

FEDERAL RESERVE BANK  
OF NEW YORK

*At Cir No. 8302*

March 27, 1978

MISUSE OF INSIDE INVESTMENT INFORMATION

Board of Governors' Policy Statement

*To the Chief Executive Officer of the State Member Bank  
Addressed, and Others Concerned:*

Following is the text of a statement issued March 20, 1978 by the Board of Governors of the Federal Reserve System:

The Board of Governors of the Federal Reserve System today issued a policy statement alerting State member banks to penalties that may arise from the misuse of inside investment information, and providing examples of steps that could be taken to avoid violation of Federal law in this field.

The Board said the policy statement—which is effective immediately—reflects the judgment of the Board that misuse of material inside information in connection with securities transactions, or recommendations about such transactions, constitutes an unsafe and unsound banking practice.

Accordingly, the statement said, the Board “expects each State member bank exercising investment discretion for the accounts of others to adopt written policies and procedures . . . to ensure that material inside information in its possession is not misused.”

The policy statement, affecting chiefly the operations of trust departments of State member banks, noted that Federal law generally prohibits the purchase or sale of securities by persons possessing material inside information about the securities until the information they have is disclosed to the public. If the information cannot be disclosed publicly because it was obtained in confidence, holders of the information must abstain from transactions or recommendations concerning the security involved until the information is divulged.

Violations of these laws, the statement noted, could expose banks to severe financial penalties and to criminal charges.

Information was defined as being “material” when there is a substantial likelihood that a reasonable investor would consider it important in deciding whether to buy, sell or hold securities.

The Board said that in its opinion, the preventive policies and procedures banks should adopt should limit activities that are likely to result in an improper interchange of material information. They should also provide the bank with ways to deal affirmatively with such information when it comes into the possession of bank personnel who make investment decisions for the account of others. The Board urged each State member bank to review its policies and procedures to make sure they would accomplish these purposes, in the particular circumstances of the bank.

The Board set forth the following examples of possible approaches to the development of written policies and procedures to avoid the misuse of material inside information:

1. Denial of access by trust personnel to commercial credit files, government, agency and municipal securities underwriting files, and other pertinent files.
2. A prohibition against attendance by trust personnel at private meetings with bank lending or underwriting personnel, except where the meeting is held solely to seek a new customer relationship.
3. A prohibition against personnel serving simultaneously on a committee authorized to make specific investment decisions or recommendations and a committee responsible for commercial lending or underwriting of government issues.

4. A requirement for a prompt report to management by any trust department, or trust department employee, of the receipt of inside information they should not have, and, if management determines that the information is material, prompt orders to:
  - Halt all bank trading of the indicated security, or bank recommendations concerning it;
  - Determine whether the information is valid and has not been made public;
  - Request the issuer or other appropriate parties to make pertinent information public;
  - Seek legal advice, if the information is not publicly disclosed, as to what else should be done before trading in the security, or recommendations concerning it, are resumed.
5. The provision for every account, of a copy of the bank's policies and procedures to the person having power to terminate the bank's discretionary investment authority over the account, or to the person to whom an accounting would ordinarily be rendered.
6. Physical separation of trust and commercial bank lending and investing personnel, as circumstances allow.

Printed below is the text of the Board's policy statement. Questions regarding this matter may be directed to our Bank Examinations Department (Tel. No. 212-791-5194).

PAUL A. VOLCKER,  
*President.*

## FEDERAL RESERVE SYSTEM

(Docket No. R-0148)

### Policy Statement Concerning Use of Inside Information

*AGENCY:* Board of Governors of the Federal Reserve System.

*ACTION:* Policy Statement.

*SUMMARY:* This policy statement reflects the judgment of the Board of Governors of the Federal Reserve System that the use of material inside information by any State member bank in connection with any decision or recommendation to purchase or sell securities constitutes an unsafe and unsound banking practice. Notification is given that the Board of Governors expects each State member bank exercising investment discretion for the accounts of others to adopt written policies and procedures suitable to its particular circumstances to ensure that such information in its possession is not misused. Guidelines are provided to aid State member banks in the development of such policies and procedures.

*EFFECTIVE DATE:* March 17, 1978.

*FOR FURTHER INFORMATION CONTACT:* Robert S. Plotkin, Assistant Director, (202/452-2782) or Robert A. Wallgren, Chief, Trust Activities Program, (202/452-2717), Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, Washington, D.C. 20551.

*SUPPLEMENTARY INFORMATION:* This policy statement is issued pursuant to the Board's supervisory authority over State member banks contained in section 9 (12 U.S.C. § 321) and section 11 (12 U.S.C. § 248 (a)) of the Federal Reserve Act and the Financial Institutions Supervisory Act of 1966 (12 U.S.C. 1818(b)) and related provisions of law.

