

Joint Market Practices Forum

Statement of Principles and Recommendations Regarding the Handling of

Material Nonpublic Information by Credit Market Participants



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THE LIAISON ENTREPRISES AND TRADING ASSOCIATION

**THE
BOND
MARKET
ASSOCIATION**

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Statement of Principles and Recommendations Regarding the Handling of Material Nonpublic Information by Credit Market Participants

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Statement of Principles and Recommendations Regarding the Handling of Material Nonpublic Information by Credit Market Participants

Preliminary Comments

Overview of Joint Market Practices Forum. The Joint Market Practices Forum (the “Joint Forum”) is a collaborative effort of The Bond Market Association,¹ the International Association of Credit Portfolio Managers,² the International Swaps and Derivatives Association,³ and the Loan Syndications and Trading Association (the “Associations”).⁴ The Joint Forum has been formed to address issues of common concern to member firms of the Associations who transact in the credit derivatives and corporate debt securities markets.

The first initiative of the Joint Forum is to articulate certain principles and recommendations regarding the handling and use of material nonpublic information by credit market participants that maintain loan portfolios (or engage in other activities that generate credit exposures) and, in that connection, enter into transactions in securities and security-based swaps (including certain credit derivatives).

In recent years, firms that originate or acquire loans or otherwise have credit exposures to particular companies have turned increasingly to the securities and credit derivatives markets to help manage risk. This development has generated efficiencies for both lenders and borrowers and has created new investment opportunities for other parties seeking to take credit risk positions. At the same time, the fact that credit market participants — in the ordinary course of their business and as a natural consequence of their lending or other relationships with a company — may receive material nonpublic information with respect to the company has raised concerns regarding the potential use of such information in the securities and credit derivatives markets.

Acknowledgments and Process

The Statement of Principles was developed and refined by members of the Joint Forum over the course of multiple meetings and discussions that occurred between November 2002 and August 2003. Participants in these meetings and discussions included senior business and legal professionals from a broad range of the Associations’ member firms, including credit portfolio risk management personnel. As an integral part of the drafting and development process, members of the Joint Forum met with representatives of federal and state bank and securities regulatory agencies in the spring of 2003, and sought comments on an exposure draft of the document that was issued to the public in May 2003. As a consequence of these efforts, the Joint Forum gained valuable input and perspective on the issues that are addressed in this final Statement of Principles, which has been approved and endorsed by the Boards of Directors of each of the participating Associations.

In addition to the time, effort and professional expertise supplied by the members and staffs of the Associations who were directly involved in this project, the Joint Forum wishes to acknowledge the invaluable contributions made by Cleary, Gottlieb, Steen & Hamilton, and Milbank, Tweed, Hadley & McCoy, special outside counsel for this project.

¹ The Bond Market Association represents securities firms and banks that underwrite, distribute and trade in fixed income securities, both domestically and internationally. Additional information about the Association is available from its website, located at <http://www.bondmarkets.com>.

² The International Association of Credit Portfolio Managers, Inc. (“IACPM”) is a not-for-profit corporation created in November 2001. The mission of the IACPM is: (1) to further the understanding and management of credit exposures by providing a forum for member institutions to exchange ideas on topics of practical interest; (2) to cooperate with other organizations on issues of mutual concern in order to promote common interests; (3) to inform members of legislative and administrative developments affecting participants in credit portfolio management and to represent its members before legislative and administrative bodies and international and quasi-public institutions, boards, and other bodies; and (4) to foster research on credit portfolio management. There are currently twenty-nine member institutions in the IACPM. These institutions are based in eight countries and include the world’s largest wholesale commercial banks and investment banks. Information about the IACPM can be found at <http://www.iacpm.org>.

³ The International Swaps and Derivatives Association is the global trade association representing leading participants in the privately negotiated derivatives industry, a business which includes interest rate, currency, commodity, credit and equity swaps, as well as related products such as caps, collars, floors and swaptions. ISDA was chartered in 1985, and today numbers over 600 member institutions from 46 countries on six continents. These members include most of the world’s major institutions who deal in and leading end-users of privately negotiated derivatives, as well as associated service providers and consultants. For more information please visit www.isda.org.

⁴ The Loan Syndications and Trading Association was founded in 1995 and is the trade association for the corporate loan market, dedicated to advancing the interests of the marketplace as a whole and promoting the highest degree of confidence for investors in corporate loans. The LSTA undertakes a wide variety of activities to foster the development of policies and market practices designed to promote just and equitable marketplace principles and to encourage cooperation and coordination with firms facilitating transactions in loans and related claims. For more information, please visit www.lsta.org.

Objectives of this Statement of Principles. The anti-fraud and related provisions of the U.S. federal securities laws generally restrict the use of material nonpublic information when entering into transactions in securities or security-based swaps. Moreover, economic and reputational damage can result from the mere appearance of inappropriate or unethical conduct by market participants. Rumors of such misconduct have the potential to erode confidence in the integrity — and thus the liquidity and efficiency — of the securities and credit derivatives markets on which the Associations’ members rely in conducting their business.

