

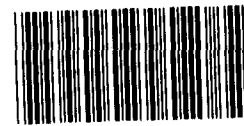
GAO

Report to the Chairman, Subcommittee
on Commerce, Consumer, and Monetary
Affairs, Committee on Government
Operations, House of Representatives

August 1991

SECURITIES MARKETS

Clearly Defined “Chinese Wall” Standards Have Been Issued



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General Government Division

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August 21, 1991

The Honorable Doug Barnard
Chairman, Subcommittee on Commerce,
Consumer, and Monetary Affairs
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

In response to your request and subsequent discussions with your staff, we reviewed Securities and Exchange Commission (SEC) oversight of broker-dealer Chinese Walls—that is, policies and procedures for deterring and detecting the abuse of material, nonpublic information (MNPI) through insider trading.¹ We found that clearly defined standards have been developed, which consider the nature of a broker-dealer's business, for (1) broker-dealers to use in establishing Chinese Walls and (2) SEC and the self-regulatory organizations (SRO) to use in assessing compliance with the law requiring them.² This report highlights the efforts that have culminated in the development of what we consider satisfactory Chinese Wall standards.

Background

Multiservice broker-dealers initially established Chinese Walls as a legal defense for the firm against civil liability when employees abused MNPI through insider trading. Congress passed the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA) to further strengthen protection against insider trading. ITSFEA amended the Securities Exchange Act by requiring every registered broker-dealer to establish in writing and to maintain and enforce Chinese Walls that consider the nature of a broker-dealer's business.

The act authorized SEC to adopt rules or regulations that require broker-dealers to have specific policies or procedures if it determined that such action was necessary.

¹ Insider trading is the purchase or sale of securities while possessing MNPI and is prohibited under various provisions of the securities laws, including sections 10(b) and 14(e) of the Securities Exchange Act.

² The Securities Exchange Act of 1934 created a system in which SEC and the SROs work cooperatively to ensure compliance with federal securities laws and regulations and SRO rules. Under this system, the SROs oversee their members and SEC, in turn, oversees the SROs.

Objective, Scope, and Methodology

To assess SEC's oversight of broker-dealer Chinese Walls, we

- reviewed ITSFEA provisions, SEC reports and memorandums, SRO memorandums, the National Association of Securities Dealers' (NASD) pilot study, congressional hearings, and professional literature related to Chinese Walls;
- interviewed officials representing SEC, the New York Stock Exchange (NYSE), NASD, the Chicago Board Options Exchange, and the Securities Industry Association³ to discuss establishing, maintaining, and enforcing Chinese Walls; and
- visited a judgmental sample of 18 broker-dealers of various sizes in 6 states and Washington, D.C., to document the types of Chinese Wall guidance that SEC and other industry sources provided and the policies and procedures the broker-dealers established.

We did our work from February 1990 to July 1991 in accordance with generally accepted government auditing standards.

The Response to ITSFEA's Chinese Wall Requirements Is Satisfactory

Until June 28, 1991, clearly defined Chinese Wall standards for use in determining compliance with ITSFEA did not exist. The SROs initially provided only general guidance to their broker-dealer members to use in determining compliance with ITSFEA. For example, NYSE notified its members that the law did not set forth specific policies and procedures that must be adopted and instructed them to seek advice from their legal counsel on the appropriate action to take to meet ITSFEA requirements.

In response to ITSFEA, SEC began a review of broker-dealer Chinese Walls in January 1989 that resulted in a March 1990 report identifying minimum requirements for Chinese Walls.⁴ However, the minimum requirements that SEC identified did not fully consider the nature of the broker-dealer's business and were not sufficiently specific for broker-dealers to use in establishing Chinese Walls or for SEC and the SROs to use in assessing compliance with the act. For example, although SEC concluded that adequate Chinese Walls should address substantial control of relevant interdepartmental communication, it did not specify what substantial control would entail.

³The Securities Industry Association is a national trade group that represents 592 of the Nation's approximately 6,000 broker-dealers that offer securities to the public.

