



Investment Banks Must Have and Enforce Policies to Prevent Misuse of Material, Nonpublic Information

The Securities and Exchange Commission recently settled charges that a Philadelphia-based broker-dealer (the “Broker-Dealer”) failed to establish and enforce policies and procedures to prevent the misuse of material, nonpublic information, as required by law.¹ The Broker-Dealer, without admitting or denying the findings, agreed to be censured and to pay an \$850,000 penalty to settle the SEC’s administrative proceeding. It also agreed to cease and desist from committing or causing any violations of Section 15(g) of the Securities Exchange Act of 1934 (the “Exchange Act”) and agreed to retain a consultant to develop such policies and procedures. The SEC’s Order reinforces the need for broker-dealers to have effective informational firewalls and policies and procedures, as well as the need to enforce existing procedures.

Section 15(g) of the Exchange Act,² requires brokers and dealers registered with the SEC to 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 the Exchange Act or the rules or regulations thereunder, of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer. Section 15(g) does not prescribe particular procedures. In response, the financial industry implemented or enhanced their existing “Chinese Walls,” which are intended to be “self-enforced informational barrier[s] consisting of systematic, as opposed to *ad hoc*, procedural and structural arrangements . . . designed to stem the flow of knowledge (in particular, unpublished price sensitive information) between different divisions within a multi-capacity financial intermediary with conflicting interests and obligations.”³ In 1990, the SEC’s Division of Market Regulation issued a report on informational barriers within financial firms,⁴ and it has been consistent in policing Section 15(g) violations. The Order once again demonstrates the consequences of failing to have strong policies or to enforce existing ones.

¹ *In re Janney Montgomery Scott LLC*, SEC Exchange Act Release No. 64855 (July 11, 2011); Administrative Proceeding File No. 3-14459, available at <http://sec.gov/litigation/admin/2011/34-64855.pdf> (the “Order”). For purposes of this News Bulletin, we assume the facts described in the Order are true. See also Press Release, SEC, SEC Charges Janney Montgomery Scott Failed to Maintain and Enforce Policies to Prevent Misuse of Material, Nonpublic Information (July 11, 2011), available at <http://sec.gov/news/press/2011/2011-144.htm>.

² Section 15(g) was originally enacted as Section 15(f) as part of The Insider Trading and Securities Fraud Enforcement Act of 1988.

³ Harry McVea, *Financial Conglomerates and The Chinese Wall: Regulating Conflicts Of Interest 123* (New York, Oxford University Press 1993).

⁴ See “Helpful Resources” at the end of this News Bulletin.

What Happened

The SEC's Order focuses on the period beginning October 2004 and specifically from at least January 2005 through July 2009, and on the relationship between the Broker-Dealer's Equity Capital Markets ("ECM") area and its research analysts. The following is a list of the SEC's findings with respect to the relevant period:

- There were no relevant written policies until September 2005.
- The policies issued in September 2005, known as the ECM Compliance and Supervisory Manual ("ECM Manual") applied to both the ECM division, which oversaw equity sales, trading, syndicate and research, and the Investment Banking group, which is part of the Capital Markets Group.
- The ECM Manual was not revised over time in response to changes in the role of research analysts.
- As of July 2009, the ECM Manual was incomplete.
- At least three compliance personnel left during the relevant period.
- The lack of appropriate coordination between different compliance functions within the entity resulted in no monitoring of overall trading strategy and trading patterns.
- There were significant differences in compliance and enforcement procedures by compliance personnel, including with regard to chaperoning and record keeping.
- Investment bankers and research analysts did not follow the chaperoning procedures that were in the ECM Manual, including having meetings and phone calls with each other without a chaperone, and having non-compliance personnel, such as the former head of Investment Banking or the head of Research, chaperoning meetings.
- There was a failure to maintain and enforce the email communication firewall.
- There was a failure to monitor contacts between investment bankers and research analysts.
- Employees were permitted to maintain trading accounts outside of the firm and this account activity was not supervised.
- Investment bankers were allowed to trade without pre-clearance.
- An employee who was not a registered principal was allowed to conduct supervisory reviews of the pre-clearance of trades and a business supervisor (without access to the Watch List) was allowed to review retail registered representatives' outside accounts.