In light of these considerations, this Statement of Principles has a number of important objectives, including to:

- identify important business and legal issues that can arise in connection with the handling and use of material nonpublic information in the context of credit market participants’ credit portfolio management activities;
- articulate recommendations designed to (i) assist credit market participants in evaluating (and, if necessary, supplementing) their policies and procedures for handling material nonpublic information in the context of their credit portfolio management activities and (ii) facilitate continued compliance with applicable laws and sound business practices;
- illustrate through examples certain procedures which credit market participants might consider implementing to handle material nonpublic information in specific circumstances;
- reassure market participants that the innovative risk management techniques and instruments that have emerged within the securities and credit derivatives markets are used responsibly and will continue to contribute to the stability and efficiency of the financial markets; and
- promote fair and competitive markets in which inappropriate use of material nonpublic information is not tolerated, and in which lenders may engage in effective credit portfolio management activities that facilitate borrower access to more liquid and efficient sources of credit.

Many credit market participants have in place sophisticated and extensive policies and procedures for handling material nonpublic information generally and in connection with their credit portfolio management activities in particular. The principles articulated below, however, will be useful to credit market participants as they review and implement their policies and procedures on an on-going basis and, to the extent they have not already done so, identify and address issues that may arise in connection with their credit portfolio management activities.

Definitions. For purposes of this Statement of Principles, the following terms have the following meanings:

- “*Credit market participants*” are institutions that (i) maintain loan portfolios (through origination, acquisition or both) or engage in other activities that generate credit exposures, (ii) may receive material nonpublic information in connection with these credit exposures or other activities, and (iii) engage in credit portfolio management activities.

- “*Credit portfolio management activities*” are the credit risk and other portfolio management activities undertaken by credit market participants to address the credit, liquidity and related risks associated with their loan portfolios or other credit exposures. These activities may be designed to achieve a reduction in credit exposure to a particular counterparty or, under appropriate circumstances, an increase in credit exposure to that counterparty.
- “*Security-based swaps*” means “security-based swap agreements” as defined in Section 3A(b) of the Securities Exchange Act of 1934 (the “Exchange Act”) — i.e., swaps that are not “securities” under U.S. federal securities laws but are subject to the anti-fraud provisions of such laws.
- “*Security-based transactions*” means purchases or sales of securities or security-based swaps that are effected in furtherance of a firm’s credit portfolio management activities. The term “security-based transactions” does not include transactions in instruments that are not securities or security-based swaps, including in general loan originations, acquisitions and dispositions (although such transactions may also be effected in furtherance of a firm’s credit portfolio management activities).⁵

Scope of this Statement of Principles. This Statement of Principles is limited in its scope and addresses only the security-based transactions of credit market participants. It is not intended to address other securities trading activities of credit market participants unrelated to their credit portfolio management activities. In preparing this Statement, moreover, the Joint Forum has focused on those activities that are governed by U.S. securities laws and regulations. Accordingly, this Statement does not address non-U.S. activities conducted in accordance with rules applicable in other jurisdictions or transactions involving instruments or obligations that are not subject to U.S. securities laws (such as loan sales).

The Joint Forum believes that the fundamental objectives underlying this initiative, including the promotion of fair and efficient markets, are of potentially broader application than the intended scope of this Statement of Principles. Credit market participants are therefore encouraged to consider the extent to which the principles and recommendations discussed herein may be relevant to securities activities beyond the scope of this Statement.

* * *

Statement of Principles and Recommendations

I. U.S. Securities Laws and Regulations Impose Prohibitions on “Insider Trading” With Which All Credit Market Participants Must Comply

A substantial and long-standing body of U.S. laws and regulations imposes significant prohibitions on “insider trading” — i.e., certain types of securities trading on the basis of material nonpublic information.⁶

⁵ Because this Statement of Principles focuses on credit portfolio management activities, the definition of “security-based transaction” is limited to transactions in securities or security-based swaps that are effected as part of such activities. As noted herein, however, the Joint Forum recognizes that the restrictions on insider trading discussed in this Statement are potentially applicable to other purchases or sales of securities or security-based swaps.

⁶ The Joint Forum notes that the applicable laws of non-U.S. jurisdictions may impose similar or analogous prohibitions on trading on the basis of material nonpublic information that are beyond the scope of this Statement of Principles.

The Joint Forum recognizes that these laws and regulations form the foundation for any recommendations regarding the handling of material nonpublic information by credit market participants. This section provides an overview of the principal U.S. insider trading laws potentially applicable to the credit portfolio management activities of credit market participants.

This area of law is complex, is shaped in large measure by judicial interpretations of various statutory and regulatory prohibitions, and is in certain respects unsettled and evolving. Accordingly, credit market participants should consult with their own legal counsel regarding the application of the securities laws to specific security-based transactions. The following summary is very general in nature and should not be relied upon by any party in lieu of or as constituting legal advice.⁷

A. Rule 10b-5. The centerpiece of U.S. insider trading law is Rule 10b-5 under the Exchange Act. Rule 10b-5 has been interpreted to prohibit the purchase or sale of a security on the basis of material nonpublic information about that security or its issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively to the issuer of that security, its shareholders, or any other person who is the source of the information.⁸

1. Definition of Material Nonpublic Information. In order for the restrictions of Rule 10b-5 to apply, information must be “material” and “nonpublic.”

