

**STAFF SUMMARY REPORT ON EXAMINATIONS OF
INFORMATION BARRIERS:
BROKER-DEALER PRACTICES UNDER
SECTION 15(g) OF THE SECURITIES EXCHANGE ACT OF 1934**

By the staff of the Office of Compliance Inspections and Examinations

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
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I. EXECUTIVE SUMMARY

Overview: The examination staff of the Securities and Exchange Commission (“SEC” or the “Commission”), FINRA, and the New York Stock Exchange’s (“NYSE”) Division of Market Regulation conducted examinations of the programs that exist at broker-dealers¹ to protect against the misuse of material nonpublic information (“MNPI”). The purpose of the review was to assess broker-dealer compliance with regulatory requirements surrounding MNPI, primarily pursuant to Section 15(g) of the Securities Exchange Act of 1934 (“Exchange Act”),² and to evaluate how broker-dealers consider and analyze new business practices, new technologies, and new controls that may impact their compliance efforts. This report contains numerous defined terms, which are set forth in Appendix A to this report.³ *This report, which discusses the staff’s observations during these examinations, reflects the views of staff and does not represent findings or conclusions of the Commission. This document should not be considered legal advice.*

Information Barriers:

In many instances, broker-dealers may receive nonpublic information regarding their clients and market events as part of their business operations, including financial advisory,⁴ origination,⁵ and trading activities, often under circumstances in which a duty of trust and confidence may be owed to the client or an involved party.⁶ When nonpublic

¹ Examiners from the Commission (the “staff”) examined six of the largest broker-dealers. Examiners from the NYSE and from FINRA examined an additional thirteen broker-dealers, and their observations were incorporated into this report. The FINRA examinations included examination of three broker-dealers that were small in size when compared to the other broker-dealers being examined and had business activities focused on private investment in public equity (“PIPE”) transactions.

² 15 U.S.C. §78o(g). The Insider Trading and Securities Fraud Enforcement Act of 1988 (“ITSFEA”) added Section 15(f) to the Exchange Act, which was later renumbered as Section 15(g) by the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd Frank Act”).

³ These definitions are used only for purposes of this report and are not intended for any other context. Some of the definitions are based on existing statutes, laws, and cases as of the date of this report. Other definitions are derived from commonly used industry terms.

⁴ “Financial advisory” is an industry term that refers to advice to business organizations such as corporations, usually by members of an Investment Banking Department, including as to the structure of mergers and acquisitions. The term does not indicate any regulatory requirement or status.

⁵ “Origination” refers to the creation and issuance of a financial instrument that may represent either equity or debt of an issuer.

⁶ Exchange Act Rule 10b5-2 (17 C.F.R. §240.10b5-2) provides a nonexclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the “misappropriation” theory of insider trading under Exchange Act Section 10(b) and Rule 10b-5 (the law of insider trading is otherwise defined by judicial opinions construing Rule 10b-5). In relevant part, Rule 10b5-2 states that a “duty of trust or confidence” exists in the following circumstances, among others: whenever a person agrees to maintain information in confidence; and whenever the person communicating the MNPI and the person to whom information is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the MNPI expects that the recipient will maintain its confidentiality.

information is material,⁷ Exchange Act Section 15(g) requires that registered broker-dealers establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of their business, to prevent its misuse in violation of the securities laws by the broker-dealer or its associated persons. Such misuse may occur through, among other activities, insider trading prohibited under Exchange Act Section 10(b) and Rule 10b-5;⁸ through trading during a tender offer in violation of Exchange Act Rules 14e-3 and 14e-5;⁹ or through issuance of a research report based on MNPI.¹⁰ Such policies and procedures created to prevent misuse of MNPI are commonly referred to as “information barriers.”

Other federal securities laws may impact information barriers in place at broker-dealers. Section 204A of the Investment Advisers Act of 1940 (the “Advisers Act”) places similar obligations on registered investment advisers.¹¹ Because broker-dealers may be dually registered as investment advisers or may be closely integrated with an affiliated investment adviser (as were most broker-dealers reviewed by the staff), broker-dealers may need to consider the specific challenges such circumstances present in designing their controls.¹² In addition to Exchange Act Section 15(g), broker-dealers may have

⁷ The terms “material” and “nonpublic” are not defined in Exchange Act Section 15(g), which relies on existing definitions of the terms established in case law. Information is material if “there is a substantial likelihood that a reasonable shareholder would consider it important” in making an investment decision or if the information “would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information available.” *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976); *see Basic Incorporated v. Levinson* 485 U.S. 224, 238 (1988) (materiality with respect to contingent or speculative events will depend on a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of company activity); *Matrixx Initiatives, Inc. v. Siracusano*, No. 09-1156, 131 S.Ct. 1309 (2011) (Information that is not statistically significant may still be material if there is a substantial likelihood that reasonable investors would view the information as significantly altering the total mix of information available); *see also* Rule 405 under the Securities Act of 1933, 17 C.F.R. § 230.405; Exchange Act Rule 12b-2, 17 C.F.R. § 240.12b-2; Staff Accounting Bulletin No. 99 (August 12, 1999) (64 FR 45150) (discussing materiality for purposes of financial statements).

Information is nonpublic if it has not been disseminated in a manner making it available to investors generally. *See, e.g., SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 854 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); *In re Investors Management Co.*, 44 S.E.C. 633, 643 (1971). For purposes of insider trading law, insiders must wait a “reasonable” time after disclosure before trading. What constitutes a reasonable time depends on the circumstances of the dissemination. *Faberge, Inc.*, 45 S.E.C. 249, 255 (1973), *citing Texas Gulf Sulphur*, 401 F.2d at 854.

⁸ 15 U.S.C. §78j(b) and 17 C.F.R. §240.10b-5.

⁹ 17 C.F.R. §240.14e-3 and 17 C.F.R. §240.14e-5.

¹⁰ *SEC v. Citigroup Global Markets Inc., f/k/a/ Salomon Smith Barney Inc.*, Civil Action No. 03-CV-2945 (WHP) (S.D.N.Y.), Litigation Release No. 18111 (April 28, 2003), settled action (broker-dealer, among other issues, did not maintain written policies and procedures reasonably designed to prevent the sharing and misuse of MNPI between an affiliated person who served as director of another company and a research analyst covering that company).

¹¹ 15 U.S.C. §80b-4a.

¹² *See, e.g.,* the settled injunctive action *SEC v. Charles Schwab Investment Management et al.*, Civil Action No. CV-11-0136 EMC (N.D. Cal.), Litigation Release No. 21806 and Release No. 34-63693 (January 11, 2011).

information barriers programs in order to rely on an exception or affirmative defense found elsewhere in the federal securities laws.¹³

The Report:

This report discusses the staff's observations from its examinations regarding potential sources of MNPI and some of the controls registered broker-dealers have in place to fulfill their Exchange Act Section 15(g) obligations. The report also discusses instances in which a broker-dealer(s) did not appear to have reasonably designed controls. Finally, the staff's review identified concerns that the staff will continue to monitor and that broker-dealers should periodically evaluate as to consistency with their obligations under Exchange Act Section 15(g).

Specific concerns that we noted in the course of these examinations include:

- A significant amount of interaction between groups that have MNPI and internal and external groups that have sales and trading responsibilities occurred on an informal (undocumented) basis. Broker-dealers instructed groups with MNPI to refrain from discussing MNPI (and sometimes any specific issuer) and instructed groups with sales and trading responsibility to identify themselves as groups that should not be provided with MNPI. However, the frequency of the discussions and the absence of documentation may make it difficult to trace any inadvertent (or even intentional) disclosures that may occur.
- At some broker-dealers, senior executives, referred to as "above-the-wall," received MNPI with no related monitoring or restrictions. Many of these senior executives had managerial responsibilities for business units involved in sales and trading on behalf of the broker-dealer. The absence of any documentation that these executives were receiving MNPI, in view of the natural motivation to have business units within one's areas of responsibility excel, as well as the apparent absence of related monitoring or other controls, raises serious concerns about the ability of broker-dealers to guard adequately against misuse of MNPI in firm and customer trading.
- Formal and documented discussions may occur between two internal business groups of a broker-dealer, in which MNPI is provided to sales, trading or research personnel for business purposes. Broker-dealers must make judgment calls between the need for information against the restrictions required, such as on the trading of securities or issuance of research reports in companies to which the MNPI related. In some cases, broker-dealers were not conducting any focused review of the trading that occurred after traders were provided with MNPI.
- The staff identified gaps in oversight coverage at most broker-dealers, although such gaps differed. Some broker-dealers did not review trading within accounts of institutional customers, asset management affiliates, or retail customers; or did not conduct any review when MNPI came through business activities outside of

¹³ See, e.g., Exchange Act Rule 14e-5(b)(8), 17 C.F.R. §240.14e-5(b)(8), and Exchange Act Rule 10b5-1(c)(2), 17 C.F.R. §240.10b5-1(c)(2).

the Investment Banking Department (“Investment Banking”) – such as participation in bankruptcy committees, employees serving on the boards of directors of public companies, changes in research ratings, or insiders of companies placing unusual trades.

These concerns by themselves may not necessarily suggest violations of Section 15(g), but broker-dealers may find it helpful to consider them in reviewing their policies and procedures.

We also highlight practices we believe to be effective:

- Broker-dealers were developing processes that differentiated between types of MNPI based on the source (e.g., business unit) from which the information originated within the broker-dealer or the nature (e.g., transaction type) of the information. In some cases, broker-dealers were creating tailored exception reports that took into account the different characteristics of the information.
- Broker-dealers were expanding the scope of instruments that they reviewed for potential misuse of MNPI by traders, including: credit default swaps, equity or total return swaps, loans, components of pooled securities such as unit investment trusts and exchange traded funds, warrants, and bond options.

Considering these practices may assist broker-dealers in reviewing their own policies and procedures. However, a practice that is effective in one context may be less effective in another. The effective practices described in this report are not an exhaustive list, and they constitute neither a safe harbor nor a “checklist.” Other practices besides those highlighted here may be appropriate as alternatives or supplements to these practices. To comply with Section 15(g), a broker-dealer must not only establish but also must maintain and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI. Whether the controls described in this report would be appropriate for a particular broker-dealer would depend on the broker-dealer’s size and business model. In addition, broker-dealers may identify and implement other controls that are reasonably designed to meet the goals of Section 15(g).

II. BACKGROUND

In November 1988, ITSFEA was enacted, adopting Exchange Act Section 15(g). In March 1990, the Division of Market Regulation issued a report, “Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Nonpublic Information” (“1990 Report”).¹⁴ The 1990 Report provided an overview of then-current broker-dealer information barrier practices and identified common practices, including the maintenance of watch and restricted lists and the accompanying review of employee and proprietary trading, written procedures, and documentation of reviews.

¹⁴ www.sec.gov/divisions/marketreg/brokerdealerpolicies.pdf. See, also, joint statement issued by the NASD and NYSE, available at NASD NTM 91-45; and *Broker-Dealer Internal Control Procedures for High Yield Securities*, a report by the Division of Market Regulation (1993), available at <http://www.sec.gov/divisions/marketreg/15freport1093.pdf>.

Information barrier programs, as described in the 1990 Report and as currently observed by the staff, have certain common features: employee training in legal and firm requirements; review and restrictions on trading; physical barriers; formal over-the-wall¹⁵ procedures prior to sharing information with public-side employees; and surveillance. The basic practices and procedures described in the 1990 Report have provided a framework to which enhanced information barriers have been added as business models and business tools have changed. The 1990 Report described practices that raised concerns, and the staff's current examinations generally found that the concerns have since been addressed by the broker-dealers examined – creation of more formal training programs, greater documentation when employees are brought over-the-wall, and significantly increased broker-dealer compliance staff involvement in determining what matters are to be added to the watch list.

Within the context of the current examinations, the staff observed that areas with ongoing access to MNPI are identified as “private-side,” and applicable physical barriers and trading restrictions are in place. Areas that have sales and trading responsibilities (“Sales and Trading”) are identified as “public-side,” and have restricted or monitored access to MNPI. Most broker-dealers centralize responsibility for managing the information barriers program into one group within the Compliance Department. The group is commonly referred to as the “Control Group” or the “Control Room,” and such terms are used interchangeably in this report.

This report does not restate the conclusions of the 1990 report, which remain generally appropriate. For example, this report does not go into detail about written procedures and employee training. Processes and controls that broker-dealers implement to meet their Section 15(g) obligations, which may include those described in this report, must be incorporated into written procedures. Employees generally should be appropriately trained on the requirements. To the extent the staff identified gaps in a broker-dealer's written procedures and training, the staff raised the issue with the broker-dealer.

In order to comply with Section 15(g), broker-dealers should continually reassess both potential sources and uses of MNPI and whether reasonable controls are in place. Practices that are sufficient for a broker-dealer at one time may not adequately comply with its legal obligations at other times. Importantly, written and implemented controls that are deemed reasonable may likely vary among broker-dealers depending on factors such as size and business model.

III. SOURCES OF MATERIAL NONPUBLIC INFORMATION

In assessing their Section 15(g) programs, broker-dealers should be aware of information flows – the MNPI directly accessible by internal broker-dealer groups, how such information is used, and whether and which internal and external parties may have access

¹⁵ The over-the-wall process is discussed in more detail below in V.C.1.

to the information.¹⁶ Some sources provide confidential information that at times is MNPI.¹⁷ The staff's review identified the activities discussed below as those that may result in broker-dealers coming into possession of MNPI.

