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RESEARCH ARTICLE

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Chinese Wall system in large finance and market institutions
—Experience and lessons of the Anglo-American legal system

Abstract Large modern professional finance and market institutions have inevitably been subject to conflicts of interest, and the Chinese Wall has been an innovation, if not always successful, which provides a convenient solution to those problems. The Chinese Wall is designed to get a balance between commercial reality and public confidence. Attitudes towards the Chinese Wall vary from country to country, depending on the level of such balance. Experience in the relevant industries, however, has cast doubt on the effectiveness of the Chinese Wall in protection of the interest of investors, which suggests the current Chinese Wall is far from ideal, and consequently there is still a long way to improve the design and enhancement of the Chinese Wall, calling for the development of a more supplementary and enforcement mechanism.

Keywords finance, market mechanism, Chinese Wall system

摘要 现代大型金融和市场专业机构中无可避免地存在着利益冲突问题，中国墙制度是解决此问题的一个重要途径。中国墙制度旨在努力平衡商业现实与公众信息之间的冲突；基于对此平衡状态的不同把握，各国对于中国墙制度的态度也相应地有所不同。但是，目前的中国墙制度远非完善，难以有效地保护投资者利益，因此中国墙制度的设计和加强任重道远，仍需要发展更多的补充机制和执行机制。

关键词 金融，市场机制，中国墙制度

With the development of modern economy, financial and market intermediaries are increasingly expanding with integrated operation of various businesses. In

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such case, there are often conflicts of interest among their different business departments. This issue is particularly outstanding in large financial groups, securities firms, banks, law firms and accounting firms. On the one hand, those professional institutions need to keep expanding for operation of scale so as to satisfy the service needs of the increasingly growing large companies and improve their own competitiveness in the market. On the other hand, serious conflicts of interest inevitably occur in large scale and comprehensive businesses. To solve such contradiction, the Chinese Wall system has emerged.

Article 136 of Chinese Securities Law as revised in 2005 recognizes the Chinese Wall system generally, requiring securities firms to establish sound internal control systems, adopt effective segregation measures and prevent conflicts of interest. However, the legal effect of the Chinese Wall system is not totally clear. For example, whether or under what circumstance may the Chinese Wall be a defense for insider trading? In addition, although large securities firms have formulated some specific Chinese Wall rules in reality as required by China Securities Regulatory Commission (CSRC), the actual role of such rules is worrisome, which will undoubtedly be of significant impacts on the legal effect of the Chinese Wall. The author has found that in most cases the Chinese Wall is nothing more than a token, and it is hard for it to fulfill the original legislative intention to prevent the conflicts of interest. (Poser, 1991) For this reason, the significance of the Chinese Wall is worth exploring.

This paper consists of five parts: (1) Overview of the Chinese Wall system, introducing the core rules of the system; (2) discussion on the jurisprudential basis of the Chinese Wall that it is a balancing mechanism between commercial reality and public confidence; (3) comparison and analysis on the attitudes of foreign courts, legislative authorities and regulatory authorities towards the Chinese Wall; (4) and discussion on the actual effect of the control of information flow of the Chinese Wall; (5) and a concluding remark.

1 Overview

The term “Chinese Wall” refers to a set of internal rules and procedures formulated by large financial and market institutions engaged in multiple businesses, which aims at preventing the transmission of certain material non-public information from one department to another of the same institution.[1] Obviously, the name of “Chinese Wall” is actually a metaphor which resembles the image of a “wall” controlling the internal information flow of a large

[1] From September to November in 2003 the author conducted a field survey and interviews in five large securities firms (among Top 10 by business turnover) and four famous law firms in Beijing and Shanghai.

institution, like the concept of "firewall" in computer science.

The rules and procedures of the Chinese Wall vary with the types of intermediaries. For instance, in securities firms, the Chinese Wall segregates investment banking from brokerage business, proprietary trading, R&D department and other departments; in banks, the Chinese Wall separates their trust departments from their commercial loan business and securities underwriting business. Nonetheless, the Chinese Wall has some common rules and procedures. Besides the general provisions that control the information flow among different departments and education projects, institutions usually formulate and implement the following rules and procedures:

(1) Segregate different departments that have conflicts of interest, putting them in different buildings or different floors and areas of the same buildings;
(2) Segregate accounts, files and business personnel;
(3) Clearly mark sensitive documents, adopt secure file management system, and restrict access to confidential information by the staff who are possible to violate the relevant provisions on information confidentiality;
(4) Restrict the attendance of people from the departments with conflicts of interest when holding meetings to discuss sensitive matters;
(5) Restrict the flow of people among different departments;
(6) Restrict directors, managers and other people from holding concurrent positions in two or more departments that have conflicts of interest;
(7) Use code names in the relevant documents to conceal the identity of issuers.[2]