- “*Material.*” Information has been defined as “material” for purposes of U.S. securities laws in circumstances 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;”⁹ or (iii) the disclosure of the information is “reasonably certain to have a substantial effect on the market price of the security.”¹⁰

A determination of materiality is a fact specific inquiry, requiring careful assessments of the inferences a reasonable person would draw from a given set of facts and the significance of those inferences.¹¹ The same information may be “material” in the context of one transaction but not “material” in the context of another.

- “*Nonpublic.*” The SEC has stated that information is nonpublic if it has not been disseminated in a manner making it available to investors generally, that insiders must wait a “reasonable” time after disclosure before trading, and that what constitutes a reasonable time depends on the circumstances of the dissemination.¹²

⁷ Consistent with the bulk of the existing regulatory guidance and precedent, this Part I discusses the Rule 10b-5 insider trading restrictions in the context of transactions in “securities.” As noted in Part I.A.3, however, more recent legislation has extended these restrictions to security-based swaps.

⁸ Rule 10b5-1(a).

⁹ *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988), quoting *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 448-49 (1976).

¹⁰ *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 166 (2d Cir. 1980).

¹¹ *Basic Inc.*, 485 U.S. at 236.

¹² Selective Disclosure and Insider Trading, 65 Fed. Reg. 51716, 51721, Release Nos. 33-7881, 34-43154, IC-24599 (August 24, 2000) (adopting release for Regulation FD and Rules 10b5-1 and 10b5-2).

2. Obligation to Disclose or Abstain. Rule 10b-5 essentially prohibits certain persons who are aware of material nonpublic information relating to a company or its securities from trading in the securities without appropriate disclosures. If such persons are not able to make the required disclosures or are unwilling to do so (e.g., due to a confidentiality agreement with the company), they must abstain from trading — an obligation that in certain contexts has been described as the duty to “disclose or abstain.” These Rule 10b-5 restrictions have been applied to several categories of persons whose use of material nonpublic information would breach a duty of trust or confidence.

- *Insiders.* Traditional insiders include directors, officers and controlling shareholders of a corporation. These persons owe common law duties to the corporation and its shareholders, including duties not to use corporate information for personal gain. Rule 10b-5 has been interpreted to prohibit these insiders from trading in the corporation’s equity securities on the basis of material nonpublic information, absent appropriate disclosure. Other persons who render professional services to a corporation, such as underwriters, lawyers, accountants or other consultants, may become “temporary insiders” subject to similar trading restrictions.
- *Other Persons Acting in Breach of a Duty.* A person may also be deemed to violate Rule 10b-5 by misappropriating material nonpublic information for securities trading purposes in breach of a duty owed to the source of the information, even if that source is unaffiliated with the buyer, seller or issuer of the securities, without appropriate disclosure. Under Rule 10b5-2, a person may have a duty of trust or confidence, for example, if the person has agreed to keep information confidential (such as in a confidentiality agreement), or if the person’s overall relationship with the source of the information, taking into consideration their history, pattern or practice of sharing confidences, gives rise to an expectation of confidentiality. Accordingly, if a lender receives material nonpublic information from a borrower to whom the lender has a duty of the type described in Rule 10b5-2, the lender would be subject to the strictures of Rule 10b-5 with respect to such information.
- *Tippers.* Tippers who for their own direct or indirect personal benefit pass material nonpublic information to other persons who trade on the basis of that information may be subject to Rule 10b-5 if trading by the recipient was reasonably foreseeable, even if the tipper does not trade on the basis of the information.
- *Tippees.* Similarly, a “tippee” in possession of material nonpublic information that the tippee knows or should know was provided to it by the tipper in violation of a duty owed to a third party may be subject to Rule 10b-5.

The use of certain types of information relevant to conducting credit portfolio management activities may not be subject to the restrictions of Rule 10b-5 because the credit market participant does not owe a duty of trust or confidence with respect to the information — e.g., information that is generated by the credit market participant from publicly available sources, or information that is not obtained from other parties (such as the credit market participant’s own positions or

transactions). In addition, credit market participants may wish to consider ways to clarify their contractual or other relationships with counterparties who may be sources of information to avoid the inadvertent creation of a duty of trust or confidence with respect to the information.

3. Application to Swap Transactions. The status of certain swaps under U.S. federal securities laws was subject to uncertainty prior to enactment of the Commodity Futures Modernization Act of 2000 (the “CFMA”). In Title III of the CFMA, the exclusion of a broad range of swaps from regulation as “securities” was adopted in conjunction with new provisions - supported by many members of the Associations — applying insider trading and other anti-fraud provisions of the U.S. federal securities laws to security-based swaps. As a result, credit market participants effecting transactions in credit default swaps that qualify as security-based swaps would be subject to the restrictions of Rule 10b-5.

