. *See* Securities Exchange Act of 1934 § 32, 15 U.S.C. § 78ff (2006).

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vestigators, and perjury. Furthermore, none of the aforementioned charges requires the government to establish the elements of insider trading.[43]

In addition, funds and financial services firms should be aware of Section 807 of the Sarbanes-Oxley Act ("SOX 807").[44] On its face, SOX 807 appears broader than Rule 10b-5 in a number of important ways. The language of SOX 807 does not include the requirement that there be a "purchase" or "sale" of a security, only that the violation be "in connection" with a security—a vague requirement that may, in itself, be subject to legal challenge. SOX 807 also imposes liability for any attempt "to execute a scheme or artifice" to defraud. Moreover, the government may argue from the face of the statute that "materiality" in the context of SOX 807 be judged from the perspective of the issuing company, rather than that of a reasonable investor.[45] Although serious questions remain about the constitutionality of SOX 807, it presents a seldom-used, but potentially powerful, tool for criminal prosecutors.

G. *Insider Trading in the Debt Markets, Credit Derivatives, and Distressed Loan Markets*

Historically, regulators have focused on insider trading in equity markets rather than in debt or credit derivatives markets. In recent years, the ability to transfer credit risk through the use of credit default swaps ("CDS") and the volatility of the

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43. The statutory bases for such charges are 18 U.S.C. § 371 (2006) (conspiracy against the United States), 18 U.S.C. § 1001(a) (2006) (false statements to investigators), 18 U.S.C. § 1341 (2006) (mail fraud), 18 U.S.C. § 1343 (2006) (wire fraud), and 18 U.S.C. § 1621 (2006) (perjury). *Compare* Indictment at 5-6, 11-12, United States v. Binette, No. 3:10-CR-30036-MAP (D. Mass. Oct. 14, 2010) (alleging defendants committed insider trading, in violation of 15 U.S.C. §§ 78j(b), 78f(a)) *with* Redacted Superseding Indictment, United States v. Stewart, 323 F. Supp. 2d 606, 624–34 (S.D.N.Y. 2004) (alleging that, in connection with a stock trade, defendants made false statements in violation of 18 U.S.C. § 1001(a), committed perjury in violation of 18 U.S.C. § 1621, and conspired to obstruct justice in violation of 18 U.S.C. § 371, but *not* alleging insider trading).

44. Sarbanes-Oxley Act of 2002 § 807, 18 U.S.C.A. § 1348 (West 2010).

45. *See* United States v. Mahaffy, No. 05-CR-613, 2006 U.S. Dist. LEXIS 53577, at *39–42 (E.D.N.Y. Aug. 2, 2006) (stating that materiality is satisfied where an employee's misrepresentation or omission "would naturally tend to lead or is capable of leading a reasonable employer to change its conduct" (quoting United States v. Rybicki, 354 F.3d 124, 127 (2d Cir. 2003))).

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fixed income markets, have drawn attention to the issue of insider trading in the debt markets.[46] Correspondingly, in recent years, the SEC has brought more insider trading cases relating to debt market activities. For example, in *SEC v. Marquardt*, the SEC brought and settled an insider trading case against the senior vice president of an investment adviser to a mutual fund, who had traded based on material nonpublic information about significant devaluations to the collateralized debt obligations, collateralized mortgage obligations, and other mortgage-related securities that the fund owned.[47] In *SEC v. Barclays Bank PLC*, the SEC brought and settled an action against Barclays Bank and one of its former proprietary traders in distressed debt for illegally trading bond securities while aware of material nonpublic information.[48] According to the settlement, the trader had misappropriated material nonpublic information he obtained while representing Barclays on several creditor committees, without disclosing the information to the bank's bond trading counterparties or disclosing

46. This attention may have been precipitated, at least partially, by a buy-side publication that questioned whether banks were using inside information obtained as lenders to take advantage of bond investors through the purchase of credit default swaps. *See* Chris P. Dialynas, PIMCO,"RED ALERT": THE CURRENT ACCOUNT DEFICIT AND CORPORATE BOND SPREADS 13-14 (Nov. 2003) (citing to Chris P. Dialynas, PIMCO, BOND YIELD SPREADS REVISITED AGAIN AND PUBLIC POLICY IMPLICATIONS (Oct. 2002)), *available at* http://faculty.fuqua.duke.edu/~charvey/Teaching/BA453_2004/Street_research/Risks_view_pimco.pdf. After publication of the 2002 article, a number of trade associations collectively published a statement concerning the prevention of insider trading in the credit markets. *See* JOINT MKT. PRACTICES FORUM, STATEMENT OF PRINCIPLES AND RECOMMENDATIONS REGARDING THE HANDLING OF MATERIAL NONPUBLIC INFORMATION BY CREDIT MARKET PARTICIPANTS (Oct. 2003). None of these publications has the force of law or creates any safe harbor.

47. SEC v. Charles J. Marquardt, SEC Litigation Release No. 21383 (Jan. 20, 2010), *available at* http://www.sec.gov/litigation/litreleases/2010/lr21383.htm; *see also* Complaint ¶ 8, SEC v. Marquardt, No. 10-CV-10073 (D. Mass. Jan. 20, 2010). Given the nature of the securities held by the fund, the investment adviser valued the assets internally based on certain pre-determined methods as there was no readily-available market price.

48. SEC v. Barclays Bank PLC and Steven J. Landzberg, SEC Litigation Release No. 20132 (May 30, 2007), *available at* http://www.sec.gov/litigation/litreleases/2007/lr20132.htm. The SEC settled the case with the defendants for nearly $11 million. *Id.*

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the bank's trading activities to the sources of his information.[49]

While the prohibition on insider trading applies as much to debt securities and credit derivatives as it does to equities, the application of the prohibition to the credit markets turns out to be particularly complicated for multiple reasons. Unlike the equity markets, the credit markets include similar products that may trade on the public side (debt securities) or on the private side (bank loans), as well as products that may be traded on both the public and private side of a financial institution (credit default swaps). For example, structured debt securities such as collateralized loan obligations ("CLOs") are composed of underlying loans for which material nonpublic information is often shared with loan traders. Determining whether material nonpublic information about particular loans *within* the CLO equates to material nonpublic information *about* the CLO securities is often a challenging task that could depend upon such facts as the concentration of the loans for which material nonpublic information is known and the risk of default of the CLO tranche of the investment.

The SEC recently applied the law of insider trading to the credit default swap market. In *SEC v. Rorech*, the SEC brought an action against a salesman at Deutsche Bank Securities for sharing information about the restructuring of an upcoming bond issuance with a hedge fund portfolio manager, who then purchased CDS covering the particular bonds.[50] Because the price of the CDS was based on the price of the underlying bonds, the SEC argued that they were "security-based swap agreements" covered under the antifraud provisions of the securities laws.[51] Although the court held that insider trading had not occurred because the information shared was not prohibited and the SEC did not show that the parties had engaged in any deceptive acts, the court found that the CDS were "security-based swap agreements" and therefore subject to insider trading prohibitions.[52]

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49. *Id.*

50. SEC v. Rorech, 720 F. Supp. 2d 367, 371 (S.D.N.Y. 2010); *see also* Complaint ¶¶ 12 -13, SEC v. Rorech, No. 09-CIV-4329 (S.D.N.Y. May 5, 2009) (arguing that a CDS is a type of credit derivative security, traded over the counter).

51. *Rorech*, 720 F. Supp. 2d at 405.

52. *Id.* at 405-06.

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The question of whether a CDS constitutes a security has been largely resolved by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"). In Dodd-Frank, Congress amended Section 2(a) of the Securities Act of 1933 (the "Securities Act") and Section 3(a)(10) of the Exchange Act to include "security-based swaps" in the definition of a security, effective July 2011.[53]

Distressed loan trading is another area that has recently received considerable attention from regulators. The primary and secondary markets for distressed bank debt have grown dramatically during the past decade. Distressed bank debt is generally not viewed as a security, at least when traded between dealers or commercial lenders. If the bank note has a maturity of less than nine months, it is expressly exempted from the definition of a security under Section 3(a)(3) of the Securities Act (unless the context otherwise requires).[54] For longer-term bank debt, courts have determined that the Securities Act's use of the phrase "any note" in the definition of a security generally does not apply to those notes issued in a consumer or commercial context, including consumer financing, home mortgages, or short-term notes secured by a lien on a small business or its assets, among others.[55] Nevertheless, courts recognize that greater scrutiny is often needed to assess whether a note may be characterized as a commercial loan or whether it is more appropriately viewed as a security in specific contexts. In the seminal case *Reves v. Ernst & Young*, the Supreme Court articulated several factors that courts must consider in determining whether a note displays the economic substance of a security for purposes of applying insider trading and other securities laws. In general, instruments that are sold to raise capital, purchased for investment purposes rather than personal consumption, commonly traded, perceived by the

53. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 761(a)(6), 768(a)(1), 124 Stat. 1376, 1755, 1800 (2010).

54. While Section 2(a)(1) of the Securities Act lists "note" among the definition of "security," 15 U.S.C. § 77b(a)(1) (2006), Section 3(a)(3) exempts short-term instruments, including "[a]ny note, draft, bill of exchange, or banker's acceptance," with a maturity of nine months or less from this definition. § 77c(a)(3).

55. *See* Reves v. Ernst & Young, 494 U.S. 56, 65 (1990) (citing Exchange Nat. Bank of Chicago v. Touche Ross & Co., 544 F.2d 1126, 1137 (2d Cir. 1976)).

