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Traps in Electronic Communications, Part Two

By Hugh H. Makens and Marcus R. Jones

This is the second part of a two part article on electronic communications.

C. Evaluation of Ecoms.

Once the electronic communications ("Ecoms") come to the lawyers, the process of analysis begins. It is obviously horribly dull to read thousands of irrelevant emails, but the task must be accomplished, since it takes only one or two needles in the haystack of Ecoms to have devastating results. Lawyers are generally looking for:

1. Ecoms on point, which reflect a violation of the law and would be relevant to the scope of the investigation that the firm believes it is confronting.
2. Ecoms not on point, but which raise issues which regulators may consider establishing a new investigative track to pursue.
3. Ecoms which are on point, but which can be misconstrued, so that at the time of production the firm may consider providing an explanation which eliminates or mitigates the construction that a person reading the Ecom out of context might assume.
4. Ecoms that reflect a failure in supervision on a routine basis as prescribed in the firm's WSPs.
5. Ecoms which reflect a failure to pursue red flags.
6. Ecoms which reflect a failure of management to adequately deal with problems presented to it.
7. Ecoms which reflect a lack of concern by management on matters relevant to the investigation.
8. Ecoms which reflect a lack of attention to staffing, quality of supervision, past problems by representatives or their supervisors, and similar reflections on the level of attention that management is giving to a problem. (In its settlement, Morgan Stanley had to agree to provide more in-depth training to its staff on email retention law and policy.)
9. Ecoms which reflect badly on persons who may be the target of the investigation, even though the contents of the Ecom are not directly relevant to the investigation.
10. Ecoms which show a systematic failure of compliance oversight.

There are many other nuances which lawyers will target in their reviews. It is essential that reviews reveal problems prior to the time that they are transmitted to regulators, so that the firm has the opportunity to put the information in context in its accompanying correspondence to regulators and to avoid misperceptions, or shed the most favorable light on information which is provided, either at the time of production or afterwards. In addition:

- Regulators want production organized; however, the definition of "organized" in the minds of investigators is often not clear. It is important to clearly identify mutual expectations.
- Counsel will maintain a book of critical documents or a computerized storage and retrieval system for them. Privileged documents should be maintained in separate files, identified as privileged.
- Document destruction can have devastating effects on a firm. In the *Southwest*[1] case, the SEC imposed a $10,000,000 fine (including other violations) on the respondent for deleting emails every 31 days and allowing users to delete emails from the system. Firms should issue clear instructions to affected parties, and those involved in document destruction, preventing destruction or erasure of any materials relevant to the investigation.
- The consequences to Arthur Andersen from the Enron criminal proceedings, though it was ultimately found not to be guilty of a crime, clearly illustrate the importance of avoiding document destruction. Further, most of the individuals who are dumb enough to intentionally destroy documents to cover up wrongdoing usually end up having them retrieved because the firm's storage or reconstruction capabilities was not contemplated at the time of their foolish action.[2]

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ELECTRONIC COMMUNICATIONS
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IV. Problematic Emails.
A. Discovery.

Careful review of the emails is essential. It is a task born in ennui; nourished in tedium; and periodically climaxing in receipt of another batch for a new target of the investigation. Yet, if not done carefully, the firm and its counsel will be caught by surprise. It is also important to look for gaps in production either in the form of missing emails or in emails with questionable dates.

B. Follow-up.

Once the Ecoms have been sorted, analysis begins.

• Is the communication subject to a privilege; is it a business communication; or is it within the requested batch and must be produced.
• If the latter, is there anything about it that causes concern?
• If there is a concern, should the Ecom be the subject of further inquiry to ascertain the background?
• Are the facts in the Ecom correct, or is further information available that would correct a misapprehension on the part of the sender? Is there confusion about what was said at a meeting or in instructions given that should have been corrected at the time (and perhaps was orally) but for which there is no corrective track in writing?
• Is the Ecom clear, or is it subject to multiple interpretations? (Is there a substantial risk that regulators, being an inherently suspicious lot, will grade the interpretation least favorable to the firm?)

There are many facets to weighing the contents of an Ecom, and each must be examined to have a full picture if the consequences of the Ecom are serious.

You may find a "smoking gun." People do stupid things, and then talk about them. On one hand, a pattern of violations may emerge. On the other hand, there may be instructions about how to do the stupid thing from a supervisor or co-worker.

• Specifically Henry Blodgett of Merrill Lynch stated, "[W]hat a POS that thing is," in an e-mail referring to a stock he was recommending. Representatives and supervisors too often say foolish things in Ecoms, treating them as though they were confidential. They also share them indiscriminately with devastatingly adverse results.
• The Ecoms may also be the source of documents that specifically rebut the allegations contemplated by regulators. It is essential (and often more difficult) to seek out the documents that establish these points.

C. Disclosure.

One can simply turn over the requested or subpoenaed documents to regulators, listing what is provided and then waiting for a response. At times that is adequate. However, there are other considerations. How much does the firm want to be seen to cooperate by organizing the documents? Does the firm really believe that regulators will give credit for cooperation? If so, will the credit be significant both monetarily and in sanctions, or does the regulator—for whatever reason—have a different agenda? Is the discussion of or potential for credit, merely a device to ease the making of their case? In a world where there was mutual trust between regulators and firms, it would be an easier decision. In the uncertainty of the present environment, it is difficult to determine cooperation credit.

An even more important question is whether the information provided needs explanation, clarification, correction, elucidation, or admission, and if so, when, if at all. The great, unanswered question is how many Ecoms actually get reviewed by regulators. Certainly the truth is that many are not reviewed, despite the fact that they have been requested and produced. If reviewed, they may not be understood. All this complicates decisions on timing and nature of disclosure. In fairness, if regulators are requesting items, they have an obligation to review them, but in truth, firms generally aren't upset if the review is not done unless the review would have revealed materials in mitigation, or substantiate that the firm was acting professionally and in accordance with laws, rules, and its internal procedures. When planning a defense, assume that key emails have

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not been adequately read or understood, and emphasize important aspects of the Ecoms.

When providing the required Ecom, one can use a wide range of methods of response and organization. There are many levels of strategic consideration, but no certain answers in the present regulatory environment of substantial sanctions, aggressive punishments, and increased targeting of individuals.[3]

D. Criminal Consequences.

Firms generally want to use the same counsel for potential respondents unless there is a painfully obvious conflict of interest. Two factors are changing the underlying basis for consideration of this issue and often mitigating in favor of separate representation.

1. First, the NASD and NYSE are hiring more attorneys from the Justice Department, SEC, and other federal agencies. They are about to consolidate enforcement into a single entity. Attorneys from federal agencies bring with them a vastly different approach than those with self-regulatory backgrounds.

2. The other consideration is the increased criminalization of the securities laws. In evaluating Ecoms, it is essential to bear in mind the possibility of criminal action in egregious cases. Ecoms can lead to an immediate decision to recommend additional outside counsel for potential respondents/defendants

3. Sanctions have rocketed upwards in the past three years, and there is no end in sight. Agencies keep score by the amount of fines and length and number of sanctions. Even if criminal charges are avoided, the consequences can be devastating to firms.

