



This is an excerpt of Chapter 49: **Investment Banking Compliance** of *Broker-Dealer Regulation (Second Edition)* (#32789), by Clifford E. Kirsch. Reprinted with permission for King & Spalding LLP.

No part of this may be used or reproduced by any means, graphic, electronic, or mechanical, including photocopying, recording, taping, or by any information storage retrieval system without the written permission of the publisher (except in the case of brief quotations). No part of this may be shared with or used by any third party, including any generative AI system such as ChatGPT, or any person who is not an Authorized User. Questions can be directed to [plipress@pli.edu](mailto:plipress@pli.edu).

# Chapter 49

---

## Investment Banking Compliance

---

**Russell D. Sacks\***

*Partner, King & Spalding LLP*

**Steven R. Blau**

*Counsel, King & Spalding LLP*

*[Chapter 49 is current as of August 7, 2025.]*

**§ 49:1 Information Control**

**§ 49:1.1 Insider Trading**

**[A] Generally**

**[B] Legal Framework**

**[B][1] Securities Exchange Act § 10(b)**

**[B][2] Insider Trading and Securities Fraud Enforcement Act**

**§ 49:1.2 Information Barriers**

**[A] Generally**

**[B] Effective Information Barriers: Minimum Elements**

**[B][1] Written Policies and Procedures**

**[B][2] Wall-Crossing Procedures**

**[B][3] Restricted List and Watch List**

---

\* The authors gratefully acknowledge the contributions to this chapter by Sumon Dantiki, Achim Döser, Shaswat Das, Timothy Fesenmyer, Sean Kelly, Kevin Manz, Andrew Michaelson, and Jarno Vanto, and to earlier versions of this chapter by Robert Evans III and Richard B. Alsop.

- [B][4] Surveillance of Trading Activity
- [B][5] Physical and Electronic Separation
- [B][6] Training and Education Programs
- [B][7] Employee Attestation
- § 49:1.3 Sales Practices; Testing-the-Waters and Gun-Jumping
- § 49:1.4 2012 OCIE Report on the Use of Material Nonpublic Information by Broker-Dealers
  - [A] Sources of MNPI
  - [B] Control Structure
    - [B][1] Issues Identified
    - [B][2] Control Room
    - [B][3] “Above the Wall” Designations
    - [B][4] Materiality Determinations
    - [B][5] Oversight of Non-Transactional Sources of MNPI
    - [B][6] Compliance with Oral Confidentiality Agreements
    - [B][7] Personal Trading Problems
  - [C] Access Controls
    - [C][1] Limiting Authorized Access
    - [C][2] Preventing Unauthorized Access
    - [C][3] Other Control Issues
    - [C][4] Surveillance
  - [D] Controls Perceived to Be Effective
    - [D][1] Control Room Monitoring
    - [D][2] Information Barriers
    - [D][3] Surveillance
  - [E] Conclusion
- § 49:1.5 Selective Disclosure by Issuers: Regulation FD
- § 49:1.6 Other Potential Sources of Material Nonpublic and Confidential Information
  - [A] Expert Networks
  - [B] Hedge Fund Interaction—Market-Sounding
  - [C] Hedge Fund Access to Corporate Executives
  - [D] Research Content As MNPI
  - [E] Use of Confidentiality Agreements
- § 49:1.7 Personal Trading Procedures
- § 49:2 Conflicts and Related Disclosures
  - § 49:2.1 Dealing with M&A Transaction Conflicts
    - [A] Generally
      - [A][1] Conflict Identification
      - [A][2] Engagement Letters
      - [A][3] Disclosure and Consent
      - [A][4] Co-Advisors and Co-Financers
      - [A][5] Standards for Frequent Areas of Conflict
    - [B] Stapled Financing
    - [C] Delaware Chancery Court Cases
    - [D] Best Practices in Dealing with M&A Transaction Conflicts

