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THE CHINESE WALL SOLUTION TO THE CONFLICT PROBLEMS OF SECURITIES FIRMS

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Given the spate of cases being brought under rule 10b-5's proscription of trading on inside information, it should come as no surprise to discover that multiservice securities firms now confront new—and unexpected—difficulties. Such firms are constantly gaining access to inside information as investment bankers, yet they continually participate in the securities markets as broker-dealers and as principals. To protect themselves from liability to those investors who lack the same knowledge, some multiservice firms have attempted to isolate their inside information from their trading departments. The firms, however, owe duties to their investment-banking clients, to their trading customers and to other investors in the market—a conflict of obligations that has yet to be resolved. In fact, the uncertain scope of the firms' various duties undermines their isolation technique—the so-called "Chinese Wall"—and threatens the very survival of the multiservice-firm concept. The authors argue that multiservice firms should be preserved and that the triangular conflict can be reconciled. They recommend a reinforced Chinese Wall—strengthened in certain situations to prevent abuse; flexible in others to preserve market liquidity; adaptable in every instance to the firms' specific functions and to their need to discharge concomitant responsibilities.

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Historically, securities dealers and investment bankers in the United States have engaged in multiple aspects of the securities business.[1] Many firms perform two or more of the broker, dealer, marketmaker, underwriter, investment banker, investment manager and investment adviser functions. Despite the conflicts inherent in the assumption of many of these multiple roles, it has long been recognized that multiservice firms perform functions vital to our capital markets.[2] The conflicts created by this multiplicity of functions have traditionally been handled through disclosure, regulation or a combination of the two.[3]

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[1] *See* SEC, REPORT ON THE FEASIBILITY AND ADVISABILITY OF THE COMPLETE SEGREGATION OF THE FUNCTIONS OF DEALER AND BROKER (1936) [hereinafter SEC, SEGREGATION REPORT]; SEC, SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, 88th Cong., 1st Sess., pt. 5, at 65-66 (1963) [hereinafter SEC, SPECIAL STUDY]; Samuelson, *Stock Brokers Spread the Risks*, N.Y. Times, Apr. 20, 1975, § 3, at 15, col. 1; note 3 *infra*.

[2] *See* SUBCOMM. ON COMMERCE & FINANCE OF THE HOUSE COMM. ON INTERSTATE & FOREIGN COMMERCE, 92d CONG., 2D SESS., SECURITIES INDUSTRY STUDY 149 (Subcomm. Print 1972) [hereinafter SECURITIES INDUSTRY STUDY]; SUBCOMM. ON SECURITIES OF THE SENATE COMM. ON BANKING, HOUSING & URBAN AFFAIRS, 93D CONG., 1ST SESS., SECURITIES INDUSTRY REPORT 68 (Comm. Print 1973); SEC, STATEMENT ON THE FUTURE STRUCTURE OF THE SECURITIES MARKETS, in [Special Studies] CCH FED. SEC. L. REP. ¶ 74,811, at 65,612 (1972) [hereinafter SEC, FUTURE STRUCTURE]; *cf.* SEC, SPECIAL STUDY, *supra* note 1, pt. 5, at 65. *See also* Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified in various parts of 15 U.S.C.A. §§ 77-80 (Supp. Aug. 1975)).

[3] The multifunction conflict problem has been described as follows:

> A striking phenomenon of the securities industry is the extent to which any one participant may engage in a variety of businesses or perform a variety of functions. A single firm with customers of many kinds and sizes, may, and often does, combine some or all of the functions of underwriter, commission house in listed securities, retailer of unlisted securities, wholesale market maker for unlisted securities, custodian of funds and securities, investment adviser to discretionary accounts, to others on a fee basis, and to one or more investment companies, and financial adviser to one or more corporations. Its principals may invest or trade for their own accounts in securities also dealt in for others. . . .
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> Since each of these functions involves its own set of obligations to particular persons or groups of persons and since the self-interest of the broker-dealer may be involved in one or more, there are multifarious possibilities of conflict of obligation or interest in matters large and small. The multitude and variety of possibilities of conflict in the securities business make it difficult, if not dangerous, to generalize as to the problems presented or possible remedies. Total elimination of all such possibilities 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 . . . each investor would have his own broker who would not be permitted to act for any other customer or for himself.
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> In some limited sectors, combinations of functions involving clearly con-

Following the 1961 landmark decision of the Securities and Exchange Commission (SEC) in *Cady, Roberts & Co.*[4]—and in its wake the increasing recognition of problems under rule 10b-5[5] relating to trading on the basis of material, nonpublic information (inside information)—the potential conflicts between the information-gathering and the investment-decision functions of multiservice firms began to undergo significant scrutiny. A recent focus of attention is *Slade v. Shearson, Hammill & Co.*,[6] a case which raises

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flicting roles may be excluded as a matter of business policy or public policy because the conflicts are deemed so fundamental and pervasive as to require separation; in most sectors, multiple roles are not excluded as a matter of policy, but here the conduct of broker-dealers performing them may require increased regulatory and self-regulatory vigilance. Some kinds of conduct (as in Cady, Roberts, [40 S.E.C. 907 (1961)], for example) are so gross that they already have been, or may in the future need to become, the subject of specific decisions or regulations. For others, more capable of being handled in terms of ethics than of law, the self-regulatory agencies would seem to have an ideal milieu for performing their role of elevating and guiding conduct of their members above and beyond strictly legal requirements. The exchanges and the NASD should be charged with continuing responsibility for keeping abreast of changing forms and methods of doing business, identifying areas of frequent difficulty, and setting forth guides to the conduct of broker-dealers serving as directors and performing other roles containing potentialities of conflict.

SEC, SPECIAL STUDY, *supra* note 1, pt. 5, at 65-66, 439-40.

[4] 40 S.E.C. 907 (1961). In *Cady, Roberts*, the SEC held that rule 10b-5 prohibits a broker-dealer from trading for a discretionary account on the basis of inside information obtained by a member of the firm through a business relationship giving access to inside information. The SEC focused upon the inherent unfairness, to the other party to the transaction, of the firm's trading on such information. *See also* text accompanying notes 171-74, 182-92 *infra*.

[5] Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements, made in the light of the circumstances under which they were made, not misleading, or,
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> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1975).

[6] [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,329 (S.D.N.Y. 1974) (denial of motion for summary judgment). The district court in *Slade* subsequently granted a motion to certify the legal question at issue for review by the Court of Appeals for the Second Circuit. [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,439, at 95,532 (S.D.N.Y. 1974); *see* text accompanying note 75 *infra*. The court of appeals, after accepting the certification, remanded the case for further factual findings. 517 F.2d 398 (2d Cir. 1974). In addition, *Slade* may well be viewed as a leading case on the issue of indemnity and contribution between persons held liable for violations of the federal securities laws. *See* Odette v. Shearson, Hammill & Co., [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,038 (S.D.N.Y. 1975). The

doubts about the technique of departmental isolation of inside information—otherwise known as the "Chinese Wall" or "Don't tell your partner" technique—which has been widely acclaimed as a practical solution to the multiservice firms' conflict problems.[7]

We believe that the Chinese Wall is generally the best solution to the inside information problems created by a single multiservice firm's performing potentially conflicting roles, *e.g.*, investment banker and investment adviser, commercial banker and trust investment manager, private placement investor and portfolio investment manager, and investment researcher for third parties and portfolio investment manager. There are, however, certain situations in which the Chinese Wall, standing alone, either does not meet the legitimate expectations of the public investor or creates an unacceptable potential for self-interest abuse. In these cases—primarily involving the recommending of investments to the

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contentions of the several litigants in the *Slade* case are discussed in detail in text accompanying notes 62-130 *infra*.

[7] *See, e.g.*, Leiman, *Conflict of Interest and Related Problems of Broker-Dealers and Investment Advisers*, in PLI FIRST ANNUAL INSTITUTE ON SECURITIES REGULATION 323, 326-28 (1970); McAtee, *Investment Bankers' Responsibilities Under the Federal Securities Laws*, in EXPANDING RESPONSIBILITIES UNDER THE SECURITIES LAWS 283, 298-313 (S. Goldberg ed. 1973) [hereinafter EXPANDING RESPONSIBILITIES].

The Chinese Wall has also been considered to be one solution for the conflict problems of those commercial banks that obtain inside information during the course of banking relationships and also maintain trust departments engaged in investment management for fiduciary accounts. *See, e.g.*, Proposed Treas. Reg. § 9.7(d), 39 Fed. Reg. 14,510 (1974); U.S. DEP'T OF THE TREASURY, PUBLIC POLICY FOR AMERICAN CAPITAL MARKETS, in BNA SEC. REG. & L. REPORT NO. 239, at D-1, D-11 to D-12 (1974) [hereinafter TREASURY DEP'T, PUBLIC POLICY]; Lipton, *Commercial Banks' and Other Lenders' Responsibilities Under the Federal Securities Laws*, in EXPANDING RESPONSIBILITIES, *supra* at 257-82 [hereinafter Lipton, *Lenders' Responsibilities*]; Herman & Safanda, *The Commercial Bank Trust Department and the "Wall"*, 14 B.C. IND. & COM. L. REV. 21 (1972); Lybecker, *Regulation of Bank Trust Department Investment Activities*, 82 YALE L.J. 977, 981-84, 1001-02 (1973); Yellon, *Trust Investments: Problems Regarding Exchange of Information between the Trust Department and Other Departments within the Bank*, 54 CHI. B. RECORD 405 (1973). *See also* Letter from Comptroller of the Currency, June 10, 1974, in BNA SEC. REG. & L. REPORT NO. 257, at E-1 (1974) [hereinafter Comptroller Letter]; Statements of SEC Commissioner John R. Evans & NASD Chairman David S. Murphy before the Subcomm. on Securities of the Senate Comm. on Banking, Housing & Urban Affairs, May 6, 1974, in BNA SEC. REG. & L. REPORT NO. 251, at G-1 (1974); Address by Commissioner John R. Evans, Ninth Annual Banking Law Institute, May 2, 1974, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,775; Address by Commissioner John R. Evans, Second Annual Bank Investments Conference, American Bankers Association, Feb. 1974, in BNA SEC. REG. & L. REPORT NO. 241, at E-1 (1974); Address by SEC Chairman Ray D. Garrett, Jr., National Trust Conference, Feb. 4, 1974, in [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,641; Solomon & Wilke, *Securities Professionals and Rule 10b-5: Legal Standards, Industry Practices, Preventive Guidelines and Proposals for Reform*, 43 FORD. L. REV. 505, 532-36 (1975).

public and investing for the firm's own account—we believe that the Chinese Wall must be reinforced: a multiservice firm should not recommend securities as to which there is a high probability that the firm will obtain inside information through a confidential relationship;[8] nor should it invest for its own account[9] in securities as to which it has obtained inside information. The Chinese Wall, so reinforced, is a reasonable reconciliation of apparently contradictory aims. From one perspective, by proscribing the misuse of inside information and thus placing all investors on an equal footing, it protects investors and creates confidence in the securities market. From another, by not unduly restricting the trading and transaction-executing activities of securities firms and by not requiring such firms—and commercial banks, investment companies, insurance companies and similar entities as well—to divest themselves of conflicting functions, it assures the liquidity of the securities markets.[10]

Part I of this Article examines the basic investment banker/broker-dealer conflict; part II demonstrates that the Chinese Wall meets a securities firm's obligations to both the investing public and its own investment-banking clients. We then discuss the impact of the Chinese Wall on the firm's duties to its trading customers (part III), the practical and policy considerations that emerged in arguments made in the *Slade* case (part IV), the pre-*Slade* Chinese Wall positions of both the SEC and the New York Stock Exchange (part V), the views of English securities regulators on the isolation technique (part VI), and the deficiencies inherent in various proposed alternatives to the Chinese Wall (part VII). Finally, in part VIII, we suggest that the Chinese Wall be reinforced and demonstrate that when reinforced it meets the practical and policy requirements of the securities and investment-management businesses.

The issues and problems raised by the contemporaneous performance of, on the one hand, activities giving rise to the receipt of

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[8] The no-recommendation policy would apply a fortiori when the firm has actually received inside information.

[9] As used in this Article, own-account investing does not include unrecommended arbitrage, dealer, marketmaker or block-position transactions. *See* text accompanying notes 200-03 *infra*.

[10] This theme was recently set forth by the House Committee on Interstate and Foreign Commerce in the following terms:

> It is a basic teaching of this nation's financial history that continued economic health fundamentally depends upon the maintenance of investor confidence, the continuous availability of investment capital and efficient secondary trading markets . . . .

H.R. REP. NO. 123, 94th Cong., 1st Sess. 43-44 (1975).

inside information and, on the other, investment-decision functions, are presented most clearly by the multiservice securities firm. In large measure the same issues and problems exist with respect to the various other entities which both engage in activities that may involve the receipt of inside information and manage investments or provide investment advice. To avoid needless repetition, we will concentrate on the multiservice securities firm and, more specifically, the investment-banking and broker-dealer departments of such a firm. Unless otherwise noted, however, the discussion is also intended to apply to all departments of multiservice securities firms and to commercial banks, investment companies, insurance companies and similar entities as well.

I

THE INVESTMENT BANKER/BROKER-DEALER CONFLICT

In their research and investment-advisory capacities, multiservice securities firms provide a flow of information which promotes knowledgeable investment decisions. Acting as arbitrageurs, dealers, block positioners and marketmakers, they provide investors with the means to make and dispose of investments. As investment bankers, they facilitate the raising of capital through underwriting, arranging private placements and other corporate finance techniques; they render advice with respect to business combinations; and they assist in tender offers and other types of takeovers. As brokers and investment advisers, such firms engage in investment research and analysis, and recommend investments. As investment managers, they manage individual and institutional accounts, often on a fully discretionary basis. In addition, principals of such firms furnish financial guidance as directors of corporations.

Inside information may be acquired by a principal of a securities firm who sits on a company's board of directors;[11] it also may be acquired during the course of a securities firm's investment-banking relationship with a company,[12] or occasionally (and often inadvertently) by an analyst in connection with his research into a company with which the firm has no confidential relationship.[13] A conflict arises when one department of the se-

[11] *See, e.g.*, Cady, Roberts & Co., 40 S.E.C. 907, 908-09 (1961); Black v. Shearson, Hammill & Co., 266 Cal. App. 2d 362, 365, 72 Cal. Rptr. 157, 159 (1968).

[12] *See, e.g.*, Slade v. Shearson, Hammill & Co., [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,329, at 96,131-32 (S.D.N.Y. 1974); SEC v. Lum's, Inc., 365 F. Supp. 1046, 1052 (S.D.N.Y. 1973); Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933, 935 (1968).

[13] *See, e.g.*, SEC v. Avis, Inc., [1973-1974 Transfer Binder] CCH FED. SEC. L.

curities firm acquires inside information while the firm's broker-dealer or investment-advisory department is making recommendations with respect to that company's securities, or when the firm's investment management department is purchasing or selling such securities for accounts managed by the firm, or when the firm's trading department is executing trades in such securities for the firm as a dealer or marketmaker. In such situations, the securities firm is faced with conflicts among (1) the duty of confidentiality owed to the investment-banking client[14] or to the company on whose board a member of the firm sits;[15] (2) the duties owed to the firm's customers to disclose, to know the "merchandise" in which it deals and to deal fairly;[16] and (3) the requirement of rule 10b-5 that one who is in possession of inside information must disclose such

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REP. ¶ 94,419 (S.D.N.Y. 1974) (summary of complaint); Hawk Indus., Inc. v. Bausch & Lomb, Inc., 59 F.R.D. 619, 621 (S.D.N.Y. 1973).

