

**INSIDER DEALING AND THE CHINESE WALL: A LEGAL, ECONOMIC,  
AND POLICY ANALYSIS**

by

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THESIS TITLE: INSIDER DEALING AND THE CHINESE WALL - A LEGAL,  
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## ABSTRACT

Insider dealing has been in the public eye for many years now. The impact of Big Bang and the growth of financial conglomerates has, however, propelled the practice to the very forefront of regulatory concern. Regulators are faced with a dilemma: financial conglomerates bring with them many economic benefits, but they also accentuate the problem of insider dealing, in that the greater availability of inside information within these open ended financial houses, increases the scope for its misuse. Regulators must ensure that the regulation imposed does not overly impede the benefits to be gained from conglomeration; yet they must ensure that regulation is sufficiently stringent to provide a fair market place. The Chinese Wall - a self-styled mechanism consisting of policies procedures designed to stop the flow of inside information within financial conglomerates - is singled out for special treatment. The legal and policy problems associated with the use of the mechanism are reviewed. These revolve around two main issues:

- (i) Is the Wall an effective policy device to rebut allegations of insider dealing in a financial conglomerate where Arm A is dealing in shares in Company X while arm B has information pertaining to Company X.
- (ii) If the Chinese Wall actually works, does the operation of the mechanism give rise to breach of fiduciary obligations ie. to what extent does the operation of the Chinese Wall in conglomerates modify traditional fiduciary law.

The conclusion reached is that the Chinese Wall offers regulators the best solution to the problem of conflicts of interest and obligation in fully fledged financial conglomerates. The Wall must, however, be 'strengthened' to prevent, for example, a corporate fiduciary dealing for its own account where another department within the conglomerate has a material interest in the transaction. At common law, the courts ought to, and probably would, accept this approach. However in an action brought under the SIB rulebook, and the rulebooks made thereunder, it would seem that the courts are bound to accept a Wall per se (ie. without being strengthened) as valid. To the extent that this differs from what ought to be the position at common law, the SIB rulebook should be modified.

A tentative import of economic analysis is used to complement the largely legal analysis. In this way it is hoped to gain a better grasp of the policy issues under study.

## INTRODUCTION

Financial markets world wide have been undergoing a process of rapid change. This is especially evident in the U.K., where the deregulation of commissions, epitomised by Big Bang, ushered in a new era which completely revolutionised the provision of financial services on the London markets. The old single capacity system was discarded in favour of a new dual capacity regime whereby financial intermediaries could operate in a number of different capacities. The formation of financial conglomerates, marked best by the erosion of the traditional division between banking and securities business caused a major headache for regulators concerned with the proliferation of conflicts both of interest and duty and the increased potential for their abuse.

The Financial Services Act 1986 represented the authorities response to the new market regime. It aimed to establish "self-regulation within a statutory framework" and to make the London markets a clean place to do business. Under the Act powers provided for the erection of Chinese Walls to segregate the flow of price sensitive information between different departments within the one financial house. The SIB have made wide use of these powers. Indeed the main means of regulating conflicts of interest generally and insider dealing in particular within the context of financial conglomerates, is through the use of these in-house Walls.

Existing reseach has been primarily U.S. based and centres mainly on the use of Chinese Walls within either the context of banks per se, or, (and this has been true only more recently) in the context of multi-functional securities firms; but never both. The reason for this is that in the U.S., the Glass-Steagall Act 1933 prohibits the formation of fully fledged bank-securities



related financial conglomerates. British research into the legal and policy problems associated with the use of the mechanism has not been much in evidence, with all but a few notable exceptions. However even here the analysis has been set in a pre-big bang context where the range of financial services on offer was substantially less. With this in mind it seems appropriate that a new study be undertaken.

In an arena where the regulatory trends are ceaselessly fluid it is not surprising that some of factual analysis contained in the thesis is already dated, but this does not detract from the importance of the underlying policy and legal questions which have yet to be resolved. The law is stated as of 1 November 1988 although occasionally it has been possible to add material after that date.

Chapter One, outlines the context of the study, considering first the processes of deregulation and reregulation and in particular one aspect of each: on the one hand the growth of financial conglomerates, and on the other the regulation of conflicts of interest accentuated by conglomeration. The methodology of the study is also explained. Chapter Two pays special attention to deregulation in the U.K. and paints an overview of the new regulatory regime adopted in Britain. Conflicts of both interest and duty, highlighted by the fusion of banking and securities business, are then given treatment. Emphasis is placed on one conflict - insider dealing - and special emphasis is placed on the appropriate regulatory response to corporate insider dealing in financial conglomerates. Chapter Three explores the economic conundrum of insider dealing. It surveys the classic literature on the subject and comes to the general conclusion that insider dealing is an economic "bad" and as a result ought to be regulated. Chapter Four then goes on to explain the legislative and regulatory prohibitions placed upon insider dealing both here in the U.K.

and in the U.S.

Chapter Five looks at one particular means of regulating insider dealing in the context of financial conglomerates, that is, by means of the Chinese Wall isolation technique. The chapter addresses the question of what sort of policies and procedures actually constitute the Chinese Wall. Some fairly novel and as yet unresolved legal questions are considered in Chapter Six. This chapter examines the common law position of the Wall mechanism and draws on case law from the U.K., the Commonwealth and the U.S. Chapter Seven reviews official recognition of the mechanism as expressed in statutory provisions and the regulatory measures which have evolved therefrom in both the U.S and the U.K. Chapter Eight offers a policy assessment of the mechanism. The analysis is couched in terms of the suitability of the Chinese Wall when compared with other competing regulatory options. When considering the Wall, special emphasis is placed on whether the mechanism works and on how it is enforced.

Finally, Chapter Nine offers a summary of the salient points of the thesis concluding that despite a number of serious reservations about the adequacy of the Chinese Wall both from an enforcement point of view and from a legal angle, the Wall represents the most appropriate regulatory mechanism available to regulatory authorities in their attempts to control the flow of price sensitive information in financial conglomerates. As a result judges at common law should, in certain circumstances permit financial conglomerates to rely on the device: (1) as a defence to rebut the imputation that information held by one arm of a conglomerate is not held by another and (2) to satisfy the rigors of strict fiduciary obligations. These special circumstances are outlined.

## CHAPTER ONE: SETTING THE SCENE

### Deregulation and Re-regulation: The International Environment

The processes of deregulation and re-regulation are assuming greater importance in financial markets world-wide. When formulating policy, governments are being put under increasing pressure to ensure that their financial sectors do not lag behind either the needs of the economy as a whole, or the rigours of a fast changing international financial environment.

The policy goals which governments seek to secure include: investor confidence, consumer protection, safety and soundness among financial institutions, efficiency, competition, and the need to ensure that economic power does not become concentrated in the hands of any one sector of the financial services industry.<sup>1</sup> Almost invariably these goals conflict and as a consequence some form of "trade-off" between the competing needs of deregulation and re-regulation is required.<sup>2</sup> The terms deregulation and

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1. See, the list of objectives underlying the U.K. Governments regulation of the U.K. financial markets in, Financial Services in the United Kingdom: A Framework for Investor Protection (1985), Cmnd. 9432, para. 3.1 (hereinafter the "White Paper"). The objectives are clearly stated as: efficiency, competitiveness, confidence and flexibility.

2. See, D. Lomax, "Financial Supervision and Regulation", (1987) August in National Westminster Bank Quarterly Review, at p.3. Therein he states that although "[t]here is no inherent conflict between the maintenance of effective regulation and supervision on the one hand ... and competition and efficient markets [on the other, it is, however,] not always easy to achieve these objectives at the same time." Indeed, Llewellyn cites a practical conflict for policy makers in that - "Consumers demand the benefits of regulation but at the same time require services to be provided competitively." See, Llewellyn, "Competition and the Regulatory Mix", (1987) August in National Westminster Bank Quarterly Review 9, at p.9.

re-regulation do not lend themselves to easy definition.<sup>3</sup> They can rarely, if ever, be considered as two opposing forces, for more often than not both processes run hand in hand. The trend in financial markets today is, however, towards a process of deregulation in the form of financial diversification.<sup>4</sup> This is being achieved by giving market forces a freer reign in the shaping of market operations.<sup>5</sup>

### What is Financial Deregulation?

Financial deregulation can mean any or all of the following: first, the removal of price restrictions - eg., the deregulation of fixed commissions in favour of a more competitive commission scheme. This took place in the U.S. in May 1975 and on the UK Stock Exchange in October 1986. Secondly, the removal of geographic limitations or cross-border barriers through developments in technology and the development of a 24 hour global market. Thirdly, the removal of legal constraints and other self-imposed restrictive barriers separating banks from other financial institutions. And finally product diversification and the introduction of new products and financial instruments brought about by technological change or competitive pressures.

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3. Llewellyn doubts the practicability of the term deregulation. Supra, note 2 (at p.4) he writes "[T]he fashionable term "deregulation" is at best ambiguous but in truth a misnomer and not an accurate description of what is happening either in this country or elsewhere." For what is happening see, accompanying text at note 5 et seq.

4. But Llewellyn, commenting on the state of affairs in the U.K. financial sector, says supra, note 2 (at p.9), "While institutions are broadening their range of financial services ... the way each sector of business is conducted is becoming more explicitly regulated."

5. Supra, note 1, at para. 3.2. "Market forces provide the best means of ensuring that an industry meets the needs of its customers." (emphasis added).

## Why is Deregulation Taking Place?

Three reasons may be given to explain why deregulation is taking place: It could be argued that there is a greater confidence among policy makers and market participants concerning the ability of the market mechanism to secure many of the aforementioned policy objectives and to challenge the appropriateness of certain forms of pre-existing financial sector regulatory measures. Similarly pressures from certain sectors within the financial services industry itself have pushed towards deregulation. For example, the formation of financial conglomerates in the U.K. was a response by market participants to embrace market forces rather than the outcome of a specific government policy. The same is true in the U.S where the banking sector has been eager for some time now to find loopholes in the Glass-Steagall Act 1933 (which segregates to a large extent the banking and securities business) and expand into other, more profitable, areas of financial service activity. The desire to diversify has been prompted by a need to boost dwindling profit margins in an increasingly competitive traditional banking sector.<sup>6</sup> Then lastly, technology, innovation and the internationalisation of the securities markets has created an environment where new products and financial packages are forcing highly regulated centers to lessen restrictions inhibiting competition in order to attract more business.

These factors have led to a situation where in the U.K., for example, the division between commercial and investment banking has largely been eroded. The tendency then has been towards greater reliance upon market forces and competitive freedom - a shifting of the emphasis in the way governments aim to

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6. Securities firms, who fear that increased competition from banks will be detrimental to their market status, are among those most eager to resist an expansion in the banking domain.

trade-off the aforementioned public policy goals and in the regulatory means by which these goals are to be secured.

### The Regulatory Paradox: The Trend Towards New Regulatory Measures

Despite this present day tendency in financial markets towards a more laissez faire environment, the forces of deregulation and reregulation create what might be called a "regulatory paradox".<sup>7</sup> While deregulation refers to the breaking down of barriers that inhibit competition, impede efficiency, and restrict consumer choice, governments nonetheless acknowledge that some policy goals are too important to be left solely to market forces. New regulatory measures are therefore necessary.<sup>8</sup> Easterbrook, observes:<sup>9</sup>

Regulation displaces competition. Displacement is the purpose, indeed the definition of regulation ... Sometimes legislation may be justified as necessary to correct "imperfections" in the markets, but in most cases regulation is designed to defeat the market altogether

Essentially this regulation is the supervision of conflicts of interest and

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7. Llewellyn alludes to this supra, note 2, at p.4, where he writes: "What is happening is that the regulatory mix is changing. It is for this reason that re-regulation is a more appropriate term than de-regulation for, in many ways, the regulatory environment is becoming more formal and detailed. At the same time institutions are being given more freedom over the type of business they may conduct. It is not clear on balance whether this creates a more or less regulated financial system than before." (emphasis in the original)

8. Ibid., at p.7, "[In] any financial system regulation is a varying mix of law, self-regulatory arrangements, moral suasion and self-imposed constraints ... De-regulation on the other hand is about the changing mix of these components. What is happening in the U.K. is that for each sector the regulatory matrix is changing." (emphasis in the original)

9. "Antitrust and the Economics of Federalism", (1983) 26 Journal of Law and Economics, 23, at p.23.

other risks that arise out of the process of deregulation.<sup>10</sup> Buxton, rightly, suggests that policies of both regulation or deregulation are neither incompatible nor exclusive. He writes:<sup>11</sup>

... financial deregulation embraces a wide range of relaxations which have one thing in common: relevant authorities have allowed the market to change its participants or products ... [but this does not mean] that the resultant markets or products are unregulated.

Deregulation, then, is allowed but limits are placed upon it. Although the market might well exhibit the characteristics of a deregulated market place there is, nonetheless, a counter-trend towards new regulatory measures aimed at protecting investors and securing the safety and soundness of financial institutions. These factors point to a need for reregulation superimposed upon any underlying tendency towards competitive freedom. Indeed as Llewellyn says:<sup>12</sup>

the process of various forms of de-regulation is enabling financial institutions across the board to widen their range of services while at the same time the authorities are imposing a more stringent regulatory environment with respect to the conduct of each of their particular areas of activity.

The reason for this is the fear that unchecked deregulation could be conducive to systemic risk and market abuse. Consequently, set against a backdrop of deregulation, it may be helpful to isolate a number of different types of rule which regulators have adopted in order to resolve the delicate balancing process between an extremely complicated set of policy goals.

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10. See, Llewellyn, who makes a helpful distinction between regulation and supervision: "[B]y regulation is meant a body of specific rules or agreed behaviour, either imposed by some government or other external agency or self-imposed by explicit or implicit agreement within the industry, that limits the activities and business operation of financial institutions. Supervision is the process of monitoring that institutions are conducting their business either in accordance with regulations or more generally in a prudent manner." Gilbert Lectures on Banking 1986 The Regulation and Supervision of Financial Institutions, (Institute of Bankers 1986) at p.9.

11. Buxton, Financial Deregulation, The proceedings of a conference held by the David Hume Institute (Ed. R. Dale), May 1986 published by Woodhead-Faulkner Cambridge 1986 at p.14.

12. See, Llewellyn supra, note 2, at p.9.

(A) Prudential Rules: prudential supervision is essential to help ensure the safety and soundness of financial institutions. A prime example would be the imposition of capital adequacy requirements.

(B) Competitive Regulation: here the aim is to ensure that competition is not eliminated or seriously hampered by the formation of cartels - anti-trust laws in the U.S. are perhaps the best, or most typical, example of this.

(C) Regulations related to Concentration of Economic Power: the concern here is to prevent certain sectors of the financial markets from being "dominated" by other sectors of the industry or indeed certain individuals. Again, the U.S., where concern over the concentration of economic power is most strong, provides a good example of this sort of regulatory measure; there controls have been imposed on Inter-State banking.

(D) Consumer Protection Rules: an example of this type of regulation is the Securities and Investments Board's (SIB) compensation scheme. Under this scheme investors who are the victims of an abuse receive compensation provided the infringement falls within the SIB's jurisdictional powers.

(E) Conflict of Interest Rules: financial institutions hold a unique position of trust in handling funds belonging to the public. As a consequence, it is a prerequisite for the smooth running of the financial markets that there exists within its confines trust, confidence and integrity. The close proximity within which these financial institutions operate, coupled with the very special nature of financial services themselves, makes the industry notorious for the prevalence of what are commonly known as conflict of interest



situations. The aim here is to require firms to make full disclosure of the nature of the conflict and to release as soon as is feasible the relevant information in order to increase transparency and thus redress information assymetry. When this is done the investor can then make informed investment decisions about which shares to buy. Disclosure requirements are a key example of this type of regulation.<sup>13</sup>

Despite the shift in emphasis from regulation to deregulation there still remains an entrenched reliance upon regulatory measures. This "counter trend", as it could be called, is an attempt by governments to secure the confidence of the investing public in the financial markets. Even though the process of deregulation strips the market place of various forms of regulatory barriers it must be remembered that these markets do not operate in a regulatory void. Indeed caught up in this reshaping process is the need to tighten loopholes through new regulatory activity. Thus, the global movement away from re-regulation towards deregulation is essentially a switch from one type of regulation to another - the moving away from "barrier" or "prohibitive" types of solutions to those based on competitive freedom.

## **The Resultant Effects of both Deregulation and Re-regulation**

### One Aspect of Deregulation - Financial Conglomerates

Though deregulation is a difficult concept to define, the reshaping process which has developed as a result of it is readily apparent. Perhaps the most important outcome of deregulation in the U.K. has been the emergence of a

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13. See, infra Chapter Eight at note 71 and accompanying text.

new corporate creature - the financial conglomerate. Today it is now possible for the one financial house to undertake a range of financial services which include stock-broking, market-making, banking, corporate finance and investment management. The merging together of different financial institutions in this way to form "one-stop multi-service financial supermarkets" would not have been possible but for the relaxation of certain types of regulatory barriers. Most significant of all has been the fact that it is now possible for banks to engage in a full range of securities related business, a practice which had hitherto been avoided in the U.K. through the imposition of self-imposed constraints. In the U.S, by contrast, such mixing of banking and securities related business has largely been held in check by the Glass-Steagall Act 1933. However, in recent years especially, that Act has been crumbling as a result of a number of judicial decisions favouring relaxations in the legislative prohibitions contained in the Statute.<sup>13a</sup>

#### Why the Move Towards Financial Conglomerates?

The rationale underlying the formation of such conglomerates has never been soundly established. Maycock highlights two reasons for their development<sup>14</sup> - economies of scale, and diversification with a view to spreading risk. He traces their history, forming initially around the deposit banks and later branching out to include hire purchase and finance houses. The termination of Selective Credit Control in favour of Competition and Credit Control and the removal of the "corset" in 1980 enabled clearing banks to move

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13a. See, R Karmel, "Glass-Steagall: Some Critical Reflections", (1980) 97 Banking Law Journal 631; and Securities Industry Association, "Public Policy Issues Raised By Bank Securities Activities", (1983) 20 San Diego Law Review 339.

14. See generally, Maycock, Financial Conglomerates: The New Phenomenon, Aldershot, Gower c1986. See also, Sir Timothy Bevan, "Banking Conglomerates - Revolution or Evolution?", (1985) August Barclays Bank Review 56.

into areas previously denied them while relaxations in a range of regulatory constraints in the run up to "Big Bang" paved the way for further expansion.

Bevan, meanwhile, suggests the reasons could be three-fold: a need to offer a full range of financial services to customers for fear of losing out to competitors; established international connections; and pre-existing strong links with the securities business. These factors, he argues, created a situation where many clearing banks were well placed to expand. But whatever the reasons put forward, it is certain that the development of financial conglomerates could not have been fully completed without the radical changes brought about by "Big Bang", and deregulation in general. It was only when the restrictive regulatory apparatus, with its traditional segregation of financial functions, was finally dismantled that conglomerates could firmly establish themselves. Financial conglomerates, and their use of the Chinese Wall regulatory mechanism occupy an integral part of this study.

Goodhart has written that:<sup>15</sup>

the breaking down of compartmentalisation is allowing financial intermediaries to take advantage of economies of scale and scope to move towards being "one stop financial supermarkets" with a fuller range of financial services provided in-house. Exactly how extensive such economies may be is uncertain, especially in the early days of mergers between commercial banks, investment banks and securities dealers ... Increased competition and the added complexity of financial activities have added to perceived risk. Where risk has increased need for capital to provide a buffer against loss ... the removal of the old protective barriers led to a rush by the smaller players to merge with new, bigger partners both to benefit from economies of scale and scope and to augment their capital base sufficiently to meet the requirements of the new more demanding market context ... Whereas once the Stock Exchange was dominated by relatively small lightly capitalised partnerships, the likely future is that trading will become much more concentrated in the hands of a limited number of massive financial conglomerates. While the institutions rushing for the exit have been the small British firms, the institutions entering these markets - in addition to a number of

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15. Goodhart, "The Economics of 'Big Bang'", (1987) Summer Midland Bank Review, 6 at p.7.

major British banks - have been the comparatively enormous foreign houses.

Such changes, however, have not been without problems. The fusion of many diverse financial services (in particularly banking and securities business) within the one conglomerate have given rise to two inter-related problems. First, the safety and soundness of a financial institution (and the financial system generally) may be put in jeopardy; and secondly, those who are consumers of financial services risk being treated unfairly because of the increased likelihood that conflict of interest situations will be abused. It is this second problem which forms the context of this study.

#### One Aspect of Regulation or Re-regulation - Conflicts of Interest and the Chinese Wall

The regulation of conflicts of both duty and interest, accentuated by the growth of financial conglomerates, necessitates careful consideration in the light of the increased potential for abuse from within the different 'arms' of financial conglomerates. The importance of the question is suitably highlighted by a quotation from the government's White Paper on "Financial Services in the United Kingdom". There it was stated that:

The rapid increase in the number of firms engaging in more than one type of investment business and the blurring of demarcation lines (for example, between brokers and jobbers) have made it more important than ever that investors are adequately protected against abuses arising from conflicts of interest within investment business.<sup>16</sup>

A search for an appropriate regulatory response to this problem is therefore required. This search represents a central issue in this thesis where various regulatory options are explored. Special emphasis, however, is given to the Chinese Wall isolation technique.

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16. The "White Paper" supra, note 1 at p.14.

## Methodology

### Introduction

The methodology adopted in this thesis attempts a fusion of economic and legal analyses to form a progressive technique for solving various policy problems associated with the regulation of the U.K. financial markets. It lays special emphasis on the corporate misuse of inside information by financial conglomerates and focuses more particularly on the use, by various regulatory authorities, of the Chinese Wall mechanism in stopping the flow of inside information within the conglomerate context.

As an enhancement of this interdisciplinary approach, and as an alternative testing ground for its application, use is made of comparative legal analysis by considering authorities in other jurisdictions, primarily the U.S.A. Two methodologies are combined then, in the hope of gaining a better understanding of the problems, public policies and possible solutions to the misuse, by financial conglomerates, of inside information.

### Law and Economics

There have been many views expressed about the technique known loosely as the "economic approach to law"<sup>17</sup>. The result has been that there is much

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17. There is now a well developed literature applying economics to legal problems. See generally, Guido Calabresi "The New Economic Analysis of Law: Scholarship, Sophistry or Self-Indulgence?" Proceedings of the British Academy LXVIII; Ogus and Veljanoski, Readings in the Economics of Law and Regulation 1984 Oxford University Press; W.Z. Hirsch, , Law and Economics - An Introductory Analysis, New York: (1979); Burrows and Veljanoski, The Economic Approach to Law, London: 1981; R.A. Posner, (1977), Economic Analysis of Law, 2nd ed., Boston: Little-brown.

confusion as to exactly what this new mode of analysis is and where it can be validly and usefully applied. Numerous attempts have been made to classify the various "schools" of economics and law,<sup>18</sup> but convenient though these are, it must be remembered that the effective use of any interdisciplinary approach varies significantly according to how, where and why it is being applied.<sup>19</sup>

The aim here is to consider the legal and economic dimensions of the Chinese Wall, and to a lesser extent the regulatory context within which the device is set. Consequently it would seem that some form of combination of law/economic analysis is appropriate, given this general field of study.<sup>20</sup>

What sort of economic approach to law then is intended for analytical use in this thesis?

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18. See, Klevorick, "Law and Economic Theory: An Economist's View" (1975) 65 Am. Econ. Rev. 237. There he attempts a threefold classification of the input an economic theorist can make to law: Firstly, there are those instances when economic concepts become important in understanding some aspect of a particular legal case even though the case may not be overtly economic in origin. Here Klevorick sees the economist as fulfilling the role of "technician". The economist "takes the problem facing the legal decision maker framed the way the legal decision maker has posed it, and brings his expertise to bear in dealing with a specific part of the case." Secondly, acting now as "supertechnician", the economist "takes the problem as set by the lawyer or legal decision maker, but in this instance the entire structure of the problem area has economic roots." If the situation is one that can plausibly be described as the accomplishment of fairly well defined economic goals then the "economist [may] be called upon to evaluate and give advice about the best ways of achieving the specified objectives ... [N]ow the problem he is addressing is in its own terms economic in nature." In the third and, as he sees it, last role, the economist is "the propounder of a new vocabulary ... he no longer takes the problem as framed by the lawyer ... [but poses it in his economic terms] ... He provides thereby, a different way of looking at the legal issue which yields alternative explanations of how current law came to be what it is and new proposals for new law."

19. Posner, supra, note 17 at p.15 writes, "The application of economics to law is not itself either new or controversial. What is new and controversial is the variety of problems in the world of law to which economics is being applied".

20. Burrows and Veljanoski supra, note 17, at p.2 write that "the marrying of economics and law is not new. "Economic approaches" they argue, "can be found in [both] the works of ... Bentham (1789) [and] Marx (1867)". It is their impression that the economic study of law and institutions within society fell into disrepute in the period 1920-1960, except in those areas where "the law had obvious economic objectives and/or effects".

## The Tentative Application of Law and Economics

It is this writer's view that, when referring to the interdisciplinary use of law and economics, he has no particular "brand"<sup>21</sup> or "mix" of economics and law in mind except that which he prefers to call the "tentative application of economics to law". This approach though somewhat vague is nonetheless important. It is based on the assumption that the use of economics as an explanatory tool in the field of legal analysis has its limitations, but that notwithstanding the diversity of the economic approaches to law which exists there can be extracted and applied a core of well tried and tested economic concepts. The analysis draws particular attention to the limitations of economics and law as applied to those problems with no obvious economic origin and suggests a "tentative" application of economic analyses to those areas which do.

Thus, this writer adheres to no particular school of economics and law, neither does he claim that the economic analysis of law is the only, or even the best, way of analysing legal phenomena - for that is not the aim of this thesis. In slightly different terms what is being propounded here is the idea that even if "non market" legal topics, where no economic root is discernable, cannot be analysed by applying law and economics<sup>22</sup> (there being heated debate

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21. See, for example, the work of Richard Posner. His book, supra note 17, is one of the seminal texts on the study of law and economics. Therein he offers a comprehensive theory of law using traditional economic analysis as applied to law in both a positive and a normative way.

22. Since the 1960's the economic approach has been applied increasingly in those areas where no obvious economic root can be discerned. The thrust of this work has been largely North American. See, for example, Chalmers and Shelton, "An Economic Analysis of Riot Participation", (1975) 13, No.3, Economic Inquiry, 322; Becker, Landes and Michael, "An Economic Analysis of Marital Instability", (1977) 85, No. 6, Journal of Political Economy, 1141.

among distinguished critics as to whether such analysis is ultimately valid,<sup>23</sup>) the interdisciplinary use of economics and law to analyse a legal problem with an economic foundation is a more soundly based proposition.<sup>24</sup>

### The Tentative Approach: Problems, Terminology and Definitions

#### (a) The Problems: Economics -v- Law

Distinguished writers have for some time applied other disciplines, notably sociology to contribute to legal scholarship.<sup>25</sup> It should come as no surprise, therefore, that another social science, and a more developed one at that - economics - should merge with law to form a coherent and progressive structure within which scholarly analysis may take place<sup>26</sup>. Burrows and Veljanoski state that:<sup>27</sup>

In law and economics the endeavour hinges on the expectation among both lawyer and economist that the disciplines are complementary and that collaboration is potentially fruitful.

Nonetheless, despite the merits of such collaboration, especially where the topic under review is economic in origin, care must still be taken. Indeed as one prominent scholar, active in the field of financial regulation and the use of interdisciplinary techniques therein, puts it thus:<sup>28</sup>

By employing an interdisciplinary approach, we have attempted to fuse [the] disparate views [of economists and lawyers] and to provide new insights into [financial regulation], all the while consciously and

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23. See, for example, R. M. Dworkin, "Is Wealth a Value" (1980) 9 J.Legal Stud. 191.

24. See, Cento Veljanoski, "I think all can agree that if there is one area where economics has a direct and immediately relevant role it is in the analysis of financial markets." in the introduction of Financial Regulation or Over-Regulation? (Ed A. Seldon, IEA 1988).

25. See, for example, the writings of Marx, Weber, and Durkheim.

26. See, R.H. Coase, "Economics and Contiguous Disciplines" (1978) 7 J.Legal Stud. 201, at p.209.

27. Supra, note 17, at p.1.

28. See, Edwards, (Ed.) preface to his book on Issues on Financial Regulation (1980).



gingerly crossing the minefield of interdisciplinary study.

The limitations on such an approach are twofold. First, the divergences in the nature of the two subjects themselves cause a great many problems. What may initially appear as "fruitful collaboration" could, on closer inspection of the principal tenets of law and economics as self-contained disciplines, seem incongruous. Hirsch illustrates this point well.<sup>30</sup> For him law embodies ideas of justice, entitlements and obligations, that is - "how a given size of pie is divided". Economics on the other hand is largely normative being more concerned with "the efficient use of resources to produce the largest pie". Following this analysis through, Hirsch outlines the lawyer's concept of the "reasonable man" and the economist's idea of the "rational man" and points out that they are very different.<sup>31</sup>

Although it may unfair to draw hard and fast conclusions based upon such divergences, it is true nonetheless that these concepts play a discernable role in each discipline. The reasonable man is distinguished by three fundamental characteristics :- "he behaves in a reasonably prudent manner - he will act with fair regard to others - any other conduct [he engages in] is subnormal or deviant."<sup>31a</sup> By contrast, rational man is an egotist - he maximises his own self interest and has "only limited concern" for the welfare of others.

Secondly, lawyers and economists approach problems from different perspectives.<sup>32</sup> The lawyer advocates formal legal propositions which he supports with reasoned arguments.<sup>33</sup> His approach, so it would seem, goes little

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30. See, Hirsch, supra, note 17, at preface xi et seq.

31. Ibid., p. 7 et seq.

31a. Ibid.

32. See generally, Burrows and Veljanoski, supra, note 17.

33. Ibid., p.14 et seq.

further than this for he may feel he has no need to! More often than not, he is criticised by the economist for adopting an "ad hoc" approach which is, when applied, "pragmatic" and "anecdotal".<sup>33a</sup> According to the economist, he tackles an issue with "unsupported empirical assumptions" or with empirical research which often lacks "statistical rigor".<sup>33b</sup> The economist, on the other hand, likes to set definite goals. He asks questions such as - have the objectives of law been attained ? - if not - what are the likely effects of the law going to be ? - and - have these effects actually occurred? <sup>34</sup> The economist is, by and large concerned with the overall picture, preferring to analyse the inter-relationship between the main actors in his area of study.<sup>35</sup> In essence, therefore, he attempts to reveal the trade-offs between various competing goals. In so doing he aims to establish a "framework in which the assumptions are clearly stated and used to derive a consistent, even if somewhat simplistic analysis of the issue under study."<sup>36</sup> In turn the lawyer focuses criticism on the economist's essentially theoretical approach where assumptions are unrealistic and where, as a consequence, they lead "to conclusions that are subject to overwhelming qualifications."<sup>37</sup> Similarly lawyers dislike the economic theorists' overt "calculatedness" whereby human conduct is subjected to, and subsequently given, quantification and rational explanation.

The lawyers' attacks may, to some extent, be countered, because the economist is actively engaged in probably the best developed of all the social sciences, there is a consensus among economists about the subject's more

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33a. Ibid.

33b. Ibid.

34. Ibid., at p.8.

35. Ibid., at p.14.

36. Ibid. But see, Posner supra, note 17, at p.13, where he argues that for lawyers or for that matter anyone else "to criticise a theory on the ground that its assumptions are unrealistic is to committ a fundamental methodological error."

37. Supra, note 32, at p.14.

fundamental techniques even if there is a diversity in the conclusions that are drawn from them.<sup>38</sup> From this the economist derives essentially two comparative advantages over the lawyer: The first is that the economist is "blessed" with what Coase calls the "measuring rod of money".<sup>39</sup> The second is the economist's statistical training in answering questions which are capable of quantification. Empirical studies are not only interesting but valuable. After all, write Burrows and Veljanoski<sup>40</sup>? "the law must ultimately be evaluated in terms of its success in achieving its goals and not purely in terms of its formal legalist structure". Lastly, lawyers, who are generally unfamiliar with scientific enquiry, tend to reject any form of legal analysis which reduces to a greater level of abstraction than which they have devised.

By virtue, then, of the fundamental differences in the two disciplines themselves, it is inevitable that these problems will carry through to the tentative application of economics to law. Nonetheless the approach can still be used when it attempts to emphasise "those aspects of law it has [a] comparative advantage in dealing with"<sup>41</sup>. It is the aim of this thesis, in order to maximise this advantage, to focus on an area - financial regulation - where law and economics do interface and where their intersection is one of clear economic dimensions. Ogus and Veljanoski express grave reservations concerning the fact that the field of regulation in general has been "shamefully neglected", not only in terms of interdisciplinary analysis, but also in terms of traditional legal scholarship.<sup>42</sup> Consequently, an interdisciplinary study of one regulatory option - the Chinese Wall - which is of great practical relevance to the financial sector seems appropriate.

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38. Burrows and Veljanoski supra note 32, at p.14.

39. Supra, note 26, at p.209.

40. Supra, note 17, at p.8.

41. Supra, note 32, at p.14.

42. Supra, note 17, in Preface.

(b) Terminology and Definitions

Inherent in the use of economic analysis as a complement to traditional legal scholarship is the fact that it invests in a new vocabulary. Therefore new terminology - opportunity cost, synergies, externality etc. - will be encountered.<sup>43</sup>

Economics can be and has been defined in many ways. One view central to the lawyer/economist is that, in a world where, on the one hand, resources (all of which have alternative uses) are limited through scarcity and where on the other hand, there exists the insatiable human desire to consume those resources, then inevitably, trade-offs and choices must somehow be made. Such a definition, therefore, makes economics the science or study of human choice.<sup>44</sup>

While the lawyers' definition of law may be stated as being a command backed up by a sanction<sup>45</sup> the economists' view is something quite different. Hirsch writes:<sup>46</sup>

[L]aws are authoritative directives that impose costs and benefits on participants in a transaction and in the process alter incentives ... [essentially therefore the making of laws is not costless] ...their drafting and enforcement require [the use of] real resources and involve the trading-off of certain costs and benefits to determine given policy objectives.

The assumption in this mode of analysis is, says Posner<sup>47</sup>, that man's actions can be explained as if he were:

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43. Rather than attach abstract definitions to these terms within this section it is intended to provide explanations as and when the concepts are encountered in the text. Ogus and Veljanoski, supra, note 17 (preface) comment that this new vocabulary and its "technical content" is a formidable obstacle to the would-be inter-disciplinary scholar.

44. See, both L.C.Robbins, An Essay on the Nature and Significance of Economic Science (1932), and Posner, supra note 17 at p.3, who hold very much to this view. It has, however, been attacked by some scholars for being too wide. See generally, for example, Coase, supra note 26.

45. See generally, the writings of the legal philosopher Austen.

46. See, Hirsch, supra note 17, at p.1.

47. Supra note 17, at p.3.

... a rational maximiser of his ends in life, his satisfactions - what we shall call his self interest ... [P]eople respond to incentives ... if a person's surroundings change in such a way that he will increase his satisfactions by altering his behaviour he will do so.

### The Tentative Approach: An Application

An application of this analysis is, for example, where the temptation for a conglomerate (ultimately controlled by individuals) to trade on inside information arises from the financial incentives accruing to it (and ultimately the controllers). However the rational wealth maximising company may refrain from such conduct even if there are strong incentives to use the information. This will occur where the corporate controllers perceive that the long run loss to the company's wealth (and to a greater or lesser extent their own - it may depend on a number of things) is likely to be greater than the short-term profits. There are indeed many factors that would operate to make insider dealing less attractive to a company and its directors. These range from, on the one hand, market forces eg. the desire to maintain an unblemished reputation, to, on the other, formal sanctions eg. prosecution at law. As regards the latter, it is essential that anti-insider dealing law and other self regulatory rules prohibiting the practice are analysed from the perspective of how they alter the incentives to engage in the illegal conduct.

It is significant to note that Professor Gower, in his study of Investor Protection in the financial markets, did not employ any significant law/economics cost-benefit analysis. In fact he doubted the feasibility of such an approach.<sup>48</sup> This has been criticised by authorities such as Goodhart

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48. See, Review of Investor Protection, Report: Part 1 (1984), Cmnd. 9125, para. 1.16 (hereinafter cited as the "Gower Report").

and Veljanoski. Goodhart writes:<sup>49</sup>

There was little enough discussion of the rationale for the proposed panopoly of regulation in the Gower Report ... There was none at all in the subsequent Financial Services Bill and the accompanying paper from the SIB, Regulation of Investment Business, which simply set out the proposed clauses to be enacted and the regulatory framework to be adopted without any attempt at justification. Even so the tone of the SIB document was less exclusive and restrictive.

Equally Veljanoski says:<sup>50</sup>

Indeed ... Gower (Cmnd 9125 [1984]) ... failed to consider the costs and benefits of [his] proposals for reform, nor did [he] systematically consider the economic ramifications of the problems put to [him].

### The Tentative Approach: a Conclusion

It could be argued that a purely economic approach cannot provide a comprehensive treatment of financial market regulation or any part thereof primarily because economics is at best a technique that is both partial and complementary to other disciplines. However the tentative application of economics to law overcomes this hurdle by taking elements of both approaches in order to provide alternative perspectives from which to view the one problem. The application of regulatory alternatives requires governments to make policy choices and to trade-off their policy goals, not only in a reasoned and cost-effective way, but with regard to issues of fairness and the continued confidence of investors in the financial sector. One regulatory structure in particular - the Chinese Wall - is be analysed to see whether it provides the

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49. See, C. Goodhart, "What is the Purpose of Regulating Financial Services?" (1986) mimeo., London School of Economics, at p.29.

50. See, Veljanoski's et al research proposal: "The Law and Economics of Insolvency with Particular Reference to Fraudulent Trading", at p.2. See also, supra, note 19, p.1-13 especially, p.7-10. This represents one of the most stinging criticisms of Gower's approach to date. He contrasts the Gower and Cork Committee reports with that of the Peacock Committee's report on the financing of the BBC which incorporated substantial economic analysis. He also notes that Gower's "narrow" approach would not have been tolerated in the U.S. Veljanoski's criticisms would thus seem to merit attention.

most attractive regulatory solution for governments and regulatory authorities reviewing this area.

It is suggested, therefore, that in pursuit of this endeavour the tentative interdisciplinary use of law and economics is a viable and effective alternative academic approach to that of traditional legal scholarship. Indeed this technique, when supplemented by a comparative legal viewpoint would seem to have much to commend itself.

### Comparative Legal Analysis

Comparative legal analysis forms a well recognised branch of traditional legal scholarship and is increasingly becoming a focus of legal study in its own right. It is proposed in the course of this work to use the USA as a comparison to analyse the recent regulatory stance adopted in the U.K. with regard to the use of the Chinese Wall technique in financial firms.

The comparative approach is of great help in this sort of study. Indeed Rider does not think that it is, "feasible to discuss anti-insider trading law without reference to the U.S. experience or elsewhere".<sup>51</sup> He writes that:<sup>51a</sup>

... there is a long history of regulation in the U.S. and [the] Commonwealth [giving rise to]... a considerable amount of experience [which] British lawyers [would do well to] make reference to.

Continuing with this view, he says, "given the internationalisation of the

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51. B.A.K. Rider, The Regulation of Insider Trading. (Unpublished Ph.D thesis London University, 1979), at p.217.

51a. Ibid.

securities market knowledge of other jurisdictions is vital".<sup>52</sup>

The comparative approach has both strengths and weaknesses. The technique's most overt strength centres on the alternative insight that it affords into similar, if not identical, problem areas. This alternative viewpoint is useful in itself from three perspectives: First, relevant case law provides a testing ground where the government and regulatory authorities can tailor regulatory reform in the light of judicial assessment of regulatory developments. Secondly, it may be useful to review the operation of a different regulatory regime ie. one which to a greater or lesser degree relies on market forces and self-regulation to police it. Issues that may have looked problematical in theory can be compared to see whether they are of consequence in practice. Some means of weighing up the costs and benefits of such an approach is therefore capable of being employed. Lastly, a comparative approach may be useful, not only from the legal norms that embody policy, but also from the policy angle that underpins law. For example, informed debate on proposed new regulatory structures tends to highlight the crucial policy questions that must be answered and the means by which competing public policy goals are to be traded off against one another and yet, at the same time, housed within a satisfactory regulatory framework.<sup>53</sup>

The comparative approach may be said to have three failings. The first, which provides a backdrop against which any further criticism may be set, is

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52. Ibid.

53. See generally, Canadian Financial Institutions, A Report of the Standing Committee on Finance, Trade and Economic Affairs, November 1985; The Regulation of Financial Institutions: Proposals for Discussion (and Technical Supplement) June 1985; Department of Finance Canada Release, Policy Framework For Canada's Financial Institutions Tabled in Parliament, December 18th, 1986. Many of the policy questions considered here are often directly applicable to the U.K. and indeed elsewhere.



probably the most important. It relates to the difference in the two jurisdictions being compared. This "difference" refers not to the difference in the law of the actual topic under study (for that is to confuse the weakness in the technique with the whole rationale for undertaking a comparative approach - if the law is not different why compare?). Instead the problem arises when there is a difference in the law that surrounds the topic under review -eg. UK insider dealing law may be X because of A; meanwhile, U.S. insider dealing law may be Y because of B : it is pointless to compare X and Y without also considering elements of A and B. The fact that the surrounding law in the other jurisdiction is different is apt to weaken, sometimes substantially, the whole comparative law approach. Consequently, large-scale transposing of one set of legal rules from one jurisdiction to another cannot be done without considering the implications of the relevant surrounding law.

As for the second weakness there is a direct link with the first. Here the difficulty revolves around the different constitutional arrangements operative in the two jurisdictions being compared. On the one hand there is the precedential weight of a case cited - ie., can it be overruled and by whom? Inherent in this is some understanding of the jurisdiction's court structure. On the other hand, it is necessary to appreciate those cases where State law has been applied and those where Federal law has primacy.

The third weakness is a fundamental one - various institutional differences in the operation and segregation of the many sectors that go to make up the financial services industry. This is a legacy of historic inception, piecemeal development and political expediency. The Glass-Steagall Act in the U.S, separating to a large extent the banking and securities business, is one such example.

But despite these weaknesses it seems that a comparative analysis of the U.S. with the U.K. regarding the regulation of the corporate misuse of inside information via Chinese Walls and the whole validity of the segregation approach in general, is of substantial benefit.

## **Summary**

Though deregulation, in the sense that barriers are being broken down, is undeniably an increasing characteristic of events in financial markets worldwide, it is not the whole picture of what is happening. In Britain at least, and to a greater or lesser extent in other financial centres also, this deregulatory trend has been accompanied by new regulatory developments to ensure that deregulation does not go too far. Chapter One considers aspects of this paradoxical deregulatory /re-regulation phenomenon. On the one hand, the transformation of formerly compartmentalised financial institutions into virtually open ended financial conglomerates offering a range of financial services to an extent not known before. On the other hand, the search for an appropriate regulatory solution to the now accentuated problem of both conflicts of duty and interest and the possible misuse of inside information within financial conglomerates. The "Chinese Wall" mechanism is singled out as a possible regulatory solution to this problem. The study uses a methodology which combines elements of traditional legal scholarship with a tentative import of economic analysis. In this way it is hoped that a more coherent and fruitful picture will emerge on the appropriateness of the Wall technique and its use within financial conglomerates.

## CHAPTER TWO: THE PROBLEM OF CONFLICT ABUSE

### Deregulation in the U.K.: The Big Bang

In the U.K., what initially began as a restructuring of the London Stock Exchange became a much wider cause embracing every sector of the financial community. "Big Bang", as it became known, was characterised by three main factors:<sup>1</sup> first, the termination of the single capacity system of trading in favour of a new dual capacity regime; secondly the movement away from fixed commissions towards a more competitive commission scheme; and lastly, the removal of outside ownership restrictions of member firms of the Stock Exchange Association. These events paved the way for the formation of financial conglomerates and made inevitable concern over the increased potential for conflict abuse. Fears revolved more around the fact that potential conflict situations were being compounded rather than being created by conglomerates, and that these conflicts would be increasingly and more easily abused. It was clear, therefore, that a new regulatory framework governing conglomerates would be necessary.

The U.K.'s sensitivity towards conflicts of interest was reflected in part by the division of functions on the Stock Exchange. Up until 26 October 1986 the London Stock Exchange was characterised by the system of trading known as "single capacity". Very broadly, members fell into two groups of partnership: on the one hand there were "jobbers", who specialised in buying and selling shares, and on the other there were "brokers", who specialised in performing

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1. For a helpful review of Big Bang, see, CAE Goodhart, "The Economics of 'Big Bang'", (1987) Summer Midland Bank Review, pp.6-15, and sources cited therein. See also, P.D.Jackson, "Change in the Stock Exchange and the Regulation of the City", (1986) 7 No.3 BLR pp.90-96.

share deals on the behalf of the public. As part of the "Big Bang" this system was discarded in favour of a dual capacity regime in which the two jobs were fused together.

The old system had certain advantages. Members benefited from both the restricted entry and competition controls. This, in turn, allowed many of them to earn oligopolistic profits.<sup>2</sup> Furthermore, the integrity of the profession was maintained by offering membership only to those who were willing to abide by prescribed standards. Investors benefited too from the segregated system, in that specialised compartmentalisation ensured that management was expert in the narrow range of financial services offered. The incentive to abuse conflicts of interest was significantly reduced, whilst limited membership guaranteed a self-perpetuating standard of good behaviour. The authorities benefited also in that there was an established and sufficiently flexible regulatory machinery with participating members generally similar in terms of capital adequacy and profitability. Moreover, provision was made for any firm that might become financial insolvent; in this way systemic risk was largely averted.

### The Pressures For Structural Change

Notwithstanding these advantages the compartmentalisation of the financial system into self-regulatory clubs suffered from many of the general drawbacks that characterise most oligopolistic arrangements. The system was very costly in terms of how resources were employed and inefficient in the sense that there was a failure to develop new products and technologies.

As well as this the Stock Exchange rule-book denied significant

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2. Goodhart, Ibid., 6.

structural reform. In particular, it prevented the U.K regime from developing along the same lines as the other major financial markets. In overseas centres market participants had become grouped into well capitalised corporate entities engaging in dual functions quite distinct from their U.K. counterparts.

Although it was the traditional policy of the Stock Exchange to allow only partnerships to come into membership, a new rule was introduced in 1982 that allowed members to become limited companies and to have an outside share ownership of up to 29.9%. But despite this member firms could not be owned by a single non-member and could not therefore become part of wider groupings - a fact which meant that the London exchange had, in some senses, closed its doors to the rest of the international community.

By the late 1950s and early 1960s the Japanese and the Americans began to develop their own sophisticated global markets. Gradually London began to struggle as a financial centre and when in 1979 the newly elected Conservative Government abolished exchange controls it became apparent that some form of restructuring of the Stock Exchange and the financial sector in general was necessary.<sup>3</sup>

The catalyst for change was the "Agreement" between the Government and the Stock Exchange. The Stock Exchange's rules, regulations and codes of conduct came to the attention of the Director General of Fair Trading as early as 1976 and indeed two years later proceedings were brought against it. The Office of Fair Trading contended that some of the Stock Exchange rules were in breach of the 1956 Restrictive Practices Act as being restrictive of competition unless the Exchange could prove otherwise. A Government initiative broke the

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3. With the removal of exchange controls in 1979 it became clear that London was losing out to other centres such as New York even in the trading of U.K. shares.

deadlock and a compromise of sorts was reached in 1983 with the Stock Exchange agreeing to amend its rule book provided the case against it was dropped.

Contained within this "Agreement", as it became known, existed a commitment on the part of the Stock Exchange to abolish fixed commissions in favour of a more competitive regime. Since 1911 fixed commissions had remained the linch-pin of the separation between brokers and jobbers - the system known as single capacity. The commencement of negotiated commissions, however, meant that it was likely that the conduct of business between brokers and jobbers would alter radically. It was believed that under the proposed arrangements brokers would accept deals that they had not "matched" through a jobber with the result that jobbers would probably receive less business and find it more difficult to compete. Similarly, the pressures which negotiated commissions would exert on the single capacity were also thought to be too much for it to sustain and that it too should be dismantled. There emerged in its place a dual capacity regime whereby financial intermediaries could fulfill the the functions of both broker and jobber simultaneously.

In addition to the above reforms the Stock Exchange adopted other measures in an attempt to maintain its international competitiveness. The first step was to help broaden the capital base of many of its members. On 1 March, 1986, the 29.9% ceiling which had been imposed on the outside ownership of Stock Exchange firms was abolished altogether. This allowed a single non-member to own 100% of a member firm, despite the fact that membership was still only open to individuals on a partnership basis. The fear of a rival market developing outside of the Exchange and the desire to attract the American and Japanese securities houses (whose participation was crucial in the Stock Exchange's fight to become a world leader) proved too much however and further

rule changes were hurriedly made to allow corporate houses not only to own firms but also to become full members themselves.

The aggregation of these moves had more profound effects than, arguably, anyone at the time fully envisaged, for they marked a momentous turning point in the market structure, operation and management of the whole U.K. financial sector. Quite remarkably, within the space of a few months, the industry reshaped and refashioned itself in advance of 27 October 1986 upon which day ("Big Bang day") the deregulation of commissions was to take place. Massive well capitalised and incorporated financial conglomerates, bringing under the one roof a multiplicity of financial services - stock-broking, market-making, insurance and insurance broking, banking, investment management, corporate finance etc., - began to appear. Most importantly in the U.K., the traditionally self-enforced, and for some, archaic separation between the banking and securities industries was finally broken down, discarded in favour of a more open and competitive regime.

**The New Regulatory Framework: The Financial Services Act - A Response to the "Big Bang", Conglomerates and Conflicts of Interest.**

The structural changes which were at the heart of "deregulation" in the U.K. necessitated a radical overhaul of the existing regulatory framework which had been in operation to ensure investor confidence in the financial markets.

Indeed, as Goodhart observed:<sup>4</sup>

The breakdown of the old, oligopolistic, single capacity, club-like, cartelised system and its transformation into the new multi-function, intensely competitive system, ... [required] an equivalent transformation of the regulatory system.

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4. Supra, note 1, at p.15.

The need for regulatory change had been mooted for some time.

### The Need For Regulatory Change

In pre-Big Bang times there existed the widespread belief that the existing regulatory framework was not only propping up an inefficient system but that it was also outmoded and fast becoming inadequate for the protection of investors. Indeed, up until the advent of the Financial Services Act 1986, regulation had been decidedly piecemeal "combining a variety of Government measures with a large degree of self-regulation".<sup>5</sup> The most important piece of legislation was the Prevention of Fraud (Investments) Act 1958 (PF(I) Act). Other legislation included several Companies Acts, the Banking Act 1979 and more general statute law such as the law of theft and fraud, insolvency law and the limited use of civil sanctions.

The Statutory intention of the PF(I) Act was to protect investors against fraud in investments dealings. This was attempted in two main ways: First, by "ensuring [that] dealers in securities, unless otherwise authorised, required a licence from the Department of Trade and Industry" (DTI)<sup>6</sup> - these would be refused if the applicants were not considered "fit and proper"; and secondly, s.13 of the Act made it an offence to knowingly make a misstatement in an investments deal. Welcome though these provisions were, they did not cater for activities such as investment management or investment advice in areas other than in securities dealings. As well as this, no provision was made for

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5. Securities and Investments Board, Financial Services - A Guide to the New Regulatory System, (Booklet 1986) at p.1. Indeed, one authority, Schmittoff has contended that by the mid-seventies there was virtually no effective investor protection law in the U.K. at all.

6. Ibid.



transactions in the expanding Futures and Options markets. Thus the PF(I) Act provided both "outdated" and "incomplete" protection for investors needs.<sup>7</sup>

Among the Government non-self-regulatory bodies designed to implement legislation in this general field were the Bank of England, the Director of Public Prosecutions Office, the Metropolitan Police Fraud department, and the DTI.<sup>8</sup> Meanwhile the self-regulatory framework, dominated largely at this time by the extra legal rules of the City Panel on Take-overs and Mergers and the Council of the Stock Exchange, was generally in not much better shape. Coupled with this came the framework's inability to meet the sophisticated demands of the large institutional investors.

In 1981, the Conservative Government commissioned Professor LCB Gower to undertake an inquiry into the degree of protection afforded to investors in all areas of the financial industry.<sup>9</sup> His efforts, more than anyone else's, were instrumental in the setting up of the City's new regulatory structure. Yet even his findings were not well received by the financial community.<sup>10</sup>

Underlying all of this, a number of scandals, the most notable being the "Lloyds affair", emerged. The resultant backlash of unwelcomed public attention forced the Government, who were already in a legislative frame of

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7. See Financial Services in the United Kingdom: A Framework for Investor Protection (1985), Cmnd. 9432, at para. 1.2, (hereinafter the "White Paper").

8. Of these, the latter two were especially criticised for their poor records of arrest and/or inactivity - records perhaps best viewed in the light of the legislation they sought to enforce, the complexity of the offences they were obliged to detect and last, but by no means least, the limited resources, in terms of finance, manpower and expertise made available to them.

9. Review of Investor Protection, Report: Part I Cmnd.9125, 1985 (hereinafter cited as "The Gower Report").

10. Gower's proposals have not found favour with some leading academics. See, B. Rider's comments in an article by Clive Woolman, The Financial Times 15 April 1989, p.14 (Gower's achievements were "too much of a one-man show").

mind, to act swiftly. The DTI had begun a work of its own even before Gower had presented his findings.<sup>11</sup> As well as this there was the Marshall Field Report<sup>12</sup> and the Sir Martin Jacomb Report,<sup>13</sup> both of which in effect proposed a modified version of Gower's findings. An acceptable set of ideas was eventually agreed. These were largely embraced in the Government's White Paper (Cmnd 9432) and embodied in the Financial Service Bill, which after amendment passed into law as the Financial Service Act 1986.<sup>14</sup>

### The Financial Service Act 1986 and the SIB Rule-book

Following the government's overhaul of the U.K. financial sector traditional self-regulation has given way to "practioner based" and "statute-backed" regulation.<sup>15</sup> The legislative machinery chosen for regulating the "investment business regime" is the Financial Services Act 1986.<sup>16</sup> Essentially the aim of the FSA 1986 is to prevent fraud by the City and fraud on the City<sup>17</sup> and effect overall efficiency in the financial markets.<sup>18</sup> In pursuit of this wide powers are given to the Secretary of State for Trade and Industry, which may, and indeed have been, transferred to a "designated

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11. See, the White Paper.

12. Date

13. Date

14. The Act came into operation in piece-meal fashion.

15. The more popularly term is that of "self-regulation within a statutory framework".

16. For commentaries on the Act, see, Rider et al, Guide to the Financial Services Act 1986, Bicester: CCH Editions, c1987. A. Whittaker and G. Morse, The Financial Services Act 1986 a guide to the new law, Butterworths 1987. A.J. Wedgewood et al, A Guide to the Financial Services Act 1986, London, Financial Training Publications, 1986.

17. This comment was made by Professor R. Jack during a Plenary Discussion on "The Financial Services Revolution: New Challenges and Opportunities". B.A.A. Conference, Glasgow University, April 15th, 1987.

18. SIB booklet Supra, note 5, at p.3.

agency"<sup>19</sup> known as the Securities and Investments Board (SIB).<sup>20</sup> This "agency" operates through a number of Self-Regulatory Organisations (SRO's) recognised by it,<sup>21</sup> is subject to the Jurisdiction of the Courts<sup>22</sup> and is exempt from liability for damages for acts and omissions in the discharge of its functions.<sup>23</sup> The members of the Governing committee of the SIB are appointed by the Secretary of State and the Governor of the Bank of England acting jointly.

Those who want to carry out investment business must first seek authorisation.<sup>24</sup> This may be had through two main channels, either by applying directly to the SIB or by applying indirectly through Self Regulatory Organisation's (SRO's).<sup>25</sup> The effect of non-authorisation is that the market operator commits a criminal offence<sup>26</sup> with the result that the transaction(s) becomes unenforceable. Some categories, however, are exempt from authorisation, for example the Bank of England.<sup>27</sup> The rules and codes of practices of an SRO must ensure that its members are "fit and proper persons"

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19. S. 114 of the Act.

20. The SIB is a Private Company and not a Government Department, funded from the financial Services Industry and not the "public purse".

21. These are: First, The Life Assurance and Unit Trust Regulatory Organisation (LAUTRO). Secondly, The Investment Management Regulatory Organisation (IMRO). Thirdly, The Association of Futures Brokers and Dealers (AFBD). Fourthly, The Financial Intermediaries, Managers and Brokers Regulatory Association (FIMBA). Finally, The Combination of Stock Exchange and International Securities Regulatory Organisation to form The Securities Association (TSA). This latter SRO is by far the most important.

22. S. 188 of the Act.

23. S. 187 (3) of the Act.

24. S. 9 (1) of the Act.

25. There are some other means of obtaining authorisation. For example, holding a certificate issued by a Recognised Professional Body (s.15(1)). This is a body which regulates a profession that is not wholly involved in investment business. Or alternatively, being a person established in another Member State of the EEC provided certain conditions are satisfied (*see*, s.31).

26. A sentence of up to two years imprisonment may be imposed on convicted offenders.

27. *See*, (s.35); Others include:- Appointed Representatives (ie., a person employed by an authorised person) (s.44); Recognised Investment Exchanges (RIE) (s.36-37, Sch. 4).

to carry on an investment business<sup>28</sup> and "in particular that they meet the standards of honesty, competence and solvency." As well as this, there must also be fair and reasonable admission, expulsion and disciplinary procedures.<sup>29</sup>

The rules and regulations made by the SIB for the protection of investors must comply with the principles embodied in Schedule 8 of the 1986 Act.<sup>29a</sup> Rules made by SRO's are required to afford investor protection at least equivalent to that offered by the SIB rules. This is known as the principle of equivalence. In the final analysis the SIB is subject to the oversight of the Secretary of State while SRO's fall under the auspice of the Board. It is important to note that, although the SIB derives its powers from Parliament<sup>30</sup> its rules do not require Parliamentary approval.

In sum then, the the method of control over businesses offering investment advice of one form or another (and indeed the many conflicts of interest that ensue from conglomeration) is one whereby Parliament through the Financial Services Act delegates power to the Secetary of State who in turn delegates his rule-making responsibilities to the SIB. The SIB confers recognition to SRO's and to these the vast bulk of investment businesses seek authorisation. However this sub-sub-delegation of wide supervisory powers to SRO's does not effectively establish a system of self-regulation, because the principle of equivalence operates to ensure that the SIB retains significant control.

Commenting on this new financial framework, even though at a time when it was still in its formative stages, Professor Goodhart observed, from an economic

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28. See, Sch. 2-1 of the Act.

29. See, Sch. 2-2) of the Act

29a. See, Appendix I which contains Schedule 8.

30. According to s. 114(11) the SIB's rules must be approved by Parliament

point of view that:<sup>31</sup>

While there has been much new legislation [to cope with the new market structure] ... it is arguable how well it has been designed. In particular, insufficient attention has been paid to the comparative costs and modalities of alternative methods of achieving the - not always specified - objectives of such regulation.

## **Conflicts Of Interest and Duty**

Conflicts of both interest and duty have traditionally been of great concern to regulators. Big Bang has heightened rather than alleviated this problem. Let us look first at the problem of conflicts of interest.

### **I. Conflicts of Interest**

A conflict of interest<sup>32</sup> occurs where there is an actual or potential preferment of one's own interest to that of another person's interest where the former owes some type of duty to the latter.<sup>33</sup> "The underlying principle of equity", says Pennington:<sup>34</sup>

is that a person who acts as a representative of another is in a conflict of interest situation if, either at the time when he accepts appointment or subsequently while he acts as a representative, there is a material interest of his own or of a third person for whom he also acts, and the pursuit or protection of that interest would create a substantial risk that he may not act in the best way to

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31. Supra, note 1, at p.15.

32. There is now extensive literature on conflicts of interest in the financial services industry. See generally, Mayer, Conflicts of Interest in Dealer-Broker Firms Twentieth Century Fund, New York, 1975; N.Woolfson, Conflicts of Interest: Investment Banking, 1976; Schotland, Introduction, in Abuse on Wall Street: Conflicts of Interest in the Securities Markets, (Twentieth Century Fund) 1980. For an excellent U.K. perspective, see, Conflicts of Interest in the Changing Financial World (Ed. by R.M. Goode), Institute of Bankers 1986 and Centre for Commercial Law Studies, Queen Mary College, University of London.

33. K. Bialkin, in "Conflicts of Interest and the Regulation of Securities, A Panel Discussion", (1973) 28 Business Lawyer 545, at p.545. He does not think it necessary for a fiduciary relationship to exist before a conflict of interest to arise as a matter of law, custom or business.

34. Goode, supra note 1, at p.2.

pursue or protect the interest of the person he represents.

Conflicts of interest cannot be avoided. They are part and parcel of everyday life. It is important to note that there is nothing inherently wrong with a conflict of interest situation; the issue is whether such a situation is handled properly - if the conflict situation is treated impartially or fairly then everything is fine - if it is abused then there is a problem.<sup>35</sup>

It would seem beyond doubt that there exists within the financial service industry a high incidence of conflict of interest situations.<sup>36</sup> It would also seem true to say that there exists a perceived notion within and without the industry that these situations are abused. In the context of the financial markets a potential conflict may be said to exist where, for example, a conglomerate when managing a client affairs "has a choice between two solutions for a deal, one choice which is preferable from its own point of view while the other represents a better deal for the client."<sup>37</sup> A conflict of interest situation also exists if the conglomerate "carries out activities involving two different groups of customers and it has to strike a balance between the respective interests of the two customer groups."<sup>38</sup> The wider the range of financial services on offer the greater the danger that these conflict situations will occur and perhaps be abused.<sup>39</sup>

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35. R. Schotland, "Alternative Views on Regulating Conflicts of Interest in the Financial Firm", Issues in Financial Regulation (1980), (Ed. by Franklin Edwards) at p.125. Schotland says: "When abuses do occur, there are always losses in fairness, and there may be losses in economic efficiency." See, note 41 and accompanying text.

36. See, Rider, "Conflicts of Interest and the Chinese Wall", in The Regulation of the U.K. Securities Industry, (Ed. BAK Rider) Oyez 1979, at p. 81.

37. OECD Report: Financial Market Trends, "Conflicts of Interest in Banking and Finance and their Control and Management", November 1987.

38. Ibid.

39. See, the Gower Report, Part I, at para. 6.30.

Why are Conflicts of Interest in the Financial Services Industry so Important?

Conflicts abound because it is efficient, despite the trend towards specialisation, to have one entity - either individual or corporate - undertake a number of potentially conflicting functions. However, if conflicts of interest are unavoidable, and often go unregulated in other business spheres, the question may be asked why the "mixing" of different financial services and in particular banking and securities business should be of such concern?

In fact two reasons may be advanced to explain why Governments have continually regarded conflicts of interest in the financial sector with more concern than those in the non-financial sectors of the economy.<sup>40</sup> The first is that the financial institutions (and the Banks in particular) that go to make up the financial services industry are "special institutions" and hold a special position within both the economy (this might be called the "efficiency principle") and society (this might be called the "equity principle").

With regard to the efficiency principle the argument runs as follows: The financial services industry is regarded as being fundamentally different from all other industries. At an economic level when a conflict of interest situation becomes abused the tendency is for that abuse to distort the efficient allocation of resources within the economy. No longer are the impartial forces of the market place brought to bear on business activity but

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40. See, the comment by Kay in, "Banking Deregulation in Europe", (1987) April Economic Policy 64, at p.98. He writes: "In its historical origins, banking regulation is political rather than economic in motivation. Much of it derives from a popular mistrust of finance, ... borne of lack of comprehension or an inclination. These political arguments are bolstered by an economic belief that the supply of money may have a macro-economic significance".

instead transactions are concluded at an extra cost to society. The end result is reduced efficiency and a false level of profitability not sustainable in the long term under true market conditions for those financial institutions involved in such practices.

The equity principle on the other hand is based on the proposition that financial markets rely, overwhelmingly, on both the confidence of (i) those who invest in them and (ii) of the general public whose trust is placed in the integrity of the financial institutions who, by and large, constitute the market. If this trust is abused confidence can and will be shaken. In an area where there is already a perceived notion among sceptics that the trust reposed in financial intermediaries is often abused, no Government can afford to ignore those situations where abuse is likely to occur. As we shall see, conflicts of interest left unregulated do not inspire confidence.

Then secondly, as Shotland argues, the nature of financial services themselves are inherently special.<sup>41</sup> This, he says, is because of the need for confidentiality between intermediary and client and because an investor is generally unable to assess the worth of the variety of services available to him.<sup>41a</sup> This gives the seller a unique opportunity to exploit the situation. But as Gower points out in his report, the idea is "not to prevent the investor from making a fool of himself, but [rather to prevent him] from being made a fool of."<sup>42</sup> In short, because the nature of financial services are special

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41. Supra, note 35 at p.129.

41a. Ibid., at p.130. See also, Kay, supra, note 40, at p.99, where he writes: "One reason for regulating banks is the existence of information assymetries between buyer and sellers." Information assymetry is the economists way of describing a situation where one person is in possession of more information than another; quite obviously such situations are common place.

42. The Gower Report, Part 1, at para 1.16.



there is, as a consequence, a special need for fairness.

With the growth of financial conglomerates in the U.K. conflicts of interest in the financial services industry are inescapable. Some way of accommodating them must therefore be found. Different perspectives can initially be taken.

One option is to take the view that conflict of interest situations are handled properly and that abuse is rare. Abuses that do occasionally come to light are wrongly sensationalised as being common place rather than being merely one off incidents. This approach emphasises that abuse is rare simply because the idea of a fiduciary relationship (a relationship where there is a special duty of trust and care), and the consequent fiduciary law that has developed to protect this sort of relationship, would neither have evolved nor survived until to-day. Nonetheless, as Schotland suggests, merely because abuses are one off, or as he puts it "episodic", it does not necessarily follow that they should not receive regulatory attention.<sup>43</sup>

An alternative viewpoint, and one that seems to command the attention of some economists and policy makers, is that it is unhelpful to aggregate and treat all conflict situations in the same way. Here the emphasis is on the need to isolate and treat differently each conflict of interest situation. The question then becomes - is there a real likelihood that this conflict situation, though capable of abuse in theory, will be abused in practice? When this sort of question is asked it becomes apparent that not all conflicts of interest are of equal importance or concern.

