Restrictions on Research and Investment Banking Personnel and Information Barrier Procedures

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Topics to be Covered

- Interaction Between Investment Banking and Research Personnel
- Information Barrier Procedures and Related Restrictions
- Insider Trading Issues
- Recent Developments

Interaction Between Investment Banking and Research Personnel

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Interaction Between Investment Banking and Research Personnel

- FINRA Rule 2241 (and corresponding NYSE Rule 472) and Global Research Settlement.
- Rule 2241 requires member firms to establish, maintain and enforce written policies and procedures reasonably designed to identify and manage conflicts of interest pertaining to research reports, public appearances and analysts' interactions with investment banking.
- 2003 Global Research Settlement
  - Principles of the Settlement, which technically apply only to the settling firms, are partly reflected in the FINRA and other SRO rules.
  - Modified in March 2010, but significant structural components of the Settlement remain in place.

Interaction Between Investment Banking and Research Personnel

- **Supervision**: Under FINRA Rule 2241, the Firm's policies and procedures must prohibit a research analyst from being supervised or controlled by personnel in the investment banking department.
  - Separate reporting lines for investment banking and research personnel.
  - No investment banking influence over compensation of research analysts.
- **Prohibition on Retaliation Against Research Analysts**: No one at the Firm may retaliate against any research analyst who publishes a negative or unfavorable research report or makes similar commentary in a public appearance.
- **Prohibition on Prepublication Review**: Investment banking personnel may not review a research report before it is published.

Interaction Between Investment Banking and Research Personnel

Research Analyst Communications With Investment Banking Clients:

- Under FINRA Rule 2241, the Firm's policies and procedures must restrict communications between research analysts and investment banking clients, including the following:
  - Participation in pitches for investment banking business or other communications for the purpose of soliciting investment banking business. (A research analyst may attend a joint meeting with investment bankers and a company that is an "emerging growth company" provided the analyst does not solicit investment banking business or otherwise violate the rule.) Participation in road shows relating to investment banking transactions; or.
  - Communications with customers in the presence of investment banking personnel or company management about an investment banking transaction.
  - Any offer of favorable research, a specific rating or a specific price target (or threat to change research, a rating or a price target) as consideration or inducement for the receipt of business or compensation.

Interaction Between Investment Banking and Research Personnel

Research Analyst Communications with Customers Regarding Investment Banking Transactions:

- The Firm's policies and procedures under Rule 2241 should prohibit investment banking personnel from using research analysts for:
  - sales or marketing efforts; or
  - communication with a current or prospective investor about an investment banking transaction.
- A research analyst may communicate with current or prospective customers or investors about an investment banking transaction *provided* that it is not in the presence of investment banking personnel or the company and is not done at the direction of investment banking. (Investment banking personnel may arrange for a research analyst to speak with a prospective investor in an emerging growth company.)

Interaction Between Investment Banking and Research Personnel

Global Research Settlement:

- The Settlement, entered into between 12 firms and regulators in 2003 and 2004 to remedy investment banking and research abuses in the wake of the internet bubble collapse, has come to form the basis of related SRO restrictions as well as industry best practices in specific areas.
- The Settlement was modified by court approval in March 2010; however, many of the substantive restrictions have been codified in SRO rules, such as Rule 2711 discussed above.

Interaction Between Investment Banking and Research Personnel

Global Research Settlement: (cont'd)

- Independent Settlement restrictions that remain include:
  - Physical separation of research and investment banking departments;
  - Prohibition on investment banking input into research coverage decisions;
  - Research input on proposed investment banking transactions to a firm's commitment committee without investment banking personnel present;
  - Requirement that communications to the sales force (or to ten or more investors) be "fair and balanced" and that the views expressed have a reasonable basis;

Interaction Between Investment Banking and Research Personnel

Global Research Settlement: (cont'd)

- Research oversight committee review of ratings, targets and quality of research; and
- Specific disclosure that conflicts of interest may exist.

- Independent Settlement restrictions that have been eliminated include:
  - Dedicated investment banking and research analyst compliance staffs;
  - Audit committee review of research budget; and
  - Analyst performance disclosure.