[14] The securities firm owes a duty to its investment-banking clients not to disclose confidential information divulged to the firm in the course of the investment-banking relationship. *See* Schein v. Chasen, 478 F.2d 817, 823-24 (2d Cir. 1973), *vacated and remanded on other grounds sub nom.* Lehman Bros. v. Schein, 416 U.S. 386 (1974); *cf.* Frigitemp Corp. v. Financial Dynamics Fund, Inc., [Current] CCH FED. SEC. L. REP. ¶ 95,323, at 98,633-34 (2d Cir. Oct. 14, 1975) (dictum), *aff'g* [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,907 (S.D.N.Y. 1974). *But see* Schein v. Chasen, 313 So. 2d 739, 746-47 (Fla. 1975). *See also* Thomas v. Roblin Indus., Inc., [Current] CCH FED. SEC. L. REP. ¶ 95,259, at 98,339 (3d Cir. July 31, 1975); Diamond v. Oreamuno, 24 N.Y.2d 494, 497-99, 248 N.E.2d 910, 912, 301 N.Y.S.2d 78, 80-81 (1969); NYSE, M.F. Educ. Circular No. 162 (June 22, 1962); Daum & Phillips, *The Implication of Cady, Roberts*, 17 BUS. LAW. 939, 950 n.25, 952 (1962). The *Restatement (Second) of Agency* has taken the same position in a broader context:

> Unless otherwise agreed, an agent is subject to a duty to the principal 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 . . . unless the information is a matter of general knowledge.

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

[15] The director who acquires or is given access to confidential information in his corporate capacity owes a fiduciary duty to the corporation not to use such information for his own benefit or to the detriment of the corporation. *See, e.g.*, Bancroft-Whitney Co. v. Glen, 64 Cal. 2d 327, 345, 411 P.2d 921, 934-35, 49 Cal. Rptr. 825, 838-39 (1966); Bimba Mfg. Co. v. Starz Cylinder Co., 119 Ill. App. 2d 251, 266, 256 N.E.2d 357, 365 (1970); 3 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 857.1 (Supp. 1974). *But see* Schein v. Chasen, 313 So. 2d 739, 746-47 (Fla. 1975); *cf.* Frigitemp Corp. v. Financial Dynamics Fund, [Current] CCH FED. SEC. L. REP. ¶ 95,323, at 98,634 (2d Cir. Oct. 14, 1975), *aff'g* [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,907 (S.D.N.Y. 1974). *See also* Diamond v. Oreamuno, 24 N.Y.2d 494, 498, 248 N.E.2d 910, 912, 301 N.Y.S.2d 78, 81 (1969); 1 G. HORNSTEIN, CORPORATION LAW AND PRACTICE § 442 (1959); RESTATEMENT (SECOND) OF AGENCY § 395 (1958), *quoted in* note 14 *supra*.

[16] The broker-dealer owes a duty to its customer to reveal information about a security which might reasonably be expected to affect a trading decision. *E.g.*, Sanders v. John Nuveen & Co., [Current] CCH FED. SEC. L. REP. ¶ 95,347, at 98,722-23 (7th Cir. 1975) (federal securities law). Black v. Shearson, Hammill & Co.,

information or refrain from using it in trading or recommending the securities in question.[17]

Faced with the investment banker/broker-dealer conflict, multiservice securities firms have adopted various policies in an attempt to meet their obligations to investment-banking clients and trading customers, while at the same time avoiding the possibility of misuse of inside information to the trading advantage of the firms or their customers. The keystone of such policies is the erection of a Chinese Wall to preclude the transmission of inside information from the investment-banking department to the broker-dealer department.[18] The operative theory is that the denial of

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266 Cal. App. 2d 362, 367-68, 72 Cal. Rptr. 157, 160 (1968) (common law); Van Alstyne, Noel & Co., 33 S.E.C. 311, 321 (1952), *modified on other grounds*, 34 S.E.C. 593 (1953) (federal securities law). *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); 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 PLI FOURTH ANNUAL INSTITUTE ON SECURITIES REGULATION 273 (1973); Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445. The duty is greatest when the broker has recommended the transaction. *See, e.g.*, Hanly v. SEC, 415 F.2d 589, 597 (2d Cir. 1969); Van Alstyne, Noel & Co., *supra* at 321.

The broker-dealer's obligation to know his merchandise and to deal fairly with his customer rests on the "shingle" theory: the broker acting as agent, and even the dealer acting at arm's length, impliedly represent that they will deal fairly with the public. 3 L. LOSS, SECURITIES REGULATION 1482-93 (2d ed. 1961). The SEC has described the broker-dealer's duty as follows:

> It should be noted that the suitability rules are cast in terms of the needs of the customer based on information he furnishes to the broker. Unarticulated but implicit in such rules is also the broker's obligation to obtain current basic information regarding the security and then to make an evaluation as to the suitability of a recommendation for a particular customer in view of both the information concerning the security and the customer's needs.
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> The Commission recognizes that some customers will independently determine to purchase or sell specific securities and will not request or desire the advice of a broker and that in these circumstances it is impractical to require rigid adherence to the suitability rules. Even in such cases, however, the broker would appear to be obliged to reveal to the customer information known to him about the security which might reasonably be expected to affect the customers' [*sic*] decision, apart from his other duties under applicable provisions of the securities laws.

SEC, FUTURE STRUCTURE, *supra* note 2, at 65,620; *cf.* Pollak v. Eastman Dillon, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,987, at 97,411-13 (S.D.N.Y. 1975).

[17] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969); Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961).

[18] The Chinese Wall approach carries with it the incidental benefit of avoiding the sometimes difficult problem of distinguishing between inside information and public or nonmaterial information. *See* Investors Management Co., 44 S.E.C. 633, 647 n.28 (1971). The difficulty of determining materiality is highlighted by cases such as Rochez Bros. v. Rhoades, 491 F.2d 402, 408-09 (3d Cir. 1973), and Gerstle v.

access to the information precludes its misuse.[19]

Recognizing, however, the other side of the coin—the obligation of a firm not to mislead its trading customers in situations in which the investment-banking department might possess inside information which, by operation of the Chinese Wall, would not be known to the broker-dealer department—a number of firms have also adopted a policy of not making any recommendations at all with respect to securities about which they are likely to obtain inside information, whether through investment-banking, directorial or similar relationships.[20] The objective of such a "no-recommendation" policy is to avoid a situation in which the broker-dealer department might be affirmatively recommending the purchase or sale of a security to customers on the basis of public information while such information is known by the investment-banking department to be false and misleading.[21]

To further guard against such an eventuality, many securities firms also have a "restricted list" procedure. Once a security is restricted, the broker-dealer department is precluded from making recommendations to the firm's customers with respect to that se-

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Gamble-Skogmo, Inc., 478 F.2d 1281, 1302-03 (2d Cir. 1973), as well as by the recent efforts of the SEC to expand rule 10b-5 to encompass disclosure as to the quality or integrity of management. *See, e.g.*, SEC v. United Brands Co., No. 75-0509 (D.D.C., filed Apr. 9, 1975) (disclosure of "slush funds," bribes and political contributions), in BNA SEC. REG. & L. REPORT NO. 298, at A-8 (1975) (summary of complaint); SEC Securities Act Release No. 5411, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,427 (July 25, 1973) (disclosure of litigation involving accountants and attorneys); Wall St. J., May 15, 1975, at 1, col. 6. *See also* Kripke, *Rule 10b-5 Liability and "Material" "Facts,"* 46 N.Y.U.L. REV. 1061 (1971); Solomon & Wilke, *supra* note 7, at 521-24.

[19] The Chinese Wall is easier to describe in conceptual terms than it is to implement in day-to-day practice. In many securities firms—both large and small—there is considerable overlap between departments, particularly at the partner or senior officer level. 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. *See* text accompanying notes 157-58, 163-64 *infra*. To enable the firm to establish its Chinese Wall as an evidentiary matter and to protect the firm in a situation in which an employee commits an unauthorized violation of the firm's Chinese Wall policy, that policy and its concomitant procedures should be part of the firm's formal compliance program, which should be reviewed regularly with the firm's employees. *See* SEC v. Lum's, Inc., 365 F. Supp. 1046, 1064-65 (S.D.N.Y. 1973).

[20] The no-recommendation policy is triggered at the time the firm enters into a confidential relationship and ends with that relationship's conclusion.

[21] This was the situation in Slade v. Shearson, Hammill & Co., [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,329 (S.D.N.Y. 1974), *discussed in* note 6 *supra* & text accompanying notes 63-130 *infra*.

curity; similarly, the firm is precluded from investing in the security for its own account. Under one form of restricted list, the securities of a company about which any principal or department of the firm obtains inside information are placed on the list; the securities are removed from the list only when the information becomes public. Under another variant, the securities of a company are restricted when the firm enters into an investment-banking or other relationship likely to lead to the firm's acquisition of inside information; they remain restricted until the relationship is terminated. The restricted list is circulated to the appropriate departments of the firm, including the broker-dealer department, and is constantly updated and revised.

The restricted-list procedure predates the Chinese Wall solution. It was originally devised to avoid rule 10b-6 and "gun jumping" violations in connection with underwritings. Today the restricted-list procedure serves four principal purposes—(1) to prevent violations of rule 10b-6, which proscribes certain trading activities by a securities firm engaged or likely to be engaged in an underwriting or other "distribution" of securities;[22] (2) to prevent

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[22] Rule 10b-6 provides in relevant part:

> (a) It shall constitute a "manipulative or deceptive device or contrivance" . . . for any person,
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> (1) who is an underwriter or prospective underwriter in a particular distribution of securities, or
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> (2) who is the issuer or other person on whose behalf such a distribution is being made, or
>
> (3) who is a broker, dealer, or other person who has agreed to participate or is participating in such a distribution, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, either alone or with one or more other persons, to bid for or purchase for any account in which he has a beneficial interest, any security which is the subject of such distribution, or any security of the same class and series, or any right to purchase any such security, or to attempt to induce any person to purchase any such security or right until after he has completed his participation in such distribution . . . .

17 C.F.R. § 240.10b-6 (1975). For a discussion of the scope of the rule as applied to underwriters, officers and subsidiaries, see O'Boyle, *Distributions and Rule 10b-6 Underwritings*, in PLI SECOND ANNUAL INSTITUTE ON SECURITIES REGULATION 125, 136-42 (1971). The isolation or Chinese Wall technique will not serve to insulate a person from the proscriptions of rule 10b-6. *Cf.* SEC Securities Exchange Act Release No. 3505, 2 CCH FED. SEC. L. REP. ¶ 22,551, at ¶ 22,562 (Nov. 16, 1943). The "directly or indirectly" language of rule 10b-6 has been construed as including within its proscriptions separate entities subject to the influence of a person directly restricted by the rule. SEC Securities Exchange Act Release No. 10,539, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,600 (Dec. 6, 1973); Edie Management Services, Inc., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,914 (SEC 1972). *See also* Jaffee & Co. v. SEC, 446 F.2d 387 (2d Cir. 1971); 3 LOSS, *supra* note 16, at 1571-1614.

recommendations that might violate the proscription of "gun jumping" in commencing the sales effort for a registered public offering;[23] (3) to assure that inside information is not used improperly in the making of trading decisions or recommendations;[24] and (4) to assure that the firm does not make recommendations contrary to any inside information it happens to possess.[25] Because the restricted list serves several functions, the addition of a security to the list does not necessarily signal the existence of inside information concerning that security.

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[23] Information, opinions or recommendations by a broker-dealer about securities of an issuer proposing to register securities under the Securities Act of 1933 for a public offering or having securities so registered, may constitute an offer to sell such securities within the meaning of Sections 2(3) and 5 of that Act, particularly when the broker-dealer is to participate in the distribution as an underwriter or selling group member. Publishing such information may result in a violation of Section 5 of the Act.

SEC Securities Act Release No. 5101, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,929, at 80,061 (Nov. 19, 1970); *see* Securities Act of 1933, § 5(c), 15 U.S.C. § 77e(c) (1970). *See also* Chris-Craft Indus., Inc. v. Bangor Punta Corp., 426 F.2d 569, 574-76 (2d Cir. 1970); Loeb, Rhoades & Co., 38 S.E.C. 843, 848-54 (1959); SEC, DISCLOSURE TO INVESTORS: A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 and '34 ACTS 132-33 (1969); Wheat, *The Disclosure Policy Study of the SEC*, 24 BUS. LAW. 33, 36 (1968).

[24] *See* text accompanying notes 28-37 *infra*. It has been argued that restriction in and of itself—without regard to whether it is triggered by favorable or adverse inside information—might be material information in that it could indicate that there will be a sharp movement in the price of the security one way or the other and thereby permit someone with knowledge of the restriction to profit. *See* Note, *Conflicting Duties of Brokerage Firms*, 88 HARV. L. REV. 396, 415 (1974) [hereinafter Note, *Conflicting Duties*]. Nevertheless, this factor does not warrant rejection of the restricted-list procedure. If the restricted list is used for rule 10b-6 and "gun-jumping" purposes, as well as for inside information purposes, restriction per se will not necessarily indicate a sharp price movement. In addition, restriction of a type that could signal such a price movement frequently results in requests by the regulatory agencies and other pressures on the company in question to make prompt disclosure. In any weighing of the policy considerations relating to the restricted-list approach, the benefits of inducing prompt disclosure would appear to outweigh the possibility that someone could profit from the knowledge of restriction. Furthermore, use for trading purposes of information concerning the restriction itself may violate rule 10b-5, since both the SEC and the courts are increasingly indicating that such market information is within the ambit of the rule. *Compare* Lipton, *Market Information*, in PLI FIFTH ANNUAL INSTITUTE ON SECURITIES REGULATION 287 (1974), *with* Fleischer, Mundheim & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798 (1973). *But see* Frigitemp Corp. v. Financial Dynamics Fund, Inc., [Current] CCH FED. SEC. L. REP. ¶ 95,323, at 98,636-37 (2d Cir. Oct. 14, 1975), *aff'g* [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,907 (S.D.N.Y. 1974) (rejecting application of rule 10b-5 to market information and limiting rule 10b-5 to inside corporate information). *See also* SEC v. Sorg Printing Co., [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,034 (S.D.N.Y. 1975); Fleischer, *Buy Now, Tender Later?*, INSTITUTIONAL INVESTOR, Mar. 1975, at 82.

[25] *See* text accompanying notes 49-55, 87-89 *infra*.

These policies—not recommending the securities of companies with which the firm has a confidential relationship likely to lead to inside information and placing on a restricted list securities as to which the firm has obtained inside information—overlap and complement each other and the basic Chinese Wall policy. In theory the no-recommendation policy is subsumed in the restricted-list policy; there would be no need for the former if the restricted list were activated every time the firm obtained inside information. That is, the addition of a security to the restricted list prevents the firm from making a recommendation about, or an investment for its own account in, that security at a time when the firm has inside information, just as well as does the policy of not recommending securities as to which there is a confidential relationship. Indeed, the restricted list goes further in that it prevents the proscribed action whether or not there is a confidential relationship. There is, however, the likelihood of frequent need to restrict the securities of companies with which there is a confidential relationship. Furthermore, it has been argued that the placing of a security on a restricted list only at the time inside information is received might somehow "signal" the character of that information, whether favorable or adverse, to customers.[26] Both of these factors militate in favor of a prophylactic combination of the no-recommendation policy and the restricted list. Similarly, the Chinese Wall itself, by insulating the personnel of the firm who are in contact with its retail customers from the inside information, works to prevent the act of restriction from constituting a signal. While these matters will be developed more fully in part III, it should be noted here that the Chinese Wall, no-recommendation and restricted list policies must be tailored to the particular firm and based upon its particular range of activities. The proper policy or mix of policies depends on the structure of, and kinds of functions performed by, the firm in question.

II

THE CHINESE WALL AND THE SECURITIES FIRM'S LIABILITY TO THE INVESTING PUBLIC AND TO ITS OWN INVESTMENT-BANKING CLIENTS

A. "Tippee" Liability of the Firm

The ultimate strength of the Chinese Wall solution in a particular case will depend upon whether the court will accept the

[26] Note, *Conflicting Duties*, *supra* note 24, at 415.

factual argument that the firm's Chinese Wall has isolated the inside information in question and the legal argument that such isolation is an appropriate reconciliation of the conflicts which the rule 10b-5 proscription of the use of inside information creates for the multiservice firm.[27] Resolution of the latter issue may depend upon demonstrating to the court's satisfaction that the Chinese Wall is consistent with recent inside information cases. A reading of those cases suggests that this solution is indeed in harmony with them and promotes the policy of rule 10b-5.

