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EMPLOYER LIABILITY FOR INSIDER TRADING

The recent highly publicized insider trading cases involving hedge funds and their senior executives unmistakably signal a shift by federal regulators toward holding employers liable for the alleged bad acts of their employees. Given this renewed focus on the enforcement of insider trading policies, procedures, and Regulation FD, brokerage firms, investment advisers, and public issuers should be acutely aware of the SEC's statutory weapons for imposing employer liability for securities violations. The authors examine significant SEC enforcement actions and related criminal actions to illustrate the importance of implementing robust compliance systems and conclude with a discussion of best practices to safeguard against such liability.

By Mary P. Hansen and William L. Carr *

The recent indictment of S.A.C. Capital Advisors and three of its internal hedge fund companies sends a clear warning to the financial industry that the U.S. Securities and Exchange Commission and the Department of Justice intend to deal harshly with companies and senior executives who either actively or idly participate in cultivating a corporate culture that encourages professionals to engage in systemic insider trading. Recent enforcement actions emphasize the need for all employers to ensure they have firm internal compliance procedures for policing insider trading and for the dissemination of material nonpublic information. The failure to adopt and enforce written policies and procedures that clearly instruct employees on how to handle high-risk environments or encounters with outside parties can expose employers to great cost.

This article examines the various ways employers, including broker-dealers, investment advisers, and public issuers, may be liable for failing to safeguard adequately against the improper disclosure of material nonpublic information. The article also examines several recent enforcement actions and criminal actions that demonstrate the significant consequences to broker-dealers and investment advisers that do not vigilantly monitor their employees through the creation *and* enforcement of compliance programs. In the final section, the article suggests certain practices that should be considered to detect and deter insider trading.

LIABILITY FOR INADEQUATE POLICIES AND PROCEDURES

Broker-dealers and investment advisers that are registered with the SEC are required by Section 15(g) of the Securities Exchange Act of 1934[1] and Section 204A of the

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[1] Section 15(g) was originally enacted as Section 15(f) of the Insider Trading and Securities Fraud Enforcement Act of 1988.

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Investment Advisers Act of 1940 to establish, maintain, and enforce written policies to prevent the misuse of material nonpublic information by the firm or its associated persons.[2] A company can be held liable under Section 15(g) or Section 204A if an SEC investigation or compliance examination concludes that the company's policies and procedures are deficient, even in the absence of any allegation that insider trading actually occurred.[3] Moreover, recent enforcement actions demonstrate that the mere establishment of policies and procedures alone is not sufficient to prevent the misuse of material nonpublic information. Compliance units must be cognizant of the need to tailor their policies narrowly to the specific activities of the individual firm, particularly as their businesses evolve, and must ensure that such policies are vigorously enforced.

The administrative proceeding brought by the SEC against Goldman, Sachs & Co. provides a noteworthy example of a broker-dealer compliance program that the SEC believed failed to account for potential risks associated with a new program.[4] In this action, the SEC alleged that Goldman lacked adequate policies and procedures to address the risk that the firm's research analysts were sharing material nonpublic information about upcoming research changes in weekly "huddles." Huddles were a practice in which Goldman's research analysts met with firm traders, and sometimes salespersons, to provide their best trading ideas, which were later passed on to a select group of Goldman's top clients. The SEC alleged that although Goldman had existing policies and procedures in place, the company did not establish a specific written policy or procedure concerning the huddle program. Moreover, the SEC alleged that Goldman's existing policies and procedures did not provide adequate controls to monitor the misuse of material nonpublic information during huddles, given the significant number of procedural breakdowns, such as the absence of compliance personnel at many of the huddle meetings, the failure to define what could be disclosed at the meetings without broad dissemination to all of the firm's clients, and the failure to implement a surveillance procedure to identify when an analyst prematurely disclosed material nonpublic information, such as a stock rating change, during the huddle meeting.