- *Credit Default Swaps.* The CFMA contains provisions defining the terms “swap agreement” and “security-based swap agreement.” Although each transaction must be analyzed individually in light of these definitions, as a general matter, credit default swaps may qualify as security-based swaps where, for example, reference obligation(s) or deliverable obligation(s) under the swaps are securities (as would be the case for many credit default swaps typically traded in the market).
- *Purchase or Sale.* The CFMA also clarified that a “purchase” or “sale” will be deemed to have occurred with respect to a security-based swap (and thus the restrictions of Rule 10b-5 will apply) upon any execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing of rights or obligations under, the security-based swap.

4. Implications of SEC Guidance Regarding Exercise of Options. The SEC staff has indicated that for purposes of Rule 10b-5 the exercise of an option may be a “separate investment decision” from the purchase of the option.¹³ Under this view, the person exercising the option would need to consider whether it has material nonpublic information at the time of such exercise, even if it did not have material nonpublic information when the option was purchased.

This interpretation could be construed to suggest, by analogy, that certain subsequent determinations made by a credit market participant with respect to a credit default swap (for example, the discretionary exercise of settlement rights upon the occurrence of a credit event) should be treated, for purposes of the firm’s procedures, in the same manner as the initial execution of the transaction. Accordingly, under this reasoning, the firm’s procedures should permit it to conclude that such subsequent determinations are not made on the basis of material nonpublic information. On the other hand, there are strong arguments that this outcome does not further the policy objectives of Rule 10b-5, particularly since the counterparty (the seller of credit protection) is not in a position to exercise any investment discretion with respect to the swap, the obligations under which it must perform regardless of any information provided to it.¹⁴

¹³ See SEC Division of Corporation Finance: Manual of Publicly Available Telephone Interpretations (Fourth Supplement), Rule 10b5-1, Question 5, available at: <http://www.sec.gov/interps/telephone/phonesupplement4.htm>.

¹⁴ This Statement of Principles does not take a position on the SEC guidance described above or whether the extension of that guidance to credit default swaps would be consistent with applicable law.

B. Other Potential Restrictions on the Use of Information. Credit market participants should consider other restrictions potentially applicable to their use of material nonpublic information, including those referenced below.

- *Other Restrictions under U.S. Federal Securities Laws.* Other provisions of the U.S. federal securities laws impose restrictions on the use of material nonpublic information, including Section 17 of the Securities Act of 1933, Exchange Act Section 20A and Exchange Act Rule 14e-3.
- *State Securities Laws.* Some state securities laws contain broad anti-fraud provisions that have been applied to insider trading.
- *Banking Laws.* Federal and state bank regulators may impose restrictions on the use of material nonpublic information. For example, the Board of Governors of the Federal Reserve System has prohibited trading in securities on the basis of material nonpublic information as an unsafe and unsound banking practice.¹⁵ Similarly, the Comptroller of the Currency has required national banks to ensure that fiduciary officers and employees do not use material nonpublic information in connection with any purchase or sale of a security.¹⁶
- *Other State Laws or Contractual Obligations.* Depending on the circumstances, a credit market participant's ability to use information may be subject to other restrictions, such as state fiduciary, fraud or other common law principles. In addition, confidentiality or similar restrictions agreed to with the source of the information may limit its use by the credit market participant. These state law and contractual restrictions may apply even if the information does not constitute material nonpublic information for insider trading purposes.

II. Information Controls and Related Policies and Procedures for Handling Material Nonpublic Information May Prevent Credit Market Participants from Entering into any Security-Based Transactions on the Basis of such Information

A. Need for Information Controls. The normal business activities of credit market participants may trigger the insider trading restrictions described above in certain circumstances. As commercial lenders, credit market participants may receive material nonpublic information from borrowers, both in connection with the origination or acquisition of loans and at subsequent stages, pursuant to standard reporting covenants in their loan agreements or in accordance with normal due diligence and related lending practices. If any such material nonpublic information is communicated under circumstances creating a "duty of trust or confidence" within the meaning of Rule 10b5-2, credit market participants would be prohibited from engaging in security-based transactions on the basis of such information, absent appropriate disclosures.

B. Objectives of Information Controls. The Joint Forum recommends that credit market participants have in place information controls and related policies and procedures appropriate to their own business activities and organizational structures to control, limit and monitor the inappropriate dissemination and use of material

¹⁵ Policy Statement Concerning Use of Inside Information, 43 Fed. Reg. 12,755 (Mar. 17, 1978).

¹⁶ 12 C.F.R. § 9.5(b).

nonpublic information. Such information controls may include (i) establishing a “wall” to prevent access to material nonpublic information by persons having responsibility for the execution of, or the decision to execute, security-based transactions, (ii) “need-to-know” policies to limit the dissemination of information within the firm, (iii) restricted lists, watch lists and trading reviews (discussed further in Part IV.F below) to help restrict, monitor or control transactions when the firm possesses material nonpublic information, and/or (iv) combinations of the foregoing. The primary objectives of such policies and procedures should be to:

- prevent the dissemination of material nonpublic information and the execution of security-based transactions on the basis of any such information in violation of applicable law; and
- avoid violations of any non-disclosure duties that the firm may owe to clients from whom the material nonpublic information was obtained.

C. Regulatory Recognition of Information Controls. The Joint Forum notes that information controls and related policies and procedures have been recognized by securities and banking regulators as appropriate mechanisms for handling the receipt of material nonpublic information in accordance with applicable legal restrictions. Indeed, certain firms are required by regulation to maintain policies and procedures for handling material nonpublic information.

