Mr. Cox. The Commission believes that insider trading undermines the expectations of fairness and honesty in the markets. The Commission also believes that legitimate information gathering is essential to market efficiency. The theft or misappropriation of information is unfair and discourages investment in legitimate information gathering.

Aggressive efforts to eradicate insider trading need not and should not rely on parity of information theories. The Commission agrees with the courts that legitimate market advantages are gained through skill, foresight, industry and the like, but not through purloining or otherwise misappropriating material nonpublic information.

The Commission does not believe that a statutory definition is at present necessary for continued successful enforcement, but recognizes that benefits could result from an appropriate definition.

We have benefited greatly from the work of the group chaired by Harvey Pitt, whose proposal was introduced as S. 1380, and are now able to present a proposal that has the Commission's unanimous support.

The proposed legislation would prohibit insider trading under a new Securities Exchange Act section 16A. Like S. 1380, the legislation builds on breach-of-duty and misappropriation principles embodied in existing law.

Trading would be forbidden while in possession of material nonpublic information that was wrongfully obtained or the use of which would be wrongful. Information is wrongfully obtained or used when it has been obtained by or as a result of, or its use would contribute (1) theft, bribery, misrepresentation or espionage, or (2) a breach of duty to maintain information in confidence or refrain from trading when the duty arises from a relationship with specified sources related to the securities markets.

The legislation also prohibits tipping when the tipper knows that information is material and nonpublic and foreseeable trading results. The tipper is also liable if a tippee tips others who foreseeably trade.

The proposal codifies existing Commission rule 14(e)(3). This prohibits trading by a person other than the tender offerer who possesses material nonpublic information relating to the tender offer where that person knows that the information was acquired directly or indirectly from the tender offerer or the target company.

Subject to specified exceptions, communications of tender offer information are also forbidden.

The legislation expressly permits reasonable efforts to make the information public. There is also a safe harbor for routine communications, but not trades, by or to securities analysts who disseminate the information to investors.

The legislation includes the existing defense to liability for multiservice firms where the employee trading on the institution's behalf did not know the inside information and the institution had reasonable procedures to prevent violations.

The legislation expressly gives contemporaneous traders the right to recover from insider traders or tippers and provides an express private right of action to anyone else injured by insider trading.

Though the similarities are substantial, the Commission's proposal also differs from S. 1380 in a number of respects.

For example, the Commission's proposal avoids inappropriate federalization of duties owed to persons without a significant nexus to the securities markets.

The Commission's proposal generally follows current rules on trading and tipping that involve tender offers, rules it believes work well.

The Commission's proposal requires that, to avoid liability for insider trading, firms have reasonable procedures to prevent it.

The Commission's proposal provides a safe harbor to promote the dissemination of information.

The Commission's proposal treats employers' liability for insider trading the same as for other securities law violations.

The Commission's proposal for an express private right of action is not limited to contemporaneous traders but extends to others who may be injured by a violation.

The Commission's proposal defines insider trading as wrongful trading while in possession of, not on the basis, of material nonpublic information. S. 1380 presently does not, although Mr. Pitt has proposed changes.

The Commission appreciates the opportunity to testify on its legislative proposal and is pleased to assist the subcommittee in its work. Thank you.

Senator RIEGLE. Thank you, Chairman Cox.

I think we'll start with 5-minute rounds and see how it goes here because we have other witnesses that we want to hear from this morning.

In June when you last testified before this subcommittee, you stated that if the Supreme Court "threw out the misappropriation theory, that would make a statute absolutely necessary for the kinds of cases that the SEC has been bringing." I'm sure you recall that quote.

Mr. Cox. Right.

Senator RIEGLE. Yet your proposal omits from the definition of wrongful trading any reference to the misappropriation theory or conversion.

Can you tell us why?

PROPOSAL OMITS MISAPPROPRIATION THEORY

Mr. Cox. Yes. I believe that the way we have approached wrongfulness, requiring either a specified theft, espionage, et cetera, or breach of a duty to keep information in confidence or refrain from trading, gets at the essence of what's involved in misappropriation. How can there be a misappropriation without a breach of duty?

Senator RIEGLE. If that is so, then why not spell that out in the law? I mean, why not go ahead and make that very clear as you've just done here?

Mr. Cox. I would think that perhaps in the legislative history that could be made clear, but I think the essence is that what's wrongful is the breach of duty.

Senator RIEGLE. But you see, this is a very important issue, and if you agree with the point that it may be necessary to have it in the legislative history, why do we have it one step removed in terms of the legislative history? Why not put it into the law? Why not say what you mean?

Mr. Cox. Well, I guess it was not done with the intent to legitimize misappropriation. It was simply done with the intent to get at a clear definition that provides guidance, and it's the breach of duty that we really regarded as what's wrongful and we wanted to make that very clear.

Senator RIEGLE. I think you, yourself, from what you've already said in response to my first question, have made a very compelling argument for being more specific about it. If it needs to be in the legislative history, I think it needs to be in the law. I'd like you to take a look at that and see if we can't find a way to do that.