Based on the foregoing deficiencies, the SEC's conclusion was that Goldman's failure to reevaluate its policies and procedures to ensure proper surveillance of new programs and services amounted to a violation of Section 15(g) of the Exchange Act. Without litigating the issues, and without admitting or denying the SEC's allegations, Goldman agreed to settle with the SEC and undertook to complete a comprehensive review of its policies and procedures, adopt and implement written policies and procedures consistent with the findings of the SEC's order, and pay a $22 million penalty.

The SEC's civil action against Friedman, Billings, Ramsey & Co. ("FBR") also emphasizes the principle that insider trading policies must be flexible and adaptive to evolving business, rather than static rules shaped by the company's primary — or old — lines of work.[5] In this settled action against FBR, the SEC alleged that the company's insider trading policies and procedures were not appropriately tailored to the nature of its new business in connection with the CompuDyne PIPE offering.[6] At the time of the PIPE offering, FBR neither had nor adopted procedures relating specifically to maintaining the confidentiality of information received in the context of PIPE offerings. The SEC claimed that this deficiency in FBR's policies and procedures contributed to its misuse of material nonpublic information. In particular, FBR improperly traded CompuDyne securities in its market-making account based on material confidential information regarding the PIPE offering. In settling the civil action

footnote continued from previous page…

The provision was renumbered by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

[2] These provisions were enacted as part of the Insider Trading and Securities Fraud Enforcement Act of 1988.

[3] *See, e.g.*, *In the Matter of Morgan Stanley & Co.*, Exchange Act Rel. No. 54047 (June 27, 2006); *In re Gabelli & Co.*, Exchange Act Rel. No. 35057 (Dec. 8, 1994).

[4] *In the Matter of Goldman, Sachs & Co.*, Exchange Act Rel. No. 66791 (Apr. 12, 2012).

[5] *SEC v. Friedman, Billings, Ramsey & Co.*, Civil Action No. 06-cv-02160 (D.D.C. Dec. 20, 2006) (complaint).

[6] The SEC defined "PIPE" as a "private investment in public equity." *Id.* ¶ 20. In a PIPE offering, a placement agent or underwriter privately places restricted securities of a public company with investors meeting certain criteria.

without admitting or denying the SEC's allegations, FBR agreed to the entry of a final judgment enjoining it from future violations, and requiring it to disgorge unlawful profits and to pay a civil penalty. FBR also agreed to hire an independent consultant to revise its policies and procedures.[7]

Compliance personnel must also ensure that the company's insider trading policies and procedures take into consideration the risks associated with using outside consultants, contractors, and other resources for specialized expertise. In an administrative proceeding against Massachusetts Financial Services Company ("MFS"), the SEC alleged that the company failed to prevent the misuse of material nonpublic information when a portfolio manager purchased $65 million par value of U.S. Treasury 30-year bonds after receiving material nonpublic information that the Treasury Department was about to announce the suspension of such bonds.[8] The SEC further alleged that the portfolio manager received this confidential information from a political consultant hired by MFS. While MFS had an existing policy on the misuse of material nonpublic information — including that "insiders" could include accountants, lawyers, investment bankers, and consultants — such policy did not discuss the use of consultants by MFS or the handling of information obtained from consultants. The SEC ultimately concluded, "[T]aking into consideration MFS' . . . regular use of paid consultants for their knowledge, contacts, and information concerning the federal Government, as well as MFS' significant investments in Government-issued debt securities, MFS' policies were not reasonably designed to prevent the misuse of material non-public information."[9] MFS settled with the SEC without litigating and without admitting or denying any of the SEC's allegations, agreed to complete a comprehensive review of its policies and procedures, and paid a civil penalty of $200,000.

Even when compliance programs may be firmly in place, broker-dealers and investment advisers must still ensure that such policies and procedures are unconditionally enforced. In July 2011, the SEC initiated proceedings against Janney Montgomery Scott LLC, a dually registered brokerage firm and investment adviser, for failing to maintain and enforce its insider trading policy.[10] The SEC's allegations focused on monitoring the trading of securities on the firm's "watch list," enforcement of restrictions on contacts between research staff and investment bankers, enforcement of policies on preclearance of personal trades, and reviews of accounts of associated persons. The SEC alleged that employees and managers did not understand their responsibilities or what policies actually were in place because, in some instances, Janney did not enforce the policies and procedures as written. The SEC also alleged Janney's existing insider trading policies were deficient, as they were incomplete in that they did not take into account the fact that research analysts began to work closely with investment bankers on new business opportunities. Without litigating and without admitting or denying the SEC's charges, Janney agreed to pay an $850,000 civil monetary penalty and to a censure. In addition, Janney agreed to hire an independent compliance consultant to assist the firm in undertaking remedial measures.

