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Scaling Chinese Walls: Insights From Aftra v. JPMorgan Chase

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SCALING CHINESE WALLS: INSIGHTS FROM *AFTRA V. JPMORGAN CHASE*

Abstract

The material non-public information financial services firms receive from clients utilizing commercial banking services may often prove beneficial to the firm's trust account clients if the information is used in making investment decisions for these trust accounts. Consequently, financial services firms confront two equally dubious options: to utilize the information to benefit the trust account client and break insider trading laws, or to disregard the information and seemingly violate the firm's fiduciary duty to the trust account client. To successfully defend against either of the above claims, firms should establish and maintain effective Chinese Walls between private and public side departments and demonstrate that decisions made with respect to private and public side clients are not tainted by conflicting interests. A recent case tried in the Southern District of New York, Aftra v. JPMorgan*, provides an opportunity to inspect these problems in light of the 2008 financial crisis.*

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INTRODUCTION

Enactment of the Gramm-Leach-Bliley Act (GLBA),[1] which repealed important portions of the Glass-Steagall Act (GSA),[2] broadened the activities that depository banks may engage in by establishing the label of financial holding companies.[3] The expected consequence of the GLBA was the consolidation of financial services into a few large, and often international, banking corporations.[4]

As purveyors of a variety of financial products, these companies are privy to material nonpublic information (MNPI) relating to their clients' business operations and future economic outlook, such as when a corporate borrower provides the lending institution with financial statements and future expected cash flows.[5] Occasionally, information gained by one division in administering its duty to clients may prove useful to another division in making business decisions that would impact the banking corporation, a separate client, or both.[6] The advantageous transfer of MNPI between departments[7] was prohibited by an early case[8] brought under the Securities and Exchange Commission's (SEC) Rule 10b-5[9] of the Securities Exchange Act of 1934.[10]

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[1] Gramm-Leach-Bliley Financial Modernization Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified in scattered sections of 12 U.S.C. and 15 U.S.C.).

[2] Banking (Glass-Steagall) Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (1933) (codified in scattered sections of 12 U.S.C.).

[3] 12 U.S.C. §§ 1841(p), 1843(l)(1) (2006). Financial holding companies are permitted to engage in activities financial in nature or incidental thereto, as well as complementary financial activities that do not pose a substantial risk to the safety and soundness of the institution. *See* 12 U.S.C. § 1843(k)(1). After 1999, financial holding companies were allowed to underwrite securities, offer all types of insurance policies, participate in market securities transactions as a broker-dealer, provide advisory services, act as trustee, and manage trust fund investments and other financial services. 12 U.S.C. § 1843(k)(4).

[4] *See* Group of Ten, *Report on Consolidation in the Financial Sector*, at 1–3 (2001), *available at* http://www.bis.org/publ/gten05.pdf (inspecting the systemic risk of a limited number of interrelated and interdependent financial institutions).

[5] *Id.* at 16, 238.

[6] *Id.* at 27.

[7] Division and department are used synonymously. Any common points of distinction are disregarded for the purposes of this Note. Here, departments are characterized and distinguished by the activities in which financial holding companies are permitted to engage. *See* 12 U.S.C. § 1843(k)(4).

[8] Cady, Roberts & Co., Exchange Act Release No. 6668, 40 SEC 907 (Nov. 8, 1961) (dealing with the use of inside information acquired by a trustee in making investment decisions for the trust). Although the inside information came to the trustee from an outside source, not an internal department, the ruling effectively prohibited a trustee from using MNPI acquired from any source. *See id.* at 907–12.

[9] SEC Commodity and Security Exchanges, 17 C.F.R. § 240.10b-5 (2003) (prohibiting the use of manipulative or deceptive devices in connection with the purchase of securities).

[10] Securities Exchange Act of 1934, 15 U.S.C. § 78 (2006).

Conflicts of interest in large financial holding companies are endemic to the industry,[11] and may take on two forms: a conflict between the firm's own economic interests[12] and those of its clients, or a conflict between the interests of different types of clients of the financial institution.[13] In either form it is the use, not possession, of MNPI in making investment and business decisions that is illegal.[14] In an attempt to preempt and combat the transfer of MNPI between divisions, financial services companies establish and monitor compliance procedures.[15]

One technique firms can use to avoid the transfer of MNPI is to construct Chinese Walls[16] between the public and private sides of the firm.[17] The effectiveness of Chinese Walls in permitting the exchange of MNPI has been a debated topic[18] since insider trading was recognized in *Cady,*

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[11] *See* Vincent Di Lorenzo, *Public Confidence and the Banking System: The Policy Basis for Continued Separation of Commercial and Investment Banking*, 35 AM. U. L. REV. 647, 676 (1986).

[12] A firm's interests are most often manifested in proprietary trading activities for the firm's own account. The Volcker Rule, a component of the Dodd-Frank Act yet to be enforced as of early 2013, attempts to prohibit proprietary trading by banking entities. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1621 (2010) (to be codified at 12 U.S.C. § 1851).

[13] Ingo Walter, *Conflicts of Interest and Market Discipline Among Financial Services Firms* 3 (NYU Stern Sch. of Bus. Asset Mgmt. Research Grp., Working Paper No. SC-AM-03-08, 2003), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1295181 (discussing the potential conflicts of interest that financial services firms face and proposing a taxonomy to constrain the exploitation of these conflicts by focusing on the impact of market discipline and external regulation).

[14] *See* Donald C. Langevoort, *Rereading* Cady, Roberts*: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1332–35 (1999). The *Cady, Roberts* decision in 1961 appeared to reject the trader's argument that his possession of the inside information alone did not constitute a violation of Rule 10b-5. To resolve this issue, the court in *Adler* imposed an inference of use when a trader possesses inside information, and it placed the burden of proof on the trader, not the SEC or the plaintiff. *See* SEC v. Adler, 137 F.3d 1325, 1336–38 (11th Cir. 1998).

[15] *See* Wesley G. Nissen, *Key Compliance Issues*, *in* HEDGE FUNDS 2008, at 245, 343 (PLI Corporate Law and Practice, Course Handbook Ser. No. 1672, 2008). *See generally* Editorial by Harvey L. Pitt, *Conflict of Interest Lessons from Financial Services*, COMPLIANCE WKLY., Feb. 22, 2005, http://www.complianceweek.com/conflict-of-interest-lessons-from-financial-services/article/183272/.

[16] The terms firewall and information barrier are synonymous with Chinese Walls.

[17] *See* HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, 10A INTERNATIONAL CAPITAL MARKETS AND SECURITIES REGULATION § 19:35 (2012). Private-side participants engage in activities where MNPI is gained, such as commercial lending or underwriting securities. The public side activities consist of advisory services and securities trading. *Id.*

[18] *See id.* § 19:37; *see also* DIV. OF MARKET REG., SEC, BROKER-DEALER POLICIES AND PROCEDURES DESIGNED TO SEGMENT THE FLOW AND PREVENT THE MISUSE OF MATERIAL NONPUBLIC INFORMATION 18 (1990), *available at* http://www.sec.gov/divisions/market

Roberts.[19] The number of potential conflicts of interest increase as a firm broadens the variety of financial services it offers, especially when sales, advisory, and underwriting functions are combined.[20] Conflicts of interest have been cited as a contributing factor to the economic meltdown of 2008.[21]

The economic meltdown of 2008 spurred a large amount of litigation against firms in the financial services industry.[22] This Note inspects one such claim—*Board of Trustees of Aftra Retirement Fund v. JPMorgan Chase Bank, N.A.*[23]—where Judge Scheindlin found that JPMorgan (JPMC) did not violate its duties of loyalty or disclosure[24] when it collected a substantial premium on repurchase agreements made between Sigma Finance (Sigma) and JPMC's commercial lending division[25] while Aftra Retirement Fund

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reg/brokerdealerpolicies.pdf (identifying the minimum elements necessary for an efficient information barrier); ARNOLD S. JACOBS, 5C DISCLOSURE AND REMEDIES UNDER SECURITIES LAWS § 12:154 (2012) (demonstrating the potentially embarrassing result of effective Chinese Walls when a bank's commercial lending and trust departments take opposing positions in a company's future financial outlook); Leo Herzel & Dale E. Colling, *The Chinese Wall and Conflict of Interest in Banks*, 34 BUS. LAW. 73, 74 (1978) (stating that Chinese Walls are the most effective solution for information flow in combined financial service firms); Carlos E. Mèndez-Peñate, *The Bank "Chinese Wall": Resolving and Contending with the Conflicts of Duties*, 93 BANKING L.J. 674, 674 (1976) (demonstrating that the implausible result of eliminating Chinese Walls would require complete divestment of some financial service firms' activities); H. Nejat Seyhun, *Insider Trading and the Effectiveness of Chinese Walls in Securities Firms*, 4 J.L. ECON. & POL'Y 369, 369–70 (2008) (testing the effectiveness of Chinese Walls by inspecting the impact of an investment banker's presence on a corporation's board of directors); Norman S. Poser, *Conflicts of Interest Within Securities Firms*, 16 BROOK. J. INT'L L. 111, 116–18, 123 (1990) (asserting that Chinese Walls are useful in preventing flow of nonpublic information, but they are not a complete solution); Christopher M. Gorman, Note, *Are Chinese Walls the Best Solution to the Problem of Insider Trading and Conflicts of Interest in Broker-Dealers?*, 9 FORDHAM J. CORP. & FIN. L. 475, 475–76 (2004) (positing that insider trading by broker-dealers may be limited by Chinese Walls, but corporate tippers and tippees are not affected by these measures); Stephen Barr, *What Chinese Wall?*, CFO MAG., Mar. 1, 2000, http://www.cfo.com/article.cfm/2988524/c_3046533?f=magazine_featured (outlining the risks of collusion between the research and underwriting departments of securities firms).

