Are Chinese Walls the Best Solution to the Problems of Insider Trading and Conflicts of Interest in Broker- Dealers?

Christopher M. Gorman

Follow this and additional works at: https://ir.lawnet.fordham.edu/jcfl

Part of the Banking and Finance Law Commons, and the Business Organizations Law Commons

Recommended Citation

This Note is brought to you for free and open access by FLASH: The Fordham Law Archive of Scholarship and History. It has been accepted for inclusion in Fordham Journal of Corporate & Financial Law by an authorized editor of FLASH: The Fordham Law Archive of Scholarship and History. For more information, please contact tmelnick@law.fordham.edu.
NOTES

ARE CHINESE WALLS THE BEST SOLUTION TO THE PROBLEMS OF INSIDER TRADING AND CONFLICTS OF INTEREST IN BROKER-DEALERS?

Christopher M. Gorman*

INTRODUCTION

The once-thriving "new" American economy is a thing of the past with the bursting of the dot-com bubble. After the huge losses in the financial markets, investors and the Securities and Exchange Commission ("SEC") have focused on cases of fraud in the financial markets. The SEC has continued its long-standing focus on insider trading in broker-dealers, but it has now begun to concentrate on conflicts of interest, particularly conflicts of securities analysts. "Chinese Walls" are an important element of broker-dealer regulation because they attempt to resolve both of these problems. Traditionally, a Chinese Wall has been an information barrier that prevents insider trading. Recently, the SEC and Congress have advocated the use of a Chinese Wall as a structural technique to help reduce analysts' conflicts of interest.

* J.D., Candidate, Fordham University School of Law, May 2004; B.S., summa cum laude, Finance, Providence College, May 2001. I would like to thank my wife, Samantha, my parents, Kathy and Paul, and my brothers, Stephen and Daniel, for their unwavering love, support, and encouragement over the years. I also want to thank the rest of my family for always supporting me.


2. NORMAN S. POSER, BROKER-DEALER LAW AND REGULATION: PRIVATE RIGHTS OF ACTION § 1.02[C] (2d ed. 1997).

Chinese Walls may partially control conflicts of interest and insider trading; however, this success comes with some significant costs. There may be more efficient and effective techniques available to deal with the problems of insider trading and conflicts of interest. This Note will begin by exploring the statutory basis for the prohibition of insider trading and its evolving definition. Part I will then explain why conflicts of interest exist in broker-dealers. Part II will discuss the origin of Chinese Walls, give examples of the policies and procedures they typically employ and discuss their advantages and disadvantages. Part III will present additions to Chinese Walls and alternatives that may better prevent insider trading and reduce conflicts of interest. Finally, this Note will conclude that Chinese Walls, whether used conceptually to prevent insider trading or structurally to prevent conflicts of interest, are inefficient, largely ineffective and have more shortcomings than advantages. Chinese Walls will only prevent insider trading at the broker-dealer level, but instances of insider trading by insiders and their tippees will continue to occur. In addition, the best solution to analysts' conflicts is a scheme where investors are given the ability to make their own fully informed decisions.

I. BACKGROUND ON CONFLICTS OF INTEREST AND INSIDER TRADING

A. Insider Trading: Statutory Basis for the Prohibition and Developing Case Law of its Definition

A Chinese Wall is the primary weapon used to prevent insider trading. Insider trading is the illegal trading of a security based on material, nonpublic information. In a multi-service broker-dealer, the investment banking department usually obtains this material, nonpublic information through its relationship with corporate clients. The investment banker then shares this information with the firm's retail brokers, who make trade recommendations to their customers based on this information. For example, a corporate client may disclose to an investment banker that it will be making a tender offer for another

4. See Poser, supra note 2.
corporation. The investment banker may then share this inside information with a retail trader, who will then recommend that his customers purchase shares of the target firm's stock. Once the news of the tender offer is released to the public, the client will then be able to sell the shares for a profit. This is a classic example of insider trading.

The prohibition of insider trading is principally based on four statutory sources. These sources are: (1) Section 10(b) of the Securities and Exchange Act of 1934 and SEC Rule 10b-5 passed thereunder; (2) Section 16 of the Exchange Act; (3) Section 14(e) of the Exchange Act and SEC Rule 14e-3 passed thereunder; and (4) statutory amendments passed in the 1980s to the Exchange Act. The most important source is Rule 10b-5, which makes it unlawful:

(a) To employ any device, scheme, or artifice to defraud,
(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

There is no specific reference to insider trading anywhere in the rule. The prohibition is based on the fact that the person who trades on

6. This news typically increases the value of the target firm’s stock. See Karmel, infra note 15.
7. The client will make money since he purchased an undervalued security that appreciated in value once the inside information was released to the public. He was then able to profit by selling the shares after the market incorporated this information into the price of the target firm’s stock.
inside information is either using a scheme to defraud in violation of subsection (a) or is engaging in a fraudulent act in violation of subsection of (c).15 The fraud is based on the failure of the party in possession of the inside information to disclose it to the other party.16

