THE SECURITIES AMENDMENT ACT 1988 AND THE CHINESE WALL

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The purpose of this article is to consider the "Chinese Wall" exception to liability for advisors to public companies for insider trading under the Securities Amendment Act 1988 and at common law.

1 Introduction

Part I of the Securities Amendment Act 1988 ("the Act") which came into force on 22 December 1988 prohibits insider trading. However, the Act contains a number of exceptions to the insider trading liability provisions. One exception which has been given statutory recognition under the Act is the "Chinese Wall". That exception is contained in sections 8, 10, 12 and 14 of the Act. This article looks at the effectiveness of the Chinese Wall exception in the context of protecting advisors of public issuers from liability under the Act and at common law.

The term "Chinese Wall" broadly describes arrangements made by a firm to ensure that inside information possessed by one part of the firm about a public issuer is not communicated to another part of the firm. Before considering the effectiveness of Chinese Walls under the Act, it is necessary to give a brief overview of the Act.

2 Overview of Insider Trading Provisions

The main provisions of the Act dealing with insider trading are contained in sections 7 to 14 of the Act. In essence, those provisions prohibit an insider from dealing or tipping (ie: advising or encouraging someone else to deal) in securities of a public company in which the insider has inside information.

The meaning of "inside information" and "insider" are central to the application of the Act. "Inside information" is defined as information, in relation to a public issuer, which is not publicly available, and which would or would be likely to affect the price of the securities if it were publicly available.[1] That definition makes it clear that the Act only relates to "insiders" of "public issuers". A public issuer is defined as a company or person that is, or that was at any time, a party to a listing agreement with a stock exchange.[2]

The definition of an "insider" is extensive and is contained in section 3(1) of the Act. Section 3(1) provides:

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1 Section 2 of the Act.
2 Idem.

(1) For the purposes of Part I of this Act, "insider" in relation to a public issuer means:
(a) The public issuer;
(b) A person who, by reason of being a principal officer, or an employee, or company secretary of, or a substantial security holder in, the public issuer, has inside information about the public issuer or another public issuer;
(c) A person who receives inside information in confidence from a person described in paragraph (a) or paragraph (b) of this subsection about the public issuer or another public issuer;
(d) A person who, by reason of being a principal officer, or an employee, or company secretary of, or a substantial security holder in, a person described in paragraph (c) of this submission, has that inside information;
(e) A person who receives inside information in confidence from a person described in paragraph (c) or paragraph (d) of this subsection about the public issuer or another public issuer;
(f) A person who, by reason of being a principal officer, or an employee, or company secretary of, or a substantial security holder in, a person described in paragraph (e) of this subsection, has that inside information.

This definition covers the public issuer, any director, company secretary, employee or substantial security holder (being a person or company holding a relevant interest in at least 5 percent of the voting securities of the public issuer)[3] who by reason of that position has inside information.[4] The definition also covers persons to whom inside information is passed in confidence by those insiders,[5] and confidants of those persons.

3 Note also the broad definitions of "security", "relevant interest" and "voting security" in s 2(1) of the Act. These definitions extend the persons who will be treated as insiders of public issuers under the Act. Section 6 sets out circumstances in which "relevant interests" are to be disregarded. However, in this article it is not intended to focus on who can be "insiders" under the Act. Rather, the author's intention is to discuss the effectiveness of Chinese Walls for insiders who are advisors of public issuers.

4 It should be noted that for a person to come within the definition of an insider under the Act, it must be shown that the person was *in receipt* of inside information. In certain circumstances, however, information held by a member or employee of the firm is, by law, imputed to the firm: see infra. Section 3(2) provides that an insider of a public issuer who has the position as a principal officer, employee, company secretary or substantial security holder of an insider and who has inside information about the public issuer or another public issuer is presumed in the absence of evidence to the contrary to have that insider information by reason of that position.

5 The advisors of public issuers who would seem to be caught by the definition would include lawyers, accountants, investment advisors, bankers, sharebrokers, and merchant bankers. To be an insider those persons must receive the inside information in confidence. It is unlikely that financial analysts would ever be caught by the definition. In most cases information given to analysts (even if non-public information) is not given in confidence, rather it is expected and intended that the analyst will disclose that information to others. Note, however, that a person disclosing inside information to an analyst may breach the provisions of the Act. In *SEC* v *Dirks* 463 US 646 (1983) the US Supreme Court held that an analyst of a broker dealer firm who received inside information from corporate insiders that the corporation's assets were vastly overstated as a result of fraudulent corporate practices, did not breach the provisions of Rule 10b-5 in disclosing that inside information to clients and others who then sold stock held in the corporation. One of the reasons that the Supreme Court gave for its decision was that the analyst did not receive the information in confidence. Note also that the analyst did not personally benefit from the inside information and his disclosure was for the purpose of disclosing the fraudulent corporate practices.

The Act imposes liability on insiders who breach the provisions of the Act relating to insider trading.[6] The liablility provisons under which advisors to public issuers can be liable are sections 7, 9, 11 and 13 of the Act. Section 7(1) applies where an insider of a public issuer who has inside information about the public issuer buys or sells securities of the public issuer. Section 9(1) relates to tipping by insiders of public issuers who have inside information about the public issuer and who tip others about the public issuer's securities. Section 11(1) relates to insiders of public issuers who have inside information about another public issuer and who buy securities of that other public issuer from any person, or who sell securities of that other issuer to any person. Section 13(1) relates to insiders of public issuers who have inside information about another public issuer and who tip others about the securities of the other public issuer.

It is important to note that an insider will not be liable under the insider trading liability provisions referred to in the preceding paragraphs if the insider uses inside information in deciding not to buy or not to sell securities of a public issuer in respect of which the insider has inside information, or if the insider uses that information to tip others not to buy or not to sell securities of the public issuer.[7]

The insider will be liable to the public issuer in relation to which he is an insider and the persons with whom he or his tippee traded.[8] The quantum of damages is set as the amount of the gain made or loss avoided by the insider or tippee.[9] The gain or loss is calculated by comparing the value of the securities at the time of the dealing by the insider with the value the securities would have had if the inside information used by the insider had been publicly known.[10] The court may also impose an additional pecuniary penalty on the insider of an amount up to three times the amount of the gain made or the loss avoided, or the consideration paid for the securities.[11]

The Act contains a number of unusual enforcement provisions.[12] Section 17 provides that members of the public issuer or persons who were members at the date the securities were bought or sold, and who consider

6 See ss 7, 9, 11 and 13 of the Act.

7 Presumably the policy reason for this is that there will be few (if any) persons harmed in those circumstances. The other, and more practical reason, is the virtual impossibility of proof in most cases. It is possible that in some circumstances the public issuer in respect of which the insider did not trade or the public issuer in respect of which the person is an insider may have an action at common law against the insider. (eg for breach of fiduciary duty). The Act does not expressly abrogate the common law.

