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'CHINESE WALLS' IN FINANCIAL FIRMS:

BY

FREDERICK E. BALDERSTON

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'CHINESE WALLS' IN FINANCIAL FIRMS

by

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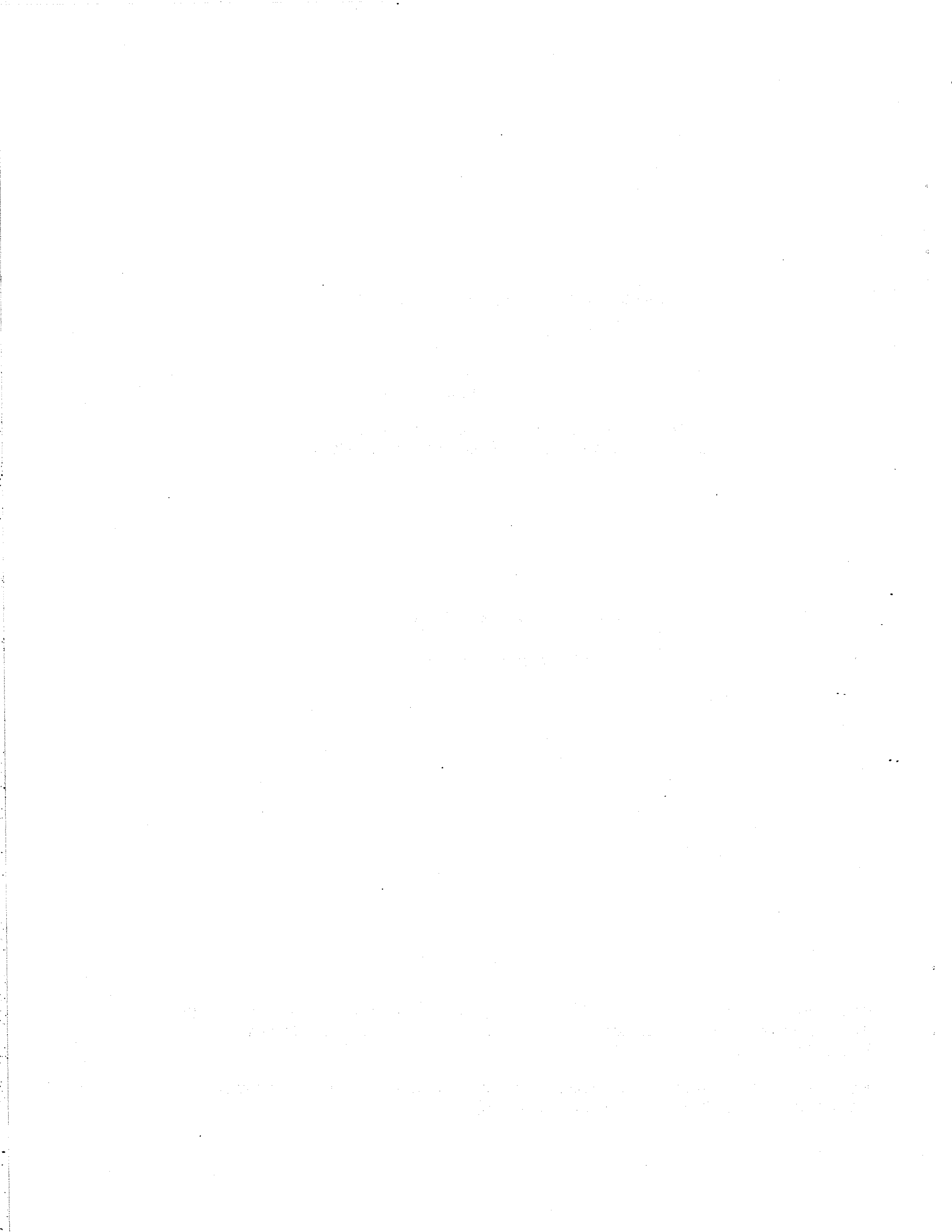
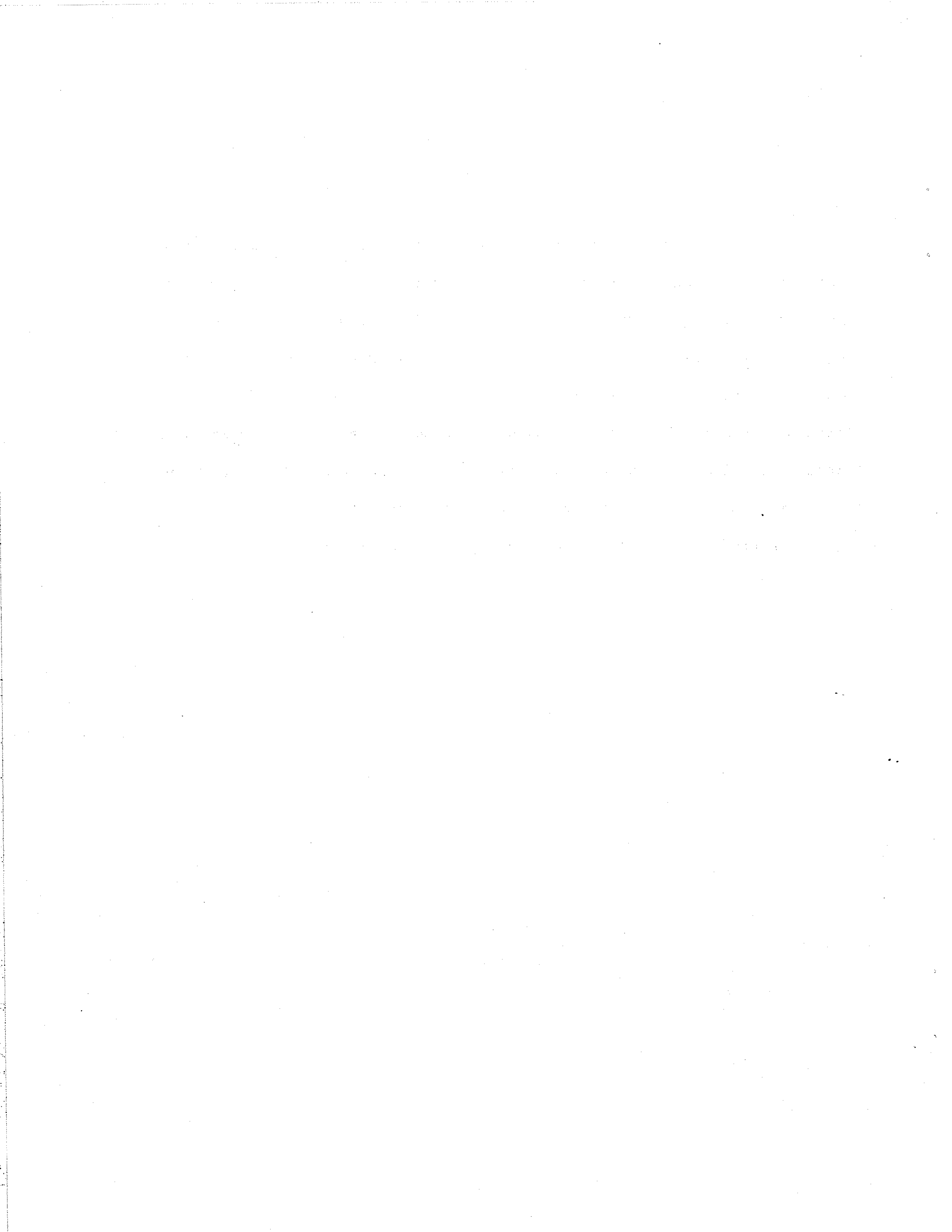