The SEC's Response

After providing a brief history of Section 15(g) of the Exchange Act, the SEC staked out its position clearly:

Broker-dealers must be cognizant of their duties under Section 15(g), particularly as their businesses evolve and as they experience personnel changes in compliance and management. The Commission has made clear that the requirement that broker-dealers implement and maintain policies and procedures consistent with the nature of its business "is critical to effectively preventing the misuse of material, nonpublic information." *[internal citation omitted]* The Commission also has consistently made clear that broker-dealers must take seriously their responsibilities to design and enforce sufficiently robust policies

and procedures to prevent the misuse of material, nonpublic information. Where they have failed to do so, the Commission has repeatedly issued sanctions against the firms.⁵

The SEC then concluded that as a result of its failure, from at least 2005 through July 2009, to adequately establish, enforce or maintain written policies and procedures reasonably designed, given the nature of its business, to prevent the misuse of material, nonpublic information, the Broker-Dealer willfully violated Section 15(g) of the Exchange Act.

The SEC imposed the following sanctions: a cease and desist order from further violations of Section 15(g), censure and an \$850,000 civil money penalty. More prophylactically, the SEC ordered that the Broker-Dealer retain at its own expense a qualified independent consultant “not unacceptable to the staff” to conduct a comprehensive review of policies, practices and procedures relating to Section 15(g) of the Exchange Act, including:

(1) the prevention of the misuse of material, nonpublic information as required . . . by Section 15(g) of the Exchange Act, taking into consideration the nature of [its] ECM business; (2) . . . ECM policies and procedures relating to: (i) the nature of its equity capital markets business; (ii) its training procedures for chaperones and its chaperoning processes; (iii) its Information Wall policies and procedures and when parties should be brought over the Information Wall; and (iv) its use of a Watch or Restricted List.⁶

The Broker-Dealer is also required to adopt and comply with the recommendations of the consultant, subject to its right to submit to the SEC an alternative policy for those recommendations considered to be unduly burdensome or impractical. The Broker-Dealer must certify to the SEC at the end of 2012 that it has established and continues to maintain policies, practices and procedures pursuant to Section 15(g) that are consistent with the findings of the Order.

The Takeaways

This is a strong reminder to broker-dealers and their compliance personnel of the need to have and enforce strong and up-to-date policies and procedures, particularly in light of rapid changes in technology and new offering protocols (such as confidentially marketed public offerings). In establishing such policies and procedures, broker-dealers should:

- Develop detailed and comprehensive policies and procedures responsive to the broker-dealer’s business and to the requirements of the regulations
- Monitor these policies and procedures to ensure that they remain relevant to the broker-dealer’s changing business and strategic plans
- Monitor the industry to ensure compliance with best practices as they evolve
- Create a culture of compliance, including
 - Support for the mission of the compliance personnel⁷
 - Training compliance personnel
 - Continuing education and training of investment banking, research and trading employees
 - Enforcing chaperone requirements

⁵ The Order, *supra* note 1 at 7. The Order cited 11 administrative proceedings from 1996 through 2010.

⁶ *Id.* at 9.

⁷ The Order emphasizes the resignations of the compliance personnel but does not identify the reasons for the departures.

- Use technology to support compliance, including
 - Strong email firewalls between investment banking and research
 - Monitoring of trading by employees, particularly in outside accounts
- Review procedures and policies regularly to capture new technologies and their use and misuse
- Monitor and frequently update Watch, “Gray” and Restricted Lists
- Review wall-crossing procedures
- Prohibit employees from having outside accounts except for very limited exceptions
- Prohibit trading without pre-clearance for specified employees

The Order addressed a violation of the Section 15(g) requirement of policies and procedures. It is also important to remember that a strong Chinese Wall can strengthen the defense against liability for insider trading or a breach of a duty to a customer (which would arise as a result of the imputation of knowledge of an employee to his employer).⁸

Recent FINRA Disciplinary Action

The Financial Industry Regulatory Authority (“FINRA”) also regulates, supervises and enforces broker-dealer requirements. On June 28, 2011, FINRA entered an Order Accepting Offer of Settlement⁹ from Midtown Partners & Co, LLC relating to Midtown Partners’ failure to have reasonable written supervisory procedures or a reasonable system of supervision regarding information barriers, particularly in connection with the firm’s role as placement agent for PIPE transactions, in violation of NASD Rules 3010¹⁰ and 2110.¹¹ As with the SEC’s Order, FINRA found that over the relevant period, Midtown Partners (i) had no written supervisory procedures regarding creation or distribution of a watch list; (ii) failed to comply with its own existing procedures regarding its restricted list; (iii) did not monitor employee accounts or trading outside the firm; and (iv) had no procedures to restrict the flow of material, nonpublic information and, in fact, shared such information with unregistered individuals who were owners of the firm, including the details of investment banking contracts. FINRA ordered sanctions of a censure and a fine of \$30,000.