- U.S. registered broker-dealers, for example, must establish, maintain and enforce written policies and procedures reasonably designed, taking into consideration the nature of their business, to prevent the misuse of material nonpublic information.¹⁷ The SEC, the NYSE and the NASD have articulated certain minimum standards for broker-dealer policies and procedures designed to segment the flow and prevent the misuse of material nonpublic information.¹⁸
- Similarly, the Federal Reserve Board has required state member banks exercising investment discretion for the accounts of others to adopt written policies and procedures, suitable to their particular circumstances, to ensure that such information in their possession is not misused.¹⁹ The Comptroller of the Currency also has required national banks exercising fiduciary powers to adopt and follow written policies and procedures adequate to maintain their fiduciary activities in compliance with applicable law.²⁰

In addition, the SEC has provided safe harbor protections for persons who establish appropriate information controls. In particular, Rule 10b5-1 provides that a firm may demonstrate that a purchase or sale of securities was not made “on the basis of” material nonpublic information, even if the firm is in possession of material nonpublic information, if the firm can show that:

- the individual making the investment decision on behalf of the firm to purchase or sell the securities was not aware of the material nonpublic information; and

¹⁷ Exchange Act Section 15(f). A similar provision appears in Section 204A of the Investment Advisers Act of 1940.

¹⁸ SEC Division of Market Regulation, Broker Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Non-Public Information (Mar. 1990); NASD and NYSE, Joint Memorandum on Chinese Wall Policies and Procedures (June 21, 1991).

¹⁹ Policy Statement Concerning Use of Inside Information, 43 Fed. Reg. 12,755 (Mar. 27, 1978); see also Trading and Capital-Markets Activities Manual, available at <http://www.federalreserve.gov/boarddocs/supmanual/trading/trading.pdf>, Sec. 2150.1.

²⁰ 12 C.F.R. § 9.5(b).

- the firm had implemented reasonable policies and procedures, taking into consideration the nature of its business, to ensure that individuals making investment decisions would not violate laws prohibiting trading on the basis of material nonpublic information.

The Rule provides that appropriate policies and procedures may include those that restrict any purchase or sale of a security as to which the firm has material nonpublic information, or those that prevent individuals making investment decisions from becoming aware of material nonpublic information.²¹

III. A Firm's Information Controls and Related Policies and Procedures Should be Tailored to the Nature and Scope of its Business Activities and Operations

Each firm's policies and procedures for handling material nonpublic information should be tailored to the unique structure and circumstances of its credit portfolio management activities. Given the significant differences among firms in terms of, for example, the types and scope of their business activities and the location of and relationship between such activities, it is neither possible nor desirable to develop standardized procedures for all credit market participants.

Applicable regulatory guidance uniformly advises that information controls and related policies and procedures be tailored to the special circumstances of each firm. Securities regulators consistently have declined to recommend specific internal procedures to be adopted by market participants. Instead, while identifying general topics or issues that each firm should address, regulatory authorities have articulated the need for the firm to develop and implement specific policies and procedures that take into account the firm's particular business activities and circumstances.

IV. Credit Market Participants Should Consider Including Certain Key Elements in Their Information Controls and Related Policies and Procedures

In designing or reviewing their information controls, credit market participants should consider including the elements described below, which incorporate certain regulatory guidance regarding effective information controls as well as the views of the Joint Forum as to recommended market practices.

A. Written and Formalized Policies and Procedures. Documentation and formalization of the policies and procedures that comprise a firm's information controls significantly enhance the efficacy of training in, compliance with, and enforcement of the policies and procedures. Written and formalized procedures may also be an important aid in demonstrating (to regulators and others) that the credit market participant has not executed security-based transactions on the basis of material nonpublic information.

B. Independent Compliance Function. An independent internal compliance function can assist in the implementation, enforcement and monitoring of a firm's information controls. Key responsibilities of the compliance function might include, among other elements:

²¹ Rule 14e-3 provides a similar safe harbor from that Rule's prohibition on trading while in possession of material nonpublic information in the context of tender offers.

- providing training regarding, and interpretations of, the firm’s policies and procedures;
- reviewing, monitoring or otherwise controlling interdepartmental communications (whether on an ad hoc basis or otherwise) and any personnel transfers over any information “walls”;
- maintaining “restricted lists” and “watch lists” and monitoring and reviewing security-based transactions involving securities or issuers on such lists (discussed in Part IV.F below); and
- creating or maintaining records relating to the firm’s activities and compliance with its policies and procedures.

C. Functional and Physical Separation of Departments. If a firm elects to establish an information wall between departments that may have access to material nonpublic information and those that do not, functional and physical separation of these departments can assist in defining and maintaining this wall. Functional separation might include, for example, separate employees, lines of authority, databases, record-keeping, and support groups. Physical separation may include limiting or restricting access to files, offices, computers and data.