ABSTRACT

Federal statutes and regulations have historically prevented financial firms from choosing freely what product markets to serve, and they have in some areas required that a firm involved in several related activities utilize safeguards against abuses or conflicts of interest by establishing administrative separations -- 'Chinese walls' -- between related services. Users of financial services may also be concerned about the efficacy of these separations, which they may feel are needed for their own protection.

This article considers both regulatory and market-induced administrative separations of function within financial firms.



The emperors built the original Chinese Wall to hold off the barbarian hordes. The best contemporary corporate analogy to this is the series of devices that law firms and investment bankers have invented to defend against raiders: shark repellents, poison pills, and the rest. But in the Wall Street vernacular, the term 'Chinese Wall' refers -- somewhat incorrectly -- to the necessary and effective separation, within the corporation, of two departments or functions so that neither can exert inappropriate influence upon the other. Examples of the corporate 'Chinese Wall'

An investment house has, among its departments, a pension fund management department and a securities underwriting department. It must assure that the underwriters do not pressure the pension fund managers into acquiring securities from them that these same managers would ordinarily refuse to buy on the open market. Therefore, as an extreme type of separation, the top management may set a policy, or internal guideline, to bar the pension fund managers from acquiring any security that the underwriting department has issued.

A financial institution has a development joint venture with a builder and a mortgage origination unit. The development joint venture needs construction financing and long-term take-out commitments. It seeks these from the mortgage origination unit; that unit, however, shelters its underwriters completely from any pressure from the joint venture, and it requires that consultants be hired to give a thorough and independent review of the terms and risks of the financing before it is approved.

In the first example, the separation is absolute: a genuine wall. In the second, functional independence is assured, or is to be hoped, but the separation is permeable in that a transaction may possibly occur if it is undertaken in accordance with some procedural safeguards.

Many other examples could be listed. They have in common the presumption that decisions involving risk must be approached with the maximum of objectivity and with the attempt to capture the best possible, unbiassed information so that the decision will be in the best long-term interest of the corporation. From this point of view, an "arm's length" bargain gives the best assurance of objectivity and thus a sound decision. Included in this conception of the "best long-term interest" of the corporation is the protection of the legitimate interests of clients or investors.

Building the Wall

First, the two departments that must be separated are placed under separate administrative jurisdictions, so that they do not report to the same "boss". (A coordinating executive, in charge of both departments, might have incentives to direct the departments to "cooperate" in a fashion counter to the concept of arm's length objectivity.)

Second, the two departments could be prohibited from any transaction with each other; or, in a less extreme form of separation, they could be required to observe restrictions on the transaction that would assure the equivalent of arm's length dealing. For example, if a fund manager is in the market to buy a particular type of security and the same firm's sales

department has a security of that type for sale, the fund manager could be required to obtain two or more outside quotations on the same security or on perfectly equivalent securities buy the security from the firm's own department if and only if that security is quoted at the lowest of the three prices. A trusteed investment fund that is set up with a securities firm as its advisor may, on advice of counsel, set up such a procedure so as to assure that the holders of the investment certificates are not disadvantaged by insider dealings.

Third, the two departments could be required to maintain complete record controls of any dealings between them, disclose fully any transactions for audit, and demonstrate that these controls are in place at all times.

Fourth, and finally, the two departments would be subject to periodic surprise audit by the internal auditors to assure that the safeguards are fully effective.

While a <u>transaction</u> record can be audited, it is very doubtful whether the attempt to seal off two departments within the same organization can be fully successful. At the very least, information leaks between them are likely to occur because informal contacts are inevitable in the social networks within an organization. Several recent "insider trading" scandals have involved illicit information transfer between the merger consultants of an investment firm and the trading partners within the same firm; highly systematic and regular information transfer is apparently detectable, but occasional and seemingly random information sharing would be extremely difficult to find.

A <u>Williamsonian</u> <u>Objection</u>

As the standard appealed to is arm's length bargaining for objectivity, it is worthwhile to ask whether a market -- or a market-like mechanism -- gives assurances of optimal or at least reasonable consequences. Williamson refers to market failures occasioned by "small numbers" and "opportunism" in his critique of some weaknesses of markets themselves. It follows that the building of the Chinese Wall may, in its turn, only give rise to what might be called "pseudo-market failure" if, despite the effort to assure functional separation, the Wall allows the existence of structural conditions conducive to the market failures that are attendant upon small numbers and opportunism. <u>What</u> <u>is</u> <u>given</u> <u>up</u> <u>when</u> <u>a</u> <u>Wall</u> <u>is</u> <u>built</u>?

In principle, the units within an organization could be managed so as to capture all of the potential gains of complementarity and cooperation, without any penalties from errors of decision. Perfect coordination, however, would require that the two departments (a) have no differences of interest or of information (except where it is <u>efficient</u> for their information sets to differ; and (b) approach every decision problem with the intent of maximizing identically the same utility function of the firm. These are the conditions specified in the Marschak-Radner <u>Theory</u> <u>of</u> <u>Teams</u>.