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public to be a security, or that fall outside other regulatory frameworks (such as banking regulations) may be considered securities.[56]

Distressed loan trading is an area in which substantial attention is required to establish effective walls. Traders at a firm that trades in distressed bank debt who receive inside information should be walled off from the traders of high-yield debt securities (subject to insider trading laws), even though the two areas are closely related from a business standpoint.[57]

H. *Insider Trading in the Commodity Futures and Derivatives Markets*

In contrast to the broad prohibition against insider trading found in the securities laws, insider trading is considered an accepted and integral practice in the commodity futures and derivatives markets. Not only does the Commodity Exchange Act (the "CEA") lack a prohibition against insider trading in commodities (except with respect to certain individuals connected with the regulation, self-regulation, or exchange governance of those markets),[58] but the CEA actually accepts insider trading as a means to facilitate efficient pricing of commodities.[59]

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56. *See id.* at 66-67 (adopting a four-part "family resemblance" test to determine the nature of specific instruments for purposes of applying the securities laws).

57. Some firms conduct bank debt trading, but do not access the inside information to which they may be entitled as a holder of the debt. This allows them to continue to trade on the public side, subject to their being able to demonstrate that they did not access the inside information. Other firms are careful to ensure that any nonpublic information they obtain on the private side is *not* material to any public securities they purchase.

58. *See* Commodity Exchange Act §9(d), (f), 7 U.S.C. §13(d), (f) (2006) (prohibiting Commissioners and Commission employees and members or employees of any governing board of trade, registered entity, or registered futures association to trade on the basis of material nonpublic information obtained through special access related to the performance of their duties); *see also* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1737-1739 (2010) (prohibiting the use of, nonpublic information by "any employee or agent of any department or agency of the Federal government" for personal gain by entering into or offering to enter into a futures contract, option on futures contract, or swap, or assisting another person to do the same).

59. *See* Sharon Brown-Hruska & Robert S. Zwirb, *Legal Clarity and Regulatory Discretion — Exploring the Law and Economics of Insider Trading in Deriva-*

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This divergence in regulatory treatment towards insider trading in the two markets is due to fundamental differences between the equities and commodity futures markets. In contrast to the securities markets, whose purpose centers on capital formation, which in turn gives rise to a number of obligations, including those of a fiduciary nature, the purpose of the commodity futures and derivatives markets is to provide a forum for price discovery and risk management. These markets, as a joint report by the SEC and CFTC acknowledges, "permit hedgers to use their non-public material information to protect themselves against risks to their commodity positions."[60] In other words, commodity futures and derivatives markets exist to facilitate trading based on information generated by participants' inside knowledge.[61]

As the CFTC has recognized, "it would defeat the market's basic economic function—the hedging of risk—to question whether trading on knowledge of one's own position were permissible."[62] In contrast to the premise within securities law that investors should have equal access to material market information and that corporate insiders owe a fiduciary duty to shareholders, there is no similar expectation in the commodity futures and derivatives markets that market participants have, or even should have, equal access to nonpublic information, or that corporate officials and personnel have a similar fiduciary duty with respect to their counterparties.[63]

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tives Markets, 2 Cap. Markets L.J. 245, 254 (2007) (observing that commodities markets, and related futures markets, *rely upon* individuals and entities that have privileged information . . . to trade on their information in the commodities markets, whether on behalf of themselves or their firm").

60. U.S. Commodity Futures Trading Comm'n et al., A Joint Report of the SEC and the CFTC on Harmonization of Regulation 7, (Oct. 16, 2009), *available at* http://www.sec.gov/news/press/2009/cftcjointreport101609.pdf.

61. Brown-Hruska & Zwirb, *supra* note 59, at 254 (observing that such markets "*rely upon* individuals and entities that have privileged information . . . to trade on their information in the commodities markets, whether on behalf of themselves or their firm").

62. U.S. Commodity Futures Trading Comm'n, A Study of the Nature, Extent and Effects of Futures Trading by Persons Possessing Material, Nonpublic Information 8 (1984).

63. *Id.* at 53-54.

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III.
LEGAL AND FACTUAL DEFENSES

Because the law has developed in the courts, insider trading law is fluid and continues to evolve as markets grow, technology changes, and the DOJ and SEC press new theories of insider trading. Inevitably accompanying those new and expansive prosecutorial theories are new legal and factual defenses that should be considered.[64]

The SEC bears the burden of proving that an insider possessed material nonpublic information on which the insider traded. Even as the law evolves, facts play a critical role in an insider trading case. The presence or absence of certain facts can make a tremendous difference in the outcome of a case. For example, in the recent decision of *SEC v. Zachariah*, the SEC lost its case against the defendant, a corporate board member, because the SEC was unable to prove that the CEO actually relayed certain information to the defendant before the defendant executed the trades in question.[65] The defendant had a pattern of trading the company's stock before joining its board and actually placed trades during a specified "black-out" period.[66] However, the SEC introduced no direct or circumstantial evidence that the defendant and the CEO spoke prior to the trades.[67] Further, the SEC was unable to show that the defendant received inside information from any other source.[68] In another high-profile case, the SEC lost a long battle against Heartland Advisors when the district court

64. The SEC often moves quickly to file cases and freeze assets, even before details regarding the exchange of inside information is known. *See, e.g.*, Complaint ¶¶ 1–2, SEC v. One or More Unknown Purchasers of Martek Biosciences Corp., No. 10-Civ-9527, 2010 WL 5523571, at *1 (S.D.N.Y. Dec. 22, 2010) (charging unidentified persons with insider trading violations based on purchases of a large volume of Martek call options days before a takeover announcement, resulting in unrealized profits of $1.2 million); Complaint ¶ 1, SEC v. One or More Unknown Purchasers of Options of InterMune, Inc., No. 10-Civ-9560, 2010 WL 5523583, at *1 (S.D.N.Y Dec. 23, 2010) (filing insider trading charges against unknown individuals who purchased call options days before a positive news release regarding one of InterMune's drugs, resulting in unrealized profits of over $900,000).

65. *See* Findings of Fact and Conclusions of Law at 45, SEC v. Zachariah, No. 08-60698 (S.D. Fla. May 12, 2008).

66. *Id.* at 11, 46-47.

67. *Id.* at 45-48.

68. Id.

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granted summary judgment in favor of the defendants because the court found that the timing and amount of the trades alone were insufficient, without more, to prove insider trading.[69]

Although highly dependent on the facts and circumstances of the particular case, legal and factual defenses generally turn on the prima facie elements of a cause of action for insider trading—that is, trading a security while in possession of material nonpublic information that was conveyed or obtained in breach of a duty. Therefore, it is instructive to evaluate possible defenses in the context of the elements of a cause of action.

A. *Public versus Nonpublic Information*

Under each theory of insider trading, the government must establish that the person traded with the requisite scienter while in possession of "nonpublic" information. While on its face the concept might seem simplistic, the dividing line between public and nonpublic information is porous. Due to the prevalence of online message boards, social networking, and blogs, information and rumors about companies can spread quickly to millions of interconnected investors. In some cases those rumors are leaked by company insiders. The growth of so-called watchdog groups, such as WikiLeaks, have generated a new level of uncertainty as to what information is considered "nonpublic".

The distinction between public and nonpublic information generally depends on both the manner in which the information is disseminated and the source of the information. At one end of the spectrum is the classic case of information disclosed by a company through official channels of communications, such as the filing of a Form 8-K, subsequent dissemination of a press release, or disclosure in a quarterly or annual

69. *See* SEC v. Heartland Advisors, Inc., No. 03-C-1427, 2006 WL 2547090, at *3-4 (E.D. Wis. Aug. 31, 2006); *see also* Memorandum Opinion and Order, SEC v. Gracia, No. 10 CV 5268 (N.D. Ill. Dec. 28, 2011) (granting summary judgment to Defendant Sanchez, explaining that the SEC could not rely on speculation without identifying the information Sanchez received and the source of that information).

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filing.[70] At the other end of the spectrum are cases involving leaks to the media, anonymous postings on message boards, or rumors circulating in online chat rooms – each of which raises a question of whether the information, which may have been closely guarded by the company, is now public.

1. *The Test of Whether Information Is Public.*

As an initial matter, determining the point *when* information is considered to be in the public realm is critical for understanding *whether* the information is public. Courts have established two theories of when information is considered public. Under the first theory, information has reached the public realm when it has been disclosed "in a manner sufficient to insure its availability to the investing public."[71] Under the second theory, information is public when trading has caused the "information to be fully impounded into the price of the particular stock."[72] In *United States v. Libera*, the Second Circuit explained this second theory:

> [I]nformation may be considered public for Section 10(b) purposes even though there has been no public announcement and only a small number of people know of it. The issue is not the number of people who possess it but whether their trading has caused the information to be fully impounded into the price of the particular stock. Once the information is fully impounded into the price, such information can no longer be misused by trading because no further profit can be made.[73]

Although this second approach, inspired by the efficient market theory, seems more sophisticated in taking account of new forms of online media and communications, the SEC has clung to the first theory, arguing that information becomes public only by a "public release through the appropriate public media, designed to achieve a broad dissemination to the

70. For this reason, company insiders "are presumed to know when information is undisclosed." SEC v. Monarch Fund, 608 F.2d 938, 941 (2d Cir. 1979).