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43. See, Schotland, supra note 35.

By and large those conflicts that in practice have no tendency to be abused do not merit the deployment of scarce resources in order to eliminate them. The reason for this is that in the long term the incentive to exploit a conflict of interest may not exist. Thus more often than not a financial institution will not risk the long term profits bound up in honest work and good reputation for the short term gains to be had from, say, trading on the basis of inside information. The "invisible hand" of market forces will mean that when faced with a conflict a financial intermediary will handle that situation in a scrupulously fair way, for the market will impose such a discipline. The problem here, however, is that market forces may be limited and, particularly in the context of the financial services industry, most conflicts occur where the rigours of competition are not as strong as they might otherwise be.

Notwithstanding the above, a third, more radical perspective exists: it could be argued that there are situations where not only will conflicts be tolerated but so too will be their abuse. Essentially the question becomes - what is the total cost of the abuse ? - who bears that cost - individuals or society, and in what proportions? If the cost of abuse is less than the cost of implementing and enforcing regulatory structures in preventing the abuse there seems to be, prima facie, a case for doing nothing - at least on a preventive level. Other alternatives include expending resources on limiting the abuse or even facilitating redress when such abuses take place. This might be the way an economist would analyse the situation. There are, however, two problems with this approach: (a) the overriding need for confidence might be compromised and (b) fairness is made a secondary consideration.

In Britain today with the merging together of the banking and securities business under the guise of financial conglomerates, nine types of conflict of interest may be identified.<sup>45</sup> This debate follows very closely the one surrounding the enactment of the Glass Steagall Act in the U.S. in 1934 when banking and securities activities were to a large extent prohibited. This Act still remains in force today. Very broadly, these nine conflicts can be split into three groups<sup>46</sup>:

- A. Conflicts involving safety and soundness
- B. Customer or selling conflicts
- C. Conflicts involving the misuse of inside information.

Though separated in this way each of the nine conflicts are related to situations where either: one party has more information than another - information assymetry; or one party has a monopoly power; or indeed where both these two factors are simultaneously present.

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44. For a more extensive debate on this see, supra note 37 Report by the OECD and more generally Walter, I, (Ed) Deregulating Wall Street, 1985 (hereinafter "Deregulating Wall Street").

45. The following discussion is based largely, though not solely, on that presented in Deregulating Wall Street at p.208 et seq., There, the author simplifies many of the conflicts originally identified in the Operation of the National and Federal Reserve Banking System: Hearings pursuant to S. Res. 71 Before a Suncomm. of Senate Subcomm. on Banking and Currency, 71st cong., 3d Sess. 999 (1931) at 1063-1064.

46. Deregulating Wall Street, supra note 44, at p. 209.

## A. Conflicts Involving The Safety and Soundness of Financial Institutions

It is proposed to explain the conflict situations with the aid of hypothetical examples within which the conflict is shown to be abused.

### 1. Imprudent Bank Loans to Third Parties to Support the Price of a Security

Facts: A commercial bank becomes affiliated with a securities firm. The securities firm acts as an underwriter for a number of various companies (an underwriter buys all residue shares not taken up in the share issue they have promoted). Conflict: Because the bank is affiliated with the securities firm it has an interest in the success of the underwriting activity. The bank could then make loans to third party investors contingent upon all or part of the loan being used to purchase shares in those companies underwritten by the securities affiliate. This could not only distort the free interplay of market forces but also jeopardise bank assets.

### 2. Imprudent Loans to Issuers of Shares Underwritten by the Banks Securities affiliate

Facts: Company X gets a bank's securities affiliate to underwrite its new issue of shares. The affiliate advises investors to buy some of the issue. The issue fails. Conflict: The bank could then make imprudent loans to Company X to keep it from failing. It may do this to prevent the securities affiliate from being sued by those who invested in Company X on the basis of its negligent advice.

### 3. The Bank Might Make Direct Loans to its Securities Division

Facts: Limits are placed on how much the bank can lend to its securities division. Conflict: The bank may be able to circumvent these ceilings by lending to a third party who subsequently re-lends to the securities division.

#### B. Customer or Selling Conflicts

### 4. The Promotional Role of The Investment Banker-V-The Commercial Banker's Obligation to Provide Disinterested Advice

Facts: The role of an investment banker is primarily promotional while the commercial banker is under an obligation to provide disinterested advice.

Conflict: Once bankers have a direct/indirect stake in the activities of a securities affiliate, investment advice to customers will no longer be impartial. The fear is that a bank might promote shares in companies underwritten by its own securities affiliate, even when more profitable investments are available elsewhere.

### 5. Using Bank Securities Affiliates to Make New Share Issues to Repay Unprofitable Loans

This is a form of debt restructuring. Facts: A bank makes an unsound loan to a customer. Conflict: To avoid suffering a loss the bank induces the customer to use its securities affiliate to make a new share issue. As a result the bank is able to recoup the loan and the securities affiliate earns an underwriting fee.

## 6. The Likelihood of Economic Tie-ins From the Different Divisions Within the Conglomerate

Facts: A conglomerate, offering a wide variety of financial services, develops around a bank. Conflict: It could then "force" its various customers, through economic tie-ins, to use the services of other divisions of the conglomerate when needing advice for other financial matters. Usually the bank would threaten to ration credit to those customers who refused.

## 7. Where the Securities Division Places its Unsold Securities in the Bank's Trust Accounts

Facts: The securities division of a conglomerate holds a number of poor quality securities on its books. These can only be sold off at a loss. Conflict: To avoid such losses the securities firm may seek to place these at a suitable price in other parts of the conglomerate structure - perhaps in the trust accounts of the commercial bank. However, this conflict is unlikely to occur because a number of legal and regulatory constraints usually operate to neutralise this sort of activity.

## 8. Director Interlocks Between the Banking Division of a Conglomerate and Other Non-financial Firms

Facts: A Bank director is on the board of another firm. Conflict: As a consequence decisions made in the boardroom - what bank to approach for loans or which underwriter to use - might be influenced by the presence and voting powers of bank directors.

## C. Conflicts Involving the Misuse of Inside Information

### 9. Informational Advantages Regarding Customers

Facts: Under the new "Big Bang" arrangements, a banking and securities house become affiliated. The securities "arm" underwrite a share issue for Company X in the course of which "unpublished price-sensitive information" about the company is obtained. Conflict: There is ample opportunity for this information to be acquired and used by other divisions within the conglomerate. For example, it may be used by the banking "arm" to the advantage of favoured customers or indeed for the banks own account. The result is an unfair competitive advantage.<sup>47</sup>

### Conflicts of Interest Distinguished From Other Forms of Market Abuse

Though conflict of interest situations are diverse in form, they can, however, be distinguished from other types of market place misconduct such as bribery, embezzlement, fraud etc. These are "blatant abuses", says Schotland, which invoke criminal sanctions.<sup>48</sup> Conflicts of interest on the other hand "are almost entirely left for civil sanctions".<sup>49</sup> He outlines two reasons why this is so. First, encapsulated in the very nature of a conflict is the whole idea of two competing and conflicting interests that are legitimately present. Secondly, conflict of interest abuse, being shrouded in secrecy, is not easy to

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47. Admittedly, legal constraints again operate to weaken the incentive to abuse this conflict. In the U.K. these are formally embodied in the Companies Securities (Insider Dealing) Act 1985. Other regulatory and legislative constraints are also operative - these are briefly referred to in the following section under "Conflicts of Duty" and given treatment elsewhere in this thesis (see especially Chapter Four for an overview of the CSA 1985).

48. Supra, note 35 at p.128.

49. Ibid.

detect still less proved beyond all reasonable doubt. Nonetheless he does go on to outline one conflict of interest situation - the misuse of inside information - where this general rule does not apply. This thesis aims to look at the misuse of inside information in financial conglomerates and more importantly to consider the appropriate regulatory response to that question.

It is proposed to concentrate on the issue of insider dealing because of the probable: extent of such trading ie. the degree to which insider dealing occurs; the damage it causes both: economically, through the disruption of the efficient allocation of scarce economic resources<sup>50</sup>, and socially, through losses in public confidence in the operation of the financial markets; and finally the problem of detection - self evident from the low levels of prosecutions over the last nine years. At the centre of the discussion is the question of whether the Chinese Wall is an appropriate, valid, and effective regulatory mechanism for neutralizing the increased potential for conflict abuse in conglomerates and one in which these corporate entities may generally place reliance upon. The credibility of the mechanism from a policy and legal point of view is therefore placed under scrutiny.

The misuse of inside information (or insider dealing as it is more commonly known) can occur in many different situations. In this general context the abuse is governed, under British law, by the Company Securities (Insider Dealing) Act 1985 - similar provisions have been in force since 1980. The growth of financial conglomerates has caused insider dealing to be a more urgent and immediate problem. This is because the mixing together of financial services has increased the scope for trading on the basis of inside (or price sensitive) information. Extra legal sanctions and new regulatory measures may

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50. See, infra at Chapter Three for a full treatment of this question.



therefore be needed to deal with what is now a more urgent and pressing problem.

Despite this, some jurisdictions, for example, West Germany, impose no formal legal sanctions either criminal or civil on those who indulge in insider dealing. This is in direct contrast to the U.S. where a statutory prohibition has, in theory, been in existence since as far back as 1934.<sup>51</sup>

The "crime" of insider dealing in relation to the efficacy of the Chinese Wall can be given treatment using the methodology employed by Becker in his economic study of crime and punishment.<sup>52</sup> There Becker couched his analysis in terms of an "expected rate of return" likely to be derived from committing a criminal offence. If the costs of an activity exceed the benefits, rational economic man will maximise his total satisfactions by choosing not to engage in it. Analysed within Becker's framework, insider dealing yields sizeable profits especially when set against the low risk of detection.<sup>53</sup> This coupled with the minimal outlay in terms of resources, time and indeed effort, results in enticing rewards. Where such factors are present one would expect the crime to attract profit-maximising individuals.

Today, however, the balance of the equation favouring the exploitation of inside information is changing. The lure of profits are as appealing as ever but the perceived, if not actual, risks of being caught have increased. The sophistication and determination of both the SIB and DTI have alerted insider's

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51. See, infra Chapter Four: Section 10 of the Securities Exchange Act 1934 at note 132 and accompanying text.

52. See, Becker, "Crime and Punishment: An Economic Approach", (1968) 76 J. Pol. Econ. 169.

53. One reason for this low detection rate, as Gower rightly points out, is because of the "off-shore" problem whereby deals are placed through countries where the rules regarding the transfer of funds happen to be very lax. See, the "Gower Report" supra note 9, at para. 1.19.

fears of being prosecuted. The greater use of computers has brought more "transparency" to the market place, transactors being readily discovered.<sup>54</sup> Despite all this, there are those who in a corporate or individual capacity will always feel compelled to break the law.

## II. Conflicts of Duty

### What Duties Do Financial Conglomerates Owe?

With the move towards financial conglomerates and the housing of a number of financial services within the one firm, there has inevitably followed the problem of conflict of duties.<sup>55</sup> A financial conglomerate can be said to have three potential duties:-

1. A duty to retain confidential information obtained from a corporate client - governed by the law of breach of confidence.<sup>56</sup>
2. A duty to the investing public not to trade on the basis of unpublished price sensitive information (commonly referred to as inside information) for its own account or to "tip" (pass on inside information) clients in its advisory capacity - governed by the CSA 1985 (as amended) and other regulatory mechanisms such as the Takeover Panel.
3. A fiduciary duty to take advantage of sources of information reasonably available. This duty is embodied in the "shingle theory" whereby a financial intermediary in a fiduciary position has a duty to have an

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54. See, *infra* Chapter Eight at note 45 and accompanying text.

55. The Gower Report recognised the inseparability of conflicts of duty and interest. *Supra* note 9, at para. 6.30: where he writes "Conflicts of interest and duty cannot be avoided."

56. For a brief review of the law of confidence see *infra* Chapter Four at note 99 and accompanying text.

adequately informed basis for his recommendations. The duty is merely an amalgam of fiduciary duties at common law requiring an agent to act in the best interests of his principal.<sup>57</sup> One of the clearest statements of the duty has been made in a U.S. case:

A securities dealer occupies a special relationship to a buyer of securities in that by his position he implicitly represents 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 ... By his recommendation he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on that investigation. (footnote omitted)<sup>58</sup>

Thus, a multi-service firm in receipt of inside information from an issuer of publicly traded securities may find itself in a position where: (1) actual compliance with its disclosure obligations to its retail customers under fiduciary law causes it to be liable in an action for breach of confidence to its corporate clients and guilty of tipping in violation of anti-insider dealing laws; and where: (2) a failure to tip could cause any recommendation it makes to be without an adequate basis in view of all information known at law by the firm about the issuer.

With the emergence of multi functional financial firms in the U.S., and more particularly in the U.K., is it possible to reconcile these potentially conflicting duties by using a Chinese Wall?

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57. See generally, infra Chapter Six.

58. In Hanley v. SEC, 415 F. 2d 589, (2d. Cir. 1969) at p596-7. The SEC has also stated on several occasions that it does not believe that fiduciary duties under state law extend the responsibilities of the fiduciary to violating Federal law.

## Summary

Chapter Two draws attention to three areas. First, to the structural changes and pressures which led up to "Big Bang"; secondly, to the need for a new regulatory framework as well as the broad principles of that framework; and lastly, to the increased potential for abuse with regard to both conflicts of duty and interest resulting from the merging together of financial intermediaries, especially banks and securities houses, under the one corporate roof. These conflict situations are given treatment, making clear that one of the greatest concerns with the growth of financial conglomerates is the problem of conflict abuse and potentially irreconcilable conflicting duties. Undoubtedly this is part of a wide problem which economists relate to information asymmetries and agency costs.<sup>59</sup>

The misuse of inside information within the new conglomerate structure is singled out for specific analysis. This conflict abuse, as will be made clear later, is to be considered not only with a view to regulation by formal law but also by the regulatory technique known as the "Chinese Wall". In subsequent chapters the Wall mechanism will be questioned as to its suitability in preventing the passage of inside information within conglomerates and in resolving the more general problems associated with both conflicts of duty and interest as they arise with corporate entities of this sort.

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59. See, *supra* note 41a. See also, Jensen and Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure", *Journal of Financial Economics* (1976), pp305-360.

## CHAPTER THREE: INSIDER DEALING – THE NATURE OF THE PROBLEM

### Introduction: What is Insider Dealing and Who is an Insider?

It is necessary from the very outset of this discussion to clarify two crucial issues. First, the main thrust of the thesis is concerned with insider dealing on impersonal stock exchange markets and not with face to face transactions. Secondly, the thesis, in so far as it covers insider dealing, analyses the practice within the context of financial conglomerates; as such, it adopts an approach which might appropriately be termed the unorthodox view<sup>1</sup> as opposed to what could be called the traditional view.<sup>2</sup> The topic is approached in this way for three reasons: first, scant academic treatment has been afforded to insider dealing in the corporate context; secondly, it is within this context that the Chinese Wall mechanism is applied<sup>3</sup>; and lastly, new rules have only recently been drawn up by the SIB dealing with the misuse of inside information in financial conglomerates in the aftermath of "Big Bang".<sup>4</sup>

#### The Traditional View of Insider Dealing

The traditional view of insider dealing is succinctly outlined by Hannigan who defines the practice as "... the use by an insider of price-sensitive information (known to him but not generally, and which he has acquired by

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1. See, note 7 and accompanying text.

2. See, note 5 and accompanying text.

3. See, King and Roell "Insider Trading" (April 1988) Economic Policy 163 at p.165, who point out that "Regulation should ... make life as difficult as possible for the less reputable players who trade on inside information obtained by breaching their fiduciary [duties] or breaking 'Chinese Walls'."

4. See, Rule 3.10 of the SIB rule-book. For a discussion of this rule see, infra Chapter Seven at note 61 and accompanying text.

virtue of his position) to trade to his advantage in the shares of his company."<sup>5</sup> Most of the traditional legal analysis of the topic adopts this approach.<sup>6</sup> Therefore, from the traditional viewpoint of insider dealing, it is generally assumed that the company director is the insider, that he deals on

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5. Farrar, Company Law, (1st edn., Butterworths 1985) at p.344, (emphasis added).

6. But compare, Painter's definition which gives more leeway (see Painter, Federal Regulation of Insider Trading (1968 Supp. 1974,) 2-3 - "Insider Trading arises wherever persons ... having fiduciary responsibilities, purchase or sell shares and the transactions are wholly or in part motivated by inside information acquired in the performance of their functions as a fiduciary" (tippees would also be covered in the sense that they would be liable for knowingly participating in a breach of trust and held liable as constructive trustees (see, D. Prentice, "Insider Trading" (1975) CLP 83, at p.88. Prentice, (ibid., at p.83), offers Painter's definition but tackles his exposition from the perspective of the director being the "archetypal" insider. He goes on to write that directors in possession of inside information may be held accountable to the company for any profit made from the use of confidential information acquired in the course of their duties. "The company", in the context of which Prentice writes, is the one for whom the director is the employee. This can be inferred from Prentice's article because he quotes as authority for the above proposition the cases of Regal (Hastings) Ltd. v. Gulliver [1942] 1 All E.R. 378. and Phipps v. Boardman [1967] 2 A.C. 46, cases which support the misuse of a corporate opportunity doctrine (see, Farrar, supra note 5 at p.339-344). He also quotes the American case of Diamond v. Oreamuno 248 N.E. 2d 910 (1968) which is also on the point of directors of the company using information about the fate of the company to whom they belong. He does, however, note that "third parties who have no direct relationship with the company may be accountable in equity for profits derived from insider trading." (see p.83). Henry Manne, meanwhile, gives a pervasive definition to insider trading. He sees it as "corporate officers, directors, and employees dealing in the shares of corporations". See, Manne, Insider Trading and the Stock Exchange, (New York: Free Press 1966), at p.1 (hereinafter "ITSM"). His definition in "Insider Trading and Property Rights in New Information", (Winter 1985), 4 Cato Journal 933 at p.933) is even more wide-ranging: insider trading is "the exploitation of non publicized information about shares of publically traded corporations." The general tone of Manne's work, however, assumes that deals will be undertaken by insiders within the company from which the inside information emanates (hence his "insider trading as appropriate compensation for entrepreneurs" argument). This is probably because such a scenario is viewed as the most common form of insider dealing. He does, nonetheless, recognise that insider traders may deal on information that does not "belong" to the company for whom they work. Such information is acquired either in the course of duty (as in the case of a financial intermediary) or bought or exchanged with other insiders (see, p.63 of ITSM). For example, Director D of D Company deals on information about X Company either because Director D of D Company is performing a service for X Company or because Director X of X Company is exchanging information with Director D. At p.67 of ITSM Manne recognises that the financial services industry is ripe for the exchange of inside information. He does not, however, give serious attention to this, the unorthodox view, discussed herein.

his own behalf, and that he (and this is the most crucial distinction) deals in the shares of the company whose employee he is.

### The Unorthodox View of Insider Dealing

The underlying assumption of the unorthodox view of insider dealing is that the financial conglomerate itself, through the directors or other corporate personnel, is the insider or quasi insider. These directors do not deal on information generated by the financial conglomerate but rather on information acquired by the financial conglomerate. There are, however, a number of exceptions: for example, where the market-making arm makes it known throughout the conglomerate that it is "long" or "short" of a particular security.<sup>7</sup> This information could of itself be considered to be highly price sensitive and in certain circumstances might constitute a breach of the the Company Securities (Insider Dealing) Act 1985.

However, the more typical example in the unorthodox context is where one arm of the conglomerate deals on inside information about another company (for example, a client of another division of the conglomerate) to whom there is owed a duty of confidence.<sup>8</sup> In the context of a financial conglomerate, this might concern information, say, in the corporate finance arm which could be used by the investment arm for its own account dealing. This view has been given very little treatment in the literature.

Therefore, in the unorthodox view, the company, or rather individuals on the conglomerate's behalf, deal on inside information acquired in the course of

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7. See, Hannigan, Insider Dealing (London Kluwer: 1988) at p. 147. There she discusses a conglomerates research recommendations.

8. See, infra Chapter Four at note 99 and accompanying text.

the business about either another company - for example, maybe an investment banking client on the verge of announcing an increase in expected profits - or information "leaked" by one arm of the conglomerate about a long or short position it has taken as market-maker on specific shares and which it would like to off-load into the accounts of customers in the conglomerate's investment division; alternatively, it might involve the leaking of information that one arm of the conglomerate is acting for an offeror in a take-over negotiation. The conglomerate (individual directors on the conglomerate's behalf)<sup>9</sup> does not ever deal in its own shares; instead it uses information generated by clients of the conglomerate (or information generated from within the conglomerate itself) to make profits or cut losses by trading with the public or even giving advice to clients at a time when it (ie. the conglomerate) has access to unpublished price-sensitive information pertaining to other publicly traded securities.

#### Economics v. Law: Different Inputs = Different Outcomes

Despite the fact that it is the unorthodox view of insider dealing (and the appropriateness of the Chinese Wall within that context) which is analysed in this thesis, a helpful prerequisite might be to consider the general issue of trading on the basis of inside information per se. In this task it is necessary to review the policy arguments for and against the prohibition of such trading even in those areas where the debate seems more applicable to the traditional view of insider dealing.<sup>10</sup> In any case, it is on the traditional view that the policy debate has essentially focused.

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9. See, infra Chapter Six, at note 93 and accompanying text which refers to the "directing mind and will" of the company.

10. In other words, for the purposes of the policy discussion which occupies this chapter no significance is made of the distinction between the traditional and unorthodox views of insider dealing.



It would seem that the dispute over the costs and benefits of the regulation of insider dealing is largely, though not totally, one of a difference in the approach used to analyse the problem. It tends to be the case that the approach used - either economic or legal - colours the conclusions derived. Very simplistically, those who favour prohibitions on insider dealing tend to take a lawyer's perspective while those who do not tend to adopt an economist's approach with an expansive view of market forces. It may be helpful therefore to engage in a law/economics discussion by way of background to the debate. This is what Manne, a lawyer/economist and ardent proponent of unfettered insider dealing, does. Moreover, as Kay, in a fashion uncharacteristic of U.K. lawyers, writes:

... it would be unwise to introduce a prohibition on insider trading before some attempt to prognosticate the economic repercussions of such a prohibition has been made. A cost-benefit approach may well yield a different result from a purely moral one. (footnote omitted).

### **Those Who Argue against Prohibition: The Deregulators<sup>12</sup>**

Henry Manne is undoubtedly the most vociferous and longstanding advocate of unfettered insider dealing. He is joined by others such as Carlton and Fischel who believe that "The desirability of insider trading is ultimately an empirical question".<sup>13</sup> Notwithstanding a great deal of recent literature on the subject, Henry Manne's 1966 book remains the most thorough and widely quoted

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11. Maurice Kay, "The Justice Report", (1973) 36 MLR 185 at p.189.

12. The term "deregulators" is used by Stephen Bainbridge, in "The Insider Trading Prohibition: A Legal and Economic Enigma", (1986) 38 University of Florida Law Review 35, to categorise those favouring a more liberal regulatory approach to insider dealing. Conversely, the term "regulators" is used by way of reference to those in favour of a more strictly regulated regime.

13. See, Carlton and Fischel, "The Regulation of Insider Trading", (1985) 35 Stanford Law Review 857 at p.866.

statement of the case against prohibiting insider dealing.<sup>14</sup> His work is explained, defended, and substantiated in numerous journals and other publications dating from 1966 until the present day.<sup>15</sup> Manne's arguments have both a legal and an economic basis to them. The emphasis, however, is overwhelmingly on economic analysis to explain why no regulatory restrictions should be imposed on the practice. Manne believes that "the debatable aspects of insider trading are capable of resolution through tools of economic analysis."<sup>16</sup> His is a view that discounts the harm and highlights the gain from what is generally taken to be bad practice. He does not, however, take a solely economic view, for though he asks questions such as - can insider dealing be prevented and at what financial and social cost?<sup>17</sup> - he argues too that there are also legal reasons for not prohibiting the practice, in that insider dealing is hard to define and that a law which is not applied and cannot be enforced might well be considered to be a bad law.

At its simplest level, Manne maintains that insider dealing has many positive aspects and very few, if any, negative. His arguments are cogent and forcefully put. Upon tracing the history of insider dealing he notes that the Pecora hearings in Congress in 1933-34 produced the first real condemnation of the practice. There the conduct of those who admitted to insider dealing was

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14. Manne, Insider Trading on the Stock Market, (New York: Free Press 1966), hereinafter "ITSM".

15. See, Manne, "In Defence of Insider Trading" (1966b) 44 (6) Harvard Business Review 113. Manne, "What's so bad about Insider Trading" (Jan-Feb 1967) 15 Challenge 14. Manne, "Insider Trading and the Law Professors" (1970) 23 Vanderbilt Law Review 547. Manne, "Economic Aspects of Required Disclosure Under Federal Securities Laws", in Wall Street in Transition: The Emerging System and its Impact on the Economy (New York University Press 1974). Manne, "Insider Trading and Property Rights in New Information" (Winter 1985) 4 Cato Journal 933.

16. See, Manne, Vand. L. Rev. supra., note 15, at p.548.

17. See, Harvard Business Review, supra note 15, at p.113. See also, Vanderbilt Law Review, supra note 15, at p.553 et seq. where he discusses the question of "partial enforcement" in depth.

described as "immoral", "unscrupulous", "unfair", a "betrayal of fiduciary duties" etc.<sup>18</sup> Manne's main grievance is with the fact that "the debate has remained essentially moralistic"<sup>19</sup> in that "Judges and lawyers have failed to probe beyond a sense of moral outrage". He suggests that such an analysis is for the "intellectually bankrupt"<sup>20</sup> - hence his tendency to engage in an economic analysis of the problem. The conclusion he and others reach is that insider dealing is socially and economically desirable. This is so for a number of reasons.

### The Positive Effects of Insider Dealing

#### 1. Most Appropriate Means of Rewarding Entrepreneurs

That insider dealing is the most appropriate means of rewarding entrepreneurs is one of Manne's main arguments in favour of the unfettered use of inside information. He rejects the suggestion that salary is a satisfactory reward to entrepreneurs and argues that the opportunity to trade on the basis of inside information should be seen as part of a compensation package to encourage innovation.<sup>21</sup> Carlton and Fischel also consider the practice from this view-point.<sup>22</sup> They argue that insider dealing by managers and other employees in the securities of their own firms based on superior knowledge is an adequate way of compensating corporate personnel. They suggest that the allocation of valuable property rights in information would be better left to

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18. See, Stock Exchange Practices, Hearings before the Committee on Banking and Currency, U.S. Senate, 73rd Congress, 1st session.

19. See, Harvard Business Review, supra, note 15, at p. 113.

20. Ibid.

21. In ITSM he referred only to entrepreneurs but subsequent articles have relaxed this condition. Compare, Kirpe, "Manne's Insider Trading Thesis and Other Failures of Conservative Economics", (Winter 1985) 4 Cato Journal 945 at p.947.

22. Supra, note 13.

private contractual negotiations rather than formal law.<sup>23</sup> Two advantages, in their view, follow from permitting insider dealing on this basis: (1) it avoids the cost of re-negotiating working conditions;<sup>24</sup> and (2) it sorts out superior managers from inferior ones. Regarding the latter, the argument is as follows: managers who are permitted to trade on inside information have an incentive to acquire and develop valuable information. Creating valuable information involves risk. It is difficult for firms to identify those who are good managers and those who are not overly risk averse. Basing a manager's compensation package on the use of inside information helps identify the better managers.<sup>25</sup>

Manne too favours private contractual negotiations because the firm is given a choice of how it will provide compensation for its corporate personnel. He sees internal policing as the most suitable means of ensuring that insider dealing only compensates those whom the company wants.<sup>26</sup> Implicit in Manne's idea of internal policing then must be the use of some sort of isolation technique akin to the Chinese Wall.<sup>27</sup> The operation and enforcement of this internal mechanism obviously imposes a cost which must be met.

Manne and his supporters see the use of inside information as a reward to

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23. *Ibid.*, at p.862.

24. *Ibid.*, at p.870. But is this really a significant cost?

25. *Ibid.*, at p.871.

26. *But see*, Roy Schotland, "Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market", (1967) 53 *Virginia Law Review* 1425 at p. 1456, who argues that insider dealing could get out of control.

27. There is, however, a crucial distinction, in that by virtue of the thrust of Manne's argument, he is referring to companies allowing their own personnel to trade on the basis of inside information which the company has generated about the price of its own securities. The concept of a Chinese Wall, by contrast, is where a financial intermediary erects an information barrier to stop the flow of inside information which it holds on trust for clients who have legitimately divulged the information to the conglomerate in the course of a fiduciary or other relationship.

entrepreneurs and other corporate employees for their initiative and ingenuity, a perk, as it were, for the role they fulfil within the economic system. The argument with regard to the entrepreneur runs thus: entrepreneurs are vital to a free market economy - they need to be recognised and rewarded as such - " ... insider trading provides the only effective compensation scheme for entrepreneurial services in large corporations."<sup>28</sup> In the Vanderbilt Law Review he writes "if any service presently being purchased by the corporation is compensated more highly, then more of that service will be offered."<sup>29</sup> He finds it hard to understand why it is unfair or unjust or immoral to allow a voluntary arrangement in which individuals are given additional incentives to produce more of a valuable commodity by sharing in the new value of the commodity they produce. His conclusion, therefore is that insider dealing should be allowed and indeed encouraged.

## 2. The Efficient Stock Market Argument

Manne, taking a very broad view which is much criticised by his opponents, sees the stock market largely as "a complex arrangement for the marketing of information."<sup>30</sup> Moreover, and somewhat melodramatically, he suggests that "[p]eople pressing for the rule barring insider trading may inadvertently be tampering with one of the well-springs of American prosperity."<sup>31</sup> Rider and French outline how this could be so. They write that capitalism is based on a market hypothesis in which supply and demand curves are rarely met. Such inequalities are inherent in a free capitalistic society. One inevitable inequality will therefore be information. This is an aspect of

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28. For a detailed analysis of this proposition, see, Manne, Harvard Business Review, supra note 15, at p.116 et seq.

29. Supra, note 15.

30. See, Manne, ITSM, supra note 14, at p.47.

31. Ibid., at p.110.

the "risk factor". To eliminate insider dealing and equalise the availability of material information would tend to de-stabilise capitalism.<sup>32</sup>

Manne argues, this time with much agreement among even his critics, that the more efficient a stock market functions the better off everyone is. The primary reason offered is because capital is allocated to its highest return uses, and from this is derived the greatest individual and social utility. Other reasons are that it has a direct effect on investment decisions, the market for corporate control and the market for managers.<sup>33</sup> But although it has been conceded by pro regulators such as Kirpe, that prohibitions on insider dealing could well decrease market efficiency, he hits back by quoting Dean Bayliss Manning who argues, "[T]he one thing that is clear about securities regulation is that, whatever the SEC is all about and whatever regulations are all about, they are not about efficiency."<sup>34</sup>

The efficient stock market argument involves:

(a) Market Speed - the speed with which markets integrate new information into the market price of a security. Manne writes "[I]nsider trading will always push stock prices in the correct direction. That is, the effect of insider dealing will always be to move a share's price towards the level correctly reflecting all the real facts about the company."<sup>35</sup> Thus, if insider dealing enables "everything known about the company whether public or not to be

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32. See, Rider and Ffrench, The Regulation of Insider Trading, pxii (Macmillan: 1979).

33. See, Manne, Cato Journal, supra, note 15, at p.935.

34. Ibid., at p. 948. It is interesting to note that Manne thinks that the stock market in the US is efficient despite anti-insider dealing laws because so much insider dealing continues to go undetected.

35. Ibid., at p.935.

reflected in the price of that company's shares"<sup>36</sup> then investors (outsiders) are unlikely to undertake investments 'blind-sided' by developments not yet reflected in the current prices of the shares. Insiders therefore reduce the luck factor and outsiders as a consequence get a fairer deal.<sup>37</sup> As Moran says,

How rapidly mispricing is corrected when insiders trade depends on the reaction of the market price to the insider's trades and the timeliness of disclosure once the insider has traded. Insider trading on undisclosed information causes a more gradual adjustment in share prices than if the information is made public (Manne, 1966, p.87). The timing of the disclosure is often prescribed by convention, however, and disclosure laws are not fully enforced, so insiders can usually trade in advance of an announcement (Manne, 1966, pp.103-104). Thus, prices begin adjusting earlier when insiders trade on their information. Once their trades are completed, insiders'incentives are to disclose the information. Therefore the interval required for stock prices to adjust to new information is reduced when insiders trade (Demsetz, 1969a, p.14)<sup>38</sup> (emphasis added)

(b) Market Accuracy - this relates to issues of (i) disclosure of information and (ii) smoothness in market operations. With regard to (i) Manne asks whether full disclosure is in anyway feasible. He concludes, for practical reasons, that it is not.<sup>39</sup> In relation to (ii) Manne also argues that insider dealing helps smooth out fluctuations in stock market prices. This idea is perhaps best explained by Manne in Vanderbilt Law Review<sup>40</sup> where he suggests that gradual movements in share prices caused by insider trading are preferable to the erratic jumps in prices brought about by enforced disclosure. The reason

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36. See, J Cottrell, "Insider Dealing in the United States - III: The De-regulation Issue" (1986) February 14 NLJ 150.

37. See, D. Seligman, "An Economic Defence of Insider Trading", (September 1983) 108 Fortune 47 at p.48.

38. Mark J. Moran, (1984) (U.S.) "Insider Trading in the Stock Market: An Empirical Test of the Damage to Outsiders", Working Paper No. 39, Center for the Study of American Business, Washington University, Missouri - cited in Report to the Minister of Justice by the Securities Commission on Insider Trading (1987) Volume I (hereinafter the "New Zealand Report").

39. See, Manne, Vand. L. Rev., supra, note 15, at p.570. This is an important outcome to arrive at because it forms the basis of a further argument outlined in more detail later by Carlton and Fischel (see, infra note 50 and accompanying text on: Insider Dealing Benefits The Firm ...).

40. At p.574. See also, Manne, Harvard Business Review, supra, note 15, at p.115.

for this is that if there is no insider trading "those who transact only a few moments apart may get very different prices and will view the market as performing unfairly".<sup>41</sup> The example that Manne uses is as follows:

Let us assume that a stock is selling at \$50, with undisclosed good news which will ultimately cause the stock to sell for \$60, and that no factors other than the good news will affect the price.

Suppose, further, that with insider trading the price of the shares rises gradually to \$60. The average price at which shares sell during this period is somewhere in the neighbourhood of \$55 (more or less depending on the shape of the time-price curve). At \$60, anyone who has held his shares will have received the full benefit of the new information whether it is disclosed to him or not. This advantage to the ultimate holder remains even if we effectively prevent insider trading.

Without insider trading, however, the position of those who sell during the time required for the price to rise from \$50 to \$60 is radically altered. No longer do they receive an average price of \$55. Assuming that the ultimate disclosure is made at the same time under either rule, they receive only \$50 for their shares without insider trading.<sup>42</sup> In short, they get less than they would with insider trading.<sup>42</sup> (emphasis in the original).

There is evidence to suggest, however, that even this argument is incorrect. Manne indeed admits it himself. In his *Cato Journal* article,<sup>43</sup> where he refers to insiders buying shares before important new information about the company is disclosed publicly, he writes, "[t]hat kind of trading may have some impact, but we cannot be sure a priori how much impact it will actually have, if it will have any at all."<sup>44</sup> He comes to this conclusion because of the assumption nowadays that the demand curve for a company's stock is extremely elastic. He continues "[t]hus even large purchases of stock will not necessarily have an immediate and noticeable effect on its price since other stocks are seen as perfect substitutes."<sup>45</sup>

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41. See, Cottrell, supra note 36 at p.151. See also, Moran, supra note 38. The two arguments are inter-connected.

42. Manne, Harvard Business Review, supra note 15, at p.115.

43. See, Manne, Cato Journal, supra, note 15, at p.938.

44. Ibid.

45. Ibid.



Similarly, in a widely recognised study conducted by Professor Wu, the findings were that a "substantial impact of insider trading on stock prices could not be expected."<sup>46</sup> Moreover, Schotland attacks Manne's notion that smooth gradual movements are preferable to sudden jumps.<sup>47</sup> Schotland argues that "unfettered insider trading is unlikely to make the market "smoother", [and] that even if it had some tendency to do so, the "smoothness" that might be gained is not worth its cost".<sup>48</sup> More significantly he notes, "[b]oth economists and the 'fairness-minded' will prefer ... a market characterised by informed transactions with sharp price shifts when the information changes, rather than one characterised by many uninformed transactions".<sup>49</sup>

### 3. Benefits the Firm in Whose Shares Insider Dealing Takes Place

The alternative to unfettered insider dealing, argue Carlton and Fischel, is disclosure.<sup>50</sup> Disclosure has many benefits but "complete disclosure, however, would not be optimal. [It] is costly and at some point the costs will outweigh the benefits of increased disclosure."<sup>51</sup> There are several reasons why communicating information through insider dealing may be of benefit to the firm. Carlton and Fischel's most persuasive argument in this respect is that through insider dealing a firm could convey information it could not feasibly announce publicly because an announcement would - (1) destroy the value of the

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46. See, Wu, "Corporate Insider Trading in the Stock Market 1957-1961" (1965) 2 Nat'l Bank Rev. 373, at p.385.

47. Schotland, supra note 26, at p.1446.

48. Ibid.

49. Ibid.

50. See, supra note 13, at p. 867.

51. Ibid.

information,<sup>52</sup> (2) be too expensive, (3) be not believable and (4) or (owing to uncertainty of information) expose the firm to liability because it was found after the fact to be incorrect. Insider dealing in this respect is controlled by restricting the number of traders who have access to information, a technique which they believe is easier than trying to control how much information is announced over a given period of time.<sup>53</sup>

## Enforcement: The SEC and Other Critics Are Misguided

### 4. Enforcement Problems

Manne attacks the whole philosophy that underlies any attempt to enforce rules prohibiting insider dealing.<sup>54</sup> His main argument here is that enforcement agencies (and here he is referring in this respect to the SEC, though how applicable it is to the SIB is uncertain - see below footnote 9) assume perfect enforcement - that full and timely disclosure rules will be perfectly enforced. "Enforcement" he says "will be imperfect at best".<sup>55</sup> He argues that the insider dealing debate turns on "the efficiency with which a rule against such trading can be enforced." He maintains that effective enforcement requires unacceptable policing measures and therefore only partial enforcement is feasible. This fact, he maintains, has important political and economic effects. When resources are limited they will inevitably be focused on those least in favour

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52. The example given here is: "It would not be in the investors' interests to disclose, for example, that a confidential study revealed the presence of valuable mineral ore deposits on land the firm intends to purchase." at p. 867-868.

53. Again this implies the use of some sort of internal screening procedure to ensure that the information is acquired by only those eligible to receive it and use it. Such procedures would not amount to a Chinese Wall in the sense referred to throughout this thesis.

54. See, Manne, Vanderbilt Law Review, *supra*, note 15, at p.552 *et seq.* See also, Manne, Cato Journal, *supra*, note 15, at p. 936 *et seq.*

55. See, Manne, Vanderbilt Law Review, *supra*, note 15, at p.552.

with the enforcement agency.<sup>56</sup>

Manne writes, "some potential violators are more risk averse than others. People who value their reputations highly will not take the risk of being ... charged by the SEC, and they will pull out of the competition for "illegal" information.<sup>57</sup> Therefore those who are "sharp operators" will move in. "[T]he absence of the more high-minded participants from the segment of the [market] makes it ... much more lucrative and attractive for those we want least to encourage." He concludes, "Partial enforcement ... gives a completely unwarranted advantage to those against whom the law is not enforced."<sup>58</sup>

Another one of Manne's arguments concerns the cost of enforcement. Manne maintains that "we [cannot] ... talk intelligibly about the costs and benefits of the SEC's rule [10b-5] without at least noting the high compliance and escape costs from rules against insider trading. The lawyers advising corporations, shareholders and others today on how to avoid the risks of an SEC complaint do not come cheaply. Furthermore, the fact that there is so much money potentially [to be had] means that people will use inefficient devices to exploit the information if straight-forward methods are [easily detected]."<sup>59</sup>

A further proposition that Manne advances is that the SEC's attempt to

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56. The SIB favours the idea that in the U.K. there will be a high level of self-policing and self-enforcement because of the increased market competition. This, it believes, will give competitors the incentive (especially market-makers) to "inform" the regulatory authorities about suspected market abuse.

57. See, Manne *Cato Journal*, *supra*, note 15 at p. 942.

58. However, if an activity is deemed unacceptable, it would seem that even partial enforcement would be preferable to no enforcement at all. It is important therefore to build into the legal disincentives that exist a heavy penalty to compensate for the difficulty of detection. See, Becker, *infra* Chapter Two at note 52 and accompanying text.

59. See, Manne, *Cato Journal*, *supra*, note 15, at p. 936.

regulate insider dealing is misconceived. First he notes that the SEC has given convincing evidence of its own inability to police its rules against insider trading especially where foreign funding of such trades is involved.<sup>60</sup>

"The ability to detect the practice will always be difficult, and when the gains that can be realized from the practice, discounted by the risk of being apprehended, are compared to the potential costs, many people will have the incentive to trade on inside information."<sup>61</sup>

Secondly, there is a more fundamental reason why there can never be a rule against the profitable use of inside information in the stock market. It is Manne's opinion that "many people who exploit new information do not buy additional stock: rather, they simply do not sell."<sup>62</sup> He points out that a failure to sell is not a violation of the SEC's Rule 10b-5 purely because there has been no securities transaction. Somewhat extravagant is Manne's claim that "not selling [may] ... be the dominant method of using inside information."<sup>63</sup>

It is very questionable whether Manne's "negative" insider dealing conception (that is, not selling because of access to inside information) is a dominant or even significant means of insider dealing. People and corporate entities who use inside information do so to make money. The best means of doing this is to actively trade on the information acquired even though it means running the risk of being prosecuted. It is accepted, however, that as the risks of insider dealing gradually increase, this form of "trading" may become more popular.

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60. Ibid., at p.937.

61. Ibid. Again this will depend not merely on the risk of detection but also on the penalty when detected.

62. Ibid.

63. Ibid.

Manne launches one more attack on the SEC which, he says, is politically grounded. He uses George Stigler's "interest theory" of regulation and asks the crucial question - "who is benefited most by an anti-insider trading rule?" Manne writes, "Look for the supporters of the rule and you will have a good idea of who benefits from it."<sup>64</sup> The suggestion here is that the SEC itself is the beneficiary of the prohibition on insider dealing and not society.

### Insider Dealing Does Not Cause Harm

#### 5. Victimless Crime

According to Manne "[t]he most fundamental economic proposition in the whole topic of insider trading is that no shareholder is harmed by a rule of law that allows the exploitation of nonpublicized information about shares of publicly traded corporations."<sup>65</sup> Put simply what Manne is getting at here is that insider dealing is a "victimless crime". Supporting Manne's argument, Moran writes, "... insiders' profits are not outsiders' losses but evidence of more efficient resource allocation."<sup>66</sup> As Manne says, "no one with an important interest is being deprived of his interest when insiders are allowed to trade."<sup>67</sup> In his view just because someone does not make as much money on the sale of a share as they would otherwise have done does not make them victims in the true sense simply because nothing has been stolen from them. He writes, "[t]he modern academic literature now recognizes that there is no significant economic harm to any identifiable group of investors from insider trading."<sup>68</sup>

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64. Ibid., at p.943.

65. Ibid., at p.933.

66. Moran, supra note 38.

67. See, Manne, Harvard Business Review, supra note 14, at p.110.

68. See, Manne, Cato Journal, supra note 15, at p.934.

Daniel Seligman,<sup>69</sup> who takes a pragmatic view supporting Manne, points out that no one knows whether those hurt by insider trading are more numerous than those hurt by trading before inside facts have impacted the market, so that they are price-takers taking a faulty price. Meanwhile, Prentice notes that "[w]hile a shareholder who deals with an insider may have a justifiable sense of grievance if at the time the insider is in possession of confidential information there is no way in which this sense of grievance can be translated into a causal connection showing loss attributable to the insider's trading."<sup>70</sup>

Similarly even if some identifiable group could be seen to be "victims" would it not be necessary, asks Manne,<sup>70</sup> to consider whether the economy would be hurt more by prohibiting the conduct? This is a classic example of the difference in approach between the economist and the lawyer.

#### 6. The Victim Receives Better Price Because the Insider is in the Market

On page 114 of ITSM Manne takes as an example the case were the long term investor (the one, he says, we should be most keen to protect) is the person who actually sells to the insider. He argues that prohibitions on insider dealing prevent investors from profiting as much as they would if the practice were allowed. First of all Manne assumes that the investor is actually selling for reasons other than to make a quick profit, ie. he trades on a time basis and would be selling in any event irrespective of the insider trader and

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69. See, supra note 37.

70. See, Prentice, supra note 6, at p.91.

70. See, Manne, Harvard Business Review, supra note 15, at p.113.

without being influenced by the price of the security in question.<sup>71</sup> Manne suggests that the outsider may actually benefit from the insider's trades because if the insider is buying on the basis of as yet undisclosed good news the outsider may get a higher price than he might otherwise simply due to the fact that the insider has entered the market.<sup>72</sup>

Manne and his supporters have been enterprising in their attempts to present the case in favour of the deregulation of insider dealing. However, some of the arguments outlined by the deregulators may be said to be flawed or weak in a number of respects. In putting forward the counter-arguments, the rebuttal has been split into five main headings. First, there is the issue of fairness. Linked to this is the important public perception of the integrity of the market place if insider dealing is left unchecked. Secondly, there is the moral and ethical side of the practice to be considered. Thirdly, the idea that insider dealing is a victimless crime is challenged. Fourthly, it is suggested, by using a number of arguments, that insider dealing is actually an inefficient distributor of scarce resources. Then finally, some miscellaneous arguments are outlined.

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71. See, J Cottrell, supra, note 36, at p.152 who rejects this assumption.

72. "Justice" quote a similar example: "when a director buys on the market in the knowledge of a forthcoming bid for the company, the seller of the shares would probably have put up his shares for sale anyway and the price he gets may in fact have been slightly raised by the fact that the director is in the market as a buyer." Justice, Report on Insider Trading (1972) para.2. However, it could be argued that this analysis misses the point. After all it is easy to give examples where individual outsiders benefit from the activity of insiders; the fact remains, however, that the expected rate of return to outsiders on stock market investments (even to the large institutional investors such as pensions funds and mutual funds etc.) is lowered. In other words the profits are "creamed off" by insiders. If this view is correct then the victims are all those constituting the market other than insiders'.

## Those Who Favour Prohibition: The Regulators

There are a number of policy issues underlying the proscription of insider dealing:

### Insider Dealing is Unfair and Damages the Integrity of the Market

The idea that insider dealing is unfair commands broad support because it is widely believed that insiders take advantage of outsiders. There are a number of related arguments here.

#### 1. A False Economic Logic

First of all, there is the argument advanced by Kirpe and supported by others, such as Schotland and Cottrell, that Manne's economic analysis excludes issues of fairness and integrity.<sup>73</sup> Kirpe attacks the underlying philosophy of Manne's essentially economic approach. He writes, "Manne and his supporters are guilty of a fault ... [in that] they assume that man is a single-faceted individual, engaged solely in maximising personal financial gain [with no thought for] fairness, honesty, respect for law, self-respect, consideration for others and so on."<sup>74</sup>

Schotland makes the point that even given Manne's premise "[w]hen we engage in economic analysis we do not banish permanently the legal and moral aspects of the problem analysed. It is precisely in order to make sounder legal judgements and to evaluate their cost that we bring economic analysis to

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73. See Kirpe, supra note 21, at 948; Schotland supra note 26, at p.1438; and Cottrell, supra note 36, at p.151.

74. Ibid.



a problem like insider trading."<sup>75</sup> Manne fails to note argues Schotland, "what our constraints on insider trading actually gain us, both economically and in terms of the quality of our society and our human relationships."<sup>76</sup>

## 2. Fairness and Inequality of Bargaining Power

What Hannigan describes as the "equity" argument also fits under this general heading of unfairness.<sup>77</sup> She relates the argument to what American commentators have come to call "market egalitarianism". This is simply the idea that the law should try to ensure that all individuals in the market are placed on an equal footing, in so far as that is possible. The belief here is that anyone making a trade based on superior information is in effect "stealing" from other market participants by acting before all other investors. The same argument was offered as the underlying policy rationale by the Second Circuit in the celebrated case of S.E.C. v. Texas Gulf Sulphur Co.<sup>78</sup> There it was said:

All investors should have equal access to the rewards of participation in the securities transactions. It was the intent of Congress that all members of the investing public should be subject to identical risks ... [I]niquities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life, or, in view of the Congressional concern in the area, remain in force. (at p.848)

Carried to its logical extreme, this doctrine would eliminate the use of all "informational advantages". Carlton and Fischel draw a distinction between the legal and economic definitions of insider dealing: insider dealing from an economic point of view is trading by parties who are better informed than their trading partners. Thus, insider dealing defined in this way includes

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75. See, Schotland *supra* note 26, at p.1438.

76. *Ibid.*, at p.1439. Likewise Cottrell, *supra* note 36 at p. 151 writes that "Manne fails to balance the possible economic gains of totally unregulated insider trading against [important issues like] fairness and integrity."

77. See, Farrar, *supra* note 5, at p.354.

78. 401 F.2d 833 (2d Cir. 1968).

all trades where information is asymmetric (ie where one party has more information than the other). Insider dealing in this sense need not be illegal - the law has never attempted to prohibit all trading by knowledgeable insiders.<sup>79</sup>

Economists, meanwhile, have argued that superior information legally obtained is fundamental to trading activity and efficiency in the stock market. Consequently, they argue that trying to ensure complete equality of information is dangerous because most trading involves some degree of asymmetry of information. In fact, "Legitimate research gives some traders informational advantages and their earnings serve as compensation for their efforts." The problem with the "market egalitarian" argument, writes Prentice, is that "It fails to distinguish the legitimate from the illegitimate exploitation of non-public information."<sup>80</sup> What is more, says Kirpe, "[i]t is impractical in a profit-making society to require everyone to give up his informational advantage against his counterpart in bargaining"<sup>81</sup>

Furthermore, as the SEC has recently stated: "[i]nsider trading in publicly traded securities undermines the expectations of fairness and honesty that underlie public confidence in [the] nation's securities markets".<sup>82</sup> In the document the Commission then goes on to argue for the need to encourage

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79. See, supra note 13 at p.860. The widely held view is that traders should not deal on the basis of an information advantage which is largely unenforceable. See, Brudney, "Insiders Outsiders and Informational Advantages" (1979) 93 Harv L Rev 332 at p.353-368 where he advocates the view that the trading prohibition should only operate where the insider possesses an "unenforceable information advantage", ie. a position of access which others are unable lawfully to obtain.

80. See, Prentice, supra note 6, at p.92.

81. See, Kirpe, supra note 21, at p.951.

82. See, Memorandum of the securities and Exchange Commission in support of the Insider Trading Sanctions Act of 1984, H.R. Rep. No. 355, 99th Cong., 2d Sess. 21 (1984).

legitimate information gathering and dissemination so as to promote the efficient operation of the nation's securities markets. Throughout it was eager to reject a "parity of information theory". The aim instead was to foster the gaining of information advantages through conduct amounting to "skill", "foresight" and "industry" rather than by conduct constituting "secreting", "stealing" and "purloining".<sup>83</sup>

### 3. Fairness: Congressional Concern about the Integrity of the Market and Confidence in the Market

Schotland makes the point that Congress has expressed an overriding concern for fairness in that the Securities Exchange Act 1934 calls for "fair dealing" in no less than six sections, twice calls for "fair and orderly markets" and cites the protection of investors as one of its dominant goals.<sup>84</sup> Kirpe writes:<sup>85</sup>

Protection of the markets against unfairness is ultimately the justification for the regulation of insider trading and this concern outweighs the slight adverse effect it may have on the efficiency of the securities markets.

Similarly, that fairness is the overriding concern in the financial markets is confirmed by Bomberg who argues that "the loss of efficiency that comes from insider trading laws is a price worth paying in order to have a fairer market."<sup>86</sup> Kirpe suggests the real victim of insider dealing is society. He writes:

[Insider] trading runs the risk of destroying an important public interest, namely, confidence in the nations securities markets. Our strong ... markets ... is one of the strongest supports of ... [the] economy. A true reading of the early history of the federal securities legislation is that it was intended to restore public confidence in the securities markets after the 1929 debacle."<sup>87</sup>

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83. See, United States v. Carpenter, 791 F.2d 1024, 1031 (2d Cir. 1986).

84. See, supra note 26, at p.1438.

85. See, Kirpe, supra note 21.

86. Wall Street Journal 18 November 1986 p.15.

87. See, Kirpe, supra note 21, at p.954.

The fact is that the perception, whether correct or not, that unfairness exists, undermines public confidence in the capital markets. A "fair" market is crucial otherwise the public will not invest in it. Former SEC Commissioner Barbara Thomas has said that insider trading "destroys the belief that they [the investing public] have an equal chance to the profit." This, she says, "makes investors reluctant to invest in the stock market."<sup>88</sup> Kirpe provides an analogy:

Informed persons may be willing to gamble in professional casinos even if they know that the odds are rigged to provide a percentage for the house, but they will act differently if they know or suspect that the house is marking the cards, or controlling the roulette wheel by means of a secret pedal.<sup>89</sup>

In the U.K. and elsewhere the same view is very much prevalent. Insider dealing, says R. Alexander, (Chairman of the Panel on Takeovers and Mergers):<sup>90</sup>

gravely weakens the integrity of the financial markets. That feeling has been increasingly emphasised by the wider diffusion of share ownership which has been the consequence of the privatisation of some of our formerly nationalised industries. To the small investor the idea that someone working in the City is using inside information to deal in what ought to be a uniformly informed market is quite repugnant. The integrity of the City of London as a financial centre is a crucial element to its success and reputation.

Manne is criticised for assuming that people sell their shares for exogenous reasons irrespective of whether or not they perceive insiders to be operating in the market. His opponents argue that people will be unwilling to buy and sell so freely if they think that they may soon become the "victims" of insider dealing. Consequently, if the public refrain from investing the result is "that the market becomes less liquid, and thus less able to fuel the expanding

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88. *Supra*, note 37, at p.47.

89. See, Kirpe, *supra* note 21, at p.954. This analogy assumes investment to be a game of chance. The reluctance to participate will apply a fortiora if, as many think, it is a game of skill.

90. Paper delivered to the New Zealand Law Conference, Christchurch, October 1987.

demands of free enterprise."<sup>91</sup> Indeed as the recent New Zealand Report on Insider Trading states:<sup>92</sup>

A market in which abnormal profits accrue to insiders on a perceptible scale is unattractive to outsiders ... It seems to us that a market economy depends upon the confidence investors have in the perceived fairness of the market process. Policies directed to widespread public shareholding in companies are therefore likely to be subverted by condoning insider trading.

There is, however, no evidence to show that investors are fleeing the market, at least in the U.S. As Prentice points out, "public confidence in the market is a product of complex psychological and economic factors and the fact that insider trading is taking place will only have a tangential, if any, bearing on it."<sup>93</sup> In any case, the argument that investors will refrain from investing because of insider dealing has greater application to American conditions than to those in the U.K. because in the latter the bulk of investment in the market is institutional. However even here, it could be suggested, that this is so because U.K investors are more troubled by the fact that some investors operate with superior knowledge and rather than be forced out of the market altogether they tend to use institutional intermediaries such as Pensions Funds.<sup>94</sup>

#### 4. Fairness and Cost

As the report by the New Zealand Securities Commission on Insider Trading states, "[n]o-one attempts to describe insider trading as fair. When

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91. See, supra note 37, at p.47.

92. See, New Zealand Report, supra note 38, at p. 27

93. See, Prentice, supra note 6, at p.91.

94. Ibid. But notwithstanding even this: "where insider trading has been proscribed there is no evidence that it had any impact on stock market trading patterns by enticing into the market those who previously been reluctant to invest." (Ibid. at p.89). Yet this still leaves the question of how such evidence could actually be obtained.

fairness is raised, the argument moves to some countervailing considerations, usually costs, or alternative solutions."<sup>95</sup> This is illustrated by a quotation from the "deregulators", Carlton and Fischel, who comment:<sup>96</sup>

if it is known that insiders cannot trade, the gains from discovering non-public information would be high and brokers would have an incentive to expend resources to uncover it. In fact the only effect a ban on insider trading might have is that brokers rather than insiders reap the gains from inside information. While this may be inefficient because brokers can only become informed at a high cost, the informed/uninformed trader problem remains. Smart brokers pose the same problem as smart insiders.

However as the New Zealand Commission Report concludes, "[o]ur view is that considerations of fairness are not always subordinate to considerations of cost especially where the totality of costs is not brought into account. The costs of discovering "non-public information" are not the only costs at stake in the argument. To assess the total costs, one would need to consider the costs of equity capital at large, including an element for the risk of loss in a market seen as unfair ... In pursuing a systematic analysis of the practice, we record that we have seen no dissent from the view that insider trading is unfair."<sup>97</sup>

#### Insider Dealing is Morally and Ethically Wrong

Again the New Zealand Report observes, "[m]oralist theories express judgements upon the behaviour of the insider through a range of condemnations from disloyalty, dishonesty to fraud and theft."<sup>98</sup> Insider dealing is "an area of law", says Woodhouse J (as he was then), "where the courts can and should

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95. Report to the Minister of Justice by the (New Zealand) Securities Commission on Insider Trading, (1987) Vol. 1 at p.16 (hereinafter the "New Zealand Report").

96. Carlton, D.W. and D.R. Fischel, "The Regulation of Insider Trading", (April 1983) University of Chicago Law School Working Paper as cited in New Zealand Report, supra note 95 Vol. I, at para. 4.4.2.

97. Supra note 95 at para. 4.4.3

98. Ibid., at p.12

find some practical means of giving effect to commercial morality in the cases that come before them ..."<sup>99</sup> Others have been more forthright, saying, "[m]orality is indivisible, though culpability may have degrees. Insider dealing, which in its nature is theft from the innocent and unsuspecting, is immoral"<sup>100</sup> Counter-arguments can, of course, be put,<sup>102</sup> but:

these and other responses ... do not answer the moral question. The shift to different questions - proof, enforceability and economic efficiency. In our opinion the moralist condemnation of insider trading is, on moral grounds, unanswerable.<sup>103</sup>

"Probably the primary justification for proscribing insider trading is that it is unethical", writes Prentice, and though this may be an "inadequate and emotive basis on which to regulate the practice ... [it still remains the most widely] accepted".<sup>104</sup> That insider dealing is unethical was a conclusion which Justice also came to. In their Report they claimed that insider dealing was contrary to "good business ethics" and that anyone holding a position of trust in a company should not use confidential information. In their opinion good business ethics needed to be backed up by legal sanctions.<sup>105</sup>

This approach is very much like the "fidelity" argument outlined by Hannigan as applied to the traditional way of looking at insider dealing.<sup>106</sup> The fidelity argument, says Hannigan, looks at the problem from the point of view of where the information has come from and the position of the person who is using it. Adopting a very strict traditional approach to the problem, she

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99. Coleman v. Myers [1977] 2 N.Z.L.R. 225 at p.324.

100. The Times, 18 November 1986. Similarly, the Chairman of the Panel on Takeovers and Mergers, Mr. Robert Alexander Q.C. has stated that insider dealing is "wholly offensive to public morality, and gravely weakens the integrity of the financial markets", supra note 90.

102. Supra, note 95, at para 4.3.2 where these are outlined.

103. Ibid., at para. 4.3.3.

104. Supra, note 6, at p.92.

105. Supra, note 72, at para.3.

106. Supra, note 5, at p.345.

writes:<sup>107</sup>

The insider has acquired [the information] from the privileged position in which the shareholders have placed him. Loyalty to the company should preclude that insider from taking that information which belongs to the company (she acknowledges that some dispute still exists as to whether information can belong to a company) and using it to his own advantage. Where the insider is a director, there is the additional factor that he is in a fiduciary relationship vis-a-vis the company and his appropriation of the information and his profiting therefrom is incompatible with that relationship.

In other words the fidelity, or fiduciary, theory maintains that a person in a position of trust cannot benefit from a personal interest which derives from that position unless he first receives the informed consent of his beneficiaries.<sup>108</sup>

#### Insider Dealing is Not Victimless

Where insider dealing is involved all net benefits must equal net losses. As Roell and King point out, "Any profit accruing to an insider must, of necessity, be offset by a loss to all other market participants taken together." Wang writes, "[d]espite the suggestions of some commentators that market participants are generally not harmed by inside trading, each act of inside trading does in fact harm other individuals. With a purchase of an existing issue of securities, someone has less of that issue; with a sale of an existing issue someone ultimately acquires more of that issue."<sup>109</sup>

He continues, "Although the average American may not think in terms of the cost of capital ... he probably has a visceral reaction that inside trading

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107. Ibid., footnotes omitted.

108. For a fuller discussion on this, see generally, Chapter Six at note 56 and accompanying text.

109. See, Wang, "Trading on Material Non-Public Information on Impersonal Markets: Who is Harmed, and Who can Sue Whom Under S.E.C. Rule 10b-5?", (1981) 54 Southern California Law Review 1217 at p.1234.



definitely harms someone else in the market and may harm the issuer. This reaction is absolutely correct. In short, any public antipathy toward inside trading has a valid foundation."<sup>110</sup> "For this reason alone", Wang maintains, "an inside trader should be forced to disgorge his gains, and this type of misconduct should be deterred."<sup>111</sup>

But who exactly is hurt? Herzel and Katz point out that "insider trading lacks credible plaintiffs, not victims. The two are not the same."<sup>112</sup> This theme is extended by Roell and King who remark:<sup>113</sup>

[f]or legal purposes it is hard to identify the victim. Is it the person who sold shares to the insider? Surely not: he would in all likelihood have sold them anyway. Indeed, he benefits from any upward pressure exerted by insider dealing. Is the loser, then, the person who would have bought if the insider had not? And who might this be?

In practice the direct victim of insider trading is most likely to be the market maker with whom he trades.

Likewise Goodhart observes:<sup>114</sup>

Sometimes [insider dealing] ... is even referred to as a "victimless crime". That is actually incorrect. The operations of insider traders effectively cause losses to market-makers with whom they deal. In order to recoup such losses, market makers have to widen their spreads that they charge all other investors, including those wishing to speculate but not privy to inside information. The ultimate victims, therefore, are the ordinary investors who have to pay indirectly higher transactions charges for the gains of the insiders. So there are real benefits to be obtained in preventing it, ...

Wang outlines how this damage/harm to the market-maker, if it does occur, may be calculated. It is necessary to compare the market-makers actual portfolio of investments at the time of the disclosure of the inside information with the

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110. Ibid., at p.1248.

111. Ibid.

112. Herzel and Kratz, "Insider Trading: Who Losses?", (1987) 165 Lloyds Bank Review 15.

113. King and Roell, "Insider Trading" (April 1988), Economic Policy 163, at p.168 et seq.

114. Goodhart, "The Economics of 'Big Bang'", (1987) Summer Midland Bank Review 6, at p. 10.

portfolio he could have had in the absence of the inside trade. Unfortunately, says Wang, this is impossible to determine, because a market-maker does not have complete control over his portfolio in that he is always required to make a market. Therefore the market-maker may well be harmed but he cannot prove that it was the inside trade that caused him to be so.<sup>115</sup> Nonetheless the question remains as to whether an insider should "be allowed to pass on a loss to another, or take a profit by taking advantage of privileged information, in the absence of any compelling reason of public policy justifying it".<sup>116</sup> If the answer is no, then it is not necessary to establish loss or injury to an individual or group. It would seem then that the market maker is most at risk from the inside trade. Thus the market maker in the short term and society in the long term are the losers. It is the market maker who is induced to make a market when insiders are purchasing shares and they are nudging upwards. Even if it is accepted that the market maker is able to diversify his portfolio and thus spread the risk and the loss, the resultant loss in efficiency throughout the market is a loss which is passed on to the investor and society as a whole.

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115. Supra, note 109 at p.1233-1234. But see, King and Roell supra, note 12 (at p.169) who show how market-makers need not necessarily lose out whenever they deal with an insider. "Such market-makers may benefit second hand, like the bookie quoted in Anthony Harris in the Financial Times (December 6, 1986), who welcomes losing money to one particularly successful punter: 'He's my most valuable client. I always shorten the odds when he bets, it saves me a fortune.' In a case like this, the market maker who executes deals for an informed trader is able to re-arrange his price quotes accordingly so that for a time he trades only on the more profitable side of the market. Thus, the losses resulting from the presence of the informed traders are effectively transferred for the initial victim to other market makers ... In theory, any information that is shared, and known to be shared, by two or more risk neutral market makers engaged in price competition will be more fully incorporated in their price quotes, and command no bid-ask premium. Thus provided market making is competitive, ordinary investors are protected by the quick dissemination of information among market makers. Regulations are designed to take this into account. For example the Insider Dealing Act specifically exempts Stock Exchange jobbers (that is, market makers) from prohibitions on the use of inside information."

