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Compliance Programs for Insider Trading

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COMPLIANCE PROGRAMS FOR INSIDER TRADING

*Marc I. Steinberg**
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I. INTRODUCTION

SINCE 1988, organizations have focused greater attention on compliance programs designed to prevent insider trading by their personnel. In that year, the Insider Trading and Securities Fraud Enforcement

Act (ITSFEA)¹ was enacted into law. Certainly, insider trading was a concern to organizations before that legislation,² but the 1988 Act increased an organization's potential liability for the insider trading of its employees and imposed an affirmative duty on broker-dealers and investment advisors to maintain reasonably effective written compliance programs.³

This article examines the compliance programs that different organizations have implemented in response to the new liability framework. Specifically, the article will review compliance programs that have been suggested and adopted in three different contexts: professional firms, with an emphasis on law and accounting firms; financial intermediaries such as broker-dealers, investment companies, investment advisors, and banks; and publicly-held companies. This article proposes elements of an insider trading compliance program that should be considered by any organization whose business merits a compliance program, and it recommends specific measures that should be adopted by organizations within the three contexts mentioned above.

II. INSIDER TRADING BACKGROUND

A. CONCERNS BEFORE ITSFEA

Before Congress passed ITSFEA, organizations had incentives to maintain compliance programs in order to avoid liability for the insider trading of their personnel.⁴ Under the federal securities laws, Section 10(b) of the Securities Exchange Act (Exchange Act or 1934 Act)⁵ and rule 10b-5⁶ prescribed thereunder have been and continue to be the principal sources of the prohibition against insider trading of securities.⁷ The controlling person provision, Section 20(a) of the Exchange Act, creates potential liability for, among others, employers of inside traders.⁸ Under such circumstances, the controlling person has a good faith defense against liability.⁹ This defense

1. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988) [hereinafter ITSFEA or 1988 Act].

2. See, e.g., William R. Harman, *The Chinese Wall* in Twelfth Annual Institute on Securities Regulation 421 (A. Fleischer, Jr. et al. eds. 1981); Theodore A. Levine et al., *Multiservice Securities Firms: Coping with Conflicts in a Tender Offer Context*, 23 WAKE FOREST L. REV. 41, 59 (1988); Richard M. Phillips, *Insider Trading Controls for Law Firms*, 23 Rev. Sec. & Comm. Reg. 113, 115 (1990).

3. See generally Howard Friedman, *The Insider Trading and Securities Fraud Enforcement Act of 1988*, 68 N.C. L. REV. 465 (1990); Larry Lavoie, *The Insider Trading and Securities Fraud Enforcement Act of 1988*, 22 Rev. Sec. & Comm. Reg. 1 (1989); John F. Olson et al., *Recent Insider Trading Developments: The Search for Clarity*, 85 NW. U. L. REV. 715 (1991).

4. See discussion *infra* notes 5-18 and accompanying text.

5. 15 U.S.C. § 78j(b) (1988).

6. 17 C.F.R. § 240.10b-5 (1994).

7. See 3 ALAN R. BROMBERG & LEWIS D. LOWENFELS, *SECURITIES FRAUD AND COMMODITIES FRAUD* § 7.2 (1992); VIII LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 3547-3769 (3d ed. 1991).

8. 15 U.S.C. § 78t(a) (1988) (subject to good faith defense, imposing joint and several liability on "[e]very person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder").

9. Securities Exchange Act of 1934 [hereinafter Exchange Act or 1934 Act] § 20(a), 15 U.S.C. § 78t(a) (1988) (A controlling person is liable for the subordinate's actions unless he "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."). Even after ITSFEA's passage, § 20(a) may be applicable in the

provides an incentive to implement procedures to preserve confidential information and to deter insider trading.¹⁰

Organizations also face potential liability under the doctrine of respondeat superior, which imposes liability on a principal for violations of law committed by its agent when such agent acts within the scope of his or her employment with actual or apparent authority.¹¹ Some courts have refused to apply respondeat superior under the federal securities laws on the ground that such application would undermine the good faith defense of the controlling person provisions.¹² The majority of courts, however, have applied respondeat superior to the federal securities laws on the theory that the controlling person provisions supplemented (rather than supplanted) common law agency theories in order to reach individuals, such as intermediate supervisors, who had no agency or employment relationship with the primary violators. Under this rationale, application of respondeat superior to the entity remains appropriate.¹³

In a prelude to the 1988 Act, Congress passed the Insider Trading Sanctions Act of 1984 (ITSA)¹⁴ which enabled the Securities and Exchange Commission (Commission or SEC) to obtain treble monetary penalties against inside traders.¹⁵ By its terms, ITSA generally imposed no derivative liability on the employer of the inside trader unless the employer, such as a broker-dealer, illegally tipped inside information to others.¹⁶ ITSA also

insider trading context, such as in private actions for damages. *See infra* note 34 and accompanying text.

10. *See* Donald C. Langevoort, *Commentary - The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*, 37 VAND. L. REV. 1273, 1284 (1984).

11. *See* Carol B. Silver, *Penalizing Insider Trading: A Critical Assessment of the Insider Trading Sanctions Act of 1984*, 85 DUKE L.J. 960, 971 n.71. *See generally* Ralph C. Ferrara & Diane Sanger, *Derivative Liability in Securities Law: Controlling Person Liability, Respondeat Superior, and Aiding and Abetting*, 40 WASH. & LEE L. REV. 1007 (1983).

12. *See, e.g.*, *Haynes v. Anderson & Strudwick, Inc.*, 508 F. Supp. 1303 (E.D. Va. 1981).

13. *See, e.g.*, *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990) (en banc); *Henricksen v. Henricksen*, 640 F.2d 880 (7th Cir. 1981); *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111 (5th Cir. 1980); *Marbury Management, Inc. v. Kohn*, 629 F.2d 705 (2d Cir. 1980). Note that, in its enactment of ITSFEA in 1988, Congress precluded respondeat superior liability in private actions brought by contemporaneous traders based on alleged insider trading violations. *See* § 20A(3) of the Securities Exchange Act, 15 U.S.C. § 78t-1(b)(3) (1988). *But see* *Central Bank of Denver v. First Interstate Bank of Denver*, 114 S. Ct. 1439 (1994) (holding that aider and abettor liability may not be imposed in private actions under § 10(b) and arguably implying the rejection of respondeat superior under the federal securities laws).

14. Pub. L. No. 98-376, 98 Stat. 1264 (1984). *See generally* Langevoort, *supra* note 10; Silver, *supra* note 11; Note, Stephen Bainbridge, *A Critique of the Insider Trading Sanctions Act of 1984*, 71 VA. L. REV. 455 (1985).

15. ITSA § 2 (originally codified at 15 U.S.C. § 78u(d)(2)(A)); ITSFEA amended and recodified this section at 15 U.S.C. § 78u-1(a)(2) (1988). The treble damage provision was enacted in response to criticism that "it often was impractical [for the SEC] to impose a greater sanction than forcing the violator to give back his ill-gotten gains and to promise never to do it again." Stuart J. Kaswell, *An Insider's View of the Insider Trading and Securities Fraud Enforcement Act of 1988*, 45 BUS. LAW. 145, 153 (1989).

16. Kaswell, *supra* note 15, at 154. *See* Harold S. Bloomenthal, *Insider Trading and Securities Fraud Enforcement Act of 1988*, 11 Sec. and Fed. L. Rep. No. 7, at 49, 53 (July-Aug. 1989). Theodore A. Levine, *Insider Trading Act Broadens Enforcement Scope*, LEGAL TIMES OF WASHINGTON, Sept. 10, 1984, at 17 ("Tippers are exposed to the penalty as aiders and abettors, but not so a broker who merely executes the trade").

specified that neither the doctrine of respondeat superior nor the controlling person provision, Section 20(a) of the Exchange Act, would apply to its penalties.¹⁷ Moreover, ITSA explicitly stated that “[n]o person shall be subject to penalty under subsection (a) of this section solely by reason of employing another person who is subject to penalty under such subsection. . . .”¹⁸

B. CONTROL PERSON LIABILITY UNDER THE INSIDER TRADING AND SECURITIES FRAUD ENFORCEMENT ACT OF 1988

Congress enacted the ITSFEA in response to a series of Wall Street trading scandals¹⁹ and in order to restore confidence in the securities markets in the wake of the stock market crash of October 1987.²⁰ At the time of ITSA, the Congress believed that the SEC had adequate enforcement remedies with respect to broker-dealers and other controlling persons. Accordingly, it did not extend the treble penalties of ITSA to controlling persons or to employers under principles of respondeat superior.²¹ The insider trading scandals of the late 1980s, however, undermined this perception and led to a belief that the problem of insider trading was an institutional one.²² As a central component of the legislation’s effort to provide a greater deterrent to insider trading, ITSFEA expanded the scope of civil penalties for “ ‘controlling persons’ who fail to take adequate steps to prevent insider trading.”²³ Furthermore, it required broker-dealers and investment advisors to maintain procedures that are reasonably designed to prevent insider trading abuses by

17. ITSA § 2, *supra* note 14, 98 Stat. at 1264 (current version at 15 U.S.C. § 78u-1(b)(2)); see Langevoort, *supra* note 10, at 1282-83.

18. ITSA § 2, *supra* note 14, at 1264; see MARC I. STEINBERG & RALPH C. FERRARA, *SECURITIES PRACTICE: FEDERAL AND STATE ENFORCEMENT* § 2:13 (1985 & 1994 Supp.).

19. *Insider Trading and Securities Fraud Enforcement Act of 1988*, H.R. REP. NO. 910, 100th Cong., 2d Sess. 7, 11-14 (1988), reprinted in 1988 U.S.C.C.A.N. 6043, 6044, 6048-51 [hereinafter HOUSE REPORT]. The House Report noted that despite the stiffer penalties imposed by ITSA, the dramatic rise of insider trading cases illustrated the need for a legislative response. The report pointed to the cases of Dennis Levine, Ivan Boesky, and Martin Siegel, the “Yuppie Five,” among others. *Id.*; see JAMES B. STEWART, *DEN OF THIEVES* (1991).

20. HOUSE REPORT, *supra* note 19, at 6044. As stated by one source: “The October 1987 crash was the largest stock market crash ever experienced in the United States.” Lawrence Harris, *The Dangers of Regulatory Overreaction to the October 1987 Crash*, 74 CORNELL L. REV. 927, 927 (1989). See generally C. Edward Fletcher III, *Of Crashes, Corrections, and the Culture of Financial Information - What They Tell Us About the Need for Federal Securities Regulation*, 54 MO. L. REV. 515 (1989); Lewis D. Solomon & Howard B. Dicker, *The Crash of 1987: A Legal and Public Policy Analysis*, 57 FORDHAM L. REV. 191 (1988).

21. See Bloomenthal, *supra* note 16, at 54.

22. *Id.* The House Report stated:

The recent wave of cases has cast serious doubt on the effectiveness of firm supervisory procedures [Q]uestions have been raised about the efficacy of some firms “Chinese Walls” The mergers and acquisitions departments of investment houses contain highly sensitive materials . . . , invaluable information in the hands of skilled market professionals. In the view of the Committee, there is a need for an affirmative statutory obligation for every broker, dealer and investment advisor to design effective procedures to restrict and monitor access to such information and prevent insider trading. The Committee links this affirmative obligation to the ITSA penalties.

HOUSE REPORT, *supra* note 19, at 6052.

23. House Report, *supra* note 19, at 6044.

their employees and associated persons.²⁴

The new penalties for controlling persons under ITSFEA were intended to "increase the economic incentives for such persons to supervise vigorously their employees."²⁵ Section 21A(a)(3) grants authority to the Commission to seek civil penalties against controlling persons up to the "greater of \$1,000,000, or three times the amount of the profit gained or loss avoided" by the inside trader.²⁶ Under this provision, controlling persons face the potential of massive liability exposure for each insider trading violation by their employees or associated persons.²⁷

While ITSFEA increased the amount of civil penalties that the Commission could seek against controlling persons, it adopted a new standard of liability for these enhanced penalties. To recover these penalties, the Commission must prove that the controlling person "knew or recklessly disregarded the fact that such controlled person was likely to engage in the act or acts constituting the violations and failed to take appropriate steps to prevent such act or acts before they occurred."²⁸ ITSFEA does not define "knowing" or "reckless" behavior, but the legislative history suggests that "[t]he risk involved must be such that to disregard it would constitute a

24. *Id.* See 15 U.S.C. §§ 78o(f), 80b-4a (1988). In the recently enacted Government Securities Act Amendments of 1993, H.R. REP. NO. 255, 103rd Cong., 1st Sess. 23-24, (1993) reprinted in 1993 U.S.C.C.A.N. 2993, 3012-13, Congress once again emphasized that broker-dealers must establish and implement reasonably adequate procedures. As stated in the House Report:

The Committee believes that the Salomon Brothers scandal and its aftermath have amply demonstrated the need to heighten the commitment of government securities brokers and dealers to assuring that their employees comply with the applicable provisions of the federal securities laws. To help deter fraud and manipulation in the government securities market, the Committee believes that it is necessary to reemphasize the need for government securities brokers and dealers to establish internal controls to prevent such violations. The general responsibility of brokers and dealers to supervise their employees in order to prevent violations of law is well established. For example, Section 15(b)(4)(E) of the Exchange Act authorizes the Commission to impose various sanctions on firms who do not meet their responsibilities. In addition, self-regulatory organizations have rules requiring the establishment of supervisory procedures.

To supplement these general rules, the Committee believes it is necessary that firms not only improve the supervision of their employees but that they implement written policies and procedures designed to prevent fraud and manipulation in connection with transactions in government securities. In addition, the bill would permit each appropriate regulatory agency, in its discretion, to require such policies and procedures with respect to other provisions of the federal securities laws. The Salomon Brothers scandal revealed both that certain employees were willing to flout the laws and that the firm's senior management explicitly or implicitly condoned such actions. Comprehensive compliance policies provide mechanisms that encourage low and mid-level employees to meet their legal obligations and signal to such employees that senior management will not tolerate violators.

H.R. REP. NO. 255, 103rd Cong., 1st Sess. 24-24 (1993), reprinted in U.S.C.C.A.N. 2993, 3012-3.

25. HOUSE REPORT, *supra* note 19, at 6054.

26. 15 U.S.C. § 78u-1(a)(3) (1988).

27. Note that a controlling person includes not only an employer but also "any person with power to influence or control the direction or the management, policies, or activities of another person." HOUSE REPORT, *supra* note 19, at 6054.

28. 15 U.S.C. § 78u-1(b)(1)(A) (1988).

gross deviation from the standard of care that a reasonable person would exercise in such a situation."²⁹

If the controlling person is a broker-dealer or investment advisor, ITSFEA provides the Commission with more potent ammunition for imposing the new monetary penalties. ITSFEA sets forth an affirmative duty on broker-dealers and investment advisors to maintain adequate procedures to protect against insider trading and it defines a separate standard for controlling person liability in reference to that duty. First, ITSFEA added Section 15(f) of the Exchange Act³⁰ and Section 204A of the Investment Advisors Act of 1940 (Advisors Act)³¹ which impose an affirmative duty on broker-dealers and investment advisors to maintain "written policies and procedures reasonably designed" to prevent insider trading violations.³² Second, Section 21A(b)(1)(B) subjects broker-dealers and investment advisors to controlling person liability if they "knowingly or recklessly failed to establish, maintain, or enforce" those procedures and "such failure substantially contributed to or permitted the occurrence" of the insider trading violation.³³

When ITSFEA defined these new standards of controlling person liability

29. HOUSE REPORT, *supra* note 19, at 6055. Elaborating, the House Report stated: Under Subsection (1)(A), the Commission must establish either "knowing" or "reckless" behavior on the part of the controlling person as a predicate for the imposition of a [treble] civil penalty against the controlling person. The statute does not define the terms "knowing" or "reckless." In order to seek imposition of a civil penalty, the Commission must establish that a controlling person objectively disregarded a risk that a controlled person was engaged in violations of the insider trading laws. The risk involved must be such that to disregard it would constitute a gross deviation from the standard of care that a reasonable person would exercise in such a situation. For example, "recklessness" encompasses a heedless indifference as to whether circumstances suggesting employee violations actually exist. The Committee's concern in this context is with an objective standard of supervision which, if breached, will result in the imposition of substantial civil fines.

The controlling person is responsible under this subsection if it fails to take an appropriate action once it knew or was reckless in disregarding indications that its controlled person was engaging in insider trading or tipping. An aiding and abetting standard was specifically considered and rejected by the Committee.

Id.

30. Section 15(f) of Securities Exchange Act, 15 U.S.C. § 78o(f) (1988).

31. Section 204A of Investment Advisors Act of 1940, 15 U.S.C. § 80b-4a (1988).

32. 15 U.S.C. §§ 78o(f), 80b-4a (1988).

33. 15 U.S.C. § 78u-1(b)(1)(B) (1988). As stated in the House Report:

Section 21A(b)(1)(B) operates in tandem with Section 15(f) of the Exchange Act and Section 204A of the Investment Advisors Act of 1940. These sections impose upon broker-dealers and advisers an affirmative duty to institute, maintain and enforce a reasonable and proper system of supervision, surveillance and internal control to protect against securities laws violations. A penalty may be imposed under Subsection (1)(B) where the failure to establish, maintain and enforce an appropriate supervisory system has "substantially contributed to or permitted" the violation's occurrence. While the failure to establish, maintain, or enforce the policy or procedure must be relevant to the conduct leading to the controlled person's violations, this provision does not condition responsibility for possible sanction upon proof that but for the controlled person's breach the violation would not have occurred. It is sufficient that the breach thereby allowed the violation to occur, or that it provided assistance to the controlled person's violations.

HOUSE REPORT, *supra* note 19, at 6055.

for its enhanced civil penalties, it specifically provided that the controlling person standard of Section 20(a) and the principles of respondeat superior would not apply to the new penalties.³⁴ Thus, in this context, a controlling person need not prove that he acted in good faith and that he did not directly or indirectly induce the controlled person's violations. Instead, the Commission must establish knowing or reckless behavior on the part of the controlling person.³⁵ As a result of this new standard and the preclusion of respondeat superior liability in this setting, ITSFEA arguably softens the impact of its enhanced penalties by imposing a more difficult burden of proof on the Commission. Nonetheless, given the astronomical liability exposure and the emergence of organizational compliance programs directed against insider trading as an industry norm,³⁶ the absence of a reasonably effective compliance program in this context makes little sense.³⁷ In a situation where an employee or other associated person engages in insider trading and the organization lacks reasonably adequate procedures, the distinct risk that the SEC will initiate an enforcement action still remains.³⁸ By alleging that the organization (or other controlling person) failed to meet ITSFEA's compliance standards, the Commission may seek a plethora of remedies, including the levying of a monetary penalty.³⁹

III. BASIC REQUIREMENTS OF COMPLIANCE PROGRAMS

Organizations should assess the nature of their business to determine the risks of insider trading and the need for preventive policies. A key determinant is the extent that an enterprise's personnel come into possession of material, nonpublic information about publicly-traded securities during the course of their work.⁴⁰ This article focuses on three types of organizations

34. Section 21A(b)(2) of Exchange Act, 15 U.S.C. § 78u-1(b)(2) (1988). Nonetheless, in other contexts involving insider trading, such as in private actions for damages and SEC actions for disgorgement, the controlling person provision of Section 20(a) remains viable.

35. See *supra* notes 28-29 and accompanying text.

36. See, e.g., Phillips, *supra* note 2, at 114-15; David S. Ruder, *Development of a Corporate Disclosure Compliance Program*, 6 Insights No. 6, at 3, 6 (June 1992).

37. See, e.g., Ruder, *supra* note 36, at 6 ("It is important that the corporation establish a formal insider trading policy."); authorities cited *supra* note 2; discussion *infra* notes 307-14 and accompanying text.

