Proskauer

A Practical Guide to the Regulation of Hedge Fund Trading Activities

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Executive Summary

The trading activities of hedge funds raise a number of complex issues under the federal securities laws. Proskauer's **Practical Guide to the Regulation of Hedge Fund Trading Activities** offers a concise, easy-to-read overview of the trading issues and questions we commonly encounter when advising hedge funds and their managers. It is written not only for lawyers, but also for investment professionals, support staff and others interested in gaining a quick understanding of the recurring trading issues we tackle for clients, along with the solutions and analyses we have developed over our decades-long representation of hedge funds and their managers.

The Guide will be published in installments (with previews of future installments) so that our readers may focus on each chapter, ask questions and provide any comments.

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Chapter 2:
Insider Trading: Focus on Subtle and Complex Issues

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Chapter 2: Insider Trading: Focus on Subtle and Complex Issues

Many hedge funds routinely face insider trading concerns as they trade equity or debt. Sometimes these issues are fairly obvious, such as where the fund has learned material, non-public information, or MNPI, directly from the company. Perhaps the company solicited the fund as an investor in a new equity offering and brought the fund "over the wall," meaning that the information is embargoed until the offering is public. However, in many cases, insider trading issues are more subtle and complex. Assume, for example, that a fund learns from one of its consultants that companies that produce solar panels are having a down quarter due to developments and trends that logically should impact sales of other renewable energy products. Can the fund short the common stock of a portfolio company that produces the blades for wind mills that generate electricity?

In this chapter, we summarize the law that applies to insider trading issues, including the practical impact, if any, of the relatively recent and widely-publicized Supreme Court and Second Circuit decisions. We then trace through a factual scenario to focus on more complex issues, including:

- Third-Party Sourcing: When a fund learns information from a source other than the issuer of the equity or debt in question, such as from a supplier, as noted in the example above;
- Big Data (a derivative of third-party sourcing): When fund managers gather information from sources rather than directly from a public company to gain insight; to inform their investment, using vendors or generated/analyzed internally. For example, "web scraping" or "spidering" refers to the practice of gathering data from websites using software. Big data also includes information from credit and debit card receipts, information from IoT, satellite imagery, and information from app developers for cell phones;
- Mosaic Theory: When a fund gathers a piece of immaterial information that, when combined with other public information, completes a mosaic that provides material trading insight. For example, assume that one of your employees took a photo of the CEO of a public company walking to his car in the evening and wearing an Abu Dhabi baseball cap, thereby perhaps providing some confirmation of market rumor that the company is doing a deal with an oil company in that country;
- Handling non-public information that you possess but don't want to have;
- "Almost" Public Information: Material information that is theoretically accessible by the public, but is not obvious, such as where an issuer posts the information in an unexpected website location. An example is when, several years ago, the CEO of Netflix posted new growth in monthly online viewing data on his personal Facebook account without having given notice that the market could find this information in that place; and
- "Big Boy" Letters: Where the buyer acknowledges that the seller may have MNPI and purports to waive its right to such information.

Today's Insider Trading Laws: Quick Primer

Before we get to more current, complex issues, here is a brief synopsis of the insider trading laws as they stand today.

Bases for Insider Trading Liability

In the United States, with a few exceptions, trading on the basis of material, non-public information does not – without more – violate the law. This distinguishes the United States from other countries, such as the UK, where the laws effectively require that buyer and seller have parity of information. In the U.S., there must be fraud, deceit or some other breach of duty in order for a violation of the federal securities laws to occur. For example, the information must have been obtained in breach of a fiduciary duty or a duty of trust and confidence owed to shareholders or the company (where the breach is by an insider of the company), or owed to the source of the information even if the source is not an insider (for example, the duty of confidentiality that an employee owes to his or her employer).

Classical Theory

The classical theory of insider trading involves a breach of fiduciary duty to the issuer and its shareholders. This situation occurs when a company insider provides material, non-public information to an investor without authorization to do so. For example, assume that a vice president for investor relations meets with a personal friend and hints at a down quarter before quarterly earnings have been released, expecting or suspecting that the friend will trade on the information. The friend then trades. The officer clearly breached his fiduciary duty to his company's shareholders by tipping his friend.

