CHINESE WALLS, LEGAL PRINCIPLE AND COMMERCIAL REALITY IN MULTI-SERVICE PROFESSIONAL FIRMS

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I. INTRODUCTION[1]

The handling of conflicts of interest has become an increasingly important concern of modern professional advisers.[2] This is especially so in relation to lawyers, accountants, brokers and financial advisers. The bureaucratisation of many areas of professional advisory work and the emergence of mega-firms[3] has hastened this process. The growth of diverse national and multinational partnerships has accentuated conflict of interest problems. The need for such large professional organizations to raise capital for the expansion of their operations and to service the needs of large corporations and governments has

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2 See generally P Finn "Conflicts of Interest and Professionals" in *Professional Responsibility*, Legal Research Foundation Inc Seminar, University of Auckland, 28/29 May 1987.

3 See for example the discussion of this term in M Galanter "Mega-Law and Mega-Lawyering in the Contemporary United States" in R Dingwall and P Lewis (eds), *The Sociology of the Professions: Lawyers, Doctors and Others* (London, 1983).

required ever larger professional groupings to be formed. This process has inevitably created severe conflict of interest problems for conglomerate professional practices and large financial advisory firms.

The emergence of the Chinese Wall[4] as a means of seeking to contain conflicts of duty and interest problems has been an innovation which has provided a convenient, if not an always successful, solution to the problem of conflict of interest.[5] Most discussion of Chinese Walls has arisen in the context of the securities[6] and banking[7] industries, although the use of these procedural mechanisms is also relevant for accountants[8] and lawyers[9] working in large firms. Although this article will focus mainly upon the respective experiences of conflicts in the securities industry and in the legal profession, many of the experiences of these industry groups with Chinese Walls are applicable to other areas of professional practice even if we accept that different types of business enterprises may generate different public interest concerns.[10]

Chinese Walls have received official sanction in relation to securities industry conduct in countries such as Australia,[11] Canada,[12] the United

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4 One commentator has suggested that the use of the term Chinese Walls can be traced back to a phrase uttered by President Franklin Roosevelt to describe a particular Chinese wall of silence; see further A Hilton *City Within a State: A Portrait of Britain's Financial World*, (London, 1987) at 81.

5 For a useful discussion of the different types of conflicts of duty and interest situations see note 2 *supra*.

6 See generally NS Poser *International Securities Regulation* (Boston, 1991).

7 R Cranston "Conflicts of Interest in the Multifunctional Financial Institution" [1990] 16 *Brooklyn Journal of International Law* 125; ES Herman and CF Safanda "The Commercial Bank Trust Department and the 'Wall'" (1972) 14 *Boston College Industrial and Commercial Law Review* 21; L Herzel and DE Colling "The Chinese Wall and Conflict of Interest in Banks" (1978) 34 *The Business Lawyer* 73; CE Mendez-Penate "The Bank 'Chinese Wall': Resolving and Contending with Conflicts of Duties" (1976) *Banking Law Journal* 674.

8 See generally R Baxt "Chinese Walls, Modern Banks and Fiduciary Relationships" (1986) *The Chartered Accountant in Australia* 56 (April 1986).

9 See for example: "Developments in the Law, Conflicts of Interest in the Legal Profession" (1981) 94 *Harvard Law Review* 1244; MR Dean and CF Finlayson "Conflicts of interest: When May a Lawyer Act Against a Former Client?" (1990) *New Zealand Law Journal* 43 (February 1990); R Nicholson and M Darling "Hitting the Chinese Wall" (1986) *Law Institute Journal* 1338 (December 1986); D Searles "Conflict of Interest - Chinese Walls or The Emperor's New Clothes" (1991) *Queensland Law Society Journal* 61 (February 1991); "The Chinese Wall Defence to Law-Firm Disqualification" (1980) 128 *University of Pennsylvania Law Review* 677.

10 Note 2 *supra* at 38.

11 See for example, *Corporations Law* s 850(2)(c) and ss 1002M and 1002N which formally provide for the establishment of Chinese Walls as a defence. Also see *ASX Business Rule* 3.5.

Kingdom[13] and the United States.[14] Chinese Walls have been defined by one international legal authority as follows:

> The term 'Chinese Wall' is a metaphor to describe a set of internal rules and procedures (sometimes including procedures to monitor these rules and procedures) established by a firm for the purpose of preventing certain types of information in the possession of one part of the firm (or of an affiliated group of firms) from being communicated to other parts of the same firm or group.[15]

Conflicts of duty and interest problems can often be traced back to the law of agency and to the fiduciary duties of professional advisers. In a partnership context these problems are accentuated as the knowledge of one partner is deemed to be known to all other partners[16] and that, even where information relates to another client of the firm, a partner is required to make available to the other client all material information that is known to the partner and which might assist that other client.[17]

Despite its American origins, the use of the Chinese Wall in the securities industry has been extended further in Australia and Britain than in the United States. In a comparison of the use of Chinese Walls in the United States and the United Kingdom securities industries, Poser has observed:

> The reliance in the United Kingdom on the Chinese Wall as a means of protecting investment firms from the possible legal consequences of conflicts of interest in

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12 The Ontario Securities Commission has advocated the use of Chinese Walls. See further J Kerbel "Chinese Walls in the Context of the Reform of Canadian Securities and Financial Institution Legislation" (1989) *Butterworths Journal of International Banking and Finance Law* 272.

13 Section 48(2)(h) of the *Financial Services Act 1986* allows the Securities Investment Board and its Self Regulatory Organisations to make conduct of business rules regarding arrangements such as Chinese Walls. See generally: R Cranston note 7 *supra* and NS Poser note 6 *supra*.

14 See for example: NS Poser "Chinese Wall or Emperor's New Clothes? Regulating Conflicts of Interest of Securities Firms in the US and the UK" (1988) 9 *Michigan Yearbook of International Legal Studies* 91 at 103.

15 Note 6 *supra* at 189. McVea provides illustrations of the kinds of procedural arrangements which the existence of a Chinese Wall might involve. These include the following:

1. Separate files could be kept for functions separated by Chinese Walls. Employees on one side of the Wall would not have access to files dealing with operations on the other side.
2. The transfer of personnel between the two groups separated by the Chinese Wall could be done only under controlled circumstances.
3. There could be a physical separation of departments where conflicting activities take place and where as a consequence it is possible for inside information to be leaked.

H McVea "Conflicts of Interest and the Chinese Wall" (1987) *New Law Journal* 827 at 827.

16 See for example *Davies v Clough* (1837) 8 Sim 265; 59 ER 105.

17 *Spector v Ageda* [1973] Ch 30.

> the post-Big bang era goes well beyond anything of a comparable nature in the United States...[A]lthough the use of a Chinese Wall was first proposed in the United States, the American courts have never allowed the Chinese Wall to be the basis for a legal defense against charges of breach of fiduciary duty. Furthermore, American securities legislation and SEC [Securities and Exchange Commission] rules relating to insider trading have permitted the defense only under limited circumstances. In the United Kingdom, on the other hand, the defense is explicitly provided for in the new statute and in several rules governing the business conduct of investment firms.[18]

The same cannot yet be said about the use of Chinese Walls in large law firms in Australia or the United Kingdom as North American courts have tended to be more prepared to sanction the use of such devices to avoid client conflicts.

II. THE POLICY DILEMMA

The popularity of the Chinese Wall rests more upon commercial convenience or practice than upon firm legal foundations. This is hardly surprising as the practise of corporation law has long rested upon fictions of this kind such as the basic fiction of the separate legal identity of the corporation, despite the economic reality that corporations are often little more than departments or divisions of larger groups of companies.[19] The questionable implications of the legal fiction of corporate identity has become apparent during the 1980s. This dissonance between legal theory and commercial reality has led to critical comments from judges, business leaders and academic lawyers.[20] Similar conclusions could be drawn about the theory and practice of Chinese Walls. Commercial pressures can have a corrosive effect upon long standing legal principles regarding the handling of conflicts of interest.

At the heart of the argument about Chinese Walls is a fundamental policy dilemma concerning the balancing of public confidence in the advisory professions against the commercial needs of those professions to operate as larger entities and to raise sufficient capital to fund such bigger organisational entities.

