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I. INTRODUCTION

HISTORICALLY, BANK TRUST DEPARTMENTS, in administering trust funds for widows, orphans, and a variety of spendthrifts, made trust investments which were restricted by statute to bonds, real estate mortgages, and United States Treasury obligations.[1] However, after World War II and with the passage in many states of "prudent man" statutes, common stocks gained respectability and consequently found their way into trust portfolios.[2] Bank trustees, once mere administrators of funds, became investment managers who were judged in the minds of many by their investment performance and subjected to pressure for better than average returns. In addition to performing their traditional roles as trustees and executors, bank trustees have expanded their activities to the extent that they now serve as investment advisors to investment companies, employee benefit plans, individuals, and institutions, and offer a wide variety of other investment and operational services.[3] The asset base of trust depart-

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1. *See, e.g.*, Act of July 2, 1935, No. 206, §§ 1 *et seq.*, [1935] Pa. Laws 545 (repealed 1972).

2. *See* Church & Seidel, *The Changing Scene in Personal Trust Departments*, 113 TRUSTS & ESTATES 370 (1974). For an example of a state statute allowing a trustee to purchase common stock, *see* PA. STAT. ANN. tit. 20, § 7302(b) (1975). For an explanation of the "prudent man" rule, *see* note 6 and accompanying text *infra*.

3. *See, e.g.*, GIRARD BANK, 1974 TRUST DEPARTMENT ANNUAL REPORT 3 (1975).

ments has expanded to the point where 3,804 commercial bank trust departments now care for over $400 billion in customer funds.[4]

Initially, the chief restraint upon a trust department in exercising its investment responsibilities was the duty it owed to the trust beneficiaries as a trustee.[5] Bank trustees followed the "prudent man" rule which merely required a trustee to make such investments as a prudent man would make in dealing with his own property, primarily with a view toward preserving the estate and producing a regular income.[6]

However, the recent and dramatic growth of insider liability under the federal securities laws has placed another restraint upon commercial bank trust departments which has presented bank officers with conflicting duties to trust beneficiaries, corporate borrowers, and the investing public, and which could well alter the structure of our capital markets. This article will analyze this dilemma presently faced by commercial banks and will review the alternative solutions which commentators and practitioners have developed to resolve it.

II. BACKGROUND — INSIDER LIABILITY UNDER RULE 10b-5

The Securities Exchange Act of 1934 (1934 Act),[7] in conjunction with the Securities Act of 1933 (1933 Act),[8] was designed to prevent fraud and unfairness in the public securities market.[9] Section 10(b) of the 1934 Act[10] generally forbids the use of "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange Commission] may prescribe as necessary or appropriate in the public interest or for the protection of investors."[11]

In 1942, the Securities and Exchange Commission (SEC, Commission) promulgated rule 10b-5[12] which generally made unlawful certain forms of fraudulent or deceptive conduct, including an omission to state a material fact in connection with the purchase or sale of

4. BOARD OF GOVERNORS OF FEDERAL RESERVE SYSTEM, FEDERAL DEPOSIT INSURANCE CORPORATION & COMPTROLLER OF THE CURRENCY, TRUST ASSETS OF INSURED COMMERCIAL BANKS — 1974, at 5.

5. *See generally* G.G. BOGERT & G.T. BOGERT, HANDBOOK OF THE LAW OF TRUSTS § 1 (5th ed. 1973).

6. *See id.* § 93, at 337; 3 A. SCOTT, TRUSTS § 227, at 1805-06 (3d ed. 1967) [hereinafter cited as SCOTT]. This common law duty of bank trust departments has also been the subject of legislation in many states. *See, e.g.,* N.Y. EST., POWERS & TRUSTS LAW § 11-2.2 (McKinney 1967). *See also* Bialkin, *Banks and Investment Managers as Institutional Investors,* 89 BANKING L.J. 883, 895 (1972).

7. 15 U.S.C. §§ 78a *et seq.* (1970).

8. *Id.* §§ 77a *et seq.*

9. *See* 5 A. JACOBS, THE IMPACT OF RULE 10b-5, §§ 3.01-.02, 10.01-.02 (1974) [hereinafter cited as JACOBS].

10. 15 U.S.C. § 78j(b) (1970).

11. *Id.*

12. SEC Securities Exchange Act Release No. 3230 (May 21, 1942).

securities.[13] The rule had little practical effect, however, until the 1946 decision of *Kardon v. National Gypsum Co.*[14] In *Kardon,* a federal district court held that although rule 10b–5 did not explicitly create a private cause of action for the violation of its provisions, an implied private right of action did exist.[15] This principle has been wholeheartedly adopted by the federal courts,[16] and imaginative plaintiffs have since helped expand liability under rule 10b–5 to encompass a broad range of defendants.[17]

While the purpose of rule 10b–5 is clear on its face, one commentator has delineated at least eight underlying policies for the rule:

> (1) maintaining free securities markets; (2) equalizing access to information; (3) insuring equal bargaining strength; (4) providing for disclosure; (5) protecting investors; (6) assuring fairness; (7) building investor confidence; and (8) deterring violations while compensating victims.[18]

Most of these policies are served by the rule's proscription of the trading or recommending of securities on the basis of "material inside information" by an "insider" or a "tippee" of an insider.[19] To appre-

13. Rule 10b–5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (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 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 (1975).

14. 69 F. Supp. 512 (E.D. Pa. 1946).

15. *Id.* at 513–14. The *Kardon* court based its decision on section 286 of the *Restatement of Torts,* which provided that the violation of a statute by doing a prohibited act renders the actor liable for the resulting injury to another if the intent of the statute is to protect the injured party and the interest injured is the one sought to be protected. *Id., quoting* RESTATEMENT OF TORTS § 286 (1934).

16. *See, e.g.,* Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Hooper v. Mountain State Sec. Corp., 282 F.2d 195 (5th Cir. 1960), *cert. denied,* 365 U.S. 814 (1961); Froth v. Robinson, 203 F.2d 627 (9th Cir. 1953). *See generally* 1 A. BROMBERG, SECURITIES LAW: FRAUD § 2.4(1) (1974) [hereinafter cited as BROMBERG].

17. *See, e.g.,* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) (bank officers); SEC v. Spectrum, Ltd., 489 F.2d 535 (2d Cir. 1973) (lawyers); Brennan v. Midwestern Life Ins. Co., 417 F.2d 147 (7th Cir. 1969), *cert. denied,* 397 U.S. 989 (1970) (regional stock exchange); Ross v. Licht, 263 F. Supp. 395 (S.D.N.Y. 1967) (corporate officers and directors).

18. JACOBS, *supra* note 9, § 6.01, at 1–113.

19. The General Counsel of the SEC has stated that "[a] major Commission objective is to eliminate the use of material nonpublic inside information in securities transactions." Cook, *The SEC and Banks,* 89 BANKING L.J. 499, 508 (1972).

For a definition of the term "insider" and its application to bank trust departments, *see* notes 31–38 and accompanying text *infra.* For an explanation of the term ciate the scope of rule 10b-5 as it affects bank trustees, an understanding of what is meant by "material inside information" is required.

"Inside information" has been judicially defined as nonpublic information[20] concerning the business of the issuer,[21] one of its securities,[22] or the market for its securities,[23] which is intended to be available only for corporate purposes and not for any individual's personal benefit.[24]

The determination of what information is "material" involves a more complicated inquiry since several closely related objective and subjective definitions have been developed. Three principal objective tests for materiality have been formulated. The first is based upon the judgment of a reasonable investor or a reasonable stockholder; if the pertinent information would affect a reasonable investor in making an investment decision, it is deemed material.[25] A second objective test that has been developed is the "probability test," which is used

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"tippee" and its relevance to the possible liability of bank trust departments under rule 10b-5, *see* note 34 *infra.*

20. "Nonpublic" has been interpreted by the courts to mean unavailable to the investing public. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969). "Nonpublic facts" include intentions, promises, opinions, predictions, recommendations, estimates, and projections which are unavailable to the investing public. *See* JACOBS, *supra* note 9, § 66.02(b).

