A Discussion on the Functions of the Chinese Wall: Prevention and Defense

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Abstract

The Chinese Wall system has two core functions: preventive function in securities operations and legal defense function under securities law. Originated from U.S. securities market practices and judicial precedents, this mechanism was initially introduced as an information isolation tool to resolve structural conflicts of interest within full-service securities firms under the mixed-operation model, preventing the improper internal transmission and leakage of non-public price-sensitive information. With the evolution of the system, it has gradually become a valid legal defense for financial institutions to refute insider trading allegations, recognized by relevant laws and regulations in the United States, the United Kingdom, Australia and other countries. At present, the preventive function of the Chinese Wall system is widely accepted globally, while the understanding and application of its legal defense function vary among different jurisdictions. Although the system faces doubts about its actual implementation effect and reliability due to its reliance on self-discipline and lack of unified objective standards, the necessity of establishing the system is widely recognized. It still plays an irreplaceable role in preventing insider trading, resolving conflicts of interest and defending legal liabilities in the global securities market.

Keywords

Chinese Wall system, Prevention of conflicts of interest, Defenses against insider trading, Securities compliance

Introduction

Comprehensive securities firms have already transitioned from single-business operations to comprehensive business models. The U.S. Gramm-Leach-Bliley Act of 1999 encouraged the formation of financial groups, while Japan's Financial System Reform Act of 1992 permitted securities firms to engage in cross-business operations. Countries such as Germany and Switzerland continue to follow the universal banking model, integrating the banking and securities industries. Comprehensive securities firms generally operate under a model of "mixed business operations - segregated operations". However, diversified operations inevitably involve the interests of different groups, making it relatively easier for comprehensive securities firms to obtain insider information and often placing them in a state of conflict of interest with their clients. To address this issue, countries such as the United States and the United Kingdom pioneered the establishment of the Chinese Wall system, which serves a preventive function. That function is to prevent improper internal circulation and leakage of undisclosed sensitive information [1]. However, as the range of business activities conducted by full-service securities firms continues to expand and their business models grow increasingly complex, more comprehensive and refined requirements are being placed on the Chinese Wall system. The issue of its effectiveness as a defense against insider trading remains to be addressed [2].

The origins and evolution of the great wall system

The Chinese Wall system originated in the United States. It refers to the requirement for diversified securities firms to establish a Chinese Wall to segregate different business departments, thereby ensuring that price-sensitive information does not leak between departments [3]. In the United States, the evolution of the Chinese Wall system has been a dynamic process. It

initially arose from the needs of market practice. It was subsequently affirmed by judicial precedents as an essential internal control mechanism for full-service brokerage firms. It later gained recognition for its defensive efficacy, thereby incentivizing brokerage firms to voluntarily establish Chinese Wall systems.

The origins of the Chinese Wall: sec v. cady, Roberts & Company (1961)

The first widely recognized case involving the Chinese Wall and insider trading is Merrill Lynch v. U.S. Securities and Exchange Commission (SEC), but the concept of information barriers can be traced back to SEC v. Cady, Roberts & Company

In this case, the director of Curtiss-Wright disclosed the board's decision to reduce dividends to his stockbroker (a partner at full-service brokerage firm Cady, Roberts & Company) after obtaining the relevant information. The broker and his clients then used the inside information to sell shares of Curtiss-Wright. In this case, the SEC rejected the defendants' defense that "no relationship of trust existed" and established the "cease trading or disclose" principle.

However, it cannot be overlooked that this case presents a legal paradox for full-service broker dealers. This paradox stems from the inherent diversity of a full-service broker-dealer's business operations and the principle of fiduciary duty under agency law. In the securities market, full-service broker-dealers may simultaneously engage in a variety of businesses, such as brokerage services, portfolio management, fund management, and securities underwriting. With the exception of proprietary trading, they provide services to clients in their capacity as agents. Once a fiduciary relationship is established, the agent's duty of loyalty arises; this duty is indivisible, and the agent owes a complete duty of loyalty to each client [4]. In this case, a full-service brokerage firm serves as both the underwriter for Company A and the broker for Company B. Upon learning of the bearish news regarding Company A's plummeting performance, if the firm uses this information to assist Company B in selling its shares, it constitutes insider trading; conversely, adhering to good faith would violate its fiduciary duty to Company B. In this scenario, regardless of which party's interests the brokerage firm chooses to serve, it will inevitably harm the interests of the other party, thereby rendering the conflict of interest a structural dilemma.