CONTROL PERSON LIABILITY

The federal securities laws provide the SEC and the Department of Justice with additional statutory weapons to pursue enforcement actions against employers for their employees' alleged bad acts. With respect to broker-dealers and investment advisers, Section 21A of the Exchange Act authorizes the SEC to seek civil penalties from a controlling person when it can prove that such person (1) "knew or recklessly disregarded the fact that such controlled person 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" or (2) "knowingly or recklessly failed to establish, maintain, or enforce a policy or procedure required [by Section 15(g) or Section 204A] and such failure substantially contributed to or permitted the occurrence of the act or acts constituting the violation." In such cases, the SEC may seek imposition of civil penalties on the controlling person of the greater of $1 million or up to three times the amount of the profit made or loss avoided by such trading.

Section 20(a) of the Exchange Act provides another mechanism by which brokerage firms, investment advisers, and public issuers may potentially face the wide reach of controlling-person liability. Section 20(a) provides that one who "controls" a person liable under another provision of the Exchange Act is liable to the same extent as the controlled person — i.e., the employee. The SEC may establish control by showing that the person had "the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."[11] A controlling person may avoid joint and several liability if the controlling person "acted in good faith and did not

[7] Press Release, *SEC Files Settled Enforcement Action Against Broker-Dealer Friedman, Billings, Ramsey & Co, Inc.* (Dec. 20, 2006), *available at* https://www.sec.gov/news/press/2006/2006-214.htm; *In the Matter of Friedman, Billings, Ramsey & Co.*, Exchange Act Rel. No. 55105 (Jan. 12, 2007).

[8] *In the Matter of Mass. Fin. Servs. Co.*, Advisers Act Rel. No. 2165 (Sept. 4, 2003).

[9] *Supra* note 8.

[10] *In the Matter of Janney Montgomery Scott LLC*, Exchange Act Rel. No. 64855 (July 11, 2011).

[11] 17 C.F.R. § 240.12b-2.

directly or indirectly induce the act or acts constituting the violation or cause of action." An employer may establish good faith by proving that a proper system of supervision and control was established, maintained, and enforced.[12]

As discussed above, even when a company has implemented policies and procedures to detect and prevent illegal trading, it may still be liable for its employees' misconduct. The most recent "control person liability" cases against CR Intrinsic Investors, LLC and Sigma Capital Management, LLC, both affiliates of S.A.C. Capital Advisors, unmistakably signal federal regulators' willingness to hold companies accountable when their employees violate the federal securities laws in the course of their employment.

In the settled action against CR Intrinsic, the SEC alleged that Matthew Martoma, a former portfolio manager, orchestrated a scheme to obtain material nonpublic information about a clinical trial of an experimental Alzheimer's drug being developed by Elan Corporation, plc, and Wyeth.[13] According to the government, Dr. Sidney Gilman, the physician overseeing the clinical trial, provided confidential information to Martoma on the results of the ongoing clinical trial. The SEC also alleged that Dr. Gilman received a copy of a presentation from Elan summarizing the results of the clinical trial two weeks before those results were to be publicly announced. Although the presentation was marked, "Confidential, Do Not Distribute," Dr. Gilman discussed and shared a copy with Martoma, who later caused several hedge fund portfolios managed by CR Intrinsic and S.A.C. Capital to sell more than $960 million in Elan and Wyeth securities in a little more than a week. The SEC alleged that this "massive repositioning allowed the CR Intrinsic and S.A.C. Capital hedge funds to collectively reap illicit profits and avoid losses."[14] To settle the insider trading charges arising from Martoma's conduct, CR Intrinsic agreed to pay over $600 million — the largest insider trading settlement ever.[15] In addition to settling with the SEC, CR Intrinsic pleaded guilty to wire fraud and securities fraud and agreed to pay a criminal fine of $900 million, to terminate its investment advisory business, to adopt policies and procedures to identify and prevent insider trading, and to retain an independent compliance consultant.[16]

