

**BROKER-DEALER
INTERNAL CONTROL PROCEDURES
FOR HIGH YIELD SECURITIES**

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



October 1993

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

SECTION ONE INTRODUCTION AND OVERVIEW

The Division of Market Regulation ("Division") has conducted a number of reviews of internal control procedures at broker-dealers that are designed to segment the flow and prevent the misuse of material, nonpublic information (commonly referred to as "Chinese Wall" procedures) and to prevent improper trading by their employees in their personal accounts.¹ The Division's earlier reviews of internal control procedures focussed on operations involving equity securities. The unique characteristics of the market in non-investment grade ("High Yield") securities² suggested that broker-dealer activities in these securities should be reviewed separately.³ Accordingly, in November 1992, the Division conducted interviews of key personnel at six broker-dealers that are among the most active firms in trading, sales, underwriting, and research operations for High Yield securities. The Division reviewed each

¹ The Division has conducted reviews of broker-dealer Chinese Wall procedures in 1987, 1988, and 1989. In 1987, the Division reviewed procedures at six large diversified broker-dealers located in New York City. Subsequent to this review, the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA") was enacted, requiring, among other things, that all broker-dealers strengthen their internal control procedures designed to prevent the misuse of material, nonpublic information. Further, the Commission was granted the authority to promulgate rules or regulations to require specific policies or procedures in this area. Accordingly, in 1989, the Division undertook a more comprehensive review of the control procedures within a larger sample of broker-dealers. As part of this review, the Division requested information concerning Chinese Wall procedures from 54 broker-dealers nationwide. Of these firms, the Division selected 23 broker-dealers for more detailed reviews and on-site interviews. An overview of the Division's findings was issued in a public report entitled Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Nonpublic Information (March 1990)("1990 Chinese Wall Report"). In addition, the Division conducted inspections in 1988 and 1989 to review efforts by the New York Stock Exchange ("NYSE") and American Stock Exchange to monitor Chinese Wall procedures at member firms with specialist operations and other business lines.

² High Yield securities include all corporate bonds that are not rated as "investment grade" by a nationally recognized rating service, such as Standard & Poor's or Moody's. An investment grade issue is defined as an issue with a high capacity to pay interest and repay principal, with little or no susceptibility to adverse effects or changes in economic conditions. A non-investment grade issue is one having predominantly speculative characteristics with respect to capacity to pay interest and repay principal. High Yield bonds, by definition, have lower credit ratings and higher rates of return than investment grade bonds (commonly referred to as "High Grade" bonds). The variety of High Yield securities and the dynamics of the secondary market in High Yield securities are discussed generally in a public report issued by the Division entitled The Corporate Bond Markets: Structure, Pricing and Trading (January 1992)("1992 Bond Report").

³ See 1990 Chinese Wall Report, at p.5 n. 16.

firm's written Chinese Wall procedures, as well as written policies and procedures concerning personal investments by the firm's employees ⁴ or their immediate family members.

In Section Two of this report, the Division outlines its general findings ⁵ concerning industry practices in the High Yield market. ⁶ The Division found that the broker-dealers interviewed have taken a number of measures to strengthen their internal control procedures for High Yield operations. In particular, firms have adopted control procedures for the dissemination of High Yield research reports that may involve material information.

Some firms have sought to address these areas primarily by applying to High Yield operations many of the same Chinese Wall procedures that have been used for years for operations involving equity securities. This was particularly common in firms that have chosen to structure their High Yield research operations along the lines of research operations commonly used for equity securities and to channel more High Yield research into formal, printed (commonly referred to as "glossy") research reports akin to those normally produced for equity research. This operational framework appears to facilitate the application of traditional Chinese Wall procedures.

Other firms have decided to maintain close links between High Yield research and trading/sales operations and to emphasize the rapid development and dissemination of informal, oral research reports for High Yield securities. These firms have determined that the rapid flow of information within the firm and to the firms' institutional customers is essential and that the time required to produce glossy research reports may render the information in the reports stale. Written reports issued by these firms are more in the nature of memorializations of research that had been orally disseminated earlier. These firms have stressed refinements to their procedures to monitor and, in some cases, restrict, their employees' personal trading in High Yield securities.

