

INSIDER TRADING INVESTIGATIONS

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Portions of this outline have been used in other programs and publications.

I. INTRODUCTION

There is no statutory definition of "insider trading". Illegal insider trading generally refers to purchasing or selling securities while in possession of material non-public information concerning such securities, or tipping such information, where the trader or tipper breaches a fiduciary duty or a duty arising out of a relationship of trust or confidence.

A. Classical Insider Trading Theory

Applies to insiders (employees of issuer whose securities are subject of the insider trading) who learn the subject material nonpublic information in the course of their employment and who owe a fiduciary duty to the issuer not to use the subject information for their personal benefit.

B. Misappropriation Theory

Applies to outsiders (non employees of issuer whose securities are subject of the "insider" trading) who learn the subject material nonpublic information in the course of their employment and who owe a fiduciary duty to someone other than the issuer not to use the information for their personal benefit. [See the O'Hagan case]

Insider trading investigations are generally started following a public announcement which materially effects the price of the issuer's securities. For example, announcements of proposed tender offers and announcements of significant earnings declines frequently warrant investigations of possible insider trading.

Over the past several years the number of insider trading cases has grown significantly, primarily because of the rise in corporate mergers and acquisitions. Illegal insider trading schemes can generate millions of dollars in illegal profits and often involve trading in numerous "deal" stocks through fictitious names and foreign accounts. Defendants have come from a wide variety of backgrounds and include corporate employees, attorneys, investment bankers, physicians, students, account executives, housewives and others.

The Division has devoted significant resources to combat the rise of illegal insider trading and has achieved impressive results

in a number of well publicized cases. In bringing these cases we seek disgorgement, monetary penalties, expulsion from the securities industry, implementation of required policies and procedures to prevent insider trading, injunctive and other relief. Illegal insider trading continues to threaten the integrity of our markets and we expect to have a significant inventory of insider trading investigations for some time to come.

Through trial and error we have developed various investigative techniques which are particularly well suited for many insider trading investigations. While no two insider trading investigations are exactly alike, we have in the following outline attempted to set forth some of the investigative techniques and considerations which have arisen in recent insider trading investigations.

Insider trading cases typically involve the use of circumstantial evidence to prove that the defendant possessed the subject material nonpublic information. Telephone records frequently provide this circumstantial evidence in "tipping" cases. Whether this type of circumstantial evidence is sufficient often depends upon the credibility of the defendant who denies, under oath, that a tip took place. For this reason, evidence bearing on the credibility of potential defendants is critical. A false exculpatory statement by a defendant in the course of the investigation is frequently the linchpin of a successful investigative strategy.

II. SOURCES OF CASES

A. Informants

1. Anonymous calls
2. Market Professionals
3. Disgruntled employees
4. Competitors

B. Market Surveillance

1. Self Regulatory Organizations [SROs]

SROs provide the SEC with hundreds of reports of suspicious trading each year. In some instances these reports are made by telephone on a virtually real time basis. Frequently, SROs provide detailed written reports of their investigations including back up materials. When pursuing an insider trading investigation referred to us by an SRO it is good practice to contact the SRO staff and

discuss the results of their investigation and request copies of all back up materials.

2. SEC Review of Market Trading

The staff monitors market trading through on line data services and through review of major periodicals. Once a decision is made to pursue an inquiry or investigation, the staff checks the Commission's computerized case tracking system [CATS] and the NRSI system to determine whether any other enforcement personnel are working the matter. The new matter is assigned a MUI number [Matter Under Inquiry] or a case number which alerts staff Commission wide that the matter has been assigned for inquiry/investigation.

III. OBJECTIVES OF INSIDER TRADING INVESTIGATIONS

1. **ESTABLISH "MATERIALITY"**
Generally a price movement of 10% or more
Obtain price/volume trade data
Contact issuer
Review News Releases
2. **IDENTIFY SUSPICIOUS TRADES**
Automated Blue Sheet review
SRO Referrals
3. **IDENTIFY "INSIDERS" AND TRADERS**
Names.dbf
Chronologies
Trades.dbf
4. **ESTABLISH "POSSESSION"**
[CONNECT INSIDERS AND TRADERS]
Interviews
Testimony
Written requests
 circulate list of traders
Daytimers
Rolodexes
Telephone records
Bank Records
Other

5. **ESTABLISH SCIENTER**
 Show Perjury
 Profit sharing
 Payoffs
 Similar acts
 Use of nominee accounts