Misappropriation Theory

The "misappropriation" theory is an alternative basis for insider trading claims. It is usually applied where the information came from a source other than the company. In other words, no breach of fiduciary duty to the company or its shareholders is involved, because the person who traded on the information did not receive the information directly or indirectly from a company insider. One well-known case involved, R. Foster Winans, a *Wall Street Journal* columnist responsible for the "Heard on the Street" column. As it does today, the column discusses individual public companies, and its contents can impact the price of a stock positively or negatively. Mr. Winans leaked information about his articles to a stockbroker and to his roommate prior to publication, and they traded profitably on the news. Mr. Winans' defense to insider trading charges was that he may have violated conflict-of-interest policies at *The Wall Street Journal*, but he had not committed a crime because he had not obtained MNPI from a corporate insider. The Court of Appeals for the Second Circuit upheld his conviction on grounds that he had "misappropriated" information belonging to his employer and that the misappropriation was a sufficient basis for his conviction. (The court speculated, however, that misappropriation might not have occurred if the *Journal* itself had traded on the information, because the information belonged to the *Journal* – although the court observed that no self-respecting news organization would do such a thing.)

What About All the Fuss in the Press About Insider Trading and Frustrated Prosecutors?

For insider trading prosecutions in the Second Circuit, which includes New York, it temporarily became significantly more difficult for the government to prevail in a criminal insider trading case under the federal securities laws. That is because the Circuit, in its 2014 "*Newman*" decision, held that, in proving a breach of duty by a tipper providing the information to a tippee, the government had to prove that the tipper received a tangible personal benefit "of some consequence," such as something of economic or "pecuniary" value – and the tippee could not be held liable for trading on the tip unless he or she knew of the tipper's breach of duty, including the tipper's receipt of the personal benefit. The required "nature" of the personal benefit went to the Supreme Court in 2016 in the "*Salman*" case, and the Supreme Court rejected the "*Newman*" decision "to the extent [it] held that the tipper must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift to family or friends." The *Salman* case thus undermined one aspect of the *Newman* decision. A subsequent Second Circuit decision in 2018 in the "*Martoma*" case undermined another aspect of *Newman*, which had held that, where the personal benefit to the tipper is inferred from the nature of the relationship between the tipper and tippee (as, for example, in a gift-giving situation), "a meaningfully close personal relationship" is required. *Martoma* held that the requisite relationship between the tipper and the tippee can be established through proof "either that the tipper and tippee shared a relationship suggesting a *quid pro* quo or that the tipper gifted confidential information with the intention to benefit the tippee."

The combination of *Salman* and *Martoma* has probably eased the burden of proof in criminal insider trading cases against tippers and their direct tippees. But neither *Salman* nor *Martoma* undercut what the *Martoma* court called "the central question in *Newman*": A tippee must have *known* (or at least been reckless in not knowing) that there was a breach of fiduciary duty in providing MNPI in exchange for a personal benefit. While this burden might not create a big hurdle in cases involving direct tippees, it could prove insurmountable in cases involving remote tippees. Tippees at the end of a long chain might have no idea of what happened at the top of that chain between the tipper and the direct tippee. If the government cannot prove the remote tippees' knowledge (or their conscious avoidance of knowledge), the prosecution will fail – as it did on appeal in *Newman*.

More Stringent Laws Might Apply

The Sarbanes-Oxley Act added a new criminal insider trading provision that has been applied by a few lower courts to criminal prosecutions without the government having to prove some of the elements in a traditional insider trading case, such as knowledge of a personal benefit to the tipper. In one recent case in New York, the defendants were acquitted of the traditional insider trading charges, but convicted under the new law. The new law is modeled after the mail and wire fraud statutes, and subjects to criminal prosecution:

> Whoever knowingly executes, or attempts to execute, a scheme or artifice to defraud any person in connection with . . . any security of an issuer with a class of securities registered under section 12 of the [Exchange Act] or to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with . . . any security of an issuer with a class of securities registered under section 12 of the [Exchange Act]...

It remains to be seen whether the appellate court will agree with the lower court judges' interpretations, and whether prosecutors will use the new law more frequently to try to avoid some of the doctrinal constraints under traditional insider trading law.

There is one other exception in the U.S. where the law does essentially require parity of information between the buyer and seller, and that is in the context of a tender offer. The SEC's Rule 14e-3 provides that, if any person has taken "a substantial step or steps" to commence a tender offer (or has already commenced a tender offer), Section 14 of the Exchange Act prohibits any other person who has material, non-public information relating to that tender offer to buy or sell the potential target's securities if such person knows or has reason to know that the information is non-public and has acquired it directly or indirectly from someone associated with either the potential offeror or the potential target. Assume, for example, that a fund has learned indirectly about a potential merger. Assume also that a potential merger partner had begun discussions with banks about financing a tender offer and had hired an attorney, who put together deal scenarios that included a friendly tender offer. The fund may have liability under Rule 14e-3 after trading on the information, or at least the SEC may take such a position, even if the fund traded on the information without any breach of duty.

Further, certain state laws could also create liability (at least in enforcement actions, rather than private damages suits) for trading based on MNPI even without a breach of duty. Some state Attorneys General have used state laws (such as the Martin Act in New York) to threaten enforcement actions based on general principles of unfairness where parity of information did not exist.

