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Diane S. Locandro

**INTRODUCTION**

At common law, a trustee had a fiduciary duty to obtain and use all information at its disposal in making trust investment decisions. Thus, it was an “established and unquestioned” practice for commercial bank trust departments to use information generated in other departments of the bank for trust investment purposes. The evolution of insider liability under rule 10b-5 of the Securities and Exchange Act of 1934 (Exchange Act) restricted this use of material inside information by banks. To protect against potential liability under the securities laws, many banks adopted procedures, meta-

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5. The latest pronouncement on materiality by the Supreme Court occurred in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976). The Court held that an omitted fact is material “if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.” *Id.* at 449. Although the case involved materiality with regard to omitted facts of a proxy statement under rule 14a-9, it is possible to read it as establishing a standard for rule 10b-5 transactions. See American Bar Association Subcommittee on Securities Problems of Fiduciaries, *Problems of Fiduciaries Under the Securities Laws—An Update,* 11 REAL PROP., PROB. & TR. J. 663, 667 (1976) [hereinafter cited as ABA Subcommittee Update].

phorically referred to as “Chinese walls,” to prevent the interdepartmental flow of information.\(^7\)

The recent case of *Slade v. Shearson, Hammill & Co.*\(^9\) casts doubt on whether banks can effectively raise a Chinese wall as a defense to an action brought by trust beneficiaries charging bank trustees with breach of fiduciary duty. Prior to *Slade*, the Comptroller of the Currency, in an effort to clarify trust department responsibility under federal securities laws, proposed an amendment to his regulation dealing with fiduciary powers of national banks.\(^10\) This amendment would have required banks to establish “appropriate policies and procedures” to insure that trust department decisions were not based upon material inside information.\(^11\) As a result of *Slade*, the proposal was withdrawn and subsequently modified.\(^12\)

This article will examine the problem of conflicting fiduciary duties inherent in the operation of large commercial banks providing diverse services. The general nature, forms, and relative effectiveness of the Chinese wall as a response to that problem will be discussed. Finally, the Comptroller’s proposed amendment will be critically analyzed in light of the questions raised by *Slade*.

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\(^8\) See text accompanying notes 28-36 infra.


\(^11\) Id.

THE PROBLEM FOR BANKS

An important purpose of the Securities and Exchange Act of 193413 was to affirmatively establish that corporate officers could not use inside information for profit when trading their corporation's securities.14 The basic disclosure principles of rule 10b-5, issued pursuant to section 10(b) of the Exchange Act,15 reflect the idea that equal access to information increases public confidence in securities markets.16 Thus, rule 10b-5 prohibits the use of material inside information in the sale or purchase of any security.17

Although banks are required to comply with the high standards of conduct demanded by rule 10b-5, as trustees they also have a fiduciary duty to beneficiaries of trusts in their care.18 The duties of a trustee are more intensive than the duties of other fiduciaries.19 Trustees must give complete loyalty to the interests of beneficiaries, "rigorously excluding selfish interests and considerations of the welfare of third persons . . . ."20 When making trust investments, bank trustees must meet the high standard of care embodied in the prudent man rule. In addition, as corporate fiduciaries, they may be held to a higher standard of competence commensurate with their expertise in the investment field.21 These standards imply that trustees should obtain all relevant information without violating federal securities laws.

As a major source of commercial credit, banks gain much information in the course of normal relations with corporate customers. Under the terms of many loan agreements, corporations are required

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15. Rule 10b-5 provides:
   It shall be unlawful for any person, directly or indirectly, by the use of any means
or instrumentality of interstate commerce, or of the mails or of any facility of any
national securities exchange,
   (a) To employ any device, scheme, or artifice to defraud,
   (b) To make any untrue statement of a material fact or to omit to state a
material fact necessary in order to make the statements made, in the light of the
circumstances under which they were made, not misleading, or
   (c) To engage in any act, practice, or course of business which operates or would
operate as a fraud or deceit upon any person,
in connection with the purchase or sale of any security.
16. Solomon & Wilke, supra note 4, at 539.
17. ABA Subcommittee, supra note 7, at 296.
18. See Restatement (Second) of Trusts § 2 (1959).
20. Yellon, supra note 7, at 407; Restatement (Second) of Trusts § 170 (1959). Accord,
21. Mendez-Peña, supra note 7, at 678-79 n.12. See Restatement (Second) of Trusts
to provide banks with current financial reports and other information relevant to the operation of the business. Some of this information will be "material" and will not have been disclosed to the public. The commercial customers from which large banks receive inside information frequently will be issuers of securities in which the trust department invests. If the information acquired through commercial lending is used for trust investment purposes, the trustee and the bank may be exposed to enormous liability. Other buyers and sellers of these securities who traded without benefit of the information possessed by the bank and suffered a loss have a potential cause of action under rule 10b-5. The threat of liability is especially acute since the injured party may no longer have to show privity. The problem is of less importance to smaller banks, since they have few commercial customers whose securities are likely to be of interest to their trust departments.