116. Rider & Ffrench, supra note 32, at p.3.

## Insider Dealing is an Inefficient use of Resources

Again a number of arguments fall under the general heading of efficiency, but before looking at them it might be helpful to precede the discussion with a comment from the New Zealand Report where it was said:<sup>117</sup>

We have examined the question whether it is feasible to test the efficiency arguments by econometric means. Cost/benefit analysis requires data about both. The requisite data is not available, and it is never likely to become available ... Overall, do the economic benefits of insider trading exceed the costs? ... There is no empirical research that we can accept as reliable. Our opinion, therefore, reflects our judgement of an untested, and we believe, untestable, problem. Our own view is that the costs to the economy of insider trading exceed the benefits, but it seems to be impossible to quantify either costs or benefits over any period of time ... [Alternatively] do the economic benefits of attempting to prevent insider trading exceed the costs? In our view, yes, but we cannot quantify them and we believe that no-one can. Our conclusion is that economic efficiency theories, carefully examined, support the prohibition of insider trading. (footnote omitted)

### 1. Incentive to Delay the Disclosure of Valuable Information

Some authorities believe that insider dealing tempts managers to delay the public disclosure of valuable information.<sup>118</sup> The efficiency argument looks at the effect on the market of non-disclosure and self-dealing by the insider.<sup>119</sup> As already noted the aim of any stock market is to rapidly assimilate all available information about a company and almost immediately reflect that in the shares of the company. Investors should be able to identify those companies where their capital is most needed and will be most profitably used. This enables resources to be efficiently allocated and not "wasted" in companies which are going into decline. An efficient stock market

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117. Supra, note 95, at p.28.

118. See, for example, Mendelson, "The Economics of Insider Trading Reconsidered" (1969) 117 U Pa L Rev 470, pp.473-476; and Farrar, supra note 5 at p. 345.

119. Supra, note 5, at p.345.

therefore is necessary to ensure an efficient use of capital. If, however, there is information of a price-sensitive nature available which is not disclosed, and on the basis of which only some people are trading, then they are distorting the market. In other words the price at which those shares are being traded is an artificial one. When this fact becomes apparent public confidence in the stock market is also reduced.

The argument is essentially that insiders have, absent tough laws, a strong incentive to keep information from the public so that they can first build up a position. Indeed it is the opinion of Jim Olsen that insiders can "accumulate quite a substantial position in stock without running up the price or otherwise attracting notice."<sup>120</sup> Only when a system operates whereby no one can benefit personally from keeping information from the market-place is there a strong incentive to announce it as soon as it makes business sense to do so.

## 2. The Cost of Collecting Inside Information

The very collection of inside information involves a social cost in that the resources used to "capture" inside information could have been used for the benefit of society as a whole.<sup>121</sup> But more importantly insider dealing may well increase the cost for a firm needing to raise capital.<sup>122</sup> Wang attributes this argument to Mendelson.<sup>123</sup> Simply stated the argument is that the cost of capital of a corporation with management that trades on inside information will

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120. See, Wall Street Journal 18 Nov 1986.

121. See, Harold Demantz "Perfect Competition, Regulation, and the Stock Market", in Economic Policy and the Regulation of Corporate Securities, ed. Henry Manne (Washington, D.C.: American Enterprise Institute, 1969).

122. Supra note 109, at p.1229. See also Carlton and Fischel supra note 13 at p.857-858. They outline, though do not advocate, this argument.

123. See, Mendelson, supra note 118, at p. 477-78.

be higher than a corporation with management that does not engage in such trading. Carlton and Fischel give an example of how and why this could happen. They take two firms, A and B, which are identical in all respects except that A prohibits the trading of its shares based on inside information. Firm B, on the otherhand, does not prohibit insider dealing. Insiders are open to trade freely on its shares.<sup>124</sup> The writers then ask the all important question "which firm will survive?" They observe, "despite the deceptive simplicity of this question, it has no obvious answer. The consensus ... appears to be that ... [firm A] will survive because it eliminates various perceived harmful effects of insider trading. Thus, investors would pay less for shares in B. The managers of B, in order to maximise the value of B shares, would have to adopt [a no insider dealing policy]". The difficulty with this hypothesis, say Carlton and Fischel is "that it appears to be contradicted by the actions of firms."<sup>125</sup>

Similarly, Prentice is critical of the view that insider dealing will impair the marketability of a company's shares. He finds it "not particularly convincing ... [because the] acceptability of a company's securities will be primarily a function of a company's profitability and not whether management was indulging in insider trading".<sup>126</sup> Indeed, although no one has conducted rigorous empirical research in this area, "it is generally believed that firms have made little, if any, attempt to prohibit insider trading, at least up until very recently ... numerous empirical studies have demonstrated that insider trading is widespread and very profitable".<sup>127</sup>

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124. Supra, note 13, at p. 856-858.

125. Ibid.

126. Prentice, supra, note 6, at p.90-91.

127. Ibid.

Professor Brudney, however, argues that if outside investors do not know which corporations have managers who trade on inside information, some members of the public will refrain from investment altogether, while others will incur costs to avoid dealing with executives with nonpublic information. This, then, would raise the cost of capital for public corporations generally.<sup>128</sup>

### 3. Not a Good Compensatory Device

Manne, himself, admits to the fact that there are practical limits on the "extent to which market exploitation is feasible".<sup>129</sup> First, it is unpredictable. Infact Manne believes that the opportunity to exploit inside information comes only "once every 10 years for each listed company".<sup>130</sup> Then secondly, it is dangerous in so far as there are other factors that the insider might not know. An information leak, for example, would have a bearing on the extent to which others who possess the information have already been buying - or selling. Thirdly, the time period to capture the information may be too small to make it worthwhile. Similarly, the entrepreneur may lack the credit and capital facilities to capitalise on the opportunity.<sup>131</sup>

Alternatively it could be argued that insider dealing over-compensates entrepreneurs. Given that it is very difficult to determine what constitutes the entrepreneurial act<sup>132</sup> the insider has complete freedom over the amount of

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128. See, Brudney, supra note 79, at p.355-356. Wang argues that though both viewpoints seem plausible. See, Wang, supra note 109, at p.1229. However he goes on to point out that another commentator has argued that ethical managers do not publicize their abstention from insider dealing. See, Dooley, "Enforcement of Insider trading Restrictions" (1980) 66 Va L Rev 1, at p.48.

129. See, Manne, ITSM, supra note 14, at p.78.

130. Ibid., at p.110.

131. See, Manne, Harvard Business Review, supra note 15, at p.115.

132. See, Hetherington, "Insider Trading and the Logic of the Law, (1967) Wis L Rev 720, at pp. 727-730.

his compensation.<sup>133</sup> He is not required to account to anyone. A similar argument could be advanced that insider dealing also over-compensates managers.

#### 4. Creates Perverse Incentives by Allowing Managers to Profit on Bad News as Well as Good.

A manager who generates "bad" news may make profits by trading on the basis of that bad news. This creates a problem in that there is no justification why a manager's compensation package should be supplemented to the detriment of the corporation as a whole or its shareholders. Indeed an incentive should ideally operate to deter a manager from creating any form of shock news.<sup>134</sup> Instead legitimising insider dealing would encourage managers to invest in risky projects. This would inturn impede correct decision-making.<sup>135</sup>

### Other Arguments

#### 1. Discharging the Burden of Proof

Schotland argues that the burden of proof lies with those who seek to alter the status quo: "The securities laws have been with us for more than a generation and are so deeply woven into the fabric of our securities markets ... change is not to be undertaken simply because the defence of the status quo is inarticulate."<sup>136</sup> Indeed he believes that it is "paradoxical that we should be urged to reverse the views and law with which we have moved into to-

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133. See, Schotland, supra note 26, at p. 1454.

134. See, Schotland, supra note 26, at p. 1453; Easterbrook, "Insider Trading, Secret Agents, Evidentiary Privileges and the Production of Information" (1981) Sup Ct Rev 309, at p.332.

135. Supra, note 36, at p.152.

136. See, Schotland, supra note 26, at p.1439-1440.

day's prosperity."<sup>137</sup>

## 2. International Comity

With the advent of international securities trading there is a growing momentum towards the harmonisation of securities laws worldwide.<sup>138</sup> As the New Zealand Report states: [the laws of various countries] ... indicate the standards of behaviour expected in other markets. They show, we believe, a consensus of international opinion, notwithstanding that there are significant differences."<sup>139</sup>

### **Summary**

By way of summary then, Chapter Three, as its title suggests, discusses the nature of insider dealing by way of a law/ economics assessment. This assessment was at best speculative. While a number of the deregulatory arguments were outlined, the conclusion derived was that insider dealing should be regulated. No outright basis could be provided for this conclusion, owing not only to the speculative nature of the inquiry but also because conclusive data does not exist and indeed is not likely ever to exist. As a result, the analysis followed closely that of the leading authorities, whereupon it was ultimately argued that the long term interests of society were best served by a set of regulatory arrangements designed to deter at all levels the misuse of

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137. Ibid.

138. See, supra note 38, at para. 4.9 et seq.

139. Ibid.



inside information.<sup>140</sup> As we shall see, not only does this involve detailed statutory initiatives (as outlined in the following chapter) prohibiting insider dealing, but also the effective implementation of other institutional arrangements such as Chinese Walls (discussed in Chapter Five and thereafter).

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140. The feeling that insider dealing is wrong because it impairs investor confidence in the capital markets is perhaps the most plausible explanation for outlawing the practice, even if the argument is based on suggestive evidence. Indeed for Rider & Ffrench, supra note 32, at p.xiii, "it matters very little whether the reaction of the investing public is logical or illogical if investor confidence is lost."

## CHAPTER FOUR: DETAILED LEGISLATIVE APPROACH TO THE PROBLEM OF INSIDER DEALING IN BOTH THE U.K. AND THE U.S.

### Introduction

As shown in Chapter Three, assessing the costs and benefits of insider dealing is by no means a straightforward task. The conclusion arrived at was that the practice should be regulated. This chapter reviews the legislative approach adopted here in the U.K. and the U.S. to prohibit such conduct.<sup>1</sup>

Regulation in this area involves a complex assessment of the various merits and demerits of the range of regulatory instruments that are potentially available. For example, the regulation of insider dealing might include: (i) formal regulation by law or alternatively (ii) self-regulation by the relevant professional bodies. The current fashion, however, is (iii) an amalgam of both, otherwise known as self-regulation within a statutory framework. These possible routes are considered below

#### (i) Formal Regulation at Law

The traditional "public interest" justification for the use of formal statutory measures in the regulation of financial markets arises from the need to protect the public from what are perceived to be inefficiencies or unfair

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1. The analysis hereinafter is largely aimed at regulatory options prohibiting insider dealing *per se*. As a result of this "blanket" approach, conglomerates are necessarily covered. Attention is focused on how this general regulation may be applied to the conglomerate context. In the following chapter however, a more specific regulatory measure - the Chinese Wall - strictly applicable to conglomerates is given consideration as an integral and essential back-up to the "blanket" approach.

market practices.<sup>2</sup> Formal regulation takes the form of technically prohibitive statements of law. While these may clarify much of the law relating to what is legitimate and what is illegitimate conduct there are many disadvantages with this approach. It is often: (a) cumbersome, because the whole weight of the judicial system is brought to bear; (b) time consuming, because of the bureaucracy involved; (c) inefficient, because of the huge resources expended in detecting and penalising abuse; and (d) ineffective, because of the difficulty of detecting abuse and the high standard of proof required for a successful prosecution. As a result formal regulation is often supplemented by self-regulatory measures.

(ii) Self-Regulation

Despite the fact that formal law lays down a minimum standard of protection, this standard may not be enough. Self-regulation is therefore a necessary additional safeguard to cover the myriad of circumstances neither envisaged nor covered by legislation.<sup>3</sup> It also serves to maintain confidence and deter abuse. Moreover, regulation from within professional bodies is often

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2. The "public interest" theory of regulation has come under increasing criticism of late and has to a large extent become superceded by what has been called the "capture theory of regulation" i.e., regulation which operates for the benefit of the group regulated. For a comprehensive survey of the literature regulation, see, R.A. Posner, "Theories of Economic Regulation", (1974) 5 Bell J. Econ. 335-51.

3. The merits of self regulation have been expounded by one commentator: "Self-regulation ... can be persuasive and subtle in its conditioning influence over business practices and business morality. By and large, governments can operate satisfactorily only by proscription. That leaves untouched large areas of conduct and activity; some of it susceptible of government regulation but in fact too minute for satisfactory control; some of it lying beyond the periphery of the law in the realm of ethics and morality. Into these larger areas, self-government alone can effectively reach. For these reasons, such regulation is by far the most preferable course from all viewpoints ... self discipline is always more welcome than discipline imposed from above." R.W. Jennings, "Self-Regulation in the Securities markets: The Role of the Securities Exchange Commission", (1964) 29 Law and Contemporary Problems 663, at 678.

considered to be a more effective method of control offering a number of advantages. It is extremely flexible; informality means that new loopholes can be speedily plugged and that needless expense and the unweildly judicial process can be neatly by-passed. Furthermore practitioners can bring their own specialist skills to bear not only in outlining practices to be avoided but also in unravelling complex questions of fact when sitting in judgement.<sup>4</sup> There exists a self-interest among the regulating profession to keep the reputations of their businesses untarnished and actively seek out abuses rather than punish offenders after an incident has occurred. But probably one of the most outright advantages of self-regulation is that the regulated must obey not only the letter of the self-regulatory codes but also the spirit.<sup>5</sup>

(iii) Self-Regulation Within a Statutory Framework

Despite some of the obvious advantages of professional self-scrutiny, concern that much is brushed beneath the carpet has traditionally been at the centre of the mistrust of this system of control. The recent trend, therefore, has been to combine elements of both formal regulation and self-regulation to form a practitioner-based, statute-backed system of supervision. This "self-regulation within a statutory framework" as it has become known is designed to capture the benefits of both types of regulation without many of the ensuing drawbacks.

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4. In discussing self-regulation in its Report the SEC observed: "... persons on the scene and familiar with the intricacies of securities and markets from daily and full time pursuit of the business can more readily perceive and comprehend some types of problems, and more promptly devise solutions than a governmental agency which, however great its collective knowledge and skill, may be able to concern itself only intermittently with specific problems, may become aware of them only after the event, and often must defer decision and action until thorough investigation or study has been completed." SEC Report of the Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong. 1st Sess. pt.4, pp. 693 -703 at 694.

5. See, for example, the Preamble to the Takeover Code.

In Britain, for example, under the new investor protection regime, formal legal principles have been outlined by the legislature.<sup>6</sup> The responsibility for drawing up more detailed rules has fallen to the appropriate minister who has himself been given the authority to delegate them to a "neutral" body - the SIB. The SIB's powers ultimately hinge on approval of the Secretary of State for Trade and Industry. The SIB operates through a number of self-regulatory agencies which apply equivalent rules to their associated members. While much of the day-to-day regulation is solely in the hands of practitioners, the overseeing of this supervision is the responsibility of the government's own designated SIB agency. The SIB, despite being largely autonomous, may be divested of its powers at the government's discretion.

Notwithstanding the recent introduction of the regulatory measures covering conduct in the financial markets in the FSA 1986, other legislation ancillary to the new market regime is, and has for some time been, in operation. For a number of years insider dealing, whether it be in the corporate/unorthodox context<sup>7</sup> or individual/traditional<sup>8</sup> context, has been governed by a range of legal sanctions. These are now considered.

## **I. THE REGULATION OF INSIDER DEALING IN THE U.K.**

### **Formal Legal Rules**

The practice of insider dealing can occur in many different circumstances.

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6. For a more detailed description of the system currently in operation in the U.K., see, *infra* Chapter Two at note 16 and accompanying text.

7. See, *infra* Chapter Three at note 1 and accompanying text.

8. *Ibid.*, at note 2.

In this general context the conduct is governed by formal legal rules the most important of which are contained in the Company Securities (Insider Dealing) Act 1985 (hereinafter "CSA 1985").<sup>9</sup>

In the U.K. insider dealing is regulated, inter alia, by both common law and statute law (SIB rules regulating the conduct will be given specific treatment in Chapter Seven, although the extent to which the SIB is involved in providing a civil remedy is analysed below). The relevant legislation is: (a) The Companies Act 1985, (b) The Company Securities (Insider Dealing) Act 1985, and (c) The Financial Services Act 1986.

The Companies Act 1985 requires a general policy of disclosure of insiders' interests while the CSA 1985 outlines the substantive elements of the offence. It is by far the most important piece of legislation, but only provides for criminal penalties and not civil remedies. The Financial Services Act 1986, meantime, significantly enhances the investigative powers of the Department of Trade and Industry (DTI) and has further spawned a detailed rule-book drawn up by the City's regulatory rule-making body - the SIB. The right of a private investor to bring a civil law action against any person who has contravened the rules and regulations of the SIB, (some of which include the misuse of inside information) a Self Regulatory Organisation (SRO) or a recognised professional body, is now established under s.62 of the 1986 Act.<sup>10</sup> This right has, however, been postponed pending review.<sup>11</sup> In the interim, therefore, a civil remedy lies only at common law and under s.61 of the FSA.

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9. For the most recent text on the regulation of insider dealing see Hannigan, Insider Dealing (London) 1988. See also, Rider, Insider Trading (London) 1983; and Prentice, The Companies Act 1980 Chapter 16 (1980).

10. See, SIB press release entitled "Insider Trading Could Lead to Civil Damages" 28 January 1987.

11. For a more detailed discussion on this infra note 117 and accompanying text.

## **A. The Companies Act 1985 - Disclosure**

Prior to 1980, when insider dealing first became a statutory offence by virtue of Part V of the 1980 Companies Act, the legislative means of curtailing the practice was limited to disclosure provisions contained in general companies legislation. These provisions required directors and other primary insiders to disclose their holdings and dealings in the company with whom they were connected by way of employment. Today similar provisions can be found in the Companies Act 1985. Section 323, for example, prohibits a director from dealing in options of the securities of his company and in other companies within the same group. Section 324 specifies that directors and shareholders of the company in question and its related companies must be disclosed, while s.325 makes it obligatory for the company to keep a record of all of its director's interests. These provisions are extended by s. 323 and 328 to include the disclosure of interests held by spouses and children, definitions of which are given in s.327. Furthermore s.329 obliges the company to inform the Stock Exchange of the interests specified in ss.323-327. This information may be made available to the public.

## **B. Company Securities (Insider Dealing) Act 1985 - Prohibition**

The Companies Act 1985 adopts a policy of disclosure to guard against insider dealing. The CSA 1985, meanwhile, contains the substantive body of legislative provisions prohibiting the practice. A concise statutory definition of insider dealing is not offered in the Act, but conduct constituting the crime may be described as:

the conscious exploitation of confidential information to make a profit or avoid a loss by dealing in securities at a price which would have been materially altered by the publication of that

information.<sup>12</sup>

### Who is a Primary Insider?

The CSA 1985 covers both what is called primary insider dealing (dealing on the basis of price-sensitive information acquired in breach of a fiduciary position) and secondary insider dealing or "tippee trading" (trading on the basis of price sensitive information acquired from a primary insider). Primary insider dealing is described in the 1985 Act as dealing<sup>13</sup> as principal or agent on a recognised exchange<sup>14</sup> where either the insider deals in the securities<sup>15</sup> of the company<sup>16</sup> with which he is connected by virtue of employment or contract of service or he deals in the securities of a related company<sup>17</sup> about which he has insider knowledge because of his connection with the first company.<sup>17a</sup>

Under the Act an insider must be an individual<sup>18</sup> who is, or has been in the previous six months, "knowingly connected" with the company in question or

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12. See, Mehigan The Independent 29 December 1986.

13. To deal is to buy or sell or agree to buy or sell any securities. See, s.13 (1) and ss(1A) of the CSA 1985 as amended by s.176 of the FSA 1986.

14. This includes the Stock Exchange and dealing through an Investment Exchange. However, s.4 makes it clear that deals in "advertised securities in the "over the counter" market are also covered. Face-to-face transactions do not come within the ambit of the Act.

15. Securities are defined in s.12 and include listed, non-listed and advertised securities.

16. "Company" is defined as any company whether or not a company within the meaning of the Companies Act 1985.

17. "Related Company", in relation to a company, means any body corporate which is that company's subsidiary or holding company, or subsidiary of that company's holding company." See, s.11(b) CSA.

<sup>17a</sup> It is not necessary to prove that the insider actually used the information - merely that he dealt at a time when the information was in his possession

18. A company cannot commit an offence under the Act, except perhaps for aiding and abetting. If a transaction is carried out in the name of the company those acting for it would be liable. As Mehigan, supra note 12 says: "This is not a loophole but a sensible realisation that even if the company is the beneficiary of a deal then there must exist individuals who caused it to be so."



a related company (such as a subsidiary of the first company) by virtue of being either a director, officer, or employee of the first company or a related company. The provisions also encompass (1) those who have, or have had within the last six months, a business or professional relationship with the first company or a related company and (2) someone who has been employed by such persons. Directors are automatically connected. Officers, employees and those who fall into the two groups outlined above are covered if it would be reasonable to expect them to have gained access to inside information.

The Act therefore embraces a very comprehensive group of people ranging from directors and company employees through to the company auditors, solicitors, accountants, bankers and brokers.<sup>19</sup>

#### What is Inside Information?

It is important to emphasise that there are two types of "inside information" which any statutory attempt to define the term must take cognisance of. On the one hand there is information which is intrinsic to the company known as corporate information, eg. where the company itself is about to announce an increase in profits or a takeover bid. On the other there is information which may be said to be external to the company and which is commonly referred to as market information. An example might be where there is advanced knowledge that a brokerage firm is about to publish a favourable research report about a company. How has the CSA attempted to embrace this

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19. It is important to reiterate that the individual must not only be connected with the first company or its related company but also know that he is so connected. The test, therefore, is a subjective one ie., did the individual know he was connected and not ought he reasonably to have known that he was so connected. Subjective elements such as these make prosecution all the more difficult.

distinction?

Under the CSA 1985 a primary insider, by virtue of his connection<sup>20</sup> must deal and know that he is dealing on the basis of a particular type of information referred to as "unpublished price-sensitive information", where it would not be reasonable for a person in his position to disclose such information other than with a view to the proper performance of his duties. The test with regard to the type of information is a subjective one, ie. whether the defendant knew that the information was of a type proscribed by the Act and not whether he ought reasonably to have known. By contrast, the test with reference to the disclosure of such information is an objective one, ie. would it be reasonable to expect the defendant not to have disclosed the information in the proper performance of his duties.<sup>21</sup>

S.10, defines "unpublished price-sensitive" information as information which:

(a) relates to specific matters relating or of concern (directly or indirectly) to that company, that is to say, is not of a general nature relating or of concern to that company; and

(b) is not generally known to those persons who are accustomed or would be likely to deal in those securities but which would if it were generally known to them be likely to materially affect the price of those securities.

The section relates only to information which is: specific, not generally known and likely to materially affect the price of the securities in question. There is, however, no guidance in the legislation as to what these terms actually mean.

20. If the inside information comes to a primary insider in a way which is unconnected with his position there is nothing in s.1 prohibiting him from exploiting it.

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21. Note, therefore, that the CSA recognises that it is possible for unpublished price-sensitive information to be disclosed (ie. communicated) if it is done so in the proper performance of the insider's duties.

The reference to specific information only can be best explained by the need to ensure that the definition of inside information is not so wide as to include legitimate research undertaken by investment analysts. In the Committee stage, in an attempt to offer practical guidance on the meaning of the distinction, the Minister of Trade suggested that what the government had in mind was the difference between "day to day knowledge" and "knowledge of important factors which, when revealed to the market, [would] shift the price of the shares."<sup>22</sup>

To satisfy the requirement of information "not generally known" it would seem that more than mere publication of the inside information is needed.<sup>23</sup> A gauge of materiality, meanwhile, may be had from the U.S, where information is material if it is the sort of information where there is a "substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision about the company's stock.<sup>24</sup> Thus the information need not actually cause the share price to move; it must however make such a move substantially likely. Rider makes the point that whether information comes within the scope of s.10 is a question of fact for the jury or the magistrates to decide.<sup>25</sup> In this respect it is important to note that a common sense view will be taken. Indeed, during passage of the Act the Minister remarked that the type of knowledge he was looking for was "knowledge of dramatic events,

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22. Parliamentary Debates, Standing Committee A, 11th sitting, col.561 (6 December 1979).

23. But see, Branson, "Insider Trading" (1982) JBL 343, at p.413. where he notes that with the repeated use of the phrase "unpublished price-sensitive" information the British statutes emphasis seems to be on publication vel non. He also argues that the generally known test can be fulfilled through word of mouth instead of any need for publication (see, p.414).

24. TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

25. See, Rider supra note 9 at p.??

major happenings and things that [would] transform the company's prospects."<sup>26</sup>

Despite s.10 and its tortuous legal complications there remains a good deal of "inside information" which according to the economist is not subject to legal proscription simply because it does not fulfil the s.10 test.<sup>27</sup> Carlton and Fischel, for example, argue that "[k]nowledge that one of the firm's top management is dispirited because of family problems or because preliminary reports on a new technological process show that costs are running much higher than expected are examples of valuable information that is almost certainly not material in the legal sense."<sup>28</sup>

#### Dealing in the Securities of Any Other Company

The prohibition outlined in s.1(2) is aimed at an individual who is knowingly connected with a company (the first company) or its related company and has information which relates to transactions (actual or contemplated) between the first company (or a related company) and any other company or involves one of them and the securities of the other. The prohibition precludes such an individual from dealing on a recognised exchange in the shares of the other company if the information is unpublished and price-sensitive which the individual holds by virtue of being connected with his own company (ie., the first company or a related company). Thus, A, a director of

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26. H.C. Deb. (Standing Committee A Minister of Trade), col. 394 (6 Dec. 1979).

27. Branson, supra note 23, at p. 415, argues that market information will very rarely be covered by s.10. He claims that market information is rarely of concern to a company because some companies are unconcerned with the market for their shares as distinct from the affairs of the company itself. He notes that "[m]any corporate officials believe that concern with share prices causes a company to play to the crowd sacrificing long term results for short term profitability." (footnote 37 at p.415).

28. Carlton and Fischel, "The Regulation of Insider Trading", (1985) 35 Stanford Law Review 857 at p.886.

XYZ and Co. Plc being aware of the placing of a major order for machinery from QPR and Co. Plc, which will entail a significant expansion in the latter's current output, will be precluded from buying shares in QPR and Co. Plc. This is so despite the subsequent shelving of the deal.

### Secondary Insider Dealing

The provisions dealing with secondary insider trading are outlined in s.1 ss.3 and 4.<sup>29</sup> They aim to prevent any person taking advantage of a tip (insider knowledge) provided by someone who holds inside information. The person who relays the information is called the tipper while the recipient of the information is called the tippee.

Consider the following example of a managing director of X Company who, knowing of impending good news about his company, tells his next door neighbour

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29. S.1 ss.3 reads:

- (a) an individual has information which he knowingly obtained (directly or indirectly) from another individual who -
  - (i) is connected with a particular company, or was at any time in the 6 months preceding the obtaining of the information so connected, and
  - (ii) the former individual knows or has reasonable cause to believe held the information by virtue of being so connected, and
- (b) the former individual knows or has reasonable cause to believe that, because of the latter's connection and position, it would be reasonable to expect him not to disclose the information except for the proper performance of the functions attached to that position.

Subject to the defences available in Section 3 the former individual according to ss.4:

- (a) shall not himself deal on a recognised stock exchange in the securities of that company and he knows that the information is unpublished price sensitive information in relation to those securities, and
- (b) shall not himself deal on a recognised stock exchange in securities of any other company if he knows that the information is unpublished price sensitive information in relation to those securities and it relates to any transaction (actual or contemplated) involving the first company and any other company, or involving one of them and the securities of the other, or to the fact that any such transaction is no longer contemplated.

of this news. As a result the neighbour buys shares in X Company. Provided certain facts apply (outlined below) it can be said that two offences have been committed under the 1985 Act. First, the managing director is in breach of s.1(8) for tipping, or, communicating inside information (or under s.1(7) for counselling or procuring<sup>30</sup> someone to deal in shares) "to another person if he knows or has reasonable cause to believe that that or some other person will make use of the information for the purpose of dealing, or of counselling or procuring any other person to deal, on a recognised Stock Exchange in those securities."<sup>31</sup> Second, the neighbour is guilty as a tippee if he obtains the information, directly or indirectly, from the other person and deals on the basis of it. Under the legislation it is also necessary for the tippee to know that the information is inside information. This "subjective knowledge" requirement is an onerous burden for the prosecution to discharge. The tippee must also know or have reasonable cause to believe that the tipper was himself precluded by subsection (1) or (2) from trading in those securities.<sup>32</sup> Here the test is objective.

Two further constraints are placed upon tippees:- First, they are prohibited from any attempt to cause or procure any person to deal<sup>33</sup> and secondly, they are prohibited from sub-tipping ie., relaying inside information to another person (the sub-tippee) where they know or ought reasonably to be aware that the sub-tippee will deal or cause or procure someone else to deal on the basis of it.<sup>34</sup>

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30. Thus if the insider tells the other person to deal without disclosing the information he is liable under the legislation.

31. See, s.1(8) CSA.

32. See, s.1(3),(4) CSA, above.

33. See, s.1(7) CSA.

34. See, s.1(8) CSA.

R v. Fisher at First Instance

A recent case which dealt with secondary insider dealing placed the whole scheme of the CSA in great jeopardy.<sup>35</sup> In R v. Fisher<sup>36</sup> Judge Butler ruled that the word "obtained" in s. 1(3) of the CSA 1985 had to be given a strict construction. By that he meant that an individual could only commit an offence under the sub-section if inter alia the individual had actively sought the information proscribed; receipt of unsolicited information was not sufficient. Thus his ruling meant that the unsolicited receipt of inside information could be used to make market trades.<sup>37</sup>

The facts of the case were straightforward. In 1985 the defendant (D) approached an ailing caravan manufacturing company called Thompson T-Line Plc., with the intention of making an offer to acquire the bulk of the company's shares. In November 1985 Mr Thompson, the managing director and acting head of the controlling Thompson family shareholding, suggested that the D should consult the firm's financial advisers, Kleinwort Benson. This he did. There the D spoke to a Miss Hedley-Miller, then head of the corporate finance division. Mr Thompson did not in fact consider the D to be a serious buyer and early in December 1985, unknown to either the D or Miss Hedley Miller, he reached a preliminary agreement regarding the sale of the Thompson family interest with a company known as Diamond Ltd. Immediately after the agreement he contacted Miss Hedley-Miller and informed her how events stood. Both agreed

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35. Since the risk of detection under the CSA is one of the key incentives for enforcing self-styled Chinese Walls any erosion of the prohibitions in the legislation (especially s.1(3)(4): because the conglomerate is more likely to be operating in the tippee context) lessens the incentives to enforce the mechanism.

36. (1988) 4 BCC 360.

37. For a more detailed comment on Judge Butler's reasoning, see, McVea, "Was the Fisher Case wrongly decided?", (1988) June Financial Times, Financial Regulation Report p.9.

that in the circumstances proper practice required that the D be told of the development. Miss Hedley-Miller then telephoned the D and told him that Mr Thompson had accepted a new offer. She did not, however, tell him the price or the amount of shares involved, but did say that an announcement would soon be made. Furthermore, according to Miss Hedley-Miller's recollection, she told the D that the information she was imparting was sensitive and highly confidential and that as a result of the conversation he would be an "insider." The D then telephoned his brokers and bought 6000 shares in Thompson T-Line Plc, which, after Diamond's announcement of the takeover, he sold at profit of £3,000.

The D was subsequently charged with dealing as a prohibited person in the securities of a company contrary to: s. 1(3) and s.1(4)(a) and s.8(1) of the CSA 1985 as amended. He pleaded not guilty and was ultimately acquitted.

The prohibitions relating to secondary insider dealing (which were at issue in the Fisher case) apply where it can be shown that an individual has information which he has knowingly obtained, whether directly or indirectly, from another individual who is connected with a particular company (here Miss Hedley-Miller) and he deals, having the requisite state of mind.<sup>38</sup>

It is patently clear that Judge Butler's decision went a long way in restricting the crime of secondary insider dealing. So much so that an individual who came into possession of inside information by way of a "tip off" which had not been actively sought or requested was immune from the U.K.'s secondary insider dealing provisions notwithstanding the fact that he made a large profit from the trade, and that the whole rationale of the legislation

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38. See, earlier at note 29 and accompanying text.



(ie. to protect the fairness and integrity of the market) was seriously undermined. The decision also represented a serious blow to the morale of the investigative authorities. As a result the Attorney-General referred the decision to the Court of Appeal.<sup>39</sup>

#### Fisher in the Court of Appeal

The Attorney General's reference to the Court of Appeal was sought in order to lay down clear guidelines for Crown Court rulings in future cases following Judge Butler's decision at first instance. The Attorney General referred the following points to the Court of Appeal for consideration:

- (a) Whether or not the word "obtained" in section 1(3) of the CSA 1985 has the restricted meaning of "acquired by purpose and effort" or whether it has a wider meaning.
- (b) Whether or not any individual who has, from another, information within the scope of the Act and is otherwise within the scope of the prohibitions contained in sections 1(4), 1(6) and 2 of the Act, may be an individual who has "obtained" within the terms of sections 1(3), 1(6) and 2 of the Act.

The Court of Appeal held that Judge Butler had been wrong in his interpretation. The word obtained had to be given its broader meaning ie. one could obtain not only as a result of purpose or effort but also through passive receipt or acceptance. The effect of the Appeal Court's ruling was to make guilty anyone who knowingly traded in shares on the basis of unpublished price sensitive information regardless of how the information was obtained unless, that is, the trader fell within certain specified defences laid down in the legislation.

In giving judgement for the court Lord Lane LCJ's thought the first task was to determine the ordinary meaning of the the word 'obtain'. Two meanings were discernable. One in the Shorter Oxford English Dictionary defined the

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39. Attorney-General's Reference (No.1 of 1988) [1988] 2 W.L.R. 195.

word as "to procure or gain, as a result of purpose and effort; hence, generally, to acquire, get." The other, in Webster's International Dictionary, defined obtain as: "to get hold of by effort; to gain possession of, to procur, to acquire in any way." The learned Judge therefore concluded that the word was "capable of supporting the contention of either party".<sup>40</sup>

The learned Judge then surveyed the arguments of both sides:

The Attorney General contended that it was necessary to look to the intention of the draftsmen and to the general scheme of the Act. In doing so he argued that in the case of each type of insider, the offence was not one of using information but rather dealing in securities whilst being in possession of relevant information. The Attorney General then went on to consider the Act as a whole noting that the wrongdoing aimed at was the exploitation of an unfairly privileged advantage gained from a particular source. He could not see then why an unsoliciting tippee should be any less culpable than the person who had deliberately sought out the information. The vice lay in the way the information was used, not in the method of its receipt.

The issue of the history of the Act was then raised, concentrating primarily on a Government White Paper on the Conduct of Company Directors (Cmd. 7037) of 1977). The purpose here was to discover the mischief which Parliament wanted to remedy. The Attorney General drew attention to two particular expressions: "the information ... would generally be in his possession" and "someone in such a position has provided him ... with the

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40. Ibid., at p. 202.

information".<sup>41</sup> These, he said, indicated that Parliament intended that the broad approach be adopted when interpreting the word "obtained" in the legislation.

Defence counsel's submissions were then heard. First, that adopting a broad construction provided inadequate protection for those who involuntarily received inside information. The Court of Appeal disagreed, saying, "[t]here is no crime in receiving the information. He [the receiver] can protect himself from prosecution by the simple expedient of not dealing in the relevant securities."<sup>42</sup> Secondly, it was argued that in previous Appeal Court rulings the word "obtain" had been interpreted according to the narrow construction and therefore this was the interpretation intended in the Act. Two cases, Fisher v. Raven<sup>43</sup> and R v. Hayat<sup>44</sup> were relied upon. Lord Lane LCJ distinguished both. Commenting on the former, he said, the judgement was "careful to confine the definition to the purposes of the case under consideration."<sup>45</sup> Upon considering the latter, he was of the opinion that the current situation was quite different in that the crucial element was dealing while obtaining on its own was of no importance. Finally, it was submitted that in the case of a penal enactment any ambiguity should be resolved in favour of the defence. However, this too the Court rejected, relying on the words of Lord Reid in DPP v. Ottewell,<sup>46</sup> where he said: "It is not enough that the provision is ambiguous in the sense that it is capable of having two meanings."<sup>47</sup>

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41. Ibid., at p. 204

42. Ibid., at p. 205.

43. [1964] A.C. 210, (H.L.'s).

44. 1976 Vol. 63 Cr.App. R. 181.

45. Supra, note 39, at p.205.

46. [1968], 52 CAR 679.

47. Ibid., at p.686.

Speaking on behalf of the Court, Lord Lane LCJ concluded that while it had not been an easy decision, he was content that it was Parliament's intention to "penalise the recipient of inside information who deals in the relevant securities, whether he procures the information from the primary insider by purpose and effort or comes by it without any positive action on his part."<sup>48</sup> This was evident from the concern which the White Paper showed about about damage to public confidence which insider dealing was likely to cause and "the clear intention to prevent so far as possible what amounts to cheating when those with inside knowledge use that knowledge to make a profit in their dealings with others."<sup>49</sup> Linked to this was the fact that it made no difference to the person cheated whether the information upon which the "tippee" based his cheating was either sought out by him or came to him by way of unsolicited gift. The learned judge continued: (at p. 204)

Against the background of public and government concern it would indeed have been surprising if Parliament had intended that persons such as, for example, the respondent in the instant case should be free to make a profit from their insider information simply because of the way they came by the information. It would do nothing to increase the confidence of the public in the probity of the business world if behaviour such as that of the respondent were to be free from sanction ... If one construes the key word "obtained" in the light of the purpose behind the Act the conclusion must, in our judgement, be that it means no more than "received".

Similarly, the wider approach was more preferable because it avoided the need to establish criteria for what did and what did not constitute sufficient purpose or effort to satisfy the narrow meaning of the word "obtain". To do so, thought the judge, "would have done nothing to enhance the reputation of the business world for honesty or of the criminal law for clarity."<sup>50</sup>

The Court of Appeal's ruling represented a much needed victory for the

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48. Supra, note 39, at p.206.

49. Ibid., at p.204.

50. Supra, note 39, at p.206.

regulatory authorities in the area of insider dealing enforcement. But the lower court's attempt to provide potential insiders with a technical loophole at a time when the obvious intention of the Act and the general thrust of securities regulation is to clamp down on insider abuse would appear to have been a rather unfortunate and anomalous development. By contrast, the Court of Appeal adopted a broad interpretation, discovering the mischief which it was Parliament's intention to remedy via legislation, and ensuring that such an intention was given effect in the interpretation of the statute.<sup>51</sup>

### Takeovers

The law in relation to takeovers is probably most important in the context of conglomerates benefiting from inside information. It would seem likely that s.1(2) also covers takeovers.<sup>52</sup> But s.1(5) deals explicitly with the conduct. The section prohibits an individual who has contemplated or who is contemplating making a takeover offer<sup>53</sup> for a company in one capacity from dealing in the shares of the offeree in another capacity if he knows that the information relating to the fact that the offer is contemplated or is no longer contemplated is unpublished price-sensitive information. Naturally the insider who falls within the above is further not allowed: (1) to counsel or procure another to deal;<sup>54</sup> (2) tip someone else who would be likely to deal or who would counsel or procure someone else to deal.<sup>55</sup> Similarly a tippee who receives information (which he knows to be inside information) from an insider

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51. The case then went to the House of Lords where Lord Lowry affirmed the Court of Appeal's decision. See, McVea, "House of Lords Clarifies Law on Insider Dealing" (1989) May Financial Times, Financial Regulation Report at p. 16.

52. See, Prentice, supra note 9, at para. 313.

53. Takeover is defined in s.14. The contemplation of a takeover may be with or without another person.

54. See, s.1(7).

55. See, s.1(8).

in this context must not himself deal, nor counsel or procure someone to deal nor tip someone else who would deal (or counsel or procure someone else to deal) in those securities.

### Failing to Sell on the Basis of Inside Information

Some economists have highlighted what they see as a significant flaw in the statutory regulation of insider dealing. Manne, for example, argues that not only is the practice hard to detect but also insiders who exploit inside information do not necessarily buy additional stock on the basis of their information; rather they buy a portfolio of stocks and basing decisions on legally proscribed inside knowledge they refrain from selling.<sup>56</sup> This has the same effect as "buying", but a deliberate failure to sell, notwithstanding the fact that the decision was prompted, indeed determined, by unpublished price-sensitive information, is not a violation of the CSA 1985. Before the legislation takes effect a positive act of buying or selling is required. Manne has even gone as far as to suggest that "not selling" could be the most common means of using inside information in securities transactions.<sup>57</sup>

### Defences

Apart from factual defences the defendant may rely upon a number of specified statutory exemptions from the prohibitions laid down in s.1&2. Four of the main exemptions are listed here.<sup>58</sup> The most important is trading other

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56. See, Henry Manne, "Insider Trading and Property Rights in New Information", (Winter 1985) 4 Cato Journal 933, at p. 936. Equally they know when not to buy.

57. Ibid.

58. For other defences, see, s.3 (2) (dealing in order to facilitate the completion or carrying out of a transaction) and s.6. (price stabilisation).

than with a view to making a profit or avoiding a loss. The prohibitions in the CSA are rendered ineffective where the defendant can show that, notwithstanding the fact that he fulfilled all the conditions mentioned in s.1&2, the dominant purpose of his trade was not with a view to making a profit or avoiding a loss for either himself or another person by using that information.<sup>59</sup>

Some commentators has expressed concern over the nature of this defence fearing that if it is construed broadly it could endanger the whole efficacy of the Act.<sup>60</sup> The second covers dealings made by individuals in the bona fide performance of their functions as liquidator, receiver or trustee in bankruptcy.<sup>61</sup>

The third exemption or defence is aimed at those who perform specialist roles within the financial sector, namely jobbers and market makers<sup>62</sup>, while under the fourth defence trustees and personal representatives are also exempted in

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59. See, s.3(a) CSA 1985.

60. See, Sugarman & Ashe, "The Companies Act 1980" (1981) 2 Co Law 13 at p.17. Likewise, Prentice, supra note 9 at para. 320. writes that "care will have to be taken [to ensure] that the all-to-easy assertion of an innocent motive does not result in the defence becoming a convenient escape for the unscrupulous." See also, Gower, Modern Company Law (1979, supp. 1981) supp. p.638, who writes that "[t]his will undoubtedly be the defence invoked by directors and other insiders detected in insider dealing. It will legitimately protect them if they can show that circumstances compelled them to realise their holdings and that they would have done so at the time whether or not they had the price-sensitive information. It would also, less legitimately, protect them if they engage in idle gossip and thus leak price-sensitive information."

61. See, s.3(b) CSA 1985. If the deals made by such persons are carried out in "good faith" then, notwithstanding the fact that they constitute an offence under s.1&2 of the Act, the transaction is exempt.

62. With the termination of the single capacity system of trading and the adoption of a new dual capacity regime whereby a financial intermediary may trade as both broker and jobber simultaneously this exemption has become extended by s.174 of the Financial Services Act 1986 to include market makers. S.174 (1) permits a market maker to do "any particular thing in relation to any particular security" which would otherwise be in breach of s.1&2 of the CSA 1985 "if the information was - (i) obtained by him in the course of a business of a market maker in those securities in which he was engaged or employed, and (ii) was of a description which it would be reasonable to expect him to obtain in the ordinary course of tha business, and that he does that thing in good faith in the course of that business." Market maker is defined as meaning any person on a recognised exchange (whether an individual, partner or company) who holds himself out to make a continuous succession of prices and is recognised as doing so by that exchange.

certain limited circumstances.<sup>63</sup>

The point to be made here is that if these defences are given a wide interpretation by the Courts (and it is too soon to tell this given the fact that too few cases have been brought) then the risk of prosecution diminishes even further. All other things being equal, this increases the incentive to breach Chinese Walls and trade illegally on the basis of inside information.

### Penalties

Contravention of s.1,2,4 or 5 of the CSA 1985 makes an individual liable to criminal penalty.<sup>64</sup> On summary conviction the statutory maximum penalty is six months imprisonment with a fine of up to L1000- while on indictment the maximum penalty is seven year's imprisonment but with an unlimited fine.<sup>65</sup> The rate of prosecution has, however, been very low.<sup>66</sup> Despite the fact that the penalty on indictment is severe, the courts have traditionally imposed little more than nominal sanctions on miscreants.<sup>67</sup> This raises a serious question mark over the efficacy of the whole of the U.K. insider dealing enforcement regime and seriously effects the cost-benefit economic calculus faced by

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63. See, s.7 CSA 1985. This exemption covers the situation where a fiduciary possesses unpublished price-sensitive information and where he trades in securities relating to that information if his trades were based on the advice of someone who appeared to be (a) an appropriate person for whom to seek such advice and (b) who did not seem to him to be prohibited by s.1, 2,4 or 5 from dealing.

64. See, s.8(1) CSA 1985 as amended by s.48 of the Criminal Justice Act 1988.

65. Under s.8(2) proceedings in England and Wales can only be initiated by the Secretary of State for Trade or the DPP; in Scotland this duty rests on the Lord Advocate.

66. This contrasts heavily with the U.S. where insider dealing is one of the most frequent violations of the securities laws. See, Bainbridge, "The Insider Trading Prohibition: A Legal and Economic Enigma" (1986) 38 University of Florida Law Review 35, at p. 36.

67. See, Hannigan, supra note 9 at pp. 90-91.



financial firms and individuals working within them when deciding to breach a Chinese Wall.

Manne notes that enforcement is never perfect, thus in an area where only limited resources are available to police what is probably a common practice, enforcement will at best be partial.<sup>68</sup> In order to maximise existing resources the enforcement regime must impose heavy sanctions so as to compensate for the relatively low risk of detection and prosecution. Any other regime is not optimal given existing resources.<sup>69</sup> Such logic does not seem to have been present in the court's decision in R v. Collier<sup>70</sup> where the defendant, a top merchant banker with the City firm Morgan Grenfell, was given a derisory fine of £25,000 and a one year jail sentence suspended for two years.

### C. The Financial Services Act 1986 - Enhanced Enforcement Powers

The Financial Services Act 1986 (FSA) deals with insider trading in two main ways: First it contains provisions which amend the substantive law of the CSA 1985 (ss.173-176). Secondly, it confers on the DTI special investigative powers aimed at detecting those who have broken insider trading laws (ss.177-178).<sup>71</sup> It is only the latter which is given treatment below.

Under s.177(1) of the new Act the Secretary of State is empowered to

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68. See, Manne, "Insider Trading and the Law Professors", (1970) 23 Vand. L. Rev. 547, at p.553.

69. But see, Brandon, supra note 23, at p.538.

70. (1987) unreported but see Financial Times, 2 July 1987.

71. For a comprehensive account of the DTI's newly acquired powers set within the context of recent case law developments, see, Trimidas, "The Financial Services Act and the Detection of Insider Trading", (1987) 8 Co. Law 162. See generally, Rider et al, Guide to the Financial Services Act 1986 by (CCH) 1987, pp. 701-730.

appoint inspectors to investigate suspected insider dealing offences. These inspectors have by virtue of s.177 (4) the power to require any person who may be able to give any information concerning whether a contravention has actually occurred to: (1) produce the relevant documents,<sup>72</sup> (2) appear before them, and, if necessary, (3) give evidence on oath as well as generally render all assistance in connection with the suspected offence. Moreover, s.199 enables inspectors to enter premises and search for evidence where there are reasonable grounds that inter alia an offence has been committed under the CSA 1985.

The penalties for failure to comply with the request of an investigator are specified in s.178(1). A refusal to answer questions for example could amount to contempt of court unless it was decided that the refusal was made with reasonable excuse. If it is adjudged that no reasonable excuse exists then the Secretary of State may revoke that person's authorisation as an investment dealer - such a power could, more than anything, prove to be the greatest incentive to cooperate. The point of course is that with the increased powers of the authorities there is a greater chance that the requisite evidence needed for a successful prosecution will be more readily available, adding a further element of risk to the possibility of evading conviction for insider dealing.

That the hands of the authorities are not tied is illustrated well by the House of Lords decision in Re an inquiry under the Company Securities (Insider Dealing) Act 1985.<sup>73</sup> The dispute arose out of a DTI investigation into a suspected "mole", working at either the Office of Fair Trading or the Monopolies and Mergers Commission, who passed on price sensitive information to

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72. For a definition of documents, see, s. 177 (10).

73. [1988] 1 All ER 203, HL.

others who then dealt on the basis of it on the Stock Exchange. It was believed that there was a ring of people involved. On the basis of two articles written by Jeremy Warner, a journalist with the Independent newspaper, the DTI were convinced that he knew members of the ring and could as a result provide helpful evidence to assist their investigations. Warner refused to comply with the DTI's request for information under s.178(1), alleging that to do so might result in the identification of his sources. The House of Lords held that Warner did not have a reasonable excuse within the meaning of the section since his evidence was required for the prevention of crime in a general sense. It was not necessary for the inspectors to show that the evidence was required to stop some identifiable future crime.

#### **D. Civil Liability For Insider Dealing: Is there a Remedy?**

The purpose of this section is to examine the civil remedies available to persons who have been adversely affected by insider traders. These persons may be either (1) companies in whose shares insider dealing has taken place, (2) the shareholders of those companies, or (3) outsiders who trade with insiders.

The criminal sanctions applicable to insider dealing were considered above; however, as one commentator notes, "[t]he issue of whether provision should be made for civil remedies is one of the most controversial aspects of insider dealing regulation. Controversy surrounds both the principles upon which liability may be based and the formulation of the remedies themselves."<sup>74</sup> What then are the civil remedies?

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74. J. Suter, The Regulation of Insider Dealing in Britain and France (European Institute Florence: 1988) at section 4.1. For a review of the controversy surrounding the basis of civil liability, see, Chapter Three, note 66 and accompanying text.

The analysis herein falls into two broad sections. First of all, the position at common law is examined. Then secondly, treatment is afforded to the recent advent of statute law in the area as laid down in the Financial Services Act 1986 (FSA) by virtue of s.61 and s.62.

Before the enactment of the FSA the only means from which civil redress for insider dealing could be had was through reliance on general common law principles. These principles remain important because of the narrowness of s.61 and s.62 of the FSA which, in theory, provide a statutory civil law remedy in the event of an infringement of the SIB rulebook. Since the SIB rulebook applies only to a limited range of circumstances - confined to the regulation of financial intermediaries in the financial sector - the common law must still be looked at in order to gain the broader perspective of the law as it currently stands. In this respect the common law position in regard to face-to-face transactions must necessarily be considered first before going on to consider the position in relation to impersonal stock market deals.

### Civil Liability at Common Law

#### The General Principle of *Percival v. Wright*

There is no general principle at common law requiring an insider to disgorge any improper gain he has made as a result of his "insider" trades. In *Percival v. Wright*<sup>75</sup>, Swiften-Eady J held that directors owed their fiduciary duties to the company and not the company's shareholders.<sup>76</sup> As a result

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75. [1902] 2 Ch 421.

76. But see, Prentice, "Insider Trading" (1975) CLP 83, at p.83, who lists a number of contraining facts about the case.

shareholders had no direct cause of action against a director who had used inside information at the shareholders' expense; and, a fortiori, a non-shareholder (ie. an outsider), had no cause of action. In other words, if an existing shareholder who bought or sold shares was owed no special duty then neither was an outsider who, having no pre-existing relationship to the company, bought shares from an insider.

#### The Special Circumstances Doctrine

Following the ruling in Percival v. Wright there developed what has become popularly known as the "special circumstances doctrine". The relevant cases here are Allen v. Hyatt,<sup>77</sup> Gething v. Kilner,<sup>78</sup> and Coleman v. Myers.<sup>79</sup> In Allen v. Hyatt it was held that where a director holds himself out to be the agent of the shareholders then he owes the same fiduciary duties as would an ordinary agent to his principal. In that case merger negotiations were taking place. The directors of one company, Lakeside Canning Co. Ltd., induced certain shareholders in the company to give them the option to sell their shares. The offer was made on the purported basis that it would strengthen the position of all the shareholders in the merger negotiations. When the negotiations were concluded the directors exercised their right to buy the shares and in doing so made a profit. The case was distinguished from Percival v. Wright because the directors had held themselves out as agents of some of the shareholders and thus were capable of being considered as fiduciaries to those shareholders.

Likewise, in Gething v. Kilner, certain dicta gave support to the view that in some circumstances directors owed fiduciary duties to shareholders.

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77. Allen v. Hyatt [1922] 30 TLR 444.

78. [1972] 1 WLR 337.

79. [1977] 2 NZLR 225.

This involved the duty to refrain from making negligent or deceitful misstatements. In that case, the plaintiffs were shareholders in R. Co.,. Another group called TC Ltd sought to acquire the plaintiff company's assets. An agreement was eventually reached. Subsequently, R.Co., called in a firm of stockbrokers whose job it was to advise R.Co., on the merits of the offer. The stockbrokers' report concluded that the offer was unsatisfactory. R.Co.,'s directors disagreed and recommended their shareholders to sell. The plaintiff's sought to prevent the directors of R. Co., from recommending the offer. It was held, that the directors of R. Co., owed a duty to their shareholders which included the duty to be honest and not to mislead. The special nature of the facts of the case mean, quite obviously, that it has a very narrow reading and for this reason might amount to nothing more than an amalgam of common law duties not to be dishonest.<sup>80</sup>

Undoubtedly the most significant case to advocate a special circumstances doctrine has been Coleman v. Myers<sup>81</sup>. There the New Zealand Court of Appeal, departing from the principle in Perceival v. Wright, held that in special circumstances a director would owe fiduciary duties to shareholders. The circumstances in that case which prompted the judge to establish a duty focused on (1) the nature of the face-to-face transaction, (2) the high degree of inside information which the insiders possessed, and (3) the actual conduct of the takeover. In the words of the Woodhouse J (as he was then):<sup>82</sup>

... the standard of conduct required from a director in relation to dealings with a shareholder will differ depending upon all the surrounding circumstances and the nature of the responsibility which in a real and practical sense the director has assumed towards the shareholder. In the one case there may be a need to provide an explicit warning and a great deal of information concerning the proposed transaction. In another there will be no need to speak at all. There will be intermediate situations.

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80. See, Pennington, Company Law, at p.684, (5th Ed. Butterworths 1985)

81. [1977] 2 NZLR 225.

82. [1977] 2 N.Z.L.R. 225 at p. 324.

It is uncertain to what extent , if any, a UK court would follow this decision. Indeed, in a recent U.K. decision, Dillon LJ said: "The directors ... owe fiduciary duties to the company though not ... to the individual shareholders."<sup>83</sup>

#### Possible Actions Derived From Existing Case Law

##### (a) Civil Action By the Company:

###### (i) against its directors

Since a director owes fiduciary duties to his company, a number of corollaries necessarily follow.<sup>84</sup> First, he must not put himself into a position where his own interest is in conflict with the interests of his principal and the duties owed to that principal.<sup>85</sup> Secondly, he is precluded, by virtue of his position as fiduciary, from making a secret profit from the company to whom he owes fiduciary duties.<sup>86</sup> According to Regal Hastings v. Gulliver any profit made by a director as a result of the misuse of confidential information is the property of the company.<sup>87</sup> The company can, therefore, bring a civil action against the director to recover these profits.

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83. See, Multi-national Gas and Petrochemical Co v. Multinational Gas and Petrochemical Services Limited [1983] 2 All ER 563 at 585 CA.

84. It is also important to note that a director occupies an agency role rather than that of a trustee in relation to the affairs of the company. As Rider points out, this is significant from two points of view: (1) the strictness of the duties owed and (2) the remedies available for breach of duty. He also argues that a director might be liable as a constructive trustee of corporate property which he misdirects. See, Rider Insider Trading (Jordans, 1983) at p.69 *et seq.*

85. See generally, Chapter Six and the sources cited therein.

86. Keetch v. Sandford (1972) Sel Cas Ch 61.

87. [1942] All ER 378. See also, Boardman v. Phipps - [1967] A.C. 46 where it was held that "any benefit derived from the use of confidential information obtained by virtue of a fiduciary position should be accounted for to the persons to whom the duty is owed even if they themselves could not have made use of the information."

In Regal Hastings the directors acquired a profit by virtue of their position as directors in Regal Hastings. They bought a company which they knew Regal Hastings could not afford to buy. Regal Hasting was thus allowed to sue.

But the decision in Regal Hastings - permitting the company to sue - is not without its difficulties. Not only has there been a reluctance on the part of directors to enforce the remedy on behalf of the company by suing fellow directors<sup>88</sup> but the remedy does very little to help the real victim: it is the shareholder (in a face-to-face transaction) and an "outsider" (in a stock market deal) who is "damaged" by insider dealing; not the company.<sup>89</sup> Indeed, as the Justice Report concluded:<sup>90</sup>

[T]he company will not normally have suffered any loss, and there seems no reason in equity why it should benefit from the punishment of the insider's misconduct ... [I]f the insider is a substantial shareholder, the damages paid by him will, in part, indirectly return to him and he will still be left with a net profit on the transaction, (... even if the rule in Foss v. Harbottle were allowed, the practical difficulties of ensuring that proceedings are taken by a shareholder on behalf of the company would be very considerable. Consequently we think that proceedings by the company are not appropriate as the primary remedy against insider trading, and we see no reason to extend the rights of action which the company appears to have (see paragraph 6 above), though equally we see no reason to restrict them.)

It is probably not necessary to show that the company has suffered loss<sup>91</sup>

As Prentice writes:<sup>92</sup>

the fact that a company suffers no loss would not constitute a bar to the company recovering from a director any profits made from insider

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88. It would probably be necessary for control of the company to change hands before such an action is contemplated. This infact was the case in Regal Hastings where an action was brought against the ex-directors to recover the profits they had gained form the misuse of the company's information.

89. However an insider of the offeror company knowing the name of the target company who buys shares in the target will effectively increase the bid price which the offeror company must make. Admittedly this is only so if the purchases by the insider are substantial.

90. Justice, Report on Insider Trading (1972) para. 32.

91. See, infra at note 140 and accompanying text.

92. Supra, note 76 at p.86.



trading as other pegs on which liability could be hung, such as access to confidential information or abuse of position, are clearly present.

Rider also argues that a company can recover from a director who misuses inside information for a purpose other than that for which it was entrusted. He says:<sup>93</sup>

Where a person in a fiduciary relationship with a company is entrusted with information in confidence on behalf of the company, then it is certain he would be in breach of his fiduciary duties if he used that information for other than the corporate purpose for which it was given to him. To engage in insider trading for himself or another ... would not be a legitimate corporate purpose and would render him accountable to the company for the profit that he makes. This would obviously cover a good many situations of [traditional] insider trading.

(ii). against a third party ("tippee") as constructive trustee

A third party - or tippee - may become liable as constructive trustee if he knowingly assists in a dishonest and fraudulent design or breach of trust undertaken by the director of a company, notwithstanding the fact that he did not acquire possession of the trust property.<sup>94</sup> The tippee must, however, know not only of the existence of the fiduciary relationship and of the fraudulent and dishonest design by the fiduciary (director), but also of his own assistance in that fraudulent design.<sup>95</sup> Furthermore, a third party may also be liable if he receives corporate property with actual or constructive knowledge of a breach of trust.<sup>96</sup> However, here the equitable remedy of tracing extends only to those who are not bona fide purchasers for value. It

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93. See, *supra* note 9, at p.79.

94. See, *Karak Rubber Co. v. Burden* [No.2], [1972] 1 All E.R. 1210 at pp. 1234-1235; *Selangor United Rubber Estates Ltd. v. Craddock* [No.3] [1968] 2 All E.R. 1073 at pp. 1123-1124; Snell, *Principles of Equity* (27th ed., 1973), 185-188.

95. See, *Belmont Finance Corps v. Williams Furniture Ltd* [No.2] 1980 1 All 393 at 405.

96. For the difficulties with this approach, see, Hannigan, *supra* note 9 at p. 119 *et seq.*

is not clear whether the company is required to show loss.<sup>97</sup> Indeed the law is very uncertain in this whole area and such actions in relation to the imposition of liability for insider dealing are very unlikely to be brought or to succeed.

(b) Possibility of a Derivative Action By The Shareholder

Another possibility of gaining civil redress is that a shareholder could take a derivative action on behalf of the company. The problem here is that the rule in Foss v. Harbottle virtually debar individual shareholders from taking such a course of action.<sup>98</sup> However by virtue of s.459-461 of the Companies Act 1985 a shareholder is allowed "to bring an action for relief on the basis that a minority (including himself) has been unfairly prejudiced by those in control of the company." This should provide some relief from the strictness of the rule in Foss v. Harbottle. But even here an individual shareholder who brings an action would be unable to secure a direct remedy because any damages that might possibly be recovered would belong to the company.

It would seem therefore that although various potential common law remedies do exist, an individual shareholder has no effective remedy against an insider. Even if the UK courts did follow Coleman v. Myers it would provide relief only in very limited circumstances. Furthermore, an "outsider" who purchased shares from an insider would have no means of redress.

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97. See, infra at note 91 and accompanying text.

98. (1843) 2 Ha 461. The rule states that shareholders may not pursue an action against a director if the directors actions are such that they can be (though they need not have been) ratified in general meeting. There are, however, exceptions to this rule and the possibility always exists that the courts could make another exception. A further motivation for shareholders to take a derivative action has arisen due to the decision in Wallenstien v. Moir (No 2) [1975] QB 373.

## Breach of Confidence<sup>99</sup>

If one arm of a conglomerate offering financial advice to a client acquires inside information about that client and subsequently deals on it or relays it to others who deal on it, the conglomerate is potentially liable for an action brought by the client for breach of confidence. Though not confined to contractual relationships,<sup>100</sup> such an action is nonetheless dependant on two main factors.

First: what constitutes confidential information? The Saltman case<sup>100</sup> addressed the question of the nature of confidential information. The acid test, said Lord Greene, was whether the information had:<sup>102</sup>

the necessary quality of confidence about it, namely, it must not be something which is public property and public knowledge.

In general unpublished price-sensitive information fulfils this requirement.<sup>103</sup>

Secondly: when does an obligation of confidence arise? According to Megarry J. in Coco v. A N Clark (Eng) Ltd<sup>104</sup> an obligation of confidence arises where: "... the circumstances are such that any reasonable man standing in the shoes of the recipient of the information would have realised that upon reasonable grounds the information was being given to him in confidence, then

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99. See generally, the Law Commission Report No.110, Breach of Confidence (1981), Cmnd. 8388, and Hannigan, supra note 9 at p.125 et seq.

100. Saltman Engineering Co Ltd v. Campbell Engineering Ltd [1963] 3 All ER 413.

101. Saltman Engineering Co Ltd v. Campbell Engineering Ltd [1963] 3 All ER 413.

102. Ibid., at p.415.

103. But see, the reservations expressed by Hannigan, supra note 9 at p.26-27.

104. Coco v. A N Clark (Eng) Ltd [1967] RPC 41, at 47.

this should suffice to impose upon him the equitable obligation of confidence. In particular, where information of a commercial or industrial value is given on a business-like basis and with some avowed common objective in mind ... I would regard the recipient as carrying a heavy burden if he seeks to repel a contention that he was bound by an obligation of confidence."

In view of this, it would appear that the corporate finance arm of a conglomerate which acts as an underwriter to a client and in the course of that relationship acquires confidential information such as earnings figures, future corporate plans, new innovations or inventions, would fulfil this test and would as a result owe an obligation of confidence to the client.<sup>105</sup> Indeed in Schering Chemicals Ltd v. Falkman Ltd<sup>106</sup> Shaw LJ said:<sup>107</sup> "... the communication in a commercial context of information which at the time is regarded by the giver and recognised by the recipient as confidential, and the nature of which has a material connection with the material interests of the party confiding that information, imposes on the recipient a fiduciary obligation to maintain that confidence thereafter unless the giver consents to relax it." Furthermore employees owe a duty of fidelity and good faith to their employer.<sup>108</sup> Knowing misuse of confidential information would be a breach of this duty. It would be implicit that City employees know that they are not to use confidential information for the purposes of insider dealing. Thus the confidence is breached where there is an unauthorised use of such information by the confidant. Insider dealing would without doubt constitute an

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105. But see, Law Commission Report supra note 99 at para.4.4 where the argument is put that Megarry J.'s test was obiter.

106. [1981] 2 All ER 321.

107. Ibid. at 337.

108. See, Hival Ltd v. Park Royal [1946] 1 All ER 350. See also, Hannigan, supra note 9 at p. 130 and the examples cited therein.

unauthorised use.<sup>109</sup> Fiduciaries would also owe similar obligations.<sup>110</sup>

What remedies are available when a confidence is breached? The remedies relevant to insider dealing are damages and an account of profits.<sup>111</sup> The important point to be made from all this is that an action for breach of confidence is a further incentive for the firm (and the individual) not to systematically breach its Chinese Walls. To do so, and in the process use confidential information to trade in shares, not only leaves open a firm (or rather those members responsible for the deals) for criminal liability under the CSA 1985 and civil liability under the FSA 1986 (discussed below) but also the client could recover for breach of obligation of confidential information conveyed to the conglomerate in the normal course of business.

### Miscellaneous Remedies

#### (a) Breach of Statutory Duty

It is possible, but very unlikely, that damages could be recoverable for a loss caused by the commission of a statutory offence. For example, in Re South of England Natural Gas Co.<sup>112</sup> it was held that damages were recoverable

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109. See, Hannigan, supra note 9 at p.134. According to Hannigan there is no longer any need to prove that the confidential information was used to the detriment of the confider.

110. See generally, discussed infra at IDC v. Cooley [1972] 2 All ER 162, Chapter Six at note 29 and accompanying text.

111. See, Hannigan, supra note 9 at p. 136 for an assesemnt of the extent of damages.

112. [1911] 1 Ch. 573.

as a result of omissions in a prospectus which were relied upon by an investor.<sup>113</sup>

(b) Powers of the Criminal Courts Act 1973

Section 35 of the Powers of Criminal Courts Act 1973 empowers the courts to require any person who has committed an offence to compensate anyone who has suffered adversely as a result of his crime. It is possible (though unlikely<sup>114</sup>) that this discretionary power could be used to provide civil compensation in cases of insider dealing.

(c) Extra-legal control by the Takeover Panel.

