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How to Detect and Prevent Insider Trading

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Insider trading continues to be a focal point of the U.S. Securities and Exchange Commission ("SEC"). Insider trading is permitted when corporate "insiders," such as officers, directors, or employees, transact in their own company so long as securities rules and regulations are followed. However, more common is *illegal* insider trading. This type of insider trading generally occurs when someone illegally "tips" another with inside, confidential information. The receipt of the confidential nonpublic information in and of itself is not per se "illegal"; it is the *use* of such material nonpublic information for ill-gotten purposes which causes a securities law violation.

Over the last decade, the SEC has found illegal insider trading abuses primarily from persons in a position of trust, such as accountants, attorneys, corporate officers, and employees—and even financial professionals. While performing their services, these professionals often come in possession of material nonpublic information (such as when conducting due diligence efforts on public companies). High-profile SEC cases (*such as SEC v. Martha Stewart and Peter Bacanovi*[1]) have highlighted insider trading abuses, particularly where an insider has an unfair advantage in the market, which results in public distrust and further regulatory scrutiny. There also are a number of insider trading "tipping" cases, where securities are traded by the person "tipped" and profited by those who misappropriated the inside information.[2]

Ensuring your firm has a robust policy to prevent insider trading is paramount in protecting your firm and strengthening your clients' trust. In this article, we are going to discuss the most common types of illegal insider trading activities and through a case study, provide guidance on how to detect and prevent illegal insider trading through internal controls development and governance.

Most Common Types of Illegal Insider Trading Activities within Financial Firms

Financial firms (such as broker-dealers and investment advisers) and their associated persons are required to comply with Section 17(a) of the Securities Act of 1933 and Sections 10(b) and 10b-5 thereunder of the Securities Exchange Act of 1934, which prohibit illegal insider trading. Such financial firms are required to develop policies and procedures to detect and prevent insider trading from occurring. If potential illegal insider trading is detected by the firm or otherwise, generally, the alleged offense would fit into one of two categories:

- Accidental insider – This may occur when an individual acquires material nonpublic information, and:
    - Either has knowledge that this is nonpublic information and reports it to Compliance and does not act upon it; or
    - Does not realize the nature of the nonpublic information, and either shares or acts upon it.

- Opportunist insider – This may occur when an individual acquires material nonpublic information and seizes a lucrative opportunity, believing that he or she will not get caught.
    - This includes misappropriation, whereby the tipper/insider breaches a duty by passing on inside information, and the tippee knows or has reason to know that the tipper/insider would benefit personally from the tip.

It is essential for financial industry firms to educate employees and associated persons about what constitutes insider trading, how to prevent it, and if in possession of inside information, what to do. Creating a culture of compliance, based on integrity and accountability, with frequent reminders on how to comply, will help generate an awareness that might not otherwise exist. It will also make potential insiders think twice before acting on material inside information.

Consider the following case study.

Case Study

You are the new CCO of Vulnerable Wealth Management (Vulnerable). The phone rings and it is the SEC. The Examiner explains that he is investigating a security by the name of Electric Sun, which was allegedly purchased by one of Vulnerable's largest clients, Billy Stearn. The Examiner asks the CCO to pull any and all trade records involving Electric Sun. The CCO immediately does just that, and sees that Mr. Stearn indeed purchased a large position (worth over $100,000) as a solicited order in the company.

Wanting to learn more, the CCO turns to Wendy Employee, the financial adviser servicing Mr. Stearn's account. The CCO asks Wendy several questions related to Electric Sun and why she solicited the order for Mr. Stearn. Suspicious of this questioning, Wendy asks if there is something that she should be concerned about—and you decide to share with her the dialogue you had with the SEC. Wendy suddenly becomes pale.

In referencing the CRM notes you learn that Wendy solicited Mr. Stearn to purchase Electric Sun as she "thought it would be a winner." You question Wendy about the CRM note and her knowledge of the company. In doing so, you learn that Wendy's husband is best friends with Taylor Masun, the owner of Electric Sun. In fact, Wendy's husband and Taylor were college roommates, and Taylor convinced Wendy's husband to become a 25% owner of the company. Wendy states, "As you can see, I have firsthand knowledge that Electric Sun is 'solid.'"

To learn more about Electric Sun, the CCO conducts an internet search and learns that the day after Mr. Stearn's trades, Electric Sun made a corporate announcement of a huge contract they just won that would make them the largest producer of solar power in the U.S. Checking the client's account, Mr. Stearn had made a handsome profit before selling the position three days later.

> *What issues do you see?* In this example, there are several troubling signs. First, the corporate announcement is made in close proximity to the client's order solicited by Wendy. Secondly, the client profited from the solicited trade and sold the position just a few days later, thereby "locking in" his windfall. Making a profit is not the concern; using insider information to generate a profit is.
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> Moreover, Wendy admits to "knowing" Electric Sun; in fact, her husband is a 25% owner of the company and likely would be deemed to be an "insider." On the surface, it appears that Wendy may have solicited this order based on inside information that she had learned from an insider. This must be further investigated.
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> Finally, there appear to be several gaps in the firm's internal control structure. The firm was not aware of Wendy's husband ownership interest in Electric Sun (which should have been disclosed by Wendy) and potential conflicts of interest associated with his ownership interest. The CCO was not aware of the short-term trading activity by Mr. Stearn or of the large profit that Mr. Stearn achieved by transacting in Electric Sun. In addition, it appears that Wendy may not have received adequate training on how to prevent insider training, and it is possible that the firm's policies and procedure prevention measures were inadequate to detect and prevent potential insider trading abuses. Also, it is likely Wendy indirectly benefited from this transaction by selecting a "winner" on Mr. Stearn's behalf.

Conclusion

In the above case study, it is uncertain if Wendy was acting as an accidental insider, opportunist insider, or none of the above. The area of insider trading is complex, and could be confusing for your employees and associated persons to understand.

Therefore, now is a good time to review your internal controls and remind firm personnel on how to prevent insider trading from occurring:

- The firm should identify those associated individuals, such as research analysts, brokers, and advisers with corporate insider clientele or family members who could potentially come in contact with inside information and conduct adequate training and heightened surveillance accordingly.

- Evaluate if the reporting requirements for all associated persons are clear and understandable.
  - Provide examples of what must be reported (such as the receipt of inside information) and to whom (e.g., the Chief Compliance Officer).

- Ensure that policies and procedures provide guidance on how to prevent insider trading and examples of what would give rise to illegal insider trading activities.

- Analyze monitoring procedures for adequacy and consider if current protocols are robust enough to detect illegal trading activities by associated persons.
  - When possible, implement automated software solutions to monitor for unusual trading activities and survey for possible illegal insider trading.

Collectively, these steps can help an organization develop reasonable safeguards to minimize the threat of insider trading. Creating this culture of compliance will help instill investor confidence, reinforce your company's integrity, and help to mitigate both business and regulatory risks.

About the Author

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[1] See https://www.sec.gov/litigation/litreleases/2006/lr19794.htm.
[2] See, for example, SEC v. Yonni Sebbag and Bonnie Jean Hoxie (10 Civ. 4241 (NRB) Nov. 05, 2010) wherein defendants consented to the entry of a final judgment of a complaint alleging that Ms. Hoxie, an administrative assistant to a Walt Disney Co. communications chief, and Mr. Sebbag, her boyfriend, attempted to sell information in Disney's second quarter earnings report before its official release to the public to various hedge funds, who in turn, notified the FBI.

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