

DATE: January 7, 1998

TO: Members and Member Firms

FROM: Department of Market Regulation

RE: Insider Trading

**\*\*\*\*\*KEY POINTS\*\*\*\*\***

- ◆ **Insider Trading is fraudulent conduct.**
- ◆ **CBOE conducts surveillance for Insider Trading in options to protect its markets, members and customers.**
- ◆ **Swift detection of unusual activity can result in immediate referrals to the U.S. Securities and Exchange Commission (SEC) for further action.**
- ◆ **Although the process is lengthy, courts can order ill gotten profits be disgorged and restitution made to harmed parties through SEC action.**
- ◆ **Disgorgement plans vary greatly and may not include all parties who consider themselves harmed by the trades.**
- ◆ **You may obtain private counsel to take action separate from that of the SEC. However, this may be costly and not result in additional awards. A list of lawyers specializing in securities law may be obtained from the Chicago Bar Association Lawyer Referral Service (312) 554-2001 or you may wish to contact the American Bar Association (312) 988-5000 or visit their Website at [abanet.org](http://abanet.org).**
- ◆ **Contact Susan Saran at (312) 786-7784 or Pat Sizemore at (312) 786-7752 of the Department of Market Regulation to report unusual activity or obtain additional information.**

## **INTRODUCTION**

The Regulatory Services Division expends considerable resources in the review of trading activity for the purpose of detecting possible instances of “insider trading”. Detection and deterrence of such conduct is a high priority for the Division as trading in options with inside information is extremely detrimental to market participants and particularly to Exchange members responsible for keeping markets fair and orderly.

This circular provides a brief explanation and background concerning the regulatory process as it relates to insider trading and provides guidance to market makers who may wish to seek restitution or other remedies.

## **PURPOSE OF INSIDER TRADING REVIEWS**

Insider Trading reviews are conducted by the Department of Market Regulation to detect option trading activity that may have been predicated upon access to material non-public corporate or industry information. Such information is commonly derived from the issuer of the security, and misuse of such information is a violation of Section 10 of the 1934 Act, specifically Rule 10b-5, Section 14e, The Insider Trading Sanctions Act of 1984 and the Insider Trading and Securities Fraud Enforcement Act of 1988. In addition, if the transactions were effected by accounts under the jurisdiction of the CBOE a violation of Exchange Rules 4.1 and 4.2 may have occurred. The detection and successful prosecution of insider traders serves as a deterrent to this conduct by others and in some cases results in restitution to harmed parties.

## **BACKGROUND**

In 1987, in an effort to strengthen the Insider Trading Detection Programs at all U. S. securities exchanges and the NASD, Self Regulatory Organizations (SROs) adopted the “SEC/ISG<sup>1</sup> Insider Trading Initiatives”. Basically, the initiatives set the framework for the initiation and investigative process to detect and refer insider trading activity to the appropriate regulatory authority.

The “Initiatives” as well as the Coordinated Investigative Procedures which are part of the ISG Agreement, govern the coordination of investigations across marketplaces. Each SRO is responsible for investigating the activity occurring in its own marketplace and by its members.

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<sup>1</sup>The Intermarket Surveillance Group (ISG) is composed of 24 U.S. and Foreign exchanges and provides the framework for the sharing of information and the coordination of regulatory efforts among market centers.

However, in multiply traded option classes the exchange with the majority of market share at the time of the news announcement generally conducts the investigation for all interested option exchanges.

**As an SRO, the CBOE has jurisdiction over its members and associated persons, but not public customers.** At any time during the course of an insider trading investigation an exchange can make a referral of unusual activity effected by public customers to the U. S. Securities and Exchange Commission (SEC or Commission) for further investigation. Often referrals of suspicious accounts are made to the SEC within 24 hours of the unusual activity. The SEC may use this information to seek court orders to freeze assets or restrict the activities in certain accounts. This immediate action may serve to preserve potentially ill gotten gains for redistribution pursuant to a court ordered disgorgement plan, upon formal resolution of the matter. In addition to SEC action, activity effected by a member of the CBOE will be referred to the Exchange's Business Conduct Committee (BCC) for disciplinary action. Further information regarding the regulatory structure of the CBOE may be found in the pamphlet entitled "CBOE's Regulatory and Disciplinary Process" available from the Regulatory Services Division or the Legal Division.

After an SRO referral, the SEC investigates the matter and determines whether to pursue or recommend that the file be closed due to a lack of evidence of wrongdoing. In cases the SEC has successfully litigated in federal court, a district judge **may** order that illegally obtained profits/losses avoided, be disgorged by the defendant(s). The SEC then proposes a plan of disciplinary action which is submitted for the court's approval, and may involve payment of such funds to parties who

have suffered monetary loss as a result of the defendants actions. Generally, the SEC contacts the Exchange, to assist in identifying the participants of the trades that meet the requirements of the plan, and makes every effort to notify members that a plan has been published for comment.

Examples of the disgorgement process are available through the Department of Market Regulation.

## **WHAT YOU CAN DO**

In the course of market making activity CBOE members may feel they have been unfairly placed in a disadvantageous financial position by other market participants who may have had access to material non-public information.

If you believe option activity based on material non-public information has occurred preceding a news announcement or market event you may consider all of the following actions:

- ◆ Complete an Order Book Official Unusual Activity Report detailing the activity.
- ◆ Contact the Insider Trading Area of the Department of Market Regulation at 312-786-7784.
- ◆ Hire private counsel to take action separate from that of the SEC.

### **CBOE ASSISTANCE**

At your request the Insider Trading Detection Area of the Department of Market Regulation will assist you in compiling necessary documents. We can provide you with computer generated reports of Exchange records detailing your stock and option activity for a specified time period; a news packet containing relevant news announcements; a recap of total option volume, open interest and option pricing; and stock price and volume information. The Exchange **cannot** provide you with the identity of the customer accounts trading, any information supplied by the corporation or another SRO or the SEC as it relates to the news announcement, or with legal advice.

The Department of Market Regulation's commitment to its Insider Trading Detection Program has been commended on numerous occasions by the SEC Enforcement staff as well as the SEC's Office of Compliance, Inspections and Examinations. The Department continues to strive to make improvements to the efficiency of this area. Should you have any questions regarding this memo or would like to talk about unusual option activity preceding a news announcement please feel free to contact Pat Sizemore at (312) 786-7752 or Susan Saran at (312) 786-7784.