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The Multi-Service Securities Firm and the Chinese Wall: A New Look in the Light of the Federal Securities Code

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The Multi-Service Securities Firm and the Chinese Wall: A New Look in the Light of the Federal Securities Code

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I. INTRODUCTION

The antifraud provisions of the federal securities laws have come to embody the rule that most persons in possession of material, nonpublic information about an issuer of publicly-held securities must either disclose that information to the general investing public, or abstain from trading in the affected securities.¹ The development of this "disclose or abstain" rule has brought with it a unique set of problems for multi-service financial institutions. These firms are also obligated to their individual trading customers not to recommend or execute transactions in securities unless fully justified in light of all the information relating to the investment that is known to the institution. Multi-service securities firms—those that have combined the functions of investment banking and corporate counselling with investment advisory, investment management, and retail broker-dealer services—are particularly subject to potentially conflicting duties with respect to the confidential information they possess. On the one hand, the firm is obliged to retain the confidentiality of any nonpublic information it acquires from a corporate client,² as well as to abstain from either trading on that information or "tipping" it to its retail customers.³ At the same time, however, the firm owes a duty to its retail brokerage and investment management clients to disclose all material information in its possession that is relevant to any proposed transactions in the affected securities.⁴

In an effort to reconcile these disparate legal duties, integrated securities firms, as well as other multi-service financial institutions, have established internal policies and procedures to restrict

1. See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1969), *cert. denied*, *Coates v. SEC*, 394 U.S. 976 (1969); *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961). See also *Dirks v. S.E.C.*, 103 S.Ct. 3255 (1983).

2. See *infra* notes 24-28 and accompanying text.

3. See *infra* notes 29-36 and accompanying text.

4. See *infra* notes 37-45 and accompanying text.

interdepartmental flows of material nonpublic information about the firm's corporate clients. These policies, which have come to be known collectively as "Chinese Walls," generally operate to isolate inside information within the department of the firm that initially receives it.

The legal sufficiency of a Chinese Wall in insulating the multi-service firm from liability under the insider trading provisions of the securities laws, and also the effect of such internal policies on the firm's obligations to its trading customers, has been much discussed,⁵ but rarely litigated.⁶ In the final analysis, however, the question facing the "walled" firm, either in a charge of trading or tipping in violation of the antifraud laws, or in a claim of insufficient disclosure or an improper recommendation to its retail customers, is whether the nonpublic information isolated within one department of the firm will be attributed to the firm as a whole, or to its retail trading and advisory personnel.⁷

The purpose of this Article is to explore these questions, both in the context of the insider trading provisions, and of the rules governing the relationship of a securities firm to its retail customers. In general, this Article supports the contention that the Chinese Wall should operate to rebut the presumption that the knowledge of one of the firm's agents or departments of a firm is the knowledge of the firm as a whole in those situations where the firm does not have a marked *economic* conflict of interest with the party in whose favor a judgment of liability is sought. There are cases, however, where the firm's own economic interests are demonstrably at odds with the interests of the investing public. This will occur, for example, when the firm engages in securities transactions

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5. See, e.g., N. WOLFSON, CONFLICTS OF INTEREST: INVESTMENT BANKING (1976); Chazen, *Reinforcing the Chinese Wall: A Response*, 51 N.Y.U.L. REV. 552 (1976); Lipton & Mazur, *The Chinese Wall: A Reply to Chazen*, 51 N.Y.U.L. REV. 579 (1976) [hereinafter cited as Lipton & Mazur, *Reply*]; Lipton & Mazur, *The Chinese Wall Solution to the Conflict Problems of Securities Firms*, 50 N.Y.U.L. REV. 459 (1975); Note, *Conflicting Duties of Brokerage Firms*, 88 HARV. L. REV. 396 (1974). See also E. HERMAN, CONFLICTS OF INTEREST: COMMERCIAL BANK TRUST DEPARTMENT (1975); L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 843-51 (1983); Herzel & Colling, *The Chinese Wall and Conflict of Interest in Banks*, 34 BUS. LAW. 73 (1978); Huck, *The Fatal Lure of the "Impermeable Chinese Wall"*, 94 BANK. L.J. 100 (1977); Méndez-Péñate, *The Bank Chinese Wall: Resolving and Contending With Conflicts of Duties*, 93 BANK. L.J. 674 (1976); Herman & Safanda, *The Commercial Bank Trust Department and the "Wall"*, 14 B.C. IND. & COMM. L. REV. 21 (1972).
 6. See, e.g., *Slade v. Shearson, Hammill & Co.*, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,329 (S.D.N.Y.) (denial of defendant's motion for partial summary judgment), *remanded*, 517 F.2d 398 (2d Cir. 1974), *settlement approved*, 79 F.R.D. 309 (S.D.N.Y. 1978).
 7. See ALI FED. SEC. CODE § 202(86)(C) (1980) (see *infra* note 149 for the text of the statute).

for its own account, in a manner akin to that of any other investor. There are also instances where the firm's interests are likely to conflict with those of its retail customers, such as the case during formal underwritings of new securities. In these instances, attributing knowledge throughout the firm, irrespective of the existence of a Chinese Wall, better comports with the economic realities of the situation. In light of this conclusion, multi-service securities firms which are in possession of inside information should refrain from purchasing or selling securities for accounts in which the firm has a proprietary interest. In addition, to avoid untoward misrepresentations to its trading customers and improper transactions in managed accounts, the firm should also avoid recommending the purchase of outstanding securities of those issuers for which the firm is simultaneously engaged as an underwriter of a new issue until the formal sales campaign for the new issue actually begins.

Part II of this Article will explore the various relationships of multi-service securities firms which regularly give rise to the receipt of inside information by the firm, as well as the firm's legal obligations with respect to information in its possession to its corporate clients, its retail customers, and the investing public at large. Part III discusses the administrative and judicial treatment accorded the Chinese Wall approach in reconciling these potentially conflicting duties. Part IV examines the approach of the American Law Institute's proposed Federal Securities Code with regard to questions of corporate knowledge generally, including the "knowledge" of multi-service financial institutions which have adopted internal policies to attempt to deal with the inside information problems faced by the firm. Part V explores the question of the legal sufficiency of the Chinese Wall as a defense to a charge that a firm has improperly utilized inside information in violation of the antifraud provisions of the federal securities laws. Part VI, in turn, discusses the effect of the Wall on the firm's obligations to its retail customers in the context of the various types of relationships with corporate clients which are likely to give rise to the receipt of inside information by the firm. Finally, Part VII summarizes the conclusions developed in the earlier sections of the Article.

II. THE PROBLEM OF CONFLICTING DUTIES

A. Sources of Inside Information

Securities firms doing business in today's capital markets have increasingly integrated a number of different professional functions into a common corporate head which offers a full range of market services to the investment community. As early as 1963,

the Securities and Exchange Commission (SEC) described the structure of the American securities industry in the following manner:

- 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, custodian of funds and securities, investment adviser to discretionary accounts, to others on a fee basis, and to one or more corporations. Its principals may invest or trade for their accounts in securities also dealt in for others. . .⁸

In addition, it is common practice for the principals, officers, and employees of such "integrated" firms to serve as directors of companies whose securities are traded in the public markets.⁹

In performing its obligations in a number of these functional areas, integrated firms regularly come into possession of unpublished information about the issuers of publicly-held securities—information which, if publicly disseminated, would likely cause a movement in the trading price of the company's outstanding issues.¹⁰ For example, in its role as investment banker to a company that is contemplating a new issue of its stock or debt, the firm is both expected and (at least where a registered offering is proposed) obliged to conduct a full investigation into the issuer's business.¹¹ In the course of any such investigation, the firm's

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8. SEC, SPECIAL STUDY OF THE SECURITIES MARKETS, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 5, 65-66 (1963) [hereinafter cited as SEC, SPECIAL STUDY]. See also Lipton & Mazur, *supra* note 5, at 460, 464; Note, *supra* note 5, at 396-97. See generally SEC, REPORT ON THE FEASIBILITY AND ADVISABILITY OF THE COMPLETE SEGREGATION OF THE FUNCTIONS OF DEALER AND BROKER (1936). The trend toward integration, and the increasing industry concentration that has ensued, has probably not been purely a matter of competitive economics. Cf. S. JAFFE, BROKER-DEALERS AND SECURITIES MARKETS § 1.02, at 3 (1977) ("The industry is characterized by an uneasy blend between undercapitalization, and intense concentration.").
 9. See SEC, SPECIAL STUDY, *supra* note 8, pt. 1, at 428-29. See generally *infra* notes 244-60 and accompanying text.
 10. Such information is often referred to as "material nonpublic information," or simply as "inside information." A more descriptive term, however, to convey the intended meaning is that used in the 1980 British Companies Act, i.e. "unpublished price-sensitive information." Companies Act, 1980, ch. 22, § 73(2). Cf. ALI FED. SEC. CODE § 202(56) (1980) (definition of "fact of special significance") (see *infra* note 169 for the text of the statute).
 11. When acting as underwriter, the securities firm regularly conducts an extensive investigation into the issuer's business, background, and financial condition in order to allocate shares among the members of the underwriting syndicate, to determine the offering price of the issue, and generally to provide information which will aid in the success of the distribution. See Note, *supra* note 5, at 396 n.6. In addition, at least in connection with public offerings requiring registration under the Securities Act of 1933, as amended, 15

investment banking personnel will, *ex necessitate*, inspect a considerable amount of confidential information about the issuer which, for one reason or another, has not been disclosed to the investing public.¹² In addition, a firm may acquire inside information about a company through a partner or employee's service (or connection with) the issuer's board of directors,¹³ or also (although on a far less systematic basis) through a research employee's investigation of a company or industry in connection with the firm's investment advisory services.¹⁴

At the same time that one department or working group within a multi-service firm is in possession of disclosed inside information about a company, other departments of the firm may be effecting market transactions in that issuer's outstanding securities. The classic case occurs when the underwriting or investment banking division acquires confidential information about a corporate issuer while the broker-dealer or investment management personnel in the firm are executing transactions or recommending those securi-

U.S.C. §§ 77a-77aa (1982), the underwriter's responsibility to fully investigate the issuer is necessitated by the act's liability provisions. Under § 11(a)(5), 15 U.S.C. § 77k(a)(5) (1982), an underwriter may be held liable for false and misleading statements in the registration statement on its effective date unless he can meet the "due diligence" defense of § 11(b)(3), 15 U.S.C. § 77k(b)(3) (1982).

12. For cases illustrating the receipt of confidential information by a securities firm in its role as investment banker to the issuer, see, e.g., *Slade v. Shearson, Hammill & Co.*, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,329 (S.D.N.Y.), *remanded*, 517 F.2d 398 (2d Cir. 1974), *settlement approved*, 79 F.R.D. 309 (S.D.N.Y. 1978) (see *infra* notes 78-134 and accompanying text for a discussion of *Slade*); *SEC v. Lum's, Inc.*, 365 F. Supp. 1046 (S.D.N.Y. 1973); *Lewis v. Spiral Metal Co.*, 317 F. Supp. 905 (S.D.N.Y. 1970); *In re Van Alstyne, Noel & Co.*, 43 S.E.C. 1080 (1969); *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933 (1968); *In re M.S. Wien & Co.*, 23 S.E.C. 735 (1946).
13. See, e.g., *Black v. Shearson, Hammill & Co.*, 266 Cal. App. 2d 362, 72 Cal. Rptr. 157 (1968); *In re Pennaluna & Co.*, 43 S.E.C. 298 (1967), *aff'd in part, rev'd and remanded in part*, 410 F.2d 861 (9th Cir. 1969), *cert. denied*, 396 U.S. 1007 (1970). *Cf. Hiller v. SEC*, 429 F.2d 856 (2d Cir. 1970) (broker was a member of issuer's board of directors yet allowed salesmen to recommend stock on the basis of unconfirmed rumors).
14. See, e.g., *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 160-62 (2d Cir. 1980); *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 9 (2d Cir. 1977) (referring to corporate officers' dealing with analysts as "a fencing match conducted on a tight-rope"); *SEC v. Avis, Inc.*, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,419 (S.D.N.Y. March 7, 1974) (summary of complaint); *Hawk Indus., Inc. v. Bausch & Lomb, Inc.*, 59 F.R.D. 619 (S.D.N.Y. 1973). See also Parker, *Ethical Issues for the Financial Analyst*, reprinted in CORPORATE FINANCIAL REPORTING: ETHICAL AND OTHER PROBLEMS 165 (1972).

Inside information may also come to the firm's attention in a far less expected way. In *Dirks v. S.E.C.*, 103 S.Ct. 3255 (1983), an officer of a broker-dealer received information from a former corporate officer that the corporation's assets were overstated as a result of internal corporate fraud.

ties on the basis of public information that is inconsistent with the inside information known to the investment banking department.¹⁵

In this unhappy situation, it appears at first blush that the firm is faced with a potentially inconsistent set of legal obligations. On the one hand, it has a common law duty (which is undoubtedly incorporated into a contract) to its investment banking client to retain the confidentiality of undisclosed information acquired in the course of its investment banking relationship.¹⁶ It also has a duty to the investing public imposed by the securities laws to refrain from transacting in securities on the basis of inside information.¹⁷ At the same time, however, the firm is obliged to deal fairly with its retail clients and to reveal all material information in its possession which might have an effect on the customer's investment decision.¹⁸

While the remainder of this Article is concerned with the nature and scope of these obligations in the context of a multi-service securities firm, it is worth noting at the outset that the problem is by no means unique to the securities industry. Similar conflicts are also faced by other financial institutions, particularly multi-service commercial banks. Even though commercial banking institutions are prohibited by statute from underwriting securities issued by private corporations,¹⁹ they remain quite active in numerous securities-related activities.²⁰ The most acute conflict of obligations faced by multi-service banks occurs when the commercial lending department receives adverse information about a publicly-held corporate customer at the same time that the bank's fiduciary trust or assets management department is purchasing securities of that issuer for its managed trust accounts.²¹ In these circumstances, the bank, like the securities firm, shares with inves-

15. See, e.g., *Slade v. Shearson, Hammill & Co.*, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,329 (S.D.N.Y.), *remanded*, 517 F.2d 398 (2d Cir. 1974), *settlement approved*, 79 F.R.D. 309 (S.D.N.Y. 1978); *Black v. Shearson, Hammill & Co.*, 266 Cal. App. 2d 362, 72 Cal. Rptr. 157 (1968). Cf. *O'Brien v. Continental Ill. Nat'l Bank & Trust Co. of Chicago*, 593 F.2d 54 (7th Cir. 1979) (plaintiffs claimed, but the court did not decide, that a multi-service bank is obliged to utilize inside information to prevent harm to trust customers).

16. See *infra* notes 24-28 and accompanying text.

17. See *infra* notes 29-36 and accompanying text.

18. See *infra* notes 37-45 and accompanying text.

19. See 12 U.S.C. §§ 24, 378 (1982).

20. See Little & Phillips, *The Chinese Wall and the Conflict of Regulatory Obligations*, in ALL-ABA COMMITTEE ON CONTINUING PROFESSIONAL EDUCATION, RESOURCES MATERIALS: FRAUD, INSIDE INFORMATION AND FIDUCIARY DUTY UNDER RULE 10B-5 593, 593-94 (1976). See also E. HERMAN, *supra* note 5; Herzel & Colling, *supra* note 5; Huck, *supra* note 5; Méndez-Péñate, *supra* note 5; Saffanda, *supra* note 5.

21. 12 U.S.C. § 24 (1982) permits banks to purchase and sell securities upon the order of, and for the accounts of, its customers. See also Schoenbaum, *Bank*

tors generally the obligation to refrain from trading in securities on the basis of inside information.²² At the same time, however, the bank as trustee is impressed with duties to the beneficiaries of the trust accounts under its control to avoid unsound investments based on all of the information which is reasonably ascertainable by the bank.²³

B. Conflicting Functions/Conflicting Duties

1. *The Duty to Retain Corporate Confidences*

In its role as investment banker or corporate financial advisor to a publicly-held corporation, the multi-service securities firm is obliged to respect the confidential nature of any nonpublic information it acquires as a result of that relationship.²⁴ Likewise, a partner or employee of a securities firm who obtains inside information by virtue of his service on a company's board of directors is prohibited from using that information either for his own benefit and from communicating it to others,²⁵ and may either be enjoined at the instance of the corporation²⁶ or held liable to it for any prof-

Securities Activities and the Need to Separate Trust Departments from Large Commercial Banks, 10 U. MICH. J.L. REF. 1, 4 (1976).

22. See *infra* notes 29-36 and accompanying text.
23. See *infra* notes 39-40 and accompanying text. In addition, a bank may have a conflict in its legal obligations between customers when it is involved in the financing of an unfriendly tender offer for the stock of one of its corporate customers. See, e.g., *Washington Steel Corp. v. TW Corp.*, 602 F.2d 594 (3d Cir. 1979); *Harnischfeger Corp. v. Paccar, Inc.*, 474 F. Supp. 1151 (E.D. Wis. 1979); *American Medicorp, Inc. v. Continental Ill. Nat'l Bank and Trust Co. of Chicago*, 475 F. Supp. 5 (N.D. Ill. 1977). See generally Note, *Bank Financing of Involuntary Takeovers of Corporate Customers: A Breach of Fiduciary Duty?*, 53 NOTRE DAME LAW. 827 (1978); Note, *Conflicts of Interest: The Chinese Wall and Bank Financing of Hostile Tender Offers*, 37 WASH. & LEE L. REV. 963 (1980).
24. See RESTATEMENT (SECOND) OF AGENCY § 395 (1958): "Unless otherwise agreed, an agent is subject to a duty to the principal not to use or communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency. . . ." (Emphasis added.) See also W. SEAVEY, HANDBOOK OF THE LAW OF AGENCY § 152, at 249 (1964) (agent is under a duty not to use or disclose confidential information except for principal's benefit). The firm's obligation to protect corporate confidences continues even after the formal agency relationship between the parties is terminated. See RESTATEMENT (SECOND) OF AGENCY, *supra*, § 396(b); W. SEAVEY, *supra*, § 154, at 250, 252; *Allen Mfg. Co. v. Lolka*, 145 Conn. 509, 144 A.2d 306 (1958).
25. See W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 857.1 (rev. perm. ed. 1975 & 1982 Supp.); *Bancroft-Whitney Co. v. Glen*, 64 Cal. 2d 327, 411 P.2d 921, 49 Cal. Rptr. 825 (1966). See also *supra* note 24.
26. See, e.g., *Schwayder Chemical Metallurgy Corp. v. Baum*, 45 Mich. App. 220, 206 N.W.2d 484 (1973). See also W. FLETCHER, *supra* note 25.

its made from its use.²⁷ The purpose of this admonition against disclosure of confidential information is to permit business entities to plan transactions and other business activities without jeopardizing the company's relationships with third parties.²⁸

2. *The Firm's Duty to the Investing Public*

Of even greater importance to the multi-service securities firm than its obligation to its investment banking clients, however, is the prohibition against the use of material nonpublic information imposed by the antifraud provisions of the federal securities laws. It has become axiomatic that engaging in securities transactions on the basis of inside information violates SEC rule 10b-5,²⁹ at least

27. See RESTATEMENT (SECOND) OF AGENCY § 388, comment (c) (1958); 3 A. SCOTT, *THE LAW OF TRUSTS* § 505 (3d ed. 1967 & Supp. 1981). In *Diamond v. Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969), the court held that a director who traded in the stock of his corporation on the basis of inside information was accountable to the corporation for his trading profits, even in the absence of specific proof of injury to the corporation. In *Schein v. Chasen*, 478 F.2d 817 (2d Cir. 1973), *vacated and remanded sub nom. Lehman Bros. v. Schein*, 416 U.S. 386 (1974), *on remand*, 519 F.2d 453 (2d Cir. 1975), the Second Circuit suggested that liability of this type might extend to the director's "tippees" as well. See also *Thomas v. Roblin Indus., Inc.*, 520 F.2d 1393 (3d Cir. 1975). *But see Schein v. Chasen*, 313 So. 2d 739 (Fla. 1975) (rejecting the rule of *Diamond v. Oreamuno*); *Freeman v. Decio*, 584 F.2d 186 (7th Cir. 1978) (same; applying federal court's view of Indiana law, the court rejected the rule of *Diamond v. Oreamuno*).

28. See *Lipton & Mazur, supra* note 5, at 474; Note, *supra* note 5, at 400-01.

29. SEC Securities Exchange Act Rule 10b-5, adopted pursuant to § 10(b) of the Securities Exchange Act of 1934, as amended, 15 U.S.C. § 78j(b) (1982), provides as follows:

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,

(a) to employ any device, scheme, or artifice to defraud,

(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

(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 (1983). The language of the rule is quite similar to that of § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1982), the principal difference being that rule 10b-5 applies to purchases *and* sales, while § 17(a) is limited to fraudulent behavior only in the sale of securities. Because the rule was promulgated prior to the 1946 passage of the Administrative Procedure Act, 60 Stat. 237, *codified at* 5 U.S.C. §§ 551-59 (1982), there is very little administrative history of the Commission's action. For what little there is, see *Freeman, Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967); *Loss, The Opinion*, 24 BUS. LAW. 527, 535 (1969). See also 5 A. JACOBS, *LITIGATION AND PRACTICE UNDER RULE 10B-5* § 5.02 (2d ed. 1981); Note, *SEC Action Against Fraudulent Purchasers of Securities*, 59 HARV. L. REV.

if that information emanated, directly or indirectly, from the issuer of those securities.³⁰ The genesis of the prohibition against trading on undisclosed information came in *In re Cady, Roberts & Co.*,³¹ an SEC disciplinary proceeding against a registered broker-dealer and Gintel, one of the firm's partners. In that case, Gintel had received a telephone call from an associate of the firm who served on the board of directors of the Curtiss-Wright Corporation informing him of a decision by the Curtiss-Wright board to cut the company's annual dividend. On the basis of that call and prior to the public dissemination of the news about the dividend decision, Gintel sold Curtiss-Wright stock both for himself and for several discretionary accounts managed by the firm.

The SEC had little difficulty in holding that Gintel's market sales of Curtiss-Wright stock on the basis of the undisclosed news about the corporation's dividend reduction were at least violative of clause (3) of rule 10b-5.

769, 770 (1946). For textual treatment of rule 10b-5, see A. BROMBERG, *SECURITIES LAW—FRAUD: SEC RULE 10B-5* (1977); 5 A. JACOBS, *supra*; L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 818-946, 1125-52 (1983); 3 L. LOSS, *SECURITIES REGULATION* 1448-74, 1757-97 (2d ed. 1961); W. PAINTER, *FEDERAL REGULATION OF INSIDER TRADING* (1968 & Supp. 1978); 6 *id.* at 3556-3647, 3864-3925 (Supp. 1969). See also Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979).

30. In *Chiarella v. United States*, 445 U.S. 222 (1980), the Supreme Court held that mere silence as to material facts in the purchase or sale of securities is actionable under § 10(b) and rule 10b-5 only if there is some special relationship of trust and confidence existing between the parties to the transaction which gives rise to a duty to speak on the part of the defendant. Thus, in *Chiarella*, the Court reversed a criminal conviction under the rule for trading in the securities of a target corporation on the basis of unpublished knowledge that a tender offer was about to be made which was garnered from sources affiliated with the offeror, rather than the target. In *Dirks v. S.E.C.*, 103 S.Ct. 3255 (1983), the Court reaffirmed its decision in *Chiarella*, holding that the "disclose or abstain" rule does not arise merely from the possession of nonpublic information. Rather, there must be some fiduciary relationship between the corporation and the person who acquires the information. *Contra United States v. Newman*, 664 F.2d 12 (2d Cir. 1981) (misappropriation of inside information from offeror's investment banker violates rule 10b-5). See also *Goodman v. Kennedy*, 18 Cal. 3d 335, 556 P.2d 737, 134 Cal. Rptr. 375 (1976) (under state securities statute, mere nondisclosures failed to give rise to a cause of action in the absence of factual allegations demonstrating a duty to disclose). But see *Lingsch v. Savage*, 213 Cal. App. 2d 729, 29 Cal. Rptr. 201 (1963) (failure of seller to disclose facts regarding value of property which buyer could not otherwise acquire constitutes actual fraud). See generally W. PROSSER, *HANDBOOK OF THE LAW OF TORTS* § 106, at 695-97 (4th ed. 1971); Morrison, *Silence is Golden: Trading on Nonpublic Market Information*, 8 SEC. REG. L.J. 211 (1980); Note, *A Corporate Outsider's Duty to Disclose Under Rule 10b-5*, 12 TEX. TECH. L. REV. 540 (1981); Note, *The Affirmative Duty to Disclose Under Rule 10b-5*, 6 U. DAYTON L. REV. 203 (1981).

31. 40 S.E.C. 907 (1961).

We have already noted that the antifraud provisions are phrased in terms of "any person" and that a special obligation has been traditionally required of corporate insiders, e.g., officers, directors, and controlling stockholders. These three groups, however, do not exhaust the classes upon whom there is such an obligation [to disclose material facts or abstain from trading]. Analytically, the obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of that information knowing it is unavailable to those with whom he is dealing.³²

The SEC's formulation of the obligation either to disclose material inside information or refrain from trading in the securities of the company involved received judicial endorsement in the landmark case of *S.E.C. v. Texas Gulf Sulphur Co.*³³ In that case, the Commission brought an action against several of a corporation's directors, officers, and employees who had made market purchases of the company's stock (or had "tipped" others to do so) on the basis of undisclosed information that the company had made an important new mineral discovery. In reversing the district court's dismissal of the complaint against a number of the insiders, the Second Circuit formulated its now famous "disclose or abstain" rule for investors who possess material nonpublic information about the issuer of publicly-traded securities:

[A]nyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or if he chooses not to do so, must either abstain from trading in or recommending the securities concerned while such information remains undisclosed.³⁴

Finally, in *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,³⁵ the Second Circuit reaffirmed its holding in *Texas Gulf*

32. *Id.* at 912.

33. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, Coates v. SEC, 394 U.S. 976 (1969).

34. *Id.* at 848. The "disclose or abstain" rule has also been adumbrated under other antifraud provisions of the federal securities laws, e.g. § 206 of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-6 (1982). See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963); SEC Securities Exchange Act Rule 14e-3, 17 C.F.R. § 240.14e-3 (1983) (adopted pursuant to § 14(e) of the 1934 Act, 15 U.S.C. § 78n(e) (1982) (regulating tender offers)). See also Brudney, *supra* note 29, at 322-23 & nn.6-7.

35. 495 F.2d 228, 236 (2d Cir. 1974) *affg* 353 F. Supp. 264 (S.D.N.Y. 1972). See also *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 165-68 (2d Cir. 1980); *SEC v. Texas Gulf Sulphur Co.*, 312 F. Supp. 77, 95 (S.D.N.Y. 1970), *modified on other grounds*, 446 F.2d 1301 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971); Butcher & Sherrerd, SEC Securities Exchange Act Release No. 9894, [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,135 (Dec. 11, 1972); *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933 (1968). See generally R. JENNINGS & H. MARSH, SECURITIES REGULATION: CASES AND MATERIALS 947-53 (4th ed. 1977) (discussing the various classes of persons upon whom there is placed a duty to disclose or abstain from transacting).

Sulphur and found it clearly controlling to impose liability even on a "tipper" of material corporate information received in its role as the prospective managing underwriter of a new issue of the company's securities, even though the defendant did not itself trade in the securities involved. Thus, taken together, the decisions in *Cady, Roberts, Texas Gulf Sulphur*, and *Shapiro* make abundantly clear that a securities firm that reveals confidential information about a publicly-held company to its customers, or uses that information to form the basis of a trading recommendation, will be exposed to the possibility of both administrative sanctions and private civil liability.³⁶

3. *The Firm's Obligation to its Retail Customers*

In addition to its duty to keep corporate secrets secret and to abstain from trading on or tipping material nonpublic information acquired from its corporate clients, the multi-service securities firm is also impressed with obligations to its retail trading customers. As a broker engaged in the execution of securities transactions for clients on a strict commission basis, the common law regards the firm as an agent of its retail customer.³⁷ As an agent, the firm owes a duty to its principal to reveal any and all information in its possession relevant to any proposed transaction which the customer would reasonably want to know.³⁸ In addition, to the

36. See Lipton & Mazur, *supra* note 5, at 472; Note, *supra* note 5, at 399-400. The American Law Institute's proposed Federal Securities Code, while not making tipping unlawful *per se*, see ALL FED. SEC. CODE § 1603, comment (b) (1980 & 2d Supp. 1981), would also generally hold a "tipper" civilly liable to the same extent as his trading "tippee." *Id.* at § 1724(c). In *Dirks v. S.E.C.*, 103 S.Ct. 3255 (1983), however, the Court held that, under existing law, a "tipper" will be held liable only if he has breached a duty to the corporation in disclosing the nonpublic information, and "the test is whether the insider personally will benefit, directly or indirectly, from his disclosure." *Id.* at 3265.

37. See *McMann v. SEC*, 87 F.2d 377, 378 (2d Cir. 1937), *cert. denied*, 301 U.S. 684 (1937) (broker is an agent and, thus, a fiduciary); *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690, 69 Cal. Rptr. 222 (1968). See also S. JAFFE, *supra* note 8, § 7.09, at 146. *Cf. Hughes v. SEC*, 174 F.2d 969, 975-76 (D.C. Cir. 1949) (under federal securities laws, even a dealer may be deemed a fiduciary).

38. See, e.g., *Black v. Shearson, Hammill & Co.*, 266 Cal. App. 2d 362, 72 Cal. Rptr. 157 (1968); *Batson v. Strehlow*, 68 Cal. 2d 662, 441 P.2d 101, 68 Cal. Rptr. 589 (1968); *Schweiger v. Loewi & Co.*, 65 Wis. 2d 56, 221 N.W.2d 882 (1974). RESTATEMENT (SECOND) OF AGENCY § 381 (1958) states the rule thus:

Unless otherwise agreed, an agent is subject to a duty to use reasonable efforts to give his principal information which is relevant to the affairs entrusted to him and which, as the agent has notice, the principal would desire to have and which can be communicated without violating a superior duty to third persons.

