

Insider Trading and the Use of Expert Networks

March 22, 2011



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Agenda

- Introduction
- Presentation
- Questions and Answers — (anonymous)
- Slides — now available on front page of Securities Docket
— www.securitiesdocket.com
- Wrap-up



Webcast Series

- Approximately every other week
- March 30, 2011: **“Avoiding Prosecution Under the UK Bribery Act: Playing Offense and Defense”**



Panel



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Insider Trading and the Use of Expert Networks

Robert W. Pommer, III

Securities Docket, March 22, 2011

Agenda

- **Overview of Expert Network Cases**
- **Materiality – Are the Rules of the Road Changing?**
- **Suggested Best Practices**
- **Questions & Answers**



Expert Network Cases

Focus on Insider Trading

In announcing the recent *Galleon* insider trading case, the SEC's Director of Enforcement warned:

“It would be wise for investment advisers and corporate executives to closely look at today's case, their own internal operations, and the increasing focus and scrutiny on hedge fund trading activity by the SEC and others, and consider what lessons can be learned and applied to their own operations.”

Oct. 16, 2009 Press Conference, Robert Khuzami

Primary Global Research Cases

- First wave November/December 2010 – focus of criminal cases on certain PGR employees and PGR expert consultants.
- Second wave February 2011 – hedge fund, portfolio manager, and analysts charged with insider trading; SEC action filed.
- Persons charged in criminal and SEC cases:
 - 3 PGR employees (Chu, Fleishman, Nguyen)
 - 5 PGR expert consultants (Longoria, DeVore, Jiau, Shimoon, Karunatilaka)
 - Barai Capital, its founder (Barai), and analyst (Pflaum)
 - Analysts at other unidentified hedge funds (Freeman, Longueuil)
 - Other unindicted co-conspirators, cooperating witnesses, unnamed hedge funds

PGR Cases – Allegations

- PGR referred to in allegations as a “criminal enterprise.”
- Jiau was part of PGR’s “private” network, reserved for exclusive engagements, paid \$10,000 per month by PGR.
- PGR promised anonymity to its experts, experts could use nicknames or pseudonyms to “protect from investor relations.”
- PGR informed experts that conversations would not be monitored or recorded.
- PGR proactively recruited current employees of public companies to provide current material and nonpublic information about their company.

PGR Cases – Alleged “Inside Information”

- Information about public companies the experts worked for.
- Information about customers instead of the public companies they worked for.
 - Longoria, supply chain manager for AMD, tipped revenue numbers, forecasts, and product line detail for AMD products.
- Not financial information but production, pricing, and product related information.
 - Shimoon, a Flextronic employee, provided information about Apple quarterly iPhone sales and forecasts and technical specifications for next generation iPhone.
 - Karunatilaka, an account manager at TSM, provided semiconductor wafer “bookings” information on TSM and its top customers.

PGR Cases – Alleged “Inside Information” (cont.)

“Later in the call, SHIMOON told CW-2 that Apple was going to be producing a new “iPhone” cellular telephone that would be “coming out early next year,” and that the new iPhone “is gonna have two cameras [Apple], you know, they’re very secretive, right? So, I don’t have [an] exact time frame but I’ve concluded we’ll start building modules probably in March” Later in the call, SHIMOON explained to CW2, “It’ll be a neat phone ‘cause it’s gonna have five megapixel auto-focus camera and it will have a VGA forward-facing video conferencing camera.” Based on my training and experience and my conversations with employees from Flextronics and Apple, and my conversations with other law enforcement agents, **I believe that this information was Inside Information.**”

Shimoon Compl. at para 42(a)(ii)