One Australian securities law practitioner has, for example, observed that:

> As a matter of policy, it appears that the Chinese wall ought to be accepted as a reasonable solution to the conflicts facing the multiple service firm, since any

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18 Note 6 *supra* at 212.

19 See further R Tomasic et al *Corporation Law: Principles, Policy and Process* (2nd ed, 1992) at 95.

20 See for example the judgment of Rogers J in *Qintex Australia Finance Ltd v Schroeder Australia Ltd* (1990) 3 ACSR 267 at 269. Also see generally R Tomasic and S Bottomley "Corporate Governance and the Impact of Legal Obligations on Decision Making in Corporate Australia" (1991) 1 *Australian Journal of Corporate Law* 55 at 63-65.

other result would impose substantial economic costs in requiring divestment of functions of such bodies.[21]

In contrast, the architect of the United Kingdom reforms enacted in the *Financial Services Act 1986*, Professor CB Gower, has observed that he was not convinced that "total reliance can be placed on Chinese Walls because they restrict flows of information and not conflicts of interest themselves."[22]

In evidence before a US Senate Committee, a leading New York banker nicely summarized the uncomfortable policy choices upon which the resort to Chinese Walls rests when he observed that:

> ...I also believe that there must be strong Chinese walls that provide protections against conflicts of interest, unfair competition, and certain kinds of 'tie-ins'. Similarly, I believe that there should be reasonable protections against undue concentrations, recognising, of course, that some concentrations in banking and finance will occur under any circumstances.[23]

In his analysis of international securities regulation Professor Poser has also observed that:

> The fundamental question, to which the courts, regulatory authorities, and securities industries of the United States and the United Kingdom have responded in somewhat different ways, is how to resolve these conflicts of interest in a way that adequately protects the integrity of the markets, the customers and corporate clients of securities firms, and the business interests of the firms themselves. In both countries, the Chinese Wall has played a pivotal role in the attempt to achieve a resolution of these sometimes competing interests.[24]

In 1975, the policy arguments which support the use of Chinese Walls in the securities industry were examined at length in the United States in an influential article by Lipton and Mazur, two proponents of this device.[25] These authors concluded that:

> On balance, the enforcement difficulties [of discovering misuse of inside information] do not outweigh the considerations which speak in favour of the Chinese Wall - the most obvious of which is that its rejection might well require forced divestiture of several functions of the typical securities firm.
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> A separation of functions would so impede the normal functioning of the securities markets that, in the language of the SEC, 'the capital-raising capability of the industry and its ability to serve the public would be significantly weakened'. Mandatory segregation of functions would force out of business many of the smaller firms, which require income from various sources to survive....

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21 A Black "Policies in the Regulation of Insider Trading and the Scope of Section 128 of the Securities Industry Code" (1988) 16 *Melbourne University Law Review* 633 at 662.

22 Quoted by NS Poser note 6 *supra* at 214. Also see H McVea note 15 *supra* at 828.

23 Statement of S Gerald Corrigan, President of the Federal Reserve Bank of New York, reproduced in "Reforming the US Financial System: An International Perspective" (1990) *FRBNY Quarterly*, (Spring) 1 at 10.

24 Note 6 *supra* at 196.

25 M Lipton and RB Mazur "The Chinese Wall Solution to the Conflict Problems of Securities Firms" (1975) 50 *New York University Law Review* 459. Martin Lipton was to go on to become one of the leading American takeover lawyers of the 1980s.

> Finally, splitting multi-service firms into separate brokerage and underwriting organizations would lead to expensive duplication of the research facilities commonly employed in both operations - a cost that would probably be passed on to the investor. Given the availability of equally satisfactory solutions, such as the reinforced Chinese Wall, there is no need for any radical restructuring which would merely substitute new difficulties for the present solvable problem.[26]

The same kinds of comments might also be made about the use of Chinese Walls in other large professional advisory firms.

Critics of Chinese Walls, such as Poser, have also concluded that a segregation of functions is not an answer to the conflicts of interest problems facing multi-service firms.[27] Reinforcement of such devices then becomes an important priority. According to Lipton and Mazur, such reinforcement of the Chinese Wall within multi-service securities firms would involve the use of a 'restricted list' procedure (prohibiting the trading in securities on that list) and a 'no recommendation' rule (prohibiting the making of recommendations in relation to certain securities).[28] These mechanisms are seen as being likely to preserve public confidence in the operations of these firms and remove temptations to make use of inside information.

However, it is not always the case that a client will be comfortable with the existence of a Chinese Wall within the advisory firm. This occurred in Australia in 1986 when BHP objected to its long standing broker, Potter Partners, also acting for Bell Group which was launching a take over of BHP, despite the existence of a Chinese Wall within Potter Partners. A legal action against Potters brought by BHP to ensure that Potters had an obligation to keep BHP's secrets was however eventually settled with BHP apparently being prepared to accept the existence of a Chinese Wall between various partners within the one department in Potters. As Nicholson and Darling have noted, "[t]his settlement extends the concept of Chinese Walls beyond which is traditionally understood as a barrier between departments to a barrier between individual partners within the same department."[29] In a country such as Australia the small pool of professional advisers in particular fields sometimes makes arrangements such as this difficult to avoid. One solution which has been adopted by the advisory firm of McKinsey & Co operating in Australia, is to seek to offer a new client what is described as a 'clean team' which has not worked directly for an old client who is a competitor of the new client. If a 'clean team' cannot be put together for the new client, the advisory firm apparently declines to take the new client's work. The new client is informed of

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26 *Ibid* at 495.

27 NS Poser "Conflicts of Interest within Securities Firms" (1990) 16 *Brooklyn Journal of International Law* 111 at 120.

28 *Ibid* at 499.

29 R Nicholson and M Darling note 10 *supra* at 1340. Also see B Phillips "Can These Walls be Trusted?" (1986) *Business Review Weekly*, June 27, 1986 at 46. Also see generally, G Haigh *The Battle for BHP* (1987).

the existence of the advisory firm's links with the competitor. It seems that clients often have little choice but to accept this 'clean team' method of seeking to avoid conflicts of interests for to do otherwise would, as one observer has noted, be "tantamount to questioning the integrity of the [advisory] firm itself."[30]

Ultimately, as we have seen, the policy arguments for the use of Chinese Walls in each professional context call for a balancing of the commercial and career needs of the practitioners working in these large firms against the need to maintain public confidence in the services provided by the particular firm. The difficulty of achieving this sometimes invites a search for simple solutions such as Chinese Walls, although it has to be stressed that this is not an area in which simple solutions will work as there is a need for an array of procedures and enforcement mechanisms which have yet to be adequately developed.

III. JUDICIAL RESPONSES TO THE USE OF CHINESE WALLS

Courts have been slow to sanction Chinese Walls as a defence to conflict of interest problems. In the United States, for example, the courts have held that a firm has a duty to the investing public not to misuse price sensitive information which it had obtained through a relationship of trust. In the 1968 case of *SEC v Texas Gulf Sulphur Co*, the Second Circuit formulated the 'disclose or abstain' rule which was applicable in circumstances such as these. As the Court observed:

> [A]nyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or if he chooses not to do so, must either abstain from trading in or recommending the securities concerned while such information remains undisclosed.[31]

This conclusion was reaffirmed by the Second Circuit in *Shapiro v Merrill Lynch, Pierce, Fenner & Smith Inc.*[32]

Therefore, the holder of inside information must either take positive steps to disclose the fact that that person is the holder of inside information or desist from acting in relation to that information. A 'restricted list' procedure is an example of such a positive step. As Cranston notes, the establishment of an effective Chinese Wall may provide a safe harbour in these circumstances.[33] Summarizing this line of judicial authorities, Varn notes that the authorities make it :

> ...abundantly clear that a securities firm that reveals confidential information about a publicly-held company to its customers, or uses that information to form

30 B Phillips *ibid* at 47.

31 401 F 2d 833 (2d Cir 1968) *cert denied* at 848.

32 495 F 2d 228, 236 (2d Cir 1974).