Since there is no explicit statutory definition of insider trading, it has been established through controversial case law. One important issue is the definition of inside information. Inside information initially meant information concerning a company’s assets or earning power that affected the stock price.17 Thus, traditional insider trading usually involved trading by directors, officers, and employees of the corporation.18 This definition has expanded over time to include “market information,” which is any information that affects the market for a company’s security, not just information affecting the company’s assets or earning power.19 This more expansive definition of inside information has led to individuals besides traditional insiders being found guilty of insider trading.20 Today, courts do not make the distinction between these two types of information.21 Therefore, trading based on traditional inside information as well as outside information is considered insider trading in violation of Rule 10b-5.22

Another important issue under insider trading law is who can be found guilty of insider trading. Under the traditional, or classical, theory of insider trading, a person violates Section 10(b) and Rule 10b-5 when a corporate insider trades the company’s stock based on material,

16. Id.
18. Insider trading initially involved these individuals since they were the only ones with the ability to obtain information relating to the company’s assets or earning power.
19. United States v. Chiarella, 588 F.2d 1358, 1365 (2d Cir. 1978), rev’d, 445 U.S. 222 (1980). Market information is often referred to as “outside information” because it is usually obtained from outsiders such as investors, traders, brokerage firms, and others. Karmel, supra note 15, at 87.
20. Under this new definition of inside information, analysts and underwriters are now more frequently convicted of insider trading. See id. at 83.
22. Id.
nonpublic information. Under this theory, only those individuals who owe a fiduciary duty to the corporation and its shareholders are guilty of insider trading.24 The term “insider” has expanded under the classical theory to include temporary insiders such as attorneys, investment bankers or accountants. The theory also now includes trades of tippees, or persons who obtain inside information from an insider.25 These corporate insiders obtain inside information from a relationship of trust and confidence with the corporation and its shareholders, so they may not use it to take advantage of uninformed individuals. They are under a duty to either disclose all material, nonpublic information or abstain from trading in the corporation’s securities.26 The classical theory requires the presence of a fiduciary relationship between the insider and shareholders because “[w]hen an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak.”27 Thus, the classical theory does not cover trades of outsiders who obtain material, nonpublic information from a method besides the breach of an insider’s duty.28 In response to this problem, prosecutors have urged courts to adopt the misappropriation theory to find these individuals guilty of insider trading.

The misappropriation theory has been used to cover instances of “outsider trading.” Under this theory, a person who trades on wrongfully obtained material, nonpublic information is liable solely for misappropriating this information, regardless of the trader owing any fiduciary duty.29 This theory holds that the person who trades on this information pretends to be loyal to the source of the information, thus creating a deceptive device in violation of subsection (a) of Rule 10b-5.30 Thus, the misappropriation theory bars this trading because the

---

24. Since the classical theory requires the presence of a fiduciary duty, it applies to trading by corporate insiders such as directors or officers, and to temporary fiduciaries such as accountants, attorneys, and consultants. Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983).
25. See id. (discussing tippees and their liability for insider trading).
27. Id. at 235.
trader is betraying some obligation owed to the source of the inside information, irrespective of the source owing any duty to the corporation or its shareholders. Therefore, this theory provides the government with an alternative method to the classical theory to prosecute instances of insider trading.

Another controversial issue in insider trading is the "possession versus use" debate. The issue here is when a person must abstain from trading based on inside information. The "use" view says that the person should abstain from trading only when he is using the inside information as the basis for the trade. The "possession" view argues that the person subject to the disclose or abstain duty is required to abstain from trading due to the mere possession of inside information, even if that information is not the basis for the trade. The possession standard is based on the idea that it is difficult for a person to possess inside information and purchase or sell a security without using that information. The SEC has attempted to resolve the dispute by adopting Rule 10b5-1, which states that a purchase or sale of a security is on the basis of inside information when the person is aware of the material, non-public information. There is significant debate over whether this "aware" standard has resolved any of the difficulty arising from the "possession versus use" debate.

B. Conflicts of Interest and Why They Exist

The second problem Chinese Walls attempt to address is conflicts of interest in multi-service broker-dealers. A conflict of interest is "a situation in which the self-interest of a person may conflict with a fiduciary duty that he owes to another, or in which a person has potentially conflicting fiduciary duties to two or more persons." A broker-dealer can frequently find itself in a situation where the firm's self-interests conflict with the interests of its client, or alternatively, where the interests of two of the firm's clients are at odds with each

31. Id. at 1056-57.
32. Id.
33. Id.
34. Id.
36. POSER, supra note 2, at § 1.02.
other. Conflicts of interest exist in broker-dealers for two principle reasons.

One reason conflicts of interest exist is the compensation scheme in the brokerage industry. Broker-dealers are compensated based on commissions, and they also give investment advice and exercise trading discretion over some customers' accounts. A broker-dealer has an incentive to encourage his customer to trade frequently since he earns a commission based on each trade. The broker-dealer's self-interest in maximizing his commission will conflict with the customer's interest in maximizing his return on investment, which is usually done by holding a security for an extended period. Commissions can also influence the specific security that the broker-dealer recommends to a customer. Generally, commissions are higher for lower-priced, riskier securities than the commissions for higher-priced, safer securities. Therefore, broker-dealers seeking to maximize their compensation are likely to recommend that a customer frequently buy and sell securities, particularly risky securities, even if this is not in the customer's best interests. This compensation scheme clearly fails to align the interests of broker-dealers with the interests of their customers.

