The Importance of Implementing an Effective Insider Trading Policy

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I. Introduction

The recent surge of insider trading investigations and civil and criminal enforcement actions involving Wall Street professionals is a reminder of the importance of broker-dealers and investment advisers having effective policies and procedures to detect and prevent the misuse of material nonpublic information.1 Although there are a significant number of insider trading cases reported every year, the last great wave of high profile insider trading actions involving investment bankers, arbitrageurs and other securities industry professionals crested in the late 1980s, almost 20 years ago.2 It appears that many of the defendants in the most recent spate of insider trading enforcement actions are too young for the notorious cases of the 1980s to have made any impression upon them.3 This suggests that the hard lessons about the pitfalls of involvement in insider trading schemes must be relearned by each succeeding generation of securities professionals.

The issue of insider trading is a particularly acute one for broker-dealers and investment advisers. These firms are under enormous pressure to generate trading profits. Securities firms and their employees in the ordinary course of business come into possession of material nonpublic information on a daily basis from a wide variety of sources. The pressure to misuse this information will often be intense. At the same time, the regulatory regime under which these firms are required to operate provides potentially grave consequences for failing to detect or prevent insider trading.

The first section of this article provides a brief overview of the development of the law of insider trading. The second section describes some of the recent regulatory enforcement actions, using them as examples to illustrate certain activities where particular vigilance is required. The final section suggests certain elements of a successful insider trading compliance program.
II. The Development of the Law of Insider Trading

There is no specific statute or rule prohibiting “insider trading.” Instead, the legal prohibition against insider trading has developed, over time, largely through judicial decisions interpreting Section 10(b) of the Securities Exchange Act of 1934 (the “Exchange Act”) and Rule 10b-5 thereunder. In general terms, insider trading can be described as the purchase or sale of a security while in possession of material nonpublic information acquired under circumstances involving a breach of a duty arising out of a fiduciary relationship or other relationship of trust and confidence.

In re Cady Roberts & Co., an SEC opinion, is universally regarded as the seminal case in the development of the law of insider trading. In that case, a director of Curtiss-Wright Corporation disclosed to a broker that the company's dividend would be reduced. The broker immediately sold shares of Curtiss-Wright. SEC Chairman William Cary stated that corporate officers and directors—those who effectively stood in their shoes—who came into possession of material nonpublic information had a duty under the relevant provisions of the federal securities laws to either disclose the information publicly or refrain from trading on it.

Seven years later, the Second Circuit upheld this so-called “disclose or abstain” rule in SEC v Texas Gulf Sulphur Co., a case involving trading by corporate insiders in advance of the public announcement of a major mining discovery.

The “disclose or abstain” rule has been applied not only to corporate officers and directors but also to attorneys, accountants, consultants and others who assume fiduciary duties of trust and confidence to the shareholders of the corporation by virtue of having been engaged to perform certain services for the corporation. Such persons are deemed to have become temporary insiders of the corporation.

The courts have also addressed the scope of “tippee” liability, that is, the extent to which persons who trade on information which they have received from a corporate insider inherit the insider's duty to disclose or abstain from trading while in possession of that information. In SEC v. Dirks, the U.S. Supreme Court held that a tippee who trades under such circumstances is liable if he knew or had reason to believe that the tipper had breached a fiduciary duty in disclosing the confidential information and received a direct or indirect personal benefit from the disclosure.

The U.S. Supreme Court injected an element of complexity into the evolving law of insider trading in Chiarella v. United States, when it reversed the conviction for insider trading of an employee of a financial printer who traded on the basis of information he learned through printing documents concerning nonpublic tender offer transactions. The Court held that because the financial printer was not an insider of the corporations whose stocks he traded, he owed no fiduciary duty to the persons with whom he traded and therefore could not be subjected to liability for failing to disclose or abstain from trading on the information.

The Supreme Court's decision in Chiarella created the potential for a large gap in the protection afforded by the federal securities laws against the misuse of material nonpublic information by purchasers and sellers of securities. In the ordinary course of business many people who are neither corporate insiders nor their tippees learn of material nonpublic information concerning particular securities. Such persons owe no fiduciary duty to the holders of those securities. For example, an investment banking employee of a firm hired to advise a company planning to make an unsolicited offer to acquire the stock of another company at a premium would owe no fiduciary duty to the shareholders of the potential target company. Chiarella created substantial uncertainty as to whether such person could be held liable for trading while in possession of material nonpublic information or for tipping others who traded.

