S. HRG. 100-155, Pt. I

DEFINITION OF INSIDER TRADING

HEARINGS

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

PROPOSED LEGISLATION TO CLARIFY THE LAW ON INSIDER TRADING WHICH WILL PROVIDE EVERY PROFESSIONAL AND FIRM ENGAGING IN THE SECURITIES BUSINESS, AS WELL AS EVERYONE ELSE, WITH A SINGLE STATUTE TO DETERMINE WHAT THE LAW IS AND WHAT THEIR LIABILITY IS IN THE AREA. PROSECUTION WILL BE EASIER AND PUNISHMENT WILL BE TOUGHER WHEN THE LAW IS CLEAR

PART I

JUNE 17, 19, 1987

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE
75-705 WASHINGTON : 1987

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

DEFINITION OF INSIDER TRADING

PART I

WEDNESDAY, JUNE 17, 1987

U.S. SENATE,
SUBCOMMITTEE ON SECURITIES,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met at 10:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the subcommittee) presiding.

Present: Senators Riegle, Proxmire, Sasser, Shelby, Wirth, D'Amato, Hecht, and Bond.

OPENING STATEMENT OF SENATOR RIEGLE

Senator RIEGLE. The subcommittee will come to order.

This morning we begin the first of three hearings on proposed legislation to clarify the law on insider trading. The current epidemic of insider trading is intolerable. This legislation will provide every professional and firm engaging in the securities business, as well as everyone else, with a single statute to determine what the law is and what their liability is in this area. Prosecution will be easier and punishment will be tougher and more certain when the law is clear.

Effective prohibitions are also necessary to preserve the integrity of our capital markets and their ability to serve important national and international economic functions, certainly foremost among them, capital formation.

Insider trading impairs the integrity of our capital markets and is undermining public confidence in them and we mean with this legislation and other companion legislation to deal directly with that problem and to do everything we can to fix it.

In terms of our hearing today, Senator D'Amato laid the foundations for this legislation with hearings that he held in the 98th Congress as chairman of this subcommittee, and we have been working together on this subject since I became chairman in this Congress.

Mr. John Olson also laid the foundations as chairman of the American Bar Association's task force on regulation of insider trading. On February 24 of this year, I requested Mr. Harvey Pitt, a former general counsel of the SEC, to work with Mr. Olson and a group of other distinguished securities lawyers to develop a plain language, workable overhaul of the law applicable to insider trading. I asked them if they would try to have a proposal ready within

90 days. The members of this lawyers' group are among the top securities practitioners in the country. They also represent a diverse set of interests. Some have close ties to industry, others have spent much of their careers as prosecutors at the SEC. Two members were SEC commissioners, one a general counsel, two were directors of the division of enforcement, and one was associate director of that division.

This ad hoc committee went about its task by considering drafts of a proposed statute, discussing the issues in a series of meetings, and arriving at a tentative proposal. The committee sought and received comments on that proposal from persons with ties to a wide range of industry groups. Those comments were circulated and discussed and the committee then adopted its current proposal which they have brought to us.

That these lawyers could develop a consensus definition and still meet the 90-day target date that we had set is a great accomplishment and we thank them for it, and it's a credit certainly to their professionalism.

I believe that this legislation, together with the bill that I introduced with Senator Proxmire and other members of the committee on June 4 on tender offer reform, will not only clarify the law regarding insider trading but will help stop that kind of abuse. It will buttress the prosecution of these cases and I think importantly help restore confidence in our capital markets.

The legislation we introduced on June 4 increases the maximum imprisonment for insider trading from 5 years to 10 years and the maximum fine from $100,000 to $1 million. It also requires a minimum sentence of 1 year for perjury or obstruction of justice in connection with an insider trading investigation.

So if one puts both the tighter and more clearly drawn law together with the tougher penalties in parallel and companion legislation, we start to see how we can really begin through legislative efforts help stop the abuses that have been taking place.

Today we are going to hear from Harvey Pitt and John Olson and we are going to hear from Dean Henry Manne of the George Mason University School of Law, and from Professor Gary Tidwell of the College of Charleston.

For June 19, we have invited witnesses from the administration and the SEC.

Now before yielding to my colleague, Senator D'Amato, I want to make one other comment that relates to this but it's on a different subject because it's topical and it's in the news this morning. That is the story in the Wall Street Journal indicating the intention of the Reagan administration to nominate a candidate to succeed John Shad as the head of the SEC, a professor by the name of Mr. David S. Ruder at Northwestern Law School. I just had it confirmed by phone a short time ago that that information is accurate and he will be formally sent up here as the nominee.

And I must say that this is one of the most important positions in our Government and certainly at a critical time with respect to what's going on in the financial markets and the whole problem—the contagion of insider trading that we have seen. So it's very important that we have someone who has a strong attitude with respect to cracking down on the abuses that have been taking place

and who would support a strong enforcement program. And while this is a person of some considerable professional history, it's unclear to me at this point as to whether or not this nominee would bring that kind of strong commitment in that area. I don't know one way or the other, but I know this—that if we were to confirm as an SEC chairman someone who's not prepared to move ahead with the same strength and commitment that John Shad and his people have done, then it would be a real setback to the country.

So we will be examining that with great care and I would hope that we would find that this nominee measures up, but if not, then we will be quite frank in saying so.

With that, let me yield to my colleague, Senator D'Amato.

Senator D'AMATO. Well, Mr. Chairman, let me commend you for moving forward on this legislative initiative and I thank you for having given us such a substantial role in the development of the legislative proposal before us today. I think that we have to undertake more of these legislative initiatives in a bipartisan fashion. So I commend you for that.

Mr. Chairman, I'm going to ask that my complete statement be included in the record as if read in its entirety so that we can hear from the witnesses, but I would like to refer to just a portion of it.

There's a very real question with respect to the clarity of the present law, the definition of what constitutes insider trading. The present state of uncertainty in the law is simply unacceptable.

Now who stated that it's unacceptable? The Supreme Court of the United States has said that it's unacceptable. They said, "Congress, you must give us clearer standards." It said that in the *Dirks* and *Chiarella* cases. So in response to those who say, "You will be providing loopholes by which people can escape the law," I state that this simply not the case.

Prosecutors believe that more clarity is needed. It's one thing for the SEC to bring cases civilly. It's another thing for the U.S. attorney's office in the Justice Department to bring successful criminal prosecutions. The U.S. attorney from the southern district of New York, Rudolph Guiliani, in testimony before this committee, Mr. Chairman, indicated the need for definition. And it's simply absolutely unrealistic to go by the standard which says, "Well, I know it when I see it but I can't tell you what it is. I can't define it." That's nonsense.

Now I recognize that there are legitimate concerns regarding a standard that people can identify. Further, we do not want certain activities to escape the definition and I believe that we have sufficient wherewithal both in this legislation as proposed to address the legitimate concerns of a few of my colleagues who are concerned that the legislation will create loopholes whereby clearly illegal activities would not be covered.

I hope we will continue with the legislation in spite of the heavy schedules and calendars that we have. I am pleased to be a part of this legislative initiative.

[The complete prepared statement of Senator D'Amato follows:]

STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. This morning Senator Riegle and I are introducing the Insider Trading Proscription Act of 1987. We are introducing this bill because it is a needed complement to the Insider Trading Sanctions Act of 1984—a bill which I sponsored, advocated and which was ultimately enacted. At that time I believed and still believe that a definition of insider trading was needed.

Why do I believe this? I think it is clear that the present state of uncertainty about the law is simply not acceptable. The ambiguities about the law were vividly demonstrated in subcommittee hearings earlier where members of the securities industry and securities bar could not specify what conduct constituted insider trading and what conduct is permissible. I believe that an "I know it when I see it standard" is totally unacceptable.