8 See ss 7(2), 9(2), 11(2) and 13(2) of the Act.

9 Idem.

10 See s 15 of the Act.

11 See ss 9(4), 11(4), 13(4) and 16 of the Act.

12 See ss 17 and 18 of the Act. Note that under ss 17 and 18 of the Act there is no provision for the Securities Commission to bring an action against insiders who breach the provisions of the Act. If parliament accepts the recommendations of the "Report of the Ministerial Committee of Inquiry into the Sharemarket", 31 March 1989, then it is likely that the Supervisory Authority recommended in that Report will be given the power to enforce the provisions of the Act (see page 8 of that Report). It is not open to public issuers and their insiders to contract out of the provisions of the Act (see s 4 of the Securities Act 1978 and s 1 of the Act).

that the public issuer may have a cause of action against an insider, may require the public issuer to obtain an opinion from a barrister or solicitor approved by the Securities Commission on the question of whether or not the public issuer has a cause of action against the insider.[13] Section 18 provides that the public issuer's right of action against the insider may, with the leave of the Court, be exercised by a member of the public issuer or a person who was a member of the public issuer at the time the securities the subject of the complaint were bought or sold by the insider.[14]

As noted above, sections 8, 10, 12 and 14 of the Act set out a number of exceptions to the insider trading liability provisions, including the Chinese Wall exception.[15]

In essence, the Chinese Wall exception contained in those provisions provides that no action can be brought against an insider of the public issuer under the Act if arrangements exist to ensure that no person who made the decision to buy and sell securities or advised others in connection with the purchase or sale of securities, received, or had access to, inside information or was influenced by a person who had inside information about the public issuer; and no person who took part in the decision to buy or sell securities or advised others in connection with the purchase or sale of securities received, or had access to, inside information about the public issuer or was influenced by a person who had inside information about the public issuer.

There are a number of important preliminary points which should be considered. The first is that the Chinese Wall exceptions never apply where it can be shown that the individual who traded or passed on inside information was in possession of the information and the information was received by virtue of the fact that he was an insider.

The Chinese Wall provisions are intended to operate in the situations where a member or employee of a firm (be it a company, partnership, unit trust or other association) receives inside information and another member or employee, without knowledge of the information, either trades or advises another to trade. In this case, the problem arises from the fact that in certain circumstances, information held by a member or employee of a firm is, by law, deemed to be held by the firm.[16]

13 See ss 17(1) and (2) of the Act. On the language of s 17(1) of the Act it is arguable that before a shareholder can exercise the rights conferred by ss 17 and 18 of the Act, the shareholder must establish that the person in respect of which the complaint is made is an "insider" for the purposes of the Act. It is not intended to discuss this aspect further in the context of this article.

14 Section 18(1).

15 An exception also exists in respect of a formal takeover made in accordance with s 4 of the Companies Amendment Act 1963. See ss 7(2) and 12(1) of the Act. There is a further exception contained in s 12(3) of the Act. Under that exception an insider is exempted from liability under s 11(3) of the Act if the insider first obtains the consent of the public issuer to whom he or she is an insider, to that purchase or sale of securities.

16 The firm could be liable on agency principles. See Halsbury's Laws of England, Vol 1, paras 833-834; *Re Hampshire Land Company* [1986] 2 Ch 743, 749; *Re Fenwick, Stobard & Co* [1902] 1 Ch 507, 511.

3 *The Chinese Wall Exceptions*

The Chinese Wall exception as it applies to corporate advisors,[17] first appears in section 8(3) of the Act, which provides:

> No action shall be brought against an insider under section 7 of this Act, in relation to the sale or purchase of securities in a public issuer, if –
> (a) Arrangements existed to ensure that no individual who took part in the decision to buy or sell the securities received, or had access to, the inside information or was influenced, in relation to that decision, by an individual who had the information; and
> (b) No individual who took part in the decision to buy or sell the securities received, or had access to, the inside information or was influenced, in relation to that decision, by an individual who had the information.

There are two elements to section 8(3) which must be satisfied before an insider can avoid liability under section 7 on the basis of this exception. First, the insider will need to establish that arrangements existed to ensure that no individual who bought or sold securities received, or had access to inside information, or was influenced in relation to that decision by a person who had the information. Secondly, that no person who took part in the decision to buy or sell the securities received or had access to inside information, or was influenced in that decision, by an individual who had the information. The exception therefore does not apply to protect insiders[18] from liability under section 7 where those insiders use inside information to buy or sell securities in the public issuer.

Another issue is, what is meant by the term "the information"? That is, does the term refer to the nature of the information, or its source? Consider the following not too unlikely scenario. Employee A of a sharebroking firm receives inside information in confidence, to the effect that X Co is going to make a bid for Y Co. The next day Employee B of that firm learns the same information from the Managing Director of X Co, who says that it is not confidential as X Co is going to make an announcement. Before X Co's announcement is made, B calls the firm's clients and advises them to buy X Co shares.[19]

It is apparent that the firm when it gave the advice had "the information" and, notwithstanding the Chinese Wall, the person giving the advice also had "the information" in the sense that he had the same knowledge. One assumes courts will take a common sense approach and recognise that if the purpose of the Act is to be achieved, then the term "the information" means the information which passes in a straight line from X Co to A to B.

17 Section 8(1) also provides an exemption for officers, directors and employees of public issuers which allows public issuers to put procedures in place to prevent insider trading in their own securities.

18 The definition of insider would catch employees and officers of an advisor to a public issuer who are, or who are deemed to be, in receipt of inside information.