The “misappropriation” theory of insider trading liability was developed as a means of addressing the potential gap created by Chiarella. As articulated by the Second Circuit in SEC v. Materia, the theory provided that “one who misappropriates nonpublic information in breach of a fiduciary duty and trades on that information to his own advantage violates Section 10(b) and Rule 10b-5.” Under the misappropriation theory the investment banking employee referred to above who purchased a company's securities based on information about the unannounced offer learned through his employment could be said to have misappropriated that information because it belonged to his employer (or his employer's client) but he used it improperly for his own benefit.
The misappropriation theory gradually gained broad acceptance among the lower courts. However, the question of whether it would be accepted by the Supreme Court remained unresolved until the 1997 decision in United States v. O’Hagan. In O’Hagan, the Supreme Court held that a person who trades in securities for personal profit, using confidential information misappropriated in breach of a fiduciary duty to the source of the information (in this case, a law firm in which the trader was a partner), violates Section 10(b) of the Exchange Act and Rule 10b-5.

The law of insider trading has developed not only through case law but also through amendments to the federal securities statutes. The Insider Trading and Securities Fraud Enforcement Act of 1988 (“ITSFEA”) was enacted in the aftermath of the last great wave of insider trading cases involving securities professionals. ITSFEA added Sections 15(f) and 21A to the Exchange Act and Section 204A of the Investment Advisers Act of 1940 (the “Advisers Act”). These provisions impose obligations on broker-dealers and investment advisers to have effective insider trading compliance policies and procedures.

Section 15(f) of the Exchange Act requires broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information by the firm or its associated persons. Section 204A of the Advisers Act imposes the same obligation upon registered investment advisers. The SEC has brought actions alleging violations of Section 15(f) or Section 204A even in cases where the allegedly deficient procedures have not resulted in any actionable insider trading.

Section 21A of the Exchange Act authorizes the SEC to seek to impose a civil penalty upon persons who engage in insider trading and upon controlling persons of such person of the greater of $1 million or up to three times the amount of the profit made or the loss avoided by such trading. With respect to broker-dealers and investment advisers, Section 21A authorizes the SEC to seek civil penalties in cases where it can prove that the controlling person (1) knowingly or recklessly failed to establish, maintain or enforce a policy or procedure required by Section 15(f) or Section 204A and (2) “such failure substantially contributed to or permitted the occurrence of the act or acts constituting the [insider trading] violation.”

III. Recent Insider Trading Cases Involving Securities Professionals

As noted in the Introduction, there have been a number of recent, high profile civil and criminal enforcement actions alleging insider trading by securities professionals. The SEC has also brought several recent enforcement actions alleging that broker-dealers and banks failed to have adequate insider trading procedures or failed to effectively enforce such procedures. Several of these cases are described below, in order to illustrate some of the business activities that may warrant particular attention in designing effective insider trading policies and procedures.

SEC v. Gutenberg, et al is one of the more noteworthy of the recent insider trading enforcement actions. This SEC enforcement action and related criminal prosecution involved two related insider trading schemes that allegedly netted more than $15 million in unlawful insider trading profits on thousands of trades, using information misappropriated from two of the world’s largest securities firms, UBS Securities, LLC and Morgan Stanley & Co., Inc.

In the first scheme, an executive director in the equity research department at UBS is alleged to have provided material, nonpublic information concerning upcoming UBS analyst upgrades and downgrades over a six-year period to two traders, one of whom was employed by several hedge funds over the period, in exchange for a share of the profits from the trading. The two traders tipped by the UBS executive are alleged to have also tipped several other persons and entities, including a hedge fund, a day-trading firm and three registered representatives at Bear Stearns.

In the second of the two schemes, an attorney in the global compliance department at Morgan Stanley, together with her husband, an attorney in private practice, is alleged to have provided material, nonpublic information concerning upcoming acquisitions involving Morgan Stanley’s investment banking clients to a registered representative at a Florida broker-dealer, in exchange for a share in his trading profits. This individual is alleged to have tipped several other securities professionals, including several of the same individuals who were participants in the other scheme.

The SEC charged another Morgan Stanley employee, together with her husband, a former employee of ING Investment Management Services, Inc., with insider trading in an emergency enforcement action filed on May 10, 2007.
case was unrelated to the Gutenberg case described above. The SEC alleged that the Morgan Stanley employee was employed in a part of the firm that provided financing for upcoming acquisitions and used information obtained from her employment to trade on three occasions through an online brokerage account set up in her mother’s name. The three allegedly unlawful trades were made approximately six months apart and using a nominee account, which suggests an effort to stay below the SEC’s “radar screen.” If so, this effort was unsuccessful.