Investing or making a recommendation on the basis of inside information of course violates rule 10b-5.[28] The policy underlying the rule was expressed by the Second Circuit in *SEC v. Texas Gulf Sulphur Co.*:[29]

> [A]ll investors should have equal access to the rewards of participation in securities transactions. It was the intent of Congress that all members of the investing public should be subject to identical market risks . . . . [I]nequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life, or, in view of the congressional concern in the area, remain uncorrected.[30]

Texas Gulf Sulphur commands that possession of inside information creates a duty to "either disclose it to the investing public, or . . . abstain from trading in or recommending the securities concerned while such inside information remains undisclosed."[31]

In *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[32] the Second Circuit reaffirmed this "disclose or abstain" principle, holding that officers, directors and employees of a prospective

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[27] In Hi-Shear Corp. v. Klaus, Civ. No. 74-434 (C.D. Cal. Dec. 19, 1974), the court rejected the defendants' attempted isolation-of-information defense in the context of a suit by a corporation to enjoin trading in its securities by a small investment management firm for the account of a corporate insider on the basis of inside information. The case turned on the special intimate relationship between the investment management firm, the insider and the corporation: the investment management firm had been formed for the purpose of managing the insider's portfolio; the sole principal of the investment management firm was himself an insider of the plaintiff corporation, sitting with his investment management client on the corporation's board of directors; and the employee of the investment management firm who actually executed the challenged trades had been hired by the sole principal and was subject to his close daily supervision. *Id.* at 2396-97.

[28] *E.g.*, Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969); Cady, Roberts & Co., 40 S.E.C. 907 (1961), *discussed in* note 4 *supra*.

[29] 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

[30] *Id.* at 851-52.

[31] *Id.* at 848.

[32] 495 F.2d 228 (2d Cir. 1974).

managing underwriter, by selectively divulging inside information to customers who then traded, had violated rule 10b-5 by "tipping."[33] Echoing *Texas Gulf Sulphur*, the court said that the goal of rule 10b-5 was "to protect the investing public," guarantee "fair dealing in the securities markets," and " 'prevent corporate insiders and their tippees from taking unfair advantage of . . . uninformed outsiders.' "[34]

Texas Gulf Sulphur and *Shapiro* make it clear that the objective of rule 10b-5 is to assure equal access by the investing public to material information and, where such access is unequal, to prevent the misuse of inside information by those privy to it. As the SEC said in *Cady, Roberts*, "Intimacy demands restraint lest the uninformed be exploited."[35] Accordingly, a securities firm may not execute transactions either for its own account or for a discretionary account on the basis of inside information,[36] nor may it pass such information on to others, whether in a research report or otherwise.[37]

On the other hand, neither the purposes of rule 10b-5 nor the policies supporting it require prohibiting the broker-dealer department of a securities firm from continuing to execute transactions which it has not recommended to its customers just because some other department has acquired inside information about the securities being traded. The policy against unfairness and the misuse of inside information is not violated by the firm's execution —either as agent or principal—of such transactions, so long as a Chinese Wall has prevented the inside information from being communicated to the broker-dealer department.[38] Since the department executing the trade would be in the same position as the investing public, the inside information could not be used by the

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[33] *Id.* at 235-38.

[34] *Id.*, at 235, *quoting* Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876, 890 (2d Cir. 1972).

[35] 40 S.E.C. 907, 912 (1961).

[36] Van Alstyne, Noel & Co., 43 S.E.C. 1080, 1085 (1969); Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961).

[37] Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237 (2d Cir. 1974); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 852 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

[38] *See* Brief for SEC as Amicus Curiae at 9-10, Slade v. Shearson, Hammill & Co., 517 F.2d 398 (2d Cir. 1974) [hereinafter SEC Brief]. An analogous principle is encountered in the lawyer-disqualification context. For example, in United States v. Standard Oil Co., 136 F. Supp. 345 (S.D.N.Y. 1955), it was held that a former government attorney in the Paris office of the Economic Cooperation Administration was *not* disqualified from representing the defendant in a suit for alleged overcharges in ECA-financed transactions, because the work of the ECA's Paris Office was unrelated to the transactions at hand and information concerning the overcharges had not been communicated to the Paris office. *Id.* at 362, 365-66.

firm or its customers to the unfair advantage of either.[39]

Although, under *Texas Gulf Sulphur* and its progeny, the fact that a firm possessed inside information at the time it was involved in a stock transaction may lead to a presumption that that information was used in connection with the trade,[40] the cases do not preclude a showing of nonuse to avoid liability.[41] Despite the broad sweep of the "disclose or abstain" rule announced by *Texas Gulf Sulphur* and embraced by *Shapiro*, neither case presents a nonuse situation.[42] The SEC has accepted this view.[43] Liability under rule 10b-5 is only appropriate where there is use of inside information, for it is *use*, not mere possession by other departments of the firm,

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[39] This reasoning also applies to customer recommendations and own-account investments by a firm with isolated inside information. Those activities, however, should be proscribed for reasons other than the disclosure provisions of rule 10b-5. *See* text accompanying notes 200-15 *infra*.

[40] *See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 235-36 (2d Cir. 1974); SEC v. Shapiro, 494 F.2d 1301, 1307 (2d Cir. 1974); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 851-53 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). In *SEC v. Shapiro*, however, the Second Circuit refused to decide whether the inference of use was a matter of law because the district court had specifically found that the information had influenced the trading. 494 F.2d at 1307; *cf.* Hi-Shear Corp. v. Klaus, Civ. No. 74-434 (C.D. Cal. Dec. 19, 1974), *discussed in* note 27 *supra*.

[41] *But cf.* Hi-Shear Corp. v. Klaus, Civ. No. 74-434 (C.D. Cal. Dec. 19, 1974), *discussed in* note 27 *supra*.

[42] In *Texas Gulf Sulphur* use of inside information in trading either was clear or was inferred on the basis of circumstantial evidence. 401 F.2d at 851-53. Where it could not be inferred, no liability was found. *Id.* at 852 n.14. In *Shapiro* use was presumed by the court for the purposes of the motion sub judice. 495 F.2d at 231, 235-36.

[43] Investors Management Co., 44 S.E.C. 633, 646-47 (1971); *see* SEC Brief, *supra* note 38, at 6. The position taken by the SEC in its *Slade* brief appears to settle in the negative the question of whether the SEC is moving away from the *use*-of-inside-information standard applied in Investors Management Co., *supra* at 644, and Cady, Roberts & Co., 40 S.E.C. 907, 911-12 (1961), to a mere *possession*-of-inside-information standard, as could be said to be adumbrated in Faberge, Inc., SEC Securities Exchange Act Release No. 10,174, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,378, at 83,100 (May 25, 1973).

Faberge involved tipping liability by tippee securities firms. There was no occasion for the Commission's opinion to focus upon the requirement that the information be a factor in a decision to sell inasmuch as the facts to which the respondents had consented indicated that, with the "possible exception" of the first of two sales by one respondent, "the sales and tipping were motivated by the adverse information." *Id.* at 83,104. Since *Faberge* was a post-*Investors Management* case, the Commission's silence might seem to indicate that mere possession—provided the inside information is material—is enough for liability under rule 10b-5. A close examination of the case, though, would suggest that the Commission's silence was due to the respondents' consent to the factual findings.

Even under the prior cases, however, there is a heavy burden on the defendant firm to show nonuse. *See* Investors Management Co., *supra* at 647 n.28 ("close scrutiny" test); Note, *Conflicting Duties*, *supra* note 24, at 414 n.108.

which constitutes the violation.[44] The Chinese Wall is designed to seal off the possibility of such use and thereby to meet the standard of conduct established by the cases.

B. The Duty of Confidentiality

In addition to duties owed to the investing public under rule 10b-5, the multiservice securities firm often owes a duty of confidentiality to sources from which it receives inside information. A member of a firm who sits on a company's board of directors is obligated not to disclose inside information he receives in his directorial capacity.[45] The firm owes a parallel duty to its investment-banking client.[46] In either case, the obligation results mainly from a corporation's need to communicate information for a corporate purpose without compromising itself in its dealings with others.[47] In the case of a director, the duty is also related to the prohibition against self-dealing by a fiduciary.[48] The Chinese Wall incidentally operates to avoid breach of these duties by preventing leaks of inside information to the broker-dealer department.

III

THE CHINESE WALL AND THE SECURITIES FIRM'S LIABILITY TO ITS CUSTOMERS

Assuming *arguendo* that the Chinese Wall discharges the firm's duty not to tip or otherwise misuse inside information and that it preserves the confidentiality of information received from investment-banking clients, the question remains whether the Chinese Wall satisfies the firm's duty to its customers. The broker-dealer's obligation to know its merchandise and to deal fairly with its customer rests on the "shingle" theory that the broker (acting as agent) and even the dealer (acting at arm's length) implicitly represent that they will deal fairly with the public.[49] There is a duty owed to the customer to reveal any information about a security which might reasonably be expected to affect a trading decision.[50]

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[44] This principle was made clear in Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 236, 238 (2d Cir. 1974), and SEC v. Shapiro, 494 F.2d 1301, 1305, 1307 (2d Cir. 1974), both of which were decided after *Faberge*. *See* notes 42-43 *supra*.

[45] *See* note 15 *supra*.

[46] *See* note 14 *supra*.

[47] Note, *Conflicting Duties*, *supra* note 24, at 401.

[48] Diamond v. Oreamuno, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969); *see* note 15 *supra*.

[49] *See* note 16 *supra*.

[50] *Id.*

In performing its other functions, the Chinese Wall complicates the fulfillment of these obligations owed to trading customers, since it may insulate the broker-dealer department from inside information acquired by another department of the firm which is material to a particular customer transaction. This conflict becomes most acute when the inside information is contrary to the thrust of the public information available to the broker-dealer department.

Despite this conflict, there is no reason why a customer trading against effectively isolated inside information should have a claim against the firm, as long as the firm did not recommend the transaction. Indeed, the policy of assuring reliable and liquid trading markets requires that an investor be able to execute a transaction promptly to secure the current price and not be forced to spend time seeking a new securities firm to handle the trade.[51]

It might be argued that a firm has a duty to dissuade its customer from executing a transaction when the firm has any information that the trade would not be in the customer's interest. It has generally been held, however, that, absent an outstanding recommendation or special relationship pursuant to which the customer is clearly relying on the firm for investment advice, the firm does not have any duty to advise the customer.[52] Indeed, if the information were nonpublic and the firm, acting on it, took steps to dissuade the customer, the firm would not only be breaching its duty of confidentiality but would also be tipping in violation of rule 10b-5.[53] There is the added danger that the customer might communicate either the recommendation or the information itself to others who might then use that knowledge in violation of rule 10b-5, thus exposing the firm to still wider "tippor" liability.[54] The Chinese Wall avoids problems which arise from selective disclosure to customers who happen to be trading during the critical period.

To assure compliance with rule 10b-5, a securities firm must remain neutral when it acquires inside information. The firm can-

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[51] *Cf.* SEC, SPECIAL STUDY, *supra* note 1, pt. 5, at 65. *See generally* SEC, ADVISORY COMMITTEE REPORT ON THE STRUCTURE OF A CENTRAL MARKET SYSTEM, in CCH FED. SEC. L. REPORT NO. 469 (extra ed.) (1973); TREASURY DEP'T, PUBLIC POLICY, *supra* note 7.

[52] Canizaro v. Kohlmeyer & Co., 370 F. Supp. 282, 286-88 (E.D. La. 1974), *aff'd*, 512 F.2d 484 (5th Cir. 1975) (per curiam); *see* Daum & Phillips, *supra* note 14, at 952; Jacobs, *supra* note 16, at 971; Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 COLUM. L. REV. 1361, 1388 (1965); *cf.* Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1172 (2d Cir. 1971); Pollak v. Eastman Dillon, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,987 (S.D.N.Y. 1975); Cant v. A.G. Becker & Co., 374 F. Supp. 36, 46-47 (N.D. Ill. 1974); Comptroller Letter, *supra* note 7.

[53] *See* text accompanying notes 27-37 *supra*.

[54] Investors Management Co., 44 S.E.C. 633, 643-44 (1971).

not give its customers the benefit of that information. The principle is the same whether the situation involves potential gain or loss: neutrality forbids making and continuing recommendations to trade, either in a manner indicated by, or in a fashion contrary to, the inside information. Even where a firm has an advisory relationship and, therefore, a special duty to a customer, that duty would not require the firm's performance of the illegal act of disclosing or using inside information in violation of rule 10b-5.[55]

The courts have had infrequent occasion to consider the merits of the Chinese Wall and the extent to which departmental isolation of inside information may constitute a breach of the duties owed to a securities firm's trading customers. In two administrative proceedings, the SEC has been faced with the basic conflict situation at issue (although not, it should be noted, with the Chinese Wall itself) and has inconsistently resolved the question of whether the firm's duty of confidentiality is a defense to its failure to disclose inside information to customers.[56] Prior to *Slade*, however, the issue appears to have been judicially considered only in *Black v. Shearson, Hammill & Co.*,[57] a common law fraud action brought against a securities firm.

A. Black v. Shearson, Hammill & Co.

In *Black*, a Shearson, Hammill & Co. (Shearson) partner had acquired adverse inside information in the course of his duties as a director of, and principal adviser to, USAMCO, a client company. Shearson was the marketmaker in USAMCO securities. The partner, among other things, failed to disclose the inside information to Shearson personnel who were strongly recommending the purchase of USAMCO securities to their customers.

The plaintiffs, customers of Shearson who had bought the securities, charged that the firm, by making the purchase recommendations while in possession of the adverse inside information, had violated the common law duty owed by a broker-dealer to its customers. Shearson admitted its fiduciary duty to the plaintiffs but argued—relying, *inter alia*, on a New York Stock Exchange policy statement[58]—that the partner had a second and higher duty to the

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[55] *See id.* at 647. In Cady, Roberts & Co., 40 S.E.C. 907 (1961), the SEC stated, "Even if we assume the existence of conflicting fiduciary obligations, there can be no doubt which is primary here. . . . [C]lients may not expect of a broker the benefits of his inside information at the expense of the public generally." *Id.* at 916.

[56] *Compare* Investors Management Co., 44 S.E.C. 633 (1971), *with* Van Alstyne, Noel & Co., 33 S.E.C. 311 (1952), *modified on other grounds*, 34 S.E.C. 593 (1953).

[57] 266 Cal. App. 2d 362, 72 Cal. Rptr. 157 (1968).

[58] NYSE, M.F. Educ. Circular No. 162 (June 22, 1962); *see* text accompanying notes 136-37, 144-47 *infra*.

company not to reveal the inside information. The court held that the partner's noncommunication of the information to the firm's salesmen making the recommendations did not absolve Shearson of liability to its purchasing customers.

The court's analysis began with the affirmation of the firm's fiduciary duty of disclosure to its broker-dealer department customers. Intentional failure to disclose material information, said the court, constituted fraud.[59] Although acknowledging the utility of the firm's performance of dual roles, the court rejected the premise of a hierarchy of obligations. Unpersuaded by the argument that one set of duties could be avoided by assuming another, the court observed, "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."[60] Thus, under *Black*, the customer cannot be deprived of protection against fraud simply because the firm has chosen to perform two conflicting functions.

On the particular facts before it, the *Black* court reached the correct result. The partner, who was Shearson's senior west coast partner, had placed some of USAMCO's initial public offering with personal clients and had acquired a sizeable block of the securities for himself. He also had made the decision that Shearson would act as marketmaker in USAMCO securities. Upon receipt of the adverse inside information, however, he sold much of his own and his personal customers' stock, while at the same time encouraging Shearson's salesmen to recommend purchases to others. Thus, the internal noncommunication of the adverse inside information appears to have been engineered by the partner, not in pursuit of the legitimate goals of the Chinese Wall, but to further his personal interests at the expense of his firm's trading customers.

The broad language of the *Black* opinion, however, goes much farther than necessary to decide the case on the particular facts before the court. The opinion can be read as requiring that whenever any principal of a securities firm has inside information, such information must be communicated to the firm's trading customers for the firm to avoid fraud liability, even if the transactions have not been recommended by the firm.[61] Thus, *Black* casts a shadow of

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[59] 266 Cal. App. 2d at 367, 72 Cal. Rptr. at 160.

[60] *Id.* at 368, 72 Cal. Rptr. at 161.