[19] Cady, Roberts & Co., Exchange Act Release No. 6668, 40 SEC 907, 910–11 (Nov. 8, 1961).

[20] *See* Di Lorenzo, *supra* note 11, at 683–85.

[21] Jacob Weisberg, *What Caused the Economic Crisis?*, SLATE (Jan. 9, 2010, 6:59 AM), http://www.slate.com/articles/news_and_politics/the_big_idea/2010/01/what_caused_the_economic_crisis.html.

[22] Steven A. Meyerowitz, *Lessons Learned*, 128 BANKING L.J. 97, 97 (2011) (discussing that increased litigation relating to the economic crisis motivated plaintiffs to also assert negligence claims to avoid contractual provisions that limit damages for breach of contract).

[23] Bd. of Trs. of Aftra Ret. Fund v. JPMorgan Chase Bank, 806 F. Supp. 2d 662 (S.D.N.Y. 2011).

[24] *Id.* at 666.

[25] *Id.* at 665.

(Aftra), under the direction and advisement of JPMC's securities lending division, lost nearly all of its investment in Sigma when it went bankrupt.[26] Integral to this inspection is the apparent conflict of interest between JPMC's commercial lending and securities lending[27] departments and the use of Chinese Walls to prohibit the transfer of MNPI.

This Note will: (1) offer background and historical information on commercial repurchase agreements, securities lending/asset management services, Chinese Walls, and the fiduciary duty of loyalty; (2) provide context to legal arguments by highlighting the elements of the *Aftra v. JPMorgan* claim; (3) analyze the *Aftra v. JPMorgan* court's discussion of the use of Chinese Walls as a defense to claims for breach of the fiduciary duty of loyalty; (4) inspect an alternative line of argumentation that may have proven successful for Aftra; and (5) discuss two possible solutions to the Chinese Walls debate enlightened by the *Aftra v. JPMorgan* ruling. The implications of *Aftra v. JPMorgan* will impact many subsequent cases that deal with conflicts of interest within large financial services firms.

This Note's analysis highlights the importance of Chinese Walls in defending against duty of loyalty claims. A financial services firm's use of Chinese Walls, if functioning properly, permits it to reject a plaintiff's claim that (1) the firm was acting in a dual and conflicted role when dealing with fiduciary assets and (2) MNPI was used in making public side investment decisions.[28] Ironically, Aftra's claim seeks to impose upon JPMC the requirement to disregard, or scale, a Chinese Wall within its organization in order to benefit the fiduciary client's assets.[29] Two alternatives are available to eliminate or minimize the importance of Chinese Walls: (1) require the break-up and separation of large financial services firms such that there is no possibility for conflicts of interest between private and public side departments, and (2) establish restricted and watch lists that serve to make both public and private side managers aware of a potential conflict of interest between fiduciary and non-fiduciary clients.[30]

I. BACKGROUND

A. Repurchase Agreements

Repurchase (repo) agreements provide for the simultaneous sale of securities with a contractual obligation to repurchase them in the future at a

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[26] *Id.* at 677.

[27] JPMC's securities lending division performs trustee services by investing cash collateral for clients. *See infra* notes 49–50 and accompanying text.

[28] *Aftra*, 806 F. Supp. 2d at 688.

[29] *Id.* at 693.

[30] *See* Gorman, *supra* note 18, at 494–97.

higher price.[31] This transaction is best viewed as a loan in which Corporation A lends the sale price of the securities[32] to Corporation B in exchange for an agreement that at a later date Corporation B will repay the sale price, with accumulated interest, to Corporation A, and Corporation A will return the securities to Corporation B.[33] Eligible collateral includes Treasury securities and other readily marketable securities.[34] One night is the most common duration for a repo agreement.[35]

Repo agreements "are subject to haircuts that are based on the nature and value of the underlying securities, [and] the amount of such agreements in relation to ... marks-to-market."[36] These "haircuts" require the value of the securities sold to be 102%–103%[37] of the sale price in order to protect the lender from a decrease in the asset's value over the duration of the agreement.[38] The Bankruptcy Code affords derivative contracts (including repo agreements) special treatment that purportedly reduces systemic risk by facilitating settlement and clearing.[39]

The United States repurchase market in mid-2008 exceeded $10 trillion, or about 70% of U.S. Gross Domestic Product (GDP), while the European market was 65% of Euro area GDP at €6 trillion.[40] Repo market

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[31] Michael J. Fleming & Kenneth D. Garbade, *The Repurchase Agreement Refined: GCF Repo*, CURRENT ISSUES IN ECON. & FIN., June 2003, at 1, http://www.newyorkfed.org/research/current_issues/ci9-6.pdf.

[32] The securities serve as the collateral for the loan. *See id.* at 1–2.

[33] *See id.* The difference between the repurchase price and the original sales price is the interest earned by the lending institution. *See* United States v. Manko, 979 F.2d 900, 902 (2d Cir. 1992).

[34] *See* Fleming & Garbade, *supra* note 31, at 2. Readily marketable securities may consist of commercial paper, corporate securities, or loan mortgages. Michael A. Spielman, *Whole Loan Repurchase Agreements: An Assessment of Investment Transaction Risks in Light of Continuing Legal Uncertainty*, 99 COM. L.J. 476, 476 (1994) (comparing the differences in bankruptcy treatment between whole loan mortgage collateral and other more common collateral in repurchase agreements).

[35] Howard R. Schatz, *The Characterization of Repurchase Agreements in the Context of the Federal Securities Laws*, 61 ST. JOHN'S L. REV. 290, 296 (1987) (discussing the implications of defining overnight repo agreements as securities instead of loans).

[36] THOMAS L. HAZEN & JERRY W. MARKHAM, 23 BROKER-DEALER OPERATIONS UNDER SECURITIES AND COMMODITIES LAW § 4:17 (2011).

[37] Matt Phillips et al., *Heading for a 'Haircut,'* WALL ST. J., July 28, 2011, at C1. Lenders typically require borrowers to give $102 in assets or U.S. Treasuries for $100 cash. *Id.*

[38] *See* MOORAD CHOUDHRY, THE REPO HANDBOOK 128, 149 (2d ed. 2010).

[39] *See* Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 YALE J. ON REG. 91, 93–94 (2005) (arguing that special treatment of derivative contracts through an automatic stay in bankruptcy proceedings may increase, not decrease, systemic risk).

[40] Peter Hördahl & Michael R. King, *Developments in Repo Markets During the Financial Turmoil*, BIS Q. REV., Dec. 2008, at 37, 39.

growth nearly doubled from 2000 to 2007, mostly due to increases in overnight repo transactions.[41] The 2008 subprime mortgage crisis tightened repo lending because lenders began to worry about the health of their own balance sheets.[42] Companies who relied on the overnight repo market, often investment banks, suffered at the "mercy of lender sentiment."[43] The overnight repo market hit a breaking point in early 2008[44] when lending all but dried up and only the highest quality collateral was accepted.[45]

B. Securities Lending/Asset Management

Securities lending is a contractual agreement between two parties where the lender transfers securities to the borrower with the agreement that the borrower will return them on a later date.[46] The borrower provides the lender with collateral against the value of the securities.[47] Borrowers often engage in securities lending for the purpose of short selling, but other purposes exist.[48]

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[41] Markus K. Brunnermeier, *Deciphering the Liquidity and Credit Crunch 2007–2008*, 23 J. OF ECON. PERSP. 77, 80 (2009).

[42] *See* Bryan J. Orticelli, Note, *Crisis Compounded by Constraint: How Regulatory Inadequacies Impaired the Fed's Bailout of Bear Stearns*, 42 CONN. L. REV. 647, 656 (2009).

[43] *Id.*

[44] *See* Brunnemeier, *supra* note 41, at 88. In March 2008, Bear Stearns "was suddenly unable to secure funding on the repo market," which led to the eventual purchase of Bear Stearns by JPMorgan with assistance from the New York Federal Reserve. *Id.*; *see also* José Gabilondo, *Leveraged Liquidity: Bear Raids and Junk Loans in the New Credit Market*, 34 J. CORP. L. 447, 465 (2009) (stating it was the "refusal of Bear's repo lenders to extend overnight loans that confirmed that Bear had a liquidity crisis").

[45] *See* Hördahl & King, *supra* note 40, at 42–43.