Further, the Supreme Court in the *Dirks* and *Chiarella* cases have requested guidance from Congress in determining prohibited and permissible conduct. Therefore, it is incumbent upon Congress to confront the basic policy questions of what uses of informational advantage are to be forbidden, rather than leaving the law to be developed on a case by case basis.

Some have criticized the legislation because a definition could permit crooks to elude the grasp of the SEC. I think that a failure to clarify the law permits creative lawyers to find loopholes in the legal theories espoused by the SEC. Clarity in the law will not handcuff the SEC. The statute embodies the insider trading theories employed by SEC prosecutors. The application of the statute by the SEC can be applied to novel and unique situations with the increased certainty provided by a congressional pronouncement on the subject. It is time that Congress state the public policy goals that the SEC, the industry and the securities bar should follow in determining what activities constitute appropriate market activities.

This legislation, which we propose as an amendment to the Securities Exchange Act of 1934 in the form of a new section 16A, codifies and clarifies the overarching principles set forth by the courts concerning the scope and purpose of the prohibition against insider trading, while eliminating the ambiguities that emerged from the case-by-case evolution of the law in this area. Indeed, considerable uncertainty permeated the jurisprudence of insider trading precisely because the theories upon which insider trading prosecutions have been founded were developed without the involvement of Congress.

In my view, Congress should take the opportunity to focus on this important issue and put its imprimatur on a legislative approach to prohibiting this brand of unfair dealing in the Nation's capital markets. In discussing the need for statutory definition of insider trading during a February 24, 1987, Securities Subcommittee hearing, there was unanimous agreement that an effort should be made to formulate a precise, plain-English definition of the offense of insider trading, to prevent the fundamental unfairness of prosecuting a crime that has never been defined.

The statute contains two operative provisions. First, the proposed legislation deals with the question of trading by persons who possess material, nonpublic information concerning the security traded. Second, the proposed legislation addresses the communication (or tipping) of material, nonpublic information. In both cases, a broad prohibition is set forth, followed by a statement of defenses and limitations imposed on governmental prosecutions.

This bill is a starting point in our deliberations on an appropriate response to a definition of insider trading. It embodies many of the principles contained in bills I introduced earlier this year.

The legislative proposal will be subject to the subcommittee's closest scrutiny in upcoming hearings. The bill represents our best efforts to provide guidance to the SEC, the courts, the securities industry and the securities bar in their determination of what constitutes permissible and prohibited conduct. The legislative proposal endeavors to establish principles that will be applied to test securities trading activity for possible abuses in cases involving the use of wrongful informational advantage.

Senator RIEGLE. Thank you, Senator D'Amato.

Let me now call on the chairman of the full committee, Senator Proxmire.

Senator PROXMIRE. Why don't you go ahead. I'm not a member of this subcommittee and I'm delighted to wait for the others to make statements.

Senator RIEGLE. Senator Shelby.

OPENING STATEMENT OF SENATOR SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

Again, I want to also commend you for your continued leadership in addressing the need to curb insider trading abuses here.

I also want to commend the work and tremendous effort put forth by the members of the Pitt Commission to develop a statutory definition of insider trading. That's no easy task.

The recent insider trading scandals have shaken the very foundation of public confidence in the financial markets. We all know this. Clearly, action must be taken to curb these trading abuses.

In developing a definition of insider trading, we must be careful, however, to strike a balance between the need to eliminate illegal insider trading and the need for the legitimate flow of corporate information in the marketplace. That's hard to do.

Efforts to establish a definition of insider trading have defied Congress in the past.

While Congress failed to enact a definition of insider trading in 1984, Congress indeed did pass the Insider Trading Sanctions Act of 1984 which stiffened penalties in an attempt to deter insider trading. Apparently, these deterrents were not sufficient.

Recent insider trading revelations, including the *Boesky, Siegel* and *Winans* cases, have been the impetus here for Congress to again focus its attention on the need for a statutory definition of insider trading.

It's obvious that the lack of clarity and uncertainty associated with these trading laws and the regulations have been the source of confusion for the securities bar, the industry, and the courts.

whatever modifications along the way, I appreciate your indication of a desire to be prepared to move ahead if we can be sure that we have legislation here that is sound and is in the public interest and that willingness to so indicate is very helpful I think.

At that point, let me now turn to our witnesses and let me say again how much I appreciate the time and the effort that's gone in and the personal leadership on both your parts in producing the work product that underlies this legislation and I want to, through you, thank the other members of the group that participated. They also gave at great length of their time and professional knowledge to help us move forward.

I'm going to start with you, Mr. Pitt, but there is one specific matter that I'd like to ask you to touch on in your presentation. That is, with respect to the way the laws would work, assuming we were to pass this legislation and we were to establish this clearer legal definition out there, if some unscrupulous person using the creativity of their mind were to figure out a way to violate the law and to take advantage unfairly in a stock trading situation that is not explicitly covered under what we have drafted here, how would that situation be dealt with? How would we envision that kind of problem?

I think this is one way of framing the issue of whether or not you can write a definition that in a sense is equal to the deviousness of a person with a corrupt motive, and obviously it's probably impossible to do that; but the question of how the insider trading law under this proposal would reach that new and novel attempt to find a way around even that written law is something I think we really need to nail down today. So at whatever point is appropriate, I'd like you to incorporate a response to that in your remarks. But let us hear from you now.

STATEMENT OF HARVEY L. PITT, PARTNER, FRIED, FRANK, HARRIS, SHRIVER & JACOBSON, WASHINGTON, DC

Mr. PITT. Thank you, Mr. Chairman and members of the subcommittee. My name is Harvey Pitt and with me is John Olson. We are pleased to have this opportunity to testify on the proposed Insider Trading Proscriptions Act of 1987, a statute that's designed to set forth in plain English the definition of, and prohibitions against, what is commonly referred to as insider trading.

As I listened to the opening remarks, I must say that I was reminded of the diversity of views between those who talk about an idea whose time has come, and I think it was Janeway who referred to "Nothing quite as apocryphal as an idea that won't go away." It's our view that this is an idea whose time has come and we hope that this committee will share that.

Since I assume that our detailed joint written statement concerning this important legislation will be made part of the subcommittee's hearing record, we will not repeat those comments now, nor do I intend to belabor this hearing with a lengthy recitation of either Mr. Olson's considerable background and expertise, or my own somewhat more modest accomplishments.

It suffices, I trust, for me to note simply that we are both corporate lawyers with large, multicity law firms, are both active in and

chair relevant committees of the American Bar Association, and are both conversant with the current state of the law on insider trading, and I might add, its considerable deficiencies. The views we will present today, however, are ours alone and do not necessarily represent those of our respective law firms, clients of those law firms, or other members of the legislative committee that we will be describing shortly.

In the time allotted, I will discuss briefly the background of the proposed legislation, the specific issues that it addresses, and how the proposed statute would change or affect existing law. Mr. Olson will discuss the need for a statutory prohibition against insider trading and certain of the procedural issues this proposal would resolve. I would like then to close with a concluding thought in our oral statement.

I do want to address, however, before I start, two specific points, since I always find it more effective to deal with the questions the committee has in the order that you have raised them than in the order that we started with.

The first is the chairman's question which is, what if some unscrupulous person came up with a devious method to evade this definition?

Let me answer that in several ways and I encourage John to participate with me. First, I think the definition has been drawn sufficiently broadly that it covers most of the kinds of theories that the Government has come up with under current law that we think would deal with a broad variety of these types of situations.