22. Bloomenthal lists examples, compiled by the compliance department of a securities firm, of information which might be deemed "material." The list includes:

- Dividend increases or decreases, earnings estimates, changes in previously released earnings estimates, significant expansion or curtailment of operations, a significant increase or decline of orders, significant merger or acquisition proposals or agreements, significant new products or discoveries, extraordinary borrowing, major litigation, liquidity problems, extraordinary management developments, purchase or sale of substantial assets.


23. ABA Subcommittee, supra note 7, at 295. Although some bank critics have argued that this dual role presents an irreconcilable conflict of interest, the SEC has recognized and approved the dual function. See SEC Institutional Investors Study Report of 1971, Volume 2, at 468-69. In addition, the United States Department of the Treasury in its report, Public Policy for American Capital Markets [1974] Sec. Res. & L. Rep. (BNA) No. 239, at D-11 and D-12, stated: "In the absence of more persuasive evidence than has been presented so far regarding the harmful effects of present arrangements, there is no reason to change public policy in this area." See Morris v. Cantor, 390 F. Supp. 817 (S.D.N.Y. 1975); accord, In re Hammer's Will, 12 N.Y.S.2d 893, 188 N.E.2d 266 (1963).

24. See ABA Subcommittee, supra note 7, at 296.

25. E.g., Schuyler, supra note 7, at 46. See Financial Industrial Fund, Inc. v. McDonnell Douglas Corp., 315 F. Supp. 42 (D. Colo. 1970), rev'd and remanded, 474 F.2d 514 (10th Cir.), cert. denied, 414 U.S. 874 (1973). In the above situation, the bank may be held to be a "tippee," the "tip" having been passed to the trust department by the commercial department. Herman & Safanda, supra note 1, at 30. See also Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (limiting a private cause of action under § 10(b) and rule 10b-5 to actual purchasers and sellers of securities).


27. See Herman & Safanda, supra note 1, at 38; Letter from J.F. Coleman, Executive Vice President, First National Bank and Trust Company, Burlington, Wisconsin, to C. Westbrook Murphy, Deputy Comptroller of the Currency (September 22, 1976) [unless otherwise indi-
THE BANKS' RESPONSE—THE CHINESE WALL

In an effort to reconcile conflicting duties and in response to the threat of liability posed by federal securities laws, many major banks established so-called Chinese walls between their commercial and trust departments. In some cases, banks have attempted to achieve departmental autonomy by issuing a policy statement prepared by the bank's counsel detailing the provisions of section 10(b) of the Exchange Act, rule 10b-5, and the interpretations of these provisions by the courts and the SEC. Generally, this statement prohibits the transmission of material inside information from the commercial department to the trust department and the use of that information by the latter. More often, banks supplement written policies by physically separating the trust and commercial departments, and by prohibiting commercial officers from sitting on trust committees. As an additional precaution, some banks establish separate buildings and financial libraries for the two departments.

The SEC AND THE CHINESE WALL

The SEC's response to the Chinese wall approach has generally...
been favorable.\textsuperscript{37} The Commission initially recognized the feasibility of creating walls in its acceptance of a settlement offer by Merrill Lynch, Pierce, Fenner & Smith for alleged violations of SEC regulations.\textsuperscript{38} The "Statement of Policy" submitted to the SEC by Merrill Lynch indicated that material inside information received by the underwriting department would be confined to that department and, with certain exceptions, would not be released to anyone outside the department.\textsuperscript{39} The SEC's approval of this procedure, however, was tempered with a warning that it could not determine in advance whether the procedure would be adequate in all circumstances.\textsuperscript{40}

