BROKER-DEALER POLICIES AND PROCEDURES DESIGNED TO SEGMENT THE FLOW AND PREVENT THE MISUSE OF MATERIAL NONPUBLIC INFORMATION

A Report by the Division of Market Regulation U.S. Securities and Exchange Commission

March 1990

* Although the Commission has authorized publication of this report, it has expressed no view regarding the findings or conclusions herein.

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EXECUTIVE SUMMARY

In November 1988, Congress enacted the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA"), designed primarily to prevent, deter, and prosecute insider trading. Section 15(f) of the Securities Exchange Act of 1934, created pursuant to the promulgation of ITSFEA, requires broker-dealers to maintain procedures designed to prevent the misuse of material, nonpublic information. This section also grants the Securities and Exchange Commission ("Commission") broad rulemaking authority concerning these so-called Chinese Wall procedures. Pursuant to this grant of rulemaking authority, the Commission's Division of Market Regulation ("Division") undertook a comprehensive review of broker-dealer policies and procedures.

In its review, the Division noted improvements to procedures employed by major New York broker-dealers, as compared to a more narrow scope Chinese Wall review conducted in 1987. Despite these improvements, however, the Division noted certain deficiencies, and identified certain practices that are necessary elements of an adequate Chinese Wall. These minimum elements include review of employee and proprietary trading, memorialization and documentation of firm procedures, substantive supervision of interdepartmental communication by the firm's compliance department, and procedures concerning proprietary trading when the firm is in possession of material, nonpublic information.

The Division determined that necessary improvements to the status of broker-dealer Chinese Walls would best be effectuated not by Commission rulemaking, but by self-regulatory examination programs, supplemented by Commission oversight. The Division will continue to examine these programs closely, and will revisit the issue of Commission rulemaking should it determine that necessary improvements are not being made through the oversight program, or that there exist deficiencies that are impossible to remedy through the actions of the self-regulatory organizations.

I. Introduction and Background

In November 1988, Congress enacted the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA"), designed primarily to prevent, deter, and prosecute insider trading. [1] Among other provisions, ITSFEA creates a specific requirement for broker-dealers to maintain procedures designed to prevent the misuse of material, nonpublic information. [2] Further, ITSFEA grants the Securities and Exchange Commission ("Commission") the authority to promulgate rules or regulations to require specific policies or procedures designed to prevent the misuse of such information. [3] In the legislative history accompanying ITSFEA, the House Committee on Energy and Commerce noted that although the Commission has indicated that flexibility is necessary to permit diverse institutions to tailor their policies to fit their particular business conditions, the Commission should retain broad rulemaking authority should it become dissatisfied with either the overall quality of broker-dealer policies and procedures, or any specific aspect of the programs in place. [4] In response to the legislation and the concomitant grant of rulemaking authority, the Division of Market Regulation ("Division") undertook a comprehensive review of broker-

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1 Pub. L. No. 100-704.

2 15 U.S.C. § 78o(f). Section 15(f) of the Securities Exchange Act of 1934 ("Act") reads, in pertinent part, "Every registered broker or dealer shall 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 in violation of this title, or the rules and regulations thereunder, of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer." The Act also creates an identical obligation for investment advisors. See 15 U.S.C. § 80b-204A.

3 15 U.S.C. § 78o(f).

4 See H.R. Rep. No. 910, 100th Cong., 2d Sess. 22 (1988). The legislative history noted that the "reasonably designed to prevent" language in paragraph (f) is similar to the rulemaking provisions contained in Sections 14(e) and 15(c)(2) of the Act, and is intended to ensure that Commission rulemaking authority extends beyond the specific requirements of Section 15(f). Id. at n.20.

dealer policies and procedures. [5] The Division also has reviewed the status of self-regulatory organization ("SRO") oversight of member firm activity concerning Chinese Walls, and the potential utility of Commission rulemaking in response to the Division's findings. The findings and conclusions of the Division, along with recommendations concerning broker-dealer procedures and SRO responsibilities, are contained in this report.

The existence of broker-dealer Chinese Walls, both as a prophylactic against illegal activity and a legal defense for broker-dealers against liability in an insider trading context, predates the recent legislation. [6] The existing regulatory requirements for adequate Chinese Wall procedures also is reinforced by newly created Sections 21A(a)(1) and (3) of the Act. These provisions of ITSFEA provide that the controlling person of a person that has violated the Act by purchasing or selling securities when in possession of material, nonpublic information or by communicating such information in connection with a purchase or sale, is liable for up to the greater of $1,000,000 or three times the profit gained or loss avoided. Section 21A(b), however, provides that no controlling person shall be held liable under subsection (a) unless the Commission establishes either that the controlling person knew or recklessly disregarded the fact that the controlled person was likely to take the act or acts constituting the violation and failed to take appropriate steps to prevent such acts, or that the controlling person failed to establish, maintain, or enforce its procedures required under Section 15(f), and that failure contributed substantially to the act or acts constituting the violation.

Broker-dealer Chinese Walls have evolved to include policies and physical apparatus designed to prevent the improper or unintended dissemination of market sensitive information from one division of a multi-service firm to another (i.e. from the mergers and acquisitions area to proprietary or retail trading), and trading procedures and reviews designed to prevent and detect

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5 Policies and procedures employed by broker-dealers to segment the flow of sensitive information often are referred to collectively as "Chinese Walls."

6 See generally Poser, Chinese Walls in the U.S. and the U.K., Securities and Commodities Regulation 210-12 (December 7, 1988) (discussion of development of Chinese Walls in the securities laws).

illegal trading. [7] Within this very general framework utilized by the majority of multi-service broker-dealers, no two systems are alike, ranging from very tight centralized control of information and review to little or no review or follow-up.