21. *See, e.g.,* Childs v. RIC Group, Inc., 331 F. Supp. 1078, 1083 (N.D. Ga. 1970), *aff'd per curiam,* 447 F.2d 1407 (5th Cir. 1971).

22. *See, e.g.,* SEC Securities Exchange Act Release No. 8713 (October 7, 1969).

23. *See, e.g.,* Affiliated Ute Citizens v. United States, 406 U.S. 128, 153 (1972).

24. *See* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961). Some authorities question whether the corporate purpose requirement is an absolute one for inside information since this classification would not encompass all of the information that can be obtained by an insider. For example, a director of a company could request and obtain a field report about an ore strike for his or her own personal investment purposes. Such information would not be considered inside information if the corporate purpose test is applied. *See* Sandler & Conwill, *Texas Gulf Sulphur; Reform in the Securities Marketplace,* 30 OHIO ST. L.J. 225, 238-39 (1969).

25. *See* List v. Fashion Park, Inc., 340 F.2d 457, 462-63 (2d Cir.), *cert. denied,* 382 U.S. 811 (1965). The category of "reasonable investor" also includes speculators and chartists. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969).

While this particular objective test has been widely utilized by the courts, they have differed as to the degree to which the investor must have been affected by the information. Some courts have concluded that the standard is whether the investor "might" or "would" have been affected. *E.g.,* List v. Fashion Park, Inc., *supra* at 463. Another formulation of this objective test is based upon whether the information "might have had a significant propensity" to affect the investor. Mills v. Electric Auto-Lite Co., 396 U.S. 375, 384 (1970) (standard under SEC rule 14a-9). These standards are analyzed in Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 569-71 (E.D.N.Y. 1971). The United States Supreme Court appears to have settled the question by opting for a broad standard. The Court stated that a material fact is one which "a reasonable investor *might* have considered . . . important in the making of [his or her] decision." Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972) (citations omitted) (emphasis added). This view has subsequently been followed by several lower federal courts. *See, e.g.,* SEC v. Koenig, 469 F.2d 198, 200 (2d Cir. 1972).

when it is necessary to measure the materiality of some event which has yet to occur.[26] The Second Circuit has framed this test as follows:

> [W]hether facts are material within Rule 10b–5 when the facts relate to a particular event and are undisclosed by those persons who are knowledgeable thereof will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the totality of the company activity.[27]

The third objective test defines materiality in terms of the extent of the anticipated change in the market price of the issuer's securities resulting from the publication of the inside information; under this standard, a fact is material if its disclosure could reasonably and objectively have a substantial impact upon the price of the issuer's securities.[28]

In addition to these objective tests, a subjective criterion has been formulated: materiality measured by the importance which the defendants themselves have accorded the undisclosed information.[29] It should be noted, however, that the courts which have employed the subjective test in determining that a fact is material have not done so without finding that at least one of the objective tests had also been satisfied.[30]

III. BANK LIABILITY

Initially, bank trustees appeared far removed from the pale of insider liability under rule 10b–5 since only officers, directors, and employees of the corporation whose securities were involved were considered insiders.[31] However, the definition of insider has been expanded

26. *See generally* JACOBS, *supra* note 9, § 61.02(b)(ii).

27. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969). An example of a situation calling for the use of this test would be when, on the basis of one test drill, an ore company learns of an ore strike but is not presently able to determine its size. The probability of a successful ore strike and its magnitude would have to be evaluated in light of the size of the company itself in order to determine if an ore strike of the projected size would be commercially significant.

28. *See* Kohler v. Kohler Co., 319 F.2d 634, 642 (7th Cir. 1963). The market impact of the material information would be measured by the ratio of the change in price resulting from disclosure of the information to the price immediately before the disclosure. *See* JACOBS, *supra* note 9, § 61.02(b)(ii).

29. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 851 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969). Under this test, materiality is inferred from the fact that the insider traded upon the basis of the inside information. *See* 2 BROMBERG, *supra* note 16, § 7.4(3)(h). A possible defense under this test would be for the defendant to show that the motivation was a result of some factor other than the inside information in question. *Id.; see* SEC v. Texas Gulf Sulphur Co., *supra* at 851.

30. *E.g.,* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848–49 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969); Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961).

31. *See* Cady, Roberts & Co., 40 S.E.C. 907, 911–12 (1961).

by recent case law to the extent that it may now include a bank trustee. The expansion was initiated in *Cady, Roberts & Co.*,[32] an SEC decision in which the Commission expressly refused to limit the prohibition of insider trading to those traditionally considered insiders. In *Cady, Roberts*, the Commission held that a broker-dealer violated rule 10b-5 by trading on the basis of corporate inside information received from a representative of the brokerage firm who also served on the corporation's board.[33] The Commission stated that the prohibition of rule 10b-5 could be applied to any person and that its application depended only upon the existence of a relationship giving a person access to information which was intended solely for a nonpublic corporate purpose.[34]

This expanded concept of insider liability was firmly endorsed by the Second Circuit in the landmark case of *SEC v. Texas Gulf Sulphur Co.*[35] That case involved officers and directors who, on the basis of inside information concerning an extremely valuable ore strike made by the corporation, traded in their own corporation's stock and tipped relatives and friends who likewise traded.[36] The court, in finding the officers and directors liable,[37] stated:

32. 40 S.E.C. 907 (1961).

33. *Id.* at 908-11. The inside information was that the dividend rate of the particular corporation's securities had been reduced by its board of directors. *Id.* at 909.

34. *Id.* at 912. The SEC and the federal courts have divided the category of persons liable for trading on inside information into "insiders" and "tippees." *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848-49, 852-53 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). An insider is an individual who receives material inside information through a business relationship with the issuer. *See* List v. Fashion Park, Inc., 340 F.2d 457, 461 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965). Examples of an insider are: the director of the issuing corporation, a broker dealing in the corporation's stock, and a banker making a loan to the corporation. A tippee is one who receives the information through some channel other than a business relationship. *See* Ross v. Licht, 263 F. Supp. 395, 409-10 (S.D.N.Y. 1967). An example of a tippee would be the wife of a corporate director who receives information from her husband who is an insider.

The reason for distinguishing between insiders and tippees is important in determining the liability of the person who gives the information to the insider or the tippee. The insider's informant is not liable for the insider's misuse of the business information since that information was merely relayed to a person who was entitled to receive it. JACOBS, *supra* note 9, § 66.02(a). However, the tippee's confidant is liable for the tippee's subsequent actions. *See* Ross v. Licht, *supra* at 411.

Because this article is concerned only with the possible liability of a commercial bank due to the special relationship between its trust department and its commercial department, and because the liability and restrictions placed upon an insider and a tippee are identical, *see* Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876, 884 (2d Cir. 1972), the ramifications of the tippee-insider distinction in relation to the liability of their informants will not be pursued further. For a detailed explanation of the liability of an informant, or "tipper," *see* JACOBS, *supra* note 9, §§ 162-68.

35. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

36. 401 F.2d at 843-47.

