



Risk Management Update July 2011

REGULATORY FOCUS: BEST PRACTICES TO COMPLY WITH INSIDER TRADING REGULATIONS

Insider trading activity remains a high priority for the SEC and other regulatory authorities. According to the SEC's website, in 2010, 53 cases were brought by the Commission against individuals and firms, which is a 43% increase from 2009. These cases have involved financial professionals, hedge fund managers, corporate insiders, attorneys and even government employees.

The federal securities laws surrounding insider trading generally seek to prevent any person who has material non-public information from using that information for unfair trading advantage in the securities markets. Investment advisers and broker-dealers are required to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material, non-public information. In one recent case brought against *Janney Montgomery Scott LLC* ("Janney")¹, the SEC stated that this dual registrant had willfully violated Section 15(g) of the Securities Exchange Act of 1934 by not following its own detailed written policies and procedures regarding insider trading and failing to implement controls to help ensure that employees were clearly aware of and understood their responsibilities under the firm's written policies. Importantly, while *Janney* appeared to have the required policies and procedures in place to help prevent insider trading, this SEC action confirms that merely having such policies is not enough, and could result in expensive consequences to a firm. This case serves as an important example of what not to do, and can serve as a guide for what firms should implement to help ensure they have detailed procedures and robust internal controls regarding insider trading which can be maintained and enforced.

Below are some steps and general guidelines for staying compliant with insider trading regulations.

Step One: Knowing the Laws

It is very important for firms to ensure they are knowledgeable of the various rules and regulations they are required to adhere to with respect to the prevention of illegal insider trading. To begin, refer to Section 204A of the Investment Advisers Act of 1940 ("Advisers Act"), which requires investment advisers to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material non-public information. In addition, Section 204A specifies that such policies and procedures must be designed to prevent violations of the Securities Exchange Act of 1934 ("Exchange Act").

Next, refer to the Exchange Act, which extends regulations to the various exchanges and over-the-counter (OTC) market, as well as to certain activities of investment advisers, broker-dealers and other financial institutions. Specifically, Section 15(g) of the Exchange Act requires the

¹ See SEC Release No. 64855 In the Matter of Janney Montgomery Scott, LLC (July 11, 2011).

establishment and sufficient enforcement of extensive written policies and procedures that will prevent the misuse of non-public material information by the firm and its associated persons.

Step Two: Implementing Robust Policies and Procedures

Having written policies and procedures is a firm's first line of defense to preventing insider trading violations. Such policies and procedures should include, at a minimum:

- a. A definition of what constitutes illegal insider trading activities;
- b. An outline of employee responsibilities to prevent the misuse of any type of material non-public information including personal trading activities; and
- c. A requirement that employees escalate and report potential and actual violations of insider trading.

It is important for these policies and procedures to be reasonably designed to prevent violations of federal securities laws and should be customized to the firm's business model. Remember: there generally are no "one size fits all" policies and procedures for financial firms.

Step Three: Enforce Policies and Procedures

As seen in *Janney*, a vital step towards effective enforcement of insider trading policies and procedures is to conduct training on what it is, how it can be prevented, and what the firm expects for safeguarding against insider trading. With this knowledge in hand, firm personnel will be able to more adeptly prevent insider trading from occurring.

There are various methods a firm can use to help enforce its insider trading policies and procedures. Some examples include:

- Requiring all employees to initially read and acknowledge their understanding of the firm's insider trading policies and procedures;
- Reviewing the firm's insider trading policies and procedures in detail with all new hires;
- Establishing a senior management committee to review firm-wide business activities and oversee receipt and distribution of any non-public information;
- Implementing a mandatory training session on insider training for all employees and repeat annually;
- Employing an e-mail surveillance system to capture electronic correspondence (including emails, instant messaging and blackberry correspondence) for supervisory review and detection of potential abuse;
- Limiting access to non-public information and implementing strict internal controls that monitor the receipt and distribution of such information;
- Imposing employee personal trading restrictions for certain securities where the firm may have insider information;
- Performing tests of trades placed by the firm and employees to monitor for potential insider trading activity; and

- Performing periodic gap analyses to help ensure policies and internal controls are adequate to prevent insider trading.

Conclusion

The increased scrutiny by regulators to detect violations of insider trading over the last few years and the cases brought have resulted in a variety of consequences to firms. These consequences include, but are not limited to, publicity of the enforcement cases, monetary fines, asset freezing, civil injunctions, criminal sanctions, and even imprisonment. Therefore, it is imperative that firms proactively take steps to ensure that they both establish and enforce their procedures and internal controls designed to prevent insider trading.

For more information on insider trading, or to learn about how CCLS may be of assistance with evaluating your current insider trading procedures and internal controls, please do not hesitate to contact us at (619) 278-0020.

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