Insider Trading and Privileged Information in a Regulatory Context

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INSIDER TRADING IS RAMPANT

• Oct. 27, 2007, SEC’s Director of Enforcement declared insider trading by Wall Street professionals “rampant”

• Following Wall Street insider trading scandals of 1980s (Boesky, Levine & Milken), SEC did not bring any such cases in early 1990s and only 10 in late 1990s

• 2007 will be record year -- 10 new SEC insider trading cases in the last month alone
WALL STREET PROFESSIONALS


- 2 overlapping schemes involving hundreds of thousands of trades and more than $15MM in profits over 6 years
- **UBS Scheme**: senior professional tipped outside traders about analyst recommendations -- $14MM in profits
- **Morgan Stanley Scheme**: global compliance attorney tipped others about corporate acquisition announcements
- Defendants being prosecuted criminally

- Barclays trader sat on creditors committees; traded bonds on inside information

- Barclays paid over $10.9MM in settlement
  - full disgorgement of $3,971,736
  - prejudgment interest of $971,825
  - civil penalty of $6MM
Trading by Other Securities Professionals

  - pharmaceutical company exec tipped three sons, all Wall Street accountants or lawyers
  - family members prosecuted criminally
- **SEC v. Heron** (SEC Lit. Rel. 20079, Apr. 18, 2007)
  - general counsel/chief insider trading compliance officer traded ahead of announcements
  - SEC seeking disgorgement, penalties and bar order
  - criminal prosecution
DEFINITION OF INSIDER TRADING

- Section 10(b) of Exchange Act and Rule 10b-5 generally prohibit securities fraud

- **Insider trading is use (or possession) of material non-public information in the purchase or sale of securities**
DEFINITION OF INSIDER TRADING

Definition of Materiality

– “substantial likelihood” that a reasonable investor would have considered information “important” in making investment decision or as

– “significantly altering” the total mix of available information

DEFINITION OF INSIDER TRADING

Examples of Material Information

- Mergers, acquisitions and significant asset sales
- Earnings reports, especially if over/under street expectations
- Capitalization events (secondary offerings, PIPEs, stock splits)
- Significant customer events (gain/loss of major contract)
- Significant business events (new products, price changes)
- Insolvency or defaults
- Changes in senior management
- Significant labor disputes
- Significant regulatory developments (e.g., FDA approvals)
- Significant actual/threatened litigation
DEFINITION OF INSIDER TRADING

Definition of Non-Public

– Insufficient time for the market to absorb the information (a day or two for a widely-traded company)
DEFINITION OF INSIDER TRADING

Two Theories of Insider Trading Liability


SANCTIONS FOR INSIDER TRADING

Civil Sanctions

- Injunction
- Disgorgement of gain or loss avoided
  - tipper can be held liable with tippee
- Civil money penalty up to 3x disgorgement
  - tipper can be penalized for tippee’s trades
- Industry bar
- Director and officer bar
SANCTIONS FOR INSIDER TRADING

Civil Money Penalties

- SEC usually willing to settle for 1x penalty
- SEC will impose higher penalty if:
  - conduct is particularly egregious
  - defendant misleads investigators
  - defendant conceals or disguises trading
  - defendant is a recidivist
SANCTIONS FOR INSIDER TRADING


– Investment banker at BAS told father (broker); father traded, but son did not

– Father and son ordered to pay $818,000
  • father ordered to disgorge profit of $204,476
  • son ordered to pay civil penalty of $204,476
  • father ordered to pay civil penalty of $408,952 for creating false documents to mislead SEC
SANCTIONS FOR INSIDER TRADING

Criminal

– SEC works closely with DOJ to jointly prosecute insider trading cases
  • 13 criminal indictments in Morgan Stanley trading ring
  • June 27, 2007, three former Countrywide Financial execs pled guilty to criminal insider trading charges
– Post-SOX, if charged as wire or mail fraud, maximum sentence of 20 years per count (Sarbanes-Oxley Act section 903)
INSIDER TRADING IS A “NO FLY ZONE”

• SEC has zero tolerance for insider trading
    • trader made only $4,317.01
    • McKay traded and tipped two siblings
    • total combined profits of only $11,416

• Low threshold for criminal prosecution
  – Countryside Financial executives indicted for profits of only $48,000, $36,000 and $20,000
INTERNATIONAL REACH

SEC will prosecute insider trading affecting US markets, no matter where trades are placed

- **SEC v. Sonja Anticevic**: Croatian resident traded through Croatian accts (SEC Lit. Rel. 19327, Aug. 5, 2005)


- **SEC v. Purchasers of TXU Corp. Options**: trades purchased through Swiss, German and UK accounts (SEC Lit. Rel. 20028, March 2, 2007)

- **SEC v. Kan King Wong, et al.**: Hong Kong residents traded through Hong Kong branch account (SEC Lit. Rel. 20106, May 8, 2007)

SEC INVESTIGATIONS & TOOLS

Market Surveillance

- SROs (e.g., FINRA, AMEX) constantly surveil trading markets
- SEC’s Office of Market Surveillance monitors markets
  - July 14, 2006 Petco announced acquisition. During preceding three weeks, trader in London purchased options and derivatives from Swiss financial institution and UK brokerage houses.
  - SEC sued July 18th (four days after announcement) against “one or more unknown purchasers of call options for the common stock of Petco Animal Supplies”
SEC INVESTIGATIONS & TOOLS

Bounty Program

- SEC operates a bounty program through which it can award up to 10% of any penalty

SEC INVESTIGATIONS & TOOLS

Vigorous and Creative Investigation

– SEC Enforcement Director testimony to the US Senate (Sept. 26, 2006):

“our staff has become particularly adept at sifting through all available forms of evidence, including phone records, emails, instant messages, and the electronic footprints of internet protocol data. Our staff culls through trading records, interviews and takes the testimony of witnesses, and reviews bank and brokerage statements. With these tools and resources, our staff has built solid, creditable enforcement actions against hundreds of wrongdoers.”
SEC INVESTIGATIONS & TOOLS

• **Intrusive Investigations**
  – SEC may demand all emails within timeframe

• **Captious Investigations**
  – SEC wants to catch trader in a lie
  – SEC and SROs will cold call traders while several staff members take notes
  – Politely decline to respond to cold call and explain that your attorney will return the call
SRO INQUIRIES

• SRO will request chronology, list of people who had advance knowledge, and will require those people to identify traders they know.