**The Courts' Response**

Courts have had few occasions to consider the merits of bank walls or to determine the extent to which departmental isolation of inside information may be a breach of fiduciary duty to trust beneficiaries.\textsuperscript{41} Moreover, the issue has not yet been raised in a banking situation. Prior to *Slade v. Shearson, Hammill & Co.*,\textsuperscript{42} however, the issue did arise in a securities firm context in *Black v. Shearson, Hammill & Co.*\textsuperscript{43} Both *Black* and *Slade* appear to cast doubt on the efficacy of a Chinese wall as a defense to an action brought by trust beneficiaries.\textsuperscript{44}

*Black v. Shearson, Hammill & Co.*

In *Black*, a partner in the securities firm of Shearson, Hammill & Co. (Shearson) also served on the board of directors of a company for which Shearson "made the market."\textsuperscript{45} As a consequence of his position, the partner acquired information concerning the deterio-

\textsuperscript{37} See Lipton & Mazur, supra note 7, at 487-88; Solomon & Wilke, supra note 4, at 533.
\textsuperscript{38} See In re Merrill, Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933 (1968). But see Huck, supra note 7, at 105, stating that the SEC affirmatively disaffirmed Merrill Lynch's statement as a policy statement of the SEC.
\textsuperscript{39} Solomon & Wilke, supra note 4, at 533.
\textsuperscript{40} Id.
\textsuperscript{41} See Lipton & Mazur, supra note 7, at 476.
\textsuperscript{43} 266 Cal. App. 2d 362, 72 Cal. Rptr. 156 (1968).
\textsuperscript{44} See Lipton & Mazur, supra note 7, at 476.
\textsuperscript{45} "Market maker" has been defined in SEC rule 17a-(9)(f)(1), 17 C.F.R. § 240.17a-9(f) (1977) as follows:

(1) The term "market maker" shall mean a dealer, who, with respect to a particular security, holds himself out (by entering indications of interest in purchasing and selling in an interdealer quotation system or otherwise) as being willing to buy and sell for his own account on a continuous basis other than on a national securities exchange.
rating financial condition of the company. The information was not revealed to Shearson's sales staff, who continued to "strongly recommend" the purchase of the company's securities. These recommendations, therefore, were based on inaccurate information.

The buyers of the securities charged that by making purchase recommendations while in possession of adverse inside information, Shearson violated the common-law fiduciary duty owed by a broker-dealer to its customers. The partner admitted his fiduciary duty to customers, but defended on the ground that he could not reveal information transmitted to him in corporate confidence. The court rejected this defense, stating "We have been given no sufficient reason for permitting a person to avoid one fiduciary obligation by accepting another that conflicts with it." The partner's further assertion that he was bound by a "hierarchy of obligations" was similarly rejected. "The officer-director's conflict of duties is the classic problem encountered by one who serves two masters. It should not be resolved by weighing the conflicting duties, it should be avoided in advance or terminated when it appears." The court held that the intentional failure of the partner to disclose material information in these circumstances constituted fraud.

A closer examination of the facts in Black indicates that the result reached may be defensible. Apparently, upon receipt of the adverse inside information the partner sold most of his personal stock in the company, yet he encouraged the sales personnel of Shearson to recommend purchases to others. Thus, the partner appeared to have prevented the internal communication of the adverse inside information not in "pursuit of the legitimate goals of the Chinese wall, but to further his personal interests at the expense of his firm's trading customers."

The language of the opinion is disturbingly, and perhaps unnecessarily, broad. As a result, the case is often cited for the proposition that to avoid liability, the only available alternative is to terminate relationships that present conflicts of duty, a proposition which, for large commercial banks, is both unworkable and unreasonable. The holding in Black can be limited, however, since the decision appeared to turn on the affirmative recommendations of the retail

47. Id.
48. See Lipton & Mazur, supra note 7, at 477.
49. Id.
sales personnel. Conceivably, if normal trading activity had continued, no liability would have ensued.

**Slade v. Shearson, Hammill & Co.**

Slade v. Shearson, Hammill & Co., the most recent case in which the Chinese wall issue is raised, involved an action instituted under rule 10b-5. The plaintiffs alleged that Shearson, acting as a broker-dealer, actively recommended a particular stock to its customers although at the time its investment banking department possessed adverse inside information concerning the issuer of the securities. At trial, the court denied the plaintiffs' request to require Shearson to reveal to the investing public the material inside information it received as a result of its investment banking relationship. There apparently was no authority for the plaintiffs' position that a broker-dealer is compelled to divulge such information.