Interaction Between Investment Banking and Research Personnel

Global Research Settlement: (cont'd)

- The modified Settlement liberalizes research analyst participation in investment banking due diligence sessions with issuers or other third parties, but only if the joint sessions:
  - take place after the receipt by a firm of an investment banking mandate; or
  - in the case of an investment banking transaction other than an IPO, is in connection with a block bid, or with a competitive secondary or follow-on offering or similar transaction in which:
    - the issuer or selling shareholder has asked the investment banking firm to submit a transaction proposal; and
    - the firm's legal or compliance staff reasonably believes that the firm will not have a meaningful opportunity to conduct separate due diligence prior to the award of a mandate.

Interaction Between Investment Banking and Research Personnel

Global Research Settlement: (cont'd)

- Legal or compliance personnel must chaperone the joint due diligence between research and investment banking personnel.
  - This task may be undertaken by underwriters' counsel who is sufficiently knowledgeable about relevant conflict issues.

- The Settlement modifications also relaxed the conditions on research personnel's communications with a firm's sales force. (It is no longer necessary for such communications to be chaperoned or pre-reviewed by legal or compliance personnel).

Information Barrier Procedures and Related Restrictions

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Information Barrier Procedures and Related Restrictions

- The Firm should have "information barrier" (f/k/a “Chinese Wall”) procedures in place to restrict the flow of material, non-public information between investment banking and research personnel (and other areas) in accordance with Section 15(g) of the Securities Exchange Act and to implement the requirements of FINRA Rule 2241 discussed above.
- Among other things, the procedures should:
  - Protect the confidentiality of client information;
  - Limit the use of confidential information to authorized investment banking personnel and other personnel on a need to know basis; and
  - Monitor the use and control of material, non-public information, including the review of proprietary and employee trading and trading restrictions.

Information Barrier Procedures and Related Restrictions

Procedures to control the dissemination of material, non-public information:

- Use of code names for investment banking deals;
- Formation of Deal Teams and Working Group; and
- Physical and electronic guards to protect confidential documents and communications:
  - Restrict access to computer files through password protection;
  - Strictly control access to all draft and final documents, including engagement letters, confidentiality agreements, draft registration statements, etc. This means that at a minimum:
    - drafts should not be left out in the open;
    - all draft documents should be marked confidential; and
    - at the end of the day, all documents should be locked in file cabinets;
  - Refrain from discussing confidential topics in public areas; and
  - Refrain from discussing confidential information with research or institutional sales and trading personnel, unless authorized to bring such personnel "over the wall."

Information Barrier Procedures and Related Restrictions

Bringing Persons "Over the Wall":

In limited circumstances, research analysts, traders or sales traders may be brought "over the wall" to provide information or advice on specific banking transactions.

- The Deal Team should consult with persons in other departments on a need-to-know basis only.
- The Lead Banker should contact his or her department head and the Chief Compliance Officer to determine whether the person may be brought over the wall.
- A person brought over the wall should be treated as a temporary member of the Deal Team. That person should not discuss any material, non-public information with any other person, other than a member of the Deal Team, and may not act on the information except in accordance with the engagement.

Information Barrier Procedures and Related Restrictions

Use of Watch List and Restricted List to Monitor and Restrict Firm and Employee Trading:

The SEC has said that surveillance concerning Watch List and Restricted List securities is the single most effective means of monitoring the use of material, non-public information.

Watch List:

- The "Watch List" is highly confidential and is used by the Firm primarily when it has or is likely to have material, non-public information about a company as a result of an investment banking or other client relationship.
  - Confidential – available only to the Compliance Department and other selected personnel.
  - Compliance Department monitors proprietary, employee and customer trading for patterns that may suggest that sensitive information has been communicated or used improperly.

Information Barrier Procedures and Related Restrictions

Watch List: (cont'd)

- Issuers may be placed on the Watch List when, for example:
  - Discussions between investment banking personnel and the issuer have passed the proposal stage and clear business objectives have been identified;
  - Discussions with an issuer result in the Firm receiving material, non-public information;
  - The Firm and the issuer sign an engagement letter or otherwise agree that the Firm shall represent the client with regard to an investment banking or other transaction; or
  - A "target" has been identified in a client merger or acquisition.