71. SEC v. Texas Gulf Sulfur Co., 401 F.2d 833, 854 (2d Cir. 1968) (en banc).

72. United States v. Libera, 989 F.2d 596, 601 (2d Cir. 1993).

73. Id.

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investing public generally and without favoring any special person or group."[74]

Courts have provided little guidance to explain when information is "available to the investing public," what is "appropriate" media, or when it has been "fully impounded into the price" of the stock. Further, the opinions construing those concepts may be outdated when applied to new media and technology. For example, in *SEC v. Texas Gulf Sulfur*, a case that was decided a quarter of a century ago, the Second Circuit held that information contained in a press release was not public shortly after the press release was made. Instead, the court stated that insiders "should have waited until the news could reasonably have been expected to appear over the media of widest circulation, the Dow Jones broad tape."[75] Over the last two decades, courts have found that periods for information to become public range from fifteen minutes, to a day, or even several days after the information has been released.[76]

In 2000, the SEC provided some limited guidance through Regulation FD (Fair Disclosure) by allowing companies to utilize their websites to distribute information to the public. Regulation FD states that information on a company's website will be considered public information where such a disclosure is "reasonably designed to provide broad, non-exclusionary distribution of the information to the public."[77] In other words, posting information on a website that requires a subscription or membership does not constitute the public realm for purposes of Regulation FD. Now, in the age of pow-

74. *In re* Faberge, Inc., 45 S.E.C. 249, 256 (May 25, 1973); *see also* SEC v. Davis, Litigation Release No. 18322 (Sept. 4, 2003) (charging consultant with insider trading for tipping clients of embargoed information relating to the Treasury's halt of long bond sales).

75. *Texas Gulf Sulfur*, 401 F.2d at 854.

76. *See* Billard v. Rockwell Int'l Corp., 526 F. Supp. 218 (S.D.N.Y. 1981) (stating that Rockwell would have fulfilled its disclosure duty by waiting fifteen minutes between announcing the favorable information and accepting tendered shares); *cf.* SEC v. Ingoldsby, No. 88-1001-MA, 1990 U.S. Dist. LEXIS 11383, at *5 (D. Mass. May 15, 1990) (holding that the investing public had fully digested the importance of the announcement at issue nine days after its release).

77. *See* Selective Disclosure and Insider Trading, Exchange Act Release No. 33-7881, 65 Fed. Reg. 51,716 (Aug. 24, 2000) (adopting, among other rules, Regulation FD and Exchange Act Rule 10b5-2), *available at* http://www.sec.gov/rules/final/33-7881.htm.

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erful search engines such as Bing and Google, information posted on a corporation's website or disseminated through electronic press releases might be seen near-instantly by thousands of potential investors and hundreds of news organizations, who may be monitoring the company's website with "spiders"[78] and other electronic means. Cataloguing how quickly information travels through the internet and is repeated by various websites can be a useful tool for determining the point at which information becomes "public."

2. *The Means by Which Information Becomes Public.*

Another aspect of nonpublic information turns on whether the information made its way into the public realm through means other than a corporate disclosure. In other words, can the spreading by rumors, postings on message boards, or leaks from insiders, convert otherwise nonpublic information into public information, even if the company guarded against the release of that information? Some courts have been reluctant to deem the circulation of rumors or "talk to the street", as constituting public disclosure, even if the rumors or talks are accurate, widespread, and reported in the media.[79]

In defending against an insider trading allegation, it is important to determine whether the alleged "inside information" already had made its way into the public domain prior to alleged insider trading. Information can reach the public domain through a variety of traditional means, including corporate disclosures, press releases, media interviews, analyst and investor conference calls, analyst reports, and television pro-

78. A spider, also known as a webcrawler, automatically searches web pages to feed to search engines. *See* Wikipedia, Web crawler, http://en.wikipedia.org/wiki/Web_crawler#cite_note-spekta-1 (last visited Nov. 30, 2011).

79. *See, e.g.*, SEC v. Mayhew, 121 F.3d 44, 51 (2d Cir. 1997) (determining that the "nonpublic" element of an insider trading charge was satisfied because material nonpublic information was conveyed by a corporate insider, which was more reliable and specific than rumors in the press about a probable merger, despite the existence of such rumors). *But see* SEC v. Rorech, 720 F. Supp. 2d 367, 411 (S.D.N.Y. 2010) (refusing to find liability for illegal tipping and trading when a bond trader shared information about possible advice that his investment banking firm might make regarding a bond offering restructuring, which the court noted was widely discussed in the marketplace).

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grams. In addition, new forms of electronic communication, such as online message boards, blogs, chatrooms, social media (e.g., Twitter, Facebook, MySpace, and Friendster), professional networking websites (e.g., LinkedIn, Plaxo, and Chamber), and specialized websites focused on leaked information (e.g., WikiLeaks[80]), can place information in the public domain. If "trading has caused the information to be fully impounded into the price of the particular stock,"[81] from an economic perspective, it would appear that the information is no longer "nonpublic," without regard to how many people actually saw the information.

3. *Fully Public vs. Partially Public.*

Difficult conceptual questions arise when additional pieces of the information remain nonpublic or when an insider provides nonpublic certainty to a public rumor. Courts have held that disclosure of partial information does not constitute public dissemination for the remaining nonpublic portion of the information.[82]

In some instances, a person may be held liable for insider trading after obtaining nonpublic information that is more specific than a general rumor already widely circulating within the public domain. For example, in *United States v. Mylett*, the Second Circuit, in a divided opinion, determined that the defendant traded on the basis of material nonpublic information after a corporate insider privately confirmed the reported rumor of an upcoming transaction and then identified the company that would be acquired. In upholding the defendant's criminal conviction, the court acknowledged the existence of public rumors about the possible acquisition but explained that the information conveyed by the insider was "substantially more specific than that in the newspaper."[83] Distinguishing from mere predictions by an insider that subsequently come true, the court explained that the information conveyed by the

80. WikiLeaks describes itself as "an uncensorable system for untraceable mass document leaking." Stephen Moss, *Julian Assange: The Whistleblower*, GUARDIAN (London), July 13, 2010, § G2, at 6, *available at* http://www.guardian.co.uk/media/2010/jul/14/julian-assange-whistleblower-wikileaks.

81. Libera, 989 F.2d at 601.

82. *See, e.g.*, United States v. Royer, 549 F.3d 886 (2d Cir. 2008).

83. United States v. Mylett, 97 F.3d 663, 666 (2d Cir. 1996).

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insider was "qualified, supported, and credible" and would have had "great value to a would-be trader."[84]

In *United States v. Royer*, a criminal insider trading case, the Second Circuit further examined whether information is nonpublic when elements of that information are available in the public domain.[85] In *Royer*, a former FBI agent used confidential, nonpublic information pertaining to certain companies and executives under investigation to short the stock of those companies.[86] The defendants argued that "much of the information" was public.[87] In upholding the convictions, the Second Circuit explained that the district court correctly stated the law when it instructed the jury that "the fact that information may be found publicly if one knows where to look does not make the information 'public' for securities trading purposes unless it is readily available, broadly disseminated, or the like," although the Second Circuit observed that the instruction "might not be universally appropriate."[88] Indeed, this instruction seems outdated because an internet search engine arguably can make even a single post of information on an obscure website "readily available" and "broadly disseminated."

4. *Information that Was Never Nonpublic.*

There are other occasions when information is not broadly disseminated but is nevertheless considered public. For instance, observing a CEO walking into the official building of a rival company should not constitute nonpublic information, even though an investor may ascertain correctly that merger talks are progressing, especially where one of the companies is rumored to be for sale.[89] Similarly for example, a

84. *Id.* at 667.
85. *See Royer*, 549 F.3d at 897-98.
86. *Id.* at 896-97.
87. *Id.* at 897.
88. *Id.* at 897-98.
89. The SEC, however, has taken an aggressive view of the concept of nonpublic information. *See, e.g.*, Complaint ¶¶34-38, SEC v. Steffes,, No. 1:10-CV-06266 (N.D. Ill. Sept. 30, 2010), 2010 WL 4018839 (alleging that freight rail yard employees and four family members violated insider trading laws when the employees observed unusual daytime tours by people in business attire, surmised that the company was being acquired, and informed family members, all of whom traded on the information).

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company might closely guard the nonpublic sales projections of its key product, but the number of trucks leaving the key factory and entering onto a public highway is not "nonpublic."[90] Institutional investors may rely on information available to the public eye that is not yet reflected in the price of the stock.[91]

In the context of understanding whether information is nonpublic, it is important to recognize that the "information" upon which an insider trading case is based does not need to originate from the company that is the subject of the trading itself. Using the misappropriation theory, courts have expanded the scope of insider trading to cover material nonpublic information *about* a security. In the landmark case *United States v. Winans,* columnist R. Foster Winans was charged with a scheme to trade securities based on information misappropriated from his employer, *The Wall Street Journal.*[92] Winans authored the famous "Heard on the Street" column and relayed confidential information about the timing and content of upcoming articles to his conspirators, who traded on the information prior to the news hitting the press.[93] Winans also placed trades in his own account based on his inside knowledge.[94] The court held that Winans's actions constituted a fraud against his employer, which did not need to be explicit under any federal or state law, but was inherent in the employer-employee relationship.[95]

Counsel should be familiar with the evolving case law defining the scope of "nonpublic" information and be well versed in the various forms of electronic media. An exhaustive search of all forms of media should be conducted to determine whether the alleged nonpublic information already has reached the public realm. Economic analysis may be useful evi-

90. It is difficult to identify cases describing situations where a person traded on "public" information because those situations usually do not result in the SEC instituting an enforcement action.

91. In defending an insider trading case based on information asserted by prosecutors to be nonpublic, counsel should be cognizant of the extent to which information could be gathered by any member of the public or seen with the naked eye.