Generally speaking, the Chinese Wall mainly restricts the behavior of the departments that usually have access to and own material, non-public information within institutions, such as the investment banking department of securities firms. However, sometimes personnel of other departments are also subject to the restriction of the Chinese Wall. In reality, different departments within the same securities firm often need to cooperate and consult with each other with respect to some material issues. For instance, an analyst from the R&D department may need to provide advice to colleagues in the investment banking department. In such case, the analyst "crosses the wall and trespasses the boundary", and accordingly, shall comply with the Chinese Wall rules and procedures normally applicable to the investment banking department. (Doty, Powers, 1988)

In reality, the discussion regarding the Chinese Wall mainly occurs in large

[2] See Board of Governors of the Fed. Reserve Sys., Policy Statement Concerning the Use of Inside Information, 43 Fed. Reg. 12755, 12756, 1978-3-17.

financial institutions such as securities firms and banks, and naturally, the Chinese Wall is often used in large law firms and accounting firms. Due to the following two reasons besides limited space, this paper will mainly focus on the Chinese Wall in securities firms and law firms: Firstly, as the mainland of China has implemented segregation policies among banking, trust business and securities business for a long time, banks have a relatively narrow business scope, mainly concentrating on the traditional loan business, and thus the issue of conflicts of interest is relatively less serious;[3] and secondly, the conflicts of interest of accounting firms are very similar to those of law firms, and consequently much relevant discussion regarding law firms are also applicable to accounting firms.

2 Jurisprudential basis: Conflicts and balance between commercial reality and public confidence

The Chinese Wall has come into being as the result of the conflicts and balance between commercial reality and public confidence. Though a company is actually composed of many different departments, it is regarded as an independent entity by law. As a commercial reality, intermediaries such as securities firms need to expand scale and undertake comprehensive business so as to improve their market competitiveness. Nonetheless, it is easy for diversified operations to have conflicts of interest legally. The issue of conflicts of interest can be traced back to the agency law and the principle of fiduciary duties. For example, according to partnership law, information known by a partner is considered known by other partners, and thus, a partner must disclose to clients the relevant information known by other partners, even such information is related to other clients. Similarly, according to corporation law, the information known by a department may be deemed known by other departments, hence leading to conflicts of interest.

As far as securities firms are concerned, such conflicts of interest will make it difficult for multiple businesses to implement in law; in other words, faced with conflicts of interest, securities firms can not but be forced to spin off business departments of different functions and end up with a single business. This is obviously not in line with the principle of economies of scale, consequently clashing with the actual needs of modern social development. First of all, the

[3] See Article 6 of the Securities Law of the People's Republic of China; Article 43 of the Law of the People's Republic of China on Commercial Banks ("A commercial bank shall not engage in trust investment or stock business, or invest in real estate for its own use within the People's Republic of China"). As for banks in foreign countries, the conflicts of interest normally occur between their trust departments and commercial loan business and stock underwriting business.

separation of businesses of a securities firm will hinder the normal operations of the securities market. The US Securities and Exchange Commission (SEC) believes that the complete separation of businesses of a securities firm will constitute a major setback against its financing capability and other intermediary functions. Secondly, the forced business segregation of securities firms will bring many small securities firms to bankruptcy, as comparatively speaking they need even more to obtain revenues from diversified channels for survival. Lastly, business separation of securities firms will result in significant economic costs. For instance, if the brokerage function and the underwriting function of a securities firm shall be separated, brokerage companies and underwriting companies will then need to bear heavy costs to set up their own research departments. This is a wasteful and redundant construction, the cost of which will eventually be passed to investors. (Lipton, Mazur, 1975) Such analysis also applies to other kinds of large intermediaries including banks and law firms.

To solve the aforesaid conflicts of interest, the Chinese Wall system has emerged. Under the Chinese Wall system, different functions within large companies are deemed to be in the state of information segregation, and each department is assumed not to know the information other departments are aware of, thus avoiding the conflicts of interest. However, many people who are skeptical and critical of the Chinese Wall system believe that it can not effectively control the internal information flow of large companies and the problem of conflicts of interest still exists, and thus complete dependence on the Chinese Wall will lead to the lack of protection of the interest of investors to the detriment of public confidence. (Poser, 1990) Of course, how effective the Chinese Wall is in controlling information flow is an empirical question, which will be elaborated later herein.