19 In these circumstances the managing director would be liable for tipping under ss 9 and 13 of the Act, unless he took steps to ensure that B did not use the information until it was publicly available information. B, of course, is not liable because he did not receive the information "in confidence".

The most common situation where the exception in section 8(3) will be invoked is where the insider is an advisor to the public issuer and an officer or employee of the advisor obtains inside information about the public issuer in the course of advising the public issuer, and another officer, employee or substantial security holder of the advisor who is not in possession of, or does not have access to the inside information and is not influenced by a person with inside information, purchases or sells securities in the public issuer in the course of employment either on behalf of the advisor firm or in connection with its business. The public issuer or a person from whom the securities are bought or sold subsequently brings an action against the advisor firm under section 7 of the Act. If it were not for the exception the advisor firm would be liable under section 7.

For example, a stockbroking firm has an advisory division and broking division. The firm puts in a place a Chinese Wall policy pursuant to section 8(3) of the Act, so that persons in the broking division do not have access to inside information acquired by the advisory division. Employee A in the firm's advisory division acquires inside information about a public issuer in the course of advising that issuer about a merger and takeover proposal. Employee B in the firm's broking division who is not in receipt of the inside information, nor has access to it and who is not influenced by A, by virtue of the firm's Chinese Wall policy, purchases shares in the public issuer on the stockbroking firm's behalf. Shortly after the purchase the public issuer makes a public announcement about the merger and takover and its share price increases. If the person from whom B purchased the shares of the firm's behalf brings an action against the firm under section 7 the firm can avoid liability by virtue of section 8(3).

The exception in Section 8(3) is inappropriate for use by officers or employees in the public issuer. If the public company has a procedure in place under section 8(1) which has been approved by the Securities Commission (by notice in the Gazette and which has not been withdrawn) then officers or employees of the public issuer can rely on the exception in section 8(1) to avoid liability under section 7. Section 8(1)(b) provides that no action can be brought under section 7 of the Act against a director, company secretary or employee of a public issuer who has bought or sold shares in the public issuer, if in buying or selling the securities the person complied with a procedure implemented to ensure that no such person who has inside information uses that information in buying or selling securities of the public issuer for personal gain.[20]

It seems obvious that an officer or employee cannot rely on the exception in section 8(1)(b) to avoid liability under section 7 if the officer or employee used inside information he or she acquired by virtue of that position to trade in securities of the public issuer. It is reasonable to assume that the Commission will only approve procedures that prohibit trading by an officer or employee with material non-public information.

20 The Chairman of the Securities Commission, Colin Patterson, has made a number of public statements to the effect that the Commission considers it desirable that those involved in public companies hold shares in those companies. See C I Patterson "Insider Trading" [1988] NZLJ 72. In a seminar in Wellington recently, the Chairman stated that the exception contained in s 8(1) was intended to be an absolute defence.

Although common law principles of agency do not usually operate to deem employees to be possession of all information held by their principals, if it were not fot the exception set out in section 8(1)(b), officers or employees who traded in securities of the public issuer and who were not in receipt of inside information or who were not in receipt of inside information about the public issuer by virtue of that office, could potentially face actions being brought against them under section 7 by the persons with whom the officer or employee traded. This is because the lack of the connection is not readily apparent to outsiders. Thus, it would appear that the constitution of such procedures is as much a matter of public relations as good law. If the officer or employee can show that they complied with a procedure of the sort described above, then it is more likely that court will find that the officer or employee did not use inside information in trading in the securities.

Public issuers should seek legal advice now (given that the Act is already in force) as to what sorts of procedures will satisfy the Securities Commission under section 8(1).[21]

The Chinese Wall exception is also recognised in sections 10, 12(2) and 14 of the Act. Those sections are similar to section 8(3). Section 10 provides that no action shall be brought under section 9 (which prohibits an insider tipping about securities of a public issuer) if the requirements set out in the section (which are identical to those set out in section 8(3)) are satisfied. For example, if in the factual situation set out above the broker recommends the public issuer's shares to a customer, the firm can only avoid an action under section 9 by virtue of section 10.

Section 12(2) and 14 are similar in operation. Section 12(2) provides that no action shall be brought under section 11 (which prohibits an insider from trading in securities of another public issuer the insider has information about) if the requirements of that section are satisfied. Section 14 provides that no action shall be brought under section 13 (which prohibits an insider tipping about securities of another public issuer the insider has information about) if the requirements of that section are satisfied. The requirements of section 12(2) and 14 are identical to those set out in sections 8(3) and 10. For example if our friend employee A learns in confidence from the managing director of X Co that X Co intends to make a bid for Y Co, then, in the absence of an effective Chinese Wall, the broking firm will be liable if B, without having received the information, buys on the firm's behalf or advises clients to buy, shares in Y Co.

4 Problems with Chinese Walls Under the Act

There are problems with the Chinese Wall exception. The Act does not set out what "arrangements" will be effective to avoid liability under section 7, 9, 11 and 13 of the Act. Unlike the exception contained in section 8(1) there is no provision in the Act for the Securities Commission to approve arrangements. Also, the exceptions in sections 8(3), 10, 12(2) and 14 only protect advisors from liability under the Act. The question therefore

21 To date the Securities Commission has given no indication as to what sorts of procedures it will give approval to under s 8(1)(c) of the Act.

arises whether the existence of a Chinese Wall, which is sufficient to protect a firm from liability under the Act, protects a firm from liability at common law. These issues are discussed below.

5 *What is Required for a Chinese Wall to Protect Advisors Under the Act?*

The Act does not give any guidelines as to what will be an effective Chinese Wall under the Act. In a verbal discussion with an officer of the Securities Commission, the author was told that, to date, the Commission has not finally considered the question of what will be an effective Chinese Wall. It was, however, noted that the wall would need to be enforced and not a "papier mache" wall. It is difficult to give any general statement as to what will be a satisfactory procedure for advisors of public issuers. The sorts of arrangements will vary depending on the type of advisor firm, the size of the advisor firm etc. Indeed, the sorts of arrangements that should be put in place may justify discussion in a separate article. In this article it is intended to give an indication of the sorts of procedures that may be appropriate in conjunction with a Chinese Wall policy. Advisor firms will need to seek specific legal advise as to the nature of the arrangements they should put in place. Some guidance can be obtained from United States practices put in place by advisors in order to avoid liability under its insider trading legislation.