Mr. Cox. All right.

Senator RIEGLE. Let me ask you this. What would be the liability of a brokerage firm under the Commission's proposal for the insider trading of one of its employees and how, if at all, does this differ from current law?

Mr. Cox. It is essentially the same as current law. If we are talking about a multiservice firm where the person doing the trading did not know the information and the firm had reasonable and appropriate procedures to prevent a violation of the law, there would be a defense. The same defense exists under the current law.

However, if you're talking about the situation where someone is off trading on his own, then that is the same as the current law, also, liability depends on the existing securities laws, controlling person provisions and common law doctrines of respondeat superior.

Senator RIEGLE. Let me ask you if you can summarize for us the basic policy differences between your proposal and the legislation that we have introduced and I'd like you to really put your emphasis on what you think are really the key proposals and if you strongly feel that there's something that we ought to change in our proposal versus your own I'd like you to try to bring the spotlight right down on that, if you would.

DIFFERENCES IN PROPOSALS

Mr. Cox. The first one I want to emphasize is one that I did point out in my opening statement. The definition should make it very clear that it's trading in possession of material nonpublic information that is prohibited. I think from the standpoint of enforcement it is essential that that be what Congress enacts.

Now as I pointed out, that's not the way it currently is in S. 1380, although Mr. Pitt proposed changes about the time that we testified before. So I think that can be worked out. We see so many arguments that are completely unbelievable—for example, arguments that trading was based on a report that someone read 6 months or 1 year ago rather than on the basis of information acquired recently. I think that we have to say that trading while in possession of the material nonpublic information is where we will draw the line in the statute.

Senator RIEGLE. My time is up. I will follow up when my next opportunity arises.

Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Cox, in your opening statement you read something that I found interesting and I didn't find it in the submission that you made to us. Your opening oral remarks differ somewhat from your written submission. Would you mind going back? Because I am having some difficulty in reconciling your written statement with your oral statement. It seems that the Commission did vote to come up with a definition, is that correct?

Mr. Cox. Yes, sir.

Senator D'AMATO. Well, let's go back to where you talked about the definition in your opening statement because you seem to suggest otherwise.

Mr. Cox. The opening statement?

Senator D'AMATO. Yes.

Mr. Cox. It was essentially a summary of what I submitted.

Senator D'AMATO. Well, it's a pretty important summary, isn't it?

Mr. Cox. Yes, sir.

Senator D'AMATO. Go back to the beginning.

Mr. Cox. I'll go back to wherever you would like, Senator D'Amato.

Senator D'AMATO. The first paragraph where you start to talk about the definition and the need of the definition because if you read that, it seems to me that you're saying one thing on one hand and another thing on the other hand. Read it.

Do you want to pass it up here and I'll read it?

Mr. Cox. I'll read it here.

Senator D'AMATO. OK, because I didn't get it submitted here and I'd like to hear you give it to us.

Mr. Cox. All right.

Senator D'AMATO. Very slowly because I want to make sure. Maybe I misunderstood.

Mr. Cox. Yes, sir. I believe this is the paragraph you are referring to. "The Commission does not believe that a statutory definition is at present necessary for continued successful enforcement, but recognizes that benefits could result from an appropriate definition. We have benefited greatly from the work of the group chaired by Harvey Pitt, whose proposal was introduced as S. 1380, and are now able to present a proposal that has the Commission's unanimous support." Is that the passage?

Senator D'AMATO. Yes. When you start and you say the Commission does not believe that a statutory definition is necessary for proper enforcement, but then contend that you support the statutory definition proposed by the SEC.

Mr. Cox. That is consistent with what I testified to.

Senator D'AMATO. That's a great political statement. I mean, I might make that on the stump when I don't want to take a position.

Mr. Cox. I'm not equivocating. We have a definition that we unanimously support.

Senator D'AMATO. OK.

Mr. Cox. We also decided prior to my previous testimony that we should go forward with the definition.

Senator D'AMATO. So is the definition necessary?

Mr. Cox. It is not necessary for the enforcement program to successfully proceed, but I think that there are enough other benefits that a definition is a good idea.

Senator D'AMATO. OK. That's what I'd like to get in a more unequivocal form. In the form in which you placed it—maybe I'm misinterpreting it—but it seemed to me to be quite equivocal. On the one hand you say we don't believe it's necessary for proper enforcement, but we're coming forward. Now you're saying to me, well, there are benefits. What are the benefits?

Mr. Cox. The benefits are a number of things clarifying the law, what I was just talking to Senator Riegle about, making it——

Senator D'AMATO. Just tell me the benefits.

Mr. Cox. Making it specific that trading in possession of nonpublic information would violate the law.

Senator D'AMATO. Why is that a benefit?

Mr. Cox. That is a benefit because it removes any doubt in people's mind as to whether it's on the basis of or in possession of.

Senator D'AMATO. Why is that important, removing doubt?

Mr. Cox. I think it's very important.