On motion for summary judgment, Shearson contended that as a matter of law, even if its corporate department knew of the non-public information, it could not, until the information was made public, use it to prevent the solicitation of purchases by its retail sales force. Moreover, the firm claimed its Chinese wall prevented communication of the information to its retail brokerage personnel. The court denied Shearson's motion and rejected the Chinese wall as a defense.

It must be remembered . . . that Shearson voluntarily entered into a fiduciary relationship with Tidal Marine, as a consequence of which it received confidential information. Shearson also voluntarily entered into fiduciary relationships with its customers. It cannot recognize its duty to the former while ignoring its duty to the latter. Having assumed fiduciary responsibilities, Shearson is required to incur whatever commercial disadvantages fulfillment of those obligations entail.

52. However, a problem would remain if the courts impute knowledge of inside information from one department to another. See notes 69-71 and 120-26 infra and accompanying text.
54. 356 F. Supp. at 305.
55. Id. at 307.
56. Id.
58. Id. at 95,131.
59. This argument is noted in the appellate court's opinion remanding the case. 517 F.2d 398, 401 (2d Cir. 1974).
Further, the court emphasized that Shearson's reliance on Merrill Lynch, Pierce, Fenner & Smith, Inc., was "misplaced . . . inasmuch as Merrill Lynch stands for no more than the proposition that a broker who receives inside information from an investment banking client cannot reveal same 'to favored customers.' "

The district court recognized the serious consequences of its decision in Slade and certified for immediate review the question of whether an investment banker/broker-dealer who receives adverse inside information about an investment banking client is precluded from soliciting customers to purchase that client's securities on the basis of public information which the firm knows to be misleading. On appeal of this issue, the Second Circuit held that certification was improperly granted and remanded for further factual determinations. The appellate court noted the "tremendous implications" that the case has for the securities industry and the investing public. A decision in the case "might possibly even have impacts in the banking business where bank trust departments are effectuating transactions in securities of companies with which the bank has a commercial banking relationship."

The applicability of the Slade decision to commercial banks remains uncertain. Some commentators state that it is "possible" to read Slade as limited to securities firms. On the other hand, many banks are concerned that the decision directly affects their practices.

A correlative aspect of the Slade case which is equally confusing is the suggestion that the court "imputed" the knowledge of the underwriting division to the sales personnel and "thereby found a constructive misrepresentation by the salesmen." This "unarticulated factual premise" is viewed by some as a "judicial

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61. 43 S.E.C. 933 (1968).
63. Id. at 95,130.
64. Id. at 95,130.
65. Id. The district court was directed to resolve three factual issues prior to any future appeals: (1) whether the material information was received before or after the plaintiff's purchases; (2) whether there was an effective separation of the investment banking department from the retail sales department; and (3) to what extent there is a difference between solicitation and recommendation with the purchase of securities. Id. at 402.
66. Id. at 400.
67. ABA Subcommittee Update, supra note 5, at 664.
68. See, e.g., Letter from Samuel S. Fuller, Executive Vice-President, Hartford National Bank and Trust Company, Hartford, Connecticut (October 19, 1976); Letter from Robert G. McKenzie on behalf of the administrative council of the Texas Bankers Association (November 30, 1976).
criticism of the wall as a defense." Thus, if a bank’s trust and lending departments were equated with the internal structure of Shearson, a trust beneficiary could claim the bank’s lending department or senior officers possessed material inside information which the trust department “knew” at the time it purchased stock in the failing company for the trust.71

THE CONTROVERSY IN LIGHT OF SLADE

Much of the controversy raised by Slade focuses upon the type of procedure necessary to shield banks from potential liability. Specifically, the discussion centers around the type of wall best suited to protect banks.