Helpful Resources

For more than 30 years, there have been judicial, regulatory and industry initiatives designed to prevent such misuse and to guide broker-dealers in establishing effective policies regarding use and misuse of information and the relationship between investment bankers and research analysts. The following is a summary list of useful resources:

⁸ See, e.g., Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 SEC 933, Exchange Act Release No. 34-8459 (1968) and Slade v. Shearson, Hammill & Co., [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) 94, 329 (S.D.N.Y. 1974).

⁹ Dept. of Enforcement v. Midtown Partners & Co., LLC (CRD No. 104223), FINRA Disciplinary Proceeding No. 2008012242901 (June 28, 2011), available at <http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=18248>.

¹⁰ NASD Rule 3010, “Supervision,” available at http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=4395&element_id=3717&highlight=3010#r4395.

¹¹ NASD Rule 2110, “Standards of Commercial Honor and Principles of Trade,” available at http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=10557&element_id=7495&highlight=2110#r10557, was effective for the period covered by the Midtown Order but has been superseded by FINRA Rule 2110. See *infra* note 18.

- Report of the SEC’s Division of Market Regulation of the SEC, “Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Nonpublic Information,” which discussed minimum elements required for adequate information barriers;¹²
- NASD and NYSE, Joint Memorandum on Chinese Wall Policies and Procedures (June 21, 1991) (NASD Notice to Members 91-45 and NYSE Information Memo 91-22);¹³
- Global Research Analyst Settlement of 2003;¹⁴
- Statement of Principles and Recommendations Regarding the Handling of Material Nonpublic Information by Credit Market Participants (October 2003);¹⁵
- FINRA Rule 2711, addressing research reports and research analysts;¹⁶
- NASD Rules 3010, addressing FINRA member supervision requirements and procedures;¹⁷
- FINRA Rule 2110, addressing recommendations and suitability requirements;¹⁸
- “FINRA Provides Guidance Regarding the Review and Supervision of Electronic Communications (FINRA Notice to Members 07-59);¹⁹ and
- Chaperoning guidelines of the Securities Industry and Financial Markets Association (“SIFMA”).²⁰

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¹² Report of the SEC’s Division of Market Regulation of the SEC, *Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Nonpublic Information* (Mar. 1990), available at <http://www.sec.gov/divisions/marketreg/brokerdealerpolicies.pdf>.

¹³ NASD and NYSE, *Joint Memorandum on Chinese Wall Policies and Procedures* (June 21, 1991), available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=1182&print=1.

¹⁴ See SEC, *Global Research Analyst Settlement of 2003*, available at <http://www.sec.gov/spotlight/globalsettlement.htm>, as well as Addendum A to the Global Settlement, available at <http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf>, and the March 2010 Modifications, available at <http://www.subjecttoinquiry.com/finra-investigations/Pauley%20March%2015%202010.pdf>.

¹⁵ *Statement of Principles and Recommendations Regarding the Handling of Material Nonpublic Information by Credit Market Participants* (Oct. 2003), available at http://www.isda.org/c_and_a/pdf/jmpfStatement.pdf.

¹⁶ FINRA Rule 2711, available at http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=4352&element_id=3675&highlight=2711#r4352.

¹⁷ See *supra*, note 10.

¹⁸ FINRA Rule 2110 consists of Rule 2111, “Suitability,” which becomes effective on July 9, 2012, and Rule 2114, “Recommendations to Customers in OTC Equity Securities,” available at http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=8228&record_id=11290.

¹⁹ *FINRA Provides Guidance Regarding the Review and Supervision of Electronic Communications*, FINRA Notice to Members 07-59, (Dec. 2007), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p037553.pdf>.

²⁰ These guidelines are available only to members of SIFMA.

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