In addition, some firms have determined that the most practical means of preventing improper trading by employees in High Yield securities (or even the appearance of questionable personal trading) is to impose absolute prohibitions against any personal trading in these securities by High Yield personnel. These firms have determined that, because much of the research (as well as other information sharing within and outside of the firms) is oral and, therefore, difficult to monitor, the application of many of the control procedures that traditionally are used in equity operations would be impractical for operations involving High Yield securities.

⁴ As used throughout this report, the term "employee" includes all personnel at a firm. For those firms structured as partnerships, therefore, this would include the firm's partners.

⁵ The Division's review of the firms' operations and procedures was conducted pursuant to the Commission's inspection and examination authority. Many of the firms' records that were provided for this review are proprietary and extremely confidential. As a result, the detailed findings from this review are nonpublic.

⁶ Section Two of the report is designed to be descriptive of industry practices and perspectives concerning High Yield operations. These descriptions should not be interpreted as endorsements or criticisms. The Division's determinations regarding broker-dealer control procedures for High Yield operations are provided in Section Three of the report.

Section Three of the report outlines the Division's determinations concerning broker-dealer control procedures for High Yield operations. The Division's overall findings suggest that, despite the firms' substantial efforts over the last year to strengthen their internal control procedures in this area, further work needs to be done.

The Division's interviews have raised some questions whether existing Chinese Wall procedures can be effective in dealing with the types of research, trading, and sales operations commonly used for High Yield securities. The Division is concerned that oral dissemination of High Yield research may not provide firms with sufficient records to ensure that traditional Chinese Wall procedures and controls of employee trading are implemented effectively. There are few, if any, records of when oral research is developed and disseminated within or outside of the firms. As a result, it would be nearly impossible to identify instances in which material, nonpublic information contained in the research might have been leaked before dissemination had been authorized by the firm, as well as instances in which employee trading around the time of the dissemination might have been improper. In such an environment, the approach already adopted by some firms, to prohibit all employee trading in High Yield securities, appears to be more realistic.

The Division, however, is not recommending that all firms, regardless of the nature of their research, trading, and sales operations in High Yield securities, immediately impose absolute prohibitions against employee trading in High Yield securities. In addition, given the limited scope of the Division's review, it would be inappropriate, at this time, to recommend to the Commission that rule-making should be undertaken in this area. Nevertheless, the Division believes that it would be prudent for those firms that choose not to impose prohibitions on employee trading to scrutinize their existing internal control procedures for High Yield securities. The Division reiterates its position that it is the firms' responsibility to ensure that Chinese Wall procedures, as well as procedures to monitor employee trading, are adequate to address operations in High Yield research, trading, and sales.

SECTION TWO INDUSTRY PRACTICES AND PERSPECTIVES

I. Overview of High Yield Operations and Chinese Wall Concerns

All of the firms reviewed have policies and procedures explicitly forbidding improper disclosures involving any securities. However, the dynamics of the High Yield market require that High Yield personnel, whether traders, salespersons or analysts, share or "pool" up-to-the-minute market information and research analyses to a greater degree than is the case in equity operations. The sharing of information between High Yield personnel functioning as a cohesive unit greatly complicates efforts to impose barriers to information flow within firms. Accordingly, firms must develop effective procedures that are reasonably designed to prevent the misuse of material, nonpublic information.

A. Interaction with Institutional Customer Base

Much of the trading activity in High Yield securities occurs at a few large broker-dealers,⁷ with ownership of High Yield securities concentrated in a relatively small group of institutional investors -- primarily mutual funds, pension funds, and insurance companies.⁸ The firms estimate that no more than 20 to 50 institutional customers are active in High Yield securities. In fact, one firm estimates that roughly 20% of these customers account for 80% of the firm's High Yield activity.

Most of the institutional investors, and in particular, the large mutual funds, are highly sophisticated, with market "leverage" vastly superior to the customer base for equities. Some of these institutional customers, especially the large mutual funds, receive daily quotation sheets (commonly referred to as "Axe" sheets) for High Yield securities from several broker-dealers. As large mutual funds may receive Axe sheets from several broker-dealers and each broker-dealer only has access to its own quotations, these customers may actually have informational advantages over the broker-dealers. In order to offset these advantages held by their customers, the firms claim that traders, sales personnel and research analysts need to continually discuss market developments.