It could probably be argued that this formulation of the agent's disclosure obligation, to the extent that it correctly represents the law, relieves the firm

extent that the firm also engages in investment or money management for retail clients (such as through the exercise of transactional authority over a discretionary account), the firm becomes subject to the even more demanding fiduciary obligations imposed by the law of trusts. As a trustee of its clients' property, the firm is obligated to manage the trust *corpus* with the same skill and care that it would use in dealing with its own property,³⁹ and to make investments for the trust only on the basis of all relevant information in the firm's possession or reasonably ascertainable by it.⁴⁰

Of greater significance to the broker-dealer firm than its common law obligations, however, are the requirements of the federal securities laws that the firm have an adequate factual basis for any

of any obligation to disclose inside information to its retail brokerage clients, because to do so would violate both the firm's obligation to its investment banking client and to the investing public at large. The fallacy in this analysis, standing alone, is that it presumes what it seeks to prove; that is, that the integrated firm's duty to retain corporate confidences, and to refrain from trading or tipping in violation of rule 10b-5, is indeed "superior" to the disclosure obligations owed to its retail customers, an issue about which the rule of § 381 does not purport to speak. *But cf. id.* § 395 (agent's duty not to disclose confidential information). In any event, any attempt to resolve the issues involved on the basis of agency law principles is largely an academic exercise in the wake of the obligations imposed upon brokers and dealers by the federal securities laws. *See infra* notes 41-45 and accompanying text.

39. *See Costello v. Costello*, 209 N.Y. 252, 261, 103 N.E. 148, 152 (1913):

[T]rustees are bound in the management of all the matters of the trust to act in good faith and employ such vigilance, sagacity, diligence and prudence as in general prudent men of discretion and intelligence in like matters [would] employ in their own affairs. The law does not hold a trustee acting in accord with such rule, responsible for errors in judgment.

See also RESTATEMENT (SECOND) OF TRUSTS § 174 (1959); 2 A. SCOTT, *supra* note 27, §§ 174, 174.1. As to the trustee's duty of loyalty to the trust, see the classic statement of Judge Cardozo, in *Meinhard v. Salmon*, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928):

A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. . . . Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions

40. *See* LITTLE & PHILLIPS, *supra* note 20, at 596. In addition, the trustee remains subject to a continuing obligation to monitor the investments in the trust portfolio and to dispose (within a reasonable time) of any investments which, though proper when made, have subsequently become improper. *See* RESTATEMENT (SECOND) OF TRUSTS § 231, comment (b) (1959); 3 A. SCOTT, *supra* note 27, § 231. It should be noted, however, that the trustee is neither obliged nor privileged to violate the law in the performance of his obligations under the declaration of trust. *See* IND. CODE § 30-4-2-12 (1976); RESTATEMENT (SECOND) OF TRUSTS, §§ 61, 166 (1959); 1 A. SCOTT, *supra* note 27, § 61, at 571; 2 A. SCOTT, *supra* note 27, § 166, at 1265. *Cf.* G. BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* § 211 (2d ed. rev. 1979) (a trust created for illegal purposes is void).

recommendations it makes, and that it disclose any adverse information in its possession relevant to any proposed transaction.⁴¹ The source of these heightened disclosure obligations is the so-called "shingle" theory developed by the Securities and Exchange Commission. The underlying premise of that theory is that, by hanging out his "shingle," a broker-dealer impliedly warrants that he will deal fairly with the investing public.⁴² The ultimate scope of these federal disclosure obligations is by no means certain.⁴³ But it is clear is that literal compliance with the language of the courts⁴⁴ by a firm in possession of inside information would mandate its disclosure to the firm's retail customers, at least in any instance where that information is contrary to that in the hands of

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41. See, e.g., *Feeney v. SEC*, 564 F.2d 260 (8th Cir. 1977); *Hiller v. SEC*, 429 F.2d 856, 858 (2d Cir. 1970); *Hanley v. SEC*, 415 F.2d 589, 596-97 (2d Cir. 1969); *R.A. Holman & Co. v. SEC*, 366 F.2d 446 (2d Cir. 1966), *modified on other grounds*, 377 F.2d 665 (2d Cir.), *cert. denied*, 389 U.S. 991 (1967); *In re Alexander Reid & Co.*, 40 S.E.C. 986, 990 (1962). 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).
 42. See 3 L. LOSS, *supra* note 29, at 1482-93; 6 *id.* at 3682-92; Jacobs, *supra* note 41, at 877; Lipton & Mazur, *supra* note 5, at 465 n.16; Note, *supra* note 5, at 398. For early administrative decisions invoking the shingle theory, see *In re Duker & Duker*, 6 S.E.C. 386 (1939), and *In re Harold Grill*, 41 S.E.C. 321 (1963). The theory first received judicial sanction in *Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944), in which the Second Circuit affirmed a finding by the Commission that a registered broker-dealer violated § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1982), and § 15(c)(1) of the 1934 Act, 15 U.S.C. § 78o(c)(1) (1982), by selling over-the-counter securities at prices substantially in excess of those prevailing on the over-the-counter (OTC) market without disclosure of the firm's abnormally large markup. See *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970) (disclosure of firm's market maker status); *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972) (same).
 43. The SEC, for example, is of the view that the broker-dealer's obligation to disclose all material information in its possession which might influence its customer's investment decision is applicable not only to recommend transactions, but to unsolicited purchases and sales as well. See SEC, *Statement on Future Structure of Securities Markets*, [Special Studies Transfer Binder] *FED. SEC. L. REP. (CCH)* ¶ 74,811, at 65,620 (1972) [hereinafter cited as SEC, *Statement on Future Structure*]. But see *Canizaro v. Kohlmeyer & Co.*, 370 F. Supp. 282, 286-89 (E.D. La. 1974), *aff'd*, 512 F.2d 484 (5th Cir. 1975) (per curiam).
 44. See, e.g., *Hanly v. SEC*, 415 F.2d 589, 596-97 (2d Cir. 1969): "A Securities dealer occupies a special relationship to a buyer of securities in that by his position he implicitly represents [that] he has an adequate basis for the opinions he renders. . . . He cannot recommend a security unless there is an adequate and reasonable basis for such recommendation. He must disclose facts which he knows and those which are reasonably ascertainable." (Footnotes omitted.) See also SEC, *Statement on Future Structure*, *supra* note 43.

the investment community generally.⁴⁵ Thus, the multi-service securities firm which obtains material nonpublic information about the issuer of publicly-traded securities may find itself in a position where literal compliance with its disclosure obligations to its retail customers will render it guilty of impermissible "tipping" in violation of rule 10b-5,⁴⁶ and where a failure to so "tip" may render any recommendation it makes without an adequate basis in light of all information about the issuer known to the firm.

C. Building a Wall

Because of the perceived conflicts between its obligations to its corporate clients and the investing public on the one hand, and its retail trading and investment advisory customers on the other, most integrated securities firms and other multi-service financial institutions have established internal policies and procedures to attempt to avoid the legal hazards flowing from the possession of inside information by one of the firm's departments. Central to the firms' efforts is the erection of what has come to be known as the "Chinese Wall," not a particularly apt metaphor for what is essentially a set of rules, regulations, and (at least in some instances) physical arrangements designed to prevent the communication of unpublished price-sensitive information about issuers of publicly-held securities to those departments of the firm that might misuse the information for market trading purposes.⁴⁷

45. See Lipton & Mazur, *supra* note 5, at 465 & n.16. See also *Slade v. Shearson, Hammill & Co.*, [1973-1974 Transfer Binder] FED. SEC. L. REP. ¶ 94,329 (S.D.N.Y.), *remanded*, 517 F.2d 398 (2d Cir. 1974); *Black v. Shearson, Hammill & Co.*, 266 Cal. App. 2d 362, 72 Cal. Rptr. 157 (1968) (state law).

46. See, e.g., *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974). See also *supra* note 35.

47. The metaphoric reference to the Great Wall of China is too obvious to let pass without a remark. It is of at least passing interest (to historians if not to lawyers) to note that the true Chinese Wall is over 1,400 miles long and is some 20-30 feet high and 15-20 feet thick. It was completed by Ch'in Shih Huang Ti about 228 B.C. as an impermeable defense mechanism for China's northern border with Mongolia. See WEBSTER'S NEW WORLD DICTIONARY OF THE AMERICAN LANGUAGE 355 (student ed. 1968); 5 ENCYCLOPEDIA BRITANICA 556 (1953). At least one prominent investment banking firm refers to its isolation policy as the "Iron Curtain," see N. WOLFSON *supra* note 5, at 62, and in the United Kingdom, the term "Bamboo Curtain" is apparently an acceptable substitute. See Rider, *Conflicts of Interest and the Chinese Wall*, in THE REGULATION OF THE BRITISH SECURITIES INDUSTRY 81, 90 (B. Rider ed. 1979). Mr. Rider also reports that the Chinese Wall has been "adopted" in many countries, citing: *Recommendation of the Commission of the EEC Concerning a European Code of Conduct Relating to Transactions in Transferable Securities*, General Principle 6 and Supplementary Principle 8 (1977); Statement of the Commission des Opérations de Bourse (France), *Les Intermédiaires Financiers et les Opérations de Bourse* (March 1974); *Hojinkankei-shain no*

The operative theory of the Chinese Wall is that adequate controls over access to inside information will preclude its misuse.⁴⁸ This, in the case of a multi-service securities firm, generally means that personnel in the retail sales and investment advisory divisions are denied access to information garnered by the firm's investment banking division.⁴⁹ There is no particular uniformity in the precise manner in which either securities firms or other multi-service financial institutions have implemented their particular procedures for dealing with inside information possessed by one of the firm's departments. Common to all Chinese Walls, however, is a policy statement, which need not be particularly formal, prohibiting personnel who have, or are likely to have, material nonpublic information about a publicly-held corporation from communicating that information to personnel in other departments of the firm.⁵⁰ In addition, some firms incorporate the wall concept into

fukumukitei seibi ni kansuru moshawase (June 1973) (Japan); SEC Broker-Director Rule, SEC BED Bo. 902-A-4, and SEC Weekly Bulletin (Jan. 1978) (Philippines); *Canadian Corporate Securities Regulations National Policy Statement No. 13* (April 1971) (Canada); and *Conflict of Interest, Registrants Acting as Corporate Directors*, Ontario Securities Commission Bulletin 78 (May 1969). See Rider, *supra* at 92, 102 n.30.

48. See Lipton & Mazur, *supra* note 5, at 466-67. The same principle has also been attempted in the context of law firm disqualification. See *id.* at 472 n.38. See also *Westinghouse Elec. Corp. v. Kerr McGee Corp.*, 1978-2 Trade Cas. (CCH) ¶ 62,169 (7th Cir. 1978) (rejecting the Chinese Wall defense to law firm disqualification). See generally Note, *The Chinese Wall Defense to Law Firm Disqualification*, 128 U. PA. L. REV. 677 (1980).
49. See Lipton & Mazur, *supra* note 5, at 466. See also Miller, *Chinese Walls*, 8 REV. SEC. REG. 865, 865 (1975).
50. A typical policy statement is that adopted by Merrill Lynch, Pierce, Fenner & Smith, Inc., in settlement of "tipping" charges brought against it by the Securities and Exchange Commission:

Material information obtained from a corporation by the Underwriting Division in connection with the consideration or negotiation of a public or private offering of its securities and which has not been disclosed by the corporation to the investing public, and conclusions based thereon, shall not be disclosed by any member of the Underwriting Division to anyone outside that Division except to

- (a) senior executives of the firm and its Legal Department;
- (b) lawyers, accountants, and other persons directly involved with the underwriters in connection with the proposed offering;
- (c) appropriate personnel of the Research Division whose views in connection with the proposed offering are to be sought by the Underwriting Division; and
- (d) members of the buying departments of other firms who are prospective members of the underwriting group for the purpose of enabling [them] to decide whether, the extent to which or the price at which, they will participate in the proposed offering.

Any employee of the firm who receives such information pursuant to the foregoing shall not disclose such information or any conclusions based thereon except as provided above for members of the Underwriting Division.

ongoing educational programs regarding insider trading, through restrictions on access to files containing (or which may contain) nonpublic information, and through controls on personnel transfers between departments and membership on interdepartmental committees.⁵¹ Finally, some larger institutions have established an even more formal physical separation of the "problem" department from the remainder of the firm,⁵² and, with respect to broker-dealer directorships, some firms simply prohibit partners and employees from serving as directors of publicly-held companies.⁵³

In addition to a Chinese Wall policy for isolating information within a firm to those personnel who may utilize it lawfully, some firms have adopted additional internal regulations restricting the firm's investment advisory or retail brokerage personnel from recommending the securities of companies about which the firm has (or is likely to receive) inside information. If the firm's Chinese Wall policy is effective in restricting interdepartmental flows of nonpublic information, additional policies are unnecessary to prevent the firm's trading personnel from improperly utilizing that in-

In re Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933 (1968), reprinted in [1967-1969 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,629, at 83,351 (Exhibit A). See also H.R. 5700, H.R. 3287, and H.R. 7440: Hearings Before the House Comm. on Banking and Currency, 92d Cong., 1st Sess., pt. 2, at 751 (1971), in which David Rockefeller, Chairman of the Board of the Chase Manhattan Bank, reported on the bank's Wall as follows:

To assure the proper use and control of information received by the bank in its several capacities, there is no flow, or incidental communication of inside information, from the commercial departments or divisions of the bank to the fiduciary investment department or to the pension or personal trust divisions of the trust department.

51. See generally Herzel & Colling, *supra* note 5, at 88-91; Carswell, *Construction of the Chinese Wall*, 14 TR. MGMT. UPDATE 1 (1979).

52. Regarding physical separation, it has been noted that:

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. . . . 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

Lipton & Mazur, *supra* note 5, at 496.

53. See SEC, SPECIAL STUDY, *supra* note 8, pt. 1, at 432; SEC v. Lum's, Inc., 365 F. Supp. 1046, 1052 (S.D.N.Y. 1973). See also Note, *supra* note 5, at 407. Cf. § 17(c) of the Public Utility Holding Company Act of 1935, 15 U.S.C. § 79q(c) (1982) (prohibiting registered public utility holding companies from having investment bankers on their boards of directors), noted at SEC, SPECIAL STUDY, *supra*, at 431 n.429. This prohibition would be retained in the proposed Federal Securities Code. ALI FED. SEC. CODE § 1510(1) (1980 & 2d Supp. 1981). As to the author's views on broker-dealer directorships, see *infra* notes 244-60 and accompanying text.

formation to effect market transactions. Instead, the perceived need for such "reinforcements"⁵⁴ to the firm's Chinese Wall stems from the concern that, *because* there is a wall, the broker-dealer department may be making recommendations based on available public information which the investment banking department, because of the inside information in its possession, knows to be false or misleading,⁵⁵ or which, if it were known, would render the firm's recommendation without an adequate basis.⁵⁶

One variant of these additional protective devices is the "no recommendation" policy.⁵⁷ A firm with such a policy, in effect, suspends any outstanding recommendation with respect to the securities of an issuer about which one department is likely to obtain confidential information. Generally, the no recommendation policy is commenced at the outset of any relationship giving rise to potential inside information problems, and is terminated when the possibility of further receipt of confidential information has expired.⁵⁸

Another procedure implemented in some multi-service firms is the "restricted list." When a security is put on the list, the firm's investment advisory personnel are immediately precluded from making any recommendation (either favorable or unfavorable) with respect to that security, and the firm itself ceases any trading in the security for its own account. Depending upon the practice of the particular firm, a security can be listed either when one department actually receives nonpublic information, or whenever one department of the firm enters into a relationship giving rise to the likelihood that confidential information will be acquired.⁵⁹

In addition to supplementing whatever policies a firm may have for restricting the interdepartmental transfer of inside informa-

54. The term is borrowed from Lipton & Mazur, *supra* note 5, at 499-511.

55. *See, e.g.*, Slade v. Shearson, Hammill & Co., [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,329 (S.D.N.Y.), *remanded*, 517 F.2d 398 (2d Cir. 1974). *Cf.* Black v. Shearson, Hammill & Co., 266 Cal. App. 2d 362, 72 Cal. Rptr. 157 (1968).

56. *See supra* note 41.

57. *See* Lipton & Mazur, *supra* note 5, at 467.

58. *See id.* at 467 nn.19-20. If a no recommendation policy is enforced strictly with respect to securities of an issuer whose board of directors includes a partner or employee of the broker-dealer, then the firm would be effectively precluded from ever recommending the securities of that company because the potential for receiving inside information always exists in such a case.

59. *See generally id.* at 467-68. In smaller multi-service institutions, where construction and enforcement of an effective Chinese Wall may be impossible because the firm's functions often overlap in a single individual, a prophylactic prohibition of this type against any trading in or recommending securities about which the firm has (or may have) inside information may be the only practical solution. *Cf.* ALI FED. SEC. CODE § 202(86)(C)(ii)(II) & comment (4) (1980 & 2d Supp. 1981).

tion, a formal restricted list procedure also serves to realize other goals.⁶⁰ The practice was originally designed, and is still useful, for preventing untoward violations of rule 10b-6 during a public distribution.⁶¹ It also operates to prevent the firm's broker-dealer department from making overly enthusiastic "buy" recommendations for outstanding securities of an issuer which might subsequently be held to have been unlawful offers of registered securities in violation of the 1933 Act.⁶² It should be noted,

60. See Lipton & Mazur, *supra* note 5, at 468-69.

61. SEC Securities Exchange Act Rule 10b-6 provides in pertinent part:

(a) It shall constitute a "manipulative or deceptive device or contrivance" as used in section 10(b) of the act for any person,

(1) Who is an underwriter or prospective underwriter in a particular distribution of securities, or

(2) Who is the issuer or other person on whose behalf such a distribution is being made, who is an affiliated purchaser, as that term is defined in paragraph (c) (6) of this section, 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 (1983). See, e.g., *In re Burns, Nordeman & Co.*, 40 S.E.C. 652, 659-61 (1962); Collins Securities Corp., SEC Securities Exchange Act Release No. 11,766, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,327, at 85,799-801 (Oct. 1975). See generally 3 L. LOSS, *supra* note 29, at 1571-1614; 6 *id.* at 3764-78; Lipton & Mazur, *supra* note 5, at 468 n.22.

62. Section 5(c) of the Securities Act of 1933, as amended, 15 U.S.C. § 77e(c) (1982), makes it unlawful either to offer to sell or offer to buy "any security" unless a registration statement has been filed with the SEC with respect to that security or unless an exemption from registration is available under § 3 or § 4 of that act. 15 U.S.C. §§ 77c, d (1982). In turn, § 2(3) of the 1933 Act, 15 U.S.C. § 77b(3) (1982), defines an "offer" to include "every attempt to dispose of . . . a security . . . for value." This broad definition of the term "offer" catches within its sweep many pre-registration activities which, though not amounting to an offer in the common law sense, "so contribute to conditioning the public mind or arousing the public interest in the issuer or in the securities of an issuer in a manner which raises a serious question whether the publicity is not in fact part of the selling effort." SEC Securities Act Release No. 3844, 1 FED. SEC. L. REP. (CCH) ¶ 3250, at ¶ 3254 (Oct. 8, 1957). Thus, even recommendations by a broker-dealer about the outstanding securities of a company proposing to register a new issue may be tantamount to an offer under § 2(3), especially in those instances where the broker-dealer is (or will be) part of the underwriting syndicate or selling group for the upcoming distribution. See SEC Securities Act Release No. 5101 [1970-71 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,929 (Nov. 19, 1970).

See also SEC Securities Act Release No. 5180 [1970-71 Transfer Binder]

though, that a firm's concern with "gun jumping" or illegal purchases during public distributions in violation of rule 10b-6 are generally unrelated to the specific problems it faces as a result of the combination of broker-dealer and investment banking functions, and cannot be alleviated through implementation of a Chinese Wall alone.

III. ADMINISTRATIVE AND JUDICIAL TREATMENT OF THE WALL

After the SEC's decision in *In re Cady, Roberts & Co.*,⁶³ it quickly became apparent within the securities industry that multi-service firms that possessed material inside information about publicly-held companies, regardless of the source of that information, might simultaneously face inconsistent obligations to the firm's customers and to the investing public generally.⁶⁴ Despite the concern about what was perceived to be a Hobson's choice between liability to the firm's investment banking clients and to the investing public for selective disclosure of inside information, or liability to the firm's trading customers for remaining silent, and despite doubts about the efficacy of the Chinese Wall as a defense to either, there has been surprisingly little official attention paid to either the wall *per se* or to other procedures designed to reconcile these seemingly disparate obligations. Moreover, what little official heed has been paid has left the industry in nearly as great a conundrum as it was at the genesis of the legal rules that it is commanded to follow.

A. The NYSE Position on Broker-Dealer Directorships

The SEC's holding in *Cady, Roberts* provided that a securities firm violated rule 10b-5⁶⁵ when it sold securities on the basis of undisclosed information about an issuer's forthcoming dividend reduction which it had received from an employee affiliated with the issuer's board.⁶⁶ Against this backdrop, the first official attempt to

FED. SEC. L. REP. (CCH) ¶ 78,192 (Aug. 16, 1971) (Guidelines For the Release of Information by Issuers Whose Securities are in Registration); *In re Carl M. Loeb, Rhodes & Co.*, 38 S.E.C. 843 (1959); *SEC v. Arvida Corp.*, 169 F. Supp. 211 (S.D.N.Y. 1958); *Lipton v. Mazur*, *supra* note 5, at 469 n.23. See generally V. BRUDNEY & M. CHIRELSTEIN, *CASES AND MATERIALS ON CORPORATE FINANCE* 803-16 (2d ed. 1979); R. JENNINGS & H. MARSH, *supra* note 35, at 59-80; 1 L. LOSS, *supra* note 29, at 212-23; 4 *id.* at 2316-20.

63. 40 S.E.C. 907 (1961). See *supra* notes 30-31 and accompanying text.

64. See, e.g., Daum & Phillips, *The Implications of Cady, Roberts*, 17 BUS. LAW. 939 (1962).

65. *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961). See *supra* note 29 for the text of rule 10b-5, 17 C.F.R. § 240.10b-5 (1983).

66. *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 913 (1961).

resolve the conflicts in the broker-dealer's legal obligations, at least in the context of broker-dealer directorships, was put forward by the New York Stock Exchange.⁶⁷ In a 1962 position paper, the Exchange took the position (to which it still adheres) that the obligation owed by a director to his corporation to retain the confidentiality of corporate secrets⁶⁸ was one that he was not free to waive, even in the presence of an arguably conflicting duty to his firm's retail trading customers.

Every director has a fiduciary obligation not to reveal any privileged information to anyone not authorized to receive it. Not until there is full public disclosure of such data, particularly when the information might have a bearing on the market price of the securities, is the director released from the necessity of keeping information of this character to himself. Any director of a corporation who is a partner, officer or employee of a [New York Stock Exchange] member organization should recognize that his first responsibility is to the corporation on whose Board he serves. Thus, 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.⁶⁹

This early "don't tell your partner"⁷⁰ approach to dealing with

67. N.Y. Stock Exchange (N.Y.S.E.), M.F. Educ. Circular No. 162 (June 22, 1962) [hereinafter cited as 1962 N.Y.S.E. Circular]. See also N.Y.S.E., *Expanded Policy on Timely Disclosure* § A-21 (1968).

68. See *supra* notes 24-28 and accompanying text.

69. 1962 N.Y.S.E. Circular, *supra* note 67. The Exchange is also of the view that confidential information about an issuer which is acquired by a N.Y.S.E. member organization in an advisory capacity should be dealt with under much the same "ground rules." *N.Y.S.E. Company Manual* § A-22. Thus, the Exchange insists that in those cases where a matter requires consultation with a firm, "[a]dequate measures should be taken to guard the confidential nature of the information to prevent its misuse within or outside" the firm. *Id.* Thus, without specifying the nature or the extent of the procedures to be followed by N.Y.S.E. member firms, it is clear that the Exchange endorses the Chinese Wall approach to handling the inside information problems of securities firms that have combined investment banking/corporate finance activities with retail trading, management, and advisory departments. *Cf. American Stock Exchange Disclosure Policies* 11 (1970): "If counsel, accountants, or financial or public relations advisers or other outsiders are consulted steps should be taken [by the issuer] to ensure that they maintain . . . precautions within their respective organizations to maintain confidentiality [of material, nonpublic information]."

70. The phrase is borrowed from Professor Loss. 6 L. Loss, *supra* note 29, at 3595. It should be noted that the quoted language from the 1962 N.Y.S.E. Circular, *supra* note 67, was relied upon by the defendant in *Black v. Shearson, Hammill & Co.*, 266 Cal. App. 2d 362, 72 Cal. Rptr. 157 (1968), for the proposition that a broker-dealer director's responsibility to the company on whose board he sits is of a higher order than this disclosure responsibility to his firm's retail clients. In rejecting the argument, the California court said: "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." *Id.* at 368, 72 Cal. Rptr. at 161. The *Black* case, however, is quite clearly distin-

the inside information problems of integrated firms undoubtedly foreshadowed the somewhat later development of more formal Chinese Wall policies to systematically restrict the flow of confidential corporate information among the various departments of the firm. The underlying premise of the N.Y.S.E. policy, however, is essentially the same as that of the wall. That is, confidential price-sensitive information about the issuers of publicly-traded securities possessed by one department or individual within a multi-service institution should be rendered unavailable to those who might misuse it to effect market transactions in the securities of that issuer. Moreover, at least in the general case, to the extent that inside information does not so permeate the wall, the firm has satisfied its duties to both the issuer and the investing public,⁷¹ without adversely affecting its obligations to its retail trading or investment advisory clients.⁷²

B. The Merrill Lynch Proceeding

The Securities and Exchange Commission's first formal encounter with the problems created by interdepartmental flows of confidential corporate information came in a 1968 enforcement proceeding against Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch"),⁷³ a large integrated firm with both an active underwriting division and an extremely broad-based retail sales organization. In that case, Merrill Lynch, acting as the prospective managing underwriter of a new issue of debentures of Douglas Aircraft Company ("Douglas"), had received a confidential report from Douglas which indicated that the company's earnings would be substantially lower than earlier public predictions had indi-

guishable from the typical situation in which a firm (or one of its officers) is in possession of inside information. In *Black*, the Shearson partner who possessed the "bearish" information not only failed to appraise the firm's salesmen, but at the same time sold stock of the issuer (on whose board he served) for his own account and those of some of his personal clients. This dichotomy in treatment could not help but have moved the court toward imposing liability. Thus, on its facts, *Black* is quite akin to *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974), *aff'g* 353 F. Supp. 264 (S.D.N.Y. 1972). See also Lipton & Mazur, *supra* note 5, at 476-78.

71. See *supra* notes 24-36 and accompanying text. It should be noted, however, that the Exchange's policy statement was issued some six years prior to the judicial formulation of the "disclose or abstain" rule in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, *Coates v. SEC*, 394 U.S. 976 (1969). As to the latter case and its progeny, see *supra* notes 33-35 and accompanying text.
72. See generally *supra* notes 37-45 and accompanying text; *infra* notes 261-320 and accompanying text.
73. *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933 (1968). See also Lipton & Mazur, *supra* note 5, at 487-88.

cated. Merrill Lynch, in turn, disclosed this bearish news to certain of its favored institutional customers who, prior to the public dissemination of the revised earnings forecast, sold (and sold short) Douglas common stock. At the same time, however, Merrill Lynch's retail division was effecting purchases of Douglas shares for other customers who remained in the dark about the adverse information.⁷⁴

In accepting Merrill Lynch's offer of settlement, the S.E.C. took special cognizance of the firm's undertaking to "adopt, implement, and ensure compliance with, revised procedures to provide more effective protection against disclosure of confidential information. . . ."⁷⁵ In particular, the Commission noted with approval the firm's adoption of a "Statement of Policy"⁷⁶ that contained provisions prohibiting the transmission of confidential information received from an issuer by the firm's underwriting division to anyone other than those individuals within the firm (or the buying departments of co-underwriters) involved directly in the issuer's new offering. The Commission took pains to point out, however, that it was expressing no opinion on whether Merrill Lynch's "Chinese Wall" would prove adequate in all circumstances to insulate the firm from liability, and made clear that the preferred approach for handling material changes in an issuer's condition which might affect the trading price of its securities is to promptly disseminate the information to the investing public generally.⁷⁷

74. The facts of the Douglas Aircraft-Merrill Lynch snafu perhaps did more than any other case to contribute to the administrative and judicial development of the contours of rule 10b-5. See *In re Investors Mgt. Co.*, 44 S.E.C. 633 (1971) (enforcement proceeding against Merrill Lynch's "tippees"); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974), *aff'g* 353 F. Supp. 264 (S.D.N.Y. 1972) (class action by purchasers of Douglas stock against Merrill Lynch, its employees, and the trading tippees); *Financial Industrial Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir.) (per curiam) (private action by market purchaser of Douglas stock against issuer and Merrill Lynch for alleged untimely disclosure of the reduced earnings forecast), *cert. denied*, 414 U.S. 874 (1973). See generally *V. BRUDNEY & M. CHIRELSTEIN*, *supra* note 62, at 1012-38, 1071-78.

75. *In re Merrill Lynch, Pierce, Fenner & Smith*, 43 S.E.C. 930, 938 (1968). See also Rule 9.7(d) of the Comptroller of the Currency, which requires national banks, *inter alia*, to adopt "written policies and procedures to ensure the national bank trust departments shall not use material inside information in connection with any decision or recommendation to purchase or sell any security." 12 C.F.R. § 9.7(d) (1983).

76. *In re Merrill Lynch, Pierce, Fenner & Smith*, 43 S.E.C. 930, 938 (1968). See *supra* note 50 for the text of Merrill Lynch's statement of policy.

77. *In re Merrill Lynch, Pierce, Fenner & Smith*, 43 S.E.C. 930, 938 (1968). The SEC has, however, urged multi-service financial institutions, such as commercial banks, to "consider the necessity of segregating information flows arising from a business relationship with a company as distinct from information received in an investor shareholder capacity." SEC INSTITUTIONAL IN-

C. The *Slade* Case

*Slade v. Shearson, Hammill & Co., Inc.*⁷⁸ represents the only significant judicial foray into the question of the legitimacy of the isolation technique in the context of a suit by dissatisfied customers who purchased securities on the basis of a recommendation that was inconsistent with inside information allegedly "walled off" in the firm's investment banking department. In *Slade*, the plaintiffs were all former retail customers of Shearson, Hammill Co., Inc. ("Shearson"), a large integrated investment banker/broker-dealer firm. They alleged that Shearson's corporate finance department had come into possession of material adverse information about the cash flow position of one of its clients, Tidal Marine International Corporation ("Tidal Marine"), yet continued to promote the sale of Tidal Marine stock to the customers of the firm's retail sales organization.