92. United States v. Winans, 612 F. Supp. 827, 829 (S.D.N.Y. 1985).

93. *Id.* at 829, 833-34.

94. *Id.* at 831-32.

95. *Id.* at 843-44.

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dence to show that the *public* aspects of the information (whether it be anonymous reports, rumors, or leaked information) were fully absorbed into the price of the stock and that any remaining *nonpublic* aspects had little to no effect on the stock price (and thus, may not be material in any event, as discussed below).

5. *Information Relayed through Expert Networks.*

Expert networks create a particular concern with the conveyance of nonpublic information. The term "expert network" refers to firms that are in the business of connecting clients, principally institutional investors, with persons who may be experts in the client's area of interest. Experts can include academics, scientists, engineers, doctors, lawyers, suppliers, and even former employees of the company of interest. Networks are used to save investors the time, cost, and uncertainty associated with obtaining specialized knowledge on their own. Expert networks can be a valuable and legitimate research tool that facilitates efficient access by clients to persons with relevant expertise. In the wake of Regulation FD, and with the growth of private funds, the use of expert networks by institutional investors has grown significantly in recent years.[96]

There is nothing inherently improper about expert networks or obtaining advice from experts through such networks.[97] Nevertheless, as is true in other investing contexts, a legitimate source of information can be misused. The principal concern with expert networks is that they often convey nonpublic information. Indeed, their *raison d'être* is to convey information that is not readily available to the public. When such nonpublic information is also material and is obtained

96. *See* Thomas Hutchinson, *Growth of Expert Networks is Accelerating*, INTEGRITY RESEARCH WATCH (Jan. 28, 2009, 1:48 PM), http://www.integrity-research.com/cms/2009/01/28/growth-of-expert-networks-is-accelerating/.

97. *See* Azham Ahmed & Peter Lattman, *Insider Inquiry Pivots Its Focus To Hedge Funds*, N.Y. Times, Feb. 9, 2011 at A1 *available at* http://query.nytimes.com/gst/fullpage.html?res=9C02E5D81030F93AA35751C0A9679D8B63&pagewanted=all (quoting Preet Bharara, U.S. Attorney for the Southern District of New York, as confirming at a Feb. 8, 2011 press conference that there is nothing inherently wrong with hedge funds or expert networking firms, while committing to prosecute those who have "galloped over the line" to engage in illegal insider trading).

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through a breach of a duty to the source, the information could trigger a violation of insider trading law.

As mentioned at the beginning of this Article, the federal government has begun to investigate the use of expert networks by hedge funds and other institutional investors to determine whether some networks are being used as a conduit for the conveyance of material nonpublic information to investors.[98] The conduct of investors who use these networks – however legitimate – could draw the attention of government enforcement officials and this scrutiny can have negative consequences for firms, including the possibility of putting them out of business. Responding to a government investigation can be costly and time-consuming, and if the investigation becomes public, the firm could suffer significant reputational damage, and again be put out of business regardless of whether the firm is ultimately charged with, or found guilty of, any wrongdoing.

In light of these developments, robust and comprehensive compliance programs are essential as a first line of defense against government scrutiny.[99] If properly executed, compliance programs can demonstrate to authorities that a firm has taken appropriate steps to guard against potential wrongdoing, such as the potential receipt of material non-public information from a "tipper," thereby showing that further investigation is unlikely to reveal violations. Moreover, strong compliance programs can reduce the likelihood of employees engaging in wrongdoing and ensure that if an investigation nonetheless results, relevant information is organized in a way that allows a firm to respond quickly. Finally, the presence of a strong and effective compliance program can dissuade the DOJ and the SEC from charging the firm itself, even if particular employees have violated the law.[100] Guidelines for develop-

98. *See SEC v. Mark Anthony Longoria,* SEC Litig. Release No. 21836, 2011 WL 334798 (S.D.N.Y. Feb. 3, 2011) (charging two expert network employees and four consultants with insider trading for illegally tipping hedge funds and other investors who gained nearly $6 million in trading profits and losses avoided).

99. *See* Cadwalader, Wickersham & Taft LLP, *supra* note 1.

100. *See, e.g.,* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934, Exchange Act Release No. 44,969, 76 SEC Docket 220 (Oct. 23, 2001), *available at* http://www.sec.gov/litigation/investreport/34-44969.htm#P54_10935 (declining to press charges against a com-

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ing compliance policies and procedures to ensure appropriate interaction with experts and expert networks, and to address insider trading generally, are discussed in Section IV, below.

B. *Materiality*

In addition to proving that the information was nonpublic, the government must prove that the information on which an individual traded was "material." The Supreme Court has set forth two definitions for materiality. In the context of an undisclosed fact, the Supreme Court in *TSC Industries, Inc. v. Northway, Inc.* held that information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision.[101] The Court explained that, to fulfill the materiality requirement, there must be a substantial likelihood that a fact "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[102] The Court acknowledged that certain information concerning corporate developments could well be of "dubious significance,"[103] so the Court was careful not to set a standard of materiality so low that it would lead management "simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decision-making."[104]

The test is not whether the fact *might* have some hypothetical significance. Instead, the materiality standard requires showing that there is a substantial likelihood that, under all the circumstances, the fact "*would have assumed actual significance* in the deliberations of a reasonable investor."[105] Some courts have looked to the market price as a determinant of materiality, explaining that the standard set forth in *TSC Indus-*

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pany because of its internal efforts to uncover and put a halt to internal wrongdoing).

101. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976); *see also* Basic, Inc. v. Levinson, 485 U.S. 224, 231-32 (1988).

102. *TSC Indus.*, 426 U.S. at 449.

103. *Id.* at 448.

104. *Id.* at 448-49.

105. SEC v. Hoover, 903 F. Supp. 1135, 1140 (S.D. Tex. 1995) (emphasis added) (citing Justin Indus. v. Choctaw Sec., L.P., 920 F.2d 262, 267 (5th Cir. 1990)).

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tries requires the information to be "reasonably certain to have a substantial effect on the market price of the security."[106]

In the context of contingent or speculative events such as mergers, acquisitions, and bankruptcies, the Supreme Court set forth an additional test for materiality. In *Basic v. Levinson*, the Court held that materiality depends upon "balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity."[107] Following *Basic*, an event with a relatively low probability, such as an upcoming merger, could have a significant impact on a small company and thus be deemed material.[108] Conversely, information regarding a similar type of event could be ruled immaterial in the context of a major, diversified company.[109]

In 1999, the staff of the SEC issued Staff Accounting Bulletin No. 99 ("SAB 99") to provide guidance on the materiality

106. Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 166 (2d Cir. 1980) (citing SEC v. Bausch & Lomb, Inc., 565 F.2d 8, 15 (2d Cir. 1977)).

107. Basic. Inc. v. Levinson, 485 U.S. 224, 238-39 (1988) (citing SEC v. Texas Gas Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968)).

108. SEC v. Geon Indus., Inc., 531 F.2d 39, 47-48 (2d Cir. 1976) ("Since a merger in which it is bought out is the most important event that can occur in a small corporation's life, to wit, its death, we think that inside information, as regards a merger of this sort, can become material at an earlier stage than would be the case as regards lesser transactions—and this even though the mortality rate of mergers in such formative stages is doubtless high."), *cited with approval* in *Basic*, 485 U.S. at 238-39; *see also* United States v. Cusimano, 123 F.3d 83 (2d Cir. 1997); *infra* note 114 and accompanying text. Indeed, a large portion of the SEC's insider trading cases concern information "tipped" or misappropriated surrounding an upcoming merger. *See infra* note 110 and accompanying text.

109. *See Hoover*, 903 F. Supp. at 1148 (concluding that the low magnitude of a revised year-end earnings estimate rendered the information immaterial as a matter of law); *see also Elkind*, 635 F.2d at 166 (finding that general information about slowing sales that was commonly known among analysts, coupled with a general comment that preliminary earnings would be released in a week, did not constitute material information). The SEC's Division of Enforcement tends to take a broad view of materiality. *See, e.g.*, SEC v. General Electric Co., Litig. Release No. 21166, 96 SEC Docket 1700 (Aug. 4, 2009) (SEC contending that General Electric overstated income because certain accounting policies it used did not comply with GAAP); In the Matter of Citigroup Inc., Respondent, Exchange Act Release No. 57970, 93 SEC Docket 1323 (June 16, 2008) (SEC contending that Citigroup materially misstated its financial results as a result of improper accounting methods used for certain bond swaps and other transactions).

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of financial misstatements.[110] SAB 99 rejected the prevailing view at the time that, to be material, the misstatement had to exceed five percent of the company's net income. [111] In its place, the SEC's staff interjected the more ambiguous concept of "qualitative materiality." According to SAB 99's qualitative test, a misstatement below the five percent quantitative threshold can be material under certain circumstances, such as if it leads to financial results that meet earnings targets or criteria for awarding management bonuses, concerns a significant segment of the company's business, affects compliance with regulations, affects the company's compliance with loan covenants, or conceals an unlawful transaction.[112] Although the SEC often cites SAB 99 in its pleadings, the bulletin is not the adopted view of the SEC (i.e., the Commission has not voted on it). It is merely an official interpretation of the staff and, therefore, should not be given undue authoritative weight.