33 R Cranston note 7 *supra* at 130.

> the basis of a trading recommendation, will be exposed to the possibilities of both administrative sanctions and private civil liability.[34]

At the same time, American courts have held that the firm is the agent of its retail customers with the consequence that:

> As an agent, the firm owes a duty to its principal to reveal any and all information in its possession relevant to any proposed transaction which the customer would reasonably want to know.[35]

The first American securities law decision in which the Chinese Wall appeared was the 1968 *Matter of Merrill Lynch, Pierce, Fenner & Smith.*[36] This was an administrative proceeding in which the SEC accepted an offer of settlement made by Merrill Lynch.[37] In this matter, Merrill Lynch, a large multi-service broking firm, was acting as the managing underwriter for a proposed offering of securities in Douglas Aircraft Company. Merrill Lynch had then received information from Douglas that its earnings for 1966 and 1967 would be substantially reduced. Merrill Lynch then selectively disclosed this information to it institutional clients who then sold their securities in Douglas. On the other hand, the clients of the Merrill Lynch retail division were not given this information, although the firm made purchases of Douglas Aircraft Company stock for these clients. As part of a settlement, the SEC sought to reduce the possibility of insider trading by requiring Merrill Lynch to establish a Chinese Wall between its underwriting division and its other departments. Although the Commission did not express an opinion on the extent to which the new Merrill Lynch Chinese Wall could be used as a legal defence, the SEC indicated that it preferred the use of prompt disclosure to the investing public of material changes.[38]

The *Merrill Lynch* decision was followed by the first American case in which the Chinese Wall was raised as a defence in a conflict of interest case. This was the 1974 Second Circuit case of *Slade v Shearson, Hammill & Co., Inc.*[39] Shearson, Hammill & Co Inc continued to recommend and sell shares of Tidal Marine International Corporation to its retail clients after Shearson had received unfavourable information regarding Tidal Marine. Tidal Marine was a Shearson investment banking client. Shearson argued in defence that it had a Chinese Wall between its investment banking department and its retail share broking activities. On the other hand, the retail clients who had been denied access to the information argued that Shearson's fiduciary duty of loyalty to its

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34 LL 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 208.

35 *Ibid* at 208.

36 43 SEC 933 (1968).

37 Note 6 *supra* at 199.

38 Ibid at 201.

39 [1973-74] Fed Sec L Rep (CCH) para 94,329 (SDNY 1974). This case has been discussed at length in M Lipton and RB Mazur note 25 *supra* at 502.

client required it to disclose to its retail clients all relevant information about Tidal Marine securities that was then in its possession.[40] At first instance the trial judge rejected Shearson's argument that its Chinese Wall could be used as a defence to legal liability for breach of fiduciary duty to its retail customers. The case then went on appeal to the Second Circuit which called for further facts to be made available before the case proceeded. Amongst these was further information concerning the effectiveness of Shearson's Chinese Wall. However, the case was settled shortly thereafter so that the opinion of the trial judge is the most authoritative statement of law arising from this case.[41] The trial judge had recognised that:

> The instant case has far reaching ramifications for the structure of the securities industry...apparently not foreseen by *Texas Gulf Sulphur* and its progeny. To require an organization like the defendant's to refrain from effecting transactions in securities of companies about which they have learned adverse inside information may be to render it exceedingly difficult for any such organization to function as an investment banker for the company and at the same time function as a broker in that company's securities.[42]

The SEC had prepared an *amicus curiae* brief in the *Slade* case. Due to the settlement of the case, the position adopted by the SEC in its *amicus* brief was important for later regulatory policy in this area. The SEC had argued that brokers should not use material price sensitive information in the market and that brokers should treat their customers fairly. As Poser notes:

> The Commission believed that these two principles could be reconciled without requiring far-reaching changes in the securities industry...Thus, the SEC, while encouraging the use of Chinese Walls, was nevertheless unwilling to concede that inside information possessed by a multi-service firm's underwriting or investment banking department should not be imputed to the firm just because the firm had a Chinese Wall. In order to avoid making a recommendation of a security concerning which the firm has contrary inside information, the SEC suggested that, in addition to a Chinese Wall, firms employ a 'restricted list' of securities as to which they may have material inside information. Nobody at the firm would be permitted to make recommendations or initiate transactions for discretionary accounts with respect to any security on the list.[43]

Thus, neither the court in *Slade* nor the SEC *amicus* brief saw the Chinese Wall as a defence to the legal obligations which might arise from a breach of fiduciary duties to the multi-service firm. But, by 1980 the SEC had moved to allow the Chinese Wall to be used as a defence where the firm breached Rule 14e-3 and traded in the securities of a target company in a takeover situation where the firm had obtained material non-public information regarding the pending takeover from either the target or the offeror company. Apart from this situation, the Chinese Wall was not to be used as a defence where there had been a breach of fiduciary duty. However, the use of the Chinese Wall had to

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40 See further NS Poser note 6 *supra* at 202 and LL Varn note 35 *supra* at 220-221.

41 NS Poser *ibid* at 203.

42 Quoted in LL Varn note 35 *supra* at 223.

43 Note 6 *supra* at 204.

be reasonable in the circumstances and might need to be supplemented by the use of other mechanisms such as a 'restricted list' or a 'watch list'. As Poser has noted:

> The SEC thus seems to be saying that, despite the existence of a Chinese Wall, a firm may be subject to liability to a customer unless it discloses to the customer (and, presumably, gains the customer's consent) that the firm may be in possession of information that it is not using on the customer's behalf.[44]

Subsequently, in the 1986 case of *Securities Exchange Commission v The First Boston Corp.*,[45] a Chinese Wall was breached for what has been described as "proper reasons relating to the necessary interaction of departments within a multi-service firm."[46] In this case, First Boston was an investment bank and it was also engaged in equity trading. As an investment banker First Boston was given market sensitive information by CIGNA, an insurance company client, to the effect that the client was considering increasing its property-casualty loss reserve. First Boston then placed CIGNA securities on its restricted list which should have prevented any officer of First Boston from recommending or trading in CIGNA securities. CIGNA was to announce the addition to its reserve on the 30th January. On the 29th, CIGNA's chief finance officer informed the managing director of First Boston of this impending announcement. The corporate finance department of First Boston had been given this information a week or so earlier. However, on the 29th, First Boston's managing director told a research analyst in his firm of the impending announcement so that he could ready himself to answer questions later that day about the impact of the announcement on CIGNA's securities. The breakdown of the Chinese Wall occurred when the analyst passed on the information to the head of First Boston's equity trading department who then took steps to trade in CIGNA securities despite the fact that CIGNA securities were included on First Boston's 'restricted list'. This insider trading was soon detected by the New York Stock Exchange and passed on to the SEC. In a settlement of this case, First Boston agreed to pay a penalty, disgorge its profits and modify its Chinese Wall and 'restricted list' procedures.[47] Poser has observed that there are a number of features of this case which illustrate "the inevitable weaknesses" of Chinese Walls.[48] As Poser explained:

> The corporation's Chinese wall was first breached when the firm's corporate finance department gave a research analyst information about an impending announcement concerning a corporate client. Apparently, this breach was a legitimate one: the corporate finance people needed advice from the analyst on the likely market impact of the pending announcement. Thus, the analyst had been brought over to the 'wrong' side of the Chinese wall. Later, the wall was breached again - this time not so legitimately - when the analyst gave the confidential

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44 *Ibid* at 207.

45 Fed Sec L Rep (CCH) para 92,712 at 93,465 (SDNY May 5, 1986).

46 Note 27 *supra* at 114.

47 This description is based upon NS Poser note 6 *supra* at 229-230.

48 *Ibid* at 230.