The Commission previously has examined the regulatory impact of broker-dealer Chinese Walls. In 1980, the Commission promulgated Rule 14e-3, an antifraud provision which prohibits the trading of securities which may be the subject of a tender offer while in possession of material nonpublic information.[8] Paragraph (b) of Rule 14e-3 provides a safe harbor for transactions by multi-service financial institutions under certain circumstances that otherwise would be proscribed under Rule 14e-3(a), provided, among other factors, that the firm has established policies and procedures, reasonable under the circumstances, to ensure that the individuals making the investment decisions for the firm were not trading on the basis of material nonpublic information obtained from another area of the firm. [9] The Adopting Release discussed in some detail what elements are probative in determining "reasonableness under the circumstances." The Adopting Release noted the need for flexibility, given the diversity of broker-dealer firms, and commented that the procedures may include, but not be limited to, restrictions on retail and proprietary purchases and sales of securities, and restrictions on the flow of information. [10] The Commission also discussed briefly the use and monitoring of restricted lists [11]

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7 See text accompanying notes 15 to 34 infra (reviewing Chinese Wall procedures for 23 integrated broker-dealers).

8 See Securities Exchange Act Release No. 17120 (September 4, 1980) 45 FR 60410 ("Adopting Release").

9 17 C.F.R. 240.14e-3(b).

10 See Adopting Release, supra note 8, at fn. 46. In particular, the Commission noted that any proprietary trading while the firm possessed material, nonpublic information would make more difficult the burden of proof as to the effectiveness of a firm's policies and procedures.

11 A restricted list is a list of securities, maintained by a firm, in which proprietary, employee, and certain solicited customer transactions are restricted or prohibited.

and watch lists [12] to detect illegal trading. [13]

The Division recently re-examined the efficacy of Chinese Walls to deter insider trading. [14] In 1987, the Division visited six major integrated New York broker-dealers to examine their Chinese Wall procedures and interview trading and compliance personnel as part of a comprehensive review of efforts by broker-dealers and SROs to detect and deter insider trading. The staff concluded that each of the firms used a combination of procedures designed to restrict the flow of information, complemented by restricted and watch list surveillance. The staff noted, however, that the terms used lacked consistent

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12 A watch list is a list of securities that, unlike restricted list securities, generally do not carry trading restrictions, but whose trading is subject to close scrutiny by the firm's compliance department. The watch list also differs from the restricted list in that its dissemination generally is limited.

13 The Commission has interpreted, and courts have reviewed, the issue of firm proprietary trading when in possession of material, nonpublic information. Although commenting that such trading should be restricted, the Commission never has stated that proprietary trading in such a context must be prohibited. See, e.g., SEC v. First Boston Corp., Lit. Rel. No. 11092 (May 5, 1986) (release indicated that proprietary trading can occur when the trader has no knowledge of inside information and procedures are followed that prevent the trader from having or acting on inside information); letter from Larry Bergmann, Assistant Director, Market Regulation, to Senator Edward Zorinsky, regarding David C. Myers (July 7, 1986) (noting in the context of Rule 14e-3 that "arbitrage activity by an investment banking firm is not per se proscribed even where the merger and acquisition department of that same firm has a role in the tender offer").

14 The Division also has examined Chinese Walls in the context of affiliations between retail trading firms and exchange specialists. In approving rule changes by the New York Stock Exchange ("NYSE") and the American Stock Exchange ("Amex") to remove prohibitions on specialist affiliations with integrated broker-dealers, the Commission relied on the maintenance of effective Chinese Wall procedures between the specialist, whose knowledge of the contents of the book could be useful, and the trading areas of the firm. See Securities Exchange Act Release No. 23768 (November 3, 1986), 51 FR 41183.

definition, and the procedures used also varied. Further, the staff found that recordkeeping in connection with Chinese Wall procedures was inconsistent at best. The Division concluded that it had concerns about the effectiveness of Chinese Wall procedures at each of the firms it visited, and determined that the development of minimum standards would aid in the industry-wide improvement of broker-dealer Chinese Wall procedures. To that end, the Division recommended that firms memorialize in greater detail their procedures, and likewise improve the documentation, communication and recordkeeping associated with their Chinese Wall activities. Further, the Division raised concerns that the continuation of proprietary trading while a firm possessed material, nonpublic information remained a sensitive and critical issue. The Division also raised concerns that minimum standards for surveillance, such as watch lists, were not being maintained.

II. Current Broker-Dealer Chinese Wall Procedures

A. Description of Firms

In response to the legislative grant of rulemaking authority, the Division initiated a comprehensive review of broker-dealer Chinese Wall procedures. The Division requested written procedures and lists of recently completed mergers and acquisitions from 54 firms that are diverse as to size, business type, and geographic location. The Division chose 23 firms from that group for more extensive review and on-site interviews. Of that group, nine were New York firms, and the remaining represented the major regional brokerage houses.[15] Division staff reviewed the procedures, surveillance, and documentation employed at the firms, and interviewed key compliance, legal, and investment banking personnel at each firm.

The staff examined the functions of six major areas within each firm: Investment Banking (which may include Corporation Finance or Mergers and Acquisitions), Research, Market Making, Retail Sales, Risk Arbitrage, and Block Trading.[16] Each firm in the sample provides some level of investment

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15 Given the proprietary nature of some of the information discussed, the Division has not identified any of the firms by name.

16 The Division did not see, nor did it conduct a specific review of, Chinese Wall procedures pertinent to high yield debt, or so-called junk bonds. Given

banking services for clients, ranging from full merger and acquisition activity by some New York firms to limited underwriting of small, lightly traded corporations by some of the regional firms. Likewise, each firm maintains an active research department, providing reports for institutional or individual customers. With the exception of two New York broker-dealers, the remaining firms all have active retail sales and market making activities. Eight of the New York firms, and one regional firm, described their risk arbitrage trading as active. Only nine of the 23 firms engaged in proprietary trading of block orders as a customer facilitation. Division staff noted trends in a number of firms that linked the retail sales and research departments, [17] as well as the risk arbitrage and block trading desks.

