Client Alert

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SEC Charges Broker-Dealer for Failure to Protect Against Insider Trading by Employees

By Daniel Nathan and Tiffany Rowe

The Securities and Exchange Commission for the first time brought charges against a broker-dealer for failure to adequately protect against insider trading by its employees. The charges stem from a broker's use of a customer's confidential information to purchase shares in a company being acquired by a private equity firm. (The SEC previously charged the broker with insider trading in a separate action.) The broker-dealer that employed the broker settled charges of violations of the securities laws for failing to adequately establish, maintain, and enforce policies and procedures reasonably designed to prevent insider trading by employees with access to confidential client information.

Since 1988, the federal securities laws have required broker-dealers to establish, maintain, and enforce written policies and procedures, consistent with the nature of their business, to prevent the misuse of material nonpublic information. The policies and procedures must be tailored to the specific circumstances of the business, and broker-dealers (and investment advisers) must not only adopt such procedures but also vigilantly review, update, and enforce them.

As the SEC's settlement order points out, broker-dealers obtain material nonpublic information ("MNPI") in various ways, including through their investment banking business and research operations, or from their customers. These various channels of obtaining MNPI and the risks of potential misuse make monitoring of trading by the firm, its registered representatives, and its customers critical to complying with the supervision requirements.

PROCEDURAL DEFICIENCIES

In its settlement order, the SEC found that the broker-dealer, failed to establish, maintain, and enforce policies and procedures reasonably designed to prevent the misuse of MNPI, specifically, any MNPI obtained from its customers and advisory clients. In 2010, the risk became reality when a registered representative of the firm used information from one of his customers before the information was publicly announced. The representative traded on the basis of that information and also tipped others, including several customers of the broker-dealer.

The SEC found that the principal failure of the firm's procedures occurred when the compliance group reviewed the representative's trading after the public disclosure of the acquisition but did not share information about the trading with other compliance groups in the firm or with senior management.

The SEC faulted the firm's insider trading procedure that required a "look-back" review of trading in employee accounts and in customer and client accounts after announcements that significantly affect the market. Specifically, the firm's written guidance regarding the look-back review procedures was insufficient. Among other things, the firm did not provide appropriate guidance on actions to be taken by employees with respect to:

- Parameters to be considered by the firm’s control group regarding the daily identification of market-moving news stories to identify securities warranting a trading review, and the documentation of work performed on those trading reviews;
- Additional review to be conducted by the control group when it found “red flags” such as profits or losses avoided greater than $5,000, trading by an “insider,” or trades in any accounts in the same branch as an insider;
- The procedure for performing personnel interviews upon identification of “red flags” and for escalating reviews of suspect trading to the control group manager when there was not a “sufficient explanation for the basis of the trade” provided during the review;
- The documentation of the look-back review performed on trading reviews, which made it nearly impossible for firm management to determine whether the firm’s policies and procedures were followed when conducting the reviews.

The SEC also found that the firm’s policies and procedures failed to address how to consider options trading as part of the look-back reviews.

FAILURES TO IMPLEMENT THE POLICIES AND PROCEDURES

The firm also failed to implement the policies and procedures in several ways, according to the Order.

- For a period of 10 months, the compliance department failed to perform reviews in a timely manner of at least 40 instances of suspected insider trading flagged for review;
- The procedures requiring the reviewer to print news stories for the review file was not consistently met and doing so was not an adequate means of ensuring enforcement;
- The requirement that the reviewer contact the branch if any red flags were found was not enforced.

Because the policies and procedures implemented by the broker-dealer did not assign responsibility to particular units and did not address coordination, in the instance of insider trading underlying this action, each of the units failed to:

- Recognize the significance of the indications of insider trading;
- Properly consider those indications; and
- Elevate those indications within their own group or communicate with other groups responsible for surveillance of trading activity.

FAILURE TO DETECT THIS INSIDER TRADING

The SEC found that the compliance officer responsible for the look-back procedure incorrectly concluded, in reviewing the particular trading at issue, that several suspicious factors were not red flags. These included the fact that the broker and his customers had purchased the subject securities within 10 days before the announcement of the acquisition, and that their purchases were the top four positions in those securities across the entire firm. Accordingly, the compliance officer failed to escalate the matter or contact the branch, and closed the review with no findings. Because of that disposition, her supervisors were unaware that the review had been conducted and failed to coordinate with other departments in the firm, including the anti-money laundering group, and the central unit that reviewed trade data, which also had received indications suggesting the misuses of MNPI by the representative in the particular security.

TAKE-AWAYS FROM THIS SEC ACTION

Notably, the SEC did not take issue with the firm's general strategy for preventing the misuse of MNPI. However, the SEC found that the firm's resources and policies and procedures for executing the strategy were deficient, and the implementation of those policies and procedures was lacking. Broker-dealers and investment advisers should review their policies and procedures with the SEC's cautionary findings in mind; as the SEC and FINRA have told the industry repeatedly, review of firms' procedures for preventing insider trading is a top priority.

The potential procedural gaps that firms should look for include:

- The failure to devote sufficient personnel to regular review of trading prior to material public announcements;
- Insufficient communication, cooperation, and assignment of responsibility among groups or units with overlapping responsibility regarding insider trading policies and procedures;
- Inconsistencies in application of policies and procedures; and
- Insufficient guidance to compliance personnel responsible for those policies and procedures. The guidance should be as specific as possible, and those carrying out the policies should be closely supervised.

Firms should carefully address these gaps at all personnel levels and ensure a "tone at the top" that encourages proper protection of MNPI in possession of the broker-dealer and its registered representative and other personnel. Means of doing so include:

- Robust employee education on insider trading laws and standards pertaining to the identification and protection of MNPI and frequent updates and refreshers on these issues;
- Implementing policies and procedures that provide significant guidance on indications of possible insider trading, including examples of varying types of indicators that may present themselves in different ways;
- Specific and consistent documentation of investigations and reviews that are conducted, including a discussion of the methods of review used; and
- Testing the effectiveness of the procedures, including adopting a schedule of "surprise" compliance reviews to ensure that the policies and procedures are being followed and are in fact identifying the risk of trading on MNPI.

CONCLUSION

As stated, regulators have emphasized this area, and if past trends are any indication, they will seek to build on this case by looking for other control systems failures. Indeed, any instance of insider trading by a registered representative is likely to prompt an investigation of any gaps that might have failed to detect it. Firms risk getting swept up in the vortex surrounding prosecution of insider trading. To avoid it, they should ensure that their policies and procedures reflect all of the applicable guidance, and that those policies and procedures are being implemented appropriately.

Contact:

Daniel A. Nathan
(202) 887-1687
dnathan@mofo.com

Tiffany A. Rowe
(202) 887-1682
trowe@mofo.com

Craig D. Martin
(415) 268-7681
cmartin@mofo.com

Randall J. Fons
(303) 592-2257
rfons@mofo.com

Brian Neil Hoffman
(303) 592-2227
bhoffman@mofo.com