• Responses to SRO inquiries should be thorough and careful.

• Incomplete or incorrect responses will put company in bad light.
AREAS RECEIVING SPECIAL SCRUTINY

• Hedge Funds
  – SEC created hedge fund working group to coordinate and enhance efforts to combat hedge fund insider trading
  – SEC working with other federal law enforcement agencies and SROs

• 10b5-1 Plans
  – Provide for pre-arranged trades at specified prices or dates
  – Executives using 10b5-1 plans outperform peers by 6%
  – SEC suspects misuse of 10b5-1 plans to facilitate trading on inside information
PUBLIC COMPANIES SHOULD PROTECT MATERIAL NON-PUBLIC INFORMATION

• Comply with listing requirements (eg, NYSE Listed Company Manual Sec. 202.01)

• Create and implement insider trading policies and procedures to protect the company’s own and its clients’ material non-public information
PUBLIC COMPANIES SHOULD PROTECT MATERIAL NON-PUBLIC INFORMATION

Key aspects of insider trading policies

- Clear written policies prohibiting insider trading
- Blackout periods for corporate insiders
- For major transactions:
  - restrict access to information
  - document who has access
  - require recipients to acknowledge insider trading prohibition
- Compliance Officer implements and monitors policies
- Periodic training on risks of insider trading
- Foster “need to know” culture for sensitive information
PUBLIC COMPANIES SHOULD PROTECT MATERIAL NON-PUBLIC INFORMATION

Key aspects of insider trading policies

– Establish IT firewalls to limit access to sensitive information

– Require Compliance Officer pre-clearance of officer/director trading in company stock

– Encourage use of 10b5-1 plans, with restrictions on making changes

– Monitor trading in company stock
  • investigate unusual trading activity
  • consider immediate public announcement if unusual activity detected

– Adopt a zero tolerance policy for insider trading
BROKERS AND INVESTMENT ADVISERS

• BDs and RIAs must have and enforce effective policies

• BDs and RIAs required to

  “establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of their business, to prevent the misuse of material, nonpublic information by them or any person associated with them.” Exchange Act section 15(f); Investment Advisers Act section 204A.

• Policies and procedures must be closely tailored to specific risks and must monitor and enforce compliance
BROKERS AND INVESTMENT ADVISERS

• In the Matter of Gabelli & Co. - $50,000 penalty each for broker and adviser

• In the Matter of Wyser-Pratte, et al.: $400,000 penalty (Admin. Proc. File 3-10479, May 9, 2001)


• In the Matter of Gintel Asset Management, Inc., et al.: $275,000 total penalties for all defendants (Admin. Proc. File IA-2079, Nov. 8, 2002)

BROKERS AND INVESTMENT ADVISERS


• In the Matter of Banc of America Securities LLC: $10MM disgorgement; $6MM penalty (Admin. Proc. File No. 3-12591, March 14, 2007)
BROKERS AND INVESTMENT ADVISERS

BDs and RIAs must:

- Identify specific risks that they or employees will abuse non-public information
- Design written policies and procedures to address those specific risks
- Design and implement systems to monitor compliance with policies and procedures
- Enforce compliance
BEST PRACTICES

• Institutions must develop, monitor and enforce effective insider trading policies

• Employees should follow a very simple rule – what happens at the office stays at the office
MITCHELL E. HERR

• Practice concentrates in securities litigation, primarily the defense of SEC enforcement matters, securities class actions and internal corporate investigations.

• Joined Holland & Knight in December 2000, after serving for over five years as the chief trial counsel for the SEC’s Southeast Regional Office where he was responsible for the SEC’s litigation in eight states and two territories.

• Since joining Holland & Knight, Mr. Herr has handled numerous SEC enforcement matters and internal corporate investigations. Mr. Herr has represented public companies, broker-dealers, registered investment advisers and associated persons, municipal issuers and bond counsel, accountants, and others concerning a variety of subjects.

• Honors and Awards
  • Elected by peers to *The Best Lawyers in America* (2006, 2007 and 2008 eds.). Additionally, in 2005, 2006 and 2007 he was recognized as a Top Lawyer in the field of Securities Litigation in the *South Florida Legal Guide*; in 2006 and 2007 he was recognized as a *Florida Super Lawyer*; he also was named by *Florida Trend* magazine in 2005, 2006 and 2007 as a member of Florida's Legal Elite; in 2006 he was selected as a finalist in the South Florida Business Journal's Key Partners competition.

• Education
  • Earned B.A. degree *summa cum laude* from Dickinson College, Carlisle, Pennsylvania, in 1978, where he was elected to *Phi Beta Kappa* in his junior year and was awarded a three-year Army ROTC full-scholarship. Received J.D. *cum laude* from the University of Chicago Law School in 1981, where he served as an Associate Editor of the Law Review and was elected to the Order of the Coif.
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