THE CHINESE WALL: A REPLY TO CHAZEN

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Leonard Chazen, in this issue of the *Review*,[1] rejects our no-recommendation and restricted-list policies as proper reinforcement for the Chinese Wall —standing alone—meets all of the problems we discussed in analyzing conflict problems of the multiservice securities firm.[2] His position is attractive. It incorporates the dual virtues of easy implementation and great practical benefit to all multiservice securities firms. We disagree with Mr. Chazen, however, in two major respects: we believe that the unreinforced Chinese Wall does not meet the expectations of the average public investor, and we doubt that the courts will accept it as an effective defense against rule 10b-5 liability.[3]

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[1] Chazen, *Reinforcing The Chinese Wall: A Response*, 51 N.Y.U.L. REV. 552 (1976).

[2] Lipton & Mazur, *The Chinese Wall Solution to the Conflict Problems of Securities Firms*, 50 N.Y.U.L. REV. 459 (1975).

[3] Lipton & Mazur, *supra* note 2, at 470-74. Since the publication of our earlier Article, the Chicago Board Options Exchange has drafted a proposed Chinese-Wall rule to deal with "tape racing" on block transactions, a practice involving trading in options at a time when the trader has knowledge that a block trade in the underlying security has been or is about to be effected. Tape racing can also involve trading in an underlying security at a time when the trader has knowledge of a block trade in options covering that security. Proposed rule 4.18 would require that the trader delay an option transaction, if he has knowledge of a block trade in the underlying security, until the fact of the block trade has been publicly disseminated. 41 Fed. Reg. 19,174 (1976). It would similarly require that the trader delay transactions in the underlying security when he has knowledge of a block trade that has not yet been made public in options covering that security. *Id.* Section .01 of the "Interpretations and Policies" (Interpretations) accompanying the proposed rule states that the rule applies only "to natural persons within a member organization but not to the organization itself. In other words, the knowledge of separate natural persons within a member organization will not be imputed to the organization." *Id.* Thus, if a firm separates its options traders from its stock traders, so that the options traders are kept unaware of the trades the stock traders are making, and vice versa, then all of the firm's traders will avoid the strictures of the rule. Section .02 of the Interpretations further states that member firms should

> assure that persons dealing in options transactions and persons dealing in unrelated transactions in underlying securities either are insulated from knowl-

Mr. Chazen's quarrel with our proposal can be reduced to three essential arguments: first, the no-recommendation policy would impair the broker's investment performance for its customer; second, our notion of customer expectations is incomplete; and third, the scope of the broker's legal duties to its customer is not as broad as we suggest. Based on those contentions, Mr. Chazen would have the broker-dealer department of the Chinese-Walled firm continue recommendations about a security, notwithstanding the firm's entry into a confidential relationship with the issuer or the receipt elsewhere in the firm of inside information concerning the company in question. In our view, Mr. Chazen's premises do not survive close scrutiny. Moreover, his proposed alternative approach—a more limited restriction on recommendations based upon a concept of "super-materiality"—is simply not viable.

I

THE IMPACT OF THE NO-RECOMMENDATION POLICY ON INVESTMENT PERFORMANCE

Mr. Chazen argues that the no-recommendation policy works to the detriment of the unsophisticated investor who relies on his brokerage firm for investment advice, depriving the investor of his broker's guidance during the period of restriction.[4] Mr. Chazen assumes that broker-dealer recommendations based on public information are useful to the unsophisticated investor even though contradictory inside information, unknown to the broker-dealer department, exists elsewhere within the firm. In support of this contention, Mr. Chazen distinguishes between, on the one hand, inside information of "transcendent importance"—such as an imminent tender offer for the company's stock at a substantial premium over market, or the collapse of a hitherto solvent company—and, on the other hand, inside information that is "useful to an analyst evaluating a company's securities," but is "by no means definitive."[5] While apparently conceding the utility of the no-recommendation policy in the former case,[6] Mr. Chazen argues

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edge of each other's transactions, or are able to comply with Rule 4.18 by deferring executions until prior transactions have been publicly disseminated. *Id.* § .02.