D. Procedures for Communications Across Information Walls. Procedures for monitoring and handling communications across any information walls can assist in maintaining the integrity of those walls. These might include, for example, procedures for:

- permitting departments in possession of material nonpublic information to obtain information from or provide permitted information to other departments without conveying material nonpublic information;
- handling circumstances in which individuals are brought “over the wall” to departments that have a need for their knowledge or expertise;
- identifying information categories that do not need to be vetted with the compliance department prior to disclosure;
- determining that certain information is not material nonpublic information and can be communicated from one side of the information wall to the other; and
- reviewing, monitoring or otherwise controlling permitted disclosures of information that is not material nonpublic information in contacts between departments or persons on opposite sides of an information wall.

E. Recordkeeping. Recordkeeping requirements to document actions taken pursuant to a firm’s procedures may assist in reviewing and monitoring the implementation of those procedures. For example, in certain circumstances records of the types of communications that occur across information walls may be helpful in demonstrating that a credit market participant has complied with the procedures establishing the information wall and, in specific instances, that the individual who made an investment decision was not in possession of material nonpublic infor-

mation. Other actions that may be helpful to document include the results of any reviews of the firm's information controls and formal actions taken in response to violations of the firm's policies or procedures.

F. Restricted Lists, Watch Lists and Trading Reviews. Many firms have found it useful to maintain some combination of "restricted lists" and "watch lists" for purposes of restricting certain transactions and reviewing compliance with their information controls, although the nature and scope of such lists vary from firm to firm.

- A "restricted list" is commonly a list of securities or issuers as to which a firm has determined to restrict proprietary, employee and certain solicited customer transactions. Some firms may also restrict (as a means of preventing violations of Rule 10b-5) transactions in security-based swaps where the underlying securities are on the restricted list. The restricted list is generally distributed to sales and trading personnel as necessary to prevent inappropriate transactions. Securities or issuers may be placed on the restricted list for a variety of reasons, including compliance with applicable laws and avoiding conflicts or the appearance thereof.
- A "watch list" is commonly a list of securities or issuers the trading in respect of which is not prohibited but is subject to close scrutiny by the firm's compliance department. The dissemination of the watch list is usually limited to persons performing legal or compliance functions, to permit review of trading activities without tipping firm personnel to the firm's possible possession of material nonpublic information.

Firms that maintain such lists should also have criteria and procedures for the addition and deletion of securities and issuers from the lists and for restricting access to the watch list.

In addition, periodic reviews or "spot checks" of security-based transactions (including, but not limited to, transactions involving securities or issuers on the restricted or watch lists) can provide a useful tool for monitoring and enforcing compliance with the firm's information controls and for identifying any potential weaknesses in those controls.

G. Education and Training Requirements. Employee education and training regarding the structure and purpose of a firm's information controls can strengthen the effectiveness of those controls. Such education and training may be useful, particularly for employees in sensitive areas, at the time an employee joins the firm, when the employee changes departments within the firm, upon changes in relevant securities laws, and after any significant modification or violation of the firm's policies.

Topics to consider in developing or evaluating an education program include, for example:

- a description of the legal prohibition on entering into security-based transactions on the basis of material nonpublic information, including definitions of concepts such as "materiality" and "nonpublic";
- reputational and client-relations consequences of the misuse of material nonpublic information;

- a description of the potentially severe consequences for employees of policy violations, including the impact on employment with the firm (e.g., potential dismissal);
- a description of the procedures that restrict the time and manner of entering into security-based transactions and that control the flow of material nonpublic information;
- the importance of consulting qualified firm personnel when uncertain as to how the procedures apply; and
- the contact person or department (typically the compliance department) that is responsible for implementing the firm's information controls and that can answer questions or approve exceptions to the firm's policies and procedures.

Consideration should be given to the manner in which participation in training programs will be documented.

H. Review and Approval of Policies and Procedures by Senior Management. The review and approval of a credit market participant's information controls by management senior to or independent of the business units engaged in credit portfolio management activities provides an independent check on the sufficiency of these controls. Similarly, a procedure for reporting to senior management regarding the implementation and efficacy of the firm's information controls underscores the institutional importance of such controls and can help ensure their adequacy on an ongoing basis.

I. Coordination with Firm's Other Procedures. Depending on their circumstances, firms may have in place procedures establishing information controls with respect to all of their securities trading activities. Such firms would not necessarily need to have or adopt completely separate information controls for handling material nonpublic information in the context of their credit portfolio management activities. As the firm reviews its general information controls, however, consideration should be given as to whether any special procedures are appropriate for purposes of its credit portfolio management activities. In addition, if a firm has separate procedures for purposes of its credit portfolio management activities, those procedures should be harmonized with the firm's general procedures applicable to other securities trading activities.

V. Credit Market Participants Should Consider Addressing the Following Special Issues that May Be Posed for Their Credit Portfolio Management Activities Depending on Whether Those Activities are Conducted on the "Private Side" or the "Public Side" of an Information Wall

As noted above, information controls may include, in addition to other restrictions on trading by those who have access to material nonpublic information, procedures to "wall off" certain individuals or groups from any such information to minimize limitations on their ability to enter into transactions in securities or security-based swaps. Credit market participants that establish such information walls must determine whether their credit portfolio management activities will be conducted by personnel located on the "private" side of the wall, the "public" side of the wall, or some combination of the two.²² For these purposes:

²² As a general matter, firms that elect not to establish an information wall would need to consider the special issues identified in Part V.A below (i.e., the issues identified for firms that adopt a private side approach).