B. Policies and Procedures

1. Training

As noted, broker-dealer Chinese Wall procedures are designed, theoretically either to prevent the inappropriate flow of material, nonpublic information or to aid in the detection of illegal trading based on such information. Each of the firms visited to some extent attempts to achieve employee awareness of prohibitions of the misuse of nonpublic information through employee training and the publication of policies concerning the misuse of such information. The staff found no consistency, however, concerning the level of sophistication of employee training. The majority of firms has no formal training procedures, but rely on a combination of internal memos, orientation materials, or certifications, acknowledging the receipt of firm policies

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that, at the small number of firms that have an active high yield area, one group may perform a variety of tasks normally segmented in a multi-service firm, Chinese Walls designed to prevent the inappropriate flow of material, nonpublic information in a junk bond context is an important issue that the NYSE and NASD must address. Because the Division believes that a review of junk bond departments requires a separate review, the Division expresses no view in this report about the status or efficacy of policies and procedures in the high yield area.

17 In fact, brokers in a number of firms may only solicit customers for securities that have been recommended by the research department.

concerning the confidentiality of information and pledging compliance. [18] Other firms vary the intensity and frequency of employee training on the basis of the sensitivity and responsibilities of the division. For example, certain firms have formal training for employees in the investment banking department but not in other areas. Other firms have extensive training for professional employees, but not for support or non-financial staff. [19] Some firms use routine interaction, such as monthly meetings between the compliance department and sensitive areas, to communicate firm procedures. The most comprehensive training efforts consist of extensive education about firm policies and securities laws during an employee's orientation period, followed by supplemental training, seminars, and memoranda, reinforcing existing policies and keeping employees abreast of significant judicial, regulatory, and industry developments. [20]

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18 At one regional firm visited, employee training is the responsibility of each individual department head, who uses a variety of memoranda, seminars, and meetings. Employees receive a memorandum entitled "Treatment of Confidential Information and Personal Securities Transactions," which emphasizes the need to adhere to the firm policy concerning the confidentiality of client information. However, at other regional firms, the staff found no formal educational programs. Instead, procedures for employees often are written and communicated on a department by department basis.

19 According to compliance officials at one New York firm, only employees in the Corporation Finance Department receive any formal training. Other staff, whether professional or clerical, have firm policies concerning the confidentiality of information communicated to them verbally by supervisors. At another major firm, the education of employees is accomplished through a series of memoranda, seminars, and lectures. All employees receive a copy of the firm's procedures at the commencement of employment. From that period on, however, the comprehensive ongoing educational efforts are directed only to employees in sensitive areas, such as Corporate Finance.

20 One multi-service New York member firm uses several methods to attempt to sensitize employees to inadvertent disclosures of material, nonpublic information. A policy manual distributed to all personnel is intended to serve as a permanent reference for employees with concerns regarding sensitive information. In addition, all employees receive a memorandum, entitled "Guidelines for Business Conduct," which is updated periodically.

Likewise, the content of the training and supplemental procedures designed to segregate information between the various departments within a multi-service firm differ from firm to firm. In a number of firms, training consists of little more than a statement of policy concerning the confidentiality of information obtained in the course of employment, and prohibitions on trading based on such information. Other firms enforce a "need to know" policy concerning the inadvertent dissemination of information, and supplement this policy with a requirement that employees report all information obtained to an immediate supervisor. Firms often support their confidentiality policy with periodic seminars reinforcing the responsibility not to discuss nonpublic, market-sensitive information.

2. Employee Trading Restrictions

All firms attempt to reinforce their policies concerning employee misuse of confidential information by placing restrictions on employee trading activity. For example, almost all firms require employees to maintain accounts with the firm.[21] Some smaller firms require pre-clearance of all employee trades, either

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Legal staff meets periodically with supervisors in each department for updates on relevant developments in the areas of Chinese Walls and insider trading. In addition to receiving the same training as other employees, the Investment Banking area receives supplemental training, including sessions consisting of a presentation on ethics, periodic memoranda updating and reiterating the contents of the policy manual, and an annual circular discussing confidentiality and security measures.

21 This restriction generally extends to accounts of family members. There are a number of exceptions to this rule, including joint spousal accounts where the spouses work at different broker-dealers, accounts to trade instruments not offered by the broker-dealer (i.e., mutual funds or futures), and accounts over which the employee exercises no investment control. Generally, firms require employees with outside accounts to route trade confirmations and monthly account statements to their own head of compliance or the employee's immediate supervisor. See NYSE Rule 407(a)(i). Rule 407 requires member firms, when executing transactions for the account of an employee of another member firm, to obtain written approval from, and route reports and account statements to, the employer member firm.

by the compliance department or the individual supervisor. Other firms require pre-clearance for investment banking employees, who generally are restricted from trading in client securities. [22] Restrictions on trading may take the form of holding periods of anywhere from 30 days to one year, or prohibitions on particular instruments or strategies, such as futures, naked options, or short selling. Firms also may take a somewhat more vague approach, counseling employees generally to trade only for investment or long-term purposes, and discouraging speculative or short-term trading. Restrictions also may be directed toward non-investment banking employees. A number of firms prohibit all employee trades in securities in which the firm is underwriter until all public clients are satisfied, and most firms prohibit employee or registered representative trading for two to five days in securities in which the firm has issued a research report.

3. Physical Barriers

All firms visited by the Division employ physical techniques to attempt to restrict the flow of information. Firms physically segregate their departments, employ procedures designed to restrict access to files, offices, and computers, and use code words or names when discussing sensitive projects. A minority of firms include periodic security checks of phone lines as part of their surveillance reviews.

4. Interdepartmental Procedures

a. Investment Banking - Research

All firms visited by the Division also have procedures designed to limit the necessary flow of information for business purposes. As a general rule, restrictions on interdepartmental communications are designed primarily to isolate the investment banking department from the various other departments

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22 Firms may require trade pre-clearance for investment banking employees and employees of certain other sensitive areas. At one firm, trade requests, either written or verbal, are checked against the firm's watch list and restricted list to ensure that the employee is not trading in a client's security. The head of Investment Banking supports the pre-clearance process by reviewing employee trades on a monthly basis.

within a firm. [23] For example, investment banking personnel often require information that can be provided by the firm's research, and to a lesser extent, sales departments. However, the process of obtaining the required information without effectively tipping confidential information to those departments presents a dilemma common to multi-service firms.