This awkward predicament of "dual loyalty" leaves full-service broker-dealers facing both regulatory penalties from the SEC and the risk of civil litigation from clients, while the existing regulatory framework does not provide them with a viable exit strategy. However, it can be demonstrated that information within the firm is segregated. That is, the brokerage division was genuinely unaware of the inside information held by the underwriting division when making decisions. Can it then be presumed that the firm did not use insider information, thereby serving as a defense?

The emergence of the Chinese Wall system: Merrill lynch v. sec (1996)

Although this case did not provide a definitive answer to the aforementioned issues, the settlement marked the first formal mention of the Chinese Wall system as a remedial internal control measure. In 1968, Merrill Lynch served as both the underwriter and retail broker for its client Douglas Aircraft. During its due diligence, Merrill Lynch obtained inside information indicating that Douglas Aircraft's projected profits would decline significantly. Prior to the public disclosure of this information, Merrill Lynch's retail brokerage division traded on this information, helping other clients sell their shares and avoid losses amounting to millions of dollars.

The SEC charged Merrill Lynch with insider trading under Section 10(b)-5 of the U.S. Securities Act, but the case ultimately resulted in a settlement. One of the terms of the settlement was that Merrill Lynch committed to implementing stricter policies and procedures in its business operations to restrict the transmission and sharing of inside information, effectively establishing a Chinese Wall to prevent the improper flow of information [5,6]. The SEC considers this system a necessary internal control measure to prevent conflicts of interest, but does not grant the Chinese Wall system the legal effect of an exemption. Even if Merrill Lynch had established this system, it could not guarantee exemption from legal liability for insider trading [7]. This case served as a precedent for

the development of the Chinese Wall system in China, laying the groundwork for its establishment. At that time, the Chinese Wall primarily took the form of written rules designed to prevent the cross-departmental flow of specific types of information. Simultaneously, it strengthened restrictions on the use of computer systems, databases, and other information systems by business personnel [8].

Since then, this system has been widely adopted by other financial institutions in an effort to limit potential liability for insider trading and avoid conflicts of interest. The Chinese Wall system has become a widely accepted practice among full-service broker-dealers. The UK has a highly self-regulated financial system, and the UK securities market has long relied on self-regulatory organizations such as stock exchanges and the Securities and Futures Commission for self-governance. Its traditional self-regulatory securities management system provided fertile ground for the development of the "Chinese Wall" as a self-regulatory system. In the UK, the term "Chinese Wall" is rarely used; instead, the term "Green Baize Doors" is commonly employed. In 1983, the UK's "Rules of Conduct for Licensed Dealers" introduced the Chinese Wall system as a special arrangement to prevent conflicts of interest. This was reaffirmed in Section 48(2)(h) of the UK's Financial Services Act of 1986. Section 128(7) of Australia's Securities Industry Code also recognizes this system as a statutory defense against allegations of insider trading.

The introduction of the Chinese Wall defense: Slade v. Shearson, Hammill & Company, and rule 14e-3

In this case, Sherason Hammill & Company acted as the underwriter for Tidal Marine International Corporation and also served as the long-standing broker for the plaintiffs,