There are essentially two aspects to compliance programmes used in the US. The first is employee education and the second is isolation of inside information to only those persons within a firm that need to know the inside information. That approach would seem appropriate in the New Zealand context.[22] It will be virtually impossible for firms to avoid insider trading if their officers and employees do not know what constitutes insider trading. In addition, firms will not be able to take advantage of the Chinese Wall exception in the Act unless they can establish that the Chinese Wall was not breached — that requirement necessitates that information be isolated and can be proved to have been isolated.

Employee education in any compliance programme should include the following aspects: an explanation to employees as to what constitutes insider trading, an explanation as to what information is inside information, the fact that insider trading is illegal, an explanation of the provisions of the Act, and an explanation of the firm's policy about insider trading, including the consequences for employees found guilty of insider trading and an explanation of the firm's procedures to avoid insider trading. Education programmes should always be reproduced in writing and the firm should be able to demonstrate that the information has been given to new employees at the time they joined the firm. Employees should be given regular reminders about the firm's policy.[23]

22 In order for a firm to take advantage of the Chinese Wall exceptions in the Act, a firm needs to satisfy both elements of the exception. In short, that a Chinese Wall existed, and that the Chinese Wall was not breached.

23 I M Pollack *Practical Measures to Reduce the Likelihood of Insider Trading* (1987). See also W H Painter *Federal Securities Code and Corporate Disclosure* (1979).

In seeking to isolate information for the purpose of developing an effective Chinese Wall, firms should seek to include the following aspects:[24] inside information should be restricted within a particular division and should not be made available to other divisions. A senior person in each division or department should be designated to determine whether information received by the department is inside information. If possible divisions should be physically separated. For example the broking division of a sharebroking firm should be physically separated from the investment advisory division. The author has been advised that a number of New Zealand sharebroking firms already physically separate their investment advisory and broking divisions.[25] In those cases the divisions operate from different levels of a building. There should not be common supervision of divisions on different sides of the Chinese Wall except at the highest level. Employees of one division should be restricted from access to files and personnel of another. If practicable there should be restrictions on transfers within the firm; personnel should not be immediately transferred from one side of a Chinese Wall to the other. Computers are a major problem as in some circumstances the ability to access the name of a client may constitute important information.

Advisors whose business is share trading should also put in place some sort of monitoring system pursuant to which they can monitor purchases and sales of securities by the firm. The purpose of such a monitoring system would be to give the firm information, which it could use as a basis for identifying whether members of the firm had used inside information to purchase securities on the firm's or a customer's behalf. For example, an unusual increase in trading of a particular security of a public issuer by the firm immediately prior to an announcement by the public issuer which should have the effect of affecting its securities price (such as a merger or takeover announcement), may indicate that members of the firm possessed inside information about the public issuer and used that information in trading the securities.

6 Will the Chinese Wall Protect an Advisor Firm from Liability at Common Law?

The issue as to whether a Chinese Wall will prevent a firm from liability at common law has been considered in a number of US decisions, but has not yet been considered under the Australian or English insider trading legislation.

24 These are based on Pollack, supra n 23 at 30-31.

25 The author understands that at least one New Zealand sharebroking firm which has a broking division and investment advisory division is as a result of the Act considering separating those functions completely, by way of having a separate subsidiary company conducting the investment advisory business. The companies would operate as separate businesses. In the author's view that is an effective although extreme solution to the problems created by the Chinese Wall, in view of the author's suggested solution in sections 6 and 7. It would, however, overcome the problem caused by information being deemed to have been received from one division of a firm to another. Care would still need to be taken that inside information was not tipped by one company to another, in circumstances that would make that company an insider of a public issuer.

(a) The American Cases

The decision of *Re Cady, Roberts & Co*[26] established the "disclose or abstain rule". In that case, an employee of a brokerage firm was also a director of a public company. At a directors' meeting of the public company, the employee learned that the public company was about to announce a reduction in its dividend. The employee director passed this information on to another partner in the brokerage firm. Before the information became publicly available, the partner sold shares in the public company out of a number of customers' accounts. The SEC held that there had been a breach of the American insider trading rules as contained in Rule 10b-5. It stated that corporate insiders and tippees have a duty to disclose material facts known to them by virtue of their position, and which are not known to the persons they are dealing with, and which, if known, would affect the investment decision. It held that in the circumstances, failure to disclose constituted fraud and was a breach of Rule 10b-5.[27] The SEC noted that where disclosure was inappropriate the transaction should be forgone.[28]

The SEC rejected the defence that the tippee's fiduciary duty to his clients required him to use the insider information on his customers' behalf. The fiduciary obligation to the customer was held to be secondary to the obligation not to use inside information.[29] The decision, however, left it unclear whether a firm could be held liable at common law for breach of fiduciary duty for not using inside information on its customers' behalf.[30]

In *Black* v *Shearson, Hammill & Co*[31] a partner of Shearson obtained adverse inside information about a client company, USAMCO, in his capacity as an advisor to, and director of, USAMCO. The partner did not disclose the adverse inside information to Shearson's trading department who were strongly recommending USAMCO's securities. Customers of Shearson who brought USAMCO securities on the basis of the firm's recommendations brought proceedings against the firm, arguing that Shearson, by recommending the securities while in possession of adverse inside information, breached the common law duty owed by a broker-dealer to its customers. Shearson admitted it had a fiduciary duty to the plaintiffs but argued that it had a second and higher duty to the company not to disclose the inside information.

The court affirmed that the firm had a fiduciary duty to disclose material information to its customers and the failure to do so constituted fraud. It noted that one set of duties could not be avoided by assuming another. It said:[32]

26 40 SEC 907 (1961).

27 In the *Cady, Roberts* decision, the circumstances which required disclosure of inside information or forgoing the transaction, were those in which the insider *possessed* inside information. In *Dirks* v *SEC* 463 US 646 (1983), the Supreme Court held that the duty imposed by the *Cady* decision was a duty to refrain from trading on inside information compared to mere possession. See also "Chinese Wall or Emperor's New Clothes? (2)" N S Poser (1988) 9 The Company Lawyer 159.