> information about the announcement to First Boston's head equity trader, who then used it in trading for the firm's proprietary trading account.[49]

Poser concluded that:

> The fact that the Chinese Wall and restricted-list procedures could be so easily ignored by senior persons at a prominent investment banking firm such as First Boston provides little reason for confidence that they will provide a bulwark against illegal action at smaller or less reputable firms.[50]

If we turn from the United States judicial experience we find that courts in other English speaking countries have also been slow to give recognition to Chinese Walls. As Finn noted in 1987:

> Commonwealth courts to date have been less than sympathetic to the argument that an enterprise should be exonerated from a breach of fiduciary duty where its wrong arises from the cumulative effect of the separate actions of several of its officers each of whom has acted in ignorance of the activities of the others. A corporate fiduciary's duty of loyalty, for example, will be violated if two departments of that company act for adverse interests in the same transaction notwithstanding that each department was unaware of the other's engagement. Ignorance here has been seen as a vice not a virtue. The courts likewise have been resistant to the view that legal recognition be given to the de facto fragmentation of large enterprises: a company is one person in law no matter how many and dispersed its various departments; a person who engages the services of a partner acting as such engages the services of the whole firm and not merely of the persons who actually render the service. This is a distinctly unpropitious environment in which to advocate the cause of Chinese Walls...[51]

An early British authority in this area is that of *Rakusen v Ellis, Munday & Clarke*.[52] This case is the basis for the so-called 'probability of real mischief' test which has continued to be widely applied in Commonwealth countries up until this day. The case involved Munday, a partner in small firm of solicitors who was consulted by Rakusen in a wrongful dismissal case. Rakusen then changed his solicitors and then commenced action. Clarke, Munday's partner, was then asked to act for the other party and agreed to do so, knowing nothing of the fact that Rakusen had consulted Munday. Rakusen then sought an injunction to prevent Clarke from acting in this matter. The judge at first instance restrained the firm of solicitors from acting in this matter. An appeal against this decision was however subsequently allowed. Although there may be some difficulty in reconciling the three judgments in this case, Fletcher Moulton LJ observed that each case had to be considered according to its own special circumstances and added:

> As a general rule the Court will not interfere unless there be a case where mischief is rightly anticipated. I do not say that it is necessary to prove that there will be mischief, because that is a thing which you cannot prove, but where there is such a probability of mischief that the Court feels that, in its duty as holding the balance between the high standard of behaviour which it

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49 Note 27 *supra* at 113.

50 Note 6 *supra* at 231.

51 Note 2 *supra* at 32-33.

52 [1912] 1 Ch 831.

> requires of its officers and the practical necessities of life, it ought to interfere and say that a solicitor shall not act.[53]

In the same case, Buckley LJ also concluded that:

> The whole basis of the jurisdiction to grant an injunction is that there exists, or, I will add, may exist, or may be reasonably anticipated to exist, a danger of a breach of that which is a duty, an enforceable duty, namely, the duty not to communicate confidential information; but directly the existence or possible existence of any such danger is negatived, the whole basis and substructure of the possibility of injunction is gone.[54]

In the United States, the *Rakusen* 'probability of mischief' approach has been rejected in favour of a more stringent approach, although Commonwealth courts have tended to gravitate between the *Rakusen* test and the stricter American approach.[55]

For example, in the recent Supreme Court of Canada case of *Martin v MacDonald Estate (Gray)*,[56] the influence of the United States debates on Chinese Walls was very evident, although the Canadian appeal court only very narrowly decided to accept that devices such as Chinese Walls could avoid conflicts problems. In a four/three decision the Supreme Court was concerned with a conflict arising out of the members of the same firm of solicitors having acted for both parties. The defendant's solicitor had in 1983 been assisted by Dangerfield, a junior lawyer in the firm, who thereby became familiar with the defendant's legal situation. In 1985 Dangerfield joined another firm which represented the plaintiff, although the junior lawyer did not undertake any legal work for the plaintiff. The defendant argued that the plaintiff's firm was ineligible to act in this matter due to the conflict, whilst both Dangerfield and the senior members of the plaintiff's firm of solicitors had sworn affadavits that the case had not been discussed with Dangerfield. On appeal, the Supreme Court was "concerned with the standard to be applied in the legal profession in determining what constitutes a disqualifying conflict of interest".[57] The majority was reluctant to see a slackening of the standards regarding conflict of interests despite the on-going pattern of mergers of law firms and the movement of lawyers between firms. As Sopinka J observed in his majority opinion:

> When the management and size of law firms and many of the practices of the legal profession are indistinguishable from those of business, it is important that the fundamental professional standards be maintained and indeed improved. This is essential if the confidence of the public that the law is a profession is to be preserved and hopefully strengthened.[58]

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53 *Ibid* at 841.

54 *Ibid* at 845.

55 For a New Zealand discussion of these issues see: MR Dean and CF Finlayson note 9 *supra*.

56 [1991] 1 WWR 705.

57 *Ibid* at 708.

58 *Ibid* at 712.

The majority declined to follow the traditional English 'probability of mischief' test, based upon *Rakusen*,[59] for resolving conflict of interest problems such as this. Instead, the Court preferred the stricter United States 'possibility of real mischief' test.[60] Sopinka J observed:

> According to this approach, once it is established that there is a 'substantial relationship' between the matter out of which the confidential information is said to arise and the matter at hand, there is an irrebutable presumption that the attorney received relevant information. If the attorney practises in a firm, there is a presumption that lawyers who work together share each other's confidences. Knowledge of confidential matters is therefore imputed to other members of the firm. This latter presumption can, however, in some circumstances be rebutted. The usual methods used to rebut the presumption are the setting up of a 'Chinese Wall' or a 'cone of silence' at the time that the possibility of the unauthorised communication of confidential information arises. A 'Chinese Wall' involves effective 'screening' to prevent communication between the tainted lawyer and the other members of the firm. A 'cone of silence' is achieved by means of a solemn undertaking not to disclose by the tainted solicitor. Other means which would constitute clear and convincing evidence that no improper disclosure has or can take place are not ruled out...[61]

However, as Sopinka J noted, some American courts have found that there was a rebutable presumption that the confidential information had been passed to the lawyer. As Coffey Dist J said in *Analytica Inc v NPD Research Inc* "[r]eliance upon antiquated notions of disqualifications such as irrebutable presumptions simply will no longer suffice in today's specialized practice of law".[62] The court in *MacDonald Estate* accepted these criticisms of the 'irrebutable presumption' test and concluded that "once it is shown by the client that there existed a previous relationship which is sufficiently related to the retainer from which it is sought to remove the solicitor, the court should infer that confidential information was imparted unless the solicitor satisfies the court that no information was imparted which could be relevant. This will be a difficult burden to discharge."[63] The Court considered that where all reasonable measures have been taken to ensure that no disclosure of confidential information to a 'tainted' lawyer occurs then, the inference that partners who work together share confidence should not be drawn. The Court concluded that "[s]uch reasonable measures would include institutional mechanisms such as Chinese Walls and cones of silence."[64]

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59 Note 52 *supra* at 841.

60 The basis for this United States test was set out by Posner J in *Analytica Inc. v NPD Research Inc*, 708 F 2d 1263 (USCA, 7th Circ 1983). In *MacDonald Estate*, the Canadian Supreme Court concluded (note 57 *supra* at 724) that the *Rakusen* 'probability of mischief' test was not sufficient "to satisfy the public requirement that there be an appearance of justice".

61 Note 56 *supra* at 715.

62 Note 60 *supra* at 1277.

63 Note 56 *supra* at 725.

64 *Ibid* at 726.

Whilst the *Rakusen* test had been previously followed by other Canadian courts, it is interesting to note that the minority in *Martin v MacDonald Estate* preferred a test which was more critical of Chinese Walls and noted that:

> No matter how carefully the Chinese wall might be constructed, it could be breached without anyone but the lawyers involved knowing of that breach. Law has, after all, the historical precedent of Genghis Khan, who, by subterfuge, breached the Great Wall of China, the greatest of Chinese walls. Nor would any system of cones of silence change the public's perception of unfairness. They do not change the reality that lawyers in the same firm meet frequently, nor do they reduce the opportunities for the private exchange of confidential information. The public would, quite properly, remain sceptical of the efficacy of the most sophisticated protective mechanisms.[65]

Recent British cases have not expressed a similar level of confidence in Chinese Walls as reflected in the majority opinion in the *MacDonald Estate* case. For example, in the 1991 Court of Appeal case of *Re a firm of solicitors*,[66] Parker LJ (with whom Sir David Croom-Johnson agreed) considered another case involving a solicitor. Here a firm of solicitors had in the early 1980s advised Alexander & Alexander (A&A), a member of a group of insurance companies. A&A had discovered certain irregularities which ultimately led to criminal proceedings against an insurance underwriter. In 1984 a subsidiary of A&A brought proceedings against the defendant who represented a Lloyd's syndicate. The issues were very similar to ones which had been investigated by A&A and its subsidiary between 1982 and 1985 but which had been settled. Thereafter, the firm of solicitors no longer acted for A & A and its subsidiaries. In 1990 the defendant changed solicitors and engaged the appellant firm of solicitors which had previously advised A&A and its subsidiaries. An effort was made to restrain the appellant firm of solicitors from acting for the defendant in view of the fact that the firm had acquired confidential information between 1982 and 1986 which would be of value to the defendant. The majority followed the views expressed by Fletcher-Moulton LJ and Buckley J in *Rakusen* and dismissed the appeal by the firm of solicitors against the injunction which had been granted by the trial judge. In reaching this conclusion, Parker LJ had occasion to comment on the adequacy of Chinese Walls in these circumstances when he said:

> The firm [of solicitors] is a very large one and it has acted for three years in a matter which attracted great public interest and much discussion in the legal profession and in the insurance world. Those who were then immediately concerned for [the insurance company client] will almost certainly have discussed

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65 *Ibid* at 730-731. Also see the earlier Canadian decision of *Standard Investment Ltd v Canadian Imperial Bank of Commerce* [1985] 22 DLR 4th 410 (Ont Ct App), in which the knowledge and intentions of the chairman and president of the bank were attributable to the bank; and *Davey v Woolley, Hames, Dales & Dingwall; Woolley et al* (1982) 133 DLR (3d) 647.