38. See Phillips, *supra* note 2, at 115 ("Given the Commission's admonition [that law firms have an obligation to safeguard inside information - see Securities Exchange Act Release No. 13437 (1977)], the large number of law firm personnel involved in insider trading cases, and the harsh penalties of ITSFEA, an increasing number of law firms have decided to adopt formal insider trading policies.").

39. Although not discussed herein, ITSFEA also (1) amended Section 32(a) of the Exchange Act to increase the maximum criminal fine and term of imprisonment, (2) created a new Section 20(A) to provide a private right of action for "contemporaneous traders," and (3) established a bounty provision to authorize the SEC to award up to ten percent of the civil penalty imposed or the amount disgorged to persons who provide information with respect to insider trading violations. See Sections 20A, 21A(e), and 32(a) of the Exchange Act, 15 U.S.C. §§ 78t-1(a), 78u-1(e), 78ff(a) (1988) (as amended by ITSFEA).

40. See Richard M. Phillips & Gilbert C. Miller, *Compliance Programs Under the Insider Trading and Securities Fraud Enforcement Act of 1988* at 8, The University of California, San Diego Nineteenth Annual Securities Regulation Institute (1992) (stating that "firms whose employees have access to confidential information that could affect the market price of securi-

that are most often implicated in insider trading situations: professional firms, especially law and accounting firms; financial intermediaries such as broker-dealers, investment advisors, and banks; and publicly-held companies.⁴¹ At a minimum, any organization within these three categories should examine such factors as the size and nature of its business in the adoption of insider trading policies and procedures. The organization should reexamine its findings in light of changed conditions on a periodic basis.⁴²

If an organization determines the need for an insider trading policy, the policy adopted may focus on three areas: (1) educating employees about the prohibitions and risks of insider trading; (2) implementing procedures to help prevent and detect abuses in this context; and (3) adopting mechanisms to limit access to confidential information.⁴³ Even a very general policy should cover the first area of educating the organization's employees and disseminating a clear statement that articulates the basic prohibitions against insider trading (and tipping).⁴⁴

A. ELEMENTS OF AN EDUCATION POLICY

All insider trading policies should provide a concise, nontechnical definition of what constitutes insider trading.⁴⁵ The definition of insider trading should make clear that both trading and tipping are prohibited and that the tipping prohibition covers spouses, members of households, and friends.⁴⁶ Likewise, the definition should make clear that insider trading prohibitions apply to securities of non-clients.⁴⁷ The policy, moreover, should provide definitions of key terms like materiality⁴⁸ and nonpublic.⁴⁹ It is also helpful

ties operate at their peril if they fail to take appropriate steps to prevent insider trading violations by their employees").

41. See *infra* notes 69-348 and accompanying text.

42. See Phillips, *supra* note 2, at 115 (asserting that firms should consider "a wide variety of factors, such as the size of the firm, number and locations of its offices, nature of its communication systems, prior problems with insider trading, firm culture, and most important of all, the nature of the firm's practice").

43. See American Bar Association's Subcommittee on Civil Litigation and SEC Enforcement Matters, *Law Firm Policies Regarding Insider Trading and Confidentiality*, 47 BUS. LAW. 235, 240-58 (1991) [hereinafter ABA Report] (reviewing law firm policies); Phillips, *supra* note 2, at 114-17.

44. See Phillips & Miller, *supra* note 40, at 14 ("For many companies, the use of a policy statement, properly disseminated and enforced, will be sufficient.").

45. See MARC I. STEINBERG, CORPORATE AND SECURITIES MALPRACTICE 95-104 (1992) (providing sample policy for law firms); ABA Report, *supra* note 43, at 241-46 (reviewing law firm policies and providing different examples of definitions of insider trading).

46. ABA Report, *supra* note 43, at 247 (providing sample definitions that make clear that tipping information to one's spouse or minor children is also prohibited).

47. In the case of publicly-held companies, the policy would make clear that the prohibition also applies to securities of other companies. See Phillips, *supra* note 2, at 115.

48. ABA Report, *supra* note 43, at 243-44 (providing three sample definitions of material information). One such example provides that "material information means information relating to a company with publicly-traded securities, its business operations or securities, the public dissemination of which would likely affect the market price of any of its securities, or which would likely be considered important by a reasonable investor in determining whether to buy, sell, or hold such securities." *Id.* at 243; see also Steinberg, *supra* note 45, at 97.

49. Steinberg, *supra* note 45, at 98; ABA Report, *supra* note 43, at 244-45. The definition should also explain when information becomes public. Steinberg, *supra* note 45, at 98 (listing

to provide examples of inside information that an organization's personnel would be likely to encounter.⁵⁰ The policy should outline the potentially severe consequences of insider trading, such as incurring substantial civil and criminal penalties.⁵¹ It should also specify the impact of violations on employment with the organization.⁵² Finally, the policy should provide the name of an individual who may be contacted to answer any questions about the policy.⁵³

B. ADMINISTRATIVE STEPS TO IMPLEMENT POLICY

An organization should adopt procedures only if it has the commitment to observe and to enforce them. The policies and procedures implemented should reflect the level of risk that insider trading in the organization may eventuate.⁵⁴ An enterprise whose operations involve relatively few opportunities for insider trading may have the need to adopt only a basic policy statement.⁵⁵ On the other hand, the greater risks present in a broker-dealer's business merit a more extensive policy.⁵⁶ Moreover, ITSFEA (as reflected in its legislative history and as codified in Section 15(f) of the Exchange Act and Section 204A of the Advisors Act) mandates the implementation of reasonably effective procedures.⁵⁷

To implement a basic education policy, an organization should distribute

media through which information can be publicly disseminated, such as Dow Jones broad tape, wire services, radio, television, and widely circulated newspapers and magazines).

50. Examples of inside information: information concerning mergers, acquisitions, anti-trust charges, threats of litigation, financial statements, income projections, proposed changes in dividend rates, labor disputes, pending large commercial or governmental contracts, key personnel changes, possible initiation of a proxy fight, major new products or services, and significant shifts in operating or financial circumstances (such as major write-offs and strikes at major plants). See Steinberg, *supra* note 45, at 97; ABA Report, *supra* note 43, at 242-44.

51. See, e.g., § 21A(a)(2) of Exchange Act, 15 U.S.C. § 78u-1(a)(2) (1988) (persons who commit insider trading violations face civil fine up to the greater of \$1,000,000 or three times the amount of any profit gained or loss avoided in the transaction); § 32(a) of Exchange Act, 15 U.S.C. § 78ff(a) (1988) (willful violations of the securities laws can incur potential criminal penalties up to \$1,000,000, imprisonment up to 10 years, or both); § 21(d)(2) of Exchange Act, 15 U.S.C. § 78u(d)(2) (Supp. III 1992) (under certain circumstances, persons found to violate Section 10(b) of the Exchange Act can be barred from serving as officer or director of an Exchange Act company).

52. For example, violations by company personnel may be grounds for dismissal. See ABA Report, *supra* note 43, at 256; Robert A. Barron, *Model Memoranda*, 17 SEC. REG. L.J. 195, 202 (1989).

53. See Barron, *supra* note 52, at 201-02 (providing a model policy on insider trading that could be distributed to all employees of a publicly-held corporation).

54. See, e.g., Kaswell, *supra* note 15, at 164 (Because "firms have different types of businesses with different types of risk . . . a small discount broker-dealer would not need nearly as extensive a surveillance system as a major firm with divisions engaged in retail brokerage, investment banking, investment advisory services, arbitrage, and specialist operations.").

55. See, e.g., Phillips & Miller, *supra* note 40, at 14.

56. See *infra* notes 120-299 and accompanying text.

57. See § 15(f) of the Exchange Act, 15 U.S.C. § 78o(f) (1988); § 204(A) of the Advisors Act, 15 U.S.C. § 80b-4(a); see House Report, *supra* note 19, at 6058 ("The requirements of these new statutory provisions reflect the Committee's belief that broker-dealers and investment advisers must not only adopt and disseminate written policies and procedures to prevent the misuse of material, nonpublic information, but also must vigilantly review, update, and enforce them.").

copies of the policy to all personnel and obtain signed acknowledgments that the policy was read, understood, and will be followed.⁵⁸ The organization should consider holding training sessions to explain the policy.⁵⁹ The organization should designate a person or a committee to monitor the implementation of the policy. This compliance official or committee should include high-level personnel with significant supervisory responsibilities.⁶⁰ The compliance personnel would be responsible for implementing a procedure that requires all employees, temporary and permanent, to sign acknowledgments when they begin work. Organizations should also consider providing employees with a mechanism that would allow them to ask questions about the policy and to report possible violations in an anonymous fashion and without fear of retribution.⁶¹

Generally, the greatest flaws in existing compliance programs relate to enforcement and documentation.⁶² An organization whose compliance program lacks these attributes incurs the risk of substantial liability exposure. One study on the legal effectiveness of compliance programs shows that outside observers often view them with skepticism.⁶³ Courts may well scrutinize the procedures adopted to assess their implementation, probable effectiveness, the timing of their implementation, and the seriousness of the organization's commitment to the procedures. An organization that cannot document the efforts taken pursuant to its compliance program will face a significant burden when trying to prove its effectiveness to an outside party.⁶⁴ In this respect, an organization would be ill advised to adopt any nonessential component of a program that cannot be feasibly implemented. Stated succinctly, once a compliance program is adopted, the organization

58. See, e.g., Phillips, *supra* note 2, at 115.

59. *Id.* See ABA Report, *supra* note 43, at 247-48.

60. See *infra* notes 315-17 and accompanying text, discussing the U.S. Sentencing Commission guidelines on effective institutional policies. These sentencing guidelines define seven elements of an effective compliance program, one of which is the designation of a high-level person as the responsible person.

61. See U.S. Sentencing Guidelines (suggesting this mechanism), *infra* notes 315-17 and accompanying text (discussing these guidelines).

62. See Harvey L. Pitt & Karl A. Groskaufmanis, *Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes of Conduct*, 78 GEO. L.J. 1559, 1604 (1990) (stating that enforcement is weak in the majority of corporate compliance programs); *infra* notes 231-99 and accompanying text; see also Ilene H. Nagel & Winthrop M. Swenson, *The Federal Sentencing Guidelines for Corporations: Their Development, Theoretical Underpinnings, and Some Thoughts About Their Future*, 71 WASH. U. L.Q. 205, 209 (1993) ("There is increasing evidence in recent months that many American businesses are revisiting - or considering seriously for the first time - their in-house policies toward employee noncompliance with the law and related misconduct.").

63. See Pitt & Groskaufmanis, *supra* note 62, at 1630-31 (stating that critics of compliance programs see them as self-serving, public relations ploys).

64. See *id.* at 1639-42; SEC Division of Market Regulation, *Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Nonpublic Information*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,520 at 80,626 (1990) [hereinafter SEC Division Report] (asserting that a broker-dealer's "failure to maintain documentation sufficient to re-create actions taken pursuant to Chinese wall procedures will make reviews and determinations of the adequacy of procedures and compliance efforts exceedingly difficult").

"must abide by it."⁶⁵

An organization should consider requiring its compliance personnel to report periodically on the program's implementation to help document its efforts. The persons responsible should report to an oversight committee, composed of individuals with high-level responsibility and some independence from the head of compliance. In these reports, some documentation of compliance efforts should be provided. Such documentation could include a log of all training sessions with the dates, number of persons attending, and the topics covered. A log tracking the dates that the organization's personnel executed the required acknowledgments or certifications also may be kept. An underlying objective should be documentation that illustrates the efforts taken by the organization to substantiate its efforts to outside parties.⁶⁶

Any organization whose employees may have access to material, nonpublic information would be prudent to promulgate a basic education policy. Many organizations whose operations merit a compliance program will implement additional procedures that are aimed at the prevention and detection of insider trading.⁶⁷ Next, this article will address the combinations of procedures used by professional firms, financial intermediaries, and publicly-held corporations.

IV. PROFESSIONAL FIRMS: ACCOUNTING AND LAW FIRMS

A. POSITIONS ON ADOPTING POLICIES AND PROCEDURES REGARDING INSIDER TRADING

In recent years, many law and accounting firms have adopted policies and procedures regarding insider trading.⁶⁸ Unlike broker-dealers and investment advisors, lawyers and accountants do not have an affirmative duty under ITSFEA to maintain written policies and procedures designed to prevent the abuse of inside information.⁶⁹ On several occasions, however, the SEC and its personnel have argued that professional firms have an affirmative duty to adopt procedures to protect confidential information.⁷⁰

65. Dan K. Webb & Steven F. Molo, *Some Practical Considerations in Developing Effective Compliance Programs: A Framework for Meeting the Requirements of the Sentencing Guidelines*, 71 WASH. U. L.Q. 375, 379 (1993) ("A sentencing court will deem a program 'noneffective' - based on lack of enforcement - if the company fails to follow its compliance program."); See *How to Comply With the Law*, AUSTRALIAN LAW NEWS No. 5, at 20 (June 1991) ("Professor Steinberg said [that while] the [compliance] program should be effectively administered . . . the company should not adopt any nonessential aspect of a prospective program that it could not feasibly implement.").

66. See Michael Goldblatt, *Corporate Compliance: Institutionalizing Compliance with Company-Wide Training Programs*, 6 Insights, No. 1, at 22 (Jan. 1992); Pitt & Groskaufmanis, *supra* note 62, at 1643-45.

67. See, e.g., discussion *infra* notes 132-46 and accompanying text.

68. See ABA Report, *supra* note 43, at 239-40 (surveying various international, national, and regional law firms and finding that at least 33 of the 40 firms surveyed had policies in effect).

69. See 15 U.S.C. § 78o(f), 15 U.S.C. § 80b-4(a) (1988) (imposing duty on broker-dealers and investment advisors to maintain written policies and procedures).

70. See, e.g., SEC v. Lerner, David, Littenberg and Samuel, SEC. Lit. Rel. No. 9049, 19

Although this position is debatable,⁷¹ law and accounting firms are prescribing procedures in the face of SEC warnings,⁷² liability exposure under ITSFEA,⁷³ and the large number of law firms implicated in insider trading scandals.⁷⁴ Indeed, in view that the adoption of a law compliance program directed against insider trading is standard fare for sophisticated accounting and law firms engaged in the representation of publicly-held enterprises, those firms that decline to have such a program in place may be viewed as recklessly disregarding the fact that a person it controls is likely to engage in such a violation.⁷⁵ This risk of liability exposure is not confined to the firm itself but extends to controlling persons of the organization, hence encompassing senior partners of law and accounting firms and others with supervisory responsibility.⁷⁶

SEC Docket (CCH) 1153 (D.D.C. 1980) (Commission asserts that law firms have duty to adopt, implement and enforce procedures designed to protect client information); Securities Exchange Act Release No. 13437, 11 SEC Docket (CCH) 2231, 2231 (1977) ("Law firms, like others which have confidential information in their possession that may affect the securities trading markets, have an affirmative obligation to safeguard such information."); Philip R. Lochner, Jr., *Lawyers and Insider Trading*, 11 BUS. LAW. UPDATE NO. 5, at 1, 14 (May/June 1991) (arguing that "ITSFEA can be viewed as imposing an affirmative obligation on law firms to take appropriate action to prevent insider trading"); *SEC Finding Law Firms Lack Safeguards to Deter Insider Trading*, *Breedon Says*, 22 SEC. REG. & L. REP. (BNA) 1378 (1990); see also Peter M.O. Wong, Note, *Insider Trading Regulation of Law Firms: Expanding ITSFEA's Policy and Procedures Requirement*, 44 HASTINGS L.J. 1159, 1182-83 (1993) (proposing that "Congress amend ITSFEA to include lawyers and law firms with broker-dealers and investment advisers under ITSFEA's requirement to establish, maintain, and enforce policies and procedures aimed at preventing insider trading").

71. See ABA Report, *supra* note 43, at 239 & n.5 (stating that "no court has held that law firms must have in place a formal statement of policy or procedures in order to avoid vicarious liability for the errant acts of misguided employees or members").

72. See sources cited *supra* note 70.

73. See *supra* notes 23-39 and accompanying text.

74. See Phillips, *supra* note 2, at 115; Theodore A. Levine & Arthur F. Mathews, *Law Firm Policies and Procedures to Prevent Insider Trading Abuses*, 21 Ann. Inst. on Sec. Reg. 395, 411-24 (1989) (reviewing several insider trading cases involving lawyers or law firm personnel). These cases include *United States v. Grossman*, 843 F.2d 78 (2d Cir. 1988) and *SEC v. O'Hagen*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,852 (D. Minn. 1989).

75. See 18 DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT & PREVENTION § 12.03[3], at 12-27, 12-28 (1993) (stating that after the passage of ITSFEA, "potential law firm liability . . . [for] failure to supervise or control is a serious possibility"); Jonathan Eisenberg, *Law Firms Beware! Recent Insider Trading Legislation Affects You Too*, WASH. LAW., at 38, 40 (Nov./Dec. 1989) (asserting that a law firm's "failure to adopt policies and procedures may itself evidence recklessness"); *Requirements of Insider Trading Act Go Beyond Securities Firms*, *Lynch Says*, 21 SEC. REG. & L. REP. (BNA) 65 (1989) (former SEC Enforcement Director opining that "there could be a case where the mere fact that a firm failed to establish any policies and procedures whatsoever would be deemed to be reckless conduct"); discussion *supra* note 28 and accompanying text; *infra* notes 307-14 and accompanying text.

76. See Phillips, *supra* note 2, at 114 (stating that "not only the law firm but partners and individuals with supervisory responsibility over the firm's operations or the violator can be subject to the controlling person penalties provided for in ITSFEA"); Wong, *supra* note 70, at 1166 (pointing out that "senior members of law firms may be subject to liability under ITSFEA, but may not realize that they are considered a controlling person").

An even broader argument can be set forth in this context: namely, that conduct by a professional firm that slights the adoption and implementation of a reasonably effective law compliance program may fail to adhere to professional norms, hence constituting evidence of negligence. See generally Steinberg, *supra* note 45, at 27 ("The standard against which an attorney's conduct is measured is the degree of care that is usual and customary practice of

On another level, professional firms have reasons to consider adopting procedures irrespective of potential liability under the applicable laws. Lawyers should abide by the ethical and professional rules of conduct adopted by their state and local bar associations.⁷⁷ Furthermore, law and accounting firms, like all professional organizations, desire to protect their reputations from insider trading scandals involving members or employees.⁷⁸

B. SPECIFIC POLICIES AND PROCEDURES THAT LAW AND ACCOUNTING FIRMS MAY ADOPT

Based on the liability framework for controlling persons introduced under ITSFEA, it would be prudent for professional firms, that represent publicly-held enterprises or otherwise that are privy to inside information, to adopt education policies that cover not only ethical rules but also legal prohibitions concerning insider trading. Specifically, such firms should have a basic policy designed to educate their personnel about the laws on insider trading, the ethical rules on confidentiality, and the attendant risks of noncompliance.⁷⁹

The primary issue with law and accounting firms should be whether to adopt policies and procedures that go beyond a basic education policy and include preventive measures. The size of a firm is an important consideration, but the most relevant factor is the nature of the firm's practice.⁸⁰

For instance, many law firms that represent publicly-held companies have instituted pre-clearance procedures for trading by their personnel in client securities.⁸¹ Moreover, firms whose practices focus principally on their clients' compliance with Exchange Act reporting requirements should ascertain whether more detailed procedures would be prudent. And, as a

lawyers under similar circumstances."), *citing*, O'Neil v. Bergan, 452 A.2d 337 (D.C. App. 1982); Sommerfeldt v. Trammel, 74 Or. App. 183, 702 P.2d 430 (1985).

