



## Good Walls, Better Compliance: OCIE's Report

On September 27, 2012, the Staff of the SEC's Office of Compliance Inspections and Examinations published a summary of examinations conducted by the SEC, the NYSE and FINRA of information barriers and practices of nineteen broker-dealers, including six of the largest broker-dealers. FINRA's examinations included a review of the practices of smaller broker-dealers that focus on PIPE transactions. The review focused on the information walls and other systems in place to ensure compliance with regulatory requirements related to the handling of material nonpublic information, or MNPI. Mishandling of MNPI may result not only in exposure to regulatory charges, but also to civil liability and reputational damage. While the report does not constitute an order or finding by the SEC, it provides valuable insight into the Staff's views, which will likely be reflected in future examination reports (and possibly enforcement actions) by the SEC, FINRA and the NYSE.

The report cites a number of specific concerns, including: informal and undocumented interaction between groups having MNPI and internal and external groups that have sales and trading responsibilities; senior executives designated as "above-the-wall" receiving MNPI without being subject to any monitoring or restrictions despite their managerial responsibilities for business units involved in sales and trading; the lack of a review process to evaluate trading that occurred after MNPI was provided to sales, trading or research personnel for business purposes; and gaps in oversight coverage.

The Staff cites in the report and in Appendix B to the report practices believed to be effective including: processes that differentiate between types of MNPI based on the business unit or source of the information or based on the nature or transaction type in order to create tailored exception reports or other tailored procedures; and processes that address a broader array of instruments for potential misuse of MNPI, including processes to identify potential misuse of MNPI through credit default swaps, TRSs, loans, composition or trading related to exchange traded funds and UITs, and warrants and bond options.

The Staff's report analyzes the different types of transactional or advisory services conducted by a broker-dealer as a result of which the broker-dealer may have access to MNPI, including, M&A advisory services, capital markets and syndicate functions, derivatives sales and trading, extensions of credit, public finance, securitized products, and research. A broker-dealer also may obtain MNPI from its institutional clients or clients that are insiders of a public company.

### **Handling MNPI within the Institution**

#### *Reporting Transactions to Control Room*

The report addresses the process employed to assess whether a transaction should be placed on a monitoring list. The report notes that often broker-dealers rely on a group in their compliance department designated as the "control room" to manage information barriers within the firm. The control room generally is responsible for

assessing the materiality of a transaction based on information shared by a deal team. However, the control room may not receive information promptly from the deal team, resulting in significant delays. Also, there may be insufficient guidance as to when information should be reported to the control room and an absence of procedures to assist bankers and other personnel to determine whether appropriate information was placed on a monitoring list. The report favorably comments on systems that provide automatic notifications to the control room. The report notes that some control rooms rely on information from pipeline reports, commitment committee minutes and other sources, which is viewed as helpful, although reliance on these approaches may also contribute to delays in adding transactions to monitoring lists.

### *Assessing Materiality*

Once information is shared with the control room, it is then assessed for materiality. The report notes that broker-dealers have an obligation to make reasonable judgments regarding materiality and should be prepared to justify their determinations regarding materiality (or immateriality). The report notes that these judgments may be subject to review in hindsight, and that transactions may be deemed “material” by the marketplace or commentators. As a result, the Staff states that it is important to identify the factors that should be considered in making a materiality assessment, and to document all assessments, including those which result in a determination that the information is immaterial. The report strongly urges broker-dealers not to exclude all transactions within certain categories—for example, all investment grade securities offerings—based on the firm’s view that they are immaterial, since some firms might consider at least some transactions within a category to be material.

### *Monitoring Lists*

The report comments on concerns arising in connection with placing transactions on a monitoring list, observing that some broker-dealers have policies that require them to be mandated officially before transactions may be added to a monitoring list. This may result in delays. The report also comments on the timing for removing transactions from the list. The report reviews the different types of lists maintained by firms and the purposes for maintaining these various lists.

### *Physical and Other Barriers*

The report also discusses the controls implemented by broker-dealers to prevent accessing and misuse of MNPI. In this regard, the report noted the importance of using appropriate technology controls and physical barriers to limit access on a need-to-know basis. The report also notes that MNPI may be compromised when an individual has dual job responsibilities, or if MNPI is shared in the course of informal discussions among members of various groups within the organization. Accordingly, broker-dealers should implement appropriate controls to test for potential breaches of their information barriers, including monitoring trading activity by employees, managed accounts, and, in some cases, customer accounts.

The Staff notes that Financial Sponsors Groups and Private Equity Groups often are not separated by physical barriers and integrated with other Investment Banking groups, which may pose risks that MNPI may be shared.