[46] André Ruchin, *Can Securities Lending Transactions Substitute for Repurchase Agreement Transactions?*, 128 BANKING L.J. 450, 451 (2011). Lending agreements, at the discretion of the lender, may specify a fixed date for borrowers to return the securities or allow lenders to request them on demand. *Id.*

[47] *See* Susan F. Pollack & Craig H. Weaver, *Legal Issues Impacting Securities Lending Activities of Banks*, *in* EXCHANGE ACTIVITIES, at 217, 223 (PLI Commercial Law & Practice, Course Handbook Ser. No. 600, 1992). The most common form of collateral is cash, but U.S. Treasuries and other readily marketable assets are also accepted. *Id.* Fluctuations in the value of the securities impact the collateral required of the borrower, which is increased or decreased according to daily adjustments by marking to market. *Id.*

[48] KEVIN A. ZAMBROWICZ, THE AM. LAW INST., SP054 BROKER-DEALER REGULATION 37, 39 (2009) ("Borrowers may engage in securities lending ... to cover short sales or failed trades, or to execute hedging or arbitrage strategies."). Ironically, although the parties have conflicting positions—the lender is long on the stock and the borrower is short—the lender allows its securities to be used in a bet by the borrower against the lender's expectation that the securities will rise in value.

Securities lending agents[49] are normally appointed by the securities lender to invest[50] the cash collateral according to predetermined guidelines set by the lender.[51] The level of discretionary investment authority the asset manager is allowed by the security lender has liability implications, and it is an important issue to be resolved in the contractual documents of the lending and management agreements.[52]

Asset managers are compensated by receiving a percentage of the gain in the invested collateral's value, typically thirty to forty percent, but do not share in any losses experienced by the securities lender.[53] Because the security lender bears the risk of loss, the asset manager is required to invest "collateral funds conservatively and prudently to safeguard principal and to maintain adequate liquidity.... [M]ost collateral pools are restricted to short-term investments because [they] usually have less volatility."[54]

C. Chinese Walls

Prior to developments in the interpretation of section 78j(b) of the Securities Exchange Act of 1934,[55] the standard process for investment decisions by a trustee was to "seek[] out and evaluate[] information" from all files and personnel across departments within the financial institution.[56] It was expected that any special skills or knowledge should be "put to use for the benefit of ... trust beneficiaries."[57] However, as previously noted, the *Cady, Roberts* decision limited the sources of information that managers were permitted to use when investing fund assets.[58]

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[49] Many large custodians, the banking entities that hold the lenders' securities, have a securities lending division within their corporate structure. *See id.* at 40; *see also* Stephen Bier et al., *Overview of Fund Securities Lending Programs*, 124 BANKING L.J. 654, 656 (2007) (discussing the care required in selecting a securities lending agent).

[50] *See* Pollack & Weaver, *supra* note 47, at 223.

[51] Gregory J. Lyons & Michael P. McAuley, *Securities Finance: Case Study of the Regulatory Roadmap Necessary to Navigate the Challenges in the New Financial Services Environment*, BANKING & FIN. SERVICES POL'Y REP., Nov. 2010, at 1, 2–3.

[52] *See* Pollack & Weaver, *supra* note 47, at 223.

[53] Timothy DeLange & Ian Berg, *Other People's Money: The Unrealized Conflicts of Securities Lending*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (June 17, 2010, 9:18 AM), http://blogs.law.harvard.edu/corpgov/2010/06/17/other-peoples-money-the-unrealized-conflicts-of-securities-lending/.

[54] *Id.*

[55] 15 U.S.C. § 78j(b) (2006).

[56] Herzel & Colling, *supra* note 18, at 76–77.

[57] Edward S. Herman & Carl F. Safanda, *The Commercial Bank Trust Department and the "Wall,"* 14 BOS. C. INDUS. & COM. L. REV. 21, 24 (1972).

[58] Cady, Roberts & Co., Exchange Act Release No. 6668, 40 SEC 907, 907–08 (Nov. 8, 1961).

Less than a decade after *Cady, Roberts*, the SEC urged financial services institutions to adopt and adhere to internal policies to guard against disclosure of confidential information.[59] These internal policies sought to prohibit communications between commercial lending or underwriting activities (private side) and trust department activities (public side).[60] More recently, the Office of the Comptroller of the Currency (OCC) has required that national banks that exercise fiduciary authority must follow written policies and procedures to "ensure[] that fiduciary officers and employees do not use material inside information in connection with any decision ... to purchase or sell any security ... and prevent[] self-dealing and conflicts of interest."[61]

Before identifying the components of Chinese Walls, it is important to pinpoint what type of information they attempt to block. Although there is no clear definition of MNPI,[62] some categories of sensitive information may be considered material.[63] Examples include nonpublic information about financial results, future earnings projections, impending bankruptcy or financial liquidity problems, or changes in senior management.[64] "In short, material nonpublic information is any information which, if publicly disclosed, could reasonably affect the price of the stock,"[65] or be a significant factor in altering an investment decision.[66] However, advantages gained by a securities investor through its own efforts "derived from publicly available

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[59] *See* Merrill Lynch, Pierce, Fenner & Smith, Exchange Act Release No. 34-8459, 43 SEC 933 (Nov. 25, 1968) (accepting an offer of settlement for violations of anti-fraud provisions by Merrill Lynch for disclosing to customers confidential information obtained in connection with its underwriting business). This case marked "the first formal Chinese Wall in the securities industry pushed for by the regulatory agency." Stanislav Dolgopolov, *Insider Trading, Chinese Walls, and Brokerage Commissions: The Origins of Modern Regulation of Information Flows in Securities Markets*, 4 J.L. ECON. & POL'Y 311, 347 (2008) (arguing that the creation of Chinese Walls regulation came about because of the demise of the fixed brokerage regime on the New York Stock Exchange).

[60] Herzel & Colling, *supra* note 18, at 79–80.

[61] Fiduciary Activities of National Banks, 12 C.F.R. § 9.5 (b)–(c) (2012). Investment managers, who also function in a fiduciary capacity, are required to maintain and enforce policies and procedures to prevent the misuse of nonpublic information; however, latitude is given to advisers to take into consideration the nature of its business in deciding on specific measures. 15 U.S.C. § 80b-4a (2006).

[62] 2 MICHAEL B. SNYDER, HR SERIES COMPENSATION AND BENEFITS § 11:211 (2011).

[63] *See* Tower C. Snow, Jr. et al., *The Return of Insider Trading and Related Developments Under Rule 10b-5*, *in* THE ART OF COUNSELING DIRECTORS, OFFICERS & INSIDERS: HOW WHEN AND WHAT TO DISCLOSE 131, 154–55 (PLI Corporate Law & Practice, Course Handbook Ser. No. 1083, 1998).

[64] *Id.*

[65] 3 ROBERT B. HUGHES, LEGAL COMPLIANCE CHECKUPS: BUSINESS CLIENTS app. 23-3 (2009).

[66] *See* Snow et al., *supra* note 63, at 146.

information" are not prohibited, even if the conclusions drawn from such information are nonpublic.[67]

The characteristics of a Chinese Wall depend on the size and structure of the bank or financial holding company.[68] A common method is the physical[69] and/or functional[70] separation of the lending and trust departments.[71] At a minimum, Chinese Walls may be erected by internally distributing a policy statement outlining the purpose and basic provisions of the information barrier.[72] An independent compliance department may review trades and activities to ensure adherence to the policy statement.[73] Restricting access to computer databases containing sensitive documents is another technique aimed at prohibiting misuse of confidential information.[74] Other characteristics include implementing educational programs for employees, eliminating shared committee membership between the departments, and establishing protocols to deal with accidental communications.[75] Large law firms have put into place similar policies and procedures to avoid conflict of interest problems between different clients and the lawyers who assist those clients.[76]

It is necessary that some individuals be allowed to cross the Chinese Walls to perform their responsibilities within the corporation,[77] most notably

[67] Thomas Lee Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information*, 61 HASTINGS L.J. 881, 883 (2010). All traders are not required to have equal information before trading. *See* Dirks v. SEC, 463 U.S. 646, 657 (1983).

[68] *See* Herzel & Colling, *supra* note 18, at 88.

[69] Mèndez-Peñate, *supra* note 18, at 686.

[70] *See* Sheldon I. Goldfarb, *Chinese Wall Policies and Procedures*, at 809, 813 (PLI Corporate Law & Practice, Course Handbook Ser. No. 692, 1990). Functional separations attempt to avoid the intermingling of bank departments that possess private information by separating tasks and activities in which staff from each department engage. *Id.*

[71] *See id.*

[72] *See* Mèndez-Peñate, *supra* note 18, at 685. The statement may include procedures that should be followed by persons responsible for private information. Herzel & Colling, *supra* note 18, at 88.

[73] *See* 3 ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG & LOWENFELS ON SECURITIES FRAUD § 6:274 (2d ed. 2011) (discussing Chinese Walls procedures ordered by a recent bankruptcy court decision). Personnel responsible for private information may be required to sign a letter acknowledging they are aware of the restrictions. *Id.*

[74] *See* Harry J. Weiss, *Outline for Enforcement Session: SEC and SRO Enforcement Developments*, *in* COPING WITH BROKER/DEALER REGULATION AND ENFORCEMENT 2008, at 49, 135 (PLI Corporate Law & Practice, Course Handbook Ser. No. 1701, 2008).