A number of the Takeover Panel rules prohibit trading on the basis of inside information.<sup>115</sup> Firms regulated by the Panel who have been found to have traded on the basis of inside information are required to disgorge any profit they make. But the remedies are extra-legal and of little assistance to an aggrieved investor. Even when ill-gained profits are disgorged they are distributed to charities rather than aggrieved investors.

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113. But see, Mayson and French, A Practical Approach to Company Law (2nd. Ed. Financial Training Publications Ltd: 1982), at p.254, where they write that: "the fact that Parliament has imposed stiff penalties for insider dealing will probably stop the courts permitting actions for damages for breach of statutory duty brought by an uninformed buyer or seller [against an insider dealer with whom he dealt]."

114. Mainly because of the difficulty of unscrambling random deals and assessing the correct amount of damages to be awarded. In any case it has been held that the remedy should only be given in the clearest cases of loss.

115. See, Chapter Seven at note 77 and accompanying text.

In the Gower Report recommendations with respect to a civil law remedy for securities fraud which extended to insider dealing were eventually translated into law in the FSA but only in a conditional rather than an explicit fashion, conditional in the sense that it was dependant on the SIB making a rule prohibiting insider dealing.

Under section 62 a private investor<sup>117</sup> who has suffered loss as the result of an insider's trades may take an action if the insider has breached one of the rules of the SIB, an SRO or an RPB.<sup>118</sup>

Clearly before s.62 can establish a civil remedy for anyone who has suffered loss from an insider's trades there must be a rule outlawing insider

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116. See generally, Alan Berg, "Sec 62: the Full Extent of Exposure" (Aug) 1988, IFLR 26; also Berg, "Sec 62 and the SIB's Legal Novelty" (Jan) 1989, IFLR 18.

117. Previously the section catered for any investor. The newly refashioned text of the section, narrowing its scope, is to be incorporated into the forthcoming Companies Bill.

118. It is important to note that s.62 does not only provide a civil remedy for insider dealing but gives civil redress for any breach of the SIB rulebook. Given the reluctance of the Parliament to provide a statutory civil remedy to those adversely affected by insider dealing did Parliament foresee the introduction of such a remedy when it passed section 62? No mention is made in the debates - an indication perhaps that the remedy was in fact unintentional. The relevant parts of section 62 read:

- (1) Without prejudice to section 56 above, a contravention of, (2) Subsection (1) applies also to a contravention by a member of a recognised self-regulatory organisation or recognised professional body of any rules of the organisation or body relating to a matter in respect of which rules or regulations have been or could be made under the Chapter in relation to an authorised person who is not a member of such an organisation or body.
- (3) A person shall not be guilty of an offence by reason of any contravention to which this section applies and no such contravention shall invalidate any transaction.

Subsection 1 allows an individual to pursue his action even though the SIB is simultaneously seeking an injunction or restitution order under s.61 of the FSA.

dealing. Rule 3.10 of the SIB rulebook has been adopted for this purpose.<sup>119</sup> According to the rule, a firm is prohibited from using inside information when dealing on its own account in those situations where the CSA prohibits individuals from insider dealing. But an exemption is allowed if the individual so prohibited by the CSA is "screened off" behind an effective Chinese Wall so as to prevent that individual(s) from being aware of the circumstances giving rise to the prohibition. Furthermore, a firm is prohibited from effecting a transaction with any person - either a customer or a counterparty - if it has reason to believe it is acting on the basis of inside information.

#### The Issue of Proving Loss

An individual has a right of action under section 62 when he is able to show that he has suffered loss as a result of a breach of the rule. In relation to insider dealing this is not an easy task. The plaintiff must prove, on the balance of probabilities, that: (1) there was a contravention of Rule 3-10 (or its SRO equivalent), (2) privity existed between himself and the defendant firm so that the firm's breach of duty caused him to suffer loss.

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119. For a more detailed review of the rule, see, infra Chapter Seven at note 62 and accompanying text. It is sufficient for the present to note that the rule states that a firm shall not effect a transaction as principle for its own account if:

... an officer or employee of a firm is prohibited by the Companies Securities (Insider Dealing) Act 1985 from effecting a transaction...

The SIB permits two exceptions to this prohibition, first if:

the only reason why that officer or emmployee was so prohibited was because of his knowledge of the firms intentions

and secondly, if an effective Chinese Wall is maintained by the firm so that:

none of the officers or employees of the firm involved in effecting or arranging for the effecting of the transaction on behalf of the firm knew or ought to have known of the circumstances giving rise to that prohibition.

The rule also prohibits a firm from effecting a transaction with or for any person:

if it has reason to believe that the effecting of that transaction by that person is prohibited by the Company Securities (Insider Dealing) Act.



Uncovering a breach of Rule 3-10 depends on the powers and resources devoted to detecting insider dealing. While these have been woefully inadequate in the past - very few convictions have resulted from the legislation - these powers have nonetheless substantially increased in recent years.<sup>120</sup> Too what extent and, more importantly, to what effect remains to be seen.

What is certain is that it is extremely unlikely that a private plaintiff will uncover insider dealing transactions where the criminal authorities have failed. However, where the plaintiff is a counterparty on the wrong side of an insider deal the counterparty would probably have greater resources, increased access to the relevant information and more impetus to bring an action. But it must be remembered that only private investors may bring an action under s.62. Of course there is always the likelihood, common in the U.S.,<sup>121</sup> that where the authorities have thought a case sufficiently strong to have the defendant charged with a criminal offence and the courts have found him guilty, then the private plaintiff may use the findings of the criminal trial to prove his own case.

Even if the plaintiff overcomes the difficult hurdle of proving a rule has been breached he must further show that the contravention caused him loss. Loss is not defined in the FSA, but it probably refers to a pecuniary loss. Thus the plaintiff would be obliged to show that he either bought/sold shares at an inflated/deflated price from what it would have been but for the

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120. See, *supra* note 71 and sources cited therein.

121. See, Cottrell, "Insider Dealing in the United States: I" (1986) January 31 *NLJ* 88 at p.90.

defendant's actions.<sup>122</sup> That is, he must show that the loss incurred was due to the insiders actions. He will have to prove that it was the defendant with whom he dealt with and that this caused him loss. Establishing this privity between the insider and outsider is, in strict legal terms, impossible.<sup>123</sup>

Will the computerisation of the UK Stock Exchange resolve this dilemma? Certainly it will make it much more easy for the authorities to find out who is trading and when, but to what extent it will show privity is yet to be seen.

#### Does Section 61 Provide a Better Alternative to Section 62?

From the foregoing discussion it is obvious that an investor attempting to recover damages from an insider will face enormous difficulties in proving not only that an insider deal occurred, but also that he has suffered a loss as a result of it. An alternative, or additional, remedy which may be pursued by an aggrieved investor is that provided by s.61 of the FSA. Section 61 empowers the SIB to apply to the court for a restitution order (or as it is sometimes referred to a "disgorgement order") requiring any firm that infringes the criminal law or the rules of the SIB or an SRO to disgorge their profits and compensate any loss suffered by the victims of the breach on behalf of investors. This disgorgement order could be used by the SIB in insider deal-

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122. Of course in nearly every instance the plaintiff will already have decided to buy or sell the securities in question, unaware of the insider's price-sensitive knowledge. In reality, therefore, it is arguable whether the defendant has caused the plaintiff any loss at all - thus the "no credible plaintiff" theory.

123. In the US the courts have done away with the need to show privity and require plaintiff's merely to show that the insiders were trading in the same time period as they themselves. In the US the plaintiff's action for damages is limited to the profit which the insider has made or the loss he has avoided and no more. See, Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); SEC v. Texas Gulf Sulphur Co., 401 F.2d 423 (2d Cir. 1968); Elkind v. Liggett and Myers Inc., 635 F.2d 156, 168-173 (2d. Cir. 1980).

ing cases where Rule 3-10 has been breached. This is so because s.61 (1)(a) provides that an order may be made where any Conduct of Business rule has been contravened.

The court may make a disgorgement order when it is satisfied that as a result of the contravention either the defendant has accrued a profit or one or more investors have "suffered loss or have been otherwise adversely affected."<sup>124</sup> In an action to recover damages for insider dealing these conditions would probably be more easily satisfied than the s.62 remedy simply because the SIB does not need to prove the difficult problem of "loss" but merely that an investor has been adversely affected by the contravention in question. However it is not at all clear what "adversely affected" means. Thus a court may apply a liberal interpretation to this concept in order to overcome the strictness of the test in s.62. It is interesting to note that Parliament struck these words out of s.62 because they took away from the purity of the section. This leaves the question: why were they not removed from s. 61 as well? This aside, the courts may still make an order if an insider has profited as a result of his dealing. Thus under s.61, if insider dealing itself can be shown and also that a profit accrued to an insider, it is substantially easier to recover damages against that insider than under s.62.

If an order is made the sum to be disgorged is based on either the amount of the profit which has accrued to the insider, or the amount of loss or adverse affect to investors, or indeed, a combination of both these factors.<sup>125</sup> The money is then to be paid into court, or to a receiver, and distributed:<sup>126</sup>

among such persons as the court may direct, being a person or persons appearing to the court to have entered into transactions with [the

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124. See, FSA s.61 (1), emphasis added.

125. See, FSA s.61 (3).

126. See, FSA s.61 (6).

insider].

Thus privity in the transaction must still be shown if a particular investor is to benefit from the disgorgement order. As mentioned earlier this should be made easier since the computerisation of the Stock Exchange in October 1986. Section 61 of the FSA is obviously crucial to the future development of civil liability for insider dealing.

It is clear that at common law there is no effective remedy for an individual who suffers loss due to insider dealing. Such a remedy is however offered by s.62 of the FSA 1986, the operation of which has presently been suspended and is due for amendment in the new Companies Bill. When it does become fully operational s.62 will, *inter alia*, theoretically, provide individual private investors<sup>127</sup> with a right of action as a result of the prohibition of insider dealing in the SIB's Conduct of Business Rules. However an attempt to bring an action will be plagued by difficulties, not the least being the need to prove loss, and the absence of a contingency fee system in the UK.

In practice it is more likely that investors will be offered a greater possibility of restitution for the illegal use of inside information by virtue of s.61 of the FSA. This section has the advantage of the SIB bringing the action, therefore the investor does not have to lay out significant amounts of money in legal fees. Further, the factors to be proven are less stringent, with the immediate advantage that this section is now legally operative whereas s.62 has been further delayed.

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127. The new newly amended section will not provide professional or business investors with a right to sue. See, *supra* note 117 and accompanying text

## II. THE REGULATION OF INSIDER TRADING IN THE U.S.

In the U.S. insider trading law has evolved at a much faster pace than any other country. Reliance has been placed mainly on case law to map the contours of the current prohibition.<sup>128</sup> Recently, however, statutory measures have become increasingly relevant. These are also considered below.

### Trading By Corporate Insiders

Insider trading is not defined in either the Securities Act 1933 or the Securities Exchange Act 1934 (SEA).<sup>129</sup> The Securities and Exchange Commission (S.E.C.), which was formed in 1933, and remains the governing regulatory watchdog body for the U.S. securities markets, has constructed its enforcement programme of insider abuse on a number of rather pragmatic bases. First, on the general anti-fraud provisions contained in the aforementioned statutes and developed by case law; and second, on what has recently emerged as the SEC's

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128. The literature on this subject is voluminous and steadily growing. The main texts are cited in the footnotes accompanying this section. It seems certain that in near future the U.S. will have in place comprehensive statutory proposals prohibiting insider trading. However at the time of writing, these had not been finally settled. For a brief review of one SEC proposal see, H. McVea, "U.S.A. - Compromise Proposal for Regulation of Insider Trading", (1988) 9 BLR, p.239. However, see, SEC Commissioner Grundfest, "Is the Sky Really Falling? The State of Insider Trading Law After the Winans Decision", speech before the Federal Bar Association, Washington, 26 January, 1988, where he states that: "The more prudent course of action may ... be to allow the courts to continue to develop the law of insider trading on a case-by case basis, and put efforts aimed at a statutory definition on the legislative back burner." (at p.2).

129. Section 16 of the SEA 1934 was the first legislative attempt in the U.S. to regulate insider trading. The section, however, has a narrow scope applying only to directors, officers, and large shareholders. Section 16 requires these individuals to report all trading activity in the shares (or options) of their company, prohibits short selling, and requires disgorgement of any profits that result from holding a position less than six months. For a more detailed review of s.16, see, William H. Painter, "Insider Trading and the Banker Director", (1967) 150 (Winter) Banker's Magazine, p. 30 et seq.

new and most potent weapon - the misappropriation theory.<sup>130</sup> The most important<sup>131</sup> anti-fraud provisions are section 10 of the SEA 1934<sup>132</sup> and Rule 10b-5 derived there-from.<sup>133</sup>

The growing body of U.S. case law which this regulation has spawned, makes it possible to devise a framework outlining the countries current proscription of the abuse. In the U.S insider trading may be defined as trading in an issuer's securities (or communicating or "tipping") while in possession of material nonpublic information<sup>134</sup> relating to the issuer's securities or the market for those securities. This may involve either the

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130. See, below at note 159 and accompanying text for a detailed review of the misappropriation theory.

131. Generally all insider dealing convictions involve violations of the mail and wire fraud statutes (see below at note 166 and accompanying text) as well as tax fraud, perjury and obstruction of justice. See, for example, Carberry & Romatowski, "Criminal Theories for Prosecution of Insider Trading," in Insider Trading 83-125 (1986) quoted in Ralph S. Janvey, "Criminal Prosecution of Insider Trading", (1987) 15 Securities Regulation Law Journal p.136 at p.138.

132. Section 10 reads in pertinent part:

It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of mails, or of any facility of any national securities exchange:

... (b) To use or employ, in connection with purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

133. Rule 10b-5 provides:

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

- (1) to employ any device, scheme, or artifice to defraud,
- (2) to make any untrue statement of a material fact or 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
- (3) to engage in any act, practice, or course of business which operates or would operate as fraud or deceit upon any person, in connection with the purchase or sale of any security.

134. Information is "material" if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision. TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). Although Northway involved proxy violations, this test has been applied in insider trading cases as well. See also, United States v. Carpenter, 791 F.2d at 1032 n.9.

misappropriation of confidential information or the breach of a fiduciary duty of confidentiality.

### Insider Trading at Common Law

At common law, an action for insider trading was originally based in the tort of misrepresentation or fraud. The main problem with this was that often the insider merely failed to disclose that he had material nonpublic information; in other words there was no positive misrepresentation. Furthermore, there needed to be proved that a duty to disclose was owed. The courts, in turn, developed three different rules specifying when, if ever, an insider would owe a duty of disclosure in face-to-face transactions.

According to the "majority rule" a director owes fiduciary duties to his corporation and not to the shareholders with whom he trades in face-to-face transactions; a fortiori no duty is owed to outsiders with whom he trades on the impersonal stock markets.<sup>135</sup>

In Strong v. Rapide<sup>136</sup> the "special facts" doctrine emerged. This says that a director has, depending on the circumstances, a positive duty to disclose any material information he holds when engaging in face-to-face transactions.<sup>137</sup>

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135. See, Goodwin v. Agazziz, 283 Mass. 358, 186 N.E. 659 (1933). Note the similarity with Percival v. Wright, [1902] 2 Ch.421, discussed supra note 75 and accompanying text.

136. 213 U.S. 419 (1909).

137. According to Lazenby v. Goodwin, 253 S.E.2d 489 (N.C. App. 1979), special circumstances likely to invoke the exception include: "the fact that the corporation is closely held ... the familial relationship of the parties initiates the sale ... and the relative ages and experiences in financial affairs of the directors and shareholders." (at p.492). Note, the similarity with Colmen v. Myers, [1977] 2 NZLR 225.

Under the "strict" rule, however, directors owe a duty of disclosure per se to individual shareholders in face-to-face transactions; that is, no special circumstances are required. Perhaps the most widely quoted statement of the rule is contained in Taylor v. Wright<sup>138</sup> where it was laid down that: "the detailed information a director has of corporate affairs is in a very real sense property of the corporation, and ... no director should be permitted to use such information for his own benefit at the expense of his stockholders."<sup>139</sup>

The "majority rule" is probably no longer the most widely followed of the three legal principles by the U.S. State courts today.<sup>140</sup> Thus, it would seem fair to say that in the U.S., common law dictates that a director will, in most circumstances, owe a fiduciary duty of disclosure to shareholders with whom he trades in face-to-face transactions (this is in distinct contrast to the position at U.K. common law under Percival v. Wright). However, his common law responsibilities do not extend to a duty of disclosure when he trades in the impersonal stock exchange markets.

The limitations of individual recovery at common law led some courts to develop a rule allowing the corporation to recover the insider's profits by way of a derivative action which encompassed the situation where the insider traded on impersonal stock markets. For example, in Brophy v. Cities Serv. Co.,<sup>140a</sup> the court held that when "an employee in the course of his employment acquires secret information relating to his employer's business, he occupies a position

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138. 69 Cal. App.2d 371, 159 P.2d 980, (1945).

139. Ibid., at p.984-5.

140. See, Henry Manne, Insider Trading and the Stock Market (New York: Free Press 1966) at p. 57-58, where he says that the special facts doctrine is "without question the prevailing approach in the states today".

140a. 31 Del. Ch. 241, 70 A.2d 5 (1949).



of trust and confidence toward it, analagous in most respects to that of fiduciary ... [consequently the information was not to be used] in competition with or to the injury of ...[the corporation].<sup>141</sup> In a further passage, the court noted that it was not necessary for the corporation to suffer injury.<sup>142</sup>

In the later case of Diamond v. Oreamuno,<sup>143</sup> Brophy was heavily relied upon. Applying strict agency principles, the court concluded that an insider who traded on the basis of material nonpublic information was liable to his corporation for the profits. The decision in Diamond, however, was not followed in Schien v. Chasen<sup>144</sup> or in Freeman v. Decio<sup>145</sup> where the courts ruled that a corporation could not recover unless it first proved that it had in fact been injured by the insider's illicit trading.<sup>146</sup> Either way, in the U.S., at common law, an insider does not owe an outsider any duty of disclosure when the insider trades on impersonal stock markets.

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141. Ibid., at p.7.

142. Ibid., at p.8.

143. 24 N.Y.2d 494, 301 N.Y.S.2d 78, 248 N.E.2d 910 (1969).

144. 313 So. 2d 739 (Fla. 1975).

145. 584 F.2d 186 (7th Cir. 1978). Indeed the court posited the view that a corporation was unable to show loss - how could inside information the corporation was not capable of using in any case be considered a corporate asset, asked the court.

146. For a comprehensive review of this whole issue see, Gerard E. Wimberly, Jr., "Corporate Recovery of Insider Trading Profits at Common Law", (1985) 8 Corp L Rev p.179-250. Wimberly's main thesis is that the Brophy-Diamond decisions are justifiable "on the grounds of fundamental principles of fiduciary law and the status of confidential information as an asset to the corporation, to which its exclusive use is reserved." (at p.201). For other types of liability premised on common law principles see, Jeffery D. Bauman and Robert H. Rosenblum, "The Resurgence of Common Law Restrictions on Insider Trading", Vol. 32 No.5 The Practical Lawyer. Other types of liability mentioned therein include: conspiracy, aiding and abetting and conversion. The general conclusion, however, is that these are at best uncertain and vary from state to state. For this reason, it is not proposed to deal with them further.

## Insider Trading at Federal Law

In 1942 the SEC promulgated Rule 10b-5. Initially the rule was not viewed with great significance by either the SEC or commentators.<sup>147</sup> However, before long the courts began to use it in an attempt to curb insider trading. In Kardon v. National Gypsum,<sup>148</sup> the court held that corporate officers who traded face-to-face with shareholders on the basis of material nonpublic information were in violation of rule 10b-5. In 1961, in the Commission's administrative proceedings against Cady Roberts<sup>149</sup>, the SEC outlined for the first time the basis of the insider trading prohibition. There it was said:

... the obligation [entails] 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 such information knowing it is unavailable to those with whom he is dealing.<sup>150</sup>

Initially then, while the insider trading prohibition was directed only at persons connected with the company whose securities were in question, the Cady Roberts decision broadened the scope of the law considerably to extend to, in this example, a trust officer who traded on the basis of inside

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147. See, Manne, "In defence of Insider Trading" (1966a) 44 (6) Harvard Business Review pp120-121.

148. 73 F. Supp. 798 (E.D. Pa. 1947).

149. In Re Cady, Roberts & Co. 40 S.E.C. 907 (1961) the facts were as follows: X, a member of the board of directors of the Curtiss Wright Corporation, was also a registered representative of the brokerage firm of Cady, Roberts. X informed one of the partners of the brokerage firm that Curtiss Wright's dividend was about to be cut. As a result, the partner sold some Curtiss Wright shares. It was held that material facts had first to be disclosed publicly before trading in the shares on impersonal stock markets could take place. Consequently, the partner, as tippee, was just as unable to make use of the material nonpublic information as was X himself. Furthermore, concluded the SEC, in the event of a conflict between duties imposed by Federal Law and fiduciary duties imposed by State law, Federal law was to remain primary.

150. Ibid., at 912.

information he had obtained from an insider.<sup>151</sup> Thus the SEC held that Rule 10b-5 was not confined to traditional insiders but was equally applicable to "those persons who are in a special relationship with a company and privy to its internal affairs, and [who] thereby suffer corresponding duties in trading [on] its securities".<sup>152</sup>

On the basis of the second limb of this key dicta, the wider principle could also be extracted: that insider trading in impersonal stock markets was in breach of Rule 10b-5.<sup>153</sup>

The Commission's ruling was soon given judicial backing in SEC v. Texas

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151. Originally trust law required all special skills and knowledge of the trust officer to be placed at the disposal of the beneficiary. Indeed the courts considered the gathering of information from insiders as evidence of the trustees "care and prudence." However this could no longer be true after the 1961 ruling.

152. Re Cady, Roberts & Co., *supra* note 149, at 912.

153. See, Langevoort, "Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement", (1982) 70 Calif L Rev 1 at p.8, who observes that Cady, Roberts contained: "little discussion of how it is that, absent any real inducement of shareholder trading, such unfair conduct becomes fraud. Instead, the decision implicitly relies on the insider's duty to act affirmatively to prevent the other party's disadvantageous trade, apparently based on the duty of loyalty. In theory, had disclosure been made to the public, marketplace buyers or sellers would not have traded (at least not at that price). By so stating the duty to disclose and resulting marketplace harm, the unfair conduct could be treated as a fraud, which would satisfy the statutory prerequisite for rule 10b-5 liability. However, this analysis involves some fiction, since had the insider simply abstained (as was his or her principal obligation), most marketplace buyers or sellers would have traded just the same, so that deception and resulting harm are difficult to find. Nevertheless, it provided the only open remedy for open market insider trading." (footnote omitted).

Gulf Sulphur Co.<sup>154</sup> There it was laid down that those persons who had access to inside information were required to observe the 'abstain or disclose' principle ie. they had either to disclose the inside information held or abstain from trading. The court said:

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 he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.<sup>155</sup>

In 1971, the Texas Gulf Sulphur decision was developed in the administrative case of Re Investors Management.<sup>156</sup> There, a brokerage house, acting as underwriter, legitimately acquired inside information from one of its client's. On learning of the information, the brokerage house sold a large stock position which it had built up in the clients shares. The brokerage firm argued that it was a non-insider with no special relationship to any insider, and did not, as a result, owe any duty of disclosure. The Commission rejected this contention. Instead it adopted an expansive interpretation which required anyone who obtained possession of material, non-public information from a corporation to disclose this information to the market. This was so because possession of such information placed it in a position "superior to other persons [and] thereby acquir[ing] a relationship ... [which made it] subject to

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154. 401 F.2d 833 (2d Cir 1968). Here, company officials, being aware of an important mineral strike by their company, TGS, bought shares in the corporation. The shares were purchased through the New York Stock Exchange before the news reached the company's full board of directors. The court held that the company officials were in breach of Rule 10b-5 because "the Rule is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information" (at p. 848). The court established the principle of fraud on the market place thereby neatly side-stepping any need to define who exactly had been defrauded. A fund was established into which the defendants were required to disgorge their illegal profits.

155. Idid., at p.848. (emphasis added).

the restraints and the purview of the anti-fraud provisions".<sup>156</sup>

The substantive law of insider trading was reviewed by the Supreme Court for the first time in Chiarella v. U.S.<sup>157</sup> where the defendant, Vincent Chiarella, a print worker in Pandick Press, a financial printing firm, decoded the names of several target companies in which takeovers were imminent. Aware that his conduct was forbidden by his employer, he bought shares in the companies prior to the announcement of the bid. When the announcement forced the price of the shares up he subsequently sold. The Supreme Court held, overturning the lower court,<sup>158</sup> that Chiarella did not owe an affirmative duty to disclose his information or abstain from trading. No duty was owed, said the court, where the defendant merely possessed material non-public information relating to the securities in which he traded. Instead the duty to disclose or abstain was dependent upon whether the trader owed the issuer of the securities a fiduciary or other relationship of trust and confidence. No such relationship was present.

#### The Misappropriation Theory

The Supreme Court's ruling in Chiarella represented a major set-back for the SEC's insider trading enforcement programme. Although the law adequately covered corporate officers who traded in the securities of their own companies - such officers owed fiduciary duties to the company if it was the issuer of

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156. SEC 633 (1971), at p.644.

157. 445 U.S. 222 (1980).

158. In the lower court, Chiarella had been convicted of a criminal violation of s.10(b) and Rule 10b-5. This was affirmed by the Second Circuit Court of Appeals who held that since he had access to inside information he was a market insider and was thus bound by the disclose or abstain rule. The court was of the opinion that its ruling was "but a logical application of the congressional policies underlying the rule of Texas Gulf Sulphur." 588 F.2d 1358 (2d Cir 1978) at p.1369.

securities in which they traded - the prohibition did not extend to persons who breached fiduciary duties to anyone other than the issuer of the securities traded in.<sup>159</sup> As a result of this weakness the SEC developed the misappropriation theory. According to this doctrine, it is theft of confidential information if an individual uses non-public information for his own personal benefit in breach of any duty.<sup>160</sup> Therefore, a lawyer, accountant or journalist aware of inside information relating to a company in whose shares he trades is liable under Rule 10b-5 notwithstanding the absence of a fiduciary duty to the issuer of the securities provided there is at least a duty owed to another person - here the law firm, the accountancy firm or the newspaper.

The lower courts have been prepared to endorse the misappropriation theory in a number of their rulings. For example, in U.S. v. Newman, a decision in which the misappropriation theory was adopted by the Second Circuit for the first time, the court held that Newman had stolen information from his employer and had thereby breached his fiduciary duties to his employer and his employers clients.<sup>161</sup> Equally, in SEC v. Materia<sup>162</sup> the Second Circuit thought that "one who misappropriates non-public information in breach of a fiduciary duty and

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159. In other words, the law did not cover a breach of duty owed to the courts, self regulatory bodies, financial intermediaries or newspapers etc.

160. The idea of a misappropriation theory was first mooted in the Second Circuits Chiarella judgement, but was rejected in the Supreme Court's majority opinion because it had not been fully argued before the jury in the lower court. Nonetheless the doctrine did find favour in the Supreme Court's concurring and dissenting judgements. Chief Justice Burger, for example, believed that "[a]n investor who purchases securities on the basis of misappropriated nonpublic information possesses ... an 'undue' trading advantage; his conduct saves no useful function except his own enrichment at the expense of others." (445 U.S. at p.241). In his opinion Rule 10b-5 prohibited trading on misappropriated nonpublic information and the majority had been wrong in not expressly arriving at that conclusion (at p.243).

161. U.S. v. Newman, 664 F.2d 12 (2d Cir. 1981).

162. SEC v. Materia, 745 F.2d 197 (2d Cir. 1984) at 203, cert. denied, 471 U.S. 1053 (1985). Here the facts resembled closely those in the Chiarella case. An employee of a financial printers specialising in documents dealing with forthcoming tender offers discovered 4 target companies and purchased shares in them. These he sold once the offers were made public.

trades on that information to his own advantage" was in violation of the law.<sup>163</sup> It was held that Materia had breached his fiduciary duty to his employers and his employer's clients, and had therefore, violated Rule 10b-5.

The most recent challenge to the validity and scope of the misappropriation theory came in the Supreme Court decision of Carpenter v. U.S., more commonly known as the Winans case.<sup>164</sup> The decision has been heralded by the SEC as judicial acceptance of their controversial doctrine. On closer inspection, however, it would appear that this interpretation is much too wide.<sup>165</sup>

It is crucial to make a clear distinction between the misappropriation involved in Winans and that which was at the centre of both the Newman and Materia cases. While in Newman and Materia the information misappropriated was the employers' clients' confidential information, in Winans the confidential information was not. Rather, the information merely related to a newspaper column which was soon to be published recommending the shares of a particular company. In other words, in Winans no confidential information was specifically entrusted to his employer whereas in Newman and Materia there was. The facts of the case make this clear. Winans was a reporter for the Wall Street Journal's "Heard on the Street Column". The column, which assessed the favourableness of certain investments in shares, had the potential for affecting the price of the securities it examined. Winans was aware that Journal policy was to keep the contents of the column secret prior to publication and that the contents of the column were regarded as the Journal's confidential information. In disregard of this fact Winan's engaged in a scheme with certain Wall Street financiers to provide them with the contents of the column prior to its

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163. Ibid., at p.203.

164. David Carpenter, et al., v. United States, 108 S. Ct. 316 (1987).

165. See, below at note 167 and accompanying text.

publication. The plan was for the financiers to place deals based on the probable impact of the column on the market and then share the profits.

At first instance the District Court found (and the Court of Appeals agreed) that Winan's had knowingly breached a duty of confidentiality by misappropriating prepublication information regarding the timing and contents of the Heard columns. With respect to the charges under s.10(b) of the 1934 Securities Exchange Act the court held that the deliberate breach of Winan's duty of confidentiality and concealment of the scheme was a fraud and a deceit on the Journal, and although the victim of the fraud - the Journal - was not a buyer or seller of the shares traded in or otherwise a market participant, the fraud was nevertheless considered to be "in connection with" the purchase or sale of securities within the meaning of the statute (ie. s.10(b) and Rule 10b-5).

On appeal the Supreme Court affirmed the Lower Court's ruling. The Justices were asked to review two questions. The first related to conviction under s.10(b) of the Securities Exchange Act 1934 and the second concerned conviction under the mail and wire fraud statutes.<sup>166</sup> On the first question, the Court was evenly divided 4-4 and for that reason affirmed the judgement of the Lower Courts which had accepted the misappropriation doctrine. Therefore the Supreme Court's analysis of the case only revolved around the second question presented to it; ie. conviction under the mail and wire fraud

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166. 18 U.S.C. S.S. 1341 and 1343. These share the same language in relevant part to s. 10(b) of the SEA 1934 and Rule 10b-5.



statutes.<sup>167</sup> As a result the misappropriation theory still rests on a rather precarious foothold.<sup>168</sup>

Tender Offers: Rule 14e-3

The SEC's Rule 14e-3, which derives validity from s.14(e) of the SEA 1934, forms the basis of insider trading liability in tender offer cases and as such would probably, had it been in operation, covered the activities of both Newman and Chiarella. The rule, which was promulgated on 4 September 1980, in relevant part reads:

[i]f any person has taken substantial steps ... to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the [Exchange] Act for any other person who is in possession of material information relating to such tender offer which information he knows or ought reasonably to know has been acquired directly or indirectly from: (1) [t]he offering person; (2) [t]he issuer of the securities sought or to be sought by such tender offer; or (3) [a]ny officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities ... unless within a reasonable time period prior to any purchase or sale such information and its source are publically disclosed by press release or otherwise.

Once "substantial steps" have taken place to commence a tender offer the Rule

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167. Although this had strictly nothing to do with the misappropriation theory it did have a direct bearing on the conviction of insider traders. See, Grundfest, supra note 1 at p.7: "[T]he scope of the Court's mail and wire fraud ruling is so broad that it effectively fills any void that may have been created by the securities law decision on the criminal side. In the wake of Winans it seems clear that insider trading violations are ... also violations of the mail and wire fraud statutes." See also, Janvey, supra note 131, at p. 140 and sources cited therein.

168. At least two commentators would seem to endorse this view. See, for example, Harvey Pitt who suggests that the split decision "leaves the Commission's own enforcement tools in a state of limbo."; and Professor James Cox who claims that the Winans decision "casts a menacing shadow on the continued effective enforcement of insider trading rules." (as cited in Grundfest, supra note 128). Note, however, the Commissioners rebuttal: "Contrary to the suggestion of ... [some] observers, Winans does not mean that the sky is falling on the Commission's insider trading program." (at p.2). He bases his argument on the fact that "Winans is not a garden-variety misappropriation case. It is an exotic case that tests the outer limits of the securities law." (at p.3).

prohibits any person who possesses material, nonpublic information concerning the tender offer from: (1) trading themselves or (2) causing others to trade, in the securities of the target company if the person "knows or ought reasonably to know" that the information has been acquired either directly or indirectly from any of the three groups specified in the Rule. If any person does fall within the remit of the rule, public disclosure of the information is essential before that person can trade. It is also important to note that the prohibition in Rule 14e-3 does not require the defendant to owe or breach a fiduciary or other duty to the issuer of the securities traded in or to any other person. In other words, although under the misappropriation theory no breach of duty to the issuer of the securities traded in is required, there only needing to be a breach of duty to another person, under Rule 14e-3 it is not necessary for any fiduciary duty to be owed or breached.

#### Trading by Secondary Insiders or Tippees

Texas Gulf Sulphur, as well as affirming the general disclose or abstain principle, made it clear that the persons communicating inside information (tippers) to others (tippees) would be in breach of the law; and the tippees themselves would also be subject to the disclose or abstain rule (ie. prevented from tipping).<sup>169</sup> The case of Shapiro v. Merrill Lynch, Pierce, Fenner & Smith Inc.<sup>170</sup> in part addressed this issue. It was clearly held that "tippees" - here institutional investors - were subject to the abstain or disclose rule. The reasoning offered by the court centred on the fact that such persons had a

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169. SEC v. Texas Gulf Sulphur Co., 401 F.2d at 852.

170. 495 F.2d 228 (2d Cir 1974). Here, Douglas Aircraft Authority was an underwriting client of the brokerage firm Merrill Lynch. In the course of the relationship the underwriting department received adverse non-public information about the Aircraft Authority. This information was "leaked" to some of the firms favoured institutional clients by employees in a number of departments.

special access to inside information which arose from communications they had received from primary insiders.<sup>171</sup> Consequently they ought to have imposed upon them the same duties as traditional insiders.

In Dirks v. SEC<sup>172</sup>, the Supreme Court curtailed the liability of both tippers and tippees considerably. Dirks, an investment analyst, uncovered a massive financial fraud. This news he relayed to some of his clients who sold the issuer's shares before the fraud was publicly disclosed. A new general rule was applied: that a tippee owed outsiders a fiduciary duty when an insider tipped or communicated to him material non-public information where the tippee knew or ought to have known that the information was of the prohibited type and was communicated in breach of a duty owed by the tipper.<sup>173</sup> However a rider was also added: the question of the tipper's liability was dependant upon the purpose of the disclosure. The test was whether the prosecution could show that the tipper received some form of direct or indirect personal benefit from the outlawed conduct.<sup>174</sup> Thus the tippee's liability was limited to those situations where he knew or ought reasonably to have known of the insider's breach of duty; and the tipper's liability was contingent upon the purpose of his action.

Much has been made by the SEC of a footnote in the Dirks case.<sup>175</sup> The note imposes 'temporary insider' status in the situation:<sup>176</sup>

where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders ... [they do not

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171. Ibid., at p. 237. Note also that Cady Roberts was also a tippee case.

172. Dirks v. SEC, 463 U.S. 646 (1983).

173. Ibid., at p.660.

174. The test is objective. See, Janvey, supra note 131. See also, the new SEC proposal discussed in McVea, supra note 128, where the requirement of a showing of direct or indirect benefit is abolished all together.

175. Ibid., at p. 655 note 14.

176. Ibid.

actively solicit or acquire inside information] but rather they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes. When such a person breaches his fiduciary relationship, he may be treated more properly as a tipper than a tippee. For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship must at least imply such a duty.

## Penalties

### Criminal and Civil Penalties at Statute Law

Basically the authorities rely on two types of legal action to penalise insider traders. First, the SEC may take an injunctive action which requires the disgorgement of illicit profits.<sup>177</sup> Secondly, the SEC can refer a case to the U.S Department of Justice who may prosecute through the U.S Attorney's Office.<sup>178</sup> The various statutory civil and criminal penalties are outlined below:

#### (A) The Insider Trading Sanctions Act 1984

While the SEA 1934 provided penalties for securities violations in general, it did not provide specific penalties for insider trading. However the SEA, as amended by both the Insider Trading Sanctions Act 1984 (ITSA) and the recent Criminal Fine Improvements Act 1987 (CFIA), provide a tough package of measures which include: suspension or disbarment from the securities industry; disgorgement of profits;<sup>179</sup> penalties of anything up to three times

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177. See, below at note 179 and accompanying text.

178. See, Janvey, *supra* note 131, at p.138-140.

179. From the 27 insider trading cases in 1986 \$30.2m was obtained through disgorgement. \$11.6m came from the case against Dennis Levine. SEC v. Dennis Levine, et al., 86 Civ. 3726 (RO) (S.D.N.Y.), filed May 12, 1986.

the illicit gains made on the insider trades; criminal fines of up to \$250,000; and prison sentences.<sup>180</sup>

The SEC action against Levine was the first of a series of major Commission "swoops" on Wall Street insider traders. Levine, an investment banker at a prestigious Wall Street firm, was alleged to have been involved in insider trading over a period of six years, during which time he made huge profits while trading on the basis of material nonpublic information in the securities of companies. It was believed that much of the information was acquired by way of his employment as an investment banker. On June 5th 1986, Levine finally agreed to settle the dispute, disgorging \$11.6m in profits and accepting permanent disbarment from the securities industry.

On November 14th, 1986, in SEC v. Ivan F. Boesky, et al.,<sup>181</sup> the Commission began its largest and most notorious case to date. Boesky, a risk arbitrageur, was charged with dealing on the basis of nonpublic information that was provided by Levine.<sup>182</sup> In the settlement that was reached, Boesky agreed to relinquish \$50m in illicit profits; pay a civil penalty of a further \$50m; accept permanent disbarment from the securities industry and to plead

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180. Since the U.S. securities markets have a system of self regulatory bodies (SRO's), penalties may be imposed through them more expediently and with better effect and without resort to the protracted complexities of expensive court battles. SRO's have powers to hold disciplinary hearings and to penalise any members found to have breached securities laws or self regulatory codes. For example, they may issue warning letters making clear that any future violation could lead to more serious action by the SRO; impose fines ranging from \$25,000 for each violation by a member and up to \$100,000 for member organisations; suspension of trading for a specified period; expulsion from trading and from SRO membership. The SRO's are actively involved in monitoring trading activity in their markets on a day-to-day basis. Violation are then referred to the SEC who pursues the investigation further and decides whether to take court action.

181. 86 Civ. 8767 (S.D.N.Y), filed Nov. 14, 1986.

182. For a concise review of the 'Levine-Boesky Saga', see, Janvey, supra note 131 at p. 148ff.

guilty to a federal charge of insider trading violation. He was subsequently sentenced to two years imprisonment. Boesky's cooperation with the regulatory authorities has resulted in a number of other SEC investigations.<sup>183</sup>

(B) Civil Penalties at Common Law<sup>184</sup>

Prior to 1984, the emphasis was on civil remedies in the form of restitution i.e. restoring the status quo by removing the profit made or loss avoided from the insider trader and compensating the 'victim' for any loss suffered. Thus at an early stage the courts recognised a right for a contemporaneous trader to bring a private right of action under Rule 10b-5. Nonetheless the plaintiff must first overcome a number of hurdles. The information withheld must be sufficiently material to have "a substantial effect on the price of a security if disclosed."<sup>185</sup> To what extent the plaintiff must also establish reliance on the non-disclosure is uncertain. The same is true of the question of causation. In stock exchange transaction it could be argued that there is never a causal connection arising from the purported loss sustained and the non-disclosure of the inside information. Once again the issue of privity fits uncomfortably into the traditional common law analysis of recovery for insider trading.<sup>186</sup> Indeed in the U.S. it has been modified to the extent that "not even a 'semblance' of privity is any longer

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183. See, SEC v. Kidder, Peabody & Co., Inc., 87 Civ. 3869 (RO) (S.N.Y.D. 1987), in which a leading brokerage firm consented to pay \$25m in disgorgement and civil penalties. See also, the recent SEC action against leading Wall Street firm Drexel Burnham Lambert - McVea, "SEC Begins Civil Action Against Drexel", (1988) October Financial Times, Financial Regulation Report, p. 10.

184. See also, supra note 140 and accompanying text.

185. See, SEC v. Texas Gulf Sulphur 401 F 2d at p. 848.

186. See, Rider and French The Regulation of Insider Trading Macmillan 19 (1979) at p.92: "If the doctrine of privity were strictly applied and only the one who can match up his actual dealings with that of an insider would recover."

required for liability under Rule 10(b)-5."<sup>187</sup>

Some cases illustrate the current position. For example, the Shapiro case<sup>188</sup> addressed the issue of to whom the duty to disclose or abstain was owed. This was important because it directly determined who had the standing to sue in a private action under Rule 10b-5. The court decided that according to the logic of both Cady, Roberts and Texas Gulf Sulphur, disclosure was owed to the whole market place. As a result, all investors who had purchased Douglas Aircraft stock between the date when the defendant first traded and the date when the disclosure was finally made were eligible to bring a private action under the rule, provided, they were able to establish injury and show the necessary causal link with the defendant's actions. However, according to Moss v. Morgan Stanley, Inc.,<sup>189</sup> in traditional insider trading cases brought under Rule 10b-5, no recovery can be made where the plaintiff neither dealt with the defendants nor was influenced in his trading decision by the defendants' trading.<sup>190</sup> Recovery by contemporaneous traders has also been precluded in misappropriation cases.<sup>191</sup>

Another interesting question which needs to be addressed is what constitutes the requisite guilty mind, or scienter, before an action can be brought under Rule 10(b)-5. According to Ernst & Ernst v. Hochfelder<sup>192</sup> it is necessary to prove scienter before a private cause of action for damages

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187. Ibid.

188. 495 F.2d 228 (2d Cir. 1974). See, supra note 170 and accompanying text.

189. 719 F.2d 5 (2d Cir. 1983), cert. denied, 465 U.S. 1025 (1984).

190. See also, Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980) (a tipper case where the amount of damages was limited to the tippee's profit).

191. Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977). (must show harm resulted from defendant's conduct).

192. 425 U.S. 185. See also, Rider, supra note 186 at p. 85.

under s.10(b) and Rule 10b-5 can succeed. Furthermore in a more recent case it was said: "In our view, the rationale of Hochfelder ineluctably leads to the conclusion that scienter is an element of a violation of s.10(b) and Rule 10b-5, regardless of the identity of the plaintiff or the nature of the relief sought.<sup>193</sup>

(C) The Insider Trading and Securities Fraud Enforcement Act 1988

New legislation aimed at improving the procedures and remedies for the prevention of insider trading has recently been passed by the U.S. Congress.<sup>194</sup> The legislative initiative - the "Insider Trading and Securities Fraud Enforcement Act of 1988" - is the first substantive statutory response to the most recent wave of insider abuse, highlighted largely by the Boesky affair. The emphasis on deterrence, by providing even stiffer penalties for those involved in insider trading, is clearly evident.

\* Civil Liability for Controlling Persons

Section 3 of the Act covers the liability and civil penalties for financial institutions (called Controlling Persons) involved in illegal insider trading. The SEA 1934, s.21 of which deals with the liability of controlling persons, is now supplemented by a new Sec. 21A. Basically this provides that firms and other controlling persons who "knowingly or recklessly" fail to supervise properly their employees and prevent insider dealing violations can be made liable for a treble penalty for violations committed by their employees

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193. Aaron v. SEC 446 U.S. 692.

194. The initiative was heralded by Congress as necessary because despite the SEC having enforced its "rules and regulations, vigorously, effectively, and fairly, ... nonetheless, additional methods are necessary and appropriate to deter and prosecute [violaters]". See, s. 1 of the Act.



or other controlled persons<sup>195</sup>

Perhaps the most novel provision in s.21A is ss. (e) which provides the SEC with the authority to award bounties to informants. In the past the Commission has used informants to good effect. In forty five enforcement actions brought in 1985 and 1986, informants were instrumental in providing information in fifteen cases. It was thought therefore that the increased use of such a system might lead to improvements in enforcement. Consequently in an SEC Commissioners document published in February 1986 the scheme was viewed positively, but owing to competing priorities legislation was never framed to give it Congressional backing. The new legislative measure rectifies this failing. Subsection (e) in part reads:

(e) ... there shall be paid from amounts imposed as a penalty under this section and recovered by the Commission ... such sums, not to exceed 10% of such amounts, as the Commission deems appropriate, to the person or persons who provide information leading to the imposition to such a penalty.

Clearly this could increase significantly the number of future indictments brought by the SEC.

#### \* Amendments Concerning Supervision

With respect to brokers and dealers s.15 of the SEA 1934 is amended by adding the following new subsection:

(f) Every registered broker or dealer shall establish, maintain, and

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195. See, s.3(a). Other activities are also specified. The legislation:

- \* Empowers the SEC with the authority to impose civil penalties on Controlling Persons,
- \* Specifies the amount of the penalty to be imposed on the person who committed the violation,
- \* Outlines the amount of penalty for the Controlling Person,
- \* Specifies limitations on the liability of Controlling Persons,
- \* Specifies procedures for the collection of payment of penalties to the treasury.

enforce written policies and procedures reasonably designed, taking into consideration the nature of such broker's or dealer's business, to prevent the misuse in violation of this title, or the rules or regulations thereunder, of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer. The Commission, as it deems necessary ... shall adopt ... regulations to require specific policies or procedures reasonably designed to prevent misuse in violation of this title ... of material nonpublic information.

Under newly implemented s.204 A of the Investment Advisors Act, 1940, the above procedural policies are also applicable to prevent the misuse of nonpublic information by investment advisers. In effect these procedures require, inter alia, the establishment of Chinese Wall informational barriers to ensure that inside information acquired by one arm of the firm is not transmitted and used by another arm of the financial entity. The provisions represent the first time that the Chinese Wall concept has been explicitly enshrined in statutory language in the U.S.

\* Increases in Criminal Penalties

Under s.4 of the new legislation, (newly amended s.32(a) of the SEA 1934) persons found guilty of insider trading "... shall upon conviction be fined not more than \$1,000,000, or imprisoned for not more than 10 years, or both." The SEC hopes that by doubling both the statutory fines and prison sentences this will do more to re-adjust the regulatory imbalance which currently favours insider trading. The aim is to deter both current and potential offenders.

\* Liability to Contemporaneous Traders for Insider Trading

Section 5 of the new initiative amends s.20 of the SEA 1934. Newly inserted s.20A (a) gives a private right of action to any person who trades contemporaneously with an insider in securities of the same class. However

under s. 20A (b) limitations on potential liability are outlined. These are:

- (i) The total amount of damages imposed against a person are reduced by any amounts that the defendant is obliged to disgorge under a Commission disgorgement order relating to the same transaction(s).
- (ii) There is a statute of limitations bar in that no action may be taken under the section more than five years after the date of the last transaction which is the subject of the violation.

Notwithstanding these limitations, the powers contained in the section do not restrict any other express or implied rights of action.<sup>196</sup>

\* Investigative Assistance to Foreign Securities Authorities<sup>197</sup>

Section 6 (b) of the new legislation amends s.21(a) of the SEA 1934 by empowering the SEC with authority to provide assistance to "foreign securities authorities". This term is defined in the legislation as "any foreign government, or governmental body or regulatory organisation empowered by a foreign government to administer or enforce its laws as they relate to securities matters." According to the amendments instituted by s. 6 of the new legislation:

... the Commission may provide assistance ... if the requesting authority states that ... [it] is conducting an investigation which it deems necessary to determine whether any person has violated, is violating, or is about to violate any laws or rules that the

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196. Section 5 thus reverses the rule of Moss v. Morgan Stanley, Inc., 719 F.2d 5 (2d Cir. 1983), cert. denied 465 U.S. 1025 (1984), which required the plaintiff to show that the insider trader breached a duty which was owed to him.

197. For a fuller review of this see, McVea, "SEC gives major boost to securities fraud cooperation", (December, 1988) Financial Times, Financial Regulation Report, at p. 10.

requesting authority administers or enforces. The Commission may, in its discretion, conduct such investigation as the Commission deems necessary to collect information and evidence pertinent to the request for assistance ... In deciding whether to provide such assistance, the Commission shall consider whether (A) the requesting authority has agreed to provide reciprocal assistance in securities matters to the Commission; and (B) compliance with the request would prejudice the public interest of the United States.

In the field of securities regulation the new Act is perhaps the most important legislative initiative to emerge from the U.S. in recent times. By approving the Act, Congress has given explicit recognition to many practices hitherto conducted on a largely pragmatic and informal basis by the Commission. For example, the adoption of a paid informant system is without doubt a novel development and one which if successful could find favour with the regulatory authorities in the U.K. However, the use of deterrent remedies such as the increased use of civil law measures and increases in statutory fines and prison sentences is yet further admission by the SEC that expending resources on detection is much too costly given the end return.

## **Summary**

Chapter Four proceeds on the premise that insider dealing is an "economic bad" and ought therefore to be regulated. The chapter looks at the formal regulatory approach as adopted in the U.K. and the U.S. These formal laws are complex and in the U.K at least rarely resorted to. However the fact is that these prohibitive rules if breached invoke restitutive and a punitive sanctions, thus imposing costs on miscreants. In this way they alter the incentives to break down Chinese Walls and engage in insider dealing. Consequently the rules themselves and the penalties imposed and indeed the likelihood of the penalties being imposed needs to be considered.

In the U.K. insider dealing was originally left to common law remedies. As is shown, these remedies are largely inadequate. Consequently more detailed statutory prohibitions have been adopted in the form of the Companies Act 1985, the Company Securities (Insider Dealing) Act 1985 and the Financial Services 1986. The increased investigative powers contained in the latter piece of legislation is likely to give the regulatory authorities a greater degree of success in detecting insider abuse, however the subjective elements of the substantive offence as enshrined in the CSA 1985 remain an onerous burden for the prosecution to discharge. Thus although the equation is changing in favour of the regulators, the skilled operator with nominee accounts and bank secrecy laws in off-shore centres is still often beyond the reach of the authorities. What effect the provision of a civil remedy under s.61 and 62 of the FSA 1986 for breach of the SIB (or an SRO) rulebook will have is, as yet, too early to tell, but most probably it will not have any significant deterrent effect.

U.S. law on insider dealing is considerably more pervasive and pragmatic than that which exists in the U.K. Case law has issued an expansive web of liability, with recent statutory provisions marking out the boundaries of this liability. It seems only a matter of time before the substantive law of insider dealing in the U.S., currently contained in case law, finds itself codified on the statute book. The pervasiveness of the SEC's misappropriation theory, notwithstanding certain reservations about Winans, plus the widespread bargaining powers of the SEC and the potential penalties it may impose, provide a formidable array of incentives to trade within the law. The strength of these penalties could deter potential offenders from breaching Chinese Walls. It must also be remembered that in both jurisdictions self-regulatory codes of conduct prohibiting insider dealing also provide strong incentives to trade fairly. For example, in Britain, the Stock Exchange Model Rules.

## CHAPTER FIVE: THE CHINESE WALL - AN INTRODUCTION<sup>1</sup>

### Regulating Insider Dealing and other Conflicts in Financial Conglomerates

While "blanket" insider dealing legislation (such as the CSA 1985) has an important role to play in deterring and penalising insider abuse in the general or traditional context, conglomerates pose special problems which arguably require special regulatory solutions.<sup>1a</sup> Not only is there an increased flow of price-sensitive information in the conglomerate context but also there is a greater potential for this information to be misused and for the abuse to go undetected. Other conflicts both of duty and interest are also capable of misuse.<sup>2</sup> A number of regulatory options are available to both regulators and policy makers. Broadly speaking they fall into two categories: either conflicts in conglomerates can be prevented or they can be controlled.<sup>2a</sup> The Chinese Wall is one means of control. It has been isolated by the regulatory authorities on both sides of the Atlantic as a key mechanism in resolving both conflicts of interest and duty.<sup>3</sup>

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1. The general term Chinese Wall is sometimes used as if there was no distinction between a "Chinese Wall" and a " 'reinforced' Chinese Wall". The term Chinese Wall (sometimes called 'naked' Chinese Wall to distinguish it from the reinforced type) is used herein to denote a Wall which is sufficiently effective to allow a financial conglomerate to operate in whatever capacity it wants. Thus it is different from a 'reinforced' Chinese wall which places restrictions on what deals the conglomerate can perform. This is a crucial distinction because it will inevitably affect the liability of the conglomerate and is an important distinction when making policy choices. A 'reinforced' Wall incorporates a 'naked' Chinese Wall but goes even further.

1a. That this is the case is evident from the SIB's own Rule 3-10 prohibiting insider dealing in the conglomerate context. Also the SIB's "build a Chinese Wall or disclose": Rule 5.07 discussed infra Chapter Seven.

2. See, infra Chapter Two at note 32 and accompanying text.

2a. For a discussion of the other means of prevention and control see generally, infra Chapter Eight.

3. For recent U.K. and U.S. developments see generally, infra Chapter Seven.

## The Chinese Wall: Description and Analysis

As a result of both the perceived and actual conflicts which arise in financial conglomerates there is a real need to balance these competing interests and obligations. On the one hand there is the financial conglomerate's obligation to its corporate clients (eg. those seeking to have their new share issues underwritten). To these clients the conglomerate owes a duty of confidence.<sup>4</sup> On the other hand, there is a duty owed to its investment advisory customers (clients whose investment portfolios the conglomerate handles). To these clients the conglomerate has a legal duty to use all legitimate information in making investment decisions.<sup>5</sup> On top of all this, the conglomerate also owes a duty to the investing public not to use inside information in conducting investment deals on its own account.<sup>6</sup> Consequently, it has been the custom of most multi-service financial firms to erect Chinese Walls (of whatever type) in an attempt to avoid potential civil liability at both common law and statute law. In this way the Wall mechanism had been, long before the arrival of Big Bang, a cornerstone of self-regulation in the UK.<sup>7</sup>

The adoption of a Chinese Wall policy, says one compliance officer, "involves a range of practices, designed to foster a culture sensitive to the

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4. Discussed *infra* at Chapter Four note 99 and accompanying text.

5. This is no more than an amalgam of the duties imposed on a fiduciary to act with due skill care and diligence. See generally, *infra* Chapter Six. See also, Financial Services in the United Kingdom: A New Framework for Investor Protection Cmnd. 9432, at para.7.5. For the position in the U.S. see, SEC v. Hanley, discussed *infra* Chapter Two at note 58.

6. See generally, *infra* Chapter Four.

7. See, for example: 1970 Takeover Statement discussed *infra* at Chapter Seven at note 30 and accompanying text. Despite not having financial conglomerates in the British sense, the same is true of multi-service firms in the U.S. For example see, Merrill Lynch, discussed below at note ? and accompanying text; and see also, E. D. Herlihy, "Insider Trading and 'Chinese Walls': Is There a Need For Reform", (1987) 16 April, a paper circulated by U.S. Law Firm - Wachtill, Lipton, Rosen & Katz.

management of conflicts of interests. They vary in formality but inevitably are becoming more formalised in the high-regulated environment into which we are moving."<sup>8</sup> The term "Chinese Wall" thus refers to a self-enforced informational barrier consisting of systematic, as opposed to ad hoc, procedural and structural arrangements designed to segregate the flow of unpublished price-sensitive information between different divisions within a multi-capacity financial intermediary with conflicting interests and obligations.<sup>9</sup>

The Wall therefore consists of essentially three components: First, it is a combination of policies and procedures. Second, these procedures are designed to halt unpublished price-sensitive information<sup>10</sup>; and lastly, the policies and procedures operate between departments within the one firm.

Thus the Wall can be distinguished from the situation where "non-conglomerate outsiders" are tipped off and they trade on the basis of the inside information provided. In other words, the Wall cannot be expected to work where, outside the normal course of business, one friend in one conglomerate swaps with another friend in a totally different conglomerate inside information they have learned at their respective work places. If this were the case the Wall would be breached in nearly every wine bar in London. The Wall works intra-department within the one conglomerate. The Chinese Wall is essentially

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8. See, Mayo, "The Role of Compliance" (1987) June The Treasurer 41, at p.43.

9. It may also be described as the collection of operational and structural constraints which financial intermediaries erect and enforce to prevent unpublished price-sensitive information acquired or created in one department of a dual capacity firm from being transmitted and used by another department within the one corporate entity.

10. This term has already been considered in Chapter Four note 21 and accompanying text. Essentially the issue here is really how to ensure that the screening procedures which constitute the "Wall" do not block out legitimate information. See also note 19 and accompanying text.



a corporate device.<sup>11</sup> It deals only with abuse in the ordinary course of business. The Wall ought not to be criticised for failing to prevent abuses it is not actually designed to prevent.<sup>12</sup>

In surveying the procedures which constitute the Wall it is necessary to distinguish between those procedures which are information blocking, ie. procedures which restrict the flow of information to the decision maker, and those which are conduct blocking, ie. arrangements which prevent a person who is privy to the information from making investment decisions.<sup>13</sup> While it is true that procedures may be of either type, more often than not they go hand-in-hand and are seen as being very much complementary to one another and indeed critical to the effective operation of the Wall mechanism.

#### **Procedural and Structural Measures Used in Constructing a Chinese Wall**

The logic upon which the Wall mechanism rests is essentially that proper controls over access to inside information will stop its misuse.<sup>14</sup> There is, however, no "standard" Wall. To what extent controls are "adequate" is uncertain. Regulatory authorities worldwide have adopted a very pragmatic approach to the question of what constitutes adequate Chinese Wall controls.<sup>15</sup> Recently in the U.S there have been calls to outline criteria for minimum Chinese Wall

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11. See, the definition of the Chinese Wall offered by the SIB infra Chapter Seven note 52a and accompanying text. See also, SEC wider definition infra Chapter Seven at note 9 and accompanying text.

12. See also, Edward D. Herlihy, "'Chinese Walls' and Insider Trading: How Well Does Self-Policing Work?" (1987) 9 National Law J. (Part 1) 39, at p.39. p.2.

13. See, Rodger D. Blanc, "Chinese Walls, Tippers, Tippees and Denis Levine", (1986) 195 New York Law Journal 23, at p.23.

14. See, L. Varn, "The Multi-Service Securities Firm and the Chinese Wall: A New Look in the Light of the Federal Securities Code", (1984) 63 Nebraska Law Review 197, at p. 212.

15. In Britain, for example, neither the SIB nor the Takeover Panel have published a rigorous set of criteria of what constitutes a Chinese Wall.

procedures. In the National Association of Securities Dealers (NASD) Final Report of the Regulatory Review Task Force, March 1988, it was to the task force's distress that:

neither the Commission nor any SRO had issued regulations establishing minimum requirements for Chinese Wall procedures. Instead regulators have allowed procedures to evolve on a firm-by-firm basis ... Recent Commission enforcement cases underscore the need for the NASD and other SRO's ... to ensure that integrated firms have adequate Chinese Wall procedures and adhere to them.

When the controls are considered to be adequate the Chinese Wall purports to resolve the disparate duties which the conglomerate owes<sup>16</sup> by compartmentalising the conglomerates decision making powers so that information acquired in one capacity is considered not to be used in another one. Thus by operating a Chinese Wall the conglomerate, while still remaining one distinct corporate entity at law, may nonetheless be considered to operate with two or more separate minds. Whether the duties owed by these separate minds (or corporate divisions) really are in fact resolved by the use of the Wall device is a moot point.<sup>17</sup>

The dilemma all Chinese Wall builders face is ensuring that the Wall is not so low as to allow unpublished price-sensitive information in and ensuring that the Wall is not so high that it blocks out legitimate information which the different arms of the conglomerate really ought to be using when making investment decisions. To do otherwise would be to expose conglomerates to the risk that legitimate information acquired by one arm of the conglomerate would be "blocked" by the Wall, thus facilitating a civil law action, for example, for breach of a conglomerate's fiduciary duty to its clients to use all information legitimately and reasonably available in the making of an investment

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16. See, supra note 3 and accompanying text.

17. See generally, Chapter Nine.

decision.<sup>18</sup> Consequently, the "screening" procedures which in effect constitute the Wall must be sufficiently flexible to deduce whether information is or is not legitimately to be transferred.<sup>19</sup>

Though it is true to say that Chinese Walls vary from firm-to-firm, at the very foundation of every Wall is the distribution of a policy statement affirming the company's prohibition of insider dealing and explaining in detail the procedures by which it is intended to prevent abuses of unpublished price-sensitive information.<sup>20</sup> Thus there are a number of policies and procedures which could form the basis of a Chinese Wall. These are now reviewed below.

#### 1. Organisational Compartmentalisation

At the heart of the Wall policy is some form of organisational separation or compartmentalisation of the different divisions within the one firm, with different financial functions being assigned to groups of employees working as though one self-contained unit. This separation is only given efficacy when access to files concerning other customers or the "positions" held by the firm, for example the market making arm, are closely monitored or, indeed, prohibited

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18. See, supra note 5 and the sources cited therein.

19. Choosing clearly between what information may legitimately pass is crucial not only because of the potential for civil liability but also because of the need for confidence in the markets. For example, if it were thought that financial conglomerates were not making use of all the information they were legally entitled to use in the making of an investment decision /recommendation for a customer this might well run counter to customer expectations and go some way to undermining investor confidence in market participants and the markets themselves. The argument here is not about insider dealing but rather about the right of investors to have legitimate information make the basis of investment recommendation. See, Gower Report Part II, at para.4.13.

20. Lipton and Mazur write: "The Chinese Wall is easier to describe in conceptual terms than it is to implement in day-to-day practice. (M. Lipton and R. Mazur "The Chinese Wall Solution to The Conflict Problems of Securities Firms", (1975) 50 N.Y.U.L. Rev. 459, at p.467.

altogether. Increasingly, complex high security systems are being introduced whereby access to files and other sections of the firm can only be had if the employee has express authorisation or the proper key code. This not only curtails the scope for a flagrant breach of the Chinese Wall but also reduces the possibility that an accidental breach could occur. Equally it is necessary to regulate the sharing of common services such as research libraries, photocopying areas and cafeterias.<sup>21</sup> As a result a duplication of such services may be required. To the extent that duplication occurs, the underlying rationale of the use of the Wall technique - to capture synergies or economies of scope - is increasingly eroded.<sup>22</sup>

## 2. Physical Compartmentalisation

Organisational compartmentalisation is often supplemented by actual physical segregation by housing various staff groups in separate buildings. Segregation of this type is really only feasible in the larger conglomerate

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21. One compliance officer has revealed that: "Preparing our own Compliance manual was not without its problems. In particular we had to review our security arrangements, looking very carefully for possible weaknesses. It is not possible or sensible for each part of a group to be wholly self-contained and therefore we had to pay particular regard to common services. We found it necessary, for example, to restrict access to our word processing department to bar the possibility of someone not waiting for urgent work to be delivered but seeking to collect it in person from the word processing area and while doing so seeing confidential papers which he ought not to see. We identified risks in the use of our main library by both asset management and corporate finance personnel and, having sought to block such risks, ended up by providing a separate library for asset managers, round which we had an especially "thick wall" and who ideally should be housed in a separate building as used to be the case and will, I have no doubt, be the case again before very long." See, Mayo, *supra* note 8, at p.47.

22. For a more detailed discussion on this see, *infra* Chapter Eight at note 15 and accompanying text.

groups.<sup>23</sup> Again care needs to be taken in the transfer of personnel from one department to another. The flexible inter-flow of personnel between any two departments separated by the Chinese Wall would greatly weaken the efficacy of the mechanism. Thus compliance personnel (ie. those responsible for the drawing-up and internal policing of the procedures that go to make up the Chinese Wall) must ensure that the transfer of personnel is done only under controlled circumstances. Failure to do so would seriously undermine the effectiveness of the mechanism.<sup>24</sup> For example, in the finalisation of certain deals it might be necessary for one department to draw upon the specialised skills of another department or of one particular individual located therein. The question then becomes to what extent the Chinese Wall policy should allow these so-called "selected" breaches to take place. In most, if not all, countries where insider dealing is regulated by law, a "flexible" Chinese Wall which permits selected breaches to occur would not be sufficient to fend off liability. However, it might be possible for legitimate enquires to be made intra-conglomerate provided the compliance department are informed and that they actually monitor the request to ensure that no improper transfer of information is undertaken. Equally the Wall policy should be sufficiently flexible to allow, for example, an employee in a broker- dealer division to respond to unsolicited requests to purchase shares in Company X after he has become an insider to information relating to the future price of shares in the

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23. "In some instances ... [physical segregation] 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 their department thereafter functions ... Physical and corporate separation, though, are very costly and impractical solutions for those securities firms, investment companies and similar other business entities faced with inside information conflict problems; furthermore, such a requirement would approximate result a mandate for separation through divestiture ...", *see*, Lipton and Mazur *supra* note 20 at p. 496).

24. The recruitment of personnel from other firms could also cause problems, however here there would be no breach of the conglomerate's own internal procedures, thus it would not strictly be a Chinese Wall problem.

company. In other words, notwithstanding the fact that broker A is apprised of unpublished price-sensitive information about Company X he should not be precluded from responding to an independent request made by a client or an occasional customer to purchase shares in Company X.

### 3. Ongoing Educational Programmes

Another integral facet of the Wall is to ensure that the policy statements issued to staff are clearly explained and regularly updated through ongoing educational programmes which emphasise the potential liability of the company and employees alike if essential procedures are not adhered to.