77. Levine & Mathews, *supra* note 74, at 398-400; Wong, *supra* note 70, at 1178-81. The ABA Model Rules of Professional Conduct contain at least three provisions that impact on insider trading. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6 (1994) (with certain exceptions, broad duty to maintain client confidences obtained during the course of representing a client, regardless of the source of the information); *id.* Rule 1.8(b) (providing that "[a] lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client consents after consultation"); *id.* Rule 5.3 and comment (responsibilities regarding nonlawyer assistants include giving "appropriate instruction and supervision regarding the ethical aspects of their employment, particularly concerning the obligation not to disclose information relating to representation of the client").

78. See Stephen R. Volk et al., *Law Firm Policies and Procedures in an Era of Increasing Responsibilities: Analysis of a Survey of Law Firms*, 48 BUS. LAW. 1567, 1568 (1993); see also Levine & Mathews, *supra* note 74, at 398-400. *But see* Helen A. Garten, *Insider Trading in the Corporate Interest*, 1987 WIS. L. REV. 573, 594 (asserting that "if professional firms . . . serve as sources of valuable information, then dealing in information, even inside information, may further the goals of the firm by enhancing its reputation for knowledge and expertise").

79. See Phillips, *supra* note 2, at 115 (recommending the minimum elements of an insider trading policy for a law firm); see also Steinberg, *supra* note 45, at 93 ("Given the extent of insider trading that has been engaged in by law firm personnel, it would be prudent for law firms to adopt and enforce formal insider trading policies."); Jonathan Eisenberg, *Protecting Against Insider Trading Liability*, 22 Rev. Sec. & Comm. Reg. 87 (1989); Herbert S. Wander, *Insider Trading: How Law Firms Can Protect Themselves*, 1 Insights No. 2, at 9 (Aug. 1987).

80. See ABA Report, *supra* note 43, at 240 n.11 (listing some factors to consider when adopting a policy); Phillips, *supra* note 2, at 115 (same); *supra* note 42 and accompanying text.

81. See ABA Report, *supra* note 43, at 248-51.

generality, corporate practices that frequently involve mergers, acquisitions, and tender offer [hereinafter M&A] work have the greatest need for extensive procedures.⁸²

Furthermore, a professional firm that performs no corporate or securities work should not necessarily assume that adoption of a basic education policy as the sole ingredient of its law compliance program is a sufficient safeguard. For example, the Commission's first insider trading suit against a law firm, *SEC v. Lerner*,⁸³ involved a small firm whose practice focused almost exclusively on patent work. In that case, the lawyers purchased securities of a client based on nonpublic information about the disposition of the client's patent application.⁸⁴ Likewise, firms with only litigation practices may face risks.⁸⁵ The point is that, irrespective of the specialties practiced, a firm should not overlook the prospect of obtaining inside information in the representation of publicly-held clients.

The remainder of this section addresses policies and procedures that have frequently been employed by law firms.

1. Education Policies

The basic education policies outlined above with respect to the prohibitions against insider trading⁸⁶ are equally suited for law firm personnel. One variation is to tailor the examples of insider trading to the situations most likely to arise in the course of each firm's practice.⁸⁷ One important difference for law firms, however, is that their education policies also should address the additional prohibitions imposed by state bar rules on professional conduct.⁸⁸

In this regard, the policy should include a definition of "client confidences." This term covers a broad range of material: any information that law firm personnel obtain in the course of the firm's representation of a client (irrespective of whether such information comes within the attorney-client

82. Firms with practices focusing on Exchange Act reporting requirements frequently encounter information regarding such matters as corporate earnings, changes in management, and major accounting write-offs that affect the price of client securities. See Phillips, *supra* note 2, at 116. See also ABA Report, *supra* note 43, at 243-44. Even if a firm's corporate practice involves only privately-held companies, insider trading concerns could arise if one of its clients obtained a major new contract at the expense of a publicly-held rival. See ABA Report, *supra* note 43, at 248-50. With respect to firms specializing in M&A practices, see Michele Galen, *Insider-Trading Probes Raise Alarm: Security More Crucial Than Ever*, NAT'L L.J., June 30, 1986, at 1 (discussing difficulty of law firms specializing in M&A work to prevent trading and tipping by their personnel).

83. *SEC v. Lerner*, David, Littenberg, and Samuel, SEC Lit. Rel. No. 9049, 19 SEC Docket (CCH) 1153 (D.D.C. 1980).

84. *Id.*; see Levine & Mathews, *supra* note 74, at 403.

85. Some examples include prospective bankruptcy petitions for a publicly-held company or contemplated litigation against a publicly-held company. See ABA Report, *supra* note 43, at 243-44.

86. See *supra* notes 45-67 and accompanying text.

87. See, e.g., ABA Report, *supra* note 43, at 243 (providing examples relating to material information).

88. *Id.* at 258-61 (providing examples of law firm policies on insider trading that include separate discussions of ethical rules on confidentiality).

privilege).⁸⁹ Of course, such information is not limited to information that could potentially affect the price of publicly-traded securities.⁹⁰ As a matter of practice, law firm personnel should assume that any information obtained at work regarding a client is confidential.⁹¹

The policy should adopt a general prohibition on discussing client confidences outside of work, with an emphasis on communications to spouses, relatives, and friends. It should direct personnel to discuss confidences only on a "need-to-know" basis.⁹² Finally, the policy should warn personnel never to use client confidences for their personal advantage, which is not necessarily limited to trading in securities.⁹³

2. Procedures and Policies to Detect and Prevent Abuses

The following is a discussion of some of the devices that law firms have adopted to prevent and detect insider trading by their personnel. Due to the administrative overhead that these measures entail, only firms with substantial insider trading risks may consider adopting them. These procedures should be generally applicable to accounting firms as well.

a. Pre-Clearance of Securities Transactions

Many law firms have adopted procedures that require all members and employees to obtain approval before they (or their spouse or minor children) can execute transactions in client securities.⁹⁴ To implement the policy, firms assign a billing or other responsible partner to screen the trades to affirm that the firm does not possess any material, nonpublic information affecting the securities.⁹⁵ Such pre-clearance policies vary in scope from screening trades only in client securities⁹⁶ to trades in any publicly-traded

89. See Model Rules of Professional Conduct Rule 1.6 (rule on confidentiality). Hence, "the confidentiality rule embraces not only communications within the ambit of the attorney-client privilege, but extends 'to all information relating to the representation, whatever its source.'" Steinberg, *supra* note 45, at 162, quoting, Model Rule 1.6 comment. See generally G. HAZARD & W. HODES, *THE LAW OF LAWYERING* 102-06 (1985); C. WOLFRAM, *MODERN LEGAL ETHICS* 670 (1986); James P. Hemmer, *Resignation of Corporate Counsel: Fulfillment or Abdication of Duty*, 39 HASTINGS L.J. 641 (1988); Simon M. Lorne, *The Corporate and Securities Advisor, The Public Interest, and Professional Ethics*, 76 MICH. L. REV. 425 (1978); Marc I. Steinberg, *Attorney Liability for Client Fraud*, 1991 COLUM. BUS. L. REV. 1; Robert J. Wilczek, *Corporate Confidentiality: Problems and Dilemmas of Corporate Counsel*, 7 DEL. J. CORP. L. 221 (1982).

90. See Rule 1.6 (comment). See also Phillips, *supra* note 2, at 115 (discussing policy statements on confidentiality).

91. See ABA Report, *supra* note 43, at 259-61.

92. *Id.* at 258-65.

93. *Id.* See Levine & Mathews, *supra* note 74, at 404-07; Phillips, *supra* note 2, at 116.

94. See ABA Report, *supra* note 43, at 249 (applying pre-clearance policy to an attorney or employee's "spouse or minor children, or any accounts or entities over which he or she or members of his or her family have investment discretion or influence").

95. Phillips, *supra* note 2, at 116 (stating that such a pre-clearance policy "is workable only if billing and responsible partners accept the obligation to respond promptly to such inquiries").

96. *Id.* (stating that "[a] pre-clearance policy for trades in client securities would seem relatively easy to implement, since personnel generally are in a position to check the client list prior to trading and obtain clearance from the billing or responsible partner").

securities.⁹⁷ Use of a "restricted list"⁹⁸ also is employed by a number of firms that require pre-clearance of securities transactions, particularly those with M&A practices.⁹⁹ Once a trade is approved, the procedures usually limit the duration of the approval's effectiveness.¹⁰⁰ Law firm policies usually exempt certain instruments, such as interests in open-end, publicly-traded mutual funds, from the pre-screening and other detection procedures that otherwise would be employed.¹⁰¹

b. Prohibitions and Limitations on Types of Trading

Law firms often supplement pre-screening mechanisms with prohibitions on certain transactions that involve a greater risk of speculative activity. These prohibitions typically cover any form of short sales.¹⁰² Option transactions also frequently face restrictions, such as bans on option transactions in client securities or a requirement that all option transactions be pre-screened.¹⁰³ Finally, some firms prohibit short-term trading of client securities by requiring that all such securities be held by firm personnel for a minimum six-month period.¹⁰⁴

c. Reporting of Security Holdings

A law or accounting firm that adopts any of the preceding devices for pre-screening trades or prohibiting certain types of transactions also may consider whether its personnel should report their holdings of publicly-traded securities to the responsible firm source charged with this function.¹⁰⁵ Such a reporting procedure may provide an effective reminder of the insider trad-

97. See ABA Report, *supra* note 43, at 248-55. Another example is to provide "for pre-clearance of client transactions and transactions in companies involved in matters on which the employee has worked within the preceding six months." *Id.* at 249.

98. ABA Report, *supra* note 43, at 251. Since restricted lists are used to a greater extent by broker-dealers, a more detailed discussion of them is provided in the next section. See *infra* notes 132-204 and accompanying text.

99. See ABA Report, *supra* note 43, at 251-52; Phillips, *supra* note 2, at 116. Restricted lists in the law firm setting generally identify publicly-traded client securities with respect to which law firm personnel are likely to have material inside information on a regular basis and publicly-traded securities of non-clients where law firm personnel currently have material inside information due to the firm's involvement in a specific transaction, such as a tender offer or merger. ABA Report, *supra* note 43, at 252. As noted by one authority, effective implementation of pre-clearance procedures, including use of a restricted list, can be "exceedingly difficult" for a firm whose attorneys are engaged in diversified practices. This is due to the attorneys' lack of sensitivity in this setting and their failure to report inside information to the firm's central clearing facility. See Phillips, *supra* note 2, at 116.

100. See ABA Report, *supra* note 43, at 250-51 (providing examples of policies that limit the duration to the day of the approval, twenty-four hours, and five business days).

101. *Id.* at 252-53 (providing examples of exempt transactions: interests in mutual funds (except those with a specific policy to invest in possible takeover situations), United States government securities, stock in a closely held company having no public market, among others).

102. See ABA Report, *supra* note 43, at 255; Phillips *supra* note 2, at 116.

103. See ABA Report, *supra* note 43, at 254-55.

104. See *id.* at 254; Phillips, *supra* note 2, at 116. Some firms, although not prohibiting the activity, "discourage" short-term trading of client securities. See ABA Report, *supra* note 43, at 254.

105. These holdings may be reported annually with the firm and when there is a change in

ing policy to a firm's personnel and may serve as a useful tool for determining compliance with the firm's trading policies.¹⁰⁶ Nonetheless, a major drawback is that accounting and law firm personnel may perceive such a reporting system as an unwarranted invasion of privacy. Moreover, if effectively implemented, an elaborate reporting system may be unduly costly and time-consuming to administer. Even more troubling, perhaps, is that, once adopted, failure to implement such a reporting system effectively may expose the firm to liability exposure under ITSFEA as well as other statutes. Given these drawbacks, few firms have opted for a reporting mechanism.¹⁰⁷

3. *Mechanisms to Limit Access to and Prevent Disclosure of Material Nonpublic Information*

Law and accounting firms frequently employ mechanisms to protect the confidentiality of client matters. These policies should instruct all members and personnel on the proper methods for the handling and safekeeping of sensitive files, letters, documents, and other such memoranda.¹⁰⁸ Confidential matters are not to be discussed in public places, including elevators, taxis, airplanes, and restaurants.¹⁰⁹ Another important area is to provide guidance on communicating with persons outside of the firm. A common policy is to instruct secretaries never to disclose an attorney's location outside of the office, such as at a client's office, to outside callers.¹¹⁰ For highly sensitive matters like merger and acquisition transactions, some firms use code names in documents to disguise the identities of clients and other parties.¹¹¹

Finally, policies should focus on security concerns relating to the use of computers. These policies address the protection of "log-in" IDs and passwords from disclosure outside the firm and instruct personnel never to leave a terminal unattended for extended periods if it is "logged-in."¹¹² Given the high stakes, it would be prudent for firms to adopt and implement effectively the foregoing practices aimed at preserving confidentiality.

V. FINANCIAL INTERMEDIARIES

As compared to professional firms and publicly-held companies, financial

one's holdings. A determination also must be made whether to limit such a reporting procedure to client securities.

106. A requirement mandating the reporting of security holdings is commonplace in the broker-dealer industry. See *infra* notes 248-54 and accompanying text.

107. See ABA Report, *supra* note 43, at 255-58; Phillips, *supra* note 2, at 116.

108. See ABA Report, *supra* note 43, at 261-65 (providing examples of such policies to include: instructions not to leave sensitive documents and other materials lying exposed on desk; clear conference rooms when absent; shred sensitive documents before disposal).

109. *Id.* at 263.

110. *Id.* at 263-65. For example, law firm policies instruct secretaries never to send documents to persons unless they have been authorized for receipt by an attorney in the firm. In regard to visitors, they should always be attended and should not be allowed to wander through the firm's offices. Visitors should be escorted to and from the reception area and directed to specified locations for phone calls. *Id.*

111. See Levine & Mathews, *supra* note 74, at 410.

112. See ABA Report, *supra* note 43, at 265.

intermediaries have the greatest need for effective insider trading procedures. The numerous functions that broker-dealers, investment advisors, investment companies and banks perform for the investment community create substantial insider trading risks.¹¹³ For instance, one department within an institution might obtain inside information on a publicly-held issuer when assisting with the issuer's capital financing needs; at the same time, a different department could be recommending and executing trades in the issuer's securities for the accounts of its customers.¹¹⁴

Congress has recognized the enhanced risks of insider trading in the financial intermediary context by imposing an affirmative obligation on broker-dealers and investment advisors to establish and maintain effective procedures that are reasonably designed to prevent insider trading abuses by their employees or associated persons.¹¹⁵ While ITSFEA did not impose this duty on investment companies, many have adopted such policies in view of the "tenor" of the statute and the existence of Section 17(j) of the Investment Company Act¹¹⁶ and rule 17j-1¹¹⁷ thereunder.¹¹⁸ Federal regulators of the banking industry also have adopted positions that require national banks to implement written procedures reasonably designed to prevent insider trading.¹¹⁹

This section begins with a brief review of the various functions that broker-dealers, investment advisors, investment companies, and banks perform and a discussion of the attendant insider trading risks in each context. It then reviews the use of Chinese Walls by financial intermediaries to address these risks and the legal sufficiency of such mechanisms. Last, this section

113. See, e.g., Ross Cranston, *Conflicts of Interest in the Multifunctional Financial Institution*, 16 BROOK. J. INT'L L. 1 (1990); James R. Doty & David N. Powers, *Chinese Walls: The Transformation of a Good Business Practice*, 26 AM. CRIM. L. REV. 155 (1988); Levine et al., *supra* note 2.

114. See Martin Lipton & Robert B. Mazur, *The Chinese Wall Solution to the Conflict Problems of Securities Firms*, 50 N.Y.U. L. REV. 459, 460-61 (1975). Other examples are provided by Levine et al., *supra* note 2, at 44:

At the same time that the investment banking department of a firm is providing confidential counseling [such as to the bidder or target in the takeover setting prior to public announcement of the bid], its research department may be preparing investment advice for brokerage or investment advisory clients concerning companies affected by the tender offer. If the firm has a retail brokerage facility, the firm's salesmen may be recommending purchases or sales of the stock of one or more of the affected companies. In addition, the firm may be buying and selling the securities of the affected companies. These purchases or sales may be made in the firm's capacity as market maker, for the firm's own proprietary accounts, or on behalf of institutions or individuals for which it manages investment portfolios.

115. Section 15(f) of Exchange Act, 15 U.S.C. § 78o(f) (1988); Section 204A of Investment Advisors Act of 1940, 15 U.S.C. § 80b-4 (1988); see also discussion *supra* notes 28-39 and accompanying text.

116. 15 U.S.C. § 80a-17(j) (1988).

117. 17 C.F.R. § 270.17j-1 (1994); see *infra* notes 194-204 and accompanying text.

118. See Harvey L. Pitt & Dixie L. Johnson, *A Renewed Emphasis on "Chinese Walls" for Investment Advisers and Investment Companies*, 6 INSIGHTS No. 11, at 19, 20 (Nov. 1992).

119. Board of Governors of the Federal Reserve System, *Policy Statement Concerning Use of Inside Information*, 43 Fed. Reg. 12,755 (Mar. 17, 1978) [hereinafter *Federal Reserve Policy*]; 43 Fed. Reg. 6759 (Feb. 16, 1978) (Comptroller of the Currency, Dept. of Treasury, adopting amendment to 12 C.F.R. § 9.7(d) (1994), effective Mar. 20, 1978).

reviews the elements of insider trading policies and procedures in the broker-dealer context.

A. BROKER-DEALERS, INVESTMENT ADVISORS, INVESTMENT COMPANIES, AND BANKS

Broker-dealers perform various functions including investment banking, brokerage activities, underwriting, research, investment advice, and investment management.¹²⁰ Potential conflicts can arise when information gathering and investment decision functions affect the same issuer. The investment banking department could obtain material, nonpublic information on a publicly-held issuer while the brokerage section is recommending trades in the same issuer's securities or while the trading department is executing trades in the issuer's securities for the firm's own proprietary accounts or as a market maker.¹²¹

For several years, the SEC has focused on the potential for insider trading by investment companies and advisors.¹²² This concern coincides with the increasing number of investment companies in the United States and the expanding amount of assets under their control.¹²³ Investment advisors and managers of investment companies can obtain inside information on portfolio securities by use of their positions and potentially enrich themselves by trading in those securities at the expense of their respective companies and the investing public.¹²⁴ Furthermore, investment companies are pursuing a broader range of securities for their portfolios, thus raising enhanced insider trading concerns. For instance, some investment company funds seek distressed securities of troubled or bankrupt companies.¹²⁵ The investment company's large holdings of such securities may cause it to be a member of the bankrupt company's creditors' committee, where the fund manager may be exposed to material, nonpublic information about the issuer.¹²⁶

120. See Levine et al., *supra* note 2, at 43-44; Lipton & Mazur, *supra* note 114, at 460.

121. See Levine et al., *supra* note 2, at 43-44; Lipton & Mazur, *supra* note 114, at 464-65; *supra* note 114.

122. See Pitt & Johnson, *supra* note 118, at 19-20. Investment companies provide a vehicle through which members of the general public can invest funds in a company that itself is engaged in investing and trading in securities. See generally TAMAR FRANKEL, *THE REGULATION OF MONEY MANAGERS* (1978).

123. Pitt & Johnson, *supra* note 118, at 20 (citing statistics showing that more than 3,500 investment companies operate in the United States, controlling more than \$1.5 trillion in assets for more than 68 million accounts).

124. See Frankel, *supra* note 122, at 565; Jonathan Clements, *Personal Trading Is Common Among Fund Managers*, WALL ST. J., Jan. 25, 1994, at C1 ("As the ethics of personal stock trades stir up a ruckus in the mutual fund industry, one thing is becoming clear: personal trading by fund managers is widespread and sometimes feverish.").