In addition, many of these institutional investors employ personnel with training and experience comparable to that of traders, salespersons, and analysts at broker-dealers. As a result, the firms indicate that most day-to-day contacts between broker-dealer and customer personnel are more in the nature of trader-to-trader or analyst-to-analyst conversations. The firms claim that analysts at the institutions have little or no interest in the "buy, sell or hold" recommendations of the High Yield analysts at the broker-dealers. Instead, the institutional analysts usually call broker-dealer analysts in High Yield securities to compare their analyses of a particular issuer's ability to pay interest and repay principal for a particular security -- so-called "credit" analyses discussed below.

In sum, the firms stress that the flow of market information and credit analyses for High Yield securities involves a fairly constant stream of discussions on a daily basis between the research, trading, and sales professionals at the broker-dealers and their counterparts at the institutions. The firms indicate that this operational framework makes it difficult to segregate High Yield research activity from trading/sales activity.

B. Transparency and Liquidity Concerns

The transparency and liquidity of the High Yield secondary market is drastically more limited than is the case in most equity markets. While there are several initiatives to improve

⁷ The Division interviewed six of the ten broker-dealers with significant High Yield operations. However, the Division recognizes that other firms are active in particular "niches" in High Yield securities. For example, some firms are active in High Yield securities for issuers in bankruptcy, while other firms are active in private placements of High Yield securities.

⁸ Considerable changes have occurred in the composition of this market, however, since the late 1980s. These changes are discussed in the 1992 Bond Report, at 6-8.

the transparency of the High Yield market,⁹ the lack of information currently available to market participants necessitates that the traders, salespersons, and research analysts within each firm's High Yield unit pool information.

In the High Yield area, firms attempt to accommodate their institutional customers by making large purchases or sales of securities. In order to accomplish this without substantial capital commitments, firms encourage traders, salespersons, and analysts to pool information concerning potential buy or sell interests among their customer contacts. The firms view this information as critical in determining the appropriate pricing and structuring of transactions in High Yield securities.

To this end, each firm's High Yield operation is organized to facilitate the free flow of market information among the High Yield personnel that have day-to-day contact with customers. The firms expect research analysts to respond to customer inquiries and to keep customers abreast of market developments. This is the case regardless of whether the analyst is a "desk analyst" working on the trading floor to support traders or a segregated "High Yield research analyst" working at another location at the firm.¹⁰ For example, each firm interviewed conducts daily meetings in which all High Yield personnel¹¹ discuss market developments and buy or sell interests and review the daily Axe sheets.¹²

Of course, the free flow of information among High Yield personnel serves other purposes beyond canvassing customer buy or sell interest. Because all High Yield personnel are encouraged to keep in constant contact with the firm's High Yield customer base, the firms

⁹ In response to concerns raised by the Commission, the National Association of Securities Dealers has developed the framework for a new screen-based trading system for fixed-income securities known as the Fixed Income Pricing System ("FIPS"). On March 18, 1993, the Commission approved the implementing rules and regulations for FIPS. See Securities Exchange Act Release No. 32019 (March 19, 1993) 58 FR 16428. Once operational, FIPS could improve significantly the transparency of the market for at least actively traded High Yield securities. Separately, several broker-dealers have initiated their own computerized trading system, known as the Electronic Joint Venture or "EJV Partners" that has the potential for improving the transparency of this market. See 1992 Bond Report, at p. 12.

¹⁰ Several firms, however, have recently implemented procedures to physically segregate research analysts from traders and salespersons pursuant to strengthened Chinese Wall procedures.

¹¹ Some firms permit investment banking personnel to attend these daily meetings in order to increase the investment bankers' familiarity with current market trends and customer interests. Several firms also permit investment banking or "Capital Markets" personnel to maintain desks on the High Yield trading floor. In these instances, however, the firms indicate that these personnel are required to maintain all confidential, nonpublic information at desks located in segregated areas off the trading floor.

