Broker-Dealer/Adviser Sanctioned for Inadequate Insider Trading Procedures

On July 11, 2011, the Securities and Exchange Commission accepted an offer of settlement from Janney Montgomery Scott LLC ("Janney") to settle allegations that Janney willfully violated Section 15(g) of the *Securities Exchange Act of 1934* the ("Exchange Act"), which requires registered brokers and dealers to establish, maintain and enforce written policies and procedures reasonably designed, taking into consideration the nature of such broker's or dealer's business, to prevent the misuse of material nonpublic information by such broker or dealer and certain associates. Without admitting or denying the SEC's findings, Janney consented to the entry of an order instituting administrative and cease-and-desist proceedings pursuant to Sections 15(b) and 21C of the Exchange Act. Pursuant to the Order, Janney will pay a civil penalty of $850,000 and will retain an independent compliance consultant to review Janney's policies and procedures and report to the SEC. Although Janney was sanctioned for violating the Exchange Act, other regulated entities that are required to adopt insider trading procedures, such as registered investment advisers, should expect similar regulatory interest. A copy of the Order can be found here.

The SEC alleged that Janney, which was dually-registered as a broker-dealer and investment adviser, failed to maintain and enforce written policies and procedures that were intended to place a firewall between Janney's equity analysts and their investment advisers to prevent the misuse of material nonpublic information. Among other things, Janney failed to enforce its written protocol for chaperoned meetings between analysts and investment bankers, the firewall intended to prevent email communication between analysts and investment bankers was repeatedly violated, and Janney failed to sufficiently monitor employees' trading activities.

Chaperone Process Not Followed

A written policy manual developed by Janney in 2005 permitted analysts and investment bankers to meet only when chaperoned by a member of the compliance or legal departments. Despite this requirement, a number of unchaperoned contacts between analysts and bankers allegedly occurred. Moreover, after a change in the compliance manager at Janney, the SEC determined that the new compliance manager was allegedly "less rigorous" in his enforcement of the chaperone protocol than the former manager (e.g., the new manager did not take steps to familiarize himself with deals on the watch list or companies in the industry segments that were the topic of the meetings that he chaperoned and failed to create adequate documentation of meetings he was involved with).

In late 2005 and early 2006, Janney began using analysts to assist investment bankers with exploring new investment opportunities, and solicit trading business by attending meetings with institutional salespersons and customers. Although the analysts' role had changed, Janney's policies and procedures were not revised to reflect the new use of analysts. The Order describes an incident where an investment banker who was advising a company during a pending merger had a meeting with an analyst who covered the company. The meeting was held in the presence of a chaperone who was allegedly unaware that Janney was advising the company on the pending merger or that the analyst covered the company. The analyst and banker had another communication, which might not have been chaperoned, and a few business days later the analyst, in a new role attending meetings with salespersons and customers, recommended the company's stock to at least three institutional clients who immediately bought the stock the day before a public announcement of the merger. Also, the Order states that unauthorized employees of Janney, such as the heads of the investment banking and research departments, acted as chaperones at times even though Janney's written

policy continued to state that only a member of the compliance or legal departments could serve as a chaperone. According to the SEC, this alleged failure to adhere to the chaperone procedure posed a danger that material nonpublic information could be misused.

Porous Firewall

Over a several year period, Janney allegedly failed to successfully enforce its email communication firewall procedures, which were intended to prevent analysts and investment bankers from sharing material nonpublic information. Investment bankers were able to breach the firewall and directly email research department employees. Even though the company was aware of the firewall breaches by at least June 2008, the firewall was still allegedly ineffective at preventing breaches as late as 2009.

Failure to Monitor Employees' Trading Activities

Janney maintained a "watch list" of companies that its investment banking group was actively advising and that was used to identify those securities where the potential for insider trading existed, but it allegedly failed in a number of ways to adequately monitor trading in securities of the firms on the watch list.

First, Janney's policies required all employees to maintain their trading accounts at Janney. However, permission was frequently granted for employees to have accounts away from the firm.

Second, while Janney required some employees to obtain pre-clearance prior to trading in securities, investment bankers were able to trade without pre-clearance.

Third, Janney's compliance manual required employees to submit an annual questionnaire and disclosure form disclosing the existence of outside employee accounts. However, in several instances, Janney failed to obtain questionnaires and disclosure forms. Further, Janney failed to request and review account activity even after becoming aware of outside accounts held by employees.

Fourth, Janney's procedures for determining whether improper trading activity occurred allegedly were lacking. Although Janney obtained trading confirmations of certain employees, Janney could not establish that these confirmations were ever compared against the watch list to determine if improper trades had been made. Also, since account statements were not initially obtained, it was difficult to monitor overall trading strategy or trading patterns. When account statements were later obtained, they were analyzed by a supervisor who did not have access to the watch list. Consequently, he was unable to determine if the trades violated company policy.

Lessons Learned

Companies should consider the following lessons:

1. The Janney Order may serve as a stark reminder of at least three practices advisers and broker-dealers should be aware of. First, it is not enough to have an insider trading policy in writing; those procedures must be followed and must be implemented consistently. Second, a firewall to prevent communications between analysts and investment bankers must actually be effective in preventing such communications and companies should promptly rectify firewall problems that allow breaches. Third, policies requiring pre-clearance of securities trades should be enforced with respect to all

employees potentially in possession of material nonpublic information, and companies should follow through on procedures that require the disclosure of trading activity or outside accounts.

2. The SEC can impose severe sanctions against both brokers and advisers for failure to adopt and implement adequate procedures to prevent insider trading, even if there is no insider trading at the firm. Inadequate procedures by themselves can be a sufficient basis for an enforcement action.

3. The Janney case seems to signal a heightened SEC interest in the adequacy of insider trading procedures. The penalty imposed was relatively harsh; the case was accompanied by an SEC press release; and the Order included a list of other cases in which the SEC had sanctioned firms for inadequate insider trading procedures. Brokers and advisers would be well advised to review their insider trading procedures to ensure that they are adequate and are being followed.

ropesgray.com

This alert should not be construed as legal advice or a legal opinion on any specific facts or circumstances. This alert is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. The contents are intended for general informational purposes only, and you are urged to consult your attorney concerning any particular situation and any specific legal question you may have. © 2011 Ropes & Gray LLP

ATTORNEY ADVERTISING