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OCIE Staff Publishes Summary Report on Broker-Dealer Practices Relating to Information Barriers

On September 27th, the Staff of the SEC's Office of Compliance Inspections and Examinations issued a summary report of information barrier examinations of 19 brokerage firms, including several of the largest broker-dealers, that were conducted by the SEC, FINRA and New York Stock Exchange ("OCIE Report" or the "Report"). The OCIE Report contains the first comprehensive statement in more than two decades of the SEC's views regarding financial firms' controls to prevent the misuse of material, non-public information ("MNPI").

Broker-dealers would be well advised to carefully consider the market practices described and the recommendations contained in the OCIE Report. In recent years the SEC has brought significant enforcement cases and imposed substantial fines against broker-dealers for perceived failures in the implementation of adequate information barriers. While the OCIE Report states that it reflects only the views of the Staff, and does not comprise legal authority, it may nevertheless be cited as setting appropriate standards by future examiners in deficiency letters or by the SEC in enforcement actions.

Reviewing the report would also be worthwhile for investment advisers, which increasingly must confront and manage MNPI and information barriers, particularly as their strategies and investment styles broaden.

I. Introduction

On September 27th, the Staff of the SEC's Office of Compliance Inspections and Examinations issued a summary report of information barrier examinations of 19 brokerage firms, including several of the largest broker-dealers, that were conducted by the SEC, FINRA and New York Stock Exchange ("OCIE Report" or the "Report"). The OCIE Report contains the first comprehensive statement in more than two decades of the SEC's views regarding financial firms' controls to prevent the misuse of material, non-public information ("MNPI").

The most recent prior report, issued in 1990, provided an overview of then-existing broker-dealer practices and a framework for enhancement of firms' controls in light of the duties that were imposed on them by the Insider Trading Sanctions Act of 1988 ("1990 Report"). The newly released OCIE Report notes that while the broker-dealer community largely has adopted the information barrier framework and has addressed the concerns set forth in the 1990 Report, best practices have evolved as businesses have changed. Accordingly, the OCIE Report stresses that firms have an obligation to "continually assess" potential sources of MNPI and the adequacy of their information barrier controls. After exploring a variety of ways in which a broker-dealer may be in possession of MNPI, the OCIE Report cites practices and controls the Staff deemed effective, as well as areas of perceived weakness and other compliance gaps.

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Reviewing the report would also be worthwhile for investment advisers, who increasingly must confront and manage MNPI and information barriers, particularly as their strategies and investment styles broaden.

The OCIE Report can be found at the following link: <http://www.sec.gov/about/offices/ocie/informationbarriers.pdf>

II. Sources of MNPI

The OCIE Report contains a series of examples of sources and types of MNPI that financial firms may encounter across lines of business, including in areas not traditionally thought of in connection with MNPI policies and procedures.

With respect to firms' corporate clients, for example, the OCIE Report notes that not only may a firm's investment banking department be in possession of MNPI regarding pending mergers & acquisitions, but its derivative sales department might be also, after being requested to provide a price quote in connection with the contemplated transaction. *Id.* at 9. The OCIE Report similarly observes that firms' capital markets functions may encounter MNPI during due diligence on a transaction, such as that a company is expected to report reduced earnings, and that firms' credit desks may receive MNPI from corporate borrowers in the form of initial and ongoing financial information. *Id.* at 10-12.

With respect to lending arrangements, the OCIE Report identifies at least seven touchpoints from which a financial firm could acquire MNPI. *Id.* at 12-13. The Report explains that financial firms that serve as the administrator for loans from corporate borrowers arrange for the receipt of confidential financial information that will be provided to lenders through "Loan Site" information repositories. Confidential information is protected by designating lender groups permitted to access the Loan Site's "private side," which groups are restricted from trading, and lender groups that do not access the Loan Site's "public side," which groups are permitted to trade. Public side groups require "Loan Monitors" to access the Loan Sites on their behalf. Thus, according to the OCIE Report, broker-dealers could have access to MNPI while acting as (among other things): 1) administrative agent; 2) syndicate member; 3) holder of interest in the loan; 4) manager of the loan site; 5) loan trader; 6) loan site monitor; or 7) bankruptcy committee member, if the borrower defaults. *Id.*

The OCIE Report also examines firms' potential for receiving MNPI in the context of public finance securities and securitized products. *Id.* at 13-14. The OCIE Report states that while broker-dealers examined by Staff generally believed that they could not be in possession of MNPI with respect to securities that did not yet have a market, firms should consider whether

non-public information could be material to any class of securities that is outstanding. *Id.* at 14. The OCIE Report also notes that after these securities have been issued, broker-dealers could possess potential MNPI regarding items such as ratings changes, liquidity problems, substitution of property underlying the securities and regulatory investigations. *Id.*

The OCIE Report denotes Proprietary Groups (subject to the requirements of Dodd-Frank), that are engaged in buy-side businesses, as sources of potential MNPI. *Id.* at 14-15. Proprietary private equity businesses, for example, may appoint board designees who receive confidential information from companies. Such groups also might be approached, as customers, about a potential investment in an offering that has not publicly been disclosed. *Id.*

With regard to sales and trading businesses, the OCIE Report flags customer order information as a possible source for MNPI. *Id.* at 15-16. The OCIE Report states that information about institutional customers' pending orders (as well as prime brokerage information about executed orders pending settlement) may be MNPI, and further urges firms to evaluate whether "market color" regarding pending orders could be MNPI, particularly when based upon or representing a particular customer's order. *Id.* at 16. Regarding wealth management businesses as well, the OCIE Report contains cautions about pending orders of company insider clients, and states that customers should evaluate the adequacy of their controls to prevent the misuse of such information. In research, the OCIE Report notes that changes in research ratings or coverage could constitute inside information. *Id.* at 17.