Laws Outside the U.S.

Beware if your transaction has contacts with jurisdictions outside the United States. The insider trading laws of other countries differ from ours, and, as noted above, some of them more simply proscribe trading on MNPI, without regard to whether a breach of duty has occurred. The European Union's Market Abuse Regulation (the "MAR"), for example, prohibits trading on material, non-public information as long as the trader knows or has reason to know that the information is non-public. The MAR applies not only to trading within the EU, but also to any securities that are listed for trading on an EU market. Thus, for example, if a stock is cross-listed in the United States and the EU, the MAR applies even to transactions on the U.S. exchange. While the MAR does not yet appear to have been enforced as to U.S. trading of a cross-listed security, you do not want to be the poster child for a first-ever enforcement action.

What Is "Material"?

One of the most difficult problems faced by funds is determining whether information is material. At the far end of the spectrum the analysis is easy. Learning the company's dress code is immaterial. Getting advance information on quarterly earnings is material. For some reason, the information in question is nearly always somewhere in between.

Analysis of materiality is confusing in part because there are multiple approaches, all of which should be considered. The first approach is to consider the rather open-ended language contained in the opinions of federal courts. The Supreme Court has stated that materiality depends on whether there is a substantial likelihood that a reasonable shareholder would consider the information important in deciding whether to buy, sell or hold the securities. The information need not be dispositive – *i.e.*, the investment decision need not turn on it. But it needs to be something a reasonable investor would consider significant. An alternative formulation is whether the reasonable investor would have viewed the information as having significantly altered the "total mix" of information made available. These are thoughtful and logical formulations, but often unhelpful in solving difficult problems. And the Supreme Court has repeatedly refused to draw bright lines, because it considers materiality to be fact-specific.

Second, there is a balancing test for uncertain future events. The Supreme Court has held that materiality depends on a balance of the indicated probability that the event will occur and the anticipated magnitude of the event for the issuer if the event does occur. In other words, the less likely the occurrence, the less likely the materiality. But if the contingent event would be enormously significant to the issuer (for example, a merger), materiality might exist even at a lower level of probability than would be the case for a less-significant event.

Third, there is the quantitative test, expressed as a percentage of assets or revenues. In some respects, the SEC has sanctioned the use of quantitative tests, at least in certain circumstances. For example, the requirement to disclose civil litigation in periodic reports is qualified by an exception where the "amount involved" does not exceed 10% of current assets. Where available, quantitative measures are important factors in many analyses of materiality, often the most important. However, the SEC has made clear that quantitative measures cannot, alone, determine materiality. For example, assume that a retailer's revenues have dropped 1% for the quarter, in a period where sales should have been strong given the overall economic environment. The drop occurred because the company was having inventory problems resulting from its adoption of new inventory software that is dysfunctional. While the 1% drop may not be material to the company in isolation, two related, intangible facts likely are material. First, the fact that sales are declining when they should be increasing. Second, the fact that the company is experiencing inventory problems that may continue into the future. The SEC thus applies qualitative as well as quantitative considerations; it does not necessarily view quantitative results in isolation. Courts also reject quantitative bright lines. For example, the Third Circuit recently held that a jury could rationally view information about only 2% of an issuer's revenues as material for purposes of an insider trading conviction.

Finally, another factor is the anticipated impact on stock price. If the event is anticipated to impact the stock price, that factor suggests materiality. Because markets are not perfect, nor always rational, stock price should not always be a significant factor. We have all heard the warning that materiality is judged in hindsight, meaning that a material change in stock price could create a strong presumption of materiality. Indeed, the SEC enforcement cases focusing on compliance with Regulation FD some years ago did pay a lot of attention to stock price movements.

Because materiality is so fact-specific and is viewed in hindsight, after the trading has produced a profit or avoided a loss, we often counsel our clients to avoid making trading decisions based on the conclusion that specific nonpublic information is not material. In some cases, the information might objectively be viewed as immaterial, but an objective interpretation is not always possible. And we frequently cannot help but feel that, if our clients are so interested in the information that they are asking us about it, then they themselves might consider the information to be material.

The "Mosaic Theory" – When Immaterial Facts Complete a Puzzle

The "mosaic" theory is the view that collecting individual pieces of immaterial non-public information cannot violate the laws against insider trading, even if those pieces of information effectively add up to material insight into trading decisions. Indeed, by definition, if the information in question is not material, then there can be no insider trading liability. The problem in implementing this theory is being certain that the information in question is not material.