Senator D'AMATO. Why? Because it would be helpful in obtaining criminal prosecutions?

Mr. Cox. Yes. I think that since people could be sent to jail there should be a clear statement of what the problem is.

Senator D'AMATO. Good. Now we're beginning to get someplace rather than your somewhat murky explanation of the SEC's position.

Mr. Cox. That was not my intention. It was simply my intention to state that the enforcement program could proceed as it presently has, and I think successfully in prosecuting insider trading on the basis of the law as it currently exists.

Senator D'AMATO. Well, we'll go back again. Could it be improved by this definition?

Mr. Cox. Yes, sir.

Senator D'AMATO. Oh, very good. Let me say this to you so we not detract from the fact that you have kept your commitment and I want to applaud you and the Commission and those of your staff who have made possible the definition that you have submitted, as I said in my opening statement, in a timely manner. I think that's very important. I think that gives us a benchmark by which to begin to compare and to see what areas we have in common—am I out of time?

Senator RIEGLE. Yes.

Senator D'AMATO. All right, Mr. Chairman. I hope we can continue to work with the SEC to draft a workable, plain English definition. Rather than belabor Commissioner Cox and the committee with some rather technical legal questions concerning the SEC's proposed definition, I would suggest that the Commission and the other witnesses work with Committee Counsel Tom Lykos in and address my concerns. Thank you Mr. Chairman.

Senator RIEGLE. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Mr. Cox, you are very familiar, I assume, with the original bill introduced by the chairman of this subcommittee and the Senator from New York, are you not?

Mr. Cox. I am familiar with it.

Senator SHELBY. You've read it, have you not?

Mr. Cox. Yes, sir.

PRESUMPTION OF USE

Senator SHELBY. So you're familiar with that part of it. Do you know that in that bill it had a presumption of use, in other words, a presumption that if someone had certain information in their possession that it would be a presumption that they used this?

Mr. Cox. Yes.

Senator SHELBY. In other words, a presumption of guilt basically.

Mr. Cox. I am familiar with the presumption of use.

Senator SHELBY. Mr. Cox, are you an attorney?

Mr. Cox. No, sir.

Senator SHELBY. Does the Securities and Exchange Commission proposal also contain a use presumption?

Mr. Cox. No, sir.

Senator SHELBY. And why does it not? Because there's a constitutional problem with it?

Mr. Cox. No. I think that we really did it on the basis of clarity, that to say that trading while in possession of material nonpublic information violates the law.

Senator SHELBY. And do you remember the words of the original bill introduced?

Mr. Cox. Not precisely.

Senator SHELBY. Didn't it speak of a presumption?

Mr. Cox. Yes, it said something to the effect that there is a presumption that trading is on the basis of the material nonpublic information.

Senator SHELBY. Who drafted this proposed Securities and Exchange proposal we have?

Mr. Cox. It was a joint effort between the staff of the SEC, mainly the Division of Enforcement, general counsel, and the contributions of the Commissioners.

Senator SHELBY. Did Mr. Pitt or Mr. Olson or any of these eminent attorneys in securities have any input into this?

Mr. Cox. Not directly, but certainly we used S. 1380——

Senator SHELBY. As a starting point?

Mr. Cox. Well, we looked at that, and, I make no bones about it, we built on that.

Senator SHELBY. I have other questions but I think they would probably, Mr. Chairman, be more appropriate for the witnesses that are going to come after this. Thank you.

Senator PROXMIRE. In the absence of the chairman, Senator Shelby, you are chairman of the subcommittee. I think Senator Armstrong is next.

Senator SHELBY. Senator Armstrong.

Senator ARMSTRONG. Thank you, Mr. Chairman. I'm going to withhold for the time being. I thank you.

Senator SHELBY. Senator Proxmire.

Senator PROXMIRE. Would Mr. Lynch, the head of the enforcement division, come forward to the witness table?

Mr. Lynch, in your judgment would S. 1380 put the enforcement division in a weaker or a stronger enforcement position than current law?

Mr. LYNCH. I think it would put us in a stronger position than current law.

Senator PROXMIRE. That's S. 1380?

Mr. LYNCH. That's correct. And certainly the Commission's submission today would put us in a stronger position than current law.

Senator PROXMIRE. That was my second question. Since you've answered that second question, let me ask you if the SEC's recommendation to replace or to modify S. 1380 would strengthen or weaken the situation as compared with S. 1380?

Mr. LYNCH. I think that the Commission's submission is preferable to S. 1380.

Senator PROXMIRE. Why? Where does it strengthen your ability to enforce?

Mr. LYNCH. Well, Acting Chairman Cox has already alluded to this. As S. 1380 was drafted, it raises problems with what we have to establish as to whether the person merely had possession of the information or whether they used that information.

Now I know Mr. Pitt has redrafted certain portions of the proposed statute based on some comments that were made by Senator Shelby at the last hearing that I think go a long way toward solving that particular problem. If those changes are made, then S. 1380 would be even more preferable to the current state of law than it was at the time that it was submitted. But I would still say that even with those changes I think that the Commission's submission is slightly preferable to S. 1380.