- § 49:2.2 Fairness Opinions
- § 49:2.3 FINRA Guidelines on Conflicts in Product Development and Distribution
  - [A] Enterprise-Level Frameworks to Identify and Manage Conflicts of Interest
  - [B] Conflicts of Interest in the Manufacture and Distribution of New Financial Products
  - [C] Compensation of Associated Persons
  - [D] Conclusion
- § 49:3 Offering Issues
  - § 49:3.1 Rule 506(b)
  - § 49:3.2 Rule 506(c)
  - § 49:3.3 Bad Actor Rule 506(d)
  - § 49:3.4 Regulation M
  - § 49:3.5 Section 10b-5 Due Diligence Defense
    - [A] Background
    - [B] When a “Reasonable Investigation” Is Required
    - [C] The Legal Standard for “Reasonable Investigation”
- § 49:4 Volcker Rule
  - § 49:4.1 Prohibition on Proprietary Trading
  - § 49:4.2 Underwriting Exemption Permitting Principal Trading
  - § 49:4.3 Prohibition on Sponsoring and Investing in Private Funds
  - § 49:4.4 Compliance
- § 49:5 Relationship of Investment Banking to Research
- § 49:6 Compensation Structures
  - § 49:6.1 FINRA Corporate Financing Rules
    - [A] General Overview and Policy Background
    - [B] Operation of the Corporate Financing Rules
    - [C] Underwriting Compensation That Is Per Se Unreasonable
    - [D] Defining “Compensation”
    - [E] Examples of Underwriting Compensation
    - [F] Conflicts of Interest
      - [F][1] Definition of “Affiliate”
      - [F][2] Compliance in the Event of a Conflict of Interest
      - [F][3] Filing Requirements Under Rules 5110 and 5121
  - § 49:6.2 Federal Reserve/SEC Guidance Regarding Individual Compensation
- § 49:7 Gifts and Entertainment
  - § 49:7.1 Gifts Over \$100 Are Not Permitted
    - [A] Scope and Exclusions of Rule 3220
    - [B] Supervision and Recordkeeping
  - § 49:7.2 Entertainment Must Be Reasonable and Customary
    - [A] Generally
    - [B] Supervision and Recordkeeping
  - § 49:7.3 FINRA Has Proposed Revisions to Its Gifts Rule

- § 49:8    **Licensing, Registration, and Exemptions from Registration**
  - § 49:8.1    **U.S. Licensing: Series 7, 24, 79, and the Securities Industry Essentials Examinations**
    - [A]    **Generally**
    - [B]    **Series 7**
    - [C]    **Series 24**
    - [D]    **Series 79**
    - [E]    **Securities Industry Essentials Examination**
    - [F]    **Series 63**
    - [G]    **Grandfathering of Existing Registrations Under FINRA's Consolidated Registration Rules**
  - Chart 49-1    **Principal- and Representative-Level Examination and Registration**
    - [H]    **Principal Financial Officer and Principal Operations Officer Requirements Under FINRA's Consolidated Registration Rules**
    - [I]    **Accepting Orders from Customers Under FINRA's Consolidated Registration Rules**
  - § 49:8.2    **Activities of Non-U.S. Broker-Dealers**
  - § 49:8.3    **Exemption from Broker-Dealer Registration for Private M&A Brokers**
    - [A]    **Summary of Exchange Act Section 15(b)(13)**
- § 49:9    **Anti-Money Laundering (AML)**
  - § 49:9.1    **AML Program**
  - § 49:9.2    **OFAC Compliance**
  - § 49:9.3    **KYC Compliance and the CIP Rule**
  - § 49:9.4    **Customer Due Diligence Requirements for Financial Institutions (the "CDD Rule")**
    - [A]    **The CDD Rule**
    - [B]    **FINRA Rule 3310**
    - [C]    **Corporate Transparency Act and Anti-Money Laundering Act of 2020**
  - § 49:9.5    **Marijuana-Related Business**
- § 49:10    **IPO Allocation and Client Sophistication**
  - § 49:10.1    **IPO Allocation**
    - [A]    **Overview**
    - [B]    **FINRA Rule 5130—the "New Issue" Rule**
    - [C]    **Practical Compliance Steps**
    - [D]    **Frequency of Representation**
    - [E]    **FINRA Rule 5131(b): The Prohibition on Spinning**
      - [E][1]    **Generally**
      - [E][2]    **25% De Minimis Test for Collective Investment Accounts**
    - [F]    **2013 Amendment to Rule 5131**
      - [F][1]    **Other IPO Allocation Regulations Set Forth in Rule 5131**
        - [F][1][a]    **Quid Pro Quo Allocations**
        - [F][1][b]    **Policies Concerning Flipping**