The "mosaic theory" has some logic, but the SEC has not endorsed it in the context of insider trading. It has adopted it in a related area of the law: Regulation FD. Regulation FD prohibits public companies from selectively disclosing MNPI to analysts and investors. In adopting Regulation FD, the SEC stated that "an issuer is not prohibited from disclosing a non-material piece of information to an analyst, even if, unbeknownst to the issuer, that piece helps the analyst complete a 'mosaic' of information that, taken together, is material."

Let's consider an example that illustrates the "mosaic theory," as well as how issues of materiality can be intertwined with the other elements of insider trading, such as whether the information is non-public. Assume that it is public knowledge that significant tariffs will be imposed on the importation of specialized rubber that is not currently available in the United States. A fund has invested equity in a public company that manufactures Zamboni machines that groom the ice at skating rinks. It is public knowledge that the specialized rubber in question is often used in Zamboni tires, as it results in superior performance. A fund principal calls an acquaintance who works as a salesman at the public company, and learns that the company in fact uses the rubber to manufacture its tires. The fund shorts the common stock of the company, anticipating a price drop when the increased price of the rubber causes an increase in manufacturing costs, and a decrease in revenue and profit. If the shorts prove profitable, did the fund violate the federal insider trading laws?

Is confirmation that the company uses the rubber in question "non-public," given that it is known that some manufacturers use the rubber in their tires because it improves performance? Assume also that the company in question is only one of four manufacturers of ice clearing machines in the world, and that it produces the most high-end, and most expensive, models. The probability that the company uses the rubber is therefore high. On the other hand, the company's oral confirmation to the fund removes any uncertainty, and changes the information from speculative to certain. Thus, the only non-public information is the final confirmation from the company. A conclusion that the information is already "public" would appear to be clearer if the manufacturer provides the information on the tire ingredients to anybody who calls its customer service number.

Even if the information were non-public, is it material? The nature of the material that the company uses to make its tires is arguably immaterial in isolation. The information provided trading insight only when coupled with the high probability that the company uses the rubber in question, and the already public news about the proposed tariffs. On the other hand, though, one could argue that the oral confirmation about the composition of that particular company's tires became material in light of the news about anticipated tariffs.

While it is not the focus on this sub-section, there may also be arguments that there was no breach of duty or misappropriation when the company employee confirmed the identity of the rubber to the fund, depending on the facts and circumstances. Indeed, as noted above, Regulation FD provides for a company to disclose immaterial information even if, unbeknownst to the employee, it completes a "mosaic" that provides material trading insight.

We advise clients not to rely on the mosaic theory except where non-materiality is clear-cut. The SEC has not formally endorsed the theory in the context of insider trading, and it relies on determinations of "materiality" that are subject to after-the-fact second-guessing. Some of the "expert network" firms have purported to rely on this approach by collecting non-material information that could, in the aggregate, provide useful investment guidance. The SEC has focused on a handful of these firms in the course of insider trading investigations.

Is the Information "Public"?

The analysis of whether information is "public" or "non-public" in some cases determines whether a fund can trade on material information. For example, assume that a technology company, perhaps accidentally, makes available select elements of a new product in background materials prepared for an industry conference. The information is included in the conference materials that are provided to participants to review later; it is not part of the actual presentation at the conference. An institutional investor that specializes in this area of technology discovers the information in the background materials, but doubts that many other investors have noticed it. The information is clearly in the public domain, but is it really "public" for purposes of the federal insider trading laws?

Just as there is no absolute rule requiring parity of information between buyer and seller, there is no rule requiring that the dissemination of material information have actually reached both buyer and seller at the time of a trade. The focus instead is the degree or manner to which the information has become available to the trading market and the amount of time the market has had to absorb it.

In the context of Regulation FD, the SEC has identified two prongs to the analysis of this question, mainly focusing on what information is "non-public." Of course, what is "public" for purposes of insider trading is not necessarily "public" for Regulation FD purposes, and vice versa. For purposes of the insider trading laws, the information need only be sufficiently publicly available to avoid being considered "non-public," while under Regulation FD the information must be publicly disclosed "in a manner reasonably designed to provide broad, non-exclusionary distribution of the information to the public." Further, under Regulation FD, the bar should be a higher one, because the company is in control of the manner in which it releases the information, and the policy objective is to ensure that every investor has a fair opportunity to access the information.

Nonetheless, as a benchmark, it is useful to understand what is "public" for purposes of Regulation FD. If information is sufficiently available for these purposes, it should normally also be for insider trading purposes. For Regulation FD purposes, a filing on a Form 8-K is always enough, normally coupled with a press release. If a conference is webcast with open access, a statement made at the conference should be "public" if there was adequate advance notice of the conference. Unconfirmed market rumors are not enough, because rumors are not the same as confirmed information. Nor are social media posts sufficient, unless investors have a reasonable expectation and practice of finding material information in the location where the posts are made. For example, the SEC has stated that a company's posting of financial information on Facebook should suffice if the company has provided notice that it will post such information in that location, and investors actually expect to find it there, and in practice do find it there.