STATUTE HAS TWO IMPORTANT CHANGES

However, the statute has two important changes which I think Senator D'Amato referred to when he referred to the Supreme Court. First, there would be congressional findings in this statute that make it clear that this committee and the Congress think insider trading is wrong and the reasons why this committee thinks it's wrong. That has never been done before and the absence of those provisions have resulted in two major defeats for the Government in prosecutions in the Supreme Court. And if I am a soothsayer and I don't know whether I am or not, I would say that they are headed for a third or at least not a very significant help in the *Winans* case.

Given those findings, the statute would specifically give the SEC rulemaking power to implement the specific findings that Congress has set forth in the statute and I might add here that the important thing that the Supreme Court has said has been missing from current law is any view by the Congress that the real problem with insider trading is its effect on the integrity and the fairness of the marketplace. This statute would for the first time articulate that.

While I am largely a corporate lawyer, as I suspect this committee is aware, I've been involved in some insider trading matters in the recent past and I would say, as a defense lawyer—and some might dispute how highly paid——

Mr. OLSON. Only your family.

Mr. PITT [continuing]. But as a defense lawyer, I would say I would much prefer to be defending insider traders or persons ac-

cused of insider trading under the current law than I ever would be under this proposal.

We took our mission that this subcommittee gave us very seriously. I drafted this the same way I would have drafted it as if I were still at the SEC and its general counsel, and I believe every member of our committee—John Olson, who played a major role in constructing it with me and the others—did exactly the same thing, and then we ventilated it with SEC people, academics, industry people and the like. And I believe that this is an idea whose time has come and one that can be implemented with great confidence by this committee as establishing its imprimatur on what the law ought to be and the reasons why the law is presently deficient.

Let me take a moment now, having responded I hope, Senator Riegle, to the specific points you raised, just to set a little bit of background and set some of the origins for the proposal.

During my testimony before this subcommittee on February 24, 1987, I criticized the current state of law on insider trading. Senator Riegle asked if I would undertake, with a group of lawyers expert in this field, to formulate a precise, plain English definition of the offense of insider trading and related prohibitions. To that end, a committee of lawyers selected at the suggestion of the subcommittee has met over the past 3 months to discuss and prepare a proposed statute to define and prohibit insider trading and tipping, and we have attached a list of the people.

Our methodology involved circulating to our committee's members various relevant materials, including the I think now landmark report of the American Bar Association's task force on the regulation of insider trading that John Olson chaired. We also relied heavily upon the pioneering legislative proposals of Senator D'Amato. I might add that we have had at all times—and I want to return in a sense the compliment—the unstinting support of this committee, Senator Riegle in particular, as well as Senator D'Amato and members of this subcommittee's staff—Steve Harris, Tom Lykos, and Rick Carnell, among others. That support has been invaluable and has enabled us to progress and to keep our committee meetings decorous. You would be surprised how emotional securities lawyers can get about this subject. We have also had the participation of SEC staff people on an unofficial basis and I do want to stress that. No member of the SEC staff is a signatory to this proposal, although I believe, as the chair of the group, that we did accommodate all of the governmental concerns.

The draft proposal, after fine-tuning and adjustment, was circulated for comments to individuals with ties to a broad cross section of industry groups that were likely to have an interest in legislation of this sort—securities firms, the SIA, the New York Stock Exchange, banks, mutual funds—all through the country. We reviewed the comments that were received in response to the exposure draft and I believe we made appropriate responsive adjustments. The product of that process, the Insider Trading Proscriptions Act of 1987, is now before this subcommittee.

Before I offer an overview of how the statute would operate and how they would change or affect current law, I should like to ask Mr. Olson to discuss the need for a statutory prohibition against

insider trading and related offenses, and to explain the reasons that we believe militate strongly in favor of the adoption of such legislation and its adoption now.

Senator RIEGLE. Mr. Olson.

STATEMENT OF JOHN F. OLSON, PARTNER, GIBSON, DUNN & CRUTCHER, WASHINGTON, DC

Mr. OLSON. Mr. Chairman, Senator D'Amato, members of the subcommittee, I would like to join Harvey Pitt in giving special thanks to the members of your staff who worked so closely with us throughout this process. Messrs. Harris, Lykos and Carnell attended all or almost all of our meetings and were of immense help to us in understanding concerns of the kind that you expressed and the kind that Senator Wirth and Senator Proxmire expressed. As Harvey has told you, we have drafted what we believe is a workable, expansive definition reflecting the law as it has developed but making that law much clearer, much more readily used by prosecutors, and much more predictable for defendants. It's a living kind of statute. It's a statute that is not narrow. It is not technical. It is based on concepts such as those developed in the second circuit which do allow the Commission and the U.S. attorneys to go after the novel situation that wasn't anticipated by the draftsmen. It is not a code that tries to specify exactly what kind of thing is going to be caught and what is not.

It sets forth general legislative findings about the integrity of the markets, which as Harvey has said, have not been ever made by the Congress officially, and it sets forth general principles which can be applied by judges in a rational and consistent and predictable manner, something which has been missing from the law to date.

In 1984, an American Bar Association task force which I chaired was appointed, as Senator Wirth has said, sort of midway through the process of considering the Insider Trading Sanctions Act because there was a widespread belief in the bar that it was inappropriate to substantially increase penalties for an offense that we could not define.

A former SEC Commissioner, Irv Pollack, who is also a former Enforcement Director, a number of distinguished securities lawyers, other former senior SEC officials, and current members of the staff on the basis of consultants, joined with us in that task force effort.

We printed our report in November 1985 long after the Insider Trading Sanctions Act had been adopted and so our recommendations played no role in the adoption of that statute. They were prompted by the statute but were not considered at the time the statute was before the Congress.

DEVELOPMENT OF LAW RESULTS IN CONFUSION

Based on our study, we concluded that the development of the law in the courts had resulted in confusion, controversy, and substantial ambiguity as to what was and what was not prohibited. As just one example, the Supreme Court has twice recently been asked to address uncertainties in the law—in the *Chiarella* case in 1980

and the *Dirks* case in 1983—and in both these instances, the Supreme Court has reversed lower court holdings of liability and defendants have been set free.

Since our task force report was issued, the Court has now taken the *Winans* case and will decide whether to affirm the criminal convictions of Mr. Winans and others some time next year. In the *Winans* case, there was a strong dissent by one of the three judges in the second circuit arguing that the law of insider trading as it exists today simply did not reach Mr. Winans' conduct. No one knows what the Supreme Court will do, but those who follow the Court say it didn't grant cert to simply affirm what had been done below. So the expectation must be that either it will reverse or that it will clarify the law in a direction which can't now be predicted. In the meantime, the ambiguity and the unpredictability continue.

Our task force concluded in 1985—and I think it is even more true today—that the present state of uncertainty about the law simply is not acceptable. The present ambiguity creates problems for prosecutors and it creates problems for securities professionals who legitimately want to obey the law but cannot be sure what it is.

As we concluded in 1985, "Congress can and should confront the basic policy questions of what uses of informational advantage are to be forbidden, rather than leaving the law primarily to case by case development."

Having issued that challenge to the Congress, I suppose it is only a fair return that Senator Riegle and Senator D'Amato sent the challenge right back to us and said, "If you feel that way, see what you can come up with."

If the Congress waits for the Supreme Court to decide the *Winans* case before addressing these critical definitional issues, we will face not only a delay of as much as a year in clarifying the law at a time when the Commission and the U.S. attorneys' prosecution program is uncovering more problems daily, but also very real risks that the Court's decision either will not give clear guidance because of the unusual facts of Winans or, possibly, of divergent views among the justices, as happened in the earlier cases; or, if the defendants prevail and the case is reversed, the Government's use of the misappropriation theory in all of its pending cases will be put very much at risk and its prosecutorial program put into a state of chaos.