Due to the imperfection of the Chinese Wall in preventing conflicts of interest and protecting public confidence, people have started to develop other rules to supplement and reinforce the Chinese Wall system. Such supplementary rules mainly include the adoption of the restricted list, the watch list and the rumor list. The restricted list covers the types of securities whose trading by the employees of securities firms is prohibited or whose proprietary trading is prohibited or whose trading is restricted. The watch list is also called the grey list, whereby normally the audit department of the securities firm incorporates in a confidential list the relevant securities whose material, non-public information will be obtained or has been owned by the firm, or the securities that the firm will underwrite, and then supervises securities trading by the firm and the employees and clients of the firm against the list to investigate any illegal trading that may breach the Chinese Wall system. The rumor list includes the securities of the issuers whose business dealings with the securities firm have just been published by the firm recently, or who will have business dealings with the firm according

to rumors, the main difference of which with the watch list is that a wider range of securities are covered, including not only the securities of the issuers who are dealing with the securities firm, but also those of the issuers who will deal with the firm according to rumors.

Comparatively speaking, the watch list is more suitable to the Chinese Wall than the restricted list for the following reasons: Firstly, the restricted list is made public to all the employees of the securities firm and is even known to people outside the firm, and thus the confidentiality is jeopardized; and indeed, the restricted list often implies some information, thus revealing it rather than concealing it, while the watch list is in the state of complete confidentiality, and the audit department monitors the relevant trading secretly according to the list. Secondly, the restricted list completely forbids or restricts some trading, even if such trading does not actually involves inside information; by comparison, the watch list allows the departments that do not own material, non-public information within the securities firm to continue grasping commercial opportunities and conducting the relevant trading without being constrained by compulsory forbidding and restrictive rules, and thus it better meets commercial needs. Therefore, in the US, the watch list is considered "the most important supplementary mechanism" for the Chinese Wall system, especially in the case of merger and acquisition; while the restricted list is usually used when a transaction is going to be disclosed, and the companies that use the restricted list rarely have substantial merger and acquisition.[4] As for the rumor list, since it involves a wide scope of securities with heavy execution costs, only a very few large securities firms adopt such mechanism in reality.

As a result, there are sometimes contradictions and conflicts between the need of the commercial reality of intermediaries and the maintenance of a fair market and public confidence, and the Chinese Wall is an important harmonizing mechanism of such contradictions, which maintains a balancing in between. Nevertheless, such balancing is hard to maintain, and consequently how to design and reinforce the Chinese Wall becomes a major issue. As will be discussed later herein, different understanding of this balancing has led to substantially different attitudes of nations to the Chinese Wall system.

As far as China is concerned, the problem of conflicts of interest in large institutions is especially serious. Take securities firms for example, China's securities industry has always been in monopoly, where the number of securities firms has been much limited and the level of business concentration is very high. For instance, in 2002, the total number of securities firms in China was only 127,

[4] See SEC Division of Market Regulation, Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Non-public Information. [1989–1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) 84, 520, at 80, 624–625.

and what deserves more attention is that in the same year 37% of the total amount of A-share trading, 41% of the total amount of B-share trading and 80% of the underwriting business concentrated in Top 10 securities firms.[5] In such general economic condition, clients have very limited choice of securities firms, and it is almost inevitable for the same securities firm to conduct multiple businesses and serve multiple companies, hence leading to conflicts of interest. Thus, considering the actual circumstance, more stringent measures may be required when applying the Chinese Wall system in China, where not only different departments within the same institution will be separated but also different persons within the same department will be segregated.

In addition, theoretically speaking, such drastic designing is not totally groundless. Early in 1986, a famous case in Australia affirmed in principle such more radical Chinese Wall system. In that case, a securities firm served two companies at the same time, and provided services for one of them to acquire a third company. The investment banking department of the securities firm had different teams, and the two companies of the aforesaid acquisition were served by different teams respectively. The Chinese Wall system between different teams of the investment banking department was eventually deemed effective. (Philips, 1986) Furthermore, the world famous McKinsey Management Consulting Firm has actually adopted such internal Chinese Wall system within a department. McKinsey would normally provide a so-called “clean team” for a new client, i.e., a consulting team that has not directly provided services to the competitors of the new client. If McKinsey can not organize such a “clean team”, it would disclose its conflicts of interest to the new client and decline such new business.