Depending on the manner of dissemination, the SEC might also focus on whether the information has had time to reach the marketplace.

We now return to the example summarized above, where new product information was included in the background materials for the conference. The information arguably is "public." However, a plaintiff or regulator may contend that the unexpected inclusion of the product information among the conference materials does not render the information immediately "public," absent the passage of time. Such conference materials are often viewed only later by conference participants, to learn more about a specific subject. On the other hand, some participants, like the fund in our example, will be motivated to review the materials expeditiously. Moreover, the materials may be available only to the conference attendees rather than the public at large (unless the company later posts them on its website), and the conference site is not an official governmental site nor a site that necessarily sees a lot of "traffic". With the passage of time, however, the information should become more clearly "public."

Extinguishing MNPI

Sometimes funds obtain information that they don't want to have. For example, it is not as unusual as one would think for a fund to obtain information by receiving an accidental email from a public company or statement by a company officer. Or the company may have deliberately communicated to the fund information about a potential equity offering, hoping the investor will participate. We are often asked how to "cleanse" the information, meaning how to reverse the fact that the fund has the information.

If a fund obtains MNPI, it is frozen from trading. There are two ways to cleanse the information: (1) the company can publicly disclose the information, and/or (2) the information could become stale. If the issuer discloses the information (or the portion of the information that it views as material), then the fund's knowledge might be cleansed (although the fund itself needs to be comfortable that the issuer has disclosed all MNPI, regardless of what the issuer thinks). Information can become stale because the company disclosed it in the ordinary course or because sufficient time has elapsed to make the information out of date (although factual questions could arise about whether old information is or is not still material). For example, if the fund received a preview of quarterly earnings before the quarterly earnings conference, the information is cleansed once the company holds its quarterly earnings conference.

"Big Boy" Letters

If a trade occurs privately with an identified buyer rather than on the public markets, there is an opportunity to enter into a "big boy" letter. That is a letter signed by the buyer in which the buyer acknowledges that the seller may have material, non-public information that it is not sharing with the buyer, and the buyer waives any right to pursue a claim based on it, as well as any assertion of detrimental reliance on the non-disclosure. These letters can be helpful as a practical matter, as they reduce the likelihood that a buyer will decide to bring a lawsuit or complain to regulators. However, waivers of rights under the federal securities laws are not enforceable as a matter of law, so the general waiver of claims may not be available for use as a defense in court or in a regulatory or criminal action. Section 29(a) of the Exchange Act states that "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of the [Exchange Act] or of any rule or regulation thereunder. . . shall be void." Moreover, the government is not a party to a "big boy" letter, so it would not be contractually bound by the letter in any event.

Elements of the letter, however, might provide a defense to a traditional insider trading fraud claim, because "deception" and "reliance" are both elements of such a claim. The disclosure of the possibility of having material, non-public information can undermine a claim of "deception," and the non-reliance language would tend to undermine "reliance." The strength of these arguments is less than clear, depending on the circumstances, and some state laws might have exceptions for situations where one party has "peculiar knowledge" unavailable to the other party.

Nevertheless, a "Big Boy" letter, where it is possible to obtain one, can be helpful even if it does not eliminate risk. As a practical matter, we believe that it is more likely to be helpful in the context of civil litigation than it is in a regulatory or criminal matter.

Now It Gets Complicated: An Illustrative Scenario

We now focus on specific problems and challenges that funds confront with frequency. In doing so, we will run through a factual scenario involving fictional entities.

The Scenario

Assume that Emerging Growth, LLC has a 9% equity stake in Unicorn Pharmaceuticals, a small public company listed on NASDAQ. Unicorn's most promising drug in development is Cressacilin. In developing Cressacilin, Unicorn is using a new advanced-technology process called "Incubus," which is faster and more efficient than previously used methods.

Emerging Growth uses a software developer for its own trading and compliance software, called SoftDevCo. A representative from SoftDevCo was working in Emerging Growth's offices and was chatting with one of the fund's portfolio managers. The SoftDevCo representative mentioned that she had heard rumor in the industry that Incubus has some defects and that some drug developers have already had to suspend development while they consider whether to give the software developer more time to fix it or whether to abandon the new process.

The representative did not have specifics. Emerging Growth isn't sure whether Unicorn is using Incubus, but believes it likely that Incubus is the only software option at this point for the new development process and that Unicorn is therefore using it too. Emerging Growth also cannot be sure of the accuracy of the information the representative has provided, as it was qualified as "rumor," and the representative lacked specifics.

