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Insider Trading

How Can Hedge Fund Managers Update Their Insider Trading Compliance Programs to Reflect the SEC's Focus on Systemic Violators, Gatekeepers, Trading Patterns, Profitable Trades and Expert Networks?

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By Cara Griffith, *Hedge Fund Law Report*

Insider trading enforcement remains a top priority for regulators and prosecutors. For example, just this month to date: (1) Joseph F. "Chip" Skowron III, a former healthcare portfolio manager at FrontPoint Partners LLC, pleaded guilty to conspiracy to engage in insider trading and obstruction of justice; (2) the DOJ brought conspiracy to commit securities fraud and wire fraud charges against Stanley Ng, the former SEC Reporting Manager at Marvell Technology Group, Ltd., for allegedly providing material nonpublic information to Winifred Jiau; (3) the SEC charged a former professional baseball player and three others with insider trading ahead of the early 2009 buyout by Abbott Laboratories Inc. of Advanced Medical Optics Inc.; and (4) the SEC charged a California man with purchasing Marvel Entertainment call options while in possession of material nonpublic information obtained from his girlfriend (who worked at the Walt Disney Company) regarding Disney's acquisition of Marvel.

In this still-heightened insider trading enforcement climate, hedge fund managers remain a prime target for civil and criminal insider trading charges. This is so for at least five reasons. First, regulators and prosecutors have been emboldened by the May 11, 2011 conviction of Galleon Group founder Raj Rajaratnam on 14 counts of conspiracy and securities fraud. See "Implications of the *Rajaratnam* Verdict for the 'Mosaic Theory,' the 'Knowing Possession' Standard of Insider Trading and Criminal Wire Fraud Liability in the Absence of a Trade," Hedge Fund Law Report, Vol. 4, No. 18 (Jun. 1, 2011). Second, wiretapping has become a viable tool for investigating insider trading by hedge fund manager personnel, and a source of persuasive evidence. See "Will a Criminal Court Admit into Evidence a Recorded Telephone Conversation Between a Hedge Fund Manager Charged with Insider Trading and an Alleged Co-Conspirator?," Hedge Fund Law Report, Vol. 4, No. 24 (Jul. 14, 2011). Third, in the course of examinations of hedge fund managers, SEC examination personnel are looking for (among other things) evidence of insider trading that can serve as the basis of referrals to the SEC's Enforcement Division. See "Is a Hedge Fund Manager Required to Disclose the Existence or Substance of SEC Examination Deficiency Letters to Investors or Potential Investors?," Hedge Fund Law Report, Vol. 4, No. 18 (Jun. 1, 2011). Fourth, the staff of the SEC's Enforcement Division can now use tools developed in the criminal context in bringing, negotiating and settling insider trading charges against hedge fund managers. See "Entry by SEC into a Non-Prosecution Agreement with Clothing Marketer

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Illustrates How Hedge Fund Managers May Survive Discovery of Certain Insider Trading Violations," Hedge Fund Law Report, Vol. 3, No. 50 (Dec. 29, 2010). And fifth, budgetary constraints have led the SEC to place a higher priority on deterrence, and insider trading actions against hedge fund managers are thought to have a powerful deterrent effect. See "Key Insights for Registered Hedge Fund Managers from the SEC's Recently Released Study on Investment Adviser Examinations," Hedge Fund Law Report, Vol. 4, No. 5 (Feb. 10, 2011).

In light of the vigor with which civil and criminal authorities are pursuing insider trading actions – and the ongoing susceptibility of hedge fund managers to insider trading charges – the Regulatory Compliance Association's Fall 2011 Asset Management Thought Leadership Symposium will feature a session entitled "Insider Trading – The New Enforcement Paradigm." That RCA Symposium will take place on November 10, 2011 at the Pierre Hotel in New York. (Subscribers to the Hedge Fund Law Report are eligible for a registration discount.)

