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Chinese Wall or Emperor's New Clothes? Regulating Conflicts of Interest of Securities Firms in the U.S. and the U.K.

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> *Ko-Ko:* Pooh-Bah, it seems that the festivities in connection with my approaching marriage must last a week. . . . I want to consult you as to the amount I ought to spend upon them.
> *Pooh-Bah:* Certainly. In which of my capacities . . . ?
> *Ko-Ko:* Suppose we say as Private Secretary.
> *Pooh-Bah:* Speaking as your Private Secretary, I should say . . . don't stint yourself, do it well.
> *Ko-Ko:* Exactly—as the city will have to pay for it. That is your advice.
> *Pooh-Bah:* As Private Secretary. Of course you will understand that, as Chancellor of the Exchequer, I am bound to see that due economy is observed. . . .
> *Ko-Ko:* I see. Come over here, where the Chancellor can't hear us. [They cross the stage.] Now, as my Solicitor, how do you advise me to deal with this difficulty . . . ?
>
> *The Mikado, Act I*

Recent scandals in both the United States[1] and the United Kingdom[2] involving insider trading and other market abuses by investment bankers and brokers have focused attention on the subject of "Chinese Walls"—attempts by multi-service firms and banks to isolate certain of their potentially conflicting functions in order to prevent the flow of sensitive information.

At the same time, developments in the markets have subjected securities firms

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1. *See* SEC v. Levine, No. 86-3726, slip op. (S.D.N.Y. July 2, 1986); SEC v. Boesky, No. 86-2299, slip op. (S.D.N.Y. filed Nov. 14, 1986).

2. *See Guinness: The Brewing Storm*, Sunday Times, March 1, 1987, at 47 (Review), col. 1.; Hughes and Bunker, *Collier Fined £25,000 with Suspended Jail Term for Inside Deals*, Fin. Times, July 2, 1987, at 1, col. 3.

to new conflicts of interest. Deregulation of the world's securities markets, which began in the U.S. during the 1970s[3] and has since spread to all of the major financial centers,[4] has encouraged the growth of highly capitalized financial conglomerates with worldwide operations. Nowhere has financial deregulation had a more dramatic impact than in the U.K., where, on the day of "Big Bang"[5] (October 27, 1986), the London Stock Exchange ("LSE") simultaneously ended fixed commission rates; inaugurated a new system of electronic trading that very quickly made the traditional exchange floor obsolete; and for the first time permitted member firms to act in the dual capacity of broker and dealer. The fundamental purpose of these changes was to encourage the formation of British financial conglomerates that could compete successfully in the international arena, and so to enhance the status of London as a major financial center.[6] Because the new firms could engage in numerous types of activity, both for their clients and themselves, they faced far more conflicts of interest than had been true for single-capacity firms.

On November 7, 1986, only twelve days after Big Bang, the Financial Services Act 1986 ("Financial Services Act"), which created a comprehensive program for the regulation of the investment business in the U.K., was enacted into law in the U.K. Its solution to the new conflicts-of-interest problem was the Chinese Wall,[7] a concept borrowed from the U.S., where securities firms had always been permitted to perform the dual functions of broker and dealer.[8] By all accounts, most large securities firms both in the U.S. and the U.K. have now established Chinese Walls.[9]

Despite its name, the Chinese Wall is generally not a physical barrier or obstacle, but simply a metaphor to describe a set of internal rules and procedures

3. An important exception to deregulation in the U.S. has been the continued existence of the Glass-Steagall Act, which separates commercial banking from investment banking. *See infra* text accompanying notes 12–20.

4. For example, of the world's major stock exchanges, only Tokyo still regulates the rates of commission charged by its members to customers. Recently, even Tokyo has begun to take steps to deregulate its markets. *Tokyo Revises Brokers' Commission Rates*, Fin. Times, Sept. 10, 1987, at 20, col. 2; Wall St. J., Oct. 7, 1987, at 43, col. 4 (admission of twenty additional brokerage firms to Tokyo exchange).

5. The term "Big Bang" was intended to refer to a current theory for how the universe came into existence.

6. A. HAMILTON, THE FINANCIAL REVOLUTION 130–54 (1986).

7. *See infra* text accompanying notes 125–177.

8. A broker is a person engaged in the business of effecting securities transactions for others. Securities Exchange Act of 1934, § 3(a)(4), 15 U.S.C. § 78c(a)(4). A dealer is a person engaged in the business of buying and selling securities for his own account. Securities Exchange Act of 1934, § 3(a)(5), 15 U.S.C. § 78(a)(5).

9. *See* Feinberg, *Wall Street Investigates Its Chinese Walls*, INVESTMENT DEALERS' DIGEST, May 18, 1987, at 22; Riley, *Chinese Walls May Be Too Thin*, Fin. Times, July 7, 1986, at 13, col. 5. This article will not focus on the use of Chinese Walls by commercial banks, except to the extent that commercial banks or their affiliates engage in securities activities.

(sometimes including procedures to monitor these rules and procedures) established by a firm for the purpose of preventing certain types of information in the possession of one part of the firm (or of an affiliated group of firms) from being communicated to other parts of the same firm or group.

What has not been generally appreciated is that the Chinese Wall may have two very different purposes in the legal system of a country. On the one hand, its purpose may be only *prophylactic*: to prevent inside information in the possession of persons in one part of a firm from being misused by persons in another part of the firm. On the other hand, its purpose may also be *legal*: to provide a defense to the firm against liability for insider trading or breach of a duty to a customer, which would normally arise as a result of the imputation of knowledge of an employee to his employer.[10]

In the U.S., the Securities and Exchange Commission (SEC) has since the 1960s encouraged broker-dealer firms to establish Chinese Walls for prophylactic purposes. Only in recent years has the wall been used for legal purposes, and then only as a defense against liability under a specific SEC rule outlawing insider trading in connection with a pending tender offer.[11] In the U.K., on the other hand, the Financial Services Act and implementing rules contemplate that the Chinese Wall will be used for legal purposes, as a defense against many types of liability, not limited to insider trading but covering many aspects of the broker-customer relationship.

This article has two principal theses. The first is that, while Chinese Walls of securities firms are undoubtedly useful in some instances in preventing the flow of confidential information, the evidence that they actually do this is insufficient to justify basing a legal defense on the existence of a wall in a particular firm. In fact, it is difficult to avoid the conclusion that at some firms the Chinese Wall is nothing but a convenient fiction aimed at avoiding liability for market abuses.

The article's second thesis is that the isolation of information within a department of a firm which is achieved by an effective Chinese Wall is inconsistent with the goals of full disclosure, self-regulation, and managerial responsibility that are fundamental to the regulatory systems governing the securities markets of both the U.S. and the U.K. This may be particularly true under the new British rules, where Chinese Walls are designed to isolate not merely non-public information concerning a firm's investment banking clients, but also information concerning the firm's internal operations, such as trading for its customers' and its own account, or the work of its research department.

Part I of this article will discuss the conflicts of interest faced by the modern multi-service securities firms, and Part II the relevant rules of agency law. Parts

10. *See generally* Varn, *The Multi-Service Securities Firm and the Chinese Wall: A New Look in the Light of the Federal Securities Code*, 63 NEB. L. REV. 197 (1984)(discussing the Chinese Wall as a defense against liability for insider trading).

11. *See* 17 C.F.R. § 240.14e-3; *infra* text accompanying notes 85–94.

III and IV will trace, in the U.S. and U.K. respectively, the background and operation of the Chinese Wall. Part V, in turn, will examine the available evidence as to the effectiveness of Chinese Walls and their impact on the ability of securities firms to discharge their managerial and supervisory responsibilities. Finally, Part VI will review and evaluate the solutions that have been proposed for the conflicts-of-interest problems of securities firms.

I. CONFLICTS OF INTEREST OF MULTI-SERVICE SECURITIES FIRMS

A conflict of interest is a situation in which the self-interest of a person may conflict with a fiduciary duty which he owes to another, or in which a person has potentially conflicting fiduciary duties to two or more other persons.[12] There are two principal reasons why conflicts of interest are common in the securities markets. First, securities professionals not only give advice to their clients but also take discretionary action or make recommendations on the basis of their own advice; and their clients may not have the ability or background properly to evaluate the advice that they receive. As a result, securities professionals have opportunities to cheat their clients by giving advice or taking discretionary action that may further their own interests but not necessarily those of their clients. Because it would be costly, however, to monitor closely the activities of securities professionals, the rules give them considerable latitude, while forbidding them from taking unfair advantage of their clients.[13] According to Professor Anderson, "[l]egal conflicts of interest are situations in which we perceive that cheating is very likely to occur, but in which we are forced to trust individuals not to cheat because the costs of preventing or detecting cheating are so high."[14]

The second reason why conflicts of interest are endemic to the securities business is that investment firms typically perform a variety of different activities, both on their own behalf and on behalf of their customers. The Report of the SEC's Special Study of Securities Markets noted 25 years ago: "the extent to which any one participant may engage in a variety of businesses or perform a variety of functions [creates] . . . multifarious possibilities of conflict of obligation or interest in matters large and small."[15]

12. *See* Schotland, *Introduction for the Steering Committee*, in TWENTIETH CENTURY FUND REPORT, ABUSE ON WALL STREET: CONFLICTS OF INTEREST IN THE SECURITIES MARKETS 4 (1980)[hereinafter ABUSE ON WALL STREET].

13. For an insightful analysis of conflicts of interest, see Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 U.C.L.A. L. REV. 738 (1978).

14. *Id.* at 747–48.

15. U.S. SECURITIES AND EXCHANGE COMMISSION, SECURITIES AND EXCHANGE COMMISSION REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, 88th Cong., 1st Sess., pt. 1, at 439 (1963) [hereinafter cited as SEC SPECIAL STUDY].

The combined effects of deregulation of the securities markets, increased competition among markets and among firms, and internationalization of the markets have blurred the barriers between different classes of financial institutions.[16] Although the Glass-Steagall Act[17] still separates commercial banking from investment banking in the U.S., its force and scope have been so eroded in recent years by administrative interpretations and judicial decisions that, in the words of one well-informed observer, Glass-Steagall is "coming apart like a cheap suitcase in the rain."[18] Today, American commercial banks, like those of the U.K. and other countries, conduct a wide variety of securities activities, while investment banks and securities companies are major providers of banking services.[19] Overseas, where Glass-Steagall is inapplicable, U.S.-based commercial banks own and operate investment banking affiliates, in direct competition with foreign securities firms, while U.S. investment banks are acquiring commercial banks.[20]

In the U.S., firms have always been permitted to perform the dual functions of broker and dealer.[21] Regulation of the potential conflicts of such firms, whether between a firm's own interest and its duty to a customer or client,[22] or between its duties to two or more customers or clients, has been accomplished largely through application of the common law of agency, as supplemented by concepts developed under the federal securities laws. In short, American firms have become accustomed to living with the conflicts of interest and of duty that are endemic to a multi-service firm. In the U.K., the repeal of the single capacity system in 1986 enabled British firms for the first time to combine broker and dealer functions, and thus to compete with foreign financial conglomerates.

The disappearance of barriers separating the functions performed by securities and banking firms and the concentration of an increasingly large proportion of the

16. *See* E.G. CORRIGAN, FINANCIAL MARKET STRUCTURE: A LONGER VIEW 6 (1987). (Mr. Corrigan is President of the Federal Reserve Bank of New York).

17. Enacted as part of the Banking Act of 1933, Ch. 89, 48 Stat. 162 (1933) (codified in scattered sections of 12 U.S.C. (1982)).

18. Interview with Gordon Macklin, then President of the National Association of Securities Dealers, Inc., in Washington, D.C. (Jan. 30, 1987). *See also* Langevoort, *Statutory Obsolescence and the Judicial Process: The Revisionist Role of the Courts in Federal Banking Regulation*, 85 MICH. L. REV. 672, 687–719 (1987); Note, *A Banker's Adventures in Brokerland: Looking Through Glass-Steagall at Discount Brokerage Services*, 81 MICH. L. REV. 1498 (1983); Note, *National Banks and the Brokerage Business: The Comptroller's New Reading of the Glass-Steagall Act*, 69 VA. L. REV. 1303 (1983).

19. CORRIGAN, *supra* note 16, at 6.

20. *Id.*

21. For definitions of "broker" and "dealer," see *supra* note 8.

22. While the terms "customer" and "client" are often used interchangeably in the literature about the securities markets, this article will use "customer" to refer to persons for whom a firm executes brokerage transactions or gives investment advice, and "client" to refer to companies for whom a firm acts as underwriter or investment banker.

securities business in a relatively few multi-service entities[23] have greatly increased the number and type of their conflicts of interest. Assume, for example, that a financial conglomerate (which may be either an affiliated group of companies or a single corporate entity) engages in the following activities: (1) retail and institutional brokerage, including sales and research; (2) portfolio management for retail and institutional accounts;[24] (3) management of mutual funds;[25] (4) market-making[26] and other trading (including arbitrage) for its own account; (5) underwriting of public offerings and private placements of securities for corporate clients;[27] and (6) investment banking, including giving financial advice and assistance to corporate clients in connection with mergers and acquisitions. The following are a few of the more obvious conflicts that the firm faces:

1. The underwriter may be tempted to prefer its own interests over those of its managed accounts by selling the unsold portion of an offering to these accounts.
2. The market maker may be tempted to place unwanted securities in managed accounts or to pressure the brokerage department to recommend the securities to retail and institutional customers.
3. The market maker may be tempted to exert pressure on the retail brokerage or the portfolio management department to recommend securities in which the market maker has a position.
4. The brokerage department may be tempted, when dealing with a customer as principal, to purchase securities ordered by the customer from the market-making department at a price unduly favorable to the firm.
5. The brokerage department may be tempted to prefer a larger or more valuable customer over other customers by giving it earlier access to inromation or recommendations or by executing its orfers at better prices.
6. A retail broker may be tempted to prefer his own interest over that of a customer by "churning" the customer's account (i.e., making recommendations to a customer or initiating transactions in a discretionary account for the primary purpose of generating commissions). This conflict may be even sharper if the firm pays the broker special compensation for recommending or buying for discretionary accounts particular securities that the firm owns and is anxious to liquidate.

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23. In the first six months of 1986, the 10 largest U.S. securities firms accounted for 61.4% of the capital and 57.2% of the revenue for the entire securities industry. The comparable figures for 1976 were 43.8% of capital and 41.6% of revenues. Securities Industry Association, TRENDS, Oct. 17, 1986, at 7–8.

24. A portfolio is a combined holding of more than one investment by an individual or institutional investor. The purpose of a portfolio is to reduce risk by diversification. J. DOWNES & J. GOODMAN, DICTIONARY OF FINANCE AND INVESTMENT TERMS 295 (1985).

25. A mutual fund is an investment company that raises money from shareholders and invests it in stocks, bonds, options, commodities, or money market securities. *Id.* at 243.

26. A market maker is a dealer who maintains firm bid and offer prices in a given security by standing ready to buy and sell such security at publicly quoted prices. *Id.* at 218.

27. An underwriter facilitates a distribution of securities by either purchasing the securities from the issuer (or a shareholder) and reselling them to customers or other dealers; using its best efforts to assist the issuer (or a shareholder) in distributing the securities; or guaranteeing to the issuer (or a shareholder) that it will purchase any securities that the issuer is unable to distribute. *Id.* at 451–52.

7. A retail broker or investment advisor may be tempted to engage in "scalping" (i.e., purchasing a security for his own account before recommending it to customers with the intention of selling the security after his recommendation has affected its market price).

8. The underwriting department may be tempted to pressure the fund management department to subscribe to new issues underwritten by the firm.

9. The investment banking department may be tempted to pressure the fund management department to back one side in a takeover bid involving a client company of the firm.

10. A member of investment banking or underwriting department may be tempted to trade upon or divulge to favored customers non-public information concerning a corporate client.

11. A member of the investment banking department may be tempted to divulge non-public information to the arbitrage or trading department concerning a prospective merger or acquisition involving a corporate client.

12. A member of the investment banking department who is also a member of the board of directors of a corporate client of the firm may be tempted to trade upon or divulge non-public information obtained from the company.

13. The arbitrage, market-making, or other trading department may be tempted to purchase (or sell) securities that are about to be the subject of a favorable (or unfavorable) report by the research department.

If the conglomerate includes a commercial bank, there will be additional conflicts of interest. For example:

14. The commercial bank may be tempted to exert pressure on the retail or investment advisory department to recommend the commercial bank's securities or, conversely, the commercial bank may be tempted to dissuade the retail or investment advisory department from issuing a negative opinion about these securities.

15. The commercial bank may be financing the target company in a hostile takeover while the investment banking department is advising the raider.

16. The commercial bank may receive non-public information concerning a corporate client whose securities are held by discretionary customers of the firm or by a mutual fund managed by the firm.