Renee Slade and Edward E. Odette. Sherason Hammill & Company became aware of this inside information immediately after the Tidal Marine International Corporation maritime accident and determined that Tidal Marine International Corporation's financial condition would deteriorate. However, Sherason Hammill & Company continued to recommend that individual investors purchase Tidal Marine International Corporation stock after this fact, causing them to suffer significant losses because they failed to sell their shares in a timely manner. In response to the insider trading allegations brought by Renee Slade and Edward E. Odette, Sherason Hammill & Company raised two defenses: First, Sherason Hammill & Company was unaware of the inside information regarding Tidal Marine International Corporation prior to May 1972. Second, while the investment banking division of Sherason Hammill & Company was aware of the inside information, it was not unlawful for the firm's securities brokerage division to recommend Tidal Marine International Corporation stock to its clients before the information became public. The court held that Sherason Hammill & Company had a fiduciary relationship with both the two individual investors and Tidal Marine International Corporation, and that it was impossible to distinguish between the relative weight of the two fiduciary relationships. Since a fiduciary relationship must be fulfilled, the court dismissed the defendant's defense. The SEC recognized that financial institutions implementing a "Chinese Wall" system can effectively prevent the improper transmission and circulation of information between their internal banking and securities departments and tentatively acknowledged that this system could serve as a basis for a defense.

Sherason Hammill & Company subsequently appealed to the U.S. Court of Appeals for the Second Circuit. Although the parties quickly reached a settlement, the case sparked panic on Wall Street: If the court had ruled that the "Chinese Wall" defense was invalid, full-service broker-dealers would have struggled to survive. In subsequent cases such as Washington Steel Corporation and American Medicorp, the views of U.S. courts and the SEC increasingly converged, recognizing that the "Chinese Wall" could serve as a valid defense against allegations of insider trading.

In 1980, the SEC enacted Rule 14e-3, marking the first formal recognition of the Chinese Wall system in federal regulations. This rule prohibits insiders from engaging in securities transactions related to a tender offer. However, a securities firm may be exempt from this rule if it meets the following conditions: (1) The trading personnel are unaware that another department within the firm has obtained relevant inside information. (2) The securities firm has adopted reasonable policies

and procedures, based on its business operations, to ensure that such inside information is not disclosed to others. This provision effectively recognizes the defensive efficacy of the Chinese Wall system. Of course, to prevent abuse of this defense, a series of restrictions have been imposed on its invocation - such as its inapplicability to fraud charges. Consequently, establishing a Chinese Wall is no longer merely a matter of ethical self-regulation for securities firms, but also serves to mitigate the risk of SEC insider trading charges.

The consequences of a lack of the Chinese Wall system: Iosefa and the "minimum standards"

The U.S. Insider Trading and Securities Fraud Enforcement Act (ITSFEA) of 1988 was the first legislation to explicitly define the status and role of the Chinese Wall system, authorizing the SEC to mandatorily intervene in the establishment of internal control systems at brokerage firms. Section 3(b) of the Act requires brokerage firms to establish written policies to prevent the misuse of information; failure to do so constitutes a violation and may result in civil and criminal liability. Under this provision, when facing insider trading charges, a defense may be asserted if the following conditions are met: (1) The decision-maker who made the trading decision did not possess insider information at the time of the trade. (2) Necessary policies and procedures have been established to prevent the improper flow of insider information. In March 1990, the SEC's Division of Market Regulation conducted a comprehensive review of the implementation of Chinese Wall systems by securities firms nationwide. In the 1990 Chinese Wall Report, it stated that Chinese walls must meet "Minimum Standards. These standards include at least four elements. They are restrictions on employee trading, control of interdepartmental information exchange, standardization of measures and procedures, and enhanced scrutiny of proprietary trading [9].

The functional role of the Chinese Wall: Prevention and defense

The SEC's 1990 Report on Chinese walls noted that the Chinese Wall system serves two functions: a preventive function in securities operations and a defense function under securities law. The academic community also endorses this classification, recognizing that Chinese walls serve two distinct regulatory purposes, which may be purely preventive. To prevent the misuse of inside information held by one group of employees by another group within the company, or they may be legal in nature, providing the company with a defense against liability for insider trading or breaches of fiduciary duties to clients. From an institutional perspective, the Chinese Wall system was originally designed as a measure to isolate information. However, as the system evolved, it provided financial institutions with a legal defense against allegations of insider trading. Currently, its preventive function is widely accepted across nations, but the legal defense function is interpreted differently in various countries.

