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Responding To SRO Market Surveillance Inquiries Into Potential Insider Trading

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The recent rise in the stock market, generated in part by the availability of easy credit, has spurred an increase in merger activity, and with it a rash of insider trading cases in numbers not seen since the go-go '80s. According to the New York Stock Exchange (NYSE), referrals of suspected insider-trading cases to the Securities Exchange Commission (SEC) in 2006 were up more than 25 percent over the previous year. As the number of violations has increased, so too has the scope and brazenness of the schemes.

Recent, high-profile prosecutions have featured highly trained associates at the country's foremost financial institutions engaging in wide ranging conspiracies that span the globe. For example, a Harvard-trained, former Goldman Sachs associate pleaded guilty last month to engineering a vast scheme that illicitly traded on inside information. He obtained the information from three sources: a Merrill Lynch analyst; employees at Business-

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Week magazine; and a grand juror participating in an investigation of Bristol-Myers Squibb. The scheme netted $6.7 million, and included one transaction that resulted in a $2 million profit for a retired seamstress in Croatia.

The profusion of information technology available today has certainly helped to facilitate the schemes. But the technology works both ways. Self-regulatory organizations (SROs) such as NYSE, Nasdaq and the NASD have remained sharply focused on insider trading and have more effective tools at their disposal to ferret out violations. Though there has been some consolidation of regulatory functions, each has a market surveillance unit that plays a critical role of monitoring trades in the securities listed on their exchanges. The principal purpose of these units is to maintain an orderly market and ensure a level playing field for market participants, investors and the general public. In particular, the Stock Watch Unit of the NYSE and the MarketWatch Unit of Nasdaq consider insider trading a high priority and suspected violations are investigated on an expedited basis.

These units make use of sophisticated computer and software systems to search and identify unusual trading patterns on an on-line, real-time basis in order to uncover potential insider trading activity. Analysts are alerted to aberrational price/volume activity in connection with news that may be suggestive of insider trading. Whenever any of these automated systems indicated unusual price or volume in a stock, analysts attempt to determine if this was the result of legitimate market forces or a violation of the rules. Among other things, analysts review press releases, review historical trading activity, interview brokers, market makers and listed-company officials.

As described by the NYSE staff, systems and software tools compare the information developed through the investigation with electronic blue sheets – customer and proprietary trading information provided in electronic format by member firms. This allows the staff to run comprehensive surveillance analyses by individual, institution, customer and proprietary trading information, and broker/dealers. Blue sheet data is reviewed for volume activity, account open date and other characteristics that may be indicative of potential insider trading and is matched with investigation-specific chronological data concerning the subject transaction.

While their ability to conduct surveillance is great, SROs have limited jurisdiction. For example, they have no power to compel non-regulated entities or individuals to provide documents or information. The Stock Watch Unit demands production from regulated entities and then refers the matter to the SRO enforcement division if warranted. The matter may also subsequently be referred to the SEC,

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which has broad powers to subpoena, and ultimately to the Department of Justice for criminal investigation.

An important tool of the SRO surveillance inquiries are written requests for information from the listed company and member firm. An initial inquiry letter is typically followed up by one or more letters seeking additional information or clarification.

The letters issued by the SROs request very detailed information concerning the transaction and everyone who worked on it. For example, the letters request the identities of all individuals associated with the company who were familiar with the deal prior to public disclosure, and the identities of the individuals associated with all third-party entities involved in the transaction, such as law firms, accounting firms, investment banks, consultants, etc., and the addresses and summer and/or part time addresses of each individual listed. In addition, the NYSE typically requests that the identifying information be provided electronically on its Electronic Filing Platform ("EFP"). Obtaining the information electronically allows the NYSE to upload the information onto a database that facilitates identifying the connection(s) between each of the individuals and entities listed.