Although most of these conflicts are caused by the multiplicity of functions that securities firms typically perform, even a firm that engages in only one type of business may nonetheless be faced with potential conflicts of interest. Thus, even a stockbroker who acts exclusively as an agent for clients may have a conflict between his own interests and those of clients; furthermore, a firm may have an incentive to prefer some of its customers or clients over others. The SEC's Special Study summarized the situation as follows:

> Total elimination of all [conflicts of interest] is obviously quite out of the question; theoretically, it would involve complete segregation of functions—a remedy often invoked or suggested where conflicts are considered. But segregation as a specific remedy for all the multifarious possibilities for conflicts in the complex securities business could not be a simple segregation in any traditional sense but would have to involve fragmentation of the business to a point where (as facetiously pointed out

in a recent magazine article) each investor would have his own broker who would not be permitted to act for any other customer or for himself.[28]

Nevertheless, the multiplicity of functions that many securities firms perform is responsible for many, if not most, of the conflicts of interest that exist in the securities business. And the more functions a firm performs, the greater the variety of its conflicts of interest. It is recognized, however, that consolidation of functions in a firm or group of firms has economic benefits, including the ability to diversify business risk, the enjoyment of potential economies of scale,[29] and the advantage of permitting a maximum amount of competition.[30] It appears that these considerations carried special weight with the framers of the new U.K. regulatory system, a large part of the purpose of which was to enable British firms to compete successfully in the international financial markets and to advance the status of London in relation to other major financial centers.

The financial conglomerate has become a worldwide phenomenom, and conflicts of interest can be expected to grow in scope and intensity. The basic problem posed by the prevalence of these firms is that of resolving the tension between the legal duties that the firm owes its customers and clients and the economic needs of the markets, or, to put it another way, between efficiency and fairness. In both the U.S. and the U.K., the main instrument chosen to achieve that resolution has been the Chinese Wall.

II. Conflicts of Interest and Agency Law

A major policy issue concerning conflicts of interest in the securities markets is whether the establishment of a Chinese Wall should constitute a valid defense by a multi-service firm against a charge that it has breached the fiduciary duties imposed upon it by the law of agency. It therefore becomes necessary to review briefly the two rules of agency law that are relevant to this discussion: first, the rule that an agent owes a duty to exercise good faith and undivided loyalty toward his principal;[31] and, second, the rule that knowledge obtained by an agent in the course of his agency will be deemed to be the knowledge of his principal.[32]

The limited discussion of these two rules that follows is not intended to provide a full analysis of the ways in which they have been interpreted by courts in the U.S. and U.K.;[33] it is designed merely to summarize the relevant principles of

28. SEC Special Study, *supra* note 15, pt. 1, at 440 (1963).

29. For example, consolidation of functions may reduce administrative and research costs.

30. *See* Saunders, *Conflicts of Interest: An Economic View*, in Deregulating Wall Street 207 (I. Walter, ed. 1985).

31. S.J. Stoljar, The Law of Agency 288 (1961); F. Tiffany, Handbook of the Laws of Principal and Agent 386 (1924).

32. Restatement (Second) of Agency § 272 (1958).

33. The law of agency of the U.S. and the U.K., while substantially similar, may vary in interpretation.

law in order better to understand why the Chinese Wall has been proposed as a method of protecting multi-service securities firms from the rigors of agency law. These rigors, however, may be more apparent than real, since courts are likely to interpret them flexibly, particularly in the context of the complex business arrangements that exist in the securities markets.[34]

Like other agents in whom trust and confidence are reposed, a securities broker owes to his principal the utmost good faith and loyalty.[35] Depending on the factual circumstances, a securities firm may owe a fiduciary duty to the persons with whom it deals as agent, including its brokerage and investment-advisory customers and, at least to some extent, the corporate clients for which it acts as underwriter, investment banker, or financial adviser.[36] The firm should not place itself in a position where its duties to customer or client conflict with its own interest or with its duty to another customer or client.[37] "[T]he law will not permit [an agent] to place himself in a position in which he may be tempted by his own private interests to disregard those of his principal."[38] It has been said that the sound principles that lie behind this rule are the Biblical precept that "no man can serve two masters"[39] and the injunction of the Lord's Prayer to "lead us not into temptation."[40]

An agent is subject to special rules of conduct that do not apply to a person dealing with another at arm's length. In the often-quoted language of a great American judge, Benjamin Cardozo:

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honour the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions.[41]

Eloquent as this statement is, it is not necessarily an accurate guide to how a court is likely to act when deciding a particular case involving the potentially conflicting obligations of a securities firm. As a British observer stated recently,

34. Regulation of conflicts of interest reflects a "tension between efficiency and fairness [which] results in a compromise which is constantly being renegotiated." Anderson, *supra* note 13, at 748. *See* Wood, *Financial Conglomerates and Conflicts of Interest*, in CONFLICTS OF INTEREST IN THE CHANGING FINANCIAL WORLD 61–65 (R.M. Goode, ed. 1986).

35. 2 F. MECHEM, A TREATISE ON THE LAW OF AGENCY § 2411 (2d ed. 1914).

36. An investment banker has a duty to preserve the confidentiality of information entrusted to it by a corporate client. *See* Dirks v. Securities and Exch. Comm'n, 463 U.S. 646, 655 n.14 (1983).

37. G.H.L. FRIDMAN, THE LAW OF AGENCY 152–53 (1983); B. MARKESINIS & R. MUNDAY, AN OUTLINE OF THE LAW OF AGENCY 84 (1979).

38. Tarnowski v. Resop, 236 Minn. 33, 36, 51 N.W.2d 801, 803.

39. Matthew 6:24; *see* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 963 (1983).

40. Wood, *supra* note 34, at 61.

41. Meinhard v. Salmon, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928)(citation omitted).

"[i]f one were to take [Cardozo's] standard as applying to the investment banking and dealing activities of the London financial conglomerate, it would be impossible to do business."[42] Instead, the courts have tended to examine each potentially conflicting situation according to its particular circumstances, including such factors as the likelihood that the conflict will give rise to abuse, the degree of discretion vested in the firm,[43] the sophistication and financial situation of the client, and the intensity of the conflict.[44]

A principal has a right to assume that he will receive his agent's undivided allegiance and loyalty.[45] The American Restatement of Agency states as a "General Principle" that, "[u]nless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency."[46] Furthermore, unless otherwise agreed, an agent may not "act or . . . agree to act during the period of his agency for persons whose interests conflict with those of the principal in matters in which the agent is employed."[47]

Thus, an agent's duty not to engage in transactions in which he may have a conflict of interest can be cured by adequate disclosure to the principal and consent by the principal. An agent is not permitted to engage in undisclosed self-dealing with his principal's property or to use his position as agent to make secret profits.[48] He is also under a duty "not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency or in violation of is duties as agent."[49] If, without the consent of the principal, he acts both as agent and principal in the same transaction, the principal may either repudiate the transaction, or adopt it and recover from the agent his profit.[50] If an agent enters into a contract with his principal, he must disclose all the material circumstances.[51]

Although the provisions of the U.S. federal securities laws concerning brokers and dealers do not explicitly adopt the common law of agency, these laws implement fiduciary principles, largely by requiring extensive disclosures to customers. For example, the SEC's confirmation rule requires a broker-dealer to disclose to his customers, among other things, "[w]hether he is acting as agent for such customer, as agent for some other person, as agent for both such customer and some other person, or as principal for his own account. . . ."[52] Similarly, in the

42. Wood, *supra* note 34, at 61.

43. For example, where the terms of a transaction have been fixed and no discretion is left with the agent, he is permitted to act as agent for both sides. Tiffany, *supra* note 31, at 391.

44. *Id.* at 63–65.

45. 1 F. MECHEM, *supra* note 35, at 881.

46. RESTATEMENT (SECOND) OF AGENCY § 387 (1958).

47. *Id.* § 394.

48. G.H.L. FRIDMAN, *supra* note 37, at 156–63.

49. RESTATEMENT (SECOND) OF AGENCY § 395 (1958).

50. TIFFANY, *supra* note 31, at 386.

51. *Id.* at 390.

52. 17 C.F.R. § 240.10b-10(a)(1) (1987).

U.K. a rule of the Securities Investment Board adopted pursuant to the Financial Services Act requires that the "contract note" to be delivered to a customer after a transaction disclose "if the firm is being remunerated for acting as an agent for the counterparty to the transaction as well as for acting as agent for the customer, that fact. . . ."[53]

A broker-dealer is under a duty to inform his customer of the risks involved in buying or selling a particular security; and a duty to refrain from self-dealing, or refusing to disclose any personal interest he may have in a particular recommended security.[54] Where the account is handled by the broker-dealer on a discretionary basis, additional duties are imposed on him.[55] Furthermore, under the so-called "shingle theory" enunciated by the SEC[56] and the courts, when a broker or dealer hangs out his shingle (i.e., goes into business), he is said to make an implied representation that he will deal honestly and fairly with the public.[57] Even where a securities firm acts as principal with a customer (i.e., buying from or selling to the customer), the duties of an agent will be imposed on the firm if, by a course of conduct, it has placed itself in a position of trust and confidence as to the customer. Where a firm acts in the dual capacity of investment adviser and broker-dealer, conflicting interests necessarily arise and the customer is therefore entitled to the protections afforded by the law of agency, even though the firm engages only in principal transactions with its customers.[58]

Although the British Financial Services Act has not yet acquired a judicial gloss, it is evident from the debates and discussions leading up to its enactment that the U.K. government did not intend to repeal "long-established legal [agency] principles" that "establish a safety net for investors."[59] The U.K. government has indicated that the new statute does not alter the common-law principles of agency.

Nevertheless, it is not difficult to think of types of situations in which a strict interpretation of an agent's duty of loyalty would make it difficult if not impossible for a multi-service securities firm to pursue its normal activities. For example, when an underwriter sets the price of an offering of securities to be sold by a corporate client of the firm and bought by the firm's retail customers, it can hardly give its undivided loyalty to both the buyers and the seller but must accommodate the interests of both. To take another example, a firm that acts as a

53. SECURITIES AND INVESTMENTS BOARD, THE FINANCIAL SERVICES (CONDUCT OF BUSINESS) RULES 1987, Rule 13.04(1)(vi) [hereinafter SIB RULES]. The Securities and Investments Board adopted the rules in October 1987.

54. Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 953 (E.D. Mich. 1978).

55. *Id.*

56. In the Matter of Duker & Duker, 6 S.E.C. 386 (1939).

57. Charles Hughes & Co., Inc. v. SEC, 139 F.2d 434 (2d Cir. 1943), *cert. den.* 321 U.S. 786.

58. L. Loss, *supra* note 39, at 966. *See* Securities and Exchange Commission v. Arleen Hughes & Co., 174 F. 2d 969 (2d Cir. 1949).

59. Wolman, *City Lobby Fails to Shake Common Law Agency Rules*, Fin. Times, Dec. 16, 1985, at 7, col. 1.

market maker may have such a large position in a security that any recommendation it makes of the security to its customers is likely to be affected by that interest. On the other hand, to avoid making recommendations in securities in which the firm makes markets can create a different set of problems. As a British writer has stated, "An acute difficulty can arise where the corporate finance arm [of a multi-service firm] has price-sensitive information which the investment advisory arm must exclude from its tip sheets, with the result that the advisory arm cannot properly give sound advice."[60]

The second rule of agency law relevant to this discussion states that knowledge possessed by an agent may be deemed to be the knowledge of his principal; or in the words of the American Restatement of Agency, "the liability of a principal is affected by the knowledge of an agent concerning a matter as to which he acts within his power to bind the principal."[61] The applicability of this rule is a direct result of the fact that every securities firm (which is usually organized as a corporation or partnership) has to act through individuals, including its partners, directors, officers, and employees, who are its own agents.

For knowledge of an agent to be imputed to his principal, three conditions must be present: first, the agent must have acquired the knowledge in the course of his employment; second, the knowledge must be relevant to the transaction in respect to which the agent is employed; and third, there must be a duty on the agent to communicate the knowledge to his principal.[62] According to a British commentator, this agency rule "touches the very centre of a principal's liability for his agent's acts."[63]

Under the rule, information acquired in the course of his employment by an officer or employee in one department of a securities firm would normally be imputed to the firm.[64] For example, confidential information concerning a corporate client obtained by persons in the course of a "due diligence" investigation of the client by a firm's underwriting department is deemed to be the knowledge of the firm; the firm may therefore be liable for recommending company's securities to the firm's retail customers or trading in the securities for its own account, even though the person making the decision to recommend or trade the shares does not himself have the confidential information. As a result of the imputation of knowledge, the firm may be under an obligation to use information on behalf of one

60. WOOD, *supra* note 34, at 65.

61. RESTATEMENT (SECOND) OF AGENCY § 272 (1958).

62. G.H.L. FRIDMAN, *supra* note 37, at 310-11.

63. S.J. STOLJAR, *supra* note 31, at 84.

64. Two alternative theories have been given for this rule of agency law. The first is that, since the agent is the "alter ego" of the principal, any knowledge coming to the agent would have come to the principal if the principal had acted in person instead of using an agent. The second is that the agent is under a duty to disclose all knowledge related to the agency that he possesses, and the law conclusively presumes that he has performed this duty. *See* 2 I.F. MECHEM, at 1389–90.

client which it is under an obligation to keep confidential on behalf of another client.

These two rules of agency law—(1) the agent's duty of undivided loyalty to his principal (the firm being the agent and its customer or client being the principal), and (2) the imputation of knowledge of the agent to his principal (the officer, partner, or employee of a securities firm being the agent and the firm being the principal)—lie at the heart of the conflicts-of-interest problem of multi-service securities firms in operating their businesses. The fundamental question, to which the regulatory authorities and securities industries of the U.S. and the U.K. have responded in somewhat different ways, is how to resolve these conflicts of interest in a way that adequately protects the integrity of the markets, the customers and corporate clients of securities firms, and the business interests of the firms themselves. In both countries, the Chinese Wall has played a pivotal role in the attempt to achieve a resolution of these sometimes competing interests.

III. The Chinese Wall in the United States

It is no coincidence that the Chinese Wall made its first appearance in the U.S. at about the same time that the Securities and Exchange Commission and the federal courts were, through a series of important decisions, developing the emerging law of insider trading. In the U.S., the concept of the Chinese Wall was created as a preventive measure to control the specific problem of misuse of inside information by multi-service securities firms.

In the 1961 *Cady, Roberts* case,[65] the SEC held for the first time that it was a violation of Section 10(b) of the Securities Exchange Act of 1934[66] and SEC Rule 10b-5[67] for a corporate insider or his "tippee" to trade while in possession of non-public corporate information in an organized stock market such as the New York Stock Exchange, where buyers and sellers deal with each other in an anonymous market rather than face to face.[68] In *Cady, Roberts*, Cowdin, an employee of a brokerage firm who was also a director of a publicly held company, learned at a directors' meeting that the company was about to announce a reduction of its dividend. Cowdin passed this non-public information to Gintel, a partner of the brokerage firm, who sold shares of the company's stock out of the accounts of several customers of the firm before the news was publicly announced.

65. In the Matter of Cady, Roberts & Co., 40 S.E.C. 907 (1961).

66. 15 U.S.C. § 78j(b) (1976).

67. 17 C.F.R. § 240.10b-5 (1987).

68. It had earlier been held that Rule 10b-5 prohibited officers, directors, and majority shareholders from effecting face-to-face transactions in the company's securities while in possession of material non-public information. Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947); Speed v. Transamerica, 71 F. Supp. 457 (D. Del. 1947).

In holding that these actions constituted a violation of Rule 10b-5, the SEC formulated what has been described as the "disclose or abstain" rule. It said that corporate insiders (or persons who receive tips from corporate insiders) have a duty to

> disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclosure in these circumstances constitutes a violation of the anti-fraud provision. If, on the other hand, disclosure . . . would be improper or unrealistic under the circumstances, we believe the alternative is to forego the transaction.[69]

Of particular interest here is the defense asserted by Gintel that his fiduciary duty to his customers required him to use on behalf of the customers the insider information that he possessed. In rejecting this argument, the Commission gave little comfort to securities firms whose multiple functions place them in a conflict-of-interest situation:

> Moreover, while Gintel undoubtedly occupied a fiduciary relationship to his customer, this relationship could not justify any actions by him contrary to law. Even if we assume the existence of conflicting fiduciary obligations, there can be no doubt which is primary here. On these facts, clients may not expect of a broker the benefits of his inside information at the expense of the public generally.[70]

Thus the SEC, in the first recorded case in which insider trading in the organized securities markets was held to violate the antifraud provisions of the federal securities laws, rejected the defense that a broker's fiduciary duty to his clients required him to use on their behalf material non-public information that was in his possession.[71]

Cady, Roberts left it unclear, however, what the result would be if a customer sued his broker for a breach of fiduciary duty, where the broker did not use, on the customer's behalf, inside information which was in the broker's possession.[72]

69. 40 S.E.C. at 911.

70. 40 S.E.C. at 916.

71. The "circumstances" referred to in the *Cady, Roberts* decision which would require a person either to disclose the inside information or to forego the transaction, were those in which the insider *possessed* the information, not necessarily that the information formed the basis for the insider's transaction. This *dictum* implicitly allowed for the possibility that a firm in possession of inside information might be liable for insider trading under a common-law theory of imputed liability, even though the individual who makes the decision to trade is not aware of the inside information and has an independent basis for the decision. However, in *Dirks v. SEC*, 463 U.S. 646 (1983), the Supreme Court described the duty imposed by the SEC in *Cady, Roberts* as a "duty to refrain from trading *on* inside information." 463 U.S. at 655 (emphasis supplied), which suggests that the Court believes the test to be one of basis rather than possession.

72. In an earlier case, however, the SEC had held that, where a broker-dealer had disseminated to its customers favorable and optimistic information concerning a company with which it had an investment banking relationship, "it made itself subject to an overriding duty of disclosure to its customers." *In re* Van Alstyne, Noel & Company, 33 S.E.C. 311, 321 (1952).