PGR Expert Network Cases

- *US v. Don Chu*, No. 10-MAG-2625 (Nov. 23, 2010 SDNY)
- *US v. Walter Shimoon, Mark Anthony Longoria, Manosha Karunatilaka James Fleishman*, No. 10-MAG-2823 (Dec. 15, 2010 SDNY)
- *US v. Winifred Jiau*, No. 10-MAG-2900 (Dec. 23, 2010 SDNY)
- *US v. Samir Barai and Donald Longueuil*, No. 11-MAG-332 (Feb. 7, 2011)
- *SEC v. Mark Longoria, Daniel DeVore, James Fleishman, Bob Nguyen, Winifred Jiau, Walter Shimoon, Samir Barai, Jason Pflaum, Barai Capital Management, Noah Freeman, and Donald Longueuil*, No. 11-CV- 0753 (Feb. 8, 2011 SDNY)

Other Expert Network Cases

- *In the Matter of: Risk Reward Capital Management Corp. and James Silverman*, No. E-2010-0057 (Mar. 9, 2011 Mass. Securities Division)
- *Big Lots, Inc. v. Retail Intelligence Group*, No. 1000022707 (Nov. 22, 2010 Fla. Cir. Ct.)

Risk Reward Capital Management

Administrative complaint against RRC and its sole investment adviser James Silverman. The complaint alleges:

- Silverman used expert consultants to access clinical investigators and obtain trial results before they were published.
- RRC traded on that information and paid \$80,000 per year to expert network firm.
- Silverman “knew that he should not have received this information, as he deleted his notes containing the study results prior to producing them to the Division in response to its subpoena.” **Compl. at p. 5.**
- Silverman’s actions “crossed the line from legitimate research, to seeking out material non-public information.” **Compl. at p. 6.**

Risk Reward Capital Management (cont.)

The complaint seeks disgorgement and revocation of RRC and Silverman's registration as Mass. investment advisers.

The expert network firm and the consultants were not charged. However, the complaint alleged:

- “Despite the inherent risk that insiders, such as investigators on clinical trials, may provide non-public information, Guidepoint does not take any proactive steps to ensure that consultants do not relay confidential information to clients. For example, Guidepoint does not prohibit consultants who are subject to confidentiality agreements from participating in consultations. In fact, Guidepoint does not screen the confidentiality agreements to which its consultants are subject. Finally, Guidepoint does not monitor consultations or inquire as to their substance.” **Compl. at p. 3.**

Big Lots, Inc.

- Civil action by Big Lots to permanently enjoin Retail Intelligence Group from wrongfully obtaining trade secrets and confidential proprietary information.
- RIG uses standard channel checking methods in its research.
- Research analysts alleged to have induced Big Lots' store managers to provide confidential company information – managers subject to strict confidentiality agreement.
- RIG used that confidential information in research reports sold to its clients.
- Alleged financial and reputational harm to Big Lots.
- Recently settled – RIG agreed not to contact Big Lots employees in the future, no monetary compensation.



Materiality – Are the Rules of the Road Changing?

The Role of Research Analysts

“The SEC expressly recognized that ‘[t]he value to the entire market of [analysts’] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by [their] initiatives to ferret out and analyze information, and thus the analyst’s work redounds to the benefit of all investors.’” *Dirks v. SEC*, 463 U.S. 646, 658 n. 17 (1983)

“A skilled analyst with knowledge of the company and the industry may piece seemingly inconsequential data together with public information into a mosaic which reveals material non-public information.” *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 165 (2d Cir. 1980)

SEC Statements on Mosaic Theory

Can an issuer ever review and comment on an analyst's model privately without triggering Regulation FD's disclosure requirements?

Yes. It depends on whether, in so doing, the issuer communicates material nonpublic information. For example, an issuer ordinarily would not be conveying material nonpublic information if it corrected historical facts that were a matter of public record. An issuer also would not be conveying such information if it shared seemingly inconsequential data which, pieced together with public information by a skilled analyst with knowledge of the issuer and the industry, helps form a mosaic that reveals material nonpublic information. It would not violate Regulation FD to reveal this type of data even if, when added to the analyst's own fund of knowledge, it is used to construct his or her ultimate judgments about the issuer. An issuer may not, however, use the discussion of an analyst's model as a vehicle for selectively communicating – either expressly or in code – material nonpublic information.