In the related case against Sigma Capital, the SEC brought charges against the company for illegal trading through one of its analysts.[17] The SEC complaint alleged that Jon Horvath, a former analyst, provided Sigma Capital portfolio managers with nonpublic details about quarterly earnings at Dell, Inc. and Nvidia Corporation. On the basis of this confidential information, Sigma Capital portfolio managers executed trades in Dell and Nvidia securities, ultimately generating $6.45 million in gains for its hedge fund affiliates. To settle the charges against the insider trading of its portfolio managers, Sigma Capital agreed to pay nearly $14 million.[18] Like CR Intrinsic, Sigma Capital also pleaded guilty to wire fraud and securities fraud.

While the SEC has not yet sought to hold a public issuer liable under Section 20(a) for an employee's trading, public issuers should be cognizant of the potential liability. Section 20(a) imposes liability on "controlling persons" — which includes public issuers — for failing to take appropriate steps to prevent or detect securities law violations committed by people who work for them. Accordingly, it is just as important for public issuers to establish adequate policies and procedures as it is for broker-dealers and investment advisers.

LIABILITY FOR FAILING TO SUPERVISE

Brokerage firms and investment advisers may also face liability for failing to supervise their employees. Most recently, the SEC charged global investment bank and brokerage firm Jefferies LLC with failing to supervise employees on its mortgage-backed securities desk who

[12] In *SEC v. Lum's, Inc.*, 365 F. Supp. 1046, 1065-66 (S.D.N.Y. 1973), the court found in favor of Lehman Brothers where a fairly robust training program was in place at the time the salesperson traded on the basis of material nonpublic information. While the court acknowledged that "the issue [was] close," it reasoned that the firm had no actual or constructive notice that the confidential information would be passed along and traded on, had no reason to distrust the salesperson's judgment, and did not book the trade in question. *But cf. SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1473 (2d Cir. 1996) (rejecting good-faith defense where the controlling person ignored "red flags" and there were a significant number of breakdowns in the insider trading policies and procedures).

[13] *SEC v. CR Intrinsic Investors, LLC*, No. 12-cv-8466 (S.D.N.Y. Mar. 15, 2013) (amended complaint) ("CR Intrinsic Complaint").

[14] CR Intrinsic Compl. ¶ 4.

[15] Press Release, *CR Intrinsic Agrees to Pay More than $600 Million in Largest-Ever Settlement for Insider Trading Case* (Mar. 15, 2013), *available at* http://www.sec.gov/News/Press Release/Detail/PressRelease/1365171513308.

[16] Press Release, *SAC Capital Management Companies Sentenced in Manhattan Federal Court for Insider Trading* (Apr. 10, 2014), *available at* http://www.justice.gov/usao/nys/press releases/April14/SACSentencingPR.php.

[17] *SEC v. Sigma Cap. Mgmt.*, No. 13-cv-1740 (S.D.N.Y. Mar. 15, 2013) (complaint).

[18] Press Release, *District Judge Approves SEC Settlement with Sigma Capital* (Apr. 1, 2013), *available at* http://www.sec.gov/ litigation/litreleases/2013/lr22662.htm.

were lying to customers about pricing, thereby misleading customers about the true amount of profits being earned by the firm in its trading.[19] Jefferies' policy required supervisors to review the electronic communications of traders and salespersons in order to flag any untrue or misleading information provided to customers. The SEC, however, alleged that the policy was not implemented in a way to detect misrepresentations about price. "Had Jefferies better targeted its supervision to the risks faced by its mortgage-backed securities desk, many of the misstatements made by its employees could have been caught."[20] Jefferies agreed to settle, without litigating and without admitting or denying the SEC's allegations, by agreeing to make payments to customers totaling $11 million. The company also agreed to pay a $4.2 million penalty to the SEC and an additional $9.8 million as part of a nonprosecution agreement with the U.S. Attorney's Office. While the Jefferies matter did not involve allegations of insider trading, it demonstrates (1) the importance of having robust supervisory policies and procedures and (2) the potential liability — civil and criminal — that could result from failing to adequately supervise employees.