[61] Such a reading of *Black* would present the conflict between the duty to customers and the proscription on use of inside information in the sharpest terms, *see* note 55 *supra*, and, assuming no exception for a *bona fide* Chinese Wall, would, as a practical matter, require a physical separation of functions by securities firms.

doubt on the efficacy of the Chinese Wall. That shadow lengthened in *Slade v. Shearson, Hammill & Co.*[62]

B. The Slade *Case: The District Court*

In *Slade*, Shearson was faced with another action brought by purchasing customers—this one under rule 10b-5. The plaintiffs charged that Shearson had promoted purchase of the securities of Tidal Marine International Corporation, an investment-banking client of the firm, while Shearson was in possession of adverse inside information about the company. Shearson moved for summary judgment, advancing two alternative theories.[63] First, the firm denied knowledge of inside information during the critical trading period. Second, Shearson argued that even if its investment-banking arm had known of the information, it was legally precluded from using that knowledge to prevent the firm's retail salesmen from soliciting purchases while the information remained nonpublic. Moreover, the firm claimed that even after the inside information was received, it could not have been communicated to the retail brokerage personnel who had solicited the purchases, because of the Chinese Wall policy effectuated by the firm.[64]

The district court, finding that there was an issue of material fact as to Shearson's asserted lack of knowledge and rejecting Shearson's Chinese Wall defense, denied the motion. In *Slade*, as in *Black*, the court acknowledged the firm's duty of confidentiality to its investment-banking client, but refused to permit Shearson to cloak itself in that obligation in derogation of its duties to its investing customers.[65] The court noted that confidentially obtained inside information may not be revealed, but seemed to repudiate the notion that "an investment banker, once it receives adverse inside information, . . . may not *prevent* its brokerage organization from soliciting customers on the basis of public information which (because of its possession of inside information) it knows to be false or misleading."[66] The "disclose or abstain" rule of *Texas Gulf Sulphur*[67] was held to apply to the investment banker/broker-dealer situation. Thus, the implicit result of applying that doctrine

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[62] [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,329 (S.D.N.Y. 1974) (denial of motion for summary judgment), *discussed in* note 6 *supra*.

[63] *Id.* at 95,131.

[64] This argument, although not specifically mentioned in the district court's opinion, is noted in the circuit court's opinion remanding the case. Slade v. Shearson, Hammill & Co., 517 F.2d 398, 401 (2d Cir. 1974).

[65] [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. at 95,131-32.

[66] *Id.* at 95,131 (emphasis in original).

[67] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969), *quoted in* text accompanying note 31 *supra*.

—that securities firms with adverse inside information about a security might be disabled from "soliciting"[68] purchasers for the security—was openly acknowledged.[69] This rule would subject firms with inside information to a disadvantage vis-à-vis other firms without it. The court reasoned, however, that this disadvantage flowed from fiduciary duties which the firm had voluntarily incurred and that it therefore provided no support for a contrary holding.[70] Thus, *Slade*, involving a less egregious set of facts than *Black*, moved beyond the prior state of the law to prohibit certain broker-dealer functions, even absent the use of inside information.[71]

In a subsequent opinion in the case, the same judge retreated from the position previously taken on the determination of the summary judgment motion. He recognized that *Slade* was, indeed, a case of first impression[72] and was so factually distinguishable from *Texas Gulf Sulphur*[73] "as to [arguably] render the ['disclose or abstain'] principle inapposite."[74] He therefore certified for review by the Second Circuit the question at the heart of *Slade*—whether an investment banker/broker-dealer who receives adverse inside information about an investment-banking client is precluded from soliciting customers to purchase that client's securities on the basis of public information which the firm knows to be misleading.[75] The Second Circuit accepted the certification.

The potential significance of the *Slade* case for the securities industry was immediately perceived.[76] As the certifying judge himself recognized, some resolutions of the issue could make it "ex-

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[68] [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. at 95,132.

[69] *Id.*

[70] *Id.*

[71] The plaintiff in *Slade*, however, asserted that Shearson was also a market-maker in Tidal Marine securities. Therefore, in alleging a further conflict, viz., that Shearson was selling from its own position in securities about which it had adverse inside information, the plaintiff was implicitly suggesting use by observing that Shearson had good motive to recommend Tidal to its customers. Brief for Plaintiff-Appellee at 11, Slade v. Shearson, Hammill & Co., 517 F.2d 398 (2d Cir. 1974) [hereinafter Slade Brief]. In addition, in criticizing Shearson's Chinese Wall the plaintiff pointed to the alleged anomaly that Shearson's salesmen were *required* to make use of the "bullish" information received from the investment-banking department. *Id.* at 5.

[72] [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,439, at 95,531-32 (S.D.N.Y. 1974), *discussed in* note 6 *supra*.

[73] *Texas Gulf Sulphur* involved corporate insiders who traded or tipped consistent with their inside information. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 843-47 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969); note 42 *supra*.

[74] [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. at 95,532.

[75] *Id.* at 95,530.

[76] *See, e.g.*, Bernstein, *Securities—Class Actions: Beyond Texas Gulf*, N.Y.L.J., Jan. 28, 1974, at 1, col. 1; *cf.* Rosenfeld, *Banks and "Chinese Wall": Theory Upset by Lawsuit*, N.Y.L.J., Nov. 19, 1973, at 1, col. 3.

ceedingly difficult for any . . . [securities 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."[77] Indeed, denial of the efficacy of the Chinese Wall solution would be tantamount to mandating separation of the two roles. *Slade* thus created the opportunity—and the need—for a complete examination of the problem.

IV

THE *SLADE* APPEAL: PROBING THE PROTECTION OF THE CHINESE WALL

The concern generated by *Slade* resulted in a thorough exploration of the policy considerations speaking to the desirability of the basic Chinese Wall solution. The dialogue emerged in the appellate briefs submitted by the parties and three amici curiae—the SEC, Salomon Brothers (a leading investment banking and marketmaking firm), and Paine, Webber, Jackson & Curtis (an important investment banking and retail brokerage firm). Each arrived at a different resolution of the problem presented. Faced with a sharp divergence of views on such an important issue, the court of appeals refused to answer the certified question on the limited factual record before it and remanded the case to the district court for further proceedings.[78] Despite the Second Circuit's sidestepping of the issue, the *Slade* appeal did serve an important function by revealing the Chinese Wall positions of the SEC and of major firms engaged in differing aspects of the securities business. Analysis of those positions illuminates the policy considerations that support the Chinese Wall.

A. Shearson's Position

In its brief, Shearson attempted to distinguish recommendations by the individual salesmen of the firm's "retail sales organization" based upon their personal analyses of public information from the formal recommendations of the firm itself contained in Shearson's "Master Buy List."[79] Shearson stated that, as a firm, it "never recommends the securities of an investment banking client"[80] and, accordingly, had never recommended Tidal Marine nor placed that stock on the Master Buy List. The plaintiffs' alleged

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[77] [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. at 95,532.

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

[79] Brief for Appellant at 5-6, Slade v. Shearson, Hammill & Co., 517 F.2d 398 (2d Cir. 1974) [hereinafter Shearson Brief].

[80] *Id.* at 6.

injury, according to Shearson, resulted solely from suggestions made by some of the firm's investment executives "[a]cting individually on the basis of extremely favorable public information."[81]

Having thus set forth its position that it had no outstanding recommendation of Tidal Marine when it received the adverse inside information, Shearson went on to contend that under the strictures of rule 10b-5, as delineated in *Texas Gulf Sulphur* and its offspring,[82] the firm was precluded from using such information for any purpose and had erected a Chinese Wall to foreclose that possibility.[83] Shearson noted that *Texas Gulf Sulphur* had proscribed recommendations based on nonpublic information, rather than on public information (as was the case in *Slade*).[84] Shearson argued that *Texas Gulf Sulphur* had been misapplied by the district court and that, indeed, such misapplication worked to undermine the *Texas Gulf Sulphur* rule itself, since it would require Shearson to use inside information to prevent recommendations by its salesmen, to the detriment of third persons trading in the market.[85] Moreover, Shearson contended that such a result could not be premised on the firm's obligation to its customers, since no fiduciary duty required the firm to use inside information for their benefit.[86]

According to Shearson, then, the "market" that is protected from misuse of inside information consists not only of actual buyers and sellers, but also of potential traders who might buy or sell at any given moment. If the potential traders are eliminated from the market on the basis of nonpublic information, the argument maintains, that group is unfairly favored to the disadvantage of other traders and to the detriment of the market.[87] Adherents to this view would obviously find fault in a restricted list triggered by receipt of inside information. Such a procedure arguably violates rule 10b-5's neutrality principle[88] in at least one situation—where customers would have been advised to make a bad trade in a security

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[81] *Id.* The plaintiff, however, asserted that Shearson's investment-banking department had transmitted "bullish" information about the security in question over "wires" to the salesmen, that Shearson's policy *required* the use of those wires by the salesmen, and that they had in fact been used. Slade Brief, *supra* note 70, at 5.

[82] *See* text accompanying notes 27-37 *supra*.

[83] Shearson Brief, *supra* note 79, at 9-17.

[84] *Id.* at 16.

[85] *Id.* at 16-17.

[86] *Id.* at 17-22.

[87] *Id.* at 8, 17. *But see* Slade Brief, *supra* note 70, at 8 ("Nobody is unfairly hurt or disadvantaged by the fact that the customers of Shearson would not be buying worthless stock.").

[88] *See* text accompanying note 55 *supra*.

but for the prevention of a recommendation due to the restriction of the security.[89] This argument, however, ignores the fact that the restricted list is activated for both good and bad news so that, in any given situation, the absence of the recommendation might be either beneficial or detrimental to the customer. Thus, neutrality inheres in the uncertainty as to the cause of the restriction.

B. Salomon Brothers' Position

Salomon Brothers questioned Shearson's attempt to characterize its brokerage salesmen as somehow separate from the "firm" itself—a distinction Salomon Brothers dismissed as "wholly artificial and . . . an exercise in semantic legerdemain."[90] The difficulty with Shearson's distinction is that it ignores the reasonable expectations of a firm's customers that the investment executives are agents of the firm, rather than independent contractors acting on their own.[91] Such expectations are, of course, at the heart of the firm's duty to its investing clientele.

Once it is accepted that a salesman's recommendation is, in the minds of retail customers, a recommendation by the firm, Shearson's attempted reliance on the *Texas Gulf Sulphur* principle and the Chinese Wall is seen to be misplaced. A doctrine formu-

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[89] It has been suggested that the specialists or marketmakers in the restricted security are the primary victims of the restricted-list procedure, since the narrowing of the potential market increases the probability of their trading. *See* Note, *Conflicting Duties*, *supra* note 24, at 417 n.118. While this may be true, it does not run afoul of the neutrality principle, so long as the market is narrrowed for both favorable and adverse inside information and the act of restriction does not operate as a signal.

[90] Brief for Salomon Brothers as Amicus Curiae at 8, Slade v. Shearson, Hammill & Co., 517 F.2d 398 (2d Cir. 1974) [hereinafter Salomon Brief].

[91] One commentator apparently confuses the relationship of the salesman to the firm for which he works, suggesting that it is one of principal (salesman) to agent (firm), rather than that of agent (salesman) to principal (firm). Note, *Conflicting Duties*, *supra* note 24, at 411-12. On the basis of authority to the effect that an agent's knowledge need not always be attributed to his principal, the commentator rejects both the position urged by Salomon Brothers and the SEC in *Slade*, *see* text accompanying notes 114-22 *infra*, and the reinforced Chinese Wall solution. Note, *Conflicting Duties*, *supra* at 411-13. Even an appropriate agency analysis, though, is not a sufficient basis on which to answer these questions. The broker-dealer has a duty to supervise adequately its salesmen and other employees. *See, e.g.*, R.H. Johnson & Co. v. SEC, 198 F.2d 690, 696-99 (2d. Cir.), *cert. denied*, 344 U.S. 855 (1952); Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 438 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970); Goodman v. Hentz & Co., 265 F. Supp. 440, 445 (N.D. Ill. 1967); Lorenz v. Watson, 258 F. Supp. 724, 733 (E.D. Pa. 1966). At a minimum, the retail customer of a securities firm should be reasonably able to expect that any recommendation by an investment executive of the firm to purchase securities is the recommendation of the firm, at least to the extent that the firm has no information, public or inside, which would render the recommendation incorrect. *Cf.* Hanly v. SEC, 415 F.2d 589, 596-97 (2d Cir. 1969).

lated to prohibit a firm from using inside information to "tip" selected customers to trade in accordance with that information, argued Salomon Brothers, cannot be convoluted to mean that when a firm acquires such knowledge it is compelled to allow its salesmen to continue to make trading recommendations to customers contrary to that information.[92] The proscription on the use of inside information was not intended to constitute a license to commit the type of common law fraud found by the court in the *Black* case. Salomon Brothers pointed out that the "Hobson's choice" postulated by Shearson—between liability to the investing public and liability to one's own customers—was of Shearson's own creation.[93] This dilemma is easily avoided: a securities firm need only prohibit its salesmen from recommending the purchase of securities of the firm's investment-banking clients.[94] The defect in the Shearson position, then, was not its Chinese Wall as supplemented by the firm's policy of not recommending the stock of investment-banking clients, but rather its attempt to exempt its salesmen from that no-recommendation policy.

In an effort to forestall appellate disapproval of the Chinese Wall,[95] Salomon Brothers stated that its own inside information policies would have averted the situation in *Slade*.[96] Salomon Brothers stated that it too had both a Chinese Wall and a no-recommendation policy, but the latter—unlike Shearson's no-recommendation policy—encompassed broker-dealer department employees. To guard further against recommendations by salesmen which might be contrary to inside information isolated elsewhere in the firm, a restricted-list procedure was also in effect. Salomon Brothers asserted its ability to inform customers that it could not execute transactions because the particular security was on its restricted list without that notification itself being taken as either a buy or sell signal.[97] The success of such a claim requires that neither the salesmen nor the customer receive any indication of the reason for the restriction of the security. If, consistent with this view, the restricted-list procedure does work without a signaling effect,[98] then it prevents not only the *Slade* situation (in which there was no outstanding firm recommendation, but individual salesmen made the trading suggestions), but also the problem aris-

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[92] Salomon Brief, *supra* note 90, at 7.
[93] *Id.* at 7-8.
[94] *Id.* at 8-9.
[95] *See id.* at 2.
[96] *Id.* at 4-5.
[97] *Id.* at 5.
[98] *See* text accompanying notes 210-15 *infra*.

ing when a firm receives inside information about a security that the firm itself is currently recommending. The policy enables the firm to stop making the recommendation—without tipping—until the information becomes public.

Finally, Salomon Brothers took issue with some language of the district court which the firm feared might result in an overly broad appellate decision. The summary judgment opinion had used the word "solicitation,"[99] rather than "recommendation," to describe the action of the Shearson salesmen, and the certified question had been framed in terms of "soliciting."[100] Salomon Brothers was concerned that, should the Second Circuit use "soliciting" in an answer to that question, it might be construed as equivalent to the SEC's technical definition of the word in other contexts—such as rule 144[101] and rule 10b-6[102]—in which mere initiation of contact without more is deemed to be solicitation.[103] Such a result would bring marketmaking and block trading within the scope of the *Slade* decision.[104] Therefore, Salomon Brothers urged the Second Circuit to make clear the fact that while a Chinese Wall should not permit a firm with inside information—even effectively isolated inside information—to execute a transaction which the firm has recommended, the policy does permit the execution of a transaction which is unsolicited, or solicited only in the sense that contact concerning the availability of the securities in question has been initiated by the firm.[105]

C. Paine Webber's Position

Paine Webber adopted the position that the Chinese Wall is the proper device for dealing with all the inside information problems of the multiservice securities firm.[106] Its brief began with an attack on Salomon Brothers' proposed distinction between "solicitation" and "recommendation." That distinction, Paine Webber argued, was lacking not only in precedential support, but also in rational basis: "From the customer's perspective it can make absolutely no difference whether he was actively or passively

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[99] Slade v. Shearson, Hammill & Co., [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,329, at 95,131 (S.D.N.Y. 1974).

[100] *Id.* ¶ 94,439, at 95,530.

[101] 17 C.F.R. § 230.144 (1975).

[102] *Id.* § 240.10b-6, *quoted in* note 22 *supra*.