VI. Words of Wisdom.

A. Rules for Email Creation:

1. Big Brother is Reading Your Emails.

Don't say anything in an Ecom that you don't want the firm or a regulator to read. Avoid putting it in writing if it does not need to be.

2. Opinions Count - Often against You!

Don't express opinions in your Ecom. Express them by direct personal or telephonic contact.

3. Grabbing Things from the Internet and Sending Them Can Be Bad.

Taking internet material and attaching it to an Ecom can be bad for many reasons. Do so with care, and remember what you attach you may be deemed to endorse.

4. Regulators Have NO Sense of Humor.

Avoid using sarcasm, cynical humor, or anything derogatory in your Ecoms, since regulators tend to take them literally. They can be read as admissions of wrong-doing even when that is not the intent.

5. Don't Admit Screw-Ups in an Ecom.

Regulators will use admissions of internal errors or mistakes to establish violations of law.

6. Use the "Dragnet Approach" to Ecom Drafting.

Ecoms should focus on the facts, just the facts. This does not preclude recommendations, but even they should be considered in light of the way they will be read by regulators.

7. Copy Only Those with a Need to Know.

Don't get carried away with copies. Send them only to people who really need to have them.

8. Never Denigrate Another Person or Firm in an Ecom.

Don't say anything in an Ecom that you would not want someone else to say about you.

9. In Communicating Through Ecom with Your Customers, Remember that You Are Creating Exhibits for an Arbitration Proceeding.

Your communications to customers can be used against you. Put only those things in your Ecoms which you would be willing to have a regulatory attorney examine you on during your testimony.

10. Don't Think You Can Erase Ecom.

Deleting an Ecom does not remove it from electronic retrieval. Absent stripping a hard disk clean, there is almost nothing that cannot be retrieved.

11. Ecoms Can Contain Red Flags.

When a supervisor receives an Ecom that raises issues of compliance, it is essential that the supervisor follow up on that information and that somewhere the supervisor have preserved written evidence of having done so.

12. Metadata is Bad Data.

Metadata can provide unintended consequences. The retention of entire keystroke histories can lead to serious consequences in future litigation.

B. Regulators Love Ecoms.

They help by making it far easier to bring cases. Ecoms present the worst of both worlds for firms.

- On the one hand, they tend to be very informal and often lacking in detail that the sender assumes the recipient knows.
- On the other hand, they tend to be long enough to clearly identify a problem, and when they violate the guidance set out above, can be devastating to the firm and the individuals involved in sending, receiving, or being copied on the Ecoms.

Recent cases have clearly spelled out the risks to the firms. They fall into categories of inadequate systems, non-retention, destruction, untimely production, and willful violation of the recordkeeping rules. Business as usual in the firm is an invitation to horrible results in investigations. Firms must continually rethink internal policies to recognize and control the risks. It is necessary to educate ***all*** users of Ecoms on their importance. The amazing thing is how many firms have failed to drive home the importance of proper Ecom use to their employees or independent contractor agents. ❑

MYOB-A
(Mind Your Outside Business Activities)

By Kerry Cunningham

When was the last time you took a good, hard look at your policies and procedures for outside business activities (OBAs)? You may have reviewed them as part of a gap analysis in connection with the CEO certification process, or as part of your general supervisory controls procedures, but did you really look at the OBA procedures to make sure they are doing the job in today's environment? Or, did you simply assure that you had a general policy and some procedures that required some type of notification to the broker-dealer? If you haven't looked at your OBA procedures for a while, now is a good time to do so.

Managing your OBAs in today's environment is an extremely important part of managing your overall business risks. With the growing diversification of the financial services industry, and the expansive opportunities on the internet, there are increased business opportunities for representatives both within the scope of their relationship with their broker-dealers and outside that scope. Regulatory authorities, at both the federal and state levels, are holding broker-dealers more accountable for the actions of their representatives, even where those actions are not necessarily securities related. Moreover, with the kinds of financial products on the market today it is increasingly more difficult for the average representative to know when he or she is, in fact, engaging in a securities business and not merely an OBA. These facts put broker-dealers in a real risk of becoming entangled in regulatory investigations, regulatory actions and/or arbitration. In some instances, broker-dealers have found themselves defending a matter in the courts, and not in arbitration, because the plaintiff was not a broker-dealer client subject to the firm's arbitration clause. In all instances, broker-dealers and representatives have faced significant costs in defending themselves.

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OBAs are a way of life in today's securities industry. For independent contractor broker-dealers, OBAs are the norm. For broker-dealers whose representatives are employees, OBAs are not unusual. Relatively few firms outright ban OBAs and those that do have the same issues as other broker-dealers – how to build policies that clearly state the firm's position on OBAs. This article will focus on those firms that permit OBAs and offer some suggestions that will hopefully be of some use. Many of the concepts, however, will also apply to those firms that outright ban OBAs.

Managing OBAs, as with any other area of the business, begins with developing a solid set of policies and procedures. That means creating a policy that covers the rule requirements, expands upon the rule requirements when it makes good business sense, and writing the procedures such that the representative understands what is required and the broker-dealer understands what it receives. The process continues with communicating the policies and procedures to the representatives in an effective manner. Lastly, managing OBAs effectively requires constant follow-up both at the initial notification of the OBA and afterwards.

Developing Solid Policies and Procedures for OBAs

NASD Conduct Rule 3030 (the "Rule") is, of course, the primary OBA rule for the vast majority of broker-dealers. In order to build a solid set of policies and procedures, it is necessary to take a look at the Rule itself. Rule 3030, which has not changed substantively since its adoption in 1988, provides, in pertinent part:

> No person associated with a member in any registered capacity shall be employed by or accept compensation from, any other person as a result of any business activity, other than a passive investment, outside the scope of his relationship with his employer firm unless he has provided prompt written notice to the member. Such notice shall be in the form required by the member….

The Rule is not a picture of clarity. While it is clear that the rule applies only to registered persons, what is "compensation" and what is a "business activity?" Does "compensation" include reimbursement of travel expenses to attend a meeting? Does "business activity" include sitting on a board of directors for a company not affiliated with the broker-dealer?[1] Both may well be covered by the Rule and it would certainly be understandable that a representative would not consider either of the above to fall within the Rule's coverage or to require any notice to be given promptly to the broker-dealer. And, by the way, what is "prompt" notice? The word "prompt" can be interpreted differently by different persons.

Because Rule 3030 itself lacks clarity, it is incumbent upon the broker-dealer to define the Rule for its own business purposes. A broker-dealer is always free to establish policies that are more restrictive than a particular rule, and for OBAs it is a good idea to do so. This means defining the activities to be covered by your policies and procedures, defining the type and content of the notice and defining when the notice must be given.

Defining the scope of the policies

A solid set of OBA policies and procedures should define for the representative exactly what the broker-dealer considers as an OBA and covered by the notice requirement. In this regard, the following are good things to consider:

a. What is an OBA? The policies should describe what is considered a covered "business activity." Most representatives would understand that formal employment accompanied with a salary by someone other than the broker-dealer would be covered by the Rule. But what about acting as an officer or director of a company or a charitable institution, or acting as a consultant to a family business? A representative might not understand these activities to be consider "business activities"

particularly if the only form of compensation is covering the expenses of attending meetings. However, a regulator might well consider these activities to be covered by the Rule.[2] More importantly, when the entity becomes an issuer of its own securities, the broker-dealer runs the risk that the representative's position with the issuer triggers the private securities rule or places the representative in a position of being involved in private litigation. These are exactly the kinds of risks that good OBA policies should be designed to avoid and you should consider including such activities in your firm's definition of an OBA.