37. The tippees of the defendants were not involved in the *Texas Gulf Sulphur* proceeding, and the court expressly refused to consider whether they were in violation

> [*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 he chooses not to do so, must abstain from trading in or *recommending* the securities concerned while such inside information remains undisclosed.[38]

In a recent case, *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[39] the Second Circuit applied rule 10b-5 to a factual situation analogous to that of a commercial bank. In *Shapiro*, a brokerage firm received adverse inside information concerning Douglas Aircraft Company (Douglas) while serving as a managing underwriter for a large public offering of Douglas securities.[40] While the brokerage firm refrained from trading in Douglas securities itself, in its role as an investment advisor it passed on the adverse information to its customers who then sold their Douglas stock.[41] Plaintiffs, who had purchased on the open market at the time the brokerage firm passed on the inside information, brought suit against the brokerage firm,[42] seeking damages under rule 10b-5.[43] The Second Circuit held that the brokerage firm had violated rule 10b-5 by transmitting the material inside information to its customers.[44]

While no court has yet held a bank liable for a violation of rule 10b-5 when its trust department trades upon information acquired by the bank, it would require no great extension of the previously discussed case law to support such a holding.[45] For example, in making

of rule 10b-5. *Id.* at 852-53. However, the court noted that the tippee's conduct "certainly could be [as] equally reprehensible" as that of the named defendant. *Id.*

38. *Id.* at 848 (emphasis added).

39. 495 F.2d 228 (2d Cir. 1974).

40. *Id.* at 231-32. The material inside information in *Shapiro* was that Douglas had recorded substantially lower profits in 1966 than it had projected and that it had lowered its profit projections for 1967. This information was not made public until after the defendants' claimed activities had occurred. *Id.*

41. *Id.* at 232.

42. *Id.* at 234. The customers of the brokerage house who had utilized the information in their trading activities were also held liable. *Id.* at 232-34.

43. *Id.* at 232-33.

44. *Id.* at 236-41. The Second Circuit specifically based its decision upon its prior holding in *Texas Gulf Sulphur. Id.* at 236. The defendants argued that *Texas Gulf Sulphur* was inapplicable because it had involved an SEC injunctive proceeding rather than a private suit for damages as in *Shapiro. Id.* The *Shapiro* court rejected this argument on the grounds that public policy required the same finding of liability, regardless of whether an SEC injunction or a private action was involved. *Id.* The defendants further argued that even if they had violated rule 10b-5, they were not liable to the plaintiffs since they had not caused the plaintiffs' injuries. *Id.* at 238. However, the Second Circuit concluded that the required causation was supplied by "the uncontroverted facts that the [defendant] . . . recommended trading in Douglas stock without disclosing material inside information which plaintiffs as reasonable investors might have considered important in making their decision to purchase Douglas stock." *Id.*

45. The author has discovered no case in which a bank trust department was found liable in such circumstances. *But see* Local 734 Bakery Drivers Pension Fund

a credit analysis of a potential corporate borrower, the commercial department of a bank often receives comprehensive financial and related information concerning that borrower.[46] In fact, the commercial department has a duty to gather all pertinent information in making its credit analysis.[47] Although in many cases the available information contains no more than any astute credit analyst could obtain,[48] it is clear that the lender-borrower relationship could give rise to a situation where the bank would receive information deemed "inside" as defined by the courts. Furthermore, since the information is generally received in the context of a confidential business relationship, the commercial department is an insider within the proscriptive realm of 10b–5.[49] However, the commercial department, as a separate entity, is not in a precarious position with respect to rule 10b–5 since that department usually does not trade in public securities, and consequently would not be in a position to so utilize the inside information.[50] However, the trust department of a bank is in an entirely different position. In its role as a trustee, the trust department actively trades a large number of public securities daily, and in its role as advisor, makes recommendations concerning securities which its customers may utilize.[51] Therefore, if the various departments of a bank are considered to be only parts of a single entity, and the commercial department receives inside information which it actually or constructively[52] transmits to the trust department, and the trust department utilizes the information in its trading activities, the bank could be considered to have traded on inside information and thus be subject to liability under rule 10b–5.

Trust v. Continental Ill. Nat'l Bank & Trust Co., [1973–1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,565 (N.D. Ill. 1974) (claim under rule 10b–5 survived motion to dismiss); notes 69 and accompanying text *infra*.

46. *See* E. HERMAN, CONFLICTS OF INTEREST: COMMERCIAL BANK TRUST DEPARTMENTS 73 (1975); 5 INSTITUTIONAL INVESTOR STUDY REPORT 2716 (1971).

47. *See* Yellon, *Trust Investments: Problems Regarding Exchange of Information between the Trust Department and other Departments within the Bank,* 54 CHI. B. RECORD 405, 408 (1973). Mr. Yellon compares this duty of the trust department to the "due diligence" standard required of a managing underwriter in a public issue of securities. *Id.*

48. An investor has no obligation to confer upon other investors the benefit of a superior financial or other expert analysis. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969).

49. *See* note 34 *supra.*

50. However, the commercial department is in a position to be a tipper, and thus potentially liable for any subsequent illegal actions by the tippee. *Id.*

51. *See* text accompanying note 3 *supra.*

52. *See* text accompanying notes 104–12 *infra.*

IV. THE CONFLICTING DUTIES OF COMMERCIAL BANKS

The application of rule 10b–5 to a bank's commercial and trust activities presents the bank with a serious dilemma arising from the existence of conflicting duties. First, through its commercial department, the bank owes a duty to its commercial loan customers not to publicly disclose any information received in confidence as a result of any loan or business transaction.[53] Secondly, through the trust department, the bank owes a duty to its trust beneficiaries to utilize all of its power to further the interest of the beneficiaries to the exclusion of all self-interests and interests of third parties.[54] This duty would appear to require the bank to utilize all of the available relevant investment information, including the inside information received by the commercial department.[55] Finally, by virtue of the expansive reading that has been given to rule 10b–5 by the courts, when trading in public securities the bank has a duty to the investing public to either refrain from trading on the inside information or to disclose that information to the public before trading.[56] Thus, when in the course of loan negotiations with a corporation a bank obtains material inside information about that corporation, or any other corporation, it is faced with a serious predicament. The bank's obligation to the commercial loan customer would require it to keep the information confidential, while its duty to the trust beneficiaries would require it to utilize the information in deciding whether to purchase or dispose of the stock for the trust accounts. Further, its responsibility to the investing public under rule 10b–5 would require the bank to either publicly disclose the inside information (which would defy its duty to the commercial loan customer) or refrain from trading in the commercial loan customer's securities for its trust accounts (which would defy its obligation to the trust beneficiaries). Finally, to compound the problem, it can be argued

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53. *See* Schuyler, *From* Sulphur *to Surcharge? — Corporate Trustee Exposure Under SEC Rule 10b-5,* 67 Nw. U.L. REV. 42, 51-52 (1972); *cf.* Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961) (duty of a managing underwriter to an issuer).

54. G.G. BOGERT & G.T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 453, at 473-74 (2d ed. 1960) [hereinafter cited as BOGERT, TRUSTS AND TRUSTEES]; 2 SCOTT, *supra* note 6, § 170, at 1298.

55. Prior to the advent of rule 10b-5, trust law required that all the special skills and knowledge of the trustee be placed at the disposal of the beneficiary, and the courts considered the gathering of information from "insiders" as evidence of the trustees' care and prudence. *See In re* Clark's Will, 257 N.Y. 132, 177 N.E. 397 (1931); *In re* Pate's Estate, 84 N.Y.S.2d 853 (Sup. Ct. 1948), *aff'd mem.,* 276 App. Div. 1008, 95 N.Y.S.2d 903 (1950), *motion for leave to appeal denied,* 301 N.Y. 814 (1950); *cf. In re* McCafferty, 147 Misc. 179, 264 N.Y.S. 38 (Sur. Ct. 1933).