125. Ron Suskind, *Delicate Situation: Mutual Fund Has Brokerage-Firm Link That Interests the SEC*, WALL ST. J., June 9, 1993, at A1 (discussing potential insider trading conflicts at one investment company whose investment strategy seeks "out-of-favor or ailing companies with hidden potential").

126. Pitt & Johnson, *supra* note 118, at 20 (citing *In re Federated Dep't Stores, Inc.*, No. 1-90-00130 (Bankr. S.D. Ohio, Mar. 7, 1991) as an example). The investment company can find itself in a "Catch-22" type situation: the fund manager may have a duty to join the creditors' committee to protect the shareholders' investment, but the position may provide access to inside information that may preclude further trading. *Id.*; see also Ralph C. Ferrara & Herbert

Commercial banks are another example of financial institutions whose multiple roles can create insider trading and conflict of interest risks. A large commercial bank frequently obtains confidential information during the negotiation of a loan with an issuer of publicly-traded securities. At the same time, the bank's trust department may be effecting or recommending transactions in the issuer's securities for customer accounts.¹²⁷ Banks thus utilize procedures to prevent confidential information obtained from a customer in the commercial department from being disclosed to personnel engaged in investment decisions in the trust department.¹²⁸

Commercial banks also can acquire confidential information relating to publicly-traded securities through the performance of other functions. Three examples are provided. First, large banks often have municipal bond departments that underwrite municipal securities, which are traded in public secondary markets.¹²⁹ Second, at times, banks are involved as advisors to issuers of publicly-traded securities in the private placement of their securities.¹³⁰ And third, banks frequently perform an important role in the financing of tender offers for publicly-held enterprises.¹³¹

B. LEGAL SUFFICIENCY OF CHINESE WALLS

1. Introduction to Chinese Walls

Chinese Wall procedures consist of policies and procedures designed to control the flow of material, nonpublic information within a multiservice

C. Thomas, *Creditors' Committees and Research Departments: Chinese Walls and Related Compliance Issues*, Twenty-Fifth Annual Institute on Securities Regulation 163 (1993); Robert C. Pozen & Judy K. Mencher, *Chinese Walls for Creditors' Committees*, 48 BUS. LAW. 747 (1993) (discussing the use of Chinese Walls by institutional investors who sit on reorganization committees of issuers).

127. See Stephen T. Greenberg et al., *The Obligations of Banks in the Public Securities Markets*, 1980 DUKE L.J. 1063, 1080.

128. See *infra* notes 205-13 and accompanying text. See generally *Federal Reserve Policy, supra* note 119 (viewing a bank's decision or recommendation to purchase or sell any securities on the basis of material, nonpublic information as an unsound and unsafe banking practice and recommending that national banks adopt written policies and procedures to ensure that trust departments do not misuse such information); Leo Herzel & Dale E. Colling, *The Chinese Wall Revisited*, 6 CORP. L. REV. 116 (1983) (arguing that banks can use Chinese Walls to resolve issues relating to insider trading and other conflict of interest problems that arise in the commercial bank setting).

129. Herzel & Colling, *supra* note 128, at 117 n.2.

130. *Id.*

131. See MARC I. STEINBERG, *SECURITIES REGULATION: LIABILITIES AND REMEDIES* § 11.02, at 11-4.3 (1994) ("In regard to banks, the situation usually arises when the lender, having obtained material, nonpublic information about a company in the course of a commercial relationship with that subject company, subsequently is approached by a bidder to finance a cash tender offer for the target company."); Edward D. Herlihy et al., *Supervisory and Compliance Policies and Procedures Under the New Insider Trading Act*, 3 INSIGHTS, No. 4, at 3, 11 (Apr. 1989).

For cases addressing the potential conflicts that a commercial bank may have in connection with financing the bidder's acquisition, see *Washington Steel Corp. v. TW Corp.*, 602 F.2d 594 (3d Cir. 1979); *American Medicorp, Inc. v. Continental Ill. Nat'l Bank & Trust Co.*, 475 F. Supp. 5 (N.D. Ill. 1977); *Humana, Inc. v. American Medicorp, Inc.*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,286 (S.D.N.Y. 1978).

financial firm.¹³² In the broker-dealer context, a Chinese Wall isolates the investment banking department from the brokerage, research, and other departments and also limits the flow of sensitive information on a need-to-know basis.¹³³ In the case of banks, the Chinese Wall segregates the trust department from the commercial lending, as well as the government and municipal securities underwriting departments.¹³⁴

Although Chinese Wall policies and procedures differ among firms, institutions employ numerous such practices to control the flow of information between departments.¹³⁵ In addition to general written policies and educational programs, consideration should be given to the implementation of procedures such as the following: (i) physical separation of departments in different wings or floors of a building; (ii) maintenance of separate accounting systems, records, and support staff; (iii) clearly identifying sensitive documents, employing secure filing systems, and restricting access by persons in departments where a breach of confidentiality could occur, such as a bank's trust department or a broker-dealer's trading section; (iv) limiting attendance at meetings where sensitive topics will be discussed; (v) restricting the transfer of personnel from one department into another; (vi) restricting directors, officers and employees from serving dual roles in more than one market sensitive area, such as the arbitrage and underwriting sections of a broker-dealer; and (vii) using code names in documents to conceal the identity of issuers.¹³⁶

Generally, these policies and procedures focus on the activities of the sections of a firm that will frequently come into possession of material, nonpublic information, such as the investment banking section of a broker-dealer. At times, persons in other departments must be consulted on sensitive matters, such as when an opinion must be obtained from an analyst in the research department. In these instances, the research analyst would be "brought over the wall": the analyst would be required to operate under the same procedures that limit the investment banking section.¹³⁷

132. Securities Exchange Act Release No. 17120, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,646, at 83,461 (1980) [hereinafter Rule 14e-3 Release] (SEC Release adopting Rule 14e-3 which discusses the use of Chinese Walls in the tender offer context).

133. See *In re Merrill Lynch, Pierce, Fenner & Smith*, 43 S.E.C. 933, [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,629 (1968) (Exhibit A) (providing example of Chinese Wall policy that Merrill Lynch agreed to employ in a settlement of charges of violating the anti-fraud provisions of the federal securities laws).

134. *Federal Reserve Policy*, *supra* note 119, at 12,756.

135. See SEC Division Report, *supra* note 64, at 80,620-80,625.

136. See *Federal Reserve Policy*, *supra* note 119, at 12,756; Doty & Powers, *supra* note 113, at 175-77 (recommending ten procedures to be considered when developing Chinese Wall procedures for a multiservice securities firm).

137. See Doty & Powers, *supra* note 113, at 175-77. As set forth in a 1993 SEC staff report:

If, in the process of developing a nonpublic underwriting transaction, a firm's investment banking personnel determine that the views of a particular research analyst would greatly assist the structuring of the potential underwriting, the research analyst may be informed of the nonpublic underwriting effort and "brought over the wall" to assist the investment banking team. The research analyst would then be informed that he or she must maintain the confidentiality of this transaction and that certain limitations will be imposed on the analyst's activities until the transaction becomes public. For example, the analyst might

2. The Need for Reinforcement Measures

In addition to the information segregation measures outlined above, the SEC and commentators have focused on the need for financial intermediaries to maintain reinforcement mechanisms. These other procedures, primarily restricted and watch lists, frequently are employed by multiservice financial firms to cope with their conflicting duties and avert the imposition of liability.¹³⁸ Internal audits and other enforcement measures are also utilized to ensure compliance and to detect breaches of the wall.¹³⁹ When personnel are brought over the wall, they become subject to these reinforcement procedures as well.¹⁴⁰

To prevent leaks of inside information, the implementation by multiservice financial firms of reinforcement measures are key components of an effective compliance program.¹⁴¹ Thus, the Commission often describes adequate procedures for financial intermediaries to include Chinese Walls,¹⁴² restricted lists,¹⁴³ watch lists,¹⁴⁴ and other procedures¹⁴⁵ designed

be prohibited from issuing research reports concerning this issuer until compliance or legal staff notifies the analyst that the limitations have been lifted.

Broker-Dealer Internal Control Procedures for High Yield Securities, Report by the Division of Market Regulation, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,251, at 84,680 n.17 (Oct. 1993) [hereinafter Commission Division Report]; see also *infra* notes 233-39 and accompanying text.

138. See Rule 14e-3 Release, *supra* note 132, at 83,461; Levine et al., *supra* note 2, at 58.

139. See Doty & Powers, *supra* note 113, at 175-77.

140. See *id.* at 177 (including restricted lists, limits on employee securities transactions, and internal audits).

141. See Commission Division Report, *supra* note 137, at 84,679-84,683; SEC Division Report, *supra* note 64, at 80,623-80,625; Rule 14e-3 Release, *supra* note 132, at 83,461.

142. See *supra* notes 132-37 and accompanying text; see also Lipton & Mazur, *supra* note 114, at 459. Herlihy et al., *supra* note 131, at 8; Levine et al., *supra* note 2, at 58.

143. Commission Division Report, *supra* note 137, at 84,680 n.15.

When an investment banking transaction becomes "public" (through a filing with the Commission or otherwise), firms will add the issuer's securities to a "restricted" list accessible to personnel throughout the firm. Once this is done, most, if not all, trading by proprietary and employee accounts is prohibited for set time periods. In addition, other firm activities, such as the issuance of research recommendations concerning the issuer's securities, also are severely limited or prohibited for set periods. Because the effects of such restrictions are so wide-ranging, securities are not added to the list until deals are made public. Otherwise, adding a security to this list might send a signal both within and outside the firm that a nonpublic transaction is imminent.

Id.

144. *Id.* at 84,680 n.14.

At most firms, the compliance or legal staff maintains a "watch" or "grey" list of securities. A security is added to this list whenever an investment banking engagement is entered into between the broker-dealer and the security's issuer - or in any other instance in which one part of the broker-dealer has received material, nonpublic information concerning the issuer. The compliance or legal staff uses this list to monitor the firm's activities. For example, if a firm employee buys or sells a security on this list, the compliance or legal staff needs to determine if this transaction is indicative of a "breach" of Chinese Wall procedures.

Id.

145. *Id.* at 84,680 n.16.

Many firms have implemented a third type of list for use after a security is added to the watch or grey list but before the security has been added to the restricted

to prevent violations of the federal securities laws.¹⁴⁶

3. *Judicial and Administrative Treatment of Chinese Walls*

This section reviews the judicial decisions and administrative actions that have addressed the legal sufficiency of Chinese Walls (and reinforcement procedures). The section first surveys the cases that have discussed whether Chinese Walls enable multiservice financial firms to resolve their potentially conflicting duties. Thereafter, the section reviews the regulatory endorsement of Chinese Walls by the Commission in its adoption of rules 14e-3 and 17j-1, by the regulators of the banking industry, and by the self-regulatory organizations (SROs) that monitor the securities markets.

a. Cases Addressing Chinese Walls

The Commission's first indication that Chinese Wall procedures might constitute an adequate mechanism came in the context of a rule 10b-5 action in *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*¹⁴⁷ In that case, Merrill Lynch, as managing underwriter of a securities offering for Douglas Aircraft Co., Inc., learned material, confidential information about its client's recent earnings. This information was transmitted to a number of the firm's brokers who selectively disclosed such information to institutional investors who in turn sold Douglas securities through accounts with Merrill Lynch. In its settlement with the SEC, Merrill Lynch agreed to institute Chinese Wall procedures to help ensure that information from its underwriting group would not be available to anyone outside the group except for certain senior executives and others who had a need to know.¹⁴⁸

The Merrill Lynch policy was basically an education policy. It defined the term "material information" and instructed all personnel not to disclose such information.¹⁴⁹ The policy was to be widely distributed¹⁵⁰ and imposed a duty on department managers to review the policy with their person-

list. If compliance or legal personnel determines that the firm's or employees' activities should in some way be limited, the security is placed on this list. For example, just prior to the public announcement of an investment banking transaction, the compliance or legal staff may instruct the firm's market makers to trade the issuer's securities in a "passive" manner, (*i.e.*, by executing only unsolicited customer trades).

Id.

146. See Rule 14e-3 Release, *supra* note 132, at 83,461. See generally Bromberg & Lowenfels, *supra* note 7, § 7.4(633); Langevoort, *supra* note 75, § 12.02.

147. Securities Exchange Act Release No. 8459, 43 SEC 933, [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,629 (Nov. 25, 1968); see also *In re Investor's Management Co.*, Securities Exchange Act Release No. 9267 (July 29, 1971) (suggesting that insider trading is actionable irrespective of presence of Chinese Wall).

148. *Id.* at 83,350; see also Levine et al., *supra* note 2, at 61; Pitt & Groskaufmanis, *supra* note 62, at 1618.

149. *In re Merrill Lynch*, [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,629, at 83,351 (Exhibit A).

150. *Id.* The policy was to be distributed to senior management, division and department managers, office managers, members of the underwriting divisions, research analysts, and account executives and was to be included in the firm's operations manual.

nel on a periodic basis.¹⁵¹ Otherwise, no reinforcement procedures such as restricted lists were discussed.¹⁵² Given the limited extent of the policy, it was not surprising that the Commission stated that it could not determine if the procedures would be adequate in all circumstances and cautioned that “[s]tringent measures [would] be required in order to avoid future violations.”¹⁵³

The Commission returned to this issue in its *amicus curiae* brief in *Slade v. Shearson, Hammill & Co.*¹⁵⁴ In this case the SEC made clear that it favored policies and procedures that prevented the transmission of material, nonpublic information among firm personnel engaged in brokerage and trading activities.¹⁵⁵ *Slade* involved brokerage customers of Shearson who claimed that the firm had continued to recommend the purchase of stock in a client’s securities after the firm’s investment banking department had obtained adverse material information during the course of providing services to that client.¹⁵⁶

The district court denied Shearson’s motion for summary judgment in which Shearson argued that it was precluded from revealing the adverse information to its brokerage customers. Although the court agreed that “an investment banker may not reveal inside information obtained pursuant to a confidential investment banking relationship to its retail customers through its brokerage organization,”¹⁵⁷ the court concluded that Shearson could have used the information to prevent its brokers from soliciting trades on the basis of information which the firm knew was false or misleading.¹⁵⁸ The court rejected Shearson’s argument that any use of the inside information, such as developing a no-recommendation policy for the subject company, would have violated its fiduciary duty to the investment banking client.¹⁵⁹

Subsequently, a controlling question of law in *Slade* was certified for re-

151. *Id.* The policy allowed disclosure to the following groups: (i) senior executives of Merrill Lynch; (ii) its legal department; (iii) personnel directly involved in an underwriting effort, such as lawyers and accountants; (iv) research personnel consulted in connection with an offering; and (v) members of buying departments of prospective co-underwriters so that they may decide whether to participate in an offering. *Id.* at 83,351 (Exhibit A).

152. *See id.* at 83,350-83,351; *supra* notes 142-46 and accompanying text.

153. *In re Merrill Lynch*, [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,629, at 83,350; *see Pitt & Groskaufmanis, supra* note 62, at 1618 (stating that “[t]he Chinese Wall [in the *Merrill Lynch* proceeding] thus made its securities law debut with a tepid showing of support”); Norman S. Poser, *Chinese Wall or Emperor’s New Clothes? Regulating Conflicts of Interest of Securities Firms in the U.S. and the U.K.*, 9 MICH. Y.B. INT’L LEGAL STUD. 91, 106 (1988) (commenting that the SEC’s settlement order with Merrill Lynch conveyed not “even a hint that the Commission intended the Chinese Wall to have any legal effect”) (emphasis in original).

154. 517 F.2d 398 (2d Cir. 1974).

155. *See Brief of the Securities and Exchange Commission, amicus curiae*, at 8, *Slade v. Shearson, Hammill & Co.*, 517 F.2d 398 (2d Cir. 1974); Levine et al., *supra* note 2, at 61.

156. *See Slade v. Shearson, Hammill & Co.*, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,329 at 95,131 (S.D.N.Y. 1974).

157. *Id.*

158. *Id.*; *see Lipton & Mazur, supra* note 114, at 478-79.

159. *See Slade*, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,329, at 95,131; *id.* at 95,132 (stating that “[h]aving assumed fiduciary responsibilities, Shearson is required to incur whatever commercial disadvantage fulfillment of those obligations entails”).

view by the Second Circuit.¹⁶⁰ Although the court declined to answer the question due to unresolved issues of fact,¹⁶¹ the SEC filed an *amicus curiae* brief that indicated its approval of Chinese Wall procedures.¹⁶² The Commission's position was that a Chinese Wall combined with a restricted list procedure was an acceptable solution to the conflicting duties.¹⁶³ The SEC asserted that at the time a firm enters into an investment banking or other confidential relationship with a client in which it is likely to receive material, nonpublic information, the firm should place the issuer on a restricted list which would prohibit recommendations of that issuer's securities.¹⁶⁴

By adopting a policy to place issuers on the restricted list at the outset of the relationship and before any inside information is actually obtained, the Commission hoped to reduce the risk of signalling adverse or favorable information to customers.¹⁶⁵ Nonetheless, as observed elsewhere, few broker-dealers appear to be following the Commission's position, either because it is not workable for larger firms or because it unnecessarily disadvantages their

160. *Slade v. Shearson, Hammill & Co.*, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,439, at 95,530 (S.D.N.Y.), *remanded*, 517 F.2d 398 (2d Cir. 1974). The certified issue was "whether an investment banker/securities broker who receives adverse material non-public information about an investment banking client is precluded from soliciting customers for that client's securities on the basis of public information which [because of its possession of inside information] it knows to be false or misleading." *Slade*, 517 F.2d at 399. In certifying the issue, the district court observed the "far-reaching ramifications" that the decision would have for the securities industry:

To require organizations like 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 a company and at the same time function as a broker-dealer in that company's securities. On the other hand, so long as such organizations continue to exercise a dual function, they incur dual (sometimes conflicting) fiduciary obligations which neither they nor this court can properly ignore.

Slade, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,439, at 95,532.

161. *Slade*, 517 F.2d at 403 (remanding for further findings); see Larry L. Varn, *The Multi-Service Securities Firm and the Chinese Wall: A New Look in the Light of the Federal Securities Code*, 63 NEB. L. REV. 197, 231 (1984) (stating that the case placed "both the securities industry and other multiservice financial institutions in considerable uncertainty"). The case ultimately was settled. See *Slade v. Shearson, Hammill & Co.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,473, at 93,731 (S.D.N.Y. 1978).

162. *Slade*, 517 F.2d at 403 (stating that the "SEC . . . apparently looks favorably upon the erection of a proper 'Chinese Wall'"); Lipton & Mazur, *supra* note 114, at 480-87 (discussing the different *amicus curiae* briefs submitted by the Commission, Salomon Brothers, and Paine Webber).