66 (1991) *New Law Journal* May 31, 1991 746-747 (Unreported, Parker, Staughton LLJ, Sir David Croom-Johnson, Ct Appl, May 24, 1991).

> it extensively with others not immediately concerned. All may genuinely believe that they have forgotten all about what then happened but anyone in the legal profession knows that a chance remark may bring details of an apparently forgotten case flooding back...I do not doubt for one moment that the firm intend that such proposals [as Chinese Walls] will eliminate any risk and believe that they will do so. For my part, however, I am not satisfied that they will do so...
>
> In my judgment any reasonable man with knowledge of the facts in the present case, including the proposal for a Chinese wall, would consider that some confidential information might permeate the wall and would indeed regard it as astonishing that the plaintiffs should be faced with solicitors on the other side to whom, over a considerable period, they have afforded much confidential information concerning matters being investigated in the main action.
>
> ...I doubt very much whether an impregnable wall can ever be created and I consider that it is only in very special cases that any attempts should be made to do so.[67]

Australian cases have gravitated between the traditional *Rakusen* test and the stricter United States test. Although the *Rakusen* test has been soundly criticised by Finn on a number of grounds as being "untenable today"[68], this test was followed by Bryson J in *D & J Constructions Pty Ltd v Head*,[69] although in 1989 Gummow J concluded in *National Mutual Holdings Pty Ltd v Sentry Corp* that the Australian legal position was as stringent as the United States judicial position in this regard.[70] The *Rakusen* test has been especially influential in a number of Australian family law cases,[71] although it has been rejected by Ipp J in *Mallesons Stephen Jaques (A Firm) v KPMG Peat Marwick (A Firm)*.[72] Australian cases have also generally applied the test laid down in the 1973 English case of *Spector v Ageda* to the effect that a "solicitor must put at his client's disposal not only his skill but also his knowledge, so far as is relevant; and if he is unwilling to reveal his knowledge to his client, he should not act for him."[73] However, this case was distinguished in *Freuhauf Finance*

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67 *Ibid* at 747.

68 Note 2 *supra* at 17.

69 (1987) 9 NSWLR 118.

70 (1989) 87 ALR 539 at 561.

71 See for example *In the marriage of A and B* (1990) FLC para 92-126 at 77,844; *In the Marriage of Gagliano, RP and Gagliano, AA* (1989) FLC para 92-012 at 77,310; *In the Marriage of Magro, PA and Magro, RM* (1989) FLC para 92-005 at 77,188. *Rakusen* was also applied in *Australian Commercial Research and Development Limited v Hampson* (1991) 1 Qd R 508 and in *Freuhauf Finance Corporation Limited v Feez Ruthning (a firm)* (1990) 1 Qd R 558.

72 Unreported decision of Ipp J in the Supreme Court of Western Australia, 19 October 1990.

73 Note 17 *supra* at 48. *Spector v Ageda* was applied in: *In the Marriage of Thevenaz RA and Thevenaz, E* (1986) FLC para 91-748 at 75,446; *In the Marriage of KR and SM Griffis* (1991) 14 Fam LR 782 at 784; *Mallesons Stephen Jaques (a Firm) v KPMG Peat Marwick (A Firm)* note 72 *supra* at 28; and cited in argument in *D & J Constructions Pty Ltd v Head and Others* note 69 *supra*.

Corporation Pty Limited v Feez Ruthning (a firm)[74] because it dealt with practitioners in a small firm of solicitors which was not comparable to a large firm such as Feez Ruthning.

Discussion of Chinese Walls has not featured prominently in the Australian cases, although where they have been raised they have not been received with much judicial enthusiasm. For example, in *Mallesons Stephen Jaques (A Firm) v KPMG Peat Marwick (A Firm)*, Ipp J remarked that the concept of the Chinese Wall :

> ...appears to be an attempt to clad with respectable antiquity and impenetrability something that is relatively novel and potentially porous. It is a practice that apparently emanates from the United States of America, having been devised by large firms of lawyers in an attempt to justify representation of conflicting interests at the same time."[75]

Ipp J rejected the adequacy of the Chinese Wall in the form of undertakings given by the partners of Mallesons to the Court that they would not disclose directly or indirectly and without the consent of the former client any confidential information acquired by Mallesons in acting for that client some years earlier. This case arose from the fact that a partner from the Perth office of Mallesons was then involved in leading the prosecution task force which was preparing the prosecution case against a Brisbane based partner of the one time client, now known as KPMG Peat Marwick. As Ipp J concluded:

> It is difficult to see, however, when preparing briefs for counsel, in preparing proofs of evidence, in suggesting what witnesses should be called by the prosecution...how the solicitors concerned could divorce from their minds relevant confidential information obtained from the accused himself. There is, in my view, the real prospect that, even with the best will in the world, that information would colour, at least subconsciously, the approach of the solicitors and influence them in the performance of the tasks I have mentioned.[76]

Ipp J relied upon the decision of Bryson J in *D & J Constructions Pty Ltd v Head and Others.*[77] In that case Bryson had been highly critical of the use of Chinese Walls to contain information within a partnership. In a much quoted passage, Bryson J observed:

> Where confidential information has been communicated by a client to a solicitor and is relevant to litigation in which that client is now engaged and is still available to the solicitor, the court should take a cautious approach to any proposal that it should allow the solicitor to act against that client: the considerations are much the same whether the information was communicated in the course of the litigation itself or in earlier business and whether or not the solicitor is a sole practitioner or is one of a number of partners or was employed by a principal. I would think that the court would not usually undertake attempts to build walls around information in the office of a partnership, even a very large partnership, by accepting undertakings or imposing injunctions as to who should be concerned in the conduct of litigation or as to whether communication should be made among

74 Note 71 *supra* at 566.

75 Note 72 *supra* at 31.

76 *Ibid* at 29-30.

77 Note 69 *supra.*

> partners or their employees. The new client would have to join in such an arrangement and give up his right to the information held by such parties and staff as held it. Enforcement by the court would be extremely difficult and it is not realistic to place reliance on such arrangements in relation to people with opportunities for daily contact over long periods, as wordless communication can take place inadvertently and without explicit expression, by attitudes, facial expression or even by avoiding people one is accustomed to see, even by people who sincerely intend to conform to control. Here in Sydney and now there is a thriving, diverse and talented legal profession and the court need not fear that a litigant who is deprived of the services of one firm will not be able to retain adequate representation.[78]

In the 1990 case of *Freuhauf Finance Corporation Pty Limited v Feez Ruthning (a firm)*,[79] Lee J took a somewhat more pragmatice view than either Ipp or Bryson JJ concerning the reliability of Chinese Walls in lawyer conflict of duty cases. After quoting the extract from the judgment of Bryson J in *D & J Constructions*, Lee J observed that it was not strictly necessary to "build walls around information in the office of the partnership" as such walls were in effect already in existence in Feez Ruthning with respect to the two items of litigation which were involved. In this case Freuhauf sought to prevent Feez Ruthning (a large Brisbane firm of solicitors) from bringing legal action against it on behalf of a bank (Westpac) as the the firm of solicitors had advised Freuhauf some time earlier on a different matter. Freuhauf argued that the firm of solicitors had obtained confidential information about its former client in the form of information about its methods of operation. However, Freuhauf declined to accept certain undertaking from both Feez Ruthning and Westpac regarding the limiting of access to the information in question. Lee J sought to balance various public interest considerations arising in this case, such as the right of a client such as Westpac to have a solicitor of its own choice, the necessity that justice must appear to be done and not be subverted by the perception that a solicitor can readily change sides and the right of a client, such as the plaintiff, to seek advice from a solicitor without the fear that it would thereby be prejudiced. In dismissing the case, Lee J concluded that there had not been any communication of confidential information within the defendant firm "so as to give rise to a real risk of prejudice or mischief" and that there was "no prospect of detriment to the plaintiff".[80]

It is evident from the above that the courts have been uneasy about the reliability of Chinese Walls and, even where judges have been prepared to endorse the use of such devices, they have preferred to look at each case on its merits rather than to generally endorse the use of Chinese Walls.

