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## Recent Events Suggest That Issuers and Executives Carefully Review Insider Trading Compliance Programs and Rule 10b5-1 Trading Plans and Monitor Trading and Filings for Compliance

Issuers, directors, and officers should expect more regulatory scrutiny of securities trades as enforcement in the insider trading area increases. Several developments suggest a renewed emphasis in this traditional enforcement area. These include: (1) congressional hearings focusing on the issue, which immediately preceded the recent spurt of high-profile insider trading cases; (2) a recent study indicating the Rule 10b5-1 plans used by many executives are being abused, coupled with comments by SEC Enforcement Director Linda Chatman Thomsen that the staff is carefully reviewing trades under these plans; (3) the formation of an elite inter-agency task force on the issue; and (4) the recently issued report by the Senate Finance Committee, which is highly critical of the SEC Enforcement Division's insider trading inquiry regarding Pequot Capital Management. In view of these events, prudent companies and executives should carefully review insider trading compliance programs and Rule 10b5-1 trading plans and closely monitor trading and filing requirements to ensure compliance.

### Congressional Hearings On Insider Trading

Congressional hearings last September preceded a number of new, high-profile insider trading cases, suggesting a renewed emphasis in this traditional enforcement area. In September 2006, the Senate held hearings on "Illegal Insider Trading: How Widespread is the Problem and is there Adequate Criminal Enforcement?" During those hearings, Enforcement Director Linda Thomsen testified that proving insider trading can be extremely difficult, but went on to note that, in response to increased merger activity and concerns about insider trading by hedge funds and other issuers, the SEC had recently "shifted our enforcement focus yet again." Despite the difficulty of bringing such cases, Ms. Thomsen assured law makers that the SEC was prepared to move aggressively in this area. *See Testimony Concerning Insider Trading, Linda Chatman Thomsen, Director, Division of Enforcement, U.S. Securities & Exchange Commission, Before the U.S. Senate Committee on the Judiciary September 26, 2006.*

During the first half of this year, the SEC brought what may be some of the most significant insider trading cases it has filed in years.

- *SEC v. Guttenberg* (S.D.N.Y.). This case focuses on two related insider trading schemes involving Wall Street professionals and names 14 defendants. According to the SEC's complaint, the illegal trading scheme netted at least \$15 million in illicit profits. Inside information came from tips supplied by employees of UBS Securities LLC and Morgan Stanley & Co., Inc. in exchange for cash kickbacks. The U.S. Attorney's Office for the Southern District of New York also announced criminal charges against a number of the same individuals in connection with the same insider trading schemes. SEC Associate Director of Enforcement Scott W. Friestad described the case as "one of the largest SEC insider trading cases against Wall Street professionals since the days of Ivan Boesky and Dennis Levine."
- *SEC v. One or More Unknown Purchasers of Call Options for the Common Stock of TXU Corp.* (N.D. Ill.). The SEC brought this insider trading case focused on trading in call options of TXU Corporation in advance of a merger announcement. On March 2, 2007, the SEC obtained a temporary restraining order freezing assets against the "Unknown Purchasers" of over 8,020 call option contracts worth approximately \$5.4 million for TXU common stock. On May 3, 2007, Hafiz Muhammad Zubair Naseem, an investment banker with Credit Suisse, was indicted in federal court in New York for securities fraud arising out of these transactions.

- *SEC v. Barclays Bank PLC* (S.D.N.Y.). On May 30, 2007, the SEC filed a settled civil injunctive action against Barclays Bank and one of its directors, Steven J. Landzberg, alleging that Barclays and Mr. Landzberg obtained and traded on inside information in six different bankruptcy cases in which they were involved. Perhaps the most notable allegation in the complaint is the statement that “[i]n a few instances, Landzberg used purported ‘big boy letters’ to advise his bond trading counterparties that Barclays may have possessed material nonpublic information.”

