

MEMO# 26539

September 28, 2012

SEC Staff Publishes Report on Broker-Dealers' Insider Trading Practices

[26539]

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TO: BROKER/DEALER ADVISORY COMMITTEE No. 48-12

COMPLIANCE MEMBERS No. 14-12

INVESTMENT ADVISER MEMBERS No. 31-12

SEC RULES MEMBERS No. 86-12 RE: SEC STAFF PUBLISHES REPORT ON BROKER-DEALERS' INSIDER TRADING PRACTICES

The staff of the Securities and Exchange Commission has published a report discussing its findings from a series of examinations conducted of broker-dealers regarding their compliance with Section 15(g) of the Securities and Exchange Act of 1934, which prohibits the misuse of material nonpublic information (MNPI). [\[1\]](#) The Report includes a detailed discussion of the types of sources of MNPI received by broker-dealers, information regarding the staff's concerns with some broker-dealers' practices, and a description of practices believed to be effective in protecting the confidentiality of such information. [\[2\]](#) The Report cautions that it is not intended to be legal advice and whether the controls described in it would be appropriate for a particular broker-dealer would depend on a firm's size and business model. The Report, which is divided into six sections, is briefly described below. While it is specifically related to broker-dealers' practices, it may contain insights useful to investment management firms.

I. Executive Summary

The Executive Summary provides an overview of the reviews conducted by the staffs of the SEC, FINRA, and the NYSE, which provide the basis for the staff's observations in the Report. It also lists four "specific concerns" noted in the course of these reviews:

- The frequency of informal discussions between groups that have MNPI and internal and external groups that have sales and trading responsibilities and the absence of documentation concerning these interactions, which may make it difficult to trace any inadvertent or intentional disclosures of NMPI.
- At some broker-dealers, senior executives (referred to as "above the wall") receive

MNPI with no related monitoring or restrictions, even though some of these executives have responsibility for sales and trading activities. The absence of any documentation of the sharing of this information “raises serious concerns about the ability of broker-dealers to guard adequately against MNPI in firm and customer trading.”

- In some cases, firms were not conducting any focused review of trading that occurred after traders were provided with MNPI.
- Some broker-dealers did not review trading within accounts of institutional customers, asset management affiliates, or retail customers, nor did they review when MNPI came through business activities outside of the investment banking department (e.g., though participating in bankruptcy committees, employees serving on boards of directors of public companies, changes in research ratings, or insiders of companies placing unusual trades).

The Report notes that, while these concerns by themselves may not indicate a violation of Section 15(g), broker-dealers may find it helpful to consider them when reviewing their policies and procedures. The two practices believed by the staff to be effective in preventing violations of Section 15(g) are:

- Developing processes that differentiated between the types of MNPI based on the source (e.g., business unit) from which the information originated within the broker-dealer or the nature (e.g., transaction type) of the information; and
- Expanding the scope of instruments reviewed for potential use of MNPI by traders to include: credit default swaps, equity or total return swaps, loans, components of pooled securities such as UITs and ETFs, warrants, and bond options.

II. Background

This section of the Report discusses the history of Exchange Act Section 15(g) and notes that, in March 1990, the SEC’s Division of Market Regulation issued a report on “Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Nonpublic Information” (the “1990 Report”). The 1990 Report provided an overview of broker-dealer information barrier practices, which included maintenance of watch and restricted lists, review of employee and proprietary trading, written procedures, and documentation of reviews. The current Report notes that the conclusions of the 1990 Report “remain generally appropriate” but adds that “broker-dealers should continually reassess both potential sources and uses of MNPI and whether reasonable controls are in place” because “[p]ractices that are sufficient for a broker-dealer at one time may not adequately comply with its legal obligations at other time.”

III. Sources of MNPI

This section of the Report discusses in detail eight different sources of MNPI: (1) corporate clients (through mergers and acquisition, syndicate activity, derivative sales, and credit reviews/extensions); (2) corporate borrowers; (3) non-corporate issuer clients (e.g., public finance securities and securitized products); (4) investment areas (e.g., principal investment or trading groups within the broker-dealer); (5) institutional investor customers; (6) insider customers (e.g., corporate officers and directors who are customers of the

broker-dealer); (7) research; and (8) secondary sources of MNPI (e.g, various support functions within the broker-dealer such as risk monitoring groups).

IV. Control Structure

According to the Report, the staff observed that broker-dealers generally categorized various groups, functions, activities, and information for control purposes. This categorization, in turn, impacts the treatment of such group under the broker-dealer's policies. The categories discussed in the Report are: public-side vs. private-side business groups; the types of sources of MNPI (i.e., transaction sourced information; item-specific information; and ongoing sources of MNPI); and monitoring list information (including general surveillance lists, hybrid restricted lists, and firmwide restricted lists). Each of these categories is discussed in detail along with staff insights regarding concerns found with some firms' control structure.

V. Controls

The longest section of the Report discusses the types of controls broker-dealers have in place to prohibit the misuse of MNPI. The seven types of controls discussed are:

- Limiting Authorized Access on a needs-to-know basis to particular employees or teams of employees;
- Preventing Unauthorized Access through imposing physical barriers, technology barriers, segregating the printing and production staff, and appropriate disposal of confidential documents;
- Imposing Controls over Information Given to Public-Side Employees by monitoring when such persons will have access to MNPI, or the type of information they will have access to;
- Imposing Controls over Information Given to External Parties to ensure that when information is shared, for example, with institutional investors, procedures are in place to prevent its misuse whether such information is shared in connection with specific transactions, through general discussions, or in connection with credit extensions;
- Email controls designed to avoid misdirected emails and ensure, as appropriate, certain emails are pre-approved. Surveillance of emails was an additional control used by broker-dealers;
- Employee Trading Pre-clearances, which differed depending on the employees and whether the person effecting the trade is a public or private-side employee. The Report noted that, while most broker-dealers compared executions of employee trades against pre-clearances obtained, they were "less effective in tracking and/or responding to multiple failures to pre-clear." As a result, employees may not have "a significant deterrent from trading without clearance"; and
- Surveillance once a matter has been placed on a monitoring list.

Conclusion

The final section of the Report, the Conclusion, notes as follows:

The staff's review observed that broker-dealers were enhancing their controls in response to developments in business activities, technologies, and business structures. The staff's review also identified gaps in controls, which were raised with the broker-dealers. Finally, the staff identified certain areas in which practices were more informal, and the staff plans to continue to review such areas in future examinations.

There are two appendices to the Report. Appendix A lists defined terms that are used in the Report. Appendix B is divided into two sections. The first discusses "Effective Practices – Observations and Considerations" and the second discusses "Potential Concerns." The topics covered in each of these sections are: identifying companies/securities for which monitoring should occur; the sharing of information; and surveillance and monitoring.

Tamara K. Salmon
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endnotes

[1] See 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 "Report"), which is available at: <http://www.sec.gov/about/offices/ocie/informationbarriers.pdf>. Generally speaking, Exchange Act Section 15(g) requires registered broker-dealers to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent its misuse by the broker-dealer or its associated persons.

[2] Appendix B to the report summarizes effective practices and potential concerns found during the review.

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