3 Attitudes of foreign countries towards the Chinese Wall

The countries including the US, the UK and Australia have officially recognized the Chinese Wall system in the securities industry. (Poser, 1988; Tomasic, 1991) The Chinese Wall system was first applied in the US, followed by such countries as the UK and Australia. But in the UK and Australia, the scope of use of the Chinese Wall system in the securities industry has exceeded that in the US. For example, no US court has ever allowed the Chinese Wall to be used as a defense for breach of fiduciary duties, and moreover, the US securities legislation and SEC rules on insider trading only allow the use of the Chinese Wall system as a defense in some limited situations. On the contrary, in the UK, the relevant

[5] See China Securities Regulatory Commission: 2003 Yearbook of China Securities and Futures Statistics. Shanghai: Baijia Publishing House, pp. 320–321.

legislation has explicitly established the legal status of the Chinese Wall system as a general defense mechanism for breach of fiduciary duties and insider trading.

However, it is just the opposite when it comes to law firms. The UK and Australia have very stringent requirements with respect to the set-up of the Chinese Wall system in large law firms, while the US courts tend to accept the Chinese Wall system as the mechanism for solution to conflicts of interest of clients in large law firms.

Another interesting phenomenon is that foreign courts are slow to accept the Chinese Wall system, while legislative and regulatory agencies are more willing to believe in the effectiveness of the Chinese Wall and more optimistic in adopting such procedural rules, which perhaps reflects the fact that legislative and regulatory agencies understand better and are closer to commercial reality than courts. Of course, it could also be that legislators and regulators are easier to be influenced by the lobby of large intermediaries. No matter what is the reason, legislators and regulators are more willing to accept the Chinese Wall system than courts in reality.

3.1 The USA

The first case relating to the Chinese Wall system in the US is Matter of Merrill Lynch, Piece, Fenner & Smith in 1968.[6] This case concerned a SEC administrative decision, where SEC and Merrill Securities reached a settlement. The case explicitly discussed for the first time whether the Chinese Wall could be taken as defense for breach of Rule 10b-5. Merrill was a large comprehensive securities firm, and acted as the principal underwriter for the shares of Douglas Aircraft Manufacturing Company in the case. Merrill learnt from Douglas that its 1966—1967 earnings would drastically decrease and then disclosed such material information to several of its institutional investors, causing them to sell the shares of Douglas. SEC conducted an investigation into Merrill's conduct and alleged that the latter had violated Rule 10b-5. In the ultimate settlement, Merrill agreed to accept the administrative punishment, including a 21 day business suspension of its institutional customer service department; and furthermore, Merrill agreed to establish the Chinese Wall system to reduce the possibility of insider trading caused by the transmission of material information its underwriting department was aware of to other departments. The Chinese Wall system adopted by Merrill at that time was very simple, mainly including employee training program regarding the prohibition of insider trading, and requesting all the employees not to disclose any inside information without

[6] See 43 SEC 933 (1968).

reason. For this reason, as to what extent such Chinese Wall system can be considered as a legal defense, though SEC has not taken a very clear position, it basically holds an affirmative and encouraging attitude.

In 1974, six years after the settlement of Merrill occurred the first court precedent concerning whether the Chinese Wall could be used as a legal defense in the case concerning conflicts of interest in the US. In Slade v. Shearson, Hammill & Co.,[7] Defendant securities firm recommended the stock of a listed company to Plaintiffs retail investors and the Plaintiffs bought the stock based on the recommendation and consequently suffered loss due to the price fall of the stock. The Plaintiffs learnt that the listed company had actually been the client of the investment banking department of the Defendant and thus initiated an action. The Plaintiffs' cause of action was that when the Defendant's retail investor brokerage department recommended the stock, it already knew the inside information of the relevant listed company and it continued recommending the stock after becoming aware of the adverse material information, thus constituting breach of the fiduciary duties to customers. The Defendant argued that as it had established the Chinese Wall system internally, the firm's retail investor brokerage department was not aware of the relevant material information of the investment banking department. The court of first instance rejected the Defendant's argument and held that the Chinese Wall system was not sufficient as a defense for the breach of the fiduciary duties, hence ruled in the Plaintiffs' favor. The Defendant proceeded to appeal to the Second Circuit Court, which collected more evidence on the effectiveness of the Chinese Wall system established by the Defendant. However, not long after both parties reached a settlement, and therefore the judgment of the court of first instance became the most authoritative opinion of the case:

> The instant case has far reaching ramifications for the structure of the securities industry…. To require an organization like the defendant's to refrain from effecting transactions in securities of companies about which they have learned adverse inside information may be to render it exceedingly difficult for any such organization to function as an investment banker for the company and at the same time function as a broker in that company's securities. (Varn, 1984)

In this case SEC provided an *amicus curiae* brief to the court. As the case ended up by settlement, such advisory opinion had a far-reaching and profound impact on SEC's future regulatory policy on the Chinese Wall system. The advisory opinion expressly supported the use of the Chinese Wall system to

[7] See [1973–1974] Fed Sec L Rep (CCH) para. 94, 329 (SDNY 1974).

control the flow of material, non-public information among different departments within large securities firms; but on the other hand, SEC also considered that the Chinese Wall system could not completely prevent the problem of conflicts of interest. In order to avoid recommending to customers the stocks of which adverse information is known by them, securities firms should use the restricted list rule to include those stocks in the restricted list so as to prohibit recommending customers to buy those stocks. Therefore, the use of inside information by securities firms can be avoided, and the performance of their fiduciary duties to customers can be guaranteed.