Shearson moved in the district court for summary judgment on two different theories. First, the firm claimed that it did not become aware of any adverse information about Tidal Marine until well after the plaintiffs had purchased their shares of Tidal Marine stock. Second, Shearson maintained that even if its corporate finance department *was* aware of the adverse information at the time of the plaintiffs' purchases, the firm was precluded by the antifraud rules from using that information to prevent the individual members of its retail sales organizations from soliciting purchases of Tidal Marine during the time that the news remained undisclosed.⁷⁹

VESTOR STUDY, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. 2539 (1971). See also *SEC v. Lum's, Inc.*, [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,659 (S.D.N.Y. 1972) (similar settlement agreement to that with Merrill Lynch); *In re Van Alstyne, Noel & Co.*, 43 S.E.C. 1080 (1969) (same); *In re Blyth & Co.*, 43 S.E.C. 1037 (1969) (same). Cf. *SEC v. Union Planters Corp.*, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,003 (W.D. Tenn. 1975) (consent order; co-defendant agreed, *inter alia*, to submit to all appropriate personnel a statement of the legal requirements for securities transactions); *In re Faberge, Inc.*, 45 S.E.C. 249 (1973) (agreement to "wall off" research department).

78. [1973-1974 Transfer Binder] FED. SEC. L. REP. ¶ 94,329 (S.D.N.Y.) (denial of defendant's motion for partial summary judgment), *question certified*, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,439 (S.D.N.Y.), *remanded*, 517 F.2d 398 (2d Cir. 1974), *settlement approved*, 79 F.R.D. 309 (S.D.N.Y. 1978).
79. Memorandum in Support of Defendant's Cross-Motion for Partial Summary Judgment and to Strike Class Action Allegations at 20-25, *Slade v. Shearson, Hammill & Co.*, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,329 (S.D.N.Y. 1974). In addition, Shearson argued, apparently orally, that the Chinese Wall policy in effect in the firm precluded its investment banking personnel from communicating inside information to its retail sales force. See Brief for Defendant, Third-Party Plaintiff, Appellant at 22, *Slade v. Shearson, Hammill & Co.*, 517 F.2d 398 (2d Cir. 1974) [hereinafter cited as *Shearson*].

The district court found "no factual predicate" for Shearson's first theory.⁸⁰ More importantly, however, the district court flatly rejected the firm's assertion that it should be absolved from liability because it was legally disabled from revealing, to its clients or otherwise, information acquired in the course of a confidential relationship with a corporate client. The court apparently saw a distinction between a firm's revelation of inside information to its retail customers and the *prevention* of its sales personnel from soliciting brokerage customers on the basis of current public information which the firm knows to be false or misleading because of the inside information it has acquired. While the former would clearly constitute conduct prohibited by rule 10b-5,⁸¹ the latter, apparently, would not.⁸² The only source cited for the district court's distinction was a singular reference to the "disclose or abstain" principle adumbrated by the Second Circuit in the *Texas Gulf Sulphur* case,⁸³ which the court read as requiring the sales department of an integrated firm to abstain from making recommendations to customers that are inconsistent with any inside information in its possession.⁸⁴

Finally, the district court seemed untroubled by the fact that the seemingly inevitable result of its application of the "disclose or abstain" rule to these facts would be to put brokerage firms that

Brief]. The district court's opinion does not specifically mention Shearson's Chinese Wall, and it is not referred to by name in Shearson's moving papers, but it is addressed in the Second Circuit's opinion remanding the case for further factfinding. *Slade v. Shearson, Hammill & Co.*, 517 F.2d 398, 401 (2d Cir. 1974). See also *Lipton & Mazur*, *supra* note 5, at 478 & n.64.

80. *Slade v. Shearson, Hammill & Co.*, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,329, at 95,131. Shearson did, however, attempt to garner factual support for its motion. See Affidavit of Sidney T. Bogardus at ¶¶ 13, 18, *Slade v. Shearson, Hammill & Co.*, 517 F.2d 398 (2d Cir. 1974) [hereinafter cited as *Bogardus Affidavit*].
 81. See, e.g., *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974); *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933 (1968).
 82. *Slade v. Shearson, Hammill & Co.*, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,329, at 95,131.
 83. Thus, anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or if he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.
- Slade v. Shearson, Hammill & Co.*, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,329, at 95,132 (S.D.N.Y. 1974) (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, *Coates v. SEC*, 394 U.S. 976 (1969)) (emphasis in original).
84. *Slade v. Shearson, Hammill & Co.*, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,329, at 95,132.

possess inside information, and who would thus be disabled from soliciting customers to purchase (or sell) the affected securities, at a disadvantage with those firms that do not. Implicit in its opinion was the belief that this commercial disadvantage flowed, not from rule 10b-5 *per se*, but rather from Shearson's voluntary assumption of a fiduciary obligation to Tidal Marine, its investment banking client, at the same time that the firm already owed fiduciary duties to its retail customers. "[H]aving assumed fiduciary responsibilities, Shearson is required to incur whatever commercial disadvantage fulfillment of those obligations entails."⁸⁵ At no point in the court's discussion of this manifestation of the investment banker/broker-dealer conflict did the district judge acknowledge or discuss that there may be effects on an integrated firm's retail *clients* ensuing from the firm's disability from providing any investment advice whatsoever concerning the securities of issuers with which the firm also has an investment banking or other confidential relationship.⁸⁶

On reargument, however, the district judge reconsidered his original holding and, recognizing that the case was indeed one of first impression under rule 10b-5, certified the following question for review by the Court of Appeals:

Is an investment banker/securities broker who receives adverse material nonpublic information about an investment banking client precluded from soliciting customers for that client's securities on the basis of public information which (because of its possession of inside information) it knows to be false or misleading?⁸⁷

By this time, the importance of the issues in the *Slade* litigation to the securities industry had become apparent,⁸⁸ and the appeal attracted *amicus* briefs from the Securities and Exchange Commission as well as from two industry giants—Salomon Brothers, a leading market maker, block positioner, and investment banking firm, and Paine, Webber, Jackson & Curtis Inc. ("Paine, Webber"), a multi-service firm active in both investment banking and retail brokerage. Even the trial judge in the course of granting Shearson's request for certification of the interlocutory appeal apparently recognized the significance of his earlier ruling on the motion for summary judgment.

The instant case has far reaching ramifications for the structure of the securities industry . . . apparently not foreseen by *Texas Gulf Sulphur* and its progeny. To require organizations like defendant's to refrain from ef-

85. *Id.* Cf. *Black v. Shearson, Hammill & Co.*, 266 Cal. App. 2d 362, 368, 72 Cal. Rptr. 157, 161 (1968).

86. See generally *infra* notes 304-06 and accompanying text.

87. *Slade v. Shearson, Hammill & Co.*, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,439, at 95,530 (S.D.N.Y. 1974).

88. See *Lipton & Mazur, supra* note 5, at 479 n.76.

fecting transactions in securities of companies about which they have learned adverse inside information may be to render it exceedingly difficult for any such organization to function as an investment banker for a company and at the same time function as a broker-dealer in that company's securities.⁸⁹

In its argument on appeal, Shearson characterized the district court's denial of summary judgment as an implicit requirement that an integrated securities firm with both corporate finance and broker-dealer departments "[m]ust use nonpublic, investment banking information for the benefit of its public customers under certain circumstances."⁹⁰ So characterized, Shearson found the trial court's ruling inconsistent with the policy of the insider trading decisions. Shearson's main line of attack was that it was prohibited by the antifraud provisions of the federal securities laws from using nonpublic information acquired by its corporate finance department for the benefit of its retail customers,⁹¹ and that it was under no other independent fiduciary obligation to do so.⁹²

Shearson premised its argument on the distinction it drew between formal recommendations by the firm's retail sales organization to purchase particular securities, which were placed on the firm's confidential "Master Buy List," and the personal recommendations of Shearson's individual sales representatives, which were based solely on the available public information about the particular issuer. Thus, pursuant to its internal policy of not formally recommending securities of issuers with which the firm's corporate finance department has an investment banking relationship, Shearson never placed Tidal Marine stock on its Master Buy List.⁹³ Shearson did, however, transmit public information about Tidal Marine to its individual account executives in the form of internal "wires," and it was on the basis of this information (which was quite favorable) that some of the firm's sales personnel independently recommended the purchase of Tidal Marine stock to a number of customers, including the *Slade* plaintiffs.⁹⁴

89. *Slade v. Shearson, Hammill & Co.*, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,439, at 95,532.

90. Shearson Brief, *supra* note 79, at 8.

91. *Id.* at 9-17.

92. *Id.* at 17-22.

93. See Bogardus Affidavit, *supra* note 80, ¶¶ 10, 28-32. See also Affidavit of R. Paul Evans at ¶¶ 5, 6, *Slade v. Shearson, Hammill & Co.*, 517 F.2d 398 (2d Cir. 1974).

94. Shearson Brief, *supra* note 79, at 5-7. Each of the written materials (the "wires") relating to Tidal Marine bore a legend similar to the following:

Attention is called to the fact that [Shearson] is acting as financial advisor in connection with the private placement of securities of [Tidal Marine] and maintains a trading market in the stock. This

In addition, Shearson argued that, for the purposes of the antifraud rules, the relevant "market" in Tidal Marine's securities included not only its immediate purchasers and sellers, but also those investors who abstain "for the moment" from transacting in Tidal Marine's shares. Because granting an information advantage to any one of these groups would affect the quantity of shares traded, and hence the trading price, any use of inside information by the firm would have created an "unfair market" in Tidal Marine stock of the type condemned by the insider trading provisions of the securities laws. Thus, Shearson concluded, it could not lawfully utilize the confidential information possessed by its corporate finance department to prevent its individual account executives from individually recommending the purchase of Tidal Marine stock.⁹⁵

Plaintiffs' took issue both with Shearson's characterization of the facts and the applicable law governing the multi-service firm in possession of inside information. As to the "wires" containing bullish public information which emanated from the firm's corporate finance department, the plaintiffs pointed out that Shearson's own policy "required" the firm's retail account executives to utilize the information they contained in any discussions about Tidal Marine with the firm's retail customers.⁹⁶ Thus, the *Slade* plaintiffs characterized the situation as not involving any true separation of departmental functions at all, but rather one in which Shearson "inexplicably" permitted its retail sales force to tout Tidal Marine stock when the investment banking department was well aware that it was worthless.⁹⁷

Moreover, the plaintiffs apparently took issue with Shearson's characterization of the relevant marketplace for Tidal Marine's stock, and thus challenged the firm's contention that the "disclose or abstain" rule rendered it legally powerless to prevent its retail salesmen from individually recommending the purchase of Tidal Marine on the basis of the available public information about the company.

Nobody is unfairly hurt or disadvantaged by the fact that the customers of

wire should not be construed as an endorsement or recommendation of the Company's securities.

Id. at 6 (citation omitted). See also Bogardus Affidavit, *supra* note 80 (Exhibits B, C, D, G). Shearson also claimed that it transmitted all news, good or bad, which it received about Tidal Marine. See Reply Brief for Defendant, Third-Party Plaintiff Appellant at 2, *Slade v. Shearson, Hammill & Co.*, 517 F.2d 398 (2d Cir. 1974) [hereinafter cited as Shearson Reply Brief].

95. Shearson Brief, *supra* note 79, at 8, 17.

96. Brief for Plaintiffs-Appellees at 5, *Slade v. Shearson, Hammill & Co.*, 517 F.2d 398 (2d Cir. 1974) [hereinafter cited as *Slade Brief*].

97. *Id.* at 6.

Shearson would not be buying worthless stock. The argument that all the other customers of brokerage concerns may continue to buy worthless stock would seem to lead Shearson to the conclusion that all members of the public have an equal right to be cheated; if some are spared by Shearson, Shearson has injured all the other purchasers throughout the land. The argument is the sheerest exercise in sophistry. The spectacle of a broker seeing his customers defrauded by the broker's own agents and being powerless to pick up an intercom and say "Don't sell", is too much.⁹⁸

Instead, the *Slade* plaintiffs would have had Shearson enforce its no recommendation policy down to the level of the individual account executive, coupled if necessary with an explanation that it is firm policy not to recommend the securities of companies with which it has a current investment banking relationship. This approach, according to the plaintiffs, would have satisfied the firm's obligations to its customers without any corresponding misuse of inside information possessed by the corporate finance department.⁹⁹

In addition to the conflicting considerations advanced by the parties to the *Slade* appeal, a great deal of light was shed on both the Chinese Wall and other internal procedures of multi-service securities houses in the briefs filed by the three *amici*. Salomon Brothers, apparently the first to join in the fray, posited that the Chinese Wall device serves a legitimate purpose in controlling information flows among the various departments of an integrated firm. It argued, however, that Shearson's position, if adopted, would give it an unwarranted imprimatur beyond what is necessary to accommodate the competing concerns of the investing public and the firm's retail customers.¹⁰⁰

Initially, Salomon Brothers took issue with the district court's use of the word "soliciting" in the certified question.¹⁰¹ The firm argued that the term should be confined to situations in which the broker-dealer makes an affirmative "suggestion" or "recommendation" with respect to a security, but that it should not be extended to cover a technical "solicitation" in which a broker merely con-

98. *Id.* at 8.

99. *Id.* But see *infra* notes 299-306 and accompanying text for the drawbacks in such an approach. The plaintiffs also pointed out that, in addition to Shearson's position as investment banker to Tidal Marine, it had an additional conflict of interest in that it was the principal market maker for Tidal Marine stock, and thus the firm had a pecuniary interest in recommending the purchase of the stock by its customers to the extent that delivery was made out of its own inventory. *Slade* Brief, *supra* note 96, at 11. See also *infra* notes 239-43 and accompanying text (own-account investing).

100. See generally Brief of Salomon Brothers as *Amicus Curiae*, *Slade v. Shearson, Hammill & Co.*, 517 F.2d 398 (2d Cir. 1974) [hereinafter cited as *Salomon Brief*].

101. See *supra* note 87 and accompanying text.

tacts a potential customer to ascertain whether the latter is interested in purchasing particular securities, but does not make any "recommendation" as to their investment merits.¹⁰² In Salomon's eyes, this distinction is crucial. Under its interpretation of the antifraud rules, a broker-dealer should be prohibited only from actively "recommending" securities on the basis of public information which the firm's investment banking department knows to be false or misleading because of confidential information it has received.¹⁰³ Salomon's view was premised on its assertion that even though a retail customer of a multi-service firm has no right to receive inside information, the customer does have the right not to be *actively* misled by a broker who is touting a stock which another department knows is overpriced. The upshot, then, is that a multi-service firm can neither recommend trading in securities on the basis of inside information nor continue to make recommendations that are contrary to that information.¹⁰⁴

Salomon Brothers would, however, find a legitimate role for the Chinese Wall, standing alone, in those instances where the firm's trading department merely "solicits" a customer to purchase particular securities, but does not make any recommendation, express or implied, as to their merits. In these cases, according to Salomon Brothers, the firm has not taken advantage of any special relationship of trust or confidence between itself and its customers, and thus the latter have not been actively misled into buying a worthless product.¹⁰⁵

The distinction drawn by Salomon Brothers between "recommending" and merely "soliciting" transactions in securities may seem largely semantic,¹⁰⁶ but it can be easily understood in the context of Salomon Brothers' business, which consists largely of a combination of investment banking and block positioning (i.e., the sales of large blocks of securities to institutional traders).¹⁰⁷ In addition, the firm is a leading market maker of over-the-counter se-

102. Salomon Brief, *supra* note 100, at 1 n*.

103. *Id.* at 6.

104. *Id.* at 15.

105. *Id.* at 14, 15.

106. Indeed, it was so characterized by another of the *amici*. See Brief of Paine, Webber, Jackson & Curtis Inc. as *Amicus Curiae* at 5, *Slade v. Shearson, Hammill & Co.*, 517 F.2d 398 (2d Cir. 1974) [hereinafter cited as Paine, Webber Brief]. See also Shearson Reply Brief, *supra* note 94, at 13-14.

107. Salomon Brief, *supra* note 100, at 4-5; Paine, Webber Brief, *supra* note 106, at 5-9. For a discussion of block trading generally, see I. FRIEND, G. HOFFMAN, W. WINN, M. HAMBURG, & S. SCHOR, *THE OVER-THE-COUNTER SECURITIES MARKETS* 19-20, 412-42 (1958); 2 L. LOSS, *supra* note 29, at 1235-39; 5 *id.*, at 3256-59. See also SEC Securities Exchange Act Rule 17a-17, 17 C.F.R. § 240.17a-17 (1983) (notices and reports by block positioners).

curities.¹⁰⁸ Unlike the typical retail sales activities of most large securities firms, these activities of Salomon Brother do not typically involve the recommending of securities to customers on the basis of comprehensive market and industry research. Instead, the firm "solicits" customers to purchase blocks of securities out of its own inventory and the portfolios of its large institutional brokerage customers.¹⁰⁹ Thus, sanctioning the Chinese Wall as a defense to a dissatisfied customer in those cases where no affirmative "recommendation" or "touting" is involved would permit firms like Salomon Brothers to continue their trading activities pretty much as usual, while at the same time requiring integrated firms with more broadly-based retail sales activities to suspend trading in securities anytime one department of the firm (even though effectively "walled") is likely to acquire inside information.

In light of this competitive effect that the "solicitation-yes, recommendation-no" rule advanced by Salomon would have on the industry as a whole, it is not surprising that it was excoriated in the *amicus* brief filed by Paine, Webber.¹¹⁰ Paine, Webber is one of the nation's largest investment banking/broker-dealer firms, and, like Salomon Brothers and many others, it maintains a "restricted list" procedure to deal with SEC-imposed restrictions on trading in advance of or during a public distribution of new securities.¹¹¹ It disagreed sharply with Salomon Brothers, however, on the need to maintain a "restricted list" to deal with problems created by the possession of inside information by the firm's investment banking personnel.¹¹² In Paine, Webber's view, the distinction between "soliciting" and "recommending" securities transactions was in conflict with precedents which it read as not sanctioning a difference between active and passive misrepresentations.¹¹³

108. Salomon Brief, *supra* note 100, at 4; Paine, Webber Brief, *supra* note 106, at 5-8. SEC Securities Exchange Act Rule 17a-9(f)(1) defines a "market maker" as "a dealer who, with respect to a particular security, holds himself out . . . as being willing to buy and sell for his own account on a continuous basis otherwise than on a national securities exchange." 17 C.F.R. § 240.17a-9(f)(1) (1983). See also R. JENNINGS & H. MARSH, *supra* note 35, at 708-10; T. LOESER, *THE OVER THE COUNTER SECURITIES MARKET: WHAT IT IS AND HOW IT OPERATES* 5-6 (1940).

109. See Paine, Webber Brief, *supra* note 106, at 7 n.* (reporting that Mr. William R. Salomon, Managing Partner of Salomon Brothers, testified before the SEC in 1971 that, in fiscal year 1970, Salomon Brothers' average daily inventory in securities was valued at \$2.2 billion.).

110. *Id.* at 5-9.

111. *Id.* at 4. See also *supra* notes 60-62 and accompanying text.

112. Paine, Webber Brief, *supra* note 106, at 4, 5-9.

113. *Id.* at 8-9 (citing *Affiliated Ute Citizens v. United States*, 406 U.S. 138 (1972)). See also *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963); *Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949); *Charles Hughes & Co. v. SEC*,

[T]here can be no rational basis for the distinction put forth by Salomon. It would hold a securities firm liable for money damages if its broker-dealer department "recommended" the purchase of a security based on public information which was contradicted by non-public information in the possession of its investment banking department. It would exonerate the firm, however, if its broker-dealer department "solicited" the purchase of a particular security from inventory at a price which the non-public information in its investment banking department would demonstrate to be grossly inflated. From the customer's perspective it can make absolutely no difference whether he was actively or passively misled. In either case, he was induced by public information to make a decision which he presumably would not have made if the non-public information had been made available to him.¹¹⁴

In Paine, Webber's view, the only acceptable solution to the conflicting obligations of a multi-service firm in possession of inside information is rigid adherence to the firm's Chinese Wall, and without resort to a "restricted list" policy of withdrawing recommendations with respect to the securities of the firm's investment banking clients.¹¹⁵ Moreover, the firm was particularly critical of the practice of listing securities at the time a firm actually receives confidential information about a corporate client. First, it contended that the mere act of "listing" a security *prior* to the existence of any outstanding recommendation would amount to an impermissible "signal" that the firm possessed inside information of one sort or another with respect to that security, a signal that could not be effectively camouflaged by the firm.¹¹⁶

Second, Paine, Webber argued that such a listing in the situation where there *is* an outstanding recommendation would pose even more serious difficulties: a failure to withdraw the recommendation would place the firm in Shearson's position in *Slade*, while withdrawal of the recommendation would expose it to liability for improperly signalling its customers or the market as to the existence of inside information.¹¹⁷ They observed that "[i]n Paine, Webber's experience, the mere act of withdrawing the recommendation would, as a practical matter, inevitably be taken by the customer as a signal that the firm has come into possession of inside

139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 353 F. Supp. 264, 278 (S.D.N.Y. 1972), *aff'd*, 495 F.2d 228 (2d Cir. 1974).

114. Paine, Webber Brief, *supra* note 106, at 9. Paine, Webber also took issue with what it termed the "distant early warning system" approach of the SEC. *Id.* at 2, 10-14. See also Brief of the Securities and Exchange Commission, *Amicus Curiae*, *Slade v. Shearson, Hammill & Co.*, 517 F.2d 398 (2d Cir. 1974) (summarized in [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,848) [hereinafter cited as SEC Brief]. See generally *infra* notes 121-31 and accompanying text.

115. Paine, Webber Brief, *supra* note 106, at 14.

116. *Id.* at 15.

117. *Id.* at 15-17.

information 'contrary to the recommendation'."¹¹⁸ In addition, even if this were not the case, "the signal would set-off speculation and rumor . . . [inducing] holders of the security to sell and speculators to sell short."¹¹⁹ In sum, according to Paine, Webber, any approach *other* than simple but strict adherence to the firm's policy of isolating inside information within the department that receives it would place the multi-service firm (other than, perhaps, Salomon Brothers) in the unhappy position where there is nothing it can do to avoid liability under the securities laws.¹²⁰

In addition to providing the only thorough public airing of the multiple policy considerations underlying the investment banker/broker-dealer conflict, perhaps the most important result of the *Slade* litigation was that it induced the Securities and Exchange Commission to express its views on the efficacy of the Chinese Wall as a defense to a complaint by an unhappy customer.¹²¹ The Commission opined that the certified question¹²² could be answered affirmatively without wreaking havoc in the industry. Thus, in the Commission's view, rule 10b-5's prohibition against the misuse of inside information, and the duty of a broker-dealer to treat its customers fairly, could adequately be accommodated without major structural changes by multi-service institutions.

If the persons within an integrated firm who actually make investment decisions and recommendations are effectively precluded by a "leakproof" wall from receiving inside information, then the Commission saw no contravention of the insider trading rules.¹²³ With respect to the firm's duties to its retail customers,

118. *Id.* at 16 (citing SEC Brief, *supra* note 114, at 11-12).

119. Paine, Webber Brief, *supra* note 106, at 16. Depending upon the character of the public information and the rumors surrounding the particular company, presumably the opposite reaction could occur as well, i.e., customers might buy up whatever holdings are available, and buy calls on the stock on the options market.

120. *Id.* at 17. Paine, Webber gave rather short shrift, however, to the unfortunate position of the *Slade* plaintiffs:

[S]uch a result [i.e., adherence to the Chinese Wall alone] would do no injustice to customers who happen to be in the same situation as plaintiffs. . . . Neither the District Court, nor the Commission, nor Salomon Brothers has suggested that such customers are entitled to receive inside information. If one of [Shearson's] salesmen misled plaintiffs herein, it was because the law prohibited the disclosure of inside information Defendant should not be penalized, in short, for complying with the law against the misuse of inside information and giving the same advice based on the same information that plaintiffs would have received had they transacted business with any other firm.

Id. at 18. *But see infra* notes 307-20 and accompanying text.

121. See SEC Brief, *supra* note 114.

122. See *supra* note 87 and accompanying text.

123. See SEC Brief, *supra* note 114, at 9-10. Such an admission on the part of the

however, the SEC took the position that if a recommendation without an investigation sufficient to yield an "adequate basis" was fraudulent,¹²⁴ then "*a fortiori* Rule 10b-5 prohibits a recommendation contrary to facts about the security in question known by the broker-dealer."¹²⁵ Further, "[t]he preservation of necessary restrictions upon the use of material inside information does not require that such misrepresentations be condoned."¹²⁶

In order to resolve the apparent conundrum created by these arguably conflicting duties, the SEC adopted a stance quite similar to that of Salomon Brothers¹²⁷—any sales effort on the part of a broker-dealer which involves an "affirmative representation," either express or implied, as to the merits of the securities being offered, should be prohibited.¹²⁸ One way in which the Commission suggested this could be effected without serious disruption in industry practices is through the adoption of procedures, such as a restricted list, whereby outstanding recommendations are withdrawn and additional recommendations prohibited until there is full public disclosure of the nonpublic data.¹²⁹ The SEC took pains to point out, however, that any such listing "must be effected in a manner which avoids disclosure as to whether any material inside information possessed by the firm is in accord with or contrary to the recommendation,"¹³⁰ and that this result could best be accomplished through listing the security at the genesis of any relationship with an issuer which is likely to give rise to the receipt of confidential information.¹³¹

In spite of (or perhaps because of) the thorough exploration of the problems created by the combination of investment banking and retail brokerage provided by the parties and *amici* in the *Slade* case, after oral argument the panel of Second Circuit to which the case had been assigned determined that permission to hear the interlocutory appeal had been improvidently granted.¹³²

Commission would appear to be inevitable after its acceptance of a Chinese Wall in the settlement of *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933, 938 (1968). See also Lipton & Mazur, *supra* note 5, at 488.

124. See, e.g., *Hanley v. SEC*, 415 F.2d 589, 597 (2d Cir. 1969). Accord *SEC v. Van Horn*, 371 F.2d 181 (7th Cir. 1966). See also *supra* notes 37-45 and accompanying text.
125. SEC Brief, *supra* note 114, at 7-8.
126. *Id.* at 10-11 (footnote omitted).
127. See *supra* notes 100-09 and accompanying text.
128. SEC Brief, *supra* note 114, at 7-8, 11 & n.13.
129. *Id.* at 11.
130. *Id.* at 11-12 (footnote omitted).
131. *Id.* at 12. "Of course, the best way of avoiding problems in this area is for the firm to take steps to bring about prompt public disclosure of the material inside information." *Id.* See also *infra* notes 218-26 and accompanying text.
132. *Slade v. Shearson, Hammill & Co.*, 517 F.2d 398, 400 (2d Cir. 1974). It should be

The court saw "at least" three factual questions, the answers to which might have a bearing on the ultimate resolution of the legal questions presented: first, whether Shearson in fact possessed the adverse information about Tidal Marine prior to the last of the plaintiffs' purchases; second, whether (as the plaintiffs claimed) the firm's investment banking department had given the retail sales force misleading information about Tidal Marine at the same time that it knew of the adverse information; and third, if, and to what extent, there is a difference (as Salomon Brothers claimed) between "solicitations" and "recommendations" in connection with the sale of securities.¹³³ Thus, in sum, the Court saw the situation in *Slade* as "precisely the kind of case in which the implications are so considerable that in the proper exercise of judicial restraint, an abstract answer to an abstract question is the least desirable of *judicial* solutions."¹³⁴

The Court's opinion left both the securities industry and other multi-service financial institutions in considerable uncertainty. Nevertheless, it represents the only significant judicial scrutiny given to date, to the Chinese Wall and other techniques designed to resolve the conflicting obligations of integrated firms that possess inside information.

D. Exchange Act Rule 14e-3

Despite some intimations by the SEC that it might adopt a comprehensive rule to govern the inside information problems of multi-service financial institutions,¹³⁵ to date the only significant exercise of the Commission's rulemaking authority in this direction has been in the tender offer context. In late 1979, the SEC

noted, as the court was quick to recognize, that § 1292(b) of the Judicial Code, 28 U.S.C. § 1292(b) (1982), which governs interlocutory orders "involv[ing] a controlling question of law as to which there is a substantial ground for difference of opinion," limits the appeal to the "order" made by the District Court, which, in the *Slade* case, was simply the denial of Shearson's motion for summary judgment. Thus, the Court of Appeals was in no way required to render an opinion on the precise legal question formulated by the trial judge. See *supra* note 87 and accompanying text. See also P. BATOR, P. MISHKIN, D. SHAPIRO & H. WECHSLER, *HART AND WECHSLER'S THE FEDERAL COURTS AND THE FEDERAL SYSTEM* 1544, 1564-65 (2d ed. 1973); *id.* at 433 (1981 Supp.) (interlocutory appeals under § 1292(b)).

133. *Slade v. Shearson, Hammill & Co.*, 517 F.2d 398, 400, 402 (2d Cir. 1974).

134. *Id.* at 400 (emphasis in original). See also *id.* at 403.

135. See Statement of SEC Commissioner A.A. Sommer, Jr., Securities Regulation Symposium, Dallas, Texas, in *BNA SEC. REG. & L. REP.* NO. 299, at A-18 (summary) (noted in Lipton & Mazur, *supra* note 5, at 488 n.137). See also SEC, *INSTITUTIONAL INVESTOR STUDY*, *supra* note 77 (advocating the adoption of codes of ethics in multi-function institutional investors to prevent violation of the antifraud rules).

released for public comment proposed rule 14e-3¹³⁶ under section 14(e) of the Exchange Act.¹³⁷ Broadly speaking, the purpose for the proposed rule was to extend the "disclose or abstain" principle developed under rule 10b-5 to situations involving trading in the securities of a target company prior to the public dissemination of the announcement of a tender offer for the target's stock. In its release accompanying the proposed rule, the Commission made clear that while the abuse at which the proposal was aimed is the "actual misuse" of inside information relating to a tender offer, the literal language of the rule's provisions, as drafted, was capable of being applied to a corporate entity, even though the individuals in-

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136. SEC Securities Exchange Act Release No. 16-385, 44 Fed. Reg. 70,349 (1979); [1979-80 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,374 (Nov. 29, 1979) [hereinafter cited as SEC Release No. 16-385]. The rule, as proposed and as ultimately adopted, 17 C.F.R. § 240.14e-3 (1983), see SEC Securities Exchange Act Release No. 17,120, 45 Fed. Reg. 60, 410, 60,418 (1980); [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,646 (Sept. 4, 1980), makes it unlawful to trade in securities of a target company on the basis of material, nonpublic information relating to a tender offer. In addition, rule 14e-3(d) prohibits insiders from "tipping" others about the tender offer under circumstances where it is likely that the "tippee" or "tippees" will trade in the target's stock on the basis of the tip. 17 C.F.R. § 240.14e-3(d) (1983). See generally Note, *Trading on Material, Nonpublic Information Under Rule 14e-3*, 49 GEO. WASH. L. REV. 539 (1981).
137. 15 U.S.C. § 78n(e) (1982). Section 14(e), originally added to the Exchange Act by the Williams Act Amendments of 1968, Pub. L. 90-439, 82 Stat. 454, 457 (1968), as amended by Pub. L. 91-567, § 5, 84 STAT. 1497, 1497-98 (1970), which added the last sentence, reads as follows:

It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition of or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

A "tender offer," though undefined in the statute, generally refers to:

[a] general invitation to all of the shareholders of a company to purchase their shares at a specified price, sometimes subject to a minimum and/or maximum that the offeror will accept, communicated to the shareholders by means of newspaper advertisements and (if the offeror can obtain the shareholders list, which is not often unless it is a friendly tender) by a general mailing to the entire list of shareholders.

