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Institutions battling insider trading

Market firms are at the frontline of the regulatory battle now being waged by the Financial Services Authority and other enforcement agencies against insider trading. The campaign indicated a growing strictness against the offence, as the agency unsuccessfully attempted to fight off government demands for its closure. Sources in the FSA insist that the fight against insider trading and market abuse will be stepped up, once the enforcement division is subsumed into the Bank of England, following the government's recently announced restructuring.

Tracey McDermott, the head of wholesale in the enforcement division and a deputy to Margaret Cole, the head of enforcement says that information the firm provides assists regulatory best practice and the efficiency of their policing of market behaviour. The division wants firms to report more rather than less and leave the decision whether to undertake the investigation to the authorities.

'The markets are on the front line; they know what is going on, on a day to day basis. However good our monitoring systems are, we are always going to be looking at these things after the event. They may see something strange out there, in relation to this stock; or they may see people who keep coming out on the right side of making deals. We encourage people to share such information with us. Often you can add that information to what we have. Again, it gives you a picture. We encourage people to do this generally, not only for market abuse cases, which have no relationship with the regulator. It is in everybody's interest that the markets are clean.'

McDermott says that the report can either be informal, between the firm's compliance officer and the FSA, or it can take the form of a suspicious transaction report (STR). But the important point is that it adds to the Authority's information base. 'T here is an obligation to submit suspicious transaction reports. The institution must report orders placed that you believe are suspicious. It could be one of your clients buying at the very last minute and then selling out the very next day.

'Without that data we find it difficult to feed into our own analysis and to follow up on our own inquiries. We need to know if the trade that is reported is a buy one or sell, it will not give the same signal as to whether it is suspicious or not. There could be situations where there is not necessarily a trigger for one of those formal reports, but someone might tell us: "I have seen this going on, and I don't really know who is doing it or what it is, but it looks a bit strange." We encourage them to tell us this because obviously we will have a lot of knowledge that they don't have.'

This request for support from the regulated sector comes as the FSA steps up its campaign to bring insider traders to book. This campaign was most visibly demonstrated w hen 143 police, IT experts and financial investigators knocked up members of the City's great and good at the crack of dawn in March, took their computers and relevant documents from their home and dragged them through a painful process of questioning, it would take the blindest or most hardened operator to fail to notice that something had changed in London's treatment of financial crime. When it emerged that the offence which was being investigated was not terrorist financing or drugs money laundering but insider trading, any lingering doubts about London's firmness of resolve would now very quickly be put to bed. The individuals were quickly named as coming from firms as illustrious as Deutsche Bank, Exane BNP Paribas (the French broker) and Moore Capital, a hedge fund. These firms have said they are co-operating with the investigation and they deny participation in any illegality.

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The move was designed to send out a warning that the era of leniency was at an end. Sarah Douglas, a partner at lawyers Irwin Mitchell, says, 'there is a forceful crackdown going on at the moment in relation to commencing insider dealing criminal investigations. This has been going on for a while.'

The view that insider trading has become a particular target of the authorities is confirmed by some recent successful prosecutions of insider traders. For example, earlier in the year, Malcolm Calvert, a former partner of Cazenove, the leading broker, was convicted of five counts of insider dealing and sent to prison. He had made £100,000 on dealing in three stocks involved in takeovers. His accomplice had had cooperated with the authorities. In another case, a young trainee broker at Hoare Govette, Mathew Uberoi, and his father were convicted of insider trading and sent to prison.

Christian Littlewood, a former banker at Kleinwort Benson, and his Singaporean wife were also charged with insider trading. It is believed that a number of further cases are in the pipeline.

The campaign has been signalled by Hector Sants, the head of the FSA, who is set to join the newly restructured Bank of England, as a deputy Governor. Sants has boosted the resources of the division, both financially and in terms of manpower. He has been quoted as saying that market abuse is at the top of his agenda. His comments come as the FSA admits that inside trading is a growing menace. He has said that he actively seeks publicity for the FSA's campaign against market abuse and insider trading. 'We do want publicity. We do want people to be afraid, to say, 'Hold on, maybe I don't want to do this. Maybe the FSA will catch me'.