163. Lipton & Mazur, *supra* note 114, at 486-87.

164. *Id.* at 487. The restricted list would not apply to the firm's block trading or market making transactions that did not involve any representation as to the merits of the transactions. Accordingly, "while the SEC-approved no-recommendation policy would more broadly affect a retail trader's activities than a restricted list triggered only by the receipt of inside information, the sweep of the SEC's position, in terms of the range of trading activities affected, was closely circumscribed." *Id.*

165. *Id.* (According to the SEC, "[t]here would be no signal . . . if the firm restricted the security and withdrew its outstanding recommendation at the time it entered into an investment banking or other confidential relationship, i.e., before any inside information was in fact received."); see also Leonard Chazen, *Reinforcing the Chinese Wall: A Response*, 51 N.Y.U. L. REV. 552 (1976); Lipton & Mazur, *supra* note 114, at 579.

brokerage customers.¹⁶⁶ The Commission's position in *Slade*, however, remains significant for its approval of the use of Chinese Wall and reinforcement procedures to resolve the conflicting duties of a broker-dealer, although the exact requirements of those procedures remain unclear.¹⁶⁷ The Commission has continued to endorse the use of Chinese Wall and reinforcement procedures in a number of enforcement actions focusing on alleged insider trading violations. Generally, in settlements entered in these cases, the subject broker-dealers agreed to review and adopt procedures and policies designed to prevent future violations.¹⁶⁸

The Commission's position on the efficacy of Chinese Walls also was manifested in response to concerns that arose from an investment firm's multifaceted role in the tender offer context.¹⁶⁹ The question arose when Shearson Lehman Brothers, Inc. provided investment banking services to a tender offeror and served as a co-bidder while the firm simultaneously held an equity position in the target company.¹⁷⁰ The target company obtained a preliminary injunction against the tender offer by showing a reasonable probability of success that the Williams Act's filing requirements had been violated.¹⁷¹ The district court also requested the SEC's position on whether Shearson's investment banking role in the takeover attempt and its simultaneous equity position in the target company had violated the federal securi-

166. Levine et al., *supra* note 2, at 64 (stating that "[a]t any given time, a large firm that has ongoing relationships with its investment banking clients would be precluded from providing investment guidance to its brokerage and advisory clients on a substantial number of issuers, even in cases where the firm did not possess material, nonpublic information").

167. *See id.* at 64-66; *see also infra* notes 258-62 and accompanying text.

168. *See, e.g., SEC v. Drexel Burnham Lambert, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,474, at 93,026 (S.D.N.Y. 1989) (settlement in which Drexel agreed, *inter alia*, to review through appointment of Independent Consultant its procedures and policies directed at compliance, including breaches of the Chinese Wall and other improprieties); *SEC v. Kidder, Peabody & Co.*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,271 at 96,349 (S.D.N.Y. 1987), *In re Kidder, Peabody & Co., Inc.*, Securities Exchange Act Release No. 24-543 (June 4, 1987) (settlement in which Kidder agreed to retain an outside consultant to review its policies and procedures designed to prevent and detect violations of the federal securities laws (such review to include addressing the firm's Chinese Wall and restricted list procedures), to adopt and maintain policies recommended by the consultant prior to resuming such activities, and not to resume risk arbitrage trading until such procedures had been implemented); *SEC v. First Boston Corp.*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,712, at 93,465 (S.D.N.Y. 1986) (settlement in which First Boston agreed to review and appropriately modify its existing Chinese Wall and restricted list procedures).

The Commission also has evidenced its approval of Chinese Wall and reinforcement mechanisms in the rulemaking context, such as in its promulgation of rules 14e-3 and 17j-1. *See infra* notes 184-204 and accompanying text.

169. *Koppers Co., Inc. v. American Express Co.*, 689 F. Supp. 1371, 1413 (W.D. Pa. 1988) (Appendix A, letter from Daniel L. Goelzer, General Counsel of the SEC, to Honorable Maurice B. Cohill, in response to a request from the court).

170. *Id.* at 1376-78; *see also* Bryan Burrough, *Shearson Risks Alienation of Its Clients by Joining Hostile Bid as Equity Partner*, WALL ST. J., Mar. 4, 1988, at 4 (acting as a bidder Shearson was the first major investment bank to expand its traditional advisory and lending functions).

171. *Koppers*, 689 F. Supp. at 1407-08. The Williams Act, adopted in 1968 as amendments to the Securities Exchange Act, focuses principally on tender offer regulation. The legislation added Sections 13(d), (e), and 14(d), (e), and (f) to the Exchange Act. *See generally* Schreiber v. Burlington Northern, Inc., 472 U.S. 1 (1985); *Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1 (1977).

ties laws.¹⁷²

The Commission responded, through its General Counsel, that "violations of the federal securities laws stemming from these conflicts can be avoided through the use of well-established preventive policies and procedures, such as Chinese Walls, restricted lists and watch lists."¹⁷³ The Commission concluded that Shearson's substantial involvement in the tender offer, including its equity position in the target company, did not affect the availability of the Chinese Wall and reinforcement procedures as methods to avoid certain violations of the federal securities laws.¹⁷⁴ The Commission stated that "[e]ven without an equity position, the firm is subject to substantial conflicts of interest that are not different in principle from the conflicts that exist where it has an equity position."¹⁷⁵ In the Commission's view, either situation could be adequately addressed with effective policies and procedures.¹⁷⁶

Despite the Commission's endorsement of Chinese Walls and reinforcement policies, few courts have addressed whether such policies can be used by multiservice financial firms to avert federal securities law liability. In *Nelson v. Craig-Hallum, Inc.*¹⁷⁷ for example, a district court denied a broker-dealer's motion for summary judgment despite the firm's reliance on its Chinese Wall procedures. *Nelson* involved a broker-dealer that allegedly violated rule 10b-5 by issuing statements and recommendations in research reports that were materially misleading in light of information possessed by its investment banking department. The broker-dealer moved for summary judgment, arguing that its Chinese Wall prevented the investment department from communicating the inside information to the research department.¹⁷⁸

The court responded that the broker-dealer had not provided any legal

172. *Koppers*, 689 F. Supp. at 1414-15. The issue presented was:

Whether Shearson Holdings' multifaceted role in the takeover attempt and its simultaneous equity position in BNS, Inc. . . . violate any federal securities laws because of the apparent, inherent conflicts of interest which these roles present. In other words, can the Chinese Wall concept, approved by the SEC in other contexts, be extended to the situation presented here?

Id.

173. *Id.* at 1415.

174. *Id.* at 1417.

175. *Id.* at 1415.

176. *Id.* Subsequently, the SEC General Counsel qualified these comments. In a letter to the Pennsylvania Securities Commission in connection with a probe conducted by the Pennsylvania legislature into the propriety of equity participation in hostile takeovers by financial intermediaries, then SEC General Counsel Daniel L. Goelzer stated "that the Commission has not expressed a view that a firm's equity position in the tender offeror is an irrelevant concern in this context." Pitt & Groskaufmanis, *supra* note 62, at 1620-21 n.367. Mr. Goelzer also stated that his earlier letter to Judge Cohill in the *Koppers/Shearson* litigation "did not address the question whether the presence of an equity position may affect the timing for the implementation of preventive procedures or may affect the types of procedures that must be implemented." *Id.*

177. [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,500, at 93,191 (D. Minn. 1989) (asserted defense of unwritten Chinese Wall policy prohibiting interdepartmental communications, when factual issue existed as to whether the policy was even followed, not sufficient to support a motion for summary judgment).

178. *Id.* at 93,191.

authority for the position that "brokerage firms who perform both investment banking and securities sales functions can rely on an unwritten 'Chinese Wall' policy as demonstrating lack of knowledge and scienter in an action under Rule 10b-5."¹⁷⁹ The court further pointed to authority that Chinese Walls must be enhanced with reinforcement procedures, such as restricted lists, to preclude improper recommendations and trading.¹⁸⁰ Nonetheless, the court declined to set forth the parameters of an acceptable Chinese Wall policy. Due to the existence of disputed issues of fact as to whether the unwritten Chinese Wall policy was even followed, the court denied the brokerage firm's motion for summary judgment.¹⁸¹

The *Nelson* case, although not very instructive due to the serious doubts that arose as to whether the firm really employed Chinese Wall procedures, is helpful in a few respects. First, the case demonstrates the importance of formal, written procedures; the broker-dealer's reliance on unwritten procedures appeared to have created an insurmountable obstacle. In this respect, the existence of a written policy should be beneficial to show that in fact certain procedures existed. Second, documentation of compliance and enforcement efforts is essential to overcome the perception that the purported procedures merely serve as an escape hatch for personal liability without providing practical benefits. In sum, the failure to undertake basic measures may illustrate the significant burden that a firm will face at the time when effective procedures can provide great value: in support of a motion for summary judgment.¹⁸²

Finally, the *Nelson* court's reference to the need for reinforcement measures like restricted lists and no-recommendation policies provides some insight into the legal sufficiency of Chinese Walls. The court's language as well as other developments provide support to the Commission's position that reinforced Chinese Walls are necessary to establish adequate procedures in the broker-dealer context.¹⁸³

b. Regulatory Treatment of Chinese Walls

(1) RULE 14e-3

In the context of tender offers, the Commission expressed its approval for Chinese Walls and reinforcement procedures when it adopted rule 14e-3.¹⁸⁴ The Commission provided a safe harbor to the rule's "disclose or abstain"

179. *Id.* at 93,192.

180. *Id.* (citing Lipton & Mazur, *supra* note 114).

181. *Id.* at 93,192.

182. See Pitt & Groskaufmanis, *supra* note 62, at 1622-23; *supra* notes 40-67 and accompanying text.

183. See *Cotton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 699 F. Supp. 251, 256 (N.D. Okla. 1988) (impliedly recognizing validity of Chinese Wall procedures as means to avoid liability); *Nelson*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,500, at 92,192; *Connell v. Chase Manhattan Bank Nat'l Ass'n*, N.Y.L.J., Jan. 15, 1981, at 7; see also Pitt & Groskaufmanis, *supra* note 62, at 1623 (observing that "the courts have been hesitant to recognize a Chinese Wall defense").

184. Rule 14e-3(a), 17 C.F.R. § 240.14e-3(a) (1994); see Rule 14e-3 Release, *supra* note 132.

provision for entities that implement certain policies and procedures. With certain exceptions, rule 14e-3 generally imposes liability on persons who are in possession of material, nonpublic information relating to a tender offer and who purchase or sell (or tip such information relating to) the subject securities, unless the information and its source are publicly disclosed in a timely manner.¹⁸⁵

The rule provides a safe harbor for entities that would otherwise violate its provisions. This safe harbor covers purchases and sales by nonnatural persons, typically multiservice financial institutions, if the entity can show that the individuals making the investment decision did not know the nonpublic information and that the entity had established policies and procedures, reasonable under the circumstances, to ensure that its individuals would not violate rule 14e-3(a).¹⁸⁶ In determining the reasonableness of the policies and procedures, the rule takes into account the nature of the entity's business.¹⁸⁷ Chinese Walls and restricted lists are specifically identified as examples of policies and procedures that may prevent individual decisionmakers from learning or using such inside information.¹⁸⁸

In the SEC's adopting release for rule 14e-3, the Commission made some observations on the use of Chinese Walls. First, the Commission stated that it may be appropriate in some circumstances for an institution to advise its customers of the use of Chinese Walls since the institution would not be using all information that it receives for the benefit of such customers.¹⁸⁹ Second, since Chinese Walls are not always effective to prevent the flow of information, the Commission noted that institutions often use other procedures to supplement the walls.¹⁹⁰ The Commission referred to watch lists as such a procedure, enabling the affected institution to monitor trading activity to detect the occurrence of leaks.¹⁹¹

The Commission stated that a particular situation may merit the use of both restricted lists and Chinese Walls and that business judgment may

185. Rule 14e-3, 17 C.F.R. § 240.14e-3 (1994). The person must know or have reason to know that the information has been acquired directly or indirectly from certain parties involved in the tender offer, including the offering person, the issuer of the target securities, and any persons acting on their behalf. *Id.*

186. *See id.* § 240.14e-3(b); Rule 14e-3 Release, *supra* note 132, at 83,460.

187. *See* 17 C.F.R. § 240.14e-3(b) (1994); Rule 14e-3 Release, *supra* note 132, at 83,461 ("Depending upon the nature of the activities of a particular institution, it may use a Chinese Wall or a restricted list or a combination of these and other procedures. The specific policies and procedures selected by an institution will be those which will be most effective in preventing the misuse of material, nonpublic information.").

188. 17 C.F.R. § 240.14e-3(b)(2)(i), (ii) (1994). *See* Rule 14e-3 Release, *supra* note 132, at 83,461. Specifically, the rule refers to policies and procedures "which restrict any purchase, sale and causing any purchase and sale of any such security or . . . which prevent such individual(s) from knowing such information." *Id.* In its release of the rule, the Commission referred to such procedures respectively as restricted lists and Chinese Walls. Note that the institution has the burden of proof to show that the elements for invoking the safe harbor have been met. *Id.*

189. Rule 14e-3 Release, *supra* note 132, at 83,461.

190. *Id.*; *see supra* notes 186-88 and accompanying text.

191. Rule 14e-3 Release, *supra* note 132, at 83,461; Commission Division Report, *supra* note 137, at 84,680 n.15; *see also supra* note 143.

counsel procedures in addition to those specified in rule 14e-3(b).¹⁹² Thus, although rule 14e-3 evidences the Commission's approval of Chinese Walls, it also reinforces the SEC's belief that Chinese Walls, by themselves, may not always prove to be sufficient under the circumstances. Rule 14e-3 therefore provides additional authority for the proposition that Chinese Walls must be reinforced with restricted lists, watch lists, and other measures that can detect leaks and prevent abuses in order for an institution to have adequate policies and procedures.¹⁹³

(2) RULE 17j-1

Rule 17j-1 is another example of the Commission's approval of written policies and procedures that are designed to prevent and detect fraudulent practices that can arise from potential conflicts of interest in the financial intermediary context.¹⁹⁴ The rule requires the adoption and enforcement of written codes of ethics in the registered investment company context. The Commission stated in its adopting release that the code of ethics should address "conflict of interest situations where access persons improperly are able to gain personal benefit through their relationship with the investment company."¹⁹⁵

Section (b)(1) of rule 17j-1 requires investment companies to adopt "a written code of ethics containing provisions reasonably necessary to prevent" violations of the rule's anti-fraud provision and requires them to "use reasonable diligence, and institute procedures reasonably necessary, to prevent violations of such code."¹⁹⁶ Section (a) of the rule is a general anti-fraud provision that makes it unlawful for any person affiliated with a registered investment company, or any person affiliated with an investment advisor or principal underwriter of a registered investment company, from committing any fraudulent and deceptive practice in connection with the purchase or sale by such person of any security held or to be acquired by such registered investment company.¹⁹⁷

The Commission emphasized in its release that an investment company's adoption of a code must go beyond the mere detection of improper acts. The release stated that an entity adopting a code of ethics also has an affirmative duty to enforce its provisions, and the code itself should include measures

192. See Rule 14e-3 Release, *supra* note 132, at 83,461.

193. See *id.* at 83,460-83,461; see also Commission Division Report, *supra* note 137, at 84,680. For further discussion on rule 14e-3, see Steinberg, *supra* note 131, § 3.06, and Comment, *Trading on Material Nonpublic Information Under Rule 14e-3*, 49 GEO. WASH. L. REV. 539 (1981).

194. Investment Company Act Release No. 11421, 21 SEC Docket 488, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,679 (Oct. 31, 1980) (codified at 17 C.F.R. § 270.17j-1 (1994)) [hereinafter ICA Release].

195. *Id.* at 83,735.

196. 17 C.F.R. § 270.17j-1(b) (1994). In the adopting release, the SEC stated that it was "not attempting to list all activities and circumstances which could or should be the subject of concern by those entities, for it is the entities themselves, required by the Rule to adopt codes of ethics, that bear the primary responsibility for identifying those areas which present a potential for abuse by access persons." ICA Release, *supra* note 194, at 83,736.

197. 17 C.F.R. § 270.17j-1(a) (1994).

addressing enforcement.¹⁹⁸

Rule 17j-1(c) requires persons covered by the anti-fraud provision that qualify as "access persons" to report transactions in any security in which the person acquires any direct or indirect beneficial ownership interest.¹⁹⁹ "Access persons" generally include directors, officers, or general partners of registered investment companies and their investment advisors or principal underwriters.²⁰⁰ The term also includes "advisory persons" who are employees of registered investment companies, or an investment advisor thereof, whose regular job functions involve obtaining information on, or making recommendations relating to, the purchase or sale of securities by a registered investment company.²⁰¹

Investment companies also must maintain records that document the code of ethics adopted and their compliance as well as enforcement efforts thereunder.²⁰² In regard thereto, a subject company must maintain a copy of its code of ethics, a list of all persons who qualify as access persons, reports submitted by such access persons, and records of any violations and subsequent actions taken in response to any such violation of its code of ethics.²⁰³ Such documentation must be maintained in an easily accessible place to accommodate examinations by the SEC.²⁰⁴

(3) BANKING REGULATIONS

Federal banking regulators have adopted positions that require banks to implement written procedures designed to prevent insider trading.²⁰⁵ In a policy statement, the Board of Governors of the Federal Reserve System ("Board") defined the use of material nonpublic information by banks in connection with decisions to effect or recommend securities transactions as an unsafe and unsound banking practice.²⁰⁶ Furthermore, the Board expects its member banks that exercise investment discretion for the accounts of others to implement written policies and procedures reasonably designed

198. ICA Release, *supra* note 194, at 83,737.

199. 17 C.F.R. § 270.17j-1(c)(1) (1994). Such report is made to the investment company, investment adviser, or principal underwriter of which such person is an access person. The report must state the date of the transaction, the title and number of shares, the principal amount of each security involved, the price at which the transaction was effected, and the name of the broker, dealer, or bank with or through whom the transaction was effected. *Id.* § 270.17j-1(c)(2).

200. *Id.* § 270.17j-1(e)(1).

201. *Id.* § 270.17j-1(e)(1),(2); see *United States v. Ostrander*, 792 F. Supp. 241 (S.D.N.Y. 1992) (denying motion to dismiss indictment based on portfolio manager's failure as an access person to disclose transactions in securities); *In re Farrer*, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,332 (Mar. 31, 1983) (finding that a securities analyst for an investment advisor, whose duties included making recommendations of securities, was an access person who violated rule 17j-1 by failing to report numerous securities transactions).

202. 17 C.F.R. § 270.17j-1(d) (1994).

203. *Id.*

204. *Id.* Generally, such documents must be maintained for a period of at least five years. *Id.*; see *In re First Investor's Management Co.*, Investment Advisers Act Release No. 1316 (June 12, 1992) (enforcement action settled alleging, inter alia, failure to maintain records and to oversee timely filing of reports by access persons); Pitt & Johnson, *supra* note 118, at 19-20.

205. Federal Reserve Policy, *supra* note 119; 12 C.F.R. § 9.7(d) (1994).

206. Federal Reserve Policy, *supra* note 119, at 12,756.

to ensure that such abuse of inside information does not occur.²⁰⁷

Rather than adopting specific policies, the Board elected not only to provide examples of possible procedures that focus on preventing the improper flow of information between bank departments but also to outline courses of action to be taken in response to leaks that are discovered.²⁰⁸ Examples of approaches included:

(i) denying trust department personnel (namely, bank personnel whose duties encompass the making of investment decisions or recommendations on behalf of agency or fiduciary accounts) access to files that may contain material inside information, such as commercial credit files;

(ii) with certain exceptions, such as where a new customer relationship is sought, precluding trust department personnel from attending meetings between or among commercial lending or underwriting personnel and bank customers;

(iii) to the extent appropriate, considering the circumstances of the particular bank, physically separating trust department personnel from the commercial lending and underwriting departments;

(iv) mandating that trust department personnel inform their superiors when they suspect having material inside information;

(v) instructing management as to the proper course of action to be pursued when leaks of material nonpublic are detected, such as ascertaining the validity and nonpublic aspect of the information, contacting the bank's legal counsel for guidance, notifying the issuer of the affected securities and requesting such issuer to promptly and publicly disseminate the information, and halting the bank's trading and recommendations in the affected securities.²⁰⁹ The Board stated that the above policies were generally more applicable to larger banks.²¹⁰

Likewise, the Comptroller of the Currency has promulgated a rule requiring the trust departments of national banks to adopt "written policies and procedures to ensure that the Federal securities laws are complied with in connection with any decision or recommendation to purchase or sell any security."²¹¹ The rule states that such policies should specifically protect against the abuse of material inside information by the trust departments of banks.²¹² The Comptroller adopted a general and flexible rule that allows individual banks to determine which policies and procedures are best suited for their situations. As such, the Comptroller provided no guidance on any particular procedures that should be adopted.²¹³

207. *Id.*

208. *Id.*

209. *Id.*

210. *Id.* (describing large banks, in 1978, as those which manage assets for the accounts of others having a market value greater than \$100 million).