Aside from SAB 99, the SEC generally views information concerning major corporate events as being material.[113] In 2000, the SEC, through rulemaking in Regulation FD, set out several types of information that it said should be "reviewed carefully to determine whether they are material," including: "(1) earnings information; (2) mergers, acquisitions, tender offers, joint ventures, or changes in assets; (3) new products or discoveries, or developments regarding customers or suppliers (e.g., the acquisition or loss of a contract); (4) changes in control or in management; (5) change in auditors or auditor notification that the issuer may no longer rely on an auditor's audit report; (6) events regarding the issuer's securities—e.g., defaults on senior securities, calls of securities for redemption,

110. SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150 (Aug. 19, 1999).

111. *See, e.g.*, COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 128 (2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf ("For many years, the rule of thumb was that, in determining the scope of an audit, a potential error exceeding five percent of annual pre-tax income would be considered material. In evaluating a misstatement, an error that exceeded ten percent of pre-tax income was considered material, while the materiality of an error between five percent and ten percent of pre-tax income was assessed, based on various qualitative factors.").

112. SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150 (Aug. 19, 1999).

113. *See* Securities and Exchange Commission Form 8-K.

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repurchase plans, stock splits or changes in dividends, changes to the rights of security holders, public or private sales of additional securities; and (7) bankruptcies or receiverships."[114] Despite this guidance, it does not appear that a materiality determination should be made by relying solely on this list without consideration of special circumstances.[115] A determination of materiality must be made on a case by case basis.[116]

Although materiality is judged from the objective standpoint of a "reasonable investor," the SEC often argues that specific investor behavior is indicative of materiality, and some courts have agreed with that assertion. For example, the court in *SEC v. Thrasher* determined that the tippee's investment behavior and his payment to the tipper for the information constituted adequate circumstantial evidence that the information was material.[117] Nevertheless, when defending against an insider trading case, attention should be focused on the objective standard of materiality, not the subjective and potentially erroneous view of the person trading on the information. Indeed, if materiality hinged on the subjective view of the defendant, the element of materiality would be arguably eliminated, as a person trading following the receipt of information could be deemed to view that information as significant, even if, in fact, the information was neither objectively material nor relevant to the investor's decision.

Although information does not have to be certain to be material, information is not deemed material if it is highly

114. Selective Disclosure and Insider Trading, Exchange Act Release No. 33-7881, 65 Fed. Reg. 51,716 (Aug. 24, 2000) (adopting, among other things, Regulation FD and Exchange Act Rule 10b5-2), *available at* http://www.sec.gov/rules/final/33-7881.htm.

115. *See* SEC v. Cuban, 620 F.3d 551, 554-55, 558 (5th Cir. 2010) (vacating the district court's dismissal of the suit and remanding for determination of whether trading on material nonpublic information obtained under a confidentiality agreement established liability in the context of a fiduciary relationship).

116. *See, e.g.*, Basic, Inc. v. Levinson, 485 U.S. 224, 238-40 (1988) (endorsing a fact-specific approach to determining the materiality of information regarding merger discussions); United States v. Smith, 155 F.3d 1051, 1066 (9th Cir. 1998) (stating that determining materiality requires a "nuanced, case-by-case approach").

117. SEC v. Thrasher, 152 F. Supp. 2d 291, 301 (S.D.N.Y. 2001).

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speculative and unreliable.[118] As the Second Circuit wrote in *SEC v. Monarch Fund*, "[c]ertainly the ability of a court to find a violation of the securities laws diminishes in proportion to the extent that the disclosed information is so general that the recipient thereof is still 'undertaking a substantial economic risk that his tempting target will prove to be a white elephant.'"[119] For this reason, the court in *SEC v. Rorech* deemed that discussions between a high-yield bond salesperson and a hedge fund portfolio manager regarding plans to modify a particular bond offering were immaterial because the information was inherently speculative in nature.[120]

In determining whether information is material, courts do not view the information in isolation. Instead, courts view the information in the context in which it was conveyed. For example, in *SEC v. Happ*, a member of the Board of Directors of Galileo Corporation was held liable for insider trading when he sold his shares after receiving information during a Board meeting that the company was facing potential financial concerns and where he later received a message from Galileo's CEO requesting a meeting to discuss difficulties the company was facing.[121] The court found that such information could be deemed material because Happ was a sophisticated investor, he had the benefit of the information shared during the Board meeting, and the call from the CEO was out of the ordinary.[122]

Information that is seemingly vague can be determined to be material. In *United States v. Cusimano*, a statement that "something was happening" between AT&T and a target company was determined to be material where several individuals had set up a scheme to obtain insider information from AT&T and where AT&T's interest was a significant event for the tar-

118. *See* Garcia v. Cordova, 930 F.2d 826, 830 (10th Cir. 1991) (characterizing information based on subjective analysis or extrapolation as "soft information" and, as such, too speculative and unreliable to be considered material and subject to disclosure requirements).

119. SEC v. Monarch Fund, 608 F.2d 938, 942 (2d Cir. 1979) (quoting United States v. Chiarella, 588 F.2d 1358, 1366-67 (2d Cir. 1978), *cert. granted*, 441 U.S. 942 (1979)).

120. SEC v. Rorech, 720 F. Supp. 2d 367, 410-11 (S.D.N.Y. 2010).

121. SEC v. Happ, 392 F.3d 12, 21-23 (1st Cir. 2004).

122. *Id.* at 22.

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get company.[123] In another case, *SEC v. Meyhew*, a tip that a company was seeking an investment partner was deemed material, despite the fact that the potential partner was not identified and no further details about the merger were provided, because the information came from an insider who said that merger discussions were serious.[124] Courts, however, have deemed information not to be material where the information was only slightly different than prior projections and where the news, when broadly released, did not result in a significant market reaction.[125]

The law of materiality becomes even murkier when an investor aggregates pieces of information to reach a nonpublic conclusion. As a general matter, piecing together fragments of nonmaterial information to understand the broader position of a company (the so-called "mosaic" theory of investing, as discussed in Section II.A.) does not violate insider trading laws and can be used as a central defense to an insider trading charge.[126] However, counsel should be cognizant of situations where information has been artificially broken into smaller pieces – similar to structuring in the money laundering context – in order to avoid being deemed material.

In defending against a claim that information is material, counsel should look to the point, albeit uncertain, when the information ultimately reached the public domain to determine what other information was released concerning the

123. United States v. Cusimano, 123 F.3d 83, 88 (2d Cir. 1997).

124. SEC v. Meyhew, 121 F.3d 44, 51-52 (2d Cir. 1997).

125. *See* Hoover, 903 F. Supp at 1144-46. Here, the company's 10-Q disclosed that it expected earnings to be 10% lower than the previous year and the individual learned that the company's earnings would actually be up to two percentage points lower than disclosed. *Id.*

126. Indeed, the Certified Financial Analyst Institute's Standards of Practice Handbook states:

> A financial analyst gathers and interprets large quantities of information from many sources. The analyst may use significant conclusions derived from the analysis of public and nonmaterial nonpublic information as the basis for investment recommendations and decisions even if those conclusions would have been material inside information had they been communicated directly to the analyst by a company. Under the "mosaic theory," financial analysts are free to act on this collection, or mosaic, of information without risking violation.

CERTIFIED FIN. ANALYST INST., STANDARDS OF PRACTICE HANDBOOK 51 (10th ed. 2010), *available at* http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2010.n2.1.

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company, the industry, and the overall market. In many instances, companies combine the release of information, particularly bad news, with other information to minimize the impact on the stock price. Economic analysis is key for both the government, which has the burden of proof, and also for the defendant, who often can demonstrate other reasons for a stock's movement. The SEC and DOJ are often unable to prove that the piece of information at issue in a case was material because so many other pieces of information about the company reached the marketplace at the same, or nearly the same, time. In addition, defense counsel should file a *Daubert* motion to exclude any expert testimony offered by the government to establish materiality that does not control for other variables at the time the information was made public.[127]

C. *Breach of a Duty*

Whether an individual has violated a duty is dependent on the particular theory of insider trading that the government is asserting. As discussed above, there are three traditional theories of insider trading liability: the "classical" theory, the "tipper-tippee" theory, and the "misappropriation" theory, each with slight variations on the duty element. The government has the burden of proving that a person trading on a tip knew or should have known that there was a breach of a duty by the source of the information.[128]

1. *Duty under the Classical and Tipper-Tippee Theories.*

The duty element is essentially the same under both the classical and tipper-tippee theories. Under the classical theory, the fiduciary duty owed by the corporate insider is often evident by the individual's position in the company, or as an

127. *See* Daubert v. Merrell Dow Pharm., 509 U.S. 579 (1993) (stating the factors to be considered in the admissibility of expert testimony).

128. Dirks v. SEC, 463 U.S. 646, 647, 660 (1983) ("[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material non-public information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and tippee knows or should know there has been a breach."); *see also* SEC v. Maoi, 51 F.3d 623, 632 (7th Cir. 1995) (quoting *Dirks*, 463 U.S. at 660). If trading is with respect to a planned or existing tender offer, Rule 14e-3 makes trading unlawful without regard to whether any fiduciary duty exists. *Id.* at 635.

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agent to that company, and the nature of the information. The fiduciary duty to abstain from trading on material nonpublic information applies to "officers, directors, and other permanent insiders of a corporation . . . [and] to attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation."[129]

Similarly, under "tipper-tippee" liability, the initial tipper breaches his or her fiduciary duty to the corporation by disclosing material nonpublic information to an outsider in violation of the tipper's fiduciary duty to the company and in return for a personal benefit.[130] Such benefit may arise through "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 by making a "gift of confidential information to a trading relative or friend."[131]

Whether an insider has breached a fiduciary duty depends on the specific facts and circumstances and often turns on the person's knowledge and intent. An insider arguably may convey nonpublic information to an outsider without violating a fiduciary duty if it is done with the good-faith intent to benefit the company or if the insider honestly believes the information is already public.[132] However, if it appears that the insider also received a personal benefit, which is an element of the violation, or if the insider is reckless[133] in sharing the in-

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129. United States v. O'Hagan, 521 U.S. 642, 651 (1997) (*citing Dirks*, 463 U.S. at 655 n.14); *see also* SEC v. Lund, 570 F. Supp. 1397, 1403 (C.D. Cal. 1983) (holding that discussion between Lund and another businessmen concerning a proposed joint venture between their respective companies created a fiduciary duty that made Lund a "temporary insider").