A few years later, however, a California state court held that a brokerage firm and an officer of the firm who was also a director of a publicly held company had breached a fiduciary duty to a customer, where the officer withheld from the customer confidential information concerning the unfavorable financial situation of the company. The court said:

> [W]e have been given no sufficient reason for permitting a person to avoid one fiduciary obligation by accepting another which conflicts with it. . . . The officer-director's conflict in duties is the classic problem encountered by one who serves two masters. It should not be resolved by weighing the conflicting duties; it should be avoided in advance . . . or terminated when it appears.[73]

In 1968, the Second Circuit Court of Appeals in the *Texas Gulf Sulphur* case[74] adopted the "disclose or abstain rule" of *Cady, Roberts*. As a result of this well-publicized decision by a prestigious federal court, the American securities industry and securities bar were made aware—if indeed the SEC's *Cady, Roberts* decision had not already made them aware—that insider trading in the organized securities markets violated the securities laws.

Shortly after the *Texas Gulf Sulphur* decision, the Chinese Wall made its first appearance in American securities law. This was in the *Merrill Lynch* case,[75] one of several decisions concerning insider trading and corporate disclosure resulting from a notorious episode that had occurred in 1966.[76] Merrill Lynch ("Merrill") was the managing underwriter for a proposed offering by Douglas Aircraft Co., Inc. ("Douglas") of convertible debentures, for which a registration statement had been filed with the SEC on June 7,1966, but which had not yet become effective. Ten days after the filing, Douglas informed Merrill's underwriting department that, owing to production problems, Douglas had substantially reduced its previous estimates of earnings for its 1966 and 1967 fiscal years. This negative information had not yet been publicly announced. The firm's underwriting department, however, disclosed the information to persons in its institutional sales department, who disclosed it to several of Merrill's institutional and other large customers. These customers immediately sold Douglas shares from their existing positions and effected short sales of the stock. At the same time, however, Merrill did not disclose the information to certain other customers for whom it was concurrently making purchases of Douglas stock.[77]

73. Black v. Shearson Hammill & Co., 72 Cal. Rptr. 157, 161 (1968).

74. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. den. sub nom.* Coates v. Securities and Exchange Commission, 394 U.S. 976.

75. *In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933 (1968) (Securities and Exchange Commission accepted an offer of settlement made by Merrill Lynch).

76. *See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514 (10th Cir. 1973), *cert. den.* 414 U.S. 874 (1973); *In re* Investors Management Co., [1970–1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,163 (July 29, 1971).

77. 3 S.E.C. at 935.

The SEC brought an administrative action against Merrill for violation of Rule 10b-5, which was settled by Merrill without admitting the SEC's allegations. As part of the settlement, Merrill agreed "to adopt, implement, and ensure compliance with, revised procedures to provide more effective protection against disclosure of confidential information. . . ."[78] These procedures included the establishment of a Chinese Wall. Merrill adopted a Statement of Policy which

> prohibits disclosure by any member of the Underwriting Division of material information obtained from a corporation in connection with the consideration or negotiation of a public or private offering of its securities and not disclosed to the investing public by the corporation, except to senior executives of registrant, its legal department, persons directly involved with the underwriters in connection with the proposed offering, Research Division personnel whose views in connection with the proposed offering are sought bythe Underwriting Division, and members of the buying department of prospective co-underwriters for the purpose of enabling them to decide whether they will participate in the proposed offering. Any employee of [Merrill] who receives such information is subject to the same restrictions as provided for members of the Underwriting Division.[79]

The SEC made it clear in its opinion that its only purpose in requiring Merrill to establish a Chinese Wall between its Underwriting Division and other departments of the firm was to reduce the possibility that there would be further insider-trading violations. The purpose of the wall was to be *practical* and *prophylactic*: to prevent material non-public information from being disseminated within the firm except on a "need to know" basis. The opinion does not contain even a hint that the Commission intended the Chinese Wall to have any *legal* effect, *i.e.*, to provide the firm with a defense in the event that its officers or employees traded in a security concerning which the firm possessed inside information, or that the firm breached a fiduciary duty that it owed to its clients.

Furthermore, the SEC expressed some doubt as to the efficacy of the Chinese Wall even for the limited, though clearly important, purpose for which it was to be established:

> As a matter of Commission policy, we do not, and indeed cannot, determine in advance that the Statement of Policy will prove adequate in all circumstances that may arise. Stringent measures will be required in order to avoid future violations. Obviously the prompt public dissemination of material information would be an effective preventive, and [Merrill] has stated that it will use its best efforts to have the issuer make public any material information given to its Underwriting Division.[80]

It was not long, however, before a broker-dealer attempted to use its Chinese Wall as a legal defense. In *Slade v. Shearson, Hammill & Co.*,[81] Shearson had

78. *Id.* at 938.

79. *Id.* (citation omitted).

80. *Id.*

81. Slade v. Shearson, Hammill & Co., [1973–1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,329 (S.D.N.Y. Jan. 2, 1974).

received negative non-public information concerning an investment banking client, Tidal Marine International Corporation, at a time when Shearson's retail salesmen were soliciting customers to buy Tidal Marine shares. The firm did not disclose this information to the customers but permitted recommendations of the stock to continue. A retail customer who claimed to have bought Tidal Marine shares on the recommendation of a saleman of the firm at a time when the firm already possessed the negative information brought suit against Shearson, on the grounds that the continued recommendation of the stock when the firm was in possession of this knowledge was a breach of the firm's fiduciary duty of loyalty to its customers. The firm's defense was that its Chinese Wall prevented communication of the information to its retail brokerage department. The underlying basis for this defense was that, because of the Chinese Wall, the non-public information in the possession of the firm's investment banking department should not be imputed to the firm, and that the firm therefore did not breach its duty of loyalty to its retail customers.

Although the district court recognized that Shearson's conflict of interest could make it "exceedingly difficult for any [brokerage firm] to function as an investment banker for a company and at the same time function as a broker-dealer in that company's securities . . . ,"[82] the court nevertheless rejected the Chinese Wall defense and denied Shearson's motion to dismiss the suit. The court said:

> It must be remembered . . . that Shearson voluntarily entered into a fiduciary relationship with Tidal Marine, as a consequence of which it received confidential information. Shearson also voluntarily entered into fiduciary relationships with its customers. It cannot recognize its duty to the former while ignoring its obligation to the latter. Having assumed fiduciary responsibilities, Shearson is required to incur whatever commercial disadvantage fulfillment of those obligations entails.[83]

The district court certified a question[84] to the Second Circuit, which, however, remanded the case for additional fact finding[85] without responding to the ques-

82. Slade v. Shearson, Hammill & Co., [1973–1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,439, at 95,532 (S.D.N.Y. Mar. 18, 1974).

83. Slade v. Shearson, Hammill & Co., [1973–1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,329, at 95,132 (S.D.N.Y. Jan. 2., 1974).

84. The certified question was:

> Is an investment banker/securities broker who receives adverse material non-public information about an investment banking client precluded from soliciting customers for that client's securities on the basis of public information which (because of its possession of inside information) it knows to be false or misleading?

[1973–1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,439, at 95,531 (S.D.N.Y. Mar. 18, 1974).

85. Among the facts that the Second Circuit said required clarification was the truth of Shearson's claim that it had an effective Chinese Wall. The court said:

> [W]hile Shearson claims that there was a solid 'Chinese Wall,' that is to say, an effective separation of its two departments, . . . the [plaintiffs] claim that in this case there was no effective separation of departments, and that misleading favorable information was given the

tion. The case was then settled before further proceedings could be held, so the district court's decision remained standing as the most authoritative statement of the law on the subject.[86]

The solution that much of the American securities industry has found to the dilemma posed by the *Slade* case evolved from the views expressed by the SEC in its *amicus curiae* brief to the Second Circuit.[87] In its brief, the Commission stated that the case involved two important principles: first, that material inside information should not be used in the market; and, second, that brokers must treat their customers fairly. The Commission believed that these principles may and should be reconciled without impairing the function of the securities industry.[88] Consistent with the position it had taken in *Cady, Roberts*, the Commission recognized that a securities firm should not be permitted to make recommendations to customers on the basis of inside information which it might have received as a result of its investment banking or underwriting activities. Conversely, the S.E.C. stated that when a broker recommends a security he is required by the antifraud provisions of the securities laws to have "an adequate and reasonable basis for such recommendation," and that he "implies that a reasonable investigation has been made and that his recommendation rests on the conclusion based on such investigation."[89] Therefore, a firm is prohibited from making recommendations that are contrary to material information known to, or reasonably ascertainable by, it.[90]

Thus, the SEC, while encouraging the use of Chinese Walls, was unwilling to permit the existence of a Chinese Wall to contravene the common-law imputation to a multi-service firm of inside information possessed by its underwriting or investment banking department. In order to avoid making the recommendation of a security concerning which the firm has contrary inside information, the SEC suggested that, in addition to a Chinese Wall, firms employ a "restricted list" of securities as to which they may have material inside information. Nobody at the firm would be permitted to make recommendations or initiate transactions for discretionary accounts with respect to any security on the list. The SEC recognized that the firm's action in placing a security on a restricted list (particularly when the effect of the action was to withdraw an outstanding recommendation)

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retail sales department by the investment banking department, possibly to protect Shearson's position as the principal market maker for Tidal's stock.

Slade v. Shearson, Hammill & Co., 517 F.2d 398, 402 (2d. Cir. 1974).

86. For an exhaustive and extremely interesting discussion of the *Slade* case, see Lipton & Mazur, *The Chinese Wall Solution to the Conflict Problems of Securities Firms*, 50 N.Y.U. L. REV. 459, 478–487 (1975).

87. Slade v. Shearson, Hammill & Co., Inc., 517 F.2d 398, SEC *Amicus Curiae* Brief, at 20.

88. *Id.* at 4–5.

89. *Id.* at 7 (citing Hanly v. Securities & Exchange Commisssion, 415 F.2d 589, 597 (2d Cir. 1969)).

90. *Id.* at 6–7. *See also* Lipton & Mazur, *supra* note 86, at 486.

might tip off customers that the firm had inside information. The agency suggested that this problem would be avoided by placing a security on the list

> at the time the firm enters into an underwriting or other financing involvement likely to result in the receipt of inside information—*i.e.*, before such information has actually been received. If a firm adopts a general policy of withdrawing any outstanding recommendations when such a relationship arises and making no further recommendations (or permitting such recommendations by its salesmen) while the relationship continues, and if this policy is known to both its salesmen and its customers, it should then be possible for the firm to withdraw a recommendation without creating any inference that inside information has been received or as to the nature of any such information.[91]

The SEC also stated that the best way of avoiding problems in this area was through prompt public disclosure of inside information. The use of a Chinese Wall, combined with a restricted list, has been prevalent among U.S. securities firms since the time of the *Slade* case.[92]

A Chinese Wall, then, was an accepted means of preventing the misuse of inside information; but neither any American court nor the SEC had provided any reason for believing that erecting a wall would relieve a firm of any legal liability it would otherwise have in the absence of a wall, or prevent the imputing to the firm of information possessed by one of its departments. In 1980, however, with its adoption of Rule 14e-3,[93] the SEC for the first time allowed the establishment of a Chinese Wall to be the basis for a defense, not against a common-law claim of breach of fiduciary duty but only against a claim of a violation of the new rule.

Rule 14e-3 makes it illegal for a person who has acquired material non-public information about a pending tender offer from the offeror or the target company to trade in the target company's securities. The rule, however, exempts a firm from this prohibition if (1) the individual making the investment decision for the firm does not know the information, and (2) the firm has

> implemented . . . policies and procedures, reasonable under the circumstances, taking into consideration the nature of the [firm's] business, to ensure that individual(s) making investment decision(s) would not violate [the prohibition against trading], which policies and procedures may include, but are not limited to, (i) those which restrict any purchase, sale and causing any purchase and sale of any such security or (ii) those which prevent such individual(s) from knowing such information.[94]

91. SEC *Amicus Curiae* Brief, *supra* note 87, at 12. *See also* Poser, *Special Report: SEC Offers "Pragmatic Solution" for Brokers in Conflict of Interest Situations*, SEC. REG. AND TRANSFER REP., Apr. 11, 1975, at 4–5.

92. *See* Weiss & Spolan, *Preventing Insider Trading*, 19 REV. OF SEC. & COMMODITIES REG. 233, 237-39 (1986).

93. 17 C.F.R. § 240.14e–3 (1987).

94. 17 C.F.R. § 240.14e–3(b)(2) (1987).

This exception appears to relieve a firm[95] from liability under the rule if the individual making the investment decision does not actually know the non-public information *and* the firm has established a combination of reasonable procedures, one of which may be a Chinese Wall, to prevent the decision-maker from acquiring the information. In its release announcing adoption of the rule, the SEC stated that "[t]he abuse at which Rule 14e-3(a) is directed is actual misuse of material, nonpublic information in connection with a sale or purchase;"[96] and that, in a situation where one department of a multi-service firm receives the information, "it could be said that the [firm] was in possession of the information," but that there would not be any "actual misuse" by the firm if the individual making the investment decision did not have the information.[97]

Although Rule 14e-3 seems to provide a firm that has a Chinese Wall with a defense against liability, it is a very limited defense. First, the establishment of a Chinese Wall alone may not be "reasonable under the circumstances" to prevent the misuse of inside information, and it may be necessary to supplement the wall with other procedures, including but not limited to a restricted list or "watch list."[98]

Second, the SEC apparently takes the position that the existence of a Chinese Wall does not provide a defense against a claim by a customer that the firm has recommended a security at a time when it had information in its possession that was contrary to the recommendation. Such a claim might be based on a violation of the antifraud rules or on a breach of fiduciary duty. In a highly significant sentence in its adoption release, the Commission stated, "[d]epending on the circumstances, it may be appropriate to advise customers of its use of the Chinese Wall, because the institution would not be using all information that it had received to the benefit of a particular customer."[99]

The SEC thus seems to be saying that, despite the existence of a Chinese Wall, the firm may be subject to liability to a customer unless it discloses to the customer that the firm may be in possession of information that it is not using on the customer's behalf—and, presumably, the customer consents. If this is a correct interpretation of the release, the exception does not provide the firm with a defense from the rules of agency law which state that (1) *unless otherwise*

95. The rule provides that the exception is available for "a person other than a natural person," 17 C.F.R. § 240.14e-3(b), presumably including entities other than broker-dealer firms.

96. Tender Offer Fraud Rule, Securities Act Release No. 6239, Exchange Act Release No. 17,120, [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,646, at 83,459-60 (Sept. 4, 1980) [hereinafter Release on Tender Offers].

97. *Id.* at 83,460. The SEC Release stated that the exception was designed to "provide flexibility to each institution to tailor its policies and procedures to fit its own situation." *Id.* at 83,461.

98. A "watch list" is a procedure for monitoring trading activity to determine whether any leaks in the Chinese Wall have occurred. *Id.*

99. *Id.*

agreed, an agent must act for the exclusive benefit of his principal,[100] and (2) information acquired by an agent in the course of his agency will be imputed to his principal.[101]

Third, the SEC stated that, despite the Chinese-Wall exception, a broker-dealer firm may not trade for its own account, such as arbitrage or other proprietary activities, when it possesses material nonpublic information relating to a tender offer.[102] The clear implication of this statement is that, although a Chinese Wall may provide some protection to a firm in connection with its activities on behalf of customers, it will not provide protection in connection with the firm's own trading activities.

The concept of the Chinese Wall has also received legislative approval in the U.S. under the provisions of the Insider Trading Sanctions Act of 1984 ("ITSA").[103] This statute permits the SEC to recover, from a person who buys or sells securities while in possession of material nonpublic information, a penalty of up to three times the profits gained or loss avoided as a result of the insider trading. ITSA also provides, however, that:

> No person shall be subject to a sanction under [ITSA] solely because that person aided and abetted a transaction . . . in a manner other than by communicating material nonpublic information. Section 20(a)[104] . . . shall not apply to an action brought under [ITSA]. No person shall be liable under [ITSA] solely by reason of employing another person who is liable under [ITSA].[105]

While this limiting language does not expressly create a Chinese Wall defense, it does make clear that Congress wished to avoid imposing vicarious liability under ITSA. Furthermore, the legislative history of ITSA indicates that Congress expected the SEC to use its rulemaking power to provide a Chinese Wall defense similar to that contained in Rule 14e-3. The House of Representatives committee that reported out the legislation stated:

> The Committee . . . believes that there should be certain limits on the liability of a multiservice firm, such as a broker-dealer or insurance company, where one employee possesses information but another employee, not knowing of the information, trades for the firm's account before the information is made public. Under both existing law and the bill, such a firm with an effective "Chinese Wall" would not be liable for trades effected on one side of the wall, notwithstanding inside information possessed by firm employees on the other side.[106]

100. RESTATEMENT (SECOND) OF AGENCY §§ 387, 394 (1958); *see also supra* notes 37-38 and accompanying text.

101. RESTATEMENT (SECOND) OF AGENCY § 268 (1958); *id.* Ch. 8, Introductory Note.

102. Release on Tender Offers, *supra* note 96, at 83,462 n. 46.

103. 15 U.S.C. § 78u(d)(2) (Cum. Supp. 1987).

104. Section 20(a) of the Securities Exchange Act of 1934 provides for "Liabilities of controlling persons." 15 U.S.C. § 78t(a) (1983).

105. 15 U.S.C. § 78u(d)(2)(B) (Cum. Supp. 1987).