R. JENNINGS & H. MARSH, *supra* note 35, at 741. See also SEC Release No. 16-385, *supra* note 136; at 70,350-51; [1979-80 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,374, at 82,603-04; ALI FED. SEC. CODE § 202(166) (1980). See generally Note, *Developing Meaning of "Tender Offer" Under the Securities Exchange Act of 1934*, 86 HARV. L. REV. 1250 (1973).

volved in making the actual decision to purchase the target's securities were unaware of any inside information relating to the tender offer.¹³⁸

This could occur, for example, where one department of a multiservice financial institution received material, nonpublic information relating to a tender offer while a separate and independent department of the same organization made the decision to purchase (or sell) securities of the subject company without any knowledge of or access to such information.¹³⁹

Thus, paragraph (b) of the proposed rule also provided that transactions in the target's securities by a person "other than a natural person" would not run afoul of rule 14e-3(a), even though the entity involved possessed inside information about the tender offer, if it could show *both* that the individuals actually making the investment decision did not know of the inside information *and* that they did not have access to it. In determining whether the individuals who made the decision to purchase (or sell) had access to any inside information, the rule also provided that "[t]he existence of policies and procedures to ensure that material, non-public information will not be used in violation of [rule 14e-3] may, depending on the facts and circumstances, be taken into account."¹⁴⁰

The final version of rule 14e-3(b) adopted by the SEC in 1980¹⁴¹ liberalized this required showing by a multi-service institution, and thus constitutes the Commission's strongest statement to date in support of the premises underlying the Chinese Wall, at least in the context of a charge of improper insider trading.¹⁴² As adopted,

138. SEC Release No. 16-385, *supra* note 136, at 70,353; [1979-80 Transfer Binder] FED. SEC. L. REP. (CCH) at 82,608.

139. *Id.*

140. Proposed § 240.14e-3(b), SEC Release No. 16-385, *supra* note 136, at 70,359.

141. SEC Securities Exchange Act Release No. 17,120 (Sept. 4, 1980), 45 Fed. Reg. 60,410, 60,418 (1980); 3 FED. SEC. L. REP. ¶ 24,297 (effective date Oct. 14, 1980) [hereinafter cited as SEC Release No. 17,120]. Rule 143-3(b) provides as follows:

(b) A person other than a natural person shall not violate [rule 14e-3] if such person shows that:

(1) The individual(s) making the investment decision on behalf of such person to purchase or sell any security described in [rule 14e-3(a)] or to cause any security to be purchased or sold on behalf of others did not know the material, nonpublic information; and

(2) Such person had implemented one or a combination of policies and procedures, reasonable under the circumstances, taking into consideration the nature of the person's business, to ensure that individual(s) making investment decision(s) would not violate [rule 14e-3], which policies and procedures may include, but are not limited to, (i) those which restrict any purchase, sale and causing any purchase and sale of any such security or (ii) those which prevent such individual(s) from knowing such information.

17 C.F.R. § 240.14e-3(b) (1983). *See also* L. Loss, *supra* note 29, at 867-70. *Cf.* ALI FED. SEC. CODE § 202(86)(C)(ii)(I), (II) (1980 & 2d Supp. 1981).

142. Of course, the defense afforded by rule 14e-3(b) is available only in the con-

rule 14e-3(b) provides that an artificial person will not be held in violation of the "disclose or abstain" aspect of the rule if the individuals making the decision to trade in the affected securities did so unaware of inside information possessed by other individuals in the firm, provided the institution itself has established reasonable policies to ensure that such individuals do not receive inside information.

In its release accompanying formal adoption of rule 14e-3, the SEC took pains to note that a "Chinese Wall" is neither mandated by the rule nor is it a foolproof defense to a charge of insider trading.¹⁴³ Despite its unwillingness to make that commitment, however, the history of the rule leaves no doubt that, at least in the general case, it is the *use* of inside information to reap trading profits, as opposed to the mere possession of the information, upon which the fraud rules are ultimately bottomed.¹⁴⁴ Given this operational premise, the Commission's support for the isolation technique, albeit a somewhat grudging one, follows as a matter of course.

IV. THE APPROACH OF THE FEDERAL SECURITIES CODE

A. Introduction

The American Law Institute's proposed Federal Securities Code,¹⁴⁵ while taking great strides in proposing far-reaching

text of a firm engaged in the purchase or sale of securities of a company subject to a tender offer. There is no reason to suppose, however, that the more general policy considerations leading to the promulgation of the rule are materially different from those which underlie the more general proscription of rule 10b-5. Indeed, the "potential harm to investors and the securities markets," SEC Release No. 17,120, *supra* note 141, at 60,410, 60,412, resulting from trading in a target's stock on the basis of inside information about a tender offer are functionally the same as those which ensue from insider trading generally. *But cf.* Note, *supra* note 136, at 546 (suggesting that the authority granted to the SEC by § 14(e) "might not include the power to impose a duty to disclose or abstain in all circumstances in which an inequality of access to information exists"). It may be worth noting that, in light of the Supreme Court's decision in *Chiarella v. United States*, 445 U.S. 222 (1980), it is possible that trading in the stock of a target company on the basis of inside information received from the *offeror* will never be held to violate rule 10b-5 (see *supra* note 30 for a discussion of *Chiarella*).

143. 45 Fed. Reg. 60,410, 60,415 (1980). *Cf. In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933, 938 (1968) (SEC refused to concede that a Chinese Wall would prove adequate in all circumstances to insulate a multi-service securities firm from liability under rule 10b-5). See *supra* note 77 and accompanying text.

144. See *supra* note 138 and accompanying text.

145. The ALI's Federal Securities Code Project had its beginning in the 1963 recommendation of the SEC's SPECIAL STUDY, *supra* note 8, that a program be undertaken for synthesizing the disclosure requirements of the Securities

changes in many areas of federal regulation of securities and securities transactions,¹⁴⁶ has stepped quite gingerly in its approach to the Chinese Wall and related devices for reconciling the conflicts problems of multi-service securities firms and other financial institutions. Early drafts of the Code did not mention the problem,¹⁴⁷ in fact, nothing appeared in print until the 1978 Proposed Official Draft ("POD") of the work.¹⁴⁸ The approach of section

Act of 1933, and the Securities Exchange Act of 1934, 15 U.S.C. §§ 771-77aa, 78a-78hh-1 (1982). The project which ultimately led to the Code itself, which was published by the American Law Institute in 1980, stemmed from two conferences on codification of the federal securities laws held by the American Bar Association's Section of Corporation, Banking and Business Law. The first of the conferences was held in late 1966, see 22 BUS. LAW. 793 (1967) (publication of proceedings), and the second was held in May, 1969. The actual preparation of the Code was undertaken by the Council of the ALI, with Professor Louis Loss of Harvard Law School serving as the Reporter. See generally ALI FED. SEC. CODE xix-xxi (1980) (Reporter's Introduction). See also Loss, *The American Law Institute's Federal Securities Code Project*, 25 BUS. LAW. 27 (1969). The Proposed Official Draft of the Code, dated March 15, 1978, was formally approved by the membership of the ALI in 1978. See PROCEEDINGS OF THE AMERICAN LAW INSTITUTE, 55TH ANNUAL MEETING (1978) 499 (1979) [hereinafter cited as 55 A.L.I. PROC.]. See also PROCEEDINGS OF THE AMERICAN LAW INSTITUTE, 57TH ANNUAL MEETING (1980) 375-85 (1981) (report by Professor Loss regarding Code's status and post-approval amendments to the Proposed Official Draft).

The three principal purposes of the Code are to simplify existing law, to eliminate (to the extent possible) duplicative regulation, and to reexamine "the entire scheme of investor protection with a view to increasing its efficiency. . . ." ALI FED. SEC. CODE, *supra* at xix. Legislative enactment of the Code has received the unanimous approval of the American Bar Association's House of Delegates, see *id.* at xxii-iii, as well as two endorsements by the Securities and Exchange Commission, one during the Carter administration and another by the Reagan Commission. See SEC Release Nos. 33-6242, 34-17,153, 35-21,716, 39-586, IC-11,362, IA-730, [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,655 (Sept. 18, 1980); SEC Release Nos. 33-6377, 34-18,437, 35-22,367, 39-692, IC-12,178, IA-790, [1981-82 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,090 (Jan. 21, 1982).

146. For example, the Code would abandon the "archaic centrality," ALI FED. SEC. CODE xix, of the registration requirement for public offerings imposed by § 5 of the 1933 Act, 15 U.S.C. § 77e (1982), in favor of *company* registration and continuous disclosure through annual reports, proxy solicitations, and the like. See ALI FED. SEC. CODE §§ 401-06 (issuer registration); §§ 501-15 (distributions); §§ 601-07 (postregistration requirements) (1980 and 2d Supp. 1981).
147. See ALI FED. SEC. CODE, Tentative Drafts Nos. 1 (Apr. 25, 1972), 2 (March, 1973), 3 (Apr. 1, 1974), 4 (Apr. 1, 1975), 5 (Apr. 1, 1976), & 6 (Apr. 1, 1977).
148. ALI FED. SEC. CODE § 287 (Proposed Official Draft March 15, 1978). The language of § 287 of the Proposed Official Draft very nearly mirrors that of § 202(86) of the final version of the Code that was published in 1980 (see *infra* note 149 for the text of § 202(86)). Thus, it is not reprinted here. The section initially came into the Proposed Official Draft as the result of the efforts of a special task force consisting of the Reporter and others. The task force initially intended to draft a provision "that would *preclude* liability in appropriate instances" if the defendant had erected a Chinese Wall. ALI FED. SEC.

287(c) of the POD, which contains nearly identical language to that of section 202(86) of the finished product,¹⁴⁹ is essentially to provide a legislative mandate to the courts and the SEC to *consider* the existence of a Chinese Wall or other procedures in the context of determining whether to impute the knowledge of one individual (or department) to another or other individuals within a firm or to the firm itself.¹⁵⁰ Before examining the particulars of this required inquiry, however, it is useful to examine the various contexts (in

CODE § 202(86)(C), comment (2) (1980) (emphasis in original). Ultimately, however, after numerous drafts, the task force abandoned this goal, taking the position that codification was premature because of the complexity of the issues involved. *Id.*; Interview with Professor Louis Loss, Reporter, American Law Institute Federal Securities Code, in Cambridge, Massachusetts (April 1, 1982). Thus, as is not uncommon in proposing legislative solutions to complex problems, the draftsmen of § 287 went up the hill and down again in a very short time. *Cf.* Shapiro, *The Enigma of the Lawyer's Duty to Serve*, 55 N.Y.U. L. REV. 735, 791-92 (1980) (discussing the efforts of the Kutak Commission of the ABA to draft a mandatory *pro bono publico* requirement for the legal profession).

149. ALI FED. SEC. CODE § 202(86) (1980) provides as follows:

Knowledge.—

(A) Dependent on context.—“Know” and its derivatives are not defined. Their meaning is left to construction in context. But see the definition of “scienter” in section 202(47).

(B) Company plaintiffs.—The fact that any or all of the directors and officers of a company plaintiff are defendants with knowledge of a fact does not of itself establish the company’s knowledge of the fact.

(C) Agency and similar relationships.—(i) Questions of imputation of the knowledge, scienter, belief, or negligence of an agent, partner, or director to his principal or company (or to another agent, partner, or director of his principal or company) are governed by the principles of common law and equity, applied as a matter of Federal jurisprudence.

(ii) In determining, for purposes of sections 915(a)(3)(B), 1602(a), 1603(a) and 1604(c), whether to make an imputation pursuant to section 202(86)(C)(i) with respect to facts concerning an issuer or its securities that are not generally available, the court or the Commission shall consider whether the principal or company operated under established procedures reasonably designed (I) to prevent transmission of those facts to persons other than those who have responsibility for administering those procedures or who act in furtherance of a purpose for which access to those facts was given by the issuer or another person, or (II) to prevent transactions in and recommendations concerning securities of the issuer.

Section 202(147), in turn, defines “scienter” as follows:

A person makes (or, within the meaning of section 2006(c), causes or gives substantial assistance to the making of) misrepresentation with “scienter” if he knows that he is making a misrepresentation (or a misrepresentation is being made) or acts in reckless disregard of whether that is so.

ALI FED. SEC. CODE § 202(147) (1980 & 2d Supp. 1981). *See also infra* note 178.

150. ALI FED. SEC. CODE § 202(86) (1980 & 2d Supp. 1981). *See also infra* notes 176-87 and accompanying text.

the Code's scheme of things) in which the question is likely to arise.

B. Recommendations of Securities to Customers

As a part of its effort to codify existing law, the Federal Securities Code would enact into the statute itself four of the most common, and opprobrious, manifestations of the "shingle theory" as it has been applied by the courts and the SEC to brokers and dealers.¹⁵¹ Section 913 of the Code would proscribe, without the necessity for further rulemaking by the Commission: (1) a broker or dealer's failure to execute promptly a customer's order;¹⁵² (2) the effectuation of purchases or sales of securities of an issuer which is in a control relationship with the broker-dealer;¹⁵³ (3) unauthorized brokerage transactions for customers' accounts;¹⁵⁴ and (4) unreasonable spreads in purchases and sales by a dealer (unless the customer is an institutional investor that is aware of the size of the spread).¹⁵⁵ A violation of any provision of section 913 automatically gives rise to civil liability on the part of the broker or dealer.¹⁵⁶

In addition, the Code would grant rulemaking authority to the SEC to define and establish prevention techniques over other

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151. *See generally supra* notes 41-44 and accompanying text. *See also infra* notes 286-98 and accompanying text.
 152. ALI FED. SEC. CODE § 913(1) (1980 & 2d Supp. 1981). *See, e.g.*, Bateman Eichler, Hill Richards, Inc., SEC Securities Exchange Act Release No. 18,401 [1981-82 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,088 (Jan. 8, 1982).
 153. ALI FED. SEC. CODE § 913(2). *See also* SEC Securities Exchange Act Rule 15c1-5, 17 C.F.R. § 240.15c1-5 (1983). As to "control" generally, *see* ALI FED. SEC. CODE § 202(29) (1980 & 2d Supp. 1981); 2 L. LOSS, *supra* note 29, at 764-783; 5 *id.* at 2696-2708.
 154. ALI FED. SEC. CODE § 913(3) (1980 & 2d Supp. 1981). *See, e.g.*, Lewis v. Walston & Co., 487 F.2d 617 (5th Cir. 1973); SEC v. First Securities Co. of Chicago, 463 F.2d 981 (7th Cir.), *cert. denied*, McKy v. Hochfelder, 409 U.S. 880 (1972). *Cf.* ALI FED. SEC. CODE § 1717 (1980) (churning); SEC Securities Exchange Act Rule 15c1-7, 17 C.F.R. § 240.15c1-7 (1983). *See also* Miley v. Oppenheimer & Co., 637 F.2d 318 (5th Cir. 1981); Fey v. Walston & Co., 493 F.2d 1036 (7th Cir. 1974); Hecht v. Harris, Upham & Co., 430 F.2d 1202 (9th Cir. 1970); Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836 (E.D. Va. 1968); Lorenz v. Watson, 258 F. Supp. 724 (E.D. Pa. 1966); *In re* Norris & Hirschberg, Inc., 21 S.E.C. 865 (1946), *aff'd*, 177 F.2d 288 (D.C. Cir. 1949). *See generally* Rosenman, *Discretionary Accounts and Manipulative Trading Practices*, in 5 INST. ON SEC. REG. 245 (1974); Note, *Churning by Securities Dealers*, 80 HARV. L. REV. 869 (1967).
 155. ALI FED. SEC. CODE § 913(4) (1980 & 2d Supp. 1981). *See also* Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944). In addition to the regulations imposed upon brokers and dealers by § 913, § 914 would make unlawful various egregious practices in the investment advisory industry. ALI FED. SEC. CODE § 914 (1980).
 156. ALI FED. SEC. CODE § 1715 (1980 & 2d Supp. 1981).

forms of conduct by brokers and dealers in specified areas that amounts to "unfair dealing" with the firm's customers or clients.¹⁵⁷ In particular, section 915(a)(3) of the Code¹⁵⁸ would give the Commission the power to declare unlawful any recommendations by a broker-dealer concerning a security, unless the broker-dealer reasonably believes that the particular purchases or sale is "not unsuitable" for that customer¹⁵⁹ on the basis of information supplied by the customer after inquiry and "any other information" known by the broker-dealer.¹⁶⁰ The scope of the "other information" is not defined, and thus the information base upon which the suitability of recommendations is to be judged is left for judicial development.

157. *Id.* at § 915. See also Exchange Act § 15(c)(1), 15 U.S.C. § 78o(c)(1) (1982).

158. Section 915(a) provides in pertinent part:

(a) It is unlawful for a broker, dealer, municipal broker, or municipal dealer, in contravention of the rules of the Commission—

(1) to buy or sell a security without disclosing (A) that he is a marketmaker in the security, or an underwriter, participant, or otherwise financially interested in a current distribution of the security . . .

(2) to recommend a transaction in a security unless the issuer is a registrant or reasonable information with respect to the issuer and the security is otherwise available; or

(3) to recommend a transaction in a security unless he reasonably believes that it is not unsuitable for the customer on the basis of (A) information furnished by the customer on reasonable inquiry with respect to his investment objectives, financial situation, and needs, and (B) any other information known by the broker, dealer, municipal broker, or municipal dealer.

ALI FED. SEC. CODE § 915(a) (1980 & 2d Supp. 1981). As to § 915(a)(1)(A), see SEC Securities Exchange Act Rules 10b-10(a)(5)(ii), 15c1-6, 17 C.F.R. §§ 240.10b-10(a)(5)(ii), 240.15c1-6, (1983); *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970). As to § 915(a)(2), see SEC Securities Exchange Act Rule 15c2-11, 17 C.F.R. § 240.15c2-11 (1983). As to § 915(a)(3), see SEC Securities Exchange Act Rule 15b10-3, 17 C.F.R. § 240.15b10-3 (1983); N.Y. Stock Exchange Rule 405, N.Y.S.E. GUIDE (CCH) ¶ 2405; N.A.S.D. Rules of Fair Practice, art. III, § 2, N.A.S.D. MANUAL (CCH) ¶ 2152.

159. ALI FED. SEC. CODE § 915(a)(3) (1980 & 2d Supp. 1981). See also *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 600 (2d Cir. 1978) (recommendation of an unsuitable transaction with "scienter" violates rule 10b-5).

160. ALI FED. SEC. CODE § 915(a)(3)(B) (1980 & 2d Supp. 1981). Implicit in the requirement that the broker reasonably believe that the transaction is "not unsuitable" for the customer is that he have a reasonable basis for any recommendations he makes.

It should be noted that a violation of a Commission rule promulgated under § 915 would not automatically give rise to civil liability on the part of the broker-dealer. See ALI FED. SEC. CODE § 916 (1980 & 2d Supp. 1981). Instead, the existence of a private right of action thereunder (if any) is left to judicial implication under § 1722, which contains standards designed to comply with the criteria for implication set forth in *Cort v. Ash*, 422 U.S. 66 (1975). See ALI FED. SEC. CODE § 1722(a) & comment (1) (1980 & 2d Supp. 1981). See also *infra* note 190 and cases cited therein.

C. Fraudulent and Manipulative Activity

In addition to the regulation of the broker-customer relationship imposed by sections 913 and 915, the Code would also rationalize and harmonize much of the existing law with respect to fraudulent and manipulative activities in connection with securities transactions. The residual "catch all" is section 1602(a),¹⁶¹ which simply makes it unlawful to engage in a "fraudulent act"¹⁶² or to make a misrepresentation¹⁶³ in connection with almost any

161. Section 1602(a) provides as follows:

It is unlawful for any person to engage in a fraudulent act or to make a misrepresentation in connection with (a) a sale or purchase of a security, an offer to sell or buy a security, (2) a proxy solicitation or other circularization of security holders with respect to a security of a registrant, (3) a tender offer or a recommendation to security holders in favor of or opposition to a tender offer, or (4) any activity or proposed activity by an investment adviser with respect to a client or a prospective client.

ALI FED. SEC. CODE § 1602(a) (1980).

162. Section 202(61) of the Code, which defines "fraudulent act," provides in pertinent part as follows:

(A) General.—"Fraudulent act" includes an act, device, scheme, practice, or course of conduct that (i) is fraudulent or deceptive, or (ii) operates or would operate as a fraud or deceit.

(B) Inaction or silence.—Inaction or silence when there is a duty to act or speak may be a fraudulent act.

(C) Knowledge or recklessness.—(i) For purposes of an action or proceeding under Part XVII or section 1821(a)(2), a person engages in a fraudulent act only if he acts with knowledge that his conduct is of the type specified in section 202(61)(A), or in reckless disregard of whether his conduct is of that type.

(ii) For purposes of any other action or proceeding, a person engages in a fraudulent act if he engages in an act, device, scheme, practice, or course of conduct that is likely to defraud or deceive, regardless of whether fraud or deception is intended.

ALI FED. SEC. CODE § 202(61) (1980 & 2d Supp. 1981). The obvious intent of this broad language, especially that of § 202(61)(A), is to preserve the construction given to existing antifraud provisions by the courts and the SEC, see *id.* at § 202(61) & comment (1) (1980), as well as to leave room for administrative and judicial development of the language to catch future mice that may not otherwise fit in today's traps.

163. Section 202(96) provides as follows:

(A) General.—"Misrepresentation" means (i) an untrue statement of a material fact, or (ii) an omission to state a material fact necessary to prevent the statement made from being misleading in the light of the circumstances under which they are made.

(B) Estimates, etc.—A statement of a fact within the meaning of section 202(55)(A) [forecasts and the like, see *infra* note 167] is not a misrepresentation if it (i) is made in good faith, (ii) has a reasonable basis when it is made, and (iii) complies with any applicable rule so far as underlying assumptions are concerned. See also section 1602(b)(2).

ALI FED. SEC. CODE § 202(96) (1980). In addition, section 202(92) defines a "material fact" as one in which there is a "substantial likelihood that a rea-

relevant securities-related activity. In addition to this omnibus provision, some manifestations of which are specifically spelled out in the Code,¹⁶⁴ two particular activities which are specifically made unlawful raise concerns relevant to the presence or absence of an institutional Chinese Wall or other procedures designed to inhibit the transmission of nonpublic information to areas in which it could be misused to effect market transactions.

Section 1603 would govern trading in an issuer's securities by a statutorily-defined "insider."¹⁶⁵ Although the section is quite clearly derived in large measure from the judicial and administrative exposition of rule 10b-5,¹⁶⁶ it would also introduce into the law

sonable person would consider it important under the circumstances in determining his course of action." *Id.* at § 202(92) (1980). *See* TSC Indus., Inc. v. Northway, 426 U.S. 438, 449 (1976); List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965); W. Prosser, *supra* note 30, at 718-20. *See also* ALI FED. SEC. CODE § 202 (147) (1980) (definition of scienter). As to § 202(96) (B), *see* SEC Securities Act Rule 175, 17 C.F.R. § 230.175 (1983), and SEC Securities Exchange Act Rule 3b-6, 17 C.F.R. § 240.3b-6 (1983) (safe harbor rule for projections in documents filed with the SEC), *adopted by* SEC Securities Act Release No. 6084, 17 SEC Dock. 1048 (June 15, 1979). *See also* SEC Securities Act Release No. 5993, 43 Fed. Reg. 53,251 (1978) (proposals for safe harbor rules); SEC Securities Act Release No. 5992, 43 Fed. Reg. 53,246 (1978) (disclosures of projections of future economic performance).

164. *See* ALI FED. SEC. CODE § 1605 (1980 & 2d Supp. 1981) (misrepresentation of official approval); *id.* § 1606 (churning); *id.* § 1607 (touting); *id.* § 1608 (fictitious quotations).

165. Section 1603, entitled "Insiders' Duty to Disclose When Trading," provides in pertinent part as follows:

(a) General.—It is unlawful for an insider to sell or buy a security of the issuer, if he knows a material fact with respect to the issuer or the security that is not generally available, unless—

(1) the insider reasonably believes that the fact is generally available;

(2) the identity of the other party to the transaction (or his agent) is known to the insider and (A) the insider reasonably believes that that party (or his agent) knows the fact, or (B) that party (or his agent) knows the fact from the insider or otherwise; or

(3) the insider proves that the fact is not a fact of special significance, except that this defense is not available in [SEC injunctive and disciplinary actions].

(b) Insider.—For the purposes of [§ 1603], "insider" means (1) the issuer, (2) a director or officer of, or a person controlling, controlled by, or under common control with, the issuer, (3) a person who, by virtue of his relationship or former relationship to the issuer, knows a material fact about the issuer or the security . . . that is not generally available, or (4) a person [who is a "tippee" or a "tippee's tippee"] with knowledge that the person from whom he learns the fact is [an insider], unless the Commission or a court finds that it would be inequitable, on consideration of the circumstances and the purposes of this code (including the deterrent effect of liability), to treat the person within [this § 1603(b)(4)] as if he were [an insider].

ALI FED. SEC. CODE § 1603 (2d Supp. 1981).

166. The Reporter's Comment to § 1603 also cites the Cal. Corp. Sec. Act § 25,402,

in this area at least one significant change from existing law. Under section 1603, trading in securities by an insider on the basis of a material fact¹⁶⁷ that is "not generally available"¹⁶⁸ is prohibited. But, unlike current implied civil liability under rule 10b-5, under section 1603(a)(3) the insider would be afforded a defense if he proves that the nonpublic fact upon which his liability is predicated is not a "fact of special significance."¹⁶⁹

Finally,¹⁷⁰ section 1604(c) of the Code would enact legislatively that aspect of the *Texas Gulf Sulphur* decision¹⁷¹ making it unlaw-

CAL. CORP. CODE § 25,402 (West 1977), as source material for the section. ALI FED. SEC. CODE § 1603 (1980) ("Source").

167. Section 202(55) provides as follows:

Fact.—"Fact" includes (A) a promise, prediction, estimate, projection, or forecast, or (B) a statement of intention, motive, opinion, or law. See also section 202(96)(B).

ALI FED. SEC. CODE § 202(55) (1980). See also *id.* at § 202(96)(B) (estimates, projections, and the like).

168. Section 202(64) provides as follows:

Generally available.—A fact is "generally available" one week (or any other period prescribed by Commission rule) after it is disclosed by means of a filing or press release or in any other manner reasonably designed to bring it to the attention of the investing public. Otherwise the burden of proving that a fact is "generally available" is on the person who so asserts.

ALI FED. SEC. CODE § 202(64) (1980). Also, see *id.* at § 1603, comment (5)(b), which makes it clear that the risk is on the defendant who trades on the basis of material nonpublic information that the fact in question will not be found to have been "generally available" at the time of the challenged transactions. ALI FED. SEC. CODE § 1603, comment (5)(b) (1980).

169. ALI FED. SEC. CODE § 1603(a)(3) (2d Supp. 1981) (see *supra* note 165 for the text of § 1603). In turn, section 202(56) provides as follows:

Fact of special significance.—A fact is "of special significance" if (A) in addition to being material it would be likely on being made generally available to affect the market price of a security to a significant extent, or (B) a reasonable person would consider it especially important under the circumstances in determining his course of action in the light of such factors as the degree of his specificity, the extent of its difference from information generally available previously, and its nature and reliability.

ALI FED. SEC. CODE § 202(56) (1980). It should be noted that the defense afforded by § 1603(a)(3) is not available in SEC injunctive and disciplinary actions. See *id.* § 1603(a), comment (1) (2d Supp. 1981).

170. The reader should be cautioned that this section is not intended to be an exhaustive discussion of the scope of the various forms of conduct that the Code would make unlawful in the sense of being "fraudulent" or "manipulative," or constituting a misrepresentation, but is limited to those sections having a particular bearing on the Chinese Wall and related procedures. The best source for somewhat broader treatment of part XVI of the Code is the Code itself and the explanatory comments of the Reporter. See ALI FED. SEC. CODE §§ 1601-14 (1980 & 2d Supp. 1981). As to civil liability under the Code, see generally *id.* §§ 1701-28 (1980 & 2d Supp. 1981).

171. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 861-62 (2d Cir. 1968), *cert. denied*, Coates v. SEC, 394 U.S. 976 (1969).

ful for a company to issue press releases or generate other publicity which constitutes a "fraudulent act"¹⁷² or contains factual misrepresentations¹⁷³ when it is reasonably foreseeable that the inaccurate publicity will induce others to trade (or not to trade) in the company's securities or the securities of another company in a control relationship with the company making the publicity.¹⁷⁴ Moreover, the clear intent of the draftsmen of section 1604(c) is that it is not limited to the issuer and "related" companies; instead, the comments assert that the section is "[b]road enough to cover broker-dealers who issue false market letters."¹⁷⁵

D. The Code and the Wall

Against this proposed statutory backdrop, the relevance and importance of a Chinese Wall or a "restricted list" procedure to a multi-service financial institution, such as an integrated securities firm, is readily apparent. In any private actions or criminal prosecutions brought under the Code which are bottomed on a "fraudulent act" on the part of the defendant, the very definition of that term *requires* a showing either that the defendant knew of the fraudulent nature of his conduct,¹⁷⁶ or perhaps that he acted in reckless disregard of whether his conduct was fraudulent.¹⁷⁷ In addition, the private actions available for "misrepresentations" either require proof that the defendant knew of the falsity of his

172. See ALI FED. SEC. CODE § 202(61) (1980 & 2d Supp. 1981) (see *supra* note 162 for the text of § 202(61)).

173. See *id.* § 202(96) (1980) (see *supra* note 163 for the text of § 202(96)).

174. Section 1604(c) provides as follows:

Publicity.—It is unlawful for any company, or a person acting on its behalf, to engage in a fraudulent act in connection with, or to make a misrepresentation in, a press release or other form of publicity (other than a filing) relating to the company if it is reasonably foreseeable that the publicity will induce other persons to buy, sell, or not to buy or sell securities of the company or of a controlling, controlled, or commonly controlled company.