The investment banking department generally will attempt to elicit the needed information from the research analyst or retail employee without disclosing the purpose of the request. However, this technique often proves ineffective, because the form of the request itself becomes a tip to the employee. [24] Given the routine failure of that approach, firms may bring the employee with the necessary expertise or knowledge "over the wall," thereby making the employee, from a surveillance standpoint, a temporary member of the investment banking department possessing material, nonpublic information.

The procedure for bringing an employee over the wall varies from firm to firm. Generally, such decisions are made jointly by investment banking, compliance and research. Given the need for compliance to know the status of employees for surveillance purposes, significant contact between investment banking and other employees should have the prior approval of the head of compliance. However, in a number of firms, the investment banking department may make the decision unilaterally to bring an employee over the wall, and subsequently report the decision to compliance. In other firms, either the compliance department is not involved, or is informed but keeps no records of the action. The lack of interaction between investment banking and compliance or the failure to maintain records presents surveillance concerns. In

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23 An obvious exception are Chinese Walls erected between specialist affiliates and upstairs firms. Although designed in part to prevent the flow of information between specialists and investment banking, adequate specialist Chinese Walls include restrictions on information flow to retail and proprietary trading.

24 For example, if a research analyst knows that a company he or she regularly follows is rumored to be contemplating some type of merger or acquisition activity and also is an investment banking client of the firm, any question from investment bankers about the company or its related industry will likely lead the analyst to conclude that the company is working actively with the investment banking department.

light of the fact that employees in sensitive areas generally are subject to more stringent trading surveillance than other employees, compliance should have complete information to permit it to maintain adequate review of sensitive employee trading.

Certain firms employ a more centralized approach to the issue of the exchange of interdepartmental information by incorporating the head of research or a research-investment banking liaison into the small group to whom confidential information and client lists are disseminated. This approach provides a benefit at times by allowing research information to be obtained without tipping the research analyst, and by maintaining tighter control on interdepartmental communication. [25] However, such a procedure also is contrary to the stated preference of the majority of firms to keep the dissemination of active client lists and confidential information as restricted as possible.

b. Investment Banking - Proprietary Trading

In general, firm procedures designed to control the flow of information between investment banking and proprietary trading (risk arbitrage, market making and block trading) lack consistency. Firms with active proprietary trading are divided as to the amount of information reported from investment banking to individuals making investment decisions and the restrictions placed on the proprietary areas. Some firms maintain the integrity of the Chinese Wall between investment banking and risk arbitrage, allowing the trading desk to operate independently of investment banking information. Other firms, however, will inform their risk arbitrage desk that either they have come into possession of material nonpublic information, or that they have been engaged by a client. These firms either require the risk arbitrage department to refrain

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25 At one active New York Firm, all contacts between investment banking personnel and the Research Department concerning companies about which the firm possesses confidential information are coordinated by the Research Department Compliance Director. It is the responsibility of this person to ensure that the Chinese Wall between Research and Investment Banking is not compromised, and if a research analyst does become aware of material, nonpublic information from Investment Banking, that the proper compliance steps are taken, including placing the security under trade review or bringing the research employee over the wall.

from trading, or give the department a one-time opportunity to liquidate an existing position. [26]

Block proprietary trading done to facilitate customer transactions is less likely to be restricted than risk arbitrage activity. [27] A number of firms noted that because block activity is not initiated by the firm and does not evidence any investment objective on behalf of the firm, it is unnecessary to restrict the activity. These firms also indicated that the sudden withdrawal by an active block trading desk in a particular security might serve to tip investors that the firm possessed information, generally presumed to be positive, about that security. However, a few firms with active block trading desks reported that such activity was restricted or discontinued.

Firm procedures governing the flow of information between investment banking and market making generally contain no restrictions on market making activity. Those firms that are over-the-counter market makers noted that withdrawing from the market in a company with whom the firm has had a previous investment banking relationship provided a clear tip about current inside information. [28] Firms that continue market making activity while in

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26 It may be important for the firm to liquidate its proprietary position because of the length of time a security may remain on the watch list. The lack of opportunity to liquidate may result in being locked into the position for a year or more.

27 Block trading, or "equity trading," departments, act to facilitate the execution of large customer orders. Block traders will shop a large customer order with other member firms to attempt to find contra-side interest for the order. In addition, the department often will take a proprietary position on the contra side of the customer's block in an attempt to facilitate a better execution. Without this additional liquidity, large orders would have to be worked against incoming order flow and slowly liquidated, potentially resulting in the execution of the large order at a variety of prices. In theory, block trading proprietary activity differs from risk arbitrage because the firm will not initiate positions in securities, but only establish the position as a reaction to the needs of a major customer.

28 The nexus between underwriting activity by a firm's investment banking department and market making by the proprietary trading area is particularly

possession of confidential information either instruct their market makers to remain passive to the market, that is, to only take the contra side of unsolicited customer trades, or claim that such instructions are unnecessary because their market making activity always is passive. All firms interviewed indicated that their market makers do not make a practice of aggressively building positions in their stocks or acting as a shadow risk arbitrage department.

c. Research Reports

As noted, the relationship between investment banking and research presents certain issues dissimilar to those raised in the investment banking-proprietary trading context. Research departments often cover companies with whom the investment banking department formerly or currently has a working relationship. In fact, it is not unusual for a research analyst to bring a client to the investment banker. The Division found that the issue of the publication of research reports while the investment banking department is in possession of material, nonpublic information resulted in a variety of procedural responses. All firms noted that the compliance department routinely reviews research reports prior to publication for a variety of reasons not directly connected to Chinese Wall procedures. The majority of firms reported that research reports routinely are pulled, or at least delayed, when the compliance or investment banking department, by virtue of its knowledge of confidential information, determines that the research recommendation is damaging or incorrect. Two firms interviewed maintain the division between research and investment banking, refusing to interrupt the publication of a report known to be in error because of its knowledge of confidential information. However, these firms did indicate that a research report would be delayed if the analyst inadvertently had uncovered or suggested accurate confidential information in the report.