The SEC has also brought several recent enforcement actions against broker-dealers involving either alleged insider trading or alleged inadequate insider trading compliance procedures. Certain of these actions included allegations of insider trading by the firms and their employees. Others involved only alleged deficiencies in policies and procedures.

The SEC alleged that Barclays and a proprietary trader on its distressed debt desk illegally traded millions of dollars in bonds, while aware of material nonpublic information received through six bankruptcy creditors committees on which the proprietary trader served as Barclay’s representative. The SEC further alleged that Barclays and the proprietary trader misappropriated material nonpublic information by failing to disclose any of their trades to the creditors committees, issuers or other sources of such information. The SEC further alleged that Barclays’ compliance personnel “failed to prevent the illegal insider trading, despite receiving notice that the proprietary desk had material nonpublic information and should have been restricted from trading.” As part of a settlement of the SEC enforcement action, Barclays consented to an injunction and agreed to pay more than $10.94 million in disgorgement, prejudgment interest and penalties.

A significant case brought by the SEC against Goldman Sachs in 2003 illustrates the risks of using outside consultants to obtain market-moving political intelligence. The SEC alleged that Goldman Sachs purchased U.S. Treasury 30-year bonds immediately after one of its employees received and conveyed to firm traders material nonpublic information that Treasury was about to announce the suspension of future 30-year bond issuances. The SEC further alleged that the Goldman Sachs employee had received this information from a political consultant on retainer to the firm and to others, who conveyed the information despite having expressly agreed to abide by Treasury restrictions on the release of the information before Treasury announced it publicly. Goldman Sachs was alleged in the proceeding to have “failed to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information potentially obtained by outside consultants.”

The SEC has also launched a number of investigations and examination initiatives to address insider trading by hedge funds. Members of the SEC Staff have publicly expressed concern that employees of broker-dealers may be conveying material nonpub-
lic information to hedge funds, which, as active traders, tend to be lucrative sources of commission income for broker-dealers.35

IV. Elements of an Effective Insider Trading Policy

Neither Section 15(f) of the Exchange Act nor Section 204A of the Adviser’s Act specify the elements that must be included in an insider trading policy in order for it to be deemed “reasonably designed” to prevent the misuse of material nonpublic information.36 In addition, self-regulatory organization rules concerning supervision do not identify any specific procedures as required for the detection or prevention of insider trading.37

Notwithstanding the absence of specific statutes or rules on the subject, the regulators have published some useful guidance in this area. In 1990, the SEC Staff in the Division of Market Regulation issued a report on the Staff’s study of the policies and procedures of certain large broker-dealers for preventing the misuse of material nonpublic information.38 The report identified four elements as essential to an effective insider trading policy for a large broker-dealer: (i) control (preferably by the compliance department) over inter-departmental communications; (ii) review of employee trading through the effective maintenance of some combination of watch, restricted and rumor lists; (iii) enhanced documentation of information barrier procedures and of actions taken pursuant to those procedures and (iv) heightened review or restriction of proprietary trading while the firm is in possession of material nonpublic information.39

The SEC Staff declined to recommend that the SEC adopt rules mandating that broker-dealers implement specific procedures to detect and prevent the misuse of material nonpublic information. Instead, the SEC Staff determined the effective operation of such procedures “would best be effectuated...by vigorous self-regulatory examination programs, supplemented by Commission oversight.”40 In response to the SEC Staff Report, the NASD and the NYSE issued a joint memorandum providing guidance on the “minimum elements” of an effective information barrier procedure.41 This joint memorandum reiterated and expanded upon certain of the conclusions set forth in the SEC Staff Report.42

Based upon the regulatory guidance contained in the SEC Staff Report and the SRO joint memorandum,43 as well as the authors’ own experience, it is recommended that the following elements be included in a broker-dealer or investment adviser’s policies and procedures:

- **Employee training.** A regular program of employee training on the need to appropriately safeguard material nonpublic information and the prohibition against the misuse of such information is critically important. Such training should be provided to every employee who could reasonably be expected to come in contact with material nonpublic as soon as practicable after the employee is hired. Employees in particularly sensitive areas such as the investment banking, proprietary trading and research departments of broker-dealers and the trading desks of hedge funds and mutual funds should receive refresher training on an annual basis.