ALI FED. SEC. CODE § 1604(c) (1980 & 2d Supp. 1981). Note that § 1604(c) would not operate of its own force to impose liability for the failure to issue any release *at all* unless there is insider trading. See *id.* § 1604(c), comment (4) (1980). See also *Financial Indus. Fund v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973).

175. ALI FED. SEC. CODE § 1604(c), comment (6) (1980). The literal language of § 1604(c), however, does not seem to support this assertion beyond the situation in which the broker-dealer is acting on behalf of the company involved. (see *supra* note 174 for the text of § 1604(c)).

176. *Id.* § 202(61) (1980 & 2d Supp. 1981) (see *supra* note 162 for the text of § 202(61)).

177. ALI FED. SEC. CODE § 202(61)(C)(i) (2d Supp. 1981). Other actions, however, such as SEC enforcement proceedings or injunction actions, do not require such a scienter-type showing. See *id.* § 202(61)(C)(ii).

statement,¹⁷⁸ or afford defenses based on the nonexistence of scienter (or negligence).¹⁷⁹ A partnership, firm, corporation, or other artificial person obviously cannot possess knowledge or act with a particular state of mind *per se*,¹⁸⁰ but can act only through its agents who, *ex hypothesi*, must ultimately be individuals. Thus, the initial inquiry in *any* private action under the Code against a securities firm or other multi-service institution must then be *whose* knowledge (or scienter or state of mind) within the firm should be attributed to the firm for purposes of making the required proof.¹⁸¹ And it is to this question that the provisions of

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178. *See, e.g., id.* § 1706(a) (underwriter not liable for false certification under § 510(c)(3) absent proof of scienter); *id.* § 1707(a) (action for misrepresentation for false publicity under § 1604(c) requires showing of scienter); *id.* § 1709(a)(1) (fiduciary liability for misrepresentation requires showing of scienter). *But cf. id.* § 1714 (liability for shortswing insider trading).
179. *See, e.g., id.* § 1703(f)(1): "A defendant has a defense—to an action for violation of section 1602(a)(1) to the extent that it is based on a misrepresentation if he proves that . . . he reasonably did not believe that there was a misrepresentation . . ." *See also id.* § 1705(f)(3) (2d Supp. 1981) (defense of lack of scienter to civil actions based on false filings). As to present law, see *Aaron v. SEC*, 446 U.S. 680 (1980) (allegation of scienter necessary to sustain civil enforcement actions by SEC under § 10(b) and rule 10b-5, 15 U.S.C. § 78j(b) (1982), 17 C.F.R. § 240.10b-5 (1983), and also under § 17(a)(1) of the 1933 Act, 15 U.S.C. § 77q(a)(1) (1982), but not under §§ 17(a)(2), (3) of the act, 15 U.S.C. §§ 77q(a)(2), (3) (1982)); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (allegation of scienter necessary to sustain private damage action under § 10(b) of the Exchange Act and rule 10b-5); *Bell v. Cameron Meadow Land Co.*, 669 F.2d 1278, 1282-83 (9th Cir. 1982) (recklessness sufficient to meet scienter requirement). *See also* 3 L. LOSS, *supra* note 29, at 1766; 6 *id.* at 3883-85.
180. Thus at one time the common law courts were unwilling to hold a corporation criminally liable whatsoever. *See Anonymous*, 12 Mod. 560, 88 Eng. Rep. 1518 (K.B. 1701) ("A corporation is not indictable, but the particular members of it are."). *See also* 1 BLACKSTONE, COMMENTARIES* 476 (noted in R. PERKINS, CRIMINAL-LAW 639 (2d ed. 1969)). The law has since moved away from this overly formalistic view, even if crimes requiring specific intent or *mens rea*. *See United States v. Union Supply Co.*, 215 U.S. 50, 54-55 (1909); *New York Central & H.R.R.R. v. United States*, 212 U.S. 481, 494-96 (1909); *United States v. Koppers Co., Inc.*, 652 F.2d 290 (2d Cir.) (criminal conviction of corporation for violating Sherman Act), *cert. denied*, 454 U.S. 1083 (1981); *United States v. T.I.M.E.-D.C., Inc.*, 381 F. Supp. 730 (W.D. Va. 1974) (corporation convicted for violating ICC regulation prohibiting truckers from driving while ill; proof based on collective knowledge of dispatcher and officers). *See also Inland Freight Lines v. United States*, 191 F.2d 313, 315 (10th Cir. 1951); *United States v. Sawyer Transp., Inc.*, 337 F. Supp. 29, 30-31 (D. Minn. 1971), *aff'd*, 463 F.2d 175 (8th Cir. 1972). *See generally* Note, *Developments in the Law—Corporate Crime: Regulating Corporate Behavior through Criminal Sanctions*, 92 HARV. L. REV. 1227 (1979).
181. *See* 10 W. FLETCHER, *supra* note 25, § 4942, at 620-21 (1978). *See also supra* note 180 and sources cited therein; *infra* notes 184, 192-99 and accompanying text. The general rule, of course, is that, absent some justification for doing otherwise, the knowledge of a corporation's agent is imputed to the corporation. *See* 19 C.J.S., *Corporations* § 1078 (1940). Agency principles have regu-

section 202(86)(C) are directed.¹⁸²

With this structural background in mind, then, perhaps the most significant contribution of section 202(86)(C) is its mandate that questions regarding the imputation of knowledge between or among agents and the principal are to be resolved "by the principles of common law and equity, applied as a matter of Federal jurisprudence."¹⁸³ Thus, the Code's scheme would focus analysis of the Chinese Wall issue into an existing body of law, an approach developed through the course of judicial decisions in analogous cases.¹⁸⁴ This approach is surely the correct one. The question of the validity of the isolation technique, as well as the need for additional policies and procedures to deal with the inside information problems of multi-service firms, should not be approached *ex ante* with an unfocused concentration on the fraud rules or the effect of one rule of law or another on the securities industry, investment performance, customer expectations, and the like. These are obviously legitimate considerations underlying the potential legal difficulties facing the firm in possession of insider information. But the *legal* question (which has been struggled with in other contexts) remains one of corporate knowledge, and a systematic application of workable rules requires that the question be analyzed broadly in all of its facets.¹⁸⁵

Beyond this "focusing" of the issue, however, the Code does not

larly been relied upon by the courts in securities litigation in determining whether to impute knowledge of an officer or employee to the corporation. See, e.g., *Schoenbaum v. Firstbrook*, 405 F.2d 200, 211-12 (2d Cir.), *rev'd en banc*, 405 F.2d 215 (2d Cir. 1968).

182. ALI FED. SEC. CODE § 202(86)(C) (1980) (see *supra* note 149 for the text of § 202(86)(C)).

183. ALI FED. SEC. CODE § 202(86)(C)(i) (1980).

184. This is not to suggest that there is a developed common law "answer" to the imputation question in any of the various situations in which it may arise in the context of an integrated securities firm or other multi-service institution which has constructed a Chinese Wall or implemented other procedures (such as a restricted list) to attempt to deal with its inside information problems. There are numerous cases dealing with the question of when the knowledge or notice of a corporate agent will be attributed to his principal. See, e.g., 19 C.J.S., *supra* note 181, at § 1078. See also *infra* notes 192-99 and accompanying text. Nevertheless *Slade v. Sherson, Hammill & Co.*, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,329 (S.D.N.Y.), *remanded*, 517 F.2d 398 (2d Cir. 1974), *settlement approved*, 79 F.R.D. 309 (S.D.N.Y. 1978), is still the only case in which the validity of the Chinese Wall solution to the investment banker/broker-dealer conflict was squarely litigated. *Buf. cf. Hazard v. Chase National Bank*, 159 Misc. 57 (Sup. Ct. 1936), *aff'd*, 257 A.D. 950, 14 N.Y.S.2d 147 (1939), *aff'd*, 282 N.Y. 652, 26 N.E.2d 801, *cert. denied*, 311 U.S. 708 (1940) (see *infra* note 263 for a discussion of *Hazard*).

185. Analysis of the considerations underlying the Chinese Wall and other solutions to the investment banker/broker-dealer conflict is reserved for *infra* parts V and VI.

stray very far. The only other significant mandate of section 202(86)(C) is its admonition to the courts and the SEC to "consider" whether the entity involved has constructed a Chinese Wall to isolate inside information,¹⁸⁶ or has adopted some variant of a "restricted list" procedure to prevent transactions in and recommendations about the securities of issuers about which the firm has (or may acquire) confidential price-sensitive information.¹⁸⁷ There is no effort, however, on the part of the draftsmen to provide any legislative guidance to either the courts or the Commission as to when (or even if) a wall or other device is an appropriate solution to the firm's conflicts problems. Perhaps half a loaf is better than no loaf at all, but the half loaf provided by the Federal Securities Code is not a very big one.¹⁸⁸

186. ALI FED. SEC. CODE § 202(86)(C)(ii)(I) (1980). *See also id.* § 202(86)(C)(ii)(I), comment (2).

187. *Id.* § 202(86)(C)(ii)(II) & comment (4). Professor Loss has described the operation of the section as follows:

[W]e have come forward with the present [§ 202(86)(C)] with a Note . . . which says to the courts, "You work this out as a matter of federal common law, and, in working out this problem in the common law tradition, bear in mind that there is a Chinese Wall when there is one and give it whatever regard you think it deserves." That is by no means the kind of solution that would be ideal, but it is the best we can come up with.

55 A.L.I. PROC., *supra* note 145, at 336-37. It is clear, however, that the section will never absolve a person who transacts in or makes recommendations with respect to securities if the individual involved has knowledge of sciencter, or acts negligently, without regard to imputation under § 202(86)(C). *See* ALI FED. SEC. CODE § 202(86)(C), comment (5) (1980).

188. This is probably not too surprising in light of the divergence of views as to the efficacy of the wall device and the complexity of the issues involved. An amendment was offered on the floor of the American Law Institute's 1978 annual meeting which would have deleted the words "consider whether" in § 287(c) of the Proposed Official Draft, and insert the court "shall not, in the absence of unusual circumstances, make an imputation where the principal or company operated under" an established Chinese Wall. 55 A.L.I. PROC., *supra*, note 145, at 337. The amendment was defeated on a voice vote, *id.* at 338-39, after the Reporter, Professor Loss, offered the following explanation for his opposition to any changes.

I would oppose any change. What I said in the task force and in the Advisory Group was that I would not like to be in the witness chair before a congressional subcommittee and be asked this question, which inevitably would be asked: "You mean, Professor, that Merrill Lynch or some other large firm could know, because it was looking into an underwriting, that Company X was on it way to bankruptcy, but by setting up what you are pleased to call a 'Chinese Wall' several thousand Merrill Lynch employees could sell that stock to a lot of widows and orphans?" I would not like to answer that question.

Id. at 337-38. *See also* ALI FED. SEC. CODE § 202(86)(C), comment (2) (1980) (an approach which is more likely to be enacted).

V. THE CHINESE WALL AND LIABILITY FOR INSIDER TRADING

The essential legal question facing an integrated securities firm with a Chinese Wall that has come into possession of inside information in its role as investment banker to a publicly-held company is whether the nonpublic knowledge of the firm's investment banking division will be imputed to the firm as a whole, or to its trading personnel.¹⁸⁹ If such an imputation is made automatically, without regard to the existence of the wall, then the multi-service firm will be exposed to liability under rule 10b-5¹⁹⁰ for any transactions in or recommendations of the securities of that issuer (that are consistent with the inside information) by the firm's broker-dealer or ad-

189. *See, e.g.*, ALI FED. SEC. CODE § 202(86)(C)(i) (1980).

190. 17 C.F.R. § 240.10b-5 (1983). In addition to rule 10b-5, other antifraud provisions may also be implicated with respect to transactions in securities on the basis of material nonpublic information. *See, e.g.*, § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1982); § 14(3) of the 1934 Act, 15 U.S.C. § 78p(c) (1982), and rule 14e-3 promulgated thereunder, 17 C.F.R. § 240.14e-3 (1983) (tender offers); § 15(c)(1) of the 1934 Act, 15 U.S.C. § 78o(c)(1) (1982), and rule 15c1-2 promulgated thereunder, 17 C.F.R. § 240.15c1-2 (1983); and § 206 of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-6 (1982). Unless otherwise indicated, however, this discussion is limited to potential liability under rule 10b-5. First, most of the private litigation in this area is conducted under the aegis of that rule, and the right of a private plaintiff to proceed under rule 10b-5 is "well recognized." *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971); *Kardon v. Nat'l Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947).

By contrast, the Supreme Court's unwillingness in recent years to imply private rights of action under federal statutes that do not specifically provide therefor casts serious doubt on the ability of private litigants to proceed under any of the other antifraud rules, at least to the extent they seek monetary damages. *See, e.g.*, *Transamerica Mortgage Advisers, Inc. (TAMA) v. Lewis*, 444 U.S. 11 (1979) (no implied private right of action for damages under § 206 of the Investment Advisers Act; private remedies are limited to suits for rescission, injunctive relief, or restitution under § 215); *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979) (no implied private right of action under § 17(a) of the 1934 Act). *See also Cannon v. University of Chicago*, 441 U.S. 677, 730-49 (1979) (Powell, J., dissenting). *But see J.I. Case Co. v. Borak*, 377 U.S. 426 (1964) (private right of action under § 14(a) of the 1934 Act for false and misleading statement in a proxy).

As to § 17(a) of the 1933 Act in particular, compare *Stephenson v. Calpine Conifers II, Ltd.*, 652 F.2d 808, 815 (9th Cir. 1981) (focusing on the minimal differences between § 17(a) and rule 10b-5, concluded that a private right of action exists under the former), with *Shull v. Dain, Kalman & Quail, Inc.*, 561 F.2d 152, 159 (8th Cir. 1977), *cert. denied*, 434 U.S. 1086 (1978) (no private right of action under § 17(a)). *See Jablon v. Dean Witter & Co.*, 614 F.2d 677 (9th Cir. 1980) (no implied private right of action for violation of stock exchange or N.A.S.D. rules). More importantly, however, for the purposes with which this Article is concerned, there is no meaningful distinction among the policies of the several provisions. *See Brudney, supra* note 29, at 324 n.17. *See also* 5 A. JACOBS, *supra*, note 29, §§ 3, 4.

visory departments as long as the information remains nonpublic.¹⁹¹

A. An Aside to Common Law

Common law precedents do not provide an "answer" to either prong of the imputation question in the context of a "walled" firm's potential liability under the fraud rules for trading on or tipping inside information. Nevertheless, they serve as a useful point of departure for understanding the general attitude of the courts with respect to what may loosely be termed "corporate knowledge." The general rule, of course, is that a corporation or other organization is charged with all relevant factual knowledge of its officers and agents, at least if that knowledge is acquired during the course of their employment.¹⁹² This is true whether or not the agents involved actually transmit their knowledge to the corporation's officers or board of directors.¹⁹³ This "general rule", however, is at best only a presumption; even the common law courts relaxed their view in certain instances. For example, the rule has not been applied when the circumstances were such to give rise to a "clear

191. See, e.g., *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980); *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), *cert. denied*, *Coates v. SEC*, 394 U.S. 976 (1969). See also *supra* notes 29-36 and accompanying text.

It should be noted that the inside information need not relate directly to the prospects or operations of the issuer. Rule 10b-5 has also been applied to purely "market information," i.e., "[i]nformation about events or circumstances that affect the market for a company's securities but not its earning power." W. CARY & M. EISENBERG, *CASES AND MATERIALS ON CORPORATIONS* 767 (5th unabridged ed. 1980). See, e.g., *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981) (misappropriation of inside information relating to forthcoming tender offers from offerors' investment banker); *Zweig v. The Hearst Corp.*, 521 F.2d 1129 (9th Cir. 1975) ("scalping"). See also *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963) (scalping by investment adviser). *But cf. Chiarella v. United States*, 445 U.S. 222 (1980); *Frigitemp Corp. v. Financial Dynamics Fund, Inc.*, [1975-1976 Transfer Binder] *FED. SEC. L. REP. (CCH)* ¶ 95,323 (2d Cir. 1975) (suggests that there may be a duty to disclose market information in some circumstances, but that this case was not one of them). See generally *ALI FED. SEC. CODE* § 1603, comment 2(j) (1980); *Fleischer, Mundheim & Murphy, An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798 (1973); *Morrison, Silence is Golden: Trading on Nonpublic Market Information*, 8 *SEC. REG. L.J.* 211 (1980).

192. See 19 C.J.S., *supra* note 181, at § 1078, and cases cited; 19 *AM. JUR. 2d, Corporations* § 1263, and cases cited (1965). See also *Simmons Creek Coal Co. v. Doran*, 142 U.S. 417 (1892); *Pacific R.R. v. Missouri Pacific Ry.*, 111 U.S. 505 (1884). *Cf. W. PROSSER, supra* note 30, § 69, at 459 ("[T]he modern justification for vicarious liability is a rule of policy, a deliberate allocation of risk.") (footnote omitted).

193. 19 C.J.S., *supra* note 181, at § 1078. See, e.g., *City of Philadelphia v. Westinghouse Elect. Corp.*, 205 F. Supp. 830, 831 (E.D. Pa. 1962).

presumption" that the agent who possessed the knowledge in question (or to whom notice was given) would not in fact communicate it to the responsible officers of the corporation,¹⁹⁴ or when the officer involved had no duty to report the information further.¹⁹⁵

The second prong of the imputation question—whether "corporate" knowledge (or knowledge of a principal) is to be attributed to the particular agents responsible for the transaction involved—is no more clearly resolved. Like the first inquiry, though, the general view of the courts has been to regard the corporate "head" as possessing the composite knowledge of all of its agents.¹⁹⁶ Thus courts have found a corporate principal liable to a third party for making a false statement, even though the individual who made the statement was unaware of its falsity.¹⁹⁷ Even here, however, there is some play in the joints, as courts have been perfectly willing to absolve a principal for failure to communicate essential facts to his agent if the former was somehow unable to do so.¹⁹⁸

194. 19 C.J.S., *supra* note 181, at § 1081. *See also* J.J. McCaskill v. United States, 216 U.S. 504 (1910) (directors defrauding company); Ruckle v. Roto American Corp., 339 F.2d 24 (2d Cir. 1964) (same); George H. Sasser & Co. v. Chuck Wagon System, Inc., 50 N.M. 136, 172 P.2d 818 (1946) (officer was interested in the transaction). *See also* 19 AM. JUR. 2d, *supra* note 192, § 1266, at 672-73.

195. 19 C.J.S., *supra* note 181, at § 1081. *See also* Sutton Manual Insurance Co. v. Notre Dame Arena, Inc., 108 N.H. 437, 441, 237 A.2d 676, 679 (1968).

196. 19 C.J.S., *supra* note 181, § 1081, at 619, and cases cited.

197. *See, e.g.*, E.S. Graynor Lumber Co. v. Morrison, 75 S.D. 132, 60 N.W.2d 83 (1953). In that case, the corporation filed a complaint to enforce a mechanic's lien which overstated the amount of the claim by 35%. The plaintiff's sales manager was aware of the facts regarding the amount the defendant actually owed, but the firm's office manager and accountant, who had responsibility for filing the claim, were not. In affirming the trial court's dismissal of the complaint, the court charged the corporate plaintiff with the sales manager's knowledge that the lien claim was overstated. *Id.* at 135, 60 N.W.2d at 84. In the case itself, however, there was of course no legitimate barrier of any sort within the company to prevent the internal transmission of the correct information, and the unfairness to the defendant of the "mistake" is readily apparent.

RESTATEMENT OF AGENCY § 256(1), comment(a) (1933), states that:

If a principal, knowing that an agent is about to conduct a transaction with inadequate or misleading information, intentionally withholds information from him for the purpose of enabling the agent honestly to misstate facts, the principal is subject to liability for his own fraudulent statement if the agent does subsequently misstate the facts.

See also W. SEAVEY, *supra* note 24, § 92 at 163; RESTATEMENT (SECOND) OF AGENCY § 356, comment (e) (1958).

198. *See, e.g.*, RESTATEMENT OF AGENCY § 256(1), comment (c) (1933) ("[A] transaction is not affected by the knowledge of a principal which he *cannot communicate* to the agent, even though he knows that the agent is acting for him without such knowledge") (emphasis added). *See also* Canadian Indem. Co. v. Tacke, 257 F.2d 342 (9th Cir. 1958) (insured not liable for failure to commu-

Despite the absence of any clearly mandated common law result, however, the cases provide a twofold lesson which carries over to the question of the validity of the Chinese Wall defense to a charge of insider trading. First, the "general rule" is that the knowledge of an agent is attributed to the firm as a whole and, once attributed, is further imputed to those of its agents directly involved with third parties. This, however, is merely the adumbration of a policy choice that the principal or firm, as the case may be, is better suited, at least generally, than the wholly uninformed outsider to bear the legal risk of its lack of knowledge. Second, however, it is to be noted that this presumption can be rebutted in those instances where there is no particular reason for the corporation to shoulder this burden, and where the more broad policy considerations implicated in the dispute suggest an alternative result. In the investment banker/broker-dealer conflict, then, the inquiry must appropriately be focused on the general policies underlying rule 10b-5 and the antifraud laws in the various contexts in which the validity of the Chinese Wall may reasonably be implicated.¹⁹⁹

nicate fact of automobile accident to his agent (his wife) who innocently obtained a predated automobile insurance policy on the same morning as the accident); *Pendergast v. Globe & Rutgers Fire Ins. Co.*, 246 N.Y. 396, 159 N.E. 183 (1927) (in case of a predated marine insurance binder, owner acted reasonably, through unsuccessfully, in attempting to communicate news of loss of a tug which had sunk before the binder was written to a character who knew the insurer's identity; insurer held liable for the loss); RESTATEMENT (SECOND) OF AGENCY § 256, comment (e) (1958).

Similarly, a principal is generally not liable for the misrepresentations of an agent who exceeds his real or apparent authority. See, e.g., *Dickinson v. Bankers Life & Cas. Co.*, 283 S.W.2d 658, 662 (Mo. App. 1955); *Mesce v. Automobile Ass'n*, 8 N.J. Super. 130, 135, 73 A.2d 586, 588 (1950); *Texas Co. v. Stone*, 232 N.C. 489, 491, 61 S.E.2d 348, 349 (1950). *But cf.* *Cornfoot v. Fowke*, 6 M. & W. 358, 151 Eng. Rep. 450, 455 (1840). (Rolfe, B., held that for a third party to defend a contract action brought by a principal's agent, the defendant must show actual fraud by the principal himself in that he gave his agent authority to make the representation. In *Cornfoot*, the agent had told the plaintiff that there was nothing wrong with the house which the defendant rented from the plaintiff-principal when in fact there was a brothel next door. In the case, of course, it is questionable whether the agent had made a misrepresentation at all.)

199. See *Lipton & Mazur*, *supra* note 5, at 471. See also *supra* note 190. It is a settled rule of statutory construction that a legislative act should be interpreted in light of its underlying purposes. See 5 A. JACOBS, *supra* note 29, § 6.01, at 1-167 (citing 2A A. SUTHERLAND, STATUTE AND STATUTORY CONSTRUCTION §§ 45.01-45.11, 56.02 (4th ed. 1973)). As noted, *supra* notes 145-88 and accompanying text, the imputation of knowledge analysis is the approach that would be mandated by the Federal Securities Code. See ALI FED. SEC. CODE § 202(86)(c) (1980).

B. The Policies of Rule 10b-5

Notwithstanding that neither the draftsmen of rule 10b-5 nor the Commissioners who adopted it had any clearly articulated rationale for the rule,²⁰⁰ it is clear through the course of its development in the courts and by the Securities and Exchange Commission that it has come to represent and adumbrate a number of (generally) mutually supportive goals and policies; policies which are promoted by the antifraud provisions of the federal securities acts generally.²⁰¹

Professor Brudney has articulated four principal functions served by the disclosure and antifraud provisions of the securities laws. First (and perhaps foremost), the legislation, particularly the antifraud rules, serves a "protective function" by operating to prevent and redress the overreaching of public investors by those with more acumen in the ways of the marketplace,²⁰² or who pos-

200. See Freeman, *supra* note 29, at 922:

We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, "Well," he said, "we are against fraud, aren't we?" That is how it happened.

See generally *supra* note 29 and sources cited therein. Justice Rehnquist has remarked that "[w]hen we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 738 (1975). Professor Loss has also referred to the rule as "[a] swift horse of dubious pedigree." Lecture by L. Loss, Harvard Law School, Spring 1981.

201. The term "securities acts" refers generally to the six separate statutes passed by Congress between 1933 and 1940. See Securities Act of 1933, 48 Stat. 74, as amended, 15 U.S.C. § 77a-77aa (1982); Securities Exchange Act of 1934, 48 Stat. 881, as amended, 15 U.S.C. §§ 78a-77hh (1982); Public Utility Holding Company Act of 1935, 49 Stat. 803, as amended 15 U.S.C. §§ 79-79z-6 (1982); Trust Indenture Act of 1939, 53 Stat. 1149, as amended, 15 U.S.C. §§ 77aaa-77bbbb (1982); Investment Company Act of 1940, 54 Stat. 789, as amended, 15 U.S.C. §§ 80a-1-80a-64 (1982); and the Investment Advisers Act of 1940, 54 Stat. 847, as amended, 15 U.S.C. §§ 80b-1-80b-21 (1982). The Federal Securities Code would integrate the several acts into a single statute. See ALI Fed. SEC. CODE xix (1980). See also *supra* note 145. As to the "antifraud provisions," see *supra* note 190.
202. See Brudney, *supra* note 29, at 334. See also *Huges v. SEC*, 174 F.2d 969, 975 (D.C. Cir. 1949), (quoting *Archer v. SEC*, 133 F.2d 795, 799 (8th Cir.), *cert. denied*, 319 U.S. 767 (1943)): "The business of trading in securities is one in which opportunities for dishonesty are of constant reoccurrence and ever present. It engages acute, active minds, trained to quick apprehension, decision and action." See also *United States v. Naftalin*, 441 U.S. 768, 775 (1979) (protection of investors and honest businessmen were goals of the 1933 Act); *Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d 876, 890 (2d Cir. 1972) (prevent insiders from taking advantage of uninformed outsiders); *Kohler v. Kohler Co.*, 319 F.2d 634, 642 (7th Cir. 1963) (rule 10b-5 calls for "fair play" by insiders in the dealings with outsiders).

sess unearned informational advantage over those with whom they deal.²⁰³ Second, the antifraud provisions reinforce the mandated disclosure provisions of the securities laws in an effort to serve an efficiency goal. The notion is that by providing the fullest possible disclosure of material corporate news, the company's securities will command a market price which as nearly as possible reflects their "true" value, thus ultimately promoting allocative efficiency of investment resources.²⁰⁴

In addition to their protective and efficiency goals, the securities acts also aim to reduce the overall cost of raising business capital through restoring trust in the operations of the public securities markets. The hoped-for result is that by restoring confidence in the integrity of the marketplace, investors will no longer require an increased return, or "risk premium," to compensate for their fear of being fleeced.²⁰⁵ Finally, the disclosure and antifraud rules serve a regulatory function through reducing the incentives to engage in fraudulent and manipulative practices. The aspiration is that the willingness to cheat will be tempered by the fear of getting caught.²⁰⁶

Of these four aspirations, the antifraud provisions, of which rule 10b-5 is by far the most frequently invoked, lean most heavily

203. See Brudney, *supra* note 29, at 334-39. As to the policies of rule 10b-5, see generally 5 A. JACOBS, *supra* note 29, at §§ 6.01-6.09.

204. See Brudney, *supra* note 29, at 334, 337. *But cf.* B. MALKIEL, A RANDOM WALK DOWN WALL STREET (college rev. ed. 1975). The fact that rule 10b-5 has a disclosure aspect to it does not, of course, mean that it operates of its own force to supplant those provisions of the securities laws requiring regularized disclosure through reports, filings, proxy statements, and the like. See, e.g., § 5 of the 1933 Act, 15 U.S.C. § 77e (1982) (registration of new securities); § 13(a) of the 1934 Act, 15 U.S.C. § 78m(a) (1982) (periodic reporting by registered companies); § 14(a) of the 1934 Act, 15 U.S.C. § 78n(a) (1982) (content of proxy statements). See also *Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514, 518 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973) (corporate disclosure is essentially a matter of business judgment); ALI FED. SEC. CODE § 1604(c), comment (4) (1980). What is clear, however, is that rule 10b-5 proscribes false or misleading statements, at least if they can be expected to have an effect on the market for the company's securities. See, e.g., *Ross v. A.H. Robins Co.*, 607 F.2d 545 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980) (false publicity generally); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968), *cert. denied*, *Coates v. SEC*, 394 U.S. 976 (1969) (false press release). See generally F. Mitomi, *The Duty to Correct* (May 11, 1978) (unpublished LL.M. thesis in Harvard Law School Library).

205. See Brudney, *supra* note 29, at 334-35. See also *United States v. Chiarella*, 588 F.2d 1358, 1362 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980) (honest markets); *Sargent v. Genesco, Inc.*, 492 F.2d 750, 760 (5th Cir. 1974) (investor trust); 5 A. JACOBS, *supra* note 29, § 6.08, at 1-185 to -186.

206. See Brudney, *supra* note 29, at 335-36. See also 5 A. JACOBS, *supra* note 29, § 6.09, at 1-186 (deterrence vs. compensation as a policy of rule 10b-5). *Cf.* § 16(a) of the Act, 15 U.S.C. § 78p(a) (1982) (reports by statutory insiders).

toward the "protective function."²⁰⁷ Thus, the general rule which has emerged with respect to those in possession of material non-public information is a contingent one: either its holders must disclose it in a way that it will reach the investing public generally, and hence be incorporated into the market pricing mechanism, or they must abstain from trading in or causing others to trade in the securities affected by that information.²⁰⁸ The legal efficacy of the Chinese Wall, then, as well as that of other protective devices of integrated financial institutions, must be assessed in light of these four goals generally, and against the "disclose or abstain" rule in particular.

