



Day Two – Nabarro LLP views

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You are Head of Securities Compliance at Big Bank. You came into the office yesterday evening to find an email from Newby which suggested that Rich Mann, a propriety trader, has been involved in suspect trading activity. Your own initial inquiries raised your suspicions further.

1. Who should you speak to first about what your inquiries have revealed?

The order of volume of responses received from participants is as follows:

- Head of Compliance
- Senior management
- Steve Hart
- Rich Mann
- LSE
- FSA
- General Counsel

The majority of participants decided that the first person(s) they would speak to about Chris Newby's e-mail was the Head of Compliance / Senior Management. This would be a sensible first discussion since it is always important to maintain a high level of confidentiality in the early stages of an investigation. This is for two important reasons. Firstly, because accurate conclusions will still have not been reached and accordingly it would be prejudicial to disclose too broadly any suspicions about an individual's behaviour. Secondly, to the extent suspicions held about individuals ultimately emerge to be true, it will be vital that the relevant individuals are not tipped off about an investigation early on.

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Some participants would commence their enquiries with Rich Mann and we would advise against this or at least recommend that any such conversation should be handled with care to ensure that he is not tipped off about any investigation. In the early stages a natural instinct is to speak to a superior of the relevant individual i.e. Steve Hart or potentially someone in senior management. However, there have been instances of supervisors being complicit with colleagues in perpetrating financial crimes so this should be handled carefully.

Interestingly, many participants noted that their first point of contact (or second following a report to the Head of Compliance) would be the FSA or the LSE. Careful thought should be given prior to talking to regulators and this is explored further below.

We worked on an enforcement case where the first thing Compliance did was discuss the matter with the relevant Line Manager. It subsequently transpired that the Line Manager was as involved in the incident as the initial suspects.

Finally, a few participants commented that they would contact their General Counsel / in-house legal team in the first instance. The primary reason given for this is privilege. Further thought is given to privilege in the context of contacting external lawyers below however, participants should note that privilege will not necessarily apply to all communications you may have with your in-house legal teams.

Regulators?

In any regulatory crisis consideration must ultimately be given to whether and when it is appropriate to inform relevant regulators and in some cases third party service providers such as clearing houses. This will first involve identification of which authorities are likely to be interested: the relevant exchange will almost always want to be notified; the FSA will usually need to be notified, along with other regulatory bodies, including in some cases SOCA and the police. Firms will need to consider what their self-reporting obligations are in each case. Where there is a self-reporting obligation it is usually worded so

We worked with a client who made an early notification to FSA and provided the initial statistical breakdown of the "incident". Further analysis showed the incident to be larger and more widespread than the initial analysis had made it look. The Compliance Officer was initially charged with breach of General Principal 11 for misleading the regulator (although this charge was later dropped).

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as to require immediate reporting of the matter. The FSA expects firms to deal with regulators in an open and cooperative way and to disclose to it, appropriately, anything relating to the firms which the FSA would reasonably expect notice of. However, there will always be a fine balance between the requirement to report and the need to have a good grip on exactly what it is that needs to be reported. On the one hand you don't want to breach your reporting obligations but on the other you need to make sure that when you report you are armed with the right amount of information about what has happened.

In this scenario it is unlikely to be appropriate to notify the FSA at this stage. You are yet to reach significant conclusions about Mann's behaviour. In any event, part of the challenge in reaching those important preliminary conclusions will be to have come to a firm view on whether Mann has committed any wrongdoing, and equally importantly, whether this is solely a case of rogue behaviour and/or whether failures in the firms systems and controls have also played a role and need to be reported.

Insurer?

It is important to give early consideration to whether the facts of the regulatory crisis might give rise to a subsequent insurance claim. This question should be approached with an open mind as not all the relevant facts are likely to be known during the early stages of an investigation.

If a claim is possible, the policy wording should be checked as most insurance policies will contain duties to keep the insurer informed on a full and frank basis of any developments that may affect a claim. Having said that, it will also be important to be able to provide enough information for the insurer to make sense of what has happened. For this reason it would be sensible, in this scenario, to wait until the preliminary investigation has been conducted

When pushed, most clients choose to waive privilege in favour of disclosure to FSA. However, there can be advantages to at least having the right to waive privilege. We have seen FSA, on receipt of version 3 of a report, ask to see copies of versions 1 and 2 in order to check that the report had not been sanitised. Being able to claim privilege may make rebutting such a request possible

Lawyers?

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The investigation of a regulatory crisis will often involve external lawyers. The advantage of doing so is that it will help to preserve privilege in communications about the investigation between the lawyers and the firm.

If Big Bank wishes to maintain privilege over the documents created in the course of the investigation, the structure, methodology and reporting lines of the investigation must be defined appropriately. This is the case whether or not external counsel is instructed. Documents created for or by lawyers will not necessarily be automatically privileged. Accordingly, it is essential that any reports made in the course of the investigation should be written to either obtain or provide legal advice. Internal legal departments may attract privilege to the extent that legal personnel are acting as legal advisers as opposed to acting as business executives.

