“ Compliance Corner

Insider Trading

Writings on the Wall: Considerations in Designing and Implementing Effective Information Barriers

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In the post-Dodd-Frank world, the Securities and Exchange Commission (the “SEC”) has directed more of its attention to insider trading activities by investment advisers, including those to private funds, and their employees, through the use of the SEC’s enforcement resources and during adviser examinations.[i] As a practical matter, the implementation and enforcement of a comprehensive compliance program is an important defense against potential liability for insider trading. Each component of the adviser’s insider trading compliance program must (i) be reasonably designed to protect against violations of the insider trading proscriptions set forth in the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and the Investment Advisers Act of 1940, as amended (the “Advisers Act”), and (ii) address the adviser’s specific business needs and circumstances. There is no standardized approach to designing a compliance program, and therefore, an adviser’s insider trading policies may include a variety of different measures to protect against the misuse of material, non-public information (“MNPI”). One such measure is a permanent “information barrier” designed to separate and isolate departments or personnel with access to MNPI from those making investment decisions, thereby restricting the flow of information throughout the adviser’s firm. In this article, we highlight some key decision points in crafting well-designed information barriers and additional considerations related to their implementation.

Background

“Insider trading” refers to trading or recommending a trade while in the possession of MNPI in violation of a relationship of trust or confidence or a duty to keep the information confidential. The prohibition against insider trading is derived from the general antifraud provisions under the federal securities laws, found most particularly in Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent practices in connection with the purchase or sale of a security. These prohibitions extend to trading while in possession of MNPI. However, Rule 10b5-1 under the Exchange Act provides an affirmative defense to insider trading liability for an entity that can prove: (i) the individual making the investment decision on behalf of the entity did not know the MNPI and (ii) the entity implemented reasonable policies and procedures designed to prevent insider trading. When used in conjunction with other compliance measures, an effective information barrier may limit the dissemination of MNPI and facilitate a showing that the individual who made the decision to purchase or sell the security did not have knowledge of the MNPI.

Additionally, advisers registered with the SEC are required under Section 204A of the Advisers Act to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI by the adviser and certain of its personnel. The Advisers Act does not describe specific types of policies and procedures that would be considered “reasonably designed” and therefore, sufficient to avoid liability; however, the SEC staff has emphasized that any such policies and procedures must be tailored to the nature and circumstances of the adviser’s business. Beyond liability under the federal securities laws, even the appearance of insider trading poses significant reputational risks for advisers. As such, advisers have numerous legal and other incentives to craft compliance programs designed to prevent insider trading and other misappropriations of confidential information.

The design of policies and procedures does not lend itself to a standardized approach and typically involves a combination of measures to restrict the internal flow of MNPI, including physical segregation of different departments, restricted access to files and computer passwords and the use of code words for discussing sensitive information. Many advisers also may consider implementing information barriers. In the broker-dealer context, the SEC staff has issued guidance summarizing the core elements of an adequate information barrier, as well as items a broker-dealer should consider when administering one.[ii] These include:

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- substantive supervision and control over interdepartmental communications;
- restriction on and review of securities trading;
- well-documented compliance procedures and the actions taken pursuant thereto; and
- increased levels of review or trading restrictions when the firm is in possession of MNPI.

Naturally, the implementation of these components will vary from firm-to-firm. The SEC staff also suggested that, in certain circumstances, an adviser should consider maintaining informational barriers.[iii] Much of the staff's guidance for broker-dealers is relevant to any information barrier designed by an adviser.

Crafting Information Barriers

As is the case with many adviser compliance measures, there is no "one size fits all" approach to designing an effective information barrier. Given this flexibility, advisers likely will face a number of difficult decision points in developing appropriately-tailored informational restrictions, including those discussed below.

Permanent vs. Temporary Barriers

A permanent information barrier may not be appropriate for all advisers in light of their size or the scope of their activities. For instance, more limited informational restrictions may be beneficial in connection with a specific investment that raises novel MNPI concerns only for a prescribed period of time. Here, an adviser may be well served to institute temporary and targeted restrictions that specifically address the high-risk individuals, subjects or scenarios. There are potential trade-offs with this more limited approach, however. For example, establishing a series of particularized barriers may require the adviser's compliance department to engage in more frequent training, monitoring and testing than if the adviser erects from the outset a permanent barrier.

"Above the Wall"

To ensure the integrity of the adviser's information barriers, an adviser typically limits (i) the number of personnel permitted "above the wall" and (ii) the investment discretion afforded to such individuals. A "control group" of compliance personnel are designated as "above the wall" so that they may monitor the flow of information throughout the firm and facilitate "wall crossings" (*i.e.,* permitting otherwise restricted communications). The decision to designate non-compliance personnel, such as a firm's senior professionals, as "above the wall" is trickier. Given the likely pervasive access to MNPI inherent in managing an advisory firm, it may be necessary to place such professionals "above the wall" simply to permit them to do their day jobs. However, an information barrier may not be effective if there is significant overlap across the adviser's operations with respect to the key individuals with access to the greatest volume of MNPI, in which case it would be a business necessity in almost all cases to designate such individuals "above the wall" to provide them with access to the relevant confidential information.[iv]

Categorical Pre-clearance

Another difficult consideration is whether to categorically permit personnel on opposite sides of the information barrier to discuss certain topics or types of information without pre-approval, for instance, macro-level information on industry sectors, geographies and market conditions. Here, there is a tension between maintaining and enforcing effective restrictions and permitting an exchange of ideas that could be beneficial to advisory clients. Relatedly, a control group may determine that recurring issuer/security-specific communications do not require pre-clearance if both sides of the information barrier have the same level of information and trading restrictions for the issuer/security. Notwithstanding these practical realities, the SEC staff does not endorse the use of categorical exclusions from information barriers.[v] Thus, advisers should tread thoughtfully (and perhaps lightly) in this area.