The “Impermeable Wall”

One prevalent view is that a Chinese wall should be impermeable. According to this position, no information, whether or not it is “material inside information,” should flow between the commercial and trust departments.72

Those who favor an impermeable wall suggest that the total prohibition on exchange of information avoids the often difficult problem of distinguishing between material and non-material inside information.73 Proponents assert that material inside information could not be used legally by the trust department. As a response to the criticism that an impermeable wall is excessive in light of rule 10b-5’s requirements, it is argued that non-material information would not, by definition, influence investment decisions. Therefore, the bank could not be held liable for failure of the trust department to receive the information. Further, an effective impermeable wall assumes that the trust department has a separate research department capable of obtaining all material public information.74

In addition, an advantage to an impermeable wall is that relative to other forms of this precaution, its existence is easier to prove. Provability is an important consideration because the success of the wall as a defense will depend on whether a court or jury will accept that it did indeed isolate the particular information in question.75 Even though trust departments painstakingly comply with internal prohibitions, a bank still may face liability if it cannot prove the

70. Mendez-Peñate, supra note 7, at 698.
71. See Mendez-Peñate, supra note 7, at 697.
72. See Lipton & Mazur, supra note 7, at 470-71.
73. Lipton & Mazur, supra note 7, at 466 n.18.
74. See ABA Subcommittee, supra note 7, at 310.
75. Id.
existence and effectiveness of the wall.\textsuperscript{76}

A major problem with an impermeable wall is that it will inevitably break down at high levels.\textsuperscript{77} As a practical matter, it is virtually impossible to extend the wall to isolate directors and most senior management from all trust department activities.\textsuperscript{78} A bank’s directors are “specifically responsible” for the trust department, including the investment and disposition of trust property.\textsuperscript{79} Furthermore, directors are legally responsible for the proper performance of fiduciary obligations in all cases where the bank is a trustee.\textsuperscript{80} Thus, even though the transmission of information will probably be limited to extraordinary situations,\textsuperscript{81} the possibility of a breakdown in an impermeable wall nevertheless exists.

\textit{The Permeable Wall}

Critics of the impermeable wall contend that the procedure is an extreme reaction to the problem of material inside information and is neither required by federal securities laws nor by the common law of trusts.\textsuperscript{82} Contrary to protecting banks, it is asserted that an impermeable wall will expose banks to charges of breach of fiduciary duty by disgruntled trust beneficiaries.\textsuperscript{83}

One way to pinpoint the disagreement between those favoring an impermeable wall and those critical of the practice is to categorize trust department transactions in “positive” and “negative” terms.\textsuperscript{84} Positive transactions are securities trades consistent with the material inside information possessed by the commercial department—buying on inside good news or selling on inside bad news.\textsuperscript{85} Negative transactions consist of trust department purchases when the commercial department possesses bad news, or sales when it

\textsuperscript{\textit{76}} Address by Martin Lipton to a Practicing Law Institute Seminar on banks and the securities laws, \textit{reported in} CXLI \textit{AMERICAN BANKER} 197, October 12, 1977, at 2.

\textsuperscript{\textit{77}} \textit{See} Mendez-Penate, \textit{supra} note 7, at 698-99.

\textsuperscript{\textit{78}} \textit{Id.}

\textsuperscript{\textit{79}} \textit{Comptroller of the Currency of the United States, Comptroller’s Manual for Representatives in Trust § 9.7. \textit{E.g.}, N.Y. Banking Law § 122 (McKinney 1971) (annual duty to inspect bank or trust company’s financial condition).}

\textsuperscript{\textit{80}} \textit{Comptroller of the Currency of the United States, Comptroller’s Manual for Representatives in Trust § 9.7. \textit{See} Herman & Safanda, \textit{supra} note 1, at 35.}

\textsuperscript{\textit{81}} \textit{See} Mendez-Penate, \textit{supra} note 7, at 698-99.

\textsuperscript{\textit{82}} \textit{See} Huck, \textit{supra} note 7.

\textsuperscript{\textit{83}} \textit{Id.} Huck further asserts that by setting up impermeable Chinese walls, banks admit to opponents that there is an inherent weakness in the combination of commercial banking and trust departments. \textit{Id.} at 104.


\textsuperscript{\textit{85}} \textit{Id.} at 2.
possesses good news.  

It is generally agreed that a positive transaction exposes a bank to liability under rule 10b-5, while refraining from this type of transaction does not expose a trustee to liability for breach of fiduciary duty. It is a basic principle of the law of trusts that a trustee has no duty to violate the law in order to benefit its beneficiaries. Therefore, trust beneficiaries should have no expectation that a trustee will use inside information when acting on their behalf.

The controversy concerning the use of an impermeable wall focuses on negative transactions. Opponents of this procedure point out that knowledge or awareness of material inside information is not illegal. Rather, it is the use of such information that is clearly prohibited by the securities laws. In light of Slade, it is maintained that an impermeable wall justifiably exposes a bank to suits by trust beneficiaries charging that the bank has prevented adverse information in its possession from reaching bank trustees who could have refrained from making further investments.