Reg. FD Compliance and Disclosure Interpretations, Question 101.01

Barai – Mosaic Theory

BBM communication from Barai to Pflaum (Nov. 20, 2010):

- > So what if we talked to anyone
- > They need proof that we acted on something
- > And its hard to have that
- > My sense is they tapped [the Firm] just recently. . . .
- > The more I think about it - just not enough
- > clues to hold something on us
- > There isn't anything though
- > Nothing material
- > We use all mosaic theory
- > So we're ok

Compl. at para 34(d)

Galleon – Mosaic Theory

Rajaratnam's Opening Statement by John Dowd:

- “The government has it wrong”
- Rajaratnam made his fortune through “shoe-leather research, diligence and hard work” and “conducted the best research in the business.”
- “He assembled a mosaic of information and did his own calculations.”
- “The evidence will show that Raj did not cheat.”

Reported by Peter Lattman, “It’s a picture of Greed vs. a Picture of Solid Research in the *Galleon* Trial,” Deal Book NY Times Blog (Mar. 9, 2010)

Recent Statements by Government

“The charging documents do not describe people engaged in legitimate market research or innocent channel checking or otherwise benign behavior. . . .

Now let me begin by making something crystal clear. There is nothing inherently wrong with or bad about hedge funds or expert networking firms or aggressive market research for that matter. Nothing at all. But if you have galloped over the line, if you have repeatedly made a mockery of market rules, if you have converted a legitimate enterprise into an illegal racket then you have done something wrong and you will not get a pass.”

Feb. 8, 2011 Press Conference, Preet Bharara

Recent Statements by Government (cont.)

“Regardless of whether it is okay or not in your view...for someone who is employed by a company and gets permission from that company to work for an expert networking firm, we have not in our criminal charges waded into...any gray area with respect to whether or not that information is informed by knowledge that that person has that was developed from employment at the public company. What we are alleging is people who were acting as consultants at the expert networking firm gave away specific, in advance, secret information about hard revenue numbers, earnings per share, and other information”

Feb. 8, 2011 Press Conference, Preet Bharara

Recent Statements by Government (cont.)

“The only thing I would add to that is if you engage an expert networking firm, you are wise to conduct due diligence, to determine whether or not public company employees are engaged as consultants, and if so, there are a variety of devices and practices, that have arisen, across Wall Street, and in many regulated entities, to ensure that material non-public information is not crossing the transom, and that you are not receiving it.

Do due diligence. Find out the nature of the information. You can monitor and chaperone calls. You can consult lawyers. You can do many things to make sure you are not obtaining material nonpublic information, but obviously if the employee is a public company employee, that is a higher risk factor.”

Feb. 8, 2011 Press Conference, Rob Khuzami



Suggested Best Practices

Suggested Best Practices

- Evaluate current relationship with expert network firms, the number of firms being used and how, review all contracts and the firms' compliance programs and tools.
- Evaluate your own firm's compliance program and monitoring of expert network firm relationships – not enough to rely on the network firm.
- Establish regular review and monitoring, training, usage reports, documentation.
- Consider additional safeguards (e.g. employee consent versus prohibition on public company experts).
- Establish restricted lists and policies if firm comes into possession of material non-public information.



Questions & Answers

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Determining Materiality in Insider Trading Cases

