

## Information Barriers: Overseas Cases and Implications

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In May 2019, Korea's Financial Services Commission unveiled its plan to ease rules on the Chinese Wall as part of its wider reform on the capital markets. If Korea switches to the proposed principal-based rule, this is expected to allow securities firms to head towards more reasonable self-regulation, and thereby fix the problems under the current rule-based regulation. However, this, at the same time, poses securities firms formidable challenges and burden because instead of merely following the existing regulation they will have to work hard for designing their own information barrier that is fitted for their own business structure and ensures proper legal defenses. Against the backdrop, the industry and the Korea Financial Investment Association should work together to form a consensus about what kind of information barrier would be suitable for Korea. Concerted efforts and sufficient discussion will help lower legal uncertainties around the principle-based regulation. Hopefully, such regulatory development helps Korea's securities firms shift towards an effective Chinese Wall fitted for their own business structure as in the case of the U.S.

In May 2019, Korea's Financial Services Commission unveiled its plan to ease rules on the Chinese wall,<sup>1)</sup> as part of its wider reform on the capital markets. Instead of making partial changes, this announcement set out a complete reform plan to build a principle-based regulation. Particularly noteworthy is its ex-post regulatory structure that gives individual firms wider discretion with penalties for contravention. This calls for both the industry and

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1) This article assumes that the term Chinese Wall is interchangeable with the information barrier.

authorities including self-regulatory organizations to work closely for thorough preparation. Under the circumstances, this article explores the backgrounds behind the reform, and briefly overviews the cases of the U.S. and the U.K., from which to draw implications for Korea.

### **Backgrounds behind Korea's regulatory reform**

Korea's information barrier regulation was first introduced as part of the 2007 Financial Services Industry and Capital Markets Act for the purpose of preventing conflicts of interest that may arise between financial investment firms and investors, as well as between a specific group of investors and other investors. However, the rule-based regulation has been the cause of many problems: For example, the uniform list fails to reflect the diversity across companies with different sizes, business scopes, and characteristics. Moreover, the physical separation required by the financial investment business under the FSCMA<sup>2)</sup> fails to take into account today's corporate reality. This forces securities firms to place unnecessary internal barriers or to make their business decisions bound by the FSCMA provisions. Although there were about ten reforms as proposed by the industry, controversies over irrationality still exist.

### **Information barrier regulation in other countries**

Because the principal-based information barrier at the heart of the issue has been already adopted by the U.S. and the U.K., it is worth looking at the two countries' cases.

In the U.S., it was 1966 when the Securities and Exchange Commission required Merrill Lynch to establish a Chinese Wall after an insider trading case involving its underwriting division employees. This could mark as the beginning of the self-regulatory information barrier. But the explicit obligation for an internal control to prevent securities firm employees from misusing undisclosed information came when the Section 15(g) of the Securities Exchange Act was adopted as part of the Insider Trading and Securities Fraud Enforcement Act of 1988. At that time, the SEC<sup>3)</sup> judged that the examination and regulation by SROs under the SEC's supervision

2) An information barrier should be placed: 1) between the management of the proprietary property, the investment trading business, the investment brokerage business, the collective investment business, and the trust business; 2) between the corporate finance affairs and the management of proprietary property or financial investment business; 3) the prime brokerage services and the management of proprietary property and financial investment business; and 4) between the corporate finance affairs and the prime brokerage services.

3) At that time, the SEC was granted the authority to enact the Chinese Wall rule under the ITSFEA, and carried out a survey on securities firms' Chinese Wall policies.



could be more effective than establishing a detailed information barrier rule. In consequence, the SEC required the NASD and NYSE to work on a Joint Memo under which securities firms should place minimum elements regarding information barrier policies and procedures.

However, the U.K. borrowed the Chinese Wall concept when dealing with the conflicts of interest issue that might arise from insider trading as the 1986 Big Bang paved the way to one entity holding the dual capacity of the broker and dealer.<sup>4)</sup> Still, the U.K. set forth the Principle for Business (PRIN) in the FCA Handbook that included the Chinese Wall provisions.<sup>5)</sup> In other words, the U.K. regards the establishment of a Chinese Wall as an important tool handling conflicts of interest.

The U.K. is on the same page with the U.S. in that U.K. securities firms are allowed to devise self-regulation in their implementation of Chinese Walls as long as they comply with minimal principles. Furthermore, the two countries are also alike in respect of legal responsibilities: When a securities firm fails to establish an appropriately and reasonably designed Chinese Wall policy, it cannot claim exemption as a legally effective defense.

Because the initial motivation of the U.K. Chinese Wall regulation was to prevent conflicts of interest, the regulatory scope covers not only corporate clients' information, but also any client information that could possibly cause conflicts of interest. However, the rationale behind the U.S. regulation was to deter inside trading, which kept the regulatory focus on material nonpublic information of corporate clients. Hence, the U.S. case could serve as a useful benchmark for a Chinese Wall specified for preventing the flow of confidential information, which usually requires more delicate policies and procedures.