The second reason conflicts of interest exist in broker-dealers is because of the multiple functions the broker-dealers perform. Broker-dealers engage in numerous financial activities. In today's economy of "mega-firms," a broker-dealer often engages in some or all of the following activities: (1) retail and institutional brokerage, including sales and research; (2) portfolio management; (3) mutual fund management; (4) trading for the firm's own account; (5) underwriting of public offerings and private placements; and (6) investment banking, including giving financial advice to corporate clients. As a result of these wide-

37. Id.
38. Id. at § 1.02[A].
39. Id.
40. Id.
41. Id.
43. See POSER, supra note 2, at § 1.02.
44. Id. at § 1.02[A].
45. Id.
ranging activities, a broker-dealer can face numerous conflicts of interest.

The conflict of interest that has received the most press recently is analysts' conflicts. This conflict arises from the difficulty in trying to serve both corporate and individual clients.\footnote{As discussed above, broker-dealers typically provide research through their analysts, sales through their brokers and underwriting services to corporate clients.} A broker-dealer is very mindful of the fact that a significant source of revenue for the firm is its underwriting activities.\footnote{Therefore, there is often concern that "analysts' recommendations might be colored by their firms' investment-banking ties."} Analysts might be persuaded to issue overly optimistic reports about a corporate client. Issuing a negative report would obviously upset the corporate client, who may threaten to take its lucrative underwriting needs to another firm. Thus, the broker-dealer has a compelling interest in making its corporate client happy with its analysts' reports. At the same time, customers have an interest in obtaining an objective analyst's report when deciding whether or not to purchase a corporation's securities. Clearly the customer's interest in obtaining unbiased, reliable research information conflicts with the broker-dealer's interest in maintaining its profitable investment banking relationship with its corporate clients.

III. CHINESE WALLS AS A WEAPON TO FIGHT INSIDER TRADING AND CONFLICTS OF INTEREST

A. Background

The Chinese Wall is the primary weapon used to combat the problems of insider trading and conflicts of interest in broker-dealers.\footnote{Chinese Walls were initially voluntary policies and procedures...}
established by broker-dealers themselves, but the SEC eventually made them a statutory requirement for all firms.\textsuperscript{51} The term "Chinese Wall" is a metaphor used to describe a broker-dealer's internal rules and procedures designed to prevent insider trading and manage conflicts of interest.\textsuperscript{52} A Chinese Wall attempts to "wall in" information obtained from one department and prevent this inside information from being disseminated throughout the firm.\textsuperscript{53} It also attempts to physically segregate the investment banking department from the brokerage, research and other departments of the firm.\textsuperscript{54} This segregation is designed to prevent investment bankers from exerting influence on analysts' research reports.

Chinese Walls first came into existence in 1968 as part of a settlement between the SEC and Merrill Lynch.\textsuperscript{55} Merrill Lynch was the lead underwriter for a potential public offering of debentures by Douglas Aircraft Company.\textsuperscript{56} Merrill Lynch learned that the company was about to issue a revised estimate of its earnings with substantially lower figures. Merrill Lynch's underwriters gave this information to the sales department, who in turn told several mutual funds and other large institutional clients.\textsuperscript{57} During the three-day period before Douglas publicly disclosed this information, Merrill Lynch and its clients sold the stock to avoid substantial losses.\textsuperscript{58} As part of the settlement Merrill Lynch reached with the SEC, the firm adopted a Statement of Policy that "prohibits disclosure by any member of the Underwriting Division of material information obtained from a corporation ... and not disclosed to the investing public."\textsuperscript{59} In effect, this Statement of Policy established the first Chinese Wall.\textsuperscript{60}

After the Merrill Lynch settlement, other brokerage firms voluntarily implemented Chinese Walls to prevent the SEC from

\begin{footnotesize}

\begin{enumerate}
\item See id. at § 1.02[C].
\item See id.
\item \textsc{practicing law institute pli order no}. b4-6872, apr. 27, 1989, at 558.
\item marc i. steinberg & john fletcher, \textit{compliance programs for insider trading}, 47 smu l. rev. 1783 (1994).
\item \textit{in re} merrill lynch, pierce, fenner & smith, inc., 43 s.e.c. 933 (1968).
\item \textit{id}. at 935.
\item \textit{id}.
\item \textit{id}.
\item \textit{id}. at 938.
\item see poser, supra note 2, at § 1.02[C].
\end{enumerate}

\end{footnotesize}
targeting them in an insider trading investigation. However, these Chinese Walls often proved futile as numerous allegations of insider trading continued to arise. Congress responded by making Chinese Walls a statutory requirement under Section 15(f) of the Securities Exchange Act of 1934, which was adopted as part of the Insider Trading and Securities Fraud Enforcement Act of 1988. It states that "[e]very registered broker or dealer shall establish, maintain and enforce written policies and procedures reasonably designed . . . to prevent the misuse . . . of material, nonpublic information." This statutory requirement has been the subject of numerous SEC enforcement actions against broker-dealers. Therefore, broker-dealers carefully design, implement and monitor all Chinese Wall procedures to avoid SEC enforcement action.