Despite the uncertainties, Emerging Growth would like to short Unicorn to hedge against the risk that Unicorn will be forced to suspend development of its principal drug. Can Emerging Growth short Unicorn's stock?

Materiality

There can be no insider trading unless (among other things) the information about the Incubus software problem is material to Unicorn. One could posit that the information about the software defect is immaterial to Unicorn. The information does not relate directly to Unicorn; the information was merely "rumor"; and, if the rumor is accurate, Emerging Growth is not sure whether Unicorn is using Incubus in any event. Under this analysis, using the "mosaic theory," Emerging Growth could take the position that it has simply combined new non-material information with already public material information about the drugs under development at Unicorn.

But this is where the "mosaic theory" often begins to fall apart. If the information about the software defect is correct, and if it applies to Unicorn because Unicorn in fact uses the same software as the other companies subject to the rumor, is the information really immaterial? In hindsight, let's assume the information is correct, and the defect proves catastrophic to Unicorn, whose stock price plummets. In hindsight, the information will appear material (especially because Emerging Growth has perhaps made a lot of money — or avoided substantial losses — by shorting Unicorn's stock), and arguments could be made along those lines. As noted above, information about a future event can be discounted by the probability of its occurring. In this case, the future event is that Unicorn will be forced to suspend development because it uses the defective software, and there is substantial uncertainty as to both the reliability of the information and its applicability to Unicorn. However, even discounted by uncertainty that the information is relevant to Unicorn, the magnitude of the contingent event (if it occurs) would be enormous because the drug in question is critical to Unicorn's success, so there would be arguments that the information is material. While the arguments in favor of materiality may not prevail, the outcome would be less than certain.

Is the Information Non-Public?

If the information about the potential difficulties with the software is in the public domain, it may be sufficiently public to eliminate any insider trading risk. The information need not necessarily be widely disseminated. It need only be sufficiently in the public domain under all the circumstances such that it is no longer considered "non-public." The information about the software defect may be sufficiently public if it has been reported, for example, in the trade press. Let's assume it has not been reported as "hard news," but the same rumors that Emerging Growth heard from its software developer have been reflected in the online trade press and/or blog posts. That would not suffice to make the information public, since unconfirmed speculation is not the same as the hard facts.

Breach of Duty/Misappropriation

In order for there to be insider trading, there has to be a breach of duty to the issuer, or a breach of duty to the source of the MNPI under the misappropriation theory.

Was there a breach of duty? Emerging Growth did not obtain the information about the software defect from Unicorn, but rather from a third party. That means that the fund did not receive it as a result of a breach of fiduciary duty at the issuer of the equity (Unicorn), the first basis for insider trading liability. An officer of Unicorn was not involved, and accordingly did not breach his or her fiduciary duty in providing the information to Emerging Growth.

The only possible basis for Emerging Growth's potential liability is the misappropriation theory – a potential breach of duty to the source of the information (SoftDevCo).

The fund did not "misappropriate" the information, either, in the traditional sense of the word. The SoftDevCo representative willingly provided the information to Emerging Growth – let's assume the representative hoped to give Emerging Growth a heads-up as a major investor in Unicorn and to retain its goodwill. However, there are counterarguments. One is that SoftDevCo shared the information with Emerging Growth as a "friendly heads-up," but expected Emerging Growth to hold it in confidence, or at least it did not intend that Emerging Growth would use the information for any specific purpose (e.g., trading Unicorn's equity). This seems somewhat inconsistent with the fact that the information was "rumor," something rarely shared in confidence, and with the fact that the representative was trying to be helpful to Emerging Growth. Nonetheless, if the information were provided in express or implied confidence, one could argue that Emerging Growth's use of the information to trade shares of Unicorn for its own benefit amounts to a misappropriation of SoftDevCo's information because Emerging Growth breached a potential duty of confidence owed to SoftDevCo. We expect that the SEC or DOJ may take this view, depending on the accuracy of the "rumor" and how widespread it had become. In past cases, those agencies have taken the position that a duty of confidentiality was implied from the circumstances and past practice and that such duty of confidence restricted use of the information. Another question is whether Emerging Growth was a "tippee" of the information, subject to tippee liability. That could be the case if SoftDevCo received the information about the software defect as a result of a breach of duty or misappropriation. However, given that Emerging Growth was not aware of any such breach (according to this hypothetical), it should not be subject to tippee liability.

Some of these same issues are reflected in funds' use of "Big Data" to make trading decisions, although the analysis is more complex. "Big Data" also involves obtaining information about an issuer from third parties (or at least from outside sources, such as the Internet) rather than from the issuer itself. We elaborate on that subject below.