Similarly, while the Rule exempts a passive investment from its reporting requirements, it is entirely possible that such an investment could become an "active" business activity when the representative's investment becomes a controlling interest or results in the representative's otherwise becoming involved in the operations of the issuing entity. While the initial investment may have been reported in connection with your private securities transaction policies and procedures, the subsequent "business activities" may not have been covered

For these reasons, a clear definition, accompanied by a laundry list of examples, of what the broker-dealer considers "business activities" will go a long way towards getting compliance from your representatives and managing the risks to your firm.

b. What is compensation? You may wish to have your policies cover business activities whether or not compensation is involved. The advantage of this approach is that you do not run the risk of "compensation" becoming a matter of interpretation or later becoming an issue when the representative receives unanticipated compensation. If you wish to have your policies only apply where compensation is involved, then defining the term is extremely important. Does "compensation" include a one-time payment, such as a referral fee? Will it include non-cash compensation as defined in other NASD rules, such as reimbursement of expenses, gifts, entertainment and the like? Will it involve increased value in an investment in the business with which the representative is associated? Again, a laundry list will assist your representatives in complying with your policies and procedures.

Deciding on the form of the notice to be given

Rule 3030 permits broker-dealers to determine their own methods of notice of OBAs. Under the Rule, something as simple as a representative's noting the OBA on his Form U-4 would be permissible. However, while merely requiring the name of an OBA on the Form U-4 or similar document may comply with Rule 3030, it offers little or no protection for the broker-dealer. Rule 3030 acts as an important backstop to Rule 3040, the private securities transaction rule. When a representative does not understand that what he is selling is a security, robust Rule 3030 policies and procedures may prevent an unintentional selling away situation and possible litigation resulting from the activity. On the other hand, some activities, such as teaching, may offer little or no exposure to the broker-dealer or to the representative.

Determining the depth of the information to be provided in a 3030 notice is a balancing act. The broker-dealer needs enough information to determine if further inquiry needs to be made or if some higher level of supervision needs to be implemented.[3] The broker-dealer does not, however, want to establish notice procedures that result in unnecessary updating requirements or that provides information that is of little value. As a general rule, the closer the OBA is to financial services, the more information the broker-dealer needs.

For theses reasons, you may want to consider having different notice forms for different kinds of OBAs. This could include a simple notice form for activities that present little exposure, such as teaching, running a gardening service, selling kitchen products or similar activities. This notice might require little more than the name of the activity, a brief description of the activity, and an estimate of the amount of time spent on the activity and income expected to be derived.

For fixed insurance business activities, which are common for independent contractor firms, the notice may include the types of insurance

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OUTSIDE BUSINESS ACTIVITES
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products to be sold as there may be errors and omissions coverage or other issues. On the other hand, requiring notice of the names of the insurance companies is an example of the need to balance – the form will likely become outdated as the representative becomes an agent for new insurance companies. In this situation, if the representative does not "promptly" update his OBA form every time a new insurance company is added, the representative may be found in violation of Rule 3030 and the firm may be liable for failure to supervise. The usefulness of the information to the broker-dealer needs to be weighed against the risk of unintentional violations of the Rule.

For other activities for which there is potential for cross-over into the securities business or present other potential conflicts of interest, substantially more information may be appropriate. You may want to obtain copies of client contracts, licensing documents, and information concerning whether the clients of the activities are also clients of the broker-dealer. These activities might include acting as an attorney or CPA, real estate broker or mortgage broker. The broker-dealer will want sufficient information to ensure that private securities transactions are not involved and that customers of the OBA will not be confused about the broker-dealer's lack of affiliation with the OBA.

For those broker-dealers that allow representatives to have Registered Investment Advisers (RIAs) that are unaffiliated with the broker-dealer, even more information may be necessary. Depending on the nature of the advisory services to be offered, the broker-dealer may be subject to supervising the securities transactions in accordance with Rule 3040 and NASD interpretations.[4] The broker-dealer may wish to review the RIA's form ADV and client contract to ensure that clients are on notice that the broker-dealer is not part of the RIA. The broker-dealer may also wish to place some added restrictions on the growth of the business. Dealing with outside RIAs as OBAs can be a complicated process, and to do the topic justice would require a separate discussion paper.

Your procedures should identify exactly to whom and how the notice should be given. Merely requiring that the OBA form be sent to the broker-dealer home office is probably not a good idea. It could easily result in misdirected faxes, e-mails or hard copies. Identifying the specific individual or department and the method of delivery is far preferable.

Following up on the notice given

Your written supervisory procedures for OBAs should include instructions to your supervisory personnel on how to review notices received. These procedures should identify who is responsible for reviewing the notices. You may want to require in the procedures a review of any web sites that may be connected with the activity to ensure that you fully understand the nature of the anticipated business.

Additionally, if you determine to have different notices for different kinds of business as suggested above, your supervisory procedures should identify what the reviewer should look for in the notice that could raise concerns. For instance, where a notice states that a representative will be an officer of a real estate company, the supervisory procedures may want to require further inquiry into whether the company is an issuer of real estate partnership interests that may involve securities and may raise questions under Rule 3040. Where the OBA involves being an attorney or CPA, the procedures may note that follow-up is necessary on whether there is any custody of funds for clients of those businesses or powers of attorney. For an employee of a financial institution, the procedures may require questioning of whether the person has the authority to place trades for the financial institution or its customers, which again could implicate Rule 3040.

Failure to follow-up on unclear OBA submissions is as risky to the broker-dealer, if not more so, as failure to have adequate procedures. If there is a subsequent issue involving the OBA, your firm is on notice of its existence and failure to have properly followed up could result in regulatory exposure to your firm for failure to supervise. The more clear your supervisory procedures are for reviewing the OBAs, the less risk your broker-dealer will have.

Deciding when notice should be required

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As noted above, Rule 3030 merely requires that "prompt" notice of the OBA be given to the broker-dealer. As a practical matter, however, any notice given after the OBA has commenced creates significant supervisory difficulties for the broker-dealer. If the OBA inadvertently involves participation in securities sales, a violation of Rule 3040 may well occur before the broker-dealer knows of the activity. Moreover, it is far more difficult to place needed limitations on the outside activities after the fact than it is before the activities have occurred. It is equally far more difficult to monitor whether notice of an OBA was given "promptly" than it is to monitor whether the OBA was permitted to even begin. For this reason, most firms require notice before the OBA commences, and this makes good sense.[5]

It is also worth noting that Rule 3030 does not require "approval" of the broker-dealer. While you may not want to "approve" the OBA itself, your procedures should contain a method for prohibiting the noticed OBA and clear notice in the policies and procedures that representatives may not engage in the proposed activities until written notice is received from the broker-dealer that there is no objection to the activity. This will avoid a representative's believing that a non-response is tantamount to an approval.