- “*Private side*” refers to the side of an information wall on which individuals may have access to material nonpublic information. Such individuals generally must pre-clear transactions they execute in securities of issuers as to which the firm may possess material nonpublic information and limit their contacts and communications with the public side that may convey or signal such information. For example, business units of the credit market participant that regularly originate loans, or engage in advisory activities, are likely to be on the private side of the information wall since these activities can lead to the receipt of material nonpublic information.
- “*Public side*” refers to that side of an information wall on which individuals do not have access to material nonpublic information — i.e., they are “walled off” from such information and personnel on the private side. Accordingly, the circumstances in which a transaction is restricted due to the possession by such individuals of material nonpublic information are limited. Traditional securities sales and trading activities with customers are normally conducted from the public side.

This section seeks to identify certain issues that may arise for a credit market participant depending on whether the personnel responsible in whole or in part for credit portfolio management activities are located on the private side or the public side. In identifying and discussing these issues, this Statement of Principles is not intended to imply that any particular approach is superior to another — instead, the Joint Forum seeks to assist credit market participants in identifying issues that should be considered in connection with designing or reviewing their credit portfolio management activities and their related information controls. In addition, some firms may elect to use an approach in which responsibility for credit portfolio management activities is divided between personnel located on both the public and private sides. Such an approach may be equally appropriate, subject to consideration of the issues described below as they relate to the private or public side activities of the firm.

A. Credit Portfolio Management Activities Conducted from the Private Side.

1. Implications. Information concerning the credit risks managed through a firm’s credit portfolio management activities historically resides on the private side, as part of the firm’s loan portfolio management and related activities. Personnel on the private side responsible for initial credit judgments may have access to nonpublic information provided by the borrower (and banks may be required by regulation to have access to certain such information). A firm may elect to locate personnel responsible for credit portfolio management activities on the private side in order to provide them with ready access to all information relevant to the risks being managed, as well as continued access to those making initial lending decisions. Since this private side information may from time to time include material nonpublic information, the credit market participant’s procedures should be designed to prevent private side portfolio management personnel with potential access to such material nonpublic information from making investment decisions regarding security-based transactions that are based on that information.

2. Topics to be Considered in Evaluating or Preparing Procedures.

- *Procedures to Determine that the Decision to Effect a Transaction is Not Made on the Basis of Material Nonpublic Information.* A credit market participant's procedures should be designed to permit it to determine, on a case-by-case basis, that the decision by private side personnel to enter into a security-based transaction is not based on material nonpublic information.

To accomplish this objective, the procedures should permit the firm to evaluate whether any relevant private side personnel are aware of material nonpublic information pertinent to a security-based transaction. In addition, the credit market participant's procedures should identify the personnel responsible for determining whether specific information is material and non-public. The compliance or legal departments may play a role in this process, particularly in situations where materiality determinations are complex. Firms should take steps to ensure that the individuals involved in this process are qualified and sufficiently experienced to make the relevant materiality determinations.

In certain circumstances, a firm may find it useful (for purposes of complying with its legal obligations while maintaining operational flexibility) to implement a "wall within a wall" — i.e., procedures to "wall off" specific individuals on the private side responsible for credit portfolio management activities from certain categories of material nonpublic information. These individuals then could be presumed not to be trading on the basis of that information even when such information is available to other individuals on the private side. A firm establishing such "wall within a wall" procedures should consider adopting the types of information barriers described in Part IV above, including physical segregation of the covered individuals from the public side and from other private side personnel that routinely have access to restricted information, and related procedures to control or limit the flow of information between each of these areas of the firm.

- *Procedures for Execution of Permitted Transactions and Handling Other Communications between Private and Public Sides.* Credit market participants should also consider whether any special procedures are appropriate to address communications that may occur between the private and public sides in connection with a security-based transaction.

For example, credit market participants should consider the handling of any communications prior to the transaction, such as those that might occur if private side employees seek pricing or other generic market information from public side employees to assist in determining the timing and strategy for entering into security-based transactions. Similarly, procedures might address how orders for a transaction will be communicated and executed, particularly if an execution desk on the public side is to be used. In order to provide protection against communications that include or signal material nonpublic information, firms should consider, for example, whether these or any other types of communications or subsequent trading should be reviewed, monitored or otherwise controlled by the compliance department.

3. Implications of Subsequent Investment Decisions. In devising their procedures, credit market participants should consider whether any subsequent actions they may elect to take with respect to a security-based transaction would involve (for purposes of Rule 10b-5) independent investment decisions requiring the application of procedures comparable to those applied when first entering into the transaction.²³ Relevant subsequent actions might include, for example, determining whether to exercise credit protection rights pursuant to the terms of an existing credit default swap, or determining to terminate such a swap prior to its scheduled maturity.