These prosecutorial concerns are very important as a matter of public policy, but they are only part of the problem with the present unsettled state of the law. There is also the question of due process. It is fundamentally unfair and contrary to our constitutional traditions, it seems to me, to impose very substantial jail sentences and fines—and the Congress has before it bills that would increase those penalties again and rightly so—but to impose those penalties for a crime that has never been clearly defined.

We have often said that our system is one of a Government of laws and not of men, that we can do in our society what is not prohibited. In other societies, one can do only what is permitted. In a constitutional system where we value civil liberties highly, the failure to define a crime which is at the heart of a major government prosecution program is just not acceptable.

INSIDER TRADING PROMOTES MARKET EFFICIENCY

Finally, there are still those, including some eminent legal scholars and economists, one of whom I gather you are going to hear from this morning, who argue that there's nothing wrong with insider trading, that indeed it promotes market efficiency. Leaving aside for a moment the fact that this is a nation of morality, a nation of law, and those fundamental concerns, from our practical standpoint, our task force which studied this subject for a period of more than a year considered those arguments, read all the literature and all of the research done in the area, and we concluded that the integrity of the markets and the public belief in that integrity far outweighs any possible economic advantage that might be gained from a reflection of nonpublic information in the market at an earlier date as a result of illegal insider trading. We reject those arguments and we believe it is time for the Congress speaking for the Nation to reject them as well, with a clear policy statement and a clear definition of insider trading.

Mr. Pitt is now going to briefly summarize the major operative provisions of the proposed Proscriptions Act that you have introduced, indicating the way in which it will address some of the problems in the present ambiguous state of the law. Harvey.

Mr. PITT. Senator Riegle, let me just ask—I know that we are here really to respond to the committee's questions. We had planned to go through an overview of some of the provisions, but if time is of concern, I would be happy to turn to questions and I know John would be as well instead of going through a detailed outline. But if not, I have a brief outline of the statute and I leave it to the committee's pleasure as to how you would like to proceed.

[Joint written statement of Harvey L. Pitt and John F. Olson follows:]

diverged as to exactly what the appropriate touchstones are in this area and, therefore, you're likely to get several opinions. Third and perhaps most important, the facts in *Winans* are rather special. They don't, for example, the way the case has been posed to the Supreme Court, raise the tipping issue. Although tipping occurred in *Winans*, that's not the question before the Court. So there will be no clarification of the confusion created in *Dirks* as to what the personal benefit test means and what is a personal benefit and when is a tippee liable and so forth.

So even if the Supreme Court resoundingly affirms the second circuit, there are going to be critical areas of ambiguity that are not going to be dealt with.

Mr. PITT. I also think you will lose a certain amount of momentum. If the case were to come out adversely to the Government, as I think most observers think, I believe it becomes far more difficult to draft intelligent legislation and I also think the point John made in his opening remarks, that is that all the while the ambiguities in the law remain, suggests that this is a good time for the Congress to act.

Senator SASSER. Well, gentlemen, this committee has been wrestling or will be wrestling further in the future with the whole problem of corporate takeovers and much insider trading appears to have taken place during the course of some of these corporate takeovers.

EFFECTS OF THIS BILL ON SEC ENFORCEMENT

Now how would this bill, if enacted, enable the SEC to better prosecute or find insider trading violations or other violations involved in takeovers? I think the sharing of inside information has helped put a company in play and has facilitated takeovers. That seems to be generally conceded.

Would this bill be of any assistance in curbing abuses in that area and, if so, how?

Mr. PITT. Yes. If I may refer the subcommittee's attention specifically to subsection c(2) of the legislation, which I might add was a provision that was suggested to us informally by members of the SEC staff and received a great deal of time and attention, it would basically deal with a problem that the SEC believes to be difficult, which is the corporate raiders or others seeking to put companies in play, tip information to third parties in the hopes of creating an active marketplace. This provision would for the first time make that conduct illegal if the standards of the provision were met.

I might add, under current law that conduct is in all likelihood not illegal and the Government would have a great deal of difficulty in prosecuting it.

What this would say is, unless there is a good faith reason, a bona fide reason for communicating information or the persons who receive the communication were effectively part of a reporting group with the person who's going to make the bid, that the communication and then subsequent trading on the basis of the communication violate this statute and the person who tips violates the law.

Mr. OLSON. As Harvey said, Senator Sasser, this is one place where we go beyond the misappropriation theory and go beyond present section 13(d) and really offer new law to clarify an area which has been of concern to the Commission, and in this respect the statute would be a significant advance over the current state of the law.

I appreciate your calling it to the subcommittee's attention.

Senator SASSER. Gentlemen, I thank you. Thank you, Mr. Chairman.

Senator RIEGLE. Thank you, Senator Sasser.

Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

Mr. Pitt, You argue that we need to define insider trading because the Supreme Court has rejected the SEC's cases on two occasions. But in one of these cases, *Dirks*, Mr. Olson says the SEC probably should have lost.

Now I agree with Mr. Olson. Dirks was merely carrying out his duty as a securities analyst to protect his client. He turned the information over to the SEC, told the Wall Street Journal, and then he told his client, having made it about as public as he could under the circumstances.

Why is this case relevant to why we need new law?

RELEVANCY OF DIRKS CASE

Mr. PITT. It's relevant, Senator, because in the course of that, the *Dirks* case articulated a variety of standards, including the much maligned and appropriately so personal benefit test.

What Dirks did was extend Chiarella and while it allowed Dirks to go free it did so, we would argue, for reasons that should prove ultimately unacceptable to this committee. That is to say, because it articulates, along with Chiarella, standards of law that unduly circumscribe what we think Congress intends to prohibit in the area of insider trading. That's why we think *Dirks* is particularly relevant and it's an example of how, even when the Supreme Court reaches a result to which this committee might agree, as could happen in the *Winans* case, some of the rationale runs counter to what we think an effective approach to this problem would be.

Senator PROXMIRE. You see, I'm puzzled again because I'm told that the problem in the *Chiarella* case was not the law but the way the case was presented to the trial court. Now if that's correct, then there is no compelling evidence that the Supreme Court decisions have weakened the ability of the SEC to go after insider trading.

Mr. OLSON. Well, the problem was that the law was so unclear that the prosecutor didn't know what to argue before the Court. And the Court said, "Ha, ha, you picked the wrong theory."

Mr. PITT. Well, let me say one other thing, Senator, on that because I think that's an important point. The fact is that it wasn't so much that the Government argued the wrong theory. It was that the Supreme Court said that this Congress had never articulated a notion that insider trading was bad for the marketplace. As a result, a person like Chiarella could not be prosecuted if his wrong was a wrong against the market.

This statute, I might add, and the congressional findings would change that. Now the Government came up with an alternative theory to deal with the defense contentions and there was division on the Supreme Court as to whether the Government had properly argued it or not, but I can assure you the Government would tell you that they think they did allege the misappropriation theory in the case.

The fact is, the Supreme Court said they didn't and came up with a result in which somebody who clearly engaged in reprehensible conduct was allowed to go free.

Senator PROXMIRE. Now you have two cases here. I'm trying to get a better understanding of the precise effect of this proposed definition of insider trading.

Can you give an example of a case that could not be successfully prosecuted under current law that could be so prosecuted under the proposed law? And are there any kinds of cases that could be prosecuted under current law that could not be prosecuted under the proposed law?

Mr. OLSON. Certainly *Chiarella* and *Winans* are both cases that could be clearly successfully prosecuted under the proposed law and where the state of the law at present is very much in confusion.

Mr. PITT. I guess another one is one some of us saw the movie the "Big Chill" and the opening scene shows the president of the company running with his friend and saying, "I shouldn't be telling you this but my company is going to be taken over and I know you're an extremist." I think under current law there is a significant question, assuming nobody perjured themselves, as to whether any governmental prosecution could be obtained because of the personal benefit test.