Senior executives of broker-dealers and investment advisers may also be held liable for failing to supervise employees under their watch. For example, the recent SEC proceeding against hedge fund adviser Steven A. Cohen illustrates the significant ramifications for allegedly ignoring an employee's suspicious trading.[21] In this civil administrative proceeding, the SEC alleges that Cohen failed to spot potential "red flags" that two portfolio managers obtained material nonpublic information about publicly traded companies and traded on the basis of that information. The SEC alleged that Cohen's portfolio managers were required to update him on their stock trading and convey reasons for their trades, and that on at least two occasions, the portfolio managers provided information to Cohen indicating potential access to inside information to support their trading. According to the SEC, the presence of these warning signs should have caused Cohen to scrutinize their activities. Instead, the SEC said, Cohen praised one for his role in the suspicious trading and rewarded the other with a $9 million bonus for his work. The SEC further alleged that Cohen's hedge funds earned profits and avoided losses of more than $275 million as a result of the illegal trades. While the fate of Cohen remains to be seen, this SEC proceeding emphasizes the need for employers to ensure that their policies and procedures are not only firmly in place, but also are enforced from the top down. Furthermore, the enforcement action against Cohen will likely incentivize senior executives to enforce their policies vigorously, as the SEC signals that it will deal harshly with executives when more than isolated wrongdoing is alleged.

[19] *In the Matter of Jefferies LLC,* Exchange Act Rel. No. 71695 (Mar. 12, 2014).

[20] Press Release, *SEC Charges Jefferies LLC With Failing to Supervise Its Mortgage-Backed Securities Desk During Financial Crisis* (Mar. 12, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541108233.

[21] *In the Matter of Steven A. Cohen,* Advisers Rel. No. 3634 (July 19, 2013); *see also* Press Release, *SEC Charges Steven A. Cohen with Failing to Supervise Portfolio Managers and Prevent Insider Trading* (July 19, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539726923.

LIABILITY UNDER REGULATION FD

In 2000, the SEC adopted Regulation Fair Disclosure ("Regulation FD") to address the concern that public issuers were "selectively disclosing" material nonpublic information to groups of investors, such as analysts and institutional investors, prior to releasing the same information publicly.[22] To combat selective disclosure, Regulation FD prohibits public companies or persons acting on their behalf from selectively disclosing material nonpublic information to certain securities professionals or shareholders, if it is reasonably foreseeable that they will trade on that information before it is made available to the general public.[23] Simply put, when the disclosure of material nonpublic information is intentional, distribution of the same information to the public must be made simultaneously. When the disclosure is inadvertent, distribution of the same information to the public must be made promptly afterward.

Focus on Compliance Policies

Like the enforcement actions for failure to establish and enforce insider trading policies, SEC enforcement actions for Regulation FD violations caution that companies must ensure that their compliance policies address selective disclosure to outside parties, as well as provide for prompt corrective action in the event of wrongful disclosure. As demonstrated by recent SEC enforcement actions, a strong internal compliance program plays an important role in SEC charging decisions. For example, in a matter involving American Commercial Lines, Inc. ("ACL"), the SEC charged an ACL employee with aiding and abetting ACL's violation of Regulation FD. The SEC did not,

[22] *See* Final Rule Selective Disclosure and Insider Trading, Sec. Exchange Act Rel. No. 34-43154 (Aug. 10, 2000).