28 *Cady, Roberts* at 911.

29 Ibid 916.

30 Poser, supra n 27.

31 266 Cal App 2d 362, 72 Cal Repts 157 (1968).

32 Ibid 161.

> The officer-director's conflict in duties is the classic problem encountered by one who serves two masters. It cannot be resolved by weighing the conflicting duties; it should be avoided in advance . . . or terminated when it appears.

A factor which may have persuaded the court to reach its decision was that the partner who received the inside information had placed some of USAMCO's initial public offering with personal clients and acquired a sizeable block of securities himself.[33] On receipt of the adverse information the partner sold much of his own and personal customer's stock, but at the same time encouraged Shearson's salespeople to recommend purchases of the securities to other customers. The partner's noncommunication of the adverse inside information therefore appears not to have been in pursuit of the Chinese Wall policy, but rather to further his personal interest at the expense of the firm's customers.

In *Re Merrill Lynch, Pierce, Fenner & Smith Inc*[34] Merrill Lynch was the managing underwriter of proposed offering of convertible debentures by Douglas Aircraft Co Inc. A registration statement for the offering was filed with the SEC on June 7 and became effective on July 12. Subsequently, Douglas advised Merrill Lynch's underwriting department that owing to production problems, Douglas had substantially revised its previously announced earnings downwards. Before the material adverse information was publicly announced, Merrill Lynch's underwriting department disclosed the information to persons in its institutional sales department. The institutional sales department then disclosed the information to several of its larger institutional customers. Those customers sold their stock. However, Merrill Lynch did not disclose the information to other customers who purchased Douglas stock before the public announcement and after it received the adverse information. In one action Merrill Lynch was held liable in damages to those customers who purchased Douglas stock in the open market without knowledge of the material inside information possessed by Merrill Lynch.[35]

The SEC also brought proceedings against Merrill Lynch for violating Rule 10b-5. Merrill Lynch settled the action without admitting the allegations. As part of the settlement it agreed to take measures to prevent insider trading. Those measures included the establishment of a Chinese Wall. However, the SEC expressed doubt about the effectiveness of the Chinese Wall. It said:[36]

> As a matter of Commission policy we do not, and indeed cannot, determine in advance that the Statement of Policy will prove adequate in all circumstances that may arise. Stringent measures will be required in order to avoid future violations. Obviously the *prompt* public *dissemination of material information* would be an effective preventative and [Merrill] has stated that it will use its best efforts to have the issuer make public any material information given to its Underwriting Division.

33 That view is endorsed in an article by M Lipton & R B Mazur "The Chinese Wall Solution to the Conflict Problems of Securities Firms" (1975) 50 NYULR 459, 477.

34 43 Sec 933 (1968).

35 See, for example, *Shapiro* v *Merrill Lynch, Pierce, Fenner & Smith Inc* 495 F 2d 228 (2d Cir 1974).

36 Supra n 34 at 935. That approach seems equally applicable to the New Zealand situation.

In *Slade* v *Shearson, Hammill & Co Inc*[37] the plaintiffs argued that Shearson promoted the purchase of Tidal Marine International Corporation (Tidal Marine) securities, an investment banking client of Shearson, when Shearson was in possession of adverse inside information about the company. Shearson denied that it had knowledge of the adverse information and argued that if it did, such knowledge was confined to its investment banking department which, by virtue of its Chinese Wall policy, prevented it from disclosing the information to the firm's trading department, until the information was publicly available.

The District Court did not accept Shearson's defence that its Chinese Wall policy and obligations to Tidal Marine precluded it from liability to other clients who purchased Tidal Marine securities on the basis of recommendations of the firm's trading department when another branch of the firm was in possession of material adverse information.

In that case the issue as to whether an investment banker/securities broker who receives material adverse non-public information about an investment banking client is precluded from soliciting customers for the client's securities on the basis of public information which (because of its possession of inside information) it knows to be false or misleading, was certified to the United States Court of Appeal. The Court of Appeal refused to answer the question on the basis that there was an insufficient factual record and referred the matter back to the District Court. The report is interesting because of the arguments presented to Court by the various parties.[38] The SEC's approach[39] has formed the basis for much of the American securities industry's resolution of the issue raised by the *Slade* case.[40]

The Court of Appeal, Second Circuit, indicated in that case that it may not be possible to give a general statement of principle as to the effectiveness of a Chinese Wall to preclude a multifunction firm from liability to clients where one branch of the firm possesses adverse inside information about one client and because of the firm's Chinese Wall policy and obligations to that client, does not pass that information on to another branch of the firm recommending the securities of that client to other clients. The Court of Appeal stated that the matter may need to be resolved by a decision-making body other than the courts.

Shearson argued that as Tidal Marine's securities were not on its master buy list, and were only being recommended by retail salespeople on the basis of publicly available information, it should not be held liable to customers who followed the recommendations since the salespeople (due to the firm's Chinese Wall policy) did not have access to the inside information. The firm argued that it could not disclose that information to its customers without violating rule 10b-5.

The firm also had in place a restricted list. When a security was placed on this list, salespeople were not permitted to recommend the security either affirmatively or negatively. Shearson argued it could not put Tidal Marine

37 [1973-74 Transfer Binder] Fed Sec L Rep (CCH) 94,439, 517 F 2d 398 (2d Cir 1974).
38 See Painter supra n 23.
39 Discussed below.
40 See Poser supra n 27.

securities on this list, as in its view by doing so, it would be violating rule 10b-5 in that persons who would otherwise have made a bad trade would avoid doing so. In Shearson's view, the receipt of inside information by Shearson could not be allowed to influence other clients one way or the other, and the neutrality principle required that clients be permitted to continue to act as they would have done had they not received the inside information.[41]

A number of other firms not party to the immediate proceedings put arguments before the court on the certified question. One firm argued that the placing of a security on a restricted list and the withdrawal of a recommendation would be seen by customers as a signal that the firm had received adverse inside information about the security.