### **Executive Rule 10b5-1 Plans**

In December 2006, a new academic study was published suggesting that executives may be abusing Rule 10b5-1 trading plans. Rule 10b5-1 was adopted to permit corporate executives to sell company stock under an appropriate, pre-established plan, without being concerned about running afoul of insider trading prohibitions. *See 17 C.F.R. § 240.10b5-1*. The study suggested, however, that a significant percentage of those trading under these safe harbor plans are beating the market.

Following publication of the study, Enforcement Director Linda Thomsen, in a March 8, 2007 speech, stated that the staff is “looking at” trading conducted under Rule 10b5-1 plans by company executives, and looking at those trades “hard.” As she explained, the SEC created this “safe harbor” to give executives “regular opportunities to liquidate their stock holdings ... without risk of inadvertently facing an insider trading inquiry.” However, Ms. Thomsen warned would-be insider traders that “[i]f executives are in fact trading on inside information and using a plan for cover, they should expect the ‘safe harbor’ to provide no defense.” It was this type of scrutiny following the publication of academic studies suggesting that executives exercising company-granted stock options frequently beat the market which led to the current options backdating scandal.

### **A New Insider Trading Watch Dog**

An elite watch dog has been created to monitor insider trading. Investigators from the SEC, the Financial Industry Regulatory Authority (“FINRA”), the Options Regulatory Surveillance Authority (“ORSA”), and New York Stock Exchange Regulation have formed what some have called an “elite team” to crack serial insider trading rings. This group shares information and reportedly uses computer models to carefully monitor, watch, and examine trading. Similarly, following the collapse of Enron and other corporations, the financial fraud task force was created to focus on enforcement efforts in that area.

The regulators also reportedly meet periodically to review suspicious trading. Suspicious trading can include such things as trading in advance of mergers and other significant corporate events. Although such trades may be subject to scrutiny by regulators, there may be innocent explanations for the transactions. Nevertheless, executives may find themselves subject to regulatory review as a result of such scrutiny.

### **Senate Finance Committee Pequot Report**

Earlier this month, the Senate Finance Committee issued a report on its review of the SEC’s investigation into insider trading at Pequot Capital Management. The report, which is sharply critical of the enforcement division’s insider trading efforts in this matter, concluded that “[t]he investigation ... could have been an ideal opportunity for the SEC to develop expertise and visibility into the operations of a major hedge fund while deterring institutional insider trading and market manipulation through vigorous enforcement. Instead, the SEC squandered this opportunity through a series of missteps ...” *See Minority Staff of S. Comm. On Finance, 110<sup>th</sup> Cong. 1<sup>st</sup> Sess., “The Firing of an SEC Attorney and the Investigation of Pequot Capital Management” 46 (S. Prt. 110-28 Aug. 2007).*

The report goes on to make a series of detailed recommendations for improving the enforcement staff. These include:

- standardizing investigative procedures by drafting and maintaining a uniform and comprehensive manual of procedures for conducting enforcement investigations (similar the U.S. Attorneys’ Manual);
- ensuring that the commission’s resources are directed to significant and complex matters by setting standards and objective criteria to assess the size, complexity and importance of cases and determine how such cases should be staffed; and

- implementing other internal procedures designed to ensure that improper influences do not alter the course of enforcement inquiries.

In the wake of this highly critical report concerning an important SEC insider trading investigation, the commission and its staff may well redouble their efforts in this traditional enforcement area, making it a high priority. That action would be consistent with the efforts that followed last fall's congressional hearings on insider trading and the comments of Enforcement Director Linda Thomsen regarding Rule 10b5-1 plans and the formation of the elite insider trading team.

### **What Can You Do?**

The repeated focus by Congress and the SEC over the last year on insider trading will no doubt lead to increased emphasis and scrutiny. No issuer or executive wants to be the subject of such review, regardless of the explanation for the trading. All of this suggests that issuers and their executives would be well advised to:

- 1) carefully review insider trading compliance plans;
- 2) periodically remind employees of trading policies and, especially during significant transactions, the need for confidentiality;
- 3) assess Rule 10b5-1 plans and the trading under them;
- 4) closely monitor trading under these plans and the filing of the required forms; and
- 5) when asked for information by the regulators in an insider trading inquiry, take the inquiry very seriously and provide thorough responses.

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