[103] Salomon Brief, *supra* note 90, at 1 n.*.

[104] *Id.*; *see id.* at 4.

[105] *Id.* at 1 n.*, 26-27.

[106] *See* Brief for Paine, Webber, Jackson & Curtis Inc. as Amicus Curiae at 14, Slade v. Shearson, Hammill & Co., 517 F.2d 398 (2d Cir. 1974) [hereinafter Paine Brief].

misled."[107] The brief further asserted that the distinction would discriminate against firms like Paine Webber, whose business largely involves recommendations to customers, and in favor of firms like Salomon Brothers, whose business does not.[108] At the same time, Paine Webber said the distinction ignores the fact that even technical solicitations contain implicit recommendations.[109]

Turning to the issue of supplementary inside information policies, Paine Webber dismissed the no-recommendation procedure as an overbroad solution that would impair the investment-banking function—the underlying premise being that recommendations are an integral part of sponsorship, which is the concomitant of the investment banker's underwriting role.[110] The difficulty with a restricted list, Paine Webber argued, is that adding or deleting a security would be construed by customers as a signal which could not realistically be camouflaged; the signal would be even stronger if the security were restricted while a recommendation was outstanding.[111] Based on its own experience, the firm stated that "the mere act of withdrawing the recommendation will, as a practical matter, inevitably be taken by the customer as a signal that the firm has come into possession of inside information 'contrary to the recommendation.' "[112] Thus Paine Webber concluded that the prohibition against misuse of inside information is best achieved by the Chinese Wall alone—without any supplementary policies.[113]

D. The SEC's Position

Perhaps the most important consequence of the *Slade* appeal was that it moved the SEC to clarify its views on the Chinese Wall approach. The position which emerged in the SEC's brief substantially adopted the stance taken by Salomon Brothers.[114] The SEC argued that the policy of recent inside information cases and the

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[107] *Id.* at 9.

[108] *Id.* at 6-8.

[109] *Id.* at 8.

[110] *Id.* at 10-14.

[111] *Id.* at 15-17.

[112] *Id.* at 16, *quoting* SEC Brief, *supra* note 38, at 11-12. Paine Webber did not explain how the customer could draw such a conclusion when the security is placed on a restricted list regardless of whether the inside information supports or undercuts the recommendation and neither the customer nor his salesman is informed of the reason for the restriction.

[113] *Id.* at 14-17.

[114] The SEC argued that the certified question should be answered in the affirmative and that, given the proper utilization of the Chinese Wall/restricted-list approach, such an answer need not mandate the complete separation of the investment-banking and broker-dealer functions. SEC Brief, *supra* note 38, at 4-5, 8-9, 11.

"disclose or abstain" directive of *Texas Gulf Sulphur*[115] were not applicable in *Slade* because Shearson had not *used* its inside information.[116] But, relying on the holdings in cases such as *Hanly v. SEC*[117] to the effect that a broker-dealer must know, and "implicitly represents" that he knows, the merchandise he recommends,[118] the SEC pointed out that rule 10b-5 also prohibits recommendations by a broker-dealer which are contrary to material information known to, or reasonably ascertainable by him.[119] *Hanly* holds the broker-dealer to a "strict" standard in this regard because he "occupies a special relationship" to his customer: "[B]y his position he implicitly represents [that] he has an adequate basis for the opinions he renders."[120] Since a recommendation without an adequate basis is prohibited, the SEC argued, a fortiori a recommendation is unlawful where, as in *Slade*, it is contrary to facts known by the firm.[121] Thus, in the eyes of the SEC, it was Shearson's affirmative recommendation which gave rise to liability.[122]

The SEC, of course, did not suggest that a broker-dealer's customers are entitled to the benefit of any inside information which the firm may possess.[123] Indeed, the SEC's brief endorsed the Chinese Wall technique of isolating such information from those engaged in trading and brokerage activities.[124] The Chinese Wall would satisfy the firm's inside information problems with respect to the general investing public and, moreover, it would avoid the need for a rule precluding a brokerage firm from having any transactions with or on behalf of customers in the securities of all its investment-banking clients. The SEC recognized that such a solution would effectively require separation of all potentially conflicting functions in the securities industry—a "Draconian" reaction laden with "drastic consequences."[125]

As to the problem which the court faced in *Slade*—satisfaction of the firm's duty to its own investing customers—the SEC suggested a species of a restricted-list procedure that was, in effect, a no-recommendation policy. Acknowledging the signal problem dis-

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[115] *See* text accompanying notes 27-37 *supra*.

[116] SEC Brief, *supra* note 38, at 5-6.

[117] 415 F.2d 589 (2d Cir. 1969).

[118] *Id.* at 592, 596, *quoted in* SEC Brief, *supra* note 38, at 7; *see* text accompanying notes 16, 91 *supra*.

[119] SEC Brief, *supra* note 38, at 6-7.

[120] 415 F.2d at 596-97.

[121] SEC Brief, *supra* note 38, at 7-8.

[122] *See id.* at 6-8.

[123] *See id.* at 8.

[124] *Id.* at 9.

[125] *Id.* at 8-9.

cussed above,[126] the SEC insisted that the placement of a security on a restricted list and the withdrawal of an outstanding recommendation be accomplished without disclosing whether the inside information possessed by the firm is contrary to or confirmatory of the previous recommendation.[127] There would be no signal to be observed, according to the SEC, if the firm restricted the security and withdrew its outstanding recommendation at the time it entered into an investment-banking or other confidential relationship, *i.e.*, before any inside information was in fact received.[128] Thus, the SEC has stated its view that the combination of the Chinese Wall and a restricted list triggered by the firm's entry into a relationship likely to lead to inside information is an acceptable solution to the investment banker/broker-dealer's dilemma.

The scope of the restriction would depend upon the strength of the broker-dealer's representation to the investor when executing a given transaction. The SEC offered conditional acceptance of Salomon Brothers' distinction between recommendations and technical solicitations: where "the situation implies an affirmative representation, the solicitations should be prohibited."[129] However, this proscription would not apply to "block-trading or market-making transactions not involving any express or implied opinion or representation as to the merits of the investment."[130] Thus, while the SEC-approved no-recommendation policy would more broadly affect a retail trader's activities than a restricted list triggered only by receipt of inside information, the sweep of the SEC's position, in terms of the range of trading activities affected, was closely circumscribed.

V

PRIOR REGULATORY APPROVAL OF THE CHINESE WALL

The SEC's position in its *Slade* brief flowed logically from its prior considerations of the isolation technique. Its endorsement of the Chinese Wall also echoed the earlier support of the New York Stock Exchange.[131]

The SEC had squarely accepted the Chinese Wall in an en-

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[126] *See* text accompanying notes 25-26, 97-98, 111-12 *supra*.

[127] *See* text accompanying notes 52-55 *supra*.

[128] SEC Brief, *supra* note 38, at 11-12. Such early action also avoids the inference arising from a purely reactive restriction. *See* note 24 *supra*.

[129] SEC Brief, *supra* note 38, at 11 n.13.

[130] *Id.*

[131] *See* text accompanying notes 144-48 *infra*.

forcement action, *Merrill Lynch, Pierce, Fenner & Smith, Inc.*[132] In that case, Merrill Lynch, acting as a prospective managing underwriter, had received adverse inside information from an issuer. Merrill Lynch then passed on that information to favored customers, who sold their holdings of that issuer's securities. At the same time, the firm effected purchases in the securities for other customers who were not apprised of the information.

The SEC accepted a Merrill Lynch offer of settlement which included the adoption of procedures designed to protect "against disclosure of confidential information."[133] Among those procedures was a Statement of Policy, incorporated in the settlement offer, "prohibit[ing] disclosure by any member of the Underwriting Division of material [nonpublic] information obtained from a corporation in connection with the consideration or negotiation of a[n] . . . offering of its securities" except to senior Merrill Lynch executives and to employees—both of that firm and of prospective co-underwriters—who were directly or necessarily involved in the underwriting.[134] All recipients of the information within the firm were subject to the same proscription and were permitted to use the information in connection with the proposed offering and for no other purpose.[135]

It has been argued that the *Merrill Lynch* Statement of Policy established SEC approval not only of the general Chinese Wall solution, but also of the proposition that the Chinese Wall permits a broker-dealer department to continue recommendations during periods when the firm's investment-banking department has contrary inside information.[136] The Statement of Policy was, however, silent on this point: it was specifically drawn only to ensure that information obtained by Merrill Lynch's investment-banking department would not be used to "tip" the firm's customers and to remedy the situation which had prompted the SEC action. Indeed, the Commission's opinion contained the caveat that it explicitly disavowed any intent to "determine in advance that the Statement . . . will prove adequate in all circumstances that may arise."[137]

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[132] SEC Securities Exchange Act Release No. 8459, [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,629, at 83,349-50 (Nov. 25, 1968).

[133] *Id.* at 83,350.

[134] *Id. See also* Van Alstyne, Noel & Co., 43 S.E.C. 1080, 1084-85 (1969).

[135] [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. at 83,350-51.

[136] *See* Shearson Brief, *supra* note 79, at 9-17.

[137] [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. at 83,350. The SEC has indicated that it may be prepared to promulgate a formal Chinese Wall rule. Statement of SEC Commissioner A.A. Sommer, Jr., Securities Regulation Symposium, Dallas, Tex., in BNA SEC. REG. & L. REPORT NO. 299, at A-18 (1975) (summary). Furthermore, in the context of the Investment Company Act of 1940, 15 U.S.C.

The individualized preventive program directed specifically at the violations present in *Merrill Lynch* foreshadowed an SEC posture in favor of industrywide measures for the isolation of inside information. In a 1971 study of institutional investors,[138] the SEC, after reviewing the problems presented by the *Cady, Roberts, Texas Gulf Sulphur* and *Merrill Lynch* cases,[139] noted that they expanded the class of "insiders" subject to the rule 10b-5 proscription: that class now includes "anyone having a special relationship to the company."[140] The study therefore urged financial institutions to "consider the necessity of segregating information flows arising from a business relationship with a company as distinct from information received in an investor or shareholder capacity."[141] Specifically, the SEC focused on the commercial bank which receives, in its role as commercial lender, detailed information about a company. Such information would have to be isolated from the bank's trust department, the SEC asserted, because its disclosure to that department might "contaminate" all of its transactions in that company's securities during the period of nondisclosure.[142] More recently, the SEC has indicated that it may be prepared to adopt a formal Chinese Wall rule.[143]

Similarly, and shortly after the decision in *Cady, Roberts*, the New York Stock Exchange issued a policy statement requiring the erection of informal Chinese Walls by member firms which have directors sitting on corporate boards.[144] The Exchange position substantiated its view that a director belonging to a member organization owes "his first responsibility . . . to the corporation on whose Board he serves."[145] However, the policy statement also appears to take cognizance of the rule 10b-5 problems created by selective disclosure of inside information: "the information might

§§ 80a-1 to -52 (1970), the SEC's proposed rule 17j-1, 38 Fed. Reg. 2182 (1973), designed to combat the potential conflicts of interest faced by the investment company/investment adviser, advocates the adoption of codes of ethics which included the Chinese Wall. Subsection (e)(5) of the proposed rule provides that a violation of the code of ethics by an employee of a registered investment company, investment adviser or principal underwriter would not be considered to be a violation of the rule by the firm if it established that it had instituted adequate procedures and used reasonable diligence to carry out the provisions of the code. 38 Fed. Reg. 2183 (1973).

[138] SEC, INSTITUTIONAL INVESTOR STUDY, H.R. DOC. NO. 92-64, 92d Cong., 1st Sess. (1971) [hereinafter SEC, STUDY].

[139] *See* text accompanying notes 28-47 *supra*.

[140] SEC, STUDY, *supra* note 138, at 2539.

[141] *Id.*

[142] *Id.*

[143] *See* note 137 *supra*.

[144] NYSE, M.F. Educ. Circular No. 162 (June 22, 1962).

[145] *Id.*

have a bearing on the market price of the securities."[146] Thus, the Exchange announced that "a member firm director must meticulously avoid any disclosure of inside information to his partners, employees of the firm, his customers or his research or trading departments."[147] In a later policy statement, the Exchange stated that the same policy applied where someone in the firm served (though not as a company director) in an advisory capacity which could occasion the receipt of material nonpublic knowledge.[148]

The Exchange has apparently not taken any position on the question of whether the principal of a member firm who acquires inside information in his capacity as a director of a company should act to prevent his firm from making recommendations to customers about the company's securities. As noted earlier, Shearson relied in *Black* on the Exchange policy statement concerning directors to support its contention that the Exchange had decided that question in the negative.[149] The *Black* court, however, explicitly rejected that argument.[150] Thus, while prior regulatory policies do provide a foundation for the Chinese Wall, neither the SEC nor the Exchange had previously reached the issue which arose in *Slade*.

VI

THE ENGLISH APPROACH

The Chinese Wall also finds support in the English regulatory approach, as evidenced by (1) the London City Code on Take-overs and Mergers (City Code),[151] which is administered by a securities industry board, the Panel on Take-overs and Mergers (Panel);[152] and (2) the now-abandoned English Companies Bill.[153] The success of the Chinese Wall solution in England and its command of recent

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[146] *Id.*

[147] *Id.*

[148] NYSE, COMPANY MANUAL § A2, at A-21 (July 18, 1968).

[149] *See* text accompanying note 58 *supra*.

[150] Black v. Shearson, Hammill & Co., 266 Cal. App. 2d 362, 368, 72 Cal. Rptr. 157, 161 (1968).

[151] PANEL ON TAKE-OVERS AND MERGERS, CITY WORKING PARTY, THE CITY CODE ON TAKE-OVERS AND MERGERS (rev. ed. 1972) [hereinafter CITY CODE].

[152] The Panel on Take-overs and Mergers is a self-regulatory organ of the English securities industry. Although the City Code "has not and does not seek to have the force of law," *id.* at 3, the Panel has the authority to take disciplinary action for breach of the Code. The Panel's sanctions include the power to deprive the offender of access to the facilities of the securities markets temporarily or permanently. *Id.* at 4.

[153] H.C. 52 (1973) (attempt, *inter alia*, to "amend the law relating to companies and to dealing in securities").

legislative interest there should point the way to resolution of the conflict problems within our own securities industry.

An appendix to the City Code, entitled "The Use of Confidential Price-Sensitive Information,"[154] faced the issue of the conflict problem in the context of English merchant banks. As is the case for certain American multiservice firms, the conflict arises for the merchant bank when it acquires inside information (such as knowledge of a contemplated takeover bid) about a particular company for which it acts as corporate adviser (*i.e.*, investment banker), or on whose board a member of the bank sits, while the firm is also serving as a portfolio manager for customers' accounts. Recognizing the inherent opportunity for abuse, as well as the impropriety of trading or recommending transactions on the basis of inside information,[155] the Panel appears to favor a two-pronged Chinese Wall policy for such multiservice firms—(1) the greatest practicable degree of physical separation between departments engaged in investment banking and investment managing; and (2) the absence of any connection with, or responsibility for, portfolio management by persons below board level who are involved with corporate advice and who may be aware of inside information.[156] Firmly rejected by the Panel, however, are the contentions that senior management and members of the board of the merchant bank should be denied access to the inside information or that those firms engaged in investment banking should be prohibited from contemporaneous investment management activities.[157] The Panel observes that the "wearing of two hats" by merchant banking firms is both common and desirable: "In the vast majority of cases [the conflict is] satisfactorily resolved. The risk of occasional abuse is far outweighed by the manifold advantages which would be lost if duality of this sort were prohibited."[158]

The Panel-recommended Chinese Wall policy is in force in most English merchant banks. There is, however, a divergence in

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[154] CITY CODE, *supra* note 151, app. 1, at 10-14.

[155] *Id.* at 10 & app. 1, at 10-14. Although such trading is not technically illegal, it may prompt an investigation. Wall St. J., Oct. 6, 1975, at 1, col. 6. Section 25 of the English Companies Act 1967, c. 81, does prohibit a limited category of trading by statutorily defined insiders. That proscription, however, is based on insider status rather than inside knowledge. The criminalization of insider trading is favored by English securities-industry authorities, CITY CAPITAL MARKETS COMMITTEE, SUPERVISION OF THE SECURITIES MARKET 17 & app. II, at 30-31 (1974), and a broad proscription on such trading, similar to rule 10b-5, was contained in an attempted amendment to the Companies Act. H.C. 52, pt. II, § 12 (1973).