From this point of view, building the Wall does imply giving up some maximization opportunities that would arise from cooperation to capture efficiencies arising from complementarity.

Glass-Steagall: a statutory Chinese Wall

Out of the wreckage of the Wall Street collapse of 1929 came significant regulatory prohibitions and regulatory superstructures. The Glass-Steagall Act required the separation of commercial banking from investment banking, and it prohibited commercial banks from underwriting or trading in a wide variety of types of securities. Some part of the 1929 collapse was ascribed to the bad effects of overlapping business functions. Banks were said to have abused their function as trust managers, when they, at the same time, served as underwriters of securities that their trust accounts might buy. Banks might also pressure their commercial loan clients to become underwriting clients, thereby tying up two kinds of business at once. The solution -- mandatory separation of business functions, by law -- was drastic.

For many years, Glass-Steagall and other, similarly motivated statutes kept commercial banks sealed off from the securities business, the insurance business, and other financial services fields not strictly within the definition of "commercial bank". Only in the 1980's has a series of developments, both legal and technological, begun to weaken and even breach these Chinese Walls.

Echoes of Harsanyi's discussion of "rule utilitarianism" vs. "act utilitarianism"

Harsanyi undertakes a fascinating discussion of an individual's construction of his own social-welfare function to guide his rational decision-making under uncertainty. He has

pointed out that the decision-maker can best satisfy the canons of rationality by concentrating on choosing (and then following) a well-designed rule for decision, rather than trying to make each individual choice conform to rationality requirements. The rule should, in fact, include the individual's considerations of concern for other people and for the social institutions that the individual considers important (Harsanyi, 1977, pp. 62-64).

Harsanyi calls this approach "rule utilitarianism", in contradistinction to "act utilitarianism." One might consider this approach as demanding that the decision-maker put in place a reasoned system for decision, rather than having to improvise for the specific occasion. The British philosopher Richard Hare alludes to differences between "rule utilitarianism" and "act utilitarianism (Hare, 1981, p.36, 43). His book, Moral Thinking, presents the view that rational decisions about moral choices require two levels of consideration: moral intuitions, which arise from upbringing and culture and are "givens"; and the critical level of thinking, whereby issues of values or morals are sorted out systematically and applied to situations involving complexity and conflict (Hare, 1981).

Executives in financial organizations, indeed, employ such decision systems for their lending decisions. These systems consist, first, of data bases that can be used to check the past record and credit-worthiness of the potential borrower, and that can also assist in gauging the risk conditions for the particular type of loan that is under negotiation. Second, the bank representative who seeks the lending opportunity and generates the loan proposal must then pass the proposal and its

documentation to loan underwriters. The underwriters assess the loan's potential risks in relation to its proposed size and terms. This separation of function is intended to assure objective and searching review of the transaction. Finally, a large loan transaction goes to a loan committee, composed of experienced senior executives, who conduct a final review and weigh the imponderables of the transaction before approving or rejecting it.

This kind of procedurally enforced scheme for rationality of decision can of course fail even if it is well designed; it can fail, either because those responsible for their parts of the process do not do their jobs well or because the process is negated. (However, a loan involves some risk; a "good" loan may go into default, just on the probabilities, but that does not mean that making that loan was a mistake.)

In "Facade and Self Deception..." I described ways whereby the self-willed and self-deluding executive could make gross errors in decisions. One of these was to dismantle the cross-checks and procedural controls that have just been discussed.

<u>Episodic decision-making vs. decision-making systems</u>

The procedural safeguards that have been mentioned are intended to assure a safe and reliable distribution of outcomes in an uncertain organizational situation. Some business decision-making, however, is essentially episodic -- it proceeds deal by deal, and each deal has such a large number of unique or undetermined elements that the decision-maker must continually

improvise. Contractual negotiations in the entertainment industries are said to display this episodic quality very strongly, as does the merger and acquisition activity that engages so many bright minds in the major corporate law firms and securities houses.