Although Chinese Walls exist principally to prevent insider trading, their formation serves other important purposes. One compelling benefit of Chinese Walls is to help ensure the integrity of research reports and other recommendations made by securities analysts. The recent emphasis on analysts' conflicts of interest has motivated the SEC, National Association of Securities Dealers, Inc. (hereinafter "NASD"), and New York Stock Exchange, Inc. (hereinafter "NYSE") to propose rules advocating the use of Chinese Walls to restore analysts' independence. The Chinese Wall attempts to maintain analysts'
independence by separating the research and investment banking units, so that analysts are not subject to review or pressure by the investment bankers. The hope is that "[i]f research operates independently ... analysts could express their true views on stocks without fear of cramping the style of investment bankers, who typically earn the bulk of most firms' income." Chinese Walls thus attempt to eliminate, or at least reduce, the conflict between the interests of the investment banking department and investors who rely on analysts' recommendations and research reports.

B. Typical Policies and Procedures of a Chinese Wall

The specific policies and procedures of a Chinese Wall are left to each individual broker-dealer considering the nature of its business. However, there are certain minimum elements and standards that a Chinese Wall should employ to be effective. Preventing communication between the various departments of a broker-dealer is the essence of a Chinese Wall. To achieve this goal, the firm should separate departments with frequent access to confidential information from the departments that trade securities or give investment advice. One method to enforce this separation is restricting access to files, offices, and computers. Some firms may ensure this separation by locating their investment banking and sales departments on separate floors, or even in different buildings. Physically locking up sensitive information, shredding sensitive documents once they are no longer needed and using code words or names in sensitive documents are other techniques to prevent the dissemination of inside information.

72. See FERRARA, supra note 21, at § 10.02[2].
73. Id.
74. See POSER, supra note 2.
75. Id.
76. See FERRARA, supra note 21, at § 10.02[2].
The SEC's Division of Market Regulation has emphasized that observance, continuing education and review of the broker-dealer's trading are also important elements of a Chinese Wall. The report recommended that "firms memorialize in greater detail their procedures, and likewise improve the documentation, communication and record-keeping associated with their Chinese Wall activities." To further achieve these goals, firms should have formal written codes of ethics that every employee should read, understand and contractually agree to obey. The SEC's report also stated the need for continuing education to update and enforce the firm's policies. Lastly, the report identified the use of watch lists and restricted lists to supplement Chinese Walls and review compliance with them.

Despite the elaborate policies and provisions of Chinese Walls, their existence has been hotly debated. The SEC maintains that they are effective and necessary to prevent insider trading and control a large, multi-service broker-dealer's conflicts of interest. Opponents of Chinese Walls argue that they are an ineffective and inefficient method to deal with these problems, and there are better alternatives available. This Note will now present the advantages and disadvantages of Chinese Walls and discuss if there are better alternatives available to prevent insider trading and reduce conflicts of interest.

79. See Broker-Dealer Policies, supra note 77, at 80,627.
80. Id. at 80,623–80,627; see discussion infra Part IV.A for watch lists and restricted lists.
81. See generally Stone, supra note 70 (discussing alternatives to Chinese Walls).
83. See POSER, supra note 2.
C. Advantages of Chinese Walls

Chinese Walls are an important weapon in the battle against insider trading. As discussed earlier, insider trading is illegal, and Chinese Walls attempt to prevent insider trading by preventing the flow of material, nonpublic information. Chinese Walls also have a beneficial purpose for the broker-dealer. "At the same time that Chinese Walls contain information within a department, they also allow other departments to act freely without fear of 'contamination.'" Chinese Walls allow a broker-dealer to still engage in trading activities even if its investment bankers receive material, nonpublic information. If a retail trader discovers material, nonpublic information, the firm would have its hands tied and be prevented from trading since this would be a violation of insider trading laws. A Chinese Wall segregates this information from the retail traders so that they can continue to engage in trading activities without any fear of being tainted and guilty of insider trading.

Chinese Walls also provide broker-dealers with a defense to an insider trading allegation under Section 21A(a) of the Exchange Act. Thus, the use of a Chinese Wall makes it less likely that the SEC will prosecute the firm for insider trading even if one of its employees engages in insider trading. Although Chinese Walls are not an absolute defense to liability, they do serve to decrease the likelihood that a broker-dealer will be found guilty of insider trading. This illustrates yet another benefit Chinese Walls offer to broker-dealers.

There are convincing public policy interests to enforce the ban on insider trading, and Chinese Walls attempt to serve those interests. There is an inherent unfairness in insider trading. Nearly every developed country has some form of laws in place prohibiting insider trading. Some insider trading legislation has been passed because of the belief that "insider trading threatens...markets by undermining the

84. See supra Part II.A.
85. See supra Part III.A.
86. FERRARA, supra note 21, at § 9.01.
87. Id.
89. See Manne, infra note 123 and accompanying text.
public's expectations of honest and fair securities markets where all participants play by the same rules.\(^9\)

When someone trades on inside information, honesty and fair play are no longer present in the market. The insider is unfairly profiting from information he obtains because of his inside connection with the firm. The rest of the market is unable to obtain this information until the firm decides to publicly disclose it. In a market where this type of trading is permitted, insiders will be able to take advantage of unsuspecting outsiders. Therefore, Chinese Walls attempt to enforce fairness and confidence in the securities markets by ensuring that insiders will not be able to engage in dishonest transactions and benefit at the expense of unknowing investors.