In this case however, it is likely to be too early to speak to external lawyers until more certain conclusions have been reached.

HR?

Regulatory crises often have an impact on the employment of particular individuals, and to this extent it will usually be the case that HR will need to become involved at some point. However, it is also probably too early in this case to be informing HR because you are yet to reach firm conclusions.

2. What factors are relevant to any preliminary investigation and who should be involved?

No matter who spots a potential issue, a senior and appropriately independent individual within the firm should be nominated to oversee the handling of the crisis. Usually this will be someone in Compliance.

Shortly after identifying the messages described in the scenario, consideration should be given to what regulatory issues might arise. It is not necessary to be certain at this early stage that there has been a definitive breach of the law or regulatory rules – a strong suspicion is enough.

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The main task of a preliminary investigation is to uncover enough information about the suspected regulatory breach to decide whether, and if so what, further action is necessary to handle the crisis. While a more thorough investigation may become necessary, this should usually come later, and in any event can happen concurrently with the multitude of other urgent issues that will need to be dealt with.

The focus of a preliminary investigation should be to identify:

- what the potential regulatory issue(s) are
- who or what is the cause
- what the potential scope of the problem may be

We were involved in a situation where a compliance officer had alerted a senior manager of a problem by email and had cc'd "Operations" because he wanted them to provide further detail. It transpired that a member of the "Operations" team was also involved and was therefore tipped-off at an early stage. This had the potential to prejudice the investigation.

The need for a swift preliminary investigation will be particularly important where a person suspected of deliberately committing the regulatory breach has been tipped off that the firm is aware of their involvement. In this scenario Newby spoke to Mann about the LSE's inquiries, and Mann is aware that his desk head is aware of the issue and that Compliance has become involved. This is likely to put Mann on notice that further action may be afoot. As a result it is imperative that your preliminary investigation is commenced and completed as quickly as possible.

We had a range of responses on who should be involved in a preliminary investigation. These varied from involving just Mann, Hart and you as the Head of Securities Compliance to involving affected buyers, the other market participant and all desk staff plus external contacts.

In our view only a few individuals should be aware of the existence of and/or involved while a regulatory crisis unfolds. There will be a number of sensitive issues that need to be handled in these early stages and rarely will this be assisted by too many people being aware of the crisis. Indeed the circulation of important information beyond those that need to know has the potential, in some cases, to seriously undermine the integrity of the investigation. Therefore firms should always strive to maintain a high level of confidence during the preliminary stages of an investigation.

This is very much the case in this scenario. For this reason, it should be considered whether all those people cc'd on the email from Chris Newby should be identified and told to not disclose any information to anyone. At this early stage it is unlikely there will be a need to interview individuals within the firm. However, where it is necessary to conduct interviews firms should always make sure a warning about the confidentiality of the investigation is given.

It is clear from the responses that there is a lot of information that people want to find out and hence why a large number of different information sources were suggested. It is important that a balance is struck between getting the information required and conducting the investigation discretely and quickly. In achieving this, the good working relationship built up between a compliance officer and colleagues in other areas of the business is pivotal.

Thought will need to be given to the source of relevant data for a preliminary investigation. The data and records available to a firm in this regard are extensive and will include:

- work emails and instant messaging communications
- trading history and the date and time of the trade in issue
- security system logs
- emails sent and received through an individual's personal email account (although it will usually be impossible for a firm to obtain this data)
- records of previous investigations or compliance reports that may relate to the investigation at hand
- hard copy documents in individuals' offices
- personnel records

3. What action, if any, should be taken with regard to Rich Mann?

Participants gave a very wide range of responses to this question that included:

- passing the matter to the fraud or financial crime department

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- questioning Mann as soon as possible
- altering his trade permissions
- immediate suspension
- taking no action until a more complete picture has been established

With a regulatory issue of this nature it will be necessary, at a relatively early point, to consider employment issues relating to Rich Mann. Although many participants' responses indicated that disciplinary action be taken now, in our view decisions about Mann's employment status should not be made until the exact nature of Mann's culpability has been established. For this reason we think it would be premature to suspend or discipline Mann at this stage.

There are a number of other steps that will become increasingly relevant over time if Mann looks increasingly culpable. These will include the monitoring of all of his trading activity, modifying his trading permissions, and maybe, depending on the information that is uncovered, removing him from the trading floor. Because it is after the main UK markets have closed on Monday, the exercise of all of these options, with the exception of requiring him to stay at home, cannot be initiated until Tuesday. At this early stage it is too soon to require Mann not to come into work. The extent of any breaches is yet to be determined with any certainty, and in any event, to instruct him to stay at home will tip him off that an investigation is underway. We also think it would be premature to interview Mann prior to having reached a more certain picture of what has happened as this will also tip him off that you are investigating. You will be able to ask more searching questions when you are armed with more facts.