Scott Pomfret – Regulatory Counsel for a Boston-based institutional money manager and a former branch chief in the SEC's Division of Enforcement – participated in the insider trading session during the RCA's Spring 2011 Symposium and is expected to participate in the RCA's Fall 2011 Symposium. As a former regulator and current in-house counsel, Pomfret has a unique, and uniquely relevant, perspective on insider trading enforcement trends as they relate to hedge fund managers. By way of revisiting some of the topics that Pomfret discussed during the last RCA Symposium, and by way of preview of some of the topics that he may discuss at the next RCA Symposium, the Hedge Fund Law Report recently conducted an interview with Pomfret. Our interview covered: Pomfret's background; a shift in the focus of the SEC's insider trading enforcement efforts; the rationale for and implications of the SEC's focus on "gatekeepers"; how the SEC collects and uses hedge fund trading data; the role of trade profitability in allocating SEC enforcement resources; how hedge fund managers can answer investor questions about SEC inquiries; specific steps hedge fund managers can take to mitigate insider trading risk when using expert networks; three specific ways in which hedge fund managers are revising their insider trading compliance policies and procedures; and insider trading concerns for hedge fund managers that typically invest in "private" securities and assets. The full text of our interview with Pomfret is included in this issue of the Hedge Fund Law Report.

HFLR: First, by way of background, can you briefly tell us what your role or roles were at the SEC, what work you did at PwC, and how you transitioned to your current role?

Pomfret: At the beginning of 2003, I joined the Division of Enforcement at the SEC in the Boston Regional Office. I became a Branch Chief, meaning that a group of front line attorneys working on cases reported to me. Being in Boston, my focus was on asset managers, initially a lot of traditional asset managers and later alternative asset managers. Insider trading cases were also a huge portion of what we did and I worked on a significant number of those and the staff who reported to me also had a number of insider trading investigations on their plate at all times.

I joined PwC in 2010 as a Director in the Financial Services Regulatory Group. In that role, I consulted with mostly alternative asset managers to either prepare them for SEC registration or to review their compliance programs in light of new regulatory initiatives and the new aggressive approach by the SEC and the Department of Justice.

In July 2011, I joined an institutional money manager in Boston as its Regulatory Counsel, where I am responsible for legal and regulatory compliance, including with the rules and regulations of the SEC, CFTC, NFA, Department of Labor, and other domestic and foreign regulators.

HFLR: You have described a shift in the focus of the SEC's insider trading enforcement efforts from one-time "opportunistic" insider trading cases to systemic and serial violators. Can you describe what this shift involves and the rationale for the shift?

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Pomfret: When I began at the SEC, the vast majority of cases that came to the SEC were referrals by FINRA or other SROs. They tended to be issuer-specific, typically involved equities trading, and focused on a single trader at a single point in time – what I call an "opportunistic" fraud. The analysis we would be given was something like this: here was a corporate event; here was some trading that looked suspicious around that event; and here were the relevant traders. Go investigate. Those cases continue to flow into the SEC from the SROs.

In my view, what's changed is that the SEC has reallocated resources toward larger frauds. This means concentrating not only on the cases that involve larger dollars, but also toward the cases that involve repeat offenders or those that are making a business out of insider trading rather than the one-time opportunistic case. The Director of Enforcement, Robert Khuzami, has been quoted as saying that he believes there are players out there, including hedge funds, that are regularly cheating: "You have funds whose business model consisted of vigorous attempts to collect information from corporate insiders and to utilize that information to trade."

As an example of the change in focus based on my personal experience, toward the end of my career at the SEC, we had a clear opportunistic case that involved the spouse of a public company employee who traded in the account of a friend and tipped a lawyer. My distinct impression was that the SEC's appetite for a case like that, where the dollars involved were relatively low (under $50,000 in sanctions), had diminished significantly from when I started in 2003. Not that the SEC wouldn't bring such a case in appropriate circumstances. In fact, in the particular case I mentioned, the gentleman confessed to me on the phone, so the SEC did bring that case. But where a case was a closer call, or the litigation risk was higher, I imagine the Division of Enforcement may have chosen to focus energy instead on serial insider traders.