Senator SHELBY. I wonder if the chairman would yield?

Senator PROXMIRE. Before I yield, would you submit in writing how you think the SEC recommendation could be strengthened?

Senator SHELBY. Mr. Lynch, you referred to some problems that I had raised in an earlier hearing and those problems as I recall them were basically a constitutional problem I had with the use presumption. Is that what you're alluding to?

Mr. LYNCH. Yes.

Senator SHELBY. And do you believe that you have dealt with some of that in this new proposal?

Mr. LYNCH. I think we have, but to be absolutely clear about this, the way we dealt with it is to say that we don't have to establish that a person used the information. We merely have to establish that the person had possession of the information and they knew or recklessly disregarded that it would be a wrongful use to trade while in possession of that information. So there still would be a state of mind requirement. It wouldn't be sufficient to show that a person merely had the information——

Senator PROXMIRE. But the burden still remains on the prosecution?

Mr. LYNCH. That's correct.

Senator SHELBY. And that would change it from the earlier presumption of possession?

Mr. LYNCH. That's correct.

Senator SHELBY. Thank you.

Mr. COX. We would have to establish that the person possessed it and also show the state of mind.

Senator PROXMIRE. Mr. Chairman, could I reclaim my time?

Senator SHELBY. I thank the chairman for yielding to me.

Senator PROXMIRE. I'd like to ask both you gentlemen, is there any kind of trading on material nonpublic information that could be prosecuted under existing law but that could not be prosecuted under the Commission's proposal?

Mr. COX. I don't think so. I think that what we have done is to be pretty careful to make sure that we've established the same parameters. I spent some time thinking about the cases that we've brought and didn't think of insider trading cases that I'm familiar with that would be excluded by the SEC definition.

Senator PROXMIRE. Is that your answer, too?

Mr. LYNCH. I would agree with that as well. We have analyzed all the cases that we've brought over the last 10 years or so, and there is no case that we have identified that couldn't be brought under this statute.

I should say at this point that there are some hypotheticals attached to the joint written statement of Mr. Pitt, Mr. Levine, and Mr. Olson where they analyze how our proposed statute would work in certain cases. We would disagree with their analysis of how the statute would work. This is probably not the time or place to go through a detailed analysis of hypothetical situations, but I think that's something that could be worked out in the legislative history, clarified if necessary in the statute, so that there would be no mistake about the coverage of the proposed statute.

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

Senator RIEGLE. Senator Wirth is next. May I just get one clarification because I want to be sure I heard it right? Did you say in response to Senator Proxmire's question that you thought that either the committee version of the bill or the version that is being proposed by the SEC is preferable to current law? Did I understand you to say that?

Mr. LYNCH. That's correct. I think that either proposed statute would be preferable to current law.

Senator RIEGLE. I'll come back to that. Thank you.

Senator Wirth.

Senator WIRTH. Thank you, Mr. Chairman.

Mr. Cox, let me just start by thanking you for your stewardship in this acting period of time. We haven't always agreed on everything, but I really appreciate the good work that you have done and, again, Mr. Lynch, to add my commendations to the aggressive operation that you all have pursued so well I think in the interest of shareholders overall.

Let me ask you first of all if I might, Mr. Lynch, are there insider trading cases that you would like to have pursued that because there is no specific definition of insider trading you have not been able to pursue?

LACK OF DEFINITION PREVENTS PROSECUTION

Mr. LYNCH. There have been some cases. I think particularly in recent months where we have had a concern as to whether or not we could satisfy the personal benefit test that *Dirks* imposes. To back up a second, under the *Dirks* decision, one has to show that a tipper giving information to a tippee will receive some type of personal benefit, even reputational benefit but some type of personal benefit, by passing that information on to the other person.

That has proved to be somewhat difficult in some cases. The cases still can be pursued perhaps on other theories of violations, but it makes for a more difficult prosecution than it should otherwise be in that circumstance.

Senator WIRTH. So this legislation——

Mr. LYNCH. If I could give an example, I think of the *Tom Reed* case where we brought an action against Mr. Reed and settled it prior to *Dirks*. It was a situation where a father who was on the board of directors of a company——

Senator WIRTH. I remember it well.

Mr. LYNCH [continuing]. Had a conversation with his son. We did allege that in that conversation the father gave information to the son, but it was never our theory that the father gave it to the son for the purpose of the son trading on it.

Now we brought our case and settled the action. Subsequent to *Dirks,* there was a criminal prosecution of that case. The Government really could not argue that the father intended to receive a benefit by giving it to his son because he didn't intend for the son to trade on it, according to the Government's theory. So you had to argue that the son had a confidential relationship with the father such that he breached the relationship with the father by trading. The district court said that one would have to show that there was a regular exchange of business confidences such that there was a legitimate expectation of confidentiality on the part of the father.

Senator WIRTH. Is the personal benefit issue the area of greatest ambiguity to you from the perspective of enforcement?

