

The Importance of Chinese Walls in Banks and Management of Information Flows

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Abstract: When conflicts of interest, period fraud, and insider trading occur in the banking industry, the stability and certainty of financial markets are undermined. The author has examined a wealth of documentation and evidence that the "Chinese Walls" plays an essential role in the management of the banking industry. However, the 'Chinese Walls' has been under constant threat of intrusion and exploitation in recent years, and the FCA has announced its abolition. The author argue that the Chinese Walls and information walls cannot be eliminated and remain helpful in the right circumstances. This paper proposes a solution that uses IFS management information technology and DLP in combination with the construction of appropriate situational and physical barriers for better information management and protection.

Keywords: Banks management, Chinese walls, conflict of interest, insider tradings, DLP, IFS, information flows.

1. Introduction

'Walls' play a major role in the finance and banking industry. They reflect the normative goal of isolating individuals for security and profit reasons and keeping sensitive information under lock and key. In early 2022, Activision Blizzard, one of the largest and most profitable independent producers of interactive media and games throughout the globe, was sold to Microsoft, Inc.[1] As per the sources, Microsoft's agreement with Activision was already in progress while the software company was dealing with Zynga.[2] However, the bankers did not get to know about the deal because of the bank's *Chinese walls*. Chinese walls, which get their name from The Great Wall of China, are the virtual barrier that exists between people with access to sensitive, non-public information and the ones who do not. Businesses and governments have created and implemented Chinese walls to avoid potential conflicts of interest.[3]

In 1933, the *Glass-Steagall Act* was enacted to legitimise Chinese walls by regulating the relationship between investment and commercial banking as the former often engaged in speculative behaviour that created risks for investors.[4] The 1933 Act aimed to protect investors from possible deception and insider trading.[5] This could be done with the help of Chinese walls. It is because, as noted above, they help reduce the conflict of interest between corporate finance, brokering divisions, who work on a commission basis and research analysts who examine financial reports.[6] Therefore, only those bank personnel who directly serve the clients or are an essential part of the due diligence procedure are permitted to jump the wall. The landmark Australian case of *ASIC v Citigroup Global Markets Australia Pty Ltd*[7] demonstrates the significance of 'adequate' Chinese wall arrangements to prevent insider trading. With the growth of cryptocurrency, the importance of Chinese walls has increased as the crypto market remains unregulated. Thus, this essay 'aims' to critically examine why Chinese walls are important in Banks. Subsequently, the essay shall assess how information flows can be better managed.

2. Chinese Walls

2.1. Meaning of Chinese walls

Before understanding the importance of Chinese walls, it is crucial to learn what is meant by Chinese walls. The 1933 Act that established and institutionalised Chinese walls got repealed by the end of the 20th century. However, the walls continue to be implemented in the US by virtue of other statutes such as the *Sarbanes-Oxley (SOX) Act of 2002*, and the Dodd-Frank Wall Street Reform and *Consumer Protection Act of 2010*. [8] In 1986, the Financial Service Act was passed in the United Kingdom, which encouraged Chinese walls not just in the context of brokering services provided by the banks along with the services of commercial banks.[9] As mentioned in the introductory paragraph, the purpose of a Chinese wall is to keep persons in possession of confidential information, such as a banker engaged in something like a firm merger, from disclosing such knowledge to others who may gain financially from it. As per the Financial Conduct Authority (FCA), Chinese walls can be understood as policies wherein bank's/businesses' internal business records are kept secret from third parties with whom or on whose behalf the bank may be transacting.[10] The rise of the multi-service bank structure and the subsequent acceptance of negotiated commission fees increased demand for Chinese walls as they help in eliminating conflict of interest. Thus, in simple terms, the Chinese walls help in preventing the abuse of financial markets and offer more stability and certainty to existing and potential investors (*Re a Firm of Solicitors*[11]).

2.2. Characteristics of Chinese walls

Even though the exact traits or nature of Chinese walls shall depend on the size and structure of every bank, broadly, the wall is a set of policies and protocols, including tangible barriers that may be put in place by big banking institutions to ensure that employees having knowledge or entrusted with confidential information, do not pass such material and sensitive non-public information to other employees such as the one involved in the trade of securities. Based on such an expansive definition, the essential characteristics of Chinese walls can be understood as follows.

