

Responding To FINRA's Insider Trading Inquiries

Law360, New York (April 13, 2012, 1:10 PM ET) -- In 2011, the Financial Industry Regulatory Authority made more referrals (285) for insider trading to the U.S. Securities and Exchange Commission than in any prior year. The referrals came from FINRA's Office of Fraud Detection and Market Intelligence (OFDMI), a high-tech, specialized unit that uses artificial intelligence and dozens of analysts to comb through SEC filings, trading records, press releases and its own database of prior investigations to look for suspicious trading. Pursuant to agreements with numerous self-regulatory organizations, FINRA has responsibility for monitoring insider trading across numerous markets.

Consequently, an increasing number of companies and nonbrokerage firm entities have been receiving inquiry letters from FINRA. In this article we discuss why unregulated recipients should respond to a FINRA inquiry that is essentially "voluntary" to them, and provide a preview of what crafting a response will likely entail.

The Typical FINRA Insider Trading Inquiry

Exactly what triggers a FINRA insider trading inquiry is a closely guarded secret within the OFDMI, but initial inquiry letters are usually prompted by a spike in trading volume in a public company's stock prior to the public announcement of a material event. Such events include mergers, asset purchases, announcement of a major contract announcement, or any event that could move the stock price.

The initial letter from FINRA typically asks for a "chronology" of all events leading up to the public announcement of the event in question. It also asks for an identification of all individuals, both inside and outside the company, who were aware of the event prior to the public announcement and the date on which they became aware. Copies of certain key documents, such as the company's insider trading policy and definitive agreements, may also be requested. FINRA now requires submission through a secure website.

After receiving responses to the initial inquiry, FINRA analysts will compare the information contained in the responses with trading and other data collected by the staff. FINRA knows who traded the stock, through access to "blue sheet" data obtained from clearing firms and other broker-dealers.

Usually, FINRA will send a second inquiry letter, providing a list of individuals and entities (accompanied by a place of residence or principal place of business for ease of identification) and requesting that the recipient circulate the list to employees, officers, directors and others to identify whether they have any current or prior relationships with the individuals and entities on the list.

The letter will probe the nature of that relationship, the frequency of contact and the last contact. Responses to the second letter are incorporated into FINRA's database and increasingly help FINRA identify relationships not just for the security in question, but often as to patterns of trading in several securities, in different markets, and over many years.

FINRA staff may ask detailed follow up about particular communications and relationships; in some cases requesting email or other documents.

Considerations in Responding to An Inquiry Letter

The first step upon receiving an inquiry letter from FINRA will be to determine whether a document hold should be implemented. Another preliminary step will be to evaluate whether any applicable insurance coverage exists that might cover the expenses of responding to the inquiry.

Most recipients of initial FINRA inquiry letters will either be broker-dealers directly regulated by FINRA, or companies listed on exchanges who are required to respond to FINRA requests for inquiry (See, e.g., NASDAQ Rule 55210(a)). However, FINRA also routinely sends inquiry letters to entities over which it does not have power to compel responses. Unlike the SEC or government agencies, FINRA does not

have subpoena power. We believe that those entities under no legal obligation to respond are generally best served by responding to the request.

If the FINRA staff believes that they have a credible lead as to possible insider trading and a firm or individual will not cooperate, it may simply turn its lead over the SEC, inviting the SEC not only to issue a subpoena for the information (and perhaps testimony under oath). The decision not to cooperate may cause negative impressions about the recipient that did not cooperate. In our experience, responding to an SEC subpoena in this context is likely to be substantially more burdensome than complying with the FINRA inquiry.

All individuals dealing with FINRA staff should be respectful, cooperative and professional. The staff's instructions should be closely followed, and if there are problems or difficulties in compiling the response, the staff should be informed promptly. A single, modest extension of the deadline is usually available. Multiple extensions, however, are frowned upon and requests for them should be supported by hardship.

The "chronology" of the events leading up to the public announcement is the centerpiece of the response to the initial inquiry letter. In the case of a business combination that is the subject of a proxy-prospectus, some respondents mistakenly attempt to restate the discussion of events contained in that document, and represent it to be the "chronology." FINRA staff will deem such a bare chronology to be inadequate. Recipients of a request for a chronology should consider the following elements:

- all formal and informal meetings of the board of directors and relevant board committees;
- integration planning meetings;
- outside advisory or industry committee communications;
- meetings with deal counsel;
- meetings with accountants;
- meetings with investment bankers;
- meetings with public relations consultants responsible for issuing and disseminating press releases;
- email communications;
- text messages; and
- knowledge of spouses, assistants or others.

The core purpose of the chronology is to allow FINRA to identify the individuals who were intentionally or inadvertently brought "over the wall" prior to the public announcement. The list will almost always be longer than the official "deal team" list that is traditionally created in connection with a transaction by outside counsel or investment bankers leading the deal.