106. H.R. REP. NO. 355, 98th Cong., 1st Sess. 11 (1983).

In view of the *Slade* decision and the careful limitations to the Chinese-Wall exception prescribed by the SEC in its adoption release for Rule 14e-3, it is difficult to understand how the House committee came to the conclusion that under existing law a Chinese Wall would protect a firm from liability as a result of its trading for its own account. Nevertheless, the language quoted above provides evidence of the degree of regulatory acceptance that the Chinese Wall has achieved.

The most recent indication of such acceptance was the approval by the SEC in late 1986 of new rules of the New York Stock Exchange ("NYSE") and the American Stock Exchange ("Amex") governing the market activities of securities firms having a specialist firm as an affiliate.[107] In this instance, as in the *Merrill Lynch* case, the purpose of erecting a Chinese Wall is to prevent insider trading, not to protect multi-service firms from liability for breaches of fiduciary duty.

Specialists are exchange members who receive an exclusive franchise from the respective exchanges to make markets in particular listed securities. Limit-price orders[108] of investors to buy and sell securities are entrusted to specialists, and specialists are not permitted to disclose the contents of the "book" of these orders to others.[109] Specialists are therefore uniquely privy to information as to the potential buying and selling interest in their "specialty" securities. Because specialists have this privileged position in the market, special restrictions have been placed upon them. Under NYSE rules in effect until recently, persons affiliated with specialists were not permitted (1) to trade in specialty securities; (2) to trade in options on specialty securities (other than for hedging purposes); (3) to accept orders in such securities from institutional investors, the issuer of the securities, or insiders of the issuer; (4) to perform research or advisory services with respect to such securities; (5) to recommend such securities to its customers; or (6) to engage in business transactions with the issuer.[110]

These restrictions made it unattractive for a multi-service securities firm to become affiliated with a specialist, since the affiliated firm would as a practical matter be foreclosed from engaging in most of its normal activities insofar as specialty securities are concerned. The new NYSE and Amex rules repeal the

107. Securities Exchange Act Release No. 23,768, 51 Fed. Reg. 41,183 (Nov. 13, 1986) [hereinafter Specialist Release].

108. "If the investor does not wish to execute at the market price, he may enter his own bid or offer to buy or sell at a particular price. This is known as a 'limit' order." SEC SPECIAL STUDY, *supra* note 15 pt 2, at 41.

109. 15 U.S.C. § 78k(b) (1983). That section provides:

> It shall be unlawful for a specialist or an official of the exchange to disclose information in regard to orders placed with such specialist which is not available to all members of the exchange, to any person other an an official of the exchange, a representative of the Commission, or a specialist who may be acting for such specialist . . . .

110. Specialist Release, *supra* note 107, at 41,183–84. *See* N.Y.S.E. Rule 113, *in* 2 N.Y.S.E. GUIDE (CCH) ¶ 2113 (1985)[hereinafter cited as N.Y.S.E. RULES].

restrictions, on the condition that any firm affiliated with a specialist firm erect a Chinese Wall between itself and the specialist firm. In approving the rules, the SEC noted they will have the potential to "increase the capitalization of exchange specialist units and therefore [to] improve the depth and liquidity of specialist market making activity. . . ."[111] Nevertheless, "significant conflicts of interest can arise," particularly in view of the ongoing relationship between the specialist and its affiliated firm and the "strong incentives of affiliated specialists to exploit their time, place, and informational advantages."[112] The Commission concluded that the Chinese Wall procedures proposed by the two stock exchanges "effectively address the potential for market abuses resulting from this ongoing relationship."[113]

According to the SEC, the Chinese Wall procedures proposed by the NYSE and Amex are aimed at ensuring (1) the confidentiality of the specialist's "book" of limit-price orders; (2) that the affiliated firm can have no influence on specific specialist trading decisions; (3) that material, non-public information obtained by the affiliated firm is not made available to the specialist; and (4) that clearing and margin financing information regarding the specialist is routed only to employees engaged in such work and in appropriate supervisory employees. The SEC also emphasized the importance of surveillance procedures "to ensure that the Wall is maintained."[114]

The Commission's approval of these Chinese Wall procedures as a means of avoiding the dangers of abuse inherent in the special conflicts of interest of a securities firm having a specialist affiliate is consistent with the agency's original endorsement of a Chinese Wall in the *Merrill Lynch* case.[115] In both situations, recognizing the potential benefits to the markets of joining various functions under one corporate roof, the SEC endorsed a Chinese Wall as a pragmatic solution to these dangers. Thus, after nearly two decades of experience with Chinese Walls, the American securities industry has adopted the Chinese Wall as a measure to prevent insider trading; but the wall has only limited usefulness as a legal defense under American law.

IV. The Chinese Wall in the United Kingdom

A. *Big Bang and the Single Capacity System*

Big Bang was a set of measures that deregulated the London Stock Exchange ("LSE"). It eliminated fixed rates of commission, lifted restrictions on access to

111. Specialist Release, *supra* note 107, at 41,184.
112. Specialist Release, *supra* note 107, at 41,186.
113. *Id.* at 41,187.
114. *Id.*
115. *See supra* text accompanying notes 67–72.

stock exchange membership, and abolished the single capacity system. In this sense, it can be regarded as a catching-up with—and a competitive reaction to — somewhat similar developments that occurred a decade earlier in the United States.[116]

Big Bang has helped transform the securities industry in London from a collection of small, specialized firms into an industry dominated by large multi-function entities, many of which are branches of banks or other financial groups based either in the U.K. or in other countries. Big Bang also has been accompanied by a technological revolution: advances in data processing and communications technology have enabled the LSE to be the first major stock exchange to give up the traditional arrangements of a trading floor in favor of an electronic trading system. As an integral part of Big Bang, work is in progress to replace the LSE's existing system of clearing and settlement of transactions with a highly automated system in which transfers will be effected solely by book entry.[117]

Big Bang was also an important step in the internationalization of the world's securities markets. The principal motivation behind the changes has been to assure London a place as one of the world's major financial centers, and possibly eventually to make it the most important market for securities of international interest.[118] Although the influx of foreign banks and brokers as major participants in the London markets began in the 1960s with the inception of the Eurobond market,[119] this process has been greatly accelerated by Big Bang.

Under the single capacity system that existed on the LSE until Big Bang, every stock exchange member or member firm could be either a "jobber" (*i.e.*, dealer), who traded only for his own account and did not deal directly with members of the public; or a broker, who traded only for the account of his customers and dealt only with jobbers; but he could not be both. The single capacity system had been in force at least since 1847, when the stock exchange's rulebook banned partnerships between brokers and dealers as being "highly inexpedient and im-

116. Fixed commission rates on stock exchange transactions were eliminated and stock exchange membership was opened to all qualified broker-dealers in the United States in 1975. 15 U.S.C. § 78f(c), (e) (1983).

117. The introduction of the new system, known as "Taurus" (Transfer and Automated Registration of Uncertificated Stock), is unlikely before the end of 1989. Meanwhile, as a result of unprecedented volume of activity following Big Bang, the number of unsettled transactions created a major crisis in the back offices of LSE member firms. Wolman, *The UK Settlements Crisis: Out of Shape for the Paper Chase*, Fin. Times, Aug. 14, 1987, at 12, col. 3.

118. According to one source, the motivation behind the changes was provided by "a complex interplay between two main factors: (a) the Bank of England and the Thatcher administration's desire to strengthen the City and British financial institutions, and (b) the desire of the Stock Exchange to survive the winds of change that are now blowing in the world of finance." NOMURA RESEARCH INSTITUTE, THE WORLD ECONOMY AND FINANCIAL MARKETS IN 1995 61 (1986) [hereinafter THE WORLD ECONOMY].

119. Curtin, *Now It's Grown Up, It's Fierce*, EUROMONEY, June, 1984, at 64, 65.

proper."[120] It was made fully explicit in 1908, when a revised rule provided that, with the exception of arbitrage outside the United Kingdom, "all members must declare whether they were brokers or jobbers, and might only change with the consent of the Committee [for General Purposes]; that brokers might not make prices and might not deal with non-members unless by so doing they could get better terms for their principal; and that jobbers might not deal with non-members."[121] Although exceptions were made to the single capacity rule, and enforcement of it was not always consistent, the rule remained in effect until October 1986.

Single capacity had the great advantage of preventing many conflicts of interest from arising. To take perhaps the most obvious example, a customer to whom a broker made a recommendation to buy a security did not have to be concerned that the broker's motive might be to unload his own position in the same security. Nevertheless, the system also had severe disadvantages, which became increasingly apparent as the world's securities markets became more internationalized. Because single capacity prevented member firms from engaging in a variety of businesses, it prevented London Stock Exchange members from acquiring capital and thus from competing effectively with large foreign investment firms.[122] Single capacity also prevented securities firms from diversifying their business risks and from achieving economies of scale.

During the 1960s and 1970s, the London markets had been essentially cut off from foreign securities markets by exchange controls, which had been imposed by the U.K. government after World War II. London brokers and jobbers, protected by membership restrictions and fixed commission rates, lived comfortably off the limited domestic market for equities and government bonds (known as gilt-edged securities or gilts).[123] Meanwhile, beginning in the early 1960s, London had become the chief location of the Eurobond market, an enormous market for debt securities which are sold and traded outside the domicile country of the issuer and are denominated in a currency other than that of the issuer's domicile.[124] The attraction of this market, in which London Stock Exchange jobbers and brokers did not participate to any appreciable degree, led large foreign banks and securities firms to establish offices in London in order to

120. E.V. MORGAN & W.A. THOMAS, THE STOCK EXCHANGE, ITS HISTORY AND FUNCTIONS 145 (1962).

121. *Id.* at 146.

122. In recent years the single capacity system was not characterized by competition among jobbing firms. By October 1986, there were only 13 jobbers in shares on the LSE, and all but five of these firms were relatively small. Ingram, *Change in the Stock Exchange and Regulation of the City*, 27 BANK OF ENGLAND Q. BULL. 54, 58 (1987).

123. *See* F. Welsh, UNEASY CITY 139–41 (1986).

124. *See also* J. PLENDER & P. WALLACE, THE SQUARE MILE 44 (1985).

participate in it. There was little connection, however, between this international market and the much smaller domestic U.K. market.[125]

In 1979 the Thatcher government abolished exchange controls, thus enabling U.K. institutional investors to buy foreign securities. In servicing these investors, LSE members were at a disadvantage to foreign firms that were not subject to the exchange's membership and trading restrictions and were in a position to service these customers in New York or in their own London offices. Furthermore, the single capacity system, by restricting the activities of member firms, prevented them from acquiring the capital to compete successfully with foreign financial conglomerates. Eurobond firms had invested large amounts of capital in new equity trading desks in London to deal in the top 500 international stocks, including large-capitalization U.K. companies. A substantial amount of the trading in these issues (either shares or ADRs) was also being done in New York by U.S. securities firms. Thus, the London Stock Exchange was threatened with the loss of the markets in the shares of major British companies, which comprised the major part of its trading volume in equities.[126]

Thus, by the early 1980s, strong competitive pressures were mounting to deregulate the LSE. To these pressures were added both the influential voice of the Bank of England, which saw deregulation as a means of enhancing the competitiveness of London as an international financial center; and a lawsuit which had been brought against the exchange in 1977 by the Office of Fair Trading, charging that fixed commission rates were illegal under the Restrictive Practices Act. In July 1983, the Secretary of State for Trade and Industry and the London Stock Exchange came to an agreement, under which the government agreed to drop the suit and the exchange agreed to abolish fixed commission rates by the end of 1986.

It quickly became apparent to the exchange that the single capacity system could not survive the abolition of fixed commission rates. The reasoning, which the LSE described as the "link argument," involves several steps. Negotiated rates would put brokers under pressure to reduce their charges in order to stay competitive. With reduced charges, brokers would have to increase their market share or lose income (assuming that total turnover did not increase), and they would try to match their customers' orders, giving less business to jobbers.[127] Where it was impossible to match customers' orders, brokers would seek to act as principal with customers, not charging any commission and trading at "net" prices. Ultimately, there would be pressure for brokers to merge with jobbers, merchant banks, and other financial institutions, in order to acquire more capital and specialized trading skills. Meanwhile, since jobbers would no longer handle

125. *See* THE WORLD ECONOMY, *supra* note 118, at 54 (1986).

126. The other major business in equities on the London Stock Exchange was trading in gilts. *See* Jackson, *Change in the Stock Exchange and Regulation of the City*, 25 BANK OF ENGLAND Q. BULL. 544, 544–45 (Dec. 1985).

127. *See* J. PLENDER & P. WALLACE, *supra* note 124, at 97-98.

all the stock exchange business, their profit margins and ability to make two-way markets in depth would suffer. As a result, jobbers would seek direct access to customers, which stock exchange rules had heretofore denied them.

The London Stock Exchange and the Bank of England had an additional reason to support abolition of the single capacity system. Foreign competition, particularly in stocks of large U.K. companies, was making inroads into the exchange's business. As they saw it, if the exchange did not eliminate its restrictive practices, it ran a risk of becoming a financial backwater, limited to providing markets in small issues of local interest only. An essential part of the deregulatory program, therefore, was to allow foreign firms to participate in the London market. Without the participation of major foreign financial institutions, it would be impossible for London to function as an international financial center.[128]

In 1984, the exchange changed its rules to permit outsiders, including foreign financial institutions, to own up to 29.9% of member firms, and the following year the exchange membership approved a rule change that, beginning in March 1986, permitted member firms to be organized as limited-liability companies and permitted outsiders to own 100% of their shares. With regard to the question of single capacity, the exchange stated:

> [I]f foreign brokerage houses and other financial institutions are to be encouraged to become Members of The Stock Exchange in order centralise dealings in securities in the UK, the dealing system must be attractive to them. The unique features of the jobbing system and the constraints it places on dealing practices would be unlikely to prove attractive to brokerage firms which had not grown up with such a system. . . . Competition from such firms, operating outside The Stock Exchange, has led Member Firms, particularly those dealing in internationally traded UK equities, to feel that in order to compete effectively, they must be permitted to act in dual capacity here as they have been in overseas securities. . . . There is growing recognition and acceptance of the fact that if The Stock Exchange is to play a significant role in the international securities market our dealing practices must be reconciled with most of the rest of the world.[129]

As a result of these considerations, the exchange decided to abandon the single capacity system and to introduce a new trading system based on the "NASDAQ" system used in the U.S. over-the-counter market, in which competing market makers, who could act in the dual capacity of broker and dealer, would publish price quotations for securities over an electronic system, to be known as "SEAQ". The exchange converted to the new trading system on the same day fixed commission rates were abolished, October 27, 1986, the date of Big Bang. The new system permitted market makers to operate either on the exchange floor, with trading being effected by open outcry, or in their own offices, through the

128. *See* THE WORLD ECONOMY, *supra* note 118, at 62 (1986).

129. *The Choice of a New Dealing System for Equities*, LONDON STOCK EXCHANGE REPORT, July 17, 1984, at 3–4.

use of telephone or telex communications. The exchange floor was very quickly abandoned, and within a few weeks after Big Bang all trading on the floor in equities ceased. The LSE thus became the world's first major stock exchange to abandon the traditional exchange-floor arrangements that had existed since stock exchanges first appeared in the seventeenth century.

In anticipation of Big Bang, commercial and investment banks from the U.S., the U.K., and the rest of Europe entered into a frenzied rush to acquire member firms of the LSE. By February 1987, 15 jobbers and 90 brokers, or slightly over half of the 200 member firms, had become part of larger groupings. The acquirers, some of which took control of more than one member firm, included 14 U.K. banks, 16 other U.K. financial institutions, 12 European banks, 4 U.S. commercial banks, and 3 U.S. investment banks.[130] The securities industry that emerged from this wholesale conglomeration was dominated by giant financial institutions, such as Citicorp (U.S.), Credit Suisse First Boston (U.S. and Switzerland), National Westminster Bank (U.K.), and Union Bank of Switzerland, which combined numerous functions, including commercial and investment banking, fund management, market making, stock brokerage, under the roof of a single corporate grouping. While the new membership of the London Stock Exchange presented a powerful competitive challenge to other European financial centers, and even to New York and Tokyo, the potential conflicts of interest which were now created were virtually limitless. It was believed by many persons in the securities business and by at least some persons in government that these conflicts of interest would make it impossible for the new multi-service firms to function under existing rules of agency law.

B. The Chinese Wall and the Financial Services Act 1986

The Financial Services Act, enacted a few days after Big Bang, and the Conduct of Business Rules adopted by the Securities and Investments Board Limited ("SIB") under the Act,[131] make liberal use of the Chinese Wall.[132] The reliance in the U.K. on the Chinese Wall as a means of protecting investment firms from the possible legal consequences of conflicts of interest in the post-Big Bang era goes well beyond anything of a comparable nature in the U.S. As described above, although the use of a Chinese Wall was first proposed in the

130. Ingram, *supra* note 122, at 55.

131. The Securities and Investments Board is a private limited company whose board of directors is appointed by the Secretary of State for Trade and Industry and the Governor of the Bank of England. The Financial Services Act 1986 grants the Secretary of State the power to transfer his regulatory functions under the Act, other than those which may affect the U.K.'s international obligations or involve certain policy discretion, to the SIB. Financial Services Act 1986, ch. 60, §§ 114–18. *See* Barnard, *The United Kingdom Financial Services Act, 1986: A New Regulatory Framework*, 21 INT'L LAW. 343, 345 (1987).

132. *See supra* note 53.