	[F][1][c]	New Issue Pricing and Trading Practices
	[F][1][c][i]	Reports of Indications of Interest and Final Allocations
	[F][1][c][ii]	Restriction on Transfer of the Issuer's Shares by Officers and Directors of the Issuer
	[F][1][c][iii]	Agreement Among Underwriters
	[F][1][c][iv]	Market Orders
	[G]	2020 Amendments to Rule 5130 and Rule 5131
	[G][1]	Rule 5130
	[G][1][a]	Amendments to the General Exemptions Under Rule 5130(c)
	[G][1][a][i]	Employee Retirement Benefits Plans
	[G][1][a][ii]	Foreign Public Investment Companies
	[G][1][b]	Amendments to Certain Defined Terms
	[G][1][b][i]	Exclusions from the Definition of "New Issue"
	[G][1][b][ii]	Family Offices
	[G][1][b][iii]	Sovereign Entities As Owners of Broker-Dealers
	[G][1][c]	Issuer-Directed Securities
	[G][2]	Rule 5131
	[G][2][a]	Definition of "Covered Non-Public Company"
	[G][2][b]	Anti-Dilution
	[G][2][c]	Lock-Up Agreements
§ 49:10.2		QIB Certification
	[A]	Introduction
	[B]	Qualification As a QIB
	[C]	How a Broker-Dealer Qualifies As a QIB
	[D]	Reasonable Belief
§ 49:10.3		FINRA Regulation of Suitability
	[A]	Introduction
	[B]	Components of Suitability Obligations
	[B][1]	The Reasonable-Basis Obligation
	[B][2]	The Customer-Specific Obligation
	[B][3]	Quantitative Suitability
	[C]	Customers and Potential Investors
	[D]	Institutional Suitability
	[E]	Suitability Requirements for Institutional Accounts
	[F]	Compliance with the Exception
	[G]	SEC Rule: Regulation Best Interest
§ 49:11		Books and Records
§ 49:11.1		SEC Recordkeeping Requirements
	[A]	Introduction
	[B]	Retention of E-mail and Text Messages
	[C]	Rule 17a-3 Recordkeeping Requirements
	[D]	Communications with the Public
	[E]	Communication Restrictions Set by the Securities and Exchange Commission

- § 49:11.2 **Electronic Communications**
  - [A] **Introduction**
  - [B] **Key Elements of an Electronic Mail Compliance System**
- § 49:11.3 **Social Networking and Social Media**
  - [A] **Static Content Regulation**
  - [B] **Interactive Content Regulation**
  - [C] **Personal Devices in Business Communications**
    - [C][1] **Compliance on a Personal Device**
    - [D] **Third-Party Posts**
      - [D][1] **Overview**
      - [D][2] **Exceptions**
      - [D][3] **Compliance Strategies**
    - [E] **Third-Party Links**
    - [F] **Data Feeds**
    - [G] **Recordkeeping**
    - [H] **Retention**
    - [I] **Supervision**
      - [I][1] **General Elements of Social Media Supervision**
- § 49:12 **Cybersecurity**
  - § 49:12.1 **SEC and FINRA Cybersecurity Guidance**
    - [A] **SEC Guidance**
    - [B] **Regulation S-P**
    - [C] **Amendments to Regulation S-P**
      - [C][1] **Incident Response Program**
      - [C][2] **Notification Obligation**
      - [C][3] **Recordkeeping Obligation**
    - [D] **FINRA Rules**
    - [E] **OCIE and FINRA Reports**
  - § 49:12.2 **Frameworks**
- § 49:13 **“Big Data” and Artificial Intelligence**
  - § 49:13.1 **Participating in the Big Data Market**
    - [A] **U.S. Securities Laws—Registration Considerations**
    - [B] **Other Select Sources of U.S. Regulatory Liability**
    - [C] **EU General Data Protection Regulation**
    - [D] **Business Considerations**
  - § 49:13.2 **Artificial Intelligence**

## § 49:1 **Information Control**

### § 49:1.1 ***Insider Trading***

#### [A] **Generally**

Insider trading and control of confidential and nonpublic information has traditionally been the most important compliance issue for persons involved in investment banking. Insider trading is the

trading of a company's securities by persons in possession of material nonpublic information about the company. Insider trading can take place legally, such as when corporate insiders buy and sell securities in their own companies in compliance with the regulations governing such trading and their own internal company guidelines, and illegally, such as when corporate insiders with material nonpublic information use that information improperly for personal gain to make profits or avoid losses.<sup>1</sup>