We have eliminated the personal benefit test from this proposed legislation and the result of that would be that I believe a successful prosecution would clearly lie.

In addition, I think John's point should be reemphasized. No case under current law that could legitimately be brought by the Government would be foreclosed under our provision. I think we are quite confident that we have caught every case that the Government legitimately could prosecute.

Senator PROXMIRE. Take the *Winans* case. You raised that as a third case. One of the major reasons advanced for this legislation is that current law is inadequate to reach insider trading by those who are not corporate officials. For example, it's argued that the Government's case against Wall Street Journal reporter Winans was possible only because the Journal happened to have an employee code of ethics which Winans allegedly violated. Now even that approach may be overturned by the Supreme Court.

Suppose the Journal did not have an employee code of conduct and you had been assigned to prosecute the *Winans* case under the proposed law. Can you describe in some detail exactly the theory you would use to prosecute the case?

Mr. PITT. Yes. I think I would start by saying—and I'm now referring to section b(1) of the proposed legislation—that it could be shown that Winans under that situation would at a minimum have engaged either in theft, conversion or misappropriation of the information or would otherwise have breached a relationship of trust and confidence with the Journal. So I think there are four or five vehicles for the prosecution of Winans under the proposed legislation and I reiterate that I do not believe under existing law the Government will be successful, or largely successful, in its prosecution of Mr. Winans.

Senator PROXMIRE. The code of ethics wouldn't be necessary under the proposed legislation?

Mr. PITT. The code of ethics would help, but its fortuity would be irrelevant under the new legislation.

Mr. OLSON. The nature of the employment relationship and its normal expectations of confidentiality would be sufficient, in my view, even if there were not a printed code of ethics.

Senator PROXMIRE. Thank you, Mr. Chairman. My time is up.

Senator RIEGLE. Thank you, Senator Proxmire.

I know Senator Shelby has another matter he wanted to raise.

Senator SHELBY. I will be brief, Mr. Chairman.

Senator RIEGLE. Fine. Senator Shelby.

PREVENT HOSTILE TAKEOVERS OR INSIDER TRADING?

Senator SHELBY. Other prominent people, including some witnesses who will testify before this committee today, have suggested and said outright that this proposed legislation confirms some of their feelings that it's the hostile takeover legislation that you're trying to pass here—in other words, you're trying to prevent—and not insider trading. In other words, the real target is hostile takeovers, not insider trading. And by pushing this bill, if it were to become law, that then you're going to create a real easy seat for a lot of corporate management not competent and not responsive to stockholders and so forth.

How do you respond to that?

Mr. PITT. Well, I start by saying it's simply untrue and misperceives——

Senator SHELBY. You know it's out there, though?

Mr. PITT. I saw the written statement this morning and I know it's out there and I want to stress that it is, in my view, not correct and I believe that this committee has before it, sponsored by Senators Proxmire and Riegle, some appropriate legislation that would deal with very difficult questions about tender offers.

This legislation deals with the problem of unfairness in our markets and trading by people who have unfair and wrongful informational advantages. That's all it deals with and it will include tender offer situations, but tender offers did not motivate this legislation and I don't believe that in any way, shape or form this legislation can be said to have any impact whatsoever on the tender offer process.

Mr. OLSON. The only way, Senator Shelby, that one could say that it affects negatively the tender offer process is if you believe that it's a good idea to make tender offers and so much so that cheating, lying, and stealing is OK to effect a tender offer. And we just don't subscribe to that.

Mr. PITT. I do want to add, if I may, one other point and I will say this because one of my major preoccupations is, as a corporate lawyer, to work on tender offers.

This bill actually will enhance tender offers. One of the things that hurts tender offers is advanced leakage of information where the target has a good idea of who may be bidding for it and can start to deal with that particular person. By cutting down on the misuse of this information which is often very instrumental in helping a target identify who the bidder is, I think this may actually have a positive effect on tender offers.

Senator SHELBY. Have either one of you gentlemen represented people involved in hostile takeovers?

Mr. OLSON. I certainly have, and on both sides. I'm happy to be employed by anybody who wants to pay the fee.

Senator SHELBY. Isn't it a fact, though, that a lot——

Mr. OLSON. As long as it's not a conflict.

Senator SHELBY. As long as it's not a conflict, and not inside, right?

Mr. OLSON. Right.

Senator SHELBY. Isn't it a basic fact, though, that a lot of the shareholders in America have profited by these hostile takeovers—you know, the marketplace? I'm not thinking so much about insider trading. I'm talking about shareholders.

Mr. PITT. I know what you're saying and I think there are situations in which persons recognize—I know those who have a view of the efficient market will say that that's never so, that the market always reflects the value of a company. I don't share that view.

Senator SHELBY. There are a lot of sleeping companies?

Mr. PITT. There are some sleepy companies and there are shareholders who profit enormously and I have represented bidders who have acquired companies in that situation. But I've also been involved in situations from the defense side where companies are far more aware of their potential, and what you're talking about is short-term gain versus long-term maximization of profits, and I guess my view is the problem isn't as simple as saying because somebody walks in and offers a premium for stock that is of benefit to shareholders. And I say that for this reason. Even representing bidders, I have never known a bidder who's willing to pay more than the company is worth and I've always known bidders who try to pay less than what they think it's worth.

Senator SHELBY. Well, that's the market, isn't it?

Mr. OLSON. I must say you have very skillfully drawn my colleague here into a debate on another piece of legislation. I want to underline the fact that, though I generally subscribe to Mr. Pitt's views, this legislation, in my view, has nothing to do with tender offers and it's really neutral as to whether tender offers are good or bad.

Senator SHELBY. Thank you, Mr. Chairman.

Senator RIEGLE. Thank you, both. I'm just going to ask a couple of items.

With respect to corporate officers, how does the legislation as you see it, affect the communications between corporate officers and financial analysts?

Mr. PITT. I think, in sum, it protects those communications because by introducing a wrongful standard into the process and by using a question of knowing or reckless in not knowing standard, we have combined with the congressional finding, which I think is the third finding about the free flow of information, put Congress squarely behind the communications that corporate officers need to have—legitimate communications with analysts and others, and get that information out into the marketplace while prohibiting the abusive practices that I think we have observed in some recent cases.

Senator RIEGLE. Let me ask you also, what are the potential damages to a firm or to an individual under this legislation and what are the potential damages under the existing law?

Mr. OLSON. Are you talking about the amount of damage or the penalties—the penalties, of course, are many and varied and they range from the civil penalties in the Insider Trading Sanctions Act to the criminal penalties that are in the Securities Exchange Act of 1934 and so forth.

But I think that perhaps what you're really driving at is what are the burdens that are going to be placed on institutions by this statute as opposed to existing law. This statute I think offers both benefits and burdens for institutions. The chief benefit is clarification, which is a great advantage in conducting their affairs. The burden is that they are going to have to carry—and this is Senator Shelby's concern—the burden of showing that there was not in fact the leakage of information which caused or influenced the trade. And that's going to be a burden which is not expressly placed on them by existing law, although one might read the case law as placing that burden. I don't know whether I've responded to your question or not, Senator Riegle.

Senator RIEGLE. You've been very helpful. Did you want to add something?

Mr. PITT. No.

Senator D'AMATO. Mr. Chairman, I have a question as it relates to misappropriation and I'd like to submit it for the record because it seems to me that some of our colleagues' concerns could be answered if we got into that and that people are placed in greater jeopardy as it relates to the law now and that there will be some clarity brought, but I would like to submit that for the record and if you could possibly get back to us on that.

Mr. OLSON. Certainly, Senator.