6. **SET STAGE FOR DISGORGEMENT**
 Profit summaries
 Location of assets

7. **ESTABLISH "DUTY"**
 Employment contracts
 Confidentiality agreements
 Other

IV. **CONDUCTING AN INSIDER TRADING INVESTIGATION**

A. **INVESTIGATIVE STEPS**

1. Analyze Blue Sheets [market trading records]
2. Obtain Chronologies, Itineraries and Other Documents
3. Conduct Interviews
4. Analyze Monthly Account Statements
5. Analyze Telephone Records
6. Analyze Other Documents
7. Chart out Connections Between Insiders & Traders
8. Take Testimony
9. Follow the Money
10. Create and Update "Names" & "Phones" Databases
11. Search Master Databases [CRD etc.]
12. Interact with Others

B. **ISSUES**

1. Time frames to Blue Sheet
2. Percentage of market to Blue Sheet
3. How to analyze Blue Sheets
4. What trades are "suspicious"
5. What telephone records should be obtained
6. How to analyze telephone records
7. How to create/use a "names" database
8. Is emergency relief warranted
9. How to demonstrate equity for emergency relief
10. How to interact with Assistant U.S. Attorneys
 Proffers
 Queen for a Day Sessions
 Cooperating Witnesses
 Search Warrants

11. How to test the credibility of witnesses
12. When and how to contact potential witnesses
13. What information should be revealed

C. **IDENTIFYING SUSPICIOUS TRADES**

The identification of suspicious trades in an investigation is an ongoing process. Trades which may not appear suspicious at the outset can later become suspicious as more evidence is developed. Similarly, trades which initially appear highly suspicious oftentimes turn out to have plausible and innocent explanations.

The process of identifying suspicious trades is part art, part science. Large trades are routinely classified as suspicious. Trades as small as 50 shares can be suspicious if they can be linked to other suspicious trades or to insiders. Any purchase which occurs shortly before a material change in the price of the issuer's securities can be deemed suspicious.

To identify suspicious trades, SRO and Commission staff routinely use the desk top computer to analyze trading records according to various criteria including:

- Size of trade
- Date of trade
- Name of Broker Dealer
- ZipCode of trader
- Registered Representative
- Branch Office
- Age of Account
- Last Name of Account Holders

D. **TELEPHONE INTERVIEWS WITH TRADERS**

1. **Seek Denials and Admissions**

Questions which seek important admissions should be asked even if the witness' prior answers suggest that no admissions will be forthcoming. **Denials are extremely important because they can serve as the predicate for false statement/perjury charges. This is especially true when the issue is knowledge of or communication with any insider or trader.**

2. **When should you start the interview process?**

Telephone interviews of suspicious traders should be conducted as soon as possible.

4. Procedures when interviewing traders

Consider speaker phone and two staffers
Identify yourself and purpose of call
Brief summary of SEC 1662
Ask "ultimate" questions
Do you know [list insiders etc]
Why did you buy
Do you know anyone else who bought
Did you know [the non public info]
Did you recommend the stock to anyone
What documents did you have/rely on
Where did you obtain them
Did anyone recommend/suggest purchase

Remind witness that testimony may still be required.

Ask witness to call you if he 'forgot' to tell you anything

Preserving the record [Memo to files]

Identify participants
Identify phone #s
Identify date, time, duration
Reference SEC 1662
Indicate date record prepared
Confirm with party called:
"My notes will reflect that"

E. DOCUMENT REQUESTS

1. Automated Blue Sheet System

Trading in securities of public companies takes place primarily through registered brokers and dealers who are required to make and keep detailed trading records. These trading records are available to SROs and the staff in computerized format via the automated Blue Sheet system. [The term "Blue Sheet" is an anachronism which refers to the forms which, years ago, the staff used to request trading information from brokerage firms. These forms were blue in color. Hence the phrase "Blue Sheet".] The staff receives Blue Sheet records in hard copy and/or computerized format. We use desktop computers to analyze and keep tract of literally thousands of potentially suspect trades

made available to use through the Automated Blue Sheet System. The operation of the Automated Blue Sheet System is explained in a separate manual.

2. Monthly Account Statements

Monthly account statements contain a detailed listing of the activity in a customer's brokerage account. This includes a listing of all securities trades, deposits and withdrawals. These records are available from the brokerage firm and from customers. The staff reviews monthly account statements to determine whether the identified suspicious trading is, or is not, consistent with the account holder's prior trading. Generally speaking, we review account statements dating back six to 12 months. In this course of this review, we additionally seek to determine whether trading in any other securities is also suspicious. Monthly account statements are also reviewed to assist the staff is tracing the flow of money into and out of the account.