The letters also request the creation of a detailed, written chronology setting forth the dates and descriptions of all significant meetings, communications, events, and developments leading up to the disclosure of the transaction. Related documents concerning the transaction are also required to be produced including, board of director meeting minutes, confidentiality agreements, research reports, "road show" materials, and records memorializing contacts with analysts and major stockholders and institutional money managers.

The letter requests may also provide a list of individuals and entities who presumably engaged in or facilitated suspicious trading of the securities at issue, and require that the firm state whether anyone at the firm involved in the transaction is related to or is otherwise familiar with the individuals on the proffered list. If the response as to any individual on the list is affirmative, the firm must provide additional information concerning the relationship, including "the nature and history" of the relationship, and the frequency of contact.

Responding to these requests raises a host of important and sensitive issues that must be carefully considered. At the outset, listed firms are required by the rules governing the SROs to respond to reasonable requests for information in connection with such investigations. Not responding is not an option. Responses should also be prompt and thorough.

It is also important to elicit the cooperation of the third party entities, such as the law firms and accounting firms, in preparing the response. As noted above, the requests typically ask for detailed information concerning the identities of individuals associated with the third party utilities involved in the transaction. It may also be necessary to share with the third party entities the list provided by the SRO of individuals and entities who presumably engaged in suspicious trading. The response will be glaringly deficient if information from the third party entities is not provided.

The third party entities have numerous incentives to cooperate with the request, despite the fact that the SROs cannot compel production of the information from them directly. There is, first of all, the duty they owe the subject company as its agent and fiduciary, and the financial incentive of wanting to continue the relationship with the company. The third party entities also risk reputational harm by failing to act proactively in identifying and rooting out rogue employees.

In addition to responding to the specific requests, the responding firm will need to take certain steps internally to secure the responsive and other relevant materials. It will be necessary to identify all the relevant documents and to suspend the company's document retention protocols to prevent their destruction or deletion. The failure to safeguard the documents relevant to the investigation may, under certain circumstances, result in criminal liability.

The firm will have to consider whether to disclose the fact of the inquiry in its public SEC filings. There is no duty to disclose the existence of an SRO inquiry or an SEC investigation flowing therefrom. However, public companies are increasingly deciding to voluntarily report such investigations in public filings.

Another complicated issue is whether to conduct an internal investigation to determine if inside trading did take place and uncover the source of the leak(s). Generally speaking, the firm should endeavor to identify and analyze the facts at its disposal as soon as possible, and ideally, before it responds to the letter request. It is important for the firm to know the facts because the directors and management of the organization have a responsibility to determine if a violation occurred, to remedy the effects of the wrong doing, and to take steps to ensure that it does not happen again. The firm can be subject to significant civil liability as a result of insider trading. For instance, though rarely used, the federal securities laws provide that the SEC can seek to fix liability of the person "controlling" the employee who engaged in insider trading. Civil penalties of up to $1 million or three times the amount of profit gained or loss avoided may be assessed against the "controlling" person.

Any internal investigation conducted in response to the letter request should be independent and thorough. As with any internal investigation, great care should be taken to identify the scope of the investigation and the individual or individuals within the firm to whom the investigators will report.

It is important in these situations that the investigation be conducted by an independent third party because the government will already be aware of a potential violation. Accordingly, there exists the possibility that the firm will want to share the results of the investigation with the government. The investigation will have more credibility if it is independent and transparent.

Once the investigation is completed, the organization should take all reasonable remedial measures suggested by the results. In particular, if the investigation confirms that an employee has engaged in insider trading, the employee should be punished accordingly (in almost all cases, the appropriate punishment will be termination). The organization should also review and revise its internal compliance policies and training materials to address the circumstances that made the wrongdoing possible.

Conclusion

The initiation of an inquiry by an SRO into potential insider trading is an event distinct from the traditional SEC or DOJ investigations with which many are familiar. However, it is an important event that deserves careful attention. The firm should move quickly to investigate the relevant events, interview the relevant individuals, and respond thoroughly and promptly to the SRO.