211. 12 C.F.R. § 9.7(d) (1994).

212. 12 C.F.R. § 9.7(d) (1994).

213. *See id.* As stated by the Comptroller in the proposed rulemaking release:

The Comptroller of the Currency believes that the objective sought by the proposed amendment will be achieved best by a general and flexible approach, and not by a regulation mandating the establishment of a "Chinese Wall." The

(4) SELF-REGULATORY ORGANIZATIONS

Broker-dealers must comply with the rules of the self-regulatory organizations ("SROs") of which they are members.²¹⁴ In this context, SROs have promulgated rules requiring the adoption of procedures designed to prevent and detect insider trading.²¹⁵ For instance, the New York Stock Exchange ("NYSE") requires its members to subject employee and proprietary trading "to review procedures that the member . . . determines to be reasonably designed to identify trades" that may violate the securities laws prohibiting insider trading.²¹⁶ If a NYSE member determines that a trade appears to have violated the securities laws, it must "[c]onduct promptly an internal investigation."²¹⁷ The NYSE rules also require its members to designate a high-level official to assume overall authority and responsibility for compliance with the securities laws.²¹⁸

In addition, the NYSE standards set forth reporting and supervisory mandates relating to each member's compliance program and procedures.²¹⁹ The rule requires each member organization to submit an annual report on its supervisory and compliance efforts to the organization's chief executive officer or managing partner. The report must include a tabulation of such matters as customer complaints and internal investigations, a discussion of significant compliance issues, and plans for instituting procedures to address future compliance concerns. The report also must provide a discussion that breaks down the firm's compliance efforts in the areas of anti-fraud, invest-

amendment allows each bank, regardless of size, to choose appropriate written policies and procedures which would prohibit the use of material inside information in connection with decisions or recommendations to purchase or sell securities. Banks may decide after consultation with counsel to adopt a "Chinese Wall," or they may decide to adopt other appropriate measures.

42 Fed. Reg. 56338 (Oct. 25, 1977).

214. See Securities Exchange Act, 15 U.S.C. § 78oA-3(b)(7) (1988); RALPH S. JANVEY, REGULATION OF THE SECURITIES AND COMMODITIES MARKETS ¶¶ 4.01-.02 (1992) (setting forth that broker-dealers must adhere to SRO rules).

215. See *infra* notes 216-22 and accompanying text. In addition, the exchanges have approved the use of Chinese Walls to "create specific exemptions from Exchange rules which prohibit specialists from affiliating and engaging in certain transactions with nonspecialist retail firms." Doty & Powers, *supra* note 113, at 166-70, discussing NYSE Rule 98 and American Stock Exchange (AMEX) Rule 193, and observing, *id.* at 169, that

[t]he SEC approved both the NYSE and AMEX rule proposals, largely relying on the Chinese Wall procedures to prevent abuse of the relationships of a specialist in affiliation with an upstairs firm . . . [and] assum[ing] that, if effective, the Chinese Wall would prevent undesirable and possibly unlawful conduct without exposing either affiliate to liability for breach of fiduciary duty or violations of the federal securities laws.

See also *Alleged Holes in Chinese Wall Net Shearson \$500,000 NYSE Fine*, 24 Sec. Reg. & L. Rep. (BNA) 1029 (1992) (NYSE fined Shearson Lehman Brothers Inc. for its failure to supervise adequately its proprietary trading and to catch short sales by an employee in securities on the firm's watch list).

216. N.Y.S.E. Guide (CCH) ¶ 2342, Rule 342.21(a) (as amended May 27, 1988). The trades that must be reviewed include trades for the account of the member organization, allied members, employees of the member and family members of employees. *Id.*

217. *Id.* Rule 342.21(b).

218. *Id.* Rule 342(b) (as amended Aug. 27, 1976).

219. *Id.* Rule 342.30 (as amended May 27, 1988); Securities Exchange Act Release No. 25,763, 53 Fed. Reg. 20,925 (June 7, 1988) (approving the rule).

ment banking, trading and sales practices, finance and operations, books and records, and supervision.²²⁰

The rule also requires members to file a quarterly certificate with the NYSE stating that the firm has established and carried out adequate review procedures for proprietary trades and for trades by employees subject to scrutiny and attesting that the personnel responsible for the procedures have "no reasonable cause to believe" that insider trading violations have occurred.²²¹ If an investigation is being conducted by a member with respect to suspect trading, such member must report to the NYSE the quarterly progress of such investigation.²²²

C. BROKER-DEALER POLICIES AND PROCEDURES: CHINESE WALLS AND THEIR MINIMUM ELEMENTS

In 1990, the SEC's Division of Market Regulation ("Division") released its Report, detailing the results of its study regarding the efficacy of broker-dealer policies and procedures designed to prevent the misuse of material, nonpublic information.²²³ The Report was a comprehensive review of broker-dealer policies used by major New York firms and representative regional firms. All firms performed some level of investment banking and research services, and all but two New York firms had active retail sales and market making activities.²²⁴ The Division concluded that, although the firms reviewed generally had improved their procedures, certain areas were in need of improvement.²²⁵ The Report concluded that while no rule-making effort was necessary at that time, if the self-regulatory process declined to make certain necessary improvements or if the process failed to remedy the deficiencies that existed, then rule-making authority may be used.²²⁶

In the Report, the Division referred to the policies and procedures required by Section 15(f) as Chinese Wall procedures, which it defined generally as "policies and procedures . . . to segment the flow of sensitive

220. N.Y.S.E. Guide (CCH) ¶ 2342, Rule 342.30; see Herlihy et al., *supra* note 131, at 4 (discussing the NYSE rules).

221. N.Y.S.E. Guide (CCH) ¶ 2351, Rule 351(e) (as amended Mar. 22, 1990). Insider trading violations include violations of the provisions of the Exchange Act, the SEC rules thereunder, and the NYSE rules.

222. *Id.*; see Securities Exchange Act Release No. 25,763, 53 Fed. Reg. 20,925, 20,926 (June 7, 1988); Herlihy et al., *supra* note 131, at 4; see also SEC Approves PSE Rule on Insider Trading Prevention, 25 Sec. Reg. & L. Rep. (BNA) 1621 (1993) (adoption of rules mandating Pacific Stock Exchange (PSE) members to adopt and implement policies and procedures to avoid insider trading violations by PSE members and associated persons).

223. SEC Division Report, *supra* note 64. In 1993, the Division issued a report focusing on internal control procedures that broker-dealers have implemented to prevent and detect the abuse of material, nonpublic information by the respective firms and their affiliated persons in non-investment grade ("High Yield") securities. See Commission Division Report, *supra* note 137, at 84,676-83.

224. SEC Division Report, *supra* note 64, at 80,619-20.

225. See *id.* at 80,617, 80,628-29.

226. See *id.* at 80,629. In its 1993 report in the area of High Yield securities, the SEC staff likewise declined to recommend the undertaking of SEC rule-making at that time. See Commission Division Report, *supra* note 137, at 84,677.

information."²²⁷ Operating on the premise that broker-dealers must establish "Chinese Walls," one of the Division's principal findings was the identification of minimum standards for adequate Chinese Walls.²²⁸

The Division identified four elements that it deemed necessary for a broker-dealer to establish an adequate Chinese Wall:

- (1) substantial control (preferably by the compliance department) of relevant interdepartmental communications;
- (2) the review of employee trading through the effective maintenance of some combination of watch, restricted, and rumor lists;
- (3) dramatic improvement in the memorialization of Chinese Wall procedures and documentation of actions taken pursuant to those procedures; and
- (4) the heightened review or restriction of proprietary trading while the firm is in possession of material, nonpublic information.²²⁹

These four minimum elements are elaborated upon in the ensuing discussion.

1. *Control of Interdepartmental Communications*

All firms in the survey had procedures designed to limit the flow of information between departments. The focus of these procedures is to segregate the investment banking departments from other departments in the firm.²³⁰

a. *Central Role of Compliance Department in Supervising Interdepartmental Communications and Chinese Wall Compliance*

In its 1990 Report, the Division repeatedly emphasized that each firm should have a compliance or legal department that plays a central role in the establishment and enforcement of Chinese Wall procedures.²³¹ The Report identified at least three areas in which the compliance department should take a central role: (i) interdepartmental communications; (ii) maintenance of watch lists and restricted lists; and (iii) employee trading reviews.²³²

i. *Significant Interdepartmental Communications*

An important function of a broker-dealer's compliance department is to control the flow of information when different departments need to communicate with one another. For instance, how can investment banking personnel request information from other departments, such as research or sales,

227. SEC Division Report, *supra* note 64, at 80,618 n.5; see discussion *supra* notes 132-37 and accompanying text.

228. SEC Division Report, *supra* note 64, at 80,625-27.

229. *Id.* at 80,625.

230. *Id.* at 80,621; see Herlihy et al., *supra* note 131, at 5 (observing that "in multiservice securities firms, personnel in retail sales, research, trading and investment advisory operations are prohibited from having access to information held by the firm's investment bankers").

231. SEC Division Report, *supra* note 64, at 80,627 (stating that "the compliance department at multiservice firms must take the central role in the administration of the firms' Chinese Wall procedures").

232. *Id.* at 80,621-25.

without tipping confidential information? The solution is usually to bring the personnel in other departments "over the wall"; i.e., they become temporary insiders of the investment banking department for surveillance purposes.²³³ The Report recommends that a firm's compliance department have a central role in the administration of the firm's Chinese Wall procedures, including decisions to bring personnel over the wall.²³⁴ In any event, the compliance department should be informed of decisions to bring people over the wall and should maintain adequate records on personnel while they are temporary insiders.²³⁵

A topic related to interdepartmental communications is a firm's review of research reports. In some instances, a research department will issue reports while the investment banking department is in possession of material, nonpublic information.²³⁶ The Division found that all firms in the survey had their compliance departments review research reports for numerous reasons, not all of which were related to Chinese Wall concerns.²³⁷ If the compliance department determines that the report is damaging or incorrect in light of inside information held by the investment banking department, the majority of firms pull or delay the report.²³⁸ To limit the risks of tipping the research analyst or the investing audience that the firm possesses inside information about a company, firms usually bring the analyst over the wall and take measures to limit his or her public comments about the company.²³⁹

ii. Maintenance of Watch and Restricted Lists

One of the compliance department's most important roles is its involvement in the placement of trading restrictions on the securities of issuers about whom the firm has inside information.²⁴⁰ In many firms, the head of the investment banking department makes the initial decision whether such restrictions are necessary, but the compliance department should be involved to evaluate such decisions.²⁴¹ Involving the compliance department can help ensure that decisions to place restrictions on issuers occur on a timely

233. *Id.* at 80,621-22.

234. *Id.* at 80,622; see *supra* note 137 and accompanying text.

235. SEC Division Report, *supra* note 64, at 80,627. The Report observed that in a number of firms the compliance department was either not adequately informed that personnel were brought over the wall or the compliance department failed to keep adequate records on "temporary insiders." *Id.* at 80,622.

236. See Herlihy et al., *supra* note 131, at 7; Levine et al., *supra* note 2, at 44; *supra* note 137 and accompanying text.

237. SEC Division Report, *supra* note 64, at 80,623.

238. *Id.* A few firms, however, maintain the division between departments and do not normally pull or delay the reports. *Id.*

239. *Id.* These measures include removing the analyst from public accessibility or instructing the analyst to give neutral responses to public inquiries. *Id.*; see Commission Division Report, *supra* note 137, at 84,680 (observing that several firms apply Chinese Wall procedures to research reports concerning High Yield securities).

240. Restricted lists and watch lists are used to identify such stocks and to ensure compliance. For a discussion of these mechanisms, see *supra* notes 142-46 and accompanying text; *infra* notes 256-80 and accompanying text.

241. SEC Division Report, *supra* note 64, at 80,623-24.

basis. Once issuers are placed on a list, the compliance department should be responsible for reviewing trades to detect breaches.²⁴²

iii. Responsibility for Review of Employee Trading

The Division's Report states that the compliance department must function in "the area ultimately responsible for employee trade surveillance."²⁴³ The different trading restrictions that broker-dealers place on employees are discussed below. The important point here is that firms must have a compliance department that is ultimately responsible for the establishment, enforcement, and documentation of those procedures.²⁴⁴

b. Physical Barriers

All firms surveyed in the Report employed some physical techniques to restrict the flow of information between departments.²⁴⁵ The devices include the physical separation of departments; procedures that restrict access to files, offices, and computers; and the use of code names or words when discussing sensitive topics.²⁴⁶ The widespread use among broker-dealers of these techniques leads to the conclusion that they are an essential element of an adequate Chinese Wall.²⁴⁷

2. Trading Restrictions

All firms in the survey placed some restrictions on trading by customers, employees, and principals.²⁴⁸ Most firms require employees to maintain all of their trading accounts with the respective firm; others require employees to submit trade confirmations and monthly account statements for their outside trading accounts.²⁴⁹ Firms require pre-clearance of trades to vary-

242. *Id.*; see Commission Division Report, *supra* note 137, at 84,681-83.

243. SEC Division Report, *supra* note 64, at 80,627.

244. *Id.*

The Division believes that the compliance departments at multiservice firms must take the central role in the administration of the firms' Chinese Wall procedures. In particular, compliance must be informed and must maintain records of significant interdepartmental communications, such as bringing an employee over the wall. Further, compliance must take an interactive role with investment banking or other departments in the placement and removal of issues from watch or restricted lists. Finally, compliance must be the area ultimately responsible for employee trade surveillance. Although useful as a supplement, employee trade review by supervisors who do not know the content of a watch list or do not have a sense of the firm's overall business position without concurrent surveillance by the compliance department is inadequate.

Id. See *supra* notes 142-46 and accompanying text; *infra* notes 256-80 and accompanying text.

245. SEC Division Report, *supra* note 64, at 80,621.

246. *Id.*

247. Indeed, because implementation of these techniques is the industry norm, failure to adhere thereto will incur liability risk. See HOUSE REPORT, *supra* note 19, at 6055; *supra* notes 36-39 and accompanying text.

248. SEC Division Report, *supra* note 64, at 80,621.

249. *Id.* at 80,621 n.21. With certain exceptions, this requirement extends to the accounts of family members of the employee. *Id.*; see HOUSE REPORT, *supra* note 19, at 6059:

[T]he Committee does not consider the responsibility of a firm to be entirely released because an employee's illicit trading occurred in an account held at

ing degrees. Some smaller firms require pre-clearance of all employee trades, while larger firms may limit pre-clearance to sensitive departments like investment banking.²⁵⁰ Firms sometimes prohibit any trades in client securities, especially for those individuals connected with the respective firm's investment banking department.²⁵¹ Another common procedure is to prevent trading in an issuer's security during a certain time period, usually two to five days, after the issuance of a research report on that issuer.²⁵²

For employee trading that is allowed, firms place general restrictions on the types of trades and holding periods. These restrictions include minimum holding periods for investments and prohibitions on short sales, options and warrants.²⁵³ As discussed earlier, compliance departments should play a central role in the development and enforcement of these restrictions.²⁵⁴

In addition to these general restrictions, broker-dealers have developed lists that identify issuers about which the firm has, or is likely to have, material, nonpublic information. These lists are usually broken down into three types: restricted lists, watch lists, and rumor lists. The Division viewed using some combination of these three lists to review employee trading as a minimum element of an adequate Chinese Wall.²⁵⁵

a. Restricted Lists

A restricted list identifies securities in which employee and proprietary trading is restricted or prohibited.²⁵⁶ The list generally also prohibits a firm's personnel from soliciting and recommending trades in the subject issuer's securities.²⁵⁷ The Division suggested that restricted lists were less suited for Chinese Wall purposes than watch lists.²⁵⁸ This is because restricted lists are generally distributed on a wide basis throughout the firm and therefore compromise secrecy.²⁵⁹ When used for Chinese Wall purposes, restricted lists are usually employed when a deal is about to go public.²⁶⁰ The Division found that the firms that continued to use restricted lists

another firm. For example, the Committee would expect that a firm's supervisory system would include, at a minimum, employment policies such as those requiring personnel to conduct their securities trading through in-house accounts or requiring that any trading in outside accounts be reported expeditiously to the employing firm.

250. SEC Division Report, *supra* note 64, at 80,621.

251. *Id.*

252. *Id.*

253. *Id.*

254. *See supra* notes 231-44 and accompanying text.

255. SEC Division Report, *supra* note 64, at 80,625-26; *see supra* notes 142-46 and accompanying text; *infra* notes 256-80 and accompanying text.

256. SEC Division Report, *supra* note 64, at 80,619 n.11; *see supra* note 143 and accompanying text.

257. *See sources cited supra* note 256; *see also* Levine et al., *supra* note 2, at 63 (pointing out that "[m]ultiservice firms developed Restricted List procedures as a means of avoiding violations of Section 5 of the 1933 Act or Rule 10b-6 of the Exchange Act").

258. SEC Division Report, *supra* note 64, at 80,624.

259. *Id.* at 80,624; *see Ferrara & Thomas, supra* note 126, at 187 (observing that restricted lists "are broadly disseminated, generally without pretense of secrecy, whenever a deal is about to be made public."); *supra* notes 165-68 and accompanying text.

260. SEC Division Report, *supra* note 64, at 80,624; *see supra* notes 164-68, 259 and ac-

instead of watch lists in this context lacked significant merger and acquisition activity; thus, these firms had less need "to maintain state of the art procedures."²⁶¹ Most firms continue to use restricted list procedures, but they are usually employed to address regulatory concerns other than Chinese Wall issues.²⁶²

b. Watch Lists

Restricted list procedures should be contrasted with watch list or grey list procedures that are often employed to monitor and reinforce a Chinese Wall. Under a watch list, the firm's legal or compliance staff prepares a confidential list of securities of issuers with respect to which the firm is about to obtain or currently possesses material, nonpublic information or whose securities the firm is considering to distribute in a public offering.²⁶³ The compliance staff uses the watch list to monitor trades by the firm, its employees, and clients in order to detect whether there are breaches in the Chinese Wall.²⁶⁴

In its Report, the Division noted that firms differed in their methods of placing companies on watch lists.²⁶⁵ Some firms adopted a flexible approach

companying text; *see also* Levine et al., *supra* note 2, at 64 (asserting that many firms place a security on their restricted list only after the transaction has been publicly announced).

261. SEC Division Report, *supra* note 64, at 80,624.

262. *Id.* at 80,624 n.35 (noting that firms use restricted lists to prevent violations of rule 10b-6 and to ensure trading in securities does not occur until after the issuance of a research report); *see* Levine et al., *supra* note 2, at 63.

263. *See* Levine et al., *supra* note 2, at 65; *supra* note 144 and accompanying text. As stated in the SEC Division Report:

Watch lists have limited distributions, and are designed to permit review without tipping firm or industry personnel as to the existence of a relationship between a broker-dealer and issuer. Generally, the contents of the watch list are known to the compliance or legal department (whichever is performing the surveillance function), the head of investment banking, select senior management, and sometimes the head of proprietary trading or research. Placement of stocks on the watch list differs from firm to firm, but generally placement occurs when discussions between the broker-dealer and client reach a point where clear business objectives have been identified.

SEC Division Report, *supra* note 64, at 80,623.