### 4. A List Recording the Reasons for Buying Certain Shares

Here, for example, discretionary fund managers would be required to produce on an up-to-the minute basis the reasons which prompted them to buy or sell a particular security. In the situation where a similar recommendation had been placed on the firm's buy or sell lists the fund manager would be required to explain the basis upon which he determined his decision.<sup>25</sup>

### 5. Procedures Which Establish Whether Information Can or Cannot be Legitimately Used by Other Departments Within the One Firm

It would seem that given the need to use all legitimate information belonging to a conglomerate it is essential that the conglomerate establish

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25. Yellon, "Trusts Investments: Problems Regarding the Exchange of Information ...", (June 1973) Chicago Bar Record 405, at p. 413.

some form of clearing procedures by which senior personnel or compliance officers with no particular interest in any one department fulfil the role of overseer with regard to the various information flow. The officer is vested with the formidable task of determining which types of information are unpublished and price-sensitive and which are not.

6. A Policy of Encouraging Clients to Disclose their "News" as soon as is Feasible

That firms should encourage clients to disclose inside information to the public as soon as is feasible is at the very cornerstone of combating insider trading.<sup>25a</sup> While there are many problems with this approach, such a policy could be explicitly expressed in the conglomerate's formal Chinese Wall statement, distributed to employees through out the firm.

7. Contingency Plans for the Accidental Disclosure of Inside Information from one Department to Another

It would be wholly impracticable to expect that a Chinese Wall will always be completely watertight. While a number of breaches would undoubtedly have to be attributed to deliberate action it is nonetheless conceivable that some breaches will be inadvertent and accidental. In such situations it is essential that appropriate procedures are available so as to ensure a speedy and convenient remedy to resolve the problem. Most obviously the "leakage" of information should be reported to the compliance department as soon as possible. It then becomes the responsibility of the compliance personnel to carry out an investigation of the incident considering the legal repercussions

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25a. Note also that the Stock Exchange disclosure requirements also apply.

and making suggestions as to any readjustments which are necessary for the Wall to undergo.

### **A Practical Viewpoint**

Bearing in mind that there are no minimum procedures on either side of the Atlantic for what constitutes a Chinese Wall it might be useful to review how other interested groups have sought to translate general Chinese Wall principles into practical guidelines. Herein it is attempted to do this by first looking at a market participant's interpretation and then comparing this with a regulatory perspective.<sup>26</sup>

(1) A Market Participant's Perspective: Re Merrill Lynch, Pirece, Fenner & Smith Inc., 43 S.E.C. 933 (1968)<sup>27</sup>

Though a ruling given by the SEC, the offer of settlement (which entailed the setting up of a Chinese Wall), was essentially put forward by Merrill Lynch itself. For the Statement of Policy see Appendix No. II

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26. It would be appropriate to consider a Judicial view with regard to the legal translation of the term "Chinese Wall" into practical guidelines. However, no substantive comment has been made on Chinese Wall procedures either here or across the Atlantic. But, see some of the comments made in Washington Steel v. T W Corp. discussed infra at Chapter Six note 83 and accompanying text.

27. For a discussion on the facts of the case see, infra Chapter Four at note 170.



## (2) A Regulatory Perspective

- (a). The SEC (see qualifying comments on Merrill Lynch below)

Despite the fact that the SEC accepted the Merrill Lynch Chinese Wall proposal it did issue a disclaimer:<sup>28</sup>

As a matter of Commission policy, we do not, and indeed cannot, determine in advance that the Statement of Policy will prove adequate in all circumstances that may arise. Stringent measures will be required in order to avoid future violation.

- (b). The Sydney Stock Exchange - See Appendix III.

### **Some Reservations**

The crucial question surrounding the Wall is to what extent it can be "straddled" by top management.<sup>29</sup> Since much of the management of conglomerates requires cross-cutting organisational lines in order to establish exactly what is happening and what the firm's policy should be, many of the top personnel will of necessity come into contact with price-sensitive information. To what extent this is a problem is uncertain. One option would be to regard the Chinese Wall as operative only at a decision-making level. As Lipton and Mazur observe:<sup>30</sup>

In many securities firms both large and small - there is a considerable overlap between departments particularly at the partner or senior

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28. Re Merrill Lynch, Pirece, Fenner & Smith, Inc., Federal Securities Law Reports 83,347 at 83, 350.

29. See, Peter Rogers, "Directors can jump over Chinese Walls", Financial Times 14 October 1986 at p.20.

30. Supra note 20 at p. 467.

officer level. As a practical matter the Chinese Wall must be applied on the decision-making level. If the personnel making the final decision with respect to the transaction in question have been isolated from the inside information, then the Chinese Wall solution is effective. The mere fact that a decision - making department or employee reports to a senior executive who knows the inside information does not vitiate the Chinese wall solution." [emphasis in the original]

This, it would seem, makes good sense. Any other interpretation would frustrate the effective use of the Wall mechanism to the point that a firm could not rebut the imputation that the information was known throughout the conglomerate and would make it impossible to engage in strategic planning in multi-functional firms.

### **Summary**

Chapter Five looks at the Chinese Wall regulatory technique as an essential backup to formal statutory anti-insider dealing controls. While the legislation operates in the general context, Chinese Walls are specific to financial conglomerates. These conglomerates pose special problems with regard to insider dealing. The Wall consists of a set of policies and procedures aimed to stem the flow of price sensitive information within the conglomerate, thus limiting the opportunity to deal on the basis of such information. It is essentially a corporate device which aims to prevent insider dealing within the ordinary course of the conglomerates business. It may, as is shown in Chapter Eight, also serve as a legal defence to criminal and civil liability for insider dealing. The 'size' of the Wall will vary from firm to firm. The courts have not yet proffered an interpretation of the Chinese Wall's procedural elements and the regulatory authorities have done little better. There still remains the difficult problem of high ranking corporate personnel who over-look the Wall but who continue to make 'high-level' boardroom decisions.

## CHAPTER SIX: A COMMON LAW ANALYSIS OF THE CHINESE WALL

### Introduction

The exact legal status of the Chinese Wall in multi-functional financial firms either here or across the Atlantic has never been clearly established. Although the idea of one entity at law operating in two separate capacities has been sanctioned in English law,<sup>1</sup> how far this doctrine extends to separate departments in financial conglomerates is uncertain. At present, support for the legality of the use and efficacy of the Chinese Wall in financial conglomerates is derived from a number of sources. In the U.K, Chinese Walls have been sanctioned by the legislature<sup>2</sup> and given recognition by the regulatory authorities. For example the SIB and SRO's and, indeed, the Takeover Panel have all adopted Chinese Wall rules.<sup>3</sup> The SIB rulebook, derived from the Financial Services Act 1986, is without doubt the clearest and strongest expression of approval yet to have been made.

It is necessary, however, in considering to what extent the SIB's Conduct of Business rules are declaratory of the law in this area, to deal first with the position of the Chinese Wall at general law. As the SIB, in draft Rule 2.05 entitled: Agency, Fiduciary and other Duties and these Rules, states:

Unless otherwise expressly provided, these Rules shall not be construed as excluding or restricting any provision of the law of agency or other duties owed by a firm to those for or with whom it

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1. See, Rusken v. Ellis, Monday and Clarke [1912] 1 Ch 831, discussed infra at note 15 and accompanying text.

2. See, s.48(6) FSA, discussed infra at Chapter Seven

3. See generally, infra Chapter Seven. A similar acknowledgement has been forthcoming in the U.S. The U.S. position is also discussed in Chapter Seven.

deals.<sup>4</sup>

This chapter, attempts a common law analysis of the Chinese wall mechanism which, owing to the lack of direct U.K. authorities on point, draws on English, U.S. and Commonwealth case law. The difficulties which this introduces into developing a consistent body of legal argument cannot be too strongly emphasised. The next chapter - Chapter Seven - considers official recognition of the mechanism as expressed in the adoption of the recent statutory and self-regulatory codes both here in the U.K. and in the U.S. Chapter Eight attempts a policy analysis concentrating on some of the as yet unresolved legal and economic issues. Chapter Nine offers a synthesis of these ideas and of the legal validity of the isolation technique. The current academic controversies are addressed while at the same time charting a basis for reliance upon the Chinese Wall mechanism by financial conglomerates.

The legal concern over the Chinese Wall revolves around two directly related problems. The first is that the Chinese Wall is inherently defective and could, as a result, facilitate insider dealing in financial conglomerates.<sup>5</sup> The second is that the mechanism will work and will therefore facilitate an action for failure to use all material and legally available information in the

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4. Securities and Investments Board Conduct of Business Rules a new approach, November 1988 p11. Rule 2.04 lays down the same principle with regard to the law of contract. See also, Wood "Financial Conglomerates and Conflicts of Interest" in Conflicts of Interest in a Changing financial World (Ed. R. M. Goode, The Institute of Bankers, London, 1986) at p.68 who points out that: "Conduct of Business rules made under the financial services legislation will set out particular obligations on financial conglomerates. But it will not be enough merely to observe the letter of the Code. The general law is not excluded. There is therefore a double layer of law: the codes themselves and, behind them, the brooding presence of law relating to fiduciaries."

5. Thus exposing the conglomerate to liability under The CSA 1985, the FSA 1986 and civil liability at common law.

making of an investment decision on a customer's behalf.<sup>6</sup> Thus the questions to be addressed at common law are: (1) whether a Chinese Wall is effective and can be relied upon as a mechanism which rebuts the presumption that knowledge held by one department in a financial conglomerate is also held by another in the same conglomerate? (ie. is the Wall effective?)<sup>7</sup> If not, the use of such an isolation technique could leave a firm open to a charge of insider dealing and or breach of confidence;<sup>8</sup> and (2) whether the Wall, if it does rebut the presumption that knowledge held by one one department in the conglomerate is also held by other departments, will actually facilitate an action at civil law against the conglomerate for breach of fiduciary duty for operating in a conflict of interest situation without adhering to a fiduciaries strict disclosure duties.<sup>9</sup> As already mentioned, owing to the absence of common law authority dealing with the Chinese Wall on these points it is necessary to resort to general legal principles in an attempt to gain an understanding of the position of the Wall mechanism at common law.<sup>9a</sup>

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6. The author does not argue that in a conflict situation all material price sensitive information held by the fiduciary should be used in the making of an investment decision for his client. The fiduciary is not under an obligation to break the law. See, source cited in Rider, "Conflicts of Interest and the Chinese Wall", at p. 97. in The Regulation of Insider Dealing (Ed. Rider, Oyez 1979). For the U.S. position see, p.8 of the SEC amicus curie brief in Slade v. Shearson Hammill 517 F.2d 398 (2d Cir. 1974) where it says: "the customers of a broker, who are normally entitled to the benefit of information the broker has, are not entitled to inside information that he possesses". The fiduciary is, however under an obligation to use all legitimate information.

7. For the proposition that knowledge held by one department is knowledge held by another, see, Harrods, Ltd v. Lemon [1931] 2 K.B. 157 at p.162. To the extent that this presumption is in operation the Chinese Wall is erected to rebut it.

8. See, infra Chapter Four at note 99 and accompanying text.

9. See, below at note 10 and accompanying text.

9a. The foregoing analysis proceeds on the assumption that there is no deceit nor negligence on the part of the firm or anyone belonging to the firm. The main head of liability therefore is breach of fiduciary duty.

## The Law Relating To Fiduciaries

The discussion is couched in the following way. First, fiduciary law relating to a fiduciary acting for two sides per se is discussed. Second, consideration is given to a fiduciary in a conflict of interest situation who self-deals, ie. who breaches the no-profit fiduciary principle. Lastly, the extent to which separation by use of the Chinese Wall neutralises fiduciary duties is then reviewed.

### 1. The Fiduciary Acting For Both Sides Per Se

While most fiduciary law is uncertain, two fiduciary principles are, however, of universal application:<sup>10</sup> first, fiduciary theory debar a person in a special relationship of trust and care from putting himself in a position with his principal where his interests and those of the principal might come in conflict, unless, that is, the fact of the conflict is disclosed and the

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10. Though not of universal interpretation. The law relating to fiduciary duties in the U.K. is currently in a state of flux, and is some way behind many of its Commonwealth counterparts. As a result, it is neither clear nor certain if and in what circumstances the courts are obliged to impose fiduciary duties. The classic statement of the standard of fiduciary care required by the courts was established in Meinhard v. Salmon (249 NY 458 [1928]) at p. 464 where Cardozo CJ stated: "Many forms of conduct permissible in a work-a-day world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behaviour. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of the courts of equity when petitioned to undermine the rule of individual loyalty by the 'disintegrating erosion' of particular exceptions." Ironically if this standard were to be imposed on financial conglomerates operating Chinese Walls it would probably mean that they could not function without fear of civil liability for breach of fiduciary duty.

fiduciary receives his principals full and informed consent;<sup>11</sup> second, (which is also part of the first) a fiduciary is unable to deriving any benefit from his privileged position without the informed consent of his beneficiary.<sup>12</sup>

Lord Upjohn, in the celebrated case of Boardman v. Phipps<sup>13</sup> summarised the state of U.K. fiduciary law in respect of both these rules when he said:<sup>14</sup>

Rules of equity have to be applied to such a great diversity of circumstances that they can be stated only in the most general terms and applied with the most particular attention to the exact circumstances of each case. The relevant rule for the decision of this case is the fundamental rule of equity that a person in a fiduciary capacity must not make a profit out of the trust which is part of the wider rule that a trustee must not place himself in a position where his duty and his interest may conflict. I believe the rule is best stated in Bray v. Ford [1896] A.C. 44, 51, by Lord Herschell, who plainly recognised its limitations:

It is an inflexible rule of a Court of Equity that a person in a fiduciary position, such as the respondent's, is not, unless otherwise expressly provided, entitled to make a profit; he is not allowed to put himself in a position where his interest and his duty conflict. It does not appear to me that this rule is, as has been said, founded upon principles of morality. I regard it rather as based on consideration that, human nature being what it is, there is danger, in such circumstances, of a person holding a fiduciary position being swayed by interest rather than by duty, and thus prejudicing those whom he was bound to protect. It has, therefore, been deemed expedient to lay down this positive rule. But I am satisfied that it might be departed from in many cases without any breach of morality, without any wrong being inflicted, without any consciousness of wrong-doing. Indeed it is obvious that it might sometimes be to the advantage of the beneficiaries that their trustees should act for them professionally rather than a stranger. (emphasis added)

Thus at common law there is no outright rule excluding an agent from acting as

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11. See, Aberdeen Railway Co. v. Blakie Bros. (1854) 1 Macq. 461, at p.471 (H.L.) per Lord Cranworth L.C.; Regal Hastings Ltd. v. Gulliver [1943] 1 All E.R. 378 at p.381 (H.L.) per Lord Sankey; and Anglo-African Merchants v. Bayley [1970] 1 Q.B. p.311. This latter case is briefly discussed below at note 66 and accompanying text.

12. This is the prohibition against undisclosed self-dealing, ie. an agent cannot secretly sell his own property to his principal or secretly buy his principal's property for himself. For the main cases see, infra at note 24 and accompanying text. The rule therefore prohibits a fiduciary from making a secret profits or any other surreptitious financial advantage obtained by the use of his position.

13. Boardman v. Phipps [1967] 2 AC 46.

14. Ibid., at p.123.

principal, ie. there are certain instances when a fiduciary will be permitted to place himself in a conflict of interest situation. For example in the English Court of Appeal decision in Rusken v. Ellis, Monday and Clarke<sup>15</sup> the issue was raised as to when a firm of solicitors could act for both sides. Fundamental to the decision in the case was whether the law should automatically and regardless of the surrounding circumstances, impute the knowledge of one partner of a company to another partner in the same company.<sup>16</sup> In the Rusken case, M and C were partners in a law firm who conducted all their business separately, never enquiring about each other's clients. R consulted one of the partners, M, regarding an action against a Company, X, but later changed solicitors before the matter went to arbitration. Meanwhile, C, having returned from holiday and knowing nothing of R's consultations with M, was appointed under the name of the law firm to act as solicitor for Company X in arbitration. R applied for an injunction to prevent the law firm from acting for the company.

It was held that there was no general rule that prohibited the law firm from acting in the way it had. Indeed the court found that the onus of proving that a mischief had been done rested on the plaintiff and as there was no danger in the present case the injunction was denied. Thus the information relating to the existence of the conflict was held not to have been imputed from one partner in the firm to the other.

This issue of the imputation of knowledge is crucial. Authorities vary. Indeed the outcome of the Rusken case may be compared with the decision in

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15. [1912] 1 Ch 831.

16. By analogy the same argument could be applied to separate departments within the one financial conglomerate.



Regina Fur Co. Ltd. v. Bossom.<sup>17</sup> Here A and B were both directors of a company. The company traded in furs. B insured the furs. The furs were stolen. The insurers refused to pay the claim. They contended inter alia that the plaintiff's had failed to disclose a material fact. Only A knew that fact. One question the judge therefore had to decide was whether A was "sufficiently concerned with the insurance transaction for his knowledge to be imputed to the company". The judge held that he was.<sup>18</sup> After setting out the difficulty he faced, Pearson J. went on to lay down the following test:

Did the P company have ... [the requisite] knowledge? The company itself had no mind, and its knowledge or ignorance must be found in the minds of its agents ... [A] knew of [it; B] ... did not ... Is the knowledge of ... [A] to be imputed to the company for the present purposes? There seems to be no decided case which is at all close to this case ... One simply cannot say, "the knowledge of the agent is the knowledge of the principal." ...

The general effect of the authorities is, in my opinion, that in deciding whether in a particular case the knowledge of the agent is to be imputed to the company, or other principal, one should consider, mainly at any rate, (1) the position of the agent in relation to the principal and whether the agent had a wide or narrow sphere of operations, and (2) the position of the agent in relation to the relevant transaction and whether he represented the principal in respect of the transaction.

In some cases the courts have interpreted the general duty of a fiduciary not to put himself in a fiduciary position very strictly. In the context of business/ financial entities there have been a number of judicial decisions directly of interest. In Harrods, Ltd. v. Lemon<sup>19</sup> the plaintiffs were a department store with a real estate section. The plaintiffs had a separate building department which was located in a totally different building. The defendant sought the services of the real estate arm to find a purchaser for her house. When a purchaser was found an agreement was signed "subject to contract and survey" which the plaintiffs building department carried out. The

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17. [1957] 2 Lloyd's Rep. 466.

18. Ibid., at p.466.

19. [1931] 2 K.B. 157.

survey discovered some defects in the house and as a consequence the dedendant received a lower sum than expected for the property. Neither the building nor the estate departments were initially aware of each others involvement.

However, when the defendant found out about the conflict of interest she refused to pay the estate department's commission, even though the sale had been completed. Commenting on the plaintiffs conflicting position Avory J. said:<sup>20</sup>

I cannot accept the contention put forward by the Plaintiffs and their solicitors that the estate department and the building department are to be regarded as two separate entities. Harrods, Ltd., the Plaintiffs, are one person in law, however many businesses they may carry on. In acting as they did through their building department for the purchaser they were committing a breach of their duty as agents for the vendor.

In the Canadian case Comeau and Comeau v. Canada Permanent Trust Co. and Arsenault<sup>21</sup> which also dealt with a real estate transaction, the defendant had both a real estate division and a mortgage department. The mortgage department was housed in a separate but nonetheless nearby building. The plaintiff, using the defendant's real estate branch sold property to T. T applied, sucessfully, to the defendants's mortgage division for a first mortgage to buy the property. The defendant's mortgage department was given a copy of the original sale agreement but did not tell T's agent that T had applied for a loan. In a mix up that subsequently ensued, the agent asked the defendant's to accept a second mortgage on the property, giving the impression that T was supplying \$20,000 of his own money. The defendants accepted. But, unbeknown to them, this was not the true state of affairs. T failed to meet the mortgage repayments and the defandant's were forced to sell the property at a loss under their powers of sale specified in the first mortgage. The

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20. Ibid., at p.162. The judgement was affirmed on appeal but no mention was made on the validity of a Chinese Wall defence.

21. (1979), 27 N.B.R. (2d) 126 (Q.B.).

plaintiff's then sued the defendant's for breach of fiduciary obligation because they had simultaneously acted for both parties. There was no specific reference made to the Chinese Wall defence and it was held by Stevenson J. that despite the fact that the real estate and mortgage departments operated independently of each other he did not consider this to help the defendant's argument in any way. In fact, he criticised the defendant's because "the left hand did not know what the right hand was doing."<sup>22</sup> Thus in doing so he endorsed the view that both departments were to be considered as part of the one corporate entity owing indivisible fiduciary duties to the plaintiff's.

In another more recent Canadian case the issue of conflict of interest in the banking context was addressed. In Standard Investments Ltd. v. Canadian Imperial Bank of Commerce<sup>23</sup> the defendant Bank allied itself with two opposing groups involved in a takeover, thus placing itself in a classic conflict of interest situation. The facts were as follows: The plaintiff's wanted to make a takeover bid for Crown Trust. In pursuit of this, the plaintiffs transferred their accounts to the Defendant bank and approached the Bank's President, Wadsworth, for advice and financial support. Not long before this, however, the defendant Bank's then Chairman, Harrison, in conjunction with MacDougall, another Bank director, persuaded the Bank's officers to increase its shareholding in Crown Trust to about 10% in order to ward off the plaintiff's hostile takeover for the company. As events turned out, Harrison was unaware of Wadsworth's meeting with the plaintiff's. By the same token, Wadsworth was unaware of Harrison's decision to buy up shares in Crown Trust and decided, in the proper exercise of his authority, to proceed with his advice to the plaintiff's. When Wadsworth did discover the bank's involvement in Crown Trust

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22. Ibid., at p.133.

23. (1985), 22 D.L.R. (4th) 410, 52 O.R. (2d) 473 (C.A.).

he warned the plaintiff's that their takeover bid was doomed to failure but did not say why. For another 5 years the plaintiff's persisted in their efforts to acquire Crown Trust, but when Black, a customer of the Bank, acquired 44% of Crown Trust with the Bank's support and subsequently sold his holding to Canwest at the same time as the Bank sold its 10% stake, the value of the plaintiff's holding fell by more than half. The plaintiff's sought damages from the Bank for breach of fiduciary duty claiming that the Bank: (1) was under a duty to inform them at the earliest date possible that their takeover plan would fail and (2) should not have favoured Black nor sold its own holding to the ultimate purchaser.

In the Court of Appeal, it was held that by acting simultaneously through Wadsworth to encourage the takeover, while at the same time having decided to prevent the scheme, the bank owed the plaintiff's fiduciary ties which it had failed to discharge. The bank was thus caught in a conflict of interest. The proper course of action, said the learned judge, would have been either to have disclosed the nature of the conflict to the plaintiff's and received their consent or have refused to advise them.

## 2. A Fiduciary Who Self-Deals

The rule prohibiting a fiduciary from self-dealing originated in Keech v. Sandford.<sup>24</sup> Although the rule becomes blurred with other fiduciary principles<sup>25</sup> the duty here is very strict. A leading case, Regal (Hastings) Ltd v.

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24. (1726) Sel Cas Ch 61.

25. See, Hannigan, Insider Dealing (London 1988) at p.102 footnote 49, where she writes: "The no-profit rule was originally regarded as an aspect of the no-conflict rule, although it is now usually regarded as a separate rule in its own right."

Gulliver,<sup>26</sup> illustrates this. There the plaintiff company formed a subsidiary called company A. The aim was for Company A to acquire the lease on two cinemas. However the owner of the cinemas would not lease the cinemas until Company A's share capital was fully paid up. Certain directors of the plaintiff company put their own money into the venture and bought up the remaining shares in company A. The aim was to sell the cinemas but before they could the plaintiff company and company A were taken over by another company. Those directors in the plaintiff company who had bought shares in Company A made a substantial profit. The plaintiff company sued them for the profits they had made. The court held that although the directors had at all times acted bona fide they were nonetheless accountable to the plaintiff company, as fiduciaries, for the profits made.

Arguing by analogy, a director is accountable to his company where, by virtue of his position, he acquires confidential information about the company, for example, an impending takeover, and makes a profit (or avoids a loss) by either buying or selling the company's shares. This is so notwithstanding the fact that the company itself is unable to make a profit from the information.<sup>27</sup>

Boardman v. Phipps<sup>28</sup> is another case in point which clearly shows the vigor with which the courts have applied the "no-profit" rule in respect of preventing fiduciaries from self-dealing. Here Boardman was a solicitor for trustees, and in this way acted as a fiduciary. The trustees were minority shareholders in a private company, X, which was capable of being more profitable than it actually was. While acting as a fiduciary agent for the trustees Boardman obtained confidential information. On the basis of this information

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26. [1942] 1 All ER 378.

27. See, infra Chapter Four at note 91 and accompanying text.

28. [1967] 2 A.C. 46.

he invested his own money in the shares of a company. At all times he acted in good faith. The venture was successful both from Boardman's point of view and from the point of view of the trust. The House of Lords nevertheless held that Boardman must account to the trustees for the profit from the shares. The opportunity for Boardman to make a profit arose from two factors: (1) his fiduciary position; and (2) the use of confidential information acquired by virtue of that position. The solicitor was however entitled to remuneration for his work and skill.

Finally, the decision in IDC v. Cooley<sup>29</sup> yet again illustrates the rigidity of the fiduciary principle against self-dealing by an agent. As well as being a managing director of a design company, the defendant was also a successful architect. He sought to secure a contract for the company with the Gas Board. He was unsuccessful. Following this, the Gas Board approached him and asked him to undertake the contract in his private capacity. Without telling the company, and making out that he was in poor health, the defendant was released from the company and took up the contract with the Gas Board. It was held that the defendant was liable to account for the profit on the contract because following the offer from the Gas Board he: (at page 173-4)

embarked on a deliberate policy and course of conduct which put his personal interest as a potential contracting party with the [gas board] in direct conflict with his pre-existing and continuing duty with as managing director of the [company].

### 3. The Fiduciary Who Erects a Chinese Wall

To recap then, there are two strict duties imposed on fiduciaries: (1) a duty to avoid conflict situations; and (2) a duty to not make a profit from a

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29. [1972] 2 All ER 162.

fiduciary position. With this in mind where does a conglomerate, which operates in a number of conflict situations and which is simultaneously involved in breaching the no-profit rule by virtue of the conduct of its various arms, stand in relation to fiduciary law. As we have seen from Lord Upjohn's statement in Boardman v. Phipps<sup>30</sup> (relying on Lord Herschell's dicta in Bray v. Ford<sup>51</sup>) the common law will tolerate some situations where a fiduciary places himself in a conflict situation and where he, as a result, self-deals. What then are these exceptions? The first is full and frank disclosure of the nature of the conflict of interest; and the second is reliance on a market practice or custom, perhaps such as the use of a Chinese Wall.

#### A. Full and Frank Disclosure of the Conflict of Interest

##### Do Conglomerates owe Fiduciary Duties?

One of the first questions to be addressed is whether conglomerates owe fiduciary duties. There is little U.K. authority on this point, thus analysis must again revert to broad principles. Some of the factors which are crucial to the determination of fiduciary duties include the degree of sophistication of the parties,<sup>52</sup> the degree of discretion vested in the firm

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30. [1967] 2 AC 46, see, supra note 13 and accompanying text.

31. [1896] AC 44, at p.51.

52. See, Chapter Seven note 50 and accompanying text for a list of market participants in the U.K.

and the likelihood of conflict.<sup>53</sup> Arguing by analogy with the situation of broker dealers in the U.S., it may be noted that: "a broker dealer is not automatically regarded as standing in a fiduciary relationship to the customer".<sup>54</sup> However as Wood observes: "A firm acting in an agency or advisory capacity will generally be a fiduciary and subject to the duty of economic loyalty."<sup>55</sup>

Once it has been established that a fiduciary duty of care exists the question then arises as to the way in which that duty is discharged. Probably the clearest and most accurate statement of law in this area is laid down by Sir George Jessel M.R. in Dunne v. English<sup>56</sup>, where he said (at p.533): "It is not enough for an agent to tell the principal that he is going to have an interest in the purchase, or have a part in the purchase. He must tell him all the material facts. He must make full disclosure". Thus in the case of a conglomerate, not only must the broker dealer disclose to his client that he is dealing as principal rather than as agent, but he must also make full and frank

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53. In Industrial Development Consultants v. Cooley [1972] 2 All ER 162, Roskill J said: "The phrase 'possibly may conflict' requires consideration. In my view it means that the reasonable man looking at the relevant facts and circumstances of the particular case would think that there was a real possibility of conflict; not that you could imagine some situation arising which might, in some conceivable possibility in events not contemplated as real sensible possibilities by any reasonable person, result in conflict."

54. Loss, Fundamentals of Securities Regulation (Little, Brown & Company: 1983) pp. 958-968.

55. See, Wood supra note 4 at p.63; see also Austen, "The Corporate Fiduciary: Standard Investments v. Canadian Imperial Bank of Commerce", (1986-87) 12 CBLJ 96 at p.100: "There is, in principle, no reason why a corporation cannot occupy a fiduciary position, though there will be some fine-tuning to be done to identify the persons who may give fiduciary undertakings on the company's behalf and the problem will inevitably arise when more than one corporate executive acquires information or deals on a fiduciary basis."; Woods v. Martins Bank Ltd. [1959] 1 Q.B. 55: "In my judgement, a fiduciary relationship existed between the plaintiff and the defendants [Martins Bank Ltd]; and generally, Standard Investments Ltd. v. Canadian Imperial Bank of Commerce (1985) 22 D.L.R. (4th) 410, discussed supra at note 23 and accompanying text.

56. (1874) L.R. 18 Eq. 524.



disclosure of all material interests.<sup>57</sup> This leads to a number of problems not the least being the definition of what constitutes a material interest? A material interest has been described as an interest sufficient to alter a client's decision about whether to enter into a particular transaction.<sup>58</sup> Therefore the onus would be on a firm to inform the customer that it was, for example, self-dealing by making a market in shares that it might possibly recommend to the customer.

As well as this there is the question of in what circumstances general disclosure might in some instances suffice. As Wood observes, "Specific disclosure will often be impracticable. How can a financial conglomerate disclose in specific detail its multiple interests which might be material?"<sup>59</sup> It would seem therefore that no hard and fast rules can be applied. Each situation must be looked at on its own merits, considering to what degree specific disclosure might have been reasonable and practicable in view of the intensity of the conflict situation. Thus it may well be the case that in some circumstances general disclosure will suffice.

While it might appear that fiduciary ties are particularly onerous, the fiduciary always has the option to make full disclosure to the principal and obtain his consent. However, the interesting point about the Chinese Wall is that more often than not the Wall device operates as the alternative to

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57. See also, New Zealand Netherlands Society Orange' Inc. v. Laurentius Cornelius Kuys [1973] 1 W.L.R. 1126, at pages 1131, 1132 (P.C.): "there must be full and frank disclosure of all material facts".

58. Ibid., at p.1132; see also, infra Chapter Seven note ? and accompanying text for the SIB definition.

59. See, supra note 4 at p. 70.

disclosure.<sup>59a</sup> Indeed, in some of the SIB's new rulebook the incentive is almost overwhelmingly to erect a Chinese Wall and not disclose.<sup>60</sup> It is because of this that the Chinese Wall mechanism can be said to run counter to a conglomerate's fiduciary duties to its customers. Can then the Chinese Wall be considered as falling within the second exception to strict fiduciary duties, that of market usage or custom?

#### B. Market Usage or Custom: The Chinese Wall

It is readily clear from existing authorities that the rule prohibiting a fiduciary from putting himself in a conflict situation or deriving a profit from his fiduciary position is subject to custom or market practice. In Jones v. Canavan<sup>61</sup>, Jacobs J.A. and Manning J.A. stated that where an agent found himself in a conflict of interest his fiduciary duties would be modified by a custom, provided, that is, the custom fulfilled the requirements of notoriety, certainty and reasonableness. As yet it has proved difficult to fulfil this test. In North and South Co. v. Berkeley,<sup>62</sup> for example, a firm of Lloyds insurance brokers placed themselves in a position where their duties and

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59a. See, for example Rule 5.07 discussed infra Chapter Seven at note ? and accompanying text. Of course it could be argued that a notorious custom, such as a Chinese Wall, equals disclosure.

60. See, The Securities and Investments Board application for Designated Agency Status under the Financial Services Act 1986 and the revised rulebook dated February 1987, where it was stated that: "Outside the life insurance/unit trust area, the Board's rules will not preclude a firm operating on a dual capacity basis (e.g. as broker/ dealer). Nor do the rules preclude a group from including firms whose interest and duties may conflict, e.g. a corporate finance arm and investment arm. The rules provide a number of safeguards (many based on disclosure, which the Board considers is effective in these contexts) to protect investors from these conflicts. "Chinese Walls" are not actually required, but the absence of such arrangements within a firm or a group may well attract such severe disclosure requirements to the firm - because otherwise knowledge in any part of the firm is imputed to the whole firm - that it is essential for it to erect and police them."

61. [1972] 2 NZWLR 236.

62. [1971] 1 WLR 470. The case which was distinguished in Jones v. Canavan [1972] 2 NZWLR 236.

interests conflicted by acting as agents for both parties. One of the arguments advanced by counsel for the respondent was that part of the training of an insurance broker was to act in a dual capacity. The fact that it was virtually unknown for an insurance broker to use this dual position to act improperly was proof of "uberrimae fidei". Donaldson J, rejecting this line of argument said (at p.482):

If a usage is to have effect in law it must be at least notorious, certain and reasonable. On the evidence before me, [the Lloyds insurance brokers dual capacity arrangement] may be certain ... For my part, I entertain doubts whether it is sufficiently notorious ... It is sufficient for present purposes to say that I regard the practice as wholly unreasonable and therefore incapable of being a legal usage.

He relied upon the general principle laid down in Fullwood v. Hurley.<sup>20</sup> There Lord Hanworth M.R. said (at p. 502):

if and so long as the agent is the agent of one party, he cannot engage to become the agent of another principal without the leave of the first principal with whom he has originally established his agency"

Donaldson J. also relied on the dicta of Scrutton L.J. who on the same page of the report said:

No agent who has accepted an employment from one principal can in law accept an engagement inconsistent with his duty to the first principal from a second principal, unless he makes the fullest disclosure to each principal of his interest, and obtains the consent of each principal to the double employment."

In a later passage (at p. 483H) Donaldson J summed up the legal conundrum which he and others faced:

[H]ow do you train anyone to act properly in such a [dual capacity] situation? What course of action can possibly be adopted which does not involve some breach of the duty to one principal or the other? I yield to no one in my admiration for the skill and honesty of the insurance brokers and other men of business of the City of London, but neither skill nor honesty can reconcile the irreconcilable.

He was "astonished that Lloyds should have evolved a practice which renders the maintenance of the utmost good faith so fraught with difficulty ... [T]he

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63. [1928] 1 K.B. 498.

practices of Lloyds must not only be reasonable, but must be seen to be reasonable."<sup>64</sup> No doubt the same could be said with regard to other "City Practices". Where then does this leave the City Practice of erecting Chinese Walls? Is the mechanism sufficiently established to constitute a custom or market practice at common law?<sup>65</sup> According to Megaw J in the earlier case of Anglo-African Merchants Ltd v. Bayley<sup>66</sup>, the general principle regarding a market custom could be stated thus:<sup>67</sup>

... a custom will not be held by the courts of this country if it contradicts the vital principle that an agent may not at the same time serve two masters - two principles - in actual or potential opposition to one another: unless he has explicit, informed consent of both principals.

There was more than a hint of Matthew 6 v.24 in this dicta.<sup>68</sup> Megaw J also referred to and approved of the passage in Bowstead on Agency which said:<sup>69</sup>

" ... he may not act for both parties in a transaction unless he ensures that he fully discloses all the material facts to both parties and obtains their informed consent to his so acting ... Any custom to the contrary will not be upheld." (emphasis added)

Consequently, it would seem that the formulation of the principle in Jones is most probably too wide. However in another passage in Bowstead it says:<sup>70</sup>

A custom or usage which converts an agent into a principal or otherwise gives him an interest at variance with his duty is *prima facie* unreasonable, and will therefore be ineffective unless known by

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64. [1971] 1 WLR 470 at p.484, emphasis added.

65. See, R. Nicholson and M. Darling, "Hitting the Chinese Wall", (1986) 60 Law Institute Journal, 1338 at p.1339: "Of course the duty that is implied between an adviser and his client may be limited either expressly by contract or by industry practice. The question thus becomes whether Chinese Walls are a sufficiently well-established part of commercial dealings in the Australian market to represent industry practice." The authors then go on to illustrate how this is probably the case. Reference is made to the Rules and regulations of the Australian Stock Exchange and s.128 of the Securities Industry Code, both of which specifically recognise Chinese Walls.

66. [1970] 1 Q.B. 311.

67. Ibid., at p. 323B and H.

68. There Jesus said: "No man can serve two masters, for either he will hate the one and love the other, or else he will hold on to one and despise the other."

69. Bowstead on Agency 13th ed., at p.144.

70. Ibid., at p. 166.

and consented to by the principal.

Thus, there would seem to be an argument for saying that such a practice is merely prima facie unreasonable at common law and not absolutely; this is crucial for it leaves the door open for common law acceptance of the Wall mechanism in those situations where it is reasonable.

A Chinese Wall would in all likelihood fulfill the notoriety test in most instances.<sup>71</sup> However it is more questionable whether it would always fulfill the certainty and reasonableness criteria. Concerning certainty, the common law might be loathe to accept, in an area as sensitive as this, a mechanism which, from an enforcement point of view, is regarded as suspect.<sup>72</sup> On the issue of reasonableness, the Wall could easily be toppled. This is especially so when anything which goes against the basic fiduciary principle outlined above is prima facie unreasonable. Since the common law will only accept the Wall mechanism where it is reasonable to do so, it is submitted that the means of resolving the reasonableness test depends on an accurate assesment of the degree of conflict and the likelihood of abuse. Essentially these questions are non-quantifiable and are dependant on reasoned judgement.<sup>73</sup>

#### **U.S. Case Law Relating to the Chinese Wall**

Owing to the absence of any more precise U.K. case law relating to the position of the Chinese Wall, analysis must of necessity draw on judicial pronouncements in other jurisdictions. Two U.S. decisions would seem to seem

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71. It has been adopted widely in the industry codes and practices. See generally, infra Chapter Seven. Such notoriety could, therefore, be a kind of disclosure. It could also be argued that a notorious custom gives implied consent and is therefore within the general consent rule.

72. See, Cmnd. 9125 Review of Investor Protection: Report Part II at para. 4.13.

73. See generally, Chapter Nine: Summary and Conclusions.

to support a strict view of fiduciary duties in relation to the interpretation of the Wall mechanism.<sup>74</sup> As noted earlier, the legal controversy surrounding the Chinese Wall is as much to do with the legal implications of effective isolation (and a defence based upon that isolation by those charged with the improper use of material non-public information) as it is to do with concern about the mechanism's ability to isolate inside information. These issues came before the courts in both Black v. Shearson, Hammill & Co.,<sup>75</sup> and Slade v. Shearson, Hammill & Co.<sup>76</sup>

In Black, a common law action brought under State law, the facts were as follows: Shearson Hammill's salesmen recommended that clients should buy shares in X company. A partner in Shearson Hammill became privy to adverse inside information concerning X company by virtue of the fact he was, simultaneously, one of its directors. The issue revolved around why he had not, on discovery of the adverse information, told his salesmen to stop recommending shares in the company. The partner contended (i) he had a duty to X Company not to tell his salesmen; (ii) the existence of an effective Chinese Wall prevented him from communicating the information. It was held: (a) that the partner was in a conflict of duty which was not to be resolved but was to be avoided in advance or terminated when it appeared; and, (b) that the isolation of inside information by a Chinese Wall was in conflict with the firm's obligation to its

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74. Two factors militate against transposing the following American judicial reaction to the U.K. First of all, the Chinese Wall has only been given tentative legislative and regulatory approval in that jurisdiction; and secondly the institutional structure of the U.S. financial markets is less integrated than in the U.K. primarily because of the restraints imposed by the Glass-Steagall Act 1933. Because the integration of financial services is less, there is less possibility of abuse and therefore more likelihood that a Chinese Wall would in fact be acceptable to the courts. See, for example, infra note 82 and accompanying text.

75. 266 Cal. App. 2d 362, 72 Cal. Rptr. 157 (1968).

76. 517 F.2d 398 (2d Cir. 1974). The special facts of both Black and Slade make it difficult to conclude decisively what the judiciary have said and it is generally considered that much still remains unresolved.

clients. The Court of Appeals said that the firm's "conflict of duties [was] 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".<sup>77</sup>

The case however should be given a narrow reading because it involved a particularly unusual set of facts. The Shearson partner who possessed the "bearish" information not only failed to inform the firm's salesmen, but at the same time sold shares in X Company for his own account and for privileged clients. As a result the Wall operated with regard to those clients to whom the firm's salesmen gave advice, but not with respect to the partner's own business dealings. No exception was made for a bona fide Chinese Wall and thus it is little wonder that the court was led to impose liability. It would be wrong, therefore, to interpret the decision as wholehearted judicial disapproval of the Wall mechanism.

The Slade decision, which involved Federal Law, once again raised the whole issue of the departmental isolation of information.<sup>78</sup> Here it was held that a broker could not recommend securities in a company when at the same time the underwriting "arm" was in possession of adverse information which was not made available to the broking "arm". Again the facts were straightforward: salesmen belonging to the firm of Shearson Hammill promoted shares in Y Company. Slade purchased some of these shares. Y Company was, however, an investment banking client of Shearson Hammill's. As a result Slade claimed (1) that Shearson Hammill held adverse inside information about Y Company at the same

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77. 266 Cal. App. 2d 362, 72 Cal. Rptr. 157 (1968) at p.

78. For a helpful review of the cases litigation history, see, Huck "The Fatal Lure of the 'Impermeable Chinese Wall'", (1977) 94 Banking Law Journal 100 at p. 110 et seq.

time as its salesmen were promoting shares in it, and (2) that by making a recommendation while still in possession of adverse information the firm had breached the common law duty it owed to its customers. This was so despite the duty of confidence owed to Y Company.

Shearson Hammill, who, in actual fact, had not used any of the inside information, contended, inter alia, that a Chinese Wall had operated to prevent its salesmen knowing about the information.

The court realised that the effect of introducing a rule proscribing the use of inside information would inevitably, in the context of the multi-service firm, place a firm which acquires inside information from one of its corporate clients, Company X, at a disadvantage vis-a-vis another firm with no such information. The latter firm would not be debarred from recommending the stock of Company X whereas the former would. Speaking on the question of a fiduciary's conflicting duties the Court said:<sup>79</sup>

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

In the ensuing appellate proceedings the SEC along with two leading financial firms submitted amicus curiae briefs. The question presented was:

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 the inside information) it knows to be false or misleading?<sup>80</sup>

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79. [1973-74 Transfer Binder] (CCH) Fed. Sec. L. Rep. 94,329 at 95, 132.

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



In other words could it make a recommendation which, in the light of the corporate group's knowledge as a whole, was patently false?

No direct judicial pronouncement was ever made in answer to this question. But in its submission the SEC concluded that the Wall was an acceptable regulatory mechanism for stemming the flow of inside information between investment banking and broker-dealer type financial services. Nonetheless, it recommended that in such a situation the Wall needed to be "reinforced", eg. through the use of a species of no-recommendation/restricted-list policy.<sup>80a</sup>

It is usual for a no-recommendation policy to operate when inside information is received, only then is the security placed on the restricted-list. The point, however, can be made that the very inclusion of a company's shares on a restricted list is itself price-sensitive information which may constitute a breach of confidence in respect of the company. An indication that something is about to happen with regard to the company would mean that informed traders could easily draw correct conclusions as to whether the financial intermediary knew of adverse or favourable information. In an attempt to by-pass this problem and to circumscribe the use of the Wall mechanism the SEC decided to lay down more stringent requirements. The firm should, said the Commission, restrict a security and withdraw any outstanding recommendations on it when the firm enters into an investment banking or other type of confidential relationship. This is a severe obligation because to fulfill it the security must be placed on the restricted-list before inside information is actually received.

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80a. See, discussion infra Chapter Eight at note and accompanying text.

The reluctance of the U.S. courts to embrace the Wall mechanism has waned considerably.<sup>81</sup> Three further U.S. cases illustrate this. In American American Mendicorp, Inc., v. Continental Illinois National Bank,<sup>82</sup> which involved a loan made by the defendant Bank to finance tender offers, the District court held that the bank could finance the tender offer notwithstanding the fact that a bank customer was the target of the offer. The court's findings were based on the belief that the bank had not used confidential information belonging to the customer.

In Washington Steel Corp. v. TW Corp.,<sup>83</sup> another tender offer case, the matter reached the Court of Appeals. Again the issue at stake was to what extent the law allowed a commercial bank to provide funds to one client in order to facilitate the takeover of another of the bank's clients. Here, Chemical Bank had two clients: Talley Industries and Washington Steel. Chemical Bank agreed to act as "lead bank" for a loan to finance a tender offer that Talley was about to make. The target of the proposed offer was Washington Steel, a company to whom Chemical Bank (and two other banks) had recently issued a loan. During the course of the arrangements for the loan, information, some of which was non-public in nature, was conveyed. Chemical also acted as the registrar of the company's stock. Washington claimed, inter alia, that Chemical had, in deciding to finance the tender offer, broken its fiduciary duty to the company because the decision had been based on the misuse of confidential information provided by Washington.

The District Court found in favour of Washington and issued a preliminary

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81. See generally, *infra* Chapter Seven.

82. No.77 C 3865 (N.D. Ill. 1977).

83. 602 F.2d 594 (3d Cir. 1979).

injunction preventing Chemical from participating in the loan to Talley. The court stated that Chemical "was acting as agent for ... Washington ... and was charged with the responsibility of advancing the best welfare and corporate interests of Washington ... [Chemical thus] ... had a duty not to act adversely to the interests of ... Washington".<sup>84</sup> It was upon this per se fiduciary duty that the Appeal Court first seized. The court rejected Washington's contention that Chemical Bank had breached its fiduciary ties on the basis of important policy grounds and went on to approve the decision in American Medicorp. Thus to some degree at least (none was explicitly stated) the Appeal Court sanctioned the Chinese Wall method of isolation. In a pragmatic judgement in which the court recognised the importance of not upsetting the status quo, as well as the likelihood of congressional action, it said:

establishing a per se common law duty of banks to their borrowers seems archetypically within the domain of legislative judgement. A legislature is best suited to consider the delicate financial issues at stake and strike the appropriate balance between sound economics on the one hand, and expectations of loyalty on the other ... [A]ny state common law that we might imply would likely give way to the preemptive force of federal law.<sup>85</sup>

The court continued, "Congress is aware of this issue and has begun the difficult process of effecting a legislative solution ... any common law duty we might imply would, in all probability, have to yield to whatever national policies might emerge from these deliberations."<sup>86</sup>

On the question of the effectiveness of the Chinese Wall a number of factors needed to be considered. Washington's main argument was that there should be a presumption that Chemical made use of the confidential information conveyed by the former in coming to a decision about making the loan to Talley.

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84. 465 F. Supp. 1100 (W.D.Pa. 1979) at p. 1104.

85. 602 F.2d 594 (3d Cir. 1979) at p.601.

86. Ibid.

The court however rejected this view, coming to the conclusion that:

there was ... no showing that those Chemical officers who were involved in the loan with Talley made any use of the information provided to Washington. We refuse to presume such a use on the basis of an unsupported assumption that, in view of Talley's ostensibly weak financial condition, Chemical would not have decided to make the loan to Talley had it not known of Washington's assertedly bright future.<sup>87</sup>

The court drew attention to the fact that Chemical Bank staff were "instructed not to talk to anyone who worked on the Washington account, nor [were they] ... to look at any files kept on the target company."<sup>88</sup> That the Wall had been further strengthened could be found in statements submitted by senior Chemical Bank official who maintained that they had personally secured all Washington files and made sure they were not available to persons working on the Talley loan.<sup>89</sup>

In the 1981 New York State Supreme Court decision in Connell v. Chase Manhattan Bank, N.A.,<sup>90</sup> further support for judicial acceptance of the Chinese Wall was found. Chase Manhattan Bank, "Chase", which acted as a pensions fund adviser, was simultaneously a lender to Villager Industries. Chase recommended that the trustees of the pensions fund purchase Villager shares as part of their portfolio. Upon purchasing the stock, it fell in value and was later sold at a loss. The trustees alleged Chase had committed a breach of its obligations in that when the advice to purchase Villager stock was made the bank had knowledge about Villager's financial difficulties. The trustees claimed that Chase ought to have disclosed the nature of its lending relationship with Villager. There was no evidence adduced to show that the actual department which advised the pensions fund actually possessed the information,

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87. Ibid., at p. 602.

88. Ibid., at p. 603.

89. Ibid.

90. NYLJ (Jan 15, 1981) p.7, col.1.

nor did the trustees claim that Chase Manhattan was under a duty to disclose the inside information.

The Court held that no conflict of interest was created by Chase's lending relationship and its advice to the pension's fund. Consequently, the court was of the opinion that Chase was not under a duty to its pension advisory unit of the range of its lending relationships. On the question of whether knowledge of the adverse inside information it said:<sup>91</sup>

[T]he legal inference of imputed knowledge is designed to represent the probable truth in situations in which an organisation is so designed that knowledge of one part will, or should be brought to the attention of another part. It has no application to a case in which a deliberate block to an otherwise appropriate flow of information has been created.

While the American Mendicorp, Washington Steel and Connell decisions do sanction the use of the Chinese Wall, reliance on the use of the technique must nonetheless be confined to the narrow facts of each of the cases - dealing with bank finance for a loan for a proposed tender offer of another bank customer in the first two; and, with advising pension funds in the latter. Whether a similar finding would be reached in a fully integrated financial environment, the like of which exists in the U.K., is more questionable. However, the Connell decision does seem particularly relevant.

#### **Other Relevant Case Law**

Of course in Britain, in the context of fully blown financial conglomerates, it is necessary to consider to what extent a 'naked' Chinese Wall is legally valid as opposed to the Slade 'reinforced' Wall. In other

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91. Ibid.

words in what circumstances would a conglomerate which erects a 'naked' Chinese Wall between its departments incur civil liability for acting or failing to act when the crucial facts pertaining to an investment decision are known by another department within the same company? Essentially the issue is whether traditional fiduciary principles should be modified to deal with the post Big Bang situation where a financial conglomerate purposely becomes involved in types of financial sector activity that will inevitably lead to conflicts of duty and interest.<sup>92</sup>

Since, as we have seen, there is no U.K. authority on point it might be helpful to look more closely at the recent Canadian case Standard Investments Ltd. v. Canadian Imperial Bank of Commerce<sup>93</sup>, where the matter of the Chinese Wall was addressed, albeit implicitly. There it will be recalled that the defendant Bank allied itself with two opposing groups involved in a takeover, thus placing itself in a classic conflict of interest situation.

Though the issue of the use of the Chinese Wall to prevent the flow of confidential information between the Bank officers was not raised as a defence by the bank, what if it had? Whether the isolation technique was impliedly rejected by the court remains a moot academic point.<sup>94</sup> A number of passages in Goodman J.A.'s judgement deserve closer scrutiny. The case also highlights some of the important issues discussed above. One of the crucial questions

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92. See, Zeigle, "Bankers Fiduciary Obligations and Chinese Walls: A Further Comment on Standard Investments Ltd. v. Canadian Imperial Bank of Commerce", (1986) 12 CBLJ 211 at p.213.

93. (1985), 22 D.L.R. (4th) 410, 52 O.R. (2d) 473.

94. Professor Zeigle is of the opinion that "any implicit rejection of ... [the Chinese Wall] by the court was at best obiter and grounded on the particular facts before the court. In my view, there is no binding precedent precluding an appellate Canadian court from accepting the defence where the facts warrant it", see, supra note 92 at p.212. But compare generally with, Austen, "The Corporate Fiduciary: Standard Investments Ltd. v. Canadian Imperial Bank of Commerce", (1986-87) 12 CBLJ 96.

which needed to be answered in Standard Investments was to what extent a corporation could owe fiduciary duties. Goodman J.A. recognised that the fact that the defendant was a corporation raised some difficult problems. These he sought to resolve by reference to existing case law, extracting, as a consequence, the doctrine of identification; that is the idea that acts and intentions of corporate officers are attributed to the actual company itself when a mens rea offence is applicable to that company.

He first relied on the dictum of Denning L.J., as he was then, in the H.L. case of Bolton (Engineering) Co. Ltd. v. T.J. Graham and Sons Ltd., [1957] 1 Q.B. 159 at p.172, where he said:

A company may in many ways be likened to a human body. It has a brain and nerve centre which controls what it does. It also has hands which hold the tools and act in accordance with directions from the centre. Some of the people in the company are merely servants and agents who are nothing more than hands to do the work and cannot be said to represent the mind or will. Others are directors and managers who represent the directing mind and will of the company, and control what it does. The state of mind of these managers is the state of mind of the company and is treated by the law as such.

Goodman J.A. also considered Lord Reid's dicta in the House of Lords case of Tesco Supermarkets Ltd. v. Nattrass, [1972] A.C. 153, where Denning L.J.'s passage in Bolton was interpreted. There Lord Reid said:

There have been attempts to apply Lord Denning's words to all servants of a company whose work is brain work, who exercise some managerial discretion under the direction of superior officers of the company. I do not think that Lord Denning intended to refer to them. He only referred to those who "represent the directing mind and will of the company, and control what it does".

Goodman J.A. then went on to deal more formally with the identification doctrine as outlined by Estey J. in the Supreme Court of Canada decision in Canadian Dredge & Dock Co. Ltd. et al v. The Queen (1985), 19 D.L.R. (4th) 314, 19 C.C.C. (3d) 1, 45 C.R. (3d) 289. At p.335 D.L.R. he said:

Criminal responsibility in our courts thus far has been achieved in the mens rea offences by the attribution of the corporation of the acts of its employees and agents on the more limited basis of the doctrine of the directing mind or identification.

In a later passage at p. 351 D.L.R. Estly J. said:

Where the criminal act is totally in fraud of the corporate employer and where the act is intended to and does result in benefit exclusively to the employee-manager, the employee-directing mind will, from the outset of the design and execution of the criminal plan, cease to be a directing mind of the corporation and consequently his acts could not be attributed to the the corporation under the identification doctrine. This might be true as well under the American approach of respondeat superior. Whether this is so or not, in my view, the identification doctrine only operates where the Crown demonstrates that the action taken by the directing mind (a) was within the field of operation assigned to him; (b) was totally in fraud of the corporation, and (c) was by design or result partly for the benefit of the company. (emphasis in the original)

Goodman J.A. was of the opinion that the identification doctrine as related to the criminal process was "equally applicable" to a civil case.<sup>95</sup> He then went on to consider exactly who constituted the directing mind and will of the bank and to find out whether, in the course of the bank's attempt to fulfil its obligations, there had been a failure to discharge the fiduciary duties that were ultimately found to have been owed to the plaintiff's. In a crucial passage the learned Judge said:<sup>96</sup>

It is my opinion that as a matter of law a corporation may have more than one directing mind operating within the one field of operations but I am of the further view that where such a state of affairs exists, a corporation cannot be found in law to have a split personality so that it can rely on the lack of knowledge on the part of one of its directing minds of the acts, intention and knowledge of the other directing mind operating in the same sphere to protect it from liability for the actions of the first directing mind or the combined activities of both directing minds. At least, in civil cases, where the element of mens rea is not applicable, when there are two or more directing minds operating within the the same fields assigned to both of them, the knowledge, intention and acts of each become together the total knowledge, intention and acts of the corporation which they represent.

Goodman J.A. then went on to consider the fiduciary aspect. He saw no

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95. In fact the doctrine was first posited in the civil case of Lennard's Carrying Co. Ltd. v. Asiatic Petroleum Co. Ltd., [1915] A.C. 705 (H.L.).

96. See, supra note 93, at p.430 D.L.R.



difficulty in holding a bank to be a fiduciary,<sup>97</sup> concluding that the Defendant bank did in fact occupy that position with respect to the plaintiff's and had failed to discharge its fiduciary duties. This was so because the plaintiff's "were relying on the advice, assistance and guidance of the defendant, [and] that the defendant through Wadsworth was aware of ... that reliance".<sup>98</sup> Goodman J.A. thought that the crucial question was whether it would have made any difference to the plaintiff's had they known that "the bank was purchasing Crown Trust stock with a view to eventually acquiring a 10% interest for the purpose of thwarting any attempt by [the plaintiff's] to acquire control of Crown Trust."<sup>99</sup> The learned Judge thought that such knowledge would have "dissuaded them from making the attempt." In the final analysis Goodman J.A. was of the opinion that:<sup>100</sup>

The breach of duty on the part of the defendants consisted in its failure to declare its conflict of interest at any time, its subsequent giving of assistance and advice, and its later sale of its shares (the acquisition of which and the purpose of such acquisition it had never revealed to the plaintiffs) for its own benefit and to the detriment of the plaintiffs ... [T]he defendant had a duty to disclose any conflict of interest and to deal fairly with the plaintiffs. This it did not do. It practised secrecy and non-disclosure while pursuing its own interests in retaining some of the plaintiffs and obtaining others of the plaintiffs as customers of the bank and in the sale of Crown Trust shares for its own benefit and for the benefit of another customer.

Thus it was held that a bank could not place itself in a conflict of interest situation by advising two separate customers or deal on its own account, without full disclosure. Of course the fact that Chinese Wall separation was not argued makes it difficult to draw any hard and fast conclusions, and the strict interpretation of fiduciary duties may be based on the particular facts of the case.

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97. Ibid.

98. Ibid., at p. 435.

99. Ibid., at p. 440.

100. Ibid.

But is it not true that a number of other problems are likely to arise with Goodman J.A.'s interpretation of the possibility of there being more than one directing mind and will of a company? At first blush it might appear that his dicta is in conflict with the decision in Strain v. Armstrong<sup>101</sup> which lays down the principle that two innocent minds do not add up to one guilty mind.<sup>102</sup> However this is not so. Goodman J.A. restricts his dicta to those situations where, in a civil case, the element of mens rea is not applicable. Since in establishing breach of fiduciary obligations it is not necessary to show a guilty mind, the learned judge had no difficulty in applying the doctrine. As well as this, Goodman J.A. further confined the scope of his ruling to situations where the two or more directing minds operated within the same field assigned to both of them.<sup>103</sup> As a consequence, there would seem to be scope for an alternative analysis in those factual situations where the directing minds and wills did not operate within the same sphere of business. Even so, the natural corollary of Goodman J.A.'s decision would be to expose a corporate fiduciary with a number of directing minds to vast potential liability. Moreover, financial conglomerates, operating banking and securities arms would, most likely, be forced to divest themselves of conflicting interests for fear of liability in those situations where the directing minds were deemed to be operating in the same business sphere, notwithstanding the establishment of a perfectly effective Chinese Wall.

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101. [1951] 1 K.B. 232.

102. That case involved liability for an intentional tort where intention to deceive or recklessness with respect to the accuracy of the misrepresentation was an essential ingredient. Thus the principle of Armstrong v. Strain is restricted only to cases of deceit where the individual has acted dishonestly and does not apply to negligence cases. See, The "Pantanassa" [1958] 2 Lloyd's Reports 449 at p.457.

103. One Canadian commentator has sought to argue that Goodman J.A.'s dicta "...is not the language of rigidity and, so far from shutting the door to the defence of Chinese Walls, it seems to leave it distinctly ajar", see, supra note 92 at p. 222. His argument is based on a narrow reading of the Standard Investments case, which it must be said, is most probably correct.

The tenor of the decision in Standard Investments, even if a case on very special facts, along with the general emphasis of English case law, would seem to stand in stark contrast to the regulatory trends currently dominating the world's major financial centres - the U.K., U.S., and Japan<sup>104</sup> and to a lesser extent in Canada and Australia and indeed elsewhere. In the U.K., for example, the thrust of the decision runs counter to the Chinese Wall ideas expressed in s. 47 and 48 of the Financial Services Act 1986, the SIB rulebook derived therefrom, the Securities Association (TSA) rulebook and also the exempt market-maker status and discretionary fund management status contained in the newly remodelled Takeover Panel Codes. In the following Chapter it is proposed to trace the recent legislative and regulatory approval of the Chinese Wall mechanism in both the U.S and the U.K.

### **Summary**

Chapter Six takes a look at the common law position of the Chinese Wall in the U.K. To this end the chapter is broken into three main sections: (1) conflicts of interest per se; (2) using a fiduciary position to secure a profit; and, (3) the extent to which separation via the Chinese Wall modifies strict fiduciary duties. Concerning the last section, owing to the absence of direct authority on point, the analysis draws on authorities from a number of jurisdictions, mainly the U.S., where the most explicit judicial comment on the use of the mechanism is yet to be found. As the analysis of the relevant case law tends to indicate, there exists a tension between on the one hand what appears to represent the legal situation at common law and on the other the

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104. For regulatory approval of the Chinese wall in Japan see, McVea, "Japanese Moves to Control Insider Dealing", (1988) December FT, FFR, 19.

strong endorsement which the mechanism has found in statute law and the rules and codes derived therefrom. Nonetheless a few U.S. decisions have, even if only in very specific situations, endorsed the Chinese Wall as a suitable regulatory mechanism in resolving both conflicts of interest and obligation. This would seem to be in accord with recent regulatory developments and legislative initiatives within that jurisdiction. These are reviewed in the next section.

Arguing by analogy, the U.K. courts could well follow their American counterparts and hold the Wall to be valid in certain special circumstances. What these circumstances are, it is suggested, is somewhat dependant on certain public policy objectives considered in Chapter Eight. Consequently an analysis of the exact legal validity of the Wall, in so far as that is possible, is deferred until the final chapter - Chapter Nine.

**CHAPTER SEVEN: LEGISLATIVE AND REGULATORY APPROVAL OF  
CHINESE WALLS IN THE U.S. AND THE U.K.**

**1. The U.S.: An Introduction**

In the U.S., the use of the Wall mechanism following the SEC's Merill Lynch decision,<sup>1</sup> developed largely on a pragmatic basis. The Slade<sup>2</sup> and Black<sup>3</sup> cases while raising many interesting issues resolved little of the uncertainty or confusion. Recently the trend has been to specify more clearly the exact use of the device. For example as early as 1977 the Comptroller of Currency issued regulations requiring national banks to establish "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."<sup>4</sup> Moreover the burgeoning legislative developments covering insider dealing in the U.S. securities markets has moved the discussion of the mechanism into the congressional arena. These developments and their link with the Chinese Wall are now considered.

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1. Re Merrill Lynch, Pirece, Fenner & Smith, Inc., Fed. Sec. Law reports, 83,347.

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

3. 517 F.2d 398 (2d Cir.1974).

4. 12 C.F.R. Rule 9.7(d) (1983).

## Recent SEC and Legislative Approval of the Chinese Wall<sup>5</sup>

### The Insider Trading Sanctions Bill 1984

It had been intended that an express Chinese Wall provision would be included in the Insider Trading Sanctions Act 1984 (ITSA) to cover the situation where one employee in a firm was in possession of inside information about certain stocks and another employee, not apprised of the pertinent information, put through deals in those stocks. However both Congress and the SEC were of the opinion that the ITSA and existing legislation implicitly provided this protection. Thus it was decided that the SEC should use its rulemaking powers under the ITSA to deal with such situations on an ad hoc basis. Accordingly, the legislative history of the statute states:

The Committee ... believes that there should be certain limits on the liability of a multi-service firm, such as a broker dealer or insurance company, where one employee possesses information but another employee, not knowing of the information, trades for the firm's account before the news is public. Under existing law and the bill, such a firm with an effective "Chinese Wall" would not be liable for trades effected on one side of the Wall, notwithstanding<sup>6</sup> inside information possessed by firm employees on the other side.

However, it is arguable whether this statement accurately reflects the correct

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5. The author has decided to discuss SEC approval and U.S. legislative developments with regard to the mechanism in the same section due to the fact that in the U.S. the SEC plays an instrumental role in devising policy initiatives and in drafting much securities legislation. Note, also the Draft Federal Securities Code which was the American Law Institute's attempt at a codification of U.S. securities laws. According to Varn, "The Multi-Service securities Firm and the Chinese Wall: A New Look in the Light of the Federal Securities Code", (1984) 63 Nebraska Law Review 197 at pp.234, "[the Code] ... has stepped quite gingerly in its approach to the Chinese Wall ... Early drafts of the Code did not mention the problem." The ultimate outcome of the code had been to afford the courts the opportunity to consider the existence of the Chinese Wall or other procedures when determining the imputation question. Thus the position advocated is much the same as that in existence under U.S. statute law. See, infra at note 6 and accompanying text.

6. Report of the House Comm. on Energy and Commerce to Accompany H.R. 559, H.R. Rep. No. 98-355, 98th Cong., 1st Sess. 11 (1983).

legal position with regard to the validity of the Chinese Wall in the U.S.<sup>6a</sup> Indeed as one U.S. Senator recognised<sup>6b</sup>: "By deleting the statutory exemption it is my intention to provide the Commission flexibility in order that they may deal equitably with this situation on an administrative basis." It would seem therefore that the validity of the mechanism rests on a largely pragmatic footing.

### Recent SEC Rule Changes

#### (i) Rule 14e-3

In 1980 the SEC introduced Rule 14e-3.<sup>7</sup> The adoption of the Rule represented the SEC's first significant exercise of its rulemaking authority in connection with the Chinese Wall. Rule 14e-3 has now been incorporated into the SEC sponsored Insider Trading Bill 1987<sup>8</sup>

It might be worth noting some of the SEC comments on the operation of Rule 14e-3. Indeed the analysis could equally apply to the attempt to place it on a statutory footing in the Insider Trading Bill 1987.

It will be remembered from Chapter Four ("U.S. Tender Offers") that the exemption from an allegation of insider dealing was dependant on two factors:

(1) a lack of knowledge by the individuals concerned in putting through the

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6a. For a tentative exposition of the law, see, note 27 and accompanying text.

6b. Senator Alfonse D'Amato, 130 Cong. Rec. S8911, S8913-4 (daily ed. June 29, 1984):

7. See, SEC Securities Exchange Act Release No. 17,120, 45 Fed. Reg. 60,410, 60,418; [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) p. 82, 646 (4 September, 1980). The Rule was discussed infra at Chapter Four, "U.S. Tender Offers".