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March 22, 2011

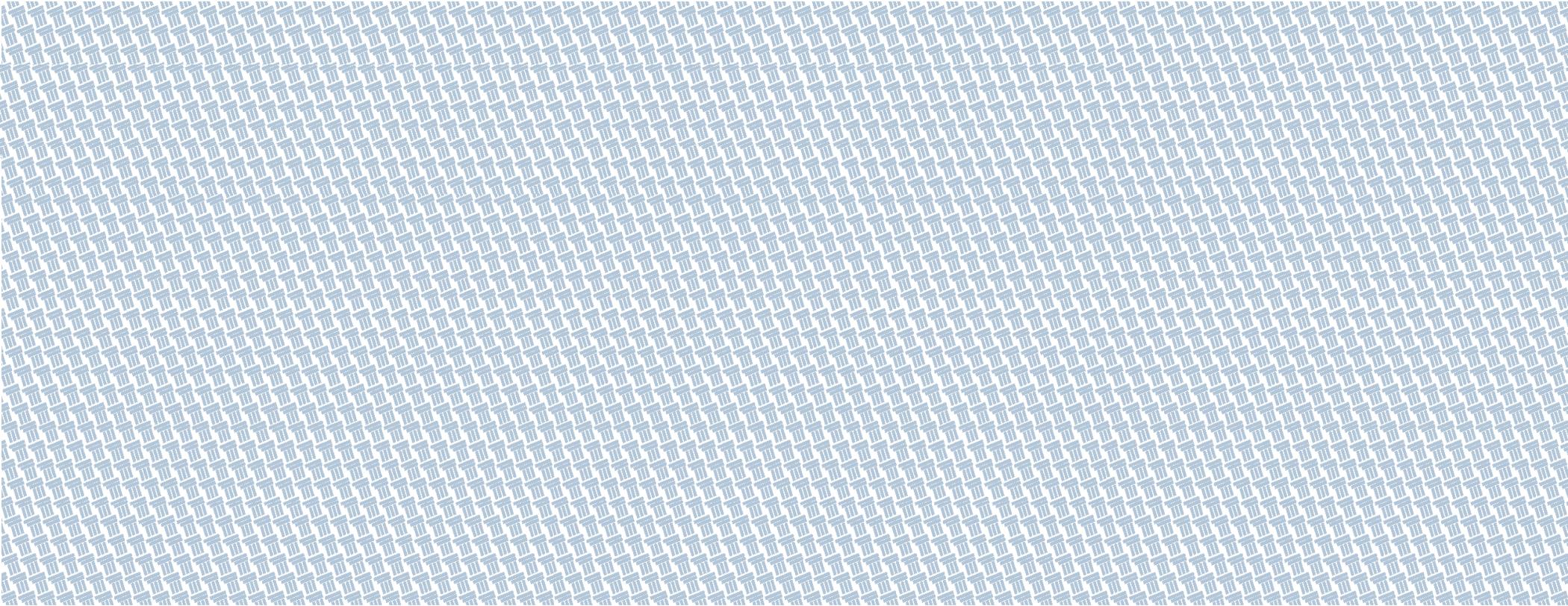
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What Information is Material?

- Supreme Court
 - Information is material if there is a “substantial likelihood” that a “reasonable investor” would have considered its disclosure to have significantly altered the “total mix” of information made available (*TSC Industries v. Northway, Inc.*)
- Economic Experts
 - Information is material if its release can be associated with a “statistically significant” movement in the Company’s stock price

Various Approaches to Determine Materiality

- Use of Expert Opinion
 - Based on scientific event studies
 - Based on subjective expert opinion
- More recent SEC approaches
 - The fact of trading (*SEC v. Steffes*)
 - The fact of payment for information?