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78 *Ibid* at 122-123. This approach was followed by Rourke J in *In the Marriage of Magro PA and Magro RM* note 71 *supra* at 77,191.

79 Note 71 *supra* at 566.

80 *Ibid* at 571.

IV. THE REGULATORY AND LEGISLATIVE RESPONSE TO CHINESE WALLS

Whilst the courts have been slow to recognise the integrity of Chinese Walls, legislators and regulatory bodies have been more easily persuaded of the reliability of these kinds of procedural mechanisms. Perhaps this may imply that law makers and regulators are more in touch with commercial realities than are the judiciary. It may also be the case that legislators and regulators have been more easily influenced by the lobbying activities of conglomerate professional advisory firms and financial institutions. For whatever reason, legislators and regulators have, not surprisingly, been more prepared than the judiciary to accept arguments based upon the commercial considerations behind the use of Chinese Walls.

In the United States, two Washington securities lawyers, Pitt and Groskaufmanis, have recently argued that the SEC "has fostered the development of Chinese Walls...[and]...has made the Chinese Wall an integral part of the day-to-day workings of the securities markets."[81] Pitt had himself been a senior lawyer with the SEC. These writers have also noted that:

> Although the courts have been hesitant to recognise a Chinese Wall defense, Congress has lent support to this tactic. This support is evident in a legislative report accompanying the Insider Trading Sanctions Act of 1984...As the securities industry becomes more concentrated, it increasingly needs a method to overcome potential conflicts of interest. Although acceptance of the Chinese Wall as a prophylactic device has been tenuous in the courts, Congress and the SEC have endorsed it as one cure for the industry's dilemma.[82]

These authors also note that:

> Throughout the 1980s, the SEC increasingly has turned to Chinese Walls as a means for resolving potential conflicts of interests. The Commission adopted rule 14e-3, which absolves from liability securities firms engaged in (or knowledgeable about) a non-public tender offer when an employee executes a trade for the firm in the takeover target's securities if effective screening procedures were in place. Specifically, the individual making the investment decisions must have been screened from the persons with knowledge of the tender offer. Chinese Walls, the SEC indicated, were representative of procedures that could be used to meet the rule's requirements.[83]

As we have seen, the US SEC in 1980 has (in Rule 14e-3) given limited support to the use of the Chinese Wall as a defence in takeover situations. In 1984, the US Congress enacted the *Insider Trading Sanctions Act* which impliedly gave legislative support to the use of Chinese Walls. This legislation states that sanctions under the Act will not apply merely because an employee

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81 HL Pitt and KA Groskaufmanis "Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes of Conduct" (1990) 78 *The Georgetown Law Journal* 1559 at 1621.

82 *Ibid* at 1623.

83 *Ibid* at 1619-20.

of the firm is liable under the Act. It was left by the SEC to formulate specific rules providing a Chinese Wall defence. As Poser notes, the passage of the *Insider Trading Sanctions Act* reflected a degree of regulatory acceptance of Chinese Walls.[84] This acceptance was also reflected in the passage of the *Insider Trading and Securities Fraud Enforcement Act*, 1988 which introduced procedures such as the establishment of Chinese Walls as part of an anti-insider trading strategy. Under s 3(b) of this Act, these procedures must be "reasonably designed to prevent the misuse of material, non-public information." Similarly, in 1986 the SEC approved Chinese Wall procedures in the form of new rules of the New York Stock Exchange and the American Stock Exchange.[85]

In contrast, the conflicts of interest debate in Australia has also turned to examine procedural mechanisms such as the Chinese Wall. Chinese Walls have long been relied upon in Australia as a defence to insider trading allegations[86] and in relation to possible conflicts of interest upon the part of securities advisers who benefit from any recommendation of securities made to a client. The current Chinese Wall provisions in relation to insider trading conduct are found in ss 1002M and 1002N of the Corporations Law, whilst s 850(2) allows the Chinese Wall defence in cases of recommendations made by securities advisers.

Section 1002M provides a corporation with a defence to a contravention of the insider trading prohibition in s 1002G in situations where an officer of the corporation who possessed the inside information did not advise in relation to the particular transaction or agreement giving rise to the alleged contravention and where that officer did not communicate the inside information to the officer of the corporation who did give such advice, provided that the corporation:

> ...had in operation at that time an arrangement that could reasonably be expected to ensure that the information was not communicated to the person or persons who made the decision and that no advice with respect to the transaction or agreement was given to that person or any other person by a person in possession of the information.

Under the predecessor to s 1002M, the Chinese Wall defence provision was somewhat more stringent than that required by s 128(7) of the *Securities Industry Act* 1980. A lower standard is now provided for under s 1002M. Chinese Walls must now only be of the kind that they "could reasonably be expected to ensure that the information was not communicated". This lesser standard is somewhat similar to that found in the 1988 United States insider trading reforms discussed above. It should also be noted that s 1002N extends the Chinese Wall defence to partners in a partnership so as to avoid the

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84 Note 6 *supra* at 209.

85 *Ibid* at 211-212.

86 That the Australian Chinese Wall provisions in relation to insider trading are to be seen as a defence rather than as a constituent element of the offence see the decision of the Full Court of the Supreme Court of Western Australia in *Sun Securities Ltd v National Companies and Securities Commission* (1990) 2 ACSR 796 at 808.

presumption that inside information that is known by any other partner is presumed to be known by all other partners.[87]

There had been some debate about the Chinese Wall defence to insider trading during the course of the hearings of the House of Representatives Standing Committee on Legal and Constitutional Affairs inquiry into insider trading.[88] In its 1989 report, the Committee recommended the retention of the Chinese Wall defence and observed that:

> At this stage, the Committee supports the maintenance of the Chinese Wall defence for insider trading. While some doubts have been expressed about the integrity of Chinese Walls, the Committee is swayed by the confidence of participants in the securities industry that Chinese Walls can and do work. Insufficient evidence has been provided to suggest otherwise. It is evident, though, that if Chinese Walls are to be effective, rigorous compliance programs need to be in place and should be subject to the scrutiny of the regulatory agencies.[89]

Of course, as we have seen, the same confidence in Chinese Walls is not often shared by Australian judges.[90] Similarly, there is some empirical evidence to suggest that many of those who work in the Australian securities industry do not have a great deal of confidence in Chinese Walls.[91] As this empirical research has shown, the effectiveness of Australian Chinese Walls depends greatly upon the standards of probity found within the organisation. However, a determined person was seen by many experienced brokers and merchant bankers as always able to penetrate such procedural arrangements as Chinese Walls. These findings parallel conclusions reached in a study of the British securities industry which found that:

> ...born of long experience of the City [of London] and its ways, that its major clients, the big institutional fund managers, are very sceptical about Chinese walls. They have expressed their reservations about the new system [introduced with the Financial Services Act of 1986]. And the richer ones have taken steps to

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87 Note 16 *supra*.

88 See further R Tomasic "Insider Trading Law Reform in Australia" (1991) 9 *Company and Securities Law Journal* 121 at 133-135.

89 *Fair Shares for All: Insider Trading in Australia*, Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs (1989) at para 4.9.7.

90 See for example the judgment of Ipp J in the decision of *Mallesons Stephen Jaques v KPMG Peat Marwick and Ors*, note 73 *supra*. This decision is discussed at greater length in Tomasic note 88 *supra*.