Therefore, in this case neither the court nor SEC considered the Chinese Wall system a defense for violation of fiduciary duties by large securities firms. Nonetheless, by the 1980s, with the emergence of acquisition spree and the increasing concentration of the securities industry, the attitude of SEC was gradually changing and it started to allow the Chinese Wall system to be taken as the defense mechanism for the problem of conflicts of interest in acquisition of companies. (Pitt, Groskaufmanis, 1990) For example, in Koppers Co., Inc v. American Express Co. of 1988,[8] Lehman Brothers Holdings Inc. (Lehman) provided investment banking service to the offeror of a tender offer, but at the same time it was the majority shareholder of the target company. The target company initiated a legal action, holding that there were conflicts of interest with Lehman, which consequently violated the Williams Act. SEC provided an advisory opinion to the court, believing that the Chinese Wall system could effectively avoid the conflicts of interest. However, except for in the case of business acquisition, such as in the event where securities firms traded the stocks of the target company by breach of Rule 14e-3, the Chinese Wall system still does not constitute a defense for violation of fiduciary duties.

In addition, the US Congress has also expressed a very positive attitude towards the Chinese Wall system. In 1984, the US Congress formulated the Insider Trading Sanction Act, which supported in principle the use of the Chinese Wall system, and the specific designing of the Chinese Wall system was authorized to SEC. In 1988 the US Congress again promulgated the Insider Trading and Securities Fraud Act, which more explicitly specified the Chinese Wall system as a strategy to fight insider trading. Consistently with this trend, SEC approved the Chinese Wall system in the new trading rules formulated by New York Stock Exchange and AMEX in 1986.

On the contrary, although SEC supports the Chinese Wall system and has been trying to improve it, very few courts have discussed whether the Chinese Wall system can be used by large securities firms to avoid the liability of securities law.

[8] See 689 F. Supp. 1371, 1413 (W. D. Pa. 1988).

In Nelson v. Craig—Hallum of 1989,[9] the Defendant securities firm was charged of breaching Rule 10b-5, as according to the information obtained by its investment banking department, the statement of the research report released by its research department was seriously misleading. The Defendant argued that the Chinese Wall system within the firm had stopped the information exchange between its investment banking department and its research department, and hence the research department was actually not aware of the information possessed by the investment banking department. However, the court rejected the Defendant's argument, holding that the Defendant could not prove the existence and effectiveness of its Chinese Wall system as the defendant did not have a formal and written Chinese Wall system. The court further pointed out that the Chinese Wall system itself was not sufficient to control the information flow of different departments, and supplementary measures such as the restricted list were needed. Although the court refused to name the specific elements of a qualified Chinese Wall system, its judgment did provide some reference opinions on the construction of the Chinese Wall system. Firstly, the Chinese Wall system should be formalized in writing; secondly, companies should record and maintain daily compliance with and implementation of the Chinese Wall so that it can be tracked; thirdly, the Chinese Wall needs other supplementary and supporting measures such as the restricted list to ensure the information flow of different departments can be really and effectively controlled.

3.2 The UK

Like the US courts, courts in the UK have also been reluctant to recognize the legal effect of the Chinese Wall system. In the UK, courts traditionally regarded a company as an independent legal entity regardless how many different departments the company has and how dispersed those departments are. Consequently the act of each department is ultimately considered as that of the company rather than that of the department itself. In this logic, even if there is no information exchange between two departments within the company, if they serve conflicting stakeholders in the same transaction, the company is deemed to breach fiduciary duties. Thus, as a tool to cut off the information exchange of different departments within the company, it is very hard for the Chinese Wall to be accepted by the UK courts as a solution to the problem of conflicts of interest. As the UK's famous scholar on company law Professor Gower (C. B Gower) said, "total reliance can not be placed on Chinese Walls because they restrict flows of information and not conflicts of interest themselves".[10]

[9] See [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) & para 94, 500 (D. Minn. 1989).
[10] Quoted in Poser N S (1991). International Securities Regulation (Boston), p.214.