¹² In addition, many of the firms interviewed use a variety of intra-firm communication systems (e.g., electronic mail).

believe that impediments to information flow could result in different personnel giving customers contradictory or outdated information.

C. Credit Analyses versus Equity Research

The firms postulated another reason for the close interaction of research analysts and traders/salespersons -- the type of analyses necessary for High Yield securities. Despite the observation that "High Yield debt trades more like equity," the firms stress that they view High Yield analyses as credit analyses along the lines of those produced for High Grade debt securities. In other words, these analyses are more in the nature of periodic analyses released incrementally. The issuers of High Yield debt often are not "public" companies subject to the Commission's financial reporting requirements. The firms indicate that the time required to prepare a glossy research report would render it useless to the institutional analyst.¹³ In this context, the institutional customer would be unlikely to request or accept buy, sell or hold recommendations for a particular High Yield security.

The firms believe that it would be highly unusual for the issuance of a High Yield research report to be a "market moving" event. The firms find it unlikely that most analyses provided by a broker-dealer analyst to institutional analysts would influence the High Yield security's prices/yields. Although the liquidity of many High Yield securities is limited and a small number of transactions by one institution may significantly influence prices/yields, the firms believe that most High Yield research rarely takes the form of a buy or sell recommendation resulting in customer transactions in the High Yield security. Therefore, the firms' view on High Yield credit analyses have influenced their determinations regarding the application of Chinese Wall procedures to High Yield research operations.

II. Current Internal Control Policies and Procedures

A. Chinese Wall Procedures

1. High Yield Investment Banking

All of the firms have long-standing Chinese Wall procedures in place to prevent the misuse of material, nonpublic information that often is received by personnel in the firms' investment banking operations. The standard procedures used by particular firms in underwritings, restructurings, or other deals involving equities are applied by these firms to comparable activities involving High Yield securities. These procedures include: (1) physical segregation of investment banking operations; (2) safeguards to limit access to documents and other materials containing material, nonpublic information; (3) educational programs for firm employees to stress prohibitions against misuse of such information; (4) monitoring tools such

¹³ While glossy research reports periodically are issued for High Yield securities, the firms view these documents as mere memorializations of analyses that already have been fully disseminated to the institutional customer base. The purpose of these formal reports is to provide documentation for the institutional analyst or trader to support his investment recommendations.

as "watch" or "grey" lists,¹⁴ "restricted" lists,¹⁵ and, in some cases, additional monitoring lists¹⁶ for selected securities; (5) procedures to document and monitor instances in which firm personnel are authorized to "brought over the wall"¹⁷ for a given project; and (6) employee investment policies and procedures to identify questionable transactions.¹⁸

2. High Yield Research

Several firms indicate that they have become more sensitive to proprietary or employee trading in a High Yield security immediately before the firm releases a material research report concerning this security. Firms believe that trading before the issuance of such a report could

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- ¹⁴ At most firms, the compliance or legal staff maintain a "watch" or "grey" list of securities. A security is added to this list whenever an investment banking engagement is entered into between the broker-dealer and the security's issuer -- or in any other instance in which one part of the broker-dealer has received material, nonpublic information concerning the issuer. The compliance or legal staff uses this list to monitor the firm's activities. For example, if a firm employee buys or sells a security on this list, the compliance or legal staff needs to determine if this transaction is indicative of a "breach" of Chinese Wall procedures.
- ¹⁵ When an investment banking transaction becomes "public" (through a filing with the Commission or otherwise), firms will add the issuer's securities to a "restricted" list accessible to personnel throughout the firm. Once this is done, most, if not all, trading by proprietary and employee accounts is prohibited for set time periods. In addition, other firm activities, such as the issuance of research recommendations concerning the issuer's securities, also are severely limited or prohibited for set periods. Because the effects of such restrictions are so wide-ranging, securities are not added to the list until deals are made public. Otherwise, adding a security to this list might send a signal both within and outside the firm that a nonpublic transaction is imminent.
- ¹⁶ Many firms have implemented a third type of list for use after a security is added to the watch or grey list but before the security has been added to the restricted list. If compliance or legal personnel determines that the firm's or employees' activities should in some way be limited, the security is placed on this list. For example, just prior to the public announcement of an investment banking transaction, the compliance or legal staff may instruct the firm's market makers to trade the issuer's securities in a "passive" manner (*i.e.*, by executing only unsolicited customer trades).
- ¹⁷ If, in the process of developing a nonpublic underwriting transaction, a firm's investment banking personnel determine that the views of a particular research analyst would greatly assist the structuring of the potential underwriting, the research analyst may be informed of the nonpublic underwriting effort and "brought over the wall" to assist the investment banking team. The research analyst would then be informed that he or she must maintain the confidentiality of this transaction and that certain limitations will be imposed on the analyst's activities until the transaction becomes public. For example, the analyst might be prohibited from issuing research reports concerning this issuer until compliance or legal staff notifies the analyst that the limitations have been lifted.
- ¹⁸ See generally 1990 Chinese Wall Report.