Preventing the release of a report without tipping either the research analyst or the investing audience presents obvious concerns. Firms noted that they attempt initially an informal approach by delaying the report, without

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acute in the context of regional broker-dealers and small issuers. In many situations, a firm will take a small issuer public with the understanding that the firm will remain a lead market maker in the stock. Given the nature of the close, multi-purpose relationship between firm and issuer, the withdrawal from the market making activity by the firm presents an obvious tip to outsiders.

explanation either to the analyst or public. Given the limitations of this approach, firms generally will ultimately bring the analyst over the wall, and remove the analyst from public accessibility or instruct him or her to give neutral responses to public inquiries. [29]

C. Review Procedures

Firms have implemented supporting procedures to prevent the inappropriate flow of confidential information by instituting routine review procedures for customer, employee, and principal trades. Trade reviews generally originate from a "watch" list, also called a "grey" list, and from a restricted list. Securities about which the investment banking department has confidential information are placed on one of the lists, thereby triggering a surveillance review by the firm's compliance department for suspicious activity.

Watch lists have limited distributions, and are designed to permit review without tipping firm or industry personnel as to the existence of a relationship between a broker-dealer and issuer. Generally, the contents of the watch list are known to the compliance or legal department (whichever is performing the surveillance function), the head of investment banking, select senior management, and sometimes the head of proprietary trading or research. Placement of stocks on the watch list differs from firm to firm, but generally placement occurs when discussions between the broker-dealer and client reach a point where clear business objectives have been identified. [30] The firms

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29 The informal delay approach generally is more successful at larger firms, because these firms can stall the publication of a research report by saying that the compliance department reviewer is occupied with other projects accorded higher priority than the pending research report.

30 Placement of a security on the watch list may occur at various stages in the investment banking process. Some firms remain vague as to the point in time, citing criteria such as "beyond the general proposal stage," or when the investment banking department determines that discussions have provided the firm with material information. Other firms use more concrete events to determine the timing of placement, such as the signing of a commitment or engagement letter, or after a potential target or buyer has been identified. The Division has concerns about the automatic use of the engagement letter to trigger watch list reviews. Although it is appropriate in some instances,

interviewed universally claimed that they are quick to place a security on the watch list, and will err on the side of caution when making the decision. A number of firms also noted that securities often remain on the watch list long after it is necessary, because decision-makers tend to focus only on the placement, and not removal, aspect of the process. [31]

Responsibility for placement of securities on a watch list involves some type of cooperative effort between compliance and investment banking. The head of investment banking generally makes the initial placement determination, either with consultation with the head of compliance or subject to compliance review and approval. A few firms noted that the decision-making responsibilities rested only with investment banking, with no consultation or review by compliance, and therefore no opportunity by compliance to evaluate when the investment banking head is making a practice of waiting too long to place a security on the watch list. Most firms maintain a watch list log, recording when each security is added to or deleted from the list. Firms with small watch lists (the result of less active Investment Banking Departments) may disseminate the list each time it is amended. Major merger and acquisition firms disseminate the new list biweekly or monthly, because of the impracticality of re-issuing a constantly changing document.

Placement of a security on the watch list will trigger a number of surveillance activities and certain trading restrictions. [32] In light of the goal of maintaining the confidentiality of the content of the watch list, broad public restrictions on employee or proprietary trading are considered to be

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the engagement letter often is signed at a point well after material nonpublic information has been disseminated to the firm. Therefore, the Division favors case by case determinations, with reviews by the compliance department, instead of reliance on an automatic triggering event.

31 Certain firms hold periodic meetings between the investment banking and compliance departments to review watch list securities for the purpose of removing outdated entries. Given that the presence of a security on the watch list triggers certain surveillance efforts on the part of compliance, such meetings are an effective tool for properly focusing surveillance resources.

32 See text accompanying notes 25 to 27 supra (discussing firm proprietary trading restrictions).

counterproductive. However, some smaller firms restrict all employee and proprietary trades in watch list securities, while other firms only prohibit trading in watch list securities by employees in investment banking. However, the majority of firms leaves all non-proprietary trading in watch list securities unaffected, yet subject to trading reviews by compliance. The effect the placement of a security on the watch list has on proprietary trading differs from firm to firm and even department to department.

Surveillance activity concerning watch list securities constitutes the single most significant element of Chinese Wall review procedures. In smaller firms, every trade executed by the firm (customer, employee, proprietary, principal) is subject to review to examine for suspicious activity in watch list securities. Major firms, because of their larger trading volume, undertake a more sophisticated review, highlighting employee or proprietary trades in watch list securities. It is common practice for a firm initially to perform a retroactive review of trading, ranging from 5 to 30 business days. Following the initial review, the compliance department then reviews trading on a next day basis, identifying potentially suspicious employee trades and reviewing proprietary positions or activity. Although employee trading in watch list securities generally is detected by the compliance department, trading will not be questioned unless a pattern develops or there is an obvious connection between the employee and a source of material, nonpublic information. [33]

Some larger firms have developed sophisticated surveillance and exception review systems. Two major New York firms, for example, review trading in all securities whose volume exceeds a pre-determined percentage of total market volume, as well as reviewing employee, proprietary, and concentrated solicited customer trades. Moreover, one firm further divides its watch list into three sub-categories, each eliciting a different type of review. Securities are placed on the "grey" list when the Investment Banking Department is convinced that the information in its possession has little market impact, or when a merger client has yet to settle on a specific target or buyer. Placement of a security on the grey list does not trigger any trade restrictions or surveillance, but only focuses the firm's Director of Research Compliance to review research reports.

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33 A small number of regional firms noted that they break or cancel employee trades in watch list securities. Although these firms stated that they break the trades without explaining the reason to the employee, the Division believes that such action probably represents a clear tip to the employee.

Clients whose projects have developed to the stage that the information would have a market impact are placed on the "grey-arb" list, which has the effect of restricting arbitrage trading. Finally, issues that have market impact and merger or acquisition activity are placed on the "grey-M&A" list, which includes restrictions on proprietary trading and also triggers employee trading reviews.

Most firms that use watch list procedures also maintain a restricted list. More widely disseminated than the watch list, the restricted list is used when a deal is about to go public. [34] Given the nature of the restricted list, most firms use it less for Chinese Wall purposes than for other regulatory purposes in connection with an offering. [35] Certain smaller, regional firms continue to use the restricted list in place of the watch list, but such procedures reflect more a lack of significant merger and acquisition activity than a failure to maintain state of the art procedures.