A. Corporate Clients

The staff has observed that the primary source of MNPI is information provided by clients of the broker-dealer that are companies with publicly traded securities.¹⁸ These corporate clients provide MNPI to broker-dealers for general advice and for specific transactions. Some corporate clients have relationship bankers within Investment Banking to provide ongoing advice. The relationship bankers at larger broker-dealers tend to specialize by industry (e.g., health care or transportation) or region (e.g., Latin America).

1. Mergers and Acquisitions

The staff has observed that information concerning mergers and acquisitions ("M&A"), also referred to as strategic transactions, appears to have a high degree of materiality. Most Investment Banking Departments have M&A specialists who work with the relationship banker in structuring the transaction. The broker-dealer could be representing either a potential seller (e.g., a company selling itself or certain assets) or the potential purchaser (e.g., a company or institutional investor seeking to purchase a company or certain assets). The broker-dealer's involvement could begin after two companies have already reached a deal in principle or could begin when a company is looking to engage a broker-dealer to search for potential buyers or potential acquisition targets. In some cases, the broker-dealer is approached not with an offer of mandate but to compete with other broker-dealers to be engaged.

The staff observed that internally, employees from other areas of the broker-dealer, including Capital Markets groups ("Capital Markets," see the description in the next section), the Credit Department ("Credit"), and Derivative Sales groups ("Derivative Sales," frequently within Capital Markets) sometimes work on the transaction and therefore have access to the information. Capital Markets assists if the M&A transaction includes a securities offering or restructuring. Credit must approve any financing commitments. Derivative Sales may provide a price quote on a derivative as part of the

¹⁶ The staff's review was conducted prior to the enactment of the "Stop Trading on Congressional Knowledge Act of 2012," commonly referred to as the STOCK Act, which was signed into law on April 4, 2012, and this report does not address the implications of such Act. In designing their information barriers, broker-dealers should consider whether information gathered as part of their government affairs or lobbying efforts may constitute MNPI.

¹⁷ "Confidential information," as used in this report, refers to information received under a duty of trust or confidence.

¹⁸ The staff's review observed that the majority of MNPI received by broker-dealers related to public corporations. Similar analysis would apply to other types of entities with outstanding securities concerning which the broker-dealer received MNPI.

M&A transaction.¹⁹ Other business units or groups within the broker-dealer may be consulted for information – the Research Department (“Research”) or Sales and Trading.

Investment bankers may discuss transactions with clients that are external investment groups (e.g., advisors for private equity funds (“Private Equity”) and hedge funds).²⁰ Staff observed that typically, a group within Investment Banking, sometimes called the Financial Sponsors Group, has ongoing discussions with institutional investors.²¹ Initial discussions may be oral, and later information may be provided through virtual data rooms, private websites on which the nonpublic documents are posted for review.

2. Capital Markets / Syndicate

Many corporations raise capital for general corporate purposes or specific transactions through the issuance of equity and/or debt. Corporations also repurchase or restructure outstanding equity or debt, for example through a tender offer, stock buyback, or consent solicitation.²² Capital Markets facilitates such issuances, repurchases, or restructurings for corporate clients by assessing market interest in pending transactions, coordinating due diligence, and advising on the structure of the deal. The syndicate group (“Syndicate”) manages the issuance (e.g., building the book of purchasers and managing the settlement process). These functions are frequently either within Investment Banking or within a unit that jointly reports into Investment Banking and Sales and Trading. Capital Markets and Syndicate sometimes serve as the conduit in communications between Investment Banking and external parties such as other broker-dealers or institutional investors and between Investment Banking and Sales and Trading.

The Capital Markets and Syndicate functions are usually divided based on types of issuance – equity, high grade or investment grade debt, high yield debt, credit facilities and loans, and commercial paper, although in some cases the Capital Markets function is integrated for various debt instruments (bonds, credit facilities, and/or loans). The MNPI that may originate from these transactions include information about the company learned during the due diligence process, information regarding use of the proceeds, or information regarding the capital markets transaction itself. For example, the broker-dealer may learn the corporation will have reduced earnings through the due diligence

¹⁹ For example, if an acquisition is agreed to between a U.S. and non-U.S. entity with currency exchange risk, the broker-dealer or its affiliate may offer to enter into a foreign exchange swap to “lock in” the current exchange rate for the buyer’s acquisition price. Similarly, broker-dealers or their affiliates may sell over-the-counter interest rate derivatives to issuers in bond offerings to permit the issuer to hedge long-term interest rate exposure.

²⁰ At the time of the staff’s review, the investment groups might include the broker-dealer’s internal principal investment areas and affiliated funds.

²¹ At the time of the staff’s review, Private Equity tended to be involved in M&A transactions, and hedge funds tended to be involved with capital markets offerings.

²² Issuer tender offers are subject to Exchange Act Rule 13e-4 (17 C.F.R. §240.13e-4), which requires a filing with the Commission, among other requirements. An issuer buyback is an open market repurchase of securities, usually under the safe harbor of Exchange Act Rule 10b-18 (17 C.F.R. §240.10b-18). A consent solicitation is a vote by shareholders to waive a provision of the debt covenants, which may be held pursuant to the proxy rules.

process. The broker-dealer may discover that the proceeds will be used to acquire certain assets. The information regarding the issuance may be material, depending on factors such as: size of the issuance compared to the overall capital structure of the company; substantial revisions to the terms (e.g., interest rate) on which the corporation borrows; changes to the corporate structure – such as a put option on change in control; or impact on concerns about the company (such as the company’s ability to borrow).

In addition to Capital Markets and Syndicate, other areas may be involved with capital markets transactions. The Investment Banking relationship manager may have initiated the matter. An interest rate derivative may be offered to be used by the client to manage exposure resulting from the offering. Traders sometimes provide color on the market appetite for certain types of offerings. Issuer buybacks are generally forwarded to a trading desk for execution, which is sometimes a private-side group dedicated to processing transactions for corporate clients.²³

3. Derivative Sales

Corporate clients may wish to enter into a derivative with the broker-dealer or its affiliate in the context of an M&A deal or in the context of a securities offering. The M&A deal may be external to the broker-dealer and its affiliates (i.e., neither the broker-dealer nor its affiliates is acting as financial advisor to either the M&A buyer or the seller). Some broker-dealers represented that if they are not engaged to work on the original M&A deal, the M&A deal will have been already announced publicly prior to Derivative Sales’s involvement.

Derivative Sales has ongoing discussions with corporate clients.²⁴ For example, a corporate client may want to enter into foreign exchange derivatives if it expects to have income or liabilities accrued outside the U.S. that must be converted into dollars. As a result, Derivative Sales may obtain MNPI, such as unannounced earnings, from corporate clients through its business interactions.

4. Credit

Credit will have contacts with corporate clients in the context of review and approval of extensions of credit to finance an M&A or for ongoing operations.²⁵ Credit must also review and approve the creditworthiness of corporations as counterparties in derivative

²³ The issuer must disclose purchases in its next Form 10-K or 10-Q, pursuant to Section 703 of Regulation S-K (17 C.F.R. §229.703). However, if the transaction is material, the issuer may need to disclose the transaction prior to execution.

²⁴ The staff observed two unique derivative sales groups – one with corporate clients and one with institutional investor clients. Derivatives Sales as discussed in this report focuses on corporate clients.

²⁵ Each of the registered broker-dealers reviewed by the staff had one integrated Credit Department that provided services to the broker-dealer as well as affiliates of the broker-dealer and was physically integrated within the broker-dealer’s location. Section 15(g) requires that broker-dealers’ information barriers be reasonably designed to prevent the misuse of MNPI by any person associated with such broker or dealer. 15 U.S.C. §78o(g).

transactions. Credit conducts initial due diligence and receives ongoing confidential information, which at times may be MNPI, from the corporations as required by the credit or derivatives agreement between the two parties.

Credit may receive MNPI both through the periodic reports of the corporate client as well as activity under the credit extensions such as unanticipated material draws on credit facilities. Based on information received from corporate clients, Credit establishes an internal credit rating(s). As a result, Credit's internal credit rating for a corporate client may at times be based on MNPI.

B. Corporate Borrowers

As discussed above, Capital Markets will advise companies on raising capital, and during that process companies provide MNPI to Capital Markets. After the capital raising has been completed, the process to disclose information to existing holders of financial instruments differs based on product. Information on public securities must be disseminated to security holders and the public through public statements and filings. In contrast, information provided to lenders of credit may be nonpublic at the time of the lenders' receipt. Both during the origination and during the term of credit facilities (which include commitments to lend, lines of credit, term loans, revolving credit, among other financing vehicles, referred to collectively herein as a "loan"), the borrower typically is circulating confidential information, which at times may be MNPI, to the lenders privately through web sites hosted by external vendors ("Loan Sites").²⁶

One financial firm, which may be a broker-dealer or its affiliate, typically will act as administrative agent for the initial issuance of the loan. That administrative agent will have responsibility for, among other things, creating a Loan Site, granting and removing access to lenders and potential lenders, and maintaining records of current lenders. Other broker-dealers or their affiliates may participate in the loan as syndicate members, purchasing interests in the loan and receiving the confidential information to review.

After the initial issuance of the loan, loan interests are frequently traded among financial institutions, including broker-dealers, and institutional investors. Once a loan interest is purchased, the purchaser has the contractual right to review the confidential information contained on the Loan Site. Loan purchasers must decide whether to act as a private-side or public-side group. When acting as a private-side group, the traders access the Loan Site, including any MNPI contained on the site but may not trade securities based on the MNPI. When acting as a public-side group, the traders choose not to access the confidential information contained on the Loan Site so that they may freely trade both loan interests and securities such as equities and bonds of the same companies. Public-side groups may go private on certain companies, with resulting trading restrictions only on that company. If the trading group holding the loan interests is designated as public-side, the lender must select another internal group to access the Loan Site on behalf of the

²⁶ Typically, two Loan Sites are created – one for the origination process and one for the secondary trading market.

trading group (“Loan Site Monitors”).²⁷ The Loan Site Monitors will then receive the confidential information the borrower must provide to lenders.

As a result, broker-dealers may have access to MNPI through the following contact points:²⁸

- as administrative agent (usually through the loan origination function, which is frequently within Investment Banking or Capital Markets),
- as syndicate member (through the loan origination function or Loan Sales),
- as holder of interests in the loan purchased during origination (through the loan origination function, Credit, or a special purpose group),
- as manager of the Loan Site (an administrative group),
- as loan trader (trading group or principal investment area of the broker-dealer),
- as Loan Site Monitors for public-side groups to monitor information coming through the Loan Site, and
- as a member of the bankruptcy committee if the loans default.

The MNPI provided to broker-dealers may include information about the borrower, as well as the borrower’s affiliates, parent, or guarantor, such as:

- enhancements to liquidity (or limitations on liquidity based on borrowing conducted under a line of credit),
- use of proceeds for non-routine transactions,
- information required to be provided pursuant to the loan agreement (e.g., material litigation), or
- failure to meet certain loan covenants.

C. Non-Corporate Issuer Clients

The staff’s review identified two categories of non-corporate securities that could result in broker-dealers receiving MNPI when engaged to work on the origination: public finance securities and securitized products. Public finance securities are issued by governmental entities other than the federal government.²⁹ Securitized products are created when an entity sells an asset or assets to a special purpose vehicle (“SPV”). The

²⁷ No specific industry term exists for this group, which is frequently within Credit or an operations group (“Operations”).

²⁸ The staff notes that in some cases, an affiliate of the broker-dealer may be the legal entity contractually specified to fulfill these roles. However, the broker-dealer may have possession of MNPI because its employees, registered personnel, or associated persons are engaged in the activities specified in this section.

²⁹ The term “public finance securities” is used in this report to be synonymous with municipal securities as defined in Exchange Act Section 3(a)(29). 15 U.S.C. §78c(a)(29). However, more broker-dealers are using the term “public finance securities” or “public sector” to reflect that such securities are frequently issued by governmental entities other than municipalities.

SPV then issues securities, with the securityholders receiving payments generally dependent on the performance of the assets owned by the SPV.³⁰

Registered broker-dealers examined by the staff asserted that activities involved in the original issuance of such securities did not result in the broker-dealer receiving MNPI because any nonpublic information obtained is unrelated to any outstanding security or security-based swap. Specifically, the broker-dealers examined by the staff expressed the view that the information they obtained during due diligence is only relevant to that specific security, which does not yet have a market.³¹ The staff believes that broker-dealers should consider the extent to which any nonpublic information obtained may be MNPI, for example, if the information is material to an outstanding class of securities or is material to the new class of securities and is not fully disclosed prior to the commencement of public trading of such securities.

Once the securities are issued, it is possible that the broker-dealer may receive MNPI on the outstanding securities based on its continuing role as financial advisor to the issuer. Examined broker-dealers thought this was less likely in the case of public finance issuers, given the issuers' disclosures of information that may be made pursuant to a written agreement entered into as described by Exchange Act Rule 15c2-12. It is possible that the broker-dealer may get advanced word that the outstanding securities are about to default or re-fund. Broker-dealers also identified the following potential MNPI that may be received from public finance issuers: ratings changes, liquidity problems, substitution of property underlying the securities, modifications to the rights of security holders, regulatory investigations, and failure of the liquidity providers to perform. MNPI relating to securitized products may include information regarding defaults in the underlying assets or regarding the financial difficulties of any guarantor of the securitized product.

