

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM  
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Please consider this my response to the questions submitted to me by Senator Riegle in his letter of December 21, 1987. I have attempted to be brief in my response, even though the questions can each entail a lengthier response. I trust this will be useful to you and your staff.

What purpose is served by proscribing insider trading?

My testimony to the Subcommittee on December 15, 1987 opens with the statement that Carpenter v. U.S. makes the express statutory proscription of insider trading imperative. It is my belief that the ambiguity in the Supreme Court's even division in Carpenter will interdict the government's enforcement and deterrence efforts. Uncertainty as to the future viability of the misappropriation theory erodes the assurance that misconduct will be successfully prosecuted. When prosecuted, defendants will trade the uncertainty created by Carpenter for a lighter sanction because the enforcement personnel have justifiable fears that any enforcement predicated upon a theory of misappropriation will, after Carpenter, not withstand appellate review.

Insider trading is not socially or economically useful. See, Cox, Insider Trading and Contracting: A Critical Response To the 'Chicago School,' 1986 Duke L. J. 628, 642-55. Moreover, insider trading causes a good deal of harm. As stated in my testimony to the Subcommittee, there is growing evidence that insider trading accompanies abusive disclosure practices in which corporate personnel or market professionals delay or otherwise take false disclosures for the purpose of increasing their insider trading profits. Two such cases are In re Orfa Sec. Lit., [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶93,225 (D.N.J. 1987) and Froid v. Berger, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶93,201 (D.N.J. 1986). Even more troubling is that those in possession of inside information have manipulated real economic (corporate) events so as to maximize their insider trading profits. For example, Messrs. Boesky and Levine made massive purchases of FMC common stock to force its management to increase the consideration to be paid to the common stockholders in FMC's confidential restructuring plan. See FMC Corp. v. Boesky, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶93,223 (N.D. Ill. 1987). In the face of evidence showing the connection of insider trading profits and manipulative conduct, it is a demonstrably sound regulatory response to not only proscribe the manipulative practices, but also to proscribe the insiders' trading profits which can be the insiders' or market professionals' incentive to manipulate disclosure practices, stock prices or economic events. Indeed, our proscription of insider trading can be justified as a necessary prophylaxis to remove the incentive corporate personnel, market professionals and others may have to engage in a wide array of abusive and manipulative practices. On this point, we are informed by the reasons offered by the Congress in 1934 when it made its first and most direct attempt to curb insider trading by enacting of section 16 of the Securities Exchange Act of 1934. The legislative history of that provision reflects that Congress was concerned that insider

trading can lead to abusive and manipulative collateral practices. See S. Rep. No. 792, 73d Cong. 2d Sess 9. It therefore enacted the short-swing profit provision to remove one incentive for certain defined insiders to engage in manipulative practices.

There is also the pervasive concern among academics, businessmen and market professionals that insider trading erodes the integrity of American capital markets and thereby interdicts their allocational efficiency. The insider who trades has few defenders. Most individuals correctly view insider trading as harmful to the efficient flow of information to securities markets. While markets are not composed of players with the same endowments. For example, some have greater resources than others, the game becomes an unfair one when any participant plays with “loaded dice.” A trader in possession of inside information plays with loaded dice. The number of participants in our capital markets would be significantly reduced if insider trading were legalized. With both investors and capital diverted to other activities, the cost of capital to American corporations would increase and a serious problem of resource allocation would arise. It should be emphasized that those discouraged by insider trading are not just the “small investor.” Even market professionals are seriously threatened by insider trading. Consider, for example, that illegal insider trading profits in the AMAX case led to the failure of two options trading firms who had the misfortune to trade with the defendants in that case. See Longstreth, SEC Battle against Insider Trading Is Worth the Effort, Legal Times, May 10, 1982, at 16, col. 2. Furthermore, the direct or indirect approval of insider trading necessarily will lead to the ill effects of a Gresham’s Law in which bad market practice drive out socially worthy market practices: the analyst whose views are available to the public will be replaced by the bribe paid for inside information which will then be available only to the few.

In sum, insider trading has little to commend itself and there are a good many reasons to believe and know that insider trading is extremely harmful to the operation of our securities markets as well as American corporations.

2. Should a separate definition of “materiality” be included in any legislation proscribing insider trading?

This is a bad idea. The first SEC insider trading prosecution occurred 27 years ago, Since that time a rich and thoughtful case law has developed which defines what is and what is not material information. It would be a serious mistake to throw that body of law out and replace it with a statutory definition of materiality. A statutory definition of materiality could never provide the certainty and wisdom of 27 years of litigation producing hundreds of decisions giving meaning and life to the meaning of materiality. Furthermore, a definition of materiality, no matter how well crafted, will certainly allow too many cases worthy of prosecution to “fall between the cracks.”

In his testimony before the Subcommittee, Mr. Bialkin forcefully and unequivocally stated that advising clients on possible insider trading questions is among the easiest tasks a securities lawyer performs. I stated in my oral presentation to the Subcommittee that insider trading cases are not “whoops” cases; the insider is aware he is

in possession of confidential information and is well aware that information is material and knowingly trades on the basis of that information. Accordingly, concerns of fairness do not even require that materiality be defined.

