



Conspicuous Compliance

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The Resurgence of Insider Trading

*Illegal insider trading is again on the rise, and in the process, the prized reputations of broker-dealers and investment advisers alike are threatened. This issue of **Conspicuous Compliance** takes a look at the current market environment and provides recommendations that firms may consider to prevent and detect insider trading.*

April Showers Bring May Flowers

We are all familiar with the seasonal rhythm enshrined as a childhood verse, "**April showers bring May flowers.**" Industry too has a rhythm as business cycles - and liquidity - ebb and flow. Along with the high tide of ultra-liquid capital markets comes the allure of substantial investment returns. As surely as heavy rain precipitates a budding spring, abundant liquidity often produces sustained merger and acquisition ("M&A") activity. Unlike the seasonal metaphor however, the business analogy assumes an adverse element which sprouts up during these liquidity-merger-acquisition cycles with the regularity of dandelion in June. **This unwelcome recurrence is illegal insider trading - the subject of intense global regulatory scrutiny and the source of many ruined reputations.**

Chief Compliance Officers ("CCOs") and their firms benefit from having a **contemporary** understanding of insider trading and its evolution. Armed with the knowledge of regulatory expectations AND the recognition of the unique risks evident in their firms, CCOs should implement policies and internal controls to prevent and detect illegal insider trading activity.

History Repeats Itself

Insider trading is not inherently illegal as corporate insiders legitimately buy and sell shares of their own company securities following prescribed regulatory protocol and disclosure. However, the potential of hefty premiums often assigned to M&A targets and the multiple parties "in the know" in today's merger-acquisition process has led to a spike in illegal insider trading in 2007. History is replete with examples whereby sustained accommodative monetary policy led to a surge in M&A activity typically accompanied by innovative financial practices of the time. Consider the formation of corporate conglomerates in the 1960's, leveraged buy-outs in the 1980's, and the private equity boom currently underway.

Getting “in” on the “Inside” Action

Disclose or Abstain

Insiders privy to material nonpublic information (“MNPI”) are required to disclose to the public the nature of that information prior to trading in the associated securities. In lieu of proper disclosure, they must abstain from trading altogether. To the extent that an insider’s “scienter” or intent is such that the trading action taken intends to defraud by leveraging MNPI, illegal activity is deemed to have occurred.

In the past five years alone, the U.S. Securities and Exchange Commission (“SEC”) has brought over 300 insider trading actions against 600 different parties. These actions have been taken either in response to the SEC’s own investigation or have been referred by the various exchanges which monitor their trading for illegal activity.

The correlation with the business cycle is not limited to enhanced liquidity scenarios. So called “bad news” insider selling often spikes when corporate earnings experience sustained contraction or when other systemic adversity is evident in the capital markets. Nor is this prohibited activity limited to employees of the entity issuing the securities. In the past two years, the SEC has brought numerous cases against hedge funds for frontrunning earnings announcements and large wire house stock orders. Most recently in March of this year, two insider trading schemes involving 14 Wall Street bankers in various firms and funds were busted.

“Insiders” are not the Only Ones in the Know

There is legal precedent in the U.S. dating back to 1909 establishing that insider trading may be fraudulent. Fast forward 25 years to the passage of the Securities Exchange Act of 1934, pointing to insider trading as a substantial contributor to the crash of 1929. Section 16(b) of the 1934 Act largely prohibits “short-swing” profits to be realized by corporate insiders in their company stock while Section 10(b) prohibits the use of “manipulative or deceptive device or contrivance in contravention” of SEC regulations pertaining to the **trading of all securities by anyone**. SEC Rule 10(b)5 was later implemented to enforce these insider trading provisions of the 1934 Act by specifying particular fraudulent activities which constitute illegal insider trading.

During the 1980’s and 1990’s, U.S. regulators and courts substantially amplified insider trading rules pertaining to corporate **outsiders** by implementing SEC Rule 14(e). This Rule prohibits **anyone** from trading on MNPI in the context of a tender offer if the information was sourced from an insider.

“The basic argument against insider trading is that insiders should not be permitted to earn such sums at the expense of uninformed traders. If people fear that insiders will regularly profit at their expense, they will not be nearly as willing to invest. Efficient securities markets, it is argued, require a “level informational playing field” to avoid frightening away speculators, who contribute to securities market liquidity, and investors, who could invest their savings in markets with less risk of insider predation.”

*David D. Haddock,
Professor of Law,
Northwestern
University*

The Insider Trading and Securities Fraud Enforcement Act ("ITSFEA") requires brokers and advisers to "establish, maintain and enforce" risk-based written compliance policies designed to prevent the misuse of MNPI.