U.S., the American courts have refused to allow the Chinese Wall as a legal defense against charges of breach of fiduciary duty. Furthermore, American securities legislation and SEC rules relating to insider trading have permitted the defense only under limited circumstances. In the U.K., on the other hand, the defense is explicitly provided for in the new statute and in several rules governing the business conduct of investment firms.

The Chinese Wall had found its way into the rulebook even before Big Bang, in a provision which relieved a securities dealer of his duty under the Licensed Dealer Rules[133] to disclose conflicts of interest to its customers. The Rules, which were adopted by the Department of Trade and Industry ("DTI") in 1983, to govern the conduct of non-exempt securities dealers, required that a licensed dealer who had "a material interest in a transaction relating to investments . . . shall, . . . before he effects the transaction with or for a client, notify the client of the nature and extent of that material interest."[134] The rules provided, however, that this requirement did not apply where

> the part of the business dealing with the client concerned is divided by a Chinese Wall from the part of the business in which the interest arises and it is reasonable to assume that no individual who is involved in the transaction on behalf of the licensed dealer, whether directly or indirectly, is aware of the interest in question . . . .[135]

The framers of the Financial Services Act approached the problem of conflicts of interest with a certain degree of ambivalence. In 1981, Professor L.C.B. Gower, an authority on British company (*i.e.*, corporate) law, had been retained by the Department of Trade and Industry to review the then-existing statutory protection of investors and to advise on the need for new legislation.[136] In his 1984 report,[137] Professor Gower expressed skepticism as to the advisability of allowing the Chinese Wall defense. Professor Gower stated that the object of rules of conduct should be to provide the essential minimum protection to investors in relation to such matters as conflicts of interest, and that preeminent among the specific rules that should be adopted—and effectively monitored and enforced—are rules "providing for full and frank disclosure in circumstances

133. THE LICENSED DEALER (CONDUCT OF BUSINESS) RULES 1983 [hereinafter DEALER RULES]. These rules were repealed in 1986. Financial Services Act 1986, ch. 60, Sched. 17.

134. Members of the LSE or of a recognized association of securities dealers (often associations of foreign stock exchange members who engage in business in the U.K.) were exempted from the licensing requirement of the Rules. L.C.B. GOWER, REVIEW OF INVESTOR PROTECTION: A DISCUSSION DOCUMENT 14 (1982).

135. DEALER RULES, *supra* note 133, § 8. The Rules defined "Chinese Wall" as "an established arrangement whereby information known to persons involved in one part of a business is not available (directly or indirectly) to those involved in another part of the business and it is accepted that in each of the parts of the business so divided decisions will be taken without reference to any interest which any other part of any person in any such part of the business may have in the matter." *Id.* § 2(c)(8).

136. L.C.B. GOWER, *supra* note 134, at 1.

137. L.C.B. GOWER, REVIEW OF INVESTOR PROTECTION (REPORT: PART I) (1984).

where there is a conflict of interests or of interest and duty." He added, "[s]uch conflicts are . . . aggravated by the increasing tendency for awide range of . . . services to be provided by a single firm or group. The wider the range the greater the risk of conflicts *which cannot be wholly avoided by erecting 'Chinese Walls.'*[138] Professor Gower concluded that any rules of conduct should be subject to "basic principles of law," including the rule "that an agent cannot act as a principal unless there is full disclosure to, and informed consent by, the client. . . ."[139]

The DTI, in a 1985 "White Paper" that laid out the government's plans to regulate the securities markets,[140] echoed Professor Gower's reluctance to endorse Chinese Walls, stating that it was not convinced "that total reliance can be placed on Chinese Walls because they restrict flows of information and not the conflicts of interest themselves."[141]

Three differing views contended with each other in the lobbying and the Parliamentary debate over the new legislation. The first view was that of the opposition Labor Party, which, applying traditional agency-law concepts, "rejected the idea of Chinese Walls and thought that firms should be prevented from acting in a situation where there was a potential conflict."[142] The second view was that of the lobbyists for the large clearing and merchant banks,[143] who asked the Government for a special exemption from the common-law rules of agency, on the grounds that these rules would prevent them from operating effectively in the securities markets.[144]

A third view, which took an apparent middle ground, was the one that prevailed in the legislation that was enacted. This was the position of the Government, which rejected the view that the common law of agency should be ousted, believing instead that these long-established legal principles gave valuable protections to investors. Instead, the Financial Services Act would "provide a framework in which those principles may be fleshed out and made easier to enforce in a rapidly changing financial environment."[145] At the same time, with the abolition of the single-capacity system, Chinese Walls seemed desirable in order to enable financial conglomerates to operate and to protect the confiden-

138. *Id.* at 62 (Emphasis supplied).

139. *Id.*

140. DEPARTMENT OF TRADE AND INDUSTRY, FINANCIAL SERVICES IN THE UNITED KINGDOM: A NEW FRAMEWORK FOR INVESTOR PROTECTION (1985)[hereinafter DTI WHITE PAPER].

141. *Id.* at 20.

142. Letter from Iain Murray, Esq., of the London solicitors firm of Linklaters & Paines, to the author (Sept. 14, 1987).

143. The so-called clearing banks are the largest commercial banks in the U.K. The merchant banks are similar to American investment banks, with the exception that, unlike investment banks, merchant banks may also engage in commercial banking.

144. Wolman, *supra* note 59, at 6, col.1.

145. *Id.*

tiality of information concerning their corporate clients.[146] Under the new regulatory system, the establishment of a Chinese Wall would not exempt a firm from common-law liability for a breach of fiduciary duty, but it would exempt it from liability for violation of specific rules adopted under the authority of the new statute.

The Financial Services Act grants the DTI broad powers to regulate "investment business" in the U.K., and authorizes the DTI to delegate most of its functions under the Act to the SIB, if the DTI finds that SIB's rules provide adequate investor protection, that they do not have an unnecessarily anticompetitive effect, and the delegation to SIB is approved by Parliament.[147]

The statute makes it a criminal act for any person to engage in the investment business in the U.K. unless he is authorized,[148] either by SIB[149] or by a self-regulating organization ("SRO") that is recognized by SIB.[150] An authorized person who violates the rules of business conduct of SIB or of an SRO is subject to injunctive or restitutionary relief at the behest of the DTI. Any such violation may also be the basis of a civil suit by any person who has suffered loss as a result of the violation.[151] In October 1987, the SIB adopted rules to regulate, among other things, the conduct of investment business by authorized persons.[152] The Act requires that the business conduct rules of the SROs offer at least equivalent investor protection to those of the SIB.[153]

The Chinese Wall is a central element of this new regulatory scheme. The Financial Services Act contains specific authorization for the establishment of Chinese Walls, providing that the SIB may adopt particular rules "enabling or requiring information obtained by an authorized person in the course of carrying on one part of his business to be withheld by him from persons with whom he deals in the course of carrying on another part. . . ."[154] If a firm acts in conformity with a rule adopted under this subsection, the firm will not be regarded as having violated the key anti-fraud provision of the statute, which makes it an offense for any person to make a statement, promise or forecast which he knows to be misleading, false or deceptive; to dishonestly conceal any material facts; or

146. Letter from Professor L.C.B. Gower to the author (Sept. 15, 1987).

147. *See infra* note 130. For a summary of the Financial Services Act, see Barnard, *supra* note 131.

148. Financial Services Act 1986, §§ 3, 4. In addition, contracts entered into by an unauthorized person are unenforceable, *id.* § 5; and courts may, upon application of the Secretary of State, enjoin violations, *id.* § 6.

149. *Id.* § 25.

150. *Id.* § 7.

151. *Id.* § 62. In October 1987, the DTI, in response to pressure exerted by the securities industry, announced that the effectiveness of the civil liability provision would be postponed for six months beyond April 1988, the date when the regulatory system is scheduled to go into operation.

152. *See supra* note 53.

153. Financial Services Act 1986, Sched. 2, § 3(1).

154. *Id.* § 48(2)(h).

to recklessly make a false or misleading statement.[155] According to one commentator, this exemption "may be particularly relevant where the offense would otherwise be committed by a company by reason of knowledge attributed to its directors, but not in fact possessed by them."[156]

The rules proposed by the SIB to regulate the conduct of the investment business provide for a Chinese Wall defense against a broad variety of offenses. The rules do not limit the use of the Chinese Wall defense to insider trading situations, as in the United States, or even to the making of false or misleading statements or omissions, as the Financial Services Act appears to contemplate. The SIB encourages the establishment of Chinese Walls; in its "Explanatory Statement" that accompanied the draft rules when they were submitted to the SSTI, the SIB said:

> 'Chinese Walls' are not actually required, but the absence of such arrangements within a firm or a group may well attract such severe disclosure requirements to a firm—because otherwise knowledge in any part of a firm is imputed to the whole firm—that it is essential for it to erect and police them.[157]

The following proposed rules of the SIB are subject to the Chinese Wall defense:

1. Suitability. The rules prohibit a firm from making a recommendation to or exercising discretion for a customer unless the firm has reasonable grounds for believing that the transaction is suitable for the cutomer, "having regard to the facts known, or which ought reasonably to be know, to the firm about the investment and as to (the customer's) other investments and his personal and financial situation."[158] Furthermore, a firm is not permitted to effect even an unsolicited transaction for a customer who is not an "execution-only customer" or a "market counterparty,"[159] if the firm "believes, or ought reasonably to believe" that the transaction is unsuitable for that customer "unless the firm has advised the customer not to proceed with his proposal and the customer, following the giving of that advice, has repeated his instructions."[160]

If the firm has a Chinese Wall, however, it may be entitled to an exemption from the suitability rule. The way in which this exemption is spelled out is as follows: the rule does not prohibit the firm from making a recommendation,

155. *Id.* §§ 48(6), 47(1).

156. A. WHITTAKER & G. MORSE, THE FINANCIAL SERVICES ACT 1986: A GUIDE TO THE NEW LAW 60 (1987).

157. SIB, EXPLANATORY STATEMENT 14 (*accompanying* THE SECURITIES AND INVESTMENT BOARD'S APPLICATION FOR DESIGNATED AGENCY STATUS UNDER THE TERMS OF THE FINANCIAL SERVICES ACT AND THE REVISED RULE BOOK) (Feb. 1987).

158. SIB RULES, *supra* note 53, at Rule 5.01(1). The firm is not held to the same standard of care if the customer is a business investor, *Id.*, at Rule 1.05, experienced investor, *Id.*, at Rule 1.06, or professional investor, *Id.*, at Rule 1.07.

159. *Id.*, at Rule 5.01(2).

160. *Id.*

exercising discretion or effecting a transaction that would otherwise be prohibited if none of the individuals involved in these activities "knew or ought to have known" the facts about the investment that make it unsuitable for the customer. Furthermore, none of these individuals shall be regarded as having a duty to know of those facts if:

> (a) arrangements exist within a firm, or within a group which includes the firm, for securing that information obtained by individuals employed in one part of the firm's business or the group's business, as the case may be, will be withheld from individuals employed in another part of it, and
> (b) those individuals are individuals from whom information about those facts is intended to be withheld under those arrangements.[161]

Thus, a firm is not subject to the suitability rule if (1) the decision-maker at the firm does not have actual knowledge of the information rendering the investment decision unsuitable, and (2) the firm has a Chinese Wall.

2. *Illiquid Investments.* A firm is not permitted to recommend "an investment which is not readily realisable" to a customer, other than a "professional" or "business investor,"[162] unless the firm warns the customer of the investment's illiquidity and also discloses to the customer any position it may have in that investment. A firm is not subject to this prohibition, however, if it has a Chinese Wall that prevents the individuals involved in effecting the transaction from knowing about the firm's position in the investment.[163]

3. *Disclosure of a Firm's Material Interest in a Transaction.* A firm is prohibited from effecting a transaction for an execution-only customer or from recommending a transaction to any customer if the firm (1) has a material interest in the transaction, or (2) has a duty to another person that conflicts with its duty to the customer, unless it discloses its interest or conflict and the customer consents to the transaction.[164] An example of a material interest would be a recommendation by the firm of a security that it is underwriting, while an example of a conflict of duty would be a situation where a firm is recommending a security of a company of which the firm is a financial adviser.[165] A firm is not subject to this disclosure requirement if it has a Chinese Wall.[166]

4. *Limitation on a Firm's Trading Because of Customers' Orders.* Where a firm is holding an unexecuted customer's order or has made a decision to execute

161. *Id.*, at Rule 5.01(3).

162. *See supra* note 158.

163. SIB RULES, *supra* note 53, at Rule 5.06(7). Since the language of the Chinese Wall exception that is used in this rule and in Rules 5.08, 5.15, 5.20, 5.21 (discussed below), is substantially identical to the language of Rule 5.01(3) quoted above, it will not be reproduced here or in the ensuing discussion of these rules.

164. *Id.*, Rule 5.08(1)(a). Alternatively, the firm may effect a transaction despite its material interest if it is authorized to do so by the customer in a customer agreement. *Id.*, at Rule 5.08(1)(b).

165. *See* Practice Note following *Id.*, Rule 5.08(1).

166. *Id.*, at Rule 5.08(2).

a transaction for a discretionary account, SIB rules prohibit it from trading for its own account or from executing a subsequently received order of another customer, in the same security.[167] The prohibition does not apply, however, if the firm has a Chinese Wall that prevents the individuals effecting the otherwise prohibited transaction from knowing about the unexecuted customer's order.[168]

5. *Recommendations Based on Research and Analysis.* A firm that regularly publishes recommendations to customers based on research and analysis is required to provide such recommendations simutaneously to all of its customers, and is prohibited from trading for its own account in the recommended security until the recommendation has been provided to its customers.[169] The latter prohibition does not apply, however, if the firm has a Chinese Wall preventing the individuals effecting the transaction from knowing about the results of the firm's research and anlysis.[170]

6. *Insider Dealing.* If an officer or director of an investment firm would be prohibited from effecting a particular transaction by the Insider Dealing Act,[171] then the firm is also prohibited from effecting the transaction.[172] This prohibition against the firm does not apply, however, if a Chinese Wall prevents those involved in effecting or arranging the transaction from knowing "the circumstances giving rise to [the] prohibition."[173]

Interestingly, the Insider Dealing Act itself does not explicitly recognize Chinese Walls, apparently for the reason that this statute applies only to an *individual* who acts while *knowingly* in possession of inside information.[174] Thus, an individual in the arbitrage department of an investment firm who purchases securities of a client company of the firm that is involved in a takeover would violate the Insider Dealing Act only if he actually possesses information about the takeover and knows that this information is confidential;[175] furthermore, prior to the effectiveness of this SIB rule, his firm could not violate the Act under any circumstances. Nevertheless, if the firm had a Chinese Wall, the wall would presumably have the practical effect of reducing the possibility that insider trading would

167. *Id.*, at Rule 5.15(1).

168. *Id.*, at Rule 5.15(3)(d).

169. *Id.*, at Rule 5.20(1)–(3).

170. *Id.*, at Rule 5.20(4).

171. Company Securities (Insider Dealing) Act 1985, ch. 8, § 1. Insider trading was first made illegal in the U.K. in 1980, through the adoption of §§ 68–73 of the Companies Act 1980. The 1985 Act, as amended by §§ 173–178 of the Financial Services Act 1986, represents a consolidation of these provisions. G. MORSE, CHARLESWORTH'S COMPANY LAW 474 (13th ed. 1987).

172. SIB RULES, *supra* note 53, at Rule 5.21(1).

173. *Id.*, at Rule 5.21(1)(b).

174. Company Securities (Insider Dealing) Act 1985, *supra* note 171, at § 1. *See* G. MORSE, *supra* note 171, at 474.

175. Because the Insider Dealing Act creates only criminal, not civil, offenses, the court would apply the higher standard of proof applicable to a criminal prosecution on the question of whether a defendant had knowledge of the inside information.

occur.[176] Even before the enactment of the Financial Services Act, it was not unusual for firms to erect Chinese Walls for this purpose.[177] With the exception of the SIB insider-dealing rule referred to above, there is no counterpart in American securities law for the Chinese-Wall defenses provided for under the new British regulatory system. This is because in the U.S. the wall has been used only in connection with insider trading. Thus, the exemption provided in Rule 14e-3 for firms that have Chinese Walls,[178] though superficially similar to the SIB exemptions, is in reality fundamentally different, since it exempts a firm only from insider-trading liability and not from liability for breaches of its duties to its customers.

It is not easy to predict how the U.K. Government's position that erecting a Chinese Wall may exempt a firm from liability for violating the Financial Services Act or SIB rules, but not from liability for violating common law rules of agency, will be implemented in actual practice. Under this contemplated two-part system, if a customer sues a broker under the common law for a breach of fiduciary duty, the fact that the broker has a Chinese Wall would not alter the usual common law rule that would impute the knowledge of an agent to his principal. On the other hand, the existence of a Chinese Wall may be used successfully as a defense in a lawsuit brought under the particular business conduct rules adopted under the Act.[179]

This apparent political compromise is likely to be most workable if it is applied to rules adopted under the Act which create offenses unknown to the common law. For example, if it is assumed, purely for the sake of argument,[180] that no common law obligation prohibits a brokerage firm from recommending unsuitable securities to a customer, the Chinese Wall exemption in the SIB's suitability rule would provide a firm with an effective defense from liability.[181] Since, however, violation of most if not all of the SIB's business conduct rules

176. This effect would be exactly the same as the intended effect of the Chinese Wall suggested by the SEC in the *Merrill Lynch* case. *See supra* text accompanying notes 75–80. I am indebted to Mr. Iain Murray for the benefit of his analysis of the effects of the Insider Dealing Act 1985.