#### *Statement of Policy Concerning Use of Inside Information*

Commercial banks may receive information about their customers that is not otherwise available to the public. In many cases, customers about which the bank possesses confidential information are firms whose securities are publicly traded. Full-service commercial banks, being institutions that provide a diversity of services, may, at the same time such confidential information is in their possession, be effecting purchases or sales of such securities for trust customers and others and advising customers as to the purchase or sale of such securities.

Where confidential information in the possession of a person is "material" (i.e., is of such nature that there is a substantial likelihood that a reasonable investor

would consider it important in deciding whether to buy, sell or hold securities), Federal securities law generally prohibits the purchase or sale of pertinent securities by such person until the information is disseminated to the public. A person in possession of such material inside information must, before effecting transactions in the affected security, disclose to the public such information or, if unable to do so (e.g., in order to protect a corporate confidence), must abstain from trading in or recommending such securities until the information is disclosed. Similarly, divulging confidential material inside information only to one's customers who then act on the basis of the information violates Federal securities law.

For a bank to purchase or sell, or recommend the purchase or sale of, securities on the basis of material inside information in the bank's possession subjects the bank not only to injunctive suits and criminal proceedings, but also to civil damage suits by persons on the other side of the transactions. In such cases, liability may not be limited to the persons on the other side of the transactions, but conceivably could extend to all persons who effected transactions in the securities before the information became public; thus potential liability could be substantial in terms of the amount of damages that may be awarded.

Accordingly, the Board of Governors will view the use of material inside information in connection with any decision or recommendation to purchase or sell securities as an unsafe and unsound banking practice. Furthermore, the Board expects each State member bank exercising investment discretion for the accounts of others to adopt written policies and procedures, suitable to its particular circumstances, to ensure that such information in its possession is not misused.

Because the size and organizational structure of individual banks that engage in investment activities vary widely, the Board does not believe that it should, at this time, mandate the specific content of policies and procedures to be adopted. The Board believes, however, that in general such policies and procedures should limit those types of activity that are likely to give rise to an improper interchange of material inside information and establish a course of action for the bank to deal affirmatively with such information that may come into the possession of personnel engaged in investment decision making for the accounts of others. In this connection, the Board urges each State member bank to review its organizational structure and methods of operation to ensure that its policies and procedures are appropriately tailored to its circumstances. System trust examiners will be instructed to evaluate regularly the adequacy of policies and procedures adopted by individual banks.

Set forth below are examples of specific approaches to dealing with inside information that State member banks may wish to consider in the development of policies and procedures for their own use. Although more generally applicable to larger banks, (i.e., those managing assets for the accounts of others with a mar-

ket value over \$100 million), they may prove useful to smaller banks as well.

#### *Examples*

(1) Trust personnel (i.e., bank employees whose duties include the making of investment decisions or recommendations for fiduciary or agency accounts) should not have access to commercial credit files, government, agency and municipal securities underwriting files or such other files that the bank can reasonably determine may contain material inside information;

(2) Trust personnel should not attend private meetings between or among personnel engaged in commercial lending activities or in underwriting government, agency and municipal securities, on the one hand, and bank customers on the other, except where the sole purpose of the meeting is to seek a new customer relationship;

(3) Officers, directors, or employees of the bank should not serve simultaneously on any committee having responsibility for the making of investment decisions or recommendations with respect to specific transactions and any committee having responsibility for commercial lending or government, agency and municipal securities underwriting activities, unless necessary to the circumstances of the individual bank;

(4) All trust department employees should be advised to report promptly to the management of the trust department suspected material inside information and, upon a determination by that management that the information is material, management should promptly:

(a) halt all trading by the bank in the security or securities of the pertinent issuer and all recommendations thereof;

(b) ascertain the validity and non-public nature of the information with the issuer of the securities;

(c) request the issuer or other appropriate parties to disseminate the information promptly to the public, if the information is valid and non-public;

(d) in the event the information is not publicly disseminated, notify the bank's legal counsel and request advice as to what further steps should be taken, including possible publication by the bank of the information, before transactions or recommendations in the securities are resumed.

(5) A copy of the bank's policies and procedures should be furnished for each fiduciary or agency account for which the bank exercises investment discretion to the person having the power to terminate the account or, if there is no such person, to the persons to whom an accounting would ordinarily be rendered;

(6) Trust personnel should be separated physically from commercial lending personnel and government, agency and municipal securities underwriting personnel to the extent appropriate to the circumstances of the individual bank.

*Board of Governors of the Federal Reserve System,  
March 17, 1978.*