At least three major New York broker-dealers supplement their watch and restricted list surveillance with a so-called "rumor" list. The compliance department at these firms will place a security on the rumor list when a deal recently has been announced and some times even when the company is the subject of rumors of an impending transaction. Importantly, the list is not limited to issuers who are doing business with that specific firm. The firms

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34 Most firms use their market information terminals (e.g., Quotron or Bridge Data) to disseminate the content of the restricted list. Restricted securities will be designated by "R" on the screen, thereby alerting the registered representative. Given the broad dissemination of the information, firms usually do not even maintain a pretext of secrecy about the content of the restricted list.

35 Firms generally use the restricted list to ensure that trading in violation of Commission Rule 10b-6 does not occur. Firms will also use the restricted list to prevent violations of firm procedures concerning trading following the publication of research recommendations. Placement on the restricted list generally means no proprietary trading, no employee trading, and no solicited transactions. Firms generally break trades in restricted securities, unlike trading in watch list securities, which are reviewed for suspicious activity but rarely broken. Again, unlike watch list trades, trades in restricted list securities may result in a warning, while watch list trades are either dismissed or, in theory, result in insider trading investigations.

perform an extensive retroactive review, usually covering the prior 30 business days, to determine if there was any suspicious activity in firm, employee, or customer accounts in the period prior to the announcement or circulation of the rumors.

III. Regulatory Issues

A. Summary of Findings

During the course of its review, the Division reached a number of conclusions about the status and effectiveness of broker-dealer Chinese Wall procedures. In particular, the Division has identified a number of policies and procedures that are necessary elements to an adequate firm Chinese Wall. Included in these minimum elements are (1) substantial control (preferably by the compliance department) of relevant interdepartmental communications; (2) the review of employee trading through the effective maintenance of some combination of watch, restricted, and rumor lists; (3) dramatic improvement in the memorialization of Chinese Wall procedures and documentation of actions taken pursuant to those procedures; and (4) the heightened review or restriction of proprietary trading while the firm is in possession of material, nonpublic information.

The Division also has concluded that oversight of broker-dealer Chinese Walls would best be effected by a thorough and aggressive SRO examination program with an active Commission oversight program. The NASD and NYSE have been pursuing pilot examination programs during recent months, and the Division expects the results of those programs shortly, so it may evaluate the effectiveness of the SROs' proposed programs. Finally, the Division, noting again the great diversity of broker-dealers, has concluded that, at this time, no aspect of current procedures require Commission rulemaking. However, if the Division finds either that necessary improvements are not made through the SRO oversight programs or, that through experience, there exist deficiencies that are impossible to remedy by SRO action, we may revisit the issue of rulemaking. The findings of the Division are discussed in more detail below.

B. Current Status of Broker-Dealer Chinese Walls

In its review, the Division noted general improvement to the procedures employed by certain major New York broker-dealers. Unlike the findings of

the 1987 review, these firms appear to be more cognizant of their responsibilities to prevent the misuse of material, nonpublic information, and are better equipped to perform effective surveillance over employee and proprietary activity. [36] By contrast, in this review the Division noted that smaller firms have less sophisticated procedures in place, perhaps because their surveillance responsibilities are less compelling. In fact, the Division noted that a number of smaller firms were beginning in early 1989 to formulate procedures as a response to the 1988 legislation, despite pre-existing regulatory incentives to have effective supervisory procedures in place. [37] At a number of these firms, the procedures submitted consist of little more than a statement concerning the confidentiality of information, supplemented by certain restrictions on trading. Written procedures explaining watch list or restricted list procedures or outlining review procedures were absent at a number of firms.

The Division believes that a number of major integrated broker-dealers have made commendable efforts to develop comprehensive Chinese Wall procedures. In particular, increased efforts to maintain the confidentiality of information through comprehensive training, more sophisticated methods of trading surveillance, and the development of new procedures such as rumor

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36 For example, the 1987 review criticized two New York firms for their lack of documentation. The 1989 review, however, found that both firms had responded to those criticisms, and the level of documentation at these firms were among the best seen by the staff.

37 For example, Section 15(b)(4)(E) of the Act provides that a registered broker-dealer may avoid liability for failing to supervise a person who has committed a securities law violation if the firm has procedures, and a system for applying the procedures, which would be expected to detect and prevent such violations. Similarly, Commission Rule 14e-3(b) provides a safe harbor for proprietary trading when a firm is in possession of material, nonpublic information in connection with a tender offer, provided that the firm has adequate procedures to prevent the flow of information between departments. Further, in May 1988, the Commission approved amendments to NYSE Rules 342, 351, and 476, instituting supervisory and compliance obligations for NYSE member firms requiring review procedures for employee and proprietary trades to detect insider trading and other manipulative or fraudulent activity.

lists, all improve the ability of firms to combat the misuse of material, nonpublic information.

C. Minimum Standards

Although the Division believes that it is more appropriate to address the issue of dispositive evaluations of Chinese Wall adequacy through a detailed examination program, there are certain aspects of firm procedures without which a determination of adequacy would be difficult. For example, the maintenance of watch lists and restricted lists and the concomitant review of employee and proprietary trading are minimum elements. For NYSE member firms, the trading review already is mandated as a result of the recent amendments to NYSE Rules 342 and 351. In fact, the trade review section of the NYSE rules is very similar to Section 15(f) of the Act, requiring trade review procedures "reasonably designed to identify trades that may violate the provisions of the Securities Exchange Act of 1934, the rules under that Act or the rules of the Exchange prohibiting insider trading and manipulative and deceptive devices." [38] While watch and restricted list procedures probably are necessary to fulfill the requirements of the Act and NYSE rules, the NYSE should consider a requirement for firms to establish procedures, including, among other things, use of rumor lists, to review customer, employee, and proprietary trading on third party deals. Moreover, because not all broker-dealers are members of the NYSE, and are therefore not subject to the employee and proprietary trade review rules, the Division believes that the NASD should examine the effectiveness of its current, more general, regimen of supervisory rules, and report its conclusions to the Division.