Senator D'AMATO. Senator Shelby when I left I had been raising that question and I'd like to follow through on it, but in the interest of time I'm wondering if we couldn't do it in writing.

Mr. PITT. Can I just say one thing on that point, if I might, and I won't go into a lengthy answer on that. I do think that any concerns about that should be heightened under the present state of the law where the Government is free to allege anything constitutes misappropriation, and the courts are free to find that either anything or nothing constitutes misappropriation.

This way, Congress will have control over the process which is where we think it rightfully belongs.

Senator SHELBY. If my colleague would yield——

Senator D'AMATO. Yes.

Senator RIEGLE. Very good.

Senator Shelby, do you have any questions?

Senator SHELBY. I'll try to be very brief. Dean, you're the dean of the law school at George Mason University and I'm sure you've been through a lot of securities law over the years and written books and so forth.

You were sitting in here earlier and, of course, I don't know—I just raise the point of the statutory presumption dealing with securities and who possesses material and so forth. In other words, it looks to me like that's a burden of proof shift there and I don't know if you teach criminal law or constitutional law.

Mr. MANNE. We certainly do in the law school.

Senator SHELBY. That certainly bothers me as a Member of the Senate up here.

Mr. MANNE. Senator, I think you are perfectly correct to be bothered by that. I have been bothered by an aspect of that even under present law because there are a lot of people who are simply put at risk who probably shouldn't be.

Under this bill, however——

Senator SHELBY. Many are innocent and then the burden becomes on them rather than the prosecution.

Mr. MANNE. Let me give you a simple scenario of the kind that happens, I think, every day and that is that a broker calls a customer and says, "Have I got a stock for you." Now the broker does this a lot.

Senator SHELBY. All the time.

Mr. MANNE. In fact, every time a broker calls he in effect says that I've got inside information because if you ask one of them why is this stock going to go up in price, he tells you, "Well, there's some information that's about to come out," and I always say, "Well, why hasn't the market already reflected this?" Because I do believe in an efficient market and typically he will say, "Well, it's because people don't know it."

Now every now and then a customer decides to have a flyer. He doesn't go to Las Vegas that week. He simply has a flyer on this stock. This time, for some poor schnook, that broker turned out to be correct. Most of the time he's not, this time in fact what he was saying was absolutely true. As far as the customer is concerned, he has taken a tip that he knows is valuable undisclosed public information.

Now I don't believe we want to make that criminal behavior. I think it raises too much of a possibility of abuse that you can point the finger at anyone who might be unpopular politically or otherwise, and put the burden on them to show that they didn't use information.

Senator D'AMATO. Could I just interrupt?

Senator SHELBY. Go ahead. I yield.

Senator D'AMATO. Just on this for clarification because, Dean, I don't see anyway, anyhow—first of all, we would not want to make that criminal conduct and I'm going to ask Mr. Olson or Mr. Pitt to reply to that, but in essence what the dean has pointed out is the case where the broker calls up and says, "I've got some great information." It turns out that his recommendation to buy a stock turns out to be tremendously accurate. The stock doubles or triples.

Reply to that. Is he going to be held under this criminally?

Mr. MANNE. If he says anything other than "This is my recommendation." If he says, "This is a tip based on something I've heard or knowledge that's not yet in the marketplace"——

Senator D'AMATO. It's your contention that he would be held, Mr. Olson?

Mr. MANNE. I think so. I think at least there is a presumption that that customer knows he has information that is wrongfully obtained.

Senator D'AMATO. Let's ask Mr. Olson. Would that be the case?

Mr. OLSON. I wouldn't come out the same way on those facts.

Mr. PITT. I wouldn't either.

Senator D'AMATO. Would you explain why?

Mr. OLSON. Well, because I don't think that the customer knows that the information has been obtained—first of all, the customer is not using the information improperly.

Senator D'AMATO. What about the broker?

Mr. OLSON. Second, he doesn't know nor is he reckless in not inquiring into the broker's misusing it. The broker is not anybody's fiduciary other than the customer's.

Senator D'AMATO. Well, what about the broker, Mr. Pitt?

Mr. PITT. I think that John has captured it. I don't think under our provision there would be the slightest problem where the customer didn't know and where there was nothing that created any reason for people to say that the customer was reckless in not knowing.

Senator D'AMATO. I'm not concerned about the customer. I'm concerned about the broker. Would you have it where he went and eavesdropped or he illicitly obtained this information but not that he got it from——

Mr. OLSON. Well, you're right, Senator. It's the same answer for the broker. Unless the broker stole the information or knew it was reckless in not knowing that it was stolen, he wouldn't be liable. The fact that you hear a rumor doesn't create liability under this statute. It was not intended to.

Mr. MANNE. This is not a rumor, but that's not the problem. The problem is that a person can be accused and the burden is then on that person to establish that he didn't know that this was wrongfully obtained.

Senator SHELBY. That's the third question I raised earlier.

Mr. OLSON. That defect exists much more dramatically under the present law than it ever would under this statute.

Mr. MANNE. It exists in both, I agree.

Senator D'AMATO. Now the issue is joined for the first time, if I might be so bold, and I finished up in the bottom of the class in law school, not the top, Dean.

Mr. MANNE. You must have been top in advocacy, Senator. Some of our best students are at the bottom of the class.

POSSIBILITY OF LIABILITY

Senator D'AMATO. The question is, whether or not you have a greater liability—the possibility of liability now under the case law theory as opposed to the definition, and I'd like to ask you, in all

due candor, it would seem to me that even in one of your presentations you suggested that this law is better than—not that your advocating it—but better than the present situation as it relates to clarity as to where that responsibility will or will not fall or the liability.

Mr. MANNE. My principal defense of this is that it does incorporate the idea of contracting out on this issue.

Senator D'AMATO. We'll return to that contracting out. That's another question.

Mr. MANNE. On this issue——

Senator D'AMATO. On the issue of possible criminal exposure, isn't the broker under this law better off as opposed to the present status?

Mr. MANNE. I'm not sure that the broker is. I was addressing more the issue of the customer, but I think the same thing is true of brokers.

Senator D'AMATO. Well, customer or broker?

Mr. MANNE. A great many of the brokers are rather innocent, but they do frequently claim to have inside information.

Senator D'AMATO. They all do.

Mr. MANNE. Now suppose after the fact it turns out that there was a leak of information. How can someone prove, having said that this is undisclosed information that in fact he really didn't know it, that he was lying? And that's a problem.

Senator SHELBY. The burden ought to be, in my opinion, on the prosecution to prove this. The man or lady shouldn't have to prove something because if they've been indicted the prosecution ought to prove it.

Mr. PITT. Can I just say one thing? I've asked that we supply you with a very full response to this and hopefully either today or tomorrow.

Senator SHELBY. Will you?

Mr. PITT. But I do want to point out that the courts and the—I'm sitting here and it's difficult to do research and search back through your mind, but I know that the courts under the Securities Act of 1933, any sale of public securities in interstate commerce must be registered and the failure to register them is a violation of the law. The statute, however, provides exemptions. But the burden of proof is on the defendant to prove his entitlement. The Supreme Court has addressed that issue. That's a criminal provision and in the fourth circuit in Maryland, *United States* v. *Custer Channeling* I think is the case, a conviction was sustained precisely because the defendant did not sustain the burden of proving that he was entitled to the exemption. That is to say, there was a statutory presumption of violation, there were defenses, that is exemptions you could rely on, and you, the defendant, had the burden. And that's been in the law since 1933.

Senator SHELBY. Did the Federal court deny certiorari on this and how long ago has this been?

Mr. PITT. I don't know whether they did or not. Custer Channeling is I think the 1960's. The Supreme Court in a civil case, however, SEC against Ralston Purina in 1953——

Senator SHELBY. A different burden of proof in civil.

