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Dear Harvey:

This letter responds to your letter of April 30, 1987 and the enclosed draft of a proposed Section 16A dealing with insider trading.

GENERAL COMMENTS

1. Policy Considerations. In general, prohibitions against insider trading are necessary in order to achieve individual fairness and in order to protect the integrity of the securities markets. The prohibitions should not, however, be extended in a manner which will have the effect of stifling trading in the equities markets and eroding the excellent secondary markets for securities which have long characterized the economy of the United States. An insider trading provision should not be drafted in a manner which will have the effect of forcing transactions away from our securities markets into overseas markets.

2. Scienter. The statute should explicitly and clearly set forth the mental state necessary for violations.

3. Relationship to Other Sections. The relationship between proposed Section 16A and other sections should be clearly set forth. For instance, will actions under Section 16(b), Section 10(b) and Rule 10b-5, and Section 14(e) and Rule 14e-3 be precluded or permitted?

4. Reliance on Commission Rule Making. Reliance on the Securities and Exchange Commission to provide exemptive rules as a means of achieving necessary protections should be avoided, since one cannot predict with certainty the content of such rules or whether they will be adopted.

5. The Misappropriation Theory. The misappropriation theory has no reasonable relationship to the desire to protect the integrity of the marketplace and should be abandoned.

The theory reaches much too far and has no identifiable limits. Instead, the legislation should identify those specific areas of activity which merit regulation and deal with them specifically. The areas which merit attention in connection with purchases or sales of securities are:

(a) Use of material, nonpublic corporate information by corporations, controlling shareholders, directors, officers, employees, and "temporary insiders";

(b) Use of material, nonpublic information about a tender offer or proposed tender offer by a person other than the bidder or the bidder's broker or agent;

(c) Communicating the information described in any of the above categories to a person who uses the information (Tippers);

(d) Using the information described in any of the above categories after receiving it from a person described in any of the above categories (Tippees).

SPECIAL COMMENTS ON PROPOSED SECTION 16A

6. Subparagraph (a)(4) is ambiguous. The phrases "without affecting existing statutory prohibitions" and "shall provide the exclusive statutory standards" make unclear whether Sections 16(a), 10(b), and 14(e) will continue to be viable with regard to insider trading.

7. Subparagraph (b)(1) should be redrafted to limit the types of "material, nonpublic information" and the definition of "wrongfully" to the categories suggested in 5(a) and 5(b) above and perhaps to other categories, such as investment advisors engaged in "scalping". As drafted, this subparagraph seems intended to adopt the misappropriation theory in order to provide latitude for regulators, prosecutors, and persons bringing private actions. As noted above, the theory reaches much too far and has no identifiable limits. Instead of introducing certainty into the law, the subsection will result in tremendous uncertainty and will make the SEC the policeman for many situations which should be resolved privately.

8. Subparagraph (b)(1) contains a confusing mental state standard, even if the wrongful use concept is retained.

(a) The phrase "has reason to know" is ambiguous. Does it imply a duty to investigate? If it does, the policy is wrong and the phrase should be deleted. If it does not, the phrase is redundant and should be deleted.

(b) The phrase "would constitute a wrongful use" has no mental state attached to it. A consistent standard of knowledge should be used. This consistency could be achieved by drafting the provision as follows (assumed deletion of the "reason to know" provision) and beginning after "securities":

> "…, if such person: (A) knows that such information has been wrongfully obtained; or (B) knows that the purchase or sale of such security would constitute a wrongful use of such information."

(c) If desired, the phrase "(or is reckless in not knowing)" could be added.

9. Subparagraph (b)(2) introduces the phrase "or the market therefor" in a manner which seems to extend the reach of the "information" to "market information." Prohibitions against the use of information about the market for securities no matter how obtained would seriously interfere with many ordinary securities transactions. The phrase "or the market therefor" should be deleted.

10. Subparagraphs (2)(A) and (B) seem necessary only if Subparagraph (2) regarding presumptions is included. Since they seem merely to state the law as one would expect it to develop, the whole subparagraph could well be deleted. If the purpose is to allow a "Chinese Wall" to be created, something different than the word "relevant" should be used. The question is what weight will be given to the creation of a wall. If the subparagraph is continued, it would be clearer by changing the provisions after the word "overcome" to say:

> "if such person sustains the burden of proving either:
>
> (A) that (i) the purchase or sale of the security was not influenced by such material, nonpublic information and (ii) the individual effecting the purchase or sale, or causing others to purchase or sell, on behalf of such person did not know the material, nonpublic information; or
>
> (B) , that such person has implemented and maintained reasonable policies and procedures to prevent violations of this Section by the individuals making or influencing investment decisions on its behalf."

Changing the subparagraphs in the manner suggested above demonstrates the weakness in the present draft. The important point is not whether a general Chinese Wall policy is in existence, but whether it was effective in the particular instance. This observation also suggests deletion of Subparagraph (b)(2) or its revision to make the Chinese Wall provision applicable to the particular transaction. If the latter course is chosen, the last sentence of Subsection (b)(2)(B) as currently drafted might read as follows:

> "A person other than a natural person may sustain its burden of proof under this Subsection (b)(2)(B) by showing that it had implemented and maintained reasonable policies and procedures to prevent violations of this Section by the individuals making or influencing the decisions to purchase or sell the security."

11. Subparagraph (c)(2) is broader than current SEC Rule 14e-3 and raises many difficult questions of interpretation. It should be deleted. Instead, the equivalent of Rule 14e-3 should be drafted as part of the class of prohibited activities (see the suggestions in 7 and 5(b) above).

12. Subparagraph 2(d) seems somewhat ambiguous. Without the second sentence one might conclude that an employer could avoid liability by a showing that he "neither participated in, nor directly or indirectly induced the acts constituting the violation of this Section." But the second sentence seems to imply that failure to have a general policy for preventing insider trading will bring one within the "indirectly induced" language. The second sentence thus seems to reduce the protection of the first sentence. To test the meaning, would it be consistent to strike the second sentence and to add at the end of the first sentence: "and if such controlling person or employer had implemented and maintained reasonable policies and procedures for preventing violations of this Section."?

13. Subparagraph 2(e) introduces redundant and possibly confusing language by use of the term "implement." The Commission already has power under Section 23(a)(1) to make rules "to implement." The language of Subparagraph 2(e) does not use the term "define, and prescribe" as used in Section 14(e) or "prescribe" as used in Section 10(b). What is the purpose of the grant of rule making power?

14. Subparagraph (f) might be easier to read if it were broken into separate subsections. Regarding the statute of limitations, why not be specific and say "more than five years after the date of the purchase or sale," rather than refer to Section 21(d)(2)(D)?

My comments should be understood as supportive of an effort to define insider trading in order to create certainty, but not supportive of an effort to increase the reach of the insider trading restrictions to persons who do not have scienter in the Rule 10b-5 sense or to persons whose activities are remote from the securities markets.

If any additional comments are desired, please contact me.

Sincerely yours,

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Professor of Law