"Material information" has been defined by the U.S. Supreme Court as information where: (i) there is a "substantial likelihood" that a "reasonable investor" would consider the information important in making an investment decision; (ii) the disclosure of the information would be "viewed by the reasonable investor as having significantly altered the 'total mix' of information made available";<sup>2</sup> or (iii) the disclosure of the information is "reasonably certain to have a substantial effect on the market price of the security."<sup>3</sup>

The U.S. Securities and Exchange Commission (SEC) has described "nonpublic information" as information that has not been disseminated or made available to investors generally.<sup>4</sup>

Sources of inside information include corporate officers or employees, corporate clients, corporate borrowers, non-corporate entities, such as government agencies, principal investments, corporate insiders, institutional investors, and research.<sup>5</sup>

## **[B] Legal Framework**

### **[B][1] Securities Exchange Act § 10(b)**

Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 promulgated thereunder prohibit fraud in connection with the purchase or sale of securities. Courts have interpreted section 10(b) and Rule 10b-5 to prohibit the purchase or sale

1. Selective Disclosure and Insider Trading, Exchange Act Release No. 43,154, 2000 WL 1201556, at \*24, n.125 (Aug. 15, 2000) [hereinafter Selective Disclosure and Insider Trading Release].
2. *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988), quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 448–49 (1976).
3. *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 166 (2d Cir. 1980), quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).
4. Selective Disclosure and Insider Trading Release, *supra* note 1.
5. SEC OFF. OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, STAFF SUMMARY REPORT ON EXAMINATIONS OF INFORMATION BARRIERS: BROKER-DEALER PRACTICES UNDER SECTION 15(G) OF THE SECURITIES EXCHANGE ACT (Sept. 27, 2012) [hereinafter STAFF SUMMARY REPORT ON EXAMINATIONS OF INFORMATION BARRIERS].



of securities on the basis of material nonpublic information in breach of a duty preventing the use of such information for personal gain.<sup>6</sup>

Rule 10b5-1, promulgated in 2000, provides affirmative defenses to violations of Rule 10b-5, including a provision that a broker-dealer or other entity may “demonstrate that a purchase or sale of securities is not ‘on the basis of’ material nonpublic information” if the person making the investment decision was not aware of the information, and the broker-dealer or other entity had implemented reasonable policies and procedures to ensure that investment decisions would not be based on such information.<sup>7</sup> In the release accompanying the rule, the SEC noted that a broker-dealer could reduce the risk of trading desk awareness of material nonpublic information by “segregat[ing] its personnel and otherwise us[ing] information barriers so that the

- 
6. In addition to liability arising from the classic case of insider trading, where a corporate insider trades in securities on the basis of material nonpublic information, liability under Rule 10b-5 can arise when information has been misappropriated. Misappropriation occurs when an outsider trades in violation of a duty of confidentiality and loyalty owed to someone else. *See* *United States v. O’Hagan*, 521 U.S. 642 (1997); *Chiarella v. United States*, 445 U.S. 222 (1980). Rule 10b5-2 “provides a non-exclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the ‘misappropriation’ theory of insider trading.” 17 C.F.R. § 240.10b5-2 (2000). In *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), the Second Circuit declined to accept the theory that a defendant who receives information indirectly—a so-called “remote tippee”—need not know that the insider had disclosed material nonpublic information in exchange for a personal benefit (while the government petitioned for *certiorari* with respect to certain aspects of this decision, it did not do so on the question of whether a remote tippee has to know about the benefit conferred on the insider; the Supreme Court rejected the petition in any event). Because industry participants frequently receive information indirectly, the *Newman* decision has caused some institutions to consider whether their policies should define insider trading more narrowly such that trading is prohibited only when the recipient of information knows that it was disclosed in breach of duty *and* in exchange for a benefit. In fact, however, the *Newman* decision’s application in the context of investment banking compliance has thus far been limited because investment banking compliance has traditionally ignored the question of whether the insider received a benefit. More recently, the Second Circuit affirmed that *Newman*’s “meaningfully close personal relationship” test is still valid for determining whether an insider tipper received a personal benefit (and thus breached a fiduciary duty), but also held that the test will be satisfied upon a showing that (1) the “tipper and tippee shared a relationship suggesting a quid pro quo” or (2) “the tipper gifted confidential information with the intention to benefit the tippee.” *United States v. Martoma*, 894 F.3d 64 (2d Cir. 2018).
  7. 17 C.F.R. § 240.10b5-1(c)(2) (2000).