Mr. PITT. There's no doubt, but in 1953, in recognizing that this statute, No. 1, applies both civilly and criminally, and in *Chiarella*, footnote 20 refers to the problems and says they're the same with respect to civil and criminal liability, and that's why he criticizes 10(b)(5). The Supreme Court in the *Ralston Purina* case specifically said that the burden is on the defendant always under the securities laws to prove entitlement to exemptions.

Senator SHELBY. Well, it ought to be changed if that's what they're saying.

Mr. MANNE. Exactly the point. I think there are some other areas of constitutional law as well in which the presumption notion has been pushed close to the line.

But the question is, whether in a situation like this, it's appropriate legislation to put the burden on any number of people who may be targeted for reasons that we can't even guess at this point, whether the burden should be put on them to prove their innocence.

Senator RIEGLE. Thank you very much for your testimony.

We have one more witness, Mr. Gary Tidwell, to call and we're running quite late, so let me thank all three of you for your comments and participation today and let me call Mr. Tidwell to the table.

I understand, Mr. Tidwell, you are accompanied by Mr. Aziz, who has helped you with your survey material, and we welcome him as well.

Mr. Tidwell, you are associate professor of business administration at the College of Charleston in South Carolina, and we're delighted to have you and would be pleased to hear from you now.

STATEMENT OF GARY L. TIDWELL, ASSOCIATE PROFESSOR OF BUSINESS ADMINISTRATION, COLLEGE OF CHARLESTON, CHARLESTON, SC; ACCOMPANIED BY ABDUL AZIZ, ASSISTANT PROFESSOR OF BUSINESS ADMINISTRATION, COLLEGE OF CHARLESTON, CHARLESTON, SC

Mr. TIDWELL. Thank you, sir.

Mr. Chairman and members of this Senate subcommittee, I'm honored that you have asked me to testify today concerning the results of a survey which Dr. Abdul Aziz and I have recently completed. We are both professors in the School of Business and Economics at the College of Charleston.

The purpose of our study was to examine a limited number of retail stock brokers to determine their understanding of the insider trading laws. Our study was prompted when we became aware of polling data that indicated that 71 percent of Americans feel that insider trading should be illegal, but yet another poll indicated that 70 percent of Americans felt insider trading was common among investment professionals. That data, spurred our research.

We began with the theory and hypothesize that when examining traditional insider trading—that is, trading by officers and directors—most people understand the law. But when people had to apply the court or judicially created theories of misappropriation, temporary insider, or tipper/tippee liability, the law was unclear and they would be unable to apply that law.

75-705 O - 87 - 4

Senator SHELBY. My concern is, as both of the panelists have surmised here, is the burden of proof in the criminal case what you would create statutorially here and I would be interested in seeing what you send me and other members of the committee regarding this because just reading this at first hand it would bother me greatly and I'd like to hear from other people and I'm sure I will, that deal in constitutional questions.

Mr. PITT. We can submit something for the record that addresses those concerns as well as the misappropriation.

Senator SHELBY. Thank you.

[The following was subsequently submitted for the record:]

Senator RIEGLE. Now let me ask our next witness to come to the table, Mr. Henry Manne, of George Mason University, who has quite a different view on this, and I'm wondering—let me invite him to come up now—I'm wondering if the two of you would be in a position to stay a bit because we might want to sort of maybe have some discussion back and forth on some of the issues that will arise here. Are either of you in a position to stay a bit longer?

Mr. PITT. Certainly.

Mr. OLSON. Fine.

Senator RIEGLE. Mr. Manne, we're delighted to have you and why don't you go ahead and make your presentation.

STATEMENT OF HENRY G. MANNE, GEORGE MASON UNIVERSITY, SCHOOL OF LAW, ARLINGTON, VA

Mr. MANNE. Thank you, Mr. Chairman. I am very honored to be here and I thank the members of the committee for inviting me.

As you may know, in 1966, I published a book entitled "Insider Trading in the Stock Market," which as far as I know was the first scientific and rigorous academic analysis of this subject. It did defend in some respects the practice of insider trading, not in any sense any part of it that represented for the manipulation, breach of contract, or any other inherently bad behavior.

The tide of thinking on that subject is very different today than it was in 1966. I believe in 1966 that I was probably the only person in the country taking that position. Today, there are vast numbers of economists, academic and otherwise, who understand the point about the efficient market, that insider trading does play a role in that.

Nonetheless, it is still difficult to oppose a very strongly held emotional position. I view that as part of my job as an honest academic and I might say in way of passing that this is one of the reasons academics are accorded the benefits of tenure and academic freedom.

Nonetheless, I am not here to discuss this question of efficient markets. I don't think that it is fully central to the bill proposed. I do think, however, that the issue of tender offers on which I have also written for close to 35 years is very much involved. For Mr. Pitt to say that this bill has nothing to do with tender offers violates I think the most cardinal rule that economists live by, namely that demand curves slope down and supply curves slope up.

The Williams Act, as is well known, can be viewed as a matter of fact was indicated in the explanatory memorandum to this bill—can be quite correctly viewed as a significant law against insider trading. What it provides, however, is very interesting and that is that evil though it may be, the raider is allowed 5 percent of the shares. He may make the profit on his undisclosed information that he plans a takeover on 5 percent. Originally, in the original act, that was 10 percent, but the people against tender offers liked it so much they reduced it to 5 percent. Effectively today, it's probably still close to 10 percent because of the window allowing some additional purchases of shares.

Now the effect of that rule is a price control mechanism. It simply limits the amount of profitability that can be had on take-

overs. If the figure were larger than 5 or 10 percent, clearly there would be more takeovers. That's the notion of an upward sloping supply curve. If the figure is made less by say closing the window, then quite clearly there will be fewer takeovers.

TAKEOVERS ARE A FINANCIAL PHENOMENON TODAY

The takeover is certainly a central financial phenomenon in American business life today. I honestly believe that it is vastly more important in its significance in the role it plays in keeping the American corporate system healthy than is the topic of insider trading. That is not to belittle the latter topic. It's simply to indicate that this has a kind of central role in the operation of a publicly held corporate system that nothing else does. We don't have alternative devices to the tender offer that are anywhere near as efficient in correctly policing either inefficiency or misbehavior on the part of corporate executives.

Widely diffused shareholders with tiny fractions of the shares are simply not in a position to do anything. The courts through derivative suits can only touch the most blatant kind of mismanagement. Subtle inefficiency can simply not be dealt with in that fashion. I think this is generally recognized today. No one today, unlike perhaps 20 years ago, is suggesting that we ought to outlaw the hostile tender offer altogether.

Nonetheless, the fact remains that without something that looks like insider trading and that is very much covered by this bill that these tender offers wouldn't occur. If in fact the original Williams Act had been effective in holding every raider to a return on 5 or even 10 percent of the shares, I think we would see literally almost no hostile takeovers today.

Now it is not by any means to justify the behavior of Messrs. Boesky, Levine or others in some of the tactics they used to suggest that it was the existence of the Williams Act that created the necessity of doing something else if tender offers were to occur. In fact, their behavior allowed these things to go on.

Now how could that be? They did three things basically since the Williams Act had prevented the full profitability on the information that the raider had established.

The first thing they did was make it clear to the raider that the shares would be there at the time the offer was actually announced.

The second thing, he would now know the price. Under the old scheme, the price was a mystery and clearly he would have to offer more to guarantee a sufficient percentage of the shares.

Third, that the shares could be delivered in a very efficient fashion. All of this substantially lowered the cost of running takeovers. That meant that even with the restricted profitability on the information that the raider might have, these things could still go on.