[75] Herzel & Colling, *supra* note 18, at 88–91.

[76] *See* Charlotte M. Fischman, *Client Conflicts: The Large Law Firm Experience and the Use of the Chinese Wall*, at 69, 98–100 (PLI Litig. & Admin. Practice, Course Handbook Ser. No. 365, 1988).

[77] *See* Mèndez-Peñate, *supra* note 18, at 699–700.

senior executives.[78] Directors and senior officers "stand[] astride the wall [and are] faced with a seemingly impossible task of maintaining a dichotomy of mind between information gained" from various departments.[79] Directors and officers are often not involved in the individual trades performed by trust department managers;[80] however, some specific instances have been reported where senior management had specific knowledge of and involvement in trust department activities.[81] Trust department employees, and the senior executives who supervise them, are under no fiduciary duty to seek out inside information for the benefit of the managed trusts,[82] but maximizing profits through increased brokerage and performance fees provides a strong incentive to exploit such information.[83]

Restricted and watch lists have been suggested as a method to supplement Chinese Walls.[84] When the commercial lending department enters into a relationship with a client, and therefore gains access to nonpublic information, the client's name is added to a firm-wide list that prohibits the trust department from recommending that client's securities.[85] Therefore, no conflict of interest exists that may lead to disclosure of nonpublic information.[86] There are two main problems that restricted lists present. First, the mere fact that a client is on the restricted list suggests something that has the potential

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[78] *See* Theodore A. Levine et al., *An Overview of Compliance Policies and Procedures for Multiservice Financial Institutions*, at 731, 762–63 (PLI Corporate Law & Practice, Course Handbook Ser. No. 692, 1990). Others allowed to cross the barrier include lawyers, accountants, and appropriate research personnel. *Id.*

[79] Steven R. Hunsicker, *Conflicts of Interest, Economic Distortions, and the Separation of Trust and Commercial Banking Functions*, 50 S. CAL. L. REV. 611, 645 (1977) (arguing that it is economically feasible to completely separate trust and commercial departments to avoid conflicts of interest).

[80] *See* Herzel & Colling, *supra* note 18, at 92 n.54.

[81] *See* Louise Story, *JPMorgan Accused of Breaking Its Duty to Clients*, N.Y. TIMES, Apr. 10, 2011, at B1.

[82] *See* Herzel & Colling, *supra* note 18, at 86–87.

[83] *See* Hunsicker, *supra* note 79, at 643–44.

[84] Slade v. Shearson, Hammill, & Co., 517 F.2d 398, 403 (2d Cir. 1974) (finding that constructing Chinese Walls alone is not a sufficient bar to liability in the case that a trust department solicits customers for a corporation's securities when the investment banking department knows of inside information pertaining to the corporation that is contrary to the assertions of the trust department).

[85] *See id.* The list can prescribe that certain actions may or may not be taken with regards to a corporation's securities—exceptions relating to whose account is permitted to trade in the security (proprietary, client, or employee), time limits on the restriction, and how to alter a previous recommendation of the security (buy, sell, or hold). *See* Levine et al., *supra* note 78, at 781–84.

[86] *See* Levine et al., *supra* note 78, at 785.

to affect the securities' value.[87] Second, large financial institutions deal with a vast number of corporations through various departments,[88] and the range of securities that may be recommended would be greatly circumscribed.[89]

D. Fiduciary Duty

1. Duty of Loyalty

Asset managers who exercise discretionary control in the management of an employee retirement plan are subject to provisions of the Employee Retirement Income Security Act (ERISA) and have a fiduciary duty to the managed fund in that capacity.[90] In order to state a claim under ERISA for breach of fiduciary duty, the pleading "must allege 1) that defendant was a fiduciary who, 2) was acting within his capacity as a fiduciary, and 3) breached his fiduciary duty."[91]

Element 2 implies there are instances where a fiduciary may act against the interests of the plan if done outside of its capacity as fiduciary.[92] *Pegram*

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[87] Gorman, *supra* note 18, at 494–95. Depending on the way the restricted list is structured (what department placed the corporation on the list, what action is prescribed, and how long the client will be on the list), an analyst may be able to glean information from and hypothesize about the corporation merely because of its presence on the list. This is most pronounced when the corporation's securities had previously been recommended by the analyst, providing grounds for even greater conjecture on the corporation's future outlook. *Id.*

[88] The same client may also be using different departments simultaneously, such as a corporation issuing new securities through the underwriting division and receiving financing through the commercial lending division.

[89] *See* Levine et al., *supra* note 78, at 786. The effect on large banks would be extremely onerous, imposing a drastic solution that is not proportional to the problem it purports to solve. *See* Herzel & Colling, *supra* note 18, at 82–83.

[90] *See* 29 U.S.C. § 1002(21)(A)–(B) (2006). ERISA was enacted in 1974 to provide protection for employee benefits such as pension plans and welfare benefit plans. *See* Andrew M. Campbell, Annotation, *Construction and Application of Employee Retirement Income Security Act of 1974 (29 U.S.C.A. §§ 1001 et seq.) by United States Supreme Court*, 150 A.L.R. FED. 441, § 2 (1998). ERISA standards impose on plan fiduciaries more stringent requirements than does the common law of trusts. *See* Susan J. Stabile, *Pension Plan Investments in Employer Securities: More Is Not Always Better*, 15 YALE J. ON REG. 61, 70–71 (1998) (arguing that accumulation of employee retirement funds in pension plans insufficiently diversifies the employee's portfolio and advocates for ERISA statutes that set a maximum limit on employee investments in ERISA pension plans).

[91] *In re* Morgan Stanley ERISA Litigation, 696 F. Supp. 2d 345, 353 (S.D.N.Y. 2009) (denying defendant's motion to dismiss because allegations were sufficient to state a claim for breach of fiduciary duty to avoid conflicts of interest, to prudently manage plan assets, and to disclose material information to the plan).

[92] *See* Pegram v. Herdrich, 530 U.S. 211, 225–26 (2000) (allowing fiduciary plan managers to act against the interests of the plan when the manager does so outside of its responsibility as fiduciary to the plan).

v. Herdrich specifically permits ERISA fiduciaries to wear multiple hats, or represent multiple interests, as long as they "wear the fiduciary hat when making fiduciary decisions."[93] This rationale has been extended to large financial services firms where fiduciary and non-fiduciary activities are carried out in various departments.[94] Consequently, the plaintiff in a breach of fiduciary duty of loyalty claim must assert that the activity complained of occurred while the defendant was administering to the plan in its fiduciary capacity.[95]

Element 3 pertains to the nature of the transaction or activity that the plaintiff, the fiduciary plan trustee, complains of, not the capacity within which the fiduciary is acting as in Element 2.[96] Fiduciaries must discharge their duties solely in the interest of participants, "for the exclusive purpose of[] providing benefits to participants and ... defraying reasonable expenses."[97] Implicit in this statute is the requirement that trustee fiduciaries act completely independent of conflicting personal interests.[98] Prohibited transactions due to conflicts of interest include (1) dealing with plan assets for the benefit of the fiduciary's own account, (2) transactions involving the plan where the interests of the plan are adversely affected, and (3) receiving kickbacks from transactions involving the plan assets.[99]

II. AFTRA RETIREMENT FUND V. JPMORGAN

A. JPMC Repurchase Agreement with Sigma

Sigma Finance was a special investment vehicle (SIV) that utilized short-term funding to invest in asset-backed securities and other long-term

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[93] *Id.*

[94] *See* EBC I, Inc. v. Goldman, Sachs & Co., 832 N.E.2d 26, 33 (N.Y. 2005) (stating that although Goldman Sachs was acting in a fiduciary role as underwriting advisor to a client, other underwriting activities on behalf of that client do not bring with them fiduciary duties).

[95] *See In re* WorldCom, Inc., 263 F. Supp. 2d 745, 757 (S.D.N.Y. 2003) (citing Pegram v. Herdrich, 530 U.S. 211, 226 (2000)).

[96] *Id.* at 758.

[97] 29 U.S.C. § 1104(a)(1)(A) (2006).

[98] *See* Dabney v. Chase Nat. Bank of New York, 196 F.2d 668, 670 (2d Cir. 1952).