Mr. LYNCH. The elimination of the personal benefit test is probably one of the biggest advantages that we get out of the statute. In addition, the clarification——

Senator WIRTH. The statute clarifies the father-son relationships?

Mr. LYNCH. No. It simply says that a violation of a personal relationship is sufficient.

Senator WIRTH. Can that be done by the Commission in a regulatory proceeding or does that require legislation?

Mr. LYNCH. I think the far preferable way to do it is through legislation.

Senator WIRTH. Let me ask you, can it be done by the Commission?

Mr. LYNCH. I hate to do this, but that's a question better addressed to our general counsel than to me.

Senator WIRTH. Is your general counsel here?

Mr. LYNCH. He is here.

Senator WIRTH. Can we ask him to come forward? Can we get a yes or no answer?

Mr. GOELZER. Well, if my choices are yes or no, I'll say yes. I think that obviously any rule that we adopted defining insider trading in a way contrary to the case law would undoubtedly be subject to challenge and we would have to litigate the validity of the rule. I do think the Commission has some latitude to define insider trading by rule.

Senator WIRTH. Mr. Cox?

Mr. COX. I guess as to the Commission's authority I'm always greatly persuaded by the general counsel, but the way you phrased the question specifying father-son relationship——

Senator WIRTH. I just said that facetiously.

Mr. COX. All right. I think that the preferable way would be legislative clarification of this issue.

Senator WIRTH. The personal benefit issue?

Mr. COX. Yes, sir.

Senator WIRTH. That would be preferable. But again let me ask the question, can you do it by rule? And the answer to that, I gather, is yes, but any rule can be challenged, right? Any rule can be challenged, as I understand it, and there are a lot of lawyers out there whose time clocks are ticking, looking for opportunities to challenge rules I'm sure, but it can be done by rule?

Mr. COX. Yes.

Senator WIRTH. Mr. Chairman, at some point I think it would be also useful for us to understand what the ramifications of the *Winans* decision may be. I think that as we have these gentlemen up here, that case I understand is being heard in October. I know my time has expired.

Mr. COX. I think that that may be a little early to estimate when there will be a decision.

Senator WIRTH. Well, my time has expired, Mr. Chairman.

Senator RIEGLE. Well, I realize it has, but you posed an important question and they want to respond to it.

Mr. GOELZER. Let me say that the case hasn't been set for argument. The Supreme Court returns for business of course in October, and I assume it will be heard shortly after the Court comes back. The decision is likely to be at least several months after the argument. I would guess the first of the year.

Senator WIRTH. And what are the implications of that for S. 1380, the SEC's proposal, and others?

Mr. GOELZER. Well, I suppose the biggest implication, as Acting Chairman Cox has testified, is that, if the Court were to strike down the misappropriation theory generally in that decision, then we would have a desperate need for legislation in order to continue our program.

If the decision is something other than that, we would have to study the implications of the decision.

Senator WIRTH. Is it assumed that it's likely that the Court will strike it down?

Mr. GOELZER. I don't believe that that's likely.

Senator WIRTH. Is it generally assumed that the *Winans* decision will be such that it puts pressure on us to take steps now on defining insider trading?

Mr. GOELZER. Well, my name is on the Government's brief in the case. I believe that our side is going to prevail in the case. Certainly people have written in law review articles and other publications that they think there's a serious risk in *Winans* that the misappropriation theory will be lost. That's not my view. It is the view of other people.

Senator RIEGLE. Maybe we can come back to that in short order. Senator Armstrong has not taken any time yet and I think has a point he wants to raise here.

COMMUNICATION OF INFORMATION

Senator ARMSTRONG. Mr. Chairman, I don't want to take very much time but I'm troubled by my inability to understand what happens when analysts communicate information to other persons.

I guess we agree under present law and under all pending proposals that a person who is a securities analyst is not passing inside information. He goes to a meeting and learns things about the company and in the due course of business passes it on to the customers of his firm. Or maybe he's a newsletter writer and passes it on. Clearly nobody intends in any way to subject such a person to any liability, but the distinction between that function and somebody who just calls up his neighbor and says, "Boy, I just heard a great report on such and such a company. I'd sure buy a few shares of that," isn't very plain to me.

Maybe I'm just dense about this, but what am I missing here?

Mr. COX. Well, I certainly don't think that you're dense, Senator Armstrong, but I think that maybe the problem is your example of the person who calls his neighbor. That's why we started from the wrongfulness approach, which asks whether that person has a duty to keep that information in confidence or refrain from trading before he calls his neighbor? Is he the CEO of the corporation who has material nonpublic information and then calls his neighbor to say, "Boy, you really ought to buy some shares of the stock in my company."

Senator ARMSTRONG. But my question is when it becomes public? Clearly, if I'm an analyst or a newsletter writer or a reporter and I put this in my publication—let's say I put it in the morning paper. From the time it appears in the morning paper, I assume that's public information.

Mr. COX. Yes.

