

NYSE INFORMATION MEMO

Number 91-22

June 28, 1991

TO: MEMBERS AND MEMBER ORGANIZATIONS

SUBJECT: NASD/NYSE JOINT MEMO ON CHINESE WALL POLICIES AND PROCEDURES

The New York Stock Exchange, Inc. (NYSE), the National Association of Securities Dealers, Inc. (NASD), and a committee of the Securities Industry Association (SIA) have developed a joint memorandum that explains the "minimum elements" of adequate Chinese Wall policies and procedures pursuant to the requirements of the Insider Trading and Securities Fraud Enforcement Act of 1988. The memo, which has been reviewed by the Securities and Exchange Commission (SEC), is reprinted on the following pages.

Edward A. Kwalwasser
Executive Vice President

TO: MEMBERS AND MEMBER ORGANIZATIONS

DATE: JUNE 21, 1991

SUBJECT: CHINESE WALL POLICIES AND PROCEDURES

I. Introduction

In November 1988, Congress enacted the Insider Trading and Securities Fraud Enforcement Act of 1988 ("The 1988 Act" or "ITSFEA") which, among other things, requires all broker-dealers "to establish, maintain and enforce written procedures reasonably designed" to prevent the misuse of material, non-public information by employee and proprietary accounts. The 1988 Act also grants the Securities and Exchange Commission ("SEC" or "Commission") broad rule-making authority concerning these so-called Chinese Wall procedures. Under these circumstances, the SEC's Division of Market Regulation ("SEC Division") undertook a comprehensive review to identify, analyze and weigh the effectiveness of Chinese Wall policies and procedures of broker-dealers and, in March 1990, issued a report of its findings, conclusions and recommendations.

The SEC Division's report identified what it viewed as necessary elements of an adequate Chinese Wall:

These minimum elements include review of employee and proprietary trading, memorialization and documentation of firm procedures, substantive supervision of inter-departmental communication by the firm's compliance department, and procedures concerning proprietary trading when the firm is in possession of material, non-public information.

The SEC Division report was particularly concerned about the need for firms to "maintain documentation sufficient to re-create actions taken pursuant to Chinese Wall procedures" and the report urged self-regulatory organizations ("SROs") to develop standards of documentation for their member firms. The report also concluded that SEC rule-making was not currently necessary since required improvements to broker-dealer Chinese Walls would best be effectuated by self-regulatory examination programs, supplemented by Commission oversight. However, the report further said that the Division will continue to monitor broker-

dealer Chinese Walls closely, and will reconsider possible Commission rule-making should it determine that necessary Chinese Wall improvements are not being made.

As a result of these concerns, the New York Stock Exchange, Inc. ("NYSE"), the National Association of Securities Dealers, Inc. ("NASD"), and a committee of the Securities Industry Association ("SIA") representing various member organizations met on a number of occasions to determine the scope and definition of the "minimum elements" of adequate Chinese Wall procedures, including minimum standards of documentation of actions taken pursuant to such procedures. This memorandum sets forth those conclusions which have been reviewed by the SEC staff. [n1]

II. Memorialization of the Firm's Chinese Wall Procedures and Documentation of Actions Taken

A firm's Chinese Wall policies and procedures must be formalized, organized and incorporated within a firm's procedural/policy manuals. The SEC Division cautioned that a "loose mixture of internal memoranda, excerpts from employee manuals and certifications" is not an adequate memorialization of these important policies and procedures.

The need to maintain documentation sufficient to re-create actions taken pursuant to Chinese Wall procedures was considered vitally important by the SEC Division. What constitutes sufficient documentation for a particular action taken is discussed in detail hereafter. In general, a firm must maintain documentation of its written policies and procedures as well as its analyses and investigations of employee and proprietary trading in accordance with SEC record-keeping requirements.

