

OCIE Staff Report on Broker-Dealer Information Barrier Practices

October 9, 2012

On September 27, 2012, the SEC's Office of Compliance Inspections and Examinations (the "OCIE") issued a [Summary Report](#) (the "Report") on the results of examinations by the SEC, FINRA and the NYSE of 19 broker-dealers focusing on controls around the misuse of material nonpublic information ("MNPI") and information barrier practices under Section 15(g) of the Securities Exchange Act of 1934. In particular, the Report identifies specific gaps in oversight that it observed, as well as practices at some firms that it believed were effective.

The Report does not break new legal ground, but essentially reaffirms and updates the basic principles contained in the SEC Division of Market Regulation's influential 1990 report entitled "[Broker-Dealer Policies and Procedures Designed to Segment the Flow and Present the Misuse of Material Nonpublic Information](#)." However, the Report can serve as a practical tool for broker-dealers to use in benchmarking their own practices against the SEC staff's observations.

Areas of concern

The Report identified the following gaps and areas of concern, among others:

- **Inadequate processes for identification of MNPI and arbitrary removal from monitoring lists.** Some control rooms did not take active steps to identify when the firm came into possession of MNPI, but instead relied solely on business units to notify them of triggering events. As a result, control rooms did not receive notice or received delayed notice of such circumstances. Some firms' processes also resulted in premature removal of transactions from monitoring lists.
- **Categorical exclusions.** Some broker-dealers categorically excluded certain information types, transaction types or departments from any monitoring, without an assessment of materiality of the information. For example, controls were ineffective when MNPI came through business activities outside of the investment banking department or from activities outside the firm.
- **"Above-the-wall."** MNPI was provided to certain public-side employees, senior supervisors and external parties without proper documentation or controls, including in connection with the common practice of designating certain categories of senior executives and supervisors as "above-the-wall."
- **Inadequate monitoring and surveillance.** Monitoring functions excluded review of emails of support groups such as Compliance and IT. *De minimis* trading cut-offs for monitoring proprietary and employee accounts were set sometimes very high (\$5 million at one broker-dealer) and did not take into account positions built over several days or trading in customer accounts.
- **Ongoing or recurring concerns.** Certain broker-dealers did not adequately track ongoing or recurring concerns and lacked documentation of any analysis or research to resolve items.
- **Physical barriers.** Some groups with access to MNPI were not physically segregated at some broker-dealers and physical barriers were not effective at other broker-dealers.
- **Technological barriers.** Technology barriers were not sufficient at some firms to prevent access to MNPI through various firm systems.

- **Inadequate controls on certain information flows.** Some firms did not control MNPI sharing between certain “private side” groups, and with unregulated parent entities.

“Effective practices”

The Report identified a number of “effective practices” observed at various broker-dealers that were examined by the OCIE, which included:

- **Classification of MNPI.** The classification of MNPI included non-transactional MNPI (such as unannounced earnings). Also, transactional MNPI was not limited to transactions that the broker-dealer was engaged in, but also included knowledge relating to transactions outside the firm.
- **Non-reliance on business unit for notification.** Control rooms did not rely *solely* on business line notification for the identification of MNPI, but also had affirmative procedures for identifying MNPI including automated notices from systems responsible for managing investment banking deals and conflicts checks. Control rooms also monitored pipeline reports, commitment committee minutes, confidentiality agreements and access reports for electronic information services to identify MNPI.
- **Expansion of products and practices monitored.** Monitoring included reviews for transactions and instruments outside of investment banking such as credit default swaps, single stock futures, equity or total return swaps and loans.
- **Formal over-the-wall processes.** Prior to sharing MNPI with public-side employees, firms followed formal over-the-wall processes, which were adequately documented.
- **Surveillance and monitoring.** Control room personnel reviewed historical patterns or accumulations of positions over time based on potential scenarios that could take advantage of MNPI, and were given greater access to relevant information such as developments on deals. Surveillance and monitoring procedures gave guidance on the method of resolving issues when they arose.
- **Contingent workers and support functions.** Broker-dealers had controls in place that were applicable to contingent workers’ and control/support functions’ employee trading.

A general theme of the Report, which we have also observed in recent SEC examinations and inspections, is an increasing focus on written documentation of policies, procedures and processes. Consistent with these concerns, we have also noted in our work on SEC matters an enhanced staff focus on clear reporting and supervisory lines within broker-dealers.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Gerard Citera	212 450 4881	gerard.citera@davispolk.com
Annette L. Nazareth	202 962 7075	annette.nazareth@davispolk.com
Lanny A. Schwartz	212 450 4174	lanny.schwartz@davispolk.com
Linda Chatman Thomsen	202 962 7125	linda.thomsen@davispolk.com
Raul F. Yanes	202 962 7122	raul.yanes@davispolk.com
Sharanya Mitchell	202 450 4983	sharanya.mitchell@davispolk.com

Any U.S. federal tax advice contained in this communication (including any attachments) is not intended to be used, and cannot be used, to avoid penalties under the Internal Revenue Code or to promote, market or recommend any transaction or matter addressed herein.

© 2012 Davis Polk & Wardwell LLP | 450 Lexington Avenue | New York, NY 10017

Notice: This publication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. If you have received this email in error, please notify the sender immediately and destroy the original message, any attachments thereto and all copies. Refer to the firm's [privacy policy](#) located at davispolk.com for important information on this policy. Please consider adding Davis Polk to your Safe Senders list or adding dpwmail@davispolk.com to your address book.

Unsubscribe: If you would rather not receive these publications, please respond to this email and indicate that you would like to be removed from our distribution list.