Senator ARMSTRONG. And even the reporter is free to trade in it if he wishes. But the question is, at what point prior to that is he free to do so? Maybe not if he's the only reporter who knows this or one of only a handful who knows it, he's not free to trade in it before the item appears in his newspaper. I guess that's right, isn't it?

Mr. COX. Well, usually he's under some obligation to the newspaper not to use this information for his own personal benefit but to use it for the benefit of the newspaper.

Senator ARMSTRONG. Well, that's exactly the situation I was getting at and I'm not quite sure—and one reason why I'm not going to pursue this too far this morning is I'm not quite sure whether I'm really addressing a problem that is hypothetical or whether it is a real problem. But conceptually, it's very hard for me to understand exactly when this information passes from the confidential

domain into the public domain. In other words, if the guy who writes for the newspaper writes his story and right after he writes it he trades before it's published, I guess we understand that to be a wrongful trade. Correct?

Mr. Cox. Yes.

Senator ARMSTRONG. What if he is not a newspaper writer but is a newsletter writer and he only sends this newsletter or this analytical report to a group of clients and suppose it's a very small group of clients? Suppose it's not 100,000 people who subscribe to a newspaper, but it's only 100 people or it's only 2 people. That's the distinction I'm trying to be sure I understand but I'm not sure whether I'm really addressing a practical problem or not.

Mr. Cox. OK. I don't think it's a problem. I think that we have attempted in our definition to clarify that—that's why we have the safe harbor for communicating information but not trading with that information. If the person who writes the newsletter and is in the business of gathering information talks to corporate executives and then sends information on to clients, and there may be a few clients or there may be many——

Senator ARMSTRONG. Precisely because he is a communicator rather than a trader?

Mr. Cox. Right. We don't want to inhibit that communication.

Senator ARMSTRONG. Even if he's communicating to a small number of people, even if it's a select clientele?

Mr. Cox. And the communication is in the ordinary course of his business.

Senator ARMSTRONG. Yes. In other words, somebody who writes a stock newsletter or who maybe has a handful of clients with whom he communicates. Are we distinguishing that person from someone who is an investment manager who attends the same meeting?

Mr. Cox. No.

Senator ARMSTRONG. Well, I thought you were saying there was a safe harbor for the person who communicates but not for somebody who is an investment manager or an investor. In other words, if you've got two guys sitting there, one of whom writes for a newsletter—or maybe there's a whole roomful of people, some are newspaper writers and some of them do other things, but also some of the people who are there hearing this information are either individual investors or managers of investment funds for others, are they bound to a different standard than those who are communicators?

Mr. Cox. No, I don't think so. In the example that you presented, if I'm an investor and sitting at a meeting where company executives are telling about the business and then I go away and trade on what I heard at that meeting, that's why the information was being communicated.

Senator ARMSTRONG. So in that case, in essence, the information becomes public when the company executives communicate it to the analysts and writers, not when it is subsequently published?

Mr. Cox. Right. The question of when the company is making the information public doesn't depend on what the individual writer does.

Senator ARMSTRONG. I think that's helpful. I'll think some more about this. I may be just over my head on this. Thank you.

Senator RIEGLE. Let me just clarify one other thing before calling on Senator Sasser, and that relates to this previous conversation before Senator Armstrong spoke. That is, Mr. Goelzer, I understood you to say that if you were to lose the *Winans* case—that you would have a real problem and in fact there would be a gap in the law as you see it and that there would be a rather immediate need for legislation. Is that in effect what you said?

Mr. GOELZER. Well, I would have to say, Senator, that it depends on exactly how the case was lost. If the nature of the loss was for the Supreme Court to reject the misappropriation theory across the board, yes, I think a very serious hole would be opened up in our authority.

Senator RIEGLE. Well, that's precisely the point. And many people have argued that the Congress ought to write the laws and the courts ought to interpret the laws. I don't like seeing us in a situation where, depending upon how the courts make an interpretation in an area that's fuzzy, that we'll wait and see what they decide and then if we find out there's a gap in the law then we'll try to rush in afterward and sort of plug that gap.

Senator D'AMATO. Mr. Chairman, would you yield for just a moment?

Senator RIEGLE. If I may just say, I think our job is to write the law clearly and forcefully ahead of time so that we don't subject people, cases or future events to that kind of sort of judgment by the court that may or may not square with what is needed. That goes right to the heart of why I think we need a clearly written, tightly written law. We should not have to have the future hinge on one or another decision of the court, in my view, not in this area.

Senator D'Amato, you asked me to yield.

Senator D'AMATO. Well, I'm sorry Senator Wirth left because I wanted to pursue if I might very quickly one case which counsel raised which was the *Thomas Reed* case.

From the evidence I review about that case that this subcommittee reviewed, it seemed to me that Reed was trading while in possession of inside information. He called his daddy who was down on a Carribean island about a half a dozen times, he couldn't wait to call his broker. He started at 5 o'clock in the morning, bought options that were running out in 12 days, made $340,000-some-odd in profits, tried to hide it by putting it in other individuals names. His wonderful secretary, her children and others; he said he was doing this as a charitable effort for them. His motives aside, it seems that he was a crook.