That said, there is one set of cases where the appetite will always remain strong, even for opportunistic-type trading, and low-dollar profits, and that is cases that involve "gatekeepers" – those the SEC regards as having a special duty to do the right thing and uphold professional ethics and standards. Thus, the SEC will continue to bring cases involving lawyers, auditors, and other gatekeeping professionals, even in the circumstance where the profits involved are fairly low. In the past six months, there's been a case where the profits involved were as low as $27,000, but it involved a lawyer, so the SEC will gladly spend the resources necessary to hold a "gatekeeper" responsible.

HFLR: Does the SEC's focus on gatekeepers increase the likelihood that the agency will direct enforcement resources and attention on lawyers and auditors within hedge fund management companies, or only on outside counsel and outside accounting firms?

Pomfret: I think the same approach applies to both internal and external lawyers and accountants.

HFLR: How has the SEC changed the way it uses the data it collects in the course of its insider trading investigation?

Pomfret: As I mentioned, FINRA refers hundreds of cases of potential insider trading to the SEC. For each referral, the SEC obtains relevant trade data. When I first started, the data was used solely for the case for which it was obtained. Beginning in the mid-2000s, the Philadelphia Regional Office got the bright idea to aggregate all the data from individual cases into one database. Using this database, the SEC could identify patterns or repeat violators over time, or more importantly, repeat violators who appear to be buying and selling in tandem with another trader or traders. Once the SEC sees that sort of pattern, it will look for connections between the traders that appear to be trading in tandem. For example, maybe the traders worked together at a firm in the past, maybe they live in the same neighborhood, maybe they were at the

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same fraternity house. Whatever the connection, the SEC is going to attempt to establish evidence to suggest a relationship through which material nonpublic information might flow.

The project of aggregating this sort of "blue sheet" data – blue sheets being the trade data – was initiated by Daniel Hawke, who is now the head of the Philadelphia office, but also the head of the Market Abuse specialized enforcement unit, whose sole focus is market manipulation and insider trading. Hawke described these efforts publicly at a SIFMA Conference earlier this year and in other venues, and his team's efforts appear to have produced results. For example, on August 4, 2011, the SEC announced it had sued a professional baseball player and three associates for insider trading. The SEC's press release notes that the Market Abuse specialized unit in the Division of Enforcement conducted the investigation and quotes Hawke as saying, "People need to understand that we are watching for suspicious trading activity, and they will pay a heavy price when we catch them insider trading."

HFLR: How should hedge fund managers use that information about the blue sheet database to revise their compliance policies and procedures relating to insider trading and information management?

Pomfret: In some ways, what the SEC is doing is hard to duplicate; no fund manager has the kind of access to aggregate data the SEC has. But there are steps a manager can take to try to detect suspicious correlated trading with another manager. First and foremost, managers should conduct an inventory of sources of material nonpublic information at the firm. Compliance personnel must understand where the information flows may come from, understand where the economic ties may lie, understand even where some of the friendships of the portfolio managers or principals or outside managers exist, understand what the opportunities for receiving material nonpublic information are, particularly if you are investing in different parts of the capital structure or you are involved in PIPEs. After you understand, by inventory, where the sources of material nonpublic information are, compliance should implement a surveillance program that detects whether there are flows of information that match up with the sources in the inventory. Consider looking, for example, at all the e-mails that go to domain addresses @hedgefund.com (where you have identified economic or personal ties with the outside manager at that domain). Consider looking at the volume and timing of phone communications. To focus those efforts, tie in-depth e-mail review or phone record review to suspicious trades rather than doing more random e-mail or phone record surveillance that is unlikely to produce a lot of "hits."