D. Investment Areas

Different groups within or associated with a broker-dealer may monitor the financial condition of issuers. Principal investment or trading groups (collectively, "Proprietary Groups") may invest or trade firm capital in public companies either in private

³⁰ Securitized product is an industry term for products that are sometimes also referred to as asset-backed securities, structured finance securities, or structured finance products. This section covers securitized products in which the entity sponsoring the issuance purchased the underlying assets in the secondary market, usually for the purpose of creating a securitized product. The discussion in this section is not intended to cover instances in which a corporate issuer securitizes its assets, which may have been created or originated by the corporate issuer. The staff believes that such transactions are more likely to provide MNPI consistent with other corporate capital markets transactions described in III.A.2, and the broker-dealers examined by the staff generally established information barriers controls for securitized products originations initiated by public corporations similar to information barriers controls in place for other corporate originations.

³¹ Broker-dealers gave as examples: public finance securities based on the revenue stream of a specific project rather than the general creditworthiness of the municipality, or instances in which the value of securitized product is derived from the pool of assets solely underlying that specific issuance.

transactions or in the open market.³² Other groups within the broker-dealer or associated with the broker-dealer may monitor issuers on behalf of customers – either broker-dealers’ institutional sales groups or internal or affiliated asset management groups (“Asset Management”, and collectively with Proprietary Groups, “Investment Groups”). With respect to Asset Management, Private Equity tends to have more frequent contacts with their portfolio companies as well as with corporations seeking potential investments.

As a holder of a substantial interest in a corporation, Investment Groups may receive confidential information, which at times may be MNPI, directly from the corporation. For example, the Investment Group may have an employee serving on the board of directors of the company or a shareholder committee. If a company has financial difficulty, a representative from the Investment Group may be invited to participate in bankruptcy or creditor committees of distressed companies (or even pre-bankruptcy committees).³³

Investment Groups may also obtain MNPI as part of the investment process. The information may be obtained by discussions between the employee and an insider of the company. For example, Investment Groups may be approached about investing in an offering that has not yet been publicly disclosed (e.g., a PIPE).³⁴

E. Institutional Investor Customers

Broker-dealers receive confidential information from institutional investors through taking orders for execution in the secondary markets and in processing and clearing such transactions as prime broker.³⁵ The order information received from institutional investors may be material to the securities being purchased, and Section 15(g) requires broker-dealers to have policies and procedures reasonably designed to prevent misuse of

³² Section 619 of the Dodd Frank Act places limitations on the ability of banking entities and certain nonbanking financial companies to engage in proprietary trading or to acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund.

³³ Such a committee may be a formal committee established by the bankruptcy court or an informal committee established by a group of creditors. *See, e.g., In the Matter of Greenfield and Blue River Capital LLC*, Release No. 34-52744 (November 7, 2005), and *SEC v. Barclays Bank PLC and Steven J. Landzberg*, Civil Action No. 07-CV-04427 (S.D.N.Y.) Litigation Release No. 20132 (May 30, 2007), settled actions.

³⁴ Section 15(g) cases have been brought against broker-dealers for failure to prevent the misuse of MNPI received by an employee as board member and officer of unrelated company (*SEC v. Citigroup Global Markets Inc., f/k/a/ Salomon Smith Barney Inc.*, Civil Action No. 03-CV-2945 (WHP) (S.D.N.Y.), Litigation Release No. 18111 (April 28, 2003), settled action; *In the Matter of Gabelli & Company, Inc.*; and *Gamco Investors, Inc.*, Release No. 34-35057 (December 8, 1994), settled action); and information regarding a proposed PIPE transaction (*In the Matter of Friedman, Billings, Ramsey & Co., Inc.*, Release No. 34-55105 (December 20, 2006), settled action; *SEC v. Friedman, Billings, Ramsey & Co., Inc. et al.*, Civil Action No. 06-CV-02160 (D.D.C.), Litigation Release No. 19950 (December 20, 2006), settled action).

³⁵ Prime brokerage departments offer custody and clearing services to institutional clients, including securities lending. Prime brokerage departments may also obtain other nonpublic information relating to shareholder activities, for example, through processing tenders made in response to a tender offer.

MNPI, which may include customer order information.³⁶ Customer order information is received by groups within Sales and Trading, usually located on open trading floors. After execution, information on the positions held by the institutional investor, including large short positions, as well as institutional investors' trading strategy, may be material.

Other areas within Sales and Trading may gain access to customer information – personnel building trading models and stock loan desks. Broker-dealers also routed aggregate information on order flow to other areas of the broker-dealer and to external parties. Broker-dealers represented that this information, referred to as market color, is intended not to be based on a specific customer but overall market trends. However, the staff believes that market color should be evaluated for whether it represents MNPI, particularly when the information provided is based on or largely represents a specific customer's order.

F. Insider Customers

Certain customers of the broker-dealer are also insiders of a public corporation or other similar entities with access to MNPI. Generally, broker-dealers dealt with two categories of insiders. Corporate officers and directors may be customers of broker-dealers' individual investor businesses. Large institutional investors may have acquired sufficient ownership of a corporation as to become an insider. Insider customers provide two types of MNPI. First, they have information gathered from their role as insider (e.g., the customer is a Chief Executive Officer about to retire). Second, insiders' personal transactions in the stock of their company may be material. Information concerning the order, which may constitute MNPI, is forwarded to certain internal groups, sometimes in Operations, with responsibility for processing insider transactions. The staff believes that broker-dealers should consider which internal groups have access to MNPI and evaluate the controls (e.g., physical barriers and personal trading reviews) in place to prevent the misuse of such information.

G. Research

Information within Research, such as the initiation of research coverage or changes in price targets, may be MNPI.³⁷ Broker-dealers are starting to incorporate into their information barriers programs other publications and ratings systems that may be

³⁶ The Commission has found violations of Section 15(g) by a broker-dealer that allowed traders without customer order execution responsibility to see customer order information on the customer facilitation traders' computer screens and hear market makers discuss customer orders. *See In the Matter of Merrill Lynch, Pierce, Fenner & Smith Incorporated*, Release No. 34-63760 (January 25, 2011), settled action. The Commission has also found violations of Section 15(g) based on a broker-dealer's failure to have appropriate controls over the squawk boxes used to disseminate customer order information. *See In the Matter of Merrill Lynch, Pierce, Fenner, & Smith Incorporated*, Release No. 34-59555 (March 11, 2009), settled action.

³⁷ *See In the Matter of Goldman, Sachs & Co.*, Release No. 34-66791 (April 12, 2012); *In the Matter of the Buckingham Research Group, Inc.*, Release No. 34-63323 (November 17, 2010); and *In the Matter of Banc of America Securities LLC*, Release No. 34-55466 (March 14, 2007); settled actions. *See, generally* FINRA Rule 5280 (regarding trading ahead of research reports).

material. For example, Research may maintain lists containing a subset of their buy and sell recommendations to highlight certain ratings for investors. The addition or deletion of names from the list may be material. Research may issue short term views on securities, with an analyst having recommendations for both a short term investment horizon and longer term investing. The short term rating may raise concerns if it, in effect, provides advanced notice of a change in a long term rating to a select group.

H. Secondary Sources of Material NonPublic Information

MNPI provided to broker-dealers is frequently incorporated into secondary sources. For example, MNPI is reported into the Control Room and incorporated into a database there. The resulting database becomes a new potential source of MNPI. The Conflicts area of the broker-dealer (“Conflicts”) also receives MNPI on potential deals and creates its own database.³⁸ Various support functions – such as information technology (“IT”), Operations, and risk monitoring groups such as Credit – have ongoing access to the MNPI initially sourced by one of the functions described above. In some cases, groups, using the MNPI, create a document or analysis that itself may be MNPI (for example, see the discussion above on internal credit ratings).

IV. CONTROL STRUCTURE

The staff’s review observed broker-dealers generally categorized various groups, functions, activities, and information for control purposes. The category into which each is placed impacts the treatment.

A. Public-Side vs. Private-Side Business Groups

Broker-dealers classify business groups as “public-side” or “private-side.” In order to manage the different types of MNPI within a broker-dealer, the controls typically consider factors beyond public or private classifications. For example, the staff observed that private-side and public-side groups frequently were segregated from other private-side and public-side groups. More broker-dealers are adopting this approach, with pockets created based on the type of MNPI to which each group has access.

Private-side groups are areas that have routine or ongoing access to MNPI. As a result, broker-dealers generally physically segregate such groups. The groups typically are restricted from personal and firm trading in securities for which the group has MNPI, regardless of actual knowledge of the individual. In effect, once classified as private-side, the broker-dealer assumes that persons within these groups do have MNPI. Private-side groups typically include Investment Banking, Credit, Capital Markets, Syndicate (and origination functions generally), certain Investment Groups, and support and control personnel supporting these areas.

³⁸ All broker-dealers have a system to check individuals and the broker-dealer generally for conflicts between the project and other projects worked on by the broker-dealer or those employees (e.g., if the broker-dealer has an exclusive agreement with one client that would preclude working for a competitor).

Public-side groups are areas that do not have access to MNPI on a routine basis. If an employee within a public-side group does receive access, that employee is supposed to be identified to the Control Room as being over-the-wall in the corporation/security (see discussion at V.C.1 below). Public-side groups are allowed by the broker-dealer to trade in securities for which the broker-dealer has MNPI as long as that trader does not have access to the MNPI (or is not directed to trade by someone with access). Most Sales and Trading groups are public-side groups. Research may be considered a public-side group by some broker-dealers. Research itself may have MNPI such as ratings changes, and the physical barriers in place between private-side and public-side groups tend to exist between Research and Sales and Trading even if both are identified as public-side.³⁹

Certain public-side groups are organized to allow them to be private on specific names. When the public-side group “goes private” on a name, the group has MNPI on that name (a company) and is restricted from trading in securities of that company. In order to accommodate the mixing of public and private, most broker-dealers either segregate the group from other public-side groups or apply the restriction to all Trading groups within the same physical location.

A few broker-dealers use an “above-the-wall” classification for certain persons and groups. Under the classification, the person and/or group are neither public-side nor private-side. As an above-the-wall category, broker-dealers allow certain MNPI to be provided on a need to know limited basis without going through the over-the-wall process. Physical barriers, documentation, or other controls may be limited or non-existent. The staff is concerned about the use of the above-the-wall category and believes that broker-dealers should consider whether the category is appropriate and whether additional controls should be in place. The staff observed the above-the-wall category used at some broker-dealers in three different situations – certain senior management to permit them to obtain MNPI for wall crossings, Research, and the syndicate group. The lack of documentation or other controls when MNPI is disclosed to above-the-wall executives may, in certain circumstances, result in activities in violation of the securities laws, such as Exchange Act Sections 10(b) and 15(g). For example, when the person receiving unreported, unmonitored MNPI has management responsibility over business units involved in sales or trading activity, staff believes that such circumstances could run the risk of facilitating rather than preventing the misuse of MNPI in firm trading. Staff expects regulated entities to be especially mindful of this risk when assessing whether an executive needs to be “above-the-wall.” For those senior executives deemed to have an actual need to know MNPI without pre-approval, broker-dealers are strongly encouraged to consider the benefits, in terms of statutory compliance, of maintaining a MNPI disclosure reporting and monitoring requirement for above-the-wall executives and others in such a category.

³⁹ While Research may routinely have MNPI (e.g., changes to research ratings), broker-dealers may need to address the adequacy of controls over the group’s receipt of MNPI from external sources, which could impact the ability to issue research. *SEC v. Citigroup Global Markets Inc., f/k/a/ Salomon Smith Barney Inc.*, Civil Action No. 03-CV-2945 (WHP) (S.D.N.Y.), Litigation Release No. 18111 (April 28, 2003), settled action.

B. Types of Material NonPublic Information Sources

The sourcing of MNPI has one of three broad characteristics. The broker-dealer may work on a transaction and through the work receives MNPI concerning the transaction and other information gathered as part of the transaction. The broker-dealer may have ongoing contacts with an information source, through which MNPI is received on a one-off basis (e.g., the corporate insider reveals that the corporation is having reduced earnings). The broker-dealer may have sources that provide on an ongoing basis confidential information, which at times may be MNPI. The type of information source has significance with respect to how broker-dealers are able to capture MNPI within their information barriers programs.

1. Transaction Sourced Material NonPublic Information

Investment Banking, Capital Markets/origination, private-side Investment Groups, or Sales and Trading may receive transactional MNPI. Information regarding the transaction is forwarded to the Control Room for consideration of placement on monitoring lists (see IV.C. for a discussion of monitoring lists). While most transaction sourced information is sourced from private-side groups, public-side groups sometimes receive transactional MNPI (e.g., when the group purchases in a PIPE).

a. Method of Notifying the Control Room

A common practice in the past was reliance on the deal team phoning the Control Room to report the transaction. Because the deal team members can be busy developing the project, they may not put priority on providing notice. The staff's review observed that all broker-dealers had at least some instances in which the Control Room did not receive notice or received delayed notice and so did not have adequate controls in place to prevent misuse of such MNPI. The staff observed the following factors at some broker-dealers that may have contributed to the absence of timely notice: sole reliance by the Control Room on the Investment Banking team to determine whether and when a matter should be placed on a monitoring list; little written guidance as to when information should be reported to the Control Room and what matters would trigger the notice requirement; and absence of a process to test whether the appropriate information was in fact being placed on the lists as necessary.

