IFC Review

Due Diligence - Insider Trading

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For me, the gimlet eyed investigator, it is getting to the point that one cannot trade on any information that is either not already public, or that comes from an ephemeral fiscal itch to invest. I understand the issue: by the time the ‘market information’ is made public the sentiment of that information is already included into the price of the issue.

Any research done by interviewing employees, customers or vendors risks smelling of insider information, especially if you choose to *tip* for the information gathered. Thus, any unique information we trade upon, other than the all too common ephemeral fiscal itch, risks establishing patterns. The more powerful the possessors of this information believe the information to be, the swifter the action, the greater the investor’s commitment and the more likely the investor will share this information.

The information is often shared for one of three reasons: to pay off a debt; ego/altruism to show others how smart they are; or if they generate enough fervor – then the additional participants to the sentiment will bolster the investor’s position. I find the last reason, becoming a tawdry tout to better one’s lot, to be far and away the most common.

So what patterns can be seen by the market monitors for different types of mischief?

• Accumulation of a position and manipulation.

The accumulation of a position could be as part of a takeover, a general belief in the company by investors, or an activist situation trader, among many others reasons.

The first is that a pro will make the issue look weak with a flood of sell orders, shorts and or puts purchased – it's a way to wipe off the little guys and buy as they liquidate their positions. Often key levels of technical support are targets with the accumulators buys just on the other side of that technical support. By breaching the support the pro triggers a number of sell stop loss orders.

The pro will also sell a position through several brokers at the same time, literally within minutes, to make it look like a broad sell off of the issue. Quietly, the pro will buy throughout the day twice the position through other brokers. This is done to keep an issue’s price that the pro wishes to accumulate a position, within a price range.

Generally trade volume increases, but just a bit. Larger round lots are traded and volume is much heavier on up days.

Another indicator is the issue regularly closing in the top 60 per cent of the day and or weeks trading range. But the stock is constrained to a range. It is part of discouraging buys and even, hopefully inviting short sellers.

When the position is amassed there is usually a significant writing of puts and call buying concurrent with a drop in volume. Now it’s time for the fortuitous rumours followed by the news stories. All of the shorts the pro invited have to unwind their position as the issues rise, creating even more buying, spiking the price upwards. The pro unloads the issue all the way up. If the position is not fully liquidated the pro will hedge the position by writing calls against the remaining position until liquidated. If this lasts more than a few days, the pro will place huge orders, orders that can be linked to his previous public sentiment that the stock is going to go higher. As the issue trades once the pro has liquidated it is time to take a large short position through the distributed network of accounts and then withdraw the large underlying order. As the buying has dried up – it is an easy risk to assume the price will naturally drop.

• The Quick Tip

The quick tip is where a pro or an amateur gets a stock tip and makes a huge commitment – for them – just prior to a large move or news release. It is a bit like going to the track and a man in a fedora behind a post goes – *"psst, hey bub, need a horse to bet?"*

The news of an event such as losing FDA Certification, the imminent resignation of an officer, a large fine, a significant divestiture, all can get a stock to swing wildly in a few days. This is what the quick tip is all about.

So how are these market manipulations and insider tips spotted by the regulators? Sometimes it is not all that hard, but they have some very sophisticated tools they can use.

An excellent tool is OATS – Order Audit Trail System, from the FINRA site: "Order Audit Trail System (OATS), as an integrated audit trail of order, quote, and trade information for all NMS stocks and OTC equity securities. FINRA uses this audit trail system to recreate events in the life cycle of orders and more completely monitor the trading practices of member firms. Under FINRA Rules 7410 - 7470, FINRA member firms are required to develop a means for electronically capturing and reporting to OATS specific data elements related to the handling or execution of orders, including recording all times of these events in hours, minutes, and seconds, and to synchronize their business clocks." With high frequency traders time and sales will be further parsed down to milliseconds.

These systems also capture information such as the IP addresses of investors who trade electronically through online BD interfaces, account names, account establishment date, etc… The systems output of data is also sifted, sorted and analysed looking for known patterns of mischief, either long term for position accumulations for manipulation or short term spikes.

The analysis is able to catch several accounts working in concert. For example, several Slovakians were buying an issue at the same time (all within two minutes) from 11 different accounts with different beneficial owners from all over the world, yet they all logged in and traded from the same IP address. Go figure! The accounts made over three million in two days and then they liquidated their position, all within one minute – yet again all logged in from the same IP address.

It is the similar trades made from different brokers at similar times that begin to develop a body of evidence that something is happening. It appears to be a concentration of trading from a concentration of brokers and accounts. It may not appear to the analysis immediately – but in time it always leaves its mark. The same IP address is just a clue at the level of this perpetrator's lack of sophistication.

It is a given that the market monitors and regulators are going to review all trades around a significant price move of say three to five per cent over a day or two. In particular they are looking for a position taken just before the event and liquidated just after the event.

Another hallmark of an inside trader is a new account that is opened just prior to the fortuitous trade and closed shortly thereafter. These types of outliers are hallmarks of trading on events as opposed to investing. There is nothing wrong with trading on events, but not with foreknowledge of the events. They are also looking for previous accumulations. It is not just concentrated buying but concentrated selling in the same issue. These are just some of the typically outliers that alert the monitoring process.

Caution Please

I regularly see in my investigations, lawyers and accountants seeing correlations and they assume there is an illegal causation without ever testing the null hypotheses called 'coincidence'. Coincidence is not causality.

They are not alone – I see the same thing occur with scientific researchers. Tons and tons of data is gathered and as soon as they see a trend they assume correlation and causality are the same – without testing the null. Now correlation and causality could very well be the same, but you still have to test for the null to exclude it as a possibility.

What can exacerbate these conclusions is the smaller the sample size the more likely one will find an outlier. The sample size of large trades made at the same time of a large movement is remarkably small. This small sample size means outliers are a near certainty.

What does it mean for us?

More and more of our clients are using structured vehicles for investing or even doing honest accumulations prior to a tender offer. We, as professionals, need to know a bit more about how the manipulators work and how they mask their deeds through legitimate channels. Private clients, private funds, hedge funds, public funds are all very active in the markets these days and can work as individuals or in concert with others.

What are some of the clues to someone inquiring about your services? The first has been the lead questions, often asked before they even understand the nature of the services offered is "Can you open up brokerage accounts for me?" Followed with, "Can I be the manager and not appear on the account anywhere?" Do we get into trouble for what our clients do? Not so much. However, their mischief becomes a serious cost centre in time, talent and treasury.

Lastly, I know of several brokers who have black listed companies with certain agents as these agents, in the broker's experience, have had more mischief-prone clients then the brokers have felt comfortable with.

This due diligence thing is, and will always be, about making informed choices.