INSIDER TRADING - CHINESE WALLS FOR BANKERS

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I am going to talk today about two concepts that we have in common. One is the notion of Insider Trading and another is the notion of Chinese Walls. Our experiences are really quite disparate however, and it may be that we can collectively learn something from the differences between our two experiences.

We have in fact a non-law. There isn't any statutory prohibition on insider trading in the United States as such. That non-law however is quite vigorously and quite publicly enforced. Here in Australia you do in fact have a quite specific statutory scheme in s.128 of the Securities Industry Act and Codes. That, as I understand it, is not enforced, so it sits quite quiescent waiting for some active enforcement effort. What I am going to do is comment a little bit about our experience in the US, for what that is worth, in terms of our analysing what may happen here in Australia. I will then talk a little bit about the Chinese Wall issues which create larger problems for us than they do for you but we have some problems there in common.

Since we are all this afternoon going to be talking essentially about the same subject matter I have been asked to start off by stepping back a little bit and taking a look at some of the basic concepts that have to do with insider trading I would start by suggesting that there is a fairly significant ambivalence with regard to the basic social policies behind insider trading as a prohibition. I am going to give you some little evidence of that at least from my perspective from a position several thousand miles away from Australia.

The University of California at Berkeley which is known in our country as a bastion of liberal thinking - it is the place where a number of our major social movements started a couple of decades ago - recently invited as a commencement speaker to instil some right thinking in graduates a man named Ivan Boesky.

Now Mr Boesky stood up and made the following remarks which are quoted: "Greed is all right, by the way. I want you to know that I think greed is healthy." Now we could spend the rest of the

afternoon talking about that, and about a society based on that premise and whether it works efficiently. I have another quote for you; it comes from the Sydney Morning Herald. It happens to be not a quote of an Australia, they were quoting a New York stockbroker, who expressed a standard of morality. He did not believe gambling is a good idea. Somewhere in his basic code of ethics that is inappropriate. This broker said: "Look, everyone trades on insider information. Those who do not are just gambling".

We are holding a major two day conference when I return to the United States on this concept - true we have insider trading and in what direction our public policy should move - and that just coincidentally will also be back at the University of California at Berkeley and hosted by an organization called the National Center on Financial Services.

Our economists tell us that prohibiting insider trading is not such a good idea because in fact it creates efficient market mechanisms. It is a technique that rewards very efficient ferreting out of information that ought to in fact appear in the market place. They would add that the mechanisms in fact to prohibit insider trading are very expensive to put in place and they do something else. They block the transmission of all information, not just information that is appropriately characterised as material non-public insider information. I will talk about that further in a few minutes.

I should tell you that although the academics have not given up on that particular theme in our country I was handed as I was leaving San Francisco a document created by our Securities Industry Association (which comprises all of the major brokers in the United States) which suggested that they as an industry condemn insider trading, believe that it in fact does erode confidence from the market place. They wish to see enforcement if anything increased. What they would also like is a statutory definition of what constitutes insider trading so that they can understand what it is that is permitted and what it is that is not permitted.

The SEC has engaged in a major enforcement effort for the last several years against insider traders. Our exchanges have very sophisticated techniques, computer programmes for detecting trading on an individual trader basis that might be suspect, and investigations are launched as these computerised statistics are generated and compared with what should happen and indicators show there may be insider trading taking place.

The newspapers are filled with the Ivan Boeskys. He is paying $100,000,000 in fines. Now he is barred from trading for the rest of his life, will be subject to one felony count, buy they are going easy on him. The reason they are going easy on him is that he is turning essentially State's evidence and is fingering a large number of very nervous people in New York, in Los Angeles

and in other locations. It is not just the traders themselves that are going to jail. There is a lawyer from a very prominent Wall Street firm who will spend a year as a guest of our government. There are two brokers also spending time, a year apiece.

Now that is not particularly the kind of sanction that any of you would like to have applied to you or your clients. The whole concept, it is believed, may be a water shed for a major social movement in our country, believe it or not. Many of the commentators think that the present "me" generation, the "yuppies", the people for whom materialism is the goal in life, who took over from a very idealistic generation that essentially had power for a period of about ten years from the mid-60s to the mid-70s are singing their swan song with these disclosures and with these prosecutions.

The law on this subject in the United States springs from a single piece of depression era legislation. Our Securities Exchange Act of 1934. It has just two provisions of which you hardly ever hear much about. One is s.16(b) by designation which permits the recovery of any profits made by insiders (these are corporate officers/directors) who buy and then sell shares within a six month period. Shareholders can require that profit to be disgorged whether the "trader" relied on inside information or not. I assume that officers and directors in the US simply do not engage in that kind of trading.