Communicating and Training on the Policies and Procedures

Communication of the firm's policies and procedures is essential to effectively managing OBAs. People today are busier than ever, and it is easy to forget that a notice to the broker-dealer is needed before accepting that position as a director of a company or accepting compensation for those seminars. Merely having procedures available on a web site or in manuals is simply not sufficient. Constant communication is necessary to avoid problems. For this reason, you should consider communicating your OBA procedures at least annually. Use of firm element CE courses written specifically for your procedures are a good idea. Presentations at your annual compliance meetings, sessions at your broker-dealer conferences and other training events, and articles in broker-dealer newsletters can help.

Frequent communication of your policies and procedures should be done not only to your representatives, but also to your home office personnel. There are a couple of reasons for this. First, your home office registered personnel are also subject to Rule 3030, a fact that they may easily forget. Second, many of your home office personnel, aside from those who are actively involved in the OBA review process, can assist in spotting unreported OBAs or OBAs that have exceeded their originally "approved" parameters. For instance, your advertising review department sees a number of communications, seminars and other writings used by your representatives, but are they trained to look for OBAs? Your registrations department sees U-4 and Form BR updates, but are they cross-referencing OBA disclosures with those approved by your firm? Do your recruiters understand your firm's limitations on permissible OBAs so that problems can be avoided when representatives transition to your firm?

Your OBA policies and procedures will only be truly effective if your entire firm understands them.

Following Up on Your OBAs Afterwards

Any effective compliance program requires good follow-up on your policies and procedures. For OBAs, at a minimum, your auditors who conduct your branch office examinations should be thoroughly versed in your OBA policies and procedures and should have procedures of their own which require them to look for OBAs and ensure that they have been properly noticed to the broker-dealer. Auditors should know when an OBA request has been denied so that a review can be made to ensure that the unapproved business is not being conducted. Reviewing office signage, business cards, websites and correspondence/advertising files are good places to start. Your auditing procedures should also include procedures for immediately reporting potential unapproved OBAs to your appropriate supervisory personnel for following up. If your broker-dealer uses an annual compliance questionnaire specific questions should be included that would elicit information about OBAs. These questions should not simply ask whether a representative is complying with the firm's policies, but should ask for information from which the broker-dealer can determine if the policies are being followed. And, of course, when unapproved OBAs are discovered, immediate action must be taken to determine the nature and extent of the OBA and whether disciplinary action is appropriate or whether there is an issue with the firm's clarity of policies and procedures.

Lastly, review of OBA notices and approvals and denials is a supervisory function. Compliance procedures should exist for your firm that call for occasional review of the OBA process for effective compliance with the firm's policies and procedures and to ensure that the supervisory personnel are performing their required functions. This review should be conducted by persons who are not in the OBA approval process. If your firm is one of those who, for whatever reasons, house review of OBA notices in the Compliance Department, this might require use of an independent consultant.

Conclusion

OBAs that go awry can result in significant financial losses to your broker-dealer. By establishing and communicating effective and clear policies and procedures and educating your representatives and home office staff, and by appropriately following up, those losses can be substantially reduced. If the policies and procedures are clear in the first instance, the rest becomes relatively easy. ❑

1. NYSE Rule 346(a) on OBAs specifically covers officers and directors of outside firms, with or without compensation. It is possible that the ultimate rule resulting from the NYSE/NASD regulatory consolidation may include this specific limitation.
2. It should be noted that the definition of "compensation" is extremely broad in the various NASD rules dealing with cash and non-cash compensation (NASD Conduct Rules 2710, 2810, 2820 and 2830) and the private securities rule (NASD Rule 3040).
3. While supervision of the actual business activity is generally not required, supervision of the representative's involvement in that activity may be such as to require updating the OBA or ensuring that the activity does not cross over into involving a private securities transaction.
4. *See, e.g.*., Notice to Members 94-44.
5. The NYSE rule currently requires prior written notice and consent of the broker-dealer which may become the standard for current NASD-only firms upon rule consolidation.

Insider Trading by Advisory Personnel: What is it and How can it be Prevented?

By Pamela M. Krill and Ellen R. Drought

I. Introduction

Over the past 20 years, insider trading has received tremendous notoriety and heightened attention from the SEC. In the last five years alone, the SEC has brought more than 300 actions against more than 600 individuals and entities for insider trading violations, and has frozen millions of dollars in illicit trading proceeds.[1] The type of fraud perpetrated in connection with insider trading has evolved in tandem with market trends. For example, in the mid-eighties, most of the insider trading cases arose out of the merger and acquisition boom, while during the recession of the late eighties and early nineties, most of the cases were what the SEC refers to as "bad news" selling cases — that is, insiders dumping shares before adverse corporate developments were disclosed.[2] Since the early nineties, globalization, the technology boom and a renewal of merger activity have caused the SEC to shift its focus once again by looking closely at the potential for fraud involving specific types of financings (e.g., PIPEs offerings) and by certain market participants (e.g., hedge funds).[3]

The most recent case brought by the SEC involving allegations of insider trading violations — and one of the most egregious in years — came to light in early March 2007. In *SEC v. Guttenberg et al.*, the SEC brought insider trading charges against 14 defendants in connection with two related insider trading schemes in which Wall Street professionals allegedly traded on the basis of material, nonpublic information ("MNPI") tipped, in exchange for kickbacks, by insiders at two major financial services firms.[4] The complaint alleged that in the first scheme, which had been in operation since 2001, at least eight securities professionals, three hedge funds, two broker-dealers and a day-trading firm made thousands of illegal trades and millions of dollars in illicit profits using inside information misappropriated by Mitchel Guttenberg, the Executive Director of Equity Research at UBS Securities LLC, to trade ahead of the firm's analyst recommendations. In the second scheme, which ran from 2004-2005, the complaint alleged that several securities industry professionals and a hedge fund made dozens of illegal trades and hundreds of thousands of dollars in illicit profits using inside information misappropriated by Randi Collotta, an attorney in the compliance department of Morgan Stanley, to trade ahead of corporate acquisition announcements. Collectively, the complaint alleged that the defendants made at least $15 million in illicit profits from the two insider trading schemes.

In light of the SEC's continued focus on insider trading and the potential for abuse within advisory firms as a result of access to MNPI, investment advisers need to be aware of what constitutes insider trading, what special rules apply to them because of their unique role in the securities marketplace and how to structure an effective compliance program to ensure that advisory personnel steer clear of all forms of insider trading. The risk of having an ineffective compliance program — not only in terms of monetary and potential criminal penalties, but also in terms of reputational damage — is simply too great. As Linda Chatman Thomsen, the Director of the SEC's Division of Enforcement, said after the charges in the *Guttenberg* case were made public, "no matter how clever you are, no matter how hard you try to avoid detection," anyone who believes that illegal insider trading is a quick and easy way to get rich "underestimates [the SEC] at your risk."[5]

II. What is Insider Trading?

The concept of "insider trading" arises under Rule 10b-5 promulgated under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Liability for insider trading depends on (1) the existence of a disclosure duty, (2) the materiality of the undisclosed information and (3) the scienter of the defendant (i.e., the defendant's intent to engage in fraudulent conduct).