When a broker-dealer trades or makes recommendations based on inside information, the firm is betraying the confidence of its corporate clients. The firm's clients are sharing material, nonpublic information with investment bankers to obtain financial advice. They do not intend for the investment bankers to betray their expectation of confidence by disclosing the information to retail traders. There is a clear conflict of interest in this situation. On one hand, the corporation has an interest in keeping the information confidential and obtaining sound advice. On the other hand, the broker-dealer has an interest in using this information for its own financial gain. Chinese Walls ensure that the broker-dealer will not disclose the information to retail traders, thus protecting the interest of corporate clients.

Chinese Walls also attempt to reduce the harm caused to other potential corporate shareholders when insider trading occurs.\(^9\) Nagy discusses one rationale why insider trading must be prevented: when an insider purchases shares based on inside information, this insider's trade preempts any possible trade by an outsider.\(^9\) If it were not for the insider's trade, Nagy argues that an outsider would have been able to execute the trade and recognize a profit when the firm releases the information to the public.\(^9\) Thus, Nagy argues that insider trading robs


\(^{92}\) Id. at 1189.

\(^{93}\) Id.
the rest of the investing public of an opportunity to invest in a profitable company.\textsuperscript{94}

An obvious flaw with this argument is that today’s markets are extremely liquid and diverse. Therefore, this outsider will still have numerous other opportunities to still purchase the corporation’s stock; the insider’s trade is really not preventing an outsider from purchasing the security. However, the uninformed shareholder who sells his shares to the insider is harmed. He is not aware of the impending positive news for the corporation, and he is deprived of the profit he would make when the corporation discloses the positive information. This profit is transferred to the insider, thus depriving the profit to the previous shareholder. Chinese Walls prevent insider trading and thus preserve the profits of existing shareholders and protect them from exploitation by insiders.

Perhaps the most important function of Chinese Walls today is their role in helping a broker-dealer manage its analysts’ conflicts of interest. There is tremendous pressure on analysts to issue favorable reports on behalf of their firms’ corporate clients.\textsuperscript{95} Charles Schwab states that there is a “profound crisis of trust” where investors don’t know what to believe when it comes to analysts’ recommendations.\textsuperscript{96} This crisis arises from the fact that most analysts’ recommendations “have been shown to be more about smoothing the relationship between investment bankers and CEOs than about providing sound information to ordinary investors.”\textsuperscript{97} The reason for the Sarbanes-Oxley Act of 2002 was a concern that investment banks weren’t maintaining Chinese Walls between retail brokerage and underwriting.\textsuperscript{98} The SEC, Congress, NASD and NYSE have all turned to Chinese Walls to minimize analysts’ conflicts.\textsuperscript{99}

Chinese Walls establish strict rules and procedures to separate analysts from investment bankers to maintain the reliability and independence of analysts’ reports. The prevalence of analysts’ conflicts can be neither overstated nor denied. In a recent study, it was stated that

\begin{itemize}
  \item \textsuperscript{94} \textit{Id.}
  \item \textsuperscript{95} \textit{See infra} note 110 and accompanying text.
  \item \textsuperscript{96} \textit{See} Schwab, \textit{supra} note 46.
  \item \textsuperscript{97} \textit{Id.}
  \item \textsuperscript{98} S. REP. No. 107-205, 107th Cong., 2d Sess., Committee on Banking, Housing, and Urban Affairs, July 3, 2002, at 34.
  \item \textsuperscript{99} \textit{Id.} at 34–38.
\end{itemize}
analysts hardly ever issued sell recommendations for a security because of the influence of the firm's investment bankers. These statistics proved that sell recommendations comprised less than two-percent of all analysts' recommendations. Clearly analysts were very reluctant, if not terrified, to issue an unfavorable recommendation. Some may argue that this only proves that analysts were overly optimistic; it does not prove that analysts were influenced by their firm's investment banking ties. However, another recent study revealed that analysts who work for firms with investment banking activities have 6% higher earnings forecasts and 25% more buy recommendations than analysts employed by firms with no underwriting activities. Other studies further evidencing analysts' conflicts state that recently the buy-sell ratio was 66 to 1, compared to only 6 to 1 less than a decade ago. These studies uncover the disturbing fact that analysts' recommendations, frequently relied on by investors, are biased and influenced by the broker-dealer's investment banking relationships. Chinese Walls attempt to resolve these analysts' conflicts by structurally separating analysts so that they are not influenced or pressured by the firm's investment bankers. The hope is that Chinese Walls will improve the disturbing results of the studies discussed.

D. Disadvantages of Chinese Walls

A Chinese Wall does not entirely stop the flow of inside information and prevent insider trading, nor does it always reduce analysts' conflicts of interest. Chinese Walls are more successful in preventing the accidental flow of inside information than they are in preventing purposeful misconduct and conspiracies to share inside

100. In one study it was revealed that 29% of recommendations were strong buy, 37% buy, 31% hold, 1% sell and 0.4% strong sell. See John C. Coffee, Jr., Virtue and the Securities Analyst, N.Y. L.J., July 19, 2001, at 5.
101. Id.
103. See Coffee, supra note 100.
104. Id.
105. See POSER, supra note 2.
Since a Chinese Wall is not successful in preventing an investment banker from intentionally disclosing inside information to retail traders, these deliberate disclosures of inside information will continue to occur. Chinese Walls also won’t be able to prevent insider trading by classic insiders of the corporation and their tippees. These instances of insider trading, which are more common than insider trading resulting from the breach of a Chinese Wall, will still continue in the markets despite a broker-dealer’s Chinese Wall.