Would you have lost that case if you would have one of these two sections of the law there?

Mr. LYNCH. We probably would have lost that case anyway. We didn't lose that case on the law. We got a very favorable opinion out of the district court judge. There were 12 jurors up in Manhattan who decided that he was innocent, who decided that that information was not passed—or at least the Government hadn't proved that beyond a reasonable doubt.

So in fairness to Mr. Reed, he was acquitted on factual grounds. The legal niceties of it had nothing to do with his acquittal.

Senator D'AMATO. It shows you what a New York jury can do sometimes. That's absolutely incredible.

I believe if you have cases where you can't bring them successfully as a result of the absence of a clear definition and have to apply different theories of the law, then we're missing the boat. That's the only statement I have to make. I'm sorry I intruded on your time.

Senator RIEGLE. Thank you, Senator D'Amato.

Senator Sasser.

Senator SASSER. Well, thank you very much, Mr. Chairman. I'm pleased that the Securities Subcommittee today is continuing to examine the issue of a definition of insider trading. It's obviously very complicated. You can judge that by the questions that are being asked here and I can see why we've left the definition of insider trading so long to the courts.

Mr. Cox, let me ask you and your colleagues, on this whole issue of insider trading, what benefits do you believe could be derived from the adoption of new insider trading legislation?

BENEFITS OF INSIDER TRADING DEFINITION

Mr. Cox. I think that the statutory definition would make clear some of the areas that we presently feel are not particularly clear. The way we have phrased our statutory definition, it would be made clear that trading while in possession of material nonpublic information is when the violation occurs.

The second, getting rid of the personal benefit test on tipping. Now it's necessary to show that the tipper had a personal benefit as a result of tipping someone. That showing would no longer be required.

Those are a couple of examples where I think the statutory definition could make a real contribution.

Senator SASSER. Well, I think you may be correct in that analysis. Let me just say that to many of us insider trading basically falls into certain categories and I'd like for you to explain to us—you or your colleagues—just as clearly as you can how the Commission's statutory proposal deals with a number of areas.

First, an individual has information and he or she trades on it. When is that person trading on insider information?

Mr. COX. Well, certainly we would have to know more than just an individual has information and trades on it.

First, is it material nonpublic information? Second, did that individual acquire it or use it wrongfully? In other words, acquire it by theft, espionage, so forth, or did that individual breach a duty to keep that information in confidence or refrain from trading? That's really the basis of this definition.

Senator SASSER. All right. Let's take another hypothetical. An individual has inside information and he or she does not trade on it themselves but they communicate this information to another person who does trade on it.

Now when is the person who communicates the information to someone else liable under your proposal?

Mr. Cox. The tipper would be liable if he had a duty to keep the material nonpublic information confidential and if there were foreseeable trading that would result from communicating this information.

Senator SASSER. So what is the word of art there? Foreseeability? In other words, if the tipper gives the tippee the information and could reasonably foresee that the tippee would use this inside information and trade on it to his advantage, then the tipper would be liable?

Mr. Cox. Yes, sir.

Senator SASSER. All right. Well, how about the person who gets the inside information, the tippee? When do they become liable or do they become liable?

Mr. Cox. Oh, yes.

Senator SASSER. Under what circumstances?

Mr. Cox. When the tippee realizes that this information was obtained in a breach of a duty to keep it confidential and then trades.

Senator SASSER. In other words, if I'm having a cup of coffee with a friend and I have access to information from a brokerage house that I happen to work for that Ajax Cleaning Powder's stock, if purchased is going to go up very rapidly, and I communicate that to the person I'm drinking coffee with, and they know that I'm breaching a duty and they use that information and trade on it to their advantage, they would be liable?

Mr. Cox. Yes. Perhaps you communicated it to the person just because of your personal relationship. You foresaw no trading. You thought that no trading would result. But the friend wasn't the friend that you thought and went out and said, "Look, I know that Senator Sasser had this material nonpublic information with a duty to keep it confidential. Now I've got it. I'm going to trade." In that case, the tippee would be liable for trading.

Senator SASSER. Well, my time has expired, Mr. Chairman. Thank you, Mr. Cox.

Senator RIEGLE. Thank you, Senator Sasser.

We have a panel of three witnesses for which one will speak and then we have a representative from the New York Stock Exchange Legal Advisory Committee. I want to pose just a comment to you. Did you want to go around a second time, Senator Hecht?

Senator HECHT. No. I'm just going to briefly make a couple of statements. I'll take about 1 or 2 minutes.

Senator RIEGLE. Please do that now.

Senator HECHT. Thank you, Mr. Chairman.

I'm just happy I made my opening remarks before all this discussion because I think it clearly shows that we have to be very, very careful which way we go on any type of legislation to unbalance this wheel that's been working so well.

Publicly, I think you, Mr. Cox, have done an excellent job as the acting chairman of the Securities and Exchange Commission during your tenure in that position, and I think publicly I just want to acknowledge that.

