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INVESTMENT MANAGEMENT

FINRA'S FORAY INTO INSIDER TRADING

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On August 1, 2013, the Department of Market Regulation of the Financial Industry Regulatory Authority, Inc. ("FINRA"), charged a distressed debt trader (the "Trader") at a well-established multibillion-dollar hedge fund manager (the "Investment Adviser") with insider trading.[1] Almost four years later, on March 13, 2017, FINRA's complaint was dismissed by its highest appellate body, the National Adjudicatory Council (the "NAC").[2] The case was brought to the NAC on appeal from a determination, on May 18, 2015, by a panel from FINRA's Office of Hearing Officers (the "OHO Panel") that FINRA's Department of Market Regulation had failed to prove, by a preponderance of the evidence, that the Trader had violated Section 10(b) or Rule 10b-5 of the Securities Exchange Act of 1934, as amended, or FINRA's conduct rules.[3]

FINRA's jurisdictional hook in pursuing the case stemmed from its perceived broad investigative authority under FINRA Rule 8210[4] and the fact that the Trader was "dual-hatted."[5] In addition to his role with the Investment Adviser, the Trader was registered with the affiliated broker-dealer (the "BD Affiliate") of the Investment Adviser. FINRA did not, however, charge the BD Affiliate with corresponding violations of FINRA rules; nor did it charge the Trader for any conduct related to his specific role with the BD Affiliate. Moreover, despite the fact that the Trader was ultimately vindicated, he lost his position at the Investment Adviser, likely incurred substantial legal defense costs, and lived with a dark cloud over his head both personally and professionally during the four-year process.

FINRA's decision to pursue this case through a multiyear appellate process raises significant questions for hedge fund and private equity managers, particularly those that have affiliated broker-dealers, as to FINRA's role in the enforcement landscape for insider trading. Specifically, will FINRA's unmitigated loss in this case deter its pursuit of future insider trading cases, or was this case just a preview of a new enforcement paradigm in which FINRA plays a more prominent role? Additionally, in light of potential budgetary constraints or policy changes at the U.S. Securities and Exchange Commission (the "SEC") under the Trump administration, this case raises these questions: Will FINRA assume a larger role in enforcing the securities laws in the alternative asset management industry whenever it can establish its jurisdiction? Or was this case only a one-off attempt by FINRA to have its moment in the spotlight in the high-profile world of insider trading prosecutions?

Aside from this, what the case fundamentally highlights is the ongoing need for investment managers to provide rigorous training to their staff on their policies, procedures, and best practices relating to the use of email and other methods of communications so they may avoid the pitfalls of the complex web of laws involving insider trading. Investment professionals are tasked with uncovering and analyzing information, understanding the financial and securities markets, and communicating their investment ideas on a daily basis; however, they require an understanding of their supervisory procedures and training as well as communication with compliance staff in order to best understand the ways to conduct their business within the bounds of current law.

Factual Background

In this case, one or more funds managed by the Investment Adviser had acquired a controlling interest in a public company (the "Issuer") through a bankruptcy process pursuant to a loan-to-own strategy. The Investment Adviser had included the Issuer on its restricted trading list because the Investment Adviser had access to material nonpublic information regarding the Issuer. The Trader was the head of the distressed debt trading desk and, in addition to trading, regularly provided portfolio managers and analysts with color on market developments on as many as 100 issuers.

The Trader had a close friend from college (the "Friend") with whom he regularly discussed investment and trading ideas. The Friend worked for a proprietary trading firm that traded equities, and was a member firm of the Philadelphia Stock Exchange.[6] The Trader believed that his conversations with the Friend were helpful in obtaining market color on the equities markets because equities and highyield credit markets trade in a similar manner. In one of their conversations, the Trader informed the Friend that the Investment Adviser had invested in the Issuer's stock. This information was public as a result of SEC filings made by the Investment Adviser in respect of its holdings in the Issuer. The Friend began to do research on the Issuer and, a couple of months later, the Friend purchased shares of the Issuer in both his personal account and his firm's proprietary account.