The other provision is the law upon which all of our common law of insider trading is based i.e. Reg. 10B of our Securities Act. Does it say anything about insider trading? It does not. Regulation 10B, and this is a surprise I think to many people, simply says that it shall be unlawful for any person to engage in manipulation or deceptive devices as that manipulation shall be defined by the SEC (I am paraphrasing the law). But those are the statutory principles. Now could the SEC have turned around and enacted a rule that would look something like s.128? It could have. Did it? It did not. What it did enact was a rule again back half a century ago which simply forbad the employment of any device or scheme to defraud with regard to purchase or sale of securities.

It was not until the 1950s when there first started to be some activity with regard to insider trading that is characterising it as an unhealthy and illegal activity. But it really was not until 1966 when a case called SEC v. Texas Gulf Sulphur was decided in the lower courts 20 years ago essentially that showed these provisions had some bite.

I am going to skip rather lightly over my outline which in the first few pages describes the basic common law theories under which insider trading is prohibited in our country. There isn't any particular reason for you to be familiar with those issues. They are there in outline form if you are interested. Let me

tell you what they are however because developments that are likely to occur in the next few months are going to impact very significantly on the direction that this law will take.

There are basically two sets of principles. One is a principle which is articulated on the very first page which is that you either disclose the inside information or that you abstain from trading. The other is a theory of misappropriation of that insider information. I have also indicated to you what constitutes material information, what constitutes non-public information. You do not have to worry about that - as all of this I take it is defined in your s.128.

Later I try to articulate some of the basic principles that form the "abstain or disclose" doctrine. That doctrine has been upheld by all United States Supreme Courts. So it is a common law principle which is not only pushed by our SEC but has been accepted by the judiciary. The judiciary attempted to include within that doctrine "tippees", persons who were locally connected with the information, or were receivers of information. They were unsuccessful in doing that. In the early 1980s the case that confirmed essentially the primary doctrine, the Chiarella case and the Dirks case which essentially indicated that the Supreme Court was not going to permit a common law extension by the SEC on this doctrine of breach of fiduciary duty to include "tippees".

That caused some scrambling at the SEC and in the early 1980s they did a couple of things. They launched a new doctrine, this misappropriation theory and the notion there is not a breach of fiduciary duty to shareholders but a breach of fiduciary duty to the party who gave you the inside information.

The SEC has had some good luck advocating that theory to the lower courts in our judicial system. It has not yet been tested but will be tested very shortly in our United States Supreme Court that is some seven or eight years after the SEC began to try to create this new common law theory. The relevant case is United States v. Carpenter and involves a Wall Street Journal reporter and it ought to be decided by our Supreme Court in 1987.

If the SEC is successful in its advocacy of this misappropriation theory there probably will be no statute to define insider trading in our country. The SEC has resisted mightily efforts to introduce definitions and principles into the statute.

If they lose that case then it is my bet that the SEC will go to Congress as rapidly as possible and seek something that looks very much like your rule - s.128 of the Securities Industry Act.

I should indicate one other thing that the SEC did in the aftermath of the Supreme Court decisions in Chiarella and Dirks. They passed a rule 14E3 which prohibits trading on the basis of insider information in a situation where there is a tender offer.

So they do not have to worry about various common law theories. There is a statutory principle that forbids it - that same rule introduced for the very first time in the US a concept of a Chinese Wall. When I say introduced it I mean in the form of any kind of legislation or regulation. You should understand that our Chinese Wall principle only applies to this very limited prohibition on insider trading contained in that single rule.

There are a number of sanctions that are available for application against those who engage in insider trading. There is no particular reason for me to discuss those. I am going to mention one in particular, the Insider Trading Sanctions Act of 1984.

The SEC went to Congress not to get insider trading defined but to say: "Look, we do not have a big enough "clout" at present. All we can basically do is get an insider trader to disgorge profits. That provides essentially no down-side risk to somebody who has the promise of making an easy $50,000,000 or $100,000,000. If we catch them the worst that we can do to them" said the SEC "is cause them to give it back. There is no down-side." And Congress, after a couple of years of debate, agreed with that argument and provided for civil penalties for up to three times the trading gains or losses. That penalty, by the way, can be provided against every person involved in a transaction that culminates in insider trading.

There are a number of prophylactic measures that companies, law firms, can and are taking in the United States to prevent insider from taking place or to shield themselves as an entity from insider trading liability.

The use of a Chinese wall is but one. Why do you have Chinese Walls at all? I would say there are two reasons. One, is to cut off institutional liability where there may be prohibitions against trading that would be directed against a single person operating within that institution. Secondly, it is a damage control technique. The fewer people who have access to information that might taint a transaction, the less likely that a tainted transaction will take place at all.

One should note, in the banking context, just how drastically the mores if you will have changed. Because pre that <u>Texas Gulf Sulphur</u> case, that is pre-1966, it was very common for the trust departments of banks to ensure, to actively seek information, from the commercial lending side, to find out all the information confidential or otherwise they could about companies with which the bank had commercial lending arrangements. The legal principle was pretty clear about that i.e. if as a trustee you did not do so you would be liable to beneficiaries who were harmed by your failure to act on information that was available to you. Of course with the 1966 case the entire reaction, the way in which banks approached that issue changed markedly and today almost all banks have Chinese Walls erected.