8. Discussed infra at note 22 and accompanying text.

deal(s); and (2) that the firm had implemented one or a combination of policies and procedures, reasonable under the circumstances", taking into consideration the nature of the person's business.<sup>9</sup> It is important to note that there are a range of possible measures. According to the SEC these might include a "Chinese Wall", a "Watch List", or a "Restricted List".<sup>10</sup> The key phrase then is: "procedures, reasonable under the circumstances". The circumstances will undoubtedly be highly dependant on the nature of the trades. For example the SEC states that a broker-dealer firm can not continue to trade for its own account when the firm is in possession of material non-public information concerning a tender offer<sup>11</sup>, ie. under the Rule the firm cannot self-deal. This is significant because a 'naked' Chinese Wall will not, as a result, be sufficient in every event.

It would seem that the SEC aims to treat every situation on its own merits and rely on the prudence of investment firms to ensure that the most appropriate measures are taken to fit any given factual context. This is far from giving a "safe harbour" Chinese Wall exemption.<sup>12</sup> It is a policy orientated approach in which the firm will have to justify the use of a naked Chinese Wall as opposed to more stringent procedures. No doubt the Wall may be used in instances where the potential for conflict abuse is slight; a Watch List where there is an increased potential for abuse; and a Restricted List for really serious potential abuse.

The SEC has also made it clear that "it may be appropriate [for the firm]

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9. The wording in the Insider trading Bill 1987 is not identical but it is similar. See, below at note 22 and accompanying text.

10. Supra, note 7 at p. 83, 461.

11. Ibid., at p.83,462 n.42. Note also, that: "Policies and procedures which may be reasonable for one institution may not be reasonable for another institution, even in the same industry" (at p. 83,461).

12. See, Varn supra note 5 at p.234.



to advise customers of its use of [such procedures] ... because the institution would not be using all information it had received to the benefit of a particular customer".<sup>13</sup> Whether the courts would accept this as sufficient disclosure is uncertain. It might also impose an added burden on the firm.

(ii) Rule 17j-1

In 1980 the SEC also adopted Rule 17j-1 in accordance with powers granted under the Investment Company Act 1940.<sup>14</sup> The rule is aimed generally at neutralising conflict of interest situations in the investment company context. A typical situation might be where an investment adviser is long on the stock of Company X and is eager to off-load it. As a consequence he might advise a fund to acquire some of this stock irrespective of the whether there is a better deal available. By virtue of paragraph (b) of Rule 17j-1 there is scope for a Chinese Wall provision in such situations. Here investment companies and each investment adviser of, and principal underwriters for, an investment adviser must comply with a written Code of ethics. The Code contains provisions reasonably necessary to prevent persons such as directors, officers and general partners and such like (called "access persons") from committing anti-fraud violations. Investment companies are required to use reasonable diligence to uncover violations of the Code.

Under paragraph (b) of the Rule the SEC envisaged the use, by investment companies, of the Chinese Wall to avoid liability by using the mechanism to rebutt the presumption that "access persons" who were about to acquire or dispose of a security were: (1) aware of the fact that the investment company

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13. Supra note 4 at p.83, 461.

14. Investment Company Act Rel. No. 40-11421 [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) p.82,679 (October 31, 1980).

was, or was considering, purchasing or selling the same security; and (2) aware that the security was being recommended (or was about to be recommended) for purchase or sale by the investment company.<sup>15</sup>

### (iii) Specialists

In 1987 the SEC gave approval to proposed rule changes affecting the provision of certain financial services on the American (AMEX) and New York (NYSE) Stock Exchanges.<sup>16</sup> The new rules involved sanctioning the use of a Chinese Wall in isolating certain types of inside information flows. Under the new regime a number of prohibitions previously imposed on retail financial service firms affiliated with what are known as "Specialist" business units were relaxed.<sup>17</sup>

Because of the important role specialists perform and the potential threat of conflict of interest abuse when specialist services are provided within the context of larger "diversified" financial firms, the operations and affiliations of specialists were in the past closely monitored. Although no rules on either exchange ever prohibited retail brokerage firms, or larger conglomerate or "diversified" firms, from owning or controlling specialist units, there had always existed strong incentives for not doing so. Up until the introduction, and SEC approval, of the new measures, financial intermediaries affiliated with specialists were restricted from undertaking a number of financial services in relation to "speciality" securities. These restrictions were a regulatory attempt to neutralise the potential for abuse

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15. Ibid., at p.83,735.

16. See, SEC Rel. No.34 - 23768.

17. A specialist is a special type of market maker responsible primarily for maintaining "an orderly succession of prices in related stocks".

which inevitably arose when the "mixing" together of associated, but conflicting, financial services took place. The SEC's approval of the Exchanges' new rule changes were designed to ease these restrictions provided an effective Chinese Wall, between the diversified firm and the specialist unit, was established.

In a document accompanying the SEC's stance it was recognised that the new measures raised basic questions regarding the regulation of informational advantages and the viability of the Chinese Wall. The Wall was defined as "the combination of policies and procedures, reasonable under the circumstances, to ensure that material, non-public information is not passed between certain departments within the one entity".<sup>18</sup>

Despite the Commission's approval of the new arrangements, a degree of apprehension was, nonetheless, expressed.<sup>19</sup> The SEC's fears centred on the development of significant conflicts of interest unless appropriate Chinese Wall procedures and the monitoring and surveillance of the continuing adequacy of those procedures could be found. Notwithstanding this, the Commission considered that the policies and surveillance system that the NYSE intended to implement addressed these concerns. Indeed, it was swayed by the fact that the Exchange had devised additional safeguards requiring the specialist who became privy to "market sensitive" information to communicate this fact promptly to his firm's compliance officer. Once done, it was the responsibility of the compliance officer to suggest what procedures the specialist should then follow after receipt of such information.

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18. Letter to the author from Ellen K. Dry, SEC Attorney, 2 April 1987.

19. See, Memorandum accompanying SEC Release No. 34-23768 at p.23 et seq.

In assessing whether the Wall was an appropriate regulatory mechanism in dealing with conflicts of interest arising from the lifting of restrictions between specialist units and other financial entities, the SEC sought a response from the U.S. business community. This response was mixed. Those who objected to the SEC's approval, stressed the insufficiency of the mechanism in alleviating potential conflict of interest abuse. It was feared that the Wall would not ensure "independence of operations" and that generally the effectiveness of the surveillance of the mechanism was decidedly suspect.

There was, however, support for the proposal. Of the 12 firms solicited half were of the view that the Wall was effective in preventing the exchange of material, non-public information among potentially conflicting departments. They based this view on the success of similar Chinese Wall procedures created to separate sensitive activities such as investment banking and research, and trading and sales activities. Some stated that a retail brokerage house, or a "diversified" firm, about to undertake speciality work in conjunction with an affiliated specialist unit, would not put its reputation in jeopardy, or risk losing its specialist franchise, by permitting the Chinese Wall to be loosely enforced. As well as this, severe penalties for any infringement of the Wall are to be imposed by way of an added deterrent.

#### The First Boston Case

In a recent SEC enforcement action against the First Boston Corporation<sup>20</sup> the issue of the Chinese Wall and Restricted List was raised. The case was settled out of court; thus the outcome reflects the SEC's attitude to Chinese

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20. SEC v. The First Boston Corp., 86 Civ. 3524 (S.D.N.Y. May 5, 1986).

Walls rather than that of the courts.

Cigna Corp. was a client of the First Boston Corporate Finance Department. First Boston operated Chinese Wall and Restricted List policies. On 21 January 1986 Cigna Corp. told First Boston's Managing Director that it was considering a \$1 billion addition to its property casualty loss reserves. This news was highly price sensitive and was certain to depress the price of Cigna's securities when publicly announced. As a consequence the Managing Director had Cigna's securities added to the firm's Restricted List. A few days later Cigna informed First Boston that it was about to announce the news publicly. First Boston's Managing Director duly informed the firm's research analyst. He in turn relayed the news to the Company's head equity trader who directed another First Boston trader to unload Cigna securities held in the firm's own inventory of stocks. The trader did this but also bought Cigna put options which were later sold. Following the announcement Cigna's shares fell. As a result First Boston made a profit on the transactions amounting to \$132,138.

It was alleged by the SEC that although Cigna had been on the First Boston restricted list for some nine days the head equity trader had failed to consult the list even though it was in his possession. Moreover First Boston's compliance team failed to uncover trading in Cigna's securities for the firm's own account. The facts came to light following a NYSE internal audit trail.

In the settlement that followed First Boston was absolved from unlawful

conduct<sup>21</sup> and agreed to forfeit the profits on the insider trades and to pay a further civil penalty of \$264, 274. As well as this the firm was required to undertake a thorough review of its Chinese Wall and Restricted List procedures and submit a report to the SEC.

#### The Insider Trading Bill 1987

A recent SEC initiative, currently before a Congressional Committee, intends to add a new s.16A to s.16 of the Securities Act 1934.<sup>22</sup> Under the Bill the SEC gives approval to the "segregation approach" in dealing with abuses of conflicts of interest whereby knowledge of events in one department are kept separate from events in another department. By virtue of s.s (b) (2) of the Commission's proposal, integrated securities houses, who would otherwise be in breach of s.s (b) (1)<sup>23</sup> or s.s (d) (1)<sup>24</sup> are afforded a Chinese Wall defence in the situation where one individual in the firm has material, nonpublic information about a security which another individual in the firm deals in for the firm's own account. The firm is exempt from liability when it can show both:

- (1) that the individual(s) making the deal was not aware of, or influenced by the information; and
- (2) that the firm operated reasonable procedures such as a Chinese Wall and/ or

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21. First Boston's President, Peter T Buchanan has explained the situation as follows: "The individuals involved with this trading did not appreciate that this information was confidential or that trading had been restricted ... [It] was an inadvertent but serious violation of [the firm's] restricted list procedures". See, "First Boston's Nasty Spill at the 'Chinese Wall'", (1986) 19 May Business Week 87 at p.88.

22. For a short review of the SEC's proposal, see, McVea, "U.S.: A Compromise Proposal for the Regulation of Insider Trading", (1988) 9 BLR 239.

23. Ibid.

24. See, the passage below at note 25 and accompanying text dealing with tender offers.

restricted list, to ensure that material, nonpublic information did not flow from one department in the firm to another.

The SEC Bill gives a Chinese Wall exemption to firms involved in "tender offers" or in British parlance - take-overs. This is significant for two reasons. First, tender offers provide the most lucrative means of trading on the basis of inside information and secondly, the effect of such trading on market prices is invariably significant.

Subsection (d) codifies the existing law in this area as laid down by the Commission's own Rule 14e-3.<sup>25</sup> This rule prohibits the use of inside information, (except for the Chinese Wall exemption contained in s.16(b)(2)) in connection with a tender offer provided certain criteria are fulfilled. First, that "substantial steps" have taken place to commence the offer (the term "substantial steps" is used because prior to that stage it is generally assumed that there is nothing for the Company to publicly disclose). Secondly, that trades have been undertaken at a time when the trader was in possession of material nonpublic information relating to the tender offer, if he (the trader) had known or recklessly disregarded the fact that the information had been acquired directly or indirectly from the offering person, the target, or any of those persons' agents. Communications of such information with regard to the aforementioned persons would also be prohibited, except in respect of certain

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25. Another initiative known as S.1380 differs significantly from the SEC on this matter. Under its terms a wide approach is adopted covering any transaction extending beyond tender offers. The communication of material, nonpublic information in this context would be prohibited other than to members of that person's group.

"good faith" communications.<sup>26</sup>

### The New Insider Trading and Securities Fraud Enforcement Act of 1988

The new legislation, sponsored largely by the SEC, contains amendments concerning supervision in certain sectors of the U.S. financial markets. With respect to Brokers and Dealers s.15 of the SEA 1934 is amended by adding the following new subsection:

(f) Every registered broker or dealer shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such broker's or dealer's business, to prevent the misuse in violation of this title, or the rules or regulations thereunder, of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer. The Commission, as it deems necessary ... shall adopt ... regulations to require specific policies or procedures reasonably designed to prevent misuse in violation of this title ... of material nonpublic information. (emphasis added)

Under newly implemented s.204 of the Investment Advisers Act 1940, the above procedural policies are also applicable to prevent the misuse of nonpublic information by Investment Advisers. In effect these procedures require, inter alia, the establishment of Chinese Wall informational barriers to ensure that inside information acquired by one arm of the firm is not transmitted and used by another arm of the financial entity. The provisions represent the first time that the Chinese Wall concept has been explicitly enshrined in statutory language in the U.S.

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26. It is interesting to note that in Congressional submissions some members of Congress have stated that arbitrageurs are: "hiding behind their Chinese Walls, rather than using them". See, Hearing Before the Subcommittee of Telecommunications and Finance, 100th Cong., 1st Sess. (5 March, 1987) (Statement of Representatives Edward J. Markey).



## Comment on the SEC's Use of the Chinese Wall Mechanism

In view of the forgoing it might appear that the SEC's position on the Chinese Wall as outlined in the Slade appellate proceedings is now redundant. Certainly the SEC has reappraised the use and validity of the mechanism. Its use has been extended. Such store would in all likelihood be important in a judicial ruling. But the Chinese Wall can in no way be regarded as a safe harbour in every context.<sup>27</sup> Even in those instances where, for example, in theory the SEC sanctions the use of the 'naked' Chinese Wall, a common law action brought on the basis of breach of fiduciary duty might oust the use and reliance upon the mechanism if its adoption is not reasonable. However it would seem that reliance upon the mechanism in an administrative action is a more soundly based proposition, especially where a specialist<sup>28</sup> is involved. In the SEC's memorandum accompanying the introduction of the Chinese Wall in respect of specialists there was no mention made that a 'naked' Chinese Wall would be insufficient in the self-dealing scenario - the Wall merely needed to be effective, the implication being that an effective Wall, and reliance upon it, is reasonable. This may well establish the criteria to be applied to other administrative Chinese Wall rules, reflecting a change in the way the U.S. aims to trade-off its policy choices in the light of global deregulation. To what extent the same analysis may be applied to an action brought under state or federal law for breach of fiduciary duty is uncertain.

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27. As Varn observes supra note 5 at p.234 "In its release accompanying the formal adoption of rule 14e-3 the SEC took pains to note that the Chinese Wall is neither mandated by the rule nor is a foolproof defence to a charge of insider trading." But compare this with Levine et al, "MultiService Securities Firms: Coping With Conflicts in a Tender Offer Context" (1988) 23 Wake Forest Law Review 41, (where it is argued (at p.61) that with Rule 14e-3 the SEC has provided a Chinese Wall safe-harbour for firms).

28. See, supra note 16 and accompanying text.

In assessing the credibility of the Wall in the U.S. and comparing it with the position in the U.K., it must be borne in mind that given the segregation of commercial banking and securities business under the Glass Steagall Act 1933, the Wall is not used in the context of situations which regulators have traditionally considered to be very susceptible to abuse. In addition the Wall in the U.S has not been given such explicit and extensive regulatory and legislative recognition as is the case in the U.K. The remainder of Chapter Seven illustrates this.

## 2. The U.K.: Official Recognition of the Chinese Wall

### Developments Pre-Big Bang

#### (i) The Takeover Panel

While financial conglomerates covering the full range of financial services were peculiar to Big Bang, the mixing together of potentially conflicting financial services was a common feature of the U.K. financial services industry for some time prior to 1986. Merchant Banks in particular were involved in providing a range of financial services which at times led to undoubted conflicts of interest.<sup>29</sup> The first self-regulatory endorsement of the Chinese Wall concept in the U.K emanates from the Takeover Panel's Statement on the Use of Confidential Information.<sup>30</sup> The Panel said:<sup>31</sup>

the risk of occasional abuse from the duality of function [ie., financial intermediaries operating in a number of potentially conflicting capacities] is far outweighed by the manifold advantages that duality brings

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29. See generally, Rider, "Conflicts of Interest and the Chinese Wall" 81 in The Regulation of Insider Dealing (Ed. Rider, Oyez 1979).

30. See, Annual Report 1970, Appendix I. The statement is reproduced at Appendix IV at the end of this thesis.

31. See, Annual Report 1970 p.12.

Throughout the 70's the Panel continued to emphasise the importance of the segregation technique in a number of its non-binding decisions.<sup>32</sup> However, in its statement on the case of Mount Charlotte Investments Ltd and Gale Lister & CO Ltd<sup>33</sup> the Panel held that the merchant bank P.R. Grimshaw, which acted as a financial adviser to the offeree company Gale Lister, could not dispose of its own shareholding in Gale Lister in a way that conflicted with its advice to that company's shareholders. Though specific reference was not made to the Chinese Wall it was implicit from the Panels statement that it would have made no difference. Thus it would seem that while the Panel was willing to provide general approval of the Wall mechanism, it was reluctant to permit the technique to operate unfairly against customers. Such an approach seems more akin to the approach of a 'reinforced' Chinese Wall policy.

(ii) Clause 14(3) of the abortive Companies Bill 1973

Clause 14(3) of what eventually proved to be the abortive Companies Bill 1973 sought to provide corporate entities with a Chinese Wall defence to both a criminal and civil charge of insider dealing. It read:

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

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

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

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32. See, L.Denning MR in Dunford & Elliot Ltd. v. Johnson & Firth Brown Ltd., [1977] 1 Lloyd's Reports 505 (CA.). Speaking of the Code said (at p. 510): "Although [the] code does not have the force of law, ... it does denote good business practice and good business standards." See also, Palmer's Company Law Vol I (London 1982) (at p.1078) "It would appear that in those areas which depend upon equitable considerations ... the Code may play an important role in indicating commercial morality Panel Statement 1970".

33. Statement 30 January 1974.

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

This was an ambitious proposal which sought to rely on an effective Chinese Wall to rebutted any imputation that because certain individuals in the firm were apprised of price-sensitive information the firm, as a whole, knew of that information. As Rider points out, in subsequent companies legislation a different approach was taken. In the Companies Bill 1978 (later to become the Companies Act 1980, part V of which was to contain insider dealing prohibitions) provision was made for only criminal and not civil liability.<sup>34</sup>

### The Advent of Big Bang and the Formation of Financial Conglomerates

#### Official Treatment of the Chinese Wall

##### (i) The Gower Report

Official recognition of the Chinese Wall approach was initially given in the Licensed Dealers (Conduct of Business) Rules 1983 (SI No 585) rr.2 and 8(2). Gower, in Part I of his Review of Investor Protection commented upon the applicability of the mechanism. The tone more than hinted at scepticism. Speaking of the resolution of conflicts by means of a Chinese Wall, he wrote:<sup>35</sup>

... conflicts are, inevitably, endemic among those providing financial services and are aggravated by the increasing tendency for a wide range of such services to be provided by a single firm or group. The wider the range the greater the risk of conflicts that cannot be wholly avoided by erecting "Chinese Walls". City opinion has been remarkably complacent about this, apparently believing that

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34. In view of this and the consequent fact that the insider must be knowingly aware of the relevant facts, Rider, supra, note 29 at p.95 argues that "it is extremely unlikely that the British courts would be prepared to countenance any form of imputed knowledge in the case of a multi-functional fiduciary." Thus, he concludes, that, "an effective Chinese Wall would be an effective defence under the proposed [1978] legislation."

35. Report on Investor Protection Part I Cmnd 9125 at para. 6.30, (hereinafter the "Gower Report").

reputable firms can be trusted to resolve the conflicts in such a way that if anyone suffers it will be they and not their clients." (footnote omitted).

It is important to note that this growing range of financial services which Gower talks about has become, in the wake of Big Bang, so wide as to be virtually open ended.

(ii) The Government's White Paper

The Government in its White Paper 1985, likewise, discussed the role of the Wall mechanism. It noted that in an environment where a range of financial services could be provided by the one corporate entity (as is the case to-day) it was not convinced that total reliance should be placed on Chinese Walls.<sup>35a</sup> The reason for this, said the Government, was because information barriers such as Chinese Walls restricted the flows of information and not the the conflicts of interest themselves. Though the Government may have good cause to refrain from placing total reliance upon Chinese Walls it could be suggested that the reasoning given in justification of this approach is open to question. As Gower and many others have pointed out, conflicts are inevitable.<sup>35b</sup> In fact, as has been shown, it is not really the conflicts themselves that are of harm but rather the abuse of those conflicts.<sup>36</sup> The question then reverts to whether it is preferable to prevent or control conflicts. It would seem that the former is too draconian in its effect to justify serious consideration. Nonetheless there may be certain factual situations where the conflicts per se may be of sufficient severity to merit segregation without the need to show abuse - in this instance abuse is presumed from the very existence of the

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35a. Financial Services in the U.K.: A New Framework For Investor Protection, Cmnd. 9432, at para. 7.4.

35b. See, Gower Report Part I at para 6.30.

36. See, infra Chapter Two at note 35 and accompanying text.

conflict. An example of such logic may be found in the U.S. where the Glass Steagall Act 1933 separates, to a large extent, the Banking and Securities businesses.<sup>37</sup>

(iii) Gower's Rejoinder

Part II of Gower's review came out following the Government's White Paper. In it he passed further comment on the Wall technique. He wrote:<sup>38</sup>

The Government's scepticism about Chinese Walls as a panacea for avoiding abuses of conflicts of interest (White Paper, paragraph 7.4) is one that I share wholeheartedly; as I have said before, I have never met a Chinese Wall that did not have a grapevine trailing over it. On the other hand, unlike some commentators I do not interpret the White Paper as seeking to ban Chinese Walls. They are a legitimate device to protect individual members of a multi-functional business from the risk of criminal liability from insider dealing. (emphasis added)

Gower went on to explain that protection for the investor had to be found in other ways and as such welcomed the Government's scheme to embrace, in the new regulatory framework, a number of principles broadly aimed at ensuring that investors were treated fairly.<sup>39</sup>

(iv) The Financial Services Act 1986

The ultimate statutory authority for sanctioning the Chinese Wall policy is derived from s.48 of the Financial Services Act 1986. Section 48 empowers the SIB to make Conduct of Business Rules regulating investment businesses. These rules must satisfy the requirements set out in Schedule 8 of the FSA 1986.

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37. See, R S Karmel, "Glass-Steagall: Some Critical Reflections" (1980) 97 Banking Law Journal 631; and Securities Industry Association, "Public Policy Issues Raised by Bank Securities Activities" (1983) 20 San Diego Law Review 339.

38. Gower Report, Part II, at para. 4.13.

39. For a further explanation and critique of this, see, infra Chapter Eight at note 51 and accompanying text.

Under S.48 (2) specific provision is made for the making of Chinese Walls rules or, as the legislation puts it, rules:

(h) enabling or requiring information obtained by an authorised person in the course of carrying on one part of his business to be withheld by him from persons with whom he deals in the course of carrying on another part and for that purpose enabling or requiring persons employed in one part of that business to withhold information from those employed in another part;

S.48 (2) (h) then, permits the SIB to issue rules concerning the implementation of Chinese Walls. Section 47 introduces another important element. The section covers misleading statements and practices.<sup>40</sup> It is a very broad anti-fraud rule. In some senses it could be argued that a Chinese Wall is a device which a conglomerate erects and relies upon while at the same time "intentionally" making recommendations which the conglomerate as a whole knows are misleading, false or deceptive. In other words one arm of a conglomerate could be making recommendations about a company's securities which another arm of the conglomerate knows is going into liquidation. But by virtue of S. 48 (6):

(6) Nothing done in conformity with rules made under paragraph (h) of subsection (2) above [ie. SIB Chinese Wall rules] shall be regarded as a contravention of section 47 above.

Thus Chinese Walls operate as an exception, permitting conduct which would

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40. The relevant part of s.47 reads:

47. (1) Any person who -

(a) makes a statement, promise or forecast which he knows to be misleading, false or deceptive or dishonestly conceals any material facts; or  
(b) recklessly makes (dishonestly or otherwise) a statement, promise or forecast which is misleading, false or deceptive, is guilty of an offence if he makes the statement, promise or forecast or conceals facts for the purpose of inducing, or is reckless as to whether it may induce, another person to (whether or not the other person to whom the statement, promise or forecast is made or from whom the facts are concealed) to enter or offer to enter into, an investment agreement or to exercise, or refrain from exercising, any rights conferred by an investment.

(2) Any person who does any act or engages in any course of conduct which creates a false or misleading impression as to the market in or the price or value of any investments is guilty of an offence if he does so for the purpose of creating that impression and of thereby inducing another person to acquire, dispose of, subscribe for or underwrite those investments or to refrain from doing so or to exercise, or refrain from exercising, any rights conferred by those investments.

otherwise be considered illegal or unfair.

### Regulatory Approval of the Chinese Wall

#### (I) The SIB's Use of the Chinese Wall Mechanism

In the U.K. the main responsibility for the implementation, operation and functioning of the Chinese Wall mechanism in the post-Big Bang regulatory arena has fallen to the newly formed regulatory rule-making body - the SIB.<sup>41</sup> The SIB has clearly endorsed the use of the isolation technique in a number of its conduct of business rules contained in the Agency's rulebook.<sup>42</sup> In November 1988 the SIB issued "Conduct of Business Rules a new approach". This was in accordance with a growing consensus that the then existing rulebook had been put together in a "piecemeal fashion".<sup>43</sup> The object of the Agency's new November review was "not to change the substance of the rules" but "to make them clearer and enhance their effectiveness, and also to present them in a more coherent and logical structure."<sup>44</sup> The SIB invited comment on the text with the aim of having a full consultative text published in February 1989. This was closely followed by the actual "recast" Conduct of Business Rules which came into force on 1 July 1989. In view of the time and funding constraints involved in this research project it is proposed to base the substantive legal analysis contained in this section on the SIB texts of November 1988.

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41. For a short summary of the SIB's powers, see, infra Chapter Two at note 9 and accompanying text.

42. See, infra at note 53 and accompanying text.

43. See, SIB, Conduct of Business Rules a new approach November 1988, at p. (i).

44. Ibid.



Although none of SIB's rules either "require" or "specify" Chinese Wall arrangements directly, (SIB purports to rely heavily on disclosure requirements)<sup>45</sup> a number of its rules are "expressly disapplied when the business of multi-functional firms are so arranged that those engaged in one function are prevented from knowing the actions of those engaged in another function."<sup>46</sup> It is upon these rules that attention is focused.

Before going on to review the scope and use of the Wall mechanism in the SIB texts it is first necessary to consider some of the broader issues addressed by the rulebook. The rules are an indication of generally accepted standards of good practice.<sup>47</sup> They are not, however, statutory instruments, even though they have the force of statutory instruments.<sup>48</sup> The crucial question is, of course, to what extent the SIB rules add to or subtract from obligations owed by firms at common law.<sup>49</sup> But leaving this aside for one moment, the legal status of the SIB's rules it is also important to note that the rules work in such a way as to afford different levels of protection according to the nature of the client. This helps set the context of the applicability of the rules. The SIB treats categories of investor or customer differently. In one of its recent publications the SIB spells this out clearly. In a section headed "Types of Customer" the booklet states:<sup>50</sup>

As required by paragraph 12 of Schedule 8, SIB's rules distinguish between customers according to knowledge, experience and circumstance. In particular, they treat specially a number of

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45. See, *infra* Chapter Eight at note and accompanying text

46. See, SIB Draft: Sept. 1986 rulebook, Rule 1.02.

47. See, Rule 2.03 (November 1988 Text).

48. It will be remembered that the Secretary of State for Trade and Industry is given wide powers to make rules by virtue of s.205 of the Financial Services Act 1986. These rules would be statutory instruments. However the Secretary of State has delegated these powers to the SIB under s.114 of the FSA 1986.

49. This is discussed *infra* Chapter Nine: Summary and Conclusions.

50. See, SIB, "The SIB Rulebook An Overview" October 1987, at p.7.

different categories of customer or investor:

- (i) the market counterparty: a business doing the same kind of investment business as the firm and with whom a firm does a transaction;
- (ii) the professional investor: another investment business (doing investment business of any kind) for whom services are provided;
- (iii) the business investor: an investor which is a company (whether or not corporate) above certain size thresholds or a local authority or other public body;
- (iv) the experienced investor: the individual with such experience or expertise in a particular kind of investment business as to enable him for the most part to look after his own interests in conducting investment business of that kind;
- (v) the execution-only customer: the customer who wishes simply to deal, not to receive advice or a discretionary service;
- (vi) the occasional customer: the customer who wants an advisory service but on a one-off rather than on a continuing basis.

In essence, a great majority of customer relations rules<sup>51</sup> and the rules protecting customers from sharp practices ... do not apply to relations between a firm and customers in categories (i) - (v) ... Conversely, the customer relations and other investor protection rules apply in their full rigour to the private individual or small company, non-experienced customer without special experience or expertise. (footnote added).

See also the term "private investor", which means:

a person who, in relation to the performance of any services for him by a firm is not a business investor and, in relation to any particular transaction<sup>52</sup> in any particular investment, is not an experienced investor.

A number of the SIB's rules embody the use of the Chinese Wall mechanism.

The term "Chinese Wall" is defined by the SIB:<sup>52a</sup>

A Chinese Wall, in relation to a firm, means arrangements within the firm, or within a group which includes the firm, for securing that information obtained by individuals employed in one part of the firm's business or the group's business, as the case may be, will be withheld from individuals employed in another part of it." [The Old SIB definition added "and, (b) those individuals are individuals from

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51. Rules governing customer relations revolve around the requirements of Schedule 8 and "ensure the achievement of best practice in the conduct of firms' relations with their customers" (at p.6 of the SIB October 1987 document). Some of the most important of these rules require firms to know their customer and to recommend only what is suitable (4:03). Firms must also give best execution (4.02), risk warnings for example where the investment is not readily realisable (5.11), disclosure of material interests (5:07) etc.

52. Supra, note 50 in Glossary at p. 9.

52a. Ibid., at p.4.

whom information about that interest or conflict is intended to be withheld under those arrangements.]

The three most important rules given treatment here are Rule 3.04, 3.10 and 5.07. However, it is intended to consider, even if somewhat briefly, the other "Chinese Wall" rules also. It is essential to spell out the broad remit of the rule thus placing the analysis of the Chinese Wall exception/ defence in its proper context.

#### (i) Rules Covering Integrity and Fair Dealing

##### \* Rule 3.04: Front Running<sup>53</sup>

This Rule is aimed at preventing a firm, or a favoured customer, from dealing ahead of a customer who really ought to have priority. Where a firm ignores this priority the practice is known as front running. Presumably the underlying rationale of the Rule is to stop a conglomerate from dealing in the shares of a company in which one of (or a number of) its customers is a major shareholder and whose trading activities are likely to affect the market for those shares. The Rule limits a firm's trading when a customer has instructed the firm to perform a transaction until that transaction has first been executed. Equally the rule applies to the unexecuted orders of its discretionary customers for whom trading decisions have also been taken.

There are, however, exceptions to the general prohibition against front running. Under paragraph 4 where the firm knows or reasonably should know that

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53. This is old Rule 5.15: Limitation on firms' trading because of customers' orders.

an earlier buying (or selling) priority is that of a connected customer,<sup>54</sup> (or of someone acting for a person who would be connected if he were a customer), then it must treat that priority as being deferred. Also the firm may deal ahead of a priority customer for another customer if (a) the customer with the priority has placed a limit on the price and the firm is not able to deal for him at that limit, or at a more advantageous limit; or (b) where the the customer's instruction cannot be executed immediately, and the terms of its execution are unlikely to be influenced by dealing for the other customer; or (c) if the firm is a recognised market maker in the investment and deals in accordance with the rules of the relevant recognised or designated investment exchange; or (d) if a Chinese Wall, in accordance with the SIB's understanding of that term, is operated.<sup>55</sup> Thus front running is permissible for a conglomerate provided an effective Chinese Wall is established with the intention of preventing individuals involved in executing the transaction for the other customer from knowing or from having a duty to know of the priority.<sup>56</sup> In other words there is no duty to know of the priority if the information which related to it is blocked of by the use of the Wall mechanism.

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54. Connected customer is given a wide definition by the SIB. See, supra, note 50 at Glossary. The term includes: a partner, employee or appointed representative of the firm or an employee of the latter; and where the firm is a company, a controller or officer of the firm. But a connected customer is not to include a customer who is, or who is a person acting on behalf of, an investment trust or a regulated collective investment scheme. See, paragraph 5 of Rule 3.04.

55. See, supra note 52a.

56. It would seem that the firm may deal only for "another customer" and not for its own account ahead of a priority customer (save as a market maker - see paragraph 7 (c)). The Rule does not seem to make this clear. This is unusual as other rules allow self-dealing.

\* Rule 3.09: Fairness in use and dissemination of research  
recommendations

Rule 3.09 stipulates, at paragraph 1, that it applies to any firm which regularly publishes to its customer (or any class of customer) the results of research which is likely to: (1) influence the future performance of investments, and (2) result in recommendations to acquire, hold or dispose of a security unless the firm states that the research or analysis was conducted for its own benefit and that it may have acted on it. Paragraph 2 requires evenhandedness in the publication of research material. In other words if a firm has conducted research or analysis it is not permitted to publish the results of the research or recommend a security in the light of the research unless those results or recommendations are published simultaneously to all customers to whom it regularly makes such material available. Paragraph 3 outlines an exception to this simultaneity stipulation. Simultaneity is not required if a firm has made special arrangements with a customer and has fulfilled them or "the medium of communication is such that it is not possible to publish to all ... customers simultaneously, [and] those to whom prior publication is made are not selected so as regularly to favour particular customers."<sup>57</sup>

Paragraphs 4 in effect contains the following prohibition: a firm is unable to deal (for its own account or for a person whom it knows or ought reasonably to know is a connected customer)<sup>58</sup> on the basis of any research or analysis which it expects to publish to customers or on the basis of which it expects to make recommendations to customers unless the results or recommend-

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57. See, Rule 3:09 (3) (b).

58. See, supra note 54 for the definition of a connected customer.

ation have been published under the stipulations in paragraphs 2 and 3.<sup>59</sup> Paragraph 5 extends this prohibition to a firm which is an associate<sup>60</sup> of a firm prohibited by paragraph 4. According paragraph 9 the full force of paragraph 4 does not apply if an effective Chinese Wall has been erected to prevent individuals from knowing of the results or recommendations in question. Moreover, the extent to which there is fiduciary duty to know of the existence of the results or recommendation in question is neutralised by the existence of a Chinese Wall which deliberately operates to conceal the pertinent information from them.

\* Rule 3.10: Insider Dealing

Rule 3.10<sup>61</sup> brings into play a new legal disincentive to insider deal and mirrors closely the substantive law as found in the Company's Securities (Insider Dealing) Act 1985. The point is, however, that the adoption by the SIB of Rule 3.10 means that the firm is liable to the civil penalties under the FSA. The rule reads:

(1) No insider dealing for the firm

If an officer or employee of a firm is prohibited by the Company Securities (Insider Dealing) Act 1985 from effecting a transaction then the firm shall not effect a transaction as a principal on its own account unless:-

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59. Rule 3.09 (6) allows firms to deal ahead of a research recommendation if it has reason to believe that: (1) publication of a "buy" recommendation, or, (2) the results of research or analysis which would suggest a recommendation, "would result in customers wishing to buy from the firm in quantities that it would require itself to buy amounts of that investment in the market, then the firm may ... , before it publishes that recommendation or those results, buy as much of that investment as it reasonably believes" is necessary to satisfy customer demand and where such purchases would not "in itself significantly increase the market price" of those securities. If a firm does decide such a course of action is necessary then under Rule 3.09 (7) it is necessary for the firm to disclose this to its customers when it publishes to them the relevant recommendation or results.

60. An associated firm is defined supra note 50 at the Glossary.

61. This is the SIB's old Rule 5.21

- (a) the only reason why that officer or employee was so prohibited was because of his knowledge of the firm's intentions, or
- (b) none of the officers or employees concerned in effecting or arranging for the effecting of the transaction knew or ought to have known of the circumstances giving rise to the prohibition and none of them shall be regarded as having a duty to know of the circumstances if information was concealed from all of them by a Chinese Wall.

(2) No dealing with or for insiders

A firm will use its best endeavours to ensure that no officer or employee of the firm effects a transaction on behalf of the firm with or for any person if that officer or employee has reason to believe that the effecting of that transaction by that person is prohibited by the Company Securities (Insider Dealing) Act 1985.

According to Rule 3.10 a firm is prohibited from using inside information when dealing on its own account in those situations where the CSA prohibits individuals from insider dealing. Two exemptions are, however, allowed. First, if the only reason why the employee is prohibited from dealing is because he knows of the firm's intention. In other words, the firm may deal in securities (where its employee would be prohibited) if the dealing relates to its intentions to perform or not perform some future act. The law does not attempt to deny a firm from capitalising on a position of knowledge emanating from itself which is in fact lucrative. However, individuals within the firm may not deal for their own personal accounts on the basis of such knowledge. Secondly, if the individual so prohibited by the CSA is "screened off" behind an effective Chinese Wall so as to prevent that individual (or a group of individuals) from being aware of the circumstances giving rise to the prohibition.

Paragraph 2 requires a firm to use its best endeavours to prevent officers and employees from executing trades for the firm or for a customer where they are aware of the illegality of the transaction under the CSA 1985.

This gives rise to one intriguing question: what constitutes a firm's "best endeavours" when preventing its employee from being aware of a breach of the CSA. Because of the various intricate facts that must be known for a breach of the CSA to have taken place, it seems unlikely that this prohibition will be much utilised by the authorities. Undoubtedly the test is subjective - what the individual firm in question thought were its best endeavours and not what the reasonable firm would consider the term best endeavours to mean.<sup>62</sup>

(ii) Rules Covering Issues of Skill Care and Diligence

\* Rule 4.03: Suitability

Rule 4.03 deals with the suitability of investments and transactions in them. The basic principle is that:

a firm must find out enough about the private investor's personal and financial circumstances to enable it to act properly for him in investment matters; and in making investment recommendations, in exercising discretion and in advising about the customer's instruction, it must ensure as far as it can that purchases and sales are not unsuitable for any customer and that they are positively suitable for him as a private customer.

A firm then has a positive duty to ensure that investments are suitable for private investors and a positive duty to ensure that investments are not unsuitable for any customer. Thus for all other customers, except private investors,<sup>63</sup> the firm is under no positive duty to ensure that investments are positively suitable; merely to ensure that they are not unsuitable. The "know your customer" doctrine as regards the private customer is spelt out in paragraph 1 - the firm must take "reasonable steps" to conform to the doctrine. Paragraph 2 outlines two exceptions to paragraph 1. First, where the firm is

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62. See also, Hannigan, Insider Dealing (London 1988) at p.152.

63. See, supra note 52.



dealing with an execution-only customer or providing services to persons generally rather than to any particular private investor; and secondly, where the firm has made enquiries and the customer has refused to answer them. Paragraphs 3 and 4 specify much of what is said in the basic principle of conduct with regard to the firm's other positive duty not to recommend unsuitable investments for any customers.

Paragraph 5 deals with the experienced investor only. Under it a firm ought not to recommend an investment which has features which it has reason to suspect the investor may not fully understand, unless it also supplies him with sufficient information as it reasonably believes will enable him to determine the suitability of the investment. Paragraph 6 deals with the disregard of advice, and allows the firm to perform the transaction even if it is regarded as unsuitable for the investor provided the firm has warned the client that it believes the investment to be an unsuitable one and the client has chosen not to heed that advice. This is reminiscent of the underlying philosophy in the Gower report ie. that the new framework was intended not to prevent the investor from making a fool of himself but from being made a fool of.<sup>64</sup>

Paragraph 7 provides relief for the firm by virtue of reliance on the Chinese Wall mechanism. In effect the paragraph states that although the firm as a whole might know that the particular investment is not suitable for the investor, the lack of knowledge of an employee, who had no duty to know that particular knowledge, is an exception to the general principle of the suitability doctrine. In other words the firm may recommend, exercise a discretion, or effect a transaction which it knows to be unsuitable if none of the individuals involved knew or had a duty to know of the pertinent facts. And none of the

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64. Gower Report Part I at para. 1.16

individuals are taken to know or of having a duty know of these facts if a Chinese Wall is erected. In one sense the Wall arrangements are intended that those specific individuals should not know. To the extent that a firm operates such Walls between department, as undoubtedly it will, the suitability doctrine will be negated, thus offering the investor less protection than at first glance might be supposed.

(iii) Rules Covering the Disclosure of Information

As has already been shown, full and frank disclosure of a conflict by an agent to his principal and the consent therefrom is sufficient to negate certain otherwise stringent fiduciary obligations.<sup>65</sup> The importance of disclosure is emphasised strongly in the SIB rulebook.

The SIB divides disclosure into two parts: disclosure in general and methods of disclosure. The general disclosure principle is set out in rule 5.01: "disclosure should be clear and comprehensible." On the issue of methods of disclosure, the rules "enable or require disclosure to be made by a firm in three main ways: in the customer agreement, by communication to the customer and the seeking of his express agreement, or by notification to the customer with no provision for his agreement, express or implied.

The following rules deal with disclosure of information by an investment firm or conglomerate.

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65. See generally, Chapter Six.

- \* Rule 5.05: Disclosure about dealing for oneself, and acting for both sides<sup>66</sup>

Rule 5.05 covers dual agency and self-dealing transactions.<sup>67</sup> It contains a general prohibition against a firm getting itself into conflict of interest situations. The basic principle of conduct recognises that the firm will be in a conflict of interest where it deals with a customer as principal for its own account or as an agent for an associate of the firm<sup>68</sup> or acts for different customers simultaneously who are on opposite sides of the same transaction. The SIB recognises that this might erode the rights of customers. Exceptions are however allowed. For example the firm may conduct otherwise prohibited deals if:

- (i) there has been fully informed consent of all the relevant facts of the transaction.<sup>69</sup>
- (ii) the investment is readily realisable and the customer agreement permits the firm to perform such transactions.<sup>70</sup>
- (iii) the transaction executed by the firm is part of a discretionary managed portfolio and there has been disclosure of the possibility of such transactions.<sup>71</sup>
- (iv) the firm is dealing off its own book as market maker and it (or its associate) effects a contemporaneous matching transaction with another

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66. It is important to read Rule 5.05 in conjunction with Rule 5.11: Investments which are not Readily Realisable (see, below) and Rule 5.07: Disclosure of a Firm's Material Interest in Transactions (old Rule 5.08) (also see below).

67. This is old Rule 5.07.

68. See, supra, note 50 in the Glossary.

69. For what constitutes full informed consent, see, infra Chapter Six at note 56 and accompanying text.

70. Rule 5.05 (ii).

71. Rule 5.05 (iii).

person.<sup>72</sup>

- (v) the transaction relates to an investment which is not readily realisable then the rules relating to such types of illiquid investments apply. These rules may be found in Rule 5.11 (below). Inter alia they include a Chinese Wall exemption.

Notwithstanding the general tenor of Rule 5.05 prohibiting conflicts of interest and self-dealing, another major rule - Rule 5.07 - covering disclosure of a firm's material interest in a transaction, undercuts much of the full vigour of the disclosure required by Rule 5.05 and indeed the SIB's purported general policy of disclosure. Rule 5.07 is now discussed

\* Rule 5.07: Disclosure of Firm's Material Interest in Transactions

Rule 5.07 (formerly old Rule 5.08) deals with conflicts that might disadvantage a client when a firm (or another "arm" of the conglomerate) has a material interest in a transaction. The Rule deals with conflicts of interest in general; whereas rule 3.10 covers one particular conflict - insider dealing. It is important to set out the Rule in full:

**Principle of conduct:** a firm should not deal or recommend dealing when it has a material interest of its own in the business or where it has a conflict of interest, unless there has been adequate prior consent.

(1) Disclosure of material interest. A firm shall not effect a transaction with or for a customer (other than an execution only customer) or recommend the effecting of a transaction with or for a customer if the firm has directly or indirectly any material interest in the subject matter or the effecting of the transaction (other than the interest arising solely from the firm's participation therein), or has any relationship with another person which causes its duty to or its interest in relation to that other person to conflict with its duty to the customer, unless there has been disclosure of the relevant information with the informed consent, or in the case of a recommendation by notification.

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72. Rule 5.05 (iv).

(2) Paragraph (1) does not apply if none of the individuals involved in the transaction or recommendation knew or ought to have known of the interest or conflict in question, and none of them shall be regarded as having a duty to know of it if the information was concealed from all by a Chinese Wall

Thus essentially the firm has two options: either it must disclose to its customers the nature of the conflict in which it finds itself or it must establish a Chinese Wall to stop knowledge of, and about, the conflict from being transmitted throughout the firm. An example of a firm having a material interest in a transaction might be where the firm recommends to a customer the purchase of an investment which has been underwritten by a different "arm" of the conglomerate. In this way a conglomerate may breach traditional fiduciary duties at common law by putting itself in a conflict of interest. This is also a position, under the SIB rules, from which the firm may self-deal, provided, it operates an effective Chinese Wall between the relevant departments.

\* Rule 5.11: Investments Which are not Readily Realisable

Rule 5.11 has a very narrow reading. It deals only with not readily realisable investments, otherwise known as illiquid investments. The general prohibition here is that a firm should not recommend to a customer an investment which is not readily realisable unless various disclosure requirements are met. Paragraph (1) (a) requires a firm to first warn a customer that an investment might be difficult to dispose of and that the proper information for determining its current value may not be available. Under paragraph (1) (b) a firm may not recommend a customer to buy an illiquid investment at a time when the firm or an associate of the firm<sup>73</sup> has a long

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73. See, supra note 50 at Glossary.

position in that investment unless it first discloses that fact to the customer. Equally under paragraph (2) a firm shall not recommend a customer to dispose of an illiquid investment if, when the recommendation is made, the firm or any associate of the firm has a short position in that investment unless the firm discloses that fact to the customer.<sup>74</sup> Paragraph (3) meanwhile prohibits a firm from acquiring "for a discretionary managed portfolio an investment which is not readily realisable unless there has been a warning and disclosure as in paragraph (1) by informed consent."

Paragraph (4) states that unless either: (1) the firm is acting as a discretionary portfolio manager; or, (2) it (or its associate) is a market-maker in the investment, the firm then cannot arrange for a customer "to buy from or sell to it (or any associate) an investment which is not readily realisable, unless: (a) the customer is not [in any case] entitled to best execution, or (b) the firm has disclosed to the customer the mark-up (or, in the case of a sale, the mark-down) or if there is no calculable mark-up or mark-down how the price (or the proposed price) has been arrived at."

These then are the rigorous conditions imposed on a conglomerate who wishes to execute orders for customers in illiquid investments. However the prohibitions in paragraph (1) (b) and paragraph (2) do not apply if the individuals involved in the transaction were unaware or had no duty to be aware of the long or short position. Employees of a conglomerate are regarded as not being aware or of having an obligation to be aware if information about the long or short position was concealed from them by a Chinese Wall.

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74. This paragraph is subject to paragraph 5 under which the firm may derogate from its responsibility under paragraph (1) and (2) if it has reason to believe that the customer is a business investor.

(iv) Rules Covering Publications Containing Recommendations

The purpose and application of part 12 of the proposed rulebook is to make "further provision concerning publications which contain recommendations which are published about investments."<sup>75</sup> The rules are intended to operate in conjunction with other related rules and to supplement those rules. For example Rule 12.02 is directly related to Rule 3.09 which covers fairness in the use and dissemination of research recommendations. Thus a firm may in certain cases be required to accompany recommendations with other material such as the firm's material interests.

Rule 12.01, though not directly applicable to the operation of the Chinese Wall, helps to indicate the context of this section of the SIB rulebook. In relevant part it reads:

This part applies to any journal, tipsheet, broker's circular or other publication (including publication by sound broadcasting or television) containing recommendations to buy, sell or hold any investment which is issued regularly or occasionally by or on behalf of a firm.

Given this frame of reference, the following Rule 12.02 addresses the issue of the Chinese Wall in relation to publications containing recommendations.

\* Rule 12.02 Disclosure of Material Interest etc.

This Rule is aimed at the situation where a firm is capable of benefiting from transactions which it recommends. The benefit may arise because: (1) it has already or may in due course deal as principal in the shares which it recommends or (2) because it has some other "outlying material interest" in

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75. Supra note 50 at Part 12.

those shares. The Rule requires that where such a benefit will accrue to the firm then it must include in the publication the proper disclosure of the source of the benefit. Notwithstanding this, there is a Chinese Wall exception from the general principle of conduct stipulated by the rule. The exception reads:

**2 Exception.** Paragraph 1 [specifying disclosure] does not apply if none of the individuals involved in the making of the recommendation knew or ought to have known of the interest; and none of them shall be regraded as having a duty to know of it if the information about it was concealed from all of them by a Chinese Wall.

(II) The Takeover Panel's Use of the Chinese Wall Technique:

Post-Big Bang

The growth of financial conglomerates and the consequent move towards dual capacity with its increase scope for conflict abuse, spelt out the necessity for some adjustments to the Panel's rulebook, the City Code on Takeovers and Mergers. The outcome of these changes are embodied in Part 2(b) Appendix 3 of the Code. In pertinent part this reads:

It is incumbent upon the multi-service financial organisations to familiarise themselves with the implications under the Code of conducting other business in addition to, for example, corporate finance or stockbroking. If one part of such an organisation is involved in an offer, for example, in giving advice to the offeree of the offeror company, a number of rules of the Code may be relevant to other parts of that organisation, whose actions may have serious consequences under the Code. Compliance departments of such organisations have an important role in this respect and are encouraged to liaise with the Panel in cases of doubt.

Despite the fact that neither the Panel's Rule-book nor its case rulings have the force of law, its rules and rulings are nonetheless accepted as statements of good practice, representing the "regulatory force" in those areas



which strictly speaking lie outside the SIB's regulatory jurisdiction.<sup>76</sup> In an official statement issued on 29 May 1986, the Panel made it clear that it was aware of the problems that conglomeration and dual capacity created. Therein the Panel expressed its intention to introduce detailed measures directed at the new market regime.<sup>77</sup> In its 6 October 1986 statement the Panel went on to outline these proposed new amendments.<sup>78</sup> They addressed two specific areas of concern. First, the circumstances in which a market-maker is to be regarded as acting in concert with: (i) an offeror - where the offeror is being advised by the corporate finance arm belonging to the same multi-service financial organisation as the market-maker; and (ii) an offeree - where the offeree is being advised by the corporate finance arm of the same conglomerate as the market-maker. Secondly, the position of dealings by Fund Managers on behalf of discretionary clients in the securities of companies concerned in an offer, when the fund managers are part of the same organisation as the financial or other adviser to an offeror of the offeree company.

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76. See, *supra* note 32. See also, The City Code on Take-overs and Mergers (1) (c) Enforcement of the Code: "The Code has not, and does not seek to have, the force of law. It has, however, been acknowledged by both government and other regulatory authorities that those who seek to take advantage of the facilities of the securities markets in the United Kingdom should conduct themselves in matters relating to take-overs in accordance with best business standards and so according to the Code.

Therefore those who do not so conduct themselves may find that, by way of sanction, the facilities of those markets are withheld. In particular, the ... SIB and SRO's may require that those subject to their jurisdiction should not act in a take-over for any person who does not appear likely to comply with those standards. Moreover, if a person authorised by the SIB or an SRO to carry on an investment business fails to comply with the Code or a ruling of the Panel, that may lead to the withdrawal of authorisation."

77. Panel Statement, Multi-service Financial Organisations and the Code 29 May 1986.

78. Panel Statement, Multi-service Financial Organisations and the Code 6 October 1986.

(i) Dealing as Principal: Market-Making

The question here is on what basis any part of a conglomerate is permitted to continue trading as principal, whether as Market Maker or otherwise, in the securities of companies involved in a takeover, when one arm of the conglomerate is acting as financial adviser to either the offeror company or the offeree company. The following two diagrams illustrates the issues involved:

Fig. 1

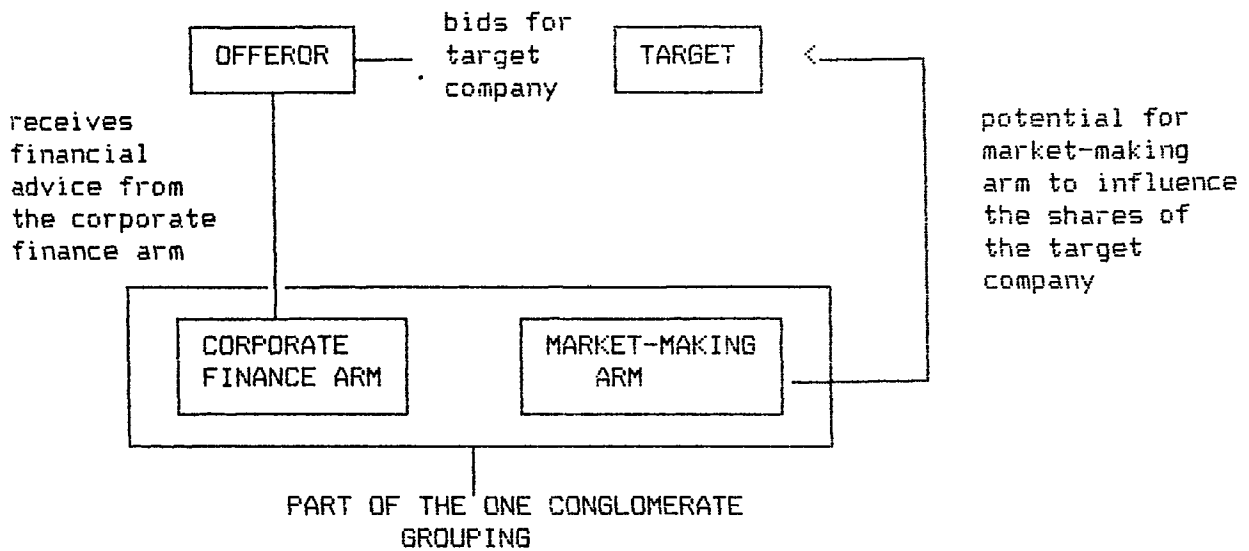
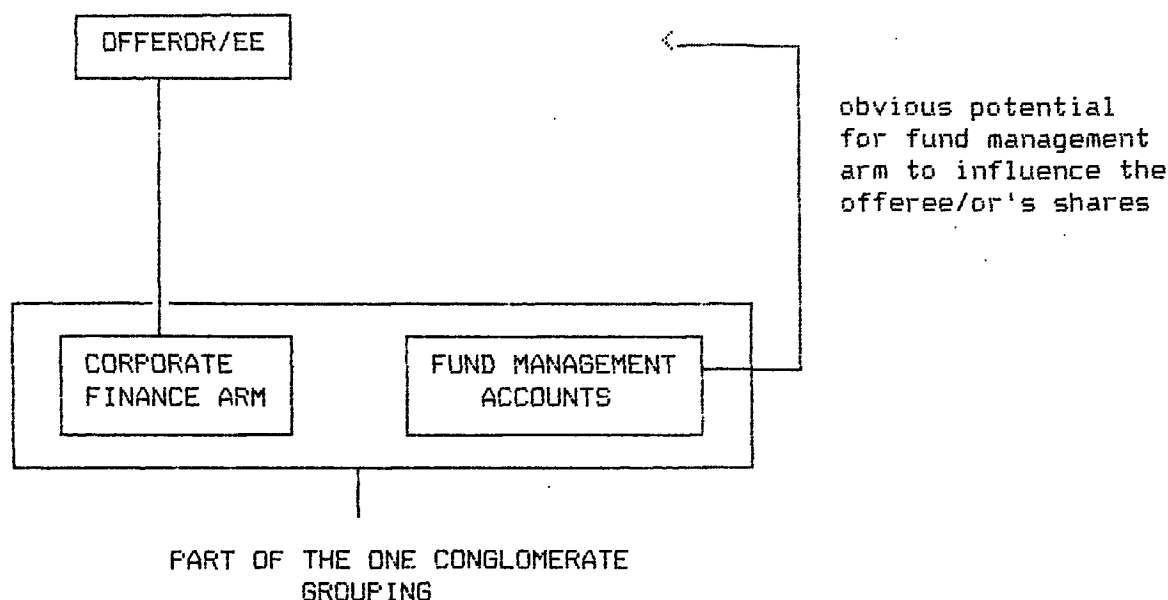


Fig. II



The general rule as laid down by the Panel is that when one arm of a financial conglomerate is advising an offeror, then all principal <sup>79</sup> dealings in the offeree's securities by any part of the conglomerate will create a presumption that the conglomerate is acting in concert with the offeror. This could also have repercussions for compliance with other Panel rules.<sup>80</sup> There is, however, one important exception to this basis principle. The exception operates where, before dealing in the offeree's securities the market-maker first obtains an "exempt market maker status" in accordance with the Panel's definition of that term. The Panel has stated that it:

accepts that in general it is the intention of multi-service financial organisations to run their market-making operations wholly independently and, in particular, without regard to the interests of clients of the corporate finance arm of the organisation. In addition the panel has been particularly concerned to avoid damage to

79. Note that the conglomerate may act as agent for other customers. It is only self-dealing that is prohibited.

80. Such dealings are most likely to affect the mandatory bid rule as well as the obligation to make a cash offer.

the liquidity of the market in relevant securities which might otherwise arise from a forced withdrawal of a significant market-maker at the time of the announcement of an offer because of its connection with the offeror. Accordingly, the Code is to provide for a category of exempt market-makers to whom the above mentioned presumption will not normally apply. (emphasis added)<sup>81</sup>

The market-making arm of a conglomerate seeking to acquire an exempt status must inter alia establish an effective Chinese Wall between itself and other arms of the conglomerate. The Panel has stated that:

[A]n applicant market-maker will have to demonstrate to the Panel that the organisation in question has in place arrangements satisfactory to the Panel relating to the separation of the market-making side from other relevant parts of its business, in particular, corporate finance.<sup>82</sup> (emphasis added).

According to new Rule 38, in the situation where an Exempt Market-Maker (EMM) is connected with an offeror or offeree company involved in a take-over, it will, notwithstanding its exempt status be precluded from using that status to act in such a way as to assist clients of the corporate finance arm.<sup>83</sup> Thus restrictions are still placed upon an EMM when a part of its organisation is connected with the offeror or offeror. These restrictions, or, 'reinforcements' as the Panel calls them, are threefold:

(1) Rule 38.2 prohibits dealings between an offeror (or any other party in concert with the offeror) and EMM in the securities of the offeree company during the offer period.

(2) Rule 38.3 prohibits an EMM that is connected with an offeror "from assenting relevant securities owned by it to the offer until the offer has been declared unconditional as to acceptances."<sup>84</sup>

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81. See, Panel Statement Multi-service Financial Organisations and the Take-over Code 6 October 1986, at p.2.

82. Ibid.

83. Rule 38.1. Discussed ibid.

84. Supra note 81, at p.3.

(3) Rule 38.4 prohibits an EMM from voting with the offeree or offeror company in the context of a takeover or a possible takeover.<sup>85</sup>

(ii) Discretionary Fund Management

Prior to the Panel's new rules, the Panel acknowledged the legitimate separation of the management of discretionary investment accounts by one part of a multi-service financial firm when another part of the organisation, for example the corporate finance arm, was acting as an adviser to an offeror or an offeree company. However, once the involvement of the corporate finance arm became public, fund managers were "required by rule 7.2 of the Code to consult with the Panel where purchases of the securities could, if the purchasers in question were to have been made by the offeror or the potential offeror itself, have consequences under certain rules including rules 6,9 or 11 of the Code".<sup>86</sup>

Under the new proposals the position of the discretionary fund manager in respect of the period prior to the involvement of the corporate finance arm becoming public remains unchanged. Thus, there is no presumption that a fund manager connected with a corporate finance arm who is involved in advising an offeror/ee in a bid is acting in concert with the offeror with regard to the discretionary investment accounts in the situation prior to that involvement being made public.<sup>87</sup>

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85. Ibid.

86. Ibid.

87. Of course this is only a presumption and if it is rebutted and actual concertedness is found then the usual concert party consequences under the Code apply.

However, once the connection of the corporate finance arm with the offeror/offeree becomes public knowledge<sup>91</sup> fund managers may gain exemption from certain consequences of the Code that would otherwise follow provided the DFM applies for and is in fact granted exempt status. To do so the DFM: "must satisfy the Panel that the Fund Manager operations are run entirely independently and without regard to the interests of the rest of the [conglomerate] ... including the advisory side."<sup>89</sup> ie. it must operate a Chinese Wall under the same criterion as applies to exempt market makers.<sup>90</sup> Thus, where exemption is granted, the Fund Management arm, notwithstanding the fact that another part of the conglomerate is advising the offeror, will not normally<sup>91</sup> be presumed to be acting in concert with the offeror in relation to its discretionary accounts, provided, that is, there is no actual concertedness.<sup>92</sup> Instead the Fund Management arm will be free to deal, without fear of breaching the Code, for discretionary clients<sup>93</sup> in securities relevant to the takeover.<sup>94</sup>

However, no such freedom exists where (in the unusual case) an EFM is

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88. Note that the DFM's connection to the offeror/ee only arises through the connection of the corporate finance arm with the offeror/ee.

89. Supra, note 81, at p.4. The rationale of this approach is, according to the Panel: (at p.4) "prompted by the recognition that the investment management sides of many banks and other institutions operate wholly independent businesses and, in these cases, the effect of continuing to treat them as if they were acting in concert with the advisory sides would be to prejudice unfairly the interests of the clients whose funds are under that management.

90. See, supra note 79.

91. Note the wide discretion the Panel gives itself by the insertion of this word.

92. And no concertedness is presumed by virtue of the fact that a DFM holds exempt status ie. operates an effective Chinese Wall between the relevant departments to prevent knowledge in one department from being transferred to another.

93. Note the DFM, notwithstanding his exempt status, cannot deal on its own account ie. it cannot self-deal. Again presumably this is because of the scope for abuse.

94. Accordingly, Rule 7 has been amended to accommodate the new measures.

connected<sup>95</sup> with the offeror (or offeree company) rather than the financial adviser or other adviser (as is the usual case).

### Recent Panel Rulings

That the Panel is prepared to give the Chinese Wall mechanism a secure place in its arsenal of regulatory techniques dealing with potential conflict abuse in the new post-Big Bang arena is not only evident from its new rules, but also from some of its recent rulings. Three cases in particular highlight the Panel's willingness to endorse a Chinese Wall segregation mechanism.

In United Newspapers (plc) and the Extel Group (plc) it was held that an investment company could continue to deal in the shares of an offeree company while the director of the investment company was also director of the offeror company provided independence of operation was assured by reliance upon the Chinese Wall criteria as normally applied to exempt market makers and that an independent board of the investment company excluded any "infected" members from making decisions relating to how the interest in the offeree's shares was to be handled.<sup>96</sup>

In that case, United Newspapers (the offerors) sought to acquire the Extel Group (the offerees) in a takeover. A director of UN was simultaneously a director of a fund management company (MIM) which managed accounts on a discretionary basis. MIM owned 7.2 % of Extel's shares. However only 0.2 % of these shares were actually held in its own account. The Panel was

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95. Meaning in the same group as the offeror/ee. See, supra note 81 at p.5.

96. Panel Statement on United Newspapers plc./ Extel Group plc., May 18, 1987.

satisfied that prior to the offer being made public neither UN nor MIM were acting in concert. The issue essentially revolved around whether, after the announcement, MIM's internal procedures were sufficient to rebut the presumption that, owing to the joint Chairmanship between UN and MIM, they were acting in concert. The Panel decided to apply the same test as when deciding whether to grant exempt fund manager (EFM) status under the code ie. whether effective Chinese Wall arrangements were in place. Although neither UN or MIM were part of the same conglomerate (the situation in which EFM status strictly applies) the Panel thought it appropriate to apply the same criterion (ie. the Chinese Wall text) because the underlying principles were consistent. The Panel went on to find that the precautions taken were sufficient. In fact it was further swayed by the fact that at MIM there operated an independent non-executive committee of the board to decide on investment trust holdings. Such a practice, if preserved, constituted an effective Chinese Wall.

In Tozer and Moulins an even more extensive reliance was placed on the Wall technique.<sup>97</sup> There the issue arose as to whether a Chinese Wall arrangement was sufficient in the situation where one department in a merchant bank acted on two different occasions in relation to a company which had at both times been the subject of a takeover and had during the course of the first relationship acquired confidential information about the company. In a non formal ruling, the Panel answered the question in the affirmative.<sup>98</sup>

The facts of the case were as follows. In May 1987 Tozer consulted Schroders, a firm of financial advisers, concerning a possible offer for

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97. Panel statement, on Tozer, Kemsley and Millbourn (Holdings) PLC ("Tozer")/ Moulins PLC ("Moulins"), 30 June 1987.

98. Morse notes that the tone of the new statement amounts to a de facto ruling, (1987) JBL 480, at p.483.



Moulins. The problem was that Schroders had previously acted for a management buyout consortium which in the normal course of business received material confidential information relating to Moulins. The confidential information concerned, inter alia, long-term projections about Moulins. The management buyout did not proceed and following that Schroders had no material involvement with Moulins. The question then became whether Schroders should act for Tozer in view of the material information it had previously acquired about Moulins.

Three crucial factors swayed the Panel in allowing Schroders to act for Tozer:

1. Tozer initiated the new takeover proceedings and Schroder did not carry out any analysis of Moulins for Tozer prior to that time.
2. the Schroders personnel acting for Tozer were substantially different from those who acted with regard to those who acted with in the buyout transaction.
3. Schroders took steps to isolate confidential documentary information previously obtained so that it could not be available to those advising Tozer.

The Panel thought that although the facts of the dispute did not fall directly within the the General Principles of the code or of the Rules of the code the issue did relate to good standards of business behaviour with which the Panel in its introduction to the Code had stated was its concern.<sup>99</sup>

In a Panel ruling given on 10 October 1988, stockbroking/market-making firm Smith New Court was found to have breached Rule 38.1 of the Takeover

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99. See, supra, note 97.

Code.<sup>100</sup> The ruling suspended the firms exempt-market making status for a three-month period.<sup>101</sup> Under the suspension Smith New Court were required to satisfy the Panel that there were in place effective procedures to ensure that a repetition of the breach would not occur.