264. *See* Levine et al., *supra* note 2, at 65; *see* Herlihy et al., *supra* note 131, at 8; *supra* notes 144, 173 and accompanying text; *see also* SEC Division Report, *supra* note 64:

Responsibility for placement of securities on a watch list involves some type of cooperative effort between compliance and investment banking. The head of investment banking generally makes the initial placement determination, either with consultation with the head of compliance or subject to compliance review and approval. A few firms noted that the decision-making responsibilities rested only with investment banking, with no consultation or review by compliance, and therefore no opportunity by compliance to evaluate when the investment banking head is making a practice of waiting too long to place a security on the watch list. Most firms maintain a watch list log, recording when each security is added to or deleted from the list. Firms with small watch lists (the result of less active Investment Banking Departments) may disseminate the list each time it is amended. Major merger and acquisition firms disseminate the new list biweekly or monthly, because of the impracticality of reissuing a constantly changing document.

Id.

265. SEC Division Report, *supra* note 64, at 80,623.

that triggered watch list status when discussions with a company provided the firm with inside information. Other firms used concrete events like the signing of an engagement letter or the identification of a potential target or buyer.²⁶⁶ Since automatic trigger events (like the signing of an engagement letter) can occur after the firm comes into possession of material, nonpublic information, the Division favored a case-by-case approach, with the firm's compliance department providing meaningful review. Nonetheless, the Division observed that most firms claim adherence to a cautious approach when deciding whether to place an issuer's securities on the watch list.²⁶⁷

As with most devices, firms utilize watch lists to varying degrees based on the size and nature of their practice. Smaller firms ordinarily review all trades executed by the firm to detect suspicious activity in securities on the watch list.²⁶⁸ Major firms generally employ more sophisticated techniques due to their large trading volumes. Their reviews will include retroactive reviews, usually from five to thirty days, from the date that an issuer is placed on the watch list. The compliance department will then review all employee and proprietary trading on a next-day basis.²⁶⁹ If trading is detected in a watch list security, firms normally do not question the trades unless a pattern develops or if there exists an obvious connection between the trader and the source of the inside information.²⁷⁰

Restricted lists have the advantage over watch lists of providing pre-transaction review that helps to ensure that certain conduct never occurs. Restricted lists, however, run the risk that an issuer on the list may become known to persons outside the firm and signal to the market a pending transaction.²⁷¹ The confidentiality of watch lists should avoid this risk of premature disclosure.²⁷² Watch lists also allow multiservice firm departments that do not have knowledge of material, nonpublic information to "continue to take advantage of business opportunities without restrictions on securities transactions."²⁷³ In its review of broker-dealer policies, the Division described surveillance of watch lists as "the single most significant element of

266. *Id.* at 80,623 n.30.

267. *Id.* at 80,623.

268. *Id.* at 80,623-25. Hence, every trade executed by the firm, (i.e., customer, employee, proprietary, and principal) is reviewed. *Id.*

269. *Id.* at 80,624. The purpose of such review is to identify potentially suspicious employee trading and examine proprietary positions or activity. *Id.* Moreover, some major firms review all trades that exceed a predetermined percentage of market volume. *Id.*

270. *Id.* With respect to those firms that break or cancel trades made by employees in watch list securities as a matter of practice, "the Division believes that such action probably represents a clear tip to the employee." *Id.* at 80,624 n.33.

271. See Levine et al., *supra* note 2, at 65; *supra* notes 165-68, 258-62 and accompanying text.

272. See SEC Division Report, *supra* note 64, at 80,623 (objective is to maintain confidentiality of content of watch list); Ferrara & Thomas, *supra* note 126, at 187 (stating that "confidentiality of a watch list is essential"). Hence, dissemination of the watch list normally is limited to the compliance department (or the department charged with surveillance), certain senior management individuals, the investment banking head, and perhaps the head of certain other departments, such as research and proprietary trading. See SEC Division Report, *supra* note 64, at 80,623.

273. See Levine et al., *supra* note 2, at 65.

Chinese Wall review procedures."²⁷⁴ As noted earlier, the Division suggested a preference for using watch lists over restricted lists, especially when a firm conducts significant merger and acquisition activity.²⁷⁵

c. Rumor Lists

Rumor lists cover securities of issuers that are involved in a recently announced deal or that are subject to rumors relating to a pending transaction.²⁷⁶ Their primary distinction from watch or restricted lists is that rumor lists are not limited to issuers that are doing business with the firm.²⁷⁷ The Division's report noted that only a few major New York broker-dealer firms in the survey employed rumor lists and that such lists served to supplement the respective firm's watch and restricted lists.²⁷⁸ In its discussion of minimum standards for Chinese Walls and reinforcement procedures, the Division stated that the New York Stock Exchange should consider "a requirement for firms to establish procedures, including, among other things, use of rumor lists, to review customer, employee, and proprietary trading on third party deals."²⁷⁹ Based on the Division's praise for rumor lists, broker-dealers should consider their adoption.²⁸⁰

3. Memorialization of Procedures and Documentation of Efforts

a. Formalization of Firm Policies and Procedures

The Division recommended dramatic improvement in the memorialization of existing broker-dealer procedures in order for firms to establish the minimum elements of an adequate Chinese Wall.²⁸¹ The Division noted that

274. SEC Division Report, *supra* note 64, at 80,624.

275. *Id.* at 80,624-25; see *supra* notes 258-62 and accompanying text.

276. SEC Division Report, *supra* note 64, at 80,625.

277. *Id.*

278. *Id.*

279. *Id.* at 80,626.

280. The use of Chinese Walls and reinforcement procedures has been subject to criticism. Professor Poser pointed out that "perhaps the focus should be shifted away from the securities firms that set up Chinese Walls, toward the customers and clients who are on the receiving end of the conflicts of interest." Norman S. Poser, *Conflicts of Interest Within Securities Firms*, 16 BROOK. J. INT'L L. 111, 112 (1990). He observed: "It is difficult to know how effective these procedures have been; despite the omnipresence of Chinese Walls, several insider trading cases involving investment banking firms have been reported." *Id.* at 113.

Even more emphatical is former Senator William Proxmire's perception that "in case after case after case, the Chinese Wall is a phony, it's a fake, it doesn't work, there's too much temptation." *Improper Activities in the Securities Industry: Hearings Before the Senate Committee on Banking, Housing and Urban Affairs*, 100th Cong., 1st Sess. 89 (1987) (statement of Sen. William Proxmire). The House Report likewise observed that "questions have been raised about the efficacy of some firms['] 'Chinese Walls.'" HOUSE REPORT, *supra* note 19, at 6052. To resolve this problem, the House Committee perceived "a need for an affirmative statutory obligation for every broker, dealer and investment advisor to design effective procedures to restrict and monitor access to such information and prevent insider trading." *Id.* The legislation enacted contains such an obligation. See *supra* notes 28-39 and accompanying text. In view of the 1988 legislation, broker-dealers and investment advisors should develop and implement sufficient Chinese Wall and reinforcement procedures so as to withstand SEC and SRO scrutiny.

281. SEC Division Report, *supra* note 64, at 80,625. The Report stated that "the proce-

many firms lacked written procedures to explain their watch and restricted lists. Firms should avoid having procedures that consist of "a loose mixture of internal memoranda, excerpts from employee manuals, and certifications."²⁸²

Based on the Division's report, broker-dealers should compile and organize their procedures in a formal fashion.²⁸³ Indeed, since ITSFEA's passage in 1988, firms have formalized their procedures that address the minimum elements of Chinese Walls.²⁸⁴ Such procedures will help demonstrate that the firm has made a serious effort to discharge its obligation to establish "written policies and procedures reasonably designed . . . to prevent the misuse . . . of material, nonpublic information"²⁸⁵

b. Documentation of Compliance Efforts

The Division also found that the majority of firms were seriously lacking in their documentation of their efforts taken under their respective Chinese Wall procedures.²⁸⁶ The Division recognized that the level of adequate documentation would differ between smaller firms and larger multiservice firms, but it warned that the "failure to maintain documentation sufficient to recreate actions taken pursuant to Chinese Wall procedures will make reviews and determinations of the adequacy of procedures and compliance efforts

dures of the great majority of firms need to be structured and memorialized more than is current practice." *Id.* at 80,626.

282. *Id.* at 80,625-26.

283. *See id.* at 80,626.

284. *See* Joint Memo on Chinese Wall Policies and Procedures, By the New York Stock Exchange and National Association of Securities Dealers, NASD Notice to Members No. 91-45 (June 21, 1991) [hereinafter Joint Memo] (stating that a firm's Chinese Wall procedures "must be formalized, organized, and incorporated within a firm's procedural/policy manuals"); Herlihy et al., *supra* note 131, at 4-10. The Joint NASD/NYSE Memo, provided in response to the 1990 SEC Division Report, is discussed in Ferrara & Thomas, *supra* note 126, at 191-94.

285. Section 15(f) of the Exchange Act, 15 U.S.C. § 78o(f) (1988). As stated in the House Report:

The requirements of these new statutory provisions reflect the Committee's belief that broker-dealers and investment advisers must not only adopt and disseminate written policies and procedures to prevent the misuse of material, nonpublic information, but also must vigilantly review, update, and enforce them. The Committee believes that directly imposing such affirmative obligations in the federal securities statutes will underscore the significance of such policies and procedures and will also enhance the ability of the Commission and the SROs to monitor and promote the effectiveness of a firm's supervisory efforts. There would be direct statutory requirements for broker-dealers and investment advisers to have written policies and procedures, and those policies and procedures and their adherence to them would be subject to Commission and SRO inspection. Where a firm failed to comply with the statutory requirement to establish, maintain, or enforce reasonable written policies and procedures, it would be subject to a Commission or SRO action for violation of Section 15(f) or 204A, and potentially subject to a fine under the new Section 21A of the Exchange Act.

HOUSE REPORT, *supra* note 19, at 6058.

286. SEC Division Report, *supra* note 64, at 80,626. The Report identified numerous areas where firms lacked adequate documentation, including: (1) interdepartmental communications; (2) entry logs for watch and restricted lists; (3) daily trading reviews; and (4) subsequent investigations. *Id.*

exceedingly difficult."²⁸⁷ The Division declined to adopt any standards for documentation, but it urged the self-regulatory organizations to develop guidance on minimum standards for their members. The SROs have responded to the Division's request.²⁸⁸

Since the Division recommended that compliance departments play a central role in the administration of Chinese Wall procedures,²⁸⁹ the most logical and efficient course for most firms would be to make the compliance department responsible for documentation. As the single body with ultimate responsibility for documentation, the compliance department can help ensure that all significant measures are recorded and that the records are consistent, complete, and nonduplicative.²⁹⁰ The documentation should include the following areas: (i) records on significant interdepartmental communications; (ii) historical records of watch, restricted, and rumor lists; (iii) records of daily trading reviews, indicating any suspicious trades that were detected; and (iv) documentation of efforts to investigate suspicious trades.²⁹¹

c. Commitment to Training Personnel

The Report found that the majority of firms lacked formal training procedures. It stressed that all broker-dealers should adopt "comprehensive, interactive training programs, particularly for employees in sensitive areas, supplemented by routine updating and reinforcement of firm policies."²⁹² The Report stated that all firms should follow the lead of a handful of New York firms that had implemented comprehensive programs.²⁹³ One pro-

287. *Id.* (emphasis added).

288. *Id.*; see Joint Memo, *supra* note 284, at 241-43. The 1991 Joint Memo focused on the minimum documentation sufficient to support the use of restricted and watch lists. For example, documentation should memorialize: (1) the standards applied for placing securities on, or removing such securities from, the restricted or watch list, (2) the date and time a particular security was placed on or removed from the restricted or watch list and identification of the contact person knowledgeable of the circumstances in regard thereto, (3) recordation of reviews routinely undertaken with respect to employee or proprietary trading in securities placed on the restricted or watch list, (4) the manner in which the firm oversees trading by employees in accounts held outside of the firm in those securities on the firm's restricted or watch list, (5) the frequency of monitoring and time periods covered with respect to employee and proprietary trading, and (6) the undertaking of investigations in connection with suspected misuses of inside information.

The record of such an investigation should include the date the investigation commenced, the name of the security involved, identification of the applicable accounts, and a summary of the investigation's disposition. In addition, the Joint Memo addressed the supervisory function that a firm's compliance department should have with respect to interdepartmental communications. This supervision should be supported by policy statements, the use of Chinese Walls, and proper recordation when an employee is brought over the wall. Moreover, the Joint Memo emphasized the importance of adequate education and training. In regard thereto, employees must attest in writing that they have adequate understanding of the applicable laws, SRO requirements and in-house policies. Records of these attestations must be retained by the firm. Employees also should be updated when the applicable requirements are subject to change. See Ferrara & Thomas, *supra* note 126, at 191-94.

289. SEC Division Report, *supra* note 64, at 80,627.

290. See Herlihy et al., *supra* note 131, at 9.

291. See SEC Division Report, *supra* note 64, at 80,626; discussion and authorities cited *supra* note 288.

292. SEC Division Report, *supra* note 64, at 80,627.

293. *Id.*; see discussion and authorities cited *supra* note 288.

gram that the Division cited favorably involved extensive education about firm policies and the applicable securities laws during an employee's orientation period. The firm would supplement this orientation with periodic training, seminars, and memoranda to reinforce the policies and to update its employees on new developments.²⁹⁴

One concern expressed in the Report was the lack of an integrated, formal approach to training in many firms. Since many firms were conducting some form of training, either through internal memos, orientation material, acknowledgments or certificates of compliance, one of the most effective ways to improve procedures would be to consolidate and formalize existing procedures. In this regard, firms should consider preparing binders that employees would receive during orientation. The binders would serve as their permanent reference for insider trading procedures and employees would be instructed to update their binders with future memos.²⁹⁵

4. *Heightened Review of Proprietary Trading While in Possession of Material, Nonpublic Information*

The final element that the Division identified as a requirement of adequate procedures relates to a heightened review of proprietary trading while the firm is in possession of material, nonpublic information. The Report defined proprietary trading to include "risk arbitrage, market making, and block trading," but its principal concern was with risk arbitrage.²⁹⁶

The Report suggests that the most prudent course would be to suspend risk arbitrage trading involving a security while the firm possessed inside information affecting the security, but it declined to find that such a prohibition was always necessary.²⁹⁷ Based on the Commission's comments, however, a firm that engages in risk arbitrage under such circumstances may face rigorous standards for proving the adequacy of its Chinese Wall procedures.²⁹⁸

The Report summarized the procedures employed by firms concerning the

294. SEC Division Report, *supra* note 64, at 80,620; see discussion and authorities cited *supra* note 288.

295. SEC Division Report, *supra* note 64, at 80,620 n.20; see Herlihy et al., *supra* note 131, at 10-11.

296. SEC Division Report, *supra* note 64, at 80,622.

297. *Id.* at 80,626-27. The Report stated: "The Commission has interpreted, and courts have reviewed, the issue of firm proprietary trading when in possession of material, nonpublic information. Although commenting that such trading should be restricted, the Commission never has stated that proprietary trading in such a context must be prohibited." *Id.* at 80,619 n.13. See *SEC v. First Boston Corp.*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,712 (S.D.N.Y. 1986) (in settlement of charges relating to insider trading, First Boston agreed to restrict its proprietary trading but declined to refrain from this practice); *supra* notes 147-83 and accompanying text.

298. SEC Division Report, *supra* note 64, at 80,626-27; see Rule 14e-3 Release, *supra* note 132, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,646, at 83,459-62 (discouraging proprietary trading when firm has inside information); Herlihy et al., *supra* note 131, at 9-10; Levine et al., *supra* note 2, at 61-62; see also Commission Division Report, *supra* note 137, at 84,683 ("We would stress, once again, that it remains the firms' responsibility to ensure that Chinese Wall procedures, as well as procedures to monitor employee trading, are adequate to address the challenging environment of High Yield research, trading, and sales.").

other forms of proprietary trading (market making and block trading), but it did not make any specific recommendations for these areas. With regard to block trading, most firms do not restrict block trading while in possession of material, nonpublic information because these trades are initiated by customers. The firms also placed few restrictions on market making activities.²⁹⁹

VI. GENERAL CORPORATE CONTEXT

A. ADOPTION OF COMPLIANCE PROGRAMS BY PUBLICLY-HELD COMPANIES

1. *Corporate Compliance Programs*

Publicly-held corporations tend to address insider trading concerns in three basic forms: (i) through institutional codes of conduct that cover insider trading; (ii) among many other topics, through memoranda or legal policy statements directed at specific issues involving the federal securities laws; and (iii) through written policy statements focusing specifically on insider trading.³⁰⁰ Generally, institutional codes of conduct are designed to promote employee compliance with the relevant laws and regulations that affect a corporation's business.³⁰¹ These codes are designed to promote employee compliance with a broad range of legal³⁰² and ethical restraints.³⁰³ A large percentage of corporate codes already addressed insider trading com-

299. SEC Division Report, *supra* note 64, at 80,622-23. With respect to these practices, the Report stated:

Block proprietary trading done to facilitate customer transactions is less likely to be restricted than risk arbitrage activity. A number of firms noted that because block activity is not initiated by the firm and does not evidence any investment objective on behalf of the firm, it is unnecessary to restrict the activity. These firms also indicated that the sudden withdrawal by an active block trading desk in a particular security might serve to tip investors that the firm possessed information, generally presumed to be positive, about that security. However, a few firms with active block trading desks reported that such activity was restricted or discontinued.

Firm procedures governing the flow of information between investment banking and market making generally contain no restrictions on market making activity. Those firms that are over-the-counter market makers noted that withdrawing from the market in a company with whom the firm has had a previous investment banking relationship provided a clear tip about current inside information. Firms that continue market making activity while in possession of confidential information either instruct their market makers to remain passive to the market, that is, to only take the contra side of unsolicited customer trades, or claim that such instructions are unnecessary because their market making activity always is passive. All firms interviewed indicated that their market makers do not make a practice of aggressively building positions in their stocks or acting as a shadow risk arbitrage department.

Id.

300. See Alan M. Weinberger, *Preventing Insider Trading Violations: A Survey of Corporate Compliance Programs*, 18 SEC. REG. L.J. 180, 186-87 (1990).

301. See Pitt & Groskaufmanis, *supra* note 62, at 1633-53.

302. See Goldblatt, *supra* note 66, at 22.

303. See Pitt & Groskaufmanis, *supra* note 62, at 1634-35 (observing that "codes of conduct inevitably facilitate and encourage the efforts of those employees who want to do the right thing").

pliance prior to the 1988 passage of ITSFEA.³⁰⁴ The increased liability exposure of controlling persons under ITSFEA is further inducement for companies to review and update their codes to address insider trading.³⁰⁵

Another common form of corporate compliance program is the memorandum or legal policy statement. The key difference from codes of conduct is that memoranda focus exclusively on insider trading concerns and usually provide a more detailed discussion of the area.³⁰⁶ This article will not distinguish between legal policy statements and codes of conduct, and it will generally refer to insider trading compliance procedures in this context as corporate compliance programs. The focus here is not on the specific form or description of the program, but on the essential elements of any corporate compliance program addressing insider trading.

2. Decisions to Adopt Insider Trading Compliance Programs

ITSFEA does not impose an affirmative duty on publicly-held corporations to establish and maintain insider trading compliance programs.³⁰⁷ Nonetheless, pursuant to the provisions of Exchange Act Section 21A, the liability net extends to any organization, including publicly-held companies, that recklessly disregarded the risk that an employee would engage in insider trading and failed to take appropriate steps to prevent such conduct.³⁰⁸ A former SEC Enforcement Director opined that if an entity outside of the securities industry had routine access to material, nonpublic information, "there could be a case where the mere fact that a firm failed to establish any policies and procedures whatsoever would be deemed to be reckless conduct."³⁰⁹ Looking at this scenario from a different view, it certainly appears

304. See Weinberger, *supra* note 300, at 181 n.2. Subsequent to the Second Circuit's seminal decision in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 404 U.S. 1005 (1971), commentators urged adoption of internal codes of conduct to help prevent insider trading violations. See Alan R. Bromberg, *Disclosure Programs for Publicly Held Companies - A Practical Guide*, 1970 DUKE L.J. 1139; Bruce A. Mann, *Prevention of Improper Securities Transactions by Employees: The Responsibility for and Feasibility of Adopting Preventative Programs*, 25 HASTINGS L.J. 355 (1974).