The SEC rejected Shearson's arguments. In its view Shearson could reconcile its duty to customers under the shingle doctrine and its obligations under rule 10b-5 (not to tip or disclose) by placing the securities on its restricted list. Under the shingle doctrine, the SEC argued, when a broker hangs out his "shingle" to solicit customers, he implicitly represents to them that he will deal fairly with them and that he knows the securities he recommends, or at least will not recommend securities when he had adverse information about those securities.[42]

The SEC argued that Shearson could follow the neutrality principle and place securities on its restricted list, without that fact indicating that Shearson was in possession of inside information if it followed a practice of placing securities on that list whenever it entered into an investment banking or confidential relationship with a client. In the SEC's view such a practice would reconcile the firm's conflicting duties to its customers, clients and investing public. Once a security was placed on the firm's restricted list nobody in the firm would be permitted to recommend the security or initiate transactions where the firm operated discretionary accounts. Unsolicited agency trades would be permitted.

Underlying the SEC's approach is the view that if customers are made aware of the purpose of the restricted list then the placing of a security on that list will not act as a trigger to the market. Customers should be made aware of the firm's policy that a security will be placed on a restricted list whenever the firm enters into an investment banking or confidential relationship with the issuer of the security, rather than when the firm receives inside information about the issuer.

Since the *Slade* case, American multiservice firms have moved to overcome their conflicting obligations by adopting the reinforced Chinese Wall.[43] The reinforced Chinese Wall combines a Chinese Wall policy with the use of a restricted or watch list. The restricted list has already been discussed. A watch list consists of a list of securities with respect to which the firm has inside information. The list is used to monitor the effectiveness

41 See Lipton & Mazur supra n 33 at 482-87.

42 It seems to the author that a broker dealer such as Shearson in the *Slade* case could avoid conflicting duties to different clients by announcing its policy to clients and thus avoid an "implicit" representation.

43 See Pollack supra n 23.

of the firm's Chinese Wall. The contents of the list are only disclosed on a need to know basis. The problem with the watch list is that since it only monitors the effectiveness of the firm's Chinese Wall, the firm may not be aware that a breach has occurred until after the event, leaving the firm open for action at common law as in the *Slade* case.

The use of the Chinese Wall was recognised by the SEC in the *Slade* case as a measure to prevent the misuse of inside information. However, neither the court or the SEC regarded the Chinese Wall as relieving a firm from liability at common law.[44] The SEC has recently recognised the Chinese Wall as a defence in certain limited cirumstances. That recognition is expressed in Rule 14e-3[45] but does not relieve a firm from a claim at common law for breach of fiduciary duty. Neither does the exception protect the firm if it trades in the securities for its own account. The Chinese Wall is also regarded as having received recognition in the US in the provisions of the Insider Trading Sanctions Act 1934. In both cases, however, the defence is only regarded as having limited usefulness.[46]

(b) The English Position

The Chinese Wall has received recognition in England under the Financial Services Act 1986 and the Conduct of Business Rules adopted by the Securities Investment Board ("SIB") under the Act. Many aspects of the legislation are similar to legislation proposed in the Report of Ministerial Committee of Inquiry into the Sharemarket recently released in New Zealand. Under the Act the Department of Trade and Industry has power to regulate investment business in the UK. The Act permits the Department to transfer many of its functions to the SIB. The SIB is a quasi-governmental organisation and has power to recognise self-regulating organisations ("SRO's") The SIB has proposed various rules to regulate investment business. An SRO's rules must give investment protection equivalent to the rules of the SIB.

The Act authorises the use of Chinese Walls in certain circumstances and provides that an SRO may adopt rules which recognise the Chinese

44 Poser, supra n 27 at 161.

45 Rule 14e-3 was adopted by the SEC in 1980. The rule makes it illegal for a person who has acquired inside information about a pending tender offer from the offeror or target company to trade in the target's securities. However, the rule contains an exemption similar to our Chinese Wall exemption in sections 8(3), 10, 12(2) and 14 of the Act. A firm will not be liable under Rule 14e-3 if the person making the investment decision for the firm does not have the inside information and the firm has "implemented policies and procedures, reasonable under the circumstances, taking into consideration the nature of the [firm's] business, to ensure that individual(s) making investment decision(s) would not violate [the prohibition against trading], which policies and procedures may include, but are not limited to, (i) those which restrict any purchase, sale and causing any purchase and sale of any such security or (ii) those which prevent such individual(s) from knowing such information" (See Rule 14e-3 (b) (2)).

46 See Poser supra n 27 at 162-163.

Wall. The SIB rules provide for the use of the Chinese Wall as a defence to a breach of a number of rules regarding insider trading.[47]

It has been noted that neither the Act nor the SIB's rules provide that a Chinese Wall will be a defence to an action brought at common law against a firm for breach of fiduciary duty to a customer.[48] The English Courts have yet to indicate whether the Chinese Wall defence provided for in the SIB's rules will relieve a firm from an action at common law.

(c) The New Zealand Position

The US cases indicate that there, a firm which puts in place a Chinese Wall policy to avoid breaches of their insider trading rules, may nevertheless be liable at common law to a customer the firm advises about securities of which the firm possesses inside information, but which is not available to the particular advisor by virtue of the firm's Chinese Wall policy.

What approach a New Zealand court will take to the issue raised in the previous paragraph is yet to be seen. Public issuers and their advisors need to take advice now as to the sorts of arrangements they should put in place to avoid liability under the Act, and what additional steps they should or can take (if any) to avoid liability at common law.

Whether or not an advisor firm would be held liable in New Zealand in a common law action in the circumstances outlined above would depend on a number of factors. One of the most important of these will be the approach the courts take to the existence of the statutory defences to insider trading under the Act when faced with a common law action. It may be that the existence of these defences will affect how the courts interpret the common law. The approach the courts will take remains an open question[49] and until that issue is resolved, public issuers and their advisors should seek to minimise any potential liability at common law.

Depending on the approach of a New Zealand court takes to the statutory defences under the Act, whether or not an advisor firm would be liable in New Zealand at common law in the circumstances outlined would depend on the nature of the particular relationship between the advisor and

47 The "Report of Ministerial Committee of Inquiry into the Sharemarket" recommended that a Supervisory Authority ("SA") be established to oversee the laws and rules of the New Zealand public securities market. The SA will have power to approve rules of Self-Regulating Organisations ("SRO's"). It may be that rules of SRO's recognising Chinese Walls will receive approval of the SA. It would be appropriate for SRO's and other advisors to public issuers to lobby parliament to clarify the position of the "Chinese Wall" in the context of the common law, when legislation is passed to implement the Report.