[99] *See* 29 U.S.C. § 1106(b)(1)–(3) (2006). It is argued that Congress deemed that some transactions by fiduciaries must be summarily avoided, and that the aims of the fiduciary and the plan are irreconcilable. Consequently, in such instances fiduciaries are completely barred from acting. *See* Laurence B. Wohl, *Fiduciary Duties Under ERISA*: *A Tale of Multiple Loyalties*, 20 U. DAYTON L. REV. 43, 59 (1994). The second prohibited transaction that is listed in the text above notes that certain transactions *involving the plan* are disallowed, which the court in *Aftra v. JPMorgan* emphasized in its opinion. *See* Bd. of Trs. of Aftra Ret. Fund v. JPMorgan Chase Bank, N.A., 806 F. Supp. 2d 662, 681 (S.D.N.Y. 2011).

financial instruments.[100] On September 30, 2008, the Sigma board of directors determined Sigma could no longer meet its obligations and should be placed in receivership.[101] During the liquidity crunch, Sigma looked to JPMC for financing through repo agreements in place of traditional commercial paper and term notes.[102] Recognizing Sigma's impending collapse, internal correspondence within JPMC's investment banking division highlighted potential gains from the unwinding of Sigma and other similar shadow banking entities.[103] Through various repo agreement plans totaling nearly $13.5 billion, from February to August of 2008,[104] JPMC's investment banking division hand-selected collateral that gave it the best prospect of profit in the event of a Sigma default.[105]

B. JPMC Securities Lending Agreement with Aftra

In June 2007, Aftra used JPMC's securities lending services to gain access to $500 million in collateral from borrowers of its securities; Aftra then authorized JPMC's asset management division to invest the collateral in Sigma's secured medium term notes (MTN).[106] These MTNs allowed Sigma to retain the right to transfer specific assets to repo lenders, rendering those

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[100] *See* Alan S. Wilmit & Suzzanne Yao, *Issues Relating to the Securities Lending and Collateral*, *in* PENSION PLAN INVESTMENTS 2010: CURRENT PERSPECTIVES, at 479, 484 (PLI Tax Law & Estate Planning, Course Handbook Ser. 907, 2010). Banks create SIVs by providing them with limited funding and making them standalone entities with no backing from the parent bank. *Id.* SIVs enjoyed lighter regulation than their depository institution counterparts, even though they serve a similar function. *See* Sarah Foster, *Structured Investment Vehicles*, *in Developments in Banking and Financial Law: 2009–2010*, 29 REV. BANKING & FIN. L. 1, pt. V at 33–34 (2009).

[101] *In re* Sigma Finance Corporation (in administrative receivership) and *In re* The Insolvency Act 1986 (Conjoined Appeals), [2009] UKSC 2, [2] (appeal taken from Eng.) (U.K.).

[102] Paul J. Davies & Anousha Sakoui, *Sigma Collapse Marks End of SIV Era*, FIN. TIMES, Oct. 1, 2008, http://www.ft.com/intl/cms/s/0/18fbcd5c-8fe4-11dd-9890-0000779fd18c.html.

[103] *See Aftra*, 806 F. Supp. 2d at 671–72. Specifically, JPMC executives outlined services that could be provided to Sigma and others involved in Sigma's financing, such as advising Sigma noteholders on unwinding its portfolios, identifying Sigma assets that would be attractive purchases for JPMC, and protecting JPMC's own monetary interests. *Id.*

[104] *Id.* at 675–76. These repo agreements were executed *after* JPMC executives recognized Sigma was near bankruptcy. *Id.*

[105] *Id.* at 675. Aftra claims JPMC gained a profit of $1.9 billion from the cherry-picked collateral after Sigma's collapse. *Id.* at 678. However, at the time of Sigma's default, JPMC faced a nearly $383 million loss on the collateral; JPMC argues that its business decision to maintain possession of the collateral over a period of years (resulting in substantial asset appreciation) has no bearing on Aftra's claim. *Id.*

[106] *Id.* at 670. The notes, which matured in June 2009, were AAA-rated and secured by Sigma assets. *Id.*

assets unavailable to MTN holders if Sigma defaulted.[107] After Sigma entered receivership, Aftra recovered about six cents on the dollar for its MTNs.[108]

C. Court's Ruling

1. Duty of Loyalty

The court did not rule on Aftra's claim that JPMC breached its fiduciary duty to prudently manage plan assets because it was not at issue in the parties' motions.[109] JPMC's motion for summary judgment was granted on Aftra's claims for breach of duty of loyalty and duty to disclose.[110] Judge Scheindlin determined, as a matter of law, "JPMC was not acting in a fiduciary capacity when it extended repo financing to Sigma," or when JPMC issued a default notice to Sigma, thereby seizing Sigma's collateral.[111] The duty of loyalty claim was of particular importance to the court's analysis, and it failed because JPMC was acting in its capacity as creditor of Sigma, not fiduciary of Aftra, when the repo agreements were made and the default order issued.[112] Congressional intent justified the holding, citing a calculated tradeoff between increasing capital formation and aligning financial services firms' bottom lines with the success of their clients' investments.[113]

D. Related Litigation

As previously noted, the 2008 financial crisis caused many lawsuits against the financial services industry.[114] Much of the litigation stemmed from negligence and breach of contract claims brought by class action plaintiffs[115] whose investments had lost substantial value due to the wide-reaching impact of the subprime loan market and the resulting credit crunch.[116] This

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[107] *Id.* at 670–71. JPMC's Asset Management division was aware of the repo lender's superior claim to Sigma's assets vis-à-vis noteholders at least six weeks prior to Sigma's collapse. *Id.* at 677.

[108] *Id.* at 677.

[109] *See Aftra*, 806 F. Supp. 2d at 666.

[110] *Id.*

[111] *Id.* at 691.

[112] *Id.*

[113] *Id.* at 691–92.

[114] *See* Meyerowitz, *supra* note 22, at 97.

[115] *See* Kevin J. Smith & Nicole M. Hudak, *Financial Services Companies Fighting Negligence Claims*, 128 BANKING L.J. 123, 123 (2011) (discussing how defendants may utilize a New York law that permits the dismissal of negligence claims where the defendant did not undertake duties outside those specifically enumerated in the contract).

[116] *See* Wayne W. Smith & Gareth T. Evans, *Understanding and Dealing with the Current Securities Litigation Environment*, *in* SECURITIES LITIGATION AND THE ECONOMIC CRISIS 7, 8, 14–15, 51 (Aspatore, 2009).

Section considers litigation related[117] to the *Aftra Retirement Fund v. JPMorgan* (*Aftra v. JPMorgan*) case.

1. BP Savings Plan v. Northern Trust[118]

The BP Savings Committee (BP Committee) entered into investment manager agreements (IMA) with Northern Trust to invest BP Committee assets (securities) in lending index funds.[119] Northern Trust, through its securities lending division, found borrowers for these assets and secured collateral to invest for the benefit of the BP Committee's plan beneficiaries.[120] When the fund containing the invested collateral lost substantial value in 2008, the BP Committee was not allowed to withdraw the remaining collateral according to the investment guidelines set forth in the IMA.[121]

The BP Committee claimed that Northern Trust breached its fiduciary duties to prudently manage plan assets and disclose conflicts of interest created by the collateral investment program.[122] The BP Committee was successful in its motion to dismiss Northern Trust's claim seeking contribution and indemnification under ERISA,[123] but the fiduciary duty claims have yet to be decided.[124]

There are key distinctions that may place *BP Savings Plan v. Northern Trust* outside the scope of *Aftra v. JPMorgan*. First, the conflict of interest claim relates to Northern Trust's activities within its fiduciary capacity as a securities lending agent,[125] whereas Aftra's claim involves JPMC's activities as a non-fiduciary commercial repo lender to Sigma.[126] Second, at this stage in the pleadings, it has not been mentioned whether Northern Trust misrepresented the risk profile of the collateral pools. In *Aftra v. JPMorgan*, Sigma's demise, according to JPMC executives, was extremely likely and the most advantageous approach for the JPMC commercial

[117] Similarities are based on the factual circumstances surrounding the lawsuit and the claims asserted by the plaintiff.

[118] BP Corp. N. Am. Inc. Sav. Plan Inv. Oversight Comm. v. N. Trust Invs., N.A., 692 F. Supp. 2d 980 (N.D. Ill. 2010).

[119] *Id.* at 981.

[120] *Id.* The collateral was invested in commingled pools, and the BP Committee had rights under the investment guidelines to portions of the pool's assets. *Id.*

[121] *Id.*

[122] *Id.* at 981–82.

[123] *Id.* at 986.

[124] *BP Savings Plan*, 692 F. Supp. 2d at 986.

[125] Amended Complaint at 16, BP Corp. N. Am. Inc. Sav. Plan Inv. Oversight Comm. v. N. Trust Invs., 692 F. Supp. 2d 980 (N.D. Ill. 2009) (Civ. Action No. 08 C 6029).

[126] Bd. of Trs. of Aftra Ret. Fund v. JPMorgan Chase Bank, N.A., 806 F. Supp. 2d 662, 666 (S.D.N.Y. 2011).

lending division was to profit from the bankruptcy while leaving the securities lending and asset management divisions to determine their own courses of action.[127] However, since the *Aftra v. JPMorgan* and *BP Savings Plan v. Northern Trust* claims for breach of fiduciary duty to prudently manage plan assets have not been ruled on,[128] the respective courts may determine that these differences are moot.