The Misappropriation Net

SEC Rule 10(b)5 posits the ***misappropriation theory***. This rule provides that a person receiving confidential information under circumstances specified in the rule would owe a duty of trust or confidence and thus could be in jeopardy under the misappropriation theory.

For a period of nearly twenty years the misappropriation theory was challenged and refined to the point of its current disposition. Corporate outsiders trading on MNPI are covered either as "constructive insiders" or as those entities that retain no direct fiduciary duty to the security issuer or its shareholders but have pre-existing duties to the source providing the information.

A constructive insider is deemed to be an outside party who legitimately acquires MNPI in the course of executing services for the issuing corporation, e.g., lawyers, consultants, bankers and even printers.

The term misappropriation is applied to the extent that the "tippee" is supplied the information by a "tipper" in a position to have access to the information. The tipper conveys or "***misappropriates***" the information to the tippee who then trades on the information for personal profit. To the extent that the tippee knew or should have known that the tipper breached a fiduciary duty in conveying the information which resulted in the tipper receiving a direct or indirect benefit, the tippee and/or the tipper are both in jeopardy. It should be clear that the regulatory arm enforcing insider trading has a long reach to implicate both purveyors and users of MNPI.

Implications for the Registered Firm

The Insider Trading and Securities Fraud Enforcement Act ("ITSFEA") amended securities law to require brokers and advisers to "**establish, maintain and enforce" risk-based written compliance policies designed to prevent the misuse of MNPI.**

Each firm has a distinctive business model that implies unique exposure to the misuse of inside information. ITSFEA requires the firm's compliance policy to effectively address these risks under consequence of sanction regardless of the actual misuse of information.

All risk-based aspects of a compliance policy (e.g., anti-money laundering, insider trading and third party reliance) must comport to the firm's business model. Variable product offerings, the size of employee payroll, ongoing relationships with attorneys, accountants and /or affiliates, as well as the investment/trading style of the firm are all factors to be considered when establishing the risk-based insider trading exposure of a particular firm.

Penalties for Failure to Prepare

Let it be clear that a broker-dealer or investment adviser may be sanctioned for inadequate insider trading procedures and internal controls, ***even in the absence of the occurrence of insider trading***. Case in point is the large broker-dealer/investment advisory firm who in 2006 incurred a \$10 million penalty for failure to maintain and enforce adequate policies and procedures to prevent illegal insider trading – despite the fact that illegal insider trading had not actually transpired.

The growth of the investment industry (hedge funds and advisers) coupled with the explosion of the derivatives market during a time of such massive evolution in communications capabilities present unique challenges to regulators in their effort to thwart illegal insider trading schemes.

Firms should expect that the SEC will devote far more attention to insider trading traffic as the violations continue to escalate. This is especially true considering the diversity of principals and their agents in the contemporary M&A model. Private equity managers, investment bankers, lawyers, hedge funds and corporate suitors all may have access to the MNPI of pending transactions.

Insider Trading - Closer Than You Think

For many firms, the risks of insider trading may seem distant from their day-to-day business. Upon closer inspection however, scenarios to access or become exposed to MNPI are evident.

Advisers to Public Companies

Consider the situation where an investment adviser manages money for a public company AND invests client portfolios in the marketable securities issued by that same entity. It may in fact be quite difficult to prevent MNPI sourced from client contacts from reaching portfolio managers and traders, thereby compromising the firm's policy to ensure that only "public" information drives trading activity in client portfolios.

Outside Activities of Employees

Further consider the scenario whereby personnel of broker-dealers or investment advisers serve on the board of directors of a public company that may be owned by clients / associated persons or perhaps recommended to clients. Once again the registered firm is instantly immersed in the vagaries of the insider trading arena. The illegal obtainment and use of MNPI represent a real and growing threat to compliant business operations in the brokerage and advisory arena today. CCOs must be creative and vigilant in discerning the nature of the threat of illegal insider trading to their unique operating environments.

"When you consider how complex and far reaching global securities markets are, you see what an ... [insider trading] ... enforcement dilemma that provides. A lot more money needs to be spent on these problems to not let insider trading be the equivalent of the HOV lane, where the chance of getting caught is quite remote."

Donald Langevoort of Georgetown Law School, as quoted in the New York Times

Building Effective Policies/Controls

CCOs of broker-dealers and investment advisers have their work cut out for them when it comes to designing and implementing effective insider trading policies and internal controls. Where to begin?