[4] Chazen, *supra* note 1, at 563-67. For a discussion of the theory that under rule 10b-5 a broker-dealer has a continuing duty to its customers to provide investment advice for a reasonable period of time after recommending securities to them, see Mascola v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1975-1976 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,470, at 99,388 & n.16 (S.D.N.Y. Mar. 17, 1976).

[5] Chazen, *supra* note 1, at 567.

[6] *See id.*

that, in the latter case, the broker-dealer's recommendation is of value to the unsophisticated customer because the investors with whom he is competing in the market also operate on the basis of imperfect knowledge.[7]

We agree that impact on investment performance is an important consideration in determining appropriate inside information policies for securities firms. We take issue, however, with the premise, implicit in Mr. Chazen's argument, that investors are significantly better off with recommendations that may or may not be inconsistent with inside information known to others in the firm than they would be if deprived of any recommendations during appropriate periods of restriction. Mr. Chazen cites no empirical evidence that supports this assumption, and we know of none.[8] But, even assuming that some of the firm's customers could derive some incremental benefit from continuing recommendations in the face of isolated inside information, that theoretical benefit must be weighed against the arguments which support the no-recommendation rule.[9] The possible benefit to investors from such continuing recommendations does not affect our conclusion that the Chinese Wall must be reinforced.

Mr. Chazen also challenges our contention that the investment banker does not usually have so many confidential relationships that investment performance will be impaired if a restricted list is implemented in the area of broker-dealer recommendations.[10] Mr. Chazen notes our observation, offered in the investment management context, that a restricted-list policy for the Chinese-Walled commercial bank that maintains confidential relationships with a multitude of public companies would so narrow the range of permissible investment for the trust department as to impair severely its investment performance.[11] He then questions our distinction between commercial banks and investment banks. He argues that even "[a]n investment-banking firm may have a substantial number of companies on its restricted list at any one

[7] *Id.* at 567, 576.

[8] Indeed, several studies of mutual fund performance have raised questions concerning the overall effect of broker recommendations on investment performance. *See, e.g.*, I. FRIEND, M. BLUME & J. CROCKETT, MUTUAL FUNDS AND OTHER INSTITUTIONAL INVESTORS 19 (1970) ("unweighted investment in all NYSE stocks would have topped mutual fund investments over the entire period [1960-1968]"); WHARTON SCHOOL OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS 17-18 (1962) (the average performance by the mutual funds over the 5-3/4 years covered "did not differ appreciably from what would have been achieved by an unmanaged portfolio with the same division among asset types").

[9] *See* text accompanying notes 17-33 *infra*.

[10] Chazen, *supra* note 1, at 564-65.

[11] *Id.* at 564, *quoting* Lipton & Mazur, *supra* note 2, at 509.

time."[12] Noting that a few public companies account for a disproportionate share of investor interest, he further argues that it is not only the quantity of confidential relationships with issuers which impact upon investment performance, but also the quality of such issuers.[13]

We are mindful, however, of the fact that the investment banker's confidential relationships with its clients are generally of much shorter duration than those of the commercial banker. Thus, if a restricted list is used, the resulting period of restriction will likely be much shorter for the investment banker than for the commercial banker. In the case of the more important issuers discussed by Mr. Chazen, that period is especially likely to be limited. Such companies are, for the most part, highly sensitive to their disclosure obligations and, accordingly, can be expected to disclose any inside information promptly, thereby limiting the period of restriction. As we noted in our Article, our reinforcement techniques are intended to be flexible in relation to the business of the securities firm.[14] We expect that the major investment banking firms dealing with multibillion dollar corporations normally would not feel a need to cease recommendations or otherwise restrict their activities with respect to such corporations' securities beyond what is now normal for such firms in order to comply with rule 10b-6.[15] The exceptional case that might require a lengthy restriction does not move us to change our basic position.[16]

Finally, it should be noted that restriction of a company's securities by a significant broker-dealer will in itself give the issuer a strong impetus promptly to disclose the information that has caused the restriction. To the extent that the use of the restricted list promotes timely disclosure of inside information, it helps to insure that all facts that reasonable investors would or might want to know in making investment decisions become available in the marketplace.