### **Chinese Wall policy in the U.S.**

This section provides a recap of two SEC reports unveiled in 1990 and 2012<sup>6)</sup> to overview the types of information and the sources, the means of limiting access to information, the internal surveillance system, etc., all of which securities firms should control.

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4) Although the U.S. has long allowed the broker and the dealer to exist in one entity, the U.K. had separated the broker from the dealer before the Big Bang.

5) The FCA Handbook has the Chinese Walls provision in SYSC 10.2.

6) Division of Market Regulation, SEC, 1990, "Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Nonpublic Information", and the Office of Compliance Inspections and Examinations, SEC, 2012, "Staff Summary Report on Examinations of Information Barriers: Broker-Dealer Practices Under Section 15(g) of the Securities Exchange Act of 1934".



The information barrier in the U.S. securities firms places its regulatory focus on the flow of material nonpublic information of publicly traded companies. According to the 2012 report, most of the information securities firms should control to prevent misuse was material nonpublic information provided by publicly traded companies. Information either produced by the research division or related to institutional investor orders could fall under the category if it includes any material nonpublic information of corporate clients. For example, an investment banking or ECM/DCM employee could be provided with material nonpublic information of a publicly traded company as part of day-to-day work, e.g., advising for M&A, due diligence for underwriting, etc. In other cases, an Investment Group in a securities company could obtain material nonpublic information from insiders. Any order information a prime broker receives from institutional investors could often be material as well.<sup>7)</sup>

U.S. securities firms focus on the effectiveness of information control by categorizing their divisions into private and public sides according to the different levels of possibility to acquire information. A private side includes the Investment Banking, Capital Market and Investment Group that are highly likely to have continuous access to material nonpublic information during their day-to-day operations. On the contrary, divisions such as sales and trading fall under the public division whose daily operation hardly involves access to material nonpublic information. Securities firms physically block the public side from the private one that is highly likely to handle material nonpublic information. It's important to note that the separation between the private and public sides is not enforced by the legal standard, but securities firms' own judgment. This certainly makes the operation highly efficient.

Alongside with the physical barrier, the U.S. establishes many other devices to limit information access. For example, access to any material nonpublic information acquired during any M&A or capital market deal is limited to the deal team who needs the information to work for the deal.<sup>8)</sup> It's common to limit the access to private side information by establishing various barriers, e.g., technical barriers restricting remote log-in and downloads to a portable storage device, and physical barriers such as an independent space for copying or electronic publishing.

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7) It's possible for the prime brokerage division to acquire material nonpublic information related to shareholder activities when handling institutional investors' bids for a takeover.

8) When a public side employee needs to acquire material nonpublic information in order to cooperate with a private sector employee, he or she should go through the compliance department to get an approval for wall-crossing.



Other than such direct restrictions on access to information, securities firms try to trace and prevent any misuse of material nonpublic information by having their compliance control and monitor information flows. A compliance department usually manages a workflow as follows. If any employee acquires or is positioned to acquire material nonpublic information as part of work, he or she should inform the compliance department of such a fact or the transaction involved. The compliance division then immediately judges the significance of the information and determines whether to include such information in the watch list or not. The division reviews every sales activity of the vehicles in the watch list to see if any of the staff profits via proprietary trading or material nonpublic information. Also widely used is a sophisticated monitoring scheme that monitors trading patterns to detect abnormal trading. On top of such monitoring activities, the compliance department serves as a data control tower that updates the databases of employees and firms on the misuse watch list. In its 1990 report, the SEC underlined that the minimum elements for an adequate Chinese Wall are: watch lists and restricted lists monitored by compliance; and review of employee and proprietary trading.

In its 2012 report, the SEC pointed out that securities firms had achieved many improvements for the past two decades in their strides to develop new processes and adopt innovative systems, proactively coping with rapidly-changing business structures and environments. Particularly, the report found some reasonable, organically-structured elements in Chinese Walls. Evidently, those elements have taken advantage of the operational autonomy U.S. securities firms have enjoyed. This could have never been possible under a uniform, rule-based regulatory system that elaborates every detail.

### Implications

If Korea switches to a principal-based rule according to the FSC's plan unveiled in May, this is expected to allow securities firms to head towards reasonable self-regulation, and thereby fix the problems under the current rule-based regulation. However, this, at the same time, poses securities firms formidable challenges and burden because instead of merely following the existing regulation they will have to work hard for designing their own information barrier that is fitted for their own business structure and that ensures proper legal defenses.

Against the backdrop, the industry and the Korea Financial Investment Association should work together to be ready for the regulatory reform. What they need is to form a consensus



about what kind of information barrier would be suitable for Korea, and to figure out what are minimum requirements, necessary protocols, and documentations based on thorough research on overseas cases. During the process, they also should think about supplementary devices that might be necessary for the new regulatory regime. Only sufficient discussion and concerted efforts will help lower legal uncertainties around the principle-based regulation.

If the principle-based regulation takes hold, Korea's securities firms are likely to develop their own way to achieve higher efficiency while ensuring proper legal defenses, rather than settling for old regulations and practices. Hopefully, the regulatory development helps Korea's securities firms shift towards an effective Chinese Wall fitted for their own business structure as in the case of the U.S.