Mr. Cox. Thank you very much, Senator Hecht.

Senator RIEGLE. Let me just say now, earlier, Mr. Lynch, when you indicated that the Commission from your vantage point would view our legislative proposal or the one that the SEC is advancing, either one, as preferable to the existing law——

Mr. LYNCH. I didn't say the Commission would say that. I can't speak on behalf of the Commission.

Senator RIEGLE. I understand.

Mr. LYNCH. Certainly I think the Commission believes that its definition is preferable to existing law. I can't speak for the Commission's view on S. 1380.

My own personal view is that S. 1380 would be preferable to the current law because of its clarification of some issues which are in doubt now.

Senator RIEGLE. Well, that's a very important statement and I appreciate it.

Now, Commissioner Cox, would it be the Commission's view that our proposal or your own either would be preferable to the existing state of affairs?

Mr. COX. The Commission hasn't made that decision. They haven't really considered that question. All that I can do is restate what we did consider. The testimony last time is that we couldn't endorse S. 1380 in its present form. But, as you've said and as we've said in our statement, there are more similarities than differences between the two bills, and clearly we unanimously endorse our proposal.

So that's what I can say on behalf of the Commission, sitting as a Commission, about what we endorse.

Senator RIEGLE. I understand. Now you're also a Commissioner, so let me just ask you now for a viewpoint as an individual Commissioner. Let me ask you, not speaking for the Commission but speaking for yourself, are you inclined to agree with the statement that Mr. Lynch just made?

Mr. COX. Yes, Senator.

Senator RIEGLE. I appreciate that.

Finally, before I call on our colleague from Missouri, let me say to you and ask you if the Commission will continue to work with us here? I think your response today within the time limits has been a forthcoming one. I appreciate it. The subcommittee and the full committee appreciates it. And can I assume that it will be the Commission's intention to want to work with us as we see if we can't find a way to reconcile what differences we may have and try to reach a proposal that perhaps we all can support?

Mr. COX. We would be very enthusiastic about your invitation to work with the subcommittee and with Mr. Pitt's group, with Mr. Phillips, and whoever is involved, to assist you in this task.

Senator RIEGLE. I appreciate that because it is a very complex area of law. I think to do it right means that we have to talk, work back and forth. It's sort of a tailoring job of cutting and fitting and cutting and fitting until we get it right, and we want to get it right. And I think we have made a lot of progress. I think we are approaching a point where if everybody proceeds in good faith we can find a common ground that would really be a substantial step forward and serve the public interest. So I appreciate what you've said and the spirit in which you've said it and it is our intention to work with you and the others to try to achieve that goal.

Mr. COX. Thank you.

Senator RIEGLE. Senator Bond.

Senator BOND. Thank you, Mr. Chairman.

From having read the testimony, I wanted to ask Mr. Cox a couple of brief questions and I know that you have touched on this before, but you talked about exempting a person or transaction from provisions of the legislation. Could you give me examples of the kind of exemptions that you might want to grant?

EXEMPTIONS

Mr. COX. Well, let me say that generally we have that provision there because in such a complex area of the law we really think that it is necessary for the Commission to have the authority to react to a fast-changing securities market. We certainly didn't construct a definition with the idea that there's a lot of people we would have to exempt. We want that exemptive authority for the situation in which we can say, look, to be consistent with what we're setting out to do, here's a situation that legitimately should be exempted.

I don't have a specific example. If we had thought of something specific, I suggest we might have put it in. But I will certainly allow either Mr. Lynch or Mr. Goelzer to speak, if they have an example of the type of situation that should be exempted.

Mr. GOELZER. I agree with your statement, that if we had thought of an area that needed exempting we would have spelled it out in the statute.

Senator BOND. You say you have some major disagreements with S. 1308. What would be the major disagreement? What's the point that the SEC finds most difficult?

Mr. COX. The most difficult point is that S. 1380 does not make it explicit that trading while in possession of material nonpublic information would constitute a violation.

Senator BOND. Is that the individual or the firm? In other words, you're saying that it is not clear that if an individual had nonpublic information and traded under S. 1380 that that would be a violation?

Mr. COX. Yes.

Senator BOND. You're not talking about the situation where a multifaceted firm had information?

Mr. COX. No, because there we rely on the current law, that if the firm has it, the trader does not know that information and if the firm has appropriate procedures——

Senator BOND. A Chinese wall?

Mr. COX [continuing]. To prevent a violation, then that trading would be allowed under our definition.

Senator BOND. Are there any other things of that magnitude that really are stumbling blocks for you?

Mr. COX. I don't think so. That was certainly the main stumbling block that would be very important.

Senator BOND. Thank you, Mr. Chairman.

Senator RIEGLE. Thank you, Senator Bond.

Let me thank all three of you for your testimony today and we look forward to working with you. Thank you very much.

Mr. COX. Thank you, Senator Riegle.

Senator RIEGLE. Let me now call to the table our remaining witnesses this morning. We have a panel of three, Mr. Theodore

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