create the appearance of impropriety or illegality. As a result, several firms have taken a number of steps to apply Chinese Wall procedures to research reports involving High Yield securities.

Two firms, for example, have removed research analyst desks from the trading floors and have reorganized their High Yield research operations as distinct departments separate from High Yield trading/sales departments. Both firms stress that if their High Yield research analysts are in the process of drafting a formal research report, they are not permitted to share the contents of this report with any firm personnel other than their supervisors until the final report is approved for distribution.¹⁹ These firms indicate that High Yield traders and salespersons should not be aware of the preparation of High Yield research reports until they receive copies of the final reports.²⁰

In order to monitor segregation of High Yield personnel, the compliance staff must be notified by supervisors in High Yield research whenever an analyst begins preparing a formal research report. This "pre-clearance" procedure serves several functions. If a report will discuss a company that already appears on a watch or restricted list, it may be appropriate to stop or delay the preparation of this report. This pre-clearance is designed to avoid situations where analysts devote time and resources to prepare a research report which cannot be released because it involves a company on a watch or restricted list.²¹ In addition, the High Yield securities that are the focus of a pending report are added to the firm's watch list. This permits the compliance staff to monitor any proprietary and employee trading in High Yield securities that are the focus of these draft research reports. Compliance staff at one firm also perform a five-day "look-back" procedure after a formal High Yield report is completed and distributed.

B. Limitations on Employee Accounts

As discussed above, some of the firms reviewed by the Division indicate that they view the application of strict Chinese Wall procedures in this area as unworkable and unnecessary, given the nature of most High Yield research activity. These firms, therefore, tend to concentrate their internal controls on approving and monitoring employee trading in High Yield securities.

¹⁹ All of the firms have procedures in place for High Yield research reports to be reviewed by compliance or legal staffs prior to distribution outside of the firm.

²⁰ Even these firms, however, continue to permit some "time-sensitive" research to be orally disseminated. For example, if an article in a financial periodical discusses the credit worthiness of a specific issue or a business development that might affect this credit worthiness, High Yield analysts might prepare a quick analysis that could be shared within the firms and with the firms' customers. The firms acknowledge that, in these circumstances, it may not be feasible to produce a glossy report that would be subject to the normal Chinese Wall and employee account controls.

²¹ If the compliance staff determines that a High Yield research report should not be distributed, the research department is usually not informed why the distribution is being delayed or cancelled, in order to prevent "tipping" research personnel concerning the contents of a watch list.

1. Approval and Monitoring of Employee Trading

Four of the six firms interviewed permit High Yield employees to buy or sell High Yield securities for their personal accounts. Each of these firms, however, requires its High Yield employees to obtain approval from their supervisors or compliance officers for any personal transactions in High Yield securities.²² These firms have also implemented routine procedures that require compliance personnel to document transaction approvals and to monitor employee transaction records.²³

2. "Holding Periods"

Two firms require that employees maintain positions in High Yield securities for at least six months. The firms view this "holding period" requirement as an important safeguard against employees trading in and out of positions in order to take advantage of short-term price swings that might be related to material, nonpublic information.