130. SEC v. Ingram, 694 F. Supp. 1437, 1440 n.3 (C.D. Cal. 1988) (relying on *Dirks*, 463 U.S. at 646, for the proposition that "the individual must have expressly or impliedly entered into a fiduciary relationship with the issuer.")

131. *Dirks*, 463 U.S. at 663-64. See discussion *supra* note 18 regarding the broad view of "personal benefit" generally claimed by the SEC and upheld by courts.

132. Company insiders "are presumed to know when information is undisclosed." SEC v. Monarch Fund, 608 F.2d 938, 941 (2d Cir. 1979).

133. *See, e.g.*, McLean v. Alexander, 599 F.2d 1190, 1197 (3d Cir. 1979); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1023 (6th Cir. 1979); Edward J. Mawod & Co. v. SEC, 591 F.2d 588, 596 (10th Cir. 1979); Hoffman v. Estabrook & Co., 587 F.2d 509, 516 (1st Cir. 1978); Nelson v. Serwold, 576 F.2d 1332, 1337 (9th Cir. 1978); Cook v. Avien, Inc., 573 F.2d 685, 692 (1st Cir. 1978); Rolf v. Blyth, Eastman Dillon & Co. 570 F.2d 38, 44-47 (2d Cir. 1978); First Va. Bankshares v. Benson, 559 F.2d 1307, 1314 (5th Cir. 1977).

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formation, then courts are likely to hold that there has been a breach of a fiduciary duty.[134]

As mentioned, liability for a tippee depends on whether the tippee was *aware* of the breach of a fiduciary duty, which often is established through circumstantial evidence. Courts generally look to whether the tippee was aware of the source of the information. A tippee who is aware that the material nonpublic information came from an insider is viewed by the courts as knowing that the insider breached a duty by selectively disclosing the information, as opposed to disclosing through an official corporate channel.[135]

The more difficult scenario arises when there is no direct evidence that the tippee knew the source of the information. In those circumstances, courts often look to the same facts that establish that the tippee knew the information was nonpublic, such as subsequent actions of the tippee upon learning the information. Did the tippee make what would be viewed as, for the tippee, an unusual investment (e.g., using futures or out-of-the-money options, liquidating a retirement portfolio to make the investment, or making an extraordinarily large purchase)?

In defending against an allegation of insider trading, counsel should pay particular attention to the government's proof of the tippee's knowledge of the breach of a duty. *Each* defendant-tippee in a chain who receives material nonpublic information must know or have reason to know of the breach of the fiduciary duty in order to be liable for insider trading.[136]

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134. *Id.*

135. *See, e.g.*, SEC v. Musella, 578 F. Supp. 425, 431-32, 442 (S.D.N.Y. 1984) (finding a corporate bond trader liable as a tippee for obtaining information about a pending tender offer from his friend who was employed by the law firm representing the acquiring company); *see also* SEC v. Maoi, 51 F.3d 623, 632 (7th Cir. 1995) (finding the tippee liable because he knew that information he received from the CEO of an acquiring company was improper).

136. *See, e.g.*, Complaint ¶¶12, 21, SEC v. Gowrish, No. 09-CV-5883 (N.D. Cal. Dec. 16, 2009), *available at* http://www.sec.gov/litigation/complaints/2009/comp21339.pdf (SEC did not charge the brother of an insider trader, but rather named him as a relief defendant, even though he allowed the defendant to trade in his account and split the profits from the trades; he was never aware that the trades were executed on the basis of inside information); Complaint ¶¶ 21-28, SEC v. Tang, No. 09-CV-05146-JCS (N.D. Cal. Oct. 30, 2009), *available at* http://www.sec.gov/litigation/complaints/2009/comp21271.pdf (SEC did not charge fifteen relief defendants for insider

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In many cases, beyond the first few tippees in a large chain, the evidence in this regard is scarce at best.[137]

2. *Duty under the Misappropriation Theory.*

Under the misappropriation theory, liability for insider trading is broadly premised on "a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information."[138] The linchpin for the government in the misappropriation theory is the establishment of a fiduciary duty or relationship of trust and confidence. Depending on the facts of the case, courts have found that such a duty or relationship exists in the following circumstances: lawyer-client,[139] director-corporation,[140] employee-employer,[141] business partners,[142]

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trading even though they were family members with accounts in which the illegal trading occurred).

137. *See, e.g.*, Complaint ¶¶ 2-3, 6-8, SEC v. Stephanou, No. 09-CV-1043 (S.D.N.Y. Feb. 5, 2009). SEC charged a UBS investment banker for tipping about material, nonpublic information regarding the acquisition of a construction materials firm and a healthcare company. *See id.* at ¶¶ 1-9. His close family friend traded on the information in both cases and, in turn, "either tipped four family members with that information or traded in their accounts on the basis of that information". *See id.* at ¶¶ 6-8. Though those family members may have traded themselves, SEC did not charge these individuals. *See id.* at ¶¶ 1-2.

138. United States v. O'Hagan, 521 U.S. 642, 652 (1997).

139. *Id.* In *O'Hagan*, a law firm partner obtained material, non-public information from his firm when it represented Grand Met in its contemplated tender offer for Pillsbury. *Id.* at 647-48. Mr. Hagan did not participate in the representation of Grand Met, but instead he obtained the information despite the efforts of Grand Met and his law firm to keep the information confidential. *Id.* Nevertheless, the Supreme Court found that O'Hagan violated the duty that he owed to his law firm when he misappropriated the information and used it to purchase a large number of Pillsbury call options and shares, making a profit of more than $4.3 million. *Id.*

140. SEC v. Talbot, 530 F.3d 1085, 1087-88 (9th Cir. 2008) (holding that a director of a public company misappropriated nonpublic information about a proposed acquisition of which he learned during a board of directors meeting of his company). The Ninth Circuit remanded the case to the district court for a determination of whether the information was material. *Id.* at 1097-98.

141. *See, e.g.*, United States v. Carpenter, 791 F.2d 1024, 1028 (2d Cir. 1986) (affirming United States v. Winans, 612 F. Supp. 827 (S.D.N.Y. 1985)); SEC v. Materia, 745 F.2d 197 (2d Cir. 1984) (affirming lower court decision that found defendant breached a fiduciary duty to his employer and its clients when he traded on the basis of confidential information obtained during the course of his employment); United States v. Newman, 664 F.2d 12

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accountant/tax planner-client,[143] doctor-patient relationships,[144] and familial relationships.[145]

The SEC set forth in Rule 10b5-2 a non-exhaustive list of the relationships that would establish a duty of trust or confi-

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(2d Cir. 1981) (reversing dismissal of an indictment against the defendant by finding that the defendant employee violated his duty to his employer brokerage firm and the firm's clients by misappropriating confidential information and concealing it when he was under a duty to disclose); *Winans*, 612 F. Supp. at 844-45 (holding that the defendant owed a fiduciary duty to his employer not to disclose contents of material, non-public information he obtained in the course of his employment).

142. SEC v. Peters, 735 F. Supp. 1505, 1520 (D. Kan. 1990), (applying the misappropriations theory in the context of a business partnership), *rev'd on other grounds*, 978 F.2d 1162 (10th Cir. 1992); SEC v. Lund, 570 F. Supp. 1397, 1403 (C.D. Cal. 1983) (holding that discussion between Lund and another businessmen concerning a proposed joint venture between their respective companies created a fiduciary duty because the two men were "long time friends and business associates").

143. SEC v. Kornman, 391 F. Supp. 2d 477, 489 (N.D. Tex. 2005) (noting that defendant's knowledge regarding estate and tax planning may indicate that a duty of trust had developed between defendant and the two corporate executives from whom he obtained information about upcoming acquisitions and buy-outs).

144. United States v. Willis, 737 F. Supp. 269, 271, 277 (S.D.N.Y. 1990) (holding that a psychiatrist could be convicted for trading on the basis of material, nonpublic information that he learned in the course of treating his patient, the wife of a corporate executive; explaining that the doctor had adequate notice that it would "be unlawful for him to disclose his patient's information and use it to trade in securities for his personal benefit").

145. *See* SEC v. Yun, 327 F.3d 1263, 1272-74 (11th Cir. 2003) (holding that the defendant spouse owed her husband, an executive at the issuer, a duty of loyalty and confidentiality not to disclose material, nonpublic information related to revised earnings information he relayed to her); SEC v. Lenfest, 949 F. Supp. 341, 345 (E.D. Pa. 1996) (denying defendant's motion for summary judgment due to her potential liability for trading based on material, nonpublic information that she obtained in confidence from her husband, the board member of a merger target); United States v. Reed, 601 F. Supp. 685, 718 (S.D.N.Y. 1985) (denying defendant's motion to dismiss, holding that sufficient facts existed for a jury to decide that defendant, the son of a corporate director, misappropriated information concerning a potential acquisition involving his father's company in violation of at confidential relationship with his father), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985). *But see* United States v. Chestman, 947 F.2d 551, 567 (2d Cir. 1991) (holding that prosecutors failed to establish a "functional equivalent of a fiduciary relationship" between the wife who shared information about a family business transaction and her husband, who relayed the information to his stockbroker who traded on the information).