New figures published from the FSA show that insider trading has risen to its worst level in six years. Of the 144 takeover bids launched in the year to April 2010, the FSA identified 'suspicious activity' before 44 deals. The number has risen by almost a third since 2008. It has not reached these levels since 2004. Insider dealing

As concerns grow about the City's reputation, City firms welcome the FSA's new drive says Simon Morris, a lawyer with CMS Cameron McKenna. 'The FSA is saying: Financial crime is a major threat to the UK market. If the United Kingdom is not viewed as a clean market, it will wreck confidence and we are all losers. The markets welcome this initiative because a clean market is a prosperous market.'

Controlling the flow and possession of information is critical to any system that seeks to guard against Insider trading. Possession of i nformation is should be limited to those who need to know, says McDermott. Moreover, access to information should be restricted to those that need to know it at any one time and access to sensitive information needs to be constantly reviewed, in line with changes in an individual's role of the status of the deal. 'One thing that we have flagged a number of times is just the number of insiders on a transaction. The more people there are, the more risk there is of a leak, whether deliberate or inadvertent. That is really one of the biggest challenges, controlling who really *needs* to know because of their specific role rather than who it might be merely convenient to know. People should also not be kept in the loop for longer than they need to be. You might need someone in at the beginning of a transaction, but then the transaction might change. Then you may not need their particular technical expertise. So do you keep copying them in on stuff or do you take them out again? Apart from practical things like that, you should also think in terms of your support teams, such as IT people. How do you control them? Are they on your inside as well?'

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Peter Haines, who runs a consultancy advising the compliance management in financial institutions, says a large onus falls on the compliance department. 'You need to control the flow of insider information; you need Chinese walls or "information barriers", to prevent the flow of such information; you need watch-lists which will contain that information, and will be highly confidential, and monitors of the watch-list of all stocks on which the firm has information. For example, any unpublished takeover bids being worked on, any rights issues, or bonds or securities will be on a watch-list. These are not circulated within the firm. Many corporate financiers or investment bankers would know individual items on the list, but they would not know the whole thing. Chinese walls include the philosophy of "need to know" - you are not told insider information unless you have a need to know, or if you are involved in the deal. The compliance function alone should have all this information on one list.'

These lists can easily be very extensive, including not merely the names of bankers handling a deal, but also those of lawyers and accountants advising on the deal, managers and directors overseeing the institutions and even the printers handling the prospectus. The task of matching names to (usually quite legitimate) trades is onerous and fraught with complications.

Firms are advised to keep their lists up to date and comprehensive because regulators will demand them when there is a hint of any insider trading, says Haines. Failure to deliver a comprehensive document will attract censure. 'The regulators will want a list of everyone who was aware of a deal, if they see something untoward going on! It is the first scan after spotting something suspicious. They will go to the advisory bank concerned, or the securities firm where they see deals emerging. And they will see who was an insider, who was aware, and they would get that list. It would often include dates of when people were aware of information.'

The heavy hand of the regulator is evident in the quality of documentation they demand, says Chris Bates, a partner at lawyers Clifford Chance. 'We have seen over the last decade much heavier focus on documented policies. This is reinforced by the FSA's increasing use of its Section 166 powers, to appoint skilled persons, to investigate firms at their own expense. This is a remedy that is used quite widely. It effectively requires the firm to appoint an accountant or someone to report to the FSA on the firm's policies, procedures and practices. Reports typically focus on a firm's own policies and the extent to which those are documented. Historically the emphasis is on policies that are visible to the front office; people also ask, about the policy when the matter was 'reported to compliance'?'

Information distribution and sharing is likely to reflect an organisation's structure and internal relationships, says Wolfgang Fabisch, the managing director of b-next, a German compliance software producer. 'W e do not look at one single silo within the bank. We look at the *whole* bank and the compliance officer gets the chance to understand if there is something connected between London, Singapore and Frankfurt. There maybe something going wrong between their security and their bond departments. They need to ask two questions. One, is there a pattern that seems to be suspicious? And two, are one of our key rules being violated? Is there somebody who is working on an M&A transaction, doing his *own* business? Maybe it is for himself, or for friends or family. They really want to understand what is going on.'