The facts of the case are as follows. Ruberoid, a roofing materials company, was faced with a hostile bid from Raine, a house building company, and a recommended bid from Tarmac another building company. SNC, who acted as broker for Ruberoid, owned a market-making arm which had a 2% holding in the company. The market making arm sold its holding to Tarmac, thus frustrating Raine's bid. When the Panel discovered that Tarmac had purchased its shares from an organisation which was also corporate broker to Ruberoid, the Panel began an investigation. The investigation brought to light two main concerns: First, it transpired that a matter of days before the pertinent transaction SNC's EMM arm was considering selling half of its long position in Ruberoid to Hoare Govett, who were acting for Raine. The advice of senior personnel was sought. It was advised that they should not sell to Raine because this might reflect badly on the position of the SNC organisation who acted as brokers to Ruberoid. The Panel held that "In light of Rule 38.1, this was clearly a consideration which should not have been taken into account and therefore amounted to a breach of the Rule".<sup>102</sup>

Secondly, SNC's broking arm were aware of EMM's wish to reduce its holding. It was arranged that the shares would be purchased by a broker who was acting on behalf of a then unknown party. This later was found to be

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100. See, Panel Statement 19 October 1988. See also, supra note 83

101. The suspension was thought unlikely to cause any significant financial loss to the company.

102. See, Panel Statement supra note 100, at p. 5.

Tarmac. It was argued that the SNC's broking arm had used the EMM's book to assist Ruberoid and that the broking arm should never have been given the opportunity to see that the excess shares were purchased by a party friendly to Ruberoid.

The Panel held that despite the fact that the broking arm had acted wrongly, "where the barrier between the market making arm and the corporate finance arm of an organisation is breached, with the result that the corporate finance arm sets out to facilitate the purchase of shares held by the market maker by a party friendly to the offeree, then the corporate finance arm becomes party to the activities of the market-maker ... the activities of all those in the corporation can be taken into account in deciding whether a breach has occurred."<sup>103</sup>

In reaching its decision the Panel reaffirmed its commitment to the proper working of the Chinese Wall technique stating that:<sup>104</sup>

In a market where organisations are permitted to act in several capacities, the Rules aim to allow sensible working of the market whilst preserving the integrity of separation between the various arms of organisations. Strict compliance with the Rules is crucial. It is necessary for those responsible for the overall management to make certain that an appropriate system is in place to ensure that the Rules are observed. It is also necessary for compliance to ensure that in actual practice that system is strictly adhered to. It is imperative that those acting in the market should know what the rules are and should exercise the most rigorous self discipline to stick to them. This task is no easier because of the potential close contacts between various members of the same organisation. But precisely because of such contacts, the systems and the checks enforced have to be strict. While physical separation, wherever it can be obtained, is important, the system ultimately depends on individuals being aware of the Rules and complying with them strictly.

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103. Ibid., at p.6.

104. Ibid., at p. 3.

In arriving at an appropriate sanction the Panel took a number of factors into consideration: SNC's full cooperation with the investigation, its reimbursement of Raine at considerable cost to itself and finally its pledge to adopt more stringent measures to ensure that there is no similar breach in the future. Taking a diplomatic approach the Panel concluded that "this case demonstrated inexperience and incompetence on the part of a number of people within SNC in an area which is of the utmost importance to the integrity of the market."<sup>105</sup> Nonetheless a three-month suspension was ordered.

While similar breaches of Rule 38.1 have recently occurred Smith New Court is the first EMM to have its status suspended. The ruling therefore marks the end of the Panel's honeymoon period for to adjust to the new rule changes. This is surely as it should be for despite the Code's non-statutory nature it would seem incumbent upon the Panel to impose penalties at least as severe as those in governmental semi-statutory domains.

### **Summary**

Chapter Seven reviews the official acceptance of the Chinese Wall mechanism in the U.S. and in the U.K. The merits of the device have been recognised by authorities on both sides of the Atlantic for some time now. In contrast to the largely pragmatic footing upon which the mechanism rested in both jurisdictions in the early years of its use, the recent trend has been to place the device on a more formal basis. In some senses this is an example of the regulatory paradox mentioned earlier in Chapter One: in Britain, at any rate, the one financial house may offer a full range of financial services; in the process regulatory barriers are being broken down (the trend towards

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105. *Ibid.*, at p.6.

deregulation) the Chinese Wall as an abstract concept is a flexible market-based regulatory mechanism (fitting conveniently within a deregulatory philosophy); yet its use is now being embodied in formal regulatory and statutory codes (the trend towards re-regulation). Despite the fact that this paradox is evident in both the U.K. and the U.S. there are, nonetheless, marked differences in the use of the mechanism by the authorities in both countries.

In the U.S recognition has been granted in a narrow but growing range of situations, capable of being expanded under the SEC's discretionary rulemaking powers. The first formal embodiment of the Chinese Wall concept in statutory language in that jurisdiction is found in the Insider Trading and Securities Fraud Enforcement Act 1988. The implementation of the mechanism is in most, if not all, instances subject to a reasonableness test. Therefore to what extent a 'naked' Chinese Wall will suffice is difficult to assess. Rule 14e-3, covering take-overs, is probably the most significant arena within which the SEC has permitted the use of Chinese Wall. But even here there is no complete safe harbour provision for a 'naked' Chinese Wall whereby the firm can self-deal. Nonetheless, there is no prohibition against self-dealing for specialists operating effective 'naked' Chinese Walls, perhaps illustrating the point that the SEC now believes that such Walls, if effective, are, by definition, reasonable and constitute a necessary by-product of deregulation in general. It is suggested that a 'naked' Chinese Wall defence is more likely to succeed in an administrative action than in a court action for breach of fiduciary.

In the U.K. statutory sanctioning of the Wall emanates from s.48 (6) (2) (h) of the Financial Services Act 1986 which gives the SIB broad based powers to implement Chinese Wall rules at its own discretion. In contrast to the SEC,

and in an arena where Glass Steagall does not operate, the SIB have made liberal use of this discretion. According to the principle of equivalence SRO's must make rules affording investors at least equivalent protection to the SIB rules. Thus Chinese Walls are also embodied in the SRO rulebooks. The SIB rules and those made thereunder are a defence to actions brought against conglomerates under the SIB rulebook (or SRO rulebooks) alleging: insider dealing, concealment of a conflict of interest, non disclosure of material interest and self-dealing. Of course to what extent this reflects the position at common law is a very moot point.

Closely linked to the SIB rules, but covering issues specifically related to take-overs, the City Panel on Take-overs Mergers has in the context of fully blown conglomerates endorsed the use of the Wall techniques in both its new rules covering dual capacity and in some of its recent case rulings. However the Panels 'naked' Chinese Wall approach will not permit self-dealing in every instance.<sup>106</sup>

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106. See, for example, supra note 93 and accompanying text.

## CHAPTER EIGHT: THE CHINESE WALL - A POLICY APPRAISAL

In Britain the policy assessment of the Chinese Wall has been shallow, failing to highlight clearly the crucial issues upon which adoption of the mechanism rests. Comments in the Gower Report<sup>1</sup> and the Government White Paper<sup>2</sup> implied that although it would be wrong to treat the mechanism as a panacea to the problem of increased access to inside information it was not to be discarded as wholly useless. This initial tentative approach would not seem to have been borne out by the current regulatory regime in the U.K.<sup>3</sup> nor by the evolving regulatory framework in the U.S.<sup>4</sup> As shown in Chapter Seven the widespread use of the Wall mechanism by the regulatory authorities in the U.K. has made the isolation technique the regulatory linch-pin of the financial conglomerate regulatory system. By not permitting Chinese Walls the operation of financial conglomerates would be severely impeded.

In the light of these facts it is now proposed to review some of the policy questions surrounding the Wall. The aim is to see whether there exists an adequate basis for confidence in the continued use of the technique, especially where banking and securities houses have merged together. For the purposes of analysis, the debate is couched in terms of a tension between economic issues of efficiency and legal issues of fairness, thus giving rise to a regulatory dilemma. How is this dilemma to be resolved? The application of strict legal principles? An economists cost-benefit approach? Or on the basis

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1. See, *infra* Chapter Seven note 35 and accompanying text.

2. See, *infra* Chapter Seven note 35a and accompanying text.

3. See, The Securities and Investments Board's Application for Designated Agency Status Under the Terms of the Financial Services Act and the Revised Rule Book Dated February 1987, Explanatory Statement, at p.14 section (e) entitled Chinese Walls. Discussed *infra* at note 59 and accompanying text.

4. See, for example, s.3 of the recently adopted U.S. Insider Trading and Securities Fraud Enforcement Act of 1988. Discussed *infra* Chapter Seven at note 26 and accompanying text.

of a policy hunch, making value judgements about the relative weights to be attached to the issues involved? Thus the difficult question of deciding which option best resolves this dilemma is addressed.

### **The Regulatory Dilemma: The Benefits of Conglomeration v. The Costs of Conflict Abuse**

Regulators are faced with a dilemma. On the one hand, there are certain benefits or "economies of scope" to be had from conglomeration<sup>6</sup> but on the other hand, there are also costs: both safety and soundness issues and conflict of interest problems.<sup>7</sup> The safety and soundness issue revolves around what the economist calls externalities.<sup>8</sup> The activities of any one bank which over-extends itself may impose costs not only on its own depositors (in that they lose their savings or a proportion thereof) but may also impose costs on other banks, because the failure of that one bank could jeopardise the viability of others. Regarding conflicts of interest, there is a strong tendency for conflict abuse to result in a misallocation of scarce economic resources, while at the same time creating a perception of unfairness in the provision of financial services. Given that there are both economic benefits and attendant costs associated with permitting the formation of financial conglomerates, a balance between the competing needs of both efficiency and fairness must be found. It is crucial to bear in mind that the stricter the regulation (in other words the greater the compartmentalisation) - the more the economies are reduced. In this way there is what might be called a regulatory dilemma.

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6. See, note 15 and accompanying text.

7. For a fuller discussion of conflicts of interest see generally, Chapters Two and Three.

8. The standard textbook example is the polluter who pollutes the environment for the rest of the community. The cost imposed is called the social cost because society rather than the polluter bears it. An externality may however create positive benefits.



Professor Goodhart has put it:<sup>9</sup>

The difficulties do not occur so much in assessing the case for regulation, but in designing how regulation can best meet the cost-benefit criterion, so that the marginal costs<sup>10</sup> of regulation do not exceed the marginal revenues to be gained. (footnote added).

### **What are the Economic Benefits of Conglomeration?**

#### **(i) Benefits from Enhanced Competition**

The merits of competition over and above restricted entry would appear to be well settled in neo-classical economic theory. It is generally assumed that increased competition will result in social benefits in the form of lower prices, increased choice, better customer service etc. It is axiomatic that the potential social benefits of competition will be greatest in those areas of financial services where there already exists a large degree of imperfect competition due to legal barriers or restrictive entry controls.

One U.S. commentator argues that investment banking exhibits a high degree of imperfection. Consequently a relaxation of the legal prohibitions on commercial bank entry into the investment banking domain would increase competition and in turn reduce underwriting fees.<sup>11</sup>

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9. Goodhart, "What is the Purpose of Regulating Financial Services?" (1986) mimeo., London School of Economics, at p.26.

10. Marginal cost, in this context, is the economist's terminology for expressing the change in total costs brought about by adding one more unit of regulation (or protection) to the regulatory framework. Marginal revenue, again in this context, would represent the change in total revenue induced by adding one more unit of regulation to the regulatory framework. Obviously it is very difficult to divide regulation into specific units and assess the relevant costs in the way envisaged in the quotation.

11. Robert Litan, What Should Banks Do?, (Brookings Institute 1987) p.61-74.

**(ii) Diversification reduces risk thereby enhancing the safety and soundness of the financial system**

It may be argued that conglomeration, far from jeopardizing the safety and soundness of the financial system through the threat of systemic risk and contagion, actually stabilises it. According to one authority:<sup>12</sup>

Available evidence suggests that new activities such as underwriting corporate securities, general insurance underwriting, mutual fund operations are actually less risky than conventional lending activities of banks.

The underlying principle here is that diversification actually reduces risk because the risks borne by one arm of the conglomerate are partially or fully offset by the activities of another arm of the conglomerate. According to Pierce securities business, particularly underwriting provides a good example of this. He writes:<sup>13</sup>

Available evidence indicates that the returns to securities firms are negatively correlated with the returns to banking in general. This means that, on average, when returns to banking are relatively low, the returns to securities activities are relatively high, and visa versa.

From this point of view it may be in the mutual interests of both banks and securities firms to merge so as to form conglomerates. The total risks of both would thereby be reduced. The stability engendered would result in consequent social benefits too, since the financial system would be less open to systemic risk.

Other studies would seem to dispute such a conclusion. On reviewing

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12. See, J.L. Pierce, "On the Expansion of Banking Powers" Deregulating Wall Street: Commercial Bank Penetration of the Corporate Securities Market (Ed. Ingo Walter, Wiley-Interscience: 1985), at p. 26. See also, Anthony Saunders, "Bank Safety and Soundness and the risks of Corporate Securities Activities" (at p.171) in Deregulating Wall. He concludes that greater diversification may actually contribute to greater institutional stability.

13. See, ibid., 26-27.

available research in the U.S., one set of commentators found that diversification did not appear to have any significant effect in reducing the overall risk of an organisation.<sup>14</sup> In a study cited by them, the correlation between commercial banking and investment banking was found to be positive (ie. a fall in the returns to one was not offset by a an increase in the other) thus indicating that there was little benefit from combining the two activities.

**(iii) Economies of scope or synergies: 2 + 2 = 5**

Although the literature isolates the above benefits, the following analysis concentrates essentially on the economies of scope, or synergies issue. Economies of scope are "cost savings derived from delivering multiple goods and services jointly though the same organisation rather than through specialised providers".<sup>15</sup> Essentially synergies arise when a firm achieves lower unit costs as a result of the joint offering of different financial products. Thus they accrue if the combined cost of providing financial services is less than would be possible if the same packages were offered separately by different firms.<sup>16</sup> In this way, economies of scope can be distinguished from economies of scale. The latter arise when an increase in the scale of production gives rise to a more than proportionate increase in output, thus lowering average costs.

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14. Fischer et al, "The Securities Activites of Commercial Banks: A Legal and Economic Analysis" (1984) 51 Tenn. L. Rev. 467, at p.505-506 and sources cited therein. See also, Litan, supra note 11, at p.97 who lists some of the methodological weaknesses in the studies he cites to support the contention that cohesion of banking and securities business would reduce risk. Notwithstanding these he concludes: "the evidence suggests that financial product deregulation would offer potential significant opportunities for reducing risk for the typical risk-averse bank".

15. Litan, supra, note 11, at p. 75.

16. See, Hall, The City Revolution, (MacMillan Press 1987) at p.90, footnote 43 & 44.

## How Do Economies of Scope Materialise in Conglomerates?

Synergies could be said to materialise where a conglomerate has the ability to apply its economics inputs - capital, labour, financial inputs, intangible assets such as information - to a variety of related activities. This is referred to as fungibility in the literature. The more fungible the inputs the more likely that economies of scope will ensue.

It is difficult to specify the exact benefits that arise from conglomeration and whether in fact they lead to increased sales and lower unit costs, especially in the short run. Few if any studies have shown conclusively that synergies in large scale financial conglomerates really exist. However it is possible to isolate four examples where synergies are likely to arise.<sup>17</sup>

First, financial conglomerates should be able to use their extensive network of customer relationships to match up buyers and sellers of different financial services. For example, customers of the banking arm of a conglomerate seeking underwriting services could be paired up with the securities arm.

Secondly, conglomerates could use the processed information stored on computer facilities which is required for the delivery of banking services generally to perform the same functions for the provision of other financial services. As a result, this might lower search/transaction costs in making credit ratings for customers or acquiring and analysing other financial data.

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17. See, Robert Litan, *supra* note 11, at p.76-81; See also, Alan Gart, Insiders Guide to the Finanical Services Revolution, (McGaw-Hill Book Company 1984 U.S.) at p. 37.

Thirdly, conglomerates should be able to realise economies in marketing and delivering services jointly. This is sometimes called cross-selling. Finally, a financial conglomerate should be able to realise economies if customers purchase a number of different but related financial services from the one financial house. The ability of customers to obtain all financial services - banking, insurance, securities, etc., - through the same organisation would be an attractive convenience. The same argument applies to supermarkets where groceries are sold along with other household goods.

The use of information and inside information in particular is likely to be an important resource available to conglomerates from which synergies are to be derived.<sup>18</sup> Ironically, this - the commodity which is most valuable in capturing synergies in conglomerates - is the sort of information which the conglomerate is by law prohibited from using. It is interesting to note that the likelihood of ascertaining whether the conglomerate did use such information is very slim indeed.<sup>19</sup>

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18. See, David Harper, The Financial Services Industry: The Effects of Regulatory Reform (N. Z. Institute of Economic Research Wellington, New Zealand, Research Paper No. 35) and the literature cited therein. He believes "Economies of scope are likely to be significant in the provision of financial services because several inputs, particularly information, can be used in many different applications without their value in any one application being substantially impaired." (at p.81, emphasis added). Unfortunately the discussion developed in the literature he cites is premised on the fact that the synergies will arise from information (and no doubt people - the two being very much linked in the financial services industry) and the application of information to "alternative productive activities" within the conglomerate (see p.63). Harper, and much of the literature he cites, ignores the fact that both Chinese Walls and legal proscriptions frustrate the use and diversion of price sensitive information (the sort of information from which economies are most likely to accrue) into alternative applications. It might be argued that the impact of a Chinese Wall which is higher than that which is necessary, could block out legitimate information, leading to both inefficiency and unfairness to customers by not using information that ought really to be used.

19. Some cynics have suggested that Chinese Walls are there to provide merely a superficial gloss of fairness so that conglomerates can benefit from the real economies of scope to be had by using inside information and management expertise on both sides of the Wall. See, The Square Mile, John Plender and Paul Wallace (Century Publishing: London, 1985) at p.15.

## Limitations on Economies of Scope

It is too early to tell whether real synergies will accrue from conglomeration. In any case, the extent to which economies of scope can actually be realised is dependant on two factors: (i) how far resources can be shared or utilised without there being complete congestion, eg. there could come a stage in the sharing of resources where, say, financial files get lost or get mixed up with other files, or where internal chains of command get confused etc.; and (ii) the extent to which the use of certain resources - namely information - is within the law.<sup>20</sup> It may be that because of the complex internal structures of conglomerates, the nature of the functions they perform and the regulatory arena within which the services are packaged, economies are largely illusory and cannot actually be realised. Moreover, if we take, for example, managerial expertise or corporate advisory skills, the provision of which is largely fixed at any given time, then an increase in the demand for these skills will lead to excess demand and insufficient supply to meet that demand, at least in the short run. A factor which compounds this problem further is that according to existing legislation and the statute backed regulation of the SIB and its SRO's, once employees are apprised of inside information they are no longer able to take decisions which are related to the information held. In addition, costs are incurred in coordinating a large volume of activity associated with the integration of services involved in diversification, the revision of the firm's organisational structure and the

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20. Other limits are noted by Hall, *supra* note 16, at p.90. These include natural limits to the extent of diversification such as consumer resistance, intense competition, managerial diseconomies and cultural barriers.

outlining of the parameters of authority for a large number of personnel.<sup>20a</sup>

Ultimately if economies of scope really are denied due to the effects of Chinese Walls and the existence of a legislative proscription on the transfer of price-sensitive information, there would seem to be an argument for capturing the synergies by abandoning both the Wall mechanism and anti-insider dealing legislation. This then takes us full circle to the question of whether insider dealing is a good or bad thing.

### **Conflict Resolution and the Regulatory Dilemma:**

#### A. The Nature of the Problem

An analogy may help to illustrate the issues involved here. Assume a self-contained community suffering from vertigo and claustrophobia. A stretch of road exists between factories "A" and "Z". "A" supplies raw materials to factory "Z". The road is in constant use. The less hold-ups the more efficient is the output of both factories. Virtually every one in the vicinity is to some extent dependant on the competitive efficiency of both plants. Unfortunately children from the residential "East side" need to cross over the road to get to the school which is on the "West side". There have been a few nasty accidents.

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20a. See, Harper, *supra* note 18, at p.85. He is also of the opinion that the limits to diversification stem from managerial diseconomies of scope. His ultimate conclusion however (without mentioning Chinese walls or proscriptions at law on the use of certain categories of information) is that "cost advantages can be derived from providing a diversified range of financial services ie., economies of scope are significant." p.90 (emphasis added)

The people of the area are in a dilemma. In analysing this dilemma it is easy to see that there are efficiencies to be had by continuous road use; but this has to be traded off against the need for safety and fairness. What should be done? All realise that there are no problem free solutions but different groups believe some solution are more free of problems than others.

The Trade Unionists and factory owner say that nothing should be done. Action would make them less efficient, put up their costs and make them less competitive than foreign counterparts. Jobs would be lost. Living standards would fall. In addition, the community would have to divert some of its productive resources to installing the new traffic lights or other measures. They agree that these resources would obviously have an opportunity cost<sup>20b</sup> in as much as they could be put to use elsewhere. They say - let the crosser beware (the market forces argument - see below). Their argument runs as follows: there are always slight gaps in the traffic - people can cross then; the odd life or limb must be balanced with the economic well being of the community as a whole. The Union will warn its drivers to be more careful in future.

Some of the community think that "modified" traffic lights should be installed - but with only a green and a red light; ie. no amber or green man ('naked' Chinese Wall). This would stop the trucks momentarily while allowing people to cross. Since the people would never know when the lights would change they would rush across as best they could and not waste time. They argue that under the modified traffic lights system a truck driver could be trusted not to run over an "Aunt Agatha" or a young child because of the social

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20b. All resources have alternative uses. Opportunity cost is the next best alternative forgone by using the resources in the particular way they have been.



stigma and/or moral guilt attached to such conduct. Furthermore, truck drivers would not have to endure the extra wait of an amber light and therefore the loss in efficiencies would be less. As well as this, the "modified" traffic lights system with no amber or green man would use up less resources in construction.

Others want "traditional" traffic lights as used in other communities (full and frank disclosure of the conflict). They don't want to be caught out in the middle of the road with the lights against them and be dependant upon the goodwill of truck drivers who get bonuses for extra fast delivery. Their lives are more important than extra efficiencies.

Still others want traditional traffic lights plus a 'lollypop' person for added protection at especially dangerous times, such as when the children are coming home from school (the "reinforced" Chinese Wall). Some even want a zebra crossing so that the pedestrian is always given the right of way (deconglomeration). This would seriously impede the operation of factories A and Z and result in a marked economic decline in the region.

In the same way as the community in the above analogy must seek an appropriate solution to the problems they face by balancing up the costs and benefits of the action they take;<sup>20b</sup> so too must policy makers, consumer groups and the financial community balance up the efficiency and fairness issues at stake when regulating financial conglomerates. Financial conglomerates, as we have seen, bring many social and economic benefits; but they also bring costs. It is essential that an appropriate regulatory solution is found, for it is

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20b. Of course the above analogy only demonstrates the nature of the dilemma; it does not show us how to solve it.

possible to have undesirable increases in protection, resulting in overprotection and imposing undue costs.

As mentioned in Chapter Five the options fall into either of two categories; either the conflicts can be controlled through a range of measures, or the risk of their abuse can be eliminated through de-conglomeration. Again it is crucial to bear in mind that the stricter the regulation - the greater the compartmentalisation - the more the economies are reduced. The regulatory options, which are considered in order of the strength of compartmentalisation, are (1) market forces; (2) "naked" Chinese Walls; (3) full and frank disclosure of the conflict; (4) "reinforced" Chinese Walls and (5) de-conglomeration. These are examined below.

#### B. Resolving the Regulatory Dilemma?

But necessary as it is to isolate the regulatory dilemma and list the regulatory options, this does not resolve the problem. If the aim is to find the most appropriate regulatory solution, two preliminary questions must be addressed: first, how do we assess the costs and benefits of the above competing regulatory techniques and how are they to be weighted against one another?; and, second, and very much related, who is to bear the costs of adopting one device as opposed to another? ie. a distributional question. Economists would claim that these issues can best be assessed by applying economic analysis, by using a cost-benefit approach. But are the costs and benefits really quantifiable? As Kate Mortimer, Director of Policy at the SIB suggests:<sup>21</sup>

[I]t seems sterile to argue about the precise level of costs being imposed by the system coming into place under the Financial Services Act. The SIB and the Government are being criticised for failing to

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21. See, K. Mortimer, "The Securities and Investments Board", in Financial Regulation - or Over-regulation? (IEA: 1988) 45, at p.45.

subject the new system to a a cost-benefit analysis before adopting it. I question whether such ex-ante analysis would have been worth the paper it would have been written on, given the number of imponderables involved.

Indeed Professor Goodhart, accepts that such a cost-benefit approach, while still of value, is "notoriously difficult to undertake, and certainly cannot be undertaken in an purely objective, value free manner."<sup>22</sup> It might be that the economists approach is rather too narrow and theoretical to prove which option is the most suitable, it being argued herein that the answer cannot be proved. It is suggested that the answer to this question essentially comes down to making a policy choice based on the fairness of a regulatory option and the ability to enforce it rather than on the basis of strict cost-benefit analysis. Gower, in a passage which casts a rather jaundiced eye on the economist's cost-benefit approach, sums up the issue well:<sup>22a</sup>

[I]nvariably there is a tension between market efficiency and investor protection which often pull in different directions. It may be that the most efficient market is that which is wholly free from regulation but it is unlikely that such a market would afford investor protection which anyone today would regard as adequate. One has to make a value judgement on the relative weight to be attached to market freedom and to investor protection.

In this way, rather than argue that the legal approach is superior to strict empirical economic analysis, it is argued that strict economic analysis is certainly not better than legal analysis. Nonetheless a tentative import of economic analysis is herein applied to assess the moral, legal, and economic incentives which would make a financial conglomerate conform to certain regulatory regimes. This approach ought to be beneficial in arriving at an appropriate policy choice. In this way, it may be possible to isolate a regulatory <sup>mechanism</sup> which is more free of problems than others.

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22. See, "The Costs of Regulation", in Financial Regulation - or Over-regulation?, ibid., at p.31

22a. See, the Gower Report Part I at para.1.16.

### C. The Regulatory Options Considered

#### 1. Allow Market Forces To Regulate Potential Abuses Within Conglomerates

It is important to remember when considering this regulatory option that it is set within the context of insider dealing as an economic bad and the operation of overall - or blanket - anti-insider dealing legislation as well as other common law prohibitions. Thus, it is important to emphasise that the question at issue here is not whether society ought to proscribe insider dealing but whether once proscribed society needs special additional anti-insider dealing regulation directed specifically at conglomerates.<sup>23</sup> Advocates of the market forces argument outlined here are in effect saying: "Take no extra official action, let market forces control insider dealing in conglomerates: we don't need special costly regulation." The essence of the philosophy is captured in the maxim caveat emptor. The underlying premise upon which the argument is based is that the rigours of competition can turn inherent conflict situations into productive and profit maximising pressures.

Such a system of regulation, or rather "non-regulation", would, at first blush, appear attractive to conglomerates. First of all, conglomerates would not have to comply with costly regulations. They would also, in theory at

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23. This "free market" argument is quite distinct from the earlier discussion infra Chapter Three where inter alia the case for unfettered insider dealing was outlined. It is not pure Chicago School economic analysis which is being applied in this section. Here the costs of allowing insider dealing are still considered to be higher than the benefits. The issue here is whether conglomerate directed regulation is required over and above general anti-insider dealing legislation covering inter alia conglomerates. The discussion is based on whether market forces will provide sufficient incentives for conglomerates to conform to existing anti-insider prohibitions without the need for policy makers to resort to new costly regulation.

least, be able to capitalise on legitimate economies of scope. Moreover, conglomerates might also be able to capitalise on "illegitimate" economies. There would be substantial potential returns from the use of inside information and the abuse of other conflicts. Nonetheless there would also be potential costs ie. the possibility of detection and the consequent damage to their reputations in the market.

Leaving conglomerates to abide by the dictates of the markets is an argument favoured by economists with a pervasive view of market forces. Implicit in this reasoning is the existence of an economic calculus. Goodhart offers an example. He writes:<sup>24</sup>

The public may ... support a regulatory proposal that actually harms them on balance, (because the restraints on competition, the deadweight costs of compliance and administration may considerably outweigh the extra likely losses in an unregulated state).

Thus the degree of conflict abuse will reflect the relevant costs and benefits. In other words in determining the short term incentive to exploit a conflict of interest by, say, abusing inside information given in confidence by corporate finance client Company X, a financial conglomerate will consider very carefully the attendant risks of losing: (i) a lifetimes business from Company X, (ii) the loss of business from other customers which results from a loss of reputation within society because of publication of the abuse<sup>25</sup>, (iii) the loss of premiership within the industry, (iv) the severity of sanction imposed by the regulatory/judicial authorities, and (v) the effort, or cost of acquiring and exploiting the information abused. Where potential conflict abusers perceive the benefits of the illegal conduct to outweigh the costs to them then

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24. See, *supra* note 22, at p.9.

25. Since both Company X and the other customers of the conglomerate will in all probability be in receipt of other conglomerate financial services, the conglomerate will also have to take in to consideration the future loss of these other services in the economic calculus.

conflict abuse will be rationally beneficial.<sup>26</sup>

There is however one further consideration to take into account. Insider dealing is not only a civil offence but also a criminal offence. Although a firm may in principle participate in insider dealing it cannot under the Company Securities Act 1985 be made criminally liable for it, except in very limited circumstances.<sup>27</sup> Instead, the individuals who perform the deal on behalf of a conglomerate are vulnerable to conviction. Thus a profit-maximising individual who contemplates insider dealing for a conglomerate will have to devise his own economic calculus. He will weigh up the value of the haul (with the return which will filter through to him) with the probability of getting caught. The time spent in jail will have an opportunity cost, namely the loss in salary, reputation and status, future job prospects, loss of family life etc. If the risk of getting caught is commensurate with the end return he, as a rational maximiser, will indulge in insider dealing.<sup>28</sup>

According to those with a strong view of market forces, not only would market forces deter abuses; they would also help uncover them. The two are very much inter-related. Probably one of the most effective ways in which competition can discourage the abuse of conflicts of interest, and in particular insider dealing, is through the incentive it creates for institutional counterparties to "blow the whistle" on miscreants. For example,

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26. See Chapter Two at note 52 and accompanying text.

27. See, Chapter Four at note 18 and accompanying text. Of course a company may be civilly liable under the Financial Services Act 1986 (see, s.61 and 62.) and the rules made thereunder (eg. Rule 3.10, discussed *infra* Chapter Seven at note and accompanying text) and also under common law principles (see *generally* Chapter Four : "The Regulation of Insider Dealing at Common Law".

28. See, Posner, *Economic Analysis of Law* (2n ed. Little-Brown 1977) pp.164-65 where he writes: "[A] ... growing empirical literature on crime has shown that criminals respond to changes in opportunity costs, in the probability of apprehension, in the severity of punishment, and other relevant variables, as if they were the rational calculators of the economic model".

X Company (on the basis of some inside information it has acquired about Y Company) buys shares in Y company. It buys those shares through a market-maker, say, at a price which significantly rises in value soon after the purchase - the market-maker suspects something and refers the matter to the regulatory authorities. The incentive to inform arises from two factors: first, the market maker is arguably the victim of the insider dealing<sup>29</sup> and second, the market maker may not want to be associated with suspected insider dealing.

There are, however, a number of factors that might militate against the successful operation of a 'whistle-blowing' or 'supergrass' system. First of all the financial markets have been traditionally close knit preferring to wash their own dirty linen in private rather than to hang it out for public airing. The innate cohesion of the community in times of close public scrutiny, whereby there is a tendency to close ranks could make people with relevant evidence reluctant to inform.<sup>30</sup> Then secondly, and very much related, parties will not want to be labelled with the stigma of passing information to the authorities, especially when they may not have clean hands themselves.

Admittedly, the above reasoning may have become rather dated. There is no doubt that the composition of the markets has changed radically over the last few years making the old club-like system of control inappropriate if not defunct.<sup>32</sup> The new international character of the market place and the increase in competition has brought with it a new willingness to ensure that no one has an unfair advantage. Indeed in the Geoffrey Collier case in the U.K in 1986

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29. See, Chapter Three at note 112 and accompanying text.

30. A cohesion well illustrated by the recent County Nat West Affair where there has been a distinct reluctance from certain sections of the financial community to put the blame on specific individuals.

32. See, Veljanoski, "Introduction", *supra* note 21, at p.3.

the regulatory authorities were alerted of Collier's insider trades by a counterparty to the deals.<sup>33</sup>

In the U.S, the informant system has been successfully tried and tested by the SEC. In 45 enforcement actions brought in 1985 and 1986 informants were instrumental in providing information in 15 cases.<sup>34</sup> Moreover, the U.S. authorities have now given express approval to the use of an informant system with the recent passage of the the Insider Trading and Securities Fraud Enforcement Act of 1988. Section 3 of the new Act adds a new section 21A to section 21 of the Securities Exchange Act 1934. Ss (e) of the newly inserted section in part reads:

(e) ... there shall be paid from amounts imposed as a penalty under this section and recovered by the Commission ... such sums, not to be exceed 10% of such amounts, as the Commission deems appropriate, to the person or persons who provide information leading to the imposition of such a penalty.

By approving the Act, Congress has given express sanction to a novel practice hitherto carried out on a largely pragmatic and informal basis. To what extent it would be politically feasible for the U.K. authorities to operate a paid 'supergrass' system whereby the like of a British "Ivan Boesky" could receive payments or immunity in return for providing the authorities with valuable information relevant to the prosecution of others is highly questionable.

The now institutionalised "informant" system in the U.S. developed because circumstantial evidence - the most common form of proof available to

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33. Collier, who was head of securities at a Merchant Bank in London, was called in to advise Hollis on the proposed take-over of AE. Before the bid was announced publicly, Collier bought shares in AE for his own account. See, "Collier's Rise and Fall", The Independent, 2 July 1987.

34. See, GAO, Report to the Chairman, Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, House of Representatives: Securities Regulation - Efforts to Detect, Investigate, and Deter Insider Trading, August 1988, at p.5. (hereinafter "GAO Report").



the authorities - tends not to meet the "beyond all reasonable doubt" standard required in criminal trials, while the use of informants is arguably a more useful way of obtaining direct evidence of insider dealing.<sup>35</sup> In any case an economist with a strong view of market forces would argue that a "whistle-blowing" regime operating through market incentives would not need to be perfect. The underlying concern would be to relieve conglomerates from unwelcome additional regulatory constraints at a cost of having some informational abuse.

Reliance on market forces to control the accentuated misuse of inside information in the conglomerate context would also have benefits and costs for society too. Society would benefit in that few if any direct resource costs would be involved in setting up the regime (except, perhaps, in dismantling the pre-existing one). Nonetheless the costs imposed on society by relying on market forces might be considered to be too high. Caveat emptor may seem fine in theory, but in an industry replete with information assymetry how does the emptor caveat? After all customers have great difficulty in discerning either in advance or after the event the quality of the service that has been performed. Moreover the benefits of the market philosophy are illusory to the extent that market forces do not work. The value of market forces will be to a

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35. "SEC ... often use tips from the public and cooperating witness to prove the evidence necessary to prove insider trading ... [P]ersuading individuals who are aware of insider trading or involved in it to provide information to the SEC can be important to successful investigations." See, GAO Report, at p.56. The report goes on to quote (at p.57) the findings of a SEC Roundtable debate where it was said that a "... a reward program could enhance market efficiency if structured to target deceptive internal corporate activities that are otherwise difficult to discover ...". The Report concludes: "Others from the securities industry and academia expressed views both favoring and opposing the idea. In general, negative comments related to concern about the number of informants who might provide hearsay evidence or information of questionable value."

large extent dependant on the degree to which uncovered abuses are publicised to others who require similar services. It is only when abuses are widely publicised that there exists the requisite knowledge for consumers to make reasoned choices. Costs would even be imposed if the public perceived that market forces were not strong enough to create a fair financial system.

In addition, a calculus such as that outlined by Goodhart is arguably too narrow. Notably it does not take into account risk aversion. For example there is a possibility that a large financial loss caused by conflict abuses or over-diversification would be so unacceptable that society might prefer tougher regulatory measures such as industry imposed Chinese Walls, disclosure etc. The benefit, in terms of peace of mind, may be far greater than any "narrow" calculus of "expected loss" to the community at large. Thus the regulatory equation runs something like this: the potential for abuse or financial mismanagement + the perceived notion that abuse occurs fairly regularly + episodic abuses that come to light + the need for confidence in the financial markets, points towards the search for a real regulatory response.

## 2. The "Naked" Chinese Wall

The theoretical attractiveness of the Chinese Wall is that ostensibly conglomerates can function in such a way as to enable them to capture synergies; yet at the same time the screening mechanisms that go to make up the Wall block out illegal inside information, thus avoiding potential abuses.<sup>36</sup> By employing the Wall mechanism, compartmentalisation is only slight and thus does not unduly burden or hamstring the operation of the conglomerate. In this way the

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36. Of course, the economic argument that Chinese Walls are useful in conglomerates and prohibit insider dealing, must ultimately rest on the basis that insider dealing is an "economic bad". See generally, Chapter Three.

Chinese Wall facilitates competitive benefits and efficiencies for the conglomerate itself and for society as a whole.

### Is the Chinese Wall Effective?

The extent to which the Wall is an attractive regulatory mechanism is dependent upon its effectiveness in stopping the flow of unpublished price sensitive information within the corporate entity. This inevitably leads us to the important question of how the Wall is policed and how breaches are detected. Undoubtedly the mechanism's greatest defect lies in ensuring that it is effectively enforced. Chinese Wall rules can be easily broken and breaches are apt to go undetected.<sup>37</sup> Moreover, the Wall may well be "paper-thin" in small conglomerates<sup>38</sup> in that one individual may be operating in two separate capacities.<sup>38a</sup>

The effectiveness of a Chinese Wall will depend upon the incentives/disincentives which exist to breach/enforce it. The enforcement mechanism upon which the Wall depends is to all intents and purposes the market forces

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37. Despite the fact that the Chinese Wall has been used extensively by banks and other financial institutions in the U.S. for over two decades there has been difficulty in establishing how effective the mechanism actually is. Owing to the very nature of the device and the context within which it operates it is virtually impossible to make any real assessment. Certainly the absence of lawsuits is no indication either way. In an examination of function of the Chinese Wall in the commercial banking context, Hunnsicker suggests that: "[I]t has not been established that a functioning wall is the reason [for the absence of lawsuits]. It is likely that the secrecy surrounding ... transactions ... coupled with other problems of proof, has more often been the proximate cause. Neither the tipper nor the tippee will have any reason to disclose the abuse of information. (footnote omitted)" See, Hunnsicker, "Conflicts of Interest, Economic Distortions, and the Separation of Trust and Commercial Banking Functions", (1977) 50 Southern California Law Review 611, at p.641.

38. See, Wood, "Financial Conglomerates and Conflicts of Interest" in Conflicts of Interest in the Changing Financial World, (Ed. Goode, The Institute of Bankers, London, 1986) at p.69.

38a. See, Solomon & Wilkie, "Securities Professionals and Rule 10b-5: Legal Standards ..." (1975) 505 Fordham Law Review at p. 532, footnote 85.

incentives discussed earlier backed up by in-house compliance personnel and general regulatory overseers, such as the SIB, SRO's and the Takeover Panel. Given that the Wall is dependant upon self-enforcement in an arena where self-interest is so prevalent it would seem unrealistic to assume a completely effective wall.

Once more an individual/ corporate distinction needs to be drawn. It would appear that detecting corporate insider dealing will be dependant upon the strength of market forces plus general regulatory oversight, since the conglomerate's compliance personnel will be acquiescing in the crime. The corporate calculus will therefore be as before.<sup>39</sup> However the Chinese Wall and its accompanying procedures may be more effective in detecting the maverick individual in a firm who misuses inside information. The powers of the regulatory authorities and in particular the attentiveness of in-house compliance personnel will reduce abuse. Assuming that the powers of the former are limited (as most probably they are) while the latter, although still faced with difficult detection problems, are in the best position to observe and monitor the Wall and detect breaches, a great deal of the enforcement mechanism will depend on in-house compliance. It follows that the level of enforcement will vary from firm to firm depending on the skill of the compliance officer and his team and the cooperation from work personnel. The more skilfull the compliance team the greater the risk of detection and prosecution.<sup>40</sup>

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39. See, supra note 25 and accompanying text.

40. Evidence from the U.S. suggests strongly that the likelihood of legal sanction is a relatively ineffective deterrent. See, Cottrell, "Insider Dealing in the United sates - I: The Law" (1986) Janurary 31 NLJ 88, at p.90 where she argues that although civil sanctions are more likely than criminal actions (because of the lower burden of proof), even this does not seem to exert a significant legal deterrent. This would be probably even more true in the U.K. where prosecutions for insider dealing have been very rare. There is no reason to believe that civil actions, under s.61 and s.62 of the FSA 1986, will prove any more successful in showing that insider dealing has occurred.

However the difficulties associated with reliance on in-house compliance personnel are compounded by the high degree of interaction between employees within the 'group', in that:<sup>41</sup>

the forces of common interest, close physical proximity and the ties of personnel loyalty could be overcome only by an extremely strong wall.

Indeed, information may be picked up by personnel over lunch, or in the lift, - basically anywhere they congregate. Thus it would appear that to the extent such interaction takes place the efficacy of the Wall is most probably compromised. What might be a more effective deterrent is dismissal by the firm or by the SIB for not being "fit and proper"<sup>42</sup>. This would put future employment prospects and general livelihood in jeopardy, factors which would have to be seriously weighed up by a profit-maximising individual.

Another factor which is likely to reduce the efficacy of the Wall is the difficulty in telling whether information is really price-sensitive or not. This may cause an individual to inadvertently pass or receive inside information because he or she is unaware that the information is price-sensitive. Similarly, the nature of the corporate structure itself frustrates the departmental isolation of inside information. Board meetings will comprise top corporate personnel who head departments with different conflicting functions. Almost certainly, when devising group policy as a whole they will be apprised of relevant insider facts.

Having discussed some of the broad principles upon which the effectiveness of the mechanism rests, it is now intended to consider some of

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41. See, Hunnsicker, *supra* note 37, at p.643.

42. For example, Geoffrey Collier was suspended for 10 years.

the more detailed institutional arrangements relevant to policing the device in the U.K.

(a) How are Chinese Walls Enforced?

Enforcement should in theory be conducted by the firm because of the secrecy and complexity of a vast number of deals which makes it enormously difficult for a central enforcement agency to ensure that abuse is not taking place. The costs involved in setting up, training and operating such an agency would be high given the likelihood that few convictions would result. Thus, the current regulatory regime with its emphasis on Chinese Walls has not tried to establish such an agency but has sought instead to leave much of the day-to-day enforcement of the Wall in the hands of the individual firms. At most, regular or random checks are conducted to inspect policies and procedures, relying more on the Stock Exchange surveillance network to provide 'regulatory oversight' on a regular basis.

Thus in Britain, the Chinese Wall, despite being given statutory backing is, in effect, a self-regulatory mechanism. The SIB and other regulatory authorities rely on firms to establish systems and procedures which will "block" inside information. All firms are required to have compliance officers who are responsible for drawing up written compliance manuals suitable for the needs of each particular firm.<sup>43</sup> These manuals must give investors the standards of protection laid down in the Financial Services Act. The SIB may inspect the validity and effectiveness of these procedures at any time though quite obviously the proper operation of a Chinese Wall depends on the integrity

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43. Unless, that is, the firm has 10 or less employees.

of the people who work on either side of it.<sup>44</sup> The Takeover Panel, for example, requires firms who ask for exempt status (on the basis that they operate effective Chinese Wall procedures) to provide among other things details of the business structure of the firm both in terms of its physical location and in terms of the type of business undertaken. With only a small number of staff it inspects every firm. How feasible this policy really is and more importantly how effective it is, could be anyone's guess.

(b) How are Breaches Detected?

Ultimately it would be unrealistic to assume that regular and random checks by the regulatory authorities could adequately cope with the detection question. There are two possible ways in which breaches of the Chinese Wall could be uncovered. The first, which involves the use of computers, is applicable to both monitoring by the regulatory authorities (external monitoring) and by an individual firm's compliance team (internal monitoring). The second, involves the use of an informant or "supergrass" system.

(i) Computerisation

Computerisation has brought greater "transparency" to the market place making it easier to prove that insider trades have taken place, and that a Chinese Wall has been breached. In theory regulators can discover transactors at a moment's notice. The result is that the authorities' powers of detection have increased as have the ability of the compliance team to detect serious

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44. See, Yellon, "Trust Investments: Problems Regarding Exchange of Information between the Trust Department and Other Departments Within the Bank", (1973) June, Chicago Bar Record 405, at p.414-415.

breaches of in-house rules.<sup>45</sup> Thus, for example, where conglomerates are seen to be consistently dealing in successful new shares issues underwritten by its securities division it might seem reasonable to assume that a Chinese Wall is being breached. The limitation, however, of computerised systems is that they operate only with regard to deals made in the U.K. Thus, if insider traders are clever enough to use "off-shore" routes and nominee accounts their dealings may be more difficult and perhaps impossible to detect. As well as that, computers are only capable of identifying suspicious trading patterns; it is a much more difficult task to prove that inside dealing has taken place.

Both regulatory officials (either SRO's or SIB) and in-house compliance teams are able to use computers to monitor regularly the reported 50,000 bargains which are put through the Stock Exchange every day. Since Big Bang it has become obligatory to report the time of striking a bargain. The authorities can therefore discover whether a deal was made before or after a company disclosed major news to the markets. The Stock Exchange, for example, operates the Stock Exchange Automated Quotations system (SEAQ) system and the Talisman system. It also conducts regular and random checks on three main

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45. Internal surveillance of individuals suspected of breaching a Chinese Wall is essential to maintain the integrity of the mechanism. According to John Mayo, Chairman of the Mercury International Group Compliance committee: "it is essential for any financial services organisation both to have strict staff dealing rules and to monitor staff dealings to spot any case where a deal raises the possibility that advantage might have been taken of unpublished price-sensitive information, What is more, monitoring needs to extend for dealings for the account of firms or its customers. Since those within one Chinese Wall should have no knowledge of confidential transactions from those within another Chinese Wall, monitoring of dealings to guard against abuse of insider information needs to be a central function to be handled by the Compliance Department with the appropriate Compliance Officer ... Our staff dealing rules are detailed and strict and apply to employees and their spouses and children, including trusts, companies and funds which they effectively control. All dealings have to be handled in-house. Particular dealings require advance clearance and some staff, such as in Corporate Finance, need advance clearance for nearly all their dealings." See, Mayo, "The Role of Compliance", (1987) June The Treasurer 47, at p.47.



areas: (1) whether the 'best execution' price was made; (2) whether there has been dealing in restricted securities and (3) any relationship between price and volume jumps. The authorities concentrate on trying to establish material links which might suggest suspect trades.<sup>46</sup>

Compliance departments also monitor deals via computers. Some teams study records of their firm's involvement in public takeovers. They get computer print-outs that go back 6 weeks or more before the public announcement. These are checked for: staff dealings, dealings for both discretionary and non-discretionary customers, changes in the market-making book and dealings for the firm's own account.<sup>47</sup> The trend emerging among both internal surveillance teams and the regulatory authorities is for the adoption of increasingly complex computer systems which draw attention to 'oddities' rather than on systems which provide only random checks.

#### (ii) Through Informants

It would seem that one of the most likely means of detecting breaches of Chinese Walls is through the informant or 'whistle-blowing' network described earlier.<sup>48</sup>

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46. According to Lindsay Thomas, the Stock Exchange's computer surveillance systems project manager, "Establishing links is the key, between people, between businesses, between deals ... We are considering applying artificial intelligence to this so that, for example, we can connect people who have worked together, relationships between a particular client account, an individual, a firm advising in a takeover - it may just be a coincidence of addresses." William Owen, "Looking for breaches in Chinese walls", (1987 May) Communications in the City 25, at p.28.

47. See, Mayo, supra note 45, at p.47. Elisabeth Nicholson, head of compliance at Natwest Investment Bank, in looking for breaches of the Chinese Wall concentrates on "price movements, collusion between market makers and broker dealers, between one client and a broker, and also at the market makers' bear and bull positions." See, Williams, supra note 45, at p.28.

48. See, supra note 34 dealing with the market forces argument.

The Wall mechanism is then a systems of checks primarily from within the conglomerate to prevent inside information flowing to the various departments in the corporate entity. Accordingly, the Chinese Wall as a preventive device can be viewed in two ways: first as a means of resolving a conglomerates obligations by providing investors with the requisite degree of protection; and second, as a protection for conglomerates against allegations of insider dealing. These are now considered.

(a) As an additional safeguard over and above market forces to prevent conflict abuse - in particular prohibiting insider dealing - and provide Investor Protection

Gower rejects the Wall's investor protection function. Such a view is based on the fact that Chinese Walls:<sup>49</sup>

[A]re not a protection to investors and may, indeed, be a detriment to them as depriving them of the benefit of the knowledge and expertise that they will expect from a financial supermarket.

Similarly he believes the Wall to be inherently defective. As noted earlier, he has written that he has:<sup>50</sup>

never met a Chinese Wall that did not have a grapevine trailing over it.

If in his experience Chinese Walls do not work, it is a serious claim to make and hardly great praise for a mechanism which represents the regulatory linchpin of the financial conglomerate regulatory system. That the Chinese Wall is a device that does not afford investor protection is an argument which needs to be explored further.

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49. Gower Report, Part II, para. 4.13.

50. Gower Report Part II, at para. 4.13.

Although the ability of firms to invoke the Chinese Wall defence in an action brought under the SIB or SRO rulebooks probably leaves investors with less protection than that which they would have at common law, Schedule 8 of the Financial Services Act 1986 tries to redress this fact.<sup>51</sup> Therein a number of guiding principles are offered, which originally stem from paragraph 7.5 of the Government's White Paper. They are summarised below.

First, there is the principle of fair dealing whereby rules are instituted to prohibit unfair practices and requiring investment firms to be conducted in accordance with good market practices.

Secondly, a duty of skill care and diligence is required in the provision of investment transactions. Consequently, anyone purporting to give investment advice is under a duty of care commensurate with their responsibilities.

Thirdly, there is a duty to disclose any material interest which a conglomerate has in a transaction, the capacity in which it is acting, the fees it would charge and the remuneration which it might receive from other parties interested in the the transaction and any connection it might have with other parties interested in the transaction.

Moreover the White Paper holds that whenever an investment business finds itself in a conflict of interest situation it must act in accordance with the general rules of agency and fiduciary law as explained earlier. In particular the firm must abide by:

- i. a best execution principle, whereby all instructions from the

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51. See, Appendix I.

clients must be executed to the clients best advantage. Thus no investment business should deal with a client from its own account or book unless this results in better terms for the client.

- ii. a subordination of interest requirement, so that the clients interests are paramount. Thus clients should be given priority in the execution of orders when an investment business is also dealing on its own account, and there should be no "churning" of a managed portfolio to generate commission income.
- iii. a "know your customer" principle requiring an investment business to satisfy itself that a particular recommendation or transaction is suitable, bearing in mind the "expertise, needs and resources of the customer". This should amount to nothing more than a duty of skill care and diligence.

All these are indeed powerful safeguards, for they are rooted in strict fiduciary law. However such principles cannot be looked at in isolation. They must be considered in conjunction with the scope of the SIB's rule making powers, especially in relation to Chinese Walls. This becomes clear later.<sup>52</sup>

Professor Gower places great faith in the above principles. Indeed it would appear from Part II of his Review of Investor Protection that he sees them as the solution to the Chinese Wall conundrum. As already shown at the centre of his analysis of the Chinese Wall are two factors which militate against wholehearted endorsement. First there is the possibility that the Wall will "leak" and therefore result in unfairness to investors; and secondly,

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52. See, below at note 56 and accompanying text.

there is the alternative possibility that it will work and result in unfairness to investors - or some investors at least. These are significant hurdles to overcome. Gower believes they are surmounted by the adoption in the FSA 1986 of the safeguards mooted in the White Paper and outlined above. Immediately after noting the ways in which Chinese Walls could well be a detriment to investors, he writes:<sup>53</sup>

[investor protection is] afforded in other ways and I warmly commend the "principles" summarised in paragraph 7.2 [of the White Paper] and the elaboration of them and of the resulting "rules" in later paragraphs of the Chapter (presumably see, 7.5 and 7.6, also summarised above - emphasis added)

The counter argument presented here is simply that these principles are not compensatory in the way Professor Gower supposes them to be.<sup>54</sup> It is submitted that the safeguards which he commends come into effect too late in the day for the investor to take comfort from them. Take the familiar scenario where one arm of a conglomerate has adverse inside information about company X while the other arm is recommending customers to buy company X's securities. Under the SIB's rules once a Chinese Wall has been erected there is, for example, no duty to disclose any material interest. The recommending arm may recommend that customers "buy company X" with impunity, despite the resultant detriment to those customers. All that the legislation requires (implementing the "safeguards" of the White Paper, which Gower commends) is that the recommending arm provide the customer with company X shares at the best price ie. best execution, or even that the deal should be taken with a duty of skill and care. In other words the fact that the advice is inconsistent with

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53. Gower Reoprt, Part II, at para. 4.13.

54. Admittedly they would be a lot more compensatory if the use of Chinese Walls were circumscribed to cover only very limited situations or even if they were compulsorily reinforced. However, because this is not so, the use of the Chinese Wall in the U.K. drives, as it were, a cart and horse through the White Paper/Schedule 8 purported safeguards.

knowledge held by another arm of the conglomerate is totally irrelevant. One is prompted to ask: "is this really investor protection?"<sup>55</sup>

It is submitted that the issue of the efficacy of the safeguards contained in the Schedule are really quite important. This is not advocacy against Chinese Walls per se but merely a rejection of any argument that suggests that the safeguards contained in schedule 8 counter-balance any losses in investor protection caused by the adoption of the Wall mechanism. It is submitted that the SIB's stance on the Wall mechanism over the last few years has been somewhat contradictory and confusing.<sup>56</sup> In 1985 the SIB said:<sup>57</sup>

The Board believes that ... [Chinese Wall] arrangements may be helpful, but does not believe that their existence alone should relieve the firm from a duty to disclose.

When the SIB rulebooks first appeared, Rule 5.08 (now Rule: 5.07) introduced an either "erect a Chinese Wall or disclose" option.<sup>58</sup> This was then followed in 1987 by a statement which said:<sup>59</sup>

Chinese Walls are not actually required, but the absence of such arrangements within a firm or a group may well attract such severe disclosure requirements to a firm - because otherwise knowledge in

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55. Loss puts it well:

"... I would not like to be in the witness chair before the 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 its way to bankruptcy, but by setting up ... 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"

Quoted in Varn, "The Multi-Service Securities Firm and the Chinese Wall: A New Look in the Light of the Federal Securities Code", (1984) 63 Nebraska Law Review 197, at p.245.

56. The issue of Chinese Walls has always been fudged by the authorities. In the Gower Report and the White Paper the response was lukewarm and skeptical (see, infra, Chapter Seven at note 35 and accompanying text). Now the tide has turned to virtually wholehearted acceptance.

57. SIB, Regulation of Investment Business: The New Framework, December 1985, at p.30.

58. Rule 5.07: Disclosure of Firm's Material Interest in Transactions, discussed infra Chapter Seven.

59. The Securities and Investments Board's Application for Designated Agency Status Under the Terms of the Financial Services Act and the Revised Rule Book Dated February 1987, at p.14.

any one part of a firm is imputed to the whole - that it is essential for it to erect and police them.

Thus a firm will almost always opt for erecting a Chinese Wall rather than choose disclosure. The impression given is that the investor is given better protection today than ever before. This may be true in some senses, especially with regard to incompetent investment advisers. But an investor now runs more of a risk of being offered investment advice which, as far as the common law is concerned, is inconsistent with knowledge known by the firm as a whole. The investor is not given the option of having the conflict or the nature of the conflict disclosed to him. This is what one would expect to happen under common law principles. Instead the SIB rules say: "there is a duty and therefore there are fiduciary responsibilities to act in the appropriate manner (ie. (i) to avoid conflict of interest situations and (ii) a prohibition against self-dealing); but no duty exists if the firm erects a Chinese Wall in those situations (a very large number) where they are catered for in the rulebook. For example rule 5.07 paragraph (1) says that if a firm has a material interest in a transaction then the firm must disclose the nature of the material interest (this duty is the same as the common law fiduciary duty) but paragraph (2) goes on to say:

And for this purpose none of those individuals shall be regarded as having a duty to know of the interest or the conflict if a [Chinese Wall] is established. (emphasis added)

The erection of Chinese Walls in such and similar situations negates the protection given by fiduciary principles. Admittedly a firm might choose not to erect Chinese Walls and instead opt for disclosure. However as we have seen this is unlikely to happen, otherwise heavy disclosure requirements will be incurred.<sup>60</sup> Thus, although Chinese Walls are not actually required by the SIB,

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60. Ibid.

the overwhelming incentive is to erect them. Once erected there is no duty to disclose any conflicting material interest as is required by common law. The Schedule 8 safeguards operate in tandem with the SIB's Chinese Wall rules, however they apply only to the extent to which the Chinese Wall rules reduce their effectiveness. That is to say the Schedule 8 principles can only start to be applied after the point to which they have been eroded in the first place, since the initial and important duty to disclose no longer exists. The safeguards come into play too late in the day to offer investors the protection they would at first glance seem to give.

Similarly, Gower's standpoint on the Chinese Wall appears to have been overtaken by regulatory events. In his report he stated any rules of conduct should be subject to basic principles of law, including the rule:<sup>61</sup>

that an agent cannot act as a principal unless there is full disclosure to, and informed consent by, the client.

In Part II of his Report it was his opinion that the "solution proposed [in the White Paper was] ... that whether acting as principal or agent the investment business must comply with ... a duty of disclosure."<sup>62</sup> However the rules of conduct now specified in the SIB's Conduct of Business Rules are peppered with Chinese Wall rules which in effect say no disclosure is required if a Chinese

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61. See, the Gower Report Part I, at para. 6.30. See also, speech by Sir Kenneth Berrill, then head of the SIB, who at the time shared Gowers's view point. There he said:

"Chinese Walls can promote confidence in the integrity of a firm and the trend now is for such arrangements to be multiplied and strengthened as clients become increasingly conscious of potential conflicts. I do not wish to discourage this process. But I am not persuaded that the arrangements themselves should give rise to an exemption from disclosure requirements." (at p.7, emphasis added)

This is a somewhat peculiar statement. It would impose a double cost. The cost of disclosure and the cost of erecting Chinese Walls. Within a matter of months it was old hat. The SIB introduced the rule as outlined *infra* the text above. Now it is either disclosure or establish a Chinese Wall. Not both. Another example of the authorities (in particular the SIB's ) use of the Chinese Wall by stealth?

62. See, Gower Report, Part II, at para. 4.14.



Wall is established. Thus Gowers suggested premise has been ignored. The system adopted to regulate multi-functional firms is not disclosure requirements. It is Chinese Wall arrangements.

For these reasons it is contended that traditional fiduciary duties are significantly eroded by the Chinese Wall. A corollary of this is that investor protection is also weakened. The schedule 8 safeguards operate as a gloss on this fact. Should then regulators abandon Chinese Walls? Undoubtedly not. The loss of investor protection caused by operating Chinese walls, if that really is the case, must be weighed up against the other potential benefits of having conglomerates.

(b) As a protection for conglomerates against allegations of insider dealing

The Chinese Wall also fulfils a specific legal function in relation to the segregation of informational flows in financial conglomerates. As Herzel and Colling note:<sup>63</sup>

Chinese Walls can be an important evidentiary aid in lawsuits involving allegations of insider trading and other conflict-of-interest abuses by making more believable a defence that personnel in the trust department made their decisions without knowledge of information that may have been in the possession of another department.

The following example illustrates the issues involved: A and B are partners in a dual capacity firm. A offers financial advice to companies during which he often learns inside information. B manages discretionary accounts for clients. A learns favourable inside information about Company X. In and around the same time B independently buys heavily on Company X's securities for his clients and

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63. Herzel & Colling, "The Chinese Wall Revisited" (1983) 6 Corporation Law Review 116 at p.119.

for his arm of the firm.

It seems very much that B did trade on the basis of inside information held by A. And in fact in such a situation there is a presumption at law that B did know of the information, because the information is imputed to the firm as a whole. However the fact that B is operating behind a Chinese Wall rebuts the presumption that he knew of the inside information possessed by A and therefore that he dealt on the basis of it. In view of this rebuttal it would be difficult to convict B with a criminal charge of insider dealing which requires a high degree of proof. However B (or the firm) would be in a more vulnerable position if the SIB (or a private investor) brought a civil claim against B (or the firm) under s.61 (SIB) (or s.62 for a private investor). Here the standard of proof is much lower: namely, was it more likely that B dealt on the inside information than he did not? Of course B's defence that there was an effective Chinese Wall will be useful but it may not be sufficient because the SIB have only to prove the lower standard. The SIB's main task will be to prove that the procedures that go to make up the Wall were defective in some respect. Once this is established the Wall as a defence to the firm or the partner will be of little use.

That Chinese Walls are a defence in law suits involving allegations of insider dealing is a view which would seem to be shared by U.K. academics. Professor Gower, for example, suggests<sup>64</sup> that the Chinese wall should not be thought of as advice for protecting investors, rather it should be limited to a defence in legal disputes. In the second part of his report on investor protection Gower wrote:<sup>65</sup>

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64. See also, Rider, "Conflicts of Interest and the Chinese Wall" in The Regulation of Insider Dealing (ed. Rider, Oyez, 1979) at p. 95.

65. See, supra note 49.

Chinese Walls ... are a legitimate device to protect individual members of of a multi-functional business from the risk of criminal liability from insider dealing.

Although at this stage Gower limited his use of the Chinese Wall to a defence at criminal law, in a subsequent comment (following the introduction of s.61 and s.62 of the FSA 1986 and ther SIB rules, which inter alia made firms civilly liable for insider dealing) he stated:<sup>66</sup>

Chinese Walls were invented by firms to protect themselves against accusations of insider dealing. They are legitimate for this purpose.

Whether by this Gower meant to extend the use of the Chinese Wall to a defence in civil trials, where, of course, the standard of proof is much lower, is uncertain.

But what is certain, is that Gower rejects the Wall's investor protection function and advocates its use as a defence in criminal trials (and perhaps even civil trials) even though, by his own admission, he has never before come across a fully watertight Chinese Wall. It would appear somewhat inconsistent to advocate legal legitimacy - in the form of protection from liability - for what is obviously a dubious mechanism. Admittedly the mechanism is defence only if it works. But it is asking the courts to perform an almost impossible task. They must find out whether it was effective. Such proof is extremely difficult to procure. The mechanism depends on trust and self-discipline. It is an incestuous problem. In any case if the Chinese Wall is as inherently defective as Gowers cliams, it might seem reasonable to suggest that the legislature and the regulatory authorities ought to have been more reticent about granting it legal validity.

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66. Gower, "'Big Bang' And City Regulation", (1988) 51 MLR 1, at p.17. (emphasis added).

On the other hand, the fact that the Chinese Wall operates as a defence does not necessarily mean that it will automatically be accepted by the courts on every occasion. On the contrary, the strength of the procedures, previous breaches, and the resources devoted to monitoring the wall and detecting breaches will all be considerations. Obviously, because of the nature of the device, it can never be certain whether the Chinese Wall was kept intact. In a criminal trial the defence counsel will find it easier to raise the Chinese Wall defence because the courts will be reluctant to impute inside knowledge to the defendant.<sup>67</sup> In a civil dispute the defence will find the burden much more difficult to discharge.

It is of course the effectiveness of the Wall mechanism which poses the key difficulty, because, notwithstanding the fact that an effective Wall would reduce investor protection, this would seem to be cost worth bearing in view of the efficiencies to be gained from conglomeration. However there are also other costs associated with operating Chinese Walls. These are now considered.<sup>67a</sup>

#### A. Direct Resource Costs

Initially there are what might be called the direct resource costs involved in the implementation of the Chinese walls. This would include:

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67. See, Rider, *supra* note 64, at p.95.

67a. Though a great deal has been written on the economics of information in general, the broad principles upon which such studies are based have never (as far as this writer is aware) been applied specifically to the Chinese Wall mechanism. It is beyond the scope of this thesis to attempt a detailed presentation on a par with the standard economic literature in respect of the economics of information. On the contrary, the analysis outlined herein can at best only be described as tentative and exploratory.

- \* The costs of compliance officers - who are usually top management in small and medium sized firms. Here the cost for the firm is not only salary but also the alternative use to which the firm could put such people by re-deploying their skills elsewhere.<sup>68</sup>
- \* The cost of compliance manuals for employees
- \* The time spent on having these procedures explained and up-dated.
- \* Duplication of facilities: libraries, wordprocessing facilities, photocopying etc

#### B. The Cost of a Non-Optimal Chinese Wall

We have already seen that one of the strongest rationales underlying the move towards conglomeration is to capture synergies - particularly those of an informational nature. Ironically the aim of the Chinese Wall is to block out information. Furthermore in view of the fact that there are no standard Wall procedures specified in the regulations, the height and strength of the Chinese Wall will vary from firm to firm. The question then becomes what ought the optimal height of the Wall to be? There are two concerns here both of which involve costs: first, a firm which operates a Wall that is too low and which allows inside information to pass through it will risk being charged with insider dealing with the consequent costs in loss of reputation plus civil or criminal penalty. Secondly, firms wanting to avoid being charged with insider dealing offences through a breach in their Chinese Walls will perhaps adopt over rigorous controls. This would block out unpublished price-sensitive

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68. Wood remarks that, "[S]enior executives in charge of monitoring (the compliance officers) must be excluded from certain decision-making or communicating conflicts to other executives. This may strike at the whole concept of collective board responsibility and involve a split of management control." Supra note 38, at p.69.

information plus information which the conglomerate really ought legally to be using when making investment decisions. Thus economies of scope are reduced.<sup>69</sup> Moreover the firm would be exposing itself to civil liability for not using all legitimate information.<sup>70</sup>

### C. The Cost of Legal Uncertainty

Even if the height of a Wall is such that it stops price-sensitive information but allows legitimate information through, the fact remains that the erection of a Wall in the circumstances outlined by the SIB means that what would at common law constitute a duty to know or disclose what is known by the corporate entity as a whole is, in fact, removed. Whether this will relieve a financial conglomerate from its fiduciary duties at common law in every case is far from certain. In as much as this risk of civil liability exists the conglomerate will be forced to strengthen or reinforce the Wall. This reinforcement imposes greater compartmentalisation and other costs, thus reducing the synergies.