56. *See* text accompanying note 38 *supra.*

that the bank may expose itself to liability merely by placing itself in a situation where it is subject to these conflicting duties.[57]

The inevitable consequence of the existence of these three opposing obligations is that, if the bank is considered a single entity, it may be simultaneously liable to a number of plaintiffs regardless of which course of action it chooses. First, if the trust department trades upon the material inside information, or merely trades after the receipt of information by the commercial department in a manner consistent with the information,[58] the SEC or the Department of Justice might initiate an action against the bank which could include civil injunctions[59] or fines and criminal sentences.[60]

A second potential plaintiff would be an investor who purchased or sold stock over a national securities exchange at the time the trust department was trading on the inside information.[61] This could expose the bank to staggering liability in a situation where the security is widely traded.[62]

A third possible plaintiff is the beneficiary of a trust managed by the bank trustee. The beneficiary would presumably sue the bank for breaching its common law duty as a fiduciary for failing to utilize the inside information available to it to protect the beneficiary's interest. As previously mentioned, the traditional fiduciary concept in trust law requires a trustee to administrate a trust solely in the interests of the beneficiaries, and also requires the trustee to exclude any self-interest

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57. *Cf.* Black v. Shearson, Hammill & Co., 266 Cal. App. 2d 362, 72 Cal. Rptr. 157 (Ct. App. 1968); Albright v. Jefferson County Nat'l Bank, 292 N.Y. 31, 53 N.E.2d 753 (1944).

58. The SEC, in reviewing the analogous situation in which a brokerage firm received inside information in its role as underwriter and then traded consistently with that information, stated:

> [W]e would view as suspect and subject to close scrutiny a defense that there was no internal communication of material non-public information and its source by a member of a broker-dealer firm or other investment organization who received it, where a transaction of the kind indicated by it was effected by his 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.

Investors Mgmt. Co., 44 S.E.C. 633, 647 n.28 (1971).

59. 15 U.S.C. § 78u(e) (1970). In *Texas Gulf Sulphur,* the Commission sought to enjoin the defendants from trading on inside information, and to have the prohibited securities transactions rescinded. 401 F.2d at 839.

60. 15 U.S.C. § 78ff(a) (1970) (fines up to $10,000 and imprisonment up to 2 years); *see, e.g.,* United States v. Guterma, 281 F.2d 742 (2d Cir.), *cert. denied,* 364 U.S. 871 (1960).

61. *See* notes 42–44 and accompanying text *supra.*

62. A number of courts and commentators have noted the enormous potential liability involved in such an action under rule 10b-5. *E.g.,* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 242 (2d Cir. 1974); Schuyler, *supra* note 53, at 48–49 & n.35.

or interest of third parties.[63] It is arguable that this traditional fiduciary duty would require the bank trustee in managing its beneficiaries' accounts to ignore the interests of the investing public protected by rule 10b–5. However, under traditional trust law, a trustee has no duty to violate the law in administrating a trust.[64] In response to a contention that a stock broker had a fiduciary duty to customers to trade upon inside information, the SEC has stated:

> [W]hile [the stock broker] undoubtedly occupied a fiduciary relationship to his customers, this fiduciary relationship could not justify any actions by him contrary to the 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.[65]

One commentator has suggested, however, that the less flexible relationship between a bank trustee and the beneficiary should give rise to a higher level of fiduciary duty to the beneficiary than the duty existing in a broker-client relationship.[66] In light of the fact that a trustee has no duty to violate the law in administrating a trust, it seems unlikely that even a higher bank trustee-beneficiary relationship would require the bank to violate rule 10b–5.

A further problem may arise for the bank if the bank trustee erroneously decides that certain inside information is material and refrains from trading in certain securities for its trust accounts. In *Investors Management Co.,*[67] the SEC stated that if the belief that the information was material was reasonable, the trustee's inaction would not be held improper. However, since this statement by the SEC may be discounted as dicta by a regulatory agency concerned only with enforcing the federal securities laws,[68] it can afford no great comfort to a bank trust officer concerned with avoiding liability under the state trust laws when deciding whether to abstain from trading in a particular security.

A trust department may also be sued by a beneficiary for failing to disclose to the beneficiary that it possesses adverse material inside

63. *See* text accompanying note 54 *supra.*

64. 2 SCOTT, *supra* note 6, § 166.

65. Cady, Roberts & Co., 40 S.E.C. 907, 916 (1961); *accord,* Investors Mgmt Co., 44 S.E.C. 633 (1971).

66. Schuyler, *supra* note 53, at 47.

67. 44 S.E.C. 633, 647 (1971).

68. *Id.* at 634. *Investors Management Co.* involved the failure of a brokerage firm to disclose a reduction in an issuer's earnings. *Id.* As such, there was no issue as to a trustee's erroneous belief that inside information was material.

information about a corporation whose securities it is purchasing for the beneficiary's account and for failing to disclose to the beneficiary that it may be prohibited from trading upon that information because of its position as an insider. At least one court has held that these circumstances give rise to a cause of action under rule 10b–5.[69] These theories of liability differ from the usual beneficiary suit at common law, where the claim is that the fiduciary violated a common law duty to the beneficiary to protect the latter's assets.[70]

The disclosure aspect involves yet another potential plaintiff: the corporate loan recipient. If, in order to avoid liability under rule 10b–5, a bank discloses information which was given to it in confidence by a corporate borrower, the corporate customer could bring suit against the bank for breach of fiduciary duty and recover for any damage suffered.[71] The potential liability of the bank in this context is substantial. For example, a corporation could make a valuable ore find and attempt to purchase options on all nearby land; if the bank publicly disclosed the information prior to the corporation's acquisition of all the options, the option prices would rise dramatically and the bank could be held liable for this price differential.

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69. Local 734 Bakery Drivers Pension Fund Trust v. Continental Ill. Bank & Trust Co., [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,565 (N.D. Ill. 1974). In *Bakery Drivers,* five cases brought by various trust beneficiaries against a commercial bank were consolidated for the purposes of discovery. *Id.* at 95,958. There were two claims central to each of the consolidated cases. First, the beneficiaries claimed that the bank failed to disclose detailed inside information about Penn Central, whose stock the bank had acquired for the beneficiaries' account at a time when the bank made substantial loans to Penn Central. The inside information was that Penn Central had "insufficient cash, substantial and accelerating operating losses, debt service requirements in excess of cash generated, and inflated market price." *Id.* at 95,961. Second, the beneficiaries claimed that the bank had failed to disclose to the beneficiaries that the bank had a conflict of interest and that it might be prohibited as an insider from trading in Penn Central stock. *Id.* at 95,956. The federal district court held that these grounds formed a cause of action under rule 10b-5, denying the banks motion to dismiss for, *inter alia,* the failure to state a claim upon which relief may be granted and the lack of the beneficiaries' standing to sue. *Id.* at 95,962.

It is important to note that in holding that the beneficiaries had standing to sue the bank under rule 10b-5, the *Bakery Drivers* court rejected the "purchaser or seller" requirement of Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952), *cert. denied,* 343 U.S. 956 (1952). The *Bakery Drivers* court held that the class of people with standing to sue under rule 10b-5 was composed of the broader class of "investors." [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. at 95,958-59. However, in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), the United States Supreme Court, in upholding the *Birnbaum* restriction, emphasized that a private right of action for damages is confined to actual purchasers or sellers of securities. 421 U.S. at 731-32. In light of *Blue Chip Stamps,* the standing of trust beneficiaries to sue their trustees can no longer be based upon principles broader than the standing requirements of *Birnbaum.*

70. 2 SCOTT, *supra* note 6, § 176.

71. *See* text accompanying note 53 *supra.*

V. ALTERNATIVE SOLUTIONS

Having recognized the inherent dilemma faced by commercial banks with respect to their disposition of inside information, positive measures must be taken to reduce or eliminate the conflicts with which they are confronted. Due to the enormous potential liability involved, there is a great possibility of harm to the investing public, to bank depositors, and to corporations attempting to raise capital. Therefore, the remainder of this article will consider various solutions to the problems faced by commercial banks with regard to their treatment of material inside information.

