CLIENT MEMORANDUM

SEC Reaches Settlement With Political Intelligence Firm, But Does Not Charge Insider Trading

December 1, 2015

AUTHORS

Martin Klotz | Elizabeth Gray | Amelia Cottrell | Michael Schachter | Christopher McNamara

On November 24, 2015, the Securities and Exchange Commission (the "SEC") announced that political intelligence firm, Marwood Group Research LLC ("Marwood"), agreed to admit wrongdoing and pay a $375,000 penalty for compliance failures, ending one of the SEC's "landmark investigations into the political-intelligence industry."[1] As part of the settlement, Marwood also agreed to retain an independent compliance consultant to review and make recommendations regarding Marwood's supervisory, compliance and other policies and procedures as they relate to the obtaining or use of material, nonpublic information ("MNPI"). Marwood, a registered broker-dealer, and state-registered investment adviser, admitted that it failed in 2010 to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI consistent with the nature of its business as required by Section 15(g) of the Securities and Exchange Act of 1934 (the "Exchange Act") and Section 204A of the Investment Advisers Act of 1940 (the "Advisers Act").

Marwood provides hedge funds and other clients with regulatory updates and insights into developments and the potential timing of future government actions or rulemaking decisions. During 2010, Marwood sought and received information from government employees concerning pending regulatory or policy issues involving the agencies that employed the government sources. Some of the information, in the context in which it was conveyed, was determined by the SEC to

[1] Brody Mullins & Aruna Viswanatha, *Marwood Group Settles SEC Charges*, THE WALL STREET JOURNAL, November 24, 2015, available here.

present a substantial risk that it could be MNPI. Marwood conveyed this information through research notes and other written and oral forms of communication to its clients, who the SEC alleged were likely to use such information to inform their trading in relevant securities. Although Marwood's written policies and procedures prohibited the acquisition and dissemination of MNPI and required employees to bring it to the attention of the compliance department if they encountered anything confidential, Marwood's analysts failed to do so.

The SEC's investigation of—and settlement with—Marwood is noteworthy. The SEC has appeared to prioritize its inquiries into political intelligence firms over the past year. Given its interest in these types of cases, it is notable that the SEC charged Marwood with compliance shortcomings, but failed to charge Marwood with violating the insider trading laws. This could reflect the possibility that the SEC was unable to identify a breach of duty by an insider in exchange for a personal benefit (the standard articulated by the Second Circuit in its seminal decision, *United States v. Newman*[2]), which has become a recurring obstacle for the government in establishing its insider trading cases. The SEC's settlement and focus on compliance also reflects its commitment to holding compliance programs and compliance officers to a high standard that takes into account a firm's business model in the program's design and implementation.

Relevant Factual Background

Marwood's business is to research and provide reports and updates to subscribing clients interested in market-moving regulatory and legislative events. Marwood's clients were historically comprised predominantly of mutual funds, investment advisers, and hedge funds. Marwood's "research notes" that were distributed to its clients often included previews of anticipated legislative or regulatory developments and analysis of already undertaken government actions, the latter of which may include insights into the implications of the government action.

To enhance Marwood's ability to provide accurate and commercially valuable research opining on future government regulatory events, Marwood encouraged its analysts to maintain contacts and seek information from personnel within the federal government. Marwood also arranged meetings and phone calls with government employees that sometimes could include representatives of Marwood's clients. During these meetings and calls, Marwood employees sought and obtained information from the government employees that it could (and would) use to inform the research which it would in turn share with paying clients.

By 2010, in addition to its written policies and procedures concerning the use and dissemination of MNPI, Marwood's policies and procedures provided for a review process over the preparation and publication of its regulatory and legislative research notes. These policies and procedures required review and approval by a licensed supervisory principal and submission of the reviewed material through the compliance department. If a Marwood employee had any doubt as to whether he or she was in possession of inside information, the employee was required to refrain from communicating it further and to promptly notify Marwood's compliance department. However, as of 2010, Marwood's policies and

[2] 773 F.3d 438 (2d Cir. 2014).

procedures did not expressly require the compliance department to be advised as to the source of the information included in the research note, or about communications with government sources, if any.

Marwood's compliance deficiencies and its analysts' failure to communicate as required with the compliance department would prove costly for Marwood in two separate instances that year—one involving the Centers for Medicare and Medicaid Services ("CMS"), and the other involving the Food and Drug Administration ("FDA"). CMS is tasked with crafting and enforcing Medicare coverage and reimbursement rates for eligible medical products and services. For certain medical products and services, CMS may make a National Coverage Determination ("NCD") to determine the criteria for coverage of that product or service on a national basis for all Medicare beneficiaries. The process that leads to an NCD is often referred to as a National Coverage Analysis ("NCA"). The goal of an NCA is to determine whether an item or service is "reasonable and necessary" for the diagnosis of a specific illness or injury; because such determination can change Medicare coverage, the announcement of an NCD can be a material event that impacts the market value of the securities of public companies sponsoring the product or service.

On June 30, 2010, CMS opened an NCA to determine whether or not Provenge, an immunotherapy manufactured by Dendreon and approved by the FDA earlier that year, was "reasonable and necessary" for Medicare beneficiaries. Upon this announcement, there was a sharp drop in the price of Dendreon's stock.