III. ANALYSIS

A. Are Chinese Walls a Defense to Breach of Fiduciary Duty of Loyalty Claims?

Aftra's theory of breach can be summarized in the following way: JPMC breached its fiduciary duty of loyalty to Aftra when it secured Sigma collateral through repo agreements, such that JPMC had a higher priority to Sigma assets than the Sigma notes in which Aftra had invested.[129] According to Aftra, this was done by JPMC to capitalize on the potential profit from the more lucrative collateral at the expense of Aftra.[130] The court dismissed this theory on the grounds that even though JPMC was acting as a fiduciary in its capacity as asset manager for Aftra, it was not a fiduciary to Sigma as a repo lender.[131]

Closely mirroring the aforementioned argument is the *Pegram v. Herdrich* court's discussion of a fiduciary's right to wear multiple hats as long as the fiduciary duty hat is worn when dealing with fiduciary plan assets.[132] Although this declaration fits nicely into academic discussions, it proves more difficult when applied to real-life situations. "Decisions [are not] made in a vacuum."[133] Decisions can rarely be isolated to represent the interests of a single client. Therefore, information barriers play an essential part in curtailing conflicts of interest between different roles, or "hats."

JPMC confronted Aftra's claim on the grounds that its information barrier between the securities lending and commercial lending departments prevented a conflict of interest that would violate the duty of loyalty.[134] Proper information barriers appear to be a necessary link in the causal chain of Judge Scheindlin's holding—if a fiduciary acts outside its capacity as

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[127] *See id.* at 674–76.
[128] *Id.* at 666; *BP Savings Plan*, 692 F. Supp. 2d at 986.
[129] *Aftra*, 806 F. Supp. 2d at 682.
[130] *See id.*
[131] *Id.* at 666.
[132] *See supra* notes 92–94 and accompanying text.
[133] STEPHEN P. ROBBINS ET AL., ORGANISATIONAL BEHAVIOUR: GLOBAL AND SOUTHERN AFRICAN PERSPECTIVES 129 (2d ed. 2009).
[134] *Aftra*, 806 F. Supp. 2d at 682, 688.

fiduciary to plan assets, or in other words the fiduciary takes off the fiduciary hat and puts another on in its place, there needs to be some tactic to inhibit the use of knowledge gained while wearing the fiduciary hat in making decisions outside of that capacity.[135] Judge Scheindlin mentioned the effectiveness of JPMC's Chinese Wall policies[136] but did not cite their use as a reason for rejecting Aftra's claim.[137]

This Section inspects the interaction between information barriers and a fiduciary's ability to act outside of its fiduciary capacity to the detriment of the fiduciary's client. It finds that when a plaintiff claims the defendant breached its fiduciary duty of loyalty due to a conflict of interest, the defendant would be wise to raise two defenses. First, the defendant should assert that it was not acting within its fiduciary capacity when the breaching event occurred.[138] Second, the defendant should illustrate the effective information barriers in place between fiduciary and non-fiduciary departments.[139]

1. Hypothetical[140]

Martha gives Invest For You, Inc. (IFY) discretion to invest her retirement assets, anticipating a reasonable return. IFY also lends money to local businesses. In Y-1, IFY decides to loan XYZ Corporation (XYZ) funds from its proprietary account, the loan being secured by XYZ property. In Y-2, IFY invests in XYZ debt on Martha's behalf, as an unsecured creditor. At bankruptcy in Y-3, IFY has a higher priority than Martha in collecting XYZ assets.

What would be IFY's best defense to a breach of duty of loyalty claim brought by Martha? If IFY offers the Hats defense, it must prove it was (1) acting outside of its role as fiduciary to Martha when it loaned funds to XYZ in Y-1, and (2) making decisions exclusively for the benefit of Martha in Y-2.[141] Logically, Martha will claim IFY's investment decisions pertaining to her retirement assets were impaired or jaded by the commercial loan to XYZ of proprietary funds.[142] How would the Chinese Wall defense

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[135] *See generally id.* at 685–86 (discussing fiduciary duties and information barriers).

[136] *See id.* at 688–90.

[137] *Id.* at 666.

[138] In the interest of brevity, this defense will be called the Hats defense.

[139] This defense is called the Chinese Wall defense.

[140] This Hypothetical is different from the *Aftra v. JPMorgan* case. Aftra asserted that JPMC breached its duty solely by creating a higher priority to Sigma assets compared to Aftra's position. *Aftra*, 806 F. Supp. 2d at 682. The Hypothetical is used primarily to demonstrate the interaction between the Hats and Chinese Wall defenses.

[141] *Aftra*, 806 F. Supp. 2d at 680, 691–92.

[142] *See* Mèndez-Peñate, *supra* note 18, at 688–89. IFY may invest Martha's retirement assets in XYZ in order to improve the likelihood that they collect on the commercial loans in the event of default; there are other reasons why an asset manager may invest

assist IFY in this situation? It would eliminate Martha's aforementioned rebuttal to the Hats defense. Successfully raising the Chinese Wall defense will mean, theoretically, that IFY's public and private side departments in charge of each of the respective transactions with XYZ were unaware of the other's position.[143] The defense allows an inference[144] that IFY blocked the transfer of information about the commercial loan terms between the asset management and commercial lending departments. The nature and type of information allowed to pass between departments is a debated topic, and even the very mention of a client's name between departments could bring liability.[145] As long as the court finds IFY's information barrier to be sufficient, IFY can avoid liability under a plaintiff's conflict of interest theory stemming from the fiduciary duty of loyalty.[146]

In the Hypothetical, as in *Aftra v. JPMorgan*, Martha may claim there is a duty to pass over, or scale, the Chinese Wall in order to protect the fiduciary client's assets.[147] The plaintiff's theory would go something like this: Once IFY became privy to MNPI in its role as commercial lender to XYZ in Y-1, IFY should be *required* to disclose that information to the asset management department if the use of the MNPI could enlighten the investment decisions made on behalf of Martha's assets.[148] Wholly separate from the above analysis is a claim of breach of the duty to prudently manage Martha's assets, which may have some bearing on what information IFY is allowed to pass between departments.[149]

2. Additional Scenario Where the Hats and Chinese Wall Defenses May Be Proper

In addition to the Hypothetical, other situations exist where the Hats or Chinese Wall defenses may help a defendant avoid liability on a conflict

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Martha's assets in XYZ, such as accumulating a corporation's stock in the discretionary accounts of its clients in order to vote proxies in a way that benefits the asset manager but not the fiduciary clients. *Id.* at 690–91.

[143] In the event that IFY is comprised of a single individual, the Chinese Wall defense is purely artificial—the same person would be in charge of both investment decisions.

[144] Memorandum of the SEC in Support of Motion of Fidelity Management & Research Co. at 6–8, *In re* Federated Dep't Stores, Inc., 144 B.R. 989 (Bankr. S.D. Ohio 1992) (No. 1-90-00130).

[145] *See* Friend v. Sanwa Bank Cal., 35 F.3d 466, 468 (9th Cir. 1994) (citing 29 U.S.C. § 1104(a)(1)) (plaintiff claiming it is a per se violation of ERISA to have dual and conflicting fiduciary duties of loyalty).

[146] *See Aftra*, 806 F. Supp. 2d at 668–69.

[147] *See id.* at 689–90.

[148] *See id.* at 665–66.

[149] *See* Gorman, *supra* note 18, at 491–92 (identifying "catch-22" scenarios where compliance with Chinese Walls produces subpar results for fiduciary clients and potential breach issues for the fiduciary).

of interest claim under the fiduciary duty of loyalty. In an often-evolving industry, new and novel episodes of conflicting interests are ever-present,[150] and there are assuredly many more scenarios that may arise in the fiduciary duty context than are shown here.

A plaintiff may allege that it is a per se violation for a defendant to represent two fiduciary clients whose interests conflict.[151] Often, this claim arises in the context of corporate executives who act in two roles: corporate officer and pension plan fiduciary for employee assets.[152] In this type of scenario, a pension plan's claim against the officer would invoke an argument similar to that of Aftra[153]—officers should utilize MNPI gained in their role as corporate officers (a fiduciary role to shareholders) when disposing of pension plan assets. Corporate executive defendants can assert a Hats defense to show that when making decisions in a fiduciary capacity to pension plan beneficiaries, they did so *independent* of any other competing interests, and vice versa for actions in its fiduciary capacity to shareholders.[154] In reaction to the same claim, a Chinese Wall defense may be called upon to protect the executive from the illegal act of transferring MNPI in violation of insider trading laws. Support for this argument comes from the rejection[155] of the previously permissible activity of trustees seeking information from any source that would assist in making decisions beneficial to the trust assets.[156]

A claim for breach of fiduciary duty of loyalty due to a conflict of interest should investigate two questions. First, is the fiduciary trustee acting within its capacity as fiduciary to the plan when a decision is made, or is a non-fiduciary hat on at the time of the decision?[157] Second, was an effective

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[150] Joanna Benjamin, *The Narratives of Financial Law*, 30 OXFORD J. LEGAL STUD. 787, 791–92, 796–97 (2010) (outlining the basic themes of the financial law and demonstrating its prominence in the industry).

[151] *See* Friend v. Sanwa Bank Cal., 35 F.3d 466, 468 (9th Cir. 1994).

[152] Curtiss-Wright Corp. v. Schoonejongen, 514 U.S. 73, 78 (1995); *In re* Enron Corp. Sec., Derivative & "ERISA" Litig., 284 F. Supp. 2d 511, 550 (S.D. Tex. 2003).