Multiple Purposes

Information barriers may serve numerous regulatory purposes other than preventing insider trading. For instance, firms may establish information barriers to avoid aggregating and matching securities positions with those of affiliates for purposes of certain provisions of Sections 13 and 16 of the Exchange Act.[vi] Firms also may avail themselves of certain exemptions from the requirement to otherwise aggregate commodities interest positions with those positions of certain affiliates.[vii] It is critical that advisers carefully consider the various regulatory risks they intend to address by implementing an information barrier because different regulations may impose more or less stringent compliance obligations. For example, an adviser likely must (i) erect a "higher wall" (*e.g.,* further limit the number of above the wall personnel and wall crossings with respect to particular securities) and (ii) obtain a third-party assessment of the operation of the information barrier to protect against aggregation under Sections 13 and 16.[viii]

Compliance Assistance

Regardless of scope, ensuring compliance with information barriers can be a full-time job for an adviser's compliance personnel. Compliance tasks may include (i) monitoring e-mails, (ii) chaperoning telephone conversations and other discussions and (iii) reviewing documents for inadvertent disclosure of MNPI or other restricted information. Inadequate compliance support to execute these tasks can jeopardize the

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integrity of an information barrier. As such, advisers may consider a range of tools, such as e-mail review software and third-party assistance, to ease the burden on the compliance department.

Practical Tips

In light of the key decision points above, the following items are practical tips an adviser may consider to ensure a well-functioning permanent information barrier that does not overly disrupt the adviser's day-to-day business activities.

Need to Know Principle

Often, it may be difficult to determine the appropriate parameters of an information barrier. An overarching principle in safeguarding and restricting information should be whether particular personnel have a need to know or access information. While it is helpful to restrict MNPI, access to other types of information also could be limited to prevent the appearance of conflicts of interest or other problem areas.

Physical Restrictions

Physical barriers often are the primary mechanism by which advisers restrict access to information. Generally, these include some measure of segregation between personnel with routine or recurrent access to MNPI and those without such access. However, it may not be feasible or practical for every firm to utilize separate offices or floors, or to erect walls or other physical restrictions. In these circumstances, an adviser should avail itself of other tools to ensure appropriate barriers are implemented, including restricted computer access and periodic e-mail monitoring.

Senior Management Buy-In

A critical aspect of any effective compliance program is buy-in from senior management, and information barriers are no different. Management can set a helpful tone by emphasizing the existence and importance of compliance with the firm's information barriers during strategy meetings, when evaluating potential deals and in other firm communications.

Clear Scope of Pre-Clearance Mandate

The control group should provide clear guidance regarding the scope of pre-clearance or approved wall-crossings. Unless otherwise specified in advance, approval to communicate across an information barrier regarding a particular issuer, security, position or scenario typically should be limited to specific, narrowly-defined topics. A lack of clear guidance may create a perception that all communications across the information barrier have been approved.

Document Exceptions

As there is no "one size fits all" approach to crafting an information barrier, there similarly will be situations that may not cleanly fit within the defined boundaries of the barrier. The compliance department should be involved in assessing the applicability of the information barrier to thorny situations and whether to permit exceptions to the policy. In these circumstances, it usually will be beneficial to document the nature of the exception and the reasoning underlying it.

Conclusion

Given the SEC's enhanced focus on insider trading, advisers should think critically about the potential risks associated with free-flowing information throughout their firms. While information barriers may not be appropriate in all cases, a well-crafted information barrier—in conjunction with a robust compliance program and routine monitoring—can provide a level of assurance that a firm is taking seriously the potential risks associated with insider trading and responding appropriately.

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[i] See, *e.g.,* SEC Press Release, "Hedge Fund Manager to Pay $44 Million for Illegal Trading in Chinese Bank Stocks" (Dec. 12, 2012).
[ii] *See* SEC Division of Market Regulation, Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Nonpublic Information (March 1990); SEC Office of Compliance Inspections and Examinations: Staff Summary Report on Examinations of Information Barriers: Broker-Dealer Practices under Section 15(g) of the Securities Exchange Act of 1934 (Sept. 27, 2012) (the "2012 Report"). *See also* NASD/NYSE *Joint Memo on Chinese Wall* Policies and Procedures (1991).
[iii] See *Compliance Alert* (July 7, 2008), *available at* <http://www.sec.gov/about/offices/ocie/complialert0708.htm>.
[iv] Such an approach is not without risk, as the SEC staff recently has highlighted the compliance risks attendant to an above the wall designation. *See* 2012 Report at 18.
[v] *See* 2012 Report at 21.
[vi] *See* SEC Release No. 34-39538 (Jan. 12, 1998) (the "Beneficial Ownership Reporting Release").
[vii] For instance, the Commodity Futures Trading Commission's ("CFTC") "independent account controller" exemption permits affiliates to disaggregate commodities interest positions if they develop and enforce written procedures to preclude the affiliated entities from having knowledge of, gaining access to, or receiving data about, trades of the other. CFTC Rule 150.3.
[viii] *See* Beneficial Ownership Reporting Release at 19-20.

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