The Division also believes that the procedures of the great majority of firms need to be structured and memorialized more than is current practice. As of February and March 1989, when the Division received submissions from the firms in response to its request for Chinese Wall procedures, those procedures to a great extent were a loose mixture of internal memoranda, excerpts from employee manuals, and certifications. During the on-site portion of the review, the Division was informed that some firms were rewriting their procedures in response to the promulgation of ITSFEA. The Division believes that this type of compilation and organization is a necessity at almost every firm. Procedures concerning interdepartmental communication, trade review

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38 See NYSE Rule 342.21(a).

and analysis, and investigation, that are designed to ensure compliance with ITSFEA must be formalized. Such restructuring will enable SRO or Commission examiners to determine whether the procedures in place are adequate.

Consistent with the Division's concern about written procedures, the documentation of efforts taken pursuant to Chinese Wall procedures must be improved. For example, the majority of firms fails to maintain adequate records of communication between the various departments. Smaller firms often do not maintain an entry log for watch and restricted lists. Division staff also found that firms did not document daily trading reviews, and the subsequent review of potentially suspicious trading also lacked documentation. The Division notes that the failure to maintain documentation sufficient to re-create actions taken pursuant to Chinese Wall procedures will make reviews and determinations of the adequacy of procedures and compliance efforts exceedingly difficult. At the same time, the Division notes that imposition of documentation requirements should take into consideration the differences between the structures and activities of smaller firms and those of large multi-service firms.

The Division believes that the SROs must develop standards of documentation for their member firms. In light of the fact that SRO examiners will comprise the first line of review of firm procedures, the SROs will be in the best position to determine such standards. The Division therefore is requesting the NYSE and the NASD in the near future to circulate Notices to Members or Information Memoranda providing some guidance as to minimum levels of adequate documentation. If the Division finds that this approach does not achieve the desired level of document maintenance, it will consider the efficacy of promulgating specific recordkeeping requirements.

Moreover, each firm must have procedures concerning the restriction or review of proprietary trading while in the possession of material, nonpublic information.[39] Given the various types of firm proprietary trading, it is clearly not appropriate to recommend that all types of proprietary activity be prohibited when a firm comes into possession of material, nonpublic information. In certain cases, such as firm market making, such a requirement would be counterproductive to the goals of both confidentiality of information

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39 All the firms reviewed had at least some procedures concerning proprietary trading.

and market liquidity. However, in the context of risk arbitrage, the case for trading prohibitions is more compelling, because unlike either market making or block trading, the impetus for trading is neither passive or reactive, the benefits to the market are arguably fewer, and the opportunity for illegal profits is greater.

It is important to note that most of the historical discussion about proprietary trading, particularly risk arbitrage, while in possession of material nonpublic information centers on the use of restricted lists to limit such trading. The Division staff, however, found that there is no uniform procedure concerning risk arbitrage activity when the firm is in possession of material, nonpublic information. The firms surveyed take a variety of positions, depending upon, among other factors, the type of risk arbitrage activity in which the firm is engaged. For example, three firms indicated that they do not permit their risk arbitrage desks to take positions in securities prior to a public announcement. [40] Accordingly, they noted that watch list-triggered trading restrictions probably are not necessary because they would not be trading in watch list securities. [41] Other firms did not indicate that their risk arbitrage trading is limited to post-announcement activity. Within this category, procedural responses also differ. Three firms noted that they make a decision about whether to continue risk arbitrage at the time the security is placed on the watch list. Another firm attempts to prohibit such trading by informing the head of proprietary trading, who will effect the liquidation of any positions taken in watch list securities. Finally, one New York firm permits risk arbitrage activity with close monitoring by Compliance.

The Division remains concerned about risk arbitrage trading when the firm possesses material, nonpublic information. Given the difficulty in categorizing firm trading, and the possibility for profit, the Division believes that firms that freeze arbitrage activity when the security is placed on the watch list

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40 The term "public announcement" is not always easily defined. News announcements, public discussions, or Commission filings such as a Schedule 13D (which would probably not trigger the placement of a security on the restricted list) all may constitute a public announcement.

41 Another firm noted, however, that it does freeze proprietary trading when a company is placed on the watch list. Further, each firm noted that there is extensive trade review of proprietary activity in watch list securities.

are choosing a prudent course. However, for firms that would choose to continue such activity in client securities, the burden of proving the reasonableness or adequacy of their internal procedures should increase dramatically, and that burden should only be met by a demonstration of the stringent review and documentation of firm trades.

The Division believes that the compliance department at multi-service firms must take the central role in the administration of the firms' Chinese Wall procedures. In particular, compliance must be informed and must maintain records of significant interdepartmental communications, such as bringing an employee over the wall. Further, compliance must take an interactive role with investment banking or other departments in the placement and removal of issues from watch or restricted lists. Finally, compliance must be the area ultimately responsible for employee trade surveillance. Although useful as a supplement, employee trade review by supervisors who do not know the content of a watch list or do not have a sense of the firm's overall business position without concurrent surveillance by the compliance departments is inadequate.

Finally, the Division believes that firms should continue to place a high priority on training. Following the lead of a handful of major New York firms, all broker-dealers should commence comprehensive, interactive training programs, particularly for employees in sensitive areas, supplemented by routine updating and reinforcement of firm policies and applicable securities laws and regulations.

D. Oversight

Given that section 15(f) of the Act requires registered broker-dealers to have policies and procedures "reasonably designed. . . to prevent the misuse. . . of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer," evaluations of "reasonableness" or "adequacy" may determine whether a firm is shielded from liability in an insider trading case. Therefore, the issue of oversight is an important one. The Division believes that member firm oversight is best effectuated by SRO examinations and regulation subject to Commission oversight.[42] In fact, SRO

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42 See S. Rep. No. 75, 94th Cong., 1st Sess. 22 (1975). In the legislative history to the 1975 Amendments to the Securities Exchange Act, Congress cited the unique historical role of the self-regulatory system, including the relationship

review of member firm activity is central to the self-regulatory concept. Therefore, the Division currently is working with the SROs to develop examination modules to assist examiners in evaluating the effectiveness of broker-dealer Chinese Walls.