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dence under a theory of misappropriation.[146] According to Rule 10b5-2, a duty of trust or confidence arises between a recipient of material nonpublic information and the source when: (1) the recipient of the information "agrees to maintain information in confidence"; (2) two individuals have a "history, pattern, or practice of sharing confidences such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality"; and (3) an individual receives "material nonpublic information from certain enumerated close family members," including "spouses, parents, children, and siblings."[147]

In attempting to clarify what relationships would indicate a duty of trust and confidence, the SEC may have exceeded the constitutional bounds of its authority with Rule 10b5-2. The district court in *SEC v. Cuban* held that Rule 10b5-2 was an unconstitutional exercise of the SEC's power, stating that the SEC "cannot by rule predicate liability on an agreement that lacks the necessary component of an obligation not to trade on or otherwise use confidential information for personal benefit."[148] The court held that finding liability on a mere agreement to maintain information in confidence exceeds the SEC's authority under Section 10(b) to proscribe deceptive conduct.[149] Additionally, the district court held that Rule 10b5-2(b)(3), which creates a presumption of a duty of trust or confidence for the enumerated family members, is an unconstitutional shift in the government's burden in a criminal case

146. *See* Selective Disclosure and Insider Trading, Exchange Act Release No. 33-7881, 65 Fed. Reg. 51,716 (Aug. 24, 2000), *available at* http://www.sec.gov/rules/final/33-7881.htm.

147. 17 C.F.R. § 240.10b5-2(b)(1) to -2(b)(3) (2010). The enumerated family members in the rule are presumed to create a duty of trust and confidence, but the SEC recognizes that it is a rebuttable presumption. *Id.*

148. SEC v. Cuban, 634 F. Supp. 2d 713, 729 (N.D. Tex. 2009). On appeal, the Fifth Circuit questioned but did not address the validity of Rule 10b5-2(b)(1). *See* SEC v. Cuban, 620 F.3d 551, 555, 558 (5th Cir. 2010). The *Cuban* case also illustrates a situation where a fiduciary duty or a relationship of trust or confidence is not apparent.

149. *Cuban*, 634 F. Supp. 2d at 730-31.

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because the government always must carry the burden to prove each element of an insider trading offense.[150]

Certain business interactions may seem ripe for insider trading opportunities, yet they do not give rise to a duty to refrain from trading under the elements established by the Supreme Court in *O'Hagan*. Consider the following scenario: an investment banker may contact a hedge fund regarding a deal and relay material nonpublic information about an issuer in the course of the discussion. The hedge fund later trades in the issuer's stock on the basis of the information. Is the hedge fund liable for misappropriating the information to trade for its benefit? The answer is dependent on whether the hedge fund owes a duty to the investment bank or to its clients. Courts have held that arm's length negotiations do not constitute a relationship of trust or confidence.[151] Even an agreement to keep the deal confidential may not give rise to a duty to refrain from trading.[152] Unless it can be shown that the in-

150. *Id.*; *see also Chestman*, 947 F.2d at 567 (holding that prosecutors failed to establish their case because they did not prove that a "functional equivalent of a fiduciary relationship" existed between husband and wife).

151. *See, e.g.*, United States v. Cassese, 273 F. Supp. 2d 481, 485-86 (S.D.N.Y. 2003) (finding that negotiations between defendant and a competitor constituted potential arms-length business dealings rather than a fiduciary relationship). *But see* SEC v. Lund, 570 F. Supp. 1397, 1403 (C.D. Cal. 1983) (holding that discussion between Lund and another businessman concerning a proposed joint venture between their respective companies created a fiduciary duty that made Lund a "temporary insider"; observing that the two men were "long time friends and business associates").

152. *See, e.g.*, Walton v. Morgan Stanley, 623 F.2d 796, 799 (2d Cir. 1980) (upholding dismissal of claims brought against defendant Morgan Stanley for trading in stock of its client's potential takeover target based on confidential information received in the course of merger discussions). In *Walton*, the court determined that the defendant did not have a relationship with the issuer other than through discussions about the possible deal, explaining that "although, according to the complaint, Olinkraft's management placed its confidence in Morgan Stanley not to disclose the information, Morgan owed no duty to observe that confidence." *Id.* Where a confidentiality agreement exists, the relevant factor is whether the parties had a relationship of trust and confidence outside of the particular discussions at issue. *See also Cuban*, 620 F.3d at 557-58 (reversing the district court's dismissal of the case for further proceedings to evaluate whether the understanding between the CEO and Cuban went beyond a "simple confidentiality agreement"). Note, however, that the SEC maintained in *Cuban* that a confidentiality agreement itself created a duty to disclose or refrain from trading based on information received under the agreement. *Id.* at 552-53.

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vestment bank and hedge fund had an established relationship of trust or confidence prior to their discussions, it might be difficult to establish the legal elements of insider trading.

In this situation, the investment bank nevertheless clearly has a duty to the issuer to ensure that the information is maintained in confidence by any potential investors. Thus, the investment bank should not disclose the information to an investor unless the bank obtains the investor's agreement to keep the information confidential and not to trade on it. When the bank discloses the information *without* having obtained a confidentiality agreement, or gone through proper procedures, the hedge fund, which may be the recipient of information that it did not seek out, is put in a difficult situation. On the one hand, if the fund trades in the securities of the company that are the subject of the unwanted disclosure, the SEC or a prosecutor might argue that the fund is guilty of insider trading under a misappropriation theory, pointing to some expectation of confidentiality based on a pattern of interactions between the investment bank and the hedge fund.[153] On the other hand, if the fund is forced to refrain from trading in the relevant securities – particularly in a situation where it would have traded the relevant securities in the absence of a call from the bank – the hedge fund's refraining from trading may be in breach of the adviser's fiduciary obligation to trade for the benefit of its investors, and it would not be able to justify its failure to trade because the hedge fund does not have any obligation to the bank or the underlying company.

In short, a hedge fund seeking to stay out of the government's eye does not want to receive unwanted information concerning securities of companies that it trades. To avoid receiving such information, funds may put banks or other agents on notice that they should not supply such information without first going to the appropriate channels and requesting consent to supply the information.

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153. *See, e.g.*, *Cuban*, 634 F. Supp. 2d at 727-29; *see also supra* text accompanying note 148. Failing to prove an agreement to maintain the information in confidence and not trade, an aggressive SEC lawyer or prosecutor might try to argue that the hedge fund somehow tricked the investment bank into divulging the information by making an affirmative misrepresentation. *See* SEC v. Dorozhko, 574 F.3d 42, 49 (2d Cir. 2009); *see also supra* text accompanying note 20.

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Although the misappropriation theory is used to establish liability, it also can be raised as a defense to insiders who provide inside information to someone who ultimately trades. For example, in a situation where a corporate executive provides material nonpublic information to a family member, friend, or business associate who trades, the corporate executive may cite Rule 10b5-2 to argue that he and the recipient of the information have a "history, pattern, or practice of sharing confidences such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality." [154] In this example, the corporate executive might not be liable for tipping the recipient, yet the recipient likely could be liable for insider trading based on the misappropriation theory.

There are several cases where the facts could suggest a tipper-tippee theory, but the government proceeded instead under the misappropriation theory. For example, in *United States v. Corbin*, a district court found that the misappropriation theory applied where a tippee received information from a friend who had breached his duty of confidentiality to his wife.[155] The friend and his wife had an express agreement to keep information that the wife learned from her company confidential, and they had a duty based on a history, pattern or practice of sharing confidences.[156] In *SEC v. Stummer*, the defendant settled with the SEC on insider trading charges after he misappropriated material nonpublic information by guessing the password to his brother-in-law's computer. [157] Stummer's brother-in-law was a director of the private equity firm that was rumored to be involved in a potential acquisition, and Stummer logged into the private equity firm's net-

154. Selective Disclosure and Insider Trading, Exchange Act Release No. 33-7881, 65 Fed. Reg. 51,716 (Aug. 24, 2000), *available at* http://www.sec.gov/rules/final/33-7881.htm.

155. U.S. v. Corbin, 729 F. Supp. 2d 607, 615-16 (S.D.N.Y. 2010).

156. *Id.*

157. SEC v. Stummer, SEC Litigation Release No. 20,529, 93 SEC Docket 115 (Apr. 17, 2008) (announcing the settlement of the action); Complaint ¶¶ 3-5, 17-18, SEC v. Stummer, No. 08-CIV-3671 (S.D.N.Y. Apr. 24, 2008).

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work to research and obtain confidential information on which he traded. [158]

IV.
COMPLIANCE PRACTICES TO ADDRESS INSIDER TRADING

Companies and financial services firms must establish policies and procedures to address insider trading and interactions with potential tippers, including experts and expert networks. For funds, such compliance procedures should also address their interaction with investment dealers or others that might have agency duties to a public company. Effective policies and procedures should address: (1) the implementation of information barriers between the firm's public and private sides; (2) the selection of expert networks and experts, including the firm's due diligence, screening, and approval process before a network or expert is engaged; (3) the interaction with investment dealers and experts, including identification of personnel designated to interact with them, the manner in which the interaction is to occur, and the documentation of that interaction; and (4) the monitoring, surveillance, and supervision of the interaction between the firm and investment dealers or experts, and of trading with issuers that are subjects of such interactions. All employees at the firm should be trained thoroughly on the laws governing insider trading and the firm's policies and procedures. A culture should be created whereby employees are encouraged to report to compliance or legal personnel any unusual or problematic activity, as well as any information that even arguably constitutes material nonpublic information. Firms should document both the processes implemented and the steps personnel take in compliance with these processes, thereby creating a detailed record of the firm's efforts to meet its legal and regulatory obligations.