[23] 17 C.F.R. § 243.1000. Regulation FD applies generally to selective disclosures made to persons outside the issuer who is a (1) broker or dealer, or person associated with a broker or dealer or (2) an investment adviser or persons associated with an investment adviser. 17 C.F.R. § 243.1000(b)(1).

however, charge ACL. The employee, acting in his capacity as the company's designated investor relations contact, sent an e-mail from his home on Saturday to eight sell-side analysts updating the company's earning guidance.[24] ACL self-reported the incident and cooperated with the SEC staff's investigation.[25] The SEC publicly acknowledged that it did not file charges against ACL for several reasons, including that (1) "ACL cultivated an environment of compliance by providing training regarding the requirements of Regulation FD and by adopting policies that implemented controls to prevent violations," (2) the employee was solely responsible for the violation and he acted outside the control systems established by ACL to prevent improper disclosures, and (3) when ACL discovered the violation it acted promptly and publicly disclosed the information by filing a Form 8-K with the Commission the same day.[26]

In March 2010, the SEC filed a civil injunctive action against Presstek, Inc., and its former CEO, Edward J. Marino, alleging violations of Regulation FD for the selective disclosure of material nonpublic information by Marino regarding the company's poor financial performance to a managing partner of a registered investment adviser.[27] Within minutes after receiving this information from Marino, the managing partner sold all of the Presstek stock the investment adviser held. Presstek disclosed the updated financial information just after midnight the following day, leading to a 20% drop in its stock price. According to the complaint, Marino was aware of Presstek's internal policy, which the SEC did not allege was inadequate or deficient, that prohibited discussion of nonpublic company information with outside parties. The SEC settled with Presstek for $400,000, pointing to the company's extensive remedial measures, which included the revision of its corporate communications policy, replacement of its management team, and appointment of new independent board members.[28] After litigating for approximately two years, Marino settled with the SEC on a neither admit nor deny basis and agreed to the entry of an order requiring him to pay a civil penalty of $50,000.[29]

Regulation FD in the Age of Social Media

Given the widespread use of technology to disseminate information electronically to investors and the market, the SEC and other federal regulators have expressed concerns regarding issuers using multiple channels of communication to release material information. When the company fails to inform investors of its intention to use different methods of communication, there is an increased risk that investors will not have the opportunity to access material information, thereby creating unfair disclosure.

In 2008, the SEC advised that disclosure made on a corporate website could comply with Regulation FD if the company first established its website as a "recognized channel of distribution."[30] In evaluating a company's recognized distribution channel, the SEC offered a nonexhaustive list of factors, such as whether appropriate notice is given to the market, whether material information is consistently posted to the website in a clear and conspicuous way, and whether market participants actually look to the website to find material information. The common theme throughout the SEC's guidance was making investors, the market, and the media aware of how the company intended to communicate material information, so that these parties know where to look for these disclosures or know what to do to be in a position to receive this information.

More recently, the SEC offered guidance on the application of Regulation FD to disclosures made through social media channels.[31] In July 2012, Reed Hastings, CEO of Netflix, posted a message to his personal Facebook page congratulating company employees on exceeding 1 billion hours of streaming content in the prior month, making it the first month this threshold had been exceeded. Following the post, the SEC commenced an investigation to determine whether Hastings or Netflix violated the federal securities laws. According to a Section 21(a) Report issued by the Commission, the SEC found neither Hastings nor Netflix had previously used Hastings's personal Facebook page to announce company performance and Netflix had not previously informed shareholders that Hastings's Facebook page would be used to disclose information about Netflix.

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[24] *In the Matter of Christopher A. Black*, Exchange Act Rel. No. 60715 (Sept. 24, 2009).

[25] *See SEC Files Settled Regulation FD Charges Against Former Chief Financial Officer* (Sept. 24, 2009), *available at* http://www.sec.gov/litigation/litreleases/2009/lr21222.htm.

[26] *SEC Files Settled Regulation FD Charges Against Former Chief Financial Officer*, Litig. Rel. No. 21222 (Sept. 24, 2009).

[27] *SEC v. Presstek, Inc.*, Case No. 1:10-cv-10406 (D. Mass. Mar. 9, 2010).

[28] Press Release, *SEC Files Regulation FD Charges Against Presstek, Inc. and its Former CFO* (Mar. 9, 2010), *available at* http://www.sec.gov/litigation/litreleases/2010/lr21443.htm.