Some broker-dealers had put controls in place to address absence or delays in notice:

- More broker-dealers are developing systems to notify automatically the Control Room based on information entered into computer systems used for deal management or for conflicts checks.
- Some Control Rooms review pipeline reports, commitment committee minutes, or news articles that reference the broker-dealer to identify items missed. However, the staff noted that such information may be received after significant work has been done on the transaction.

- Some broker-dealers conducted lookback reviews of trading activity that took into account possible delays, including a standard review of a few weeks prior to placement on the watch list or a special purpose review when a delay in placement was identified.

b. Materiality

Information reported into the Control Room is assessed for materiality with respect to public companies (issuer, target, acquirer, competitor, or shareholders that are public companies) to determine whether that specific company should be placed on a monitoring list to check for possible improper trading.⁴⁰ For example, the acquisition of a small company by a larger company may be material to the securities of the smaller company only or may be material to both companies' securities. Broker-dealers stated that such materiality determinations permitted them to focus surveillance on significant transactions. Typically the Control Room, after discussions with deal team members, determines materiality.

The staff believes that registered broker-dealers have a responsibility to make reasonable judgments regarding the materiality of such information. If in fact the transaction is determined later to be material, broker-dealers should be prepared to justify their decisions not to monitor a transaction.

The staff observed the following practices at some broker-dealers that may make it difficult for broker-dealers to monitor and evaluate whether their materiality determinations were reasonable:

- failure to memorialize transactions deemed immaterial, although all broker-dealers reviewed by staff had changed this practice during the course of the review,
- failure to document the basis of the determination of immateriality,
- lack of any specific factors used to assess materiality, and
- failure to identify later receipt of MNPI (e.g., the transaction size is increased significantly).

One broker-dealer excluded all transactions within certain categories from monitoring lists, such as investment grade securities offerings and credit extensions. However, the staff observed that some such offerings and extensions were considered significant by contemporaneous public commenters. Most broker-dealers did assess materiality of investment grade securities offerings and credit extensions and included at least some of

⁴⁰ In order to evaluate materiality, some broker-dealers use measures such as the relative size of a transaction compared to the size of the companies, with some assessment of likely impact on share price. The monitoring list referred to here is used for automated surveillance of public securities, and private companies are not generally included on such list. This discussion should not be interpreted to limit the scope of Section 15(g), which is not limited to misuse of MNPI related to public companies.

these transactions on monitoring lists. To the extent that such transactions are material, failure to include such MNPI within the broker-dealer's information barrier program may be a violation of Section 15(g). As such, the staff would strongly urge broker-dealers not to exclude categorically transactions.

As discussed above, transaction sourced information may provide MNPI both regarding the transaction and information received while working on the transaction (e.g., through the due diligence process). When broker-dealers exclude transactions from monitoring lists because they deem information about the transaction immaterial, the staff notes that the broker-dealer may later come into possession of MNPI through the due diligence process. The staff believes that broker-dealers need to have a process to identify such MNPI, and some broker-dealers did rely on the process described in IV.B.2 on item-specific MNPI to identify which items should be placed on a monitoring list.

c. Placement on a Monitoring List

The purpose of notification to the Control Room is to trigger placement on a monitoring list (discussed in more detail below). While all broker-dealers reviewed had policies to place material transactions on a monitoring list,⁴¹ broker-dealers could not give a bright line test as to when this would occur. Broker-dealers stated that corporations frequently discuss potential transactions, many of which never proceed beyond generalized discussions. Broker-dealers stated that they would make judgment calls as to when the transaction was of reasonable certainty prior to placing on a monitoring list. The staff's review confirmed the variations that may occur between potential transactions. In some cases, the broker-dealer is approached because a corporation wants to discuss potential assets or companies to be purchased but has no specific candidates identified and no definitive intention to proceed with any acquisition. However, in some cases, the first contact conveys MNPI to the broker-dealer as in the case of a corporation that has already received an offer to be acquired, and the staff believes that even a tentative offer may constitute MNPI.⁴²

The staff observed two practices that resulted in a delay in placement on the monitoring list. Some broker-dealers focused on whether they were formally mandated by a client to evaluate for placement on a monitoring list. However, the staff observed that mandate frequently occurred only shortly prior to announcement and/or after significant work by the broker-dealer had taken place. Some broker-dealers wait until the materiality assessment has been conducted. As a result, the processes delayed placement on a monitoring list even though the broker-dealers already had possession of MNPI.

⁴¹ The staff observed that broker-dealers create monitoring list entries based on specific matters or transactions. For example, if a broker-dealer is engaged to work on an offering for a corporate client and is also engaged to work on an acquisition for the same client, two separate entries will be created. The staff believes that this practice may assist broker-dealers monitor for misuse of the information, as potential misuse (e.g., purchasing or selling the related security) will differ based on the matter involved.

⁴² See footnote 7.

Broker-dealers are sometimes provided with MNPI while seeking a specific engagement, and in some cases another broker-dealer is selected to work on the transaction. As a result, the broker-dealer may have MNPI regarding the existence of the transaction, although it would be unaware of ongoing developments within the deal. Some broker-dealers continued to monitor trading in the company's stock even if they were not hired if they had reasonable certainty that the transaction was progressing at another broker-dealer (see V.G. for a discussion of the scope of monitoring). Some broker-dealers immediately remove the item from any monitoring list and so may not have adequate controls in place for MNPI in their possession.

The staff also noted another practice that may result in an absence of monitoring that it believes may be inconsistent with Section 15(g). Some broker-dealers removed items from any monitoring list upon public announcement or shortly thereafter. While the information regarding the transaction is now public, the broker-dealer continues to work on the transaction until closing and may receive additional MNPI regarding the transaction. For example, the broker-dealer may be aware of the progress towards getting shareholder approval or may be aware that one of the parties is considering terminating or renegotiating the transaction.

2. Item-Specific Material NonPublic Information

Various public-side and private-side groups within the broker-dealer may have ongoing contacts with insiders outside the context of any transaction. The relationship between private-side and insiders may contemplate at times that MNPI will be provided (e.g., for financial advisory purposes). The relationship between public-side and insiders is generally intended to be based on public information only, but private information may be inadvertently disclosed. Broker-dealers generally provide written policies to employees as to their obligation to notify the Control Group.

Two broker-dealers did not require MNPI within the possession of the Credit Department to be reported into the Control Room. The staff raised this as a concern with the broker-dealers, and the broker-dealers responded by implementing new procedures directing the Credit Department to report MNPI into the Control Room.

3. Ongoing Sources of Confidential Information

Certain sources provide ongoing access to confidential information that at times may be MNPI. Sales and Trading, Investment Banking, Capital Markets, and Credit may access information given to lenders under a credit agreement or information obtained as a large investor in a corporation. Typically, the recipient must execute a confidentiality agreement prior to being granted access. Employees sometimes serve as directors of public companies, as members of bankruptcy committees, or as the broker-dealer's contact when the broker-dealer owns a large percentage of the company. Employees also may serve on board of directors as the result of an outside business interest.

Broker-dealers should take into account when a public-side group with investment or trading responsibilities has ongoing access to confidential information that may at times be MNPI.⁴³ The *Gabelli* action illustrates concerns with reliance on a public-side employee to self-report when a specific instance of MNPI arises. The staff believes that similar concerns are presented when the public-side employee has ongoing access to confidential information, which at times is MNPI, through other sources (e.g., Loan Sites).

The staff's review observed that broker-dealers did differentiate between public-side and private-side business units with access. In most instances, broker-dealers immediately alerted the Control Group when a public-side area is receiving the confidential information for monitoring purposes. For private-side areas, the information was usually not forwarded to the Control Room unless the private-side employee believed that a specific item constituted MNPI (i.e., as discussed under the prior section). The staff identified instances in which public-side employees who served as directors of public corporations were not monitored, and the staff raised this concern with the broker-dealers.

Information from Research generally is not reported into the Control Room until shortly prior to being publicly released. However, usually all information within a given category is reported in (e.g., all upgrades and downgrades), without a materiality determination for each specific item. Two other sources of confidential information (that are at times MNPI) are generally not reported into the Control Room: institutional customer information (e.g., orders) and corporate insider customers, although other controls are in place as discussed below.

C. Monitoring Lists

The 1990 Report focused on watch lists and restricted lists. Current information barriers are more complex. Matters reported into the Control Room receive different treatment based on the information source. All broker-dealers examined by the staff maintain a watch or grey list, as described in the 1990 report. Broker-dealers also maintain other lists, which were sometimes called private names lists, confidential lists, or control lists or did not have any specific name at all. Because no industry standard term is in use, the staff will discuss the lists by their function.

Information reported into the Control Room is generally entered into a database ("Control Database"), which then generates the lists discussed below. Each list is generated based on the coding or fields selected when the item is created or updated. In general, all items reported into the Control Room are entered into the Control Database. As discussed above, broker-dealers at one time did not record matters they deemed immaterial, but most have since altered their procedures.

⁴³ See *In the Matter of Gabelli & Company, Inc; and Gamco Investors, Inc*, Release No. 34-35057 (December 8, 1994), settled action.

1. General Surveillance Lists

The first type of list results in general surveillance of trading activity, as discussed below in V.G. Traditionally, the watch or grey list fulfilled this function. All large broker-dealers have a watch or grey list, which continues to capture instances in which a private-side group (and sometimes a public-side group) has possession of MNPI.⁴⁴ Some broker-dealers maintain additional lists for certain events (e.g., Credit risk ratings or over-the-wall),⁴⁵ and the resulting surveillance may be different, as discussed below in V.G. Most transaction sourced (IV.B.1) and item-specific MNPI (IV.B.2) will be placed on a general surveillance list, although some items may instead be placed on one of the other lists discussed below.

2. Hybrid Restricted and Surveillance Lists

The second type of list acts as a restricted list for certain specific groups and a surveillance list for the rest of the broker-dealer. The most common example of this type of list is when public-side groups have access to ongoing sources of confidential information, which at times may be material, referred to as “going private on a name”. Broker-dealers may create lists that implement a complete restriction on trading by that group and other groups that share the same physical space. The list generally serves to monitor trading by other public-side groups that are physically segregated and employee trading generally. One broker-dealer maintained surveillance lists that restricted the specific group that had access to the MNPI but did not result in surveillance of the rest of the broker-dealer, and the staff raised this as a concern.

3. Firmwide Restricted Lists

In some cases, broker-dealers may decide that certain sources of MNPI should be placed on a restricted list.⁴⁶ This process is more common when the placement does not indicate that MNPI has been received but rather that it could be received. The types of MNPI sources placed on a restricted list varied considerably by broker-dealers but may include: corporations on which employees served as directors; for which Trading groups accessed private Loan Sites; or for which the broker-dealer was facilitating a transaction by an insider.

Another example is the use of restricted lists after transactions have been announced. While the specific transaction has become public, the broker-dealer may continue to have two types of MNPI. First, some transactions are contingent upon certain conditions being

⁴⁴ Examiners identified a small broker-dealer that did not have a watch list and relied solely on its restricted list.

⁴⁵ Some broker-dealers maintain over-the-wall as a separate list, other broker-dealers annotate watch /grey list entries.

⁴⁶ The restricted lists discussed in this section differ from restricted lists based on legal requirements. Legal restricted lists incorporate restrictions mandated by specific regulatory requirements, such as Exchange Act Rule 14e-5, 17 C.F.R. § 240.14e-5; Regulation M, 17 C.F.R. § 242.100-105; and Regulation S, 17 C.F.R. § 230.901-905.

met. For example, the transaction may be completed only upon an affirmative shareholder vote, regulatory approval, or director approval. The broker-dealer may receive MNPI about the approval prior to public announcement.⁴⁷ In addition, the broker-dealer may receive MNPI about financial conditions of the corporation. For example, in the context of an offering, the broker-dealer may receive nonpublic information, such as unannounced earnings information, in order to assist the issuer in updating its filed but not yet effective registration statement to reflect unannounced earnings information.

Some broker-dealers have implemented trade-through policies that permit certain types of firm accounts to trade without restriction in restricted list securities and allow other types of firm accounts to trade below certain thresholds. The staff is concerned that restricted list surveillance only reviews whether the account is trading consistently with any applicable restrictions rather than a review to determine whether such trades may be based on MNPI.

In order to implement the restriction, broker-dealers must disseminate information to the groups that are restricted. At one time, it was common to relay information to traders on restrictions through emails or a list posted on the intranet. The effectiveness of such notice is questionable for high volume traders who may not have time to consult a list (with several hundred names) prior to each trade. More broker-dealers are implementing other methods of notice that may be more effective, such as coding of order entry systems, pop-up notices in the trading systems, or hard blocks in trading systems that require a code from Compliance in order to complete the transaction.

V. CONTROLS

After establishing the overall control structure, broker-dealers must implement controls reasonably designed to prevent inadvertent or deliberate accessing of MNPI by unauthorized persons and to identify instances in which it appears that an unauthorized person has accessed MNPI.⁴⁸ The staff's review identified the following controls implemented to address potential misuse of MNPI.