Determining Materiality Through the Use of an Event Study

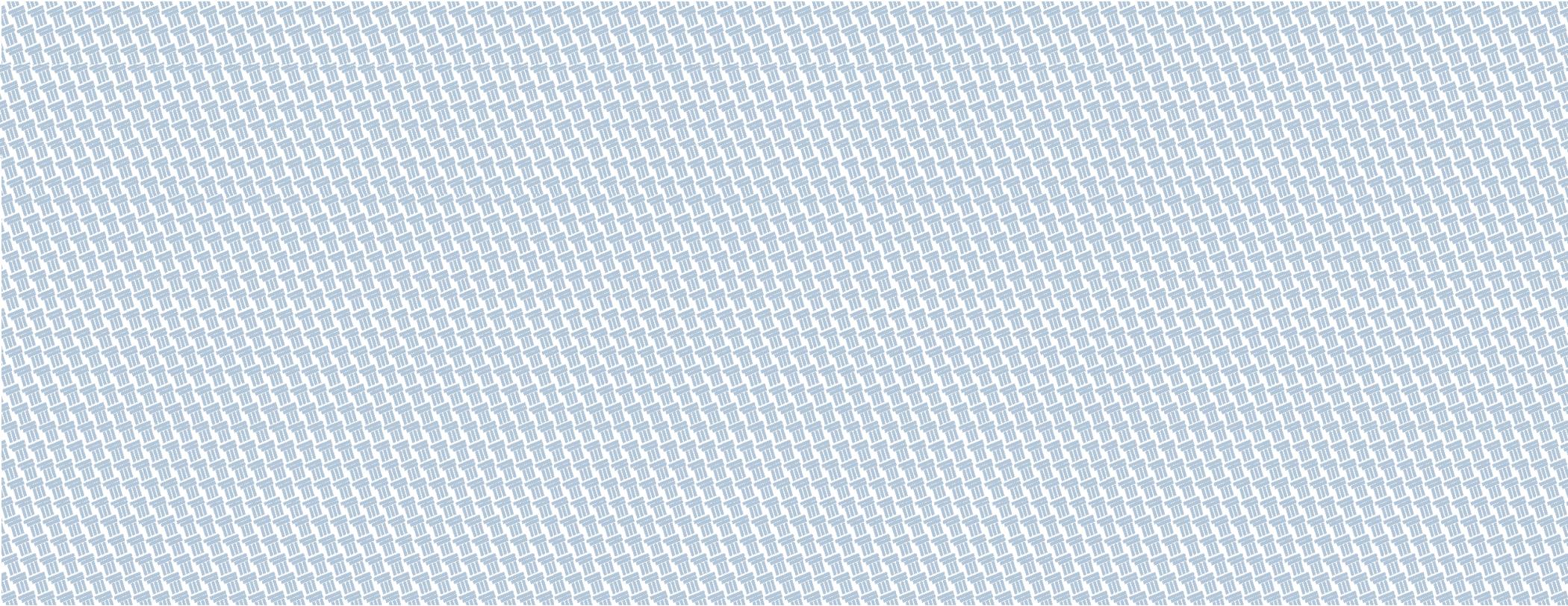
- The information must
 - Have not previously been disclosed to the market
 - Be associated with a “statistically significant” stock price movement i.e. one that can be reliably be distinguished from the normal day-to-day volatility of the Company’s stock price
 - Be able to be distinguished in its effect on the stock price from other, potentially confounding information, released at the same time
 - Note that many of the companies relevant to the recent SEC insider trading cases are highly volatile stocks that have large and diverse amounts of information released about from many sources on a daily basis (*see USA v Rajaratnam*)

Recent Inside Information Alleged by the SEC

- Examples of material nonpublic information alleged by the SEC in recent matters range from broad information to more specific, detailed information:
 - New product development
 - “Company ABC is expected to produce a new phone having two cameras”
 - Internal sales forecasts, including pricing and volume of purchases from suppliers
 - “Company ABC is planning to manufacture twice as many smart phone handsets in 2010 as it had in 2009.”
 - Quarterly financial results, including specific financial metrics
 - “Company ABC’s revenues for the second quarter will be at the low-end of the range provided in the company’s guidance and gross margins will be better than expected”

Issues Presented in Determining Materiality of Recent Inside Information Alleged by the SEC

- Mosaic Theory
 - Relevant information to analyze is the various inputs, not the conclusions drawn by the Defendant
- The alleged inside information may often have been disclosed previously to the market
- The alleged inside information may often have been disclosed simultaneously with other confounding information
- The relevant company's stock price may be highly volatile on a day-to-day basis



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Questions?



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