A. *Immunity from Rule 10b–5*

From the bank's viewpoint the most effective solution to the dilemma would be to confer upon them an immunity from rule 10b–5 liability when they trade on the basis of material inside information. Such a proposal has been advanced by Professor David M. Schuyler.[72] Positing that a bank trustee in the typical inside information situation has only two alternatives — to trade or not to trade — Professor Schuyler questions the validity of imposing a non-trading requirement since it would not necessarily operate to curtail the possibility of securities fraud.[73] He argued that the trading of securities in the open market by an insider, as opposed to a face-to-face transaction, is not the cause of a public investor's subsequent loss, but rather the loss is caused by the insider's nondisclosure.[74] However, an insider who refrains from trading on inside information, even though failing to disclose such, is not held liable under rule 10b–5 since the insider has not shown an indifference or disregard to the rights of other investors.[75] Therefore, Professor Schuyler reasoned that it is unjust to impose liability upon a bank trustee when it trades on inside information in a public market if it demonstrates a regard for the rights of the investing public and if it is attempting to protect the interests of the trust's beneficiaries "to whom [it] owes a higher duty of care than any which [it] may have to an unknown open-market buyer."[76]

Professor Schuyler submitted that to avail itself of this limited liability a trust department should be required to prove: 1) that the loss suffered by the public investor was not caused by the bank trustee's

72. Schuyler, *supra* note 53, at 51–55.
73. *Id.* at 53.
74. *Id.*
75. *Id.* at 53–54.
76. *Id.* at 54. However, as previously noted, no court has yet held that the trustee's duty to an open-market buyer is less stringent than that which the trustee owes to the beneficiary. *See* text accompanying note 66 *supra.*

conduct; 2) that there was a total lack of reliance by the public investor upon the bank trustee's trading activities; and 3) that the bank trustee's activities were not perpetrated with a conscious disregard or indeference to the risk that public investors would be misled or sustain losses.[77]

Under this immunity theory, a bank trustee's problems with respect to rule 10b-5 would appear solved; as long as it acted without conscious disregard for public investors, it could trade on the basis of inside information free from any liability to the investing public or disgruntled beneficiaries. However, it is submitted that this solution, though attractive to banks, is unreasonable. First, it is highly doubtful whether the SEC and the courts would accept the theory since it runs directly counter to the disclosure policy of rule 10b-5.[78] Second, it would be exceedingly difficult, if not impossible, to meet the requirement of regard for the investing public, since any sale based upon undisclosed inside information would seem to be inherently in disregard of the risk of loss to the investing public. Third, according to the theory, banks trading upon inside information could avoid liability by superficial compliance with its requirements. Finally, the rule gives a trust beneficiary the privilege of taking investment advantage of inside information — a privilege denied to all other investors — simply because a trust relationship is involved. It is submitted that in view of the disclosure policy behind rule 10b-5, such a broad grant of immunity cannot be justified.[79]

B. *Full Disclosure*

Since it is unlikely that commercial banks will be immunized from the operation of rule 10b-5, the next most effective solution would appear to be to ensure the prompt public dissemination of all material inside information. Disclosure could be achieved in two ways: by banks voluntarily adopting a policy of encouraging corporate customers to disclose confidential information, or by legislation and administrative rules requiring either the banks or the corporate customers to make such disclosures.[80] A bank policy of encouraging its corporate customers to disclose would probably have little practical effect as those customers would most certainly resist an attempt to make public

77. Schuyler, *supra* note 53, at 54.

78. *See* text accompanying note 18 *supra*.

79. *Id.*

80. *See* text accompanying notes 119-24 *infra*.

any confidential corporate information.[81] However, this policy could conceivably reduce the bank's potential liability to the extent that it indicates the bank's intent not to misuse the information.

On the other hand, requiring banks to disseminate to the public all material inside information within a reasonable time period after it is received would substantially reduce the risk of the information being misused, although misuse could still occur between the time the information is received and the time it is disseminated. If this disclosure requirement were imposed upon a bank, it would of necessity take precedence over the duty of a bank to its corporate loan customers not to disclose the confidential information given in order to obtain a loan. However, the status of the duty of a bank to its trust beneficiaries to gather and utilize all of the information for the benefit of its beneficiaries would remain uncertain. The trust department, as a part of the single entity which includes the commercial department, might still have access to the inside information prior to its public dissemination and therefore, could use it unlawfully in the course of its trading activities.

A statutory requirement of public disclosure by corporations of any material inside information they possess would eliminate the inside information problem of banks under rule 10b–5. The weakness of this mandatory disclosure approach is the assumption that the investing public should have complete access to an issuer's confidential corporate information. There are many instances when a corporate treasurer must maintain a confidential relationship with a bank in order to structure the details of the proposed plan which is the subject of financing.[82] To disrupt such a relationship merely to avoid the potential misuse of information by a bank trustee seems shortsighted. However, at the same time a more complete disclosure of non-confidential information by banks and their corporate borrowers would reduce, although not eliminate, any potential abuse by reducing the quantity of inside information available for the bank trustee's exclusive use.[83]

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81. *See* text accompanying note 71 *supra*.

82. For example, confidentiality is essential where a proposed corporate restructuring entails the sale of a profitable, partially owned subsidiary. If the plan or its details were made public, the price of the stock of the subsidiary could become distorted, thereby disrupting the delicate negotiations.

83. Bank trust departments have recently set about disclosing information about their asset size and their policies with respect to such matters as trading and proxies. *See generally* GIRARD BANK TRUST DEPARTMENT, ANNUAL REPORT (1974). Additionally, the SEC is now authorized to require the disclosure of certain portfolio holdings and trading activities of banks and other large institutional investment managers. 15 U.S.C.A. § 78m(f) (1975). Certain banks are already required to file similar reports with the Comptroller of the Currency. 12 C.F.R. § 9.102 (1975).

C. *Spin-Offs*

On its face, a complete spin-off of a bank's commercial and trust activities would appear to be one of the simplest solutions to the insider information problem of commercial banks.[84] This concept gained favor following a 1968 report issued by the Subcommittee on Domestic Finance of the House Banking and Currency Committee dealing with the concentration of economic power in commercial banks.[85] While the report primarily focused on the power that banks could exercise over non-bank corporations,[86] the observations made are applicable to the rule 10b-5 dilemma of commercial banks. If the banking and trust departments of commercial banks were completely separated and rendered independent entities, the potential flow of information would be eliminated. Although each would still be subject to liability under rule 10b-5, each would be free of the conflicting duties they possess when considered as parts of a single entity. However, the potential benefits of such a solution would be outweighed by the far more serious problems the solution would pose to the structure of our financial institutions and capital markets. For example, one of the most difficult problems to resolve in considering a complete spin-off of trust activities is whether the resulting independent companies would have sufficient capital accounts out of which potential surcharge claims could be satisfied.[87] As of December 1974, commercial banks insured by the Federal Deposit Insurance Corporation had a total of over $60 billion of capital accounts.[88] Although it is arguable whether such a large amount of capital is necessary, this abundance of capital can assure a degree of public confidence in financial institutions, even after a period of substantial stock market decline. Additionally, in the absence of

84. Bank trust department activities are generally within the corporate structure of a bank rather than within the structure of a bank holding company. Although the term "spin-off" can refer to a movement of these activities from the bank to the holding company, this article contemplates a complete separation of the functions, including separate incorporation and capitalization. For further discussion of the holding company spin-off concept, *see* D. GREEN & M. SCHUELKE, THE TRUST ACTIVITIES OF THE BANKING INDUSTRY 18-21 (1975) [hereinafter cited as GREEN & SCHUELKE] (study prepared for the Trustees of the Banking Research Fund Association of Reserve City Bankers).

85. STAFF REPORT FOR SUBCOMM. ON DOMESTIC FINANCE OF THE HOUSE COMM. ON BANKING AND CURRENCY, 90th Cong., 2d Sess., COMMERCIAL BANKS AND THEIR TRUST ACTIVITIES: EMERGING INFLUENCE ON THE AMERICAN ECONOMY (Comm. Print 1968).