In law firms we of course do not divide by function. The way we handle it, at least in our law firm, is that information is communicated to those with a need to know. It is those persons working on a particular project and no other persons who have access to insider information.

The question of how this relates in our country to a brokerage house - as I understand it your banks can perform a number of financial service functions that ours cannot - is a big issue in the United States. There is talk about forcing a separation of arbitrage and investment advisory functions. I do not know whether that is going to take place but it is a topic that is being seriously discussed.

What about the legal affects of Chinese Walls? You have a clear legal principle known as the attribution principle. The ordinary attribution principles disappear according to your s.128(7). The only remaining problem that I see in respect of that aspect of the law is that it does not, as I understand it, cover unincorporated bodies. That aspect, particularly for those of you who are in law firms, ought to have some interest in seeing that that aspect of s.128 is changed.

In the United States, as I have indicated, we have no clear insider trading principles at all and we certainly have no clear Chinese Wall defence to principles which are unclear. There is no statutory principle save that one very limited purpose rule I described to you. It happens to be the SEC's policy in enforcement actions to recognise the Chinese Wall concept. But for private causes of action or causes of action by any other entities there is no assurance whatsoever in our country at the moment that a mere creation of a Chinese Wall will protect an entity from liability.

The difficult problems are not going to be in that area because I suspect that the Chinese Wall principles will be upheld as a matter of common law in our country. The remaining issues are going to be questions of conflicting duty. You have got information inside an organization, you have a duty not to use it and not to disclose it, and yet with respect to some activities in that same organization you have a duty to use all information that is within your possession.

Now in your Green Paper which I found very interesting there is a proposal, a very specific proposal at page 148, which is that if you establish a Chinese Wall and if you inform your client of the existence of that Chinese Wall, that information will not be used for the benefit of that client. If you do use it you will not be in breach of the fiduciary obligation if fulfilment of the obligation would have made the defence, the Chinese Wall defence, unavailable. That is the proposed piece of legislation and one that I would think you would be very interested in seeing placed on the books. We do not have anything like that. In fact to the extent our courts have indicated any view on this at all is

nowhere near as rosy a set of principles for those in the United States who feel caught between these two conflicting principles.

There were a few cases involving brokers where the broker had insider information indicating that an investment in a security would be inadvisable and failed to inform the customer who asked that shares be traded, be purchased. The courts have said that you cannot ignore your other duty simply because you have a duty not to divulge information. You cannot ignore completely your fiduciary obligation to communicate information and advise your customer. What they settled on was a way of dealing with that in a brokerage context was to give no recommendation whatsoever. That requires in turn that that stock be listed for a major brokerage house on a restricted list. That raises the issue of whether or not the mere placing of a stock on a restricted list does not communicate information in itself that could be viewed as a tip.

We do not have any cases today concerning a trust beneficiary coming in and suing a bank on the basis of the bank's failure to use information in its possession for the benefit of that trustee. I cannot tell you that the result is likely to be very clear when that does happen because that instance, that issue is not going to be argued before our Securities and Exchange Commission. It is going to be argued before one of our State courts. They barely know that there is a securities law. It is going to be a widow and orphan's case where the trust is going to have been depleted, and the bank is likely to have had information in its possession which it could have used to preserve that trust, and there may a case where the information that the bank did not use isn't non-public, isn't even material, but should in fact have affected the investment decision by the bank trustee. What will happen is a result of the creation of a very effective Chinese Wall. That information will not have been communicated to the trustee because the Chinese Wall, at least every instance that I have seen of its implementation, does not serve as a wall for only material non-public information, it serves as an informational wall that seals off certain activities in a bank from certain other activities. I suspect that neither the statutory principle that you are thinking about enacting, nor any principle that we have in our common law, is going to protect the banks at this juncture from prospective liability.

You might also think there is a less dangerous problem in the reverse flow of information. What about the commercial lending side of the bank making loans to an organization that the bank has information about and that information would indicate that that loan was a very bad idea. There is no legal principle that I know about that says the Chinese Wall must prevent information going in that direction where trading is not accomplished based on the information, but it is used to make a decision with regard to commercial lending activities.

Well, all the walls I have seen are walls that prohibit information going in both directions. What happens if a bank

makes very large improvident loans in the oil and gas area for instance and the bank becomes insolvent? Do shareholders have the right to sue bank officers/directors for a failure of fiduciary obligations to the shareholders? That is the dark side. Let me leave you, as we go on to the other commentators, with at least one commentator in the US's view on this whole thing. He says: "This is terrific. Even if the insider trading rules disappear tomorrow, the body of law that has been created which requires us to put up walls and to be able to insulate ourselves from liability because of information that we have inside of our institution but which can essentially pretend is not there, is the greatest development in a very long time. It will essentially prevent our bank assuming risks that it has historically assumed over time". That commentator at least views that whole development as segmentation, the compartmentalisation of banking, for these legal purposes, as an important and good development.