[29] Press Release, *Former CEO of Presstek, Inc. Settles Regulation FD Charges* (May 15, 2012), *available at* http://www.sec.gov/litigation/litreleases/2012/lr22369.htm.

[30] *Commission Guidance on the Use of Company Web Sites*, Rel. No. 34-58288 (Aug. 7, 2008).

[31] *SEC Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Netflix, Inc. and Reed Hastings*, Exchange Act Rel. No. 69279 (Apr. 2, 2013).

Rather than pursue an enforcement action against Netflix and Hastings for this alleged violation of Regulation FD, however, the SEC used the opportunity to provide guidance to all companies regarding the use of "social media." The SEC clarified that the principles of the SEC's 2008 Guidance apply with equal force to disclosures made through social media. Specifically, the SEC emphasized the issuers' duty to provide notice to investors of the specific channels of communication it will use for the dissemination of material nonpublic information as critical to fair and efficient disclosure. Moreover, the SEC made it clear that "[t]his Report is not aimed at inhibiting corporate communication through evolving social media" and suggested that issuers may use social media channels, such as Facebook and Twitter, to share corporate communications so long as the issuers "examine rigorously the factors indicating whether a particular channel is a recognized channel of distribution for communicating with their investors."

While the SEC's recent guidance does not give any bright-line rules on exactly how companies should handle the electronic landscape of corporate disclosure, the Netflix case serves as a reminder that companies must have in place strong and up-to-date disclosure policies, particularly in light of rapidly changing technology. As companies eagerly compete in marketing their products and touting their market performance to the public, compliance units must be sure senior executives are aware of the company's disclosure policies and that investors know where to look for corporate disclosure of material information.

BEST PRACTICES

As the SEC and the Department of Justice continue to investigate suspicious trading aggressively and to charge individuals with insider trading, companies should ensure that they have taken adequate steps to protect themselves against allegations arising from their employees' misconduct. As discussed above, registered investment advisers and broker-dealers have a statutory duty to put in place policies and procedures designed to prevent the misuse of nonpublic information. In light of the potential to hold entities liable under a "controlling-person" liability theory, however, public issuers must also be cognizant of the fact that their employees could misuse confidential corporate information for their own personal gain. While companies may never be able to prevent employees from engaging in misconduct, it is imperative that they have policies and procedures in place that will help identify and address any breach of company policy as quickly and fully as possible. In particular, companies should consider the following actions.

Narrowly Tailored Policies and Procedures

While most, if not all, broker-dealers, investment advisers, and public companies have some form of general policy prohibiting employees from disclosing confidential information, companies should consider whether their policies adequately address the particular risks associated with the company's business. For example, if a company uses contractors or subcontractors rather than employees to perform services, it is important that the company's policies and procedures extend to those contractors and subcontractors. As another example, if a company receives confidential information from its customers, the company's policies and procedures should be broad enough to encompass not only its confidential information, but also the confidential information of its customers. In addition, it is important that companies periodically review their insider trading policies and procedures, especially as new business opportunities and relationships arise.

Social Media Policies

As directors, executives, and employees of registrants and public companies become increasingly more comfortable with Facebook, Twitter, and the host of other social media platforms available today, registrants and companies should update their policies and procedures to clarify that everyone must take care not to disclose material nonpublic information through social media. Even seemingly innocuous posts about an executive's travel plans or busy schedule may appear suspicious in retrospect. In addition, to the extent that employees include company-related information on social media venues, the company will become responsible for monitoring and possibly preserving those posts. Companies must also insure they have adequate control systems in place that not only prevent improper disclosure, but also promptly detect and respond to such disclosure.

Risks Associated with Expert Networks

In the recent high profile cases, the SEC and the Department of Justice have filed numerous charges involving "expert networks." Some of these cases involved employees of public companies who were also acting as consultants.[32] Public companies may want to consider whether to prohibit their employees and directors from acting as consultants or employees of expert network firms or similar companies. Public companies may also want to include specific clauses in consulting agreements to prohibit consultants from disclosing specific information relating to the company.