[156] CITY CODE, *supra* note 151, app. 1, at 11.

[157] *Id.* at 11-12.

[158] *Id.* at 12.

practice in situations in which inside information is actually acquired. Some firms have implemented a "stop list" procedure, which is similar to the American restricted list/no-recommendation approach. This policy precludes a firm from executing as investment manager any transactions in securities on the list, unless the trades are "ordered apparently in good faith by outside clients."[159] Other firms rely on unreinforced Chinese Walls "but insist with special strictness that no information not available with normal diligence to the ordinary investment analyst or stockbroker . . . be taken into account" and hold each transaction to a test of "clear and public justification by reference to ordinary investment criteria."[160]

The Panel does note a difference of opinion on the question of whether a director with inside information may advise against a trade by the investment management department which would be inadvisable in light of the information. The Panel states that the "better, if Draconian, opinion" is that such advice cannot be rendered, even if it would not indicate the specific information: "The transaction should proceed in exactly the way it would have done if no one had, in fact, been in possession of any inside information not available to others exercising due diligence."[161]

The proposed Companies Bill[162]—which was introduced in the House of Commons in late 1973 but then lapsed with a change in the English government—also attempted, among other things, to deal with the problem of transactions in securities by firms with inside information. One section of the bill specifically provided that proof of the existence and effective operation of a Chinese Wall would be a defense to charges of impropriety in connection with such transactions.[163] That provision, moreover, rejected any requirement of reinforcement: a firm would not be precluded from executing any transactions just because it had acquired inside in-

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[159] *Id.* at 13.

[160] *Id.*

[161] *Id.*

[162] H.C. 52 (1973).

[163] A company should not be precluded . . . from entering into any transaction by reason only of, or of having obtained, any information in the possession of a director or employee of that company if—

(a) the decision to enter into the transaction was taken on its behalf by a person other than the director or employee; and

(b) arrangements were then in existence for securing that the information was not communicated to that person and that no advice with respect to the transaction was given to him by a person in possession of the information; and

(c) the information was not in fact so communicated and advice was not in fact given.

H.C. 52, pt. II, § 14(3) (1973).

formation, so long as an impermeable wall had been erected.[164] Another section of the bill would have permitted a firm to execute agency trades even in the absence of a Chinese Wall, provided that the firm had neither selected the securities involved nor recommended the transaction.[165]

Several policy judgments underlie the English approach.[166] One premise is that potential conflicts are inherent in the legitimate functioning of securities firms and that these conflicts can be effectively controlled through segregation of information in the various departments of the firms. A second is that customers have no recognizable expectation that such firms will accord interdepartmental access and use of inside information. Also reflected is the decision that in order for the securities markets to function properly securities firms must have complete freedom to execute agency transactions that do not result from recommendations by the firm. This freedom is necessary, even though the executing firm may have inside information. Thus, the English approach, like that of Salomon Brothers and the SEC, considers that "recommendations" involve some element of selection or advice—something more than the mere initiation of contact which constitutes technical solicitation.[167]

While merchant banks do act as investment managers for their customers, they do not typically serve as broker-dealers or investment advisers. Accordingly, the Panel has not considered the question of whether a Chinese Wall permits a securities firm to continue recommendations to customers while it has inside information.[168] Except for the Panel's silence on that issue, the Eng-

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[164] *Id.*

[165] [A] person [shall not be precluded] from entering into any transaction if—

. . . .

he enters into the transaction as agent for another person and has neither selected nor advised on the selection of the securities to which the transaction relates . . . .

Id. § 14(2)(c).

[166] *See* Lipton, *English Company Law Reform Proposals*, 2 SEC. REG. L.J. 16, 16-20 (1974). The basic policy objectives are the same in England as in the United States:

The City associations and institutions have as their primary objective the creation and maintenance of a capital market which is efficient, effective and honest. . . . To this end, the City associations and institutions strive to ensure that the market operates on the basis of full disclosure of all relevant information, is non-discriminatory and functions in such a manner that the possibility of financial loss through the malfunction of the market organs is reduced to an acceptable minimum.

CITY CAPITAL MARKETS COMMITTEE, *supra* note 155, at 2.

[167] *See* text accompanying notes 101-03, 130 *supra*.

[168] *See* note 223 *infra*.

lish approach to the Chinese Wall tracks that of the SEC in *Slade*:[169] a firm with departmentalized inside information may execute both agency and principal transactions and may engage in investment management through isolated, uninformed departments.[170]

VII

ALTERNATIVES TO THE CHINESE WALL: PITFALLS AND INCONSISTENCIES

Despite the breadth of support for the Chinese Wall, the solution has met with neither unanimous nor unconditional approval. It has been argued that the concept of one partner's not communicating to another partner information that could result in significant profit or loss to the firm or its clients is so contrary to human nature as to be unworkable and unacceptable.[171] It may also be argued that the practicalities of enforcement of rule 10b-5 require rejection of the Chinese Wall solution.[172] Indeed, the SEC has stated that it would presume communication of inside information in a situation involving unusual trading by a securities firm following receipt of such information by an employee or principal of the firm.[173]

The difficulty of discovering misuse of inside information is, of course, the greatest shortcoming of the Chinese Wall approach. The SEC's presumption doctrine should, however, serve to miti-

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[169] *See* text accompanying notes 123-30 *supra*.

[170] Unlike the English regulators such as the Panel on Take-overs and Mergers, which, although only quasi-official, do have substantial enforcement powers, *see* note 152 *supra*, neither Congress nor the SEC has yet codified a Chinese Wall policy in statutes, rules or regulations. *But cf.* note 137 *supra*. The federal securities law codification project of the American Law Institute has left open the Chinese Wall question. The present draft of the proposed code contains a comment that states:

> Nothing here affects the question whether undisclosed information learned by an agent of a corporate "person" (for example, a bank) is attributed to the corporation and its other agents. *The question of the efficacy of intracorporate "Chinese walls" is left to the courts.*

ALI FED. SEC. CODE § 1303(b), Comment 6(a) (Tent. Draft No. 2, 1973) (emphasis added).

[171] *Cf.* 6 LOSS, *supra* note 16, at 3594; Note, *Conflicting Duties*, *supra* note 24, at 412-13. *See also* 6 LOSS, *supra* at 3595 ("In short, the 'Don't tell your partner' solution to the conflict-of-interest problem simply won't stand up against the disclosure principle as we have seen it developed."). However, Professor Loss, in a recent panel discussion, expressed apparent acceptance of the Chinese Wall technique in the commercial-bank trust department context. *See* Lipton, *Lenders' Responsibilities*, *supra* note 7, at 257, 280-81. The present draft of the American Law Institute Federal Securities Code, of which Professor Loss is the Reporter, leaves the question open for resolution by the courts. *See* note 170 *supra*. *See also* Hi-Shear Corp. v. Klaus, Civ. No. 74-434 (C.D. Cal. Dec. 19, 1974), *discussed in* note 27 *supra*.

[172] *See* Hi-Shear Corp. v. Klaus, Civ. No. 74-434 (C.D. Cal. Dec. 19, 1974), *discussed in* note 27 *supra*.

[173] Investors Management Co., 44 S.E.C. 633, 646-47 & n.28 (1971).

gate this enforcement difficulty. The preservation of the firm's right to make a showing of nonuse[174] should enable the securities firm to carry on its various functions after erecting a Chinese Wall, without fear of unwarranted exposure to rule 10b-5 liability. On balance, the enforcement difficulties do not outweigh the considerations which speak in favor of the Chinese Wall—the most obvious of which is that its rejection might well require forced divestiture of the several functions of the typical securities firm.

A separation of functions would so impede the normal functioning of the securities markets that, in the language of the SEC, "the capital-raising capability of the industry and its ability to serve the public would be significantly weakened."[175] Mandatory segregation of functions would force out of business many of the smaller firms, which require income from various sources to survive.[176] The extinction of the smaller firms would not only increase concentration in the industry, but also make the underwriting process more difficult and costly since a number of firms are often required to underwrite a single issue.[177] The market for the securities of small, local companies would also suffer, since those companies —whose issues usually do not attract the interest of the larger underwriters—must often rely on the smaller securities firms for financing.[178] Finally, splitting multiservice firms into separate brokerage and underwriting organizations would lead to expensive duplication of the research facilities commonly employed in both operations[179]—a cost that would probably be passed on to the investor. Given the availability of equally satisfactory solutions, such as the reinforced Chinese Wall, there is no need for any radical restructuring which would merely substitute new difficulties for the present solvable problem.

Some firms have extended the basic Chinese Wall approach beyond a procedure for internal isolation of inside information. They have separated the problem department itself—usually the investment-advisory or investment management unit—from the

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[174] *See* text accompanying notes 40-43 *supra*.

[175] SEC, FUTURE STRUCTURE, *supra* note 2, at 65,623, *quoted in* SEC Brief, *supra* note 38, at 9 n.11.

[176] SEC, SEGREGATION REPORT, *supra* note 1, at 74; Note, *Conflicting Duties*, *supra* note 24, at 409 & n.81.

[177] Note, *Conflicting Duties*, *supra* note 24, at 409-10; *see* 1 LOSS, *supra* note 16, at 167-68; M. WATERMAN, INVESTMENT BANKING FUNCTIONS 176 (1958).

[178] SEC, SEGREGATION REPORT, *supra* note 1, at 73, 493-96; Note, *Conflicting Duties*, *supra* note 24, at 410; *see* SEC, SPECIAL STUDY, *supra* note 1, pt. 1, at 493-96; WATERMAN, *supra* note 177, at 160.

[179] Note, *Conflicting Duties*, *supra* note 24, at 409; *see* SEC, SEGREGATION REPORT, *supra* note 1, at 72; WATERMAN, *supra* note 177, at 140-41.

remainder of the firm. In some instances, this is accomplished by housing the staff of the isolated department in offices which are removed from the quarters of the rest of the firm; in others, by creating a separate subsidiary or affiliate through which the department thereafter functions. Still other firms utilize both physical and corporate separation. Where there is complete separation of the foregoing types and the separated department is not held out to be an adjunct of any department with access to inside information—so that it is clear to the clients of the separated department that they are dealing with a separate entity and should not expect the services of the other parts of the firm—an unreinforced Chinese Wall would itself meet all relevant policy considerations and effectively avoid both disclosure and customer reliance problems.[180] Physical and corporate separation, though, are often costly and impractical solutions for those securities firms, investment companies and similar business entities that are faced with inside information conflict problems; furthermore, such a requirement would approximate in result a mandate for separation through divestiture, with the attendant problems discussed above.[181]

An approach that appears to solve the customer-conflict problems of a multiservice securities firm without resort to either separation or a Chinese Wall is to require such firms to promptly disclose or force disclosure of any inside information which they obtain, whether through a confidential relationship or otherwise.[182] In the eyes of the SEC, prompt disclosure is the preferred approach.[183] It is also the technique that Shearson claimed to have

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[180] In an analogous context, the SEC has indicated that in determining whether intrafirm separation is sufficient to warrant nonapplication of the Investment Advisers Act, 15 U.S.C. §§ 80b-1 to- 21 (1970), to a holding company with an investment-advisory subsidiary, the relevant considerations are that the subsidiary have a majority of independent directors, adequate independent capital and a separate staff, and that research information conveyed to the adviser meet certain criteria. SEC Investment Advisers Act Release No. 353, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,146, at 82,481 (Dec. 18, 1972) (rule 202-1, which was later designated rule 202-2 in Investment Advisers Act Release No. 363 (Feb. 21, 1973)). Since the policy considerations, *e.g.*, disclosure and customer expectations, which must be taken into account in determining the acceptability of the Chinese Wall solution do not reach the level of those involved in preventing circumvention of the Investment Advisers Act through the use of "shell" advisory subsidiaries, somewhat lesser separation seems justified in determining whether the Chinese Wall alone is sufficient in these circumstances. *Cf.* note 22 *supra*.

[181] *See* text accompanying notes 175-79 *supra*.

[182] *See* Note, *Broker Silence and Rule 10b-5: Expanding the Duty to Disclose*, 71 YALE L.J. 736, 743, 746 (1962) [hereinafter Note, *Broker Silence*].

[183] Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC Securities Exchange Act Release No. 8459, [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,629, at 83,350 (Nov. 25, 1968); SEC Brief, *supra* note 38, at 12.

encouraged its investment-banking client to employ in the situation which gave rise to the *Slade* action.[184] This solution to customer conflict problems, however, creates a number of other difficulties. Unless the securities firm is able to convince the company itself to release the information, disclosure would violate any confidential relationship between the firm and the company,[185] as well as the company's right to withhold information for a proper purpose.[186] Such securities firm disclosures would, moreover, run the risk of being misleading in circumstances in which the firm lacks complete information. A disclosure requirement would impose a new type of obligation on securities firms that they might not be able to handle properly. Finally, the policy might encourage companies to employ underwriters that do not engage in broker-dealer activities, thus leading to further concentration in the underwriting business. Guided by one or more of these considerations, commentators have generally rejected mandatory disclosure as a viable solution to the inside information conflict problems of securities firms.[187]

Another comprehensive proposal recently advanced suggests not a Chinese Wall but, first, the acceptance of the premise that certain inevitably conflicting functions are not of such general benefit as to warrant toleration and, second, the adoption of a scheme of notification to inform the customers of a securities firm that it is disabled from making certain disclosures or rendering particular kinds of advice.[188] Although the author of this proposal does recognize the desirability of a security firm's performance of both investment banker and broker-dealer functions, he would preclude principals of such firms from serving as directors of corporations.[189] As a practical and logical matter, though, there is very little difference between the investment-banking and directorial relationships. In the typical situation, a principal of a traditional investment banker for a company will also serve as a director of that company.

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[184] Shearson Brief, *supra* note 79, at 7.

[185] *See* note 14 *supra*.

[186] *See, e.g.*, Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514, 518 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973); Matarese v. Aero-Chatillon Corp., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,322, at 91,732 (S.D.N.Y. 1971).

[187] *See, e.g.*, Jacobs, *supra* note 16, at 968 & n.572; Note, *Conflicting Duties*, *supra* note 24, at 403-06; Note, *The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120, 1155 & n.160 (1950). *But see* STAFF OF SEC, 92d CONG., 2D SESS., REPORT ON THE FINANCIAL COLLAPSE OF THE PENN CENTRAL COMPANY TO THE SPECIAL SUBCOMM. ON INVESTIGATIONS OF THE HOUSE COMM. ON INTERSTATE & FOREIGN COMMERCE 120 (Subcomm. Print 1972).

[188] Note, *Conflicting Duties*, *supra* note 24.

[189] *Id.* at 408-09.

In either role, the same conflict of interest must be confronted. The essential issue remains segregation of functions, and the weight of opinion is overwhelmingly against *forced* segregation.[190]

The author also suggests the implementation of procedures which would disable the securities firm from continuing certain activities after it has entered into a confidential relationship and would require that the firm notify its customers of both the overall policy and the specific disability. The proposed approach is three-pronged. First, a firm which manages discretionary accounts would have to announce to its customers at the outset of an investment management relationship that the firm is unable to exercise discretion with respect to the securities of any investment-banking client.[191] Second, a firm which executes transactions which it has not recommended would be required to inform its customers —both at the start of a confidential relationship with a company and at the time of any specific transaction in that company's securities ordered by a customer—that the firm cannot give advice as to transactions in that company's securities.[192] Third, a firm would not be permitted to recommend the securities of a company with which it has a confidential relationship. If it had established such a relationship at a time when it had a recommendation with respect to the company's securities outstanding, it would have to notify its customers that it will be unable to update or change that recommendation and that, therefore, no further reliance should be placed upon it.[193]

The difficulty with this approach lies not in the trading and recommendation proscriptions, but in the notification requirements. To appreciate the unworkability of having a large securities firm inform its customers at the outset of every confidential relationship of its inability to exercise discretion or render advice with respect to particular securities, one need only consider the cost of communication to thousands of customers and the danger of exposure to claims based upon nonreceipt of the notice.[194]

The preceding discussion suggests some of the pitfalls and inconsistencies inherent in various inside information policies. Some of the alternatives to the Chinese Wall are unjustifiable in their underlying premises or unworkable in practice; others raise more questions than they answer. It is equally apparent, though, that the

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[190] *See* text accompanying notes 2-3 *supra*.