On April 29, 2011, the Trader received an email forwarded from one of his colleagues who was a credit analyst and also on the board of directors of the Issuer. The forwarded email was from the Issuer's CEO and detailed the timing of the Issuer's upcoming earnings release (but not the earnings numbers themselves) and information regarding a large, new contract awarded to the Issuer that would be disclosed with its earnings. Later that same day, in a conversation covering a number of topics, the Trader informed the Friend of the expected timing of the Issuer's upcoming earnings release and mentioned that "the story should read well." As reported in the NAC decision, the Trader said nothing further regarding the Issuer. Following their discussion, the Friend asked his supervisor if he could purchase additional shares of the Issuer in the firm's proprietary account and his personal account. Despite his supervisor's denial of this request, the Friend purchased more shares of the Issuer in his personal account. On May 4, 2011, the Trader learned that the Friend was "fired" by his firm for disobeying his supervisor's orders not to trade in the Issuer's stock. In July 2011, the Investment Manager accepted the Trader's resignation after he admitted he "may" have violated the Investment Manager's policies regarding the treatment of confidential and proprietary information. During an internal investigation, the Investment Manager determined that the Trader's disclosure did not harm any clients and did not violate any law, rule, or regulation. Following the Trader's resignation, the BD Affiliate filed the Trader's Form U5, terminating the Trader's FINRA and state registrations with the BD Affiliate. This Form U5 filing (including the disclosed reasons for his termination) is what led FINRA to open an investigation and ultimately file its complaint against the Trader.

Although the Investment Adviser conducted an internal review and concluded that the Trader did not disclose any material, nonpublic, or confidential information, FINRA's Department of Market Regulation filed a complaint in August 2013 against the Trader. In addition to insider trading, the complaint alleged that the Trader had violated the Investment Adviser's policies and procedures because he violated the confidentiality obligations of his employment agreement as well as the affiliated broker-dealer's supervisory and compliance procedures regarding insider trading and disclosing of material, nonpublic information.

Approximately four years after FINRA filed its complaint, the NAC affirmed the determination of the OHO Panel that the information provided by the Trader to his friend was neither material nor nonpublic. The NAC concluded that the information regarding the timing of the Issuer's earnings was publicly available. In addition, the NAC ruled that the Trader's statement regarding the positive story lacked specificity and merely reiterated information that was "fairly obvious" to anyone who followed the Issuer's stock. Put differently, the NAC determined that the information the Trader communicated did not alter the total mix of information that a reasonable investor would consider important in making an investment decision. The NAC dismissed all of the charges alleged by FINRA.

Observations

This is the first case we have seen in the hedge fund industry involving insider trading in which FINRA took a lead prosecutorial role. Interestingly, neither the SEC nor the U.S. Department of Justice ("DOJ") filed any charges against the Trader or the Investment Adviser. We can only speculate that those agencies reached the same conclusions in any investigatory process that the NAC reached in its decision. Following this case, the biggest question for investment managers using the services of dual-hatted professionals is this: Going forward, what role will FINRA play in the enforcement of insider trading laws and any other areas in which it will seek to claim jurisdiction? It is unclear whether FINRA could be asked to take on more enforcement responsibility and oversight of investment managers if the SEC's enforcement program is reined in, or the SEC's budget is reduced by the Trump administration; based on this case, FINRA seems ready, willing, and able to take a more prominent role in insider trading. It also seems to be continuing to push the limits of its authority through Rule 8210.

This case speaks to the importance of the rigorous training of investment professionals on the risks of their oral discussions, emails, text messages, and other forms of communications with people inside and outside their organizations. What may seem to a trader, analyst, or portfolio manager to be regular "market" banter or discussion could lead a regulator down a multiyear path of an investigation, charges, trials, and appeals that is distracting, costly, and personally detrimental to all involved.

It is important that the training and compliance programs of investment advisers continue to emphasize the perils of how a seemingly simple statement such as "the story should read well" could cause a ripple effect of damage to the individual and the reputation of the firm. This case particularly highlights the need for investment advisers with affiliated broker-dealers to not only focus on training related to the insider trading laws but also to help registered representatives of the broker-dealer better understand FINRA's conduct rules and the reach of FINRA's jurisdiction. Once FINRA has begun an investigation of someone at an investment adviser's affiliated broker-dealer, the possibility increases that it may uncover issues at the investment adviser itself, creating the risk of referral of such matters to the SEC or the DOJ for further investigation. While insider trading is far from a new topic in the world of hedge funds and private equity funds, FINRA's zeal in pursuing an ultimately fruitless case should be carefully noted by an industry that will seemingly continue to face significant regulatory pressures in this area of law.

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[1] http://disciplinaryactions.finra.org/Search/ViewDocument/33968

[2] http://www.finra.org/sites/default/files/NAC_2011027926301_Sheerin_031317.pdf

[3] https://www.finra.org/sites/default/files/OHO_Sheerin_20110279263-01_051815.pdf

[4] Broadly, Rule 8210 authorizes FINRA to conduct investigations of its members and requires its members to fully comply with FINRA during the investigation. See http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=3883

[5] For the purposes of this publication, "dual-hatted" refers to an employee of an investment adviser who is simultaneously a registered representative of a broker-dealer affiliated with the investment adviser.

[6] FINRA does not have jurisdiction over member firms of the Philadelphia Stock Exchange and, as a result, could not compel testimony from the Friend.