86. *Id.* For a comprehensive analysis of the report, *see* AMERICAN BANKERS ASSOCIATION, THE ECONOMIC POWER OF COMMERCIAL BANKS 1 (1970).

87. A surcharge claim is a suit for damages brought against a trustee for losses to the beneficiaries caused by a breach of trust. *See* BOGERT, TRUSTS AND TRUSTEES, *supra* note 54, § 862.

88. *See* FEDERAL DEPOSIT INSURANCE CORPORATION, BANK OPERATING STATISTICS Table A (1974).

protective legislation, spin-offs could lead to takeovers by non-financial institutions which might be more prone to misuse the economic power of trust assets.[89] Finally, since as a matter of history only the largest trust departments have been profitable,[90] there would be pressure in the industry to consolidate, thereby exacerbating the already extant problems of concentration.[91]

D. *Abstention*

Another possible solution would require a bank to abstain from trading in a particular corporation's securities when, due to a banking relationship with a client, it is in a position to obtain material inside information about that corporate customer. Assuming that the commercial and trust departments are considered as merely parts of a particular entity, two questions must be resolved. First, would this abstention violate the duty a bank trustee owes to its trust beneficiaries, particularly if the information is determined later to be neither material nor inside? Second, since a large bank is in a position to obtain material inside information about many corporations, would this restriction prevent a trust department from trading in such a large number of securities that it could no longer operate effectively?

89. The authors have observed that the Federal Reserve Board uses a guideline that capital should be equal to twice a trust department's annual gross income. Therefore, a department with $4 billion in trust assets and $12 million in annual gross revenue would require capitalization of only $24 million. In such a situation a non-bank entity could acquire control over the investment of this $4 billion in trust assets at a cost of only $12.2 million or 51% of the total required capital.

90. *See* Ehrlich, *The Functions and Investment Policies of Personal Trust Departments — Part II*, FED. RESERVE BANK OF N.Y. MNLY. REV. 14 (Jan. 1973). *See also* FEDERAL RESERVE SYSTEM, FUNCTIONAL COST ANALYSIS — 1974 AVERAGE BANKS 16. Product mix is also responsible for varying degrees of profitability between different trust departments. Product mix includes the range of various services that a particular trust department offers such as estates, personal trusts and investment advising. It should be noted that it is primarily the larger commercial banks that offer the more extensive range of fiduciary services. Ehrlich, *supra*, at 12.

91. The problem of concentration has been summarized as follows:

> Bank trust departments are too big. Their total of $400 billion of assets administered puts too much of the private capital of the country — and, therefore, corporate control — in the hands of one kind of institution — banks. This is particularly true of the 250 banks that administer 89% of the trust assets.

Trust Separation from the Bank, 66 BANKING (Feb. 1974), at 26.

In response to the allegation of over-concentration, it has been stated:

> Separation of the trust function from banks would not necessarily reduce the amount of assets administered by trust companies. In fact, it might well increase the concentration in few institutions, as smaller trust companies found it difficult to attract capital and had to drop out of the business. Moreover, the concentration issue is a synthetic one, because banks do not alone make the investment decisions involved in hundreds of billions of dollars of assets for which the banks are custodians.

Id. at 27. For an analysis of the impact of institutional investing on corporations and the capital markets, *see* C. ELLIS, INSTITUTIONAL INVESTING 227-35 (1971).

From the standpoint of the beneficiary, abstention involves serious problems since it would result in the beneficiary being bound to an illiquid investment over a considerable length of time. For example, if the commercial department was deeply involved with a troubled corporation, it would have access to a stream of inside information covering a period of months or years. Since most trust instruments do not provide for an automatic or simple method of changing trustees, the beneficiary would be burdened with an investment even though a decision on purchase or sale could be reached independently of the inside information. Furthermore, the bank trustee's abstention would be based solely upon its desire to avoid liability under rule 10b–5 with a resultant detriment to the trust beneficiary. It is arguable that such a self-serving action should increase the trustee's liability to the beneficiary, particularly if the information was later determined not to be material.[92]

Brokerage firms, faced with similar inside information difficulties, have periodically attempted to resolve their dilemma by abstention.[93] If the underwriting department of a firm is in negotiation with a corporation, the retail department will not trade in or recommend that corporation's securities. Often the abstention is internally effectuated by the use of a restricted list which includes the names of all the corporations with which the underwriting department is dealing. The retail department will abstain from trading in the securities of the corporations listed.

Abstention proves effective in the brokerage industry since most underwriting is concluded in a relatively short period of time. The retail customer does not permanently loose any liquidity since a transaction can always be executed with another firm. As applied to trust departments and their beneficiaries, however, such a proposal could prove disastrous. Large commercial banks maintain long-term, multiservice relationships with a wide number of corporations throughout the country;[94] with such a large customer base, it would not be practical to create a restricted list or to abstain from trading in the securities of corporations where there is a substantial chance the commercial department would obtain inside information. Not only would trust department investment activity be limited, but stock prices would be adversely affected if a trust department had a substantial amount of money invested in a limited number of securities. Both of these conse-

92. *See* text accompanying notes 54 & 67–68 *supra.*

93. *See* Brief for Salomon Brothers as Amicus Curiae at 5, 13, Slade v. Shearson, Hammill & Co., 517 F.2d 398 (2d Cir. 1974).

94. FORTUNE MARKET RESEARCH, BUSINESS & BANKING 1 (1975).

quences would obviously be detrimental to the interest of the trust beneficiary.

E. *The Chinese Wall*

Commercial banks frequently attempt to resolve their dilemma by creating a so-called "Chinese Wall" (Wall) between their commercial and trust departments. The Wall consists principally of policy statements purporting to either restrict or eliminate the flow of information between these departments.[95] In some cases the Wall also involves a physical separation, although such a separation normally occurs only in larger commercial banks.[96] The Wall not only prohibits the flow of material information, but in many cases eliminates the flow of all information without regard to its materiality, thus ensuring independent investment decisionmaking by the trust department.[97] The policy statements vary from bank to bank, but they generally restrict the trust personnel's access to the commercial department's credit files. Since most Wall policy statements do not refer to routine communications between departments, it can be inferred that such communications are not restricted.[98] In fact, many banks encourage coordinated communications in such areas as marketing and sales.[99]

At first glance, the Wall appears to resolve two of the bank's three conflicting duties. The trust department in a "walled" environment would not, theoretically, have access to material inside information upon which it could trade and would therefore not violate the duty that it owes to the investing public to disclose or abstain from

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95. E. HERMAN, *supra* note 46, at 76, 83–87.

96. A Wall is more difficult to create in a small bank because the bank personnel may be in close physical proximity and may be assigned overlapping trust and banking functions. *Id.* at 83.

97. *Id.* at 84.

98. The policy statement of one bank dictates:

> 3. No Trust Department action or investment decision such as the purchase or sale of a security, shall be made on information that could reasonably be construed as "insider information." Employees who possess such information are prohibited from taking independent action, either on behalf of an account or for his personal benefit, until that information is available to the market place generally. This is particularly true in the relationship between the Girard banking and trust departments where inside information could be construed to have been obtained through banking relationships. . . .
>
> 4. Trust Department personnel shall not have access to the files of the Bank's Credit Department and should advise their customers, when possible, that they should not expect us to rely on any information received through banking relationships when making investment recommendations for their account.

GIRARD BANK, TRUST DEPARTMENT POLICY HANDBOOK 7 (1975) (emphasis omitted).