3. Account Opening Documents

Broker dealers are also required to make and keep customer identifying information. This new account information contains the customer's name, address, telephone numbers, employer name, date the account was opened and other information. This information is especially useful when the staff is seeking to discover connections between the account holder and any "insider".

4. Order Tickets

Broker dealers are required to make and keep records of customers' orders for securities and their execution of those orders. These records are called order tickets and are useful in insider trading investigations because they contain time stamps showing the time the order was received. In addition, these records indicate whether the order was solicited or unsolicited. [However, the staff's conclusion as to whether the order was or was not solicited should not be based solely on these records since many firms do not accurately

record this information.] Frequently, time stamps are placed on the back of order tickets. Accordingly, where appropriate, both side of order tickets should be requested. Confirmations are brokerage notices sent to customers confirming the receipt and, where appropriate, execution of customer orders for securities. Confirmations are similar to order tickets but do not contain time stamps.

5. Price Volume Runs

Price Volume Runs show trading volume and price movements in a security over a period of time. We review these records to determine whether there was a suspicious surge in volume prior to a significant public announcement concerning the issuer. In addition, we review these records to assist us in determining which and how much trading we will review. Price volume runs are available from periodicals and various computerized data bases such as the "Bridge" system.

6. Broker Dealer Clearing Sheets

These are records which break out securities trading volume by broker dealer. These records are available from SROs and they assist the staff in determining which broker dealers should be Blue Sheeted.

7. Commission Runs

Commission Runs are broker dealer records which show the amount of commissions paid to account executives. These records are generally computer generated and "break out" commissions by account executive, security, customer etc. We review these records to assist us in determining which account executives were active in a particular security during the relevant periods. In addition, we review these records to assist us in determining whether branch managers and supervisors knew or should have known of suspicious trading.

8. Exception Reports

These are reports of "exceptional" trading activity. Brokerage firms generate the reports as part of their supervisory and management programs. Different firms have different criteria which govern the content of these reports.

9. Section 15(f) [1934 Act] Policies and Procedures

"(f) Every registered broker or dealer shall 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 this title, or the rule or regulations thereunder, of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer. ..."

10. "Deal" Documents

These are the documents which contain the subject material non public information. In requesting these documents, be sure to request all drafts and nonconforming copies.

11. Confidentiality Agreements

Employees of law firms, broker firms, investment banking firms and issuers routinely execute blanket confidentiality agreements with respect to information they receive in the course of their employment. The agreements are obviously most helpful in establishing a duty of trust and confidence with respect to information which may have been used or conveyed in connection with the suspect trading.

12. Personnel Files

Personnel files are extremely useful in establishing connections between insiders and traders. Frequently, these files include personal identifying information such as residential addresses, histories of schools attended, jobs held and telephone numbers. Analysis of this information can uncover connections between insiders and traders. These files are available from a number of sources, including, employers, witnesses, institutional data bases [CRD, NRSI etc.]

13. Analysts' Reports

Traders frequently seek to explain their trading by basing it on analysts' recommendations and/or news articles concerning the issuer. Knowledge of the existence and content of these documents enables the staff to question witnesses thoroughly. These documents are available from issuers, broker dealers, investment advisors, witnesses, news retrieval services, etc.

14. Internal Corporate Accounting Records

Insider trading cases which involve selling into the market prior to public announcement of poor earnings and other negative events will almost always involve the review of internal accounting documents. In requesting these documents it is important to seek nonconforming drafts. In addition, consideration should be given to obtaining copies of the various computerized files utilized in preparing these records.

15. Telephone Records

The value of telephone records in insider trading cases cannot be overstated. In some cases the staff has obtained and analyzed records of over 20,000 telephone calls in order to establish connections between insiders and traders. Computer analysis of telephone records has helped solve many major insider trading cases.

a. Types of Telephone Records

- Directories
- Subscriber information
- Telephone Call Records
 - Long Distance Detail
 - Local Usage Detail [LUDS]
- Telephone message slips
- BD's recordings of customer calls
- Hard Copy records
- Computerized records

b. Sources

Witnesses
Phone Companies
Employers
Hotels
Daytimers
Calendars
Rolodexes
Other

c. Retention Schedules

Telephone companies and others routinely destroy telephone records 18 months after billing date. Care should be taken to subpoena all relevant telephone records on a timely basis.

d. Analysis of Telephone Records

In analyzing telephone records we seek to determine not only connections between insiders and traders, but also other important information including sequence of calls and potential witnesses. In one case for example, the analysis revealed a "third party number" which was called by both the trader and an insider. The staff contacted the third party who happened to be a real estate broker who had brokered a real estate transaction between the trader and the insider. That transaction turned out to be the mechanism by which the trader compensated the insider for an illegal stock tip.