An early famous UK precedent concerning the Chinese Wall system is Rakusen v. Ellis, Munday & Clarke.[11] The case establishes the test of the so-called "probability of real mischief". In the case, Rakusen consulted Munday with respect to his dismissal, and the latter was a partner of a small law firm. Rakusen later changed the lawyer and instituted legal proceedings. Clarke and Munday were partners of the same law firm. Clarke was the attorney for the Defendant in the suit, but he did not know that Rakusen once consulted Munday. Rakusen applied for a court injunction, requesting to forbid Clarke to be the attorney for the Defendant. The court of first instance agreed to the request, but the court of appeal allowed Clarke to act as the attorney for the Defendant. The reason for the court's judgment was as follows, "As a general rule the Court will not interfere unless there be a case where mischief is rightly anticipated. I do not say that it is necessary to prove that there will be mischief, because that is a thing which you can not prove, but where there is such a probability of mischief that the Court feels that, in its duty as holding the balance between the high standard of behavior which it requires of its officers and the practical necessities of life, it ought to interfere and say that a solicitor shall not act." Therefore, as long as the Chinese Wall system can avoid the "probability" of information flow, the court would support the Chinese Wall system.

The US has not accepted such test of "probability of real mischief", but on the contrary, as discussed above, the US is more stringent in the application scope and judgment standard of the Chinese Wall system. Compared with the test of the UK, the test of the US can be called the test of "possibility of real mischief".[12] Specifically, in the US, as long as there exists the "possibility" of information flow, the Chinese Wall system may be announced as invalid, as the UK test of "probability" is considered insufficient to effectively realize fairness and justice.[13] As a result, courts in the UK are more optimistic about the Chinese Wall system than courts in the US. The legislative authority of the UK also officially established the Chinese Wall system when formulating the Financial Service Act 1986.[14]

Nonetheless, recent precedents in the UK do not seem to demonstrate the traditional high level of trust in the Chinese Wall system. For instance, an appeal case in 1991 involved the same issue of conflicts of interest of solicitors.[15] The

[11] See [1912] 1. Ch. 831.
[12] In English, "probability" and "possibility" are near-synonyms, but to be more specific, the former has a higher level of possibility than the latter.
[13] See Analytica Inc. v. NPD Research Inc., 708 F. 2d 1263 (USCA, 7th Cir. 1983).
[14] See Financial Services Act 1986 (UK), Section 48(2)(h). It affirms the role of the Chinese Wall and requests the government's regulatory authority and the self-regulatory organizations of the securities industry to formulate specific rules of the Chinese Wall.
[15] See Re a firm of solicitors (1991), New Law Journal, 746–747.

case was very similar to that of the aforesaid Rakusen: A law firm provided consulting service to an insurance company about five years before. Later, in a suit where the insurance company was the Plaintiff, the law firm became the attorney for the defendant. The insurance company applied to the court for forbidding the law firm to participate in the litigation. The court of first instance released an injunction, and the court of appeal maintained such ruling. The court held that the law firm once provided consulting service to the insurance company for three years and had access to a great deal of confidential information and in addition, the cause of the litigation was closely related to the previous consulting service. Thus such information was of high relevance, and more importantly, such information might have passed though the Chinese Wall to the whole law firm.

3.3 Australia

The attitude of the Australian courts towards the Chinese Wall system is between the US test of "possibility" and the UK test of "probability", or can be said to waver between both tests. On the one hand, some Australian precedents followed the UK test, such as the D&J Constructions Pty Ltd v. Head of 1987 in New South Wales and the Freuhauf Finance Corporation Limited v. Fees Ruthning (a firm) of 1990 in Queensland.[16] On the other hand, some judges radically criticized the UK test, believing that the UK test does not suit the modern commercial reality anymore. In 1989, Justice Gummow, a senior judge at the High Court of Australia, clearly pointed out that Australia's attitude towards the Chinese Wall system was as stringent as that of the US.[17]

In Mallesons Stephen Jaques (a firm) v. KPMG Peat Marwick (a firm) judged by the West Australian Supreme Court in 1990, the UK test of "probability" was rejected by the court. Mallesons Law Firm in the case was a top Australian law firm in commercial law with branches in major cities of Australia. In the case, Perth branch of the firm acted as the attorney for the Plaintiff in a material case, but the Defendant was a client of Brisbane branch of the firm several years ago. The client believed there existed conflicts of interest in Mallesons Law Firm, and the firm argued that the Chinese Wall had been set up among its branches, which could prevent the information flow among the branches, hence avoiding the conflicts of interest. The court eventually rejected the defense of Mallesons Law Firm mainly for the following reasons: Firstly, in essence the Chinese Wall was

[16] See (1987) 9 NSWLR 118; see (1990) 1Qd R 558.