The duty to disclose material information (or abstain from trading) has been traditionally imposed on corporate "insiders," particularly officers, directors and controlling shareholders.[6] However, the duty also extends to a person who receives and trades on inside (material) information (i.e., a tippee) that has been improperly divulged by a corporate insider (i.e., a tipper) who, by divulging such information, has breached a fiduciary duty to the corporation's shareholders.[7] Liability will result under these circumstances if the tipper personally benefits, directly or indirectly, from the disclosure and the tippee knew or should have known that the insider breached his or her fiduciary duty by disclosing the confidential information to the tippee.[8] Another form of insider trading liability that has been recognized by the Supreme Court is known as the misappropriation theory of insider trading. This theory extends liability to non-insiders who posses MNPI and who use the information in violation of a duty owed to someone other than the shareholders of the corporation whose securities were traded.[9]

Whether a fact is material for purposes of Rule 10b-5 will depend on whether there is a substantial likelihood that a reasonable investor would consider it important to his decision to buy or sell.[10] As for scienter, the

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Supreme Court has stated that to have this required state of mind, a person must have acted with the intent to deceive, manipulate or defraud.[11]

III. Special Rules Applicable to Investment Advisers

Investment advisers and their personnel often become privy to MNPI. For example, an employee of an advisory firm who serves as a director of another company is a potential source of inside information to other personnel at the advisory firm.[12] Advisory personnel may receive tips from contacts in the securities industry, consultants and others who are privy to such information.[13] Alternatively, an employee could learn of inside information from a friend or relative employed by a public company.

In recognition of the access to inside information that advisory (and brokerage) firm personnel have, and the resultant temptation to trade on that information, Congress passed the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA"). ITSFEA added Section 204A to the Investment Advisers Act of 1940, as amended (the "Advisers Act"), which requires every investment adviser subject to Section 204 of the Advisers Act[14] to establish, maintain and enforce written policies and procedures reasonably designed, taking into consideration the nature of such investment adviser's business, to prevent the misuse of MNPI in violation of the federal securities laws.[15] Section 204A is designed to bolster the insider trading provisions found elsewhere in the federal securities laws, such as Rule 10b-5. While the statute does not specify the kind of policies and procedures required, the policies and procedures implemented by investment advisers should take into account the special circumstances of their particular businesses and organizations.[16]

It should be noted that an investment adviser may be sanctioned for the absence of proper procedures under Section 204A even if the inadequacy has not resulted in an occurrence of insider trading. For example, in 2006, the SEC took enforcement action against Morgan Stanley for failure to maintain and enforce adequate written policies and procedures to prevent the misuse of MNPI, which resulted in substantial sanctions against the broker-dealer/ investment adviser, notwithstanding the absence of any allegation by the SEC that illegal trading had actually occurred.[17]

In that case, Morgan Stanley consented to an order censuring the firm, imposing a $10 million penalty and requiring it to cease-and-desist from further violations of Section 204A of the Advisers Act and Section 15(f) of the Exchange Act. The firm also agreed to undertake certain remedial actions, including retaining an independent consultant to review the firm's policies for preventing and detecting insider trading and recommend additional procedures to be implemented. Morgan Stanley further undertook to review retrospectively the trading that had occurred at the firm during the more than four-year period at issue, and to report promptly to the SEC any information discovered during the review indicating that illegal trading may have occurred. Included among the items Morgan Stanley was cited for by the SEC were the firm's failure to conduct any daily surveillance of trading in any accounts with respect to some or all of the securities that had been placed on the firm's Watch List specifically so that trading in those securities could be monitored, and the firm's failure to conduct any surveillance of trading in approximately 900 employee accounts held outside of Morgan Stanley and approximately 30,000 employee accounts held at Morgan Stanley that the firm failed to identify as held by employees.

In addition to Section 204A of the Advisers Act, ITSFEA added Section 21A to the Exchange Act which authorizes the SEC to seek civil monetary penalties in insider trading cases against "controlling persons." While the term "controlling person" is not defined, if a person has the power to control the specific transaction upon which the primary violation is

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predicated, regardless of whether that power is actually exercised, then the person will be deemed a controlling person.[18] Accordingly, it is safe to assume that an employer will be characterized as a controlling person of an employee.

Under Section 21A(b)(1)(A), a controlling person will be subject to liability if the SEC establishes that the controlling person knew or recklessly disregarded the fact that the controlled person, who committed the insider trading violation, was likely to do so and did nothing to prevent the violation. The statute does not define "knowing" or "reckless" behavior, but the legislative history suggests that the risk involved must be such that to disregard it would constitute a gross deviation from the standard of care that a reasonable person would exercise in such a situation.[19] Moreover, under Section 21A(b)(1)(B), if the controlling person is an investment adviser (or broker-dealer), the controlling person will be subject to liability if the SEC establishes that the controlling person knowingly or recklessly failed to establish, maintain or enforce any policy or procedure required by Section 204A of the Advisers Act[20] (or Section 15(f) under the Exchange Act), and such failure substantially contributed to or permitted the occurrence of the insider trading violation by the controlled person. While the failure to establish, maintain or enforce a policy or procedure must be relevant to the conduct leading to the controlled person's violations in order for the SEC to charge a controlling person under Section 21A(b)(1)(B), sanctions are not conditioned upon proof that, but for such failure, the violation would not have occurred. Rather, it is sufficient that the failure allowed the violation to occur, or that it provided assistance to the controlled person's violations.[21]

For insider trading violations, Section 21A grants the SEC authority to seek civil penalties from controlling persons of up to the greater of $1,275,000 or three times the amount of the profit gained or loss avoided by the insider trader.[22] As a result, controlling persons face potentially massive liability exposure for each insider trading violation by their employees or associated persons. Given this liability exposure, the absence of an effective compliance program by investment advisory firms makes little sense.

IV. How to Structure an Effective Compliance Program

A. First Steps

As in designing any compliance program, investment advisers should take a risk-based approach in creating an effective insider trading program. When enacting ITSFEA, Congress acknowledged that appropriate policies will depend on the nature of a firm's business "and the circumstances in which they conduct business and may differ from case to case."[23] Accordingly, the first step in designing an insider trading policy is to evaluate the firm's business and the likelihood that advisory personnel will receive MNPI. This analysis may include evaluating the following questions:

1. How big is the firm?

• *Number of employees*. Advisers with a small number of employees may be able to control the flow of information, educate their employees and police personal trading more effectively than larger firms. On the other hand, small firms may find it challenging to enact information barriers if employees work in close proximity to one another.

• *Assets under management/number of accounts*. Firms that manage a moderate number of assets or client accounts may be better able to detect suspicious trades than larger firms. Advisory personnel of large firms may be able to mask suspicious trades due to the volume and frequency of firm trading. Further, small firms may be less likely to receive MNPI from Wall Street insiders than bigger shops due to the perceived economic clout of big firms.

2. What is the firm's business?

The firm should consider its product line as well as its investment style(s) in creating safeguards against the misuse of MNPI.