3. Application of a "48-Hour Rule"

Many broker-dealers limit employee trading of securities mentioned in an equities research report until a set time period elapses to permit all of the firms' customers to receive and review the research report. Because many firms set a two-day period for such limitations, this procedure is commonly referred to as the "48-Hour Rule."²⁴ The four firms that permit High Yield employees to trade High Yield securities restrict trading in these securities for 48 hours after the issuance of glossy research reports, at least in instances in which the reports are deemed to be material. As previously discussed, however, the firms indicate that such material research reports for High Yield securities are relatively rare.

4. Absolute Prohibitions Against High Yield Transactions

While four of the six firms reviewed by the Division significantly limit High Yield employee transactions in High Yield securities, the two remaining firms have moved even further by adopting absolute prohibitions against High Yield employees investing in any High Yield securities under any circumstances. These firms acknowledge that these absolute restrictions have been difficult to justify to their personnel, given the lack of such restrictions on personnel at rival firms. However, due to the constant flow of information throughout High Yield departments, these firms believe that absolute restrictions are the best means of minimizing the likelihood of improper employee trading. For these firms, even the appearance

²² NYSE members are required under NYSE Rule 407 to obtain pre-trade clearance for all member firms' employee transactions. NYSE Rules 342 and 351 contain additional supervision, control, and reporting requirements.

²³ NYSE Rule 407 also requires NYSE members to maintain all employee personal or family trading accounts at the employees' firm. Exceptions may be granted, for example, in instances in which an employee's spouse works for another broker-dealer. Under these circumstances, the spouse would be permitted to maintain his or her account at the spouse's firm. Even in these circumstances, however, firms are required to obtain duplicates of the confirmations and statements for the spouse's accounts.

²⁴ The 48-Hour Rule is frequently applied to proprietary trading in equity securities.

of impropriety or conflicts of interest is sufficient rationale for prohibiting any employee trading.

SECTION THREE THE DIVISION'S DETERMINATIONS

As discussed in Section Two of this report, the broker-dealers interviewed by the Division have taken a number of measures over the last year to strengthen their internal control procedures for High Yield operations. In particular, firms have adopted control procedures for the dissemination of High Yield research reports that may involve material information; some firms stress elaborate Chinese Wall procedures, while others rely more heavily upon absolute or partial restrictions on employee trading in High Yield securities.

The Division does not believe that it would be appropriate or useful to recommend that the Commission develop guidelines or rules that establish specific internal control procedures that must be maintained by all firms active in High Yield securities, regardless of the firms' operational structures or the types of securities involved. Nevertheless, the Division's interviews have raised some questions whether existing Chinese Wall procedures, which mostly are patterned after those applied to equity securities, can ever be as effective in dealing with the types of research, trading, and sales operations commonly used for High Yield securities.

As discussed in Section Two of the report, a few firms have chosen to structure their High Yield research operations along the lines of research operations commonly used for equity securities. These firms have taken measures to segregate High Yield research departments from High Yield trading/sales operations. In some cases, not only have the research departments been moved to locations physically separate from trading/sales floors, but research department managers attempt to monitor and limit discussions between research analysts and traders or salespersons, particularly concerning pending research reports. This is possible because the firms have devoted resources to channel more High Yield research into glossy research reports akin to those normally produced for equity research. The production and issuance of written reports provides managers and compliance personnel with records of when a report was initiated and finalized by particular analysts and when it received clearance for dissemination within and outside the firm. These records, in turn, permit compliance staff to use watch list and "look-back" Chinese Wall procedures to review trading in the High Yield securities discussed in the report both before and after the report's dissemination. These procedures would be used to identify any instances in which some unauthorized release of information contained in the report might have affected prices/yields or the firm's trading or positions in the High Yield security. These records also facilitate efforts to monitor employee trading in High Yield securities. In addition, should the firm choose to enforce a 48-Hour Rule for employee trading in the security covered by a written research report, this also can be used to avoid even the appearance of any impropriety involving employee trading.