Information Barrier Procedures and Related Restrictions

Watch List: (cont'd)

- All affected companies should be added to the Watch List. For example, if a client has confidential plans to takeover a target, the client and the target ordinarily should be added to the Watch List.
- Issuers may be removed from the Watch List (sometimes to the Restricted List) when the Firm is no longer in possession of material, non-public information. For example:
  - A registration statement or other filing is made with the SEC in connection with a public offering or other transaction handled by the Firm; or
  - A public announcement has been made regarding the Firm's involvement in a transaction.

Information Barrier Procedures and Related Restrictions

Restricted List:

- An issuer is added to the "Restricted List" when a sensitive transaction is about to go public or when the Firm agrees to participate in a distribution of securities announced to the public. When an issuer is placed on the Restricted List, the Firm may limit proprietary and employee trading in the securities of that issuer to comply with applicable rules or to avoid the appearance of impropriety.
  - Widely distributed to all employees.
  - Typical restrictions include proprietary trading (other than customer facilitation or passive market making); transactions in employee accounts; or soliciting orders.

Information Barrier Procedures and Related Restrictions

Restricted List: (cont'd)

- Issuers may be placed on the Restricted List when, for example:
  - A public announcement is about to be made regarding a transaction in which the Firm is acting as placement agent, underwriter or selling group member;
  - A public announcement is about to be made regarding a merger, acquisition, reorganization, tender offer or other corporate transaction in which the Firm is involved;
  - When trading or other market conditions indicate that confidential information about an issuer may have been disclosed but no public announcement has been made by the company; or
  - Any time it is necessary to restrict trading in securities of an issuer when it is impossible or impractical to limit access to material, non-public information.

Insider Trading Issues

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Insider Trading Issues

Federal Anti-Fraud Provisions:

- Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 prohibit fraudulent, deceptive or manipulative acts, practices or courses of dealing by any person in connection with the purchase or sale of securities.
- These provisions have been interpreted to prohibit:
  - Trading by an insider while in possession of material, non-public information; and
  - Trading by a non-insider while in possession of material, non-public information where the non-insider knows or is reckless in not knowing that the information was disclosed in violation of an insider's duty to keep it confidential or was misappropriated by the non-insider.

Insider Trading Issues

Traditional Theory of Insider Trading:

- Insiders: A corporate "insider" trades on material, non-public information, typically obtained in the course of his or her employment with the company.
  - Insiders owe a duty of trust and confidence to the company and its shareholders.
  - They may not use material, non-public information acquired during the course of their employment for their own personal benefit.
  - Insiders must either *disclose* the material, non-public information or *abstain* from using it in transactions with company shareholders or prospective shareholders.

Insider Trading Issues

Traditional Theory of Insider Trading: (cont'd)

- Insiders generally include an issuer's directors, officers, employees or controlling shareholders.
  - Insiders also can include attorneys, consultants, investment bankers and other professionals who receive confidential information from a company in the course of providing services.
- Non-Insiders: Prohibited insider trading also extends to a non-insider — the "tippee" — who trades on material, non-public information about a company that he or she received from a corporate insider — the "tipper" — knowing that the disclosure is in violation of the tipper's fiduciary duty to the company.

Insider Trading Issues

- "Non-Public" Information: Information is "non-public" until it has been effectively communicated to the marketplace. One must be able to point to some fact to show that the information is generally public. For example:
  - Information in a report filed with the Securities and Exchange Commission or contained in a public court filing;
  - Information appearing in publications of general circulation (*e.g.*, *The Wall Street Journal, The New York Times*, etc.) or in a press release distributed through a widely disseminated news or wire service;
  - Any other non-exclusionary method of disclosure reasonably designed to provide broad public access would be considered public and normally constitutes adequate disclosure.

Insider Trading Issues

- Internet chat rooms and blogs: Transmitting or receiving information via Internet chat rooms or blogs ordinarily does not qualify that information as “public” information. Such information should be treated with caution.