⁴Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Nonpublic Information, SEC, Division of Market Regulation (Mar. 1990).

SEC also concluded in its March 1990 report that SROs would be in the best position to develop Chinese Wall standards because they provide the first line of broker-dealer oversight. Therefore, in a March 15, 1990, letter, SEC asked NYSE and NASD to develop standards for formalizing and documenting broker-dealer Chinese Walls, but no time frame was set for issuing such standards.

In response to SEC's request, NYSE and NASD, working with the Securities Industry Association, began developing Chinese Wall standards. SEC and industry officials initially told us that broker-dealer operations were too diverse for standards to be developed that (1) considered the nature of the broker-dealer's business and (2) prescribed specific policies and procedures. In our opinion, however, the standards need to consider the nature of the broker-dealer's business so that those whose business provides less of an opportunity to abuse MNPI are not unduly burdened by having to establish unnecessary policies and procedures. The standards also need to be specific enough for broker-dealers to use in establishing Chinese Walls and for SEC and the SROs to use in assessing compliance with ITSFEA. Because of our concern about the potential vagueness of the standards, we had a continuing dialogue with SEC and the SROs on the need for more clearly defined standards.

On June 6, 1991, SEC officials told us that the SROs had developed Chinese Wall standards and that SEC had approved them. The standards were issued on June 28, 1991. In our view, the standards consider the nature of the broker-dealer's business and are sufficiently detailed for broker-dealers to use in establishing Chinese Walls and for SEC and the SROs to use in assessing compliance with ITSFEA. Further, the standards address each of the minimum requirements that SEC identified in its March 1990 report. For example, to address the need for substantial control of relevant interdepartmental communication at a multiservice broker-dealer, the standards require Chinese Walls designed to limit or contain the flow of MNPI by (1) physical separation of the trading and sales departments from departments that regularly receive confidential information, (2) separate record-keeping and support systems for sensitive departments, and (3) supervision of interdepartmental communications involving MNPI.

The standards apply to NYSE and NASD members, which includes all registered broker-dealers doing securities business with the public. According to an SEC official, such broker-dealers account for 99 percent of all securities business revenues. SEC officials told us that the remaining broker-dealers are generally small, specialized firms that do not deal directly

with the public and therefore do not need extensive Chinese Walls. They also said that these firms are solely members of other securities exchanges that oversee broker-dealer compliance with exchange rules designed to prevent abuse of MNPI. Additionally, the other exchanges are individually developing standard procedures or forms to help their broker-dealer members comply with ITSFEA Chinese Wall requirements. Further, all exchanges will require their members to review employee securities trading for MNPI abuses.

Conclusion

The Subcommittee's request and our work have had a significant impact on SEC and the SROs issuing, at this time, satisfactory Chinese Wall standards that should better ensure broker-dealer compliance with ITSFEA. SEC and the SROs still need to ensure, however, that the standards are properly implemented.


Agency Comments

We did not obtain official agency comments because, during the course of our work, SEC and the SROs responded to our concern that clearly defined Chinese Wall standards be developed.

As arranged with the Subcommittee, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will provide copies of this report to SEC, NYSE, NASD, the Chicago Board Options Exchange, and the Securities Industry Association as well as other interested parties.

Major contributors to this report are listed in the appendix. Please contact me at (202) 275-8678 if you or your staff have any questions concerning this report.

Sincerely yours,



Craig A. Simmons
Director, Financial Institutions
and Markets Issues

Major Contributors to This Report

**General Government
Division, Washington,
D.C.**

Cecile O. Trop, Assistant Director, Financial Institutions and Markets
Issues
Charles M. Johnson, Evaluator
Steven G. Lozano, Evaluator

**Chicago Regional
Office**

Patrick C. Dolan, Evaluator-In-Charge
David J. Diersen, Site Senior
Richard S. Tshara, Evaluator

**New York Regional
Office**

Vincent R. Morello, Site Senior
Jay S. Henry, Evaluator

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