While CMS staff were permitted to inform the public on various topics, they were also governed by a confidentiality policy and agency regulations that restricted the information they could disclose. In the summer of 2010, Marwood employed an analyst who was a former CMS employee who had worked in the NCA group. On July 7, 2010, the Marwood analyst was able to obtain "decent color" from a former colleague at CMS as to why an NCA had been issued for Provenge. The CMS employee expressly warned the Marwood analyst of the sensitivity of this information. Based on this information, the Marwood analyst formed an opinion predicting CMS's continued coverage and reimbursement of Provenge's on-label usages; however, this information was never disclosed to Marwood's compliance department, in violation of Marwood's written policies and procedures. On July 8, Marwood published a research note entitled "Provenge NCA Likely to Support On-Label Coverage," which it circulated to hundreds of clients.

Separately in 2010, Marwood had retained a former high-ranking FDA official to consult on and assist with Marwood's analysis of FDA issues, including a pending application for a new diabetes drug called Bydureon. On September 14, 2010, the consultant and certain Marwood employees had a 73-minute phone call during which they discussed the consultant's assessment of Bydureon's new drug application. According to one Marwood employee's notes, the consultant conveyed that certain FDA contacts of his were "concerned about approval" and that there was "a debate between safety and reviewers." The consultant described several specific safety concerns that he believed the FDA was deliberating. This information was never quarantined or brought to the attention of Marwood's compliance department; rather, Marwood began communicating with clients between September 14 and October 19, 2010, informing them of this internal debate at the FDA concerning the safety of Bydureon and of the under-appreciated risk in the market that the new drug application could be denied.

The SEC's Investigation and Findings

The Wall Street Journal reported on October 28, 2014 that the SEC was investigating whether or not officials at CMS may have leaked news relating to Provenge to, among others, Marwood.[3] A little more than a year later, on November 24, 2015, the SEC announced that it had instituted and settled an administrative proceeding against Marwood.

The SEC order (the "Order") states that Marwood's analysts used potential MNPI that they had gained from interactions with government contacts in formulating research notes that were distributed to clients. The SEC found that Marwood had no written policy or procedure to reasonably ensure that its chief compliance officer would be provided with sufficient information to assess whether a research note may have been influenced by improperly obtained MNPI *or* to evaluate independently other Marwood employees' assessments that any information they had received from a government employee was not MNPI. Rather, Marwood's policy principally relied on employees and managers' own assessments of the risk.

Relying on earlier precedents, the SEC posited that Marwood's written policies and procedures "failed to address the substantial risk that its analysts who were in contact with government employees likely to be in possession of potential MNPI, could obtain and disseminate MNPI to Marwood's clients, who were likely to use that information to inform their securities trading."[4] Thus, the SEC concluded that Marwood's written policies and procedures "were not reasonably designed to address the risks associated with the nature of its business activities . . . [and that] its policies in this regard were also not reasonably enforced."[5]

Based on this conduct, the SEC charged Marwood with violating Section 15(g) of the Exchange Act, which requires every registered broker-dealer "to establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such broker's or dealer's business, to prevent the misuse in violation of . . . [the Exchange Act] or the rules or regulations thereunder, of material nonpublic information by such broker or dealer or any person associated with such broker or dealer."[6] However, as the SEC noted in the Order, there is "no requirement under Section 15(g) that there be an underlying insider trading violation or any other violation of the Exchange Act or the rules thereunder."[7] The SEC also charged Marwood with violating Section 204A of the Advisers Act, which contains the same

---

[3] *See* Brody Mullins, Susan Pulliam & Christopher Weaver, *Insider-Trading Probe Focuses on Medicare Agency*, THE WALL STREET JOURNAL, October 28, 2014, available here.

[4] Order at ¶ 36. The Order is available here.

[5] *Id.*

[6] *Id.* at ¶ 37.

[7] *Id.* at ¶ 37, n.2.

policy and procedure requirements for investment advisers as required of broker-dealers under Section 15(g) of the Exchange Act.

Conclusion

The SEC's settlement with Marwood is noteworthy in several respects. For one, the SEC's willingness to settle with Marwood without charging insider trading could reflect the increasing difficulty regulatory authorities face when instituting enforcement proceedings in a post-*Newman* world, where the Second Circuit has held that the government must establish a breach of duty in exchange for a personal benefit, and thus an indication that the SEC was unable to identify a breach in exchange for a personal benefit by the purported government insider. Second, and perhaps of more practical significance, the SEC found a way to charge Marwood through compliance failures. The Order notes that "if the nature of a particular broker-dealer's or investment adviser's business exposes employees to persons in possession of MNPI on a regular basis, a general policy that those employees self-evaluate information they receive is insufficient to comply with Section 15(g) of the Exchange Act and Section 204(A) of the Advisers Act."[8] Consequently, registered investment advisers and broker-dealers should review their written policies and procedures and implementation of the same with respect to MNPI that may enter the firm and its relationship to the firm's business operations.

If you have any questions regarding this memorandum, please contact Martin Klotz (212-728-8688; mklotz@willkie.com), Elizabeth Gray (202-303-1207; egray@willkie.com), Amelia Cottrell (212-728-8281; acottrell@willkie.com), Michael Schachter (212-728-8102; mschachter@willkie.com), Christopher McNamara (212-728-8546; cmcnamara@willkie.com) or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is an international law firm with offices in New York, Washington, Houston, Paris, London, Frankfurt, Brussels, Milan and Rome. The firm is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our fax number is (212) 728-8111. Our website is located at www.willkie.com.

December 1, 2015

Copyright © 2015 Willkie Farr & Gallagher LLP.

This memorandum is provided by Willkie Farr & Gallagher LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum may be considered advertising under applicable state laws.

[8] *Id.* at ¶ 35.