To avoid this type of liability, a "permeable" wall has been recommended. The main characteristic of a permeable wall is an administrative structure through which material inside information relating to corporate customers is channelled. Bank personnel receiving the information inform the trust department that a "hold" is being placed on transactions in securities of a particular corporate customer. The "hold" order does not indicate whether the information is favorable or adverse. Therefore, the order itself does not "tip" the trust department, but simply prevents "negative" transactions by trustees. By establishing internal procedures in this manner, a

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86. Id.
87. Id. at 2, 3.
91. Huck, supra note 7, at 108. The argument is equally applicable where a trustee sells securities when the commercial department has beneficial information. Accord, Garrett Letter, supra note 84, at 3. But see Letter from Martin Lipton, at 1 (September 22, 1976) stating that Slade did not hold that beneficiaries of trust accounts are entitled to the benefits of confidential information isolated in the commercial department of a bank.
92. See Huck, supra note 7. For a detailed proposal in setting up a permeable wall, see Huck's discussion of an "Administered Wall." Id.
93. Id. at 107.
94. Id.
permeable wall avoids those transactions which potentially expose banks to suits by trust beneficiaries. At the same time, it avoids the use of material inside information in violation of rule 10b-5.  

THE COMPTROLLER’S PROPOSAL

On April 24, 1974, the Comptroller of the Currency proposed an amendment to the regulation designed to prevent the misuse of material inside information by bank trust departments. Purportedly, by giving regulatory recognition to the fiduciary dilemma encountered by banks, the legal sufficiency of precautionary procedures would be clarified. The proposed amendment permitted trust departments to utilize personnel and facilities of other bank departments but mandated the establishment of “appropriate procedures” to insure that investment decisions were not made on the basis of material inside information.

As a result of the *Slade* litigation, however, final action on the amendment was deferred. According to the Comptroller, compliance with the regulation would be “extremely difficult” until the imputation question suggested in *Slade* was resolved. Noting the “severe dilemma” that conflicting fiduciary duties pose for banks, the Comptroller solicited comments on whether an amendment in-

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95. *Id.* at 104, 108. This type of permeable wall is similar to the use of a “restricted list,” a device brokers employ to prevent their salespersons from recommending a particular stock when the investment banking department of the firm is working on an underwriting for the company. *See generally* Lipton & Mazur, *supra* note 7, at 467-70. Some commentators have expressed the view that a restricted list is not feasible for most large banks because of the large number of corporate clients from whom inside information could be received. *Id.* at 509. *See also* Comments from Seminar on Banks and the Securities Laws, *reported in* CXLII *AMERICAN BANKER* 197, October 12, 1977, at 2; Letter from F. Richard Ford III, Senior Vice President and Secretary, State National Bank of Connecticut, Connecticut (October 21, 1976).

96. 39 Fed. Reg. 14,510 (1974) (to be codified in 12 C.F.R. § 9.7(d)). This proposed amendment was as follows:

The trust department may utilize personnel and facilities of other departments of the bank, and other departments of the bank may utilize the personnel and facilities of the trust department; however, the trust department shall establish appropriate policies and procedures to insure that investment decisions of the trust department are not based upon non-public information, regardless of how that information may be attained.

The present section, 12 C.F.R. § 9.7(d), adopted November 15, 1972, provides: “The trust department may utilize personnel and facilities of other departments of the bank, and other departments of the bank may utilize personnel and facilities of the trust department only to the extent not prohibited by law.”


100. *Id.* at 28,144-46.
tended to provide guidance to national banks would be well-advised. 101

Most commentators expressed qualified approval of such an amendment. 102 However, regardless of the perceived advantages of a Chinese wall, most stated specific objection to any regulation that would mandate adoption of the procedure. 103 The comments reflected a concern that a mandatory wall would be onerous and unworkable for small banks. 104 Further, such a requirement would inhibit the legitimate exchange of information between the commercial and trust departments. This exchange is considered vital to the efficient administration of both large and small banks. 105

Two substantive suggestions were repeatedly offered by those responding to the Comptroller's request. First, it is strongly urged that the amendment specifically address and negate any possible infer-

101. 41 Fed. Reg. 37,812 (1976). Commentators were asked to submit suggested wordings or comments on:
   a. Whether a "wall" should be required;
   b. whether a lesser requirement would be preferable; that policies be established to insure that no investment decisions shall be made on the basis of significant non-public information;
   c. whether such a regulation, affecting as it would only national banks, would be effective;
   d. whether some other form of restriction or prohibition is necessary.