A different problem arises if a Chinese Wall is successful in preventing the sharing of inside information. A Chinese Wall may prevent a large multi-service firm from fulfilling its duty of undivided loyalty to customers. According to this fiduciary duty, a broker-dealer must disclose to its customers all material facts within its knowledge that in any way affect the transaction. The existence of a Chinese Wall may prevent retail traders from using information obtained from investment bankers to satisfy this duty of the firm’s retail traders.

In Slade v. Shearson, Hammill & Co., a broker-dealer’s retail brokers recommended the stock of one of its corporate clients, Tidal Marine. During this same period, the underwriters of the firm had apparently received information that Tidal Marine was expected to suffer heavy financial losses because its fleet of tankers had been damaged in a typhoon. Shearson’s Chinese Wall hid this information from its retail brokers, who continued to recommend the stock to their customers. One of Shearson’s customers bought the stock based on Shearson’s recommendation and then sued the firm under Rule 10b-5, claiming that the firm had a duty not to recommend the stock. Shearson claimed that its Chinese Wall provided a legal defense to the claim, but the district court rejected this defense. The court held that Shearson voluntarily entered into conflicting fiduciary relationships with retail customers and corporate clients, so the firm could not recognize its...
duty to one while disregarding its duty to the other. Therefore, even though a broker-dealer established a Chinese Wall that proved effective in preventing the flow of inside information, the firm still faced liability for not using this information to withdraw its buy recommendation on the stock.

Although the Slade case was eventually settled without any definitive ruling, it illustrates the potential “jackpot” that a broker-dealer can potentially face. The broker-dealer has a duty of confidentiality to its corporate clients. Simultaneously, the firm has a duty to its retail customers to disclose all material facts affecting the transaction. This puts the broker-dealer in a catch-22 position. If the firm obeys its Chinese Wall and duty of confidentiality to corporate clients, it will be subject to suit by its retail customers for failing to disclose the adverse information. Alternatively, if the firm discloses the information to its retail customers to fulfill its duty to disclose all material facts, it will face suit from its corporate clients for disclosing the information in violation of its duty of confidentiality. Further, the firm will then face regulatory action by the SEC for insider trading. This example shows that although Chinese Walls may be successful in helping broker-dealers prevent insider trading, compliance with a Chinese Wall can have unsolvable, adverse consequences for the firm.

Another problem with a Chinese Wall is that “the compartmentalization of information accomplished by a Chinese Wall may increase rather than reduce the conflict-of-interest problems.” A Chinese Wall withholds information from a department of the firm that could use the information to benefit its customers. This clearly may be inconsistent with customers’ expectations. Customers expect that their broker-dealers will be their loyal representatives and serve their interests foremost. A Chinese Wall may run counter to these expectations. For example, investment bankers may know that a firm is restating its earnings because of accounting fraud. However, a Chinese Wall will keep this information from retail traders, who may continue to recommend this company’s stock. Although a restricted list may

114. Id.
115. Id.
117. Id.
118. Id.
119. POSER, supra note 2, at § 9.01.
prevent the firm from recommending the stock, the broker-dealer will still have to remain silent if a client wishes to purchase the security. Customers' expectations of being informed of all information available to the broker-dealer is entirely reasonable because an agent owes his principal a duty to disclose all relevant information that the agent knows regarding the transaction. Therefore, a broker-dealer's interest in obeying its Chinese Wall to avoid liability for insider trading will conflict with the customer's interest in being fully informed about all material facts affecting the transaction.

Chinese Walls are partly unsuccessful because of the lack of strong incentives for broker-dealers to establish and supervise compliance with them. If a large firm is unable to share information among its different departments, there are several advantages that are lost. These include cost savings, opportunities for collective thinking and other synergies of combining and integrating various departments. When a broker-dealer can integrate its trading and underwriting activities, the underwriters, who are very familiar with their corporate client, can share this information with retail traders and analysts. With a Chinese Wall, analysts have to perform their own research of a corporation. The analysts may never discover some information that the investment bankers know, or they will duplicate the information that investment bankers know, but at a significant cost. This is one reason why opponents of Chinese Walls argue that they are extremely inefficient.

Not everyone agrees that insider trading should be prohibited, and hence they argue that Chinese Walls are unnecessary. The law and economics school argues that insider trading prohibitions create market inefficiencies and should be eliminated. Insider trading can benefit markets by promoting efficiency through the swift incorporation of new information into the marketplace. This should reduce volatility in the markets and promote economic efficiency. Insider trading also may be an appropriate method of compensating executives and entrepreneurs without causing any significant injury to other investors. The

---

120. Restatement (Second) of Agency §381 (1958); see also H.R. Rep. No. 98-355, supra note 90 and accompanying text.
121. See Poser, supra note 2.
argument is that the ability to capitalize on inside information is a benefit of working for the corporation, similar to an employee’s ability to exercise stock options. Thus, insider trading should just be another economic benefit to employees. Another argument is that given the huge amount of time and money needed to combat insider trading, it is not worth the cost to ban an activity that may encourage economic gains to society.124 The argument that insider trading should be allowed is based on economic theories and gives little weight to policy concerns of fairness and honesty. However, these concerns may outweigh the possible economic gains to be achieved from insider trading.