The preventive function of the Chinese Wall

In the early days, the Chinese Wall, as a form of "procedural architecture", primarily served to isolate conflicts of interest and prevent the flow of information. It was typically designed to separate the "private sector" from the "public sector" in order to prevent the dissemination of insider information [10]. The "private sector" was most likely to have access to insider information, while the "public sector" was most likely to engage in securities trading.

In theory, the Chinese Wall can indeed play a positive role in preventing and deterring insider trading. The principle is simple: by "containing" insider information within a single department and prohibiting its free flow, conflicts of interest are prevented, and insider trading is avoided. Since the occurrence of insider trading relies on the improper flow of inside information, when underwriting or investment banking departments lawfully obtain such information in the course of their business, they lack the legal authority or practical ability to use it for trading profits. This is due to the nature of their operations or other restrictions. They must disclose this information to the proprietary trading department or other entities with trading authority, relying on the latter to execute trades. The Chinese Wall system prevents conflicts of interest and curbs the occurrence of insider trading by blocking this transmission pathway.

In addition to comprehensive brokerage firms using the Chinese Wall system as a measure to prevent insider

trading, Section 912A(1) (aa) of the Australian Corporations Act also applies the Chinese Wall system to other organizations engaged in the financial services industry to manage conflicts of interest. Particularly in the fields of accounting and law firms, the establishment of the Chinese Wall system in such circumstances is primarily intended to ensure compliance with fiduciary and contractual obligations, act in the best interests of clients, and avoid conflicts of interest. It is also intended to prevent the exchange of information between lawyers and accountants representing different parties, opposing parties in a dispute, or parties to legal proceedings [11].

However, the reliability and actual effectiveness of the Chinese Wall system have been widely questioned. Although the Chinese Wall is widely used, there is no evidence to suggest that it has played a significant role in isolating critical information. Furthermore, the Chinese Wall system relies primarily on self-discipline, and its effectiveness depends entirely on the moral standards of those involved - the efficacy of such self-restraint is highly debatable. Some scholars have remarked that trusting the Chinese Wall system in the secondary market is as difficult as believing in a fairy tale.

Similarly, the implementation of this system in China has not yielded ideal results. The effectiveness of the system depends on securities firms. The standards of ethical conduct and professional ethics currently prevailing in China's securities industry are relatively low. Therefore, it is unrealistic to rely solely on the moral integrity of securities firms to ensure the preventive function of the Chinese Wall. In the face of financial incentives and market pressures, this wall is easily breached.

The defensive function of the Chinese Wall

With regard to defenses against insider trading charges, the purpose of the Chinese Wall system is to provide a legal defense for brokerage firms that comply with its provisions. This allows them to argue that, although the firm as a whole was aware of the inside information, the decision-making department or decision-makers were not aware of it. This thereby exempts them from fiduciary duty under agency law and shields them from allegations of breach of fiduciary duty.

Under the common law system, the relationship between a brokerage firm and its clients is primarily governed by the agency framework. There are two fundamental principles of agency law: an agent owes the principal a duty of good faith and complete loyalty and information obtained by the agent in the course of performing their duties is deemed to be known to the principal. Based on these principles, any inside information held by any department of a brokerage firm should be considered as information the firm itself has obtained. While strict adherence to this rule helps protect client interests, it may adversely affect the brokerage firm's interests.