⁴⁷ The potential for leakage of information may be greater at this point because public-side traders are more likely to be brought over-the-wall after public announcement of the transaction.

⁴⁸ The report of the House Committee on Energy and Commerce on ITSFEA stated: "The requirements of these new statutory provisions reflect the Committee's belief that broker-dealers . . . must not only adopt and disseminate written policies and procedures to prevent the misuse of material, nonpublic information, but also must vigilantly review, update, and enforce them. . . . the Committee expects that institutions subject to the requirements of this provision will adopt policies and procedures appropriate to restrict communication of nonpublic information and to monitor its dissemination, such as restraining access to files likely to contain such information; providing continuing education programs concerning insider trading; restricting or monitoring trading in securities relating to which the firm's employees possess nonpublic information; and vigorously monitoring and reviewing trading for the account of the firm or of individuals." H. Rep. No. 100-910 at 21-22 (1988).

A. Limiting Authorized Access

The staff believes that one important component of an information barriers program is restricting access to MNPI only to those persons that need to know the information. Examined broker-dealers placed limitations on access to nonpublic information generally regardless of whether the employee is public-side or private-side. Most broker-dealers have written policies that instruct personnel not to discuss confidential information with other public-side and private-side personnel unless they need to know the information.

1. Deal Team Members

Initially, information on M&A and capital markets transactions is generally limited to deal team members, both to address concerns about conflicts and to limit dissemination of MNPI. Broker-dealers have processes to add employees to the deal team working on a transaction. Public-side employees must go through an over-the-wall process prior to being given access (see discussion at V.C.1 below). Some broker-dealers also use the over-the-wall process when a private-side employee outside of Investment Banking is to join the deal team, which may assist broker-dealers in monitoring the dissemination of information. Within Investment Banking, most broker-dealers rely on Conflicts to approve the addition of a private-side employee to the deal team.

2. Sharing of Information

General information about transactions is circulated to the Control Room to incorporate into the Control Database. At most broker-dealers, only the Control Room has direct access to the Control Database. However, certain groups may have limited access to certain information within the database. For example, some broker-dealers provide supervisory analysts within Research only with the corporate names in order to compare to research reports being prepared for publication. Other broker-dealers send all draft research reports to the Control Room to perform the review. When broker-dealers did provide limited Control Database access to select Research employees, information barriers generally covered such employees similar to other private-side groups, such as physical separation from the rest of Research.

Conflicts also receives information on corporate client transactions. Broker-dealers generally either integrated the group physically within Investment Banking or walled the group off into an area separate from all other groups.

One broker-dealer provided deal information regularly to its unregulated parent. The information included both the deals worked on and ongoing information as to deal developments. The broker-dealer did not evaluate whether the parent had any controls over use of the information. Examiners raised this as a concern with the broker-dealer.

Some broker-dealers have established cross-selling groups between Asset Management and Investment Banking.⁴⁹ The access provided to the cross-selling groups varies among broker-dealers. In some cases, the cross-selling group is provided with access to information generally about transactions within Investment Banking. Other broker-dealers have Investment Banking personnel forward only certain transactions to the cross-selling group for consideration. The staff observed that some broker-dealers have detailed processes designed to limit when the Asset Management personnel may be given information on the potential client. The staff observed concerns with some broker-dealers' practices – failure to document when the cross-selling group was given access to Investment Banking information or lack of adequate physical barriers surrounding the group.

3. Dual Function Employees

Access to MNPI inconsistent with Section 15(g) may result when an employee has dual job responsibilities.⁵⁰ For example, internal committees (e.g., commitment committees) review and approve Investment Banking transactions prior to public disclosure. Broker-dealers should be careful not to include as committee members employees who have trading responsibilities or otherwise have controls reasonably designed to prevent misuse of the information. The staff's review identified different processes at broker-dealers to prevent misuse by public-side employees. Some broker-dealers only permit private-side employees to serve on the approval committees. Other broker-dealers allow public-side employees to serve on approval committees, but they must either leave the meeting prior to discussion of any MNPI or be logged over-the-wall.

4. Informal Discussions

Private-side employees on occasion have general discussions with employees in other areas of the broker-dealer, which creates a potential for unauthorized disclosure of MNPI. Most of the interactions occur on an informal (undocumented) basis, with procedures specifying that all such discussions may not be related to any specific transaction. Broker-dealers state that Investment Banking employees may speak with employees in certain public-side areas of the broker-dealer to obtain background information on a client (Research, Investment Groups) or on market trading conditions (Sales and Trading). Sales and Trading employees sometimes speak to Research employees. Broker-dealers instructed the private-side personnel to refrain from discussing MNPI (and sometimes any specific issuer) and instructed the public-side personnel to identify themselves as such to any private-side personnel. The staff is concerned that the

⁴⁹ The cross-selling efforts could include identifying employees of Investment Banking clients who will have funds to invest after completion of a deal and referring the client to Asset Management. Alternatively, Asset Management customers (e.g., CEOs of companies) could be referred to Investment Banking.

⁵⁰ See *SEC v. Friedman, Billings, Ramsey & Co., Inc.*; Civil Action No. 06-cv-02160 (D.D.C.), Litigation Release No. 19950 (December 20, 2006), settled action. See, also, *SEC v. Charles Schwab Investment Management et al.*, Civil Action No. CV-11-0136 EMC (N.D. Cal.), Litigation Release No. 21806 (January 11, 2011), settled action.

frequency of the discussions and the absence of documentation may make it difficult to monitor for any inadvertent (or even intentional) disclosures that may occur.

B. Preventing Unauthorized Access

As discussed in the 1990 Report, controls to prevent unauthorized access to MNPI have been a long standing practice of broker-dealers. The initial focus was on physical barriers such as locked doors with key card access. Broker-dealers have incorporated other controls to prevent unauthorized access of MNPI. The movement to electronic copies required evaluation of access to network systems or potential leakage of information through electronic media (e.g., flash drives) or through emails. Broker-dealers remove authorized access when employees move from private-side to other areas of the broker-dealer or terminate their employment. Hardcopy documents are disposed of through secure methods to protect MNPI.

1. Physical Barriers

The staff's review noted that broker-dealers were moving more groups into separate physical spaces with key card access: Investment Banking, Capital Markets (including Derivative Sales), Syndicate, Credit, and Research. Some broker-dealers impose at least some physical separation between public-side groups that routinely receive MNPI and are brought over-the-wall and other Sales and Trading areas. As discussed above, broker-dealers are considering which groups need to be kept separate based on the information within the group.

Some broker-dealers limit key card access to physical spaces by department, others restrict key card access further by floor. In other words, if Investment Banking is divided into multiple floors, some broker-dealers grant access to a specific floor only to employees permanently assigned to that floor. In addition to the employees working on each floor, access will also be given to certain control persons (e.g., Compliance) and senior managers. Some broker-dealers periodically review the access lists to confirm that each person should still have access. In addition, access may be limited to certain hours.

Broker-dealers generally implemented a higher degree of physical separation for Investment Banking, Credit, Corporate Capital Markets and Syndicate, Private Equity, Research covering corporate issuers, Conflicts, and Control Room than for other private-side areas. These private-side areas frequently were on their own floor or (less frequently) were walled off with a separate entrance from other groups on the floor. The staff identified concerns at some broker-dealers where the origination functions for non-corporate issuers⁵¹ were located near trading floors. In contrast, some broker-dealers placed origination groups for non-corporate issuers within the physically segregated Capital Markets floors. Physical barriers may also be in place for certain public-side groups with access to confidential and sometimes material information: prime brokerage, stock lending, certain Investment Groups, and issuer buyback desks.

⁵¹ Origination for non-corporate issuers is discussed above at III.C.

The staff identified concerns with the adequacy of the physical barriers. Some private-side areas had glass walls, permitting visual access to information. Some broker-dealers had private-side groups on the trading floor (e.g., Derivative Sales). The staff raised these concerns with the broker-dealer(s).

Some broker-dealers did not have physical barriers surrounding certain groups that support private-side areas, such as IT, Operations, or the Loan Site Monitors.⁵² The lack of physical barriers may result in unauthorized access through the IT systems to which the support personnel have access. For example, sensitive information may be viewable on computer screens, or the electronic systems may be accessible when employees step away from their desks. Broker-dealers may need to consider controls to prevent unauthorized access through these systems.

The staff also observed that the Financial Sponsors Group within Investment Banking and Private Equity groups are sometimes integrated with other Investment Banking groups. The staff is concerned about potential conflicts between the interests of the Financial Sponsors Group and Private Equity compared to interests of the corporate clientele of other Investment Banking groups.

2. Technology Barriers

The staff observed that most information is stored electronically on network computer drives. Some broker-dealers have automated systems within Investment Banking to limit access to information by deal so that only approved deal members may access the information. Employees are able to log in only after Conflicts has approved them to work on the project. Other broker-dealers permit access to employees by department or group so that all of Investment Banking (or a unit within Investment Banking) may access the documents. The staff believes that broker-dealers should consider limiting access based on the need to know principle as well as to prevent conflicts between deal team members working for competing corporations.

Some broker-dealers prevent access to Investment Banking computer systems in public areas of the broker-dealer (i.e., no remote log-ins). More broker-dealers disable the ability to download information to removable storage from computers. Requests to download the information must be approved by a supervisor and forwarded to the appropriate support group. Documents may not be downloaded or printed when accessing the network remotely.

3. Printing and Production

Most broker-dealers maintain reprographics and desktop publishing areas (collectively, “Printing and Production”). Broker-dealers stated that the overwhelming majority of users came from Investment Banking and Capital Markets. The reprographics areas are

⁵² See discussion in III.B. regarding the information handled by the Loan Site Monitors.

responsible for taking electronic files and (less frequently) hard copy documents and creating multiple copies. The desktop publishing areas create presentations or word documents. Most large broker-dealers have a centralized Printing and Production with a few smaller satellite locations. Broker-dealers generally created physical barriers around these groups.

Personnel external to Printing and Production may need to enter through a single door, which provides access only to a limited visitors section. In some cases, broker-dealers created separate entrances for public-side vs. private-side areas. Work jobs for private-side employees might be identified as such by cover sheet. Some centers use different machines to copy private-side vs. public-side documents. Print jobs may be locked up between production and being picked up. Broker-dealers might check the identification card of persons picking up the job and confirm that the person is from the correct office. Other broker-dealers require that only the person or their specifically named designee can pick up the print job.

4. Disposal of Confidential Documents

Most private-side areas have document disposal policies to prevent MNPI being disseminated through discarded paper. Broker-dealers may have two sets of paper bins – one for regular recycled trash and locked bins for MNPI. Broker-dealers had processes to move the locked bins from each floor to the disposal truck. The processes may include a security escort, movement from one locked bin to another locked bin for transport, and/or a transport bin that incorporates a paper shredder. Some broker-dealers shred all paper that is removed from a private-side area, while other broker-dealers only shred those documents placed by the private-side personnel in the locked bins. The staff believes that the shredding of all paper from private-side may prevent inadvertent disclosures when MNPI accidentally gets mixed in with the normal recycle bins. Given the high percentage of MNPI within certain private-side groups, the staff believes that broker-dealers should consider expanding the scope of disposed documents shredded.

C. Controls over Information Given to Public-Side Employees

As discussed above, public-side employees are not supposed to access routinely MNPI. Broker-dealers need to be able to monitor when public-side employees have or will have access to MNPI so that appropriate controls may be implemented.

1. Information Provided by Internal Groups

Public-side groups at times have a limited number of employees who receive access to MNPI related to a specific company through the over-the-wall process. The over-the-wall process involves the private-side group with MNPI identifying to the Control Room the names of the public-side employees who will be given access to MNPI regarding a specific company. As a result, the over-the-wall employee is prohibited from both personal and firm trading in any security of that company. Some broker-dealers' over-the-wall processes require pre-approval by Compliance, which may help to ensure that

Compliance receives timely notice of over-the-wall crossings. For other broker-dealers, if Compliance is not required to pre-approve access to the information, it must be notified in a timely fashion. The over-the-wall employee generally is logged into the Control Database. The staff observed concerns at some broker-dealers that did not maintain complete listings of individuals who were deemed over-the-wall and may have had access to MNPI.

Most broker-dealers will contact the supervisor of the employee to be crossed to obtain authorization. Some broker-dealers do not log the supervisor over-the-wall, and this may create an issue if the supervisor is provided with sufficient information to allow them to identify the MNPI. Some broker-dealers will bring an entire desk over-the-wall if a large number of employees have access to the MNPI. Some broker-dealers also maintain some level of physical separation between groups routinely over-the-wall and other public-side personnel.

Credit creates an internal credit rating, which may at times be based on MNPI. Some broker-dealers do not provide internal credit ratings outside of Credit and a small select group of private-side personnel. Some broker-dealers provide the credit rating to public-side personnel only if not based on MNPI.