On the other hand, some firms have decided to maintain close links between High Yield research and trading/sales operations and to emphasize the rapid development and dissemination of informal, oral research reports for High Yield securities.²⁵ These firms have determined that the rapid flow of information within the firms and to the firms' institutional customers is essential and that the time required to produce glossy research reports may render the

²⁵ This free flow of information among departments may continue even when High Yield research departments are physically located away from trading/sales floors.

information in the reports stale. Written reports issued by these firms are more in the nature of memorializations of research that had been orally disseminated days earlier.²⁶

The Division is concerned that oral disseminations of High Yield research may not provide firms with sufficient records to ensure that traditional Chinese Wall procedures and controls of employee trading are implemented effectively. There are few, if any, records of when oral research is developed and disseminated within or outside of the firms.²⁷ As a result, it would be nearly impossible to identify instances in which material, nonpublic information contained in the research might have been leaked before dissemination or instances in which employee trading around the time of the dissemination might have been improper.

Several firms interviewed by the Division indicated they view research (oral and written) for High Yield securities as credit analysis that rarely, if ever, moves the market in these securities. This credit analysis is shared with analysts and traders at a select group of large sophisticated customers, such as mutual funds. These customers are reported to rarely, if ever, rely to any great extent on this credit analysis or the firms' investment recommendations for High Yield securities.²⁸ As a result, the firms indicated to the Division that many of the concerns over the possible misuse of material, nonpublic information in equity research simply are inapplicable to research for High Yield securities.

Nevertheless, the Division is concerned that there could be circumstances in which High Yield research, even if oral, might be deemed material, nonpublic information for purposes of Chinese Wall or employee-trading procedures. One example is credit analysis involving confidential information obtained through an ongoing business relationship between the firm and the issuer of a High Yield security. Another example is research constituting a significant change in the firm's previous investment recommendation or "credit outlook" for a High Yield security. Whenever the price/yield for a security moves sharply immediately after

²⁶ Even those firms that emphasize the production of written research reports for High Yield securities continue to permit some time-sensitive research to be orally disseminated. For example, if an article in a financial periodical discusses the credit worthiness of a specific issue or a business development that might affect this credit worthiness, High Yield analysts might prepare a quick analysis that could be shared within the firms and with the firms' customers. The firms acknowledge that, in these circumstances, it may not be feasible to produce a glossy report that would be subject to the normal Chinese Wall and employee account procedures. The Division would stress, however, that even in these cases, it is the firms' responsibility to identify instances of improper trading by employees before the dissemination of time-sensitive oral research.

²⁷ For these purposes, the date when a written research report is issued subsequent to the oral dissemination is largely irrelevant.

²⁸ Equity research, in contrast, traditionally is disseminated to a wide range of retail and institutional customers who make trading decisions based upon information or recommendations contained in written reports. The Division recognizes that this distinction may be weakened if the High Yield market should attract more retail customers and new (perhaps less sophisticated) institutional customers that might rely more heavily on the firms' research recommendations or outlooks than do the large institutional investors who reportedly were active in these securities at the time of the inspection.

research dissemination, concerns could be raised whether this particular research was material, nonpublic information.

As discussed in Section Two, some firms evidently have determined that it is impractical to monitor the constant interaction among the firm's analysts, traders, salespersons, and customers to ensure that the firm's employees do not effect personal trades in High Yield securities while in possession of material, nonpublic information. Because a substantial amount of oral research may never be formally released as a glossy research report subject to watch list, "look back" or 48-Hour Rule procedures,²⁹ it may be difficult, if not impossible, for compliance personnel or supervisors to identify any material information. The Division acknowledges that, in such an environment, prohibiting employee trading in High Yield securities appears to be more realistic. However, the Division is not recommending that all firms, regardless of the nature of their research, trading, and sales operations in High Yield securities, immediately impose absolute prohibitions against employee trading in High Yield securities. Given the limited scope of the Division's review, we do not believe that it would be appropriate, at this time, to recommend to the Commission that rule-making should be undertaken. Nevertheless, the Division believes that it would be prudent for those firms that choose not to impose prohibitions on employee trading to scrutinize their existing internal control procedures for High Yield securities. We would stress, once again, that it remains the firms' responsibility to ensure that Chinese Wall procedures, as well as procedures to monitor employee trading, are adequate to address the challenging environment of High Yield research, trading, and sales.

²⁹ Each of these procedures is described in detail in Section Two of the report.