Consequently, countries to varying degrees treat securities trading as an exception to the agency doctrine and recognize the defensive function of the Chinese Wall. Countries such as the United States, the United Kingdom, Australia, India, and New Zealand have explicitly codified the Chinese Wall defense in their statutes, though the provisions vary. Specifically, Section 3(b) of the U.S. Insider Trading and Securities Fraud Enforcement Act stipulates that the "Chinese Wall" system may serve as a defense if the following conditions are met: (1) The decision-maker making the trading decision was unaware of the inside information at the time of the trade. (2) Necessary policies and procedures have been established to prevent the improper flow of inside information. Section 4(1)(iii) of India's Prohibition of Insider Trading Regulations states that if the insider is a corporate entity, the fact that the person with access to inside information is different from the person making the trading decision may serve as a defense. It is argued that the company has implemented a Chinese Wall system to ensure that information does not flow from persons in possession of inside information to those making trading decisions. Section 1043F of the Australian Corporations Act sets out the three elements of the defense, summarized as follows: (1) The person deciding to trade in the relevant financial product was not aware of the inside information. (2) The company had established adequate Chinese walls. (3) The person deciding to trade did not receive inside information or a recommendation to buy from a person in possession of inside information.

From this perspective, there are three prerequisites for using insider trading as a defense: First, the decision-maker was unaware of the inside information

at the time the decision was made. Second, the company has fully implemented a Chinese Wall system. Third, the holder of inside information neither disclosed such information nor offered any suggestive purchase advice to decision-makers. Any such attempted conduct was blocked by the Chinese Wall system. This can be summarized as the absence of any evidence of insider trading.

Admittedly, based on the above logic, a full-service brokerage firm that has established adequate Chinese walls would be immune to insider trading charges. Even if other departments within the firm possess inside information, its proprietary trading desk or other departments with trading authority may still execute trades. Of course, if the firm hires third parties to execute trades, the Chinese Wall defense no longer applies. While the logic is clear, the question remains: How are the standards for establishing adequate Chinese walls determined?

The United States currently applies the minimum standard set forth in the SEC's 1990 Chinese Wall Report. The extent to which a Chinese Wall system that merely meets this "minimum standard" can serve as a valid defense remains a matter of debate. Section 104F(b) of the Australian Corporations Act stipulates that to establish an adequate Chinese Wall, it must be demonstrated that "reasonable arrangements have been put in place that can reasonably be expected to ensure that information is not communicated to decision-makers (regarding a transaction or agreement)". It must also be demonstrated that "the holder of the information does not provide advice to decision-makers regarding the transaction or agreement". These are the two key elements of an adequate Chinese Wall under the Australian Corporations Act.

The phrase "can reasonably be expected to ensure" appears to be an excessively high standard and is overly stringent for financial institutions. For the company to rely on this system as a defence, it must prove that two conditions are met. First, it must prove "it had in operation at that time arrangements that could reasonably be expected to ensure that the information was not communicated to the person or persons who made the decision". Second, it must prove that "no advice with respect to the transaction or agreement was given to that person or any of those persons by a person in possession of the information".

The Chinese Wall system is regarded in most countries as a defense sufficient to counter allegations of insider trading, and it typically requires certain fundamental characteristics. However, the lack of an objective standard to measure its adequacy creates inherent uncertainty regarding the effectiveness of the Chinese Wall defense. The key to ensuring the effectiveness of the Chinese Wall defense lies in identifying an objective and appropriate standard for demonstrating its adequacy. Insider trading is, by its very nature, a highly covert illegal act, and detecting it is extremely difficult. Without precise empirical evidence, it is hard to objectively determine whether a Chinese Wall is effective, especially since a Chinese Wall is only subject to scrutiny in cases of insider trading or conflicts of interest under specific circumstances [12]. When reviewing insider trading cases, courts must comprehensively consider the following factors: (1) Relevant case law citing statutory provisions on the Chinese Wall system. (2) Market rules and generally accepted industry practices related to the Chinese Wall. (3) The design standards of leading Chinese Wall software developers. (4) The standards for demonstrating adequacy in Chinese Wall case law involving non-insider trading scenarios.

Conclusion

Overall, while there are indeed current doubts about the China Wall system, these doubts primarily concern its effectiveness. However, there is broad agreement on the necessity of establishing such a system, and there are high expectations for its preventive and defensive functions. Rather than a rejection or questioning of the system itself, the situation stems from overly high expectations regarding its implementation coupled with a relative lack of research on its design.

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Conflicts of Interest

The authors declare no conflict of interest.

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