HFLR: Are SEC examiners using profitability of specific trades as a screen to determine which trades to look at closely in the course of an examination or inspection?

Pomfret: A standard approach that the SEC has used for quite some time is what they call the "give me your ten most profitable portfolio trades during a given period" approach. The idea is that the trades in which you receive material nonpublic information are going to be the big wins (although the Galleon case involved at least some trades that did not turn out to be profitable). The staff will take that information and see if there was personal trading around the portfolio trade or they will try to match the trades up with some release or public announcement. If the staff finds a connection, it will probably issue a big document request or email request around that situation to try to determine whether in fact there was a bit of good luck or research or if the trade was the product of the receipt of material nonpublic information.

Hedge fund managers should consider similar analytics to help them identify in advance trades the staff may regard as suspicious. For example, some firms focus on purchases of securities of issuers that are new to the firm; the CCO might ask, "why are we in this position and what prompted us to get there." Similarly, some firms focus on trades where the firm gets into and out

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of a position very quickly. A public announcement between the in and the out might signal a suspicious trade. These are the kinds of things that the SEC staff, too, will examine. [See "SEC's Hedge Fund Focus to Include Review of Funds That Outperform the Market," Hedge Fund Law Report, Vol. 4, No. 14 (Apr. 29, 2011).]

HFLR: Here's a scenario that various hedge fund managers may be facing: the SEC seeks information from a hedge fund manager about another hedge fund manager, the SEC asks the first hedge fund manager not to disclose the fact of the SEC's inquiry or its substance, then an investor with that first hedge fund manager asks the manager if it is "under investigation" or "involved in any investigation." We have heard that managers faced with this situation have generally told inquiring investors: "No comment." But that does not sound good. Is there a better way for hedge fund managers to negotiate this scenario?

Pomfret: My view is that a manager should acknowledge to the inquiring investor that the manager regularly receives inquiries from a host of regulators about a range of topics, counterparties, and industry players and activity (and expects the volume of such inquiries to grow as aggressive regulation continues). The manager should assure the investor that it responds to such inquiries as a matter of course, but does not disclose the details of the inquiry.

I would also caution managers to listen closely to what the regulator communicates. In my experience, the SEC very rarely requests a manager to keep mum. The staff may note that the investigation is nonpublic, but this only means the SEC is prohibited from revealing that the investigation exists. It is not an obligation of the hedge fund. Obviously, it is hard to imagine circumstances in which revealing the existence of the investigation would be beneficial, however, and it would certainly not be regarded as cooperative behavior by the staff.

HFLR: Let's talk about expert networks. First off, have you seen hedge fund managers banning their investment professionals from using expert networks altogether, and if so, have such bans been framed as outright prohibitions or temporary suspensions pending greater clarity from regulators on what is and is not permitted?

Pomfret: Some firms banned the use of expert networks entirely, particularly around November of last year when The Wall Street Journal broke the story. Also, many analysts were predictably gun-shy about using experts after the news broke; a firm I worked with when at PwC told me there was a precipitous decline in requests by analysts to use experts late last year.

Since then, the SEC and the Department of Justice have made clear in public announcements that expert networks per se are not a bad thing, and indeed they are a good thing, provided they are used correctly and are not used as vehicles for material nonpublic information. So while we do have a small minority of hedge fund clients who have elected to ban their use all together, they are very much in the minority. Instead, managers have begun to take a look at their use of expert networks and private research consultants, at the precautions and procedures they have in place, and at the precautions and procedures the expert networks themselves have in place concerning their roster of experts.