Extinguishing MNPI

What if Emerging Growth, deciding not to trade on the basis of the rumor about the software defect, instead wishes it had never received the information in the first place? In other words, possessing the information could inhibit the fund from ordinary-course trading decisions, such as perhaps acquiring additional shares of Unicorn when the price dips with an overall market decline. The options for extinguishing information, and their relative merits, depend on the facts and circumstances in each case.

In this case, several ways might be available to extinguish the information. Emerging Growth could obtain confirmation that the rumor about Incubus's defect is false. Or Emerging Growth could confirm that Unicorn does not use Incubus. Or Unicorn or some other company that uses Incubus might disclose the problem with Incubus and its potential impact on product development. Or Emerging Growth could wait for the information to become stale in some other way. Perhaps Emerging Growth could approach Unicorn in hopes that Unicorn would confirm that the information is false, or investigate the question. Perhaps one of the other issuers that are experiencing problems with Incubus could disclose the information, but even if it identified such issuers, Emerging Growth lacks control over their disclosure practices. The problem with waiting for information to become stale is that it is hard to predict when that time will arrive. It could occur in the short term, such as if the Incubus software developer expressly denies the rumors, or it could take longer, such as when an issuer that uses Incubus discloses problems with the software, or alternatively discloses the timely success of its product.

Big Data: More Information from Third-Party Sources

"Big Data" refers to the efforts to refine and analyze data available from sources other than the issuer of the equity in question to assist in investment decisions. As noted above, this is a unique application of the analysis where an investor receives potentially material information from third parties, rather than from the issuer, either by buying the data from a vendor or generating and analyzing it in-house. Sources of data may include e-commerce receipts and credit-card transaction data, satellite images, sensors from internet-connected machines or smart devices, data from cell phone apps, and online data collected via "screen scraping" (or "web scraping" or "spidering").

Assume, for example, that Emerging Growth has also invested in a public company named Small Business

Loans, Inc., which (unsurprisingly) makes loans to small businesses. Emerging Growth engages a "Big Data" firm, BD Enterprises, which gathers information from a variety of sources in order to gain a better understanding of trends in small-business practices for raising capital. BD Enterprises in turn uses a combination of all of the sources noted above in gathering and analyzing data for Emerging Growth.

Let's assume that Emerging Growth uses the data and analyses it receives from BD Enterprises in deciding to increase its investment in Small Business Loans, as well as in other companies involved in the same industry. Six months later, Emerging Growth sees solid capital gains, and takes some profits.

Is Emerging Growth taking any risk in using the analyses provided by BD Enterprises to buy common stock in Small Business Loans and related businesses? As in the example above, where Emerging Growth obtained information relevant to Unicorn from a vendor, this isn't a classic breach-of-fiduciary duty case, because the information did not come from the issuers of the equity being purchased. No officer or director of an issuer provided the information to BD Enterprises. Here as well, the only possible basis for insider trading liability is the misappropriation theory. Since Emerging Growth obtained the information through a legitimate commercial relationship with BD Enterprises, it would not seem to have misappropriated anything – at least on initial consideration.

There is a risk, however, and it derives not from the relationship between Emerging Growth and BD Enterprises, but from how BD Enterprises gathered the information. The law in this area is still developing, but in theory BD Enterprises could be found to have misappropriated the data upon which Emerging Growth relied.

How can Emerging Growth be exposed to liability in these circumstances? Let's focus on "web scraping," as an example. Assume that BD Enterprises "scraped" relevant data from the website of an online business that provided relatively small but quick revolving loans to small businesses. This business model is different from Small Business Loan's model, but the business is similar, and the client base is comparable. The "scraped" data tends to show that clients of the online business are taking out fewer loans, but that loans are growing in size, suggesting growth in Small Business Loan's business involving larger, stand-alone loans.

The online business's website has several paragraphs of "terms of use," which could limit use of the website to the business's own marketing and sales. Many websites have terms that preclude "web scraping," such as the following craigslist term:

> USE: You agree not to use or provide software (except for general purpose web browsers and email clients, or software expressly licensed by us) or services that interact or interoperate with CL, e.g. for downloading, uploading, posting, flagging, emailing, search, or mobile use. Robots, spiders, scripts, scrapers, crawlers, etc. are prohibited, as are misleading, unsolicited, unlawful, and/or spam postings/email. You agree not to collect users' personal and/or contact information ("PI").

It is unclear whether a given website will enforce such a term, or at this point whether a court will view it as being enforceable, or whether violation of this term of use would be sufficient to amount to a "misappropriation" for insider trading purposes. There are weighty policy issues involved, including the open nature of the Internet, as well as proprietary, privacy and property rights. Nonetheless, although we are not aware of an insider trading case against a Big Data vendor or its client, one could imagine an argument that BD Enterprises somehow deceived the online business's website when it entered the website under the guise of a legitimate business purpose, but then proceeded to scrape the site in violation of the terms of use. If BD Enterprises did misappropriate information from the website, and if Emerging Growth knew or was reckless in not knowing about BD Enterprise's misappropriation, then Emerging Growth could theoretically be held liable by trading on MNPI obtained from the online business through BD Enterprise's breach of duty.