[153] *See Aftra*, 806 F. Supp. 2d at 690.

[154] *See* Shelby D. Green, *To Disclose or Not to Disclose? That Is the Question for the Corporate Fiduciary Who Is Also a Pension Plan Fiduciary Under ERISA: Resolving the Conflict of Duty*, 9 U. PA. J. LAB. & EMP. L. 831, 852 & nn.118–19 (2007). Courts are split on when the Hats defense is appropriate; the determining factor appears to be when the decision regarding the pension plan is a business decision (amending a plan) or a fiduciary decision (offering new investment options to employees as part of their pension plan). *Id.*

[155] Cady, Roberts & Co., Exchange Act Release No. 6668, 40 SEC 907 (Nov. 8, 1961).

[156] Herzel & Colling, *supra* note 18, at 76–77.

[157] Under the broad functional definition of fiduciary in 29 U.S.C. § 1002(21)(A), the question of whether the entity was acting in its fiduciary capacity will be a fact-intensive inquiry. *See* Thomas Gies, *Current Issues in ERISA Fiduciary Breach and Benefit Claims Litigation*, *in* PRACTISING LAW INST., ERISA LITIGATION 10 (2008).

information barrier in place to prohibit the transfer of MNPI between public side (fiduciary) and private side (commercial lending or underwriting) activities?[158] Depending on the plaintiff's theory of breach, the first question may end the inquiry. However, in most instances, as in the Hypothetical above, the second question must also be addressed.

B. An Alternative Theory of Aftra's Breach Claim

Judge Scheindlin noted on three occasions that Aftra's theory of breach was *not* based on the belief that JPMC's position as repo dealer influenced its decisions as fiduciary of Aftra funds.[159] If Aftra had pled this theory, they would have been required to show JPMC engaged in a prohibited transaction where a conflict of interest existed.[160] The factual evidence to assert this theory of breach would likely have come from internal JPMC correspondence between public and private side departments outlining their respective investments in a third party and how JPMC could benefit at the expense of Aftra. However, it is unlikely JPMC executives would have been naive enough to put such a plan in writing. Therefore, an inference would have been required by taking into account communications between the departments where the assets of JPMC, Aftra, and Sigma are managed. The record indicates three exchanges, discussed below, where either 29 U.S.C. § 1004(a)(1)(A) or 29 U.S.C. § 1106(b)(2) could be implicated.[161]

In the first communication (Email #1), a private side executive mentioned discussions he had with SIV market investors, including the JPMC securities lending division, about the likely upheaval of the SIV market.[162] After distribution of Email #1 to various public and private side executives, another communication (Email #2), sent on behalf of JPMC CEO Jamie Dimon, directed that a study be carried out by the asset management division of the JPMC clients who had the most exposure to the SIV market, with a particular emphasis on Sigma.[163] The third communication (Email

[158] Whether the Chinese Walls guidelines are upheld in a particular case is a question of fact. Gary Barnett & Michael Herman, *Selected Securities Law Issues with Respect to Commercial Mortgage-Backed Securities: Market-Maker Prospectus Delivery Requirement; Research Reports; Insider Trading Issues and Chinese Walls*, *in* NEW DEVELOPMENTS IN SECURITIZATION 29, 55 (PLI Commercial Law & Practice, Course Handbook Ser. No. 732, 1995).

[159] *See* Bd. of Trs. of Aftra Ret. Fund v. JPMorgan Chase Bank, N.A., 806 F. Supp. 2d 662, 666, 685, 687–88 (S.D.N.Y. 2011).

[160] *See supra* notes 97–99 and accompanying text.

[161] *See* 29 U.S.C. §§ 1104(a)(1)(A); 1106(b)(2) (2006).

[162] *See Aftra*, 806 F. Supp. 2d at 671–72. The email contained evidence of the SIV market panic and outlined possible profit opportunities due to the poor financial shape of the market. *Id.*

[163] *Id.*

#3), an email within the private side between executives, stated that the JPMC asset management division was a large purchaser of SIV and Sigma assets, and it questioned if a firm-wide position would need to be taken into consideration before entering repo agreements with Sigma.[164]

The content of Emails #1 and #3 was permissible because the private side did not divulge any MNPI about Sigma; in fact, it was doing market research to decide if JPMC should lend to Sigma on a repo basis.[165] However, Email #2 provides telling insight into the knowledge of wall-straddlers.[166] Because Dimon was privy to information on both sides of the Chinese Wall, his decisions are inherently suspect for a conflict of interest.[167] Dimon's request for a study of exposures may indicate to the asset management department that something needs to be done regarding Aftra's investment in Sigma,[168] but it does not call into question its loyalty to Aftra. Both 29 U.S.C. § 1004(a)(1)(A)(i) and 29 U.S.C. § 1006(b)(2) are written as obligations on the fiduciary actor, not the non-fiduciary commercial lender.[169] In order to find a violation of these statutes, we must find evidence of the fiduciary acting within that capacity to the detriment of the fiduciary client.[170] No indication is given in Email #2 that Dimon directed the asset management department to maintain its position in Sigma's MTNs (on behalf of Aftra) to help JPMC's firm-wide position. Although courts are content to allow circumstantial evidence and reasonable inferences to prove intent in these types of cases,[171] no such evidence appears in the record. Therefore, if Aftra would have pled a separate theory of JPMC's breach of fiduciary duty of loyalty, it would probably not have prevailed on the facts provided.

C. Solutions to the Chinese Walls and Duty of Loyalty Debate

Debate against the consolidation of the financial services industry has only increased since the financial crisis of 2008.[172] The number of conflicts

[164] *Id.* at 673.
[165] *Id.* at 672–73.
[166] *See supra* notes 77–79 and accompanying text.
[167] *See Aftra*, 806 F. Supp. 2d at 669, 689.
[168] Aftra's duty to prudently manage plan assets was not decided on by the court. *Id.* at 666.
[169] Although they both may be part of the same commercial entity.
[170] *See* 29 U.S.C. §§ 1104(a)(1)(A); 1106(b)(2) (2006).
[171] *See* Robert N. Eccles et al., *Fiduciary Litigation Under ERISA*, *in* ERISA LITIGATION 555, 591 (PLI Litig. & Admin. Practice, Course Law Handbook Ser. No. 788, 2008) (citing Davidson v. Cook, 567 F. Supp. 225, 236 (E.D. Va. 1983)).
[172] Jeff Merkley & Carl Levin, Policy Essay, *The Dodd-Frank Act Restrictions on Proprietary Trading and Conflicts of Interest: New Tools to Address Evolving Threats*, 48 HARV. J. ON LEGIS. 515, 531–32 (2011); *see also* Sharon E. Foster, *Systemic Financial-Service Institutions and Monopoly Power*, 60 CATH. U. L. REV. 357, 400 (2011) (discussing financial

of interest increase with the size of the financial institution and the types of activities in which it engages.[173] Many solutions are proffered to deal with these conflicts, and two are inspected here.

1. Breakup of Multiservice Financial Institutions

One suggestion is to break up, or separate, the functions of multiservice institutions.[174] This proposal attempts to segregate investment and commercial banking activities, much like the GSA did in 1933.[175] Under this proposal, JPMC would be required to break up and disaffiliate public and private side departments.[176] Such a shift in the financial services landscape would have tremendous effects—impacting the securities market's ability to raise capital[177] and corporate profit margins,[178] to name just one.

Separation of public and private side businesses would have avoided the plaintiff's perceived conflict of interest claim in *Aftra v. JPMorgan*.[179] The JPMC asset management department would have been its own separate entity and not subject to the influence of wall-straddlers, firmwide positions, or the like. Judge Scheindlin dismissed the disaggregation of financial services because it would "negat[e] the legislative will and public policy expressed in decades of legislation and regulation."[180] The monetary costs of divesting and disaggregating the financial services industry would likely far exceed any benefit gained by omitting losses to investors due to perceived (or actual) conflicts of interest.[181]

2. Restricted and Watch Lists

Restricted and watch lists function to make both public and private side employees aware of clients who may present a conflict of interest to the

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services institutions' monopoly power and suggesting the Dodd-Frank Act gives insufficient authority to breakup these institutions on antitrust grounds).

[173] *See supra* notes 3–4, 11–13 and accompanying text.

[174] Poser, *supra* note 18, at 120.

[175] *See generally* Banking (Glass-Steagall) Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (1933) (codified in scattered sections of 12 U.S.C.).

[176] Poser, *supra* note 18, at 120–21.

[177] *See id.*

[178] *See* David L. Abney & Mark. A. Nadeau, *National Banks, The Impassable "Chinese Wall," and Breach of Trust: Shaping a Solution*, 107 BANKING L.J. 251, 255–56 (1990); *see also* Mèndez-Peñate, *supra* note 18, at 703–04.

[179] *See generally* Bd. of Trs. of Aftra Ret. Fund v. JPMorgan Chase Bank, N.A., 806 F. Supp. 2d 662, 690–91 (S.D.N.Y. 2011) (discussing why separation is essential to minimize bias).