In analyzing telephone call records we use desktop computers to index the records on a variety of "fields" including:

Time of Call
Phone number called
Phone number calling
Subscriber
Putative caller
Putative recipient

The computer can identify calls made to or from certain numbers or subscribers. For example, once a trader and/or insider's phone records have been input into the master data base, we can instantaneously retrieve records of any and all calls between the trader's phone and the insider's phone.

16. Chronologies

The staff routinely requests chronologies from issuers, law firms, investment bankers and tender offerors in order to determine what the material nonpublic information was, when it was created and when various persons had access to it. These chronologies show the locations, dates, times, participants and subject matter of relevant meetings and documents from the inception of discussion of the material event through its public disclosure. Chronologies also contain a listing of the names, addresses and telephone numbers of persons referenced therein. Chronologies are prepared voluntarily in recognition of the fact that the staff can seek to compel production of the requested information through testimony of numerous company employees.

In many investigations the staff creates a master chronology using information from trading records, travel records, daytimers, calendars, telephone and other records. These master chronologies help the staff marshal the evidence for settlement discussions and litigation.

17. Rolodexes, Daytimers, Address Books, Calendars and similar records.

These documents are essential in insider trading investigations. They assist the staff in establishing connections between insiders and traders and they play an important role in the creation of the "names" data base file.

18. Other Records

Depending on the facts and circumstances of the particular investigation, the staff will need to obtain additional records, such as:

- Bank Records
- Wire transfer instructions
- Floor plans
- Photographs of individuals
- Guest Lists
- Passports
- Handwriting samples
- Embarkation forms
- Airplane manifests
- Rental Application forms
- Real estate closing documents
- Building security sign in logs

V. CASES INVOLVING SIGNIFICANT FOREIGN TRADING

A. Need to Consider Emergency Relief

In order to prevent a dissipation of illegal profits, we frequently seek emergency relief when the suspicious trading occurs in a foreign based account. Since these cases usually involve options trades which settle in one day, the need for speed is apparent.

B. What to do

1. Telephone U.S. broker dealer's General Counsel or member of GC's staff.
 - Request identity of account holder
 - Ask to be informed if account holder seeks to withdraw/transfer funds or securities
 - If identity is not disclosed, ask that account holder be contacted and told to contact SEC ASAP [Prepare and fax letter to BD for delivery by fax to the foreign account holder. Letter should stress seriousness of situation, request info re

knowledge of deal, insiders, reasons for trade, voluntary freeze, immediate telephone interview, possibility of TRO]

- Fax letter to BD to memorialize requests [All of these documents will help beef up an essentially bare bones motion for TRO and will show the Judge that we gave account holder every opportunity to explain and respond.]
 - Request Monthly Account Statements
 - Request immediate interview with AE
 - Request immediate "Blue Sheet" data
 - Request new account information
2. Telephone foreign Broker Dealer [Coordinate with our Office of International Affairs]
- [Same as above] + [if appropriate]:
 - Inform foreign Broker Dealer that its failure to identify customer or freeze funds could result in staff conclusion that trade was for benefit of the foreign broker dealer and that it could be named as a defendant in immediate TRO action.
3. Contact your litigation staff
4. Contact issuer [acquiror], investment bank etc.
- Describe situation
 - Request immediate Chronology
 - Discuss draft affidavits describing the existence of confidential, material nonpublic information. Tie events to trading chronology.
 - Request copy of deal documents, relevant SEC filings etc.

6. Alert appropriate HO staff of possible need for emergency Commission action
7. Consider advantages of filing in SDNY

VIII. POSSIBLE VIOLATIONS

Insider trading investigations have uncovered violations of the following provisions of federal law:

- A. Tender offer provisions [§14(e) Rule 14e-3]
- B. Failure to Supervise [§15(b)(4)(E)]
- C. Aiding and Abetting
- D. Policies and Procedures [§15(f)]
- E. Perjury/False statements to Government
- F. Obstruction of Justice
- G. Issuer's Books and Records
[§13(a) Rules 13a-1,11,13]
- H. Broker Dealer's Books and Records [§15]
- I. Reporting of Beneficial Ownership [§13(d)]
- J. Manipulation [§10(b) Rule 10b-5, §9]
- K.. Antifraud §17(a) of the '33 Act