Materiality:

- Information is “material” if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision.

Insider Trading Issues

Misappropriation Theory:

- Under the "misappropriation theory," any person who uses material, non-public information in breach of a duty of trust and confidence owed to the source of the information to trade in the security can be liable for insider trading.
  - Such persons may include, for example, an employee of an investment bank, law firm or service provider of an issuer, who obtains material, non-public information about the company in the course of his or her employment and has a duty to the employer to keep the information confidential.
- A company's non-public information may qualify as property to which the company has a right of exclusive use. The unauthorized disclosure or use of the information in violation of a fiduciary duty may constitute fraud similar to embezzlement.

Insider Trading Issues

Misappropriation Theory: (cont'd)

- A company's non-public information may qualify as property to which the company has a right of exclusive use. The unauthorized disclosure or use of the information in violation of a fiduciary duty may constitute fraud similar to embezzlement.

Insider Trading Issues

Penalties for Insider Trading:

- Penalties for insider trading are severe, both for individuals involved and their employers. They can include:
  - Civil injunctions;
  - Treble damages;
  - Disgorgement of profits;
  - Jail sentences;
  - Fine for the person who committed the violation of up to three times the profit gained or loss avoided; and
  - Fine for the employer or other controlling person of up to the greater of $1,000,000 or three times the amount of the profit gained or loss avoided.

Recent Developments

Recent Developments

Issues in Recent Insider Trading Cases and Probes by the U.S. Justice Department and the SEC:

Issuers

- Potential tipper liability: Did insiders or other employees of companies disclose information to individuals outside the company? Did they have a duty to keep the information confidential? Did they act intentionally or recklessly in breach of that duty? Did they benefit personally in some way from passing along the information?

Recent Developments

Issues in Recent Insider Trading Cases and Probes by the U.S. Justice Department and the SEC: (cont'd)

Hedge Funds and Mutual Funds

- Potential Tippee Liability: Did employees at hedge funds receive material, non-public information? Did they know or were they reckless in not knowing that the person conveying the information was doing so in violation of a duty of confidence? Was the information material?

Recent Developments

Issues in Recent Insider Trading Cases and Probes by the U.S. Justice Department and the SEC: (cont'd)

"Expert Network Firms" Analysts and consultants who work for these firms provide information to institutional investors and funds and may be the source of information for "channel checks," or independent expertise.

- Potential liability: Are the analysts/consultants insiders with a duty of confidence to their employers? Is the information material or insignificant by itself until included within mosaic of other information? Is any breach of confidence in connection with the purchase or sale of a security?

Recent Developments

Hypothetical:

- A fashion industry consultant learns through a channel check, from the manager of a factory that handles overflow denim manufacturing as an independent contractor for a major publicly traded apparel company, that the factory has had a number of large order cancellations. The consultant, who works for an expert network firm, passes the information to a hedge fund manager.
- The fund manager also learned from conversations with low level employees at twelve of the manufacturers' stores in his city that customer traffic is down.

Recent Developments

Hypothetical: (cont'd)

- The fund manager also observed extended deep discounts on jeans at those twelve stores and has learned from widely reported statistics that consumer discretionary spending is down. He knows based on his own research from publicly available information that jeans comprise 70% of the company's sales.
- He concludes that sales of the issuer's jeans are likely trending down and therefore sells his fund's position short ahead of the company's quarterly release. He is correct, and the company's sales are down, sending the stock price down following the release and netting the fund a healthy profit when the manager covers the short position.

Recent Developments

Hypothetical: (cont'd)

- Was the information about the factory order cancellations material? Non- public? What about the information from the low-level store employees?
- Did the factory manager have a duty to maintain the confidentiality of the information about the cancellations? Should the consultant have asked if the manager was permitted to disclose the information? Was any breach of confidence in connection with a securities transaction?
- Should the fund manager have inquired about the source of the information about the factory cancellations? About the confidentiality (or not) of the information?
- Should the factory manager be liable for insider trading? The consultant? The low-level store employees? The fund manager?

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