Within a firm's compliance infrastructure, the OCIE Report notes that in some instances a broker-dealer's control room and control systems can themselves become sources of MNPI. *Id.* at 17. In particular, the Report warns that broker-dealers must be cautious with the MNPI contained in control room databases and conflicts checks systems. *Id.*

III. Potential Sources of Concern

The OCIE Report expresses various concerns about current broker-dealer information barrier practices, including (but not limited to) the following.

"Above the Wall" Designations

The Report notes approvingly that broker-dealers classify their activities as being on either the "private side" or the "public side" of information barrier walls. *Id.* at 18. The Report expresses concern, however, about the use of an "above the wall" designation for certain persons and groups, such as senior managers, as well as research department and syndicate group employees, who are permitted to receive MNPI without preapproval or monitoring. *Id.* The Staff believes that broker-dealers should consider "whether the category is appropriate and whether additional controls should be in place." *Id.* As for personnel who truly may need to receive MNPI without preapproval, such as senior executives, the Report says that firms should consider implementing disclosure and monitoring requirements for them. *Id.*

Materiality Determinations

The OCIE Report criticizes the practice of not monitoring transactions a firm may deem immaterial, particularly when those determinations are not sufficiently documented in the Staff's view. *Id.* at 20. The Report emphasizes that the Staff believes that registered broker-dealers have responsibility to make and document the basis of their materiality judgments.

Id. Moreover, the Report discourages a categorical determination that certain types of transactions are not material, and states that if a transaction is later determined to be material, broker-dealers must be prepared to justify the decision to forego monitoring the transaction. *Id.* The Report further notes that some transactions that categorically had been excluded from monitoring by one firm had been considered significant by contemporaneous public commentators. *Id.*

Informal Discussions Between Departments

The Report expresses concern about frequent, undocumented, informal discussions that occur between employees in different parts of an organization, some of whom may possess MNPI, such as dialogue between investment bankers and sales people to obtain information about a client. *Id.* at 27. According to the Report, the undocumented nature of such discussions makes any disclosure of MNPI difficult to monitor. *Id.* at 27-28.

Compliance with Oral Confidentiality Agreements

The Report notes that while firms' legal departments act as an independent check to ensure the control room has been notified of the provision of MNPI about pending offerings when the deals are governed by written confidentiality agreements, this check is lacking in deals that are governed by oral confidentiality agreements confirmed through e-mails, such as overnight deals. *Id.* at 32. The Staff expresses concern that this may impair the control group's ability to conduct appropriate monitoring. *Id.* However, the Report notes with approval certain firms' look-back reviews for trading in advance of the announcement of M&A transactions and of PIPEs. *Id.*

Personal Trading Problems

The Report notes without criticism that most firms do not monitor personal trading in discretionarily managed accounts, but expresses concern about firms' failure to scrutinize employees' ability to influence trading in those accounts. *Id.* at 37-38. In addition, the Report criticizes firms for failing to respond, or offering only a weak response, to employees' repeated failures to obtain pre-clearance prior to personal trading. *Id.* at 38.

IV. Controls Perceived To Be Effective

The Report applauds the following controls as examples of best practices.

Control Room Monitoring

The Report praises firms that use independent checks (such as automatic notices from conflicts systems and review of confidentiality agreements) to ensure that the control room has been promptly notified that the firm may come into possession of MNPI. *Id.* at 47. The Report also applauds control rooms that make and document determinations of the materiality of information received, and that actively assess whether they may be in possession of MNPI that is unrelated to a securities transaction, such as the results of a corporate issuer's unannounced earnings. *Id.*

Information Barriers

The Staff also applauds the use of formal, documented processes for taking public side employees over information barrier walls. *Id.* at 30-31, 47. The Report also positively references the use of controls around conversations between investment bankers and institutional investors, such as prequalification of the investor, advance submission of questions subject to discussion and mandatory participation by senior bankers. *Id.* at 35. In addition, the Report applauds physical barriers, including segregation of departments that routinely have access to MNPI (e.g., investment banking, credit and private equity, research covering corporate issuers, conflicts and control room, and printing and production). *Id.* at 28-29, 48. The Report also discusses approvingly the use of technological barriers, such as limiting access to databases and shared network spaces, disabling "autocomplete" to reduce misaddressed e-mail and disabling users' ability to download and print information. *Id.* at 29-30, 48.

Surveillance

The Report observes positively that many broker-dealers have expanded their surveillance of trading by including a wider range of transactions and instruments being reviewed (e.g., credit default swaps, total return swaps, warrants and bond options), employing pattern-based surveillance that assesses historical trading patterns or accumulations of positions over time, and conducting lookback reviews upon announcement of information. *Id.* at 39-40, 49. Broker-dealers also are reviewing e-mails for information barrier concerns, including the circulation of “internal use only” documents outside the firm, and are reviewing employee trading by contingent workers who have access to MNPI. *Id.* at 37, 49.

V. Conclusion

The OCIE Report is important because it provides a primer on financial firms’ prevailing practices and controls for policing the use and handling of material nonpublic information and – more importantly – the OCIE Staff’s assessment of those practices. Any firm seeking to improve its controls over MNPI and to understand the Staff’s view of “do’s” and “don’t’s” in this area will benefit from understanding the Report’s contents.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

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