91 See further R Tomasic *Casino Capitalism? Insider Trading in Australia*, Canberra, Australian Institute of Criminology, 1991 at 90-92. The evidence presented to the House of Representatives' insider trading inquiry by securities industry sources on the reliability of Chinese Walls is flimsy to say the least. See further the submissions to the inquiry from Mallesons Stephen Jaques (p S58), the Australian Merchant Bankers Association (p S64), the Australian Stock Exchange (p S90), the National Companies and Securities Commission (p S113), the Law Council of Australia (p S254), Clayton Utz (p S431), the Macquarie Bank (p S457-S458) and the Commonwealth Attorney-General's department (p S544-S546).

> defend themselves against it, by hiring their own teams of dealers, and by beginning to do their own research so that they do not have to rely on the adulterated product of investment houses. It is a fitting judgement on the system that those customers of the City who know the City best are the ones with least faith in this aspect of self-regulation.[92]

In its submission to the House of Representative Standing Committee on Legal and Constitutional Affairs insider trading inquiry, the Business Law Section of the Law Council of Australia (LCA) criticised the vagueness of the Chinese Wall insider trading defence when it noted that "it is not clear what will constitute a sufficient arrangement for the purposes of the defence. It is unsatisfactorily vague for a defence in the context of a criminal sanction." The LCA Business Law Section added that:

> There are many other questions raised about Chinese Wall defences. These include the question whether if, despite the existence of a Chinese Wall, the managing director has access to all branches of or divisions of the business, it can be said that there is an arrangement within sub-section (7) [of s 128 of the Securities Industy Act].[93]

A submission from Clayton Utz, solicitors, also suggested that there was a need for the preparation of guidelines from the Commission or some similar body to assist in answering these kinds of questions.[94] However, another national firm of solicitors argued that the "prescription of standards in that way is unnecesary and inappropriate."[95] There already is a limited regulatory system regarding the use Chinese Walls which has been established by Business Rule 3.5 of the Australian Stock Exchange. Should the Chinese Wall defence become more widely used than it has been up until this time, it is clear that the case for guidelines issued and policed by the Australian Securities Commission will become necessary.

Turning to s 850(2) of the Corporations Law which provides for a Chinese Wall defence in the context of recommendations made in relation to securities by a dealer or investment adviser. Section 849(2) requires a securities adviser who is making a recommendation to a client to provide the client with particulars of any benefits or advantages that the adviser or an associate may gain or receive in connection with the making of the recommendation or the dealing by the client who receives the advice. Section 850(2) provides a defence to a breach of s 849(2) where the dealer or investment adviser had in

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92 A Hilton note 4 *supra* at 83-84. Also see M Clarke *Regulating the City: Competition, Scandal and Reform* (1986). For a discussion of the operation of Chinese Walls in the United Kingdom after the "Big Bang" of 1986 see NS Poser note 6 *supra* at 231-236.

93 Reproduced in Committee Hansard at S248.

94 "Insider Trading and Other Forms of Market Manipulation: A submission prepared by Clayton Utz for the House of Representatives Standing Committee on Legal and Constitutional Affairs" Committee Hansard at S431.

95 "The Adequacy of Existing Insider Trading Provisions in the Securities Industry Act 1980 and the Companies Act 1981" by Mallesons Stephen Jaques, Committee Hansard at S58.

operation a Chinese Wall between the person who gave the advice and the person who had the information.

It has been argued that in circumstances such as these that the economic interests of the firm may be at odds with those of the client. As Varn has explained:

> This will occur, for example, where the firm engages in securities transactions for its own account, in a manner akin to that of any other investor. There are also instances where the firm's interests are likely to conflict with those of its retail customers, such as the case during formal underwriting of new securities. In these circumstances, attributing knowledge throughout the firm, irrespective of the existence of a Chinese Wall, better comports with the economic realities of the situation. In the light of this conclusion, multi-service securities firms which are in possession of inside information should refrain from purchasing or selling securities for accounts in which the firm has a proprietary interest. In addition, to avoid untoward misrepresentations to its trading customers and improper transactions in managed accounts, the firm should also avoid recommending the purchase of those securities of those issuers for which the firm is simultaneously engaged as an underwriter of a new issue until the formal sales campaign for the new issue actually begins.[96]

The relevance of these comments to Australia is evident from a reading of the report of the 1974 Senate Select Committee on Securities and Exchange, chaired by Senator Peter Rae, which documented practices of this kind.[97] The relationship between principal trading and insider trading was also highlighted by the Rae Committee and practices such as these continue to be of concern.[98]

V. THE EFFECTIVENESS OF CHINESE WALLS

Any attempt to assess the effectiveness of Chinese Walls must first establish what the object of this device is to be. As Poser has reminded us:

> What has not been generally appreciated is that a Chinese Wall can have two very different regulatory purposes. Its purpose may be merely prophylactic: to prevent inside information in the possession of persons in one part of a firm from being misused by persons in another part of the firm. Its purpose may also, however, be legal: to provide a defense to the firm against liability for insider trading or breach of duty to a customer that would normally arise as a result of the imputation of knowledge of an employee to the employer.[99]

There is little systematically collected evidence that Chinese Walls are as effective in quarantining material information as their widespread use might suggest. Hamermesch noted in 1986 that "no objective evaluation of the

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96 LL Varn note 34 *supra* at 199-200.

97 *Australian Securities Markets and their Regulation: Part 1*, Report from the Senate Select Committee on Securities and Exchange (1974).

98 See further note 19 *supra* at 821-825.

99 Note 6 *supra* at 189-190.

effectiveness of the Chinese wall exists."[100] She added that "[t]he many court decisions that find inadequacies in those walls, however, suggest that, at a minimum, the courts need more information about the security of such a wall before permitting a relaxation of the imputation of disqualification."[101] Thus it is suggested that courts should require firms to provide more data on firm size and their screening practices before accepting a Chinese Wall defence.[102]

Writing as recently as 1991, Poser also noted that "it seems surprising how little evidence there is that Chinese Walls are effective."[103] Poser went on to observe:

> The existing evidence suggests that the Chinese Wall, despite its solid-sounding name, is not particularly difficult to penetrate...
>
> Doubts about the effectiveness of Chinese Walls are supported by common sense and knowledge of human nature. Because the Chinese Wall is essentially an exercise in self-discipline, its success ultimately must depend on the ethical values of the particular persons involved. Where the financial stakes are high and the temptations great (for example, where a principal or employee of a securities firm is in possession of confidential information concerning a pending takeover), the pressures on the ethical values of some persons are likely to be irresistible.[105]

Poser added that "[t]here is a widespread feeling that the intense pressure to create profits is breaking down Chinese Walls".[105] Earlier, Poser had also noted, somewhat pessimistically, that:

> A large multi-service firm has so many sources of material, non-public information that an interlocking network of walls would be necessary - in effect, an entire Chinese city - to be reasonably sure that all of this information remains pent-up in the department in which it belongs. A modern securities firm would have to isolate its underwriting, corporate finance, and mergers and acquisitions departments not only from each other, but also from the firm's trading, over-the-counter market-making, arbitrage, institutional sales, retail brokerage, investment advisory, individual-account management, fund management, and research departments. Besides being fearfully complicated, the system would be difficult and expensive to police.[106]

Chinese Walls are unlikely to be of value in small firms where a member of the firm is concerned with making decisions concerning different levels of the firm's business. On the other hand in larger firms with a variety of operations, Chinese Walls must be more complex and as a result become increasingly difficult to monitor. [107] In the context of the use of Chinese Walls in law firms

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100 FW Hamermesch "In Defense of a Double Standard in the Rules of Ethics: A Critical Re-evaluation of the Chinese Wall and Vicarious Disqualification" (1986) 20 *Journal of Law Reform* 245 at 270.

101 *Ibid* at 270-71.

102 *Ibid* at 272-73.

103 Note 6 *supra* at 227.

105 *Ibid* at 227-228.

105 *Ibid* at 229.