Credit market participants may elect to address this issue in several ways.²⁴ One approach followed in other markets is to rely on the “written trading plan” safe harbor established by Rule 10b5-1(c)(1). Under this safe harbor, a person will not be deemed to have entered into a transaction on the basis of material nonpublic information, even if the person is in possession of material nonpublic information at the time of the transaction, as long as prior to becoming aware of the information the person adopted a plan for the transaction effectively eliminating discretion as to whether to execute the transaction.²⁵ Credit market participants seeking to rely on this safe harbor in the context of security-based transactions might consider adopting procedures pursuant to which, upon any occurrence of a “credit event” permitting them to exercise their rights to deliver an obligation under a credit default swap, the steps to be taken by the firm are mandated by internal procedures.

Credit market participants may elect not to follow the “written trading plan” approach described above for a variety of reasons, including their desire to retain maximum flexibility to determine when and whether to exercise their credit protection rights (subject to any limitations that may apply if such exercise is deemed to be an independent investment decision). Credit market participants following the “written trading plan” approach should consider how to include within the safe harbor any related determinations that must be made upon exercise of the credit default swap, such as whether an obligation will be delivered (i.e., whether the swap will be physically settled), which obligation will be delivered, and if the obligation is not currently held, how it may be acquired consistent with the safe harbor.

B. Credit Portfolio Management Activities Conducted from the Public Side.

1. Implications. If personnel responsible for credit portfolio management activities are located on the public side, they would normally not have access to material nonpublic information. As a general matter, such persons should be permitted to execute security-based transactions without the need to determine, on a case-by-case basis, whether they or the firm are in possession of material nonpublic information with respect to a particular transaction.

As noted above, however, much of the information regarding the credit exposures being managed through security-based transactions typically would be located on the private side of an information wall. When conducting credit portfolio management activities from the public side, therefore, credit market participants face the practical challenge of providing relevant public side personnel with the information necessary to perform these activities effectively, without communicating to them material nonpublic information.

²³ See Part I.A.4 above.

²⁴ As stated in note 14 above, this Statement of Principles does not take a position on whether the extension of the SEC guidance described in the text accompanying note 14 to credit default swaps would be consistent with applicable law.

²⁵ See Rule 10b5-1(c)(1) for the full requirements applicable to this safe harbor.

2. Topics to be Considered in Evaluating or Preparing Procedures.

- *Determining the Scope of the Credit Portfolio Management Activities.* A credit market participant should define the scope of the credit portfolio management activities to be performed by public side employees and the types of information to be provided to these employees in order to conduct such activities. The credit market participant's objectives may include: (i) maximizing the ability of public side employees to perform a full range of credit portfolio management activities, including by providing them with as much relevant information as possible, and (ii) minimizing the circumstances in which those activities are disrupted because information cannot be provided to and used by such employees (i.e., because such information includes, is based on or signals material nonpublic information).

In balancing these objectives, firms should consider the practical implications for their credit portfolio management activities if certain information cannot be transferred from the private side to the relevant public side personnel without conveying or signaling material nonpublic information. For example, if information that has been previously provided to the public side is subsequently updated, and the communication of such updated information would signal material nonpublic information, it may not be possible to convey such updated information to the public side without a process or procedure to prevent its improper use (such as a requirement that upon such communication the public side must refrain from entering into any relevant security-based transaction).

- *Procedures for Determining Whether Information to be Communicated to the Public Side is Material or Nonpublic and for Handling Such Communications.* Credit market participants using a public side approach should establish procedures for (i) determining whether information proposed to be transferred from the private side to the public side for purposes of conducting credit portfolio management activities is material and nonpublic and (ii) managing (or establishing protocols for) the communication of such information.

A credit market participant's procedures for handling information transfers from the private side to the public side may vary based on a number of factors, including the nature of that information. For example, a firm may determine that certain categories of information, such as the amount of the exposures being managed, should normally be transferable to the public side (subject to a procedure for addressing situations in which the existence or amount of the exposure is itself material nonpublic information).

Transfers of other types of information, however, may require more detailed procedures designed to prevent signaling or other inappropriate transfers of material nonpublic information. For example, if the firm proposes to transfer information regarding internal ratings (or other information derived from such ratings, such as exposure limits) that are established or modified on the private side, the firm's procedures should address any rating changes that may be made by personnel in possession of material nonpublic information, so that the communication of such changes to the public side does not signal the existence of material nonpublic information.

Possible approaches for addressing the transfer of rating information might include, among others that may be equally effective, one or more of the following: reviews of rating changes (e.g., by compliance personnel) to determine whether they are based on material nonpublic information; if any change in ratings was based on material nonpublic information, controls, limits or delays on the communication of that change to the public side or on the execution of any transactions involving the relevant securities (such as a pre-clearance requirement for security-based transactions); or other appropriate procedures designed to prohibit securities trading on the basis of such material nonpublic information. Alternatively, a firm may seek to develop sufficient capability to prepare internal ratings on the public side (such that the establishment of or any changes to the ratings would not be based on material nonpublic information).

Firms should also consider whether in certain circumstances the nature or frequency of communications between the private and public sides that may occur when public side employees are responsible for credit portfolio management activities may make it desirable to have special procedures limiting or managing (or establishing protocols for) such communications to help prevent inappropriate transfers of material nonpublic information.

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