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[12] *Id.* at 565.

[13] *Id.* at 565 & n.72.

[14] Lipton & Mazur, *supra* note 2, at 499-510.

[15] 17 C.F.R. § 240.10b-6 (1976). Rule 10b-6 proscribes certain trading activities by a securities firm engaged in or likely to be engaged in an underwriting or other distribution of securities. *See* Lipton & Mazur, *supra* note 2, at 468 n.22.

[16] Even if a company has a continuing relationship with an investment banker, in the sense that the issuer repeatedly returns to the same firm to handle its underwriting, our proposed restriction period would not extend for the life of that relationship. It would last only so long as the firm had access to, or possession of, inside information. Obviously, the restriction would apply as long as an investment banker acted as a director or confidential advisor of an issuer, but such occasions would neither be as numerous nor as lengthy as Mr. Chazen's analysis suggests.

II

THE IMPACT OF THE NO-RECOMMENDATION POLICY ON CUSTOMER EXPECTATIONS

In discussing the question of investor expectations, Mr. Chazen contends that the brokerage customer expects the firm to provide him with continuing advice about securities he has bought on the firm's recommendation.[17] Thus, he concludes that "unless it appears that favored clients . . . have benefited from a selective disclosure . . . customers should generally be tolerant when they receive recommendations . . . contradicted by information isolated in another department."[18] Again, we think otherwise. The buying or selling of securities on a firm's recommendation made in the face of contradictory inside information known to the firm seems to us a far more significant event to an unsophisticated investor than the temporary deprivation of advice during a period of restriction. Mr. Chazen may be correct that "[v]iolations of the no-recommendation principle have not elicited angry newspaper columns,"[19] but the district court in the *Slade* case[20] and the Securities and Exchange Commission,[21] have certainly made their feelings known.

We think that the unsophisticated brokerage customer—the supposed beneficiary of Mr. Chazen's attack on the no-recommendation policy—is more likely to appreciate that there may be occasional periods during which the firm will have to suspend recommendations in particular securities than he is to be understanding and tolerant of occasional misrepresentations.[22]

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[17] Chazen, *supra* note 1, at 565.

[18] *Id.* at 569.

[19] *Id.* at 568.

[20] *See* Slade v. Shearson, Hammill & Co., [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,329 (S.D.N.Y. 1974), *discussed in* Chazen, *supra* note 1, at 557 n.2, *and* Lipton & Mazur, *supra* note 2, at 461 n.6, 478-80.

[21] Brief for SEC as Amicus Curiae at 11, Slade v. Shearson, Hammill & Co., 517 F.2d 398 (2d Cir. 1974); *see* Lipton & Mazur, *supra* note 2, at 485-87.

[22] *See* M. MAYER, CONFLICTS OF INTEREST: BROKER-DEALER FIRMS (1975). In discussing the problem of a broker-dealer's recommendations in the absence of input from the firm's investment banking department, Mr. Mayer states:

> [A]s a matter of common sense, a customer cannot help feeling that a financial analyst is negligent if he fails to pick up information about a stock that is available in the files of the underwriting department down the corridor.

Id. at 62. After discussing the ramifications of the *Slade* case, Mr. Mayer concludes that divorcing functions is the best solution to the investment-banker/broker-dealer conflicts problems. *Id.* at 64. *See generally* Mascolo v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1975-1976 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,470, at 99,387-88 (S.D.N.Y. Mar. 17, 1976) (granting of class action status where plaintiffs alleged that defendant made recommendations to purchase securities of its proposed investment-banking client while defendant's underwriting department was in possession of material adverse facts concerning the issuer).