Investment advisers and broker-dealers should have specific policies and procedures to ensure employees who use expert network firms do not obtain material nonpublic information. For example, detailed records of calls,

[32] *See, e.g., CR Intrinsic, LLC*, No. 12-cv-8466 (charging hedge fund portfolio manager and the pharmaceutical "consultant" who provided material nonpublic information).

meetings, and information obtained should be maintained. At a minimum, compliance officers should have access to and review these records in connection with their review of trading activity. Investment advisers and broker-dealers may also consider having compliance officers participate in telephone calls or meetings that present a high risk of material nonpublic information being shared.

Information Barriers between Certain Employees/Divisions

Broker-dealers and investment advisers must establish sufficient "information barriers" between departments that are likely to obtain material nonpublic information about public companies and departments responsible for making recommendations to customers or placing trades in funds or proprietary accounts. For example, research analysts should not be permitted to have discussions with investment bankers working with a public company on a merger, acquisition, or other material nonpublic transaction. In the event a research analyst were to meet with an investment banker, the firm should consider appointing a compliance officer to attend the meeting to ensure that no material nonpublic information is discussed.

Trading on Behalf of Funds and/or Proprietary Accounts

Broker-dealers and investment advisers should implement robust compliance review of all trading in all pooled investment vehicles, as well as proprietary accounts, to identify suspicious trading. All instances of suspicious trading and the company's investigation of that trading should be documented. Companies should take care to consider all of the circumstances surrounding the trading and any relationships that the responsible employees have with potential sources of material nonpublic information. Investigations of suspicious activity should not begin and end with a request for the responsible employee's "due diligence" files. In fact, "due diligence" files have long been used to justify trades done while in possession of material nonpublic information. Regulators routinely dismiss even the most comprehensive due diligence files as shams or cover-ups. The company should also review the employee's telephone calls, e-mails, instant messages, and Internet browsing histories.

Monitoring Employee Trading

A robust compliance program at broker-dealers and investment advisers should include active monitoring of employee trading. For accounts maintained internally, regular surveillance and exception reports are paramount in identifying suspicious trades. Firms should actively look for trading ahead of material announcements; trading in stock in which the firm is known to have material nonpublic information; trading in concert with a customer's trades; and similar trading patterns in the same stock by multiple customers. Employees should be prohibited from trading stock in companies about which they may be more likely to have material nonpublic information. For example, a broker should not be permitted to trade or recommend shares of the public company for which his spouse, parent, sibling, or other close family relation serves as an officer or director.

Public issuers should provide clear guidance on limitations on employee trading in the company's stock. Companies should actively remind directors and officers about regular trading "blackout" periods prior to quarterly earnings announcements. A public company should also ensure that the timing of its blackout period coincides with the release of quarterly earnings results to directors and officers. Moreover, public companies should include in its blackout periods all employees who have access to material nonpublic information regarding earnings.

Finally, companies must take appropriate disciplinary action in the event that an employee trades in violation of company policy.

Employee Training

The best policies and procedures will never be effective unless employees are aware of and understand them. Companies should have robust employee training programs with respect to handling confidential information and insider trading. Training should not be limited to new employees. It is equally important to remind employees about policies and procedures, including specific examples of cases brought by the SEC and the Department of Justice, to underscore the seriousness of the conduct and to highlight the potential consequences for employees who engage in unlawful trading or tipping.

CONCLUSION

Brokerage firms, investment advisers, and public issuers should be mindful of the enforcement arsenal available to federal regulators in light of the renewed focus on insider trading cases, including the imposition of sanctions against employers or other "control persons." In particular, all employers must ensure they have robust internal compliance procedures for policing insider trading and for the dissemination of material nonpublic information, because failing to adopt and/or enforce such written policies and procedures increases the risk these employers face. Consideration of the "best practices" identified above — in connection with a specific review of the unique circumstances of the particular brokerage firm, investment adviser, or public issuer — will be a positive step toward avoiding the liabilities discussed in this article. ■