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Alert

Expert Networks: New Commentary by SEC Officials About Insider Trading

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The recent government investigations into insider trading involving the use of expert consultant networks — and the cases brought by the Department of Justice and Securities and Exchange Commission arising from those investigations — has led to much speculation as to where the government believes the line is between permissible and impermissible use of such networks. Two SEC officials recently made comments that may shed some light on where federal regulators believe that line may be. In a March 21 speech made at the IA Watch Annual IA Compliance Best Practices Seminar, Carlo V. di Florio, director of the SEC Office of Compliance Inspections and Examinations, emphasized that contrary to some reports, the investigations and cases relating to expert networks:

> [D]o not represent some inherent hostility by the Commission toward expert networks, nor do they indicate that the Commission is seeking to undermine the mosaic theory, under which analysts and investors are free to develop market insights through assembly of information from different public and private sources, so long as that information is not material nonpublic information obtained in breach of or by virtue of a duty or relationship of trust and confidence.

He indicated that investment firms that utilize expert networks "should address any increase to their compliance risks that expert networks may pose, and build appropriate controls around information obtained from expert networks, at both the front end and the back end." Those controls could include the following:

Front-end controls

- Reviewing the terms of any agreement with an expert network firm;
- Having the adviser's staff read and acknowledge the adviser's insider trading policies;
- Pre-approving every conversation with an expert;
- Evaluating any controls in place at the expert networks;
- Compliance monitoring of conversations between an expert and the adviser's staff; and
- Where an expert is employed at a public company, extra controls, or prohibiting such consultations altogether.

Back-end controls

- Obtaining certifications from the adviser's staff who utilize expert networks that they are not trading on insider information,

- Identifying any trades made by the adviser following a conversation with an expert and testing at least some of those trades against publicly available information, and

- Monitoring personal trading by the adviser's staff who may have access to material nonpublic information.[1]

Mr. di Florio's remarks were echoed by those made by Rob Khuzami, director of the SEC's Division of Enforcement, during a March 23 panel discussion following his speech to the SIFMA Compliance and Legal Society Conference.[2] During the panel discussion, Mr. Khuzami expressed the view that there is nothing inherently wrong with utilizing expert networks and that the SEC has no interest in undermining the mosaic theory or preventing market participants from obtaining "market color." He characterized the recent cases filed by the SEC in this area as involving conduct that was "clearly over the line" and noted that the SEC does not pursue cases where the conduct is in the "gray area." He did recommend that advisers perform adequate due diligence on expert networks before utilizing them, and that they should adopt policies and procedures governing the use of such networks that may include taping calls, using blackout periods and not paying public company employees to provide information on the companies that employ them.

Although comments by SEC officials only represent their own views and do not necessarily represent the views of the Commission or other staff members, these recent statements do provide insight with respect to how regulators view these important issues.

SRZ attorneys routinely advise clients on how to approach and analyze issues associated with the use of expert networks and how the client's compliance policies and procedures should address such use, including use of the above-referenced controls. A Dec. 17, 2010 SRZ *Client Alert* entitled "Government Ratchets Up Investigation Into Insider Trading Involving Expert Networks" discusses insider trading issues related to the use of expert networks.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

[1] A complete copy of the remarks made by Mr. di Florio at the March 21 seminar can be found at http://www.sec.gov/news/speech/2011/spch032111cvd.htm.

[2] A complete copy of that speech can be found at http://www.sec.gov/news/speech/2011/spch032311rk.htm.

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