2. Information Provided by External Groups

Investment Groups may receive MNPI from external parties. The information may be provided as a solicitation to participate in a transaction (e.g., purchase in an offering) or may be accessed through the monitoring of current investments.

a. *Information Received Pursuant to a Confidentiality Agreement -- Electronic Sources of Information*

Confidential information, which at times constitutes MNPI, frequently is circulated through electronic websites requiring authorization to access. For example, corporate borrowers provide confidential information to lenders through Loan Sites. As discussed above, a public-side group will either forgo receipt of confidential information or will go private on the name.⁵³ Most broker-dealers implemented controls to identify when a public-side group accessed confidential information without having gone through the formal process. The controls typically involved periodic review of reports from the website as to public-side employees' access of information. Alternatively, broker-dealers may prevent public-side employees from directly accessing the website. Instead, another group will download and forward information consistent with the group's authorized access.

Some Loan Sites have implemented controls that permit broker-dealers selectively to block access by their employees to information contained on Loan Sites. For example, the broker-dealer may block all public-side employees from accessing private-side

⁵³ See discussion at IV.C.2 for the impact of going private on a name.

webpages, as well as webpages that do not differentiate between public and private information. The broker-dealer selects a gatekeeper, such as someone within the Control Group. The gatekeeper has the ability to grant or deny access to employees to access private information. Broker-dealers then are able to confirm that public-side groups have been logged as private on the name prior to accessing the information.

When the public-side group has decided not to receive confidential information on a company, the Loan Site Monitors will review the information being provided. At times, this information may be significant or may require that the lender take action. For example, a borrower may request that all lenders agree to waive a loan covenant, such as cash flow requirements or minimum equity levels. Some broker-dealers have the Loan Site Monitors forward the information to the Legal or Compliance Department for their determination as to whether the public-side group should be informed and made private on the name. Some broker-dealers have Loan Site Monitors vote consistently with the majority of external lenders or with other groups within the broker-dealer or its affiliates that are lenders (e.g., Asset Management).

b. Information Received Pursuant to a Confidentiality Agreement – Oral or Written Sources of Information

Public-side groups may receive orally confidential information, which at times may be MNPI, typically for specific transactions rather than ongoing sharing of information. For example, public-side groups may be approached by external underwriters to invest in an unannounced offering. The information provided regarding the existence of the offering may be MNPI, and additional MNPI may be received during the investment process. Broker-dealers generally relied on identifying the provision of information based on the signing of a written confidentiality agreement. Broker-dealers stated that Legal would review any confidentiality agreements and would notify the Control Group if appropriate.

The staff's review noted that a written confidentiality agreement may only be required in certain circumstances. Some MNPI may be provided based on informal confidentiality agreements – oral discussions followed by emailed confirmation or emailed informal agreements to maintain confidentiality. No broker-dealer indicated that it had 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.

Some broker-dealers have instituted surveillance to monitor for possible disclosures to their public trading groups of external deals, including M&A and PIPEs. For example, upon announcement of a material M&A transaction for which the broker-dealer did not have a role, the broker-dealer may review the positions established by their trading groups. Broker-dealers may also review short positions created in advance of announcements of PIPEs.

c. *Informal Discussions*

Public-side employees have ongoing discussions with persons in possession of confidential information and sometimes MNPI. For example, public-side traders have discussions with insiders of corporations or with consultants who may have confidential information, which at times is MNPI.⁵⁴ The only control identified to the staff was a written procedure directing employees to identify themselves as public-side to the insider and to self-report receipt of MNPI to the Control Room. No documentation was maintained of the contacts made, and no specific controls were in place. Broker-dealers stated that the contacts were too numerous to document. The staff is concerned about information barriers that consist solely of a written procedure directing employees not to engage in certain behaviors and to self-report when they come into possession of MNPI.⁵⁵

3. Public-Private Transitions

The staff's review observed informal controls over the transition from public to private and vice versa. For example, private-side employees on occasion transfer to public-side business units. At that point, the employee may still have MNPI. The staff inquired about controls over the transition process. Most broker-dealers did not have any formal processes and relied on employees self-reporting. The staff is concerned that no systematic reviews are conducted of employee transfers from private-side areas. One broker-dealer will review transfers for the purpose of eliminating physical key card and electronic systems access. However, the staff did not observe any formal broker-dealer processes to monitor potential misuse of the MNPI in possession of the now-public-side employee.

Most broker-dealers do not have a process for identifying when private corporations become public corporations through issuance of securities, which may result in an absence of monitoring inconsistent with Section 15(g). Public-side employees sometimes are permitted by broker-dealers to access MNPI on private corporations,⁵⁶ which were not included within automated surveillance. The staff's review observed instances in which broker-dealers' monitoring processes were incomplete because corporations continued to be categorized as private by the Control Group after the corporation had a securities distribution. The gap in coverage remained for extended periods of time, and the staff raised this as an issue with the relevant broker-dealers.

⁵⁴ The Commission has brought Section 15(g) actions based on the failure to have procedures reasonably designed to prevent misuse of MNPI obtained through interactions with company insiders (*In the Matter of Guy P. Wyser-Pratte*, Release No. 34-44283 (May 9, 2001)); and received from consultants relating to an announcement regarding 30 year U.S. Treasury bonds (*In the Matter of Goldman, Sachs & Co.*, Release No. 34-48436 (September 4, 2003)), settled actions.

⁵⁵ See e.g., *In the Matter of Gabelli & Company, Inc. and Gamco Investors, Inc.*, Release No. 34-35057 (December 8, 1994), settled action.

⁵⁶ In the instances reviewed by the staff, a private corporation was typically owned by a limited number (e.g., one or two) private equity funds, and securities interests were not traded on even a limited basis.

The staff believes that broker-dealers also need controls for instances in which an employee or group had MNPI and related restrictions (e.g., over-the-wall or private on a name) and now wants removal of the restrictions. Some broker-dealers establish a set period – two reporting periods (i.e., the company has filed two Forms 10Q/10K) between the time the group accessed the MNPI and when they may begin trading. Other broker-dealers have no such periods and analyze the information accessed to determine when stale. While the reliance on two reporting periods does provide an opportunity for the corporation to make public disclosure and a bright line test for broker-dealers to follow, the staff believes that broker-dealers should have some type of control procedures to protect specific nonpublic information with continued materiality.

D. Controls over Information Given to External Parties

Various groups within the broker-dealer may have discussions with external institutional investors, both on an informal basis and with respect to unannounced transactions. Institutional investors are generally considered by the industry to be either public or private. Private institutional investors, which include Private Equity, trade mainly in the primary market (e.g., Rule 144A purchases). Public institutional investors, which include many hedge funds, trade in the primary and secondary trading market. Some institutional investors have both private and public investment areas. The staff's review observed that confidential information, at times MNPI, may be provided to institutional investors. The most common instances are when institutional investors are approached to participate in M&A transactions, capital markets transactions, and loans.

1. Specific Transactions

Broker-dealers represented that private institutional investors were more likely to be contacted on M&A transactions, and public institutional investors were more likely to be contacted on capital markets transactions.⁵⁷ The staff's review noted that broker-dealers are developing control procedures over providing information in both contexts. Some broker-dealers might pre-qualify institutional investors, including determining the appropriate contact person or procedure established by that institutional investor. For example, some investors prefer that all contacts be initiated with the investor's Legal or Compliance staff. Other investors select a specific person within their organization who is authorized to access MNPI. The broker-dealer's M&A control procedures may require an internal conflicts check prior to discussions with an institutional investor. Controls around capital markets transactions may include provision of limited information with the contact made only shortly prior to public disclosure. The control procedures typically specify the information that may be provided based on the type of confidentiality

⁵⁷ With respect to M&A transactions, institutional investors are invited to participate in purchasing assets or an interest in a company. The transaction typically is not announced until agreement is reached. With respect to capital markets transactions, the investor is queried as to market interest (aka sounding the market) in purchasing in an offering. The offering may or may not be publicly disclosed prior to completion of the deal (depending on whether it is a public offering or private placement).

agreement obtained: oral with an email confirmation by the broker-dealer, oral with an affirmative email reply from the investor, or a written agreement. Most broker-dealers reviewed by the staff maintain a log of contacts made with investors. The contact is recorded even if the investor declines to participate and does not receive MNPI.

While some broker-dealers require at least an oral confidentiality agreement followed by an email confirmation of the agreement prior to providing the name of the corporation that is the subject of the transaction, some broker-dealers provided information based solely on oral confidentiality agreements. Documentation that information was provided may be limited, potentially impacting the broker-dealers' ability to monitor for misuse of MNPI.

Information regarding a transaction may be circulated to investors through an electronic website, referred to as a virtual data room. Broker-dealers stated that virtual data rooms were used more frequently in M&A transactions rather than offerings. Broker-dealers also indicated that the virtual data rooms were more likely to come into play later in the transaction when the potential buy-side participants had gone through initial rounds of discussions. Access to virtual data rooms is based on specific users, so that each individual within an institutional investor will have a unique log-on. Broker-dealers stated that either the sell-side participant or its financial advisor could control access to the data room. The broker-dealers stated that no formal process was used to remove access from buy-side participants that had exited the negotiations. Broker-dealers believed that if the investor continued to access the data room after exiting negotiations, the broker-dealer or the sell-side participant would notice the activity. While audit trails were maintained of the accessing of information, broker-dealers were divided as to whether the documents would be maintained after the transaction had closed. 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.

2. General Discussions

Institutional investors frequently request wide-ranging discussions with private-side employees, such as investment bankers. Some broker-dealers have instituted controls surrounding the discussions. The controls include requiring that questions be submitted in advance, pre-qualifying the institutional investor, requiring that senior bankers participate in the discussion, and maintaining a log of meetings held. Implementing such requirements or prohibiting them from occurring are relevant controls to prevent misuse of MNPI.

Public-side employees provide information to institutional investors referred to as market color. The information is developed from customer confidential information. Some broker-dealers create detailed matrices for the public-side as to how the public-side anonymizes the information. For example, the information may need to be based on a minimum number of customers, and no single customer may represent more than a certain percentage of the color. The broker-dealer allows customers to specify that their

trading information may not be used in developing market color. Providing clear guidelines to employees may prevent inadvertent disclosure of customer trading orders.

3. Credit Extensions

During the loan origination process, institutional investors are given access to Loan Sites in evaluating whether to lend. In the secondary market, the administrative agent⁵⁸ for the borrower grants and removes access to Loan Sites to institutional investors and other lenders. The administrator of the loan controls the granting and removing of site access based on purchases and sales of the loan.

During the initial sale of loan interests, some broker-dealers create lists of potential lenders to grant access to the Loan Site based on credible investors. Institutional investors are given access to the borrower's confidential information in order to evaluate loans for purchase. If such institution is routinely accessing the information without purchasing loans, this may indicate that the institution does not have a legitimate need to know the information. Some broker-dealers indicated informally that they might eliminate access to potential investors with a history of accessing sites without participating in the issuance. In some cases, a supervisor must specifically approve the list of potential investors. Other broker-dealers could not articulate when they would or would not grant access to the Loan Site to potential investors. The staff observed that the controls in this area remain informal and without any specific standards and believes that broker-dealers should consider where additional controls may be needed.

Broker-dealers or their affiliates may have control over the addition and removal of third party investors from the ongoing Loan Site. The staff's review noted that broker-dealers are creating better controls to limit access to actual lenders. Some broker-dealers have processes to grant access to Loan Sites only upon purchase of a loan interest and to remove access upon sale of a loan interest. The process may include reviewing trading reports to identify lenders that no longer hold interests and comparing against access to the Loan Sites. Some broker-dealers have processes to identify institutional investors' designated contact for the Loan Sites and the same contact is used for all access to the Loan Site (or to authorize others within the institutional investor to access the Loan Site). Some broker-dealers only grant access to Loan Sites to user email addresses that include the institution's name (e.g., user@institution.com) and not to user email addresses that use generic third party services.⁵⁹

⁵⁸ At most of the broker-dealers examined by the staff, a group within the Investment Banking Department performed the functions of administrative agent during the loan origination, while a group within the Investment Banking Department or Operations performed the functions during secondary market trading.

⁵⁹ The use of generic email addresses creates significant risk that there will be a failure to identify when an individual contact person has left the financial institution or may otherwise create concerns regarding the use of false identities.

E. Email Controls

The use of emails to transmit MNPI between persons working on a transaction is common. Within a specific department, information is shared between employees through a network drive. However, when employees across departments work on a transaction, the information is usually emailed to the employee. In addition, emails may be sent between broker-dealer employees and external clients. The staff's review observed instances in which emails were sent to the wrong party so that unauthorized public-side employees and external parties received MNPI. Broker-dealers were implementing controls to minimize misdirected emails. Some broker-dealers require private-side employees affirmatively to identify emails as appropriate to be sent outside of the department or outside of the broker-dealer. Some broker-dealers turned off the autocomplete function of email systems to require employees to type in the full email address. Some broker-dealers created pop-ups to identify to the employee that the email was being sent externally.

Broker-dealers generally review emails for information barriers concerns (e.g., inappropriate disclosures of MNPI). Broker-dealers represented that email review systems do not have keyword sets to take into account information barriers issues. As a result, broker-dealers must develop other techniques. At the most basic level, most broker-dealers conduct random samplings of emails to identify potential concerns. Some broker-dealers have targeted reviews for when an "internal use only" document is sent outside the broker-dealer or for large attachments sent to generic internet email domains. Some broker-dealers will conduct ad hoc email reviews when surveillance identifies concerns in trading or based on announced deals.