99. E. HERMAN, *supra* note 46, at 79–80. *See also* GREEN & SCHUELKE, *supra* note 84, at 39.

trading.[100] At the same time, the commercial department of the bank would not have cause to violate its duty to the corporate customer not to disclose any confidential information. However, the Wall does not completely resolve the duty that a trustee owes to the trust beneficiaries to seek and utilize all available information in making trust investment decisions. As previously stated, a trustee has no duty to violate the law.[101] However, it is uncertain whether this principle will apply to banks because of a possible "higher" duty arising from a trust relationship.[102] The question would be further complicated by banks who restrict all credit information regardless of its materiality, since they are deliberately closing a source of valuable information merely to protect themselves from liability under rule 10b–5.[103]

Presently, there are two main problems with the use of a Wall as a successful solution to the dilemma faced by commercial banks: its present uncertain legal status and the difficulty in constructing an effective Wall.

1. *Legal Effect*

The legal effect of a Wall is currently the subject of litigation in the Second Circuit. In *Slade v. Shearson, Hammill & Co.*,[104] the retail salesmen of a brokerage firm had allegedly promoted the sale of common stock to various customers without divulging to them material adverse information possessed by the firm's investment banking department.[105] The purchasing customers brought an action against the brokerage firm under rule 10b–5. In support of its motion for a summary judgment, the firm alleged, *inter alia*, that it had a Chinese Wall policy which prevented the adverse information from being communicated to the retail brokerage department.[106] Rejecting this defense, the district court denied the motion for summary judgment[107] and certified[108] the following question for review by the Second Circuit:

> Is an investment banker/securities broker who receives adverse material non-public information about an investment banking

100. *See* text accompanying note 38 *supra.*

101. *See* text accompanying note 64 *supra.*

102. *See* text accompanying note 66 *supra.*

103. *See* text accompanying note 54 *supra.*

104. 517 F.2d 398 (2d Cir. 1974). For a comprehensive analysis of the *Slade* case, *see* Lipton & Mazur, *The Chinese Wall Solution to the Conflict Problems of Securities Firms*, 50 N.Y.U.L. REV. 459, 478–87 (1975).

105. One of the disputed issues on appeal was whether the defendant had "solicited" the purchase of securities or had "recommended" them, and whether this distinction had any bearing on the defendant's liability. 517 F.2d at 402.

106. *Id.* at 401.

107. Slade v. Shearson, Hammill & Co., [1973–74 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,329 (S.D.N.Y. 1974).

108. *Id.* at ¶ 94,439.

client precluded from soliciting customers for the client's securities on the basis of public information which (because of its possession of inside information) it knows to be false or misleading?[109]

The Second Circuit remanded the case to the district court, stating that the question could not be answered without certain factual determinations, including whether an effective Chinese Wall existed in the brokerage firm.[110] Hopefully, in requesting a determination of whether a Wall existed, the *Slade* court was contemplating giving judicial approval of a Wall, with a view to imposing liability only if it could be proven that a trust department knowingly traded on the basis of inside information. Such a judicial position is at present only a matter for conjecture, and the legal effect to be given the Wall by the judiciary will depend on the outcome of the *Slade* litigation.[111] However, one immediate result which has brought comfort to the banking community is the favorable position adopted by the SEC in the *Slade* case with respect to the Chinese Wall.[112] The concern of the banking industry with *Slade* is well-taken since both the Second Circuit and the SEC have recognized that the considerations involved in the case have an effect on the commercial department/trust department relationship of commercial banks.[113]

Federal legislation and administrative regulation would facilitate the successful implementation of the Chinese Wall as well as the utilization of any of the other alternative solutions. To the authors' knowledge, neither the federal agencies regulating commercial banks[114] nor the SEC has directly dealt with the dilemma. The Office of the Comptroller of the Currency prepared a regulation which favored the estab-

109. 517 F.2d at 399.

110. *Id.* at 402-03.

111. One recent development favorable to the legal validity of a Wall is the decision of the United States Supreme Court, in Ernst & Ernst v. Hochfelder, 44 U.S.L.W. 4451 (U.S. Mar. 30, 1976). In *Hochfelder,* the Court held that a private cause of action for damages will not lie under rule 10b-5 in the absence of an intent to deceive, manipulate, or defraud. *Id.* at 4460. While the issue of intent is distinct from the issue of the legal effect to be given a Wall, *Hochfelder,* when read in conjunction with the recent decision of the Court in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), indicates a judicial trend to restrict the scope of liability under rule 10b-5. *See* note 69 *supra.*

112. *See* Brief for SEC as Amicus Curiae at 8-9, Slade v. Shearson, Hammill & Co., 517 F.2d 398 (2d Cir. 1974).

113. 517 F.2d at 400; *see* text accompanying note 118 *infra.*

114. There are three agencies primarily responsible for the federal regulation of bank trust departments: 1) the Comptroller of the Currency, who is mainly responsible for overseeing the trust departments of national banks, 2) the Federal Reserve System, which examines its member banks, and 3) the Federal Deposit Insurance Corporation (FDIC), which regulates state banks that are not members of the Federal Reserve, but which are insured by the FDIC. *See* AMERICAN BANKERS ASSOCIATION, *supra* note 86, at 56-59.

lishment of a Wall, but it furnished few guidelines and the regulation was ultimately abandoned.[115] The SEC has conducted studies on the general problem of insider liability and disclosure, but not specifically as it relates to bank trust departments.[116] However, as previously mentioned, the SEC has recognized that the problem does exist in the commercial banking industry,[117] and has expressed the following concern:

> [D]rastic consequences may flow from a rule which would preclude a brokerage firm from having any transactions with or on behalf of customers in the securities of the perhaps numerous companies with which it has investment banking relationships, or from a comparable rule which would preclude a bank trust department from effecting transactions in the securities of companies with which the bank has a commercial banking relationship.[118]

The present problem with federal administrative regulation is that none of the federal agencies has the authority to formulate rules which could resolve the entire dilemma of commercial banks. While banks are subject to liability under section 10(b) of the 1934 Act, they are for the most part otherwise exempt from the securities acts and outside of the purview of the SEC.[119] On the other hand, the bank regulators are inexperienced in the intricacies of the securities markets and their regulation. Their authority is limited to the regulation of the banking industry, and traditionally they have been more concerned with the safety of depositors' funds than with the interests of the investing public.

Accordingly, some form of cooperation among the federal agencies is necessary. This cooperation may be forthcoming, at least to

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115. Proposed Treas. Reg. § 9.7, 39 Fed. Reg. 14510 (1974). The amendment as initially proposed contained a requirement that banks establish policies and procedures to "ensure that investment decisions of the trust department [were] not based upon non-public information." *Id.* The proposal was not adopted. 39 Fed. Reg. 28144 (1974).

116. *See Hearings on "A Study of the Securities and Exchange Commission" Before the House Comm. on Interstate and Foreign Commerce,* 82d Cong., 2d Sess. 81, 635, 840 (1952).

117. *See* text accompanying note 113 *supra.*

118. Brief for SEC as Amicus Curiae at 8–9, Slade v. Shearson, Hammill & Co., 517 F.2d 398 (2d Cir. 1974).

119. Sections 3(a)(2) and 3(a)(5) of the 1933 Act exempt bank securities from registration of their securities. 15 U.S.C. §§ 77(c)(a)(2), (5) (1970). Sections 3(a)(4) and 3(a)(5) of the 1934 Act exclude banks from the definition of broker or dealer. 15 U.S.C. §§ 78c(a)(4), (5) (1970). Sections 202(a)(3), 202(a)(7), and 202(a)(11) of the Investment Advisers Act of 1940 exempt banks from the definition of a broker, dealer, or investment adviser. 15 U.S.C. §§ 80b-2(a)(3), (7), (11) (1970). Sections 3(c)(3) and 3(c)(11) of the Investment Company Act of 1940 exempt common trust funds from the definition of an investment company. 15 U.S.C. §§ 80a-3(c)(3), (11) (1970). This pattern of legislative exemption of banks has resulted in the SEC having relatively little experience with banks or their activities.

some degree, as under the Securities Acts Amendments of 1975,[120] the federal securities and banking regulators are now required to work together in the areas of transfer agent registration,[121] institutional disclosure,[122] and municipal dealer registration.[123] If the federal agencies work cohesively in these areas, appropriate rules and regulations dealing with the dilemma of commercial banks are possible.