Changes in definitions of insider trading and market abuse are yet another challenge for the regulated firm operating in the securities markets. Bates says the FSA is 'pushing out the boundaries of what amounts to price-sensitive information.' He cites the case of two investment managers from Kleinwort Benson who were censured for trading while in position of information about a new issue of debt securities. 'The information didn't appear to be price sensitive in the *classic* sense. In other

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words, it was not likely to cause material change to the price of the securities. Yet it was seen as inside information because it was information that a reasonable investor would have been likely to use as a basis for his investment decision. That is the so-called 'reasonable investor' test. This creates more difficulties for firms managing information, because it is less easy to identify what is relevant for investors, and what is price sensitive to the market.'

Even the best systems are open to abuse, and the employer is likely to be helpless, says McDermott. 'No matter how brilliant your systems of control are, if someone is determined to flout the rules, to act in a dishonest way - as in every other case of fraud - then there is not a lot employers can do to stop it. Employers can certainly make it a lot more difficult, by discouraging it, and making it very clear that when someone does it, it was obvious that they were trying to get round a clear and defined system.'

Background to the crack down

Today's convictions for insider trading have their origins in a change of tack by the FSA made some four years go. That was the time when senior officials in the enforcement area, in particular Hector Sant and Margaret Cole, grew frustrated at the softly softly approach adopted to inside trading and market abuse. The authorities were typically using the remedies provided by the market abuse directive, rather than those of the criminal law. The result was few cases and little scope for the FSA to win publicity.

The Tribunal which handled the case (under the MAD), could only fine the villain, and because the matter was part of an obscure regulatory process, had little deterrence effect. Simon Morris, a lawyer at CMS Cameron McKenna says that, 'the FSA woke up one morning and Margaret Cole actually said: "Yes, we are going to make an effort here". We have got the power to bring criminal prosecutions for insider dealing. That power needs to be used.' Chris Bates of lawyers Clifford Chance, says, 'the FSA is using the criminal route as a tool to pursue its objective of 'credible deterrence', its stated philosophy. It is thought that the administrative regime is not really a sharp enough deterrent. The only thing that people understand is the criminal regime and the threat of imprisonment! The other things we have seen is a focus on raids, powers of searching premises and taking away property. That has shock value, and that is valuable for deterrence.'

The FSA has rethought its approach to using market abuse procedures, says Sarah Douglas. 'The market abuse route was thought to be a quicker way to deal with people, because criminal trials take a long time. They are fraught with difficulties and they are expensive to prosecute and defend. So when the Market Abuse regime was introduced in the Financial Services Act, 2000, the philosophy was that this was a quicker way to deal with market misconduct. It hasn't quite turned out that way for insider dealing. There haven't been that many Market Abuse insider trading cases.'

While the FSA has had a good run of convictions against insider traders, Douglas warns about the difficulty of bringing a criminal case, where the prosecutor has to prove a case to the highest standards of the criminal law. 'It is tricky because insider information can be passed in the street! It can be passed on in ways that are not recorded. And then you have to base it on 'inferences', you have to infer that someone may have had this information, and that someone passed it on. To have a strong inference you have to have other evidence, to create that strong inference. There are ways in which you can see how information is passed: looking at phone records, banking records.

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Sometimes the provider of the informer may be paid for providing it. Seeing patterns of phone calls takes time but it helps you build up a picture.'

A further string was added to the FSA's prosecutorial bow in April 2010 when the authority introduced a 'co-operating witness' regime. McDermott indicates how this work. 'The more sophisticated schemes put maximum distance between the person with the information and the person who ultimately trades. People are quite canny about how they communicate. We only very rarely find a nice email chain, saying 'buy this share, there will be a takeover tomorrow'. So you are often drawing inference from people's conduct, on where they live, do they know each other, do they have social connections, whether phone calls - or contact calls, so you can tell where the call was made.

'All those things can go together to build a very compelling picture, which points in the direction of information having been passed. But clearly none of these things are as strong or as powerful as evidence of standing up and saying: "Yes, I traded because Fred told me, and this is the what and how of what happened". We think that encouraging co-operating witnesses is a very important part of the overall strategy. We are not naïve and believe that it is some kind of magic bullet. We don't expect to have lots of people flooding to tell us things! But even if it helps in one or two cases, it is worth having.'