

SEC Fires Another Warning Shot Over Insider Trading Policies and Procedures

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For well over a year, SEC enforcement and examination officials have emphasized the staff's focus on insider trading, particularly by securities industry professionals. This focus has proceeded largely on two fronts. The first involves high-profile cases in which industry employees have been charged with engaging in illegal insider trading. The second takes a more preventative approach to insider trading enforcement, and involves cases against broker-dealers and investment advisers that, even in the absence of actual insider trading, have failed to adopt or enforce insider trading policies and procedures. Although this second line of attack has received less attention in the press, a recent SEC enforcement action against Chanin Capital LLC and its chief compliance officer demonstrates that legal and compliance staff should be paying close attention to the effectiveness of their policies and procedures that are designed to prevent insider trading.

Recent Enforcement History

Over the last 20 years, the SEC has occasionally cited broker-dealers and investment advisers for failing to comply with Section 15(f) of the Securities Exchange Act of 1940 (Exchange Act) and Section 204A of the Investment Advisers Act of 1940 (Advisers Act). Section 15(f) and Section 204A require broker-dealers and investment advisers, respectively, to establish, maintain, and enforce policies and procedures that are "reasonably designed, taking into consideration the nature" of the firm's business, to prevent the misuse of nonpublic information by the firm or its associated persons.

Recent cases such as the SEC's 2006 case against Morgan Stanley, *In re Morgan Stanley & Co.*, Exch. Act Rel. No. 54047 (June 27, 2006), signaled a renewed focus and more aggressive stance regarding these cases. Earlier this year, the SEC also released a Section 21(a) report that warned public pension fund advisers, many of whom are unregulated, of the risks that they take if they do not have adequate compliance policies, procedures, and training regarding insider trading. (For more details, see our LawFlash concerning that topic issued on March 10, 2008:

http://www.morganlewis.com/pubs/Securities_LF_EnforcementSession_10mar08.pdf.)

The *Chanin* Case and "Minimum Standards" for Insider Trading Policies

Last week, the SEC took another seemingly aggressive step in its emphasis on these cases with separate settled enforcement actions against Chanin, a broker-dealer that was acquired by Duff & Phelps in 2006, and its former chief compliance officer, A. Carlos Martinez. (Links to the cases can be found at <http://www.sec.gov/litigation/litreleases/2008/lr20551.htm> and <http://www.sec.gov/litigation/admin/2008/34-57755.pdf>.) The *Chanin* and *Martinez* cases are notable

for three reasons. First, the SEC appears to have cited the broker-dealer for failing to adopt or enforce policies that are viewed by the SEC staff as “minimum standards,” but are not specifically required by the Exchange Act. Second, for what appears to be the first time, the SEC brought charges of aiding and abetting Section 15(f) violations against an employee whose primary job function was to act as the firm’s chief compliance officer.¹ Third, the SEC was critical of the firm’s failure to perform a number of administrative tasks, such as failing to evidence attendance at compliance meetings, a concern for the minutiae not often seen in SEC orders. Based on these alleged failures, the SEC imposed a \$75,000 penalty on Chanin and a \$25,000 penalty on Martinez.

The SEC’s complaint against Chanin alleged that the firm initially failed to establish and then failed to enforce fairly rudimentary policies regarding the misuse of material nonpublic information. The latter allegation is not controversial, as the SEC has long warned that not following existing procedures is just as bad, if not worse, than not having required procedures at all. For example, Chanin was alleged to have failed to enforce policies requiring employees to acknowledge receipt of the firm’s insider trading policies and to preclear securities trades in writing. Chanin also held mandatory training for its associated persons regarding the firm’s insider trading policies, but allegedly did not evidence attendance at these training sessions.

Certain allegations in the SEC’s complaint, however, go beyond the failure to follow existing policies, and appear to mark the first time in the context of Section 15(f) that the SEC has cited a broker-dealer for failing to adopt what the SEC staff views as necessary policies or “minimum standards.” For example, although Chanin required its associated persons to identify their securities trading accounts and provide the firm with duplicate account statements, the SEC appears to have cited Chanin for failing to adopt any procedures that would allow the firm to subsequently identify new accounts.

The SEC’s settled administrative proceeding against Martinez goes even further in implying that a failure to follow what the SEC staff views as “minimum standards” could result in liability under Section 15(f). For example, the SEC found in its settled order that Chanin did not maintain a “watch list or restricted list” of securities as part of its insider trading program. The order against Martinez cited a report issued by the SEC’s Division of Market Regulation (now Trading and Markets) in 1990 in which the Division viewed the “maintenance of watch lists and restricted lists” as “minimum standards” for compliance with Section 15(f). That report, which legal and compliance officers may wish to review again, can be found at <http://www.sec.gov/divisions/marketreg/brokerdealerpolicies.pdf>.

Important Takeaways

Overall, the *Chanin* and *Martinez* cases represent an aggressive step by the SEC on the proactive side of its two-front war against insider trading. By pursuing an action against the chief compliance officer, the SEC is clearly signaling that it will be looking to hold individuals accountable for future misconduct.²

¹ Martinez also served as Chanin’s chief financial officer, but the allegations relate solely to his chief compliance officer duties. Although in the past the SEC has charged persons who served as chief compliance officers with aiding and abetting or causing Section 15(f) violations, those individuals also served as the principal or chief executive officer of the broker-dealer. See *In re Van D. Greenfield and Blue River Capital LLC*, Exch. Act Rel. No. 34-52744 (Nov. 7, 2005).

² The action against Martinez continues the SEC’s recent enforcement efforts against compliance officers for their alleged failure to implement or enforce policies and procedures, even in the absence of underlying misconduct that resulted from that failure. Another recent example is the SEC’s case against the chief compliance officer in *In the Matter of Consulting Services Group, LLC and Joe D. Meals* (Admin. Proc. File No. 3-12863, Oct. 4, 2007) (finding that the firm and Meals failed to adopt and implement a code of ethics as required by Rule 204A-1 under the Advisers Act).