III

THE NEED FOR A NO-RECOMMENDATION POLICY

The third prong of Mr. Chazen's assault on the no-recommendation policy is his assertion that the policy is unnecessary.[23] He argues that it is too simplistic merely to view a firm's recommendation made contrary to inside information as a proscribed misrepresentation under rule 10b-5. Rather, according to Mr. Chazen, the firm does not face rule 10b-5 liability to its customers for misrepresentation unless it is somehow at fault.[24] He asserts that the firm's employee who makes a representation inconsistent with inside information that has been isolated from him is not at fault.[25] But, in making those representations, the employee represents the firm.[26] Therefore, it is likely that the long-established rule that a securities firm has a duty to police its salesmen —a rule with its genesis in the "shingle-theory" cases[27]—will continue to have vitality.

We submit that the no-recommendation policy implemented through a restricted list is the appropriate procedure to satisfy the firm's policing obligation in this regard. Mr. Chazen, however, disputes our reading of the shingle-theory cases. He argues that these cases do not impose any policing obligation at all.[28] Rather,

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[23] Chazen, *supra* note 1, at 557-63.

[24] *Id.* at 556. Mr. Chazen might well have added to the cases in support of this general proposition the Supreme Court's recent pronouncement in Ernst & Ernst v. Hochfelder, 96 S. Ct. 1375 (1976). The Court there stated that a private action for damages under rule 10b-5 could not be based on mere negligence: there must be an allegation of an "intent to deceive, manipulate, or defraud." *Id.* at 1381.

[25] Chazen, *supra* note 1, at 558.

[26] *See* Lipton & Mazur, *supra* note 2, at 482. *See generally* E. HERMAN, CONFLICTS OF INTEREST: COMMERCIAL BANK TRUST DEPARTMENTS, 73-87 (1975). Mr. Herman states that "banks benefit from the belief, which they have cultivated in the past and still do not discourage, that association with a bank gives a trust department a knowledge advantage." *Id.* at 78. He observes that the institution of a total Chinese Wall between the commercial banking and trust departments of the commercial bank may impede the flow of material *public* information to the trust manager and argues that there is a resultant exposure to suit by trust beneficiaries. *Id.* We do not believe, however, that any such exposure is significant because any public information blocked by the Chinese Wall is by definition available to the diligent trust manager from some source. In any event, assuming that there may be isolated incidents in which material public information is not communicated by the commercial-banking departments to the trust manager *and* that the trust manager does not receive such information from some other source *and* that he effects a transaction contrary to the thrust of the public information, such potentiality hardly rises to the level where it obviates the Chinese Wall's overall utility to the bank.

[27] *See, e.g.*, R.H. Johnson & Co. v. SEC, 198 F.2d 690, 696-97 (2d Cir.), *cert. denied*, 344 U.S. 855 (1952); Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 438-39 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970); Goodman v. H. Hentz & Co., 265 F. Supp. 440, 445 (N.D. Ill. 1967); Lorenz v. Watson, 258 F. Supp. 724, 733 (E.D. Pa. 1966).

[28] *See* Chazen, *supra* note 1, at 562.

he states that the shingle-theory cases—which hold, among other things, that a broker-dealer must have a reasonable basis for its recommendation and must disclose to the customer any contrary information known to the firm[29]—are not applicable to the Chinese-Walled securities firm in the situation typified in *Slade*. According to Mr. Chazen, the shingle-theory was directed only at bad-faith conduct.[30]

It is too late in the day to make that argument. The offspring of the shingle-theory cases now delineates a full panoply of duties owed by the broker-dealer to its customer[31]—a panoply that is consistent with customer expectations and, indeed, gives rise to them. These duties include an obligation to reveal all information about a security that might reasonably be expected to affect the customer's trading decision.[32] Investment advisors and investment managers are under even more stringent statutory strictures against misrepresentation.[33] Faced with such duties, the multiservice firm that opts for an unreinforced Chinese Wall risks not only the prospect of customer wrath due to its employee's misrepresentations, but also liability to customers for failure to police its employees adequately.