• *Products*. Advisers that manage a number of different products, such as mutual funds, hedge funds and separate accounts, need a more sophisticated program to address different trading platforms, types of issuers and additional points of contact with potential sources of MNPI. Like it or not, hedge funds are in the regulatory "hot seat," and, therefore, firms that manage unregistered products should consider themselves high risk and take additional precautions in designing an insider trading policy.[24]

• *Investment Style*. Firms that focus on small-cap or thinly traded securities are more likely to have close contact with management of the company, other shareholders and market makers. Investment advisers or mutual funds that take an activist approach to investing will likely engage in frequent dialogue with company personnel. These types of investment approaches increase the likelihood that MNPI may be communicated to advisory personnel.[25] Investment advisers that use consultants as part of their research process, may receive information that at the very least requires a determination as to materiality.[26] Hedge funds that engage in corporate lending may receive MNPI during conference calls or meetings between company personnel and their lenders.[27]

3. Is the firm affiliated with other financial services companies?

Multi-service firms are more likely to come into contact with MNPI and may require additional protections against the misuse of MNPI, such as information barriers to separate trading, investment and research functions.

4. Does the firm have any past regulatory problems?

Investment advisers that have previously been the subject of regulatory investigations or proceedings, even if unrelated to insider trading issues, will be considered higher risk and should take additional steps in designing an insider trading compliance program. Of course, if the past issues involved the firm's insider trading program, the firm must ensure that the program is working effectively so that it does not become a "recidivist."

5. Do any of the firm's personnel have professional, family or other connections

to a public company?

Outside connections to public companies should be discouraged but at times may be unavoidable, such as if the firm itself is affiliated with a public company. In such a case, the firm's insider trading policy must work in tandem with the public company's own policy and include an oversight mechanism for trading by advisory personnel with other connections to a public company.[28]

B. Required Elements

Although any insider trading policy must be tailored to the firm, at a minimum, every policy should have the following elements: [29]

1. Written insider trading policy covering the following topics:
• Policy statement setting forth the prohibition against insider trading, the misappropriation of MNPI and tipping MNPI to others.
• Legal consequences of violating the insider trading laws for traders, tippers and the employing firm.
• Definition of what constitutes "material" information.
• Definition of when information should be considered "nonpublic," including appropriate time lags when information is first publicly disseminated.
• Steps to take if an employee thinks he or she is in possession of MNPI or is aware of a violation of the policy by others.
• Identification of a "point person" for questions about or reports under the policy, which will likely be the Chief Compliance Officer.
• Sanctions to be imposed for violations of the policy.

2. Education and training component that includes:
• Distribution and acknowledgement of the policy.
• Periodic training sessions to increase awareness and to learn about possible new sources of MNPI at the firm.

3. Procedures to protect confidential information, which may include:
• Restricted access to departments or certain documents to authorized personnel.
• Use of code names to describe pending acquisitions or other material events.
• Computer safeguards, such as password protection and/or the use of encryption.
• Information barriers, a.k.a. "Chinese Walls."[30]
• Use of confidentiality agreements with third parties.
• Encouraging a "clean desk" policy and other ways to secure confidential information, such as locked cabinets and file drawers.
• Document destruction policies.

Registered investment advisers are likely to employ many of these practices under the privacy protection policies and procedures required by Regulation S-P.

4. Trade review:
• Registered investment advisers are required to obtain quarterly transaction reports and periodic holdings reports from "access persons."[31] The Chief Compliance Officer or other designated person should review these reports to detect any unusual trading patterns, including transactions in close proximity to public announcements of corporate events, or transactions involving securities on the restricted or watch lists maintained by the firm.
• The compliance department should "spot-check" client trades on a regular basis for the same purposes.

5. Documentation of steps taken to prepare, implement and review the insider trading program, including:
• Dates of distribution of the policy.
• Copies of acknowledgments of receipt and compliance with the policy.
• Reviews of personal and client trades.
• Dates and attendees at training sessions.
• Steps taken to contain MNDI.
• Actions taken in response to any violations of the policy.
• Copies of non-disclosure agreements.
• Reviews and amendments to the policy.

6. Review and update of program:
• The insider trading program should be updated and revised periodically to address changes in the firm's business and personnel, as well as technology[32] and regulatory developments.

C. Other Recommended Practices

Depending on the firm profile, culture and other factors discussed in

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Part IV.A, above, investment advisers may wish to implement additional procedures to counter the risk of insider trading activity. These may include the following:

1. Restricted and/or Watch Lists:[33]

• *Restricted List*. Investment advisers may wish to maintain a "restricted list" of companies about which the firm has received MNPI. Restricted lists are commonly used by broker-dealers and multi-service firms.[34] The restricted list is typically available to all firm personnel and is maintained electronically by the Chief Compliance Officer or other designated person. Once a company is on the restricted list, no trading in client or personal accounts may take place until the company has been removed from the list.

• *Watch List*. Firms may also wish to maintain a "watch list" of companies which are sensitive for various reasons, such as industry rumors, third party contacts which do not rise to the level of MNPI, companies with whom firm personnel have business or personal relationships and companies which have been mentioned by firm personnel in public appearances or interviews. The watch list does not restrict personal or client trading, but is used by the compliance department to monitor trading. The list should be maintained in confidence by the compliance department.

2. Firms may wish to circulate an annual survey of firm employees to ensure all public company affiliations have been identified.

3. Firms may elect to have all personal trades of public companies submitted to the compliance department for pre-approval. In addition, firms may wish to require all employees, instead of only "access" persons as required by the Advisers Act, to be subject to personal trade pre-clearance and reporting procedures.

4. The Chief Compliance Officer may be designated as the "gatekeeper" for non-disclosure agreements and other communications that may involve the transmission of MNPI to advisory personnel.

5. Firms may monitor email to pick up "chatter" that may indicate MNPI and to identify companies that should be added to the restricted and/or watch lists.

6. Firms may wish to employ outside consultants and/or internal auditors to review the effectiveness of the program.

D. Potential Pitfalls Drawn From Enforcement Cases

A review of selected SEC enforcement actions highlights some of the traps that advisers should seek to avoid in designing and implementing an insider trading policy.

1. Not tailoring the program to the firm's business.

A registered investment adviser was sanctioned for failing to maintain effective insider trading policies. In particular, the firm's policy was not tailored to its business because it did not address the receipt of MNPI from outside consultants and the potential misuse of MNPI regarding government-issued fixed income securities.[35]

2. Reliance on self-reporting.

The SEC sanctioned an investment adviser and broker-dealer for insufficient insider trading policies and procedures. In particular, the policies "relied too heavily on self-reporting" in light of the fact that the firm's chief investment officer was also the chairman and CEO of a publicly traded company.[36] The SEC stated that in these circumstances, "objective, third-party review" was necessary to determine whether the employee possessed MNPI and whether a company should be added to the restricted list.[37]

3. Control failures.

In the Morgan Stanley case (see discussion above in Section III), the firm's process for placing a company on the Watch List lacked a "system of accountability" to ensure that required steps were in fact followed. Further, the determination of materiality was left in the hands of a single analyst, and was not subject to further review.[38]

4. Oversight of compliance personnel.

The defendants in *Guttenberg* included an attorney and compliance personnel, those responsible for overseeing the insider trading program. Firms with a higher risk profile or who wish to enhance their program may want to consider retaining an outside consultant or internal auditors to review the program.[39]

V. Conclusion

As evident from public statements by SEC officials as well as recent enforcement actions, insider trading remains a hot button topic with the SEC. The focus has changed in recent years to address the growth of PIPE offerings, hedge funds and developments in technology, among other factors, but the basic allegation of trading on the basis of MNPI remains the same. Investment advisers are required to design and implement an effective insider trading policy, tailored to the needs and business of their firm. As the Morgan Stanley case demonstrates, the SEC is willing to take enforcement action regarding ineffective compliance programs even when there is no evidence of insider trading. ❑