In the final analysis, congressional legislation may be the only effective way to resolve the dilemma.[124] Such legislation could recognize the validity of the Wall and place a prohibition on the flow of information between the commercial and trust departments of a commercial bank. Ideally, the burden could be placed upon a potential plaintiff to prove that the Wall had been pierced and that the trust department had in fact acted upon the material inside information. To resolve the predicament fully and without ambiguity, such legislation would also have to contain a provision overriding conflicting state law and eliminating the duty of a trustee to gather all relevant investment information in this situation.

2. *Constructing a Wall*

In the absence of Congressional action, a self-imposed Wall seems to be the only practical alternative to which commercial banks can turn in order to reduce their potential liability. In terms of liability under rule 10b–5, the success of a Wall is ultimately dependent upon its credibility; it is important that the Wall be perceived by the public as effective and, more importantly, that a bank can demonstrate such effectiveness in a rule 10b–5 proceeding.[125] There appear to be several factors which detract from the credibility of a Wall. For example, a Wall does not prohibit common dining facilities where commercial department and trust department officers may share lunch-

120. 15 U.S.C.A. §§ 78a *et seq.* (Supp. 1975).

121. *See id.* § 78s(a)(2).

122. *See id.* § 78m(f)(1).

123. *See id.* § 78*o*–4(c)(6).

124. Congress has recently resolved one conflict between the areas of trust law and federal securities regulation with the "paying up" provision of the Securities Acts Amendments of 1975. *Id.* § 78bb(e). "Paying up" refers to the payment of a brokerage commission in an amount which exceeds the actual cost of executing the security transaction, frequently used to compensate a broker for research services. Traditional trust law would prohibit this, since it requires a trustee to execute a transaction at the lowest possible price. Section 78bb(e) is an attempt to legalize the concept of trustee utilization of part of the commission received from the trust as compensation for research services. *See generally* S. REP. No. 75, 94th Cong., 1st Sess. 69–71 (1975).

125. The inherent credibility of the Wall has been openly questioned by a number of commentators. *See* E. HERMAN, *supra* note 46, at 77; Harfield, *Texas Gulf Sulphur and Bank Internal Procedures Between the Trust and Commercial Departments,* 86 BANKING L.J. 869, 878 (1969); Yellon, *supra* note 47, at 412–14. *See also* note 58 *supra.*

time conversations. A Wall cannot realistically prevent these informal conversations and does not pretend to guarantee such a complete blockage of information. Also, there will always be doubt whether in a crisis situation an officer such as the bank president would not, or more importantly could not, obtain and use all of the information held by the bank.[126] In short, unless a bank takes positive steps to ensure compliance with the Wall policy, the Wall will be of questionable value.

Several steps may be taken to enhance the Wall's credibility. Initially, in formulating their policy statements, banks should consider eliminating the flow of both material and nonmaterial information, since allowing a trust officer access to credit files for routine or nonmaterial information presents several problems. First, bank officers may not be in a position to determine what is material for rule 10b–5 purposes, and second, it is doubtful whether a court would consider such a partial screen effective.[127] Banks might also consider notifying their customers of their policies and stating clearly that trust customers should not expect the trust department to use any information the commercial department may possess. However, because of the possibility of unknown or unborn remaindermen involved with trusts, such a task could be formidable. To the degree it was possible, however, this policy would reduce the number of potential plaintiffs. Additionally, banks should adopt a "two-way" rather than a "one-way" Wall. The "one-way" concept would allow commercial officers to use trust department files and only prohibit trust officers from utilizing commercial department files. While there seems to be no legal prohibition to the "one-way" concept, it is damaging to the extent that it reduces the credibility of the Wall. Finally, trust officers and commercial officers should not sit on common committees such as the trust department's investment policy or stock selection committee. Such a situation would obviously raise a question of whether a commercial officer would influence the group based on material inside information. Furthermore, in every bank there is usually one member of senior management who has responsibility for both the banking and trust departments. This officer should, to the extent possible, avoid involvement in the day-to-day operations of either group.

Other procedures a commercial bank might consider in creating a Wall include physical separation of the departments and a compliance program. Physical separation is receiving more attention in recent years because many people feel that it serves as a concrete

126. For an illustration of such a crisis, *see Investigation of Conglomerate Corporations. Part 2: Leasco Data Processing Corp. Before the Antitrust Subcomm. of the House Comm. on the Judiciary,* 91st Cong., 2d Sess., pt. 2 at 148, 532 (1969).

127. *See* note 58 *supra.*

manifestation of the concept of complete trust department autonomy. In some instances, physical separation is accompanied by a transfer of all or part of the bank's investment management functions to its holding company. Compliance programs are helpful if effective; however, most compliance programs are composed of policy statements or rules of conduct which may be difficult to enforce.

A business practice detrimental to an effective Wall is the joint calling and sales program conducted by most banks. These programs consist of banking officers introducing trust officers to their corporate clients and vice versa, and are premised upon the belief that a long-standing banking relationship is a strong inducement to creating a trust relationship. Bankers, for the most part, believe that these programs are essential in generating new business and serve the public interest by fulfilling the needs of customers. In further support of the joint calling and sales programs, bankers point to the fact that there exists little evidence of abuse in these areas. Nevertheless, these programs do represent a potential weakness in what might otherwise be considered a credible Wall.

VI. CONCLUSION

Banks have historically been proud of the working relationship between their commercial and trust departments. In fact, for many years trust departments have offered this relationship as a selling point, contending that a trust department could make more informed investment decisions because it had access to more information.[128] The growth of liability under rule 10b–5 and the disclosure dilemma it has created for banks has obviously brought an end to this era. In developing a solution to the dilemma currently faced by commercial banks, two factors must be considered. First, to what extent is change necessary? Second, what impact will any change have on the structure of our financial institutions?

In response to the first question, little damage has resulted from the current operating structure of commercial banks. The dilemma does not arise from the practical operations of commercial banks, but rather from the extension of rule 10b–5 to situations not originally contemplated by the rule.[129] In such a case, it would seem appropriate to cure only the technicality and not subject the system to major surgery.

The critical nature of the answer to the second question requires

128. For a discussion of the desire of corporate financial executives for full-service banking, *see Why Corporate Customers Like Banking's New Power,* BUS. WEEK, Sept. 15, 1973, at 150.

129. *See* 1 BROMBERG, *supra* note 16, §§ 2.2(410)-(420).

a careful evaluation of each of the proposed solutions; only those with the least amount of disruption to the capital markets should be adopted.

The solution offered by Professor Schuyler of immunity from rule 10b–5 would have the least effect upon the present operating structure of our financial institutions. However, this solution has only a minimal chance of adoption since it runs directly counter to the disclosure policy of rule 10b–5 as perceived by the courts and the SEC. While the alternative of full disclosure would relieve the commercial banks from liability under rule 10b–5, it would cause a severe disruption of the capital markets by destroying the confidential banker-corporate client relationship essential to the smooth operation of the capital markets. A spin-off of the trust department from the other departments of a commercial bank would create more problems than it would solve in the nature of potential insufficient capitalization or increased concentration. Abstention cannot be realistically adopted by the banking industry since it would result in a distortion of stock market prices and an undesirable illiquidity in the investment of trust assets.

In the final analysis, the most effective solution can only result from a dedication of legislative and administrative resources to the dilemma. However, since this seems unlikely at the present, commercial banks must protect themselves by the implementation of a Wall.

Conflicts of interest exist in every business. However, it is essential that these conflicts be recognized and resolved in a manner equitable to all parties. Commercial banks have attempted to do this by erecting the Wall and it remains for Congress and the courts to give recognition and viability to its existence.