The NYSE and NASD act as the designated examining authority to the majority of registered broker-dealers. Therefore, the examination programs developed by these two SROs constitute the most important element in ensuring broker-dealer compliance with the statute. [43] In response, the NYSE and NASD are in the process of completing pilot programs, during which each SRO is examining a number of firms to test the effectiveness of its examination modules. [44] Both SROs may consider possible amendments or alternatives to their current exam modules. [45]

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between broker-dealers and SROs. In particular, Congress noted, "In enacting the Exchange Act, the Congress balanced the limitation and dangers of permitting the securities industry to regulate itself against the sheer ineffectiveness of attempting to assure [regulation] directly through the government on a wide scale. The result was a unique pattern of regulation combining both industry and government responsibility. Industry organizations, i.e., the exchanges and the NASD, are delegated governmental power in order to enforce ... compliance by members of the industry with both the legal requirements laid down by the Exchange Act and ethical standards going beyond those requirements." Id. at 22-23.

43 The Amex and Chicago Board Options Exchange serve as the designated examining authority to a smaller number of firms, and therefore must also develop examination programs. The Division anticipates that SRO examinations of Chinese Walls will be performed pursuant to the normal FINOP or sales practice cycle.

44 The NYSE examined the Chinese Wall procedures for 41 firms in connection with its pilot program. The NASD conducted examinations of 19 firms using its pilot module. The NYSE also requested, and is in the process of reviewing, the written procedures for all its member firms.

45 As presently constructed, the NYSE exam module includes a "question bank" of 62 questions concerning confidentiality of information, employee trading, trade review and other supervisory and compliance issues, along with a "matrix" which instructs examiners as to those questions which are pertinent

Further, because Section 15(f) is directed to "every registered broker or dealer," steps need to be taken to ensure that entities for whom Chinese Walls may not be necessary or useful (i.e. floor brokers or direct participation placement firms) are in conformity with the Act. The SROs recognize this concern, and, through the facilities of the Intermarket Surveillance Group ("ISG"), presently are developing a questionnaire that these firms must complete. [46] It is anticipated that the accuracy of the questionnaires or surveys will be reviewed as part of the routine examinations of these firms.

The Commission also will supplement the oversight activities of the SROs. As part of their routine examinations of registered broker-dealers, the Commission's regional offices will conduct a preliminary review to evaluate firm compliance with ITSFEA, which will include an examination of Chinese Wall written procedures. Further, the Division and regional offices are establishing a committee which will develop a detailed checklist specifically tailored for regional office examinations of broker-dealer Chinese Wall. To aid in the development of the checklist, and to assist in oversight, Division staff has accompanied regional office personnel on their first two Chinese Wall examinations. Finally, following the completion of the NASD and NYSE pilot programs, the Division will include the SROs' Chinese Wall activities as a high

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to each firm or area within a firm. The NASD module consists of questions and requests for documentation divided into five areas, supplemented by questionnaires asking firms to provide clients, employee lists, and a copy of their written procedures. The NASD has indicated that it currently is considering comments from its examiners, and anticipates that a revised module should be complete by the first quarter of 1990.

46 The ISG recently submitted a draft of the questionnaire to the Division for its comments. In its current form, the document clarifies what types of firms may use the questionnaire to satisfy the requirements of §15(f). The questionnaire consists of a number of forms which require members and employees to certify knowledge of the requirements concerning material, nonpublic information, and requires that they list contacts with insiders of publicly traded companies and accounts in which they have an interest. See letter from Jeffrey B. Schroer, Chicago Board Options Exchange, to Julio A. Mojica, Assistant Director, Division of Market Regulation, dated October 26, 1989.

priority in its routine oversight inspection program. Through these actions, the Division believes it can stay aware of Chinese Wall activity both at the broker-dealer and SRO levels, and be prepared to amend its position concerning rulemaking should it find that either level of implementation or review is unsatisfactory.

E. Need For SEC Rulemaking

The Division has concluded from its comprehensive review of broker-dealer Chinese Walls that Commission rulemaking, at this time, is not a necessary response to the promulgation of ITSFEA or the current state of firm procedures. While the procedures in place vary widely in scope and comprehensiveness, the Division believes that the firms reviewed generally had adequate procedures in place. In this connection, we are concerned that SEC rulemaking standards risk being unnecessarily rigid. The type and formality of Chinese Wall procedures must vary with the size and activities engaged in by each firm. Moreover, we do not wish to discourage experimentation and new ideas by firms to revise their Chinese Wall procedures over time.

As discussed above, there are areas in which we believe improvement can be made in many firms' procedures. We believe these improvements can best be obtained, however, through an aggressive examination program, perhaps aided where necessary by limited SRO regulation. Accordingly, the Division will not commence any rulemaking projects. Instead, it will focus its resources on monitoring closely in its oversight capacity the development of SRO examination procedures for reviewing member firm Chinese Walls, and working with the SROs and the securities industry in addressing the issues noted in this report, particularly the need for better documentation of Chinese Wall compliance. [47]

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47 The Division notes that it has participated in an ongoing, productive dialogue with the Securities Industry Association which, in response to the ITSFEA legislation, has formed an ad hoc group to work with the staff on these issues.

IV. Conclusion

In its comprehensive review of broker-dealer Chinese Walls, the Division of Market Regulation found policies and procedures varying widely in scope and sophistication. While identifying certain areas of concern, the Division has concluded preliminarily that generally these systems are well conceived and conscientiously executed. Despite this promising overall view, the Division identified certain deficiencies common to the procedures of most firms, and outlined certain practices that are necessary elements of an adequate Chinese Wall.

Further, the Division determined that necessary improvements to the efficient operation of broker-dealer Chinese Walls would best be effectuated, not by Commission rulemaking, but by vigorous self-regulatory examination programs, supplemented by Commission oversight. However, the Division will continue to monitor closely the self-regulatory programs, and Chinese Walls generally, and will reconsider a recommendation of Commission rulemaking should it become dissatisfied with either of these programs.