

MEMO# 5361

November 29, 1993

SEC REPORT ON BROKER-DEALER COMPLIANCE PROCEDURES FOR HIGH YIELD SECURITIES

November 29, 1993 TO: COMPLIANCE COMMITTEE NO. 28-93 TASK FORCE ON INSIDER TRADING RE: SEC REPORT ON BROKER-DEALER COMPLIANCE PROCEDURES FOR HIGH YIELD SECURITIES _____ The SEC's Division of Market Regulation recently issued the attached report concerning the internal control procedures of broker-dealers for high yield securities. The Division interviewed key personnel at six broker-dealers "that are among the most active firms in trading, sales, underwriting, and research operations for High Yield securities." The Division found that "despite the firms' substantial efforts over the last year to strengthen their internal control procedures in this area, further work needs to be done." In particular, the Division's interviews: have raised some questions whether existing Chinese Wall procedures can be effective in dealing with the types of research, trading, and sales operations commonly used for High Yield securities. The Division is concerned that oral dissemination of High Yield research may not provide firms with sufficient records to ensure that traditional Chinese Wall procedures and controls of employee trading are implemented effectively In such an environment, the approach already adopted by some firms, to prohibit all employee trading in High Yield securities, appears to be more realistic. The Division did not, however, recommend that all firms immediately impose absolute prohibitions against employee trading in high yield securities. The Division does believe "that it would be prudent for those firms that choose not to impose prohibitions on employee trading to scrutinize their existing internal control procedures for High Yield securities." The report estimates that no more than 20 to 50 institutional customers (including mutual funds) are active in the high yield market. The report found that the large mutual funds are "highly sophisticated" with "market 'leverage' vastly superior to the customer base for equities." The report also found that since some investors receive quotation sheets from several broker-dealers, they may have informational advantages over the broker-dealers. Brokerage firms indicated that their contacts with institutional investors "are more in the nature of trader-to-trader or analyst-to-analyst conversations", due to the training and experience of the institutional investors' personnel. The report found that institutional investors generally have little interest in the broker-dealers' "buy, sell or hold" recommendations. Thomas M. Selman Assistant Counsel Attachment

should not be considered a substitute for, legal advice.