[191] *See* Note, *Conflicting Duties*, *supra* note 24, at 414-15.

[192] *Id.* at 418.

[193] *Id.* at 420.

[194] *See also* note 223 *infra*.

Chinese Wall is not by itself a completely satisfactory solution to all of the conflicts that arise in the performance of a variety of roles by multiservice firms. Therefore, in devising inside information policies for such firms, attention must be given to the various combinations of functions performed and the supplementary policies appropriate to each.

VIII

THE REINFORCED CHINESE WALL

For the most part, the English position seems sound, striking the right balance between the competing policy considerations in all but two situations—where the firm makes investment recommendations to its clients, and where the firm invests (as distinguished from making or facilitating a trading market) for its own account. When the firm makes recommendations to customers, the customers' expectations are such that it is reasonable to insist that the firm supplement the Chinese Wall with either the no-recommendation policy, or the restricted-list policy, or both.[195] When the firm invests for its own account, three factors—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 to the general rule 10b-5 proscription—tip the scales in favor of absolute prohibition against investment transactions in securities as to which even an isolated department of the firm has inside information. A firm which invests for its own account must have a restricted-list procedure applicable to any inside information, whether obtained through a confidential relationship or some other source.[196] Thus we believe that the Chinese Wall, as reinforced by a restricted list and a no-recommendation rule, best protects the multiservice securities firm.

A. Unrecommended Agency Transactions

Even absent a Chinese Wall, reinforced or not, there appears to be support for the proposition that a securities firm may serve as an agent in executing a customer's buy or sell order which has not been recommended by the firm, notwithstanding the fact that the firm may be in possession of inside information concerning the security in question.[197] We are of the same opinion. Such agency

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[195] *See* text accompanying notes 205-08 *infra*.

[196] *See* text accompanying notes 200-03 *infra*.

[197] *See, e.g.*, Daum & Phillips, *supra* note 14, at 951-52; Jacobs, *supra* note 16, at 971; Painter, *supra* note 52, at 1388; text accompanying note 165 *supra*. *Contra*,

executions do not involve the misuse of the inside information, and the firm owes the customer no duty to inform him or to dissuade him from a trade he himself has determined to make. The policy judgment here is that the usual rule as to nonuse of inside information for the benefit of customers applies: the relatively low expectations of the customer who makes his investment decisions independently[198] need not interfere with the normal functioning of the securities markets by requiring procedures to guard against effecting such transactions when the firm happens to possess inside information.

B. Unrecommended Principal Transactions

The securities firm which acts as an arbitrageur, dealer, marketmaker or block positioner frequently acts as a principal in the execution of unrecommended trades. When a firm acts as a principal, the firm is at risk and, in addition to the dealer's spread on the trade, may also have a substantial profit or loss on the transaction. This is a more difficult situation than that involving a firm which engages in agency transactions alone. Inside information could color the decision whether to act as a principal or an agent or whether to act at all. While the expectation of the customer is the same as in the case of an unrecommended agency transaction, the self-interest of the firm creates a possibility of abuse which should be eliminated. An effective Chinese Wall eliminates the possibility of abuse by preventing the inside information from being used by the firm in reaching its decision to act as a principal. Accordingly, we believe that a firm with an effective Chinese Wall may continue to execute unrecommended arbitrage, dealer, marketmaker and block-positioner transactions at a time when an isolated department has inside information about the security in question.[199]

Note, *Broker Silence*, *supra* note 182, at 746. In Robinson v. Penn Central Co., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP ¶ 93,772 (S.D.N.Y. 1973), however, the court, in deciding whether a broker might be an aider and abettor, rejected the argument that a broker who did not trade or tip, but merely executed unsolicited orders for a customer who used inside information, did not violate rule 10b-5. *Id.* at 93,367-68.

[198] *See* White v. Abrams, 495 F.2d 724, 735-36 (9th Cir. 1974); Pollak v. Eastman Dillon, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,987, at 97,411 (S.D.N.Y. 1975); Canizaro v. Kohlmeyer & Co., 370 F. Supp. 282, 289 (E.D. La. 1974), *aff'd*, 512 F.2d 484 (5th Cir. 1975) (per curiam); Daum & Phillips, *supra* note 14, at 951-52; Jacobs, *supra* note 16, at 971. *But cf.* Hanly v. SEC, 415 F.2d 589, 595-96 (2d Cir. 1969).

[199] Recent amendments to the securities laws prohibit Exchange members from acting as their own brokers, but contain special exceptions for securities firms performing certain essential market functions. Securities Acts Amendments of 1975 § 6(2), 15 U.S.C.A. § 78k(a) (Supp. Aug. 1975), *amending* 15 U.S.C. § 78k(a) (1970). The statutory exceptions include transactions by dealers acting in the capacity of

C. *Investing for a Firm's Own Account*

The possibility of self-interest abuse mandates that the Chinese Wall approach not be extended to permit a firm with departmentally isolated inside information to invest for its own account through a department that does not have the information. We recognize that this position is logically inconsistent with our views on unrecommended arbitrage, dealer, marketmaker and block-positioner transactions and on investment management for customers. The short answer is the Holmesian maxim that "[t]he life of the law has not been logic, it has been experience."[200] Where self-interest is intense, abuses are so likely as to warrant a proscription that is absolute. Neither the liquidity-of-the-securities-market considerations applicable to the dealer-type transactions, nor the practical and competitive considerations applicable to investment management activities, have any bearing on own-account investments. Thus there is no public interest to be served in permitting them to continue in the face of inside information.

The definition of own-account investment presents some difficulty, as does the distinction between securities firms and other investing entities. With respect to a securities firm, the basic question is whether the personal accounts of the principals of the firm should be included in the proscription. With respect to other investing entities, the core issue is whether substantial ownership by management should result in such entities being deemed own-account investors, *i.e.*, what is the threshold of self-interest? For securities firms, we believe that principals with personal accounts should be subject to the same proscriptions as the firms themselves.[201] Investment companies, insurance companies and similar entities, however, should not be defined as own-account investors

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marketmaker, stabilizing transactions to facilitate distribution of securities, bona fide arbitrage and risk arbitrage transactions. *Id. See also* H.R. REP. NO. 123, 94th Cong., 1st Sess. 57 (1975). Risk arbitrage, *i.e.*, arbitrage in connection with mergers, acquisitions, tender offers and similar transactions, falls between marketmaking and own-account investing. Since risk arbitrage has been equated with marketmaking by Congress, *id.*, and by the SEC's rule 19b-2, 17 C.F.R. § 240.19b-2 (1975), and since its benefits to the public investor have been specially recognized by the SEC, SEC Securities Exchange Act Release No. 9395, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,417, at 80,918 (Nov. 24, 1971), we have accorded it the same treatment as marketmaking.

[200] O.W. HOLMES, THE COMMON LAW 1 (1881).

[201] Ordinarily an employer is not responsible for a personal securities law violation committed by its employee that is outside the scope of his employment and is unknown to the employer. *E.g.*, SEC v. Sorg Printing Co., [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,034, at 97,613 (S.D.N.Y. 1975). However, it is not unreasonable to impose a policing obligation on a securities firm with respect to its principals. *See* note 203 *infra* and the discussion of proposed rule 17j-1, 38 Fed.

if management has less than a 10% interest in the entity.[202] Thus a securities firm which invests for its own account would need a restricted list which would be applicable to the personal investments of its principals, as well as to the firm itself.[203] But investment companies, insurance companies and similar entities that do not have 10% management ownership could operate with only a Chinese Wall.

D. Investment Advice and Recommendations

The conflicts presented by the securities firm which obtains inside information and also makes recommendations or gives investment advice are the most difficult to reconcile. As noted above, acceptance of the Chinese Wall standing alone would mean that a firm with inside information in an isolated department could find itself in a situation where another department is making recommendations or rendering investment advice contrary to that information.[204] This does not meet the reasonable expectations of the average public investor who relies on the recommendations of a broker-dealer. The dependence of the unsophisticated investor on such recommendations generally receives special recognition[205] and is essential to the continuance of public participation in the securities markets. Such public participation has generally been recognized as a fundamental element of our national securities

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Reg. 2182, in note 137 *supra*. Because of the basic differences in access and sources of inside information between securities firms and other investing entities, we would not extend to those other entities this policing requirement. Such a position of course assumes the existence of an effective Chinese Wall as to the principals. Moreover, *Sorg* indicates that a securities firm or any employer which has, or reasonably should have, knowledge that its employee is using his position in connection with a personal securities law violation may be held responsible as an aider and abettor.

[202] This suggestion finds an analogue in the definitions of "person" which pertain under the SEC's rules 144-45 and the definition of "offeree representative" under rule 146. *See* 17 C.F.R. §§ 230.144-46 (1975).

[203] This practice could be policed through a requirement that principals of a securities firm not effect securities transactions other than through their own firm or with the specific permission of their own firm. A useful model for comparison is Rule 407(b)(1) of the New York Stock Exchange. CCH NEW YORK STOCK EXCHANGE GUIDE § 2407 (1973). By analogy to § 3(a)(18) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(18) (1970), *as amended*, 15 U.S.C.A. § 78c(a)(18) (Supp. Aug. 1975), "principal" could be defined as "any partner, officer, director or branch manager" of a securities firm.

[204] *See* text accompanying note 19 *supra*.

[205] *Compare* Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1172 (2d Cir. 1970), *and* Cant v. A.G. Becker & Co., 374 F. Supp. 36, 46 (N.D. Ill. 1974), *with* Pollak v. Eastman Dillon, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,987, at 97,408 n.1 (S.D.N.Y. 1975), *and* Canizaro v. Kohlmeyer & Co., 370 F. Supp. 282, 284 (E.D. La. 1974), *aff'd*, 512 F.2d 484 (5th Cir. 1975) (per curiam).

policy.[206] It cannot, therefore, be accepted that some sort of disclosure by the broker-dealer at the commencement of the customer relationship (to the effect that because of the broker-dealer's Chinese Wall procedures the client may in the future be the victim of a bad recommendation) would satisfy this expectation. Customers forget these caveats, and simplistic disclaimers should not be the answer if there is a better one.

That communication to customers of inside information policies will not alone suffice does not mean that it is unnecessary.[207] Indeed, in order to avoid customer claims based on detrimental reliance, a firm would be well advised to provide a full explanation of its inside information policies at the outset of a customer relationship and also to update statements of such policies periodically.[208]

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[206] For example, SEC Commissioner A.A. Sommer, Jr. said recently that the involvement of small private investors in the securities market "has been the means by which America's free economy has prospered." Address by A.A. Sommer, Jr., *Going Private: A Lesson in Corporate Responsibility*, Nov. 20, 1974, in [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,010, at 84,694. Observing a decline in such participation, he stated:

> The absence of the individual investor from the market place is deplored on all sides. While I feel that in large measure this absence has been the consequence of inflation, high interest rates, more profitable investments elsewhere, I do believe that to some extent the departure of the small investor from the market place has been the consequence of a deepening suspicion of the motives and the fairness of many responsible for the conduct of corporate enterprise. Surveys have indicated time and time again that small shareholders believe they are disadvantaged vis-à-vis large and institutional investors as far as information goes.

Id. at 84,699.

[207] Those firms or departments of firms which deal only with institutional investors should logically constitute an exception to the requirement that the Chinese Wall be reinforced to prevent recommendations. There would appear to be no reason why such firms cannot use the same type of disclosure as is used for investment management clients, *see* note 223 *infra*, and thereby meet the customer-expectation objective. In Anderson Co. v. John P. Chase, Inc., [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,009 (S.D.N.Y. 1975), *aff'd mem.*, No. 75-7239 (2d Cir. Nov. 18, 1975), for example, the court interpreted § 2(a)(13) of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-2(a)(13) (1970), which defines "investment supervisory service" as the "giving of continuous advice as to the investment of funds on the basis of the individual needs of each client," as permitting an adviser to limit the scope of its advisory services by contract with a sophisticated client. The *Anderson* court stated that

> the parties were free to contract for the particular nature of the investment supervisory service to be provided, and . . . they indeed . . . agreed upon a far less extensive investment service than that represented by the full panoply of "investment supervisory services" . . . .

[1974-1975 Transfer Binder] CCH FED. SEC. L. REP. at 97,509. The *Anderson* court distinguished cases requiring investment advisers to provide a broader scope of services as involving self-dealing by the investment adviser. *Id.*

[208] An analogy can be drawn to the hornbook principle of trust law that a trustee may be permitted by the express terms of the trust instrument to act in a manner

The reinforced Chinese Wall does prevent a securities firm from making recommendations that are contrary to inside information obtained by an isolated department.[209] In fact, the reinforcement devices alone—without the Chinese Wall—achieve this result. If the only conflict problem faced by a firm is that of recommendations when in possession of inside information, the dual policies of not recommending the securities of companies with which there is a confidential relationship and of placing on a restricted list securities as to which inside information has been obtained would probably prove sufficient. Indeed, the latter policy alone would meet the strict requirements of rule 10b-5, but the combination is desirable to avoid both the possibility that restriction would act as a signal and the problem that arises when the firm receives inside information after making a recommendation. The Chinese Wall prevents the employee of the broker-dealer who is in contact with the customer from knowing whether the information is favorable or unfavorable and thus is useful in preventing the act of restriction from resulting in an impermissible signal. Therefore, even when the firm's conflict is between recommendation and possession of inside information, the Chinese Wall performs an important function: it enables a firm to establish that it did not tip when it informed a customer that it had restricted a security.[210]

The procedure to be followed when a firm obtains inside information *after* it has made a recommendation presents the most difficulty. It arises in two contexts when a prior recommendation is outstanding—either with the commencement of a confidential relationship or with the receipt of inside information outside of a confi-

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which would otherwise constitute a violation of his fiduciary duties. 2 A. SCOTT, TRUSTS § 170.9, at 1321 (3d ed. 1967).

[209] Where a customer deals with two or more securities firms, it is possible that one of the firms which does not have inside information will recommend a security about which another of the firms has received such information and therefore placed the security on its restricted list. This and similar possibilities can be used to question the logic and policy objective of the reinforced Chinese Wall. A perfect solution would require that all material information be immediately reflected in the market place. Therefore, the reinforced Chinese Wall must be recognized as the best practical solution, even though it is not necessarily the ideal solution in every possible circumstance.

[210] It has been argued that use of the restricted-list procedure after receipt of inside information "indirectly benefit[s] the firm's customers, at the expense of the public," since those customers knowing of the firm's policy "would be assured that the firm's recommendations were warranted in light of the nonpublic information possessed by the [firm]." Note, *Conflicting Duties*, *supra* note 24, at 403 n.40. This would be true if the restricted list were activated only for inside information contradictory to the firm's recommendations. It is not true if the restricted list is activated, as it should be, for all inside information, whether contradictory to or confirmatory of any firm recommendation.

dential relationship. While the question is close and we could understand a contention that there is no duty to correct or withdraw prior recommendations, we believe that the better answer is that a restricted-list procedure must be implemented. By placing the securities on a restricted list, the firm avoids executing transactions based on the prior recommendations. That this does not solve the problem of the customer who does not communicate with the broker giving the original advice but rather goes to another broker to execute the transaction is not persuasive. If the customer does not check back at the time of the trade, the customer-reliance element is not present and, accordingly, the basis for the restricted-list requirement has been removed. The argument that advising the customer that the security has been restricted constitutes an impermissible signal has been dealt with before.[211] If the person who informs the customer of the restriction does not know whether the inside information is favorable or unfavorable, the problem should not arise.

The approach we suggest does not distinguish between confirmatory and contrary inside information. In either case the customer who seeks to trade after the recommendation must be informed that trading has been restricted and that the firm cannot handle the transaction, but he must not be told or signaled as to the nature of the inside information. The customer who wishes to trade anyway can go to another firm.

The acceptance of a distinction between recommended and unrecommended transactions necessarily rejects the argument that customers do not distinguish between being actively misled and passively misled. That argument ignores the crucial factor of customer expectation, which differs considerably depending upon the relationship.[212] The securities firm which actively recommends that

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[211] *See* text accompanying note 112 *supra*.