IV. ADDITIONS TO CHINESE WALLS AND ALTERNATIVES TO CONTROL CONFLICTS OF INTEREST AND PREVENT INSIDER TRADING BESIDES CHINESE WALLS

A. Watch Lists and Restricted Lists

The SEC has proposed one method to deal with the dilemma of conflicting duties presented in the Slade case.125 To assist broker-dealers in dealing with this problem, the SEC has proposed that a firm use a "restricted list" in addition to a Chinese Wall. No employee at the firm would be allowed to make recommendations or solicit trades for a security on this list. If a customer makes an inquiry about such a security, he would be told that the firm is unable to make recommendations or give advice regarding that security. An obvious problem with this is that the firm’s placing of a security on the restricted list may be equivalent to revealing the adverse information itself, particularly if the firm previously recommended the security.126 If the firm has an outstanding buy recommendation on a security, it will place the security on a restricted list if it obtains adverse information. This will rescind the recommendation but also keep the information

124. See FERRARA, supra note 21, at § 1.01.
125. As discussed previously, Chinese Walls could place a broker-dealer in a “catch-22” where disclosing a corporate client’s confidential information may make the broker dealer liable to the corporate client; however, failure to disclose this material information to a retail client may make the firm liable to retail clients. See discussion supra Part III.D.
126. Id.
customers. However, the placement of the security on the restricted list signals that the firm has obtained negative information because otherwise it could continue to recommend the security. The SEC has attempted to address this problem by stating that the firm should place a security on the restricted list as soon as it enters into any relationship "likely to result in the receipt of inside information." Obviously, this is not a very precise rule and may result in inconsistent application and uncertainty by broker-dealers regarding their potential liability. A restricted list is merely an addition to a Chinese Wall, so all the disadvantages of Chinese Walls still exist.

Broker-dealers typically employ watch lists in addition to Chinese Walls and restricted lists. Implicit in the use of watch lists and restricted lists is the assumption that Chinese Walls are insufficient to prevent the flow of inside information. A watch list is a list of securities whose trading is monitored by the firm’s compliance department, but there are no formal trading restrictions placed on them. The watch list is the most important element of Chinese Wall review procedures. This list enables the firm to determine if the Chinese Wall is effectively preventing the flow and misuse of material, nonpublic information. A watch list is only successful in detecting insider trading after it has already occurred, so it does not serve to improve the effectiveness of a Chinese Wall. Restricted lists, in contrast, attempt to prevent insider trading in the beginning. These attempts at improving Chinese Walls ultimately have proved ineffective and simply perpetuate their disadvantages.

B. The Emergence of Discount Brokers

The changing demographics of broker-dealers will play an important role in reducing broker-dealers’ conflicts of interest as well as reducing the occurrences of insider trading. One important development has been the advent of discount brokers. In 1975, the SEC and Congress prohibited the stock exchanges from fixing the

128. See discussion supra Part III.D.
129. See Broker-Dealer Policies, supra note 77, at 4 n.12.
130. See FERRARA, supra note 21, at § 10.03[1].
131. See POSER, supra note 2.
and Congress prohibited the stock exchanges from fixing the commissions charged by their members.\textsuperscript{132} This event paved the way for the emergence of discount broker-dealers.\textsuperscript{133} Discount firms typically only provide trade execution and clearing services and do not have research or investment banking departments.\textsuperscript{134}

Since discount brokers do not perform investment banking services, there is less opportunity for these firms to engage in insider trading. As discussed earlier, the largest source of inside information in broker-dealers is their investment banking relationship with their corporate clients.\textsuperscript{135} With the lack of an investment banking department, there will be no source of inside information in a discount broker, and therefore no opportunity to engage in insider trading. The increasing number of discount brokers underscores the fact that most insider trading violations seen today do not arise from the sharing of inside information within a multi-service broker-dealer.\textsuperscript{136} Insider trading more frequently arises in connection with trading based on material, nonpublic information by corporate insiders and their tippees.\textsuperscript{137} This calls into question if Chinese Walls are necessary and able to prevent the type of insider trading prevalent today.

The only major disadvantage of discount brokers is that customers may have to go elsewhere if they want the investment advice usually offered by full-service firms. However, this advice comes at a price in the form of analysts' conflicts. Perhaps the best approach may be for a customer to use research reports from independent research firms and then use a discount broker to execute the desired trade. This may be more expensive for investors, but reliable, valuable research will not come cheap. Thus, this scheme will eliminate the potential for analysts' conflicts. Another way for investors to obtain financial advice in this scheme is for discount brokers to begin to provide some investment advice to their clients. This advice won't be colored like analysts' reports from large multi-service firms because discount brokers do not have underwriting departments to influence their advice. Although these

\textsuperscript{132} Id.
\textsuperscript{133} Id.
\textsuperscript{134} Id.
\textsuperscript{135} See discussion supra Part II.A.
\textsuperscript{136} See POSER, supra note 2.
firms may have to increase the fees they charge customers, this approach provides investors with a choice. If customers want cheaper financial advice that may be biased, they can get this from multi-service broker-dealers. If they want more objective research advice, they can obtain it from discount brokers or independent research firms. Using either approach, the investor has the choice of what to do, rather than mandating the use of an ineffective and inefficient Chinese Wall.