### D. Compartmentalisation Costs

Ironically fully effective Chinese Walls militate against the original rationale for having conglomerates by erecting information barriers which segment and compartmentalise the selling of financial products. This leads to

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69. It might, however, be argued that a Chinese Wall which is too high is not a realistic scenario.

70. When the author mentioned this point to both the TSA and the SIB, they admitted that a Wall which would be too high had not been envisaged and no rules had been included to cover the situation in the Rule book(s). This is indicative, perhaps, of the fact that the regulatory authorities had never entertained the thought that firms would operate over rigorous Chinese Wall procedures! However Walls which are too high also unfairly prejudice the customer.

inefficiencies. Segmentation will increase search costs to the consumer since Chinese Walls will force consumers of financial services to "shop around" for better prices and quality of service, even when the purchase of two services from the same house might be advantageous.

### 3. Full Disclosure

Securities Laws in both the U.S. and the U.K. are based on a philosophy of full disclosure. This impact of this philosophy differs slightly in relation to insider dealing in particular and conflicts of interests in general. Obviously the best way to eliminate insider dealing in conglomerates and indeed insider dealing per se is to have companies disclose significant corporate developments to the public as soon as is feasible, allowing market participants to evaluate and use this information accordingly. While the under the Stock Exchange listing requirements, known as the "Yellow Book", such disclosure is already called for it is not always as immediate as it might be. Disclosure may be delayed if "the directors consider that disclosure of information to the public might prejudice the company's business interests."<sup>71</sup> It could be argued that financial conglomerates ought to be under a duty to make full disclosure on the client's behalf<sup>72</sup> or to notify the regulatory authorities when the corporate client has failed to make prompt disclosure.<sup>73</sup>

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71. LSE Admission of Securities to Listing (1987) 5.08-5.10.

72. See, Linville, "A Crack in The "Wall" Against 10b-5" (1975) 44, UMKC Law Review 105, at p.117. See also, Woolfson, "Investment Banking" in Abuse on Wall Street: Conflicts of Interest in the Securities Markets (1980) at p.413.

73. Millar, "Every Market Player Deserves to be in on Insider Trading", Wall Street Journal 2-3, December 1988.

Of course a policy of immediate disclosure of all material corporate news would itself raise a number of problems not the least being how to determine when a piece of corporate news is material.<sup>74</sup>

As far as conflicts of interest generally are concerned, full disclosure of the facts of the conflict could be made. For example, where a client asks his broker to buy some ICI shares, the broker ought to be required to disclose the fact that he also makes the market in ICI shares. The conflict arises because the broker could sell off his own book when a better price may be had elsewhere. On discovery of the nature of the conflict, the client is better able, in theory at least, to decide whether to proceed with the transaction or go elsewhere. Disclosure requirements are the most traditional means of resolving conflicts of interest.

Disclosure needs to be made in such a way that an ordinary investor can understand the relevance of the information being disclosed to him - we have already seen in Chapter Six Part I that it is required to be full and frank. Essentially there are three facts that ought to be disclosed if this method of conflict control is to work effectively:

(i) the existence of any material interest a conglomerate has in a particular transaction.<sup>75</sup>

(ii) the capacity in which the conglomerate is dealing. In the above example

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74. See, Carlton & Fischel, *infra* Chapter Three, who, at note 52 and accompanying text, list some other difficulties associated with prompt disclosure.

75. For a definition of material interest, see, Rule 5.07, *infra* Chapter Seven.



it is dealing both as principal and as agent for its own account and most probably for another customer's account.

(iii) when acting as agent for the customer the secret profit made on a deal.<sup>76</sup>

Here the golden rule is that a conglomerate must never put itself in a position where its duties to a client conflict with duties owed elsewhere unless, that is, the client is made aware of the conflict and assents to it. The conglomerate must notify the client of any "secret profit" made on the deal irrespective of whether it was made at the expense of the client.

However, using disclosure requirements is expensive and is very often confusing for ordinary customers who are most in need of protection.<sup>77</sup>

Disclosure imposes a financial burden on the firms required to comply. This cost is ultimately passed on to the consumer of financial services. If, as is supposed, the demand for financial services is elastic, then a small increase in price will lead to a more than proportionate decrease in the demand for those services.<sup>78</sup> Therefore, it could be argued that the financial intermediaries will themselves be the ultimate losers if such a regulatory route is chosen.

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76. See, infra Chapter Six at note 56 and accompanying text.

77. See, Kay, "The Forms of Regulation" in Financial Regulation - or Over-Regulation? (IEA: 1988), at p.38.

78. See, Goodheart, supra note 22, at p.20.

#### 4. The Reinforced Chinese Wall (the prohibition of "in house" deals)

Prohibitions on "in-house" dealing, while retaining a large degree of fairness and not totally abandoning the Wall concept, nonetheless runs against the true rationale of conglomerates - synergies<sup>79</sup> - and seriously impedes the ability of firms to perform proper financial; service for client if they are unable to deal or recommend certain categories of shares. Furthermore there are the signalling effects of the mechanism to be considered and costed. These are probably high.<sup>80</sup>

However in situations where it is likely that the "naked" Chinese Wall will leak there are strong reasons for adopting a process of reinforcement. Reinforcement may take a number of different forms, each one more stringent and thus, by degree, undercutting the synergies to be gained by conglomeration:

##### (a) No recommendation Policy

Here, when one arm of the multi-functional firm legitimately acquires inside information from a client, all other arms are prevented from recommending the security to which information pertains. However the firm may continue to deal for its own account. The logic here is that if one arm of a conglomerate legitimately acquires adverse news about Company X it will not be placed in the invidious situation where its discretionary fund management arm is, because of a Chinese Wall, unwittingly recommending dud Company X shares. Thus with a no-recommendation policy, the conglomerate is under no risk of

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79. For a fuller discussion of this in the context of de-conglomeration, see, below at footnote 85 and accompanying text.

80. C/f. Chazen, "Reinforcing the Chinese Wall: A Response" (1975) 51 N.Y.U.Law Rev. 552; and Slade v. Shearson Hamill & Co., 517 F.2d 398 (2d Cir. 1974) discussed infra Chapter Six, at note 78 and accompanying text.

being sued for breach of fiduciary duty for having acted for two different customers. It may, however, place itself in an undisclosed conflict-of-duty type situation by dealing for its own account. The crucial question is at what stage in the relationship with company X the no-recommendation policy should apply - when the Company becomes a client? or only after a confidential relationship has been established and the possibility of the acquisition of inside information becomes much more probable?

(b) Restricted List

A restricted list incorporates a no-recommendation policy. However a conglomerate is not allowed to deal on its own account.<sup>81</sup> Again it is uncertain whether a confidential relationship must exist before the restricted list applies. The firm may still continue to carry out unsolicited orders. In other words if the department is apprised of inside information about company X, it cannot trade nor can it recommend, but it may execute a deal for a customer who rings up and asks for "100 Company X" shares.

(c) Stop List

Under the Stop list procedures the firm may not carry out even unsolicited orders for customers. Again the question arises as to when the list applies: once the relationship is initiated; or only when inside information is conveyed?

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81. See, the Slade case ibid. See also, the First Boston Case discussed infra Chapter Seven at note 20 and accompanying text.

## Signalling Costs Associated With Operating a "Reinforced" Chinese Wall

The very inclusion of a company's shares on a conglomerates restricted list could itself be considered to be price-sensitive information and could therefore constitute a breach of confidence in respect of the company. The indication that something is about to happen with regard to the company would mean that informed traders could easily draw correct conclusions as to whether the financial conglomerate knew the of adverse or favourable information. This would impose a cost in that it would compromise the underlying purpose and deterrent effect of anti-insider dealing legislation which is to achieve a fair and efficient market. In an attempt to by-pass the problem the SEC in its amicus curiae brief in the Slade case said that a firm should withdraw any outstanding recommendation on a security when the firm enters into an investment banking or other type of relationship. This would represent a severe obligation, and one which would further erode synergies because it requires the firm to place the security on the restricted list before inside information is actually received. However even the restricted list is far from fullproof, as the First Boston Case shows.<sup>82</sup>

### 5. De-conglomeration

One of the most effective and fullproof ways of dealing with conflict abuse in the conglomerate context is to eliminate it. This would involve breaking up existing conglomerates through the adoption of formal Glass Steagall type legislation or a return to pre-Big Bang days with the adoption of self-imposed constraints on the range of financial services offered by the one

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82. Ibid.

house. Many consider such a policy option to be too draconian. Goodhart writes:<sup>83</sup>

In so far as separation involves additional costs, there will tend to be pressures to avoid, or to evade, such limitation; in particular, (international) competition with markets not subject to such high cost regulation will lead to pressures for de-regulation, [however] ... if economies of scale and scope are such that the option of single capacity operation is too expensive, or otherwise unattractive, ... there remains the option of trying to limit conflicts of interest, eg "Chinese Walls", prosecution of the use of insider information, etc.

It would seem that the logic in the second part of Goodhart's quotation has won the day and that the authorities have opted for Chinese Walls, prosecution of insider dealers etc. rather than the heavy handed approach of breaking up conglomerates.

However, even the SIB advocate de-conglomeration of a sort in respect of the insurance business, where they have adopted a policy of "polarisation" to avoid the creation of conflicts, rather than regulate their potential abuses. Under this policy, neither disclosure rules nor Chinese Walls are considered sufficient to ensure fair practice. As the SIB states:<sup>84</sup>

The Board have been reluctant to deal with potential investor protection problems by restricting the provision of a service as such. In one area in particular, however, it considers this to be essential for the protection of investors. The Board considers that, if firms are permitted to advise on and sell life assurance policies and units in collective investment schemes otherwise than either on a fully independent basis or as the representatives of a single company or group, the investor will be confused as to the nature of the service available to him and as to the position of the person advising him and accordingly liable to make decisions abased on erroneous assumptions.

Thus the SIB recognises areas of financial services which are so prone to abuse that restricting the provision of such a service in a financial house, which would otherwise provide a full range, is mandatory.

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83. Goodhart, supra note 9, at p.26.

84. See, SIB, supra note 3 at p.13.

In the aftermath of Big Bang in Britain some firms have in fact purposely chosen not to form conglomerates or have de-conglomerated and have become instead niche suppliers of financial services peddling the virtues of independence and the absence of conflicts of interest. The break-up of conglomerates might be precipitated by natural market trends which indicate that the purported synergy argument is largely illusory. As one commentator states:<sup>85</sup>

Critics of this strategy [ie. conglomeration] argue that the policing of all the complex boundaries (the "Chinese Walls") between the different departments forced together has become so burdensome, and the risk of losing clients so great when breaches are published, as to outweigh any synergies or returns to scale from putting together conglomerates.

Almost all firms have admitted that in any case the synergies have been much more difficult to extract than they anticipated. Those firms which stuck to their original niches or made more limited diversifications ... have retained or increased [their] market shares at the expense of the more ambitious conglomerates and new entrants.

The break-up of conglomerates would also engender greater fairness in the market by reducing the number of conflict of interest situations, thus curtailing conflict abuse especially in the form of insider dealing.

Despite the attendant benefits of de-conglomeration in terms of increased fairness, it is unlikely, in the current deregulatory environment, that the forces pushing for the break-up of conglomerates are sufficiently strong to have much of an impact.

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85. Clive Wolman, "Loopholes in the Chinese walls", The Financial Times 17 August 1988.

## Summary

Chapter Seven attempts a policy analysis of the issues surrounding the use, by regulatory authorities, of the Chinese Wall in regulating both conflicts of interest and duty in financial conglomerates. The analysis is couched in terms of a regulatory dilemma. On the one hand it is shown that there are certain economic benefits to be had from conglomeration; namely, enhanced competition, risk diversification and synergies. On the other, there are the increased costs of conflict abuse in general and insider dealing in particular. Thus the regulatory dilemma paradigm: the stricter the regulation, the greater the compartmentalisation, the more the economies are reduced. A proper trade-off or balance is required. It is argued that a strict cost-benefit analysis would be extremely difficult, and that the decision about which option ought to be chosen rests ultimately on the basis of a policy hunch.

The various policy options are considered, ranging from one extreme - reliance on market forces; to the other extreme - de-conglomeration. The Chinese Wall, disclosure requirements and the reinforced Chinese Wall lie somewhere in between. Again the Wall mechanism is signalled out for special treatment.

The acceptability of the Chinese Wall as a valid policy instrument for regulating financial conglomerates is a highly controversial area. The Wall is considered within the context of its effectiveness as a device which restricts the flow of inside information within a financial conglomerate. The preventative function of the mechanism is important when reviewing it both as a form of investor protection and as a defence at law. It is shown that Wall does not provide investors with added protection, far from it, the mechanism

actually works to their detriment at times. When raised as a defence at law, it is not certain what criterion the courts will apply when endeavouring to determine its effectiveness. However, there would seem every reason on the basis of public policy for approving the use of an effective Chinese Wall in a criminal prosecution where the standard is "beyond all reasonable doubt". In such an instance the device might be capable of casting a doubt into the minds of the jury. In a civil case, the fact that the mechanism can be easily bypassed must be a weighty adverse consideration. This carries through to discredit the device's validity as (i) a form of investor protection and (ii) a fullproof defence at law. The Wall has other associated economic costs. These are also considered.

In view of the overwhelming adoption of the Chinese Wall rules in U.K. securities law, it would seem that policy makers have decided that the costs of the device compare favourably with other competing mechanisms. As events unfold and scandals are uncovered this policy calculation may well have to be adjusted to take into account any loss of confidence in the fairness and integrity of the financial markets.



## CHAPTER NINE: SUMMARY AND CONCLUSION

### PART I: SUMMARY

#### Deregulation, financial conglomerates and conflicts

The trend towards deregulation in the form of financial diversification is best illustrated by recent events which have transformed the provision of financial services in the U.K. The most important outcome of this process has been the development of a new corporate creature, the financial conglomerate. These conglomerates are the result of a desire by market participants to expand rather than limit the range of financial services on offer. It is now possible for a single financial house to provide a range of financial services including stock-broking, market-making, banking, and corporate finance. Most importantly the traditional self-imposed separation of banking and securities business has now been broken down. But by embracing banking and securities activities within the one firm, two inter-related problems arise. First of all, the safety and soundness of a financial institution is potentially put in jeopardy. Secondly, consumers of financial services run the risk of being treated unfairly because of the increased likelihood that conflict of interest and duty situations will be abused.

There is nothing inherently wrong with conflict situations; the issue is whether such situations have been handled properly. If the conflict situation is treated impartially then there is no problem; if, however, the situation is abused, this gives cause for concern. Governments have continually regarded the existence of conflicts in the financial sector with more concern than those in the non-financial sectors of the economy. Financial institutions are seen as being "special institutions" - this is particularly true of the banking

sector. The view is also prevalent that the nature of financial services are themselves inherently special. However, before pressing for regulation, it must be borne in mind that not every conflict of interest is of equal importance.

With the merging together of banks and securities houses to form financial conglomerates nine conflicts have traditionally been isolated. Arguably insider dealing is the most important since it is easy to foresee the situation where, under the new "Big Bang" arrangements, a banking and securities house become affiliated, with the securities "arm" underwriting a share issue for X Company. During the course of the underwriting "unpublished price-sensitive information" - say a future earnings report about the company - is obtained. There is ample opportunity for this information to be acquired and used by the banking "arm" to the advantage of favoured customers or indeed for the bank's own account.

There is currently a heated debate between "regulators" and "deregulators" over the social and economic costs and benefits of insider dealing and whether the practice ought to be left unfettered by regulatory constraints. The regulators seem to have won the day. At a general level, legal constraints operate to prohibit insider dealing in almost every advanced nation. In the U.K. these are embodied in the Companies Securities (Insider Dealing) Act 1985. In the U.S. anti-insider dealing law has developed on a more ad hoc and pragmatic basis. But in both jurisdictions this legislation is aimed at all forms of insider dealing and has no special emphasis on financial conglomerates. Conglomerates however pose special problems which arguably require special solutions and specific regulations. Not only is there an increased flow of price-sensitive information in the conglomerate context but also there is a greater potential for this information to be misused and for

the misuse to go undetected. What then ought regulators to do?

### **Conflict Resolution and the Regulatory Dilemma**

It is important to note, before considering the regulatory options, that regulators are faced with a dilemma. Essentially this dilemma revolves around the fact that on the one hand there are certain benefits to be had from conglomeration, namely diversification and synergies; but on the other hand there are also costs, both safety and soundness issues and conflict of interest problems. Some form of regulation (or protection) ought reasonably to be imposed. However the stricter the regulation the greater the compartmentalisation. The greater the compartmentalisation the less the efficiencies derived. So there is, as it were, a regulatory dilemma. A balance therefore has to be struck between the competing forces of fairness (in the form of strict legal duties) and efficiency (in the form of important economic interests). The key question underlying the discussion of the regulatory options is this: which option strikes the right balance?

### **What are the Regulatory Options?**

#### **I. Greater Reliance on Market Forces**

First of all regulators could place greater reliance on the use of market forces to regulate potential abuses within conglomerates. The underlying principle here is that the long-term incentive to exploit a conflict of interest may not exist. A financial conglomerate, so the argument goes, will not risk the long-term profits bound up in honest work and good reputation for the short-term gains to be had through insider dealing or other conflict abuse. However market forces may not provide sufficient incentives to induce

conglomerates to act within the existing insider-dealing legal framework since most buyers will not be in a position to assess the quality of the services they receive and as a result will not be in a position to withdraw their custom if financial institutions are acting unfairly. Therefore new regulatory measures may be needed as a back-up to existing anti-insider dealing legislation.

## II. The "Naked" Chinese Wall

Secondly, "naked" Chinese Walls could be used. The theory behind the Chinese Wall mechanism is that adequate controls over access to inside information will stop misuse, thus allowing the firm to act in its multiple capacities without incurring liability. The Wall comprises a number of policies and procedures designed to prevent the misuse of inside information within conglomerate structures and to neutralise the conflict of interest and duty dilemma.

The Government's 1985 White Paper recognised a role for the Wall mechanism in the newly reconstituted financial markets. Professor Gower likewise gave it his tentative approval. However both parties emphasised the inherent weaknesses and inadequacies in the use of the device to regulate financial conglomerates. Notwithstanding this the Chinese Wall found statutory endorsement in s.48 (2) of the Financial Services Act 1986 which, in giving general powers to the SIB to make Conduct of Business Rules regulating investment businesses, made specific provision for the implementation of Chinese Wall rules.

The SIB have made liberal use of this authority by endorsing the use of the isolation technique in a number of its conduct of business rules.

Interestingly the SIB does not require firms to erect Chinese Walls. However the absence of them within a firm, or a group, will attract severe disclosure requirements. A firm will not want to bear this costly burden of disclosure. Therefore the overwhelming incentive is to erect Chinese Walls. Disclosure operates as a penalty if the firm does not. The two most important SIB rules indirectly "sanctioning" Chinese Walls are Rule 3.10 - covering insider dealing and Rule 5.07 - dealing with the disclosure of a firm's material interest in a transaction. Basically the firm, if it operates an effective Chinese Wall, is furnished with a defence from an action brought under the rulebook alleging the misuse of inside information if arm A of the conglomerate is in possession of inside information and arm B deals in the security to which the information relates. The Wall therefore rebuts the presumption that information held by arm 'A' is imputed to arm 'B'. By implication an action would not lie under the SIB rule-book for breach of fiduciary duty for operating an effective Wall.

The Chinese Wall as a preventive device can be viewed from two distinctly separate angles. First, as a defence for conglomerates against a charge of insider dealing; and secondly, as a means of investor protection over and above market forces. The crucial question is that of enforcement - does the Wall work? Essentially the Chinese Wall is a self-regulatory mechanism. The proper functioning of the device is therefore strongly reliant on the conglomerates themselves to establish and monitor systems and procedures which will "block" inside information. It is here that the skill and thoroughness of the compliance personnel is crucial. But ultimately the proper operation of a Chinese Wall will depend on the integrity of the people who work on either side of it. Breaches of the mechanism may be detected either through an informant - whistle-blowing - network or through the sophisticated computerised systems operated by the leading regulatory bodies.

With regard to the second perspective from which the Chinese Wall can be considered, doubts may be expressed as to whether the mechanism really can be viewed as granting investors protection. Either the device may operate in such a way as to relieve a conglomerate of traditional disclosure responsibilities, previously recognised as a stalwart of any investor protection system; or it may cause one arm of a conglomerate to recommend a share which is inadvisable in the light of knowledge known by the conglomerate as a whole. Moreover a Wall which is too high will block out legitimate information therefore depriving investors of all legitimate information in investment decisions. Investors are, however, unlikely to be able to gain the requisite degree of proof for an action to be taken. These deficiencies in the mechanism ought to be considered as part of the public costs associated with having conglomerates and gaining their competitive efficiencies.

### III. Full Disclosure

Disclosure operates at two levels. At the outset corporate clients must be encouraged to publically announce material price-sensitive news as quickly as possible, in order to restrict the opportunity of individuals within the client company and the conglomerate itself, from dealing ahead of the market. There are many drawbacks with this approach as shown in Chapter Three.

Regulators could also rely more on the principle of full disclosure to regulate conflict situations in conglomerates. In this way a client is made aware that the firm holds a material interest in a transaction and the nature of the material interest. Thus the customer is, in theory, able to assess the risks involved and either give his assent by proceeding with the transaction or revoke his custom by going elsewhere. To the extent that customers perceive the risk of abuse to be high and duly withdraw their custom, conglomerates will

have an increased incentive to break up business into separate independent units. Of course disclosure requirements are the most traditional means of regulating conflicts and represent general position of the common law in this area.

#### IV. The "Reinforced" Chinese Wall

Another alternative would be to reinforce existing Chinese Walls by preventing any arm of a conglomerate from dealing in or recommending to customers the securities of a company about which another arm has inside information. Reinforcement varies in nature and form. But essentially the result is an erosion of the synergies to be had through conglomeration. A no-recommendation policy for example would prevent the firm from recommending a security to customers if another arm was apprised of inside information pertaining to the security. However the firm could deal on its own account and could execute unsolicited orders. A more stringent procedure is that of a restricted list which incorporates a no-recommendation policy but also prevents the conglomerate from dealing on its own account. Under a stop list a conglomerate is prevented from carrying out even unsolicited orders for customers where another arm of the conglomerate is apprised of inside information relating to the execution of the unsolicited order.

#### V. Prohibit Conglomerates

The most effective solution to the conflict problem is of course the break-up of conglomerates through a process of de-conglomeration. Either the de-conglomeration of all conflicting functions or the separation of those functions most susceptible to abuse, namely banking and securities business. This would be costly in terms of the synergies lost by the fragmentation of

financial service participants. Nonetheless it would significantly reduce the risk of insider abuse - both corporate and individual - and would do much to restore confidence and fairness in the markets. This solution is, in all probability, too draconian to be taken seriously in relation to the provision of all financial services. Yet in the U.S, regulators have seen fit to segregate to a large extent banking and securities business by means of the Glass Steagall Act 1933 - thus preventing conglomerates "U.K.- style".



## **PART II: CONCLUSION**

### **An Assessment of the Legal Validity of the Chinese Wall**

When does the Wall successfully rebut the presumption that information acquired by one arm of a conglomerate is imputed to another? Does the answer depend on the effectiveness of the Wall? And even if the Wall is effective will this give rise to an action at common law involving a breach of fiduciary duties? Indeed, is there an inherent and irreconcilable tension between the dictates of statute law (and the rules and codes thereunder) and common law concerning the Chinese Wall? In other words has statute law endorsed a view of the device which is in conflict with the fulfillment of traditional fiduciary duties at common law?

It is a vague though nonetheless important response to all the above questions to say that the position is not entirely clear. However, it would appear that an effective Chinese Wall operates as a defence against an alleged breach of the SIB rule-book (and the other SRO rule books derived therefrom) in those instances where the Chinese Wall is expressly endorsed in the rules as a valid regulatory option. Similarly where the Wall is effective it cannot, by implication, lead to an action under the SIB rule-book for breach of fiduciary duty. If this were not the position with regard to actions brought under the SIB rule-book, the SIB would in actual fact be setting a trap for firms by encouraging them to operate effective Chinese Walls while at the same time permitting clients to bring actions under the rules for breach of fiduciary duty on the basis that the Wall was effective. It is then implicit under the SIB rule-book that an effective Chinese Wall is unimpeachable within the context it is utilised.

The issue of the Chinese Wall at common law is, however, not so clear. It has never before been squarely faced and therefore remains unresolved. Owing to this absence of authority at common law it is impossible to give a definitive statement of whether a Chinese Wall can be relied upon as a corporate/individual defence to insider dealing or as a suitable means of neutralising a firm's conflicting interests and duties by absolving the conglomerate from the threat of a common law action for breach of fiduciary duty. The SIB rule-book does not exclude a remedy under agency law. As we have seen, an effective Wall might well be the cause of an action brought at common law on the basis of breach of fiduciary obligations.<sup>1</sup> On the other hand common law might not hold the Chinese Wall to have breached fiduciary duties. Yet although some U.S. cases<sup>2</sup> dealing with financial market transactions do support this line of argument none of them would necessarily convince the U.K. courts given the closely interrelated nature of the market players in this jurisdiction.

This dilemma has created great uncertainty among conglomerates operating in the U.K. financial markets. The question they must decide is twofold: whether, first, to erect a "naked" Chinese Wall governing conflicting functions and risk (i) having inside information imputed to other arms of the conglomerate and as a consequence being sued for breach of the Companies Securities (Insider Dealing) Act 1985 (or Rule 3.10); or (ii) being sued under common law agency principles for breach of fiduciary duty (even though the Wall would be a legitimate defence to an action brought under an alleged breach of the SIB or SRO rule-books); or, second, to erect a "reinforced" Chinese Wall

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1. For U.S. authority see the Slade and Black cases infra Chapter Six.

2. See especially, the Connell, Washington Steel and American Mendicorp cases discussed infra Chapter Six.

and avoid both the risks outlined above but suffer the ensuing constraints on the operation of their business.

Right from the very outset of the reforms to introduce a new regulatory framework for the City, the conglomerates were well aware of the problem caused by this "double layer of law".<sup>3</sup> Prior to the run up to Big Bang and the introduction of the Financial Services Act a considerable degree of lobbying of parliamentary opinion was much in evidence. Ostensibly three views were mooted. On the one hand the Labour party rejected any contention that the "safeguards" enshrined in the new Rulebook would oust traditional common law agency principles.<sup>4</sup> On the other hand the large conglomerate groupings were especially eager to be exempted from the strict common law rules<sup>5</sup> on the basis that to do otherwise would hamstring their operations and offset many of the economic reasons for conglomeration. In the middle ground was the view that the common law rules should be maintained but that a new code should be drawn up. The new code was to include Chinese Wall rules which would operate as a

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3. See, Sir Kenneth Berrill (then SIB Chairman), "Conflicts of Interest: The SIB's Approach", extracts from a speech given to The Society of Investment Analysts, 28 November 1985 who, in trying to allay City fears, was correct when he said:

Recent financial mergers appear to have given rise to ... [the fear] ... that the new conglomerates will run foul of ... agency law ... This ... has led to suggestions that the new Bill should, in some way, waive or modify agency law as it applies to financial service companies ... I do understand these concerns, but I think I have said enough to suggest that our rules, far from disapplying the law of agency, will in fact be making clearer and more detailed provision to help in resolving potential conflicts of interest. In no sense are we prepared - even if we were able - to undermine the protection that agency law gives to the clients of an investment business. My firm intention is that our rules will do a thorough job of tackling the same concerns. If they do, it may well be that the court, in applying the principles of agency in this field, will conclude that its requirements are not too dissimilar from those of our rule. In that case the fears that have been expressed about the implications of agency law will prove unfounded. If our rules do not make adequate provision in this area then the courts may quite properly take a different and less welcome view. (at p.2 emphasis added).

4. See, Commons Debates 24th April 1984 p.956 Vol 64, Bryan Gould.

5. See, Berril, supra note 3.

defence to actions brought under them but not necessarily for actions brought at common law. It was upon this middle ground that the Government ultimately trod.<sup>6</sup>

#### **A Question for the Courts to Decide**

When faced with the Chinese Wall conundrum, the courts at common law have three possible options. First, they could take an expansive view of the Chinese Wall and accept the mechanism (if effective) in the eight situations provided for by the SIB rulebook. Despite the fact that this would involve a severe curtailment of strict fiduciary principles (for the reasons already explained in Chapter Six), it would be more in tune with the current regulatory climate. Thus, under this view, if an investor claimed breach of fiduciary duty, whether under the SIB rule-book or at common law on the basis that a financial conglomerate operated a Wall which actually worked, the action would fail.

Secondly, the courts could take a narrow view of the Chinese Wall, holding that at common law strict fiduciary principles oust the Wall defence. Such a route, if followed, would cause significant problems for the operation of conglomerates who would, as a result, be forced to erect "reinforced" Chinese Walls, with restricted lists and no-recommendation policies, in an attempt to avoid civil liability. This would also impose costs in the sense that firms would lose out on many of the purported synergies to be derived from conglomeration.

The third or "intermediate route" is one which is advocated hereafter as

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6. See, The Financial Times, 16 Dec. 1985.

the position which the courts ought to adopt. It is contended that strict legal reasoning must be balanced with sensible legal and economic outcomes. In pursuit of this endeavour, there must be a trade-off between what is perceived as the prerequisites of fairness and those of economic efficiency. In many ways this takes the discussion full circle - to the various policy objectives underlying the remodelling of the U.K.'s securities codes and investor protection laws. Balancing the objectives - striking the right blend or mix - is an extremely difficult task. The current approach favours deregulation in the form of greater competitive freedom. As was shown such developments are not only true of the U.K. but also of other financial centres too. In view of this, and upon summary of the economic costs involved, there seems little point in running against this tide of change. At least, not without good reason. In such a deregulatory, multi-capacity environment, Chinese Walls are not an option, they are a necessity. The question is merely one of degree. Where and when ought they to be used and accepted by the courts? The SIB have made liberal use of the mechanism, reflecting, no doubt, their own and practitioners' expansive views of competitive freedom.

It is submitted that the thrust of the SIB's approach - pragmatic, and based on the fundamental realisation of deregulation - is ostensibly correct. If the Chinese Wall works in a way which erodes traditional common law fiduciary obligations, then the common law must accommodate these new market structures and consequent market practices. By looking back to its own legal precedents in order to achieve a set of logically consistent principles, common law serves to thwart the reaching of a truly just outcome in the decision demanding adjudication. The courts should be encouraged to look further than the justice of the particular parties before them. They must be made to see the dispute as part of a wider movement of change affecting the operation of

the financial markets. This being so, it is clear that it is the impact of a decision that is crucial; not the decision's logical consistency with previous outdated legal precedents. Common law should not be allowed to frustrate major (and to a large extent beneficial) developments affecting the U.K.'s standing as an international financial centre.

That the law should not be allowed to remain static is a view advocated by one of the most influential judges this century. As Lord Denning says:<sup>7</sup>

New days may bring the people into new ways of life and give them new outlooks; and with these changes there may come a need for new rules of law, to control the new order and reflect the new outlook. The old rules must then be modified or else the society itself will stagnate.

This must surely be true in the financial markets - an environment which of necessity requires flexibility to keep pace with the development of ideas and developments in technology.

### What Factors Might Influence a Court to Accept the Chinese Wall?

What then are the factors that ought reasonably to prompt the courts to accept a Chinese Wall as (i) effective in rebutting the presumption that information held by one arm of a conglomerate is imputed to another; and (ii) acceptable as a means of resolving strict fiduciary duties owed at common law?

#### 1. Statutory and Regulatory Acceptance of the Mechanism

The fact that there has already been significant statutory and regulatory acceptance of the mechanism is a strong indication that the courts would be

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7. See, Lord Denning, The Family Story, (Butterworths 1981), at p.176.

influenced by such developments. Today it is not so much a question of deciding whether Chinese Walls actually fit in with the underlying policies of the new legislation governing the U.K.'s financial services industry; on the contrary, the Chinese Wall is actually sponsored by it.

That in the past the courts have in the part been reluctant to interfere in the regulation of the financial markets is suitably illustrated by the case of Dunford & Elliot Ltd. v. Johnson & Firth Brown Ltd.<sup>8</sup>. This should provide some help in pointing to how the courts, when faced with a Chinese Wall-type dispute, might adopt a pragmatic or intermediate route.<sup>9</sup> In that case the plaintiffs' company made steel. Owing to severe losses it was decided to launch a rights issue to the shareholders. 43% of the company's shares were owned by institutional shareholders. At a meeting arranged by the plaintiffs the institutional shareholders agreed to underwrite the new issue. The plaintiffs prepared a confidential report on the company and gave it to them. The institutional shareholders, of their own accord, decided to invite the defendants, a rival steel company, to help underwrite the issue. The institutional shareholders allowed the defendants to see the confidential report even though it was not available to the other shareholders. The defendants decided not to underwrite the issue but instead made an offer to the shareholders in the plaintiffs' company. The offer was 35p compared with a market price of 17p. The plaintiffs issued a writ claiming an injunction to forbid the use of the confidential information in pursuit of the bid.

The Court of Appeal allowed the bid to continue. In a judgment adopting

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8. [1977] Vol.1, 505 (C.A.)

9. It is probably worth noting that the case arose before the current wave of re-regulation. Thus to-day the courts would have more Parliamentary and regulatory indication of what is the preferred policy approach.

a "hands-off" approach Roskill L.J. held:<sup>10</sup>

As Lord Denning, M.R., has already said, there was some discussion during the argument regarding the the difficulties that could arise in relation to the giving of information to those who are invited to underwrite issues. We were told, as a matter of City practice, that underwriters do insist upon getting information which may from time to time not be available to shareholders. If that be the practice, so be it: it is not for us to criticise, and certainly nothing is further from my intention ...

Without for one moment presuming to criticise - other people are far better able to judge the rights and wrongs of such a situation than any judge can possibly be - ... the problem of confidential information ... has to be solved if it possibly can be solved. Above all any solution must surely rest on some principle which secures fairness to all shareholders whether institutional or private so that all are dealing and are dealt with on the same terms. (emphasis added)

If the courts adopt this attitude, they will be looking heavily to the regulators to set the pace. The only caveat, as Roskill L. J. himself says, will be a "solution ... which secures fairness for all". This leads on to the second factor.

## 2. The Degree of Unfairness Caused by the Use of the Mechanism

As has been argued the Chinese Wall gives rise to two areas of concern: where it leaks and provides opportunities for insider dealing; and where it works and erodes strict traditional fiduciary duties. The degree of unfairness resulting from the use of the mechanism is dependant upon the nature of the transaction where the Chinese Wall deployed. It is important to reiterate that whilst there are no problem-free solutions, some are less problematic than others. In determining the most appropriate policy route regarding acceptance of the Chinese Wall, it is argued that the use of a tentative law-economics approach may validly be applied. By this method then, it is possible to analyse the appropriateness of the SIB's policy approach in relation to the the legitimacy

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10. Ibid., at p.515.



of the Chinese Wall.

The fact that the Chinese Wall relieves a financial conglomerate from the burden of fulfilling certain otherwise obligatory fiduciary duties must be weighed up against the degree to which non-use of the mechanism (and the adoption of another option) has an adverse effect on other policy goals such as competition, efficiency, liquidity, flexibility. Thus it would seem reasonable to suggest, when balancing (on a broad more or less basis rather than on any precise economic cost-benefit scale) the various policy interest underlying the recent regulation of the financial markets, that an effective Chinese Wall ought not, bar certain special circumstances, to be ousted by common law. Put another way, despite the fact that an effective Chinese Wall encroaches upon strict traditional fiduciary duties (as outlined in Chapter Six) this ought to be a cost accepted by society in view of the other benefits of the use of the mechanism. However, that being said, the courts should adopt the guiding principle that the common law ought not to accept the Chinese Wall as an effective corporate defence to insider dealing nor as an viable means of reconciling disparate fiduciary duties in those situations where the self-interest of the firm is so strong as to make a reasonable man conclude that the Wall has in fact been breached or where it would be inappropriate in the light of surrounding policy considerations to accept the device as suitable in fulfilling fiduciary obligations.

Where this conclusion is reached the inside information held by one department in the firm ought to be imputed to the rest of the conglomerate and an action would lie for breach of the CSA 1985 and under common law for breach of fiduciary duty. But where this conclusion is not reached (ie. where the Wall is deemed not only to have worked but also to have relieved the

conglomerate from the threat of a common law action for breach of fiduciary duty) the conglomerate ought to be allowed to continue business in the normal way.

The crucial question then is: in what circumstances is the firm's self-interest so strong as to make a reasonable man conclude that the Wall has not been effective or that it would be inappropriate as a means of neutralising a conglomerates conflicting interests and obligations?

(i) Self-interest and Own Account Trading

The answer expounded here is that a conglomerate should not trade for its own account in the securities of a firm about which arm another of the conglomerate holds inside information. Thus if the securities arm has inside information about Company X then any other arm of the conglomerate may not deal in shares in company X for its own account. If it does, then common law ought to hold that the firm is dealing on the basis of inside information in breach of the CSA 1985 owing to the strong self-interest to directly benefit from the use of such information. Thus a restricted list solution ought reasonably to apply whereby Company X is placed on a restricted list which is circulated throughout the firm and on the basis of which departments are not permitted to perform deals for their own accounts. Moreover it would seem highly inappropriate to accept a Chinese Wall as a valid regulatory option in these circumstances owing to the highly sensitive nature of the fiduciary duties owed compounded with the strong incentive to breach the Wall.

While there will almost always be a degree of self interest in every transaction which the conglomerate performs, a direct self-interest is more

likely, on balance, to be abused. Indeed where the firm has a direct self-interest the incentive to abuse the position is increased significantly because the firm is the direct beneficiary. Nonetheless, the conglomerate ought to be able to perform (i) unsolicited orders from customers seeking to purchase shares in Company X<sup>11</sup>; and (ii) normal market-making functions. This latter proposition is a shade more difficult to justify. However attention is drawn to the word "normal" and to the fact that market-makers perform a crucial liquidity function which traditionally has given them special exemption from certain activities on the basis of "good faith".<sup>12</sup> Despite this, it would be difficult to permit such an exemption if, for example, a market-making arm of a conglomerate held a position of 500,000 XYZ shares when over the previous six months it had only held an average position of 50,000 XYZ shares with no significant fluctuations. If this were the case, the market-making arm's holding of 500,000 XYZ shares could not be construed as "normal". Therefore in the absence of any other contradictory evidence, such facts would constitute a breach of the Chinese Wall.

(ii) Self-interest and the Performance of Deals for Customers

Consider, however, the situation where arm 'A' of the conglomerate holds inside information about Company X and behind a Chinese Wall arm 'B' of the conglomerate is recommending Company X to customers. There is, on balance, no overwhelming policy reason why the Wall should not be construed as being anything other than effective in prohibiting insider dealing and at the same time reconciling seemingly disparate fiduciary duties. In this instance the Wall option would fulfill a positive policy function. Admittedly, in such a

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11. Given the earlier discussion in Chapter Eight, there is no overriding policy reason why the conglomerate ought not to be able to execute such orders.

12. See, infra Chapter Four at note 62 and accompanying text.

situation there remains an incentive for the recommending arm to base decisions on inside information held by another arm. However, the incentive is less strong in that the conglomerates stands to benefit only indirectly by maintaining custom. That being said, the situation could arise where, for example, the market-making arm is long on Company X shares, the corporate finance arm being aware of the fact that the company is going into liquidation. At first blush the incentive is to unload the shares into the discretionary accounts of customers or even to recommend Company X to customers. Does then this distinction between a direct self-interest and an indirect self interest hold?

What the above scenario fails to take into account is the long-term incentive against abusing the conflict situation. The incentive to abuse is diffused to the extent that it will be in the firm's own self-interest to avoid any legal liability or self-regulatory sanction; in effect it will have an overriding desire to protect its integrity and reputation in the market-place. Moreover the extent to which a "whistling blowing network" is effective will reduce abuse within the context outlined. Again it is worth noting the Collier incident where a counterparty to the deal alerted the regulatory authorities. The recent incident at County Nat West (CNW) is another example in point. There Mr. Dobbie was a managing director at CNW in its corporate finance stockbroking arm. Grand Metropolitan were a corporate client of the CNW arm. Grand Metropolitan informed Dobbie that it was going to sell its hotel chain. The information was highly price-sensitive and was likely to have a favourable impact on Grand Met.'s shares. Dobbie then passed the information on to an equity saleswoman specialising in Grand Met. shares. In turn she made a telephone call to an analyst, part of which was heard by two market makers in the CNW market making arm. Already they had agreed to sell about £1m Grand Met

shares which had not as yet been actually bought. The potential loss to CNW, when Grand Met.'s shares rose, was as much as L50,000. One of the market makers being new to the job and wishing to avoid an embarrassing loss so close to his appointment decided to buy L2m-Grand Met. shares from four different market makers. The deals were executed only minutes before the news was announced publicly and were consequently picked up by the Stock Exchange surveillance department. As well as that other market makers complained about the deals.<sup>13</sup>

Even if the forgoing analysis is wrong, there may be a greater cost involved in imposing alternative, more restrictive, regulatory constraints than the actual cost of the abuse caused by the conglomerate's underhanded and illegal activities. After all not all conglomerates will indulge in illegal activity. One might ask what is the real likelihood that such underhand activity will take place and will not under the existing policing regime be detected? Undoubtedly the current emphasis of the policy makers on preventing abuse must, in view of the extensive use of the Chinese Wall device, be matched with a willingness to provide investors with remedies if abuses are uncovered. Perhaps an "informant" scheme with a percentage of the recovered illicit trading profits going to the informant. This will provide a further incentive for conglomerates to ensure that their Walls are effective. No doubt the Wall will undergo tremendous pressures in a "bear" market, but then even in the recent crash, a rash of Chinese Wall scandals did not come to light. It would seem therefore that the implementation of the Chinese Wall to regulate the use of inside information by a firm in the situation where it is not trading for its own account has a certain merit.

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13. See, "Loopholes in the Chinese walls", The Financial Times 17 August 1988.

The position of individuals within financial conglomerates has been deliberately neglected. While on balance a Chinese Wall approach to regulating conglomerates is likely to enhance the opportunity for individuals to indulge in insider dealing, the phenomenon would remain whatever regulatory regime was adopted. This is so given that there is (and has always been) the potential to "swap" inside information within the financial community whether it be over the telephone or in a London wine bar.

### **Final Remarks**

The increased misuse of inside information and abuse of other conflicts of interest and duty is likely as a result of the merging together of the City's financial institutions into what have become known as financial conglomerates. While a number of regulatory alternatives are available in resolving this problem they in effect boil down to two choices: either conflicts in conglomerates can be prevented by deconglomerating or they can be controlled through a range of regulatory options. The Chinese Wall is one means of control that has been isolated for use by regulators.

In Britain and the U.S the Wall has received regulatory and legislative backing. From a theoretical point of view it remains an attractive mechanism for preventing the misuse of inside information while at the same time allowing conglomerates to capture socially and economically beneficial economies of scope. However, serious flaws exist when theory is set aside from practice. The relative ease with which the wall is by-passed makes the effectiveness of this mechanism in isolating inside information, at best, suspect. Equally the fact that the use of an effective mechanism could leave a firm open to an

action at common law for breaking fiduciary duties to clients places a cost on firms in the form of legal uncertainty.

If the aim of conglomeration is to capitalise on informational synergies, while the intention of the Chinese Wall is to act as an effective information blocking device, then the question may be asked as to the whole rationale of combining corporate finance, broking jobbing, fund management etc within the one corporate entity. A Chinese Wall thus frustrates many of the purported advantages which might well accrue from conglomeration - such as pooled expertise and other shared resources. A cynical suggestion would be that Chinese Walls merely provide a superficial gloss of fairness so that conglomerates can benefit from the real economies of scope to be had by using inside information and management expertise on both sides of the Wall. If this is so might then another solution be adopted? Authorities have suggested that the Wall should be "reinforced" by either a no-recommendation policy or a restricted list, or indeed, even both. But such a "reinforced" Wall would introduce the further danger of internal Glass Steagall-type barriers so that there is separation of functions in fact even if not in name. This would, in effect, amount to de facto Glass-Steagall, stopping a banking arm from, for example, recommending a certain share or self-dealing on its own account where the securities arm is underwriting that issue.

It would seem that given the flaws in the Chinese Wall system, these are pertinent questions to ask. However one must bear in mind the totality of the issues which regulators face. Weighing up the costs and benefits of efficiency with the costs and benefits of fairness. The underlying current is that of deregulation by breaking down barriers governing the types of business that firms may conduct and implementing new more suitable regulations. This new

wave of change offers regulators the choice of moving away from barrier-type solutions to those based on competitive freedom. It is a new realignment of the policy objectives that is required. In seeking to achieve this it is argued that regulators do best by adopting "naked" Chinese Walls to regulate the situation where the conglomerate finds itself in a traditional conflict of interest/duty. But a "strengthened" Wall so that a conglomerate cannot self-deal in those situations where another arm of the conglomerate has a material interest in a transaction.

This reasoning is pragmatic and is not necessarily proposed as a long-term solution. The financial markets are in a process of change. In this deregulatory environment Chinese Wall systems come close to being a necessity. It has been advocated here that the courts ought to recognise, and to an extent embrace, the changes in evidence in the financial markets. It could be that before long (or in the wake of new scandals), deregulation and financial conglomeration may go out of fashion. In that case the regulators should adjust their rule books and the courts ought equally to adjust their sights and accommodate these changes. In the meantime the Wall will, most probably, facilitate abuses even where (under the argument presented herein) it is not required to be strengthened. But that is a risk, given the benefits of conglomeration, society ought to take. If abuses are detected violators ought to be punished very heavily indeed, as a form of effective deterrent.

In sum then, regulators have in large part been correct to adopt "naked" Chinese Walls to regulate conflicts in conglomerates. However it is to be *recognised that the Wall is not a panacea and may in some instances need to be strengthened.* The Government indeed recognised this in their White Paper but in practice the lead regulator - the SIB - has adopted the 'naked' Chinese Wall



as the regulatory linch-pin for the regulation of financial conglomerates. This is not sufficient. The Wall needs to be strengthened, especially where the conglomerate has a direct self-interest in the transaction. Where, however, it has only an indirect self-interest no strengthening is required. At law, conglomerates ought reasonably to rely on the SIB's codes and the Chinese Wall rules derived thereunder. While there remains uncertainty at common law about the validity of the Wall device, it is unlikely that an action will get as far as the courts. If, indeed, one does, it will be interesting to see whether the courts will hold a bona fide Chinese Wall to have reconciled what can only be described as the irreconcilable.

**FINANCIAL SERVICES ACT 1986**

**SCHEDULE 8**

**PRINCIPLES APPLICABLE TO DESIGNATED AGENCY'S RULES AND REGULATIONS**

**Standards**

1. The rules made under section 48 of this Act (in this Schedule referred to as "conduct of business rules") and the other rules and regulations made under Part I of this Act must promote high standards of integrity and fair dealing in the conduct of investment business.
2. The conduct of business rules must make proper provision for requiring an authorised person to act with due skill, care and diligence in providing any service which he provides or holds himself out as willing to provide.
3. The conduct of business rules must make proper provision for requiring an authorised person to subordinate his own interests to those of his clients and to act fairly between his clients.
4. The conduct of business rules must make proper provision for requiring an authorised person to ensure that, in anything done by him for the persons with whom he deals, due regard is had to their circumstances.

**Disclosure**

5. The conduct of business rules must make proper provision for the disclosure by any authorised person of interests in, and facts material to, transactions which are entered into by him in the course of carrying on investment business or in respect of which he gives advice in the course of carrying on such business, including information as to any commissions or other inducements received or receivable from a third party in connection with any such transactions.
6. The conduct of business rules must make proper provision for the disclosure by an authorised person of the capacity in which and the terms on which he enters into any such transaction.
7. The conduct of business rules, or those rules and rules under section 51 of this Act, must make proper provision for requiring an authorised person who in the course of carrying on investment business enters or offers to enter into a transaction in respect of an investment with any person, or gives any person advice about such a transaction, to give that person such information as to the nature of the investment and the financial implications of the transaction as will enable him to make an informed decision.
8. Rules made under section 48 of this Act regulating action for the purpose of stabilising the price of investments must make proper provision for ensuring that where action is or is to be taken in conformity with the rules adequate arrangements exist for making known that the price of the investments in respect of which the action is or is to be taken (and, where relevant, of any other investments) may be affected by that action and the period during which it may be affected; and where a transaction is or is to be entered into during a period when it is known that the price of the investment to which it relates may be affected by any such action the information referred to in paragraph 7 above includes information to that effect.

**Protection**

9. The conduct of business rules and any regulations made under section 55 of this Act must make proper provision for the protection of property for which an authorised person is liable to account to another person.
10. Rules made under sections 53 and 54 of this Act must make the best provision that can reasonably be made under those sections.

**Records**

11. The conduct of business rules must require the keeping of proper records and make provision for their inspection in appropriate cases.

**Classes of investors**

12. The conduct of business rules and the other rules and regulations made under Chapter V of Part I of the Act must take proper account of the fact that provisions that are appropriate for regulating the conduct of business in relation to some classes of investors may not (by reason of their knowledge, experience or otherwise) be appropriate in relation to others.

## APPENDIX II

### *Statement of Policy*

This Statement of Policy is adopted to provide more effective protection against disclosure of confidential information.

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 such other firms 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.

Material information, as used herein, refers to matters relating to a corporation which would be important to a reasonable investor in deciding whether he should buy, sell or hold securities of the corporation or which would be likely to have substantial market impact. Any such information which has not been disclosed by the corporation to the investing public, communicated in accordance herewith, shall be clearly identified as non-public information which is to be used by the recipient solely for the purpose of carrying out his responsibilities in connection with the proposed offering and which is not to be disclosed orally or in writing for any other purpose.

Any question as to the applicability or interpretation of this statement of policy or any portion thereof should be promptly referred to the Legal Department or Department of Supervision and Guidance, as appropriate.

The above statement of policy shall be promulgated by a bulletin which shall be distributed to all senior management personnel, all Division Directors, all Department Managers, all Office Managers, all members of the Underwriting Division, all Research analysts and all Account Executives and shall be included in the firm's Operations Manual.

It shall be the duty of each Department and Office Manager to review periodically with the personnel subject to his supervision the provisions of this statement of policy.

APPENDIX III

THE SYDNEY STOCK EXCHANGE LIMITED

PRIVATE AND CONFIDENTIAL  
CIRCULAR TO MEMBERS NUMBER 8

SEPTEMBER 26, 1985

RULE 3.14 - PROHIBITION OF ADVICE TO CLIENT -(CHINESE WALLS)

A recent survey of Chinese Walls in Member Organisations has indicated that many Member Organisations have not formalised Chinese Walls or are, in fact, unsure as to the necessity of installing Chinese Walls.

Any Member Organisation, whether it has 20 partners/directors or is a sole trader, is at some time liable to be in possession of price sensitive information within the meaning of Rule 3.14(1). The effect of Rule 3.14(1) and (2) is to prohibit a Member Organisation which has such price sensitive information from giving advice to other clients where the advice would be prejudicial to one client or another, unless the Member Organisation has established Chinese Walls. For the purposes of this Rule, "Client" includes a shareholder in a Member Corporation.

To ensure Member Organisations are not unnecessarily restricted in advising clients, it is essential that they erect Chinese Walls between those areas likely to be in possession of price sensitive information e.g. underwriting, corporate advising, market making departments, and those investment/client advisers who advise or trade in public securities markets.

The recommended procedures for installing the walls are set out in the Interpretation to Rule 3.14 (attached), whilst under Rule 3.14(4)(b)(ii) advice must be provided to the Exchange when Chinese Walls are erected or any change is made to existing Walls.

In smaller Member Organisations, either being partnerships or sole traders, it is common practice for one or more partners or employees to be in possession of sensitive information and, at the same time, to advise clients. The Exchange strongly recommends that Member Organisations in that situation erect Chinese Walls by completing the administrative procedures set out in the Interpretation to Rule 3.14, including formalisation of documentation required by paragraphs (a), (g) and (j) to that Interpretation, and then advise the Exchange as required by Rule 3.14(4)(b)(ii).

Any enquiries on this matter should be referred to Manager, Regulation and Compliance.



PETER W. MARSHMAN  
MANAGING DIRECTOR

.....  
No responsibility is accepted for any inaccuracies in the matter published

### **3.14 PROHIBITION OF ADVICE TO CLIENT**

- (1) Where as a result of its relationship to a client, a Member Organisation is in possession of information that is not generally available in relation to a Security and which would be likely to materially affect the price of that Security if the information was generally available, the Member Organisation shall not give any advice to any other client of a nature that would damage the interest of either of those clients.
- (2) A Member Organisation shall not be regarded as having possession of information that is not generally available in relation to a Security where the Member Organisation has Chinese Walls in place and the person advising the client is not in possession of that information.
- (3) A Member advising a client that the Member Organisation is precluded from giving the client advice shall not, for the purposes of this Rule, be regarded as giving advice.
- (4) (a) For the purposes of this Rule, "Client" includes a shareholder in a Member Corporation which constitutes the Member Organisation.  
(b) For the purposes of this Rule a reference to Chinese Walls in place means an arrangement has been established by a Member Organisation —
  - (i) whereby information known to persons included in one part of the business of the Member Organisation is not available (directly or indirectly) to those involved in another part of the business of the Member Organisation and it is accepted that in each of the parts of the business of the Member Organisation so divided decisions will be taken without reference to any interest which any other such part or any person in any other such part of the business of the Member Organisation may have in the matter; and
  - (ii) the Member Organisation has advised the Exchange in writing that —
    - (a) it has created Chinese Walls;
    - (b) those Chinese Walls which have been created are in accordance with the guidelines prescribed by the Exchange;
    - (c) the Chinese Walls as created will not be removed or altered without prior advice being given to the Exchange; and
    - (d) it requires the Exchange to place its name on the register of Member Organisations maintaining Chinese Walls which is made available by the Exchange for public perusal.

### **INTERPRETATIONS OF RULES**

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#### **Rule 3.14 — Prohibition of Advice to Client**

##### **Chinese Walls Procedures Prescribed by the Exchange**

The basic elements of Chinese Walls procedures are —

- (a) the Member Organisation shall prepare, for the instruction of its staff, a written policy statement forbidding communication of non-public information to investment officers who advise or trade in public securities markets. The flow of general market information from investment and trading departments to the underwriting and corporate advisory departments would not be inhibited.
- (b) access to documents including computer records likely to contain non-public information is restricted and this restriction be monitored.
- (c) frequent transfers of personnel between underwriting, corporate advising and market making departments and other departments be avoided.
- (d) prohibition of corporate advisory, underwriting or market making staff from sitting on investment committees.
- (e) physical separation of underwriting corporate advisory and market making departments from investment advisory and securities trading departments.
- (f) continuing education programmes to give staff a common sense understanding of insider trading and other conflicts of interest situations.
- (g) partners and directors to acknowledge in writing that they agree to be denied information regarding the Member Organisation's business activities where the communication of that information would be in breach of Chinese Wall procedures.
- (h) in the event that insider information is inadvertently communicated to personnel in breach of Chinese Wall procedures the recipient be immediately prohibited from initiating dealings in any securities the market prices of which are likely to be affected by the disclosure of that information.
- (i) arrangement must be in place for the internal and external auditing of the Chinese Wall procedures, and
- (j) all employees shall acknowledge in writing that they have read and understood the policy statement referred to in (a) above, and the Member Organisation shall retain this acknowledgement

.....

(April 1985 — 1/85)

STANDARD PROCEDURES

FOR

CHINESE WALLS

For: \_\_\_\_\_  
Member Organisation name

Issued: \_\_\_\_\_  
Date

Return completed Agreement/Acknowledgement to \_\_\_\_\_

To be issued to all staff of all branches

Prepared by Regulation & Compliance Dept.  
The Sydney Stock Exchange Limited

PROCEDURES RELATING TO CHINESE WALLS

All staff are required to take note that this Member Organisation of The Sydney Stock Exchange Limited has instituted "Chinese Walls" in accordance with the Rules of the Stock Exchange. This procedure applies to all branches of our Member Organisation.

The following information is included in this document:-

Rule 3.14 of The Sydney Stock Exchange Limited.  
Rule Interpretation 3.14 of The Sydney Stock Exchange Limited.  
Two declarations:

- Staff or License holder Agreement
- Principals Agreement - For Partner/Member Director or Non-Member Director.

The Basic elements of Chinese Walls, which must be adhered to at all times, are:-

1. Communication of non-public information to investment officers who advise or trade on behalf of clients or this firm is strictly prohibited.
2. Access to documents, including computer records, which may contain non-public information will be restricted and the restriction monitored.
3. No member of staff who is in a position of knowing non-public information may participate in any investment committees or similar discussions.
4. Departments likely to be in possession of non-public information will be physically separated from advisory and trading departments.
5. Should any member of staff come into possession of non-public information he/she must immediately report the matter to the Senior Partner/Director and cease to advise and/or trade in the relevant securities.

In addition, Section 229(3) of the Companies Code prohibits improper use of information, not only by employees but also by former employees.

229(3) [Improper use of information] An officer or employee of a corporation, or a former officer or employee of a corporation, shall not make improper use of information acquired by virtue of his position as such an officer or employee to gain, directly or indirectly, an advantage for himself or for any other person or to cause detriment to the corporation.

Penalty: \$20,000 or imprisonment for 5 years, or both.

All staff and principals are required to agree to be bound by the procedures and provisions contained herein and should signify their agreement by returning the second part of their Agreement to \_\_\_\_\_

Signed .....  
Partner/Director of Member Organisation

RULE 3.14 OF THE SYDNEY STOCK EXCHANGE LIMITED.

"3.14 PROHIBITION OF ADVICE TO CLIENT

- (1) Where as a result of its relationship to a client, a Member Organisation is in possession of information that is not generally available in relation to a Security and which would be likely to materially affect the price of that Security if the information was generally available, the Member Organisation shall not give any advice to any other client of a nature that would damage the interest of either of those clients.
- (2) A Member Organisation shall not be regarded as having possession of information that is not generally available in relation to a Security where the Member Organisation has Chinese Walls in place and the person advising the client is not in possession of that information.
- (3) A Member advising a client that the member Organisation is precluded from giving the client advice shall not, for the purposes of this Rule, be regarded as giving advice.
- (4)
  - (a) For the purposes of this Rule, "Client" includes a shareholder in a Member Corporation which constitutes the Member Organisation.
  - (b) For the purposes of this Rule a reference to Chinese Walls in place means an arrangement has been established by a Member Organisation -
    - (i) whereby information known to persons included in one part of the business of the Member Organisation is not available (directly or indirectly) to those involved in another part of the business of the Member Organisation and it is accepted that in each of the parts of the business of the Member Organisation so divided decisions will be taken without reference to any interest which any other such part or any person in any other such part of the business of the Member Organisation may have in the matter; and
    - (ii) the Member Organisation has advised the Exchange in writing that -
      - (a) it has created Chinese Walls;
      - (b) those Chinese Walls which have been created are in accordance with the guidelines prescribed by the Exchange;
      - (c) the Chinese Walls as created will not be removed or altered without prior advice being given to the Exchange; and
      - (d) it requires the Exchange to place its name on the register of Member Organisations maintaining Chinese Walls which is made available by the Exchange for public perusal."



RULE INTERPRETATION 3.14 OF THE SYDNEY STOCK EXCHANGE LIMITED.

"Chinese Walls Procedures prescribed by the Exchange pursuant to Rule 3.14

The basic elements of Chinese Walls procedures are:-

- (a) the Member Organisation shall prepare, for the instruction of its staff, a written policy statement forbidding communication of non-public information to investment officers who advise or trade in public securities markets. The flow of general market information from investment and trading departments to the underwriting and corporate advisory departments would not be inhibited,
- (b) access to documents including computer records likely to contain non-public information is restricted and this restriction be monitored,
- (c) frequent transfers of personnel between underwriting, corporate advising and market making departments and other departments be avoided,
- (d) prohibition of corporate advisory, underwriting or market making staff from sitting on investment committees,
- (e) physical separation of underwriting corporate advisory and market making departments from investment advisory and securities trading departments,
- (f) continuing education programmes to give staff a commonsense understanding of insider trading and other conflicts of interest situations,
- (g) partners and directors to acknowledge in writing that they agree to be denied information regarding the Member Organisation's business activities where the communication of that information would be in breach of Chinese Wall procedures,
- (h) in the event that insider information is inadvertently communicated to personnel in breach of Chinese Wall procedures the recipient be immediately prohibited from initiating dealings in any securities the market prices of which are likely to be affected by the disclosure of that information,
- (i) arrangement must be in place for the internal and external auditing of the Chinese Wall procedures, and
- (j) all employees shall acknowledge in writing that they have read and understood the policy statement referred to in (a) above, and the Member Organisation shall retain this acknowledgement."

STAFF OR LICENSE HOLDER ACKNOWLEDGEMENT -  
PROHIBITION OF ADVICE TO CLIENT

I, \_\_\_\_\_, hereby state that I have read

1. the Procedures Relating to Chinese Walls,
2. Rule 3.14 of The Sydney Stock Exchange Limited, and
3. Rule Interpretation 3.14 of The Sydney Stock Exchange Limited

and agree to be bound by the procedures and provisions contained therein.

\_\_\_\_\_  
Signature

\_\_\_\_\_  
Date

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(Detach here)

COPY TO BE HELD BY  
MEMBER ORGANISATION

STAFF OR LICENSE HOLDER ACKNOWLEDGEMENT -  
PROHIBITION OF ADVICE TO CLIENT

I, \_\_\_\_\_, hereby state that I have read

1. the Procedures Relating to Chinese Walls,
2. Rule 3.14 of The Sydney Stock Exchange Limited, and
3. Rule Interpretation 3.14 of The Sydney Stock Exchange Limited

and agree to be bound by the procedures and provisions contained therein.

\_\_\_\_\_  
Signature

\_\_\_\_\_  
Date

PRINCIPALS ACKNOWLEDGEMENT

FOR PARTNER/MEMBER DIRECTOR OR NON MEMBER DIRECTOR

PROHIBITION OF ADVICE TO CLIENT

I, \_\_\_\_\_ acknowledge and agree to be denied information, the communication of which would be in breach of Chinese Walls procedures. I also state that I have read

1. the Procedures Relating to Chinese Walls,
2. Rule 3.14 of The Sydney Stock Exchange Limited, and
3. Rule Interpretation 3.14 of The Sydney Stock Exchange Limited

and agree to be bound by the procedures and provisions contained therein.

\_\_\_\_\_  
Signature

\_\_\_\_\_  
Date

-----  
(Detach here)

COPY TO BE HELD BY  
MEMBER ORGANISATION

PRINCIPALS ACKNOWLEDGEMENT

FOR PARTNER/MEMBER DIRECTOR OR NON MEMBER DIRECTOR

PROHIBITION OF ADVICE TO CLIENT

I, \_\_\_\_\_ acknowledge and agree to be denied information, the communication of which would be in breach of Chinese Walls procedures. I also state that I have read

1. the Procedures Relating to Chinese Walls,
2. Rule 3.14 of The Sydney Stock Exchange Limited, and
3. Rule Interpretation 3.14 of The Sydney Stock Exchange Limited

and agree to be bound by the procedures and provisions contained therein.

\_\_\_\_\_  
Signature

\_\_\_\_\_  
Date

#### APPENDIX IV

- 1 Clients of Corporate Advisory and of Investment Advisory Departments should be made aware of the existence of the other Department and understand that in order to avoid conflict of interest these activities are confidential and segregated, and they cannot expect to receive any advantage nor need fear any disadvantage from the fact that the house conducts both.
- 2 Privileged price-sensitive information which a House may hold about a company which is a client or on whose Board some member of the House may sit may not in any case be taken into account for the purpose of forming an investment decision.
- 3 Special knowledge available to a House about a client company or one upon whose Board some member of the House may sit is only to be used for the purpose of forming investment decisions if it is or would be equally available to an independent investment analyst or stockbroker upon reasonable enquiry from the company or other sources.
- 4 Whilst (subject to the rules of the Code on Take-overs and Mergers)<sup>24</sup> Houses are not precluded during the public transaction of a take-over from purchasing for their own account securities of a company for which they are acting, they must not purchase such securities for their discretionary investment clients except by reference to ordinary investment criteria and in no case simply to support the market in their client company's shares. Nor may they in advance of the public announcement of a take-over advise investment clients to accumulate shares in the offeree company in order to secure acceptance of the offer.
- 5 Equally investment clients need not necessarily be deprived of the advantage of transactions based on ordinary market criteria simply because the House is acting for a party to the take-over transaction, although it is realised that some Houses prefer to operate a stop list.
- 6 The number of persons in the House made privy to an impending take-over transaction or other confidential or price-sensitive information should be as restricted as practicable.
- 7 Houses should periodically review their security arrangements.
- 8 Houses should prohibit members of their staffs from dealing in any securities on their own account except through the House itself.
- 9 The standard by which the propriety and therefore permissibility of any proposed line of action in relation to deals in securities, the subject of price-sensitive information or of a take-over transaction, is to be judged is whether the House is prepared subsequently to justify at a public enquiry the action taken.

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