### *Information Received Pursuant to Confidentiality Agreements or Undertakings*

The Staff notes its concerns regarding the lack of controls in connection with receiving information about confidentially marketed offerings. The report notes that information may be shared pursuant to a written confidentiality agreement, as well as through oral discussions followed by emailed confirmation or emailed confidentiality undertakings. The report notes that, “No broker-dealer indicated that it has a control to identify emailed or oral confidentiality agreements entered into without notification to the Control Group. The staff is concerned that the lack of controls in these circumstances impacts the Control Group’s ability to monitor receipt

of confidential information by the business unit.” Given the prevalence of confidentially marketed offerings, broker-dealers would be well advised to implement procedures designed to notify the control room or otherwise monitor these transactions.

The staff also noted that broker-dealers need to consider controls to address circumstances in which an employee or group received MNPI and subsequently wants the restrictions removed. The report notes that some broker-dealers have established a set period of time that must elapse before the restrictions may be lifted.

The report notes that some broker-dealers have implemented surveillance measures to monitor disclosures of PIPE transactions and to review short positions created in advance of announcements of PIPE transactions.

### **Controls over Information Shared with External Parties**

The Staff notes in the report that confidential information, and at times MNPI, may be shared with institutional investors, usually when institutional investors are approached to participate in transactions. For example, in trying to gauge market interest in a potential offering, a broker-dealer may approach institutional investors.

The report notes that broker-dealers may pre-qualify institutional investors and determine the appropriate procedure established by that investor to receive information, which may be through a communication with the investor’s legal or compliance department. The report notes that the type or nature of the information to be shared will be identified in a confidentiality agreement or orally and confirmed subsequently by email. The report notes that some broker-dealers relied only on oral agreements and notes that reliance on oral agreements may impact the broker-dealer’s ability to monitor for misuse of MNPI. Most broker-dealers that were reviewed maintained a log of contacts made with investors.

The report also comments on the sharing of confidential information with investors through a virtual data room, and notes that, generally, broker-dealers are able to control access to these data rooms through unique passwords. However, the staff noted that there were no formal procedures to restrict access from investors that were no longer actively engaged in the process nor were there procedures in place to shut down the data room after the transaction has closed. The report notes that “The staff is concerned about the informal nature of controls surrounding virtual data rooms, including the lack of documentation, written procedures, and absence of an audit trail.”

The report discusses the sharing of more general market information (“market color”) with institutional investors. Such information may be derived from confidential information. The staff concludes that requirements or controls should be implemented to address these discussions. As an example, the report notes that some broker-dealers pre-qualify the institutional investors, require senior banker participation, “anonymize” the information that is being shared, and maintain a log of all meetings.

### **Surveillance**

The report discusses the surveillance procedures maintained by those broker-dealers that were examined. As to product scope, the report notes that broker-dealers generally have expanded the range of products that are being examined given that many products may be used to profit from MNPI. As noted above, broker-dealers are reviewing transactions in related derivatives. The staff notes that it “believes that broker-dealers should consider all instruments that may be used to profit from MNPI.” The report notes that “some broker-dealers issue structured products for which it or an affiliate is the issuing entity. If the structured product references specific securities and the broker-dealer has MNPI regarding the reference security, the broker-dealer may need to have controls to prevent the issuance of the structured product from being based on MNPI.”

The report also notes that broker-dealers are conducting a broader array of reviews to detect problematic trading patterns, including surveillance reports that address specific fact patterns. For example, the report cites instances in which broker-dealers generate reports related to trading by employees or desks that have obtained confidential information about a PIPE transaction or a confidentially marketed public offering.

## Conclusion

The SEC report provides many useful insights regarding the measures that are regarded by regulators as effective in preventing the misuse of MNPI. As we have noted in prior client alerts (see <http://www.mofo.com/files/Uploads/Images/110719-Investment-Banks.pdf>), the SEC and other enforcement authorities remain focused on the potential misuse of MNPI by broker-dealers and have been proceeding with enforcement actions to address inadequate procedures and information walls that have led to the misuse of MNPI. Given the proliferation of offering techniques that rely on confidential pre-marketing, broker-dealers should pay special attention to the types of procedures that can be implemented to prevent sharing of MNPI. Many broker-dealers are engaged in swaps activities and now focused on implementing information wall procedures for their derivatives businesses to address the requirements arising from the Dodd-Frank Act. By reading this report and comparing their policies and practices to those discussed by the SEC's staff, broker-dealers can try to ensure that their policies satisfy the regulator's standards.

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