1. Linda Chatman Thomsen, Director of the SEC's Division of Enforcement, *Testimony Concerning Insider Trading before the U.S. Senate Committee on the Judiciary* (Sept. 26, 2006), http://www.sec.gov/news/testimony/2006/ts092606lct.htm.
2. *Id*.
3. *Id*. A "PIPE" offering—which refers to a "private investment in public equities"—is a form of stock offering often used by distressed companies to raise capital when they are unable to obtain financing by other means. Hedge funds frequently invest in such offerings, but typically agree not to trade the stock before the PIPE offering is publicly announced by the issuer. In May 2006, the SEC charged that Deephaven Capital Management, LLC, a registered investment adviser that manages hedge fund assets, violated its agreements not to trade by selling stock short before PIPEs offerings were announced, and then covering the short sales with shares obtained in the offerings. In settling the case, the SEC obtained permanent anti-fraud injunctions and a total of $5.8 million in disgorgement, penalties and interest from Deephaven and the portfolio manager involved with the trades, as well as an industry bar against the portfolio manager. *SEC v. Deephaven Capital Management, LLC and Bruce Lieberman*, Lit. Release No. 19683 (D.D.C. May 2, 2006). In September 2005, a Massachusetts-based hedge fund manager and his fund were charged with trading on material, nonpublic information regarding Citizen Bank's planned takeover of Charter One Financial, making nearly $750,000 in illegal profits. In settling the case, the

SEC obtained permanent anti-fraud injunctions, disgorgement of profits and civil money penalties. In addition, the hedge fund manager agreed to be barred from association with any investment adviser and later pled guilty to five counts of criminal securities fraud. *SEC v. Michael K.C. Tom, et al.*, Lit. Release No. 19404 (D. Mass. Sept. 29, 2005).

4. *SEC v. Guttenberg et al.*, No. 07-CV-01774 (S.D.N.Y. filed Mar. 1, 2007).

5. Linda Chatman Thomsen, Director of the SEC's Division of Enforcement, *Division of Enforcement Statement concerning SEC v. Guttenberg et al.* (March 1, 2007), http://www.sec.gov/news/speech/2007/spch030107lct.htm.

6. *Chiarella v. United States*, 445 U.S. 222 (1980). The term "insider" is not, however, limited to those persons. Insiders include anyone possessing MNPI concerning a security by virtue of the person's relationship to the issuer. The term therefore covers corporate employees who possess material undisclosed information obtained in the course of their employment. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

7. *Dirks v. SEC*, 463 U.S. 646 (1983). The Dirks court also recognized that certain persons who receive corporate information legitimately for a particular purpose may become fiduciaries to the corporation's shareholders as "temporary insiders," and, accordingly, such persons are liable to the same extent as corporate insiders. *Id*. at 677 n.14. For example, a financial adviser who became a temporary insider with access to confidential information about a company's tender offer plans committed securities fraud when, in breach of his fiduciary duty, he traded on information about an impending tender offer for personal gain. *SEC v. Tome*, 833 F.2d 1086 (2d Cir. 1987).

8. *Dirks* at 660-62. In *Dirks*, a former employee of a company whose books had been "cooked" disclosed the fraud to Dirks, a securities analyst, who in turn disclosed the information to his institutional clients who immediately disposed of the company's stock. The *Dirks* court found that since the insider who disclosed the nonpublic information to Dirks did not do so for personal gain, there was no breach of fiduciary duty by the insider, and therefore Dirks had no duty to refrain from using the information even though he knew it was MNPI that came from an insider. The holding in *Dirks* served to limit the SEC's ability to use enforcement as a means of limiting selective disclosure to analysts in the context of Rule 10b-5. Accordingly, in 2000, the SEC adopted Regulation FD as a means of outflanking *Dirks* by prohibiting issuers from making selective disclosure of MNPI to analysts and other enumerated persons. Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43,154, 65 Fed. Reg. 51, 716 (Aug. 15, 2000).

9. *See U.S. v. O'Hagan*, 521 U.S. 642 (1997) (a law firm partner misappropriated information about a tender offer by one of the firm's clients and traded on the information, in breach of a confidentiality duty to his firm and the client). *See also* Rule 10b5-2 under the Exchange Act (this rule addresses the circumstances under which there is a duty based on a relationship of trust and confidence sufficient to find liability under the misappropriation theory as approved in *O'Hagan*). The misappropriation theory is designed to protect the integrity of the securities markets against abuses by "outsiders" to a corporation who have access to confidential information that will affect the corporation's security price when revealed, but who owe no fiduciary duty or other duty to that corporation's shareholders.

10. *Basic, Inc. v. Levinson,* 485 U.S. 224 (1988).

11. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). However, some lower courts have accepted recklessness as equivalent to scienter. *See e.g., Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044-45 (7th Cir. 1977).

12. Given the rise in shareholder activism among hedge fund and mutual fund managers (e.g., requesting seats on boards of directors), the circumstances under which advisory personnel may have direct access to inside information seems likely to increase. *See e.g.*, Joe Morris, Big Shops Flexing Activist Muscles, Ignites, Mar. 14, 2007, http://www.ignites.com/articles/20070314/shops_flexing_activist_muscles.

13. It has been reported recently that certain institutional investors and their investment advisers are seeking trading advantages through access to information gathered from unlikely sources. For example, lobbyists have been hired not to influence government but rather to tell these investors what Congress is going to do. Known as "political intelligence," the SEC is currently investigating whether the passing of market-sensitive information by lobbyists to Wall Street could violate insider-trading laws. *See e.g.*, Brody Mullins and Kara Scannell, Hedge Funds Hire Lobbyists to Gather Tips in Washington, Wall St. J., Dec. 8, 2006, at A1. Another source of market-sensitive information is research firms that pay employees of public companies and others to serve as consultants to institutional investors. One such research firm is Gerson Lehrman Group, which is currently being investigated by the New York Attorney General's office to determine whether any of Gerson's consultants may have inappropriately disclosed important information about the companies for which they work to Gerson's clients. Separately, the SEC is also investigating to see whether hedge funds have received nonpublic information due to the use of research firms like Gerson. *See e.g.*, Gregory Zuckerman and Peter Lattman, Research Firms, Consultants Draw Scrutiny, Wall