A. *Insider Trading – Information Barriers*

Firms should implement adequate information barriers between their public and private sectors. Employees who have acquired or who, in the course of their normal business deal-

158. Complaint ¶¶ 15, 17-19, Sec v. Stummer, No. 97-CIV-3671 (S.D.N.Y. Apr 24, 2008).

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ings, are likely to acquire material nonpublic information (i.e., private side employees) should be screened from communications with employees that are involved in trading (i.e., public side employees). Furthermore, persons in a position to make trading decisions should be trained in distinguishing "nonpublic" information from "public" information.

Public side employees must understand the need to promptly inform compliance or legal personnel when they are exposed, for any reason, to material nonpublic information and to refrain from sharing such information or otherwise using or relying upon it. Moreover, the line between legitimate, public information and material nonpublic information is frequently unclear. Therefore, it is most important for public side employees to understand that, where there is any doubt as to whether information may be material nonpublic information, or where red flags may be present, the employee must promptly consult with appropriate compliance or legal personnel. The employee should not share, use, or rely on such information unless and until such information is approved following a review by compliance and legal personnel.

B. *Expert Network Procedures*

1. *Expert Network Compliance Program.*

Firms should consider instituting a review and approval process to document that the expert network being used employs reasonable practices and compliance efforts. In particular, firms should ensure that the expert network employs a strong screening process. Firms should ask who at the network approves experts, what processes are employed for checking the backgrounds of experts, and whether there is adequate documentation of the process. Furthermore, firms should consider inquiring about the contractual arrangements between the expert network and their experts, including compensation structure and any representations and warranties provided. A firm's compliance and/or legal personnel should formally review and approve use of the network.

2. *Expert-Specific Procedures.*

In addition to the expert network's compliance program, firms should screen experts independently. Firms should perform at least basic background checks (e.g., use public search

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engines) on all experts utilized. Any potential "red flags" that appear in the background check, such as disciplinary and regulatory actions, could be reviewed by a member of the firm's compliance or legal team before any discussions with the expert occur. Consideration should be given to criteria that might cause firms to prohibit the use of an expert, or at the very least, subject such approval to stricter scrutiny or involve more senior reviewers within the firm. One important consideration is whether the firm should prohibit the use of experts who were employed within a certain time frame at a company in which the firm is considering investing. Experts who were recently employed by, or affiliated with, the company at issue may have been exposed to material nonpublic information. Even if the former employees do not possess material nonpublic information, government investigators may view such experts with suspicion.

3. *Pre-Approvals.*

Employees should not hold any discussions with experts unless and until they have first received approval from their supervisor and the firm. The approval should be appropriately documented and should reflect the expected scope of the discussions as well as the general purpose behind the use of such experts.

4. *Documentation of Meetings.*

Firms are urged to document all discussions or meetings with experts. These records should include, at a minimum, who participated, the expert's current place of employment, the expert's basis of knowledge, and the topics covered. Firms should also consider whether to require a member of the compliance or legal team to participate in certain discussions with experts, particularly with experts who may have had direct involvement with a relevant issue.

Furthermore, dealings with particular experts should be conditioned on the expert providing certain commitments prior to or at the opening of the meetings. Firms also may consider requiring that all discussions with an expert begin with a script in which the expert assents to the following points:

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- that the expert understands that the client does not wish to receive material nonpublic information;
- that the expert has not breached, and will not breach, any confidential agreement or legal duty that the expert has to any party;
- that no one else has breached a legal duty in providing information to the expert;
- that the expert is not an employee, affiliate, or supplier of the company that will be discussed on the call;[159]
- that the expert did not pay an employee, affiliate, or supplier of the company at issue in order to obtain the information;
- to the extent possible, an acknowledgement that the information the expert plans to provide was not obtained directly or indirectly by anyone who would not be able to assent to each of the foregoing representations.

At the end of the meeting, confirmation should be obtained that nothing discussed changed the assent obtained at the beginning of the meeting.

Documentation from meetings with expert networks should be reviewed and approved by a supervisor. Firms may also wish to consider routine review of such information by a member of the firm's compliance or legal teams. Moreover, all employees who may engage in discussions with experts and their supervisors should be trained to identify problematic answers to scripts or to other issues noted during these meetings and should understand the need to bring issues to the attention of compliance or legal personnel for prompt review. No sharing or other use or reliance should be made with respect to any information pending completion of the review process and, if applicable, the approval process. This protocol is especially important with respect to any information that is flagged as problematic and warrants further review.

159. Where such status is ongoing, it is recommended that confirmation be obtained from the issuer as to the issuer's knowledge and approval of the expert's activities and any limitations thereon.

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Securities of relevant issuers should be added to the firm's watch list to ensure appropriate monitoring of future trading therein.

5. *Follow-Up Communications.*

Communications with experts should be made only through approved means of communication that are tracked by the firm. Firms should prohibit employees from using informal means of communication when interacting with experts. Communications through text messaging, instant messaging, and social networking lend themselves to informality and can easily be taken out of context. Their informality makes them easy targets for enforcement authorities looking for evidence of inappropriate behavior. Accordingly, employees should be instructed to communicate by phone or in person with experts using the compliance procedures outlined in this section.

To the extent that there are any email communications with experts, those communications should be reviewed by compliance personnel or the employee's supervisor. If a message is ambiguous, firms should consider follow-up written communications to clarify the intent of the message. At the very least, firms should document the meaning of an ambiguous phrase to avoid confusion later after memories have dimmed.

C. *Other Procedures*

1. *Supervision.*

Supervisory programs should be ongoing and tailored to the particularities of a firm's business. Supervisors should meet regularly with persons supervised and should be fully informed of the person's conduct and of the business being conducted. Firms' supervisory procedures should include appropriate documentation of applicable processes, including (1) monitoring of employees' compliance with procedures; (2) supervisory approval; and (3) trade monitoring and review. As noted, the purpose of supervisory documentation is to document compliance with internal firm processes. Such documentation should not, however, extend to conclusions as to findings and other evidence of wrongdoing. Instead, such matters should be discussed with legal and/or compliance person-

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nel, who should take responsibility for documenting any reviews, findings, conclusions, and the like with respect thereto.

2. *Surveillance.*

Internal surveillance programs should closely monitor the firm's trading positions and strategies. Surveillance should not be limited to firm proprietary accounts but should also include trading that occurs in customer accounts and employees' personal trading accounts. These surveillance systems should monitor for, among other things: (1) significant gains and avoidance of large losses; (2) patterns of trades in advance of market moving news; (3) unusual trading methods, products, and the like; and (4) trades outside the firm's strategy. The firm should investigate any triggering events and document the resulting investigation, including any reasonable explanations for the conduct. While supervisory personnel and traders should be consulted during the course of any such investigation, the investigation should be led by the firm's compliance or legal personnel or outside counsel. All trading in securities related to any expert discussions should be subject to ongoing surveillance.

3. *Encourage Questions.*

Compliance programs should encourage employees to voice concerns and question conduct where doubt exists as to the propriety of trading on certain information. Even firms with the most well-designed and well-operated compliance programs will find it difficult to completely safeguard themselves from all regulatory problems. Creating an atmosphere in which employees feel comfortable raising legal and compliance questions helps firms ensure that they are taking a broad view on regulatory concerns.

4. *Training.*

Training programs should be robust, regular, and well-documented, including topics covered and attendance. Such programs should focus on:

- the substance of the law;
- the substance of the firm's procedures; and
- the need to self-report or flag problematic issues for further discussion and review.

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To the extent possible, training should avoid abstract analysis and instead reflect and speak to real life activities and behaviors faced by firm personnel. Firms should consider more focused training programs for individuals who will actually communicate with experts and their supervisors. Training should emphasize the need to immediately reach out to compliance and legal personnel when there is any doubt as to whether certain information can be used.

5. *Documentation.*

It is important to be able to demonstrate to government investigators the extent to which a firm strives to comply with the law. For this reason, a firm should maintain consistent and thorough documentation of its compliance program. Firms should be able to show investigators that they have taken steps to inform employees of appropriate policies and procedures, actively followed through in implementing and enforcing the policies and procedures, and consistently investigated red flags and other unusual matters.

V.
CONCLUSION

The law of insider trading is nuanced and highly dependent on the facts and circumstances of a particular case. Different theories of insider trading may be more appropriate for different groups of companies and financial services firms. Because the law has developed in the courts, however, insider trading law is fluid and continues to evolve as markets grow, technology changes, and the DOJ and SEC press new theories of insider trading. Inevitably accompanying those new and expansive prosecution theories are new legal and factual defenses that should be considered.

The first line of defense to insider trading is a strong compliance program. Companies and financial services firms must establish policies and procedures to address insider trading and interactions with potential tippers, including, where applicable, experts and expert networks. For funds, such compliance procedures should also address their interaction with investment dealers or others that may have agency duties to a public company.

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The consequences for noncompliance with the laws pertaining to insider trading can be devastating. The DOJ may bring a criminal prosecution, resulting in a significant prison sentence and fine if an individual defendant is found guilty. The SEC may bring an enforcement action seeking disgorgement of ill-gotten gains (or losses avoided), a civil monetary penalty, and certain professional bars. A strong compliance program is not only essential for preventing insider trading but also provides defenses to charges and serves as a mitigating factor if there is a prosecution or enforcement action.

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