[212] The Court of Appeals for the Ninth Circuit articulated perhaps the best statement of the so-called "flexible duty" principle in White v. Abrams, 495 F.2d 724 (9th Cir. 1974). The *White* court said that a determination of liability under rule 10b-5 should give consideration to

> the relationship of the defendant to the plaintiff, the defendant's access to the information as compared to the plaintiff's access, the benefit that the defendant derives from the relationship, the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions and the defendant's activity in initiating the securities transaction in question.
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> [For example, w]here the defendant derives great benefit from a relationship of extreme trust and confidence with the plaintiff, the defendant knowing that plaintiff completely relies upon him for information to which he has ready access, but to which plaintiff has no access, the law imposes a duty upon the defendant to use extreme care in assuring that all material informa-

a customer purchase a security is engaged in an investment-advisory function and owes a whole panoply of federal securities law and common law duties to the customer. The customer has a right to expect that these duties will be competently discharged.[213] In contrast, the securities firm which passively solicits a customer by informing him of the availability of an opportunity to buy or sell a particular security raises no such expectations. In view of our acceptance of the distinction predicated on the customer's expectation, we believe that the SEC's definition of recommendation in its *Slade* brief is essentially correct.[214] The threshold of recommendation is crossed when the broker-dealer does more than merely inform the customer of the trading possibility. The answer in any given situation will be a function of the representations made by the broker-dealer, the sophistication of the customer and the historical relationship between the two parties.[215]

E. Investment Management

A firm which is engaged only in investment management does not have a conflict problem. To avoid the proscription against trading on inside information, such a firm needs nothing more than an effective policy of not trading on inside information.[216]

A firm which combines investment management with investment banking, though, faces the possibility that the investment-banking department may have inside information about a security which the investment management department is about to buy or sell.[217] A Chinese Wall blocking access by the investment man-

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> tion is accurate and disclosed. If the defendant has breached this duty he is liable under rule 10b-5, provided the other elements of materiality, causation and damages are established. On the other hand, where the defendant's relationship with the plaintiff is so casual that a reasonably prudent person would not rely upon it in making investment decisions, the defendant's only duty is not to misrepresent intentionally material facts. Under this standard the duty to investigate and disclose material facts will necessarily vary according to the fact situation.

Id. at 735-36 (footnotes omitted).

[213] *See* Note, *Conflicting Duties*, *supra* note 24, at 397-400; notes 16, 205 *supra*.

[214] *See* text accompanying note 129 *supra*.

[215] *See* note 212 *supra*. Pollak v. Eastman Dillon, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,987 (S.D.N.Y. 1975), is an example of the reluctance of the courts to impose liability upon a broker-dealer in favor of a sophisticated customer who is basically making his own investment decisions. While the decision is premised upon a technical application of the *Birnbaum* purchaser-seller requirement, *id.* at 97,412, it is clear from the opinion that the court would apply a flexible suitability standard in light of the level of sophistication of the customer. *Cf.* note 207 *supra*.

[216] This policy should also proscribe insider trading by employees. *See* note 201 *supra*.

[217] *See* text accompanying notes 11-15 *supra*.

agement department to the inside information possessed by the investment-banking department prevents the use of the inside information and permits the investment management department to make investment decisions without violating the proscription against trading on the basis of inside information.[218] However, the question of the firm's duty to the investment management client remains.[219] Must the Chinese Wall be reinforced in the same manner with respect to investment management as it is with respect to recommendations?

While it might be argued that the multiservice firm's function is the same whether it is managing investments or making and executing trading recommendations, and that the same isolation technique is mandated for either activity, we believe that there is a distinction which renders the unreinforced Chinese Wall sufficient in the investment management situation.[220] The requirement of

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[218] *See* text accompanying notes 27-44 *supra*.

[219] *See* O'Donnell v. Continental Ill. Nat'l Bank & Trust Co., [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,920 (N.D. Ill. 1973) (summary of complaint). *See also* Rosenfeld, *Banks and 'Chinese Wall': Theory Upset by Lawsuit*, N.Y.L.J., Nov. 19, 1973, at 1, col 3; Schuyler, *From* Sulphur *to Surcharge?—Corporate Trustee Exposure Under SEC Rule 10b-5*, 67 NW. U.L. REV. 42, 51-55 (1972).

[220] Two recently enacted statutes which speak, *inter alia*, to fiduciary duty problems in investment management, appear, at first glance, to cast other kinds of doubts on the acceptability of the Chinese Wall in this context. First, the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, 88 Stat. 829 (codified at 29 U.S.C.A. §§ 1001-1381 (1975)), by prohibiting the performance of multiple services for pension plans by plan fiduciaries, 29 U.S.C.A. § 1104(a) (1975), may arguably vitiate the Chinese Wall solution for such fiduciaries. For example, under ERISA, a brokerage firm that serves as an investment adviser to a plan may not, after June 30, 1977, provide brokerage services to the plan. *Id.* § 1114(c)(4). This prohibition cannot be avoided by placing either the advisory or brokerage services in an affiliate firm. *Id.* § 1106(a)(1)(A)-(D). However, in enacting the fiduciary responsibility sections of ERISA, Congress was aware of the multiple services traditionally performed by brokerage firms and banks for managed pension plans and expected that exemptions to ERISA's prohibitions would be granted for such services. The Conference Committee Report, in dealing with § 408, *id.* § 1108, recognizes that

> some transactions which are prohibited . . . nevertheless should be allowed in order not to disrupt the established business practices of financial institutions which often performs [*sic*] fiduciary functions in connection with these plans consistent with adequate safeguards to protect employee benefit plans. . . .

H.R. REP. NO. 1280, 93d Cong., 2d Sess., in U.S. CODE CONG. & AD. NEWS, 93d Cong., 2d Sess. 5038, 5089-90 (1974). The Report gives as an example the firm which renders both investment advisory and brokerage services. Yet a statutory exemption for such brokerage firm activity was not granted because of (1) "the difficulty of establishing precise statutory standards for protecting against potential abuses," *id.* at 5090, and (2) the expectation that action taken on requests for exemptions from ERISA's prohibitions would be consistent with the outcome of the then-anticipated Securities Acts Amendments of 1975 addressing the general issue of institutional investment management by brokers. *Id.* Still, it might be argued that the Chinese Wall is for the benefit of the fiduciary in order to enable it to be in two or more lines of business and that, therefore, such solution does not meet the standards of § 404(a)

reinforcement in the case of recommendations is based upon the reasonable expectation of the typical retail customer and upon rejection of the concept that mere disclosure of a firm's Chinese Wall policy is sufficient to meet such expectation.[221] The investment management customer is usually more sophisticated, and the nature of his relationship with the firm makes disclosure more meaningful.[222] It is this difference which is sufficient to warrant

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of ERISA, 29 U.S.C.A. § 1104(a) (1975), requiring the fiduciary to act "solely in the interest of the participants and beneficiaries" of the plans. Based on the preceding legislative history, however, it does not appear that Congress intended ERISA to affect either the basic inside information problems of fiduciaries or the Chinese Wall solution one way or the other.

Second, the Securities Act Amendments of 1975, Pub. L. No. 94-29, §§ 6(2), 11(4), 89 Stat. 97, 110, 126 (codified at 15 U.S.C.A. §§ 78k(a), 78o(c)(5) (Supp. Aug. 1975)), reflect a policy determination by Congress to separate investment management and brokerage. *See* H.R. REP. NO. 229, 94th Cong., 1st Sess. 105 (1975). However, the separation mandated by § 6(2) of the Amendments is not of the functions of investment management and brokerage, as such, but of the performance of brokerage services for certain accounts managed by a securities firm. 15 U.S.C.A. § 78k(a)(1) (Supp. Aug. 1975). The major policy consideration concerned competition between traditional securities firms and institutional investors which create captive broker-dealers. *See* H.R. REP. NO. 229, 94th Cong., 1st Sess. 105 (1975). The minor issue was the "churning" conflict arising from a broker's ability to earn commissions on transactions it initiates as an investment manager. *See id.* at 106. The primacy-of-the-competition consideration is evidenced by the exception from the Amendments' proscription for managed accounts of "natural persons," 15 U.S.C.A. § 78k(a)(1)(E) (Supp. Aug. 1975), *amending* 15 U.S.C. § 78k(a) (1970), where the "churning" problem is far more likely than it is for managed institutional accounts. The Amendments also give the SEC authority to prohibit a firm from acting as both a broker and a dealer in the same security. *Id.* § 78o(c)(5), *amending* 15 U.S.C. § 78o(c)(5) (1970). Here the legislative purpose was the regulation of the market activities of specialists and marketmakers, *see* H.R. REP. NO. 229, 94th Cong., 1st Sess. 95 (1975), rather than a policy decision antithetical to the continuance of multiservice securities firms. Thus, the Amendments do not evidence any intent by Congress to affect the Chinese Wall solution or any of the basic policy considerations upon which it is premised.

[221] *See* text accompanying notes 204-08 *supra*.

[222] Fiduciary investment managers, who otherwise have the obligation to obtain "best execution," *see, e.g.*, Provident Management Corp., SEC Securities Act Release No. 5115, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,937, at 80,086-87 (Dec. 1, 1970), are permitted, under § 21(2) of the Securities Acts Amendments of 1975, 15 U.S.C.A. § 78bb(e) (Supp. Aug. 1975), to "pay-up" for research services provided by brokers if the fiduciaries disclose their "pay-up" policies to the shareholders or beneficiaries for whom they act as investment managers. The same basic policy of permitting a relatively slight impingement on strict fiduciary standards to accommodate activity deemed to be in the best interest of the investment management function would be applicable to the Chinese Wall solution so long as there was similar disclosure to investment management customers. This concept is subsumed by the decision in Anderson Co. v. John P. Chase, Inc., [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,009, at 97,515-16 (S.D.N.Y. 1975), *aff'd mem.*, No. 75-7239 (2d Cir. Nov. 18, 1975) *discussed in* note 207 *supra*. Proposed rule 206(4)-4 under the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (1970), would require investment advisers to deliver written disclosure statements to their clients at the outset of their relationship. The required disclosures

acceptance of the unreinforced Chinese Wall in the investment management context.[223]

Indeed, short of complete physical or corporate separation of its trust department, this is the only solution for the major commercial banks, which typically maintain banking relationships with numerous public companies whose securities are bought and sold by their trust departments for managed accounts. To preclude a major bank's trust department from trading in the securities of the bank's commercial-banking clients would so narrow the range of potential investment as to severely impair the performance of the trust department as an investment manager. Commercial banks engaging in investment management should, however, incorporate a disclosure of their inside information policies in their trust agreements as a limitation upon their fiduciary duties.[224] While the investment banker, unlike a major commercial bank, will not usually have confidential relationships with a vast number of clients and, accordingly, a policy against the investment management department trading in securities of investment-banking clients would not be overly restrictive of the investment manager's range of permissible investment, such a policy would place the investment banker at a disadvantage to the commercial bank in the competition for investment management business. In our opinion, the investment

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would include the sources of information used by the adviser. SEC Investment Advisers Act Release No. 442, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,128, at 85,150 (Mar. 5, 1975). This proposal quite clearly contemplates disclosure of the adviser's Chinese Wall and other inside information policies. Indeed, it provides further support for the proposition that disclosure to clients should permit the implementation of any reasonable inside information policy.

[223] There is a further distinction between managing investments and making recommendations to retail customers. If an investment manager were unable to use the Chinese Wall approach and, in order to fulfill its duties to clients, had to announce to all of them its inability to exercise investment discretion concerning a particular security each time the firm obtained inside information, there would be wide knowledge of the situation, possibly giving rise to rumors and an impact on the market. The signalling danger of such announcements would be acute. On the other hand, the use of a restricted list to supplement the Chinese Wall of a firm that makes recommendations is essentially passive. The disclosure of the fact of the restriction of a particular security only occurs when a customer independently makes a trading decision. Therefore, the restriction of a security does not have the potential market impact of an announcement to all of the firm's investment management clients.

[224] *See* notes 207-08 *supra*. One commentator has suggested the following clause:

> The trustee shall be under no duty and shall not be liable to any beneficiary for failure to buy, sell or engage in any transaction directly or indirectly involving securities issued or to be issued by any corporation or other business organization concerning which the trustee, in its corporate capacity, may have acquired any information which has not been disclosed to the public.

Schuyler, *supra* note 219, at 57 n.68.

management conflict problem is not of sufficient moment to warrant imposing that competitive disadvantage.

IX

CONCLUSION

If we are to avoid segregation of functions into separate entities in the securities, banking, insurance and investment management businesses, the Chinese Wall has a legitimate and essential role to play in dealing with inside information conflict problems. Once we accept the multiservice concept, the issue becomes not the acceptance of the Chinese Wall, but rather the reconciliation of the Chinese Wall with both the expectations of customers and the prevention of self-interest abuses. The solution is the reinforced Chinese Wall.

Recently proposed solutions[225] to other aspects of insider-trading and disclosure problems, of which the Chinese Wall is one, may be essential to the continuance of our present economic system: The dramatic expansion by the SEC and the courts of the concept of materiality and of the scope of disclosure requirement,[226] coupled with the almost unlimited damages to which

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[225] The SEC recently released a package of proposed reforms, explaining that [b]ecause of widespread public interest in this area and because of its importance to investors, the Commission determined that it was the appropriate time to take action in this area, to recognize the realities of the situation, and to take the lead in developing standards and guidelines that will enable all issuers to understand their responsibilities and all investors to have equal access to projection information.

SEC Securities Act Release No. 5581, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,167, at 85,301 (April 28, 1975). For other proposed solutions, see SEC Securities Exchange Act Release No. 10,316, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,446, at 83,262 (Aug. 1, 1973) (general guidelines); SEC Securities Exchange Act Release No. 10,174, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,378, at 83,106 (May 25, 1973) (corporations and brokers); Letter from the ABA Committee on Federal Regulation of Securities to the SEC, Oct. 15, 1973, in BNA SEC. REG. & L. REPORT NO. 233, at D-1 (1973) (responding to SEC Release No. 10,316 *supra*); Address by SEC Chairman G. Bradford Cook, New York Society of Security Analysts, March 27, 1973, in [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,301, at 82,911 (analysts); Address by SEC Chairman Ray Garrett, Jr., Arthur D. Little, Inc. Corporate Directors Conference, Washington, D.C., in CCH FED. SEC. L. REPORT NO. 566, at 3-4 (1974) (summary) (directors); Address by SEC Commissioner A.A. Sommer, Jr., Feb. 27, 1974, in BNA SEC. REG. & L. REPORT NO. 241, at F-1 (directors).

[226] *See* note 18 *supra*. *See also* Letter from Federal Reserve Board Chairman Arthur F. Burns to Senator Thomas J. McIntyre, May 5, 1975, in [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,172, at 85,320. There are, however, recent indications that the pendulum may have begun to swing back in this regard to a more narrow view of materiality and a more limited disclosure requirement. *See*,

even an inadvertent rule 10b-5 violation may lead,[227] might so inhibit securities firms—and, indeed, all business—as to threaten the foundations of that system. Only if procedures and guidelines, such as the Chinese Wall, for avoiding violations of the insider-trading proscriptions and disclosure requirements develop and are accepted apace will it be possible to assure the securities industry, and business generally, that it is not necessary to cease innovation, experimentation and initiative to avoid violations of rule 10b-5.[228]

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e.g., Ehrler v. Kellwood Co., [Current] CCH FED. SEC. L. REP. ¶ 95,271, at 98,389 (8th Cir. Sept. 3, 1975); Black v. Riker-Maxson Corp., [Current] CCH FED. SEC. L. REP. ¶ 95,270, at 98,385-86 (S.D.N.Y. Aug. 21, 1975); Spielman v. General Host Corp., [Current] CCH FED. SEC. L. REP. ¶ 95,267, at 98,367-70 (S.D.N.Y. Aug. 14, 1975).

[227] *See, e.g.*, Chris-Craft Indus., Inc., v. Piper Aircraft Corp., [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,058, at 97,699-707 (2d Cir. 1975); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 241-42 (2d Cir. 1974).

[228] *See* Solomon & Wilke, *supra* note 7, at 505-06.