The large size and scope of the transaction in the merger and acquisition business is so great that the single deal may well mean the life or death of one or more participating firms: in fact, the negotiation often covers issues of the terms of the disappearance of one firm into another.

In these circumstances, a reasoned decision system is unavailable: the decision, and the major elements of the sequence leading up to it and its implementation, are so significant that they must be labelled strategic.

Implications of 'Chinese Walls' for marketing strategy

Financial services firms often seek to expand their product/service assortments in order to capture profitable incremental volume from the same customers or attract additional customers. Recent examples include insurance companies that have arranged to offer mutual fund shares through their agent sales forces; S&Ls that offer checking accounts or NOW accounts, which are essentially equivalent; and securities brokerage organizations that have acquired real estate brokerage firms. (See Balderston and Carman, 1988, for an extended discussion of several delivery systems for consumer financial services.)

If statute or regulation mandates a Wall between two types of financial services, however, the resulting prohibition against offers of both services by a given vendor prevents anyone

from discovering whether there might be useful complementation between them. Current efforts of commercial companies to establish "non-bank banks" and numerous attempts to circumvent Glass-Steagall are indicative of the desire of managers of many firms to experiment with new possibilities.

Absent a governmental restraint on attempts at complementation, however, either the seller or the potential buyers may determine that the offer of two types of service is not appealing. The seller may find that organizational and cost problems, on the supply side, render the attempt unprofitable. Apparently, this proved to be the case when Merrill Lynch bought into the real estate brokerage business, only to find that it was not advantageous to try to meld together its securities sales and its real estate brokerage.

Consumer resistance to purchase of a new or added financial service

Consumers may also defeat an attempt at complementation, refusing to buy both types of product from a single vendor and preferring to continue with traditional patterns. From the standpoint of motivations for constructing a 'Chinese Wall', the most interesting rationale for such refusal would be a belief, on the consumer's part, that the vendor of multiple products would not be objective and professional in selling each.

The consumer may resist because it appears costly and unnecessary to evaluate the new service purchase --especially if the existing source that the consumer is currently using is

satisfactory. The 'switching cost' to change from the current source to another one may be high enough to be a barrier.

Alternatively, the consumer may simply not believe that the vendor of one service is a competent or desirable vendor for the new product or service that the company is seeking to add. The vendor may be known as an expert specialist in the type of product already provided, but the new service may be so different in character as to raise questions about the company's competence to provide it. The vendor's credibility becomes an issue in this instance.

Still more damaging to the vendor's credibility is any hint of conflict of interest in the offer of the new product. For example, the consumer may want to buy shares in a mutual fund that is "the best available" according to a specific criterion. But suppose that the vendor, far from surveying the entire set of available mutual funds that might meet the criterion, simply pushes the one that that company has available. If the consumer sees that the vendor has not made an adequate comparison of alternatives and is simply attempting to capture a high commission, the consumer will infer bias and assign low credibility to the vendor as a source. In fact, this kind of bad experience may spill back to the consumer's view of the vendor as a source for all products and cause reevaluation of what had been a satisfactory relationship as to the original product.

<u>How may the seller convey 'source credibility' with respect to new products?</u>

For those cases in which source credibility is an issue, the seller must attempt to demonstrate to the consumer

that statements made about a product offer are objective, unbiassed, and reliable. The seller may begin by seeking to use the 'halo effect' of competence and good service already provided. But with respect to the new product offered, it becomes necessary to assure the consumer that the information being provided meets the necessary standards. Sophisticated and skeptical consumers, then, are likely to enforce upon the vendor the equivalent of a 'Chinese Wall' if the assurance of functional separation is the only way to guarantee objectivity!

Necessary and sufficient conditions for a self-administered and self-enforced Chinese Wall

We may now summarize the necessary and sufficient conditions for a self-administered, self-enforced Chinese Wall within a corporate organization:

(1) Corporate objective: long-term effectiveness.

Taking the long view assures that the corporation will maintain safeguards against overvaluing immediate, short-term gains at the expense of long-term performance and market position.

(2) Clear separation of departmental organizations and duties.

There must be, so to speak, cleared ground on which to build the Wall. If departments' functions are so intertwined that separation of duties becomes ambiguous, the Wall fails.