[17] In December 2004, the author participated in a symposium in Sydney, and Justice Gummow was a keynote speaker. At the tea break of the meeting, the author had the pleasure to talk about this with Justice Gummow and found that he still clung to his view.

just a virtual system full of loopholes; secondly, the Chinese Wall was very hard to implement, and it was not realistic for courts to completely rely on the Chinese Wall; thirdly, even if the Chinese Wall could cut off the explicit information flow, it could not eliminate the implied information transmission, since certain attitude, facial expression and even the avoidance to answer questions itself could actually transmit information.

On the contrary, in Freuhauf Finance Corporation Limited v. Feez Ruthning (a firm) of 1990 in Queensland,[18] the court adopted a more lenient and flexible attitude towards the Chinese Wall. The case was very similar to the above-mentioned Mallesons, and it also involved the conflicts of interest in a firm of solicitors. The firm was the attorney for the Plaintiff of a case, where the Defendant was a client of the firm several years ago. In judging the effectiveness of the Chinese Wall set up by the firm, the court considered and weighed up the interests of all the parties in issue, such as the confidentiality of the information of the Defendant client of the firm, the right of the Plaintiff client to entrust litigation to the firm, and the business development of the firm itself. The court's final conclusion was that the Chinese Wall of the firm effectively cut off the flow of confidential information, and thus there did not exist the "probability" of conflicts of interest.

In summary, the attitude of Australian courts towards the Chinese Wall is not clear, which swings between the attitude of the US and the attitude of the UK; specifically speaking, it seems more inclined to the attitude of the US, taking rather a cautious approach to the Chinese Wall. In judging the effectiveness of the Chinese Wall, Australian judges pay close attention to specific circumstances of a case instead of generically accepting or rejecting the Chinese Wall.

Compared with courts, Australia's legislative authorities and regulatory authorities rather prefer the Chinese Wall system. In Australia, the discussion on the conflicts of interest basically centers on the use of procedural mechanisms such as the Chinese Wall; moreover, for a long time, the Chinese Wall system has been a statutory defense for the conflicts of interest in cases of insider trading and in the securities consulting industry. At present, the use by companies of the Chinese Wall in cases of insider trading under Section 1043F Corporations Act 2001 is further extended under 1043G to partnerships; Section 850(2) of Corporations Act 2001 provides for the use of the Chinese Wall in the securities consulting industry; and Section 3.5 of the trading rules of Australia Stock Exchange also specifies the use of the Chinese Wall system.

According to Section 1043F of Australian Corporations Act 2001, the valid criterion of the Chinese Wall is that "it had in operation at that time arrangements that could reasonably be expected to ensure that the information was not

[18] See (1990) 1 Qd R 558.

communicated." This criterion is very similar to that in the US' Insider Trading and Securities Fraud Act of 1988 mentioned above. It is worth noting that Australia's early legislative criterion was stricter. Section 128(7) of the Securities Industries Act of 1980 is an example in point. Nonetheless, some people criticize the criterion of Section 1043F for being too broad and elusive. For instance, Business Law Section of Australia Law Association regarded, "It is very unclear what kind of Chinese Walls is qualified. For a defense of insider trading cases that may involve criminal responsibility, such ambiguity is regrettable." However, there are some people who think it not appropriate or realistic to give the Chinese Wall rigid and excessively detailed provisions.

4 Effectiveness of the Chinese Wall

As discussed above, nations adopt different attitudes regarding whether the Chinese Wall is of legal effect as a defense. The roots of such difference lie in the different views of different nations on the actual effect of the Chinese Wall in controlling information flow. Up to now, there have been very limited empirical studies on the actual effect of the Chinese Wall system. An article in 1986 even pointed out, "no objective evaluation of the effectiveness of the Chinese Wall exists." (Hamermesch, 1986) In such limited studies, few data supports that the Chinese Wall may effectively control information flow, and such result forms a striking contrast with the reality of extensive application of the Chinese wall at present. Poser, a US professor, is a famous law scholar on the Chinese Wall. He exclaimed that it seems surprising how little evidence there is that Chinese Walls are effective. In the opinion of Professor Poser, it is not very difficult to break the Chinese Wall, and it is not abnormal to doubt the effectiveness of the Chinese Wall as the Chinese Wall is in essence a kind of self-regulation mechanism whose implementing effect ultimately depends on the professional ethics of related securities firms. Indeed, when breaking the Chinese Wall can yield substantial interest (as usual in reality), the temptation may become so hard to resist that it is sufficient to defeat all the moral standards. Professor Poser called this phenomenon the "inevitable weaknesses" of the Chinese Wall.[19] (Poser, 1988)

[19] See Poser N S (1988), at 91, 96–97. Professor Poser listed 12 kinds of conflicts of interest that securities firms in the US and the UK may face, for example, it is most likely for the brokerage department and the proprietary trading department to conduct corresponding trading based on the report of the research department; the merger and acquisition department may leak material information regarding merger and acquisition to the arbitrage department; and the market department may press the brokerage department or the assets management department to request the brokerage department to recommend the relevant securities to customers.