103. See, e.g., Letter from Neal L. Peterson, Assistant General Counsel, Bank of America, to John Schockey, Deputy Comptroller of the Currency, at 2 (October 28, 1976). The letter recommended the adoption of a regulation but rejected any "concept of a 'Wall' implying requirements such as the separation of trust and fiduciary services from the commercial banking functions by ... separation ... in the normal course of day-to-day business ... ."

104. See, e.g., Letter from Daniel R. Smith, Senior Vice President and Trust Officer, The First National Bank, Kalamazoo, Michigan (September 20, 1976).

ence that knowledge possessed by the commercial department should be imputed to the trust department.\textsuperscript{106} Second, it was proposed that the amendment reiterate the rule that trustees, as fiduciaries, have no obligation to violate the law. Hence, they are not required to use inside information for the advantage of beneficiaries.\textsuperscript{107}

In response to the comments, the Comptroller recently revised the language of the proposed amendment as follows:

The trust department may utilize personnel and facilities of other departments of the bank, and other departments of the bank may utilize personnel and facilities of the trust department only to the extent not prohibited by law. Every national bank exercising fiduciary powers shall adopt appropriate 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 securities. Such policies and procedures, in particular, shall ensure that national bank trust departments shall not use material inside information in connection with any decision or recommendation to purchase or sell securities.\textsuperscript{108}

At the same time, the Comptroller expressed the opinion that the objective sought by the amendment would be best achieved by a "general and flexible" approach.\textsuperscript{109} As a result, use of a Chinese wall was not mandated by the revised proposal. Banks are free to choose "appropriate written policies and procedures" to prohibit the use of material inside information in connection with decisions and recommendations to purchase or sell securities.\textsuperscript{110}

\textbf{Effect of the Comptroller's Proposal}

Many commentators, although approving the earlier amendment to the regulation, expressed concern that a regulation was not the appropriate solution.\textsuperscript{111} Yet, the consensus seemed to be that a regu-

\textsuperscript{106} See, e.g., Letter from Ben Ames Williams, Jr., Executive Vice President, The First National Bank of Boston, at 2 (October 29, 1976).

\textsuperscript{107} See, e.g., Letter from John W. Heilshorn, Executive Vice-President Citibank, to the Comptroller of the Currency, at 1 (October 18, 1976). But see Garrett Letter, supra note 84, at 3, stating that while there is general agreement that a fiduciary is under no duty to perform an illegal act, beneficiaries "are unlikely to agree that a trust department is justified in purchasing or selling to their detriment when another department of the bank is in possession of contrary information."

\textsuperscript{108} 42 Fed. Reg. 56,338, 56,339 (1977). Commentators had suggested that the language of the proposal be drafted so that it would be more consistent with federal securities laws.

\textsuperscript{109} Id. at 56,338.

\textsuperscript{110} Id.

\textsuperscript{111} See, e.g., Letter from Victor J. Riley, Jr., President and Chief Executive Officer, First Commercial Banks Inc., Albany, New York, at 1 (October 20, 1976); Letter from William D.
lation was a "satisfactory stopgap measure pending enactment of legislation." The recently proposed revision of the amendment, however, is not even a "stopgap" measure. As proposed, it does little more than reiterate federal securities law prohibitions on the use of material inside information. It provides no answers to the difficult questions facing banks.

The Comptroller's comments accompanying the proposal evade the most controversial issues. The Comptroller merely repeats the proposition that "a trustee has no duty to violate the law in order to benefit his beneficiaries." Therefore, "beneficiaries cannot expect their trustee to use material inside information whether actual or imputed in connection with the sale or purchase of securities." This response is inadequate. The use of material inside information to buy or sell securities for the benefit of trust beneficiaries has never been the fundamental problem. The conclusion reached by the Comptroller clarifies only the most obvious area.

Second, the Comptroller's comments recognize that mere knowledge of material inside information is not necessarily illegal or improper. "Rather... it is primarily the intent to defraud or the actual use of such information in connection with the purchase or sale of securities which may lead to liability under section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder." Yet, the Comptroller did not require the establishment of a Chinese wall to prevent the illegal use of material inside information, apparently because of contrasting views concerning its effectiveness.