III. Review of Employee and Proprietary Trading

The SEC Division concluded that firms which conduct investment banking, research or arbitrage activities must maintain some form of watch and restricted lists and conduct reviews of employee and proprietary trading in securities appearing on those lists. [n2] NYSE members are also required by NYSE Rules 342 and 351 to conduct and report upon such trading reviews. The firm's written procedures should address its method for determining whether proprietary trading should be restricted or prohibited once a department of the firm comes into possession of material, non-public information.

Generally speaking, a restricted list is a current list of securities in which proprietary, employee and certain solicited customer transactions are restricted or prohibited. [n3] A watch list is a current list of securities that generally do not carry trading restrictions, but whose trading is subject to close scrutiny by the firm's compliance and/or legal department. Although the dissemination of a watch list generally is limited, a restricted list is usually distributed periodically throughout the broker-dealer to make employees aware of those securities that the firm is restricted or prohibited from recommending and/or trading.

A firm's procedures should explain why, when and how a security should be placed on and deleted from a restricted list or watch list and which activities are prohibited or restricted when a security is on either list. The minimum documentation for the use of restricted and watch lists is as follows:

- a. Reasonable written standards or criteria for placing a security on and deleting a security from such lists must be established.
- b. Restricted list documentation must include the date and time the security was added to and deleted from the list. It should also include the name of each contact person (such as the involved investment banker or research analyst) who was responsible for the addition or deletion and can answer specific questions concerning the timing and circumstances of the addition or deletion.
- c. Watch list records must include the date the security was added to and deleted from the list. They should also include the name of each contact person (such as the

involved investment banker or research analyst) who was responsible for the addition or deletion and can answer specific questions concerning the timing and circumstances of the addition or deletion.

- d. The firm's rationale for additions to and deletions from the watch and restricted lists need not be recorded as long as the name of the contact person is recorded. This person should know the rationale if questioned by the SEC or an SRO.

The firm's procedures must adequately address how the firm monitors employee trading outside the firm for transactions in a watch list or restricted list security. **[n4]** If the firm permits an employee to maintain a securities account with another broker-dealer, it must require the employee to have duplicate confirmations and account statements sent to it as the employing member with supervisory responsibility. See NYSE Rule 407 and NASD Rules of Fair Practice (Article III, Section 28).

The firm's procedures should specify the time period covered and frequency of any review of proprietary and employee trading and the department or person responsible for the review. The procedures also should impose a requirement that the reviewer initial or sign a record or form reflecting the completion of the review.

Documentation is a required element in evidencing routine reviews of employee and proprietary trading. Each firm should also establish a manual or automated exception report, or procedure, to at least record the pertinent details of any transaction by an employee or proprietary account in a restricted list or watch list security. Additionally, firms must maintain a sample of any exception report and must be able to provide to SEC or SRO examiners data concerning proprietary or employee transactions in restricted list or watch list securities. Both lists must be maintained in accordance with SEC record-keeping requirements.

A firm must reasonably inquire into or investigate for possible misuse of material, non-public information transactions by any employee or the firm's proprietary accounts, particularly those transactions in restricted list or watch list securities. The need for or extent of such an inquiry or investigation of an employee transaction should be determined by reasonable criteria, including consideration of the timing or unusual nature of the transaction, such as whether the employee traded on a short-term basis or in a size or dollar amount larger than his normal trading pattern. However, a failure to investigate merely because the employee worked in a "non-sensitive" department may be insufficient.

Any investigations initiated must be documented. At a minimum, an investigation record should include: (1) the name of the security; (2) the date the investigation commenced; (3) an identification of the accounts involved; and (4) a summary of the investigation disposition. The underlying investigative records, including any analyses, inter-office memoranda and employee statements, should also be made available to the SEC or SRO staff upon request.

Although the maintenance of a so-called "rumor" list is not a required element for an adequate Chinese Wall, some firms have employed such lists as part of their Chinese Wall monitoring systems. The SEC Division report encourages firms to do so. Securities are generally placed by the firm on a rumor list when the issuer of the security becomes the subject of rumors of a significant impending third party deal.

