McINTYRE | LEMON

FINRA Settlement Affirms the Importance and Enforcement of Insider Trading Policies

C. Dirk Peterson
McIntyre & Lemon, PLLC
Washington, DC

A recent FINRA settlement should remind firms of the protective benefits of developing and enforcing robust insider tradin g policies and procedures [*see In the Matter of Brian McGuire,* FINRA Letter of Acceptance, Waiver, and Consent No. 2020067348501 (April 6, 2021)]. Among other things, the federal securities laws expressly require securities and investment advisory firms to establish policies and procedures that are reasonably designed to protect, and to prevent the abuse of, material, non-public information (MNPI) in violation of applicable law. Effective insider-trading policies and procedures, and a strict, no-tolerance enforcement of them, protect firms themselves from becoming implicated in control-person liability and charges of a failure to supervise if an employee abuses MNPI in violation of the federal securities laws.

The particular context of FINRA's settlement centered on personal trading by a research analyst of a prominent investment banking firm. FINRA's investigation focused on the analyst's alleged violations of Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 (and FINRA's corollary antifraud rule), FINRA's business conduct rule, specific conflicts provisions of FINRA's equity-research rule, and provisions of the investment bank's own internal policies and procedures. The analyst, a nearly 10-year veteran of the investment bank, traded in the securities of several companies covered by his research unit while in possession of imminent ratings' upgrades of the company's stock prior to the publication of the research report. He additionally traded in the stock of companies that he individually covered in contravention of recommendations in the research report, in the absence of disclosing that accounts over which he had control were invested in the stock of the company covered by the report, and in violation of the investment bank's prohibition against trading in the stock of companies he covered.

Certain of the analyst's trades triggered the investment bank's market surveillance, which led to locking the trades and preventing trade execution in violation of the firm's internal policies and the antifraud provisions of the federal securities laws. Ultimately, the investment bank immediately terminated its association with the analyst and FINRA opened an investigation leading to this settlement, a permanent bar from the industry for the analyst, and the resulting statutory disqualification of the analyst. Notably, the investment bank was not implicated in the settlement; nor was it subject to findings that it violated the express provisions requiring it to implement policies and procedures reasonably designed to protect, and prevent the abuse of, MNPI.

Indeed, as highlighted below, the investment bank's actions provide useful guidelines on reasonable ways in which securities and investment advisory firms may execute their obligations to protect and to prevent the abuse of MNPI. Highlights of the settlement include:

- Ratings upgrades and recommendations in a research report are material and non-public information before their imminent publication, and frontrunning the report to trade on the basis of the report's recommendations is impermissible insider trading.

- A strict, no tolerance enforcement of a firm's policies and procedures, particularly in the context of insider trading, are viewed favorably, inasmuch as the investment bank immediately terminated the analyst upon discovering trades in violation of its internal policies and procedures.

- Policies that proscribe trading on the basis of MNPI, that identify MNPI in the context of the relevant business of the firm, and that mitigate or eliminate conflicts of interest, such as in the case here by prohibiting any trading in securities covered by the research analyst, are reasonably designed to comply with the federal securities laws and can protect a firm from control-person liability and resulting compliance and reputational risks, even if an associated person of the firm is accused of violating applicable law and the firm's own internal policies.

- A sophisticated system of market surveillance is an important component of insider trading policies and is essential to their enforcement, inasmuch as the investment bank's policies here imposed size and volume limits that discovered violative trades and prevented transactions in securities on the basis of the analyst's possession of MNPI.

FINRA's settlement is a reminder that regulators continue to bring insider trading enforcement actions. Although investment advisory firms are not subject to FINRA's authority, FINRA's research rules and enforcement actions provide effective guidelines useful for all organizations in administering required insider trading policies and procedures. Implicit in this particular settlement is that effective insider trading policies and strict enforcement are keys to protecting securities and investment advisory firms from compliance and reputational risk.

Do not hesitate to contact C. Dirk Peterson at (202) 659-3905 with any follow up or questions concerning insider trading compliance programs.

MCINTYRE | LEMON

C. Dirk Peterson

OF COUNSEL

202-659-3905

202-296-4202

dpeterson@mcintyrelf.com