(3) Internal audit is competent and vigorous.

The functional separation, once designed, must be adequately policed. This is a prime task of the internal

auditors of the corporation.

(4) Legal oversight is clear-cut.

Especially where the Chinese Wall is to guard against conflicts of interest or potential damage to clients, legal counsel should participate both in design and oversight.

(5) Comprehensive procedural controls and auditable records, for self-enforcement.

The mere intent to observe appropriate separation of functions is insufficient, as the incentives of departmental managers may very well run in opposition to the requirements of the separation. Therefore, the departments in question must be required to maintain full records of transactions so that monitoring and oversight will be effective.

External enforcement of the Chinese Wall

Self-administration and self-enforcement may not be workable. Externally-enforced Chinese Walls may then be necessary.

One possible mode of external enforcement is through the market itself: if the consumers of financial services actively demand the effective separation of functions and require evidence that this is taking place, the market mechanism may successfully impose Chinese Wall concepts on an otherwise reluctant organization. The price of failure to install and enforce the separation of duties would be the loss of business and the threat of bankruptcy.

The users of financial services who might be able to mount successful pressure of this kind would have to be both technically competent and large in size. Ideally, they might

band together and apply group pressure. The organization of managers of state-level pension funds is perhaps a case in point: in Fall, 1988, this organization prevailed upon a reluctant management of Texaco Corporation to agree to nomination of several candidates for Texaco's board of directors.

If neither self-administration nor market pressure will work to bring about desired separation of duties, the task falls to the regulatory authorities. The US Securities and Exchange Commission polices the behavior of investment fund managers under the Investment Companies Act of 1940 and its subsequent amendments. The Federal and state-level agencies that regulate banking and other financial industries may set and enforce standards of effective separation of duties and may define conflicts of interest and set penalties for failure to avoid them.

The task of enforcement, however, requires sophistication in the design of appropriate standards as well as competence and vigor in financial supervision. The process will fail if either of these conditions fails to be met. The recent history of the U.S. savings and loan industry, 1982-88, is replete with examples of a failed process. Some of the losses were due to regional economic trouble, in the Farm Belt and the Oil Patch. However, top managers of some financial firms not only in those areas but in economically healthy markets were themselves imprudent and were able to move much faster than the regulators could, and the resulting damage to financial institutions has resulted in heavy losses to the Federal Savings

and Loan Insurance Corporation.

If regulatory supervision of a discretionary type cannot be competent, foresighted and forceful, it may be necessary to embalm in statute certain categorical separations between submarkets and between decision elements. The underlying presumption behind Glass-Steagall was that financial firms and their executives could not be trusted to act wisely, and regulatory authorities could not be granted discretion to oversee these financial firms on a case-by-case basis. That was a most pessimistic prescription for separating important elements of financial risk. Technological and market changes have poked holes in Glass-Steagall, however, and it is not clear that legislated separation of submarkets is fully workable either.

System-building vs. deal-making organizations

The long-sighted organization -- one having a long planning horizon and an indefinite expected life -- has the task of building an organizational system that is durable as to the consequences of a substantial stream of transactions over time. In an uncertain world, it needs to guard against biasses and mistaken interpretations that could push its net worth into the negative at some point. As we have seen, it tends to rely upon procedural safeguards and separations of function as means of assuring objectivity.

The deal-making organization, on the other hand, confronts an immediate, all-or-nothing challenge: to overcome all obstacles to a major transaction that is expected to have a favorable outcome. If the deal is for purchase or sale of the entire company, or for such a major portion of assets as to swamp

all other magnitudes, then the single transaction embodies all of the value that the company's decision-makers can control. This implies that the single act -- the deal -- must embody all of the features of concern that the executives are able to consider. No 'rule utilitarianism' or 'prudent system-building' here: simply, and only, the ultimate win or loss of the entire game. Any 'Chinese Wall' that might ordinarily serve well is useless -- or an active impediment -- when only one dominating, strategic transaction is to be negotiated.

Perhaps it is for this reason that the deal-making organization must behave in a fashion that collides absolutely in philosophy and executive values with the ongoing organization that expects its lifetime to be a long one and that seeks to preserve credibility and probity for the long term.

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