[180] *Id.* at 690 (citation omitted).

[181] *See* Herzel & Colling, *supra* note 18, at 74.

firm.[182] The components of these lists vary greatly, from complete prohibitions on trading (restricted list)[183] to supervision of trading by compliance personnel (watch list) to ferret out conflicts of interest.[184]

The record does not reflect if JPMC had either type of list in place at the time of the *Aftra* ruling. However, there are drawbacks to both approaches. If JPMC imposed restricted list requirements, either the public side or the private side would lose business, because if the private side is associated[185] with a client or company, the other is restricted from dealing with that client, and vice versa.[186] Watch lists require the involvement of the compliance department[187] in both public and private side activities, greatly increasing compliance costs.[188] Also, when more employees are permitted to stand astride the information barrier,[189] the potential for insider trading violations increases.[190] Restricted and watch lists have been proven ineffective at improving Chinese Walls,[191] and while the lists might have altered the decisions of JPMC executives in the *Aftra* case, they would pose a substantial cost if implemented as a mandatory fixture in the financial services industry.[192]

CONCLUSION

Conflicts of interest have long been an issue in the financial services industry because of the "complex and opaque web of relationships" and products offered by multi-service institutions.[193] In an attempt to combat these

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[182] *See* Kenneth L. Josselyn, *Legal Issues Relating to Offerings of "Securitized Derivatives*,*"* UNDERSTANDING FINANCIAL PRODUCTS 2012, at 481, 490 (PLI Corporate Law & Practice, Course Handbook Ser. No. 1928, 2012) (noting the importance of walling off MNPI in financial institutions).

[183] *See* Poser, *supra* note 18, at 118. When a client or security is on a restricted list, the client or security cannot be the subject of recommendations or be traded. *Id.*

[184] *Id.*

[185] Involvement would include, but is not limited to, being an underwriter for a company's securities, commercial lender to a company, or asset manager to a company or entity.

[186] *See supra* notes 88–89 and accompanying text.

[187] *See* Poser, *supra* note 18, at 118.

[188] *See id.* (suggesting increased internal costs due to the extra workload placed on the compliance department).

[189] *See* Hunsicker, *supra* note 79, at 645.

[190] *See* Poser, *supra* note 18, at 118.

[191] Gorman, *supra* note 18, at 494–95.

[192] Bd. of Trs. of Aftra Ret. Fund v. JPMorgan Chase Bank, N.A., 806 F. Supp. 2d 662, 690 (S.D.N.Y. 2011).

[193] *See* Onnig H. Dombalagian, *Investment Recommendations and the Essence of Duty*, 60 AM. U. L. REV. 1265, 1282 (2011) (focusing on the conflict of interests stemming from the compensation structure of multiservice financial institution employees).

conflicts, firms establish walls between departments where those interests may conflict.[194] Characteristics of these barriers, or Chinese Walls, range from disseminating a written policy that outlines prohibited communications between departments and employees to more expensive actions like physical separation of departments or sophisticated computer firewall protections.[195] If MNPI passes over or is allowed to scale the Chinese Wall, then in a subsequent lawsuit for breach of fiduciary duty, the defendant has the burden to prove the information was not used illegally.[196]

When a claim is not likely to prevail on Rule 10b-5 grounds because a functioning Chinese Wall was in place at the defendant's institution,[197] a plaintiff may claim the defendant breached its fiduciary duty of loyalty because of conflicting interests.[198] Defendants have, among others, two possible defenses to this claim—the Hats and Chinese Wall defenses.[199] When and in what circumstance these defenses may be used depends on the plaintiff's theory of breach.

The court in *Aftra v. JPMorgan*[200] deemed the defendant's Hats defense sufficient to rule in its favor on a motion for summary judgment on the plaintiff's fiduciary duty of loyalty claim.[201] Interestingly, the court appears to utilize the Chinese Wall defense as a partial justification for its ruling.[202] The Hypothetical offers an examination of the relationship between these defenses.[203]

In the Hypothetical, the defendant fiduciary profited from a commercial loan at the expense of its fiduciary client.[204] The fiduciary may defeat the client's duty of loyalty claim by showing it did not act in its capacity as fiduciary[205] when collecting on the commercial loan. Because of the difficulty in determining which hat a defendant is wearing at a particular moment in

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194 *See* Herman & Safanda, *supra* note 57, at 21.

195 *See supra* notes 68–75 and accompanying text.

196 *See* SEC v. Adler, 137 F.3d 1325, 1336–38 (11th Cir. 1998).

197 *See* BROMBERG & LOWENFELS, *supra* note 73, § 6:274.

198 *See* Christine M. Bae & Carlton R. Asher, Jr., *Chinese Walls—Procedures and Remedies for Dealing with Conflicts of Interest and Other Abuses by Broker-Dealers in Connection with Conduct by Their Securities Analysts*, *in* SECURITIES ARBITRATION 2002: TAKING CONTROL OF THE PROCESS, 123, 129–30 (PLI Corporate Law & Practice, Course Handbook Ser. No. 1327, 2002) (noting that the defendant's liability in *Slade v. Shearson* was under a breach of fiduciary duty claim, not a 10b-5 violation).

199 Bd. of Trs. of Aftra Ret. Fund v. JPMorgan Chase Bank, N.A., 806 F. Supp. 2d 662, 668–69 (S.D.N.Y. 2011).

200 *Id.*

201 *Id.* at 666.

202 *See supra* notes 134–37 and accompanying text.

203 *See supra* notes 140–47 and accompanying text.

204 *See supra* notes 140–47 and accompanying text.

205 *See* 29 U.S.C. § 1106(b)(2) (2006); *supra* notes 91–94 and accompanying text.

time, the Chinese Wall defense complements the Hats defense by assuring the court that no MNPI was acquired by the fiduciary when it transacted in its fiduciary role.[206] Although illegal,[207] a client may argue for the fiduciary to pass MNPI over or through the information barrier. Wise financial institutions will construct Chinese Walls and document the effectiveness of these measures in order to rebut a plaintiff's duty of loyalty claim.

Aftra could have brought its breach of duty of loyalty claim on an alternative theory, asserting that JPMC's management of Aftra assets was influenced by its repo positions with Sigma.[208] Under this claim, a court must analyze internal JPMC correspondence in search of proof, by inference or circumstantial evidence,[209] that executives forced or coerced JPMC asset managers into decisions relating to Aftra assets, which were not in the plan's best interests. The inquiry is fact-specific and susceptible to failure because executives are unlikely to put such directives in writing that can later be divulged in discovery. However, this approach permits the plaintiff to put forth a theory that is not necessarily rebuffed by a defendant's Hats defense.

In response to the conflicts of interest in the financial services industry, two proposals have been advanced to limit or eliminate fiduciary duty of loyalty claims. Complete divestment by a financial holding company of its public or private side operations would harm the financial services industry beyond any gain acquired by fiduciary clients from avoiding the issue of conflicting interests.[210] Additionally, and perhaps more importantly, such an action would be incongruent with Congress's intent in enacting the Gramm-Leach-Bliley Act.[211] Restricted and watch lists are offered as alternatives to conventional Chinese Walls policies.[212] Imposing broad restricted lists on large multi-service financial firms eliminates many potential

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[206] *See supra* notes 91–94 and accompanying text.

[207] *See* Cady, Roberts & Co., Exchange Act Release No. 6668, 40 SEC 907 (Nov. 8, 1961). *But see* Slade v. Shearson, Hammill & Co., Inc., 517 F.2d 398 (2d Cir. 1974) (finding the defendant liable for breach of fiduciary duty of loyalty in spite of the defense that the information barrier functioned correctly on the grounds that defendant voluntarily entered into two conflicting fiduciary relationships). The case was ultimately settled after the appeals court remanded without answering the trial court's certified question involving a controlling question of law. *See* BROMBERG & LOWENFELS, *supra* note 73, § 6:274.

[208] *See supra* notes 161–62 and accompanying text.

[209] *See* Eccles et al., *supra* note 171, at 591.

[210] *See supra* notes 182–83 and accompanying text.

[211] Gramm-Leach-Bliley Financial Modernization Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified in scattered sections of 12 U.S.C. and 15 U.S.C.).

[212] *See* JEFFREY M. KAPLAN & JOSEPH E. MURPHY, COMPLIANCE PROGRAMS AND THE CORPORATE SENTENCING GUIDELINES § 24:20 (2011).

clients and securities from both public and private side functions,[213] whereas watch lists provide more opportunities for insider trading[214] and increase costs by requiring additional compliance personnel to monitor trading. Although Chinese Walls may be inept at protecting investors from large losses,[215] as in the case of *Aftra v. JPMorgan*,[216] they will continue to occupy an important locus in the panorama of financial services regulation.

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213 *See supra* notes 88, 89, 185, 187 and accompanying text.

214 *See supra* notes 189–90 and accompanying text.

215 *See* Gorman, *supra* note 18, at 491–92.

216 Bd. of Trs. of Aftra Ret. Fund v. JPMorgan Chase Bank, N.A., 806 F. Supp. 2d 662, 695–96 (S.D.N.Y. 2011).

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