The staff did observe specific gaps in the email review process, and the gaps were discussed with the broker-dealers. Some broker-dealers did not review emails of personnel within control functions with access to MNPI, including Compliance and IT. Some broker-dealers only required reviews of the names of the sender and recipient without any assessment of the content of the email. One broker-dealer did not review any internal emails so that no controls existed over emails between private-side and public-side groups.⁶⁰ Some broker-dealers did not monitor internal communications through chat rooms.

F. Employee Trading Pre-clearances

Most broker-dealers require pre-clearance of employee trading throughout the broker-dealer, and pre-trade clearance processes differ for public and private-side employees. At some broker-dealers, public-side employees only pre-clear through their supervisor, although employees in Research (which may or may not be classified as public) may also pre-clear through Compliance. Other broker-dealers require public-side employees to pre-clear with Compliance, which will review against the watch list, although the trade

⁶⁰ The 1990 Report noted the need for substantial control, preferably by Compliance, of interdepartmental communications.

will not necessarily be denied.⁶¹ At some broker-dealers, all personal trade requests of private-side employees are denied if the matter is on the watch list. Other broker-dealers make a case-by-case analysis based on the employee's job function. Broker-dealers were moving to require pre-clearance of personal trades by contingent workers (e.g., persons performing work on behalf of and as directed by the broker-dealer but employed by third parties) and control/support functions if the worker/employee has access to MNPI. Broker-dealers are taking into account whether the employee was over-the-wall in approving or denying the request. Certain pre-clearances may be done to take into account specific information held by the employee. For example, employees in areas that process trades for corporate insiders may have scrutiny of their personal trades against pending and recent orders.

Broker-dealers generally exempt employee managed accounts from the pre-clearance process. Some broker-dealers select certain permitted managed products, none of which were individually managed accounts, and employees were only allowed to choose from the broker-dealer specified list. The staff had concerns about practices at broker-dealers that permit employees to use any external manager and do not conduct any scrutiny as to the ability of the employee to influence trading in the account (e.g., individually managed accounts or managers with any connections, familial, business, or otherwise, with the employee that might allow the employee to influence the trading in the account).

Most broker-dealers compare executions of employee trades against pre-clearances obtained. Broker-dealers were less effective in tracking and/or responding to multiple failures to pre-clear. One broker-dealer responded to multiple failures to pre-clear with a "letter of education," and the employee failed to pre-clear subsequent to receiving the letter. In response to the staff's concerns, the broker-dealer revised its procedures to place restrictions on employees who failed to pre-clear multiple times. In responding to failures to pre-clear, some broker-dealers did not have any specific remedy and only reversed if the trade would not have been approved. As a result, the employees did not have a significant deterrent from trading without clearance. Some broker-dealers have policies to reverse trades made without pre-trade authorizations even if the trade would have been approved, which may be an effective deterrent and cause employees to pre-clear.

G. Surveillance

The placement of a matter on a monitoring list triggers surveillance.⁶² The ability to surveil adequately may be circumscribed based on excessive volume as well as limited

⁶¹ Broker-dealers should be alert to the possibility that the denial of the trade of a public-side employee based on a watch list entry may in effect tip off the employee that the broker-dealer has possession of MNPI regarding the security. In designing its controls around employee pre-clearance, broker-dealers should evaluate the use of controls, such as heightened surveillance or over-the-wall processes, to prevent misuse of the information when the denial may result in the employee identifying the MNPI.

⁶² Some broker-dealers integrate information barriers surveillance in the Control Group; other broker-dealers place the surveillance responsibility within the Surveillance group. Both groups are usually within Compliance.

information access (e.g., the reviewer may not know that a significant milestone had occurred, such as a definitive agreement). The staff observed that while some broker-dealers continued to rely on manually intensive reviews, improvements, as described below, have been made and continue to be made in review scope and review process.

1. Scope of Review

Historically, surveillance focused on employee and firm accounts. Surveillance scope has expanded to capture trading in other types of accounts that may indicate misuse of MNPI. Broker-dealers may review activity of institutional customers, Asset Management affiliates, and retail customers. Broker-dealers are reviewing the trading done by contingent workers to whom the broker-dealer has given access to MNPI.⁶³

Broker-dealers were expanding the scope of their review to take into account all products that could be used to profit from MNPI. For example, broker-dealers may review transactions in related derivatives – credit default swaps, single stock futures, equity or total return swaps, warrants, and bond options. Broker-dealers also may review interests in companies held through loans or as components of pooled securities such as unit investment trusts and exchange traded funds. When such instruments may not be easily captured by automated surveillance reports, some broker-dealers respond by reviewing reports of all such instruments traded. Other broker-dealers conducted targeted reviews by searching the trade blotters when a deal is announced. The staff notes that the lack of automation and standardization has hindered broker-dealers from reviewing derivative products in the same manner as other securities. The staff is encouraged that some broker-dealers are continuing to enhance their review as technology becomes available. The staff believes that broker-dealers should consider all instruments that may be used to profit from the MNPI. For example, 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.

Broker-dealers may conduct lookbacks to determine if there are unusual trading patterns preceding a significant event or receipt of MNPI. In some cases, broker-dealers consider transactions for which the broker-dealers did not have any involvement when conducting lookback reviews. For example, the broker-dealer may follow up if one of its employees made a trade prior to the announcement of a major merger for which other broker-dealers served as financial advisors.

2. Pattern Surveillance

Broker-dealers are enhancing the types of reviews being conducted to allow identification of behavior patterns. When an employee trades in a security on the monitoring list, the

⁶³ Some broker-dealers hire personnel as an outside contractor or consultant to fill some support positions such as IT and Printing and Production. The staff observed that these persons could be referred to as consultants, contractors, or vendors.

report might identify all trades by the employee in the security during the prior few months. Surveillance of firm trading accounts might identify the pattern of trading by the accounts during a time frame, noting when the account has built a position over time. Other pattern analysis might create exceptions based on accounts that trade in multiple securities on the monitoring lists, accounts that have not historically traded in the security, accounts that are newly open, or positions in monitoring list securities that constitute a substantial percentage of the account. With respect to firm accounts, most broker-dealers establish size cut-offs based on dollar value or percentage change in position so that only significant exceptions are reviewed.⁶⁴ While the staff agrees that excluding de minimis trading may help broker-dealers focus on significant concerns, the staff is concerned that the cut-offs were very high (\$5 million at one broker-dealer) or did not take into account positions that are built over several days.

Broker-dealers are also generating reports to take into account specific fact patterns. For example, reports may compare broker-dealer trading for transactions in which a trading employee is over-the-wall, identifying exceptions when the over-the-wall employee trades, other employees on the desk trade, or nearby desks trade. Reports may be generated based on instances in which a public-side area has become private on a specific name – which would include instances in which the desk has obtained borrower confidential information, has been invited to participate in a PIPE or other unannounced offering, or has received information through a bankruptcy committee. A report may review for concerns of cross-tipping – trading desks that are private on different names tip each other.

Restricted list placement typically also results in a lookback review. The lookback review provides heightened scrutiny of transactions prior to public announcement. At some broker-dealers, the lookback review is the only scrutiny of trading that occurred prior to publication of research reports. Other broker-dealers will place the subject of a research report on the general surveillance list a day or two prior to publication.

Certain types of MNPI are not generally placed on monitoring lists, including large customer orders, institutional investor information, and ongoing contacts with insider clients. Broker-dealers rely on surveillance reports to identify problematic behavior. Frontrunning reports review for trades prior to a large customer order. Shadowing reviews look for patterns of trading that appear to take advantage of customers' investment strategies. Registered representatives with insider customers may be subject to special scrutiny of their personal and customers' trades in those companies.

3. Compliance Access to Information

In order to perform their responsibilities, surveillance personnel need to have sufficient information in order to evaluate effectively trading activity. The staff noted that surveillance personnel are being provided greater access to developments that occur

⁶⁴ The staff observed that surveillances for broker-dealer positions are starting to take into account profit potential rather than size. The profit potential may be based on actual market movements or may be based on theoretical movements of price up and down.

within deals. At some broker-dealers, Compliance personnel have direct access to Investment Banking deal management systems. At other broker-dealers, the Control Database would contain detailed status updates, with Control Group personnel periodically speaking with the deal team in order to maintain awareness of current developments.

The staff's review did identify instances in which limited information was available to Compliance, which could impact the ability to monitor for misuse of MNPI. Compliance may be unaware of all deal team members. While Compliance may monitor developments in the deal, it generally does not obtain information regarding events that occurred prior to the first contact into the Control Room.⁶⁵ Some broker-dealers do not have mechanisms to identify transactions that are removed from all monitoring lists because they were terminated when they subsequently are reactivated.⁶⁶

4. Resolution of Matters

The staff reviewed the adequacy of how broker-dealers were researching and resolving surveillance items. At some broker-dealers, the staff was unable to determine that the broker-dealer was appropriately resolving matters because documentation was limited to a simple notation that the trade was reviewed. If the analyst researched the item, no documentation was maintained of the research or that the research was conducted. As a result, the staff was unable to conclude that the broker-dealer had an effective surveillance process. In contrast, some broker-dealers are enhancing the documentation maintained, with a brief description of the reason for resolving the exception (e.g., consistent with historical trading patterns).

The staff also observed that two broker-dealers resolved exceptions based solely on the assertions of the person being reviewed, without any independent confirmation. The staff believes that broker-dealers need to consider when the subject of surveillance has a motive to dissemble and therefore independent information should be obtained. The staff also is concerned when resolution is based on assumptions without verification – for example that trading by a customer-facing trading desk is for customer facilitation even though the desk is able to create and hold positions.

The staff has significant concerns about limited monitoring that may not be reasonably designed to identify misuse of MNPI. Most broker-dealers' analysis does not take into account when the broker-dealer first had possession of MNPI or other developments in the deal. An analysis is sometimes based on the historical trading patterns of an account,

⁶⁵ For example, the first entry in the Control Database may indicate that Investment Banking has been working on the transaction for a while. No documentation indicates that Compliance determines the date on which the project began. This information might be needed to determine whether trading in a company began before or after the broker-dealer first became aware of the transaction.

⁶⁶ For example, the Control Room may receive notice that the buyer and seller could not reach agreement and that all negotiations have stopped. The matter is then removed from the monitoring list. Shortly prior to announcement, the Control Room may learn that the negotiations were renewed and that it did not receive timely notification.

but the analysis does not necessarily consider whether an account began trading prior to or after the broker-dealer first began working on a transaction, or consider the possibility that a leak may have occurred as of a certain date. Instead, the compliance analyst might close out an exception based on the account having traded in the security before, even if the trading started after the broker-dealer first received MNPI. The staff also did not observe much in-depth analysis of trading – whether an account traded in multiple securities that may indicate a specific source of information, a position built over time in a security, or trading correlated with deal developments. Instead, most broker-dealers’ review tend to look for a “quick hit” type of trading, where an account purchases a large position in a single day in a transaction that is about to announce.

5. Risk Arbitrage

The 1990 Report discussed in-depth the concerns surrounding the risk arbitrage desk.⁶⁷ Because the risk arbitrage desk is building positions in announced M&A deals, it may be more difficult to distinguish between positions built on public information (including circulated rumors or speculation) or built on inside information. The staff noted that at the time of their review, broker-dealers had recently eliminated restrictions on risk arbitrage trading (which required pre-clearance or restricted their trading). The staff is concerned that no targeted or focused review of the desks’ trading activity was implemented at these broker-dealers. The concern may be reduced in part because most broker-dealers subsequently eliminated desks that focused on a risk arbitrage strategy. The staff believes that broker-dealers should consider controls to the extent that certain trading desks may engage in risk arbitrage.

VI. CONCLUSION

The staff’s review observed that broker-dealers were enhancing their controls in response to developments in business activities, technologies, and business structures. The staff’s review also identified gaps in controls, which were raised with the broker-dealers. Finally, the staff identified certain areas in which practices were more informal, and the staff plans to continue to review such areas in future examinations.

The examination staff members who participated in these exams are:

Headquarters-DC: Christine Sibille, Juanita Hamlett, Roberta Boyd, Jane Cash, Michelle B. Davis, Everardo DeArmas, Wanda Hunter, Judy Lee, Danielle Perfetuo, Lisa Wardlaw.

⁶⁷ Traditionally, risk arbitrage was considered the simultaneous purchase of stock in a company being acquired and the sale of stock of the acquirer. Modern risk arbitrage focuses on capturing the spreads between the market value of an announced takeover target and the eventual price at which the acquirer will buy the target's shares.

New York Regional Office: John M. Nee, Stephanie Morena, Theresa D. Gleason,
Hermann Vargas, Claudia Arroyo

APPENDIX A -- DEFINED TERMS USED IN THIS REPORT⁶⁸

1990 Report	Report issued by the Division of Market Regulation, “Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Nonpublic Information” (March 1990) http://www.sec.gov/divisions/marketreg/brokerdealerpolicies.pdf
Asset Management	Area(s) with responsibility to manage assets and funds on behalf of individual and institutional customers, frequently on a pooled basis
Capital Markets	Area(s) that work on capital raising efforts for issuers, whether through equity, debt, securitizations, or other instruments
Confidential information	Information received under a duty of trust or confidence
Conflicts	Area(s) within a broker-dealer with responsibility to monitor for a broker-dealer’s conflicts of interests, such as those between clients of the broker-dealer and the interests of the broker-dealer in transactions on which the broker-dealer is engaged
Control Group or Control Room	Area(s) with responsibility to manage the information barriers program
Control Database	Database maintained by the Control Room that identifies the MNPI being monitored by Compliance
Credit	Area(s) with responsibility to monitor the financial standing of entities to which the broker-dealer has extended credit
Derivative Sales	Collectively, area(s) that have a corporate client base with a focus on facilitating transactions in swaps and other over-the-counter derivatives
Dodd Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
Exchange Act	Securities Exchange Act of 1934
Financial Advisory	Industry term referring to advice given to business organizations, such as corporations, usually by employees in a broker-dealer’s Investment Banking Department

⁶⁸ These definitions are used only for purposes of this report and are not intended for any other context. Some of the definitions are based on existing statutes, laws, and cases as of the date of this report. Other definitions are derived from commonly used industry terms.