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St. J., Jan. 16, 2007, at C1.
14. Advisers subject to Section 204 of the Advisers Act include advisers who engage in interstate commerce in connection with their business as investment advisers, other than advisers specifically exempted from registration pursuant to Section 203(b) of the Advisers Act.
15. ITSFEA also added Section 15(f) to the Exchange Act. Section 15(f) applies to registered broker-dealers and is virtually identical to Section 204A of the Advisers Act
16. *In re Gabelli & Co. and GAMCO Investors, Inc.*, Exchange Act Release No. 35,057, 58 SEC Docket 443-708 (Dec. 8, 1994) (hereinafter, "*Gabelli*").
17. *In the Matter of Morgan Stanley & Co. Incorporated and Morgan Stanley DW Inc.*, Exchange Act Release No. 54,047, 2006 WL 1749842 (June 27, 2006).
18. *Harrison v. Dean Witter Reynolds, Inc.*, 974 F.2d 873, 881 (7th Cir. 1992) (defining "controlling person" in the context of Section 20(a) of the Exchange Act). The concept of "controlling person" in Section 20A is based on Section 20(a) of the Exchange Act. H.R. Rep. 100-910, at 17 (1988) (hereinafter, the "*House Report*").
19. *House Report* at 18.
20. In December 2003, the SEC adopted Rule 206(4)-7 under the Advisers Act which requires every SEC registered investment adviser to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws, review those policies and procedures annually for their adequacy and the effectiveness of their implementation, and designate a chief compliance officer to be responsible for administering the polices and procedures. Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204, 68 Fed. Reg. 74,714 (Dec. 17, 2003). Such policies and procedures should encompass insider trading proscriptions. In May 2004, the SEC adopted Rule 204A-1 which requires SEC registered investment advisers to promulgate codes of ethics for their advisory personnel. Any such code must require certain supervised persons (known as access persons) to report their personal securities holdings and transactions, including transactions in mutual funds advised by the adviser or an affiliate, and to pre-clear any personal investments in initial public offerings and limited offerings. Investment Advisers Code of Ethics, Investment Advisers Act Release No. 2256, 69 Fed. Reg. 41,696 (July 2, 2004). Both of these rules were adopted in response to the mutual fund market timing scandal that emerged in the fall of 2003. *See e.g., In re Alliance Capital Mgmt., LP*, Investment Advisers Act Release No. 2205, Investment Company Act Release No. 26,312, 81 SEC Docket 2800-62 (Dec. 8, 2003). Interestingly, neither rule was adopted pursuant to the authority granted to the SEC under Section 204A of the Advisers Act, thus precluding controlling person liability for a violation of either rule premised upon Section 21A(b)(1)(B); however, controlling person liability may still be imposed under Section 21A(b)(1)(A).
21. *House Report* at 18.
22. Section 21A(a)(3) of the Exchange Act states that the maximum penalty for control persons shall not exceed the greater of $1 million or three times the profit gained or loss avoided. This dollar amount has been increased for inflation over the years, and currently stands at $1,275,000. *See* Adjustments to Civil Monetary Penalty Amounts, Securities Act Release No. 8530, Exchange Act Release No. 51,136, 70 Fed. Reg. 7,606 (Feb. 4, 2005).
23. 134 Cong. Rec S17218 (daily ed. Oct. 21, 1988) (Statement of Sen. Proxmire).
24. *See, e.g.*, Elizabeth LeBras, SEC Looks at Information Flows to Hedge Fund Managers, Compliance Reporter, Vol. 13, Issue 30 (July 31, 2006). *See also* note 3, above.
25. *See In the Matter of Guy P. Wyser-Pratte, Wyser-Pratte Management Co., Inc. and Wyser-Pratte and Co., Inc.*, Exchange Act Release No. 44,283, Investment Advisers Release No. 1943, 74 SEC Docket 2073-29 (May 9, 2001). In this case, a registered investment adviser and its affiliates engaged in merger arbitrage and changes in corporate governance as part of its investment strategy. The firms and their control person were sanctioned for inadequate policies and procedures. "The firms' businesses, as practiced, have involved interaction with market participants who are in possession of material nonpublic information. . . Under these circumstances, the firms' policies needed to be particularly sensitive to the possibility of misuse and to include safeguards tailored to the particular risks attending such interactions with market participants." *See also* note 12, above.
26. *See* note 13, above; *see also In the Matter of Massachusetts Financial Services Company*, Investment Advisers Release No. 2165, 80 SEC Docket 2939-51 (Sept. 4, 2003) (registered investment adviser that regularly used paid outside consultants to provide market, political, budgetary and regulatory information was sanctioned in part because insider trading policy did not address information obtained from consultants) (hereinafter *"MFSC"*).
27. Jenny Anderson, As Lenders, Hedge Funds Draw Insider Scrutiny, N.Y. Times, Oct. 16, 2006, at A1.
28. For example, in *Gabelli*, the firm was sanctioned because, among other things, its insider trading policy did not include written procedures to address routine access to insider information by the firm's CIO, who was also the chairman and CEO of a public company.
29. *See* William K.S. Wang and Marc I. Steinberg, Insider Trading § 13:3 (Basic Requirements of Compliance Programs (2d ed. 2005) (hereinafter "*Insider Trading*"); Susan L. Merrill, Responding to Insider Trading Inquiries, Prac. Law. Dec. 2001, at 15 (noting that a company that adopts certain prophylactic measures "will be able to present a persuasive affirmative defense to controlling person liability").
30. *See Insider Trading* § 13.5.2 (Legal Sufficiency of Chinese Walls), 6 Alan R. Bromberg and Lewis D. Lowenfels, Bromberg and Lowenfels on Securities Fraud & Commodities Fraud § 273 (2d ed. 2003) (hereinafter "*Securities & Commodities Fraud*"); SEC's Division of Market Regulation, Report on Broker Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Non-Public Information (March 1990) (hereinafter "*SEC Broker-Dealer Report*").
31. *See* Rule 204A-1 under the Advisers Act.
32. For example, in *Guttenberg*, the defendants allegedly tipped MNPI through coded text messages on disposable cell phones. *See Guttenberg* complaint at page 11.
33. For more background on restricted lists, watch lists and other tools, see *6 Securities & Commodities Fraud*, § 275; *Insider Trading*, § 13.5.3.
34. *See SEC Broker-Dealer Report*.
35. *See MFSC.*
36. *See* note 16, above.
37. *See also In the Matter of Gintel Asset Management, Inc., Gintel & Co. LLC, Robert M. Gintel and Stephen G. Stavrides*, Investment Advisers Release No. 2079, Investment Company Release No. 25,798, 78 SEC Docket 2580-60 (Nov. 08, 2002) (registered investment adviser was sanctioned because, among other things, the firm's insider trading policy did not have any special procedures to address likely access to MNPI by owner and chairman and instead relied on self-reporting procedures that "were not reasonably designed to prevent the misuse of such information").
38. *See* note 17, above.
39. *See also* Mary Jo White, Insider Trading: Former Compliance Officer Pleads Guilty over Alleged Insider Trading Conspiracy, 29 Sec. Reg. & L. Rep. (BNA) 1678 (1997) (defendant, former compliance officer for two major Wall Street firms, reportedly misappropriated MNPI from employer's "watch list" for insider trading purposes).

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NSCP 2007 Board of Director Nominations

Any member in good standing is eligible for nomination and election to the Board of Directors. (Please note that, as NSCP's board members now serve three-year staggered terms, pursuant to bylaw amendments adopted at the 1993 National Membership Meeting, there will be five vacancies to fill in 2007.) The deadline for submissions from interested parties is May 24, 2007.
The criteria for selection are as follows:
(1) prior and current level of participation and involvement in NSCP affairs;
(2) ability to contribute energy and expertise to the management of NSCP affairs; and
(3) whether the candidate's contributions will complement those of the currently serving board members and other nominees.

Should you wish to be considered for nomination, please submit, on or before May 24, 2007, the Nomination Form:

Adobe Acrobat PDF
http://www.nscp.org/media/board_nomform.pdf
Microsoft Word version:
http://www.nscp.org/media/board_nomform.doc

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