trader for the firm's proprietary account is not made aware of the material nonpublic information."<sup>8</sup>

### **[B][2] Insider Trading and Securities Fraud Enforcement Act**

In the 1984 Insider Trading Sanctions Act (ITSA), Congress gave the SEC more power to combat insider trading.<sup>9</sup> In 1988, amid several insider trading scandals, Congress passed the Insider Trading and Securities Fraud Enforcement Act (ITSFEA).<sup>10</sup> Congress intended the act to "augment enforcement of the securities laws, particularly in the area of insider trading, through a variety of measures designed to provide greater deterrence, detection and punishment of violations . . . ."<sup>11</sup>

ITSFEA created section 15(f) of the Exchange Act, renumbered as section 15(g) by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"),<sup>12</sup> which, for the first time, created an affirmative duty for broker-dealers to "establish, maintain and enforce written policies and procedures reasonably designed . . . to prevent the misuse . . . of material nonpublic information."<sup>13</sup>

Section 15(g) requires broker-dealers not only to implement information barriers to prevent the misuse of material nonpublic information, but also to regularly review and to vigorously enforce the barriers. ITSFEA expanded the enforcement power of the SEC by allowing it to seek sanctions against firms that fail to have adequate policies and procedures in place, even if no actual trading violations occur.<sup>14</sup> ITSFEA does not expressly outline the types of procedures necessary to avoid liability; however, the ITSFEA House Report cited some examples, including:

- 
8. Selective Disclosure and Insider Trading Release, *supra* note 1, at \*24, n.125.
  9. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, § 2, 98 Stat. 1264 (1984).
  10. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988).
  11. H.R. REP. NO. 100-910, at 7 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6044 [hereinafter ITSFEA House Report].
  12. Pub. L. No. 111-203, 124 Stat. 1376 (2010).
  13. Securities Exchange Act of 1934, 15 U.S.C. § 78o(f) (section 15(g)).
  14. For an example of a case in which the SEC brought charges under section 15(g) without identifying trading violations, see Litigation Release No. 20,551 (May 1, 2008) (announcing the filing and settlement of a civil complaint against Chanin Capital LLC for failure to establish, maintain, and enforce adequate procedures under section 15(g)).

- restraining access to files likely to contain material nonpublic information;
- providing continuing education programs concerning insider trading regulations;
- restricting or monitoring trading in securities about which firm employees possess material nonpublic information; and
- diligently monitoring trading for firm or individual accounts.<sup>15</sup>

Following the passage of ITSFEA, the SEC Division of Market Regulation (the “Division”) published a report in March 1990 of its review and analysis of broker-dealers’ information barrier policies and procedures.<sup>16</sup> Although ITSFEA explicitly granted the SEC broad powers to mandate specific policies to be adopted by broker-dealers, the SEC provided some general observations regarding the elements of an adequate information barrier and concluded that the self-regulatory organizations (SROs)<sup>17</sup> were best equipped to test the adequacy of current broker-dealer policies and procedures and to formulate any required improvements or modifications.<sup>18</sup> Throughout its report, the Division emphasized the need to tailor a firm’s policies and procedures to the nature of its businesses and the importance of a firm’s compliance department to the proper functioning of the firm’s information barriers. In June 1991, the NASD and the NYSE issued a Joint Memo on Chinese Wall Policies and Procedures, discussing the minimum elements necessary to create and maintain an adequate information barrier.<sup>19</sup>

---

15. ITSFEA House Report, *supra* note 11, at 22 (reprinted in 1988 U.S.C.C.A.N. 6043, 6059).

16. See Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Non-Public Information, Fed. Sec. L. Rep. ¶ 84,520 (Mar. 1, 1990) [hereinafter 1990 SEC Market Reg. Report].