Any other action should not be taken lightly. If there is a likelihood that a preliminary investigation and conclusions can be reached quickly, it will usually be best to wait until that preliminary investigation has concluded. For example, if by mid-morning on the following day you are certain that Mann has manipulated the market it might be necessary to remove Mann from the trading floor. However, if conclusions have not been reached by this point it will usually be appropriate to consider this issue on an ongoing basis. For

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example, if there is a delay in retrieving the evidence necessary to dig deeper, consideration should be given to whether silent monitoring of Mann's trading activity should be conducted in the meantime.

In any event, on Monday evening you together with Senior Management at Big Bank can and should start planning how you intend to deal with this issue.

4. What IT help would you request?

There are a number of ways in which the IT department of a firm will be helpful in an investigation of this nature.

Perhaps the most important will be to assist in the production of any electronic evidence that may be available and relevant to the investigation. In this scenario the main evidence that IT might be able to assist with is providing Mann's email and instant messaging records. Although employees will usually seek to avoid communications involving suspicious activity via work email accounts, this will occasionally occur where the individuals have not had an opportunity to think of the consequences or may be communicating using code language. For these reasons it will often be useful to secure IT's assistance early on to find and provide these records.

A record of Mann's trading history is likely to be useful in this case. Depending on the trading systems that are used at Big Bank, and the extent of trading history data that is available to be obtained at the user level, it may be necessary for IT to identify appropriate backups of this data.

IT should also be asked to ensure that all data likely to be relevant to any preliminary investigation and ultimately any more extensive investigation has been backed up in accordance with the firm's data security procedures. This is particularly the case where there is a potential risk of evidence being destroyed or altered. Mann has been with Big Bank for a year, so it is worth checking that records, such as taped lines (which are often not retained for longer than six months), are not due to be destroyed, and action is taken to preserve them if they are.

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Additionally IT will need to play a role in ensuring the security of certain electronic data. It will often be appropriate for IT to take action to ensure certain electronic files and records including communications, and where relevant voicemails, cannot be modified or deleted. However in doing this you should always be mindful that it may result in the suspect being tipped off that an investigation is taking place. It was suggested that the other market participant should be contacted and asked to provide information. If the other market participant is in cahoots with Mann there is an inherent risk that he will tip off Mann. For this reason this course of action may not be advisable.

It may also be helpful to obtain archive information from external IT providers who would have supplied market data for ABZ Resources.

As well as providing past information, IT could also be asked to put a flag on Mann's trades (presuming he has not been suspended from trading). If, however, it is anticipated that the conclusions of any preliminary investigation will be reached within a matter of hours, this may be unnecessary given IT are likely to be stretched dealing with your other information requests.

Whoever from IT assists with a preliminary investigation should be subject to the same requirement of confidentiality as others privy to the investigation are.

5. How well has Newby handled the issue?

Participants gave a wide range of views ranging from Newby having done what was required of him through to questioning his ongoing employment with Big Bank on the basis of having handled the issues poorly.

Although Newby has reported the problem to you, as Head of Securities Compliance, he has not demonstrated a particularly strong appreciation of the salient issues. He has taken Mann's seemingly plausible explanation of what has happened on face value and not questioned any aspect of it. The wording of his email to you also suggests he does not really understand the mechanics behind trading well enough to stand toe-to-toe with a trader and maintain any real authority. The role of Compliance in a situation of this

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nature should always be to question the responses that are given by the individuals concerned. We certainly think it would be premature for Newby to be sacked. A junior compliance officer may only need to see one problem like this before they know how to react in the future.

Many participants pointed out that Newby's failure to pick up on the issues was compounded by his failure to notify you until the end of the day just before he went on holiday. We agree that Newby should have emailed you earlier in the day to let you know of the issue and to give you an opportunity to consider what steps might need to be taken.

Some participants thought that Newby should have responded to the LSE at some point on the Monday. However we think even a holding email might be premature. Unless the LSE have chased Newby throughout the day it would not be unreasonable to hold off responding until tomorrow once the preliminary investigation is complete and you have more solid views. At that point you can give greater thought to exactly what you should tell the LSE. If you approached the LSE at this point, what would you say? "There is an issue, it looks bad, but I haven't got to the bottom of it yet?" We think you probably need more facts before a proper report can be made,

Newby has also cc'd the email to a number of individuals. That may be unhelpful as he has lost some of the confidentiality over the "problem". It might have been better for him to leave you a voicemail, or send an email just to you, mentioning you might want to involve Operations. The decision to speak to Mann is also potentially problematic. On the one hand there is a temptation to want to get to the bottom of the issue and the natural person to make enquiries off is the source of the problem. On the other hand you run the risk of tipping of the culprit which, particularly if the problem is not investigated further, has the potential to give Mann the chance to cover up records that might reveal his actions.