C. Rule 10b-5 and the Chinese Wall

In the general case, none of these four goals of the antifraud laws—investor protection, market efficiency, investor confidence, or regulation—are compromised unless inside information is actually *used* by an integrated firm for market trading purposes, or unless it is acquired in such a manner that *any* transaction is so fraught with the risk of misuse that denial of access to inside information altogether, or precluding the possibility of its use, is less costly than the effect of that denial on other policies. In the case of a firm with a Chinese Wall in place, the degree to which inside information is in fact isolated must be weighed against the threat which the risk of abusive use of that information by the firm poses to the policies of the fraud rules. It is only where that threat can be effectively neutralized by the wall that the multi-service firm in possession of inside information should be permitted to continue "business as usual" in its other departments. The remainder of this section will apply this analytical structure to three activities of securities firms where either a conflict of duty or conflict of interest

207. See Brudney, *supra* note 29, at 336. See also *id.* at 337-38 ("[T]he object of the disclosure requirement in the antifraud laws is focused more on prohibiting overreaching than on forcing disclosures.").

208. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, Coates v. SEC, 394 U.S. 976 (1969); *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961). Thus, the basic philosophy underlying the rule is that parties to securities transactions should, insofar as it is possible, have equal access to material information. See, e.g., *Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d 876, 890 (2d Cir. 1972). See also 3 A. BROMBERG, *supra* note 29, § 12.2. But see *Dirks v. S.E.C.*, 103 S. Ct. 3255 (1983) (see *supra* note 36 for a discussion of *Dirks*) Professor Manne, however, argues that executives and officers should be rewarded for their entrepreneurial ability through recourse to inside information for transactional purposes. H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966); Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547 (1970). But see O. WILLIAMSON, *CORPORATE CONTROL AND BUSINESS BEHAVIOR* 93-96 (1970); Schotland, *Unsafe At Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425 (1967).

is inevitably present: (1) retail brokerage activities; (2) own account trading; and (3) broker-dealer directorships.

1. *Broker-Dealer Recommendations*

A securities firm which has combined both investment banking and retail brokerage (or over-the-counter dealer) functions under one roof may often find itself in the position of recommending or executing transactions in securities of an issuer about which its corporate finance or investment banking department possesses inside information.²⁰⁹ To the extent that its brokerage recommendations are consistent with the tenor of the inside information possessed by the firm's investment banking personnel, the firm as a whole is in constant jeopardy of being charged with improperly using that confidential information to benefit its trading customers. In the case of an effectively "walled" firm,²¹⁰ the core legal question presented by such a charge is whether the inside information isolated within the investment banking department will be imputed to the firm as a whole, or to its trading personnel. Such an imputation, of course, will often result in the finding of a "tip" in violation of rule 10b-5.²¹¹

The investment banking/broker-dealer conundrum illustrates the classic case where the multi-service institution is caught between two "masters." In such a situation, as will be more fully explored, the policies of the antifraud rules are not compromised unless it is demonstrated that the firm actually *used* inside information to benefit its retail customers. Absent such a showing, the firm should not be exposed to liability to the investing public for their trading losses or to sanctions by the SEC.

That rule 10b-5, at least in the general case, is predicated on the actual *use*, as opposed to the mere *possession*, of material, nonpublic information (and hence that the imputation question should be answered in the negative) is borne out by the cases arising out of

209. See, e.g., *Slade v. Shearson, Hammill & Co.*, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,329 (S.D.N.Y.), *remanded*, 517 F.2d 398 (2d Cir. 1974). Cf. *Alton Box Board Co. v. Goldman, Sachs & Co.*, 560 F.2d 916 (8th Cir. 1977) (broker-dealer was recommending securities to customers as "prime" investments without disclosing that its trading department was simultaneously reducing its own inventory in those securities).

210. This section proceeds on the assumption that the firm's investment banking department is in fact effectively "walled," and that inside information does not trespass over departmental lines. To the extent that a multi-service institution, securities firm or otherwise, is unable to maintain sufficient isolation of inside information, there can, of course, be no room for the Chinese Wall defense. See ALI FED. SEC. CODE § 202(86)(C), comment (5) (1980).

211. See, e.g., *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974). See also *supra* notes 36 & 191 and accompanying text.

the Merrill Lynch/Douglas Aircraft fiasco.²¹² In *In re Investors Management Co.*,²¹³ the SEC brought disciplinary proceedings against a number of investment advisers, mutual funds, and investment partnerships to whom Merrill Lynch had "tipped" the bearish news about Douglas Aircraft's revised earnings forecast, and who in turn quickly sold (or sold short) Douglas stock. In affirming the hearing examiner's imposition of sanctions against all but one of the respondents, the Commission explained the elements of a rule 10b-5 trading violation as follows: "We consider those elements to be that the information in question be material and nonpublic; that the tippee . . . know or have reason to know that it was nonpublic . . ., and that the information be a factor in his decision to effect the transaction."²¹⁴

As to the last requirement for imposing liability—that the inside information somehow affect the tippee's investment decision, the Commission developed a presumption in favor of a finding of misuse.

[W]e are of the opinion that where a transaction of the kind indicated by the information . . . is effected by the recipient prior to its public dissemination, an inference arises that the information was such a factor [in the decision to trade]. The recipient of course may seek to overcome such inference by countervailing evidence.²¹⁵

212. See *supra* notes 73-77 and accompanying text for the facts of the case. As to the "use" vs. "possession" dichotomy, see SEC Release No. 16-385, *supra* note 136, at 70, 353. See also *supra* note 138 and accompanying text.

213. 44 S.E.C. 633 (1971).

214. *Id.* at 641 (emphasis added). See also *id.* at 648-49 (Commissioner Smith, concurring in the result).

215. *Id.* at 646-47. Thus, the SEC affirmed the hearing examiner's dismissal of the proceedings against one of the respondents, a large investment adviser, because the employee who had received the nonpublic information from Merrill Lynch had not communicated the bearish news to his superior, who made the decision to sell Douglas stock solely on the basis of available public information. The Commission reiterated, however, that it would

[v]iew as suspect the subject to close scrutiny a defense that there was no internal communication of material non-public information . . . where a transaction of the kind indicated by it was effected by [the] organization immediately or closely thereafter. A showing of such receipt and transaction prior to the time the information became public should in itself constitute strong evidence of knowledge by the one who effected the transaction and by the firm.

Id. at 647 n.28.

The SEC's silence on the use vs. possession issue in *In re Faberge*, 45 S.E.C. 249 (1973), may have been taken by some as an indication that the Commission was moving toward a *possession*, as opposed to *use*, of insider information standard for purposes of imposing liability under rule 10b-5. As Lipton & Mazur correctly note, however, the respondents in that case consented to a finding that inside information was in fact used in all but perhaps two transactions, and thus the issue was not really faced. In any event, any doubt on this score would have been settled by the SEC in its brief in the

The SEC's "presumption doctrine," which leaves open the door to a showing that inside information was not utilized in an improper manner, has not given way to any more absolute imputation of knowledge as a matter of law.²¹⁶

A more fundamental reason than *stare decisis*, however, for not automatically imputing the knowledge of the investment banking department of a "walled" firm to its broker-dealer personnel is that the Chinese Wall, at least in this context, supports, rather than threatens, the legitimate policies of the fraud rules. There is no occasion to invoke rule 10b-5 to impose liability for normal brokerage recommendations under the banner of "investor protection" unless market investors have actually been victimized through the knowing use of the inside information. In the absence of such misuse, the retail customers of a multi-service firm stand *in pari materia* with all other market investors in the affected security.²¹⁷ That they may profit from a particular transaction may be a testament to their relative analytical superiority, or to that of the firm's investment advisory personnel who recommended the transaction. Absent a showing that they somehow benefited from inside information, however, such transactions do not endanger public investors in the same security.

It might nonetheless be argued, however, that the Chinese Wall operates as a disservice to the goals of market efficiency and investor confidence which also underlie the antifraud rules. Under this approach, these goals would be more fully realized if *immediate* public disclosure of all material corporate and market information by the issuer, or by its investment banker, were the governing rule of law.²¹⁸ To the extent that it can practicably be accomplished, full and prompt disclosure of all news which might affect the relative value of an issuer's securities is clearly the preferred ap-

Slade case. See SEC Brief, *supra* note 114. See also Lipton & Mazur, *supra* note 5, at 473 n.43.

216. See SEC v. Shapiro, 494 F.2d 1301, 1307 (2d Cir. 1974) ("[W]e need not decide whether the facts here establish such an inference [that the recipients of inside information used it] as a matter of law because the district court found that inside information *had influenced* appellant . . . and that finding was certainly not clearly erroneous.") (emphasis added). *But cf.* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 851 (2d Cir. 1968), *cert. denied*, Coates v. SEC, 394 U.S. 976 (1969) ("[T]he timing [of the transactions] virtually compels the inference that the insiders were influenced by the by [inside information]."). See also *infra* note 232.

217. See Lipton & Mazur, *supra* note 5, at 472-73.

218. See N. WOLFSON, *supra* note 5, at 70 ("Swift, total, and immediate public disclosure of all material news must be the rule."). See also *supra* note 131 (quoting SEC Brief, *supra* note 114, at 12); *supra* note 204. See generally Talesnick, *Corporate Silence and Rule 10b-5: Does a Publicly Held Corporation Have an Affirmative Obligation to Disclose?*, 49 DENVER L.J. 369 (1973).

proach, and no one should be permitted to hide behind a "Chinese Wall" in these circumstances. But it has long been recognized that issuers have a legitimate right to withhold certain information to protect themselves in dealings with third parties.²¹⁹ In addition, premature disclosure (particularly of "soft" information, such as forecasts, projections, and the like) before some developments can be fully verified for accuracy²²⁰ may subject the company to an independent charge of misrepresentation if the news turns out to be false.²²¹ Moreover, such premature disclosure may operate to interfere with the efficient pricing of the company's securities, and thereby also operate to erode investor trust in the operations of the marketplace.²²² Finally of course, there is the danger the disclosure of particularly favorable corporate news, even if it is fully accurate, at a time when the issuer is contemplating public distribution of new securities might very well subject the company to a charge that it "jumped the gun" in violation of the registration provisions of the 1933 Act.²²³

In addition to these constraints upon issuers against immediate public disclosure of *all* material corporate developments, a corporation's investment banker is confronted with an additional barrier to disclosure of the confidential results of its investigation into the company. If securities firms were to immediately make public all theretofore undisclosed information about issuers which they have unearthed, and the information ultimately turned out to be incorrect, the firm involved would not only be exposed to a charge of misrepresentation under rule 10b-5, but it might also find itself the defendant in a suit for libel or defamation brought, either directly or derivatively, by the corporation itself.²²⁴

219. In *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, *Coates v. SEC*, 394 U.S. 976 (1969), for example, the news of the exceptional new mineral strike was delayed to enable the company to acquire options on surrounding property. *See also* *Matarese v. Aero-Chatillon*, [1971-1972 Transfer Binder] *FED. SEC. L. REP.* ¶ 93,322, at 91,732 (S.D.N.Y. 1971) (issuer had a "valid business reason" for not disclosing an impending merger agreement until it was formally approved by its shareholders).

220. *See, e.g.*, *Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973) (dictum) (earnings forecast). *See also* *ALI FED. SEC. CODE* § 1604(c), comment 4 (1980). *See supra* note 174 and accompanying text for a discussion of § 1604(c).

221. *See supra* note 204. *Cf.* *James v. Gerber Prods. Co.*, 587 F.2d 324 (6th Cir. 1978); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 861-62 (2d Cir. 1968), *cert. denied*, *Coates v. SEC*, 394 U.S. 976 (1969) (false press release with insider trading). *See generally* *BRUDNEY & CHRELSTEIN*, *supra* note 62, at 1066-83.

222. *See supra* notes 204-05 and accompanying text.

223. *See supra* note 62 and sources cited therein.

224. *See* *Solomon & Wilke, Securities Professionals and Rule 10b-5: Legal Standards, Industry Practices, Preventative Guidelines and Proposals for Reform*, 43 *FORD. L. REV.* 505, 525 (1975). A corporation or other organization may

These practical and legal difficulties should not, however, be taken to suggest that a securities firm (whether or not integrated) which has an investment banking relationship with a publicly-held company should be permitted to stand idly by while an issuer knowingly withholds information which it is legally obliged to disclose. On the contrary, the firm should take whatever steps are at its disposal to encourage public companies to make both full and prompt disclosure of any events material to the issuer or its securities which it can lawfully make public, and to report any illegitimate intransigence to the SEC and other appropriate regulatory bodies.²²⁵ But the dangers, both to other policies of the federal securities laws, and to the firm itself, of imposing upon it the role of judge and jury over corporate disclosures are too great to justify such a rule of law.²²⁶ Confronted with this dilemma, a solid Chinese Wall within the firm which effectively prevents the abusive use of undisclosed news is clearly the next best thing.

There remains to be considered, however, the effect of legitimizing a Chinese Wall between the firm's investment banking and broker-dealer departments on the regulatory aspirations of the antifraud rules. As noted, one of the operational premises of the prohibitions against fraudulent and manipulative practices is that they will exercise a deterrent effect on conduct that has been legislatively determined to serve no useful economic or social purpose.²²⁷ In a word, the hope is that the temptation to "stack the deck" will be ameliorated if the erstwhile card shark must do so in full view of his fellow players. In the case of a "walled" firm's activities in recommending and executing transactions for its retail customers, the incentives to "cheat" through leaks in the wall are sufficiently outweighed by both practical and legal considerations that the isolation technique should be recognized as a legitimate defense to tipping charges under the antifraud rules. Moreover, as reported cases in both the securities world and elsewhere aptly demonstrate, there is very likely to be ample evidence to prove that a "tip" occurred to enable either a private litigant or the SEC

bring an action for defamation. See W. PROSSER, *supra* note 30, § 111, at 745. These difficulties are in addition to the securities firm's obligation to keep corporate secrets secret. See *supra* notes 24-28 and accompanying text.

225. Indeed, in *Slade v. Shearson, Hammill & Co.*, 517 F.2d 398 (2d Cir. 1974), the company's investment banker allegedly did just that. See Shearson Brief, *supra* note 79, at 7. See also Chazen & Lipton, *Restrictions on Multi-Service Securities Firms that Possess Inside Information: The Chinese Wall and the Restricted List*, in PLI EIGHTH ANNUAL INSTITUTE ON SECURITIES REGULATION 397, 401, 411 (1977) (discussion) (remarks of Mr. Sporkin).

226. But see N. WOLFSON, *supra* note 5, at 70. But cf. *In re Carter*, [1981 Transfer Binder] FED. SEC. L. REP. ¶ 28,847 (CCH) (professional responsibilities of securities lawyers).

227. See *supra* note 206 and accompanying text.

to overcome any defense based on a Chinese Wall that, as a factual matter, did not repel the informational invader.²²⁸

At the outset, though, it can scarcely be denied that a securities firm in possession of inside information has at least some incentives to pass it along to its trading customers, either directly or in the form of a "buy" or "sell" recommendation. It can hardly be gainsaid that satisfied customers make the best customers, and that customers who receive investment advice that yields trading profits are more likely to remain longstanding customers of the firm than those who do not fare so well.²²⁹ Against this side of the economic calculus, however, are several considerations which make it in the integrated firm's self-interest to police the workings of its inside information policies to prevent improper transmissions of inside information across departmental lines. One of the greatest of these factors is the prospect of whopping civil liability to market investors who were (or may have been) on the opposite side of its customer's transactions.²³⁰

That evidence can be adduced to convince the trier of fact that a leak occurred is borne out by similar cases.²³¹ Moreover, any such

228. See *infra* notes 229-39 and accompanying text.

229. Thus, the ultimate profit to the firm and its sales representatives from tipping should probably be expressed as the discounted present value of the commission or spread received from the particular transaction, *plus* future commissions resulting from increased business from the customer.

230. In *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974), the securities firm, a nontrading "tipper," was held jointly and severally liable with its trading "tippees" to the plaintiffs, who had purchased the stock of Douglas Aircraft during the same period that the "tippees" were selling. See also ALI FED. SEC. CODE § 1724(c) (1980). *But cf.* *Fridrich v. Bradford*, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977) (broker defendant who purchased stock on inside information not liable to market sellers whose sales were not causally connected with defendant's purchases). Moreover, the greater the "leak" in the wall and the trading which occurs as a result (which may, of course, include the "tippees' tippees"), the more likely it is that it will come to the attention of private plaintiffs. To the extent that it is brought as a class action under FED. R. CIV. P. 23, once it is certified, it may not be dismissed or compromised without court approval. FED. R. CIV. P. 23(e). *Cf.* FED. R. CIV. P. 23.1 (same; shareholders' derivative actions).

231. See, e.g., *SEC v. Geon Indus., Inc.*, 531 F.2d 39, 46 (2d Cir. 1976) ("[T]he circumstantial evidence sufficed to justify the court's inference that [the tippee] was getting from [the tipper] something that was not available to the public."); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 852 (2d Cir. 1968), *cert. denied*, *Coates v. SEC*, 394 U.S. 976 (1969) ("[T]he [tippee's purchase] . . . was 'strong circumstantial evidence that Darke must have passed the word. . . .'").

Proving the leak will, in the main, require resort to circumstantial evidence. Such evidence, however, is regularly employed in securities cases to prove knowledge, intent, scienter, and the like. See 1 C. TORCIA, *WHARTON'S CRIMINAL EVIDENCE*, § 6 at 4-5 (13th ed. 1972); 2 J. WIGMORE, *EVIDENCE IN TRI-*

evidence—such as a change in the firm's outstanding recommendation, an increased volume of transactions in the affected security, and the like—is likely to be quite difficult for the firm to rebut, particularly if the scenario is one in which the SEC's presumption doctrine is invoked.²³² In addition to the risk of civil liability, a multi-service firm engaged in impermissible tipping risks disciplinary action by the SEC.²³³ It is also likely to suffer the oppor-

ALS AT COMMON LAW §§ 266-72 (Chadbourn rev. 1979). See also 11 Del. Code § 307 (1978) (circumstantial evidence permissible to show states of mind); *United States v. Shelton*, 82-1 U.S. TAX CAS. ¶ 9166 (7th Cir. 1982) (use of circumstantial evidence to prove conspiracy); *Gower v. Cohn*, 643 F.2d 1146 (5th Cir. 1981) (use of circumstantial evidence to show intent to defraud creditors); *Huddleston v. Herman & MacLean*, 640 F.2d 534 (5th Cir. 1981) (scienter); *McLean v. Alexander*, 599 F.2d 1190 (3d Cir. 1979) (scienter); *Nelson v. State*, 628 P.2d 884 (Alaska 1981) (knowledge that property was stolen); *State v. Greenawalt*, 128 Ariz. 150, 624 P.2d 828 (1981) (conspiracy); *Upshur v. State*, 420 A.2d 165 (Del. 1980) (intent). Indeed, it has been recognized that “[t]he advantages [of circumstantial evidence] are that, as the evidence commonly comes from several witnesses and different sources, a chain of circumstances is less likely to be falsely prepared and arranged, and falsehood and perjury are more likely to be detected and fail to their purpose.” *Commonwealth v. Webster*, 59 Mass. (5 Cush.) 295, 312 (1850) (per Shaw, C.J.).

232. See *Chazen & Lipton*, *supra* note 225, at 415. Given the likelihood that there will be ample evidence to prove a breach of the firm's Chinese Wall, the SEC's "presumption doctrine," see *supra* notes 215-16 and accompanying text, may well be unnecessary to enable either a private plaintiff or the Commission to prove its case. It should be noted that civil plaintiffs proceeding under rule 10b-5 may avail themselves of the liberal discovery provisions of FED. R. CIV. P. 26-37. See *Hickman v. Taylor*, 329 U.S. 495, 507 (1947) (“[T]he disposition-discovery rules are to be accorded a broad and liberal treatment. No longer can the time-honored cry of ‘fishing expedition’ serve to preclude a party from inquiry into the facts underlying his opponent's case.”). The SEC is also accorded broad investigative powers under § 21 of the 1934 Act, 15 U.S.C. § 78u (1982). Moreover, by placing the “risk of nonpersuasion,” 9 J. WIGMORE, *supra* note 231, § 2485, at 285, on the defendant, the presumption doctrine in effect requires the firm to prove that the fact in dispute did *not* occur, a task that may be formidable indeed. A private plaintiff does, of course, operate at some evidentiary disadvantage in actions against a multi-service firm in that the latter is in possession of all of the relevant information. But this disadvantage is not atypical of civil actions generally, where the general rule is that the party seeking to establish a fact has the burden of producing evidence on that point. See *generally id.* §§ 2485-86, 2489.

233. See, e.g., *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933 (1968). The SEC has recently suggested that monitoring of insider trading is a high priority of the Commission. See Address by Commissioner Bevis Longstreth before Fed. Bar Ass'n Sec. L. Comm., Nat'l Lawyers Club, Washington, D.C. (March 17, 1982). In addition, the New York Stock Exchange has increased the monitoring and analytical capabilities of its “stock watch” department in recent years, and has also moved to establish an “audit trail” to more closely match buy and sell orders executed on the Exchange. In 1981, the N.Y.S.E. opened trading investigations into 78% of the mergers and acquisitions that year involving Exchange-listed companies. Telephone Interview with Agnes Gauthier, Vice President of Trading Surveillance, The New York

brium and general loss of reputation which ensues from a public finding of unethical or illegal behavior by one invested with professional and fiduciary responsibilities.²³⁴

Perhaps the greatest incentive to the integrated firm to ensure that interdepartmental flows of inside information do not occur, however, is the very same reason that calls for judicial approval of the Chinese Wall as a defense to insider trading liability. That, in short, is the consequence that would result from rejection of the isolation technique, even in those instances where it can be expected to operate effectively. A failure to recognize the legitimate role of the Chinese Wall in these circumstances would seem to lead inexorably toward the requirement, *de facto* if not *de jure*, of full-scale segregation of investment banking from retail brokerage and investment advisory services.²³⁵

Perhaps if one were devising a regulatory utopia²³⁶ for the securities industry, it would not be wholly irrational to decree that an individual securities firm could hold out its shingle as an investment banker, or a broker-dealer, but not both.²³⁷ Given the industry and market structure as it has developed, however, the argument for that result comes quite late to carry the day.²³⁸ Even

Stock Exchange (April 6, 1982). Such investigations by regulatory authorities are regularly relied upon by putative plaintiffs to bring subsequent civil suits. See generally E. BRODSKY, GUIDE TO SECURITIES LITIGATION (1974). As to the mechanics of SEC enforcement actions in particular, see H. FRIEDMAN, SECURITIES AND COMMODITIES ENFORCEMENT: CRIMINAL PROSECUTIONS AND CIVIL INJUNCTIONS 1-134 (1981).

234. Cf. Méndez-Péñate, *supra* note 5, at 702-04 (banks).

235. See Lipton & Mazur, *supra* note 5, at 495.

236. "Utopia" has been defined as "[an] impractical and usually impossible ideal scheme. . . ." WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE 2525 (unabridged ed. 1981)

237. Cf. § 406 of the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. § 1106 (1982) (prohibiting a broker-dealer from providing multiple sources to an employee benefit plan); § 11(a) of the 1934 Act, 15 U.S.C. § 78k(a) (1982) (providing for various trading restrictions on the combination of retail brokerage and investment management).

238. See generally Lipton & Mazur, *supra* note 5, at 495. They note, *inter alia*, that mandated segregation would force many small integrated firms out of business. This would accentuate industry concentration, increase the cost of underwriting, diminish the market for securities of small, local companies, and lead to costly duplication of research facilities. See also 1 L. LOSS, *supra* note 29, at 167-68; N. WOLFSON, *supra* note 5, at 69.

A somewhat less extreme alternative, of course, would be to simply prohibit an individual firm from active involvement in retail activities with respect to securities of companies about which it possesses inside information, or with which it has an investment banking and corporate advisory relationship. For various reasons, mostly arbitrary, considerations of various formulations of a rule of this type are reserved for Part VI. See *infra* notes 279-306 and accompanying text. But, as to broker-dealer directorships, see *infra* notes 244-60 and accompanying text.

the SEC has recognized the enormous costs that forced segregation to the two functions would cause, both in terms of the industry's ability to raise capital for private business, and in its ability to serve adequately the needs of the investing public.²³⁹ Against this background, then, the upshot is that the only conclusion available for an integrated securities firm's retail broker-dealer business is that a good Chinese Wall, like a good fence, will make the investment banking department a much better neighbor.

2. *Investing for the Firm's Own Account*

As Lipton and Mazur have recognized, a markedly different set of considerations applies in the case of a walled firm with inside information (or access to it) which simultaneously engages in transactions for accounts in which the firm as a whole, or its principals, have a proprietary interest. The considerations call for a different result from that concerning retail brokerage activities, even though transactions for the firm's own accounts are executed by a separate department of the firm that does not generally have access to inside information acquired by its corporate finance division.²⁴⁰

At the outset, it should be noted (as Lipton and Mazur observed) that the ability of a multi-service firm's own-account trading division to continue "business as usual" in the face of inside information is neither essential, nor even necessarily desirable, to promote market liquidity. Nor is it essential to allow firms in the securities industry *per se* to remain competitive with other institutions (such as banks) in the investment management business.²⁴¹ Thus, there is no discernible social "good" which is actively promoted by permitting a securities firm to reap trading profits through market purchases and sales of the securities of public companies with which it also has an investment banking or corporate advisory relationship.

In the broker-dealer paradigm, the threat to the policies of the antifraud laws is sufficiently offset by other considerations to permit an effective Chinese Wall to serve to prevent the automatic imputation of inside information throughout the firm. In own-account investing, however, the threat to those policies is far less

239. See SEC, *Statement on Future Structure*, *supra* note 43, at 65,623 ("[T]he capital-raising ability of the industry and its ability to serve the public could be significantly weakened."). See also SEC, SPECIAL STUDY, *supra* note 8, pt. 5, at 39-40; SEC Brief, *supra* note 114, at 9 n.11.

240. Lipton & Mazur, *supra* note 5, at 501-02 (citing, *inter alia*, O.W. HOLMES, THE COMMON LAW 1 (1881) ("The life of the law has not been logic, it has been experience.")).

241. Lipton & Mazur, *supra* note 5, at 500.

counterbalanced.²⁴² In own-account trading, the firm, like any

242. The dangers of own-account trading by multi-service firms are aptly illustrated by *Walton v. Morgan Stanley & Co.*, 623 F.2d 796 (2d Cir. 1980). In that case, the plaintiffs brought a derivative action on behalf of Olinkraft, Inc. against Morgan Stanley. Morgan Stanley had been engaged by Kennecott Copper Corp. to find a company that it could acquire. Morgan Stanley considered Olinkraft, and the latter's management cooperated with the firm's Mergers & Acquisitions Department, supplying it with highly favorable internal earnings projections which were to be used only in connection with a possible bid by Kennecott. Ultimately, Kennecott did not bid for Olinkraft, but two other corporations did at a substantial premium above its market price at the time, whereupon Morgan Stanley's Arbitrage Department purchased nearly 150,000 shares of Olinkraft common stock on the "informed conviction" that a competing offer would be made. Later, Morgan Stanley utilized the confidential information it acquired from Olinkraft to induce Johns-Manville Corp. to make a substantially higher offer. Ultimately, Johns-Manville and Olinkraft came to an agreement in principle to merge, and presumably Morgan Stanley tendered its holdings of Olinkraft stock.

The Second Circuit held, applying Delaware law, that plaintiffs had standing to bring the action. It nonetheless upheld the trial judge's dismissal of the complaint for failure to state a claim upon which relief can be granted, since the parties had dealt only at arm's length, and the mere receipt of confidential information by Morgan Stanley did not change that relationship. Judge Oakes, dissenting, felt that "[t]he question presented very briefly is whether the complaint, broadly construed, states a sufficient relationship between Morgan Stanley and Olinkraft so as to prevent the former from using nonpublic material information obtained from the latter for his own profit." *Id.* at 800 (Oakes, J., dissenting). Judge Oakes felt that permitting plaintiffs to state a claim would not overly inhibit investment bankers, and alluded to the possibility of construing a Chinese Wall between the Mergers and Acquisitions Department and the Arbitrage Department. Even Judge Oakes, however, was unprepared to decide the validity of the wall in these circumstances, since the issue had not previously been decided by the Second Circuit. *Id.* at 802 n.4 (citing *Slade v. Shearson, Hammill & Co.*, 517 F.2d 398 (2d Cir. 1974)).

The author shares the same general difficulties as Lipton and Mazur in arriving at a workable definition of own-account trading for the purpose of translating this prohibition into a manageable rule for the industry to follow. Surely normal unsolicited dealer and marketmaking activities must be permitted to continue to ensure market liquidity. See Lipton & Mazur, *supra* note 5, at 501-02. I must, however, profess sharp disagreement with their conclusion with respect to arbitrage transactions by multi-service firms in connection with tender offers, mergers, acquisitions, and the like. Other potentially manipulative activities, such as post-distribution stabilizing activities, see SEC Securities Exchange Act Rule 10b-7, 17 C.F.R. § 240.10b-7 (1983), and marketmaking generally, promote investment liquidity and market depth, or permit a new distribution to be completed without a sharp price depression. These promote policies which are sufficiently strong to outweigh the general prohibitions of the antifraud rules. However, arbitrage transactions, like own-account trading generally, present one of the sharpest clashes between the firm's pecuniary self interest and its duty to refrain from trading on inside information. Moreover, unlike stabilizing activities, arbitrage transactions do not require the same public disclosure. See SEC Securities Exchange Act Rule 10b-7(k), 17 C.F.R. § 240.10b-7(k) (1983). See also SEC

other market investor with inside information, stands to profit by the full amount of the difference in the price of the security calculated without reference to the undisclosed information, and the "correct" price of that security measured by all relevant factors. Thus, the threat that self-interest will color the firm's investment decisions, coupled with the nonexistence of any policy served by permitting own-account trading to be continued, suggests that the general rule that the knowledge of any of a firm's agents is that of the firm itself should not be relaxed.²⁴³

3. Broker-Dealer Directorships

In its 1963 *Report on Special Study of the Securities Markets*, the SEC noted the prevalence of professionals in the securities industry who also serve on the boards of directors of publicly-held corporations.²⁴⁴ The very existence of such broker-dealer directorships, of course, presents the same conflicting obligations to the issuer, the investing public, and the firm's trading customers that are faced by an integrated firm which has an investment banking or corporate advisory relationship with a public company.²⁴⁵ Thus,

Securities Exchange Act Rule 17a-17, 17 C.F.R. § 240.17a-17 (1983) (notices and reports by block positioners).