- **Surveillance of employee trading.** It is essential for securities firms to regularly monitor the personal securities trading of firm employees for suspicious trading. The most effective way for a broker-dealer to facilitate the monitoring of this activity is to require employees to maintain all securities accounts at the firm. If such a requirement is not practicable, employees must be required to disclose any accounts they maintain at other firms and to have duplicate confirmations and account statements sent to the employing firm. Compliance personnel should conduct regular surveillance of employee trading activity with a view to identifying suspicious trading.

- **Maintenance of restricted list and watch list.** The firm should create and maintain a “restricted list” that includes all securities as to which the firm has obtained material nonpublic information. Neither employee nor proprietary trading should be permitted with respect to securities on the restricted list. The firms should also create and maintain a separate watch list of securities for which there is a significant possibility that the firm may come into possession of material nonpublic information. Trading in securities on the watch list should be monitored closely.44

- **Maintenance of effective information barriers between sales and trading employees and employees who routinely are exposed to material nonpublic information.** Firm employees who learn material nonpublic information should be “walled off” from em-
ployees engaged in securities sales and trading activities. Among the categories of employees who will most frequently need to be “walled off” are employees in the investment banking and research areas. In addition to maintaining appropriate physical separation, the procedures should also provide for controls over access to physical and electronic files that contain material nonpublic information.

As with other required policies and procedures, it is essential that firms effectively document not only the steps required to comply, but also the actions taken to perform those steps. As described above, the failure to do so can expose firms and firm employees to regulatory enforcement actions, even in situation where there is no proof that material nonpublic information was actually misused.

ENDNOTES

1 For example, on March 1, 2007, the SEC sued 14 defendants in connection with two related insider trading schemes in which Wall Street professionals serially traded on information tipped, in exchange for cash payments, by insiders at UBS Securities and Morgan Stanley. See SEC v. Guttenberg, et al., SEC Litigation Release No. 20022 (March 1, 2007).
2 For a detailed description of this prior insider trading scandal and its colorful cast of characters, including Ivan Boesky, Dennis Levine and others, See Den of Thieves, by James B. Stewart (1993).
3 In the Guttenberg case, the defendants named in the SEC enforcement action ranged in age from 30 to 43.
5 Section 10(b) of the Exchange Act and Rule 10b-5 apply to purchases and sales of securities. Section 17(a) of the Securities Act of 1933 applies to securities sales only. Section 14(e) of the Exchange Act and Rule 14e-3 apply to insider trading in connection with a tender offer.
6 Person who receive material nonpublic information from corporate insiders under circumstances involving a breach of duty by the insider are said to inherit the duty of the insider to disclose or abstain from trading. Such persons are frequently referred to as “tippees.”
8 Id. at 655, n. 14.
15 See Section 21A(a)(3) of the Exchange Act.
16 Section 21A(b)(1)(B).
18 Id.
19 Id.
20 Id.
21 Id.
23 Id.
25 Id.
26 Id.
27 Id.
29 Id. at page 3.
30 Id. at pages 11-12. Morgan Stanley is dually-registered with the SEC as a broker-dealer and investment adviser.
32 Id. The employee, John Youngdahl, a Vice President and Senior Economist, also settled SEC civil and related criminal insider trading charges.
33 Id.
34 Id.
35 See SEC Hunting Insider Trading in Hedge Funds, By Edward Hayes, CCH Wall Street Spotlight News (February 21, 2007).
36 Rule 204A-1 under the Advisers Act, which requires registered investment advisers to adopt a code of ethics further requires the code of ethics to include mandatory reporting by “access person” of specified information concerning securities holdings and transactions. Rule 204A-1 defines “access persons” to include employees with access to nonpublic information concerning clients’ purchase or sale of securities or the portfolio holdings of any reportable fund.
37 See NASD Rule 3010 (“Each member shall establish and maintain a system to supervise the activities of each registered representative, registered principal and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules.”)
38 See Report by the SEC Division of Market Regulation, Broker-dealer Policies and procedures Designed to Segment the Flow and Prevent the Misuse of Material Non-public Information (March 1990) The SEC has since changed the name of the Division of Market Regulation to the Division of Trading and Markets.
39 Id.
40 Id.
41 See NASD NTM 91-45 (July 1991).
42 Id.
43 The SEC Staff Report and the SRO joint memorandum are addressed only to broker-dealers. However, much of the regulatory guidance contained in these documents is equally applicable to investment advisers.
44 As illustrated by the enforcement action against Morgan Stanley described above, restricted lists and watch lists are of no value unless they are regularly used to monitor trading.