177. "The best protection against allegations of insider dealing is to take measures to guard against the possible leakage of price-sensitive information. Thus merchant banks generally separate their investment division from their corporate finance division. . . ." COUNCIL FOR THE SECURITIES INDUSTRY, STATEMENT ON INSIDER DEALING 5–6 (1981).

178. *See supra* text accompanying notes 93–106.

179. Any person who suffers loss as a result of violation of the Conduct of Business rules adopted under the Financial Services Act, or of the corresponding rules of a self-regulatory organization, has a cause of action for damages. Financial Services Act 1986, § 62.

180. United States courts have held the knowing recommendation to a customer of unsuitable securities or insurance to be a violation of the anti-fraud provisions of the federal securities laws, Clark v. John Lamula Investors, 583 F.2d 594 (2d Cir. 1978)(involving securities), or common-law deceit, Anderson v. Knox, 297 F.2d 702 (9th Cir. 1961), *cert. denied*, 370 U.S. 915 (1962)(involving insurance).

181. *See* SIB RULES, *supra* note 53, at Rule 5.01; *supra* text accompanying notes 158–162.

cited above that allow the Chinese-Wall defense would also be violations of agency law, the compromise inevitably creates a large degree of uncertainty as to the efficacy of the Chinese Wall.

For example, it appears that a violation of SIB Rule 5.08, which prohibits a firm from effecting transactions for its customers if the firm has an undisclosed material interest in the transaction; or of SIB Rule 5.15, which forbids a firm to trading in its own account in a security in which it holds an unexecuted customer's order, would also be a breach of a common-law fiduciary duty.[182] Under the Government's view, the Chinese Wall defense could be raised in a customer's suit alleging a violation of either of these rules, but not in a suit based on the same facts alleging a breach of fiduciary duty.[183]

Since the question of the legal effect of establishing a Chinese Wall has not yet been considered by any British court, it is not clear at this time whether it would preempt common law agency rules or whether it would merely provide an exemption from the specific disclosure requirements of the SIB's Rules of Conduct. If the common law is not preempted by the SIB Rules, any protection from civil liability that a Chinese Wall provides to a firm may turn out to be illusory.[184] If, on the other hand, the common law is preempted, the agency rules that have provided a "safety net" for investors will be seriously damaged. There is a possibility that the courts will be reluctant to hold that there has been a breach of the common law in a situation where the existence of a Chinese Wall provides a defense against a claim of violation of an SIB Conduct of Business Rule.[185] Thus the SIB rules may influence the future development of the common law.

The establishment of multi-service firms as a result of the termination of the single capacity system has also led to changes in the City Code on Take-overs and Mergers ("Take-over Code"), a non-statutory system of self-regulation that has been in operation in London for more than a decade. These changes encourage the establishment of Chinese Walls. Under the Take-over Code, any person who, *together with persons acting in concert with him*, acquires 30% or more of a company's voting shares is required to make an offer to purchase the remaining

182. *See, e.g.*, 1 MECHEM ON AGENCY § 1189 (agent may not put self into antagonistic relationship with principal), § 1192 (agent authorized to purchase for principal cannot purchase for self), § 1197 (agent authorized to sell cannot sell for self) (1914).

183. In an interview with the author in London on July 21, 1986, Professor L.C.B. Gower suggested that, even if a firm has a Chinese Wall, a court might still hold that a firm's failure to disclose to a client material information in the possession of someone within the firm was a breach of the firm's common law fiduciary duty to its client.

184. It should be kept in mind, however, that common–law actions for breach of fiduciary duty are rare in the U.K., owing to the English rule of awarding attorneys' fees to the successful party and the prohibition of contingent fee arrangements.

185. One reason supporting this view is that the amount of disclosure required to satisfy common–law agency requirements is affected by the customs of the markets, of which SIB and SRO rules presumably would be evidence. Letter to the author dated Sept. 15, 1987, from Professor L.C.B. Gower.

shares on at least as favorable terms.[186] A securities firm that is acting as a financial adviser to an offeror and also makes purchases of the target company's voting shares for its own account is presumed to be acting in concert with the offeror, and would therefore be subject to this requirement.[187]

On October 6, 1986, in anticipation for Big Bang, the Panel on Take-overs and Mergers ("Take-over Panel"), a non-governmental body of practitioners that administers the Take-over Code, amended the Code to accommodate the situation of firms whose planned activities included advising corporate clients concerning takeovers and also making markets in securities.[188] If such a firm can establish to the Take-over Panel's satisfaction that the two operations are run "wholly independently and, in particular, without regard to the interests of clients of the corporate finance arm," it will be accepted by the Panel as an "exempt market maker," which is not subject to the Code's "acting in concert" provisions.[189] Similarly, a firm (or group) that acts both as a fund manager and as a financial adviser in takeovers can acquire the status of an "exempt fund manager" if it establishes the independence of the two operations, and thus can escape the "acting in concert" rule.

V. The Chinese Wall Considered

A. *Is the Chinese Wall Effective?*

In view of the considerable dependence that has been placed on the Chinese Wall to police conflicts of interest in the securities business, particularly in the U.K., it seems surprising how little evidence there is that Chinese Walls are effective. The idea of erecting a Chinese Wall was first suggested by the SEC in 1968 as a way of preventing insider-trading abuses,[190] and it was in general use by American securities firms by the mid-1970s.[191] Yet today the existing evidence

186. Council for the Securities Industry, The City Code on Take-overs and Mergers, § 9 (1987) [hereinafter Take-over Code].

187. The Take-over Code's definition of the term "acting in concert," states: "Without prejudice to the general application of this definition the following persons will be presumed to be persons acting in concert with other persons in the same category unless the contrary is established: . . . (5) a financial or other professional adviser (including a stockbroker) with its client in respect of the shareholdings of the adviser. . . ." Take-over Code, *supra* note 186, at B1.

188. Market makers are required to register with the London Stock Exchange in order to perform this function.

189. The Panel on Take-overs and Mergers, Report on the Year Ended 31st March, 1987, 7; Riley, *Takeover Panel Relaxes Market-Making Rules, Fin. Times, Oct. 6, 1986, at 8, col.1. For definitions of "exempt fund manager" and "exempt market-maker," see Take-over Code, supra* note 186, at B3.

190. *In re* Merrill Lynch, Pierce, Fenner, & Smith, Inc., [1967–1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,629, at 83,350 (Nov. 25, 1968).

191. *See* Slade v. Shearson, Hammill & Co., 517 F.2d 398, 402–03 (2d Cir. 1974).

suggests that the Chinese Wall, despite its solid-sounding name, is not particularly difficult to penetrate.[192] This is not to say that Chinese Walls may not be effective at some firms in deterring or preventing insider trading.

Doubts about the effectiveness of Chinese Walls, however, are supported by common sense and knowledge of human nature. Because the Chinese Wall is essentially an exercise in self-discipline, its success ultimately must depend on the ethical values of the particular persons involved. Where the financial stakes are high and the temptations great (for example, where a a principal or employee of a securities firm is in possession of confidential information concerning a pending takeover) the pressures on the ethical values of some persons are likely to be irresistible. The truth of this observation is supported by the numerous instances of non-public information concerning prospective tender offers and other corporate changes which has leaked from the investment-banking or mergers-and-acquisitions departments of multi-service firms, either to outsiders[193] or to other departments of these firms.[194] Even the temptation to use inside information in order to benefit customers (as opposed to oneself), and thereby to improve one's business position, may be overpowering.[195] According to Senator William Proxmire, Chairman of the Senate Banking Committee: "In case after case after case [involving insider trading], the Chinese Wall is a phony, it's a fake, it doesn't work, there's too much temptation. . . ."[196]

The recent *First Boston* case[197] is an indication of the essential flimsiness of Chinese Wall procedures, even at a well established and highly reputable invest-

192. One commentator has written:

> Although the large securities firms have attempted to establish separate underwriting divisions, this structural separation has often not been particularly effective as a means of preventing inside information gathered by the underwriting division from becoming known to the brokerage division. . . . Experience in the banking industry . . . casts siginificant doubt on the effectiveness of voluntary restrictions on the flow of information within a single firm.

Note, *Conflicting Duties of Brokerage Firms*, 88 HARV. L. REV. 396, 412–13 (1974).

193. "People in the investment banking section of a firm have incentives to leak information to arbitrageurs anyway, whether or not they have an arbitrage section within the firm." *Improper Activities in the Securities Industry: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 1st Sess. 89 (1987) (statement of Gary Lynch, SEC Director of Enforcement)[hereinafter *Hearings*]. In this connection, see United States v. Newman, 664 F.2d 12 (2d Cir. 1981).

194. "[T]here is a widespread feeling that the intense pressure to create profit, which has swelled both mergers and acquisitions departments and risk arbitrage, is also breaking down the "Chinese Wall" that is supposed to stop the passage of secret corporate information between them." Buchan, *Shadow of McCarthy Falls on Wall Street*," Fin. Times, Feb. 21, 1987, at 6, col. 1.

195. The *Cady, Roberts* and *Merrill Lynch* cases both involved the misuse of inside information by a brokerage firm on behalf of its customers. *See supra*, text accompanying notes 54–69.

196. *Hearings*, *supra* note 193, at 89 (statement of Senator William Proxmire).

197. SEC v. First Boston Corporation, Fed. Sec. L. Rep. (CCH) ¶ 92,712, at 93,465–66 (S.D.N.Y. May 5, 1986).

ment banking firm. According to the SEC complaint in the case,[198] the chief financial officer of CIGNA, a major insurance company and an investment banking client of First Boston, told representatives of the firm's Corporate Finance Department on January 21, 1986, that CIGNA was considering increasing its property-casualty loss reserves by $1–1.5 billion. Becuase of the sensitive nature of this non-public information, the firm's Legal Department then placed CIGNA on the firm's restricted list, meaning that no person at the firm was permitted to recommend its securities to customers or trade in them for the firm's own account. On January 29, the CIGNA chief financial officer told a First Boston managing director that he expected CIGNA to announce the addition to the reserves following a meeting of the board of directors on the following day.

Before trading began on January 30, the First Boston managing director told a First Boston research analyst about the impending announcement and requested that he make himself available at the end of the day to answer questions about the impact of the announcement. The research analyst, however, passed the information on to the firm's head equity trader, who immediately took steps to sell the CIGNA shares owned by the firm and to buy CIGNA put options.[199] As a managing director of the firm and the senior person in its equity trading department, the head trader possessed a copy of the restricted list, but did not check to see if CIGNA was on the list before trading in the stock.

After First Boston's trading had been detected by the NYSE's market surveillance staff, the SEC brought suit against the firm under the federal securities laws. First Boston, without admitting or denying the SEC's charges, agreed to disgorge its profits from the insider trading, to pay a penalty under the Insider Trading Sanctions Act of 1984,[200] and to review and modify its existing restricted list and Chinese Wall procedures.

While the *First Boston* case provides no evidence concerning the frequency of such abuses, several aspects of it highlight the inevitable weaknesses of the Chinese Wall. First, in order to perform its complex activities, the investment banking arm of a multi-service firm that receives non-public information in the course of its duties may find it necessary to communicate the information to persons in the firm's other departments. Thus, the First Boston investment banker felt it necessary to tell a research analyst about the impending announcement in order to enable the firm to assess the impact of the announcement on the com-

198. At the time of filing of the SEC's complaint, First Boston, without admitting or denying the allegations of the complaint, consented to the entry of a permanent injunction, disgorgement of it profits, the payment of a civil penalty, and to review its Chinese Wall and "restricted list" procedures. *Id.*

199. A put option gives the purchaser the right to sell shares of the underlying stock at a fixed price. The purchase of a put option is a highly leveraged method of profiting from an anticipated decline in the market price of a stock.

200. 15 U.S.C. § 78u(d)(2)(A) (Supp. II 1984).

pany's securities as soon as it had been made. The fact that the information was given to another department complicated the task of maintaining a Chinese Wall.

Second, under the pressure of an impending announcement concerning a stock held in the firm's trading account, self-interest, perhaps combined with negligence, prevailed over good practice, despite the fact that CIGNA had been placed on the firm's restricted list. Third, the decision to sell the stock was taken by the head equity trader—a managing director of the firm and a senior person in the firm's hierarchy, to whom supervisory responsibilities had been entrusted—not by a low-level employee. The fact that the Chinese Wall and restricted-list procedures could be so easily ignored by senior persons at a prominent investment banking firm such as First Boston provides little reason for confidence that they will provide a bulwark against illegal action at smaller or less reputable firms.

Perhaps the most persuasive evidence against the effectiveness of Chinese Walls is the skepticism expressed toward them by members of the securities industry itself, both in the U.S. and the U.K. John H. Gutfreund, chairman of Salomon Brothers, has called the Chinese Wall "a very difficult concept . . . [that] still depend[s] on the ethics of the people who run the business."[201] It is significant that, of the twelve industry representatives who submitted comments to the SEC in 1986 concerning the NYSE rule proposal to allow stock exchange specialists to engage in a full-scale retail business on condition that they erect a Chinese Wall,[202] six commentators, including two investment banking firms, opposed the proposal, on the grounds that a Chinese Wall would prove ineffective in alleviating potential conflicts of interest.[203] In particular, these commentators were concerned that "the primary roles and activities of the retail broker-dealers and their respective specialist units would conflict."[204] Furthermore, many brokerage firm officials reportedly believe that, despite the existence of a Chinese Wall, "traders will be able to get more information from specialists about demand for a stock, if they both work for the same firm. . . . 'It's all one pocket ultimately. . . .'"[205]

Similar skepticism has been expressed by members of senior management of British brokerage firms. The chairman of one of the few major U.K. firms to have decided to continue to limit itself to agency business despite the abolition of the single capacity system, has expressed the view that no real Chinese Walls exist between research analysts and market-makers at multi-service firms. In addition, he said that several analysts at these firms, unhappy at being pressured by market-makers to provide them with sensitive information, were seeking employment at

201. Sterngold, *Wall Street Is Facing Reappraisal*, N.Y. Times, Mar. 2, 1987, at D1, col.6.

202. *See supra* text accompanying notes 101–106.

203. 51 Fed. Reg. 41185 (1986).

204. *Id.*

205. *Bear, Stearns Building "Chinese Wall" Around Specialists*, INVESTMENT DEALERS' DIGEST, Feb. 23, 1987, at 8.

the few remaining agency-only firms. He concludes: "Anyone who believes in Chinese Walls in the secondary markets believes in fairies."[206] Although no empirical studies have been made to ascertain how well Chinese Walls work in practice, it appears that many of the new U.K. conglomerates that have installed Chinese Walls are beginning to doubt their effectiveness.[207]

The problem of making a Chinese Wall effective differs with the size of the firm involved. Since a Chinese Wall must apply to persons on the decision-making level as well as to those lower down in a firm's hierarchy,[208] its value diminishes to the extent that decisions concerning different areas of a firm's business are made by the same persons. The Chinese Wall, therefore, has little application to small firms, although one securities practitioner is reported to have asserted that he had a Chinese Wall running down the middle of his head.[209] It seems unlikely, however, that a psychological Chinese Wall will provide legal protection under the proposed rules of the SIB.

Large securities firms have problems of a different nature. Because of the variety of the operations of many of these firms, their Chinese Walls must be highly complex and therefore difficult, if not impossible, to monitor effectively.[210] In the U.K., where the establishment of a Chinese Wall provides a defense against charges of the violation of several different rules,[211] the Chinese Wall would have to be extraordinarily complex. It must include procedures to prevent the spread of a particular item of information from each department that may legitimately receive the information to each department that does not need the information in order to perform its functions. The legal correspondent of the Financial Times put it this way: "My computer tells me that as many as 50 Chinese Walls might be necessary within a conglomerate to provide for all possible situations. As it may be difficult to erect so many, it suggested that partners might sit in spacesuits and lunch apart."[212] Others believe that barriers to the internal flow of information within large firms are feasible, since the firms have "complex security systems to keep the various teams of specialists apart, and the largest groups can even afford to install separate banks of lifts [*i.e.*,

206. Interview with Peter Quinnen, Chairman of James Capel & Co., (Feb. 25, 1987).

207. Letter from Professor L.C.B. Gower to the author (Sept. 15, 1987).

208. *See* Lipton & Mazur, *supra* note 86, at 467, n.19.

209. Interview with Dr. A.D. Cosh, Senior Bursar at Queens College, Cambridge University, Cambridge, U.K., (Feb. 27, 1987). Dr. Cosh, an economist, is co-author of a report on a research project carried out for the Office of Fair Trading entitled *Institutional Investment, Company Performance and Mergers: Empirical Evidence for the U.K.*

210. Ralph Ferrara, Partner, Devevoise & Plimpton, and former General Counsel of the SEC, has remarked, "[t]here is only one Great Wall of China. . . . Regrettably, when you attempt to transport the phrase to fit the needs of broker-dealers, it doesn't fit. There are very few multi-service financial institutions that have come to grips with the problem. Feinberg, *supra* note 9, at 23.

211. *See supra* text accompanying notes 154–170.