243. Lipton & Mazur, *supra* note 5, at 501-02. In addition, a prophylactic rule forbidding transactions for the firm's own accounts while another department is in possession of inside information has the incidental benefit of preventing situations in which the firm's trading activities are inconsistent with the recommendations given to its customers. *Cf.* Alton Box Board Co. v. Goldman, Sachs & Co., 560 F.2d 916 (8th Cir. 1977). Also, since no third parties are directly involved, a suspension of own-account trading need not give rise to any "signal" that the firm has come into possession of inside information. *See infra* notes 300-02 and accompanying text.
244. The SEC reported that of 4,964 firms responding to its questionnaire, 476 (9.6 percent) stated that firm members, officers, or employees served as directors of one or more companies whose stock was traded on an exchange, and 995 (20.0 percent) replied that they had directorships in one or more over-the-counter (OTC) traded companies. Of these, 101 firms (2.0 percent), including several of the largest underwriters and brokerage houses, were represented on the boards of at least 10 public companies. SEC, SPECIAL STUDY, *supra* note 8, pt. 1, at 428-29.
245. *See generally supra* notes 24-45 and accompanying text. Thus, some firms have prohibited their members and officers from serving as corporate directors. *See* SEC, SPECIAL STUDY, *supra* note 8, pt. 1, at 432; Solomon & Wilke, *supra* note 224, at 520. *See also* Note, *supra* note 5, at 407-08. As noted, *supra* note 53, § 17(c) of the Public Utility Holding Company Act of 1935, 15 U.S.C. § 79q(c) (1982), prohibits registered public utility holding companies from having investment bankers on their boards of directors. In addition, the New York Stock Exchange prohibits partners, stockholders, and employees of specialists from serving as directors of companies in whose stock they specialize on the floor of the exchange. N.Y.S.E. Rule 406(b), 2 N.Y.S.E. GUIDE (CCH) ¶ 2460. *See also* 6 L. LOSS, *supra* note 29, at 3222, 3595-96.

in the wake of the development of the contours of the antifraud laws, it is not surprising that broker-dealer directorships have come under increasing scrutiny by both the Commission and commentators.²⁴⁶

Numerous benefits are alleged to ensue to corporations and their shareholders from having a broker-dealer occupy a seat on the board. In particular, the broker, by virtue of his general knowledge of business affairs, is said to be able to assist the company in formulating general corporate policy.²⁴⁷ In addition, the broker is able to bring his particular expertise regarding the modes and moods of the securities markets to bear in aid the corporation in its capital-raising endeavors.²⁴⁸ Third, it has been argued in support of the practice that the broker-dealer helps maintain a more orderly market in the company's securities by acting as its marketmaker, thereby promoting liquidity and depth for the company's shareholders, a benefit which redounds to the corporation through reduced capital costs.²⁴⁹

It has also been reported that many underwriters feel a certain responsibility for the post-distribution trading market in newer securities which they have helped put on the market in the first instance.²⁵⁰ In this regard, at least some firms apparently feel that their obligation to the company's public shareholders, particularly in the case of a first offering, extends beyond the underwriting period, and that they accept directorships to help ensure that the issuer is both honestly and competently managed.²⁵¹ The president of one firm put it this way:

— We do not believe that reputable investment banking houses are willing to accept the responsibility of underwriting and sponsoring the initial issuance of securities on the over-the-counter market by small and financially unsophisticated corporations unless a representative is placed on the

246. See *supra* note 245 and sources cited therein. See also Guttman, *Broker-Dealers Serving on Boards of Directors*, 77 COMM. L.J. 5 (1972). Cf. *Blau v. Lehman*, 368 U.S. 403 (1962) (investment partnership with a partner on a corporate board will be treated as a director for purposes of recovery of short-swing profits under § 16(b) of the 1934 Act, 15 U.S.C. § 78p(b) (1982), only if the partner was "deputized" to represent partnership's interest on the board); *Feder v. Martin Marietta Corp.*, 406 F.2d 260 (2d Cir. 1969) (deputization found to hold second corporation of which director was chief executive officer liable for short-swing profits under § 16(b)), *cert. denied*, 396 U.S. 1036 (1970). *But cf.* § 16(d) of the 1934 Act, 15 U.S.C. § 78p(d) (1982), which exempts market makers from the operations of § 16(b).

247. Guttman, *supra* note 246, at 5.

248. *Id.* See also Note, *supra* note 5, at 407.

249. See SEC, SPECIAL STUDY, *supra* note 8, pt. 3, at 43-45; Note, *supra* note 5, at 407-08.

250. See SEC, SPECIAL STUDY, *supra* note 8, pt. 3, at 44; Note, *supra* note 5, at 407-08.

251. SEC, SPECIAL STUDY, *supra* note 8, pt. 1, at 429.

board to check on the activities of the company and guide it in fulfilling its responsibilities as a "publicly held corporation," at least during a period of several years after it has first "gone public."²⁵²

Against these supposed benefits of broker-dealer directorships, of course, are the risks that such a regularized pipeline of confidential corporate information poses to the policies of the antifraud rules. In the particular case where the directorship is of a company that has only recently gone public through the underwriting efforts of the firm, the incentive to "tip," at least if the company's prospects unexpectedly go sour, may be considerably stronger than that present in the typical investment banker/broker-dealer paradigm. The stockholders of the new company will in all likelihood include a number of the firm's former customers, and to the extent that the broker-dealer has been placed on the board specifically to represent *their* interest, the ability of the director to keep such bearish news within walls may be sorely strained. Moreover, unlike more established companies for which there is an active and continual market, the risk of liability for such "tipping" may be considerably less.

In many cases, too, the firm may be the principal (if not the sole) marketmaker for the company's outstanding securities. Thus, it will likely have a significant proprietary interest in the issuer which the firm, however well intentioned, may find difficult to maintain in the face of bad news from the company.²⁵³ In sum, then, in the case of the typical broker-dealer directorship, the incentives to cheat may not be adequately ameliorated by other considerations.

These threats to all of the policies of the fraud rules suggest that the normal application of the rule that the firm's knowledge includes that of its partner or employee-director should not be relaxed, even though the firm may have constructed a Chinese Wall around that particular director.²⁵⁴ In addition, upon critical analysis it appears that the benefits that are alleged to flow from broker-dealer directorships are of quite minimal magnitude. The advantages to corporations, particularly small ones, of the securities professional's expertise in business affairs generally can scarcely be denied. But it is also quite clear that those benefits can be made equally available to the issuer by an underwriter contracted for in

252. *Id.*

253. *See, e.g.,* Black v. Shearson, Hammill & Co., 266 Cal. App. 2d 362, 72 Cal. Rptr. 157 (1968) (broker-director sold for his own account on receipt of adverse news while permitting retail salesmen to continue recommending purchases of the same securities to retail customers).

254. In any event, to the extent that the director is prohibited from transmitting confidential information to others within the firm, his role as a "watchdog" for the company's public shareholders is considerably reduced.

advance of any new issue, or by the purchase of corporate advisory services on a more continuous fee-for-service basis. One commentator has already noted that securities firms appear to extract compensation for their directorial services anyway through the expectation that any future underwriting business of the issuer will inure to the firm.²⁵⁵ Even if this were not the case, however, there is no apparent policy to justify the inevitable subsidization which must occur of the corporate clients who receive directorships from those who do not. And there is clearly no justification for permitting that director to continue as the marketmaker for the same company's securities while he occupies a seat on the issuer's board.

Furthermore, there are apparently other ways for the securities firm to assure both itself and the issuer's new public stockholders that the company is being both competently and honestly managed, without presenting the dangers to the antifraud laws that exist if the broker-dealer also makes a market in (or actively recommends) the securities of that issuer. In fact, many market makers who do not accept directorships have found that other mechanisms, such as outside directorships, work equally well.²⁵⁶ Such outside directorships might well be filled by others with financial and managerial expertise, or even by other investment bankers whose firms are not generally engaged in sponsoring the aftermarket for the securities of that company. Thus, the upshot is that broker-dealer directorships do not appear to promote the realization of other policies sufficient to neutralize the dangers that such a pipeline of inside information poses to the policies of rule 10b-5 in the case of a firm that is also actively engaged in retail activities with respect to the company's securities.²⁵⁷

Lipton and Mazur, however, take issue with this conclusion. They see little or no difference between the investment banking and directoral relationships of integrated securities firms and corporate issuers, since typically the broker-dealer director will be a principal in the same firm that serves as the corporation's investment banker.²⁵⁸ Having rejected forced segregation in the investment banking/broker-dealer situation, they would also reject it with respect to broker-dealer directorships.²⁵⁹ Their analysis, however, ignores critical distinctions between the two relation-

255. Note, *supra* note 5, at 407 (citing SEC, SPECIAL STUDY, *supra* note 8, pt. 3, at 46).

256. See SEC, SPECIAL STUDY, *supra* note 8, pt. 1, at 431.

257. See Note, *supra* note 5, at 408-09.

258. Whether this double symbiosis is of any benefit to the issuer is at least open to doubt. See *supra* note 255 and accompanying text.

259. Lipton & Mazur, *supra* note 5, at 497-98.

ships. Unlike the investment banker/broker-dealer situation, which in and of itself operates to promote liquidity and depth in the market without the attendant risks to the policies of the antifraud laws, the broker-dealer directorship, in and of itself, serves none of these policies. More importantly, as Lipton and Mazur apparently recognize, the investment banking relationship between a firm and a company tends to be of relatively short duration.²⁶⁰ Hence, the opportunities for the firm to obtain inside information from the issuer are relatively limited, and infinitely more sporadic, in the investment banking context. In contrast, however, when a member or employee of the firm occupies a board position, the potential for access to nonpublic news about the company is present for as long as the firm is represented on the board, which may be many years. This fact, coupled with the minimal benefits ensuing from the relationship that cannot be obtained equally well through other means, sufficiently distinguishes the directorial situation from that of investment banking. This commands that an exception to the normal rule of firm-wide imputation of knowledge should not be created to allow a firm to attempt to wall off one of its partners or employees who occupies a corporate directorship. Finally, it should be noted that this rule is not tantamount to full-scale segregation of any important market functions. The risk of liability for insider trading is only present if the firm wishes *both* to have a directorship *and* to make a market (or actively make recommendations) in the company's securities. Thus, if a particular multi-service institution concludes that a directorship is necessary to protect the interest of the shareholders or to aid a company, it need only give up its market making or advisory role.

VI. THE CHINESE WALL AND THE MULTI-SERVICE FIRM'S OBLIGATIONS TO ITS TRADING CUSTOMERS

An effective Chinese Wall surrounding the integrated securities firm's investment banking department may operate quite adequately to mitigate the danger that the firm will improperly utilize confidential information to benefit its retail broker-dealer and investment management customers. Nevertheless, the very existence of the wall places the firm in constant jeopardy that its investment advisory and management personnel will make recommendations and execute transactions that are *inconsistent* with the tenor of that inside information.²⁶¹ In these situations, how-

260. See Lipton & Mazur, *Reply, supra* note 5, at 582 ("[T]he investment banker's confidential relationships with its clients are generally of much shorter duration than those of the commercial banker.").

261. See, e.g., *Slade v. Shearson, Hammill & Co.*, [1973-1974 Transfer Binder] (CCH) ¶ 94,329 (S.D.N.Y.), *remanded*, 517 F.2d 398 (2d Cir. 1974).

ever well the firm's Chinese Wall may satisfy its obligation to the investing public not to tip or trade in violation of the "disclose or abstain" aspect of rule 10b-5, the isolation policy arguably serves to frustrate the fiduciary and disclosure obligations owed to the firm's retail customers.²⁶² As in the insider trading paradigm, the essential legal question facing the firm in any claim of insufficient disclosure is whether the nonpublic knowledge about the issuer possessed by its investment banking department will be attributed to the firm as a whole, and to its broker-dealer and investment management divisions.²⁶³ Such an attribution, of course, will result in the firm's having made a recommendation, or executed a transaction for a managed account, in violation of the duties imposed upon it both as a common law agent and fiduciary,²⁶⁴ and by the "shingle theory" developed under the federal securities laws.²⁶⁵

Any judicial imputation of knowledge "across the wall," however, must be premised either on some perceived duty of the firm to utilize inside information to benefit its retail trading customers (or at least to save them from financial harm), or upon the premise that, under the particular circumstance, the firm should have refrained from making *any* recommendation or executing *any* discretionary transaction in the tainted securities until the inside information was made public. As will be more fully developed, however, there is no justification in the policies of the antifraud laws for making such an imputation of knowledge in those situa-

262. See *supra* notes 37-46 and accompanying text.

263. See ALI FED. SEC. CODE § 202(86)(C) (1980). As in the insider trading situation, common law cases do not provide a definitive answer to the imputation question. See *supra* notes 192-99 and accompanying text. *But cf.* *Hazard v. Chase Nat'l Bank*, 159 Misc. 57 (N.Y. Sup. Ct. 1936), *aff'd*, 257 A.D. 950, 14 N.Y.S.2d 147 (1939), *aff'd*, 282 N.Y. 652, 26 N.E.2d 801, *cert. denied*, 311 U.S. 708 (1940). In *Hazard*, bondholders of a defunct company brought an action against the indenture trustee, a bank. The court attributed the knowledge of one of the bank's non-trust department officers of the obligor's insolvency to the bank as a whole, even though the trust department was fully segregated and operated at a different address from the remainder of the bank, because the *entire* bank was the trustee under the terms of the indenture. The bank was nonetheless absolved from liability because it was not "grossly negligent" as required by the indenture agreement. *Hazard* is distinguishable, however, from the typical situation of a multi-service securities firm with a Chinese Wall policy, because the officer's knowledge of the obligor's insolvency clearly *should* have been available to the fiduciary trust department. The case is also interesting for the trial judge's lamentations of the "ostrich clauses" in trust indentures, which absolve the trustee from nearly any type of behavior. Much of this, of course, has since been alleviated by the Trust Indenture Act of 1939, 53 Stat. 1149, *as amended*, 15 U.S.C. §§ 77aaa-77bbbb (1982).

264. See *supra* notes 37-41 and accompanying text.

265. See *supra* notes 42-45 and accompanying text.

tions where the firm's relationship to its corporate client on the one hand, and its trading customers on the other, merely involves the performance of fiduciary obligations to two masters whose underlying interests may diverge, but where the firm's *own* economic interests are not particularly allied with either. By contrast, however, in those instances—particularly involving formal underwritings of new securities—where the investment banker's service to an issuer inescapably places the firm's interests at odds with those of its retail customers, imputation of knowledge throughout the firm supports the policies of the fraud rules, with a minimal corresponding cost in terms of the quality of investment advice the broker-dealer is able to render. In these latter situations, then, the multi-service firm should both abstain from making recommendations concerning, or executing transactions for managed accounts in, the outstanding securities of the firm's underwriting client. Because any such recommendations or transactions possess the inherent danger of being motivated by the economic interests of the firm itself, this "hands off" policy is necessary to ensure that the firm does not give short shrift to the investment performance goals of its retail clientele.²⁶⁶

A. *The "Dual Master" Paradigm*

The classic instance in which an integrated securities firm may find itself positioned between two sets of clients whose individual economic interests may diverge, but where the firm itself is not peculiarly allied with either, is when its investment banking or corporate finance department is engaged in providing general financial or managerial guidance to a publicly-held issuer. So long as the firm is remunerated on a contracted for, or fee-for-service basis, and not on the basis of its success in peddling the securities of that issuer to its retail customers, there is no reason to suppose that the firm will act in derogation of its fiduciary obligations to its trading customers in an effort to benefit either itself or its corporate customer.

In performing its contractual obligations to the issuer, the firm may, of course, come into possession of material nonpublic information about the company or its securities that is contrary to the thrust of the total mix of publicly-available information about that company. Once it has acquired any confidential information, the

266. Regardless of the type of relationship between the firm and the user, if it is of a type that is likely to lead to the acquisition of inside information by the firm, it should also suspend transactions in the affected securities for its proprietary accounts until that relationship is terminated and any inside information in its possession is made public. *See supra* notes 240-43 and accompanying text.

firm is immediately obliged to respect its confidential character, at least until the issuer releases it from that obligation.²⁶⁷

Simultaneously with the performance of its advisory services to its corporate client, the firm's retail sales force may be making recommendations and executing transactions in the outstanding securities of that issuer on the basis of whatever public information is available regarding that company. To the extent that these retail transactions result in financial loss to their ultimate beneficiaries, the firm may be subject to a claim for damages by its retail customers for those transactions which are inconsistent with *all* relevant information possessed by the firm, including the confidential information "walled off" in the files of its corporate finance or investment banking division.²⁶⁸ As noted, however, any attribution of the nonpublic knowledge of the investment banking department throughout the firm must somehow ultimately be premised on a perceived duty of the integrated firm to utilize *all* information, including inside information, to benefit or avoid investment loss to its trading clients. Alternatively, the notion must be that the firm should simply avoid *any* recommendations concerning, or discretionary transactions in, the securities of its corporate clients during the pendency of any relationship giving rise to the receipt of confidential information by the firm. There is no justification for either premise, however, in these instances where the firm's self-interest is not somehow allied with that of its corporate client and at odds with the interests of its retail account holders.

1. *Inside Information and Retail Customers*

The cases arising under rule 10b-5 make it abundantly clear that a multi-service securities firm may not, consistent with the strictures of the antifraud rules, utilize inside information garnered in its role as investment banker to a publicly-held corporation either to recommend or execute discretionary transactions for its favored customers.²⁶⁹ As the Second Circuit said in *Shapiro*,

267. See *supra* notes 24-28 and accompanying text.

268. See, e.g., *Local 734 Bakery Drivers Pension Fund Trust v. Continental Ill. Nat'l Bank and Trust Co. of Chicago*, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,565 (N.D. Ill. 1974), *aff'd sub nom. O'Brien v. Continental Ill. Nat'l Bank & Trust Co. of Chicago*, 593 F.2d 54 (7th Cir. 1979); *Slade v. Shearson, Hammill & Co.*, [1973-1974 Transfer Binder] (CCH) ¶ 94,329 (S.D.N.Y.), *re-manded*, 517 F.2d 398 (2d Cir. 1974).

269. See, e.g., *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974); *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933 (1968); *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961). See also *In re Investors Management Co.*, 44 S.E.C. 633 (1971) (unlawful for customers to use such inside information) (see *supra* notes 213-15 and accompanying text for a discussion of this case).

the “[d]ivulging of confidential material inside information to [its] customers” is a clear violation of section 10(b) and rule 10b-5.²⁷⁰ Nor may the firm simply make inside information available to *all* of its customers; inasmuch as they would still possess unearned information advantages vis à vis customers of all other securities firms and the investing public at large, the firm would still be guilty of impermissible tipping in violation of the rule. Indeed, the wider the firm’s disclosure of inside information (short of public disclosure), the wider the “tipper” liability to which the firm would ultimately be exposed.²⁷¹

Nonetheless, it might still be argued that the firm is at least obliged to act to prevent its investment advisory personnel from

270. *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 237 (2d Cir. 1974). Were it not for the development of the prohibition against trading on or tipping inside information under the federal antifraud rules, a respectable common law argument could be made that a fiduciary has a duty to use confidential information to benefit or prevent harm to his principal. See Rider, *supra* note 47, at 81-82 (citing G. COOPER & R. CRIDLAN, *THE LAW AND PROCEDURE OF THE STOCK EXCHANGE* 104 (Butterworths 1971)). In *North & South Trust Co. v. Berkeley*, [1971] 1 All E.R. 980, an insurance broker that acted for both the insured and an insurance underwriter received a confidential assessor’s report for the underwriter. The insured demanded delivery of the assessor’s report, and the underwriter brought an injunction action against the broker to restrain the latter from releasing it on that ground that the report was its confidential property. The court ruled that the broker was under a duty to deliver the report to the insured, and that it was irrelevant that it would have been privileged if it had been in the underwriter’s possession. In the course of its opinion, the court underscored the “fundamental rule” that an agent cannot place himself in a fiduciary position to a second principal (the underwriter) without obtaining his first principal’s (the insured’s) consent, and if he does so, the agent will nonetheless be liable to his first principal for his inability to fully discharge his duties to the latter. Thus, “[i]f X, a third party, knowing that A is the agent of P, the principal, enters into an agreement with A involving duties which are inconsistent with those owed by A to P, then, the absence of the fully informed consent of P, X acts at his own peril. . . .” [1971] 1 All E.R. at 993. Moreover, even at common law, it is clear that the fiduciary may not use confidential information to benefit himself at the expense of his beneficiary. See, e.g., *Boardman v. Phipps*, [1967] 2 A.C. 45 (trustee/solicitor and one beneficiary held accountable to the trust for profits made through the use of confidential information relating to a company which they had acquired while representing the trust), *aff’g* [1965] Ch. 992, *aff’g* [1964] 2 All E.R. 187. See also *supra* note 39. Prior to the Companies Act 1980, of course, insider trading in Great Britain was not illegal, only “unfair.” Rider, *supra* note 47, at 83 (citing *Buttle v. Saunders*, [1950] 2 All E.R. 193; *Chuckmere Brick Co. Ltd. v. Mut. Fin. Ltd.*, [1971] Ch. 949; Ffrenchh & Rider, *Should Insider Trading be Regulated? Some Initial Considerations*, [1978] 95 S.A.L.J. 79, 82-87).
271. In addition, as has been adumbrated earlier, see *supra* notes 218-24 and accompanying text, there are both practical and legal obstacles to requiring the firm to make public disclosure of all material, inside information which may come into its possession during the course of an investment banking relationship with a corporate client.

recommending (or its trading customers from executing) transactions which inside information in its possession suggests are ill-advised. Under this formulation of the scope of the broker-dealer's obligation, the firm would be required, for example, to attempt to prevent purchases of securities of companies which the firm, through its investment banking division, knows to be overpriced because the issuer is having, or about to have, undisclosed financial difficulties.²⁷² Similarly, the firm would be obliged to act to *prevent* its customers from selling securities issued by investment banking clients which the firm believes, on the basis of inside information, will make a major new discovery, be subject to a tender offer, or otherwise to increase in price.²⁷³ To the extent that no transactions actually result from the firm's dissuasion, a rule of this sort has an appealing aura to it. The firm can avoid claims against it from both dissatisfied customers, and, since there is no market investor on the other side of its customers' transactions, it does not run the risk of widespread civil liability for impermissible

272. See, e.g., Herzel & Colling, *supra* note 5, at 85; Rider, *supra* note 47, at 81, 89 (citing Jones v. Canaron, 1972(2) N.S.W.R. 236. See also Local 734 Bakery Drivers Pension Trust Fund v. Continental Ill. Nat'l Bank & Trust Co. of Chicago, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,565 (N.D. Ill. 1974) (plaintiffs claimed, but the court did not decide, that a multi-service bank is obliged to utilize inside information to prevent its fiduciary trust department from making ill-advised purchases), *aff'd sub nom.* O'Brien v. Continental Ill. Nat'l Bank & Trust Co. of Chicago, 593 F.2d 54 (7th Cir. 1979); Slade v. Shearson, Hammill & Co., [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,329 (S.D.N.Y.), *remanded*, 517 F.2d 398 (2d Cir. 1974).

It is clear, however, that the Securities and Exchange Commission is of the view that even withdrawal of an outstanding "buy" recommendation on the basis of material inside information is a violation of rule 10b-5. See Complaint filed in SEC v. Celanese Corp., 74 Civ. 3053, ¶ 13 (S.D.N.Y. 1974); Complaint filed in SEC v. Bausch & Lomb, Inc., 73 Civ. 2458 (S.D.N.Y. 1973).

Finally, it should be noted that in those circumstances where the firm does "tip" some customers, but not others, the "untipped" customers have no cause of action against the firm under rule 10b-5. In two cases arising out of the Merrill Lynch/Douglas Aircraft proceedings, the Southern District of New York has ruled that because they were neither purchasers nor sellers of securities, untipped customers do not meet the requirement of *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1956). See *Smachlo v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1970-1971 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,148 (S.D.N.Y. 1971); *Shulof v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1970-71 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,147 (S.D.N.Y. 1971). See also *Levine v. Seilon, Inc.*, 439 F.2d 328, 333 (2d Cir. 1971) (dictum) ("[Plaintiff] could hardly be heard to claim compensation for the premium he might have extracted from some innocent victim if he had known of the fraud and the buyer did not."). As to the "purchaser" or "seller" requirement for standing under rule 10b-5, see *infra* note 277.

273. See, e.g., SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (rich new mineral discovery), *cert. denied*, *Coates v. SEC*, 394 U.S. 976 (1969).

tipping.²⁷⁴

Even such advice *not* to trade, however, is fraught with both practical and legal hazards to the firm. In the first place, *any* transmission of confidential information by the firm acquired in its capacity as agent to the issuer, whether explicitly or implicitly in the form of a naked "hold" recommendation, is a breach of the firm's obligation to its corporate client to keep corporate secrets secret.²⁷⁵ In addition, there is always the danger that the firm's customers will pass along the inside information to others who *will* utilize it to transact in the affected securities at the current market price, thereby exposing the firm to potential tipping liability for the transactions of its "tippees' tippees."²⁷⁶

More importantly, however, even advice or knowledge that does not lead directly to market transactions which would otherwise occur presents the very same abuse that the antifraud rules were designed to curb in the transactional context. In either instance, the relevant market for the affected securities is skewed from that market that would otherwise exist if all investors made their investment decisions solely on the basis of available public information. Further, allowing some investors to avoid the general market risk of loss attending their investments would smack of the same inherent unfairness as would reaping untoward gains, and can thus be expected to further erode investor confidence in the workings of the public securities markets. That this ultimate effect may occur in instances where transactions are *prevented* may be even more marked than in cases where purchases or sales actually occur, since private litigants are in cases of the former type disabled from suing to recover their trading losses.²⁷⁷

It was surely considerations such as these that led the SEC to remark on the scope of the securities professional's obligation to its trading customers as follows:

While [the broker] undoubtedly occupied a fiduciary relationship to his customers, this relationship could not justify any action by him contrary

274. In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), the Court held that a private plaintiff in a rule 10b-5 action must actually have been a purchaser or seller of securities. *See also* *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1956); A.L.I. FED. SEC. CODE § 1722(b) (2d Supp. 1981).

275. *See supra* notes 24-28 and accompanying text. *See also* Lipton & Mazur, *supra* note 5, at 475.

276. *See* Lipton & Mazur, *supra* note 5, at 475. In addition, the SEC might bring disciplinary proceedings against a firm engaged in dissuading investors from transacting on the basis of inside information. *See supra* note 272. The Federal Securities Code would make this possibility clear. *See* ALI FED. SEC. CODE § 1603(b), comment (3)(a)(ii) (1980).

277. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). *See supra* note 274.

to law. Even if we assume the existence of conflicting fiduciary obligations, there can be no doubt which is primary here. On these facts, clients may not expect of a broker the benefits of his inside information at the expense of the public generally. . . .²⁷⁸

2. *The Effect of a "Restricted List"*

Lipton and Mazur, however, argue that permitting a multi-service securities firm which has a confidential relationship with a publicly-held corporation to continue "business as usual" in its broker-dealer and investment advisory departments would operate to the detriment of ordinary investors, at least in those instances where the firm's advice turns out to be imprudent in light of the inside information known to its investment banking department.²⁷⁹ They suggest that the firm may not rely solely on the Chinese Wall to restrict interdepartmental flows of nonpublic information. Rather, in order to avoid liability to its customers for advice which is inconsistent with *all* the information known to it, the firm must suspend all activities in which a recommendation, express or implied, as to the investment merits of a transaction in the securities of a corporate client may fairly be inferred from the communications by the firm to its customers.²⁸⁰ In addition, they contend that this "no recommendation" or "restricted list" policy should be imposed on the firm's brokerage and advisory departments at the outset of the firm's relationship with the issuer, and should be continued until that relationship is terminated.²⁸¹

The obvious merit in Lipton and Mazur's approach is that it operates both to avoid recommendations that are inconsistent with the total mix of information about the issuer available to the firm as a whole,²⁸² and also to prevent improper trading or tipping on inside information if the firm's Chinese Wall proves inadequate to bar interdepartmental flows of inside information.²⁸³ In addition, it appears to be quite consistent with the approach suggested by the SEC in the *Slade* case.²⁸⁴

Lipton and Mazur recognize that the inside information cases prohibit a securities firm in possession of inside information from

278. *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 916 (1961) (footnote omitted). See 2 A. SCOTT, *supra* note 27, § 166, at 1265 (trustee is not obliged to violate the law to benefit the trust); RESTATEMENT (SECOND) OF TRUSTS §§ 61, 166 (1959). See also *supra* note 40.

279. *Lipton v. Mazur*, *supra* note 5, at 499, 502-03.

280. *Id.* at 489, 506. See also *Chazen*, *supra* note 5, at 553; *Solomon & Wilke*, *supra* note 224, at 536.

281. *Lipton & Mazur*, *supra* note 5 at 468, 502-06.

282. See *Chazen*, *supra* note 5, at 555.

283. *Id.* at 556.

284. See SEC Brief, *supra* note 114, at 4-13.

utilizing that information to directly benefit its retail brokerage and investment management customers.²⁸⁵ They argue, however, that the firm's customer-oriented disclosure obligations, stemming from the "shingle theory" cases, also prohibit a firm from making recommendations that might subsequently turn out to be inconsistent with the inside information available to the firm as a whole at the time of the recommendation. They conclude, then, that the only way for both sets of obligations to be accommodated is for the firm to avoid *any* recommendations during the pendency of the investment banking department's relationship with the issuer of the affected securities.²⁸⁶

A careful reading of the shingle theory cases, however, suggests that their internal rationale does not extend so far as to require a multi-service firm's retail departments to suspend normal investment advisory services *merely* because another department of the same firm has come into possession (or is likely to come into possession) of material inside information. Moreover, requiring the integrated firm to so suspend its advisory functions poses independent dangers to the policies of the antifraud rules, and has a deleterious effect on both the investment performance of unsophisticated investors and in the firm's ability to serve adequately its trading clientele. Thus, such a rule ought not to be superimposed on the industry in the absence of a showing that it is required by the economic realities of the firm's relationships with its various customers.

As noted, the premise of the shingle theory is that in many instances a broker-dealer, merely by hanging out his shingle, impliedly warrants that he will deal fairly with the investing public.²⁸⁷ Thus, among other things, a firm may not take an excessive spread on dealer transactions;²⁸⁸ nor may it deal with a customer as a market maker in the underlying securities without disclosing that fact.²⁸⁹

In addition, a number of the early cases decided by the Commission or the courts found that the broker-dealer's implied warranty of fairness had been breached through its failure to disclose material factual information relating to the investment. The early cases, primarily involving "boiler room blitz" activities of over-the-counter securities houses,²⁹⁰ led to the following articulation of the

285. Lipton & Mazur, *supra* note 5, at 470-74.

286. *Id.* at 474, 502-05. *See also* Chazen, *supra* note 5, at 559-60.

287. *See supra* note 42 and accompanying text.