Now it's hard to believe that a great deal of the attention being paid to insider trading today doesn't evolve out of the *Boesky* case. While it's true that the emotional focus is on the insider trading, the deception, the inducement of breach of fiduciary duties, and employment contracts and things of that sort, nonetheless, the concern that seems to be voiced most significantly is that let's get rid

of this because this clearly demonstrates that these takeovers were generating a lot of bad behavior.

Now the truth of the matter is that the Williams Act was generating a lot of bad behavior. It left things profitable enough that some people were willing to take the risk of engaging in illegal behavior. The parallel to the operation of the black market in Russia is 100 percent, and yet the Russian economy probably could not survive today if it were not for those criminals who were willing to sell goods on the black market.

At any rate, I believe that that part of this current bill raises very significant questions that ought to be addressed apparently differently than Mr. Pitt and Mr. Olson have.

Having said that, however, I want to congratulate them on some other aspects of this bill. By defining wrongful uses of inside information, the bill makes it clear that any other use of information would not be wrongful. In fact, in the definition section it indicates explicitly that these are the only forms of wrongful behavior. This allows for the first time something that I and a number of other people, including a substantial element on the Securities and Exchange Commission, have proposed; namely, that when there is no inherent evil in certain regulatory provisions, that parties be allowed to contract out of them.

Under this rule, a corporate board of directors who agreed with the widely held academic position that insider trading can be used as an effective device for motivating corporate executives, similar to participation in patent royalties, a board could with proper public disclosure authorized trading by certain individuals. I think this is a definite advance, a very laudible form of deregulation that is long overdue, both in connection with insider trading and other parts of securities regulation.

The other points I think I would leave for questions if you have any. I haven't addressed a number of details in the act but these were the major points that I would like to touch.

[The complete prepared statement of Henry G. Manne follows:]

Testimony of
Henry G. Manne, Dean
George Mason University
School of Law

There is perhaps no better way to begin my discussion of the pending Bill on insider trading than to paraphrase the piece I wrote for The New York Times that was published on November 25, 1986, at the very height of outrage about the Boesky disclosures. In this piece I sought to explain the relationship between enforcement of the S.E.C.'s insider trading rules and Congressional actions, notably the Williams Act, to regulate corporate takeovers. I believe that my analysis demonstrated this connection for the first time, but it is amply confirmed by the Bill presently under consideration. After my summary of this background material, I shall turn my attention to what I consider to be the major issues in the pending Bill.

During the 1960's, the takeover phenomenon accelerated at a rapid and, to some people, frightening pace. It so threatened some members of the established corporate community that they sought and obtained protection from Congress.

The main result was adoption of the Williams Act in 1968. That Act and related Securities and Exchange Commission rules effectively required that a bidder who has bought 5 percent of the shares of a target company in the open market disclose his takeover plans to the public and not make further open market purchases. Clearly, when such a "raider" has correctly identified a target company and formulated a takeover plan, he possesses valuable undisclosed information. The more shares the bidder can acquire before disclosing his takeover intention, the more likely is his plan to succeed and the more profitable will his effort be. The 5 percent rule therefore limited the profitability of a tender offer.

The rule was plainly aimed at reducing the number of tender offers. But the popularly accepted explanation for the Williams Act was that it was aimed at abuses connected with the so-called midnight special. Under this older, simpler approach to tender offers, a few people might gather in a hotel room over a weekend, formulate a takeover plan and advertise for the desired shares in Monday morning's New York Times and Wall Street Journal. Little information about the bidders would be given and often less than a week would be allowed for tendering shares.

Under this practice, a raider could easily determine who would have access to his information. If only a few people were in on the plan, there was little danger of unauthorized leaks. And the raider would know in just a few days whether his takeover would be successful or not. Thus, his period of exposure to the extremely high interest charges on the money borrowed for the takeover would be limited.

Despite the fact that no one has ever demonstrated that these practices in aggregate cost shareholders money, the Williams Act changed the old way of doing things. And it was not surprising that new techniques soon developed. Confronted with the 5 percent rule, the bidder needed a fresh device that would increase his knowledge of how many shares might be offered at a given price, assure the availability of large blocks of shares when needed and allow him to control the flow of valuable information. Foremost among these new devices was what we now call "risk arbitrage." This is basically a matter of "pre-positioning" or "parking" shares before a tender offer is made public. The most successful of the new breed of risk arbitrageurs was Mr. Boesky.

The arbitrage function probably evolved in the marketplace without any direct communication between the arbitrageurs and the raiders themselves. The raider would know just by watching the tapes what the arbitrageurs were doing; and the arbs would know from their trading profits whether they were getting reliable information about pending takeovers. The fact remains, however, that systematic access to valuable information such as Mr. Boesky had about forthcoming takeovers could probably not be gained without at least the tacit approval of the raiders. There has been sufficient evidence for the S.E.C. to implicate other Wall Street figures in the Boesky case, but so far no prominent corporate "raider." However, the fact that the raiders themselves might be implicated is one reason why there are a lot of happier faces in some of America's executive suites.

The smiles would be even broader if the Boesky case can be used to justify additional regulations making tender offers even more difficult to mount. But the damage to American investors would then be even greater. The tender offer is the most important and beneficial financial invention of the 20th century. Its very existence has probably added hundreds of billions of dollars to American capital values. Without it, noncontrolling shareholders in companies with widely diffused ownership are nearly helpless in the face of managerial incompetence, self-dealing or inattention to business.

The S.E.C.'s crusade against insider trading has been on a collision course with desirable takeover policy for a long time. The Commission has been so blind to arguments that insider trading is harmless and even beneficial that it has now stumbled like a drunken sailor into the fragile, complex apparatus of post-Williams Act takeovers.

The S.E.C., the public, and Congress should be aware of just how high the Commission has raised the stakes in the stock market game. If the insider trading net is extended to cover the activities of takeover activists like Carl Icahn or Victor Posner, this could ultimately cause the most serious permanent decline in stock values in modern history. The Williams Act

should be repealed forthwith; its very existence exerts a tremendous downward pressure on stock prices.

The pending Bill confirms everything I have suggested. It does nothing to strengthen the existing rules against insider trading. In fact it contains probably one of the most notable deregulatory moves that we have seen in this field, and one to be highly commended. By defining "wrongful" uses of inside information, the Bill makes it clear that any other use of information would not be wrongful. Thus a corporate board of directors who agreed with the widely-held academic position that insider trading can be used as an effective device for motivating corporate executives, could, with proper public disclosure, authorize trading by certain individuals. For some time there has been a strong element on the Securities and Exchange Commission that favored this idea of "contracting out" of regulatory provisions. I am pleased to see that Congress has adopted this salutary point of view, since no one can be injured by a properly disclosed corporate provision allowing insider trading. This recognition of a position strongly held by a number of economists and law professors is much to be applauded.

But this Bill also confirms my earlier suggestion that the hostile takeover, and not insider trading, is the real target of current political action. By focusing its enforcement strength on the use of information by control acquirers and arbitraguers the Bill significantly boosts the anti-takeover force of the Williams Act.

The proposed legislation, like the Williams Act before it, uses a rule against insider trading to deter takeovers. Given the easy proof of guilt requirements for insider trading charges against arbitraguers and control acquirers - as compared to the relaxed standard and approval of the Chinese Wall scheme for investment banking houses - a fair reader would conclude that the Bill is aimed mainly at takeovers. Perhaps while shooting at one target, the drafters of the Bill have hit an entirely different one. The target they have hit, hostile takeovers of publicly-held corporations, needs to be understood and nurtured for the ultimate protection of American and foreign investors in American corporations and not hindered further. Takeovers should not be attacked under the guise of a moral crusade against insider trading, when in fact that is not even a serious evil in itself.