The experience of the UK Takeover and Mergers Panel indicated that segregating different departments of securities firms can not always avoid conflicts of interest. Business Law Section of Australia Law Association also doubts the effectiveness of the Chinese Wall for the reason that although there exists the Chinese Wall, directors of a company can still obtain information of all the departments in the company and make corresponding decisions. The statement of Supreme Court of Canada is even more pessimistic but rather vivid: "No matter how carefully the Chinese Wall might be constructed, it could be breached. After all, the historical precedent of Genghis Khan, by small tricks, had breached the Great Wall of China, the greatest of Chinese walls."[20] Even scholars who support the use of the Chinese Wall admit that the Chinese Wall alone can not adequately prevent conflicts of interest, and the Chinese Wall needs supporting mechanism such as the restricted list to supplement and reinforce it.

Securities Exchange Commission v. the First Boston Corp. of 1986 in the US highlighted the vulnerability of the Chinese Wall.[21] In the case, the First Boston Corp., a famous international investment bank, was also engaged in securities trading. In an investment banking business, the First Boston Corp. got to know some material information of a customer and consequently listed the customer in the restricted list. The measure should have prevented anyone from the First Boston Corp. from recommending or trading the securities of the customer. One day before the customer publicly announced the material information, the customer notified the president of the First Boston Corp. of the information and confirmed it. The president then told the information to an analyst of the company so that he could prepare for answering questions regarding what kind of impact the information would have on the customer the next day after the information was disclosed. The issue was that the analyst relayed the information to the manager of the securities trading department of the First Boston Corp. Though the securities of the customer were listed in the restricted list, the manager still traded the stocks of the client. And then, the Chinese Wall that the First Boston Corp. had elaborately constructed fell apart in a second. Such conduct of insider trading was soon noticed by New York Stock Exchange and reported to SEC. The case ended up by settlement. The First Boston Corp. agreed to "disgorge" the illegal profit and pay the penalty; and in addition, it would enhance the supervision and implementation of the Chinese Wall and such rules as the restricted list. Professor Poser commented: "The fact that the Chinese Wall and restricted-list procedures could be so easily ignored by senior persons at a prominent investment banking firm such as First Boston provides little reason for confidence that they will provide a bulwark against illegal action at smaller or

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] Martin v. MacDonald Estate (Gray) [1991], 1 WWR 705, 730–731.

[21] See Fed. Sec. L. Rep. (CCH) para. 92, 712 at 93, 465 (SDNY May 5, 1986).

less reputable firms".[22]

In reality, for small institutions, the Chinese Wall does not make much sense, while for large institutions, the Chinese Wall is inevitably fine and sophisticated, making it difficult to supervise and implement. Therefore, when discussing the Chinese Wall system of law firms, a US court noted that the following factors needed to be considered when judging the effectiveness of the Chinese Wall: The size of the law firm; the establishment structure; the possibility of information flow; and whether internal rules that prevent information flow have been formulated.[23]

5 Conclusion

How to prevent the internal conflicts of interest in large financial and market intermediaries is a rather big and complex topic, to which there is no easy solution. The Chinese Wall is an important step towards the solution to this problem. Its objective is to reach a balance between the needs of the commercial reality of intermediaries and the maintenance of public confidence. Based on different understanding of the level of balancing, attitudes towards the Chinese Wall system vary from country to country accordingly. However, the existing Chinese Wall system is far from ideal and can not effectively protect the interest of investors. Consequently there is a long way ahead to improve the designing and enhancement of the Chinese Wall, and more supplementary and enforcement mechanisms need to be developed. Of course, continuous information disclosure is another important measure for preventing conflicts of interest. In order to overcome effectively conflicts of interest, we need to combine continuous information disclosure system with the Chinese Wall system.

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[22] N S Poser, International Securities Regulation (Boston, 1991), p. 231.

[23] See La Salle Nat'l Bank v. County of Lake, 703 F. 2d 252 (7th Cir. 1982).

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