The lack of endorsement by the Comptroller of the Chinese wall leaves unanswered the question of common law liability of trustees when they engage in "negative" transactions. If use of material inside information, and not mere knowledge violates rule 10b-5, the issue becomes whether failure to obtain knowledge combined with resulting damage to beneficiaries violates the trustee's fiduciary ob-

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Ahonen, Vice-President and Attorney, National City Bank, Cleveland, Ohio, at 1 (October 22, 1976).

112. Letter from William D. Ahonen, Vice-President and Attorney, National City Bank, Cleveland, Ohio, at 1 (October 22, 1976), But see Letter from W. Boardman Jones, Jr., Vice Chairman of the Board, Mercantile Bank & Trust Company, St. Louis, Mo. (September 27, 1976).

113. The Comptroller's proposed regulation was recently deemed "superficial" and "inadequate" by Federal Reserve Board staff members at a public meeting held to consider his plan. Securities Week (BNA) at 9-10 (December 26, 1977).


114. Id.

115. Id.

116. Id.

117. See text accompanying notes 84-91 supra.
lignations to beneficiaries. If the trust department obtains adverse information about a particular corporate customer from the commercial department, and refrains from buying stock in that company, it has not used that information in the purchase or sale of a security. Nevertheless, the trustee has prevented damage to the beneficiaries. The other type of negative transaction occurs when the trust department receives beneficial information and sells. This may not be a violation of rule 10b-5, since there would be no benefit from acting contrary to the inside information. However, it may be a breach of fiduciary duty of care. This is the fundamental obstacle for those who favor the use an impermeable Chinese wall. It is also a situation for which the regulation provides no guidance.

Finally, the proposed regulation and comments fail to specifically consider the imputation of knowledge question first raised in Slade. As previously discussed, if a trustee actually knows of inside information, and buys or sells securities in accord with that information, the bank may be liable under rule 10b-5. On the other hand, if, as a consequence of the bank's Chinese wall (whether permeable or impermeable) the trust department has no actual knowledge of such information, there is no liability for positive transactions unless the knowledge of the commercial department is "imputed" to the trust department. At least one case, however, which held that a 10b-5 violation could not exist without intentional wrongdoing, may have "exorcised the imputed knowledge specter." If this holding is applicable to a banking situation, and the trust department has no actual knowledge, it will have acted innocently in such a positive transaction. Therefore, the trust department's lack of requisite intent could be ascribed to the bank as a whole. The courts, however, have not yet specifically accepted this proposition. Many fear that if the validity of the imputation of

118. It should be noted, however, that systematic accrual by a trust department of such material inside information for the purpose of avoiding or retaining investments could be viewed as contrary to the purpose of the securities laws. It could be argued that such unique access to information itself results in unfairness. Since rule 10b-5 has been interpreted in an extremely elastic manner to prevent unfairness, it is not inconceivable that it could be stretched this far. If such were the case, an injunctive action by the SEC in this situation would be a possibility.

119. See generally Garrett Letter, supra note 84; Huck, supra note 7; Restatement (Second) of Trusts § 174 (1959).

120. See text accompanying notes 69-71 supra.

121. See text accompanying note 87 supra.

122. See Garrett Letter, supra note 84, at 2.


125. Id.
knowledge doctrine is upheld, the only recourse for banks will be to divest themselves of their trust departments, a step which is felt by many to be both economically and practically unworkable.\\footnote{126}  

**CONCLUSION**

The Comptroller's proposal is an illusory remedy to the fiduciary problems faced by commercial banks. It does not, and perhaps cannot, speak to the banks' major concerns. So long as courts continue to proceed on a case-by-case basis and refuse to establish clear guidelines and Congress fails to provide explicit legislation addressed to these problems, banks will continue to perform conflicting fiduciary roles uncertain whether their adherence to the federal securities laws can result in liability under the common law of trusts.

Diane S. Locandro

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\\footnote{126. For a discussion of the drawbacks of divestment, see Harfield, *supra* note 7; Lybecker, *Regulation of Bank Trust Department Investment Activities: Seven Gaps, Eight Remedies*, 91 Banking L.J. 6, 43-47 (1974); Mendez-Peñate, *supra* note 7, at 705-09.}