- ❖ **Step 1** – Take a careful look at your firm and the risks inherent in your business model. Consider:
 - Critical paths for information flows into and out of the firm
 - Job descriptions, business procedures, and compensation programs relevant to those responsible for generating firm revenue
 - Counterparties benefiting from trade activity engaged in by the firm
 - Affiliate businesses in a position to share MNPI
 - Potential conflicts of interest related to outside activities of personnel as well as employment connections of spouses and household members.
- ❖ **Step 2** – Develop and implement an Insider Trading Policy which addresses specific risks facing your firm, considering all the factors listed above and other relevant risks. Design a Code of Ethics to complement these policies.
- ❖ **Step 3** – Build a system of internal controls to address known and potential risks. Consider:
 - Monitoring personal trading activity of staff
 - Requiring periodic employee disclosure of outside activities, interests and connections of household members
 - Documenting critical information sources for internally generated research reports
 - Documenting resources utilized to make portfolio purchase and sale decisions
 - Segregating and delegating critical duties
 - Inserting Chinese Walls between those inside the firm who have access to MNPI and those who do not “need to know” such information due to the scope of their job functions
 - Creating Restricted and Watch Lists for those companies that introduce heightened risk of insider trading
 - Supervising personnel
 - Implementing confidentiality agreements with third parties.
- ❖ **Step 4** – Communicate all relevant policies, internal controls, and the Code of Ethics to all personnel, requiring them to certify their understanding and compliance on a regular basis.
- ❖ **Step 5** – Train, Train, and Train again – and advertise the consequences of non-compliance.

DID YOU KNOW?

The SEC may award bounties of up to 10% of penalties recovered, through litigation or settlement, to informants who provide information leading to successful enforcement actions against insider traders.

Compliance Bytes:

- 1) *Soft dollars – Going the Way of the Dinosaur?*
- 2) *Attorney – Client Privilege*
- 3) *When Regulators Comes Calling*
- 4) *Compliance Alert*

- ❖ **Step 6** – Monitor channels of information, for example:
 - Surveil email communications between personnel and outsiders
 - Review taped conversations of “at risk” personnel
 - Follow the paper by monitoring those with whom the firm is doing business
 - Follow the money by tracking substantial pools of revenue dollars to their sources
 - Interview personnel on a periodic basis to ensure their understanding of obligations under the policy AND to ensure that the policy remains current, relevant and effective.

- ❖ **Step 7** - Stay informed, for example:
 - Review “Testimony Concerning Insider Trading” by Linda Chatman Thomsen, Director, SEC’s Division of Enforcement, 9/26/06
 - Read up on regulatory developments and attend industry programs focused upon Insider Trading.

Compliance Bytes ...

Soft dollars – Going the Way of the Dinosaur?

According to [Dow Jones Newswires](#) (5/30/07), SEC Chairman Christopher Cox is urging Congress to consider repealing the soft dollar safe harbor provisions of the Securities Exchange Act of 1934. The safe harbor protects investment advisers from liability for possible breach of the fiduciary duty to their clients while engaging in soft dollar arrangements at other than the lowest transaction costs. The safe harbor can be invoked if the firm makes a good faith determination that the amount of the commission is reasonable in relation to the value of the permitted services received. Cox is concerned about the risks of conflicts of interest and investor confusion which beleaguer soft dollar arrangements. Stay tuned!

Attorney-Client Privilege

Firms might assume that the use of the phrase “attorney-client privilege” in the subject line of emails effectively prevents a regulatory examiner from gaining access to such communications. Think again. What firms fail to recognize is that such emails often evolve into “email strings” as they are forwarded multiple times inside and outside the confines of the firm. This common practice leaves the firm and its privileged/confidential information very vulnerable to misguided employees AND to regulatory purview and scrutiny. Solution? Consider funneling all privileged communications, such as those with outside legal counsel, through one person – logically, the CCO or internal legal counsel – to ensure that the information is not improperly shared and forwarded in a manner that effectively renders its privileged nature null and void.

When Regulators Comes Calling

The NASD/SEC's first impression of a firm's compliance culture may be formed long before they actually knock on the door. For many firms, the regulator's incoming phone call to the CCO may well set the tone for things to come. Solution? Make sure that all personnel in a position to field an incoming call from the NASD, SEC, or any regulator know exactly what to do and say. The NASD and SEC assume that the CCO is "always standing guard" even when he/she is out of the office. So if a regulator calls, and the CCO is not available to field the call, be sure to have a very clear and well communicated protocol in place to demonstrate a solid culture of compliance in their absence. Even when the CCO is out to lunch, the regulator's call should be handled properly! Finally, due to the recent surge in telephone pretexting, each incoming regulatory call should be vetted to ensure that the caller is legitimate.

Compliance Alert

SEC Staff has released its first "ComplianceAlert" letter to help CCOs of SEC-registered firms learn more about common deficiencies and weaknesses that SEC examiners are finding during compliance examinations. This communication of recent examination findings can help broker-dealer and investment advisory CCOs fine-tune their compliance and supervisory controls. The letter is available on the SEC's website by linking <http://www.sec.gov/about/offices/ocie/complialert.htm>

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