48 Poser supra n 27 at 169. It is implicit in that author's article that a common law fiduciary duty exists in the United Kingdom in the circumstances outlined in the *Slade* case.

49 In a telephone discussion with the Executive Director of the Securities Commission, Mr Farrell stated that the Securities Commission intended that the statutory defences in the Act would be an absolute defence for firms and that firms which introduced compliance programmes under the Act would be immune from liability at common law.

customer.[50] Depending on the nature of the relationship the firm could be held liable in contract,[51] tort,[52] or breach of fiduciary duty.

The most likely cause of action would seem to be an action for breach of fiduciary duty to one client, on the grounds that the firm failed to disclose all relevant information (which includes inside information) in advising the client.

In order to succeed the client would need to establish that:

(a) the firm was acting as its agent in the transaction (that requirement would not in most circumstances be difficult for the client to establish);[53]
(b) that the firm breached its duty of undivided loyalty to its principal (the client) by:
  (i) failing to disclose relevant information possessed by the agent (the firm) in respect of the transaction;[54] and
  (ii) by doing so the agent (the firm) placed its duty to its principal (the client) in conflict with other interests of the principal.

It is well recognised that a firm has a duty not to act where it has a conflict of interest.[55]

To establish that the advisor firm continued to act when in a conflict situation the client will need to establish that the firm was in possession of relevant information that it failed to disclose to the client. In many cases it will not be difficult for clients to establish this.[56]

It should be noted that it is not a breach under the Act for an advisor to fail to use inside information about a public issuer when advising a client (indeed the reverse is the case), nor is it a breach of the Act to use inside information to decide not to sell or not to buy securities of a public issuer

50 The result may be different depending on whether the adviser is a stock broker, solicitor, banker, accountant, or other professional. The obligations of each of these persons is complex and could well be the subject of separate articles.

51 Note that it is irrelevant under s 6 of the Contractual Remedies Act 1977 that a misrepresentation is innocent. In general, however, a statement of opinion is not actionable. See F Dawson & D W McLauchlan *The Contractual Remedies Act 1979* 15-18. In many cases, statements by advisor firms will be statements of opinion and, therefore, in general, not actionable, provided that the opinion is genuinely and reasonably held.

52 Any action in tort would be based on negligence. It is not intended to canvas the likelihood of success of such an action in this article.

53 See N S Poser "Chinese Wall or Emperor's New Clothes? (1)" (1988) 9 The Company Lawyer 123, where the author recognises that a securities firm could be liable in the circumstances outlined in the present article on the basis of agency principles.

54 See Halsbury's Laws of England Vol 1, paras 833-834. See also P D Finn *Fiduciary Obligations* (1977) 122.

55 See Finn supra n 54, 256.

56 Knowledge of an employee or officer of the firm will be imputed to the firm if the knowledge was acquired by the officer or employee in the course of his employment, was material to the transaction at issue and was required to be communicated by the officer or employee of the firm. See Halsbury's Laws of England Vol 1, paras 833-834. See also Poser supra n 27, 162.

or to tip others not to buy or not to sell securities of a public issuer. The Chinese Wall exceptions in the Act therefore do not cover these possibilities. Note, however, that a firm could be liable at common law in these various circumstances.

In the circumstances outlined in the previous paragraph, if the inside information was not passed to other clients of the firm by virtue of the firm's Chinese Wall policy then no action could be brought against the advisor firm under the Act.[57] The advisor firm could, however, face an action at common law from those clients to whom it did not communicate the inside information. In those cases the advisor firm would argue that the statutory recognition of the Chinese Wall under the Act should modify the common law not just in respect of actions in which firms seek to avoid liability under the relevant Chinese Wall exception in the Act, but in all other situations in which a firm does use inside information by virtue of its Chinese Wall policy.

A firm would need to argue that the Chinese Wall exceptions in the Act effectively recognise that where a Chinese Wall is in place, divisions on opposite sides of the wall have separate legal personalities, so that information acquired by one division is not imputed to the other division on the other side of the wall. It would need to be argued that this by implication also affects the Chinese Wall in all situations at common law where, by virtue of a Chinese Wall policy, inside information is not used by a firm. The author doubts that such an argument would be successful. It is the author's view that for a court to adopt such an argument, the wording of the Act would need to specifically override the common law. Accordingly, the author considers that advisor firms should take steps now to put in place procedures to avoid liability under the Act and at common law. In the following paragraphs the author considers the applicability of the US solution and puts forward a solution which she considers is appropriate in the New Zealand context for advisor firms to reconcile their conflicting duties under the Act and at common law.

It does not seem that the whole US solution (ie the reinforced Chinese Wall) to the conflict problem created in the circumstances outlined is a practical solution in the New Zealand context. Given that our securities market is considerably smaller it is probably not a practical solution for New Zealand firms to use a reinforced Chinese Wall (ie not recommend or advise about securities of a public issuer whenever the firm enters into a confidential relationship with the public issuer) to resolve the problem. However, at least one stockbroker has advised the author that the broker's firm presently uses a type of reinforced Chinese Wall. In that case, when the broker firm receives inside information about a public issuer, it advises its brokers that they cannot deal in securities of the public issuer either on their own behalf, the firm's or clients'. In the author's view, that approach is not a satisfactory solution to the problem. As the particular broker noted, that course of action (the firm refusing to allow its brokers to deal in a public issuer's securities when it is in receipt of inside

57 In that case, the firm would not have used the inside information. It is only persons having inside information who trade or tip that breach the Act.

information) effectively acts as a tip to persons seeking to trade in the particular securities – if they are told that for "undisclosed reasons" the broker firm is not dealing in those securities at the particular time.

In the New Zealand context a compromise position between the pure and the reinforced Chinese Wall seems an appropriate resolution to the problem. Although the position will not be clear until the courts or parliament resolves the issue it would seem sufficient on ordinary contract and agency[58] law principles for firms to vary their contracts with clients to provide that the firm will not make information available to the client pursuant to its Chinese Wall policy. This can be done by a letter of engagement for new clients and an information letter to existing clients offering to terminate the relationship if it is not satisfactory.