Primarily, the Chinese wall is a set of *policies and protocols*.^[12] When the banks want to maintain the confidentiality of information, they inform all the employees about the policies and rules to which the employees must adhere to avoid being held liable for an offence like insider trading and breach of duty to avoid conflict of interest. The banks prohibit the communication of sensitive non-public information between employees responsible for investment decisions of securities and the ones in possession of such information. Further, a guideline is laid down for the process that ought to be followed if someone in the investment department gets to know such information. Hence, Chinese walls are policies and rules set by banks. The large banks may physically separate the departments to prevent the transfer of information.^[13] Second, Chinese walls entail *restrictions on access* to certain documents.^[14] The files containing credit information may be regarded as inside information that needs to be protected and the banks limit access to such documents by employees who work in the investment department. Third, the banks inform their *fiduciary clients* about the existence of such walls and how they are being used to prevent the misuse of client information.^[15] Lastly, when Chinese walls are put in place, the banks prevent the regular transfer of employees from one department (in possession of confidential information) to another to maintain the efficacy of the walls.^[16] Also, the banks take steps to educate and train employees about Chinese walls.

3. Importance of Chinese Walls

Having noted the meaning and characteristics of Chinese walls, it is equally fundamental to learn and understand the significance of these walls in the context of the banking industry.

3.1. Role in eliminating conflict of interest

The banks have a special level of public confidence because of their exclusive access to and responsibility for managing people's money. Therefore, the financial markets cannot function properly unless there is credibility, loyalty, and integrity inside them. Nevertheless, due to the interconnectedness of banks and the complexity of financial services offered by them, the likelihood of the occurrence of a conflict of interests increases. A conflict of interest arises when an individual's personal goals clash with the fulfilment of their fiduciary obligation owed to another entity or when an individual owes a conflicting fiduciary obligation to more than one entity.^[17] It is argued that Chinese walls help in eliminating such conflict of interest.^[18]

In the landmark case of *Prince Jefri Bolkiah v KPMG*^[19], the House of Lords examined the conflict between fiduciary duties owed to a former and existing client. In this case, the former client of KPMG argued that the firm could not act for the new client, the former client's brother, because the Chinese walls put in place were not effective. KPMG counter-argued by asserting it was "*very experienced in the erection and operation of information barriers*" and regularly made sure that its staff respected the confidentiality of clients. However, Lord Millett asserted that a Chinese wall can only be successful if it is built into the firm's organisational structure rather than being thrown together last minute. He argued that a wall built inside a single division could not provide sufficient physical isolation. The decision of *Bolkiah's* case shows that the mere creation of Chinese walls is not enough particularly when they exist between people

who work together and are in regular contact with each other, thereby increasing the chance of inadvertently sharing confidential information. The Chinese walls cannot be made ad hoc depending on the assumption that employees would abide by them; the banks/firms need to take positive steps to ensure that they are genuinely effective.

Contrary to *Bolkiah's* case, in the recent case of *The Bank of London Group Ltd v Simmons & Simmons LLP*^[20], the High Court of England and Wales refused to restrain the bank from acting for the new client and did not grant an injunction to the former client. Even though the Court applied *Bolkiah's* case, it noted that there did not exist any real risk of disclosure of confidential information as the bank had put an effective information barrier in place i.e., there was an effective Chinese wall in place. As manifest from *Bolkiah's* case, the burden of proof on the former client is not high; however, the new ruling stresses that it is not sufficient for the former client to just declare that information provided to the bank is relevant. Instead, it should specify the details of the material it claims is significant and persuade the judge that it is in fact, pertinent to the case that is currently made against it. *Simmons'* decision should be welcomed as more than two decades later, the information barrier has gotten advanced and pervasive. In *Young v Robson Rhodes*^[21], the High Court rejected *Bolkiah's* argument to emphasise that as long as barriers put in place by the banks work, it does not matter if they were established before or after the problem arose. Nevertheless, the Court went to accept that built into the institution's structure had a higher chance of being effective than one that was erected for a specific issue.