IV

CHAZEN'S CONCEPT OF "SUPER-MATERIALITY"

Finally, Mr. Chazen describes an alternative approach to the flat prohibition on a firm's making broker-dealer and investment advisory recommendations while the firm is in possession of isolated inside information. He proposes that firms adopt a policy of continuing recommendations unless the information is "of such supreme importance that it precludes a reasonable investment

[29] *See, e.g.*, Hanly v. SEC, 415 F.2d 589, 597 (2d Cir. 1969); Van Alstyne, Noel & Co., 33 S.E.C. 311, 321 (1952), *modified on other grounds*, 34 S.E.C. 593 (1953); Black v. Shearson, Hammill & Co., 266 Cal. App. 2d 362, 367-68, 72 Cal. Rptr. 157, 160 (1968). *See generally* Brudney, *Origins and Limited Applicability of the "Reasonable Basis" or "Know Your Merchandise" Doctrine*, in PLI FOURTH ANNUAL INSTITUTE ON SECURITIES REGULATION 239 (1973) [hereinafter FOURTH ANNUAL INSTITUTE]; Jacobs, *The Impact of the Securities Exchange Act Rule 10b-5 on Broker-Dealers*, 57 CORNELL L. REV. 869, 876-81 (1972); Lipton, *The Customer Suitability Doctrine*, in FOURTH ANNUAL INSTITUTE, *supra* at 273; Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445.

[30] Chazen, *supra* note 1, at 562.

[31] *See* Lipton & Mazur, *supra* note 2, at 465 n.10.

[32] *Id.*

[33] *See* Investment Advisors Act of 1940, 15 U.S.C. § 80b-6 (1970) (anti-fraud provision); Proposed rule 206(4)-4 under the Investment Advisors Act of 1940, SEC Investment Advisors Act Release No. 442, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,128, at 85,150 (Mar. 5, 1975) (requirement of written disclosure statements).

judgment from being made on the basis of publicly available information."[34] Mr. Chazen himself recognizes one difficulty in implementing this solution—defining super-materiality.[35] Moreover, no such concept is likely to receive court approval given the present well-established tests of materiality.

A restricted list activated only by the receipt of super-material inside information has the additional defect that it might impermissibly "signal"[36] the significance of the inside information received by the firm. Our proposed restricted list, which is sensitive to all material inside information received by the firm—whether "super" or otherwise, whether confirmatory or contradictory of the public information upon which the firm has been formulating its recommendations—tells the investor virtually nothing. Mr. Chazen's approach, in contrast, might alert an investor to the fact that an event of supreme importance to the issuer's securities has occurred.[37] Even though the investor would theoretically be unaware of the thrust of the event, Mr. Chazen's own argument that the market thrives on rumors[38] seems a particularly apt reason for rejecting the concept of super-materiality.

V

CONCLUSION

As noted above, we find Mr. Chazen's approach very appealing. It is easy to implement. It adapts readily to any type of securities firm. It permits the maximum scope of activities by multiservice firms. Unfortunately, we believe that the policy considerations set forth in our original Article and referred to above demonstrate the necessity of reinforcing the Chinese Wall. It is simply unlikely that the courts will accept the unreinforced Chinese Wall as a securities firm's defense to a retail customer's action for misrepresentation.

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[34] Chazen, *supra* note 1, at 576.

[35] *Id.*

[36] For a discussion of the "signal" issue, see Lipton & Mazur, *supra* note 2, at 469-70, 483-84, 485 n.112, 486-87, 504-05.

[37] Under Mr. Chazen's proposal an investor who became aware that a security had been placed on a restricted list theoretically would not know whether the suspension was due to the receipt of super-material information, or to rule 10b-6 requirements concerning a pending public offering. *See* Chazen, *supra* note 1, at 569 n.85; Lipton & Mazur, *supra* note 2, at 468-69; note 12 *supra*. But in practice, an investor might deduce—in light of the historical relationship between the corporation and the firm and the rumors circulating in the market—that there was a good probability that an event of supreme importance had occurred.

[38] Chazen, *supra* note 1, at 575.