The suggested resolution also seems appropriate on the principles of a fiduciary's duties. It has been recognised that a fiduciary can act for two beneficiaries, where there is a conflict, so long as there is informed consent of the beneficiaries to the double employment, or alternatively where a beneficiary knew of the double engagement at the time of engaging the principal.[59]

On the basis of the contract, agency and fiduciary principles referred above, to avoid liability at common law, advisor firms should, when entering into contracts with their clients, make it clear that they operate a Chinese Wall policy within their firm and the consequences of that policy for the client. In doing so it should be made clear to clients that the firm will not accept any liability for the loss suffered by one client when inside information possessed by the firm about another public issuer is not made available to it, by virtue of the firm's Chinese Wall policy. Advisor firms would need to make their clients fully aware of the firm's policy and obtain an acknowledgment from the client that it agrees to accept the firm's advisory services on that basis, ie that the advisor firm will not pass on or use inside information which the firm has about a public issuer when advising the client by virtue of the firm's Chinese Wall policy, its obligations under the Act and its duty to loyalty to other clients.

Clients should be made aware that the firm's Chinese Wall policy will mean that the firm is unable to pass on adverse inside information the firm has about a public issuer to the client, or another member of the firm recommending the public issuer's securities to the client on the basis of publicly available information (that member of the firm will not have that information by virtue of the firm's Chinese Wall policy).[60] The consequence

58 See Halsbury's Laws of England Vol 1 para 729, where it is stated that:

> ". . . As between the agent and his principal, an agent's authority may be limited by agreement . . ."

59 See Finn supra n 54 at para 583.

60 It should be noted that it remains an open question in negligence cases whether a disclaimer of liability can protect a firm from liabilities. See R K Stephenson "The Role of the Stockbroker as an Investment Adviser – What Duty of Care." (1982) 12 VUWLR 139. In the author's view, there are different policy reasons, in the insider trading context, as to why a disclaimer should be effective. By implementing a Chinese Wall policy and by refusing to disclose inside information a firm receives about a public issuer to clients, an advisor firm is seeking to meet its obligations under the Act and its duty of loyalty to the public issuer client. However, the question is still to be decided.

of the firm's policy may mean that the client could invest in securities recommended by one member of the firm, when another member of the firm has adverse inside information about the security recommended, and suffer a loss as a result of acting on that recommendation – the client, by virtue of its agreement, will have no action against the firm in these circumstances.

In implementing the solution referred to above firms will need to take great care that clients are fully informed of the firm's policy and the consequences of the policy to the client. The firm will need to ensure that the Chinese Wall is not breached. If the wall is breached not only could the firm be liable under the Act but also at common law.

7 Conclusion

In certain circumstances, the Act protects an advisor firm which would otherwise be liable for insider trading under the provisions of the Act, on the basis of knowledge of officers or employees being imputed to the firm, if the firm has in place an effective Chinese Wall. The Act does not protect an advisor firm from potential liability at common law for failing to pass on inside information in its possession to its clients.

In order to rely on the statutory exceptions, advisor firms need to put in place arrangements to ensure that inside information is not received by persons on the other side of a Chinese Wall, that persons on the other side of a Chinese Wall do not have access to inside information from across the Wall, and are not influenced by persons from across the Wall with inside information. If put to the test, advisor firms will need to establish that they had arrangements in place to prevent the foregoing and, in addition, that inside information was not received by, available to, nor did it influence, the persons in the firm who made or took part in the decision to buy or sell the securities of the public issuer.

In this article a description has been given as to what sorts of general arrangements will be regarded as an effective Chinese Wall. Essentially, an effective Chinese Wall involves two elements. Firstly, advisor firms have to educate their officers and employees about insider trading and their obligations under the Act. Education programmes should be on an ongoing basis. Secondly, advisor firms need to take steps to isolate inside information within their firms, so as to prevent that inside information being used by other members of the firm on the firm's or on clients' behalf.

The issue has also been raised whether an advisor firm which has in place a Chinese Wall policy, can be held liable at common law, where one division of a firm which, by virtue of the firm's Chinese Wall policy, does not possess inside information about a public issuer purchases or sells securities of that public issuer or advises others about securities of that public issuer, in which another division of the firm possesses inside information. Although there is US authority for the view that advisor firms would be liable to their customers for any loss suffered by them as a result of purchasing securities in the public issuer on the firm's recommendations when the firm was in receipt of adverse inside information, it is not known whether a New Zealand court would find a firm liable in similar circumstances.

Whether or not a New Zealand court would do so, depends on a number of factors. One of the most important of these is the extent to which the New Zealand courts will be influenced by the fact that the Act recognises the Chinese Wall as a defence to insider trading under the Act, and that in many cases if firms disclose the inside information to their clients to avoid liability at common law, they will be liable under the Act. It should be noted that the New Zealand courts have in the past, in many cases, been reluctant to follow US case law.[61]

In the author's view, advisor firms should be able to reconcile their common law duties to make all relevant information available to their clients and their obligations under the Act, by expressly varying the terms of their ordinary contractual relationship with the firm's clients. This could be done by firms expressly advising their clients that the firm operates a Chinese Wall policy, what that policy is, and that the effect of this policy is that the firm will not be able to pass inside information to the client or use inside information when advising the client. Clients should be made aware that this policy may mean that the client could suffer a loss as a result of this policy. Firms should seek an express acknowledgment and agreement from clients that they accept the firm's Chinese Wall policy and will not hold it liable for any loss they may suffer as a result of the firm failing to provide inside information to them or in failing to use inside information when advising them.

It may be that parliament will clarify this issue when introducing legislation to put into place the recommendations of the Report of Ministerial Committee of Inquiry into the Sharemarket. Until such time, or until the courts clarify the issue, the position is not clear. However, the solution suggested in this article seems a practical one which should on the basis of ordinary contract principles, be recognised by the courts. Advisor firms and public issuers should, however, seek specific legal advice now on their obligations under the Act and at common law, with a view to introducing a compliance programme which will satisfy the firm's responsibilities under the Act and at common law.

61 It should be noted that there is no statutory recognition of the Chinese Wall as a defence in the U.S.