212. Hermann, *Two Basic Rules for the Big Bang,* Fin. Times, Mar. 20, 1986, at 29, col.1.

elevators] to serve different functional areas."[213] Some large U.K. firms have even located different departments in different buildings.[214]

The difficulty with such attempts at physical separation of the departments of a firm is that the Chinese Wall, despite its name, is not a tangible barrier but simply a set of rules and procedures designed to prevent colleagues from discussing sensitive information with each other. According to the Investment Dealers' Digest, when First Boston built its new headquarters building five years ago, the firm "built one of its Chinese Walls by ending elevator access to the mergers and acquisitions department; the cars don't stop at that floor. Employees and visitors have to go to a higher floor and walk down a flight of stairs."[215]

The futile nature of these complex and expensive arrangements is apparent. In the *First Boston* case described above,[216] the physical restriction on access to the firm's mergers and acquisitions department became totally irrelevant when a research analyst simply decided to pass confidential information to the firm's head equity trader. Even if one assumes that physical separation will deter people from violating Chinese Wall procedures, it would have been necessary, in the First Boston situation, not only to isolate the mergers and acquisitions department physically, but also to build a special means of access to the research department and to any other department of the firm with whom the mergers and acquisitions department might find it necessary to share confidential information in order to do their job.

Of course, to dwell on physical separation misses the point. Even if it were feasible to separate every department of the firm physically, the Chinese Wall might be no less porous. However elaborate the physical arrangements—or, for that matter, the internal rules and procedures—of a firm, the Chinese Wall is likely to be breached constantly by ordinary social relationships. Employees of a firm are likely to transfer from one department to another during the course of

213. Riley, *Chinese Walls May Be Too Thin*, Fin. Times, July 7, 1986, at 13, col. 5. The notion that elevators may be an important ingredient of a Chinese Wall is not new. One government study quoted a partner of a multiservice securities firm:

> Kelly [partner in charge of the trading department] is on the 16th floor at the end. I am on the seventh floor. To get to the 16th floor, and you cannot get him on the telephone, you have to go out, get on the elevator to the 12th floor, change on the 12th floor and go to the 16th floor.
>
> * * *
>
> If you have ever been in that office, the counterroom, I guarantee you, you cannot discuss anything in there.
>
> * * *
>
> All the rest of the partners are down on the seventh floor.
>
> * * *
>
> Geographically, in our firm we do not have much of a problem. SEC, REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS, pt. 1, at 434 (1963).

214. Waddington, *Codifying the Split Personality*, Fin. Times, Oct. 27, 1986, at II-32, col. 1.

215. Feinberg, *supra* note 9, at 23.

216. *See supra* text accompanying notes 197–99.

their careers and to continue to see their former working colleagues socially.[217] When they do meet or talk on the telephone, they are likely to "talk shop." Even lunch rooms and car pools are likely to make Chinese Walls comically irrelevant. It is true that educational programs can help make some persons aware of their responsibilities, and the threat of substantial penalties will deter some persons from penetrating the Chinese Wall. Nevertheless, policing the wall effectively, even if possible, would require an intensity of surveillance that would turn securities firms into small police states.

More generally, any evaluation of the Chinese Wall is necessarily tied to the effectiveness of securities-industry self-regulation generally. In a sense, the Chinese Wall may be regarded as the extreme application of self-regulation, since it requires each firm to establish its own internal procedures under which employees are expected to act in ways inconsistent with their perceived self-interest. In the last analysis, the effectiveness of a Chinese Wall has to depend on the honor system, thus far without the benefit of guidance from the regulatory authorities of either the U.S. or the U.K., which have not issued rules establishing proper policies and procedures for erecting and maintaining Chinese Walls.[218] Legislation was introduced into the U.S. Senate in September 1987, however, which, if enacted, would give the SEC the authority to adopt rules requiring brokerage firms to maintain Chinese Walls for the purpose of preventing the misuse of inside information.[219]

The U.S. securities markets since 1975[220] and the U.K. securities markets under the newly enacted Financial Services Act[221] are regulated by means of systems of government-supervised self-regulation. However, disclosure in 1986 of major insider trading and other abuses in both countries[222] has created considerable doubt as to the effectiveness of self-regulation in practice. The substantial increase in the number of complaints of customers to the SEC and the self-regulatory organizations in recent years is an indication that self-policing is inadequate.[223] Although most, if not all, large firms and many smaller firms have established compliance departments to create and monitor the firms' internal

217. *See* Brooks, *Corporate Pension Fund Asset Management,* in TWENTIETH CENTURY FUND REPORT, ABUSE ON WALL STREET: CONFLICTS OF INTEREST IN THE SECURITIES MARKETS 239 (1980).

218. *See* Feinberg, *supra* note 9, at 22.

219. Tender Offer Disclosure and Fairness Act of 1987 § 14, S. 2334 (1987).

220. Although the Securities Exchange Act of 1934 as orginally enacted provided for self-regulation, the Securities Acts Amendments of 1975 greatly strengthened the SEC's supervisory powers over the self-regulatory organizations. *See* Securities Exchange Act of 1934, §§ 6, 15A, and 19; codified at 15 U.S.C. §§ 78f, 78o(A), (S).

221. *See, e.g.*, Financial Services Act 1986, Pt. I, Ch. III.

222. *See* cases cited *supra* notes 1–2.

223. The SEC received 10,392 complaints in 1986, up 121% from 1982, while the NASD had a 171% increase. Ingersoll, *Sleepy Watchdogs: Regulation of Brokers by Securities Industry Seems to Be Faltering,* Wall St. J., July 21, 1987, at 1, col. 6.

regulatory procedures, including their Chinese Walls, the effectiveness of these units is questionable. At some securities firms, the compliance effort is merely window-dressing and has little practical impact on the firm's operations. Even where the compliance officers are diligent and skillful, however, their efforts are often sidetracked or ignored by senior management who are less committed to compliance than to maximizing their firms' profits.[224]

B. What Is the Impact of the Chinese Wall?

If, on the other hand, a Chinese Wall is successful in preventing the flow of information among a firm's different departments, a different set of difficulties is raised, both for the firm and for its customers. From the firm's point of view, internal separation of functions tends to undercut the entire purpose of creating a financial conglomerate. For example, it has been asserted—whether cynically or naively—that the affiliation of a fund management company with a investment banking firm does not add any value to the fund management company's business if a Chinese Wall prevents it from acquiring information concerning takeovers in which the affiliated investment banker is involved.[225] More legitimately perhaps, internal separation of functions seems to run counter to the U.K. government's efforts to encourage the formation of large firms that are able to compete successfully in the international financial markets. A member of a British jobbing firm, which was shortly to be come part of a financial conglomerate assembled by Barclays Bank, wrote in 1985:

> It is important to remember that the Government, in countenancing the abandonment of single capacity, accepts the value of multi-function organisations; there will be no point in forming them unless the economic benefits they bring, such as greater liquidity and a wider range of services under one roof, can be utilised.[226]

A difficult management question is how high in the firm's hierarchy to build the Chinese Wall. If the wall prevents senior officers in each department of a firm from acquiring information about the firm's current operations, their value in guiding the firm's policies is likely to be reduced.[227] If, on the other hand, the

224. One report suggests these attitudes may be widespread:

> Firms are now putting compliance procedures back on the front burner, but it's hard to because no profits can be traced to tough internal controls. [One SEC official] says that compliance 'is a loss-leader. People don't make money out of compliance. . . .' [One securities lawyer] points out that 'I've seen firms where the legal-compliance function is regarded as a joke. Even if a person tries to carry out the rules he or she won't be listened to.'

Feinberg, *supra* note 9, at 24.

225. *See Creepers on the Chinese Wall*, Fin. Times, July 22, 1985, at 42, col. 6.

226. Letter from J.W. Robertson of Wedd, Durlacher, Mordaunt & Co. to the Financial Times, Mar. 28, 1985, at 27, col. 1.

227. It would be absurd if the effect of the internal procedures of a firm were to withhold operational information from its senior management and their supporting staff, who necessarily must

wall only reaches the level of relatively low-level employees, a much greater number of people will be in a position to use confidential information or to pass it on to others.[228]

Although the question is not free from doubt, the SIB rules seem to provide that the wall must be high enough to prevent information from reaching decision-makers. For example, Rule 5.08 prohibits the recommendation of a transaction in which the firm has a material interest but provides an exemption if a Chinese Wall prevents all of "the individuals involved in . . . making the recommendation" from knowing about the material interest.[229]

The quoted language raises difficult questions. Who are the persons "involved in making a recommendation"? Are they limited to the analyst who makes a study of a particular company and then writes a research report that is sent to salesmen of the firm, or do they also include the research director who supervises the analyst? Should the answer to the question depend on whether the research director has the authority to approve or reject research reports written by analysts under his supervision? Or on how often he actually exercises this authority? Further, does a salesman who tells customers about the contents of the research report "make a recommendation"? Does the office manager to whom the salesman reports? Or the regional manager to whom the office manager reports? And so on.[230]

The effectiveness of a Chinese Wall would be reduced if the wall does not reach to the level of a senior executive who knows that a recommendation is being made to the firm's customers, could stop the recommendation from being made, but decides not to do so. If, on the other hand, the wall does prevent information from reaching this level, there would be few managers left at the firm who would be in a position to have an overview of the firm's entire operation. As a British securities-industry trade group has pointed out, "[t]he establishment of Chinese Walls may lead to some less economic arrangements. . . . [I]ndividuals who can and should sensibly contribute to decision making in several facets of business . . . may have to be excluded in some circumstances, at cost to the

have an overview of the firm's entire operation. Nevertheless, some of the recent scandals have implicated chief executive officers of important firms. *See* cases cited *supra* notes 1–2.

228. It may be recalled that in the *First Boston* case the person responsible for initiating the insider trading was not a low-level employee, but the head of the firm's equity trading department. *See supra* text accompanying notes 197–99.

229. SIB RULES, *supra* note 53, at Rule 5.08(2).

230. Commenting on this issue with respect to the use of a Chinese Wall to prevent the use of inside information, Lipton and Mazur wrote:

> As a practical matter, the Chinese Wall must be applied on the decisionmaking level. If the personnel making the *final* decision with respect to the transaction in question have been isolated from the inside information, then the Chinese Wall solution is effective. The mere fact that a decisionmaking department or employee reports to a senior executive who knows the inside information does not vitiate the Chinese Wall solution. Lipton & Mazur, *supra* note 86, at 467 n.19.

organization.[231] Furthermore, by separating the skills and knowledge that are available within a firm, a Chinese Wall may weaken the firm's ability to provide services to its customers and clients.[232] The head of the arbitrage department at a major securities house told the New York Times, "there are no Chinese walls here. . . . A real wall, that kept information from me, would really change the way most firms operate."[233]

From the point of view of a firm's customers, the problems created by an effective Chinese Wall would be just as serious. A retail customer of a brokerage firm would normally be reasonable in assuming—and in most cases probably does assume—that his broker is acting as his agent in his best interests and that the firm which employs the broker stands behind the investment recommendations that his broker makes to him. The print advertisements and television commercials of many firms that do a substantial retail business are aimed at assuring prospective and actual customers that the firm has substantial research and other resources for the purpose of being used on the client's behalf. It is most unlikely that a customer's expectations would include the possibility that recommendations will be made to him despite the firm's possession of important contrary information, let alone that the firm might be trading for its own account on the basis of this information.

The expectations of a customer can, of course, be changed by making disclosures to him in advance. Under the rules of the SIB, the "contract note" (*i.e.*, confirmation) that a firm is required to send to a customer after each transaction must specify the existence of any conflict of interest or of duty that the firm has in relation to the transaction.[234] However, this requirement is satisfied if the contract note simply contains a box where the "categories of interest or conflict which the firm may have" can be checked off.[235] It is hardly likely that this manner of disclosure will be effective or meaningful to the customer, particularly where the disclosures run directly counter to the entire "pitch" that is concurrently being made to him and other investors by the firm in its advertising and by the individual broker through personal contact with the customer.[236] Of course, a firm may protect itself from legal liability for conflicts of interest if it makes full disclosure of the conflicts to its customers and if the customer knowingly consents. Such disclosure and consent may be difficult in the case of discretionary or managed accounts, or unsophisticated customers.

231. COUNCIL FOR THE SECURITIES INDUSTRY, BACKGROUND PAPER ON CONFLICTS OF INTEREST 11 (1985).

232. *Id.*

233. Sterngold, *Wall Street Is Facing Reappraisal*, N.Y. Times, Mar. 2, 1987, at D6, col. 6.

234. SIB RULES, *supra* note 53, at Rule 13.04 (1)(vii).

235. A firm may, but is not required to, disclose the existence of a Chinese Wall in the customer agreement required by *Id.*, at Rule 4.02. *See Id.*, at Rule 4.03.

236. Although misleading advertising is prohibited, *Id.*, at Rule 7.05, it is not clear that advertising that fails to disclose the fact that the firm has a conflict of interest would be deemed misleading.

Curiously, the rules of the SIB which create a Chinese-Wall exemption to a firm from various disclosure requirements that reflect common-law agency principles, such as required disclosure of a material adverse interest,[237] do not require any disclosure to the customer of the fact that the firm has a wall, by reason of which the firm is permitted by the rules to have undisclosed conflicts of interest that are prohibited under the common law.[238] For example, under the SIB rules, a firm may trade for its own account ahead of publishing recommendations to customers (a practice known as "front-running"), if the firm has a Chinese Wall and if the person or persons doing the trading for the firm do not know of the recommendations.[239] Again, it is unlikely that most customers expect that their firm will engage in front-running, regardless of the state of knowledge of the person effecting the trading.[240] Furthermore, even if the firm does have a Chinese Wall, front-running may be harmful to the customer by increasing the price of the security before the customer has an opportunity to buy it.[241]

Another difficulty of the Chinese Wall is that it is inconsistent with the goal of corporate responsibility which is basic to the self-regulatory system that exists under both U.S. and U.K. securities regulation.[242] The common law rule of *respondeat superior*, which holds a firm legally responsible for the torts of its

237. *Id.*, at Rule 5.08. *See supra* text accompanying notes 164–66.

238. The SIB rules do not require that firms disclose the existence of Chinese Walls to their customers in the required "customer agreement." *See Id.*, at Rule 4.03. Voluntary disclosure of the Chinese Wall, however, if fully understood by the customer, may in some instances protect a firm from liability for breach of fiduciary duty. The SIB rules provide that the "business letter" that may be substituted for the customer agreement (if the customer is "a business investor," "an experienced investor," or "a professional investor") may specify that where the firm acts as principal with the customer it does have not have a duty to secure best execution of such transactions for the customer. *Id.*, at Rule 4.07(2).

239. *Id.*, at Rule 5.20(4). It has been argued plausibly that, where any department of a firm has inside information about a security, the firm should not be permitted to trade for its own account in that security, even though the firm has an effective Chinese Wall. Three reasons have been given for this conclusion: "the need to assure public confidence in the securities markets, the practical consideration of removing temptation, and the absence of any compelling reason for an exception" from the general insider trading proscription. Lipton & Mazur, *supra* note 86, at 499.

240. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

241. Professor L.C.B. Gower has pointed out that, if a rule were to require firms to disclose the existence of their Chinese Walls, it would be difficult to decide exactly what disclosures should be made, "having regard to the undoubted fact that no Chinese Wall can be completely impervious and that there may be some circumstances where it may be the duty of the firm to breach it." Letter from L.C.B. Gower to the author (Sept. 15, 1987).

242. For example, the N.Y.S.E. requires its members to exercise diligent supervision over all accounts and to "use due diligence to learn the essential facts relative to every customer, every order, [and] every . . . account. . . ." N.Y.S.E. RULES, *supra* note 110, Rule 405. The N.Y.S.E. has also established detailed rules and procedures to implement these requirements. *See id.*, Rules 342–345. *See also* N.Y.S.E., PATTERNS OF SUPERVISION (1982). The Conduct of Business Rules of the SIB also require investment firms to establish and maintain supervisory procedures. SIB RULES, *supra* note 53, at Rule 2.12.

officers and employees,[243] serves the positive value of providing a strong incentive to the firm's top management to exercise diligent supervision. Additionally, in view of the complexity of the securities business and the relatively limited resources of the regulatory agencies, application of the rule is probably the only practical way to achieve effective regulation.[244] To the extent that a wall keeps information from supervisors and absolves the firm from responsibility for the activities of its personnel, it is likely to detract from the effectiveness of industry self-regulation.

Finally, it is necessary for senior management to be actively involved in the supervisory process.[245] An effective compliance program cannot be left entirely to a compliance department. It requires that managers take responsibility for compliance with relevant rules by those under their supervisory jurisdiction. In order to do this, the managers may have to have access to information in the possession of of several departments of a firm. For example, in order to detect insider trading effected through the facilities of the firm, it may be necessary to have information about corporate clients (which may be in the possession of the investment banking department), trading data (which may be in the possession of the retail and institutional sales, arbitrage, or other departments), and possibly information in the possession of other departments, such as the research department. To the extent that a Chinese Wall insulates managers from such information, the effectiveness of the firm's compliance program will be reduced.

VI. Toward a Solution of the Conflicts Problem

It has been said that the regulation of conflicts of interest reflects a compromise between the demands of efficiency and those of fairness.[246] This compromise is constantly being renegotiated as the pendulum of public concern swings between a desire to prevent abuses and a desire to promote economic growth.[247] Opinions of course differ as to where the proper balance between efficiency and fairness should be struck. For example, those persons—many of them economists—who emphasize efficiency rather than fairness believe that conflicts of interest do not create serious risks to investors or society at large; and that the likelihood that conflicts will be improperly exploited is limited by several factors, including market forces, fear of suffering reputational harm, and monitoring by regulatory agencies.[248] Judges and lawyers, on the other hand, no doubt because their training includes background in agency law, are more likely to emphasize fair-

243. Marbury Management, Inc. v. Kohn, 629 F. 2d 705 (2d Cir. 1980), *cert. denied sub nom.* Wood, Walker & Co. v. Marbury Management, Inc., 449 U.S. 1011; Sharp v. Coopers & Lybrand, 649 F. 2d 175 (3d Cir. 1981), *cert. denied* 455 U.S. 938 (3d Cir. 1981).