Firms that do not conduct investment banking, research or arbitrage activities usually would not need to include a restricted list or watch list as part of their written procedures to prevent the misuse of material, non-public information. Nonetheless, their written procedures must include a reasonable method of periodically reviewing employee and proprietary trading for misuse of material, non-public information, given the nature and scope of the firm's business, and include reasonable provisions for investigating any suspect trades as described above. Of course, any investigation of such trading would need to be documented as described above. In addition, such a firm must have reasonable procedures for the education and training of its employees about insider trading, as discussed under Section V herein.

IV. Supervision of Inter-Departmental Communications

Adequate Chinese Walls must include policies and procedures reasonably designed to limit or contain the necessary flow of material, non-public information to employees who have a "need to know." They include: (1) policy statements in this regard; (2) the physical separation of the trading and sales departments from departments which regularly receive confidential information; (3) other restrictions to access, such as separate record-keeping and support systems for sensitive departments; and (4) supervision of inter-departmental communications involving material, non-public information.

Restrictions on inter-departmental communications of material, non-public information may be designed primarily to isolate a firm's investment banking department from other departments. Occasions arise when the investment banking department requires information from the research or sales departments. Such occasions necessitate procedures that allow an investment banking employee to obtain the needed information without disclosing the purpose of the request and tipping the research or sales department. The scope and form of an information request itself may, in certain circumstances, tip the employee. In these instances, it may be necessary to bring a research or sales employee "over the wall" before making a request. Prompt notification should be made to the Compliance and/or Legal Department of any "wall crossing."

An employee who is brought over the wall is treated as a temporary member of the investment banking department possessing material, non-public information for Chinese Wall surveillance purposes.

In instances where employees are brought over the wall, the firm must document and maintain written records of: (1) the name of the employee brought over the wall; (2) the employee's department; (3) the date; (4) the name of the issuer(s) involved; and (5) the name of the person requesting that the wall be crossed. It is not necessary for the firm to record the reasons for bringing a particular employee over the wall if it is apparent from the employee's department affiliation.

V. Education and Training of Employees

Another important element of an effective Chinese Wall system, according to the SEC Division's report, is employee understanding of federal and state laws, self-regulatory organization requirements, and the firm's own policies and procedures relating to the use of material, non-public information. First, to assure every employee's awareness of such requirements, every firm must establish a procedure whereby such requirements are provided to or made available to each employee. Second, the firm's procedures must require each employee, at least once during the course of employment (e.g., upon hiring for new employees or upon initiation of this requirement for existing employees), to sign an attestation of his or her knowledge and understanding of such requirements. Such attestation or statement of understanding must be retained in the firm's files. Firms should consider requiring employees in sensitive departments (e.g., investment banking) to sign such attestation on an annual basis. Third, the firm's procedures must include some process to update employees as to new or revised requirements, and to continue their education and compliance in this area. Policy or education memos may be used for this purpose in conjunction with the "annual compliance review" for registered employees, which is required under Article III, Section 27 of the NASD Rules of Fair Practice.

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Firms are reminded that the "minimum elements" for an adequate Chinese Wall system, as discussed in this memorandum, must be addressed in the firm's written policies and procedures designed to detect and prevent insider trading and must be reasonable for individual circumstances and conditions at each firm.

Questions concerning this memorandum may be directed to Mary Anne Furlong at (212) 656-4823 or Patricia Dorilio at (212) 656-2744 at the NYSE or William R. Schief at (202) 728-8229 at the NASD.

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- n1 Uniform Chinese Wall procedures are not required. Moreover, whether a firm's procedures to detect and prevent insider trading are adequate under the 1988 Act will depend upon the nature and scope of the firm's business and its organizational structure.
 - n2 For trade review purposes, the term "employee" includes employee-related accounts.
 - n3 For example, most firms prohibit employee trading for one to five days in securities in which the firm has issued a research report. Some firms also use the restricted list to ensure that proprietary trading does not occur in violation of SEC Rule 10b-6.
 - n4 In addition, NYSE Rules 342 and 351 and the NASD Rules of Fair Practice require member firms to monitor transactions in other securities such as those in which there is a known close relationship with the issuer's management.