106 Note 27 *supra* at 114-115.

107 Note 6 *supra* at 233.

one American court has suggested that the effectiveness of these procedures might be assessed by reference to the following factors, which the law firm must show are sufficient under the circumstances:

> ...the size and structural divisions of the law firm involved, the likelihood of contact between the 'infected' attorney and the specific attorneys responsible for the present representation, the existence of rules which prevent the 'infected' attorney from access to relevant files or other information pertaining to the present litigation or which prevent him from sharing in the fees derived from such litigation.[108]

Even defenders of the Chinese Wall such as Lipton and Mazur note that without major reinforcement or strengthening, the Chinese Wall is problematic because:

> ...acceptance of the Chinese Wall standing alone would mean that a firm with inside information in an isolated department could find itself in a situation where another department is making recommendations or rendering investment advice contrary to that information. This does not meet the reasonable expectation of the average public investor who relies on the recommendations of a broker-dealer. The dependence of the unsophisticated investor on such recommendations generally receives special recognition and is essential to the continuance of public participation in the securities markets.[109]

Lipton and Mazur also argue that reinforcing the Chinese Walls against the weaknesses which have from time to time become apparent in the context of investment advisory firms:

> ...is a reasonable reconciliation of apparently contradictory aims. From one perspective, by proscribing the misuse of inside information and thus placing all investors on an equal footing, it protects investors and creates confidence in the securities firms and by not requiring such firms - and commercial banks, investment companies, insurance companies, and similar entities as well - to divest themselves of conflicting functions, it secures the liquidity of the securities market.[110]

The confidence of Lipton and Mazur in the possibility of salvaging Chinese Walls is not universally shared. Even with Lipton and Mazur's radical reform scenario it has been suggested that:

> Although the large securities firms have attempted to establish separate underwriting divisions, this structural separation has often not been particularly effective as a means of preventing inside information gathered by the underwriting division from becoming known to the brokerage division. Firms found to have violated the securities laws as a result of such seepages have sought to tighten their restrictions on the flow of information between departments,

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108 *Schiessle*, 717 F 2d 417 (1983) at 421 (citing *La Salle Nat'l Bank v County of Lake*, 703 F 2d 252, 7th Cir 1982); referred to in HL Pitt and KA Groskaufmanis "Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes of Conduct" (1990) 78 *The Georgetown Law Journal* 1559 at 1628.

109 M Lipton and RB Mazur note 25 *supra* at 502. For a different view see: L Chazen "Reinforcing the Chinese Wall: A Response" (1976) 51 *New York University Law Review* 552.

110 M Lipton and RB Mazur *ibid* at 463.

> usually under prodding from the SEC. Experience in the banking industry, however, casts significant doubt on the effectiveness of voluntary restrictions on the flow of information within a single firm. Hence, reliance by brokerage firms on such restrictions as a means of avoiding a conflict of duties would seem to be misplaced.[111]

More recently, Pitt and Groskaufmanis have provided a pragmatic response to the critics of procedures such as Chinese Walls. They point to the fact that devices such as these have "become a permanent part of the corporate landscape"[112] and they go on to stress the "pragmatic factors militating in favour of adopting a [self regulatory] code [of conduct]."[113] These pragmatic factors include the encouragement of those employees "who want to do the right thing" and the fostering of public goodwill.[114] If the Australian experience over the last decade is any guide, none of these factors is likely to be very effective without substantial legislative and regulatory intervention.

Also, the experience of the Takeover and Mergers Panel in England has shown that the value of segregating the operations of a firm will not always overcome conflicts of interests.[115] It is clear that, in itself, tinkering with the Chinese Wall will not be the panacea that many have suggested. Thus, Cranston has concluded that "[w]hat is needed is a multi-pronged attack; one aspect of this attack should be legal."[116] In the City of London, for example, the creation of Chinese Walls has often been accompanied by 'subsidiarisation' and the appointment of compliance officers. Under subsidiarisation, the merchant banking arms of many London financial institutions have been located in subsidiaries, even though this may create capitalization problems for the subsidiary. However, the problem of informal contacts is not eliminated. In contrast, the effectiveness of compliance officers in London financial institutions remains to be fully assessed,[117] although one observer has noted that the job of compliance officer is not a popular one.[118]

On the other hand, there are others who remind us of the need for caution in relation to the use of Chinese Walls. Professor Finn has for example concluded:

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111 "Conflicting Duties of Brokerage Firms" (1974) 88 *Harvard Law Review* 396.

112 Note 81 *supra* at 1632.

113 *Ibid* at 1634.

114 *Ibid* at 1634-36.

115 R Cranston note 7 *supra* at 132-133.

116 *Ibid* at 143.

117 *Ibid* at 138-142.

118 Carey has noted that: "the compliance officer is on the sharp end from all directions whenever things go wrong... It is, therefore, a difficult and dangerous job and many firms are acknowledging its particular problems by instituting special systems to help rule-checking and the impermeability of barriers between departments. But, nonetheless, cases of the walls being breached seem to be becoming increasingly frequent"; P Carey "City Whispers and Chinese Walls" (1990) *New Law Journal*, April 6, 472 at 473.

> ....I do not see devices such as Walls as having wide ranging and ameliorative effects upon potential enterprise liability at least in the areas that I have considered. I am not unmindful of the economic and efficiency arguments which can favour the growth of large enterprises; I am not unmindful of the desire enterprises may have to provide a complete range of services to clients. But I am equally not unmindful of the fragility of the trust that clients and the public repose in institutions rendering fiduciary services. The maintenance of that trust has to be weighed against the pursuit by such institutions of their own interests.[119]

Both critics of Chinese Walls like Poser and proponents such as Lipton and Mazur take the pragmatic view that, as Poser put it, "the Chinese wall seems to be here to stay."[120] The securities industry has traditionally been regulated by less formal mechanisms such as self regulation and co-regulation. This has led some to refer to corporate law as a place where the law ends.[121] Lawyers, in contrast to other professionals working in the securities and finance firms, have been subject to more stringent codes of conduct due both to the existence of the legal tradition within which lawyers work and to the fact that they are seen by judges as officers of the Court and custodians of the reputation of the legal system. However, the rise of mega firms and the increasingly entrepreneurial approach of corporate lawyering has led to pressure for a departure from traditional approaches to conflicts and greater reliance upon devices such as Chinese Walls.

Nevertheless, complete self regulation in this area has had only limited success and the public interest demands that self regulatory mechanisms, despite their obvious deficiencies, need to be supplemented and improved. Of course there are major limits to the extent to which governmental regulation can have an impact on professional firms of the kind discussed here. Elsewhere, I have argued that corporate law offences such as insider trading are crimes of opportunity and that breaches of such offences in the securities industry are very difficult to detect let alone to prove.[122] In similar terms, Varn has concluded that:

> The construction and maintenance of interdepartmental Chinese Walls to accommodate the conflicting legal duties of multi-service securities firms and other financial institutions has been a salutary development within an industry that is distinguished by a plethora of conflicts and constant opportunity for fiduciary abuse.[123]

In this environment there are no simple solutions to the problems of conflicts of duty and interest. Whilst it is clear that there is a need for improved

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119 Note 2 *supra* at 40.

120 NS Poser note 27 *supra* at 114. See also the views of two proponents of Chinese Walls: M Lipton and RR Mazur, note 2 *supra.*

121 CD Stone *Where the Law Ends: Social Control of Corporate Behavior* (New York, 1975).

122 R Tomasic and BD Pentony "Crime and Opportunity in the Securities Markets: The Case of Insider Trading in Australia" (1989) 7 *Company and Securities Law Journal* 186.

123 Note 34 *supra* at 287.

legislative rules and regulatory guidelines dealing with Chinese Walls and similar practices, ultimately these will have to be implemented by the advisory professions themselves. Continuous disclosure of material information is of course an important means for avoiding conflicts problems in the securities industry. The wider investigation of the application of this principle to the use of Chinese Walls in other context need to be looked at more closely. At the same time, the continuing lack of empirical information on the effectiveness of Chinese Walls should caution against the wider resort to such mechanisms. Nevertheless, as the pressure for the wider availability of the Chinese Wall defence is an on-going one, it is unlikely that judges, legislators and regulators will be able to long resist this commercially based influence. Nevertheless, there is already sufficient information available on procedural devices such as Chinese Walls to lead to a more informed and critical approach to this matter. What is called for is a multi-faceted approach to Chinese Walls which in part relies upon formal legal rules and which also draws heavily upon informal and self regulatory mechanisms with credible and effective internal enforcement structures. In relation to securities and financial matters, this needs to be coupled with a broader commitment to prompt disclosure of material information.