244. Bateman Eichler, Hill Richards v. Berner, 472 U.S. 299 (1985).

245. *See* Poser, *Supervision of Broker-Dealers*, 1 Rev. Sec. Reg. 966 (1968).

246. Anderson, *supra* note 13, at 748 (1978).

247. *Id.*

248. *See, e.g.*, Saunders, *supra* note 30, at 224.

ness than efficiency. During times when there has been a public disclosure of abuses arising from conflicts of interest, the primary emphasis is likely to be placed on fairness, and at these times proposals to segregate economic functions to avoid conflicts of interest tend to resurface. Thus in the U.S., following the Great Crash of 1929, commercial banking and investment banking were segregated by the Glass-Steagall Act,[249] and Congress seriously considered (but never adopted) a proposal to segregate the functions of securities brokers and dealers.[250]

Conversely, when the public concern and emphasis are primarily on efficiency and competition, proposals have been made—and implemented—to deregulate the financial services industry. Thus, during the early-and mid-1980s the scope of Glass-Steagall was steadily circumscribed, and in the U.K. the single-capacity system on the LSE was abolished. It is possible that, in the wake of the market crash of October 1987, the pendulum will begin to swing back toward greater regulation, including the elimination of some conflicts of interest.

It is unlikely, however, that even in a climate of greater regulation, segregation of functions will make much headway as a practical solution to the conflicts of interest problem. In the U.S., the SEC has consistently held to the position that separation of functions is undesirable, because it would damage the ability of the securities industry to raise capital.[251] In the U.K., the considerations that led the financial community, with the approval of the Government, to abandon single capacity[252] are unlikely to permit a reversal of the new policy.

While total segregation of functions potentially offers the most protection to investors against abuses arising from conflicts of interest, it has obvious drawbacks. Well-capitalized multi-service firms are needed in today's huge internationalized securities markets. Furthermore, splitting firms or affiliated groups into single-function firms, so that each firm acts only as a broker, dealer, investment manager, or underwriter, etc. would require costly duplication of research, administrative and other facilities. The additional costs of segregation of func-

249. *See supra* note 17 and accompanying text.

250. Under Section 11(e) of the Securities Exchange Act of 1934, as originally enacted, Congress directed the SEC to study the advisability of segregation of functions. In 1936, the SEC advised Congress that, while "the combination of the broker and dealer functions in the same individual or firm involves a conflict of interest which is provocative of abuse of the fiduciary relationship inherent in the brokerage function . . . ," legislation requiring the segregation of these functions was not advisable. Instead, the SEC recommended the adoption of a number of regulatory steps "toward the elimination of the conflict of interest implicit in the combination of the broker and dealer functions. . . ." SEC, REPORT ON THE FEASIBILITY AND ADVISABILITY OF THE COMPLETE SEGREGATION OF THE FUNCTIONS OF DEALER AND BROKER 109–10 (1936).

251. In 1972, for example, the SEC stated that, while there are potential conflicts of interest in the broker-investment company, broker-underwriter, money manager-underwriter, and dealer-money manager relationships, "[i]f all of these functions were to be separated, the capital-raising capability of the industry and its ability to serve the public could be significantly weakened." SEC POLICY STATEMENT ON THE FUTURE STRUCTURE OF THE SECURITIES MARKETS 52 (Feb. 2, 1972).

252. *See supra* text accompanying note 122.

tions, which would be ultimately borne by customers and clients, make this solution unacceptable.[253] On the other hand, as the markets become more complex, an increasing number of firms may, as a business decision, limit the functions they perform.[254]

There is also a strong suspicion among many economists and lawyers that some regulatory measures whose ostensible purpose is to protect investors from conflict-of-interest abuses are actually designed more for the purpose of protecting regulated persons from competition. Regulations which restrict entry into an industry or limit the functions that certain classes of market participants may perform tend to have substantial support from the least efficient elements of the industry, who have the most to lose from competition. According to Professor Goodhart, regulation is not feasible without the willing acceptance of the regulated; and the most frequent way by which regulation is made acceptable to the regulated is to include restrictions over entry into the business.[255]

These comments clearly apply to the securities business. For example, Glass-Steagall has sometimes been described less as a measure to curb abuses resulting from conflicts of interest than as an allocation of markets—a "horse-trade" that was intended to satisfy the respective interests of large commercial banks, small commercial banks, investment banks, and brokerage firms.[256] Similarly, the purpose of the British single-capacity system has been described as less to protect investors than to protect the interests of the jobbers on the London Stock Exchange;[257] and the restrictions placed on the brokerage activities of stock exchange specialists in the U.S. have been characterized as an allocation of markets between specialists and retail brokerage firms, rather than as a way of preventing conflict-of-interest abuses.[258] Whether or not these and other conflict-of-interest regulations can be explained entirely on this basis, Professor Llewellyn's statement that "regulation is not necessarily always designed for the benefit of the consumer" is virtually beyond dispute.[259]

If segregation of functions does not offer a solution, how should conflicts of interest of securities firms be dealt with? In approaching this problem, it is

253. Note, *supra* note 192, at 413.

254. An example is James Capel Co., the largest U.K. stock brokerage firm, which chose not to perform market making functions after Big Bang. By all accounts, the firm has continued to prosper in its single-capacity role as a broker. *See* Wolman, *James Capel First Again in Extel Analysts' League*, Fin. Times, Oct. 14, 1987, at 8, col. 4.

255. GOODHART, WHAT IS THE PURPOSE OF REGULATING FINANCIAL SERVICES? 12 (1987).

256. Llewellyn, *The Regulation and Supervision of Financial Institutions*, GILBART LECTURE ON BANKING 27 (1986).

257. Gower, *Conflicts of Interest and the City Revolution*, in CONFLICTS OF INTEREST IN THE CHANGING FINANCIAL WORLD 9 (R.M. Goode, ed. 1986).

258. According to this view, the trade-off was that the specialists would not handle the lucrative brokerage business of institutional investors, while the retail firms would not make off-board markets in listed stocks. This agreement was allegedly reflected in N.Y.S.E. Rules 113 and 390. N.Y.S.E. RULES, *supra* note 110, Rules 113, 390.

259. Llewellyn, *supra* note 256, at 28.

important to keep in mind that the securities laws in both the U.S. and the U.K. are based on a philosophy of full disclosure. In most important regulatory areas, disclosure requirements are preferred over substantive regulation. It therefore makes sense to inquire whether disclosure may offer a solution to the conflicts-of-interest problems of multi-service firms. Because the problems of insider trading and of breach of fiduciary duty are different, the inquiry may yield a different result in each case. We will therefore examine the two problems separately.

In theory, the best way to avoid insider-trading abuses that arise from a securities firm's conflicts-of-interest problem is to require publicly owned companies to make immediate public disclosure of all material non-public information. By eliminating inside information, we would eliminate insider trading. It has even been suggested that if an investment banking firm's corporate client does not voluntarily make prompt disclosure of inside information that it possesses, the investment banker should be required to make the disclosure on the client's behalf.[260] Since prompt disclosure unquestionably reduces the likelihood of insider trading occurring, this solution has a surface appeal. Furthermore, requiring prompt disclosure would be consistent not only with underlying philosphy of the securities laws but also with the stock exchange rules requiring listed companies to make timely disclose all material corporate information.[261]

Immediate disclosure of all material information, however, is not always feasible or even desirable. Situations will arise where premature disclosure of material information would subject a company to possible liability.[262] At any given time, corporate information that is material in the sense that investors are likely to be influenced by it in making their investment decisions may not be sufficiently certain to justify its release by a prudently managed company.[263] In fact, the premature release of information may mislead investors and expose the company to possible liability.[264] There may also be valid business reasons for keeping information confidential on such matters as merger negotiations, particularly

260. Wolfson, *Investment Banking*, in ABUSE ON WALL STREET, *supra* note 12, at 413.

261. Nevertheless, the policies of the New York and London stock exchanges permit non-disclosure of material information in a variety of circumstances. For example, the London Stock Exchange may give a listed company a "dispensation" from the requirement to make information public if "the directors consider that disclosure of information to the public might prejudice the company's business interests." LONDON STOCK EXCHANGE, ADMISSION OF SECURITIES TO LISTING 5.08–5.10 (1987)[hereinafter YELLOW BOOK].

262. The courts have held that a publicly-held company is not required to disclose material non-public information at least until the information is reasonably certain and thus its publication would not subject the company to possible liability. *See, e.g.*, Financial Industrial Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514; Radol v. Thomas, 772 F. 2d 244 (6th Cir. 1985).

263. In Financial Industrial Fund v. McDonnell Douglas Corp., 474 F.2d 514, it was held that a company was justified in delaying disclosure of corporate information until it could be adequately verified. This information was material even prior to its verification, and tippees who traded prior to disclosure violated Rule 10b-5. Shapiro v. Merrill Lynch, 495 F2d 228 (2d Cir. 1974).

264. *See, e.g.*, Starkman v. Marathon Oil Co., 772 F.2d 231 (6th Cir. 1985).

where the situation is in a state of rapid flux.[265] The Supreme Court has held that under such circumstances it is not illegal for a company to avoid immediate disclosure and to limit its public statement to "No comment" when queried by the press.[266] Finally, requiring—or even permitting—an investment banker to make the determination as to when information concerning its corporate client is ripe for release would undermine not only the legal responsibility of corporate management to direct the affairs of the company but also the investment banker's relationship with its client.

Nevertheless, prompt corporate disclosure is likely to reduce insider-trading problems and to contribute to the efficiency of the markets.[267] Similarly, to the extent that they are effective, Chinese Walls have a useful place in limiting the flow of inside information. The skepticism about Chinese Walls expressed in this article should not be taken to negate the fact that a firm is justified in taking precautions to prevent material non-public information in the possession of a firm's corporate finance or investment banking department from floating freely around the firm. On the other hand, as stated above, there is no justification for—and some evil in—carving out an exception from the usual rule of imputation of an agent's knowledge to his principal if the firm has a Chinese Wall.

The suggestion by the SEC in its *amicus curiae* brief in the *Slade* case that firms maintain, along with a Chinese Wall, a "restricted list" of securities still offers the best protection against misuse of material non-public information. While the SEC proposed the restricted list as a voluntary measure, insider trading has become a sufficiently large and intractable problem so as to justify its adoption as a mandatory requirement.

Under this proposal, when a securities firm enters into "an underwriting or other financing involvement likely to result in the receipt of inside information,"[268] or when a member of the firm becomes a director of a publicly held company, the firm would be required to cease any discretionary trading for its customers in the securities of the company and would notify all of its customers that it will be unable to make recommendations or update old recommendations with respect to these securities.[269] Unsolicited customers' transactions in the securities would, however, be permitted.[270] The restricted list would not prevent a

265. *Id.*

266. *In Re* Carnation Company, Exchange Act Release No. 22,214 (July 8, 1985); *see also* Schlanger v. Four-Phase Systems, Inc., 582 F. Supp. 128 (S.D.N.Y. 1984); Greenfield v. Heublein, Inc., 742 F.2d 751 (3d Cir. 1984); Reiss v. Pan American World Airways, Inc., 711 F.2d 11 (2d Cir. 1983); Levinson v. Basic, Inc., 786 F.2d 741 (6th Cir. 1986), *aff'd in part, rev'd in part sub nom.* Basic, Inc. v. Levinson 108 s. cf. 978 (1988).

267. In the 1968 *Merrill Lynch* case, the SEC pointed out that "prompt public dissemination of material information" is an "effective preventive" of insider trading. *See supra* text accompanying note 80.

268. Slade v. Shearson Hammill & Co., Inc., SEC *Amicus Curiae* Brief, at 12.

269. This solution has been proposed at greater length. Note, *supra* note 192, at 413–22 (focusing on the insider-trading problem).

270. This exception should be limited to situations in which the firm and its agent do not

firm from making markets or engaging in other proprietory trading in the securities of its investment-banking clients, but a firm doing this would not be protected from insider-trading liability. In order to avoid such liability, many firms may decide avoid the potential conflict by refraining from trading for their own account in the securities of their corporate clients.

It must be conceded, however, that the restricted-list solution also has drawbacks. First, by placing a company on its restricted list, a firm may unintentionally "tip" customers and others that the firm is in possession of inside information. If, however, the company is placed on the restricted list sufficiently early, before any inside information is received, the problem of inadvertant "tipping" will be substantially reduced.[271] Second, the restricted list has the disadvantage of limiting the number of companies about which multi-service firms are able to give investment advice to, or enter discretionary orders for, their customers. From the firm's standpoint, the restricted list reduces its ability to compete in the marketing of securities; and from the customer's standpoint, it narrows the range of investment advice that he receives.[272] Firms that have the greatest amount of investment banking and underwriting business, as well as the customers of these firms, would be the most affected. Third, a customer with whom a broker has a continuing fiduciary relationship (e.g., one for whom the broker is exercising discretionary authority) may have difficulty understanding that, when a security is placed on the restricted list, the broker is no longer acting in a fiduciary capacity for him with respect to that security.[273] Such disclosure would have to be spelled out in an agreement with the customer.[274]

Outside the area of insider trading, many of the conflicts of interest of multi-service firms can (and should) be resolved by full disclosure to the customer. For example, a firm acting as a market-maker in a security that it is recommending to

participate in any way in the decision whether to buy or sell a security. *See* Note, *supra* note 192, at 416–417.

271. A problem would arise where Company A, client of investment banker X, is planning to make a tender offer for the shares of Company B. X would place A's securities on its restricted list as soon as it enters into the investment banking relationship with A, but when would X put B on its restricted list? Presumably, this would have to be done as soon as B begins to be considered as a takeover prospect by X.

272. *See* Wolfson, in ABUSE ON WALL STREET, *supra* note 12, at 408.

273. This would be a particular problem with respect to a discretionary account. Under U.S. law, a broker handling a discretionary account is "the fiduciary of his customer in a broad sense." The broker is required, among other things, to keep his customer "informed regarding the changes in the market which affect his customer's interest and act responsively to protect those interests." Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 953 (E.D. Mich. 1978). Generally, a broker does not have such a continuing duty to a non-discretionary customer. *Id.* In the U.K., a firm handling a "discretionary managed portfolio" is required to include in its written agreement with its customer a statement specifying "whether or not there is any restriction on the categories of investment in which the fund comprised in the portfolio may be invested . . . and, if so, what those restrictions are. . . ." SIB RULES, *supra* note 53, at Rule 4.08(a).

274. In the U.K., it would presumably be spelled out in the customer agreement required by the rules of the SIB. *See id.*, at Rule 4.02-4.05.

its customers should be permitted to continue the two activities if the market-making is properly disclosed and the customer gives his informed consent. Similarly, a firm should be permitted to engage in "riskless" principal transactions (*i.e.*, buying securities for its own account in order to fill a customer's order) if it discloses to the customer the capacity in which it is acting and the amount of the markup.[275]

As the U.K. Government stated in 1985, Chinese Walls restrict flows of information but not the conflicts of interest themselves.[276] The establishment of a Chinese Wall should not be the basis for a defense against charges of breach of fiduciary duty. As I have tried to point out in this article, there is little evidence that Chinese Walls are effective at securities firms, and in addition the existence of an effective wall at a firm may interfere with proper management, supervision, and protection of customers.

The securities laws of both the U.S. and the U.K. are based on a philosophy of full disclosure,[277] a philosophy that is consistent with common-law rules of agency and in direct conflict with the secrecy of the Chinese Wall. To some extent, the conflicts of interest of securities firms can be satisfactorily resolved by means of disclosure to, and an informed consent by, the customer or client. Even though no universal solution exists for every such conflict of interest, disclosure offers by far the best solution, not only for the investor but also for the firm as an alternative to more intrusive regulation.

Even in those situations where disclosure does not provide a ready solution to a conflict of interest, an exemption from liability based on the existence of a Chinese Wall is not the answer. Instead, the continuing enforcement and reinterpretation of traditional rules of fiduciary duty in the context of the modern securities markets will give securities firms an incentive to provide the maximum disclosure to their customers and, where disclosure is not feasible, to limit or avoid their conflicts of interest.

275. *See* 17 C.F.R. § 240.10b-10. Some conflicts of interest, however, cannot be cured by disclosure. For example, suppose a firm that has just taken an order from an institutional customer to buy a large amount of a security in the open market receives an inquiry from a retail customer as to whether he should sell his holdings of the same security. If the firm informs the retail customer of the large buy order, it would be breaching its duty of loyalty to the institutional customer; if the firm remains silent about the order, however, it could be charged with breaching its duty of loyalty to the retail customer. This example of a conflict between a firm's fiduciary duties to two customers makes it clear that neither disclosure, a Chinese Wall, nor segregation of functions can completely solve the problem of the conflicts of interest of securities firms. In any event, segregation was rejected in the U.S. during the 1930s and more recently in the U.K. It does not follow from this rejection, however, that firms should be exempted from liability for breaching their fiduciary duties to their clients or customers. The risk of liability is one of the inevitable costs of doing business, and this risk is bound to be greater for a firm that engages in several types of businesses that involve it in conflicts of interest.

276. DTI WHITE PAPER *supra* note 140, at 20.

277. *See* L. LOSS, *supra* note 39, at 25–35.