Information Barriers	Controls, procedures, and processes required to be established under Exchange Act Section 15(g)
Investment Banking	Area(s) that provide financial advisory services to corporate clients relating to, among other things, M&A, restructurings, and strategic alternatives
Investment Groups	Collectively, Proprietary Groups and Asset Management
IT	Information technology, area(s) within the broker-dealer responsible for computer systems, software, and networks
ITSFEA	Insider Trading and Securities Fraud Enforcement Act of 1988
Loan Sites	Electronic systems offered by vendors used to provide information from borrowers to lenders, frequently through websites, as required under credit agreements
Loan Site Monitors	Area(s) selected to review information on Loan Sites on behalf of the broker-dealer's trading group
M&A	Mergers and acquisitions
MNPI	Material NonPublic Information
Operations	Area(s) within the broker-dealer with processing and other physical functional responsibilities (e.g., confirmations, payments, and settlements) related to broker-dealers' financial services
Origination	Creation and issuance of a financial instrument that may represent either equity or debt of an issuer
PIPE	Private investment in public equities
Printing and Production	Area(s) within the broker-dealer with responsibility to create presentation materials, photocopy materials, or provide other publishing support
Private-Side Areas	Areas with ongoing access to MNPI
Private Equity	Area(s) with responsibility to invest funds (sometimes on behalf of external clients and sometimes on behalf of the broker-dealer or its parent or affiliate) typically in private companies or in public companies that are brought private

Proprietary Groups	Principal investment or trading area(s) that trade on behalf of the broker-dealer using firm capital not for the purpose of facilitating customer order flow
Public-Side Areas	Areas generally without access to MNPI, typically with sales, trading, or investment responsibilities
Research	Area(s) within the broker-dealer that analyze companies, securities, and markets and provide related written analysis and investment recommendations to customers
Sales and Trading	Area(s) within the broker-dealer that engage in trading or sales activity with respect to equities or fixed income securities
Syndicate	Area(s) within the broker-dealer with responsibility to manage offerings of securities

APPENDIX B – SUMMARY OF EFFECTIVE PRACTICES AND POTENTIAL CONCERNS

Below is a summary of the staff’s observations of effective practices and potential concerns discussed in more detail in the report. Exchange Act Section 15(g) requires a broker-dealer to establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of a broker-dealer’s business, to prevent the misuse of material nonpublic information. As such, the list below is not intended to be prescriptive. Different practices may be necessary or appropriate depending on the facts and circumstances. The effective practices described below are not an exhaustive list, and they constitute neither a safe harbor nor a “checklist”. Other practices besides those highlighted here may be appropriate as alternatives or supplements to these practices.

EFFECTIVE PRACTICES - OBSERVATIONS AND CONSIDERATIONS. The staff observed the following practices used by broker-dealers to comply with Exchange Act Section 15(g).

Identification of Companies/Securities for which Monitoring Should Occur

- Independent control functions, such as the Control Room, did not rely solely on notice from the business unit but had other controls and information sources available to identify when the broker-dealer may come into possession of material non-public information or MNPI, including:
 - automatic notices from computer systems responsible for managing investment banking deals or for conflicts checks,
 - reviews of pipeline reports or commitment committee minutes,
 - reviews of confidentiality agreements,
 - reviews of access reports for electronic information services, and
 - blocked access to electronic information services to public-side employees until authorization is given and the item is coded for monitoring.
- The Control Room had responsibility for determining the materiality of nonpublic information, after discussions with the relevant business unit. The Control Room maintained a list of items not placed on a monitoring list based on a determination that such information was not material.
- The assessment of whether the broker-dealer had possession of MNPI was not limited to transactions on which the broker-dealer was engaged but also included instances when employees had knowledge of transactions for which another broker-dealer had been engaged. Broker-dealers also assessed when they came into possession of non-transactional MNPI, such as unannounced earnings.

Sharing of Information

- Broker-dealers had formal over-the-wall processes that were used prior to sharing MNPI with public-side employees.
 - Compliance pre-approved the sharing of information.

- Compliance logged the names of public-side employees given the information.
 - Compliance logged an entire desk as over-the-wall if a large number of employees within the desk have the information.
 - Some level of physical separation existed between groups that routinely received MNPI and other Sales and Trading employees.
 - Over-the-wall processes were used for sharing information between two private-side groups to monitor the flow of information.
- Broker-dealers had controls over other sources of potential MNPI and generally limited access based on a need to know. For example, the following information sources had restrictions on access:
 - databases containing internal credit ratings,
 - committees that approved engagements on nonpublic transactions, and
 - databases containing information received from borrowers.
- Broker-dealers had formal written processes and documentation surrounding the sharing of MNPI between two private-side groups and between private-side groups and internal public-side groups or external parties.
- Broker-dealers had physical barriers to prevent unauthorized access to MNPI.
 - Physical barriers were used to separate two functions that had different types of MNPI (e.g., Investment Banking and Research) or two public-side functions when one of the public-side functions routinely had MNPI (and related trading restrictions).
 - Access to segregated spaces was limited by key card access, and such access was periodically reviewed to remove unauthorized personnel.
 - Physical barriers took into account support functions such as Printing and Production, Operations, and Information Technology.
 - Access to confidential paper documents was limited through controlled disposal techniques.
- Broker-dealers had technology barriers to prevent unauthorized access to information.
 - Private-side employees were blocked from remotely logging-in to their computers from public-side physical space.
 - The ability to download electronic files to removable storage was blocked.
 - Controls were in place to minimize misdirected emails, such as pop-up messages for external emails and eliminating autocomplete addressing functions.
 - Access to electronic documents on network drives was limited, in some cases to the specific employees with a need to know (e.g., members of a deal team). Access rights were periodically reviewed.

Surveillance and Monitoring

- Broker-dealers had expanded the scope of their surveillance of trading as well as enhanced the process for identifying anomalous trading.
 - The type of transactions and instruments being reviewed included: credit default swaps, single stock futures, equity or total return swaps, warrants, and bond options.
 - Lookback reviews were conducted upon the announcement of information or in instances in which the broker-dealer failed to begin monitoring upon receipt of MNPI.
 - Pattern-based surveillance assessed historical patterns or accumulations of positions over time. Surveillance evaluated trading based on potential scenarios that could take advantage of the MNPI and based on trading patterns and trends.
 - Surveillance was triggered not only by transactions on which the broker-dealer was involved but also by non-transactional MNPI within the broker-dealer's possession and by transactions on which the broker-dealer did not have involvement to take into account information provided by external sources to their employees.
 - Surveillance personnel were being provided greater access to relevant information such as developments that occur within deals.
 - The documentation maintained provided descriptions of the reasons for resolving the exceptions.

- Broker-dealers reviewed emails for information barriers concerns, including targeted reviews when an "internal use only" document was sent outside the broker-dealer or for large attachments sent to generic internet email domains. Some broker-dealers conducted ad hoc email reviews when surveillance identified concerns in trading or when deals were announced.

- Controls around employee trading captured trading by contingent workers (e.g., persons performing work on behalf of and as directed by the broker-dealer but employed by third parties) and control/support functions if the worker/employee had access to MNPI.

POTENTIAL CONCERNS. The staff observed the following concerns at some broker-dealers that may raise questions about the broker-dealers' compliance with Section 15(g).

Identification of Companies/Securities for which Monitoring Should Occur

- The independent control function at some broker-dealers did not actively identify when the broker-dealer came into possession of MNPI. Instead, the group was dependent on the business unit notifying them of possession of MNPI. Procedures for the business units may be generic across the broker-dealer, so that employees within specific business functions had little guidance as to the types of information that should be reported. The independent control function did not test

whether it was being notified of information as required under the broker-dealer's procedures.

- The coding and removal of coding for monitoring within the Control Database was not timed based on the broker-dealer's possession of MNPI.
 - Placement on a monitoring list did not occur until formal mandate had been received or a materiality assessment had been conducted.
 - Some broker-dealers removed items from all monitoring lists upon public announcement or shortly thereafter. While the information regarding the existence of the transactions was public, the broker-dealer continued to work on the transactions until closing and received additional MNPI regarding the transactions.
 - Some broker-dealers removed items based on a specified period of time elapsing without any assessment as to whether the information continued to be MNPI.
 - Some broker-dealers lacked processes to identify events that could impact monitoring, such as a private company having a securities distribution or significant changes to the status of the transaction (e.g., a change in timing or a formerly inactive deal being re-activated).

- Certain practices raised concerns about the ability of the broker-dealer to monitor and evaluate whether its materiality determinations were reasonable, including a lack of documentation, a lack of factors to assess materiality, and a lack of a process to identify later receipt of MNPI (e.g., through the due diligence process or based on an altered transaction structure).

- Some broker-dealers excluded certain information types or departments categorically from monitoring without any assessment of whether specific information was material. Exclusions observed related to:
 - debt transactions for corporations rated as investment grade,
 - information within the Credit Department obtained as a result of their monitoring or contacts with insiders of corporations, and
 - information obtained by public-side employees who served as directors of public corporations.

Sharing of Information

- Broker-dealers provided MNPI to certain public-side employees and senior supervisors or external parties without any documentation or other controls. As such, the ability to identify potential misuse of such information was curtailed.
 - Some broker-dealers created categories of employees who had supervisory responsibility over trading groups and who were authorized to receive MNPI without any restrictions or monitoring. At some broker-dealers, this was referred to as "above-the-wall." In the staff's view, this practice limits the ability of the Control Group to investigate effectively suspicious

- firm or other trading and significantly impedes the broker-dealer's ability to prevent the misuse of MNPI.
- Supervisors who approved bringing employees over-the-wall were not themselves logged over-the-wall at some broker-dealers, even though they were aware of the company involved and potentially the nature of the transaction.
 - Private-side employees were permitted to have informal discussions with public-side areas of the broker-dealer, and the frequency of the discussions and the absence of documentation limited the ability to monitor for potential disclosures of MNPI.
 - Information regarding unannounced transactions was shared with external parties without any documented confidentiality agreement.
 - Controls surrounding virtual data rooms were informal, including the lack of documentation, written procedures, and absence of audit trails.
- Broker-dealers did not take into account conflicting interests between two groups of private-side personnel and so permitted information to be freely shared without any documentation or other controls.
- The Financial Sponsors Groups within Investment Banking Departments have institutional investor clients, while other Investment Banking groups have corporate clients.
 - Broker-dealers had cross-selling groups that were organizationally within the asset management function but were provided with Investment Banking information regarding unannounced transactions.
- One broker-dealer provided deal information regularly to its unregulated parent. The information included both the deals worked on and ongoing information as to deal developments. The broker-dealer did not evaluate whether the parent had any controls over use of the information.
- The physical barriers at some broker-dealers did not prevent the possible access of MNPI. Some private-side areas had glass walls or only had walls of half-height, permitting visual access to information.
- Some groups with access to MNPI were not physically segregated. The groups included sales functions with corporate clientele, origination functions for non-corporate issuers, as well as certain groups that support private-side areas, such as Information Technology and Operations.

Surveillance and Monitoring

- Surveillance and monitoring focused solely on a broker-dealer's formal processes rather than potential misuse of MNPI. For example, restricted list surveillance only assessed whether accounts were trading consistently with any applicable restrictions rather than reviewing to determine whether such trades were based on

MNPI.

- Surveillance did not have sufficient information to resolve adequately exceptions.
 - Surveillance was unaware of employees who transferred from the private-side to the public-side and continued to have knowledge of MNPI.
 - Some broker-dealers only monitored trading in entities with public securities and failed to identify when a formerly private corporation created a public securities market.
 - Compliance was unaware of all employees working on a transaction or did not obtain information regarding events that occurred prior to the first contact into the Control Room.
 - Compliance relied solely on the assertions of the person being reviewed without any independent confirmation.
 - Surveillance reports only identified large positions built on a single day and did not take into account positions that were built over several days.

- Monitoring functions excluded relevant groups.
 - Email monitoring excluded groups with access to MNPI, including Compliance and Information Technology. Other broker-dealers failed to review internal emails for information barriers purposes.
 - Employee trade surveillance excluded managed accounts without any consideration that the manager could have personal connections with an employee.
 - Some broker-dealers did not review activities of asset management affiliates, institutional customers, or customer facilitation trading groups.

- Broker-dealers did not adequately track ongoing or recurring concerns.
 - Documentation of surveillance was limited to a simple notation that the trade was reviewed. No documentation was maintained of any analysis or research conducted to resolve the item.
 - Broker-dealers did not enforce their policies and procedures when employees failed to pre-clear personal trades.