Even in other jurisdictions, the courts have examined the usefulness of Chinese walls in reducing the risks of conflict of interest. For instance, in *Mallesons Stephen Jaques v KPMG Marwick* ^[22], the Supreme Court of Canada examined the potential for a conflict of interest between defending a new client and using information given by a prior client along with the question of the lawyer's professional privilege and utility of Chinese walls. The court said that when there is a "*real and sensible possibility of the misuse of confidential information*", the court must grant the injunction.^[23] While applying the objective test, the court granted the injunction and said that a reasonable person possession of all relevant facts, would be able to foresee a risk of confidential information being misused and there was a real and sensible possibility that the interest of the firm in defending its new clients may conflict with its obligation to maintain the secrecy of the information provided by the previous client.^[24]

Prior to this, the Third Circuit court examined the bank's fiduciary duty in *Washington Steel Corp. v. TW Corp*^[25] and refused to grant an injunction against the bank. As per the court, the defendant had put up a Chinese wall to separate themselves from the plaintiff's records and the employees responsible for managing the plaintiff's account. The defendant strictly forbade its Talley account workers from communicating with their Washington Steel counterparts or even seeing any of their files.^[26] With this statement, the Court implied that Chinese walls are virtual barriers. Moreover, the court confirmed that there were physical barriers in place as an office in charge of the plaintiff's account physically locked down each of its files to ensure that none of the defendant's employees could access them.^[27] This essay argues that the Third Circuit court rightly dismissed the notion of a *de facto* fiduciary obligation

preventing a bank from funding a hostile bid offer made to a client. There must be no special protection afforded to bank customers from aggressive tender offers. While customers' interests should be prioritised, they must not be far-reaching to the extent to prevent banks from conducting their functions efficiently. Hence, as long as effective Chinese walls are in place, the banks can successfully discharge their burden of taking measures to eliminate conflict of interest. It must be noted that if Chemical had not put up such walls, the Court's decision would not have been in its favour.

3.2. Permeability/problems of Chinese walls

The effectiveness of Chinese barriers is often cited as a significant concern. It is well known that Chinese walls may be easily penetrated. In *Bolkiah's* case, Lord Millet stated that it would be wrong to say that Chinese walls or comparable structures are inadequate to minimise the chance of transfer of confidential information; however, they can only be effective when additional safeguards are adopted.[28] Whoever is unrestricted in their movement around the office and has exposure to different departments and teams is said to be *over the wall*. When their knowledge is required, certain people are constantly or often *over the wall*, whereas others must be *brought over the wall*. Some employees who are continuously over the wall include senior executives, legal managers and internal auditors. Even though such people have obligation to not use or disclose the information obtained from across the wall, they retain access to confidential information and can abuse their position and access to such information. On many occasions, the directors of companies have been found to use their position and information obtained by virtue of their position to divert corporate opportunity or engage in insider trading.[29] Therefore, even when there are Chinese walls in place, a large number of people are permitted to move over the wall which reduces its efficiency. Even in the *Merrill Lynch* case, Henry Blodget, known for his very bullish forecasts for dot-com stock, trespassed the Chinese wall speaking disparagingly about these firms in private discussions and emails.[30]

Moreover, as part of FSA 1986, the Securities and Investments Board Limited (SIB) adopted Conduct of Business Rules to freely use the Chinese wall as a defence measure. Even though the origin of Chinese walls can be traced to the US, the US courts have shown an unwillingness to permit Chinese walls to be used as a defence against an allegation of violation of fiduciary duty.[31] In *AFTRA v. JPMorgan Chase Bank*[32], the issue before the court was regarding the use of Chinese walls as a defence to claims for breach of the fiduciary duty of loyalty; the court answered in negative. However, this is not the case in the UK as the UK statute expressly permits Chinese walls to be used as a defence. The SIB rules permit the use of Chinese walls as a defence in several cases. According to the rule, the firm must disclose relevant information before providing services.[33] Such information includes a material personal interest in the transaction, conflict of interest and charges, remuneration and commission. The person is said to have a material interest when they are likely to receive a commission on transactions like the sale of a security. Nevertheless, the firm does not need to comply with such rules if they have Chinese walls in place.[34] Similarly, as per Rule 4.7, the firm is prohibited from recommending a product that cannot be realised i.e., only products with high liquidity must be recommended. However, the firm does not need to comply with this

requirement when it has Chinese walls. Even insider trading laws can be overlooked where Chinese walls are in place.[35] Such extensive use of Chinese walls as defence makes them a tool for committing financial and banking frauds instead of letting these barriers achieve their intended purpose.