C. Segregation of Broker-Dealer Activities

Some have proposed complete segregation of the various activities of broker-dealers, much like the Glass-Steagall Act once segregated the functions of investments banks from commercial banks. This separation is tantamount to a severe Chinese Wall, where investment banking and retail services will be separated so that no firm can offer both of these services to customers. This will prevent insider trading because a broker-dealer will be unable to obtain inside information from a client through its investment bankers and pass this information on to traders in the retail department. A firm with retail traders will only be able to engage in trading activities, so it won’t have an underwriting department with the potential to receive inside information. Likewise, if a firm offers underwriting activities, it will not be able to have a trading department, so underwriters will have no retail traders with whom to share the information.

This segregation would also prevent a firm from offering research and analyst advice at the same time it offers investment banking. This will also help solve the conflicts of interest problem. This separation will prevent underwriters in the firm from asserting pressure on analysts to issue favorable reports for the firm’s corporate clients. Under this proposal, there is a higher probability that analysts’ reports will be more objective and reliable for investors.

However, there are several significant drawbacks to this approach. One is that segregation would prevent broker-dealers from recognizing economies of scale that could be achieved by combining various financial services. The benefits of segregation may outweigh this loss, but it still must be considered in conjunction with the other drawbacks. Another problem is that segregation may be a naïve solution. Just as

---

138. Id.
Chinese Walls have not completely eliminated all conflicts of interest and instances of insider trading, segregation will not completely eliminate these problems. An investment banker at one firm can just as easily call a friend who is a retail broker for another firm and share inside information. Similarly, an investment banker can call a friend who is an analyst and ask for a favorable report. Given these drawbacks and the realities of the marketplace, it is likely that any segregation would eventually give way to the integration of services we have today. This is precisely what has happened today in the banking industry as the segregation of various banking and other financial services has disappeared with the passage of the Gramm-Leach-Bliley Act.

D. Full and Immediate Disclosure of All Information

Another feasible and realistic solution to the problem of insider trading is to encourage full and prompt disclosure of all corporate information. This rule will eliminate the existence of inside information. If all information is immediately disclosed to the public, all parties to the transaction will have access to the same information. Nicholas Wolfson has suggested that if an investment banking client of a broker-dealer does not make timely disclosure of inside information, the investment banker should have an obligation to make the disclosure on behalf of his client. However, corporations may no longer use investment banking services as frequently because of the possible loss of confidentiality. This disadvantage must be balanced with the benefits of such a rule. Even a more lenient disclosure requirement will eliminate inside information, and Chinese Walls will no longer be necessary if there is no longer inside information in broker-dealers.

There also needs to be better and more disclosure about the relationships in broker-dealers that might create conflicts of interest. This will allow clients to make their own informed decisions about the reliability and objectivity of analysts' reports. Rather than requiring firms to erect Chinese Walls, disclosure would be a better solution to

141. See Schwab, supra note 46.
analysts' conflicts. Many naïve investors assume that Chinese Walls are sufficient to keep investment bankers from asserting pressure on analysts. These investors rely on analysts' reports and discover the hard way that the analyst was not as objective as they thought. Stricter disclosure rules would cause investors to think about analysts' recommendations before they naively accept them as unbiased. This rule will clearly benefit investors more than the current focus on Chinese Walls, which have proved ineffective in reducing analysts' conflicts. Similar to the use of discount brokers, this approach leaves the ultimate decision regarding analysts' objectivity up to the investor rather than mandating the use of ineffective and inefficient Chinese Walls.

CONCLUSION

In conclusion, the current emphasis on Chinese Walls is misplaced. Although they may be partially successful in curbing insider trading and minimizing conflicts of interest, there are significant drawbacks that outweigh the benefits. Even with the existence of Chinese Walls, there has been and will continue to be many instances of insider trading. Chinese Walls may prevent cases of insider trading in broker-dealers, but there will continue to be numerous instances of insider trading by inside officers and their tippees. Chinese Walls will not prevent these instances of insider trading, which are the most common cases of insider trading. Increased disclosure and enforcement of these disclosure rules will eliminate the presence of inside information in the markets, preventing all forms of insider trading.

Although Chinese Walls may reduce analysts' conflicts of interest, this will come with significant costs. In the end, the best solution may be to leave the choice about the reliability of analysts' reports to investors. Discount brokers and independent research firms provide investors with the option of obtaining investment advice that won't be biased by a broker-dealer's investment banking ties. Increased disclosure about possible conflicts will also place the decision about the reliability of analysts and their reports in the hands of investors. In the end, honesty and full disclosure in the markets is necessary, not inefficient and ineffective Chinese Walls.