17. FINRA was formed in 2007 upon the merger of the NASD and certain divisions of the NYSE. The FINRA rulebook currently consists of both NASD rules and certain NYSE rules that FINRA has incorporated. For purposes of this outline, these rules will be referred to as NASD and NYSE rules, respectively, or where applicable FINRA rules. FINRA also has incorporated certain interpretive guidance issued by the NASD and the NYSE related to NASD rules and the incorporated NYSE rules. See Order Approving Proposed Rule Change to Amend the By-Laws of NASD to Implement Governance and Related Changes to Accommodate the Consolidation of the Member Firm Regulatory Functions of NASD and NYSE Regulation, Inc., SEC Release No. 34-56145 (July 26, 2007), <https://www.sec.gov/rules/sro/nasd/2007/34-56145.pdf>.

18. See 1990 SEC Market Reg. Report, *supra* note 16.

19. NASD/NYSE Joint Memo on Chinese Wall Policies and Procedures, NASD Notice to Members 91-45 (June 21, 1991), NYSE Information Memo 91-22 (June 28, 1991) (“NASD/NYSE Joint Memo”).

**§ 49:1.2 Information Barriers****[A] Generally**

Multi-service firms establish information barriers<sup>20</sup> to restrict the flow of material nonpublic information between employees who regularly receive or develop that type of information, such as investment bankers, and employees who buy, sell, or recommend the securities to which the information relates.<sup>21</sup> Information barrier policies and procedures initially adopted by firms generally focused primarily on the control of material nonpublic information obtained by investment bankers in connection with corporate transaction and advisory assignments. However, there are other potential sources of material nonpublic information that require careful handling.<sup>22</sup> While the nature of investment banking activities has led regulators and investment banks themselves to focus on material nonpublic information, it is worth mentioning that regulators' and investment banks' focuses have increasingly evolved to consider protection and control of all confidential information, even if the same does not constitute material nonpublic information about a public company. This is because, increasingly, poor control of confidential information, broadly defined, is perceived to lead to violations of other regulations (for example, privacy), or to poor customer experience for investment banking customers.

- 
20. The legislative history of ITSA reveals strong support for the idea that effective information barriers can provide a defense to alleged insider trading violations. The then-Chairman of the SEC stated in a letter to Congress that "[I]t is . . . important to recognize that, under both existing law and the bill, a multiservice firm with an effective Chinese wall [or information barrier] would not be liable for trades effected on one side of the wall, notwithstanding inside information possessed by firm employees on the other side." Letter from John S. R. Shad to Rep. Timothy E. Wirth (June 29, 1983), *reprinted in* H.R. REP. NO. 98-355, at 28 n.52 (1983) (the "1984 Act Report"), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2301 n.52.
21. There is a distinction to be noted between public-side versus private-side business groups. Public-side groups do not have access to material nonpublic information on a routine basis. On the other hand, private-side groups are areas that have routine or ongoing access to material nonpublic information and, typically, it is assumed that people in these groups do have material nonpublic information. Groups such as: Investment Banking, Credit, Capital Markets, Syndicate, and support and control groups of these areas are considered to be private-side. *See* STAFF SUMMARY REPORT ON EXAMINATIONS OF INFORMATION BARRIERS, *supra* note 5, at pt. IV.
22. For example, research departments' knowledge of to-be-published research reports is considered to be material nonpublic information.

**[B] Effective Information Barriers: Minimum Elements**

Firms have flexibility to tailor information barriers, but the SEC and SROs have set certain minimum elements of an effective information barrier program.

**[B][1] Written Policies and Procedures**

Information barrier policies and procedures must be incorporated in a firm's procedure and policy manuals and must restrict material nonpublic information to employees who have a "need to know" such information. These procedures include: policy statements, restrictions on access to records and support systems for sensitive departments, and supervision of all interdepartmental communications ("wall-crossing") involving material nonpublic information. There is leeway to compartmentalize organizations within the firm (such as between the investment banking business and the sales/trading/research businesses), but it is still important to incorporate a "need to know" policy within organizations. Information can be subject to non-disclosure requirements even if it is confidential, but not material. As a result, some firms have imposed the "need to know" policy more broadly to apply to all types of confidential information.

**[B][2] Wall-Crossing Procedures**

Firms must have "wall-crossing" procedures designed to facilitate situations that require an employee to cross an information barrier. Wall-crossings must be controlled and monitored, preferably by the compliance departments, must be specifically documented in writing and records must be retained.