Other "terms of use" could also be relevant. In addition, there is a laundry list of possible legal violations, each of which may (or may not) form the basis of a "misappropriation". These include, for example, violations of copyright laws, the Computer Fraud and Abuse Act, privacy laws and/or common-law conversion or trespass.

Does it insulate the fund from liability if it engages a third party to gather the data, so that any legal violations are committed by the vendor? It might help, but may not prove a solid firewall, for a variety of legal and practical reasons that are beyond the scope of this chapter. For insider trading purposes, however, the fund manager might not be insulated if it knows or is reckless in not knowing about the vendor's misappropriation. Any fund manager or other potential trader that wishes to obtain trading information from a third-party vendor should therefore engage in appropriate due diligence before hiring the vendor and in monitoring the vendor's activities.

In April of last year, craigslist obtained a $60.5 million judgment against a real-estate listings site that had allegedly received scraped craigslist data from an independent vendor. In addition, craigslist reached a $31 million settlement and stipulated judgment with Instamotor, an online and app-based used-car listing service, over claims that Instamotor had scraped craigslist content to create listings on its own service and sent unsolicited emails to craigslist users for promotional purposes.

We recommend that investors ensure that agreements with vendors include appropriate representations and other terms, and that they conduct due diligence, asking the following types of questions:

- Who is the vendor? Is it credible, established, respected?
- What are the vendor's data sources?
- Where is the data coming from? Government or private sources?
- What is the nature of the data? What techniques does the vendor use?
- Personal identifying information ("PII")? Child PII? Sensitive Information?
- Any MNPI or other "confidential" information? (Spot-check!)
- Is the vendor collecting the same data for anybody else?
- Has there been any litigation involving the vendor or its sources?
- How does the vendor provide the data? Is the vendor a collector, packager, analyzer, aggregator?
- Does the vendor have the right to provide the data to you? Consider requesting documentation and indemnity.
- If using drones, does the vendor employ or contract with drone operators possessing proper commercial licenses acting in compliance with state and federal laws and NTIA best practices?
- Does the vendor have adequate insurance?

Does the Vendor spider? If so:

- Do the targeted websites have restrictive terms of use? Does the vendor check regularly?
- Does the vendor use technology to simulate the creation of any user accounts?
- Does the vendor circumvent any "captchas" or similar technologies?
- Does the vendor respect the "robots.txt" parameters?
- Does the vendor identify its "User-Agent" in the site logs?
- How does the vendor structure IP addresses for spidering?
- Does the vendor throttle/pause/alternate times to simulate human interaction?

"Big Boy" Letters

Because it is difficult to execute a short sale in a private transaction, let's assume that Emerging Growth instead decides to sell some of its common stock in Unicorn after hearing the rumor about the Incubus software defect. Emerging Growth finds a single buyer for a block representing 2% of the outstanding common stock of Unicorn. Because Emerging Growth may have material, non-public information about the development software (and is also a 9% equity holder in Unicorn), it asks the buyer to execute a "Big Boy" letter that waives any claims and disclaims reliance on the omission of any material, non-public information. For the reasons discussed above, the waiver of claims may not have any definitive protective effect. However, it may have some protective properties, and it could dissuade the buyer from pursuing legal action.

Concluding Thoughts

The scenarios described above, even with their variations, present complex issues under the federal insider trading laws. While we describe these issues to help funds to better identify and understand the insider trading questions that they face routinely, we do not intend to suggest that any fund trade where there is any material uncertainty as to compliance with the federal securities laws. In advising our clients, we consistently recommend a conservative approach when it comes to insider trading issues.

That is because the mere public announcement of even an informal SEC investigation could have a significant negative impact on a fund. A conservative approach means not engaging in any trades even if there are reasonable arguments that information is not material and/or that no duty has been breached. In addition to business reputational issues, the risks include SEC enforcement, which can include injunctions, fines and other penalties, such as disgorgement. The Department of Justice could pursue criminal charges against the fund or individuals. We want our clients to know the defenses to claims of insider trading, but, more important, we want them to have a basic understanding of the law so as to be able to avoid being in a position where they need defenses. Once a client needs defenses, the larger game – the ability to engage in business with a sterling reputation – might already be lost.

Chapter 3: Sections 13(d) and 16 for Hedge Funds

In the next chapter, we dive deeper into reporting and liability issues under these Sections of the Exchange Act, from the straightforward recurrent issues, traps for the unwary, and new developments for hedge funds.

Proskauer