One way to approach the response is to marry the chronology with the list of individuals who had knowledge. The creation of one is integrally related to the creation of the other. We find it useful to ensure that the first date on which an individual became aware of the event actually appears on the chronology, together with a description of how the individual became aware (meeting, email, conference call, etc.).

Of course, the decision to include email and text message communications in the chronology (and for the purpose of determining which individuals were aware of the event, and when they became aware) might be seen as adding a crippling amount of investigatory resources to an already-expensive project. This, however, is not necessarily the case, and while doing so will always be somewhat more expensive, we believe the benefits outweigh the burdens.

First, as to expense, consider the alternatives. Is it cheaper to deeply interview the myriad employees who could possibly have learned of the event prior to the public announcement, or would it be more efficient to conduct an electronic poll of such individuals, backed up by a computer-aided search of all email during a defined time period (and to the extent possible text messages)?

Neither method is foolproof. Nevertheless, we believe it is appropriate to set aside outdated assumptions about what truly is more expensive in the context of responding to regulatory inquiries. Technological strides made in the area of e-discovery — such as predictive coding and computer-aided electronic

document review — allow investigators to do more with less. The regulators are (or soon will be) using technology to make their investigations more efficient — respondents need to do the same.

Second, the use of email and text messages to inform the chronology provides reasonable assurance that the company is not just relying on the self-serving statements of employees. Passing along false information to FINRA, with knowledge that it likely will be shared with the federal government, could potentially be seen as a violation of 18 U.S.C., Section 1001, depending on the circumstances.

In any event, using electronic communications as a source for the chronology is likely to be far more accurate and precise than human memory and selective responses by employees. If the company is intent on using the chronology to form its own view of whether it or its employees were involved in any aspect of insider trading activity (whether it be evidence of trading, or tipping others who may have traded), then it has a paramount interest in conducting a thorough review of all information reasonable available to it.

Certain aspects of the initial inquiry letter response can prove to be controversial. For example, the letter requests home addresses of individuals. Companies sometimes choose to provide only business addresses, citing either privacy concerns, or a desire to control communications between the authorities and their employees. While these privacy concerns are legitimate, the FINRA investigation is confidential and nonpublic, and the staff will be quick to assure recipients that the information will be used for investigative purposes only. Moreover, the staff has a legitimate need for the home addresses as they permit the staff to infer relationships between individuals based on location of residence. For example, an insider might be providing tips to a neighbor.

Similarly, attorney-client communications are sometimes at the center of a subject transaction or event. Many of the examiners are attorneys, and will not only be sensitive to the assertion of privilege, but should be receptive to creative solutions that will allow for disclosure of information the staff needs without violating or waiving the privilege. Responding to a second inquiry letter raises other potentially difficult decisions. Former employees may be unavailable, and current employees may be reluctant to provide information.

Similar concerns arise when FINRA asks auditors and other third parties that worked for the company on the merger to provide information. A company should consider whether it is appropriate to compel responses from its employees third and parties or leave the responses voluntary. Even when employees respond, the company may wish to ask for more detailed responses. For example, an employee may merely state that one of the identified individuals was a “fraternity brother,” without sufficient detail to make the response meaningful.

As relationships come to light, the recipient may well consider whether to investigate possible connections or patterns to “flesh out” the response, or simply disclose the information provided in response to the polling in its unaltered form. These issues should be evaluated carefully. It is always appropriate to fully and transparently describe to FINRA staff any limitations on the company’s response, such as the company’s decision not to investigate further or followup on statements made by employees in response to the polling, but rather, the practice of passing along the employee’s responses directly as part of the company’s response to the second inquiry letter.

After FINRA’s investigation is complete, the staff will usually present the evidence to the SEC, which will decide whether to initiate an enforcement action. FINRA investigations can be completed in a manner of days (e.g., FINRA may seek to conclude inquiries concerning foreign issuers before the trades settle, in order to keep the funds within the United States), but more typically take several months. Sometimes FINRA will approach the company directly, particularly if it is a company within its direct or indirect jurisdictional purview. If FINRA presents evidence of insider trading to the company, the company will have to evaluate that evidence and decide what, if any, disciplinary or other action to take, either pursuant to its insider trading policies or otherwise.

Conclusion

A FINRA insider trading inquiry letter should not be taken lightly. Even companies that are directly or indirectly under compulsion should usually choose to cooperate. The response process is a challenging endeavor for most companies, but can be accomplished more efficiently by using technology and employing experienced counsel. Knowing what to expect from the beginning is crucial to navigating the process to its appropriate conclusion.

--By Joseph D. Edmondson Jr. and Richard Wallace, Foley & Lardner LLP

This article first appeared in [Law360](#) on April 12, 2012. Reprinted with permission from Portfolio Media.