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

289. *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972); *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970). *See also supra* note 42.

290. *See, e.g., In re Mayo & Co.*, 41 S.E.C. 944 (1964); *In re Norman Joseph Adams*,

grounds for imposing duties beyond that of common law fraud:

The essence of [the "shingle theory"] is that in certain circumstances one who sells securities to the public—who hangs out his shingle—implicitly warrants the soundness of statements of stock value, estimates of a firm's earnings potential, and the like. When a firm conceals known information inconsistent with this "implicit warranty of soundness" it has omitted a material fact without which the statement made would be misleading.²⁹¹

The propriety of imposing sanctions upon a firm for engaging in the fraudulent activities involved in the typical "boiler room" operation can hardly be disputed. Indeed, resort to the shingle theory was probably necessary in light of the positive misrepresentations that inevitably seem to accompany that type of sales campaign. The cases in which the disclosure aspect of the shingle theory has been applied have not, however, stopped with such blatantly egregious conduct by industry professionals. In 1962 the SEC described the "adequate basis" requirement in the following terms:

[I]t is a violation of the anti-fraud provisions for a broker-dealer to recommend a security unless there is an adequate and reasonable basis for the recommendations and further . . . such recommendations should not be made without disclosure of facts known or reasonably ascertainable, bearing upon the justification for the recommendation. As indicated, the making of recommendations for the purchase of a security implies that the dealer has a reasonable basis for recommending securities which, in turn, requires that, as a prerequisite, he shall have made a reasonable investment. In addition, if such dealer lacks essential information about the issuer, such as knowledge of its financial condition, he must disclose this lack of knowledge and caution customers as to the risk involved in

41 S.E.C. 501 (1963); *In re Harold Grill*, 41 S.E.C. 321 (1963); *In re Banner Sec., Inc.*, 41 S.E.C. 304 (1962); *In re MacRobbins & Co.*, 41 S.E.C. 116 (1962), *aff'd sub nom. Berko v. SEC*, 316 F.2d 137 (2d Cir. 1963). See also *Kahn v. SEC*, 297 F.2d 112 (2d Cir. 1961).

It has been observed that:

Generally speaking, a boiler room in its full flower means an organization which is engaged almost exclusively in selling securities over the long-distance telephone to customers whose names are derived from lists obtained from either prior boiler rooms or compilers of lists, and where the only criterion for a salesman's performance is how many sales can be made at the lowest cost of long-distance tolls, with the result that the high pressure really builds up. Hence the name boiler room.

Usually the securities they sell are somewhat obscure, partly because these securities are easier to get hold of in quantity, and partially because the boiler room prefers to have a security about which there is not any information available, so nobody will check up on what they say or at least until it is too late.

SEC, SPECIAL STUDY, *supra* note 8, pt. 1, at 265 (footnote omitted) (remarks of Philip A. Loomis, Jr.). See also *Commodity Futures Trading Comm'n v. Crown Colony Commodity Options, Ltd.*, 434 F. Supp. 911 (S.D.N.Y. 1977) (boiler room sales of commodities).

291. *Kahn v. SEC*, 297 F.2d 112, 115 (2d Cir. 1961) (Clark, J., concurring).

purchasing the securities without it.²⁹²

Taken to its literal extreme, this formulation of the firm's obligation to its trading customers would require it to avoid *any* recommendation, or execute *any* transaction that is inconsistent with any inside information known to any department of the firm. It is clear, however, that the theory does not extend that far.²⁹³ Moreover, the cases in which the obligation *has* been brought home do not command such a wooden application of the rule to impose liability upon an effectively walled firm *merely* because it possesses inside information that is inconsistent with the firm's overall recommendation. In the vast majority of the "adequate basis" or "Know Thy Security" doctrine cases, the broker-dealer involved was on both sides of the informational fence, and made *knowing* false statements or half-truths (or widely optimistic and unfounded predictions) concerning the future value of the customer's investment.²⁹⁴ In many cases, it was also clear that the omitted

292. SEC Securities Exchange Act Release No. 6721, at 3, 2 FED. SEC. L. REP. (CCH) ¶ 22,758 (Feb. 2, 1962). As noted, *supra* note 43, the Commission is of the view that this obligation extends to unsolicited transactions as well. See SEC, *Statement on Future Structure*, *supra* note 43. But see *infra* note 293 and sources cited therein.

293. See, e.g., *White v. Abrams*, 495 F.2d 724, 735-36 (9th Cir. 1974) (lower expectations of customers who make independent investment decisions); *Canizaro v. Kohlmeyer & Co.*, 370 F. Supp. 282, 286-89 (E.D. La. 1974), *aff'd per curiam*, 512 F.2d 484 (5th Cir. 1975); *Phillips v. Reynolds & Co.*, 294 F. Supp. 1249 (E.D. Pa. 1969). Cf. *Anderson v. John P. Chase, Inc.*, [1974-1975 Transfer Binder] FED. SEC. L. REP. ¶ 95,009 (CCH) (S.D.N.Y. 1975) (investment adviser not liable for trading losses of sophisticated investor when parties by contract specifically limited the scope of the advisory services defendant was to provide), *aff'd mem.* No. 75-7239 (2d Cir. Nov. 13, 1975). But cf. *In re Scientific Control Corp. Sec. Litig.*, 71 F.R.D. 491, 512 (S.D.N.Y. 1967) (dictum) ("As a general matter, the securities laws do not distinguish between sophisticated and unsophisticated investors; both are entitled to the protections of its disclosure and antifraud provisions."). See also S. JAFFE, *supra* note 8, § 7.02, at 132:

[A] second problem arises when the standards of liability imposed in Commission enforcement cases are applied to brokerage firms which engage in secondary trading transactions . . . A literal reading of some enforcement cases would require a due diligence investigation for each sale effected by the broker, notwithstanding commission limitations which limit the charges to five per cent of the sale proceeds. The economic issue presented is whether the law requires a \$1,000 investigation for a \$1,000 transaction, when the commission will be less than \$50.00.

See generally N. WOLFSON, R. PHILLIPS & T. RUSSO, *REGULATION OF BROKERS, DEALERS AND SECURITIES MARKETS* ¶ 2.09 (1977 and Supp. 1979).

294. See, e.g., *Feeney v. SEC*, 564 F.2d 260 (8th Cir. 1977); *Hiller v. SEC*, 429 F.2d 856 (2d Cir. 1970); *Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124 (4th Cir. 1970); *Hanly v. SEC*, 415 F.2d 589 (2d Cir. 1969); *R.A. Holman & Co. v. SEC*, 366 F.2d 446 (2d Cir. 1966), *modified on other grounds*, 377 F.2d 665 (2d Cir.), *cert. denied*, 389 U.S. 991 (1967); *In re Aircraft Dynamics Int'l Corp.*, 41 S.E.C. 566

information could (and should) have been lawfully disclosed,²⁹⁵ and the securities involved were often of new and highly speculative companies for which, *ex hypothesi*, there was little or no public information available.²⁹⁶ Further, even in those cases where the firm making the recommendation was genuinely ignorant of the challenged facts, there is the air of an ostrich-with-its-head-in-the-sand attitude on the firm's part whereby it continued to recommend purchases despite strong warning signals that all was not as had been made out to be.²⁹⁷ Finally, in at least some of the decisions, the firm had been actively trading for its own account in a manner that was wholly at odds with the advice it was simultaneously giving to its retail customers.²⁹⁸

The reported cases, then, all involve the appearance if not the reality of real fraud or bad faith. Thus, they stand in marked contrast to the situation in which a multi-service securities firm makes a recommendation after it *has* conducted a thorough investigation of the merits of the investment based on all of the publicly-available knowledge about the securities involved. To extend the threadbare language of these cases to impose liability on a firm merely because its investment banking department possessed contradictory inside information—which it was prohibited from disclosing—would represent an unwarranted addition to the obligations imposed on the securities industry.²⁹⁹

In addition to the dearth of support in the shingle theory cases, the imposition of such a rule would pose positive dangers to the policies of the antifraud rules. The most significant of these is the

(1963); *In re Alexander Reid & Co.*, 40 S.E.C. 986 (1963); *In re Biltmore Sec. Corp.*, 40 S.E.C. 273 (1960).

295. *See, e.g.*, *Feeney v. SEC*, 564 F.2d 260 (8th Cir. 1977); *Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124 (4th Cir. 1970); *Hanly v. SEC*, 415 F.2d 589 (2d Cir. 1969).

296. *See, e.g.*, *Feeney v. SEC*, 564 F.2d 260 (8th Cir. 1977); *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, SEC Securities Exchange Act Release No. 14,149 [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,365 (Nov. 9, 1977); *In re Shearson, Hammill & Co.*, SEC Securities Exchange Act Release No. 7743, [1964-1966 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,306 (Nov. 12, 1965).

297. *See, e.g.*, *Alton Box Bd. Co. v. Goldman, Sachs & Co.*, 560 F.2d 916 (8th Cir. 1977); *University Hill Found. v. Goldman, Sachs & Co.*, 422 F. Supp. 879 (S.D.N.Y. 1976); *Robinson v. Penn Cent. Co.*, [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,772 (S.D.N.Y. 1973). *But cf.* *Carroll v. Doolittle*, 21 Misc. 2d 203, 191 N.Y.S.2d 398 (Sup. Ct. 1959) (at common law, a broker has no duty to inquire behind the decisions of an investment banker).

298. *In Alton Box Bd. Co. v. Goldman, Sachs & Co.*, 560 F.2d 916 (8th Cir. 1977), for example, the defendant was sharply reducing its own inventory in Penn Central commercial paper at the same time that it was touting it as a "prime" investment to the plaintiff. *See also* *Black v. Shearson, Hammill & Co.*, 266 Cal. App. 2d 362, 72 Cal. Rptr. 157 (1968) (state law). *Cf.* *SEC v. Capital Gains Research Bureau, Inc.*, 376 U.S. 180 (1963) (scalping by investment adviser).

299. *See also* *Chazen*, *supra* note 5, at 559-63.

almost inevitable "signal" effect that results when a major securities house places a particular security on a master list that is "off limits" to its retail sales force. Lipton and Mazur attempt to alleviate this effect by requiring that a firm list a security as soon as the investment banking department enters into any relationship with a corporate issuer that is likely to give rise to the receipt of inside information by the firm. By this technique, they argue, the mere act of listing will not be perceived as a signal to the investment community that the firm has come into possession of inside information. Nor would it reveal the character—confirmatory or contradictory—of that information relative to the available public information about the issuer.³⁰⁰ As Chazen correctly observes, however, the very act of listing a security must be analyzed in the context of a market in which rumors may be every bit as powerful a motivating transactional force as confirmed facts.³⁰¹ As he notes, "[i]magine, for example, the market impact of a notice that a public company, rumored to be a prospective tender offer target, had been placed on the restricted list of an investment banking firm known to have counseled the rumored tender offeror."³⁰²

As Chazen's example illustrates, the mere act of listing a security will often either fan the flames of existing rumor, or independently give rise to new ones. In either event, the listing procedure operates to cause market transactions that would not otherwise occur on the basis of available public information about the issuer and its securities. In so doing, of course, the restricted list procedure endangers the goal of allocational efficiency of investor resources and also operates, at least in those instances (which are likely to be many) where the rumored facts do not materialize, to further erode public confidence in the workings of the securities markets.

In addition, there is probably good reason to believe that such a blanket "no recommendation" or "restricted list" procedure will be difficult, if not impossible, to enforce within the firm itself. A large institution, such as Merrill Lynch or Paine, Webber, which has a large and widely diverse retail sales force, may have considerable difficulty in preventing "side" recommendations by overly enthusiastic brokerage personnel who have (or think they have) something to offer that the rest of the investment community does not share.³⁰³ In the absence of a showing that a Chinese Wall, stand-

300. Lipton & Mazur, *supra* note 5, 505. See also *id.* at 469-70, 483-84, 485 n.112, 486-87; Lipton & Mazur, *Reply, supra* note 5, at 585-86.

301. Chazen, *supra* note 5, at 575.

302. *Id.* See also Paine, Webber Brief, *supra* note 106, at 15-17.

303. An institution is generally liable for the securities law violations of its employees. See, e.g., *Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981); *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202, 1210 (9th Cir. 1970) (failure adequately to supervise employees). See also § 15 of the 1933 Act, 15 U.S.C. § 78o

ing alone, does not operate adequately to restrain the abusive practices at which it is aimed, these additional difficulties should not be visited upon the industry. In sum, if the cure is worse than the disease, the patient may well be advised to remain a little bit ill.

A requirement that integrated firms must suspend their normal advisory functions whenever one department has, or is likely to acquire, confidential information, also carries with it an adverse effect on the quality of service which the multi-service firm can offer its retail customers, and thus operates adversely on the investment performance of its customers' portfolios. Each time that securities of a particular company are added to the firm's "hands off" list, the overall number of securities about which the firm can provide meaningful investment advice is reduced. Moreover, the effect of this reduction could be disproportionate, depending upon the companies whose securities are actually listed. The restriction of transactions in particularly active stocks will have a much more severe effect on the firm's overall quality of service than will the listing of less active, more thinly-traded securities.³⁰⁴ Even with relatively inactive issues, however, a listing by the firm that is a principal (or sole) market maker for the issuer's securities will render it extremely difficult for most investors to obtain *any* meaningful advice about the issuer. Thus, the imposition of a "restricted list" requirement for the securities of a firm's corporate clients may, in the long run, impact most severely on small, individual investors who have little choice but to rely on the advisory services of the firm.³⁰⁵

(1982) (controlling person liability); § 20 of the 1934 Act, 15 U.S.C. § 78t (1982) (controlling person liability); Lipton v. Mazur, *supra* note 5, at 482 n.91. *But cf.* SEC v. Sorg Printing Co., [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,034, at 97,613 (S.D.N.Y. 1975) (employer not liable for the *personal* rule 10b-5 violation of its employees either under the theory of *respondeat superior* or aiding and abetting when employees were not acting within the scope of their employment, and where employer had acted reasonably to prevent such violations).

304. *See* Chazen, *supra* note 5, at 565.

305. *See generally id.* at 563-67. *See also* Rider, *supra* note 47, at 94:

The problem with the restricted list technique is that it may place clients of large financial intermediaries at a significant disadvantage, as they could find themselves deprived of investment advice for a considerable proportion of the investment market. Moreover the managed funds that the firm may be responsible for are also placed at a significant trading disadvantage.

In addition, of course, the restricted list technique frustrates whatever obligation a broker has to provide continuing advice to customers who invest in securities on the basis of the broker's recommendation. *See, e.g.*, Complaint filed in Mascola v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,470 (S.D.N.Y. 1976).

Finally, there is the added danger that the adverse effects on the quality of investment advice which a multi-service firm is able to provide will spill over to other securities that, even though not on the firm's restricted list, may be a part of the same industry as the company whose securities are actually listed. Some investors, both individuals and institutions, have a penchant for investing in securities of companies involved in particular industrial or commercial activities. By the same token, the research and advisory departments of some securities firms have developed a reputation for offering particular expertise concerning securities of companies engaged in particular lines of business activity. When the particular investor and the firm which specializes, in whole or in part, in specific industries, are brought together, the odds for a happy and successful "investment marriage" are likely to be quite good. If the firm, however, is disabled by virtue of a relationship between its corporate finance division and a publicly-held issuer within that industry from rendering *any* advice at all about the securities of that issuer, not only has the investor lost the services of the firm that may well be best suited to render the advice he seeks, but also the relative value of the firm's advice concerning other companies within the same industry is also undermined.

It is axiomatic that "value" is a relative concept, and thus the "value" of any particular investment can be meaningfully ascertained only in reference to the "value" of marginal substitutes. Thus, for example, Eastman Kodak's investment banker is disabled from advising its customers concerning the investment merits of Kodak stock during the time that it is serving the company in an advisory capacity, the firm's advice about the securities of similar companies, such as Polaroid, is also less meaningful to the firm's retail customers.³⁰⁶

The sum of these considerations leads inexorably to the conclusion that, in the absence of a clear justification for doing so, the knowledge of a multi-service securities firm's corporate finance or investment banking department should not *automatically* be imputed throughout the firm if the firm itself is able to effectively isolate that information and prevent its misuse for transactional purposes. Such an automatic imputation as a matter of law would leave the firm with only one safe course: an internal restricted list prohibiting its advisory personnel from giving any advice about the securities of any of the firm's corporate clients during the full course of any relationship (long or short) that may yield inside in-

306. Hence any firm that serves as the investment banker or provides financial advice to a large and actively traded "blue chip" customer would be generally disabled from formulating broad portfolio strategies for mutual funds and other large investors. See Chazen & Lipton, *supra* note 225, at 401.

formation to the firm. The effect of such a rule, as we have seen, is detrimental both to the policies of the fraud rules and to the quality of service which the firm would be able to provide its retail customers. As in the insider trading situation, then, the policies of the securities laws are best served in these instances by an effective Chinese Wall, standing alone. And the Wall, if it is effectively implemented and monitored, will operate to make the various departments of the multi-service institution much better neighbors.

B. The "Conflict of Interest" Paradigm

In the main, a "naked" Chinese Wall policy within an integrated securities firm will operate adequately to reconcile the conflicting obligations arising from the combination of investment banking and broker-dealer activities. There are instances, however, in which the firm's relationship with its corporate client is so structured that its *own* economic interests are inescapably placed at odds with those of its retail trading and investment management clientele. In these instances, any favorable "buy" recommendations by the firm concerning the securities of its corporate client possess the inherent danger of being motivated by the firm's own interests rather than concern for the investment performance of its customers' market purchases or that of its managed portfolios. In those cases where the firm's interest is so firmly implicated in this manner, imputation of *all* knowledge within the firm to the firm as a whole serves the purpose of legally reflecting, as accurately as possible, the relative economic interests of the parties as well as the relationship of the securities firm to the outside world.

An examination of the role of the investment banker generally in the underwriting and distribution of new securities serves as a useful point of departure for delineating those situations in which the integrated firm's financial interest as a whole is likely to diverge from that of its trading customers. In the process of underwriting a new issue of corporate stock, the investment banker occupies the position of "middleman" between the corporation (the "issuer") and the ultimate purchasers of the newly issued stock or debt.³⁰⁷ When the firm thus puts its formal underwriting

307. See generally JENNINGS & MARSH, *supra* note 35, at 19-28; 1 L. LOSS, *supra* note 29, at 159; PRACTICING LAW INSTITUTE, *When Corporations Go Public* (C. Israels & G. Duff ed. 1962); Berman, "Role of Underwriting and His Counsel," in *PLI Going Public Workshop* 67 (A. Sommer & S. Friedman co-chairmen 1970); Wing, *Guidelines for Underwriting Activity*, 25 BUS. LAW 397 (1970). Section 2(11) of the 1933 Act defines the term "underwriter" for the purposes of that act as "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security. . . ." 15 U.S.C. § 77b(11) (1982). See also § 2(a)(20) of the Investment Company

"hat" on, its role is essentially that of a salesman. Unlike other commodities, such as automobiles, foodstuffs, and toasters, there is no established public demand for the securities of most issuers, and this is particularly true of new and unseasoned companies who are going to the market for the first time. "Securities are sold, not bought . . .,"³⁰⁸ and the underwriter is the salesman of first instance.

That the underwriter is essentially rewarded for his ability to find a nice home for commodities that might otherwise go begging is reflected in the compensation structure for underwriting new issues as compared with brokerage fee for executing trades in the aftermarket.

Salesmen's underwriting commissions are generally two, three, or four times the rate negotiated on trading outstanding issues of stock. A risky venture may even boost underwriters' compensation to six or seven times the secondary market rate. Obviously, there must be a selling effort to launch a new issue. The more generous commissions provide the marketing incentive.³⁰⁹

Thus, in the course of selling its allotment of a new issue of securities, the financial interest of the underwriting house, whether or not it is simultaneously engaged in retail broker-dealer activities, is inescapably at odds with the interests of its customers. It is in the former's interest to secure the highest possible per share price for the commodities offered, an interest quite at odds with the rational investor's desire to receive the greatest amount of "intrinsic value" for each invested dollar.

In the case of the investment banking firm that also engages in retail brokerage activities (the "integrated" firm), however, this inherent conflict of interest is manifest far in advance of the actual distribution of the securities comprising the new issue. It is present even with respect to customers to whom the firm has no expectation that it will ultimately sell any part of its underwriting allotment. From the embryonic stages of any underwriting relationship between a securities firm and a corporate issuer, the firm's interest in receiving the highest possible price for the securities that will ultimately be offered (and, in cases of firm commitment underwriting, the danger that the firm will be "stuck" with

Act of 1940, 15 U.S.C. § 80b-2 (20) (1982); BLACK'S LAW DICTIONARY 741 (5th ed. 1979).

308. N. WOLFSON, *supra* note 5, at 6. As to the problem of "hot issues," see SEC Securities Act Release No. 4150, [1957-1961 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 76,671 (Oct. 22, 1959); JENNINGS & MARSH, *supra* note 35, at 659-66; Prifti, *The "Hot Issue"*, 24 BUS. LAW. 311 (1968); Rotberg, *The "Hot Issue"*, 17 BUS. LAW. 360 (1962); Sowards & Mofsky, *The "Hot Issue": Possible Hidden Causes*, 45 ST. JOHN'S L. REV. 802 (1971).

309. N. WOLFSON, *supra* note 5, at 6; *id.* at 33-37 (underwriters' compensation).

any portion of its allotment which remains unsold) if the deal is closed makes it also in the interest of the integrated firm to foster and promote a favorable attitude on the part of the investing public toward that issuer. Similarly, unlike other flat fee-for-service advisory relationships in which the firm may engage, an underwriter may also be allied with its corporate client in its desire to forestall dissemination of any unfavorable news about the company, especially if immediate public disclosure can legitimately be avoided.³¹⁰ Thus, as long as any self-interested relationship, such as an underwriting, is "in the offing" between the firm and a corporate issuer, any "buy" recommendation made by firm, even with respect to the outstanding securities of that issuer, carries with it the intrinsic danger that it is tainted by the firm's interest in successfully distributing the forthcoming new issue. Thus, any recommendations made by the firm to purchase securities of that issuer may or may not reflect a dispassionate analysis of the investment merits of the transaction, an analysis which the firm's retail customers have every right to expect.³¹¹

That this undesirable effect on the neutrality of the firm's investment advice during the course of a formal underwriting may exist is illustrated by the facts of the *Slade* case.³¹² According to the plaintiffs, Shearson's investment banking department was playing both sides of the fence. While it scrupulously concealed any adverse nonpublic information it may have had about Tidal Marine, its corporate client, Shearson also simultaneously transmitted extremely favorable public information about Tidal Marine to its retail brokerage personnel, and *required* the latter to use that information in formulating any personal recommendations they might make.³¹³ Thus, the *Slade* plaintiffs characterized the entire situation in the following terms:

The essence of Shearson's position is that the investment banking department is the investment banking department and the sales department is the sales department and the twain must never meet. Even if this were a correct formulation of law, it would not avail Shearson on the facts of this case. For the facts here show that the banking department and the sales department *together* made up the effective sales team. . . . [T]he investment banking department was inundating the sales department with repeated bulletins, all of which . . . were designed to show that Tidal was growing rapidly. . . . These bulletins were all transmitted to the sales de-

310. See generally *supra* notes 218-24 and accompanying text.

311. Similarly, purchases by the firm for accounts of its managed portfolios which operate to increase the activity (and hence the price) in the issuer's securities possess the same inherent dangers.

312. *Slade v. Shearson, Hammill & Co.*, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,329, *remanded* 517 F.2d 398 (2d Cir. 1974) (see *supra* notes 78-134 and accompanying text for a discussion of *Slade*).

313. *Slade* Brief, *supra* note 96, at 5.

partment by the investment banking department. . . . However ignorant the salesmen may have been of the troubles of Tidal, the investment banking department admittedly knew of them. Yet, here was the investment banking department falsifying the truth by withholding material adverse facts while at the same time demanding that the salesmen represent false facts to Shearson's customers. . . . In short, this is a simple situation where Shearson, as a corporate entity, was touting stock by misrepresenting to its customers.³¹⁴

However accurate (or not) the *Slade* plaintiffs characterization of the facts may have been, there can be no doubt that there is a danger of such unwarranted "touting" in those situations where it is in the interest of the integrated firm to promote a favorable climate toward its corporate client. Moreover, it benefits the firm as a whole to foster and create such a climate, even for the outstanding securities of its underwriting clients. Accordingly, the situation need not be as extreme as that posited by the *Slade* plaintiffs to evoke justifiable concern that, when push comes to shove, the retail trading and investment management customers of the multi-service firm will get the shorter end of the firm's loyalties.³¹⁵ This danger is inescapable during any prospective formal underwriting. The burden should therefore fall on the firm to demonstrate that any transactions it has recommended (or executed for discretionary accounts) during the pendency of any such relationship are consistent with the whole of the information possessed by the firm. And neither courts nor the Commission should hesitate to impute the knowledge of the firm's investment banking department, confidential or not, throughout the institution.³¹⁶

314. *Id.* at 9 (emphasis in original).

315. Even if the firm does engage in impermissible "tipping" to inform its trading clients of adverse news about an underwriting client, there is good reason to believe that it would be done selectively in favor of large institutional concerns. Compare *In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933 (1968), and *In re* Investors Management Co., 44 S.E.C. 633 (1971), with *Shulof v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1970-1971 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,147 (S.D.N.Y. 1971), and *Smachlo v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1970-1971 Transfer Binder] FED. SEC. L. REP. ¶ 93,148 (S.D.N.Y. 1971).

316. That a greater duty to purchasers of securities is imposed on underwriters than upon aftermarket broker-dealers is well recognized and borne out by the cases. Compare *Sanders v. John Nuveen & Co.*, 524 F.2d 1064 (7th Cir. 1975), *vacated and remanded*, 425 U.S. 929 (1976), *on remand*, 554 F.2d 790 (7th Cir. 1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), and *University Hill Found. v. Goldman, Sachs & Co.*, 422 F. Supp. 879 (S.D.N.Y. 1976), with *Marbury Management, Inc. v. Kohn*, 470 F. Supp. 509 (S.D.N.Y. 1979) and *Phillips v. Reynolds & Co.*, 294 F. Supp. 1249 (E.D. Pa. 1969). See also *In re* Heft, Kahn & Infante, Inc., 41 S.E.C. 379 (1963); *In re* Charles E. Bailey & Co., 35 S.E.C. 33 (1953). In addition, in the case of underwritings which are registered under the Securities Act of 1933, the underwriter will be liable for any misrepresentation in the registration statement unless it meets specified standards of investigation. 15 U.S.C. § 77k(a)(5), (b) (1982). See also *supra* note 11.

It should be noted, though, that treating the firm as a single entity for the purpose of measuring its knowledge concerning recommended transactions gives rise to the alternative danger that integrated firms will *in fact* transmit confidential information about their underwriting clients throughout the firm. Thus, any recommendations or transactions in the securities of those clients will bear the taint of inside information and result in liability under the "disclose or abstain" aspect of rule 10b-5.³¹⁷ This dilemma need not exist. All the firm needs to do to avoid liability is to suspend any recommendations concerning the securities of its underwriting clients until the commencement of the actual sales campaign (if the deal is formalized) for the distribution of the new issue.

It can be argued, of course, that imposing a "restricted list" or "no recommendation" policy in these instances will result in the same "signalling" effect and diminution in the quality of the firm's investment advice as would the imposition of such policies across the board during the pendency of other types of confidential relationships with an integrated firm's corporate clients.³¹⁸ As a practical matter, however, these effects are likely to be rather minimal in the context of the typical underwriting. Unlike other relationships, which may extend over a long period of time, the time period preceding a distribution of new securities tends to be a rather short one. It is, after all, in the mutual interest of the issuer and the underwriter alike to get the new issue onto the market as soon as possible before current market conditions change for the worse.³¹⁹ Thus, the adverse effects that are likely to ensue from listing are of relatively small magnitude in these circumstances. More importantly, the critical differences between the economic position of the securities firm in the underwriting context, as opposed to other corporate advisory relationships, are ones which cannot be compensated for adequately without some reinforcement of the firm's isolation policies. Further, once the formal sales campaign begins, the firm is perfectly free to resume normal operations and to become a member of the selling group for the purpose of distributing its allotment in the underwriting. At this latter stage, however, there can be no excuse for either misrepresenting facts or withholding information which would be material to a customer's decision to purchase the newly-issued stock.³²⁰

317. See *supra* note 269.

318. See generally *supra* notes 300-06 and accompanying text.

319. Cf. Lipton & Mazur, *Reply*, *supra* note 5, at 582.

320. See, e.g., § 11 of the 1933 Act, 15 U.S.C. § 77k (1982). It should be noted that there may be other activities of multi-service firms, such as wholesale marketmaking of securities of the firm's corporate clients (where the firm "solicits" purchasers for securities in its own inventory) that carry with them

VII. CONCLUSION

The construction and maintenance of interdepartmental Chinese Walls to accommodate the conflicting legal duties of multi-service securities firms and other financial institutions has been a salutary development within an industry that is distinguished by a plethora of conflicts and constant opportunities for fiduciary abuse. I have attempted to demonstrate that, in the main, a Chinese Wall can be expected to work effectively to isolate material inside information with the firm. The device thus merits legal sanction, so long as the firm is not engaged in relationships that cause its own economic interests to diverge markedly from either that of the investing public or its retail clientele. When the firm's own interests are likely to be implicated, however, as is typically the case during prospective underwritings of new securities, and is always the case when the firm engages in trading in securities for its proprietary accounts, a Chinese Wall, standing alone, does not respond adequately to the danger that its own interest will color its trading and advisory activities. Thus, the firm that elects to engage in these activities while one of the departments is in possession of relevant inside information must do so at the risk that the inside information possessed by the firm will be imputed throughout the institution.

The principal advantage of this imputation approach, derived from that suggested by the proposed Federal Securities Code, is that it serves to attribute the relevant knowledge of the integrated firm's various departments in accordance with the economic realities of its activities. Moreover, because it provides meaningful standards to ascertain the knowledge of the multi-service institution in the various contexts in which the isolation technique is implicated, it bears the seeds of legislative or administrative fruition into predictable guidelines for the industry to follow. Congress or the Securities and Exchange Commission, then, should undertake to consider and adopt a formal rule along these lines, and bring an end to the confusion and divergence of views that has attended the perplexing conundrum of the servant who serves two masters.³²¹

the same types of dangers as do "buy" recommendations preceding a new distribution. More study should be devoted to this possibility, and firms in this position should be sensitive to the dangers inherent in these dual activities.

321. Cf. *Matt. 6:24* (King James).