**[B][3] Restricted List and Watch List**

The restricted list is a list of issuers whose securities or other financial instruments are subject to restrictions on sales, trading, or research activity. An issuer or security may be placed on the restricted list in order to reinforce a firm's information barrier, to comply with trading practices and other rules, to avoid the potential appearance of impropriety, or to meet other compliance or regulatory objectives. When an issuer appears on the restricted list, certain sales, trading, and research activities involving that issuer's securities or other financial instruments may be restricted. Restricted activities may include: proprietary trading, including market-making; solicitation of client orders; the recommendation of the issuer's securities; and transactions for any employee or related account with respect to the related securities or financial instruments. The restricted list

is usually maintained by a firm's compliance department, or by an institutional control room.

The watch list (sometimes called the "grey list") is a confidential list of issuers or securities about which a firm may have received or may expect to receive material nonpublic information, or about which the firm expects a reason to monitor activities. The placement of an issuer or security on the watch list generally will not affect sales and trading activities, except by personnel who have access to material nonpublic information that may be the reason for the addition to the watch list. Trading in and research regarding watch-list securities or issuers are subject to surveillance by the firm's compliance department. The contents of the watch list and any related restrictions that may be imposed by the legal or compliance department are extremely confidential, and access to the watch list is very limited.

Firms that conduct both investment banking and research or arbitrage activities must maintain some combination of restricted and watch lists, and should conduct regular reviews of trading in securities appearing on the lists.<sup>23</sup> The SROs set forth specific minimum documentation standards concerning such lists, including records of the firm's methods for conducting reviews of employee and proprietary trading, the firm's procedures for determining whether trading restrictions will be implemented and the firm's explanations of why, when, and how a security is placed on or deleted from a restricted or watch list.<sup>24</sup> Further, the firm must adequately document how it monitors employee trading outside the firm of securities on the restricted or watch lists.

#### **[B][4] Surveillance of Trading Activity**

Firms must take reasonable steps to investigate any possible misuse of material nonpublic information, including any transactions in restricted or watch-list securities. Each investigation initiated must be documented and should include the name of the security, the date the investigation began, an identification of the accounts involved, and a summary of the disposition of the investigation.

- 
23. Even firms that do not conduct investment banking, research, or arbitrage activities must have documented procedures to review employee and proprietary trading for misuse of material nonpublic information. *See* 1990 SEC Market Reg. Report, *supra* note 16, at pt. III.
  24. The NASD/NYSE Joint Memo further mandates documentation for the use of restricted lists and watch lists. First, the firm must develop reasonable written standards or criteria for placing a security on and deleting a security from such lists. Second, documentation must include the date and, for restricted lists, the time the security was added to or deleted from the list.



**[B][5] Physical and Electronic Separation**

Information barriers must include arrangements for reasonable physical separation of public-side businesses (for example, sales and trading) from private-side businesses (for example, investment banking) that regularly receive confidential information. Information barriers must also consider secure separation of databases and systems used by private-side businesses.

**[B][6] Training and Education Programs**

Firms must establish and maintain reasonable training and education programs to ensure sufficient employee understanding of federal and state securities laws, SRO requirements, and the firm's policies and procedures to prevent the misuse of material nonpublic information.

**[B][7] Employee Attestation**

Firms must require each employee to sign an attestation, to be maintained in the firm's files, of his or her knowledge of insider trading rules and regulations at least once during the course of employment. The SROs encourage firms to require employees in sensitive departments, such as investment banking, to sign an attestation on an annual basis.<sup>25</sup> In our experience, such attestations are commonplace.

**§ 49:1.3 Sales Practices; Testing-the-Waters and Gun-Jumping**

The SEC imposes restrictions on the ability of securities offering participants to communicate publicly<sup>26</sup> about a securities offering when such an offering is contemplated or occurring. The restrictions generally apply to all forms of communications, including press releases, interviews, and social media. Violations, or "gun-jumping," can result in delays of offerings, fines, or sanctions by the SEC. The SEC's authority to restrict communications in this manner derives from section 5 of the Securities Act of 1933 (the "Securities Act").<sup>27</sup> The statute divides an SEC-registered offering into three periods: the pre-filing period, the waiting period, and the post-effective period. Different types of communications are allowed during each period.

The Jumpstart Our Business Startups Act (the "JOBS Act") significantly eased the restrictions on offering communications by

---

25. 1990 SEC Market Reg. Report, *supra* note 16, at pt. V.

26. For registered offerings, the SEC also imposes restrictions on private communications, for example, "testing the waters" communications are limited to QIBs and IAs.

27. Securities Act § 5.