4. Better Management of Information Flows

In 2021, FCA announced that it shall be scrapping the use of the term 'Chinese wall' in its communication and as part of its rules.[36] However, the main purpose of FCA behind scrapping is to foster diversity and inclusiveness. The goal of FCA is not to find a better alternative for the management of information flows. Nonetheless, as manifest from the paragraphs above, the Chinese walls may not always ensure better information flows.[37] In *Westinghouse Elec. Corp. v. Kerr-McGee Corp.*[38], the US seventh circuit court rejected Chinese walls as an adequate and appropriate solution to the conflict of interest in large banks. However, this essay argues that Chinese walls or Information walls must not be completely eliminated because as rightly held by Lord Millet, they are useful when properly implemented.

To improve the efficiency of Information Walls and manage information flows in a better way, this essay recommends the identification of the different type of information. The information must be categorised into public information, proprietary information, non-public information and material non-public information. After identifying diverse information, the banks must take appropriate steps for each piece of information; for instance, public information does not need to be protected. Contrarily, the banks must ensure that material inside information is safeguarded sufficiently. For such inside information, the banks must ensure that information is shared only on a 'need to know' basis. This means that confidential information can be disclosed to employees, officers and directors who 'need' to know that information to fulfil their responsibilities, but they should be informed of its existence and should be told that they are under a legal duty to retain the secrecy.[39]

Furthermore, with the growth of technology and internet, it is advisable that banks implement both electronic and physical control in place. As noted above, only some large banks implement physical barriers between the vulnerable information and the people who are likely to misuse such information, thereby making Chinese walls ineffective. It is recommended that every bank and organisation, notwithstanding their size, must put some physical barriers in place to ensure that only certain people have physical access to inside information. Moreover, to increase compliance in investment banking, Doty and Powers have suggested that there should not only be separate investment banking and brokerage subsidiaries or divisions for maintaining separate records but there should also be internal controls like monitoring of telephone calls between operations and restrictions on transactions in certain stocks.[40] Likewise, as part of electronic controls, the information must be stored in electronic folders that are encrypted with strong passwords. Additionally, the access to IT equipment and emails that can expose inside information must be limited. A novel concept known as information flow control (IFC) allows a computer to monitor the transmission of data from one place to another and block it when it is not needed. It is a method of securing a network by monitoring data transmissions between a local

area network and the internet.[41] The banks must enforce IFC to track the movement of all inside information.

The banks can manage information by using Data Loss Prevention solutions. The term DLP is used to describe the process of locating and keeping tabs on sensitive information in order to avoid unauthorised access and disclosure. This might occur accidentally or at the hands of an attacker. The banks can protect inside information against theft and misuse by using DLP software. Besides making sure that a bank's cybersecurity is up to par with industry norms, these technologies may help them comply with data privacy legislation like the General Data Protection Regulation. Also, it is equally important to educate the employees about laws related to protection of inside information and the consequences of failing to comply with those laws. The employees must also be trained to handle confidential information.

5. Conclusion

This essay aimed to critically examine why Chinese walls are important in Banks. how information flows can be better managed. From the paraps above, it is evident that the banking industry presents unique regulatory issues due to its structure. Under the law, financial institutions are required to serve several, conflicting clients due to the structure. In practice, the system gives banks and their employees access to a large amount of sensitive data that they may exploit for their own benefit, perhaps at the expense of customers and other parties. In other words, the access to confidential information of the customers, former customers and even competitors may give rise to a conflict of interest. The Chinese walls help in combatting such conflict of interest.

The Chinese walls, information walls or data walls are in the form of virtual or physical barriers that help in separating confidential information from the people who may misuse this information for personal gain. In the context of banking, the walls ensure the people in the investment department do not have access to such information. The cases like *Simmons & Simmons* and *Bolkiah* illustrate that as long as effective Chinese walls are put in place, the banks can eliminate situations of conflict of interest, misuse of confidential information and instance of insider dealing. Nevertheless, Chinese walls may not be adequate to protect information as pointed out by the American court in the *Westinghouse* case. In the UK, Chinese walls can be used as a defence for numerous finance-related offences. Therefore, this essay has made several recommendations to manage information flows in a better way. The essay has advised strengthening internal control with tools like DLP and IFC. Further, it is suggested that banks must continuously monitor different departments, impose restrictions on transactions in certain stocks and educate and train employees.

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