305. See Barron, *Model Memoranda*, *supra* note 52; Weinberger, *supra* note 300, at 183-85 (and authorities cited therein); discussion and sources cited *supra* notes 19-39 and accompanying text. Compare Harvey L. Pitt and Karl A. Groskaufmanis, *Update on Procedures for Preventing Insider Trading in Publicly-Traded Companies*, Browne Dig., Apr. 1989, at 5 ("We read [ITSFEA] to impose a de facto requirement of all publicly-traded companies to develop procedures governing employee securities transactions."), with Weinberger, *supra* note 300, at 185 ("Whether failure to develop, implement, and effectively enforce policies and procedures to prevent employee insider trading itself evidences corporate recklessness may well depend on the standard established by the behavior of other firms that are comparable in terms of geography, industry, and size.").

306. See Weinberger, *supra* note 300, at 187; Goldblatt, *supra* note 66, at 22-23.

307. See Section 15(f) of the Exchange Act, 15 U.S.C. § 78o(f) (1988) (imposing affirmative duty on broker-dealers); Section 204A of the Investment Advisors Act of 1940, 15 U.S.C. § 80b-4a (1988) (imposing affirmative duty on investment advisors). Of course, publicly-held companies that are broker-dealers or investment advisors must maintain such procedures. See *supra* notes 28-39 and accompanying text.

308. Section 21A of the Exchange Act, 15 U.S.C. § 78u-1(b)(1)(A) (1988); Pitt & Groskaufmanis, *supra* note 62, at 1592 (stating that "controlling person provisions extend to any public company"); *supra* note 305 and accompanying text.

309. *Requirements of Insider Trading Act Go Beyond Securities Firms*, Lynch Says, 21 SEC.

that the presence of reasonably adequate procedures will render it more difficult for the SEC to establish recklessness on the part of controlling persons under Section 21A of the Exchange Act.³¹⁰

In this regard, it is important for companies to determine what procedures similarly situated companies are adopting. When a court determines whether a company acted "recklessly" or "failed to take appropriate steps,"³¹¹ it should be strongly influenced by the corporate community's standard of care.³¹² Since a high percentage of large, publicly-held corporations had addressed insider trading prohibitions in their corporate codes even before ITSFEA,³¹³ companies that decline to adopt a compliance program are at risk. Prudence dictates that publicly-held companies, with adequate documentation, should adopt and implement reasonably effective procedures to safeguard material, nonpublic information.³¹⁴

In a context not limited to the federal securities laws, corporations may receive additional incentives to adopt legal compliance programs under the criminal sentencing guidelines.³¹⁵ Under these guidelines, a mitigating factor in determining the criminal sentence to be imposed is whether the subject organization has in place an effective and operational code of conduct.³¹⁶ The guidelines set forth seven hallmarks of such a code, including effective training, monitoring, and enforcement, as well as the designation of high-level personnel with overall responsibility for compliance.³¹⁷

REG. & L. REP. (BNA) 65 (1989) (statement by Gary Lynch); *see* authorities cited *supra* note 305.

310. Barron, *supra* note 52, at 195; Weinberger, *supra* note 300, at 183-85; *supra* notes 37-39, 68-76, 305 and accompanying text.

311. Section 21A of the Exchange Act, 15 U.S.C. § 78u-1(b)(1)(A) (1988); *see supra* notes 19-39, 68-76, 305 and accompanying text.

312. Pitt & Groskaufmanis, *supra* note 62, at 1637 ("The fact that other similarly situated companies have adopted, implemented, maintained, and enforced restrictive codes could rebound to the evidentiary disadvantage of a company that declines to follow suit."); *see* sources cited *supra* notes 305, 309, 310.

313. *See supra* notes 4-18, 304 and accompanying text.

314. *See* authorities cited *supra* notes 19-39, 68-76, 304-05.

315. *Amendments to the Sentencing Guidelines for United States Courts*, 56 Fed. Reg. 22,762, 22,787-88 (1991); *Sentencing Guidelines for United States Courts*, 55 Fed. Reg. 46,600, 46,603-04 (Nov. 5, 1990); *see* CORPORATE SENTENCING GUIDELINES: COMPLIANCE AND MITIGATION (Jed S. Rakoff et al. eds. 1993); Jeffrey S. Jacobovitz, *How to Bring Down Your Culpability Score*, LEGAL TIMES, Dec. 14, 1992, at 35; sources cited *supra* notes 62, 65.

316. 55 Fed. Reg. 46,600, 46,604 (1990); *see* Webb & Molo, *supra* note 65, at 380-83.

317. 55 Fed. Reg. at 46,605:

The hallmark of an effective program . . . is that the organization exercised, prior to the offense, and continues to exercise due diligence in seeking to prevent and detect criminal conduct by its agents. Due diligence requires at a minimum that the organization has taken at least seven general types of steps to assure compliance with the law. First, the organization must have had policies defining the standards and procedures to be followed by its agents and employees. Second, a specific high-level person within the organization must have been designated and assigned ultimate responsibility to ensure compliance with those standards and procedures. Third, the organization must have used due care not to delegate significant discretionary authority to persons whom the organization knew, or should have known, had a propensity to engage in illegal activities. Fourth, the organization must have effectively communicated its standards and procedures to agents and employees, e.g., by requiring participation in training programs and by the dissemination of publications. Fifth, the organization must

B. ELEMENTS OF A CORPORATE COMPLIANCE PROGRAM

In this context, an insider trading compliance program for a publicly-held corporation should focus primarily on securities issued by that corporation and its affiliates. The program also should address the additional reporting requirements and trading restrictions imposed on statutory insiders by Section 16 of the Exchange Act.³¹⁸ Since these rules affect officers, directors, and ten percent shareholders, corporations should adopt additional policies to provide these persons with the necessary guidance for compliance.³¹⁹ Moreover, corporate compliance programs should provide guidance to employees on how to respond to inquiries from outsiders to avoid risks of tipping material, nonpublic information.³²⁰

1. Procedures and Policies Directed at All Corporate Personnel

A corporate compliance program with respect to insider trading should encompass the basic elements and administrative steps outlined earlier in the article.³²¹ A policy directed at all personnel of a large organization should be as clear and concise as practicable.³²² Such a policy should stress that the prohibition on insider trading encompasses trading as well as tipping material, nonpublic information to others, including spouses, minor children, and other relatives residing in the same household, and securities issued by any publicly-held corporation. The policy should provide examples of insider trading that are tailored to the corporate context.³²³ As discussed below, the policy should instruct employees not to respond to inquiries from outsiders

have taken reasonable steps to achieve compliance with its standards, e.g., by utilizing monitoring and auditing systems reasonably designed to ferret out criminal conduct by its agents and employees and by having in place and publicizing a reporting system whereby agents and employees can report criminal conduct within the organization without fear of retribution. Sixth, the standards must have been consistently enforced through appropriate disciplinary mechanisms. Seventh, after an offense has been detected, the organization must have taken all reasonable steps to prevent further similar offenses. Such steps should include any necessary modifications to the organization's program to prevent and detect violations of law and appropriate discipline of individuals responsible for the offense and, as appropriate, the individuals responsible for the failure to detect the offense. Discipline of the individuals responsible for the offense is a necessary step to prevent a recurrence of similar offenses, but the form of discipline that will be appropriate will depend on the facts of the case and can range from discharge to verbal or written censure.

Id. During the recent past, there has been a proliferation of compliance programs adopted by organizations, particularly by publicly-held enterprises. See Paul J. Curran & Gregory J. Wallace, *Measuring the Need for Early Disclosure*, NAT. L.J., Sept. 27, 1993, at 26, 30; Nagel & Swenson, *supra* note 62, at 209.

318. For discussion on Section 16, see generally 16 ARNOLD S. JACOBS, SECTION 16 OF THE SECURITIES EXCHANGE ACT (1989); PETER I. ROMEO & ALAN L. DYE, SECTION 16 REPORTING GUIDE (1994).

319. See *infra* notes 331-42 and accompanying text.

320. See Ruder, *supra* note 36, at 5-6.

321. See *supra* notes 40-67 and accompanying text.

322. See Barron, *supra* note 52, at 201-02 (providing a model policy on insider trading that could be distributed to all employees of a corporation).

323. *Id.* at 201 (examples of insider trading in the publicly-held corporation context: dividend announcements and changes in quarterly earnings).

and to refer all such inquiries to a designated officer or compliance official.³²⁴

2. *Specific Policies for Directors and Officers*

The federal securities laws place certain restrictions on the conduct of officers and directors with respect to their securities transactions. Accordingly, a corporate compliance program should seek to provide guidance to such persons. This section addresses certain matters that a publicly-held company may elect to include in its policy.

As a general matter, the policy should require all officers and directors to consult with the corporate secretary or a designated compliance person before purchasing or selling securities issued by the corporation.³²⁵ This policy should extend to transactions in options or other derivative securities that relate to the issuer's securities.³²⁶ These measures should assist insiders to comply with the restrictions placed on them by applicable law.

The policy for high-level officials should provide a more detailed treatment of the basis for prohibitions on insider trading than the policy provided to all employees. For example, the policy may provide examples that such officials will be more likely to encounter than the average employee.³²⁷ The company should consider instituting "blackout periods" during which officers and directors would not be allowed to trade as a matter of company policy.³²⁸ For example, the company could prohibit trading three weeks before and forty-eight hours after public announcement (and dissemination) of the company's earnings.³²⁹ The policy may also provide guidance to officers and directors so that they may determine whether they are affiliates and thereby face restrictions on the resale of their securities.³³⁰

a. Reporting Requirements Under Section 16(a)

Section 16(a) of the Exchange Act requires officers, directors, and ten percent beneficial holders of an equity security of certain publicly-held enterprises to report their ownership of such securities.³³¹ Such publicly-held corporations should consider the adoption of a policy that explains the requirements under Section 16(a) and establishes procedures that help ensure that these statutory insiders file the required forms.³³² In 1991, the Commis-

324. See *infra* notes 343-48 and accompanying text.

325. See Barron, *supra* note 52, at 196.

326. *Id.*; see John F. Olson et al., *Compliance Programs and Procedures*, 5 INSIGHTS No. 4, at 32, 33-34 (Apr. 1991).

327. See Barron, *supra* note 52, at 196-201.

328. *Id.* at 201; see Weinberg, *supra* note 300, at 188-89 (describing corporate policies prescribing "blackout" periods).

329. See Barron, *supra* note 52, at 201.

330. *Id.* at 199-200. See generally MARC I. STEINBERG, *SECURITIES REGULATION* 449-96 (2d ed. 1993).

331. Section 16(a) of the Exchange Act, 15 U.S.C. § 78p(a) (1988). Section 16 applies only to issuers which have securities registered under Section 12 of the Exchange Act. *Id.* See Steinberg, *supra* note 131, at §§ 4.01-4.08; sources cited *supra* note 318.

332. See Barron, *supra* note 52, at 196-200 (providing a sample policy directed at statutory insiders).

sion adopted new rules under Section 16(a) that encourage such practices by requiring publicly-held companies to disclose any company procedures that assist insiders with Section 16 compliance and to disclose the names of any statutory insiders who failed to properly file the required forms.³³³

The policy should explain the basic purpose of each form that must be filed under the Section 16(a) rules³³⁴ and the timing for the filing of each form.³³⁵ Finally, the policy also should state the number of copies required of each form and the organizations with whom each such form must be filed.³³⁶

In addition to distributing a policy statement to all statutory insiders, companies also should consider establishing procedures designed to assist and monitor the compliance of these persons with Section 16(a) requirements. In connection therewith, the company should designate a senior person, such as the corporate secretary or a senior attorney in the compliance (or legal) department, to be in charge of assisting insiders and tracking their compliance.³³⁷ The company also should consider establishing procedures for date stamping reports received by the issuer from Section 16(a) insiders.³³⁸

b. Avoiding Short Swing Liability Under Section 16(b)

The policy statement directed at the statutory insiders of a publicly-held corporation may include procedures designed to avoid Section 16(b) liability for short swing profits.³³⁹ Such a policy statement should describe Section

333. See Item 405(a) of Regulation S-K, 17 C.F.R. § 229.405(a) (1994); Securities Exchange Act Release No. 28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,709, at 81,274-75 (SEC 1991); Steinberg, *supra* note 131, § 4.01[1], at 4-10.

334. Form 3 (Initial Statement of Beneficial Ownership of Securities); Form 4 (Statement of Changes in Beneficial Ownership of Securities); Form 5 (Annual Statement of Beneficial Ownership of Securities); see 17 C.F.R. § 240.16a-3(a) (1994).

335. Form 3 must be filed within ten days of the event that caused the person to become an officer, director, or ten percent beneficial owner. A. Jacobs, *supra* note 318, § 2.09. Form 4 must be filed on or before the tenth day of the month following the month in which the reportable event occurs. *Id.* Form 5 must be filed within forty-five days after the end of the issuer's fiscal year if certain transactions have occurred during the year. *Id.* See Steinberg, *supra* note 131, § 4.01[1], at 4-9; Barron, *supra* note 52, at 196-97.

336. The statutory insider must file: i) three copies of each form, one of which must be manually signed, with the SEC; ii) one copy with each Exchange of which any class of securities of the issuer is registered; if the issuer has designated a single Exchange to receive Section 16 filings, one copy need be filed with that Exchange only; and (iii) one copy with a designated person within the corporation, such as the corporate secretary. See 17 C.F.R. § 240.16a-3; General Instruction No. 3, Form 3; General Instruction No. 2, Form 4; General Instruction No. 2, Form 5; Barron, *supra* note 52, at 197.

337. See Lawrence D. Ginsburg, *25 Months and 2 Releases Later: The SEC Adopts New Rules and Forms Under Section 16*, Securities Regulation ¶ 1135 (1991); see also Olson, *supra* note 326, at 33.

338. Ginsburg, *supra* note 337, at ¶ 1135. Another suggestion is to have the Board of Directors, on the advice of counsel, create a list of Section 16 officers. *Id.*; see Steinberg, *supra* note 131, § 4.01[1], at 4-10, (relying on Item 405(b)(1) of Regulation S-K, 17 C.F.R. § 229.405(b)(1) (1994)) (providing that "[a]ny form received by the registrant [from an officer or director of such registrant] within three calendar days of the required filing date may be presumed [by the registrant] to have been filed with the SEC on a timely basis").

339. Section 16(b) of the Exchange Act, 15 U.S.C. § 78p(b) (1988). See generally Jacobs, *supra* note 318, § 2.09.

16(b)'s application to short swing trading and its disgorgement of profit (or loss avoided) provision.³⁴⁰ The policy may explain how courts apply the section strictly to match the highest and lowest prices for the insider's transactions over a six-month period; as a result, an insider can actually incur a loss over a series of trades but still be required to disgorge "profits."³⁴¹ The policy also may explain key concepts underlying Section 16(b). These concepts include, for example, the grant and exercise of options, the concept of beneficial owner, and the requisite holding periods.³⁴²

3. Public Disclosure Procedures

Insider trading compliance programs for publicly-held companies should address procedures that control public disclosures made by their officers and employees. Such procedures should minimize the risk that officers and employees tip confidential, material information to outsiders when fielding inquiries from persons outside of the company.³⁴³ Companies should consider distributing a concise policy to all personnel, instructing them to refer all inquiries about the company to a designated corporate officer or spokesperson. It may be beneficial to include this policy in the company's insider trading compliance material so that employees may better understand the potential consequences of tipping information to outsiders.³⁴⁴

In conjunction with the above policy, companies should designate an information officer, or a group of persons, to be responsible for the preparation and dissemination of "unstructured public disclosures."³⁴⁵ Companies also should consider implementing detailed procedures that will guide the information officer or group in this process. Guidelines should be established for the periods before and after public dissemination of the company's disclosures.³⁴⁶

The policy adopted may provide specific guidance on responding to inquiries from investors and analysts. One such policy would be to refrain from disclosing material information, except through the above guidelines,

340. See Barron, *supra* note 52, at 198.

341. *Id.* at 198-99. For case law applying this principle, see, for example, Whitaker v. Whitaker Corp., 639 F.2d 516 (9th Cir. 1981); Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir. 1943); and Morales v. Mylan Labs., Inc., 443 F. Supp. 778 (W.D. Pa. 1978).

342. See Robert A. Barron, *Control and Restricted Securities: Some Comments on Current Questions Under § 16(b) of the Securities Exchange Act of 1934*, 18 SEC. REG. L.J. 194, 195 (1990). The policy statement for statutory insiders also should address Section 16(c)'s prohibition on short sales. See Jacobs, *supra* note 318, § 2.09; Barron *supra* note 52, at 199.

343. See generally Wesley S. Walton, *Disclosure Guidelines Formulated*, NAT. L.J., June 18, 1990, at 16 (outlining the elements of a public disclosure policy for publicly-held companies).

344. See *id.* at 24; Ruder, *supra* note 36, at 5.

345. See Walton, *supra* note 343, at 16, 22 (defining "unstructured" public disclosures to include press releases, executive speeches, and reports to stockholders, as opposed to "structured" disclosures which are the documents required to be filed with the SEC).

346. *Id.* (asserting that the designated officer should review all unstructured disclosures prior to publication, and after publication the designated officer or group should monitor the accuracy of reporting of the disclosures and the market reactions thereto; also, suggesting that all material information disclosed pursuant to unstructured disclosures be made by press release and circulated to appropriate financial media and trading facilities (such as exchanges)).

unless it has already been publicly released in a prior disclosure.³⁴⁷ A policy may elect to guide the information officer's response in a variety of situations like responding to rumors not attributable to the company, inquiries into sensitive topics such as mergers and acquisitions, and inquiries about the accuracy of analysts' reports. Selective disclosure of material information to specified analysts, shareholders, or the media should be avoided.³⁴⁸

VII. CONCLUSION

The key point that perhaps should be taken from this article is that any organization that comes into possession of inside information with respect to publicly-held enterprises would be prudent to adopt and implement a law compliance program designed to prevent insider trading violations. Although by its terms ITSFEA may be construed to saddle this requirement on broker-dealers and investment advisors only, publicly-held corporations and professional firms (that are privy to inside information of publicly-held enterprises) would be shortsighted to conclude that they may forego such mechanisms. As seen from customary practice and the stance taken by regulators and commentators, there arguably exists today a *de facto* obligation for these organizations to adopt and implement reasonably effective policies and procedures. Provided that certain basic procedures are adhered to, the complexity of the program adopted should be left largely to the good faith discretion of high-level personnel within the respective organization. These organizations can best assess the benefits and costs involved. Nonetheless, an organization would be prudent to embrace a cautious posture. In sum, such organizations, taking into account the costs involved, should adhere to as effective a program as can feasibly be implemented.

347. *Id.*; see Ruder, *supra* note 36, at 5 (observing that "the persons making disclosures should have sufficient knowledge and skill to avoid pitfalls in making those disclosures").

348. See J. ROBERT BROWN, JR., *THE REGULATION OF CORPORATE DISCLOSURE* §§ 3.2, 7.3 (1989); Walton, *supra* note 343, at 24; see also Ruder, *supra* note 36, at 5-6 ("The most important task of the office assigned responsibility for responding to inquiries will be to establish a program for dealing with requests from analysts, but other areas of concern include dealing with the press, responding to rumors, communicating with institutional investors and other shareholders, and communicating with specialists and stock exchanges.").

