



COMPLIANCE CLARIFIED

Responding To Suspected Insider Trading

The government's continuing probe into allegations of insider trading at hedge fund firms and expert networks has prompted firms to reevaluate compliance programs related to material, nonpublic information. This review should focus not only on whether existing policies and procedures are designed appropriately to prevent insider trading, but also on whether they lead to prompt detection of insider trading and appropriate responses.

The Importance Of Early Detection

With the U.S. Department of Justice and the Securities and Exchange Commission focused on insider trading, firms must respond swiftly to warning signs. Early detection is essential to containing problems, reducing firm liability and avoiding negative publicity. Failure to implement reasonable procedures to detect and respond to wrongdoing exposes firms and their managers to the risk of civil penalties. For example, section 21A of the Securities Exchange Act subjects an employer to liability if it "knew or recklessly disregarded the fact that [an employee] was likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent such act or acts before they occurred."

The SEC also may bring an action for failure to supervise under section 15(e) of the Exchange Act, with respect to broker/dealers, and section 203(e)(6) of the Investment Advisers Act, with respect to investment advisers.

Early detection procedures should focus on monitoring and surveillance while also enabling a prompt response to indications of wrongdoing. Indeed, perhaps the biggest mistake firms make with respect to insider trading is failing to pay attention to warning signs, particularly early on when such signs are likely to be subtle and easy to overlook.

Notify, Preserve, Stop

Upon discovery that a firm employee may have engaged in insider trading, the first step is to notify the firm's general counsel. This allows for the attorney-client privilege to be invoked and puts the firm's handling of the matter under the direction of a senior member of

management with a professional sensitivity to conflicts and other issues.

How promptly and effectively a firm acts to stop violations of federal securities laws and preserve evidence are critical to avoiding or minimizing liability. Counsel must assess whether the suspected conduct is continuing or likely to be repeated, and promptly stop any continued misconduct, which in some situations may include suspending employees or halting trades. At the same time, counsel should move quickly to preserve relevant documents by instructing IT personnel to suspend any routine document deletion, issuing a preservation hold notice to appropriate employees and securing hard drives and other physical evidence.

Investigate

If a preliminary investigation indicates that an employee may have violated insider trading laws, a more thorough investigation usually will be necessary. In many instances, a regulated entity is obligated to conduct such an investigation. Even aside from regulatory requirements, a firm may wish to undertake an internal investigation to be in a position to disclose voluntarily wrongdoing to regulators for the purpose of obtaining cooperation credit.

Firms should consider whether to retain outside counsel or use in-house counsel to conduct the internal investigation. Although using in-house counsel may be more cost efficient and just as effective, outside counsel may be necessary if there are concerns regarding counsel's objectivity or if the matter is likely to attract tough scrutiny from the regulators. The DOJ and the SEC generally prefer for outside counsel to investigate serious violations.

Self-Reporting

The decisions of whether, when and to whom to self-report alleged insider trading by employees can be difficult. At a minimum, the firm should take into account whether the failure to self-report might itself be a regulatory violation. It should consider the incentives to self-report wrongdoing as a result of the various policies set out by the DOJ (for example, the Filip Memo and Federal Sentencing Guidelines) and the Commission (such as the Seaboard Report). The firm also should bear in mind the probability that regulators may learn of the alleged misconduct via other means, such as through their own investigation or through whistleblowers, who now are rewarded handsomely under section 922 of the Dodd-Frank Act.

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