To mitigate risk, firms look at all phases of the engagement with the expert network. For example, they are looking at measures that they want to take before retaining an expert consulting firm (such as creating a pre-approved list of expert networks analysts can use). They are also looking at steps they want to take in advance of a particular consultation (including prior notice to legal or compliance about a possible meeting with a consultant). They are taking steps during the expert consultation. For example, some firms have compliance chaperone calls. Some require that more than one person participate on the call, even if it is not a compliance professional. Post-consultation, firms undertake surveillance to look at any red flags that may have arisen. Lastly, hedge fund managers are making sure that their contracts state
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very, very clearly that they do not wish to receive material nonpublic information through the use of the expert networks. I think it is important to set that tone and convey that message as often as possible. Perhaps most important is an open and frequent dialogue between compliance people at the firm and compliance people at the expert network.

Nevertheless, real risks exist. Just this month (August 2011), authorities announced yet another arrest in a case related to expert networks.

HFLR: Beyond expert network issues specifically, and focusing on insider trading more generally, have you seen hedge fund managers enhancing their compliance programs, and if so, can you provide a few specific examples of ways in which hedge fund managers are doing so?

Pomfret: In light of increased regulatory pressure and the private fund registration requirement, managers are giving compliance renewed scrutiny. Many of them are looking at software systems. Some of the newer software that is available can run surveillance of both portfolio and personnel trading and correlate that with public announcements made by the issuers. The software can do that efficiently, without requiring the human interaction that it used to require. I have not seen any software systems in action, so I do not know exactly how good they are, but they are apparently better than they have been in the past.

The second thing that hedge fund managers are doing, which I think is one of the most easily implemented, is revising training programs. With respect to insider trading, the first step is to avoid generic content and replace it with specific examples that you found from doing the inventory of sources of material nonpublic information so your employees can be educated about the particular risks in the firm. So whether the potential source of MNPI is board seats, PIPE transactions, or bank loans, wherever your vulnerabilities are, use those examples for training. The second step is to have senior management at the firm conduct or introduce the training. Set the tone at the top: document that senior management clearly said to its employees, the firm does not tolerate insider trading.

Lastly, I have seen fund managers consider adding compliance staff, particularly staff with regulatory experience, to help them meet the challenges. Of course, the cost – particularly for smaller funds – can present a serious obstacle to adding headcount. Hence, managers are trying to get creative: seeking a compliance hire who can deliver other skills and services to the firm in addition to compliance; seeking a more junior person overseen by in-house legal persons and assisted by compliance consultants; and/or seeking to share compliance resources with other firms. I also see more attempts by existing compliance personnel to network with their peers, especially concerning best practices. [See "Who Should Newly Registered Hedge Fund Managers Designate as the Chief Compliance Officer and How Much Are Chief Compliance Officers Paid?," Hedge Fund Law Report, Vol. 4, No. 7 (Feb. 25, 2011); "To Whom Should the Chief Compliance Officer of a Hedge Fund Manager Report?," Hedge Fund Law Report, Vol. 4, No. 22 (Jul. 1, 2011).]

HFLR: A number of types of private funds do not actively trade securities, for example, private equity funds, real estate funds and some distressed debt hedge funds. Are there specific compliance steps that the managers of such funds should take to avoid insider trading violations in connection with trades in funds or personal accounts of manager personnel?

Pomfret: One of the things often heard from private funds that are not in publicly traded securities is that their risk is basically zero. I believe they are mistaken. If you look, for example, at the most recent expert network cases, you do not have to be invested in public companies to get material nonpublic information about public companies. It is possible, for example, that a private portfolio company could be a material supplier or customer of a public company and therefore be in possession of material nonpublic information that could flow back through the
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adviser. Alternatively, a portfolio company that is a private financial printer may also be a source of MNPI. And information from such sources could be used inappropriately, either in personal trading by the adviser's personnel or flowing out of the adviser to another money manager that does trade in the public markets (and employees of the first adviser may be invested in funds of the other money manager). Accordingly, though the risk may be less, the precautions and procedures managers should take are the same: inventory potential flows of MNPI, set up e-mail surveillance to help you capture any information that may be moving around the firm or set up information barriers to prevent the flow of any such information, and training (and, of course, hiring compliance resources appropriate to the firm's risks).

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