In sum, a statutory definition of materiality is not needed for clarity; such clarity is currently provided by a highly developed, informative case law. That case law does not reveal a single instance in which any insider trading case defendant has been disserved by the current case law definition of materiality.

### 3. Response to Tipping Hypotheticals:

Introduction: As I stated in my written submission to the Subcommittee as well as my oral presentation, tipping and tippee practices should be regulated in the same manner as approved by the Supreme Court in Dirks v. SEC, 463 U.S. 646 (1983). In Dirks, the Supreme Court held that a tippee and a tipper violate the antifraud rule only when a tip is improperly made. The Court narrowly defined when a tip is improper so that a tip is improper only when “the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings.” Id. at 663 The sole exception to the requisite receipt of a pecuniary gain is when the tip is “to a trading relative or friend.” Id. 664. Dirks embraces a clear and certain standard by which to resolve whether a tip and trading on a tip is unlawful. The wisdom of Dirks is its recognition that a less certain a standard would be dysfunctional for the efficient operation of capital markets. Investment analysts deprived of a brightline standard defining unlawful tipping must proceed at their peril whenever their efforts yield from a corporate source new information. Certainly the dynamic that the securities laws ought to foster is the market professionals’ aggressive pursuit of corporate information, confidential as well as public. To be sure, their pursuit should not be completely unregulated. The Supreme Court in Dirks wisely introduced a highly workable restraint on the analysts’ pursuit of information: a pecuniary gain to the tipper. I believe that Dirks has served us well and commend its formulation to the Subcommittee.

I will now answer the tipping hypotheticals in the order in which they appear on your letter.

a). An individual who comes into possession of inside information does not personally use the information, but passes it along (a “tipper”) to another person who then uses the information to trade securities (a “tippee”): When should the tipper be liable?

Consistent with the above introduction, I would hold the tipper liable if his tippee were a friend or relative or the tippee conferred upon the tipper a pecuniary gain. I believe it would be a rare case in which a tipper would ever deliberately relay to a tippee with knowledge that his tippee will trade. This kind of tipping would can be expected to occur, and generally has always occurred, only in cases in which the tip is circumscribed as being improperly under Dirks. It should also be remembered that corporations take great steps to preserve the confidentiality of their information and their employees are

usually aware of their employer's concern. If there is no pecuniary gain and no tipping to a relative or friend, I believe the proper complainant would be the employer vis-à-vis its employee, but that action does not occur under the federal securities laws.

b). A tippee receives inside information from another person and trades securities on the basis of that information: When Should the tippee be liable ?

Consistent with the above introduction, the tippee should be liable only if he is a relative or friend of his tipper or the tippee is aware that he or another has conferred a direct or indirect pecuniary benefit upon the tippee as the "price" paid to obtaining the selective disclosure. This is a brightline test which assures certainty and, therefore, maximum deterrence.

c) An entity comes into possession of inside information and uses that information to trade securities: When should the institution be liable ?

The entity is in no different position than the individual referred to in b) above. Each has knowingly traded "on the basis" of information secured from another. The liability of the entity is resolved in the same manner that it was for the individual in b): if not affiliated with the tipper, then it will be liable only if it is aware that one of the entity's employees or another has conferred a direct or indirect pecuniary benefit upon the tippee.

d). An employee of an institution trades on inside information: When should the institution be liable ?

There are two bases under which an institution can be held liable. One is the statutory controlling person provision of section 20(a) of the Securities Exchange Act of 1934. The second is under traditional agency law considerations, the most important being that of respondeat superior.

As a controlling person, the employer avoids liability if it can demonstrate its "good faith." Within the context of the securities laws, and especially as applied to brokerage houses, this defense is established whenever the brokerage house has maintained a reasonably designed program to deter and detect its employees unlawful tipping – trading practices. The advance sheets report instances in which brokerage firms have successfully established their "good faith" defense with a modestly designed and staffed securities law compliance programs.

An important feature of our common law heritage is the vicarious responsibility of employers for the misbehavior of their employees committed within the scope of the employee's employment. This occurs under the doctrine of respondeat superior. The reasons for vicarious liability are well established both within and without the federal securities laws. Only the Ninth Circuit Court of Appeals has held there is no respondeat superior liability under the federal securities laws. It should be borne in mind that an entity will be liable under respondeat superior only if its employee tips or trades on a tip

“within the scope of his employment.” Thus, a tip or trade on a tip will expose an employer to vicarious responsibility only when its employing is acting on behalf of the employer.

As my prepared statement to the Subcommittee and oral testimony emphasized, the Congress should not retreat from either the present configuration of controlling person liability under section 20(a) of the Securities Exchange Act of 1934 or the application of respondent superior liability. Indeed, there is no evidence in the advance sheets that either basis of liability has been imposed upon employers when their employees have engaged in unlawful tipping or trading. The reason for the dearth of control person or respondeat superior liability for tipping or insider trading is that those offense usually involves an employee’s abuse of his position in that the employee invariably acts to reap a secret profit solely for himself. In sum, there is no reason for the there to be any change in the law on the question of employer liability.

e). An entity that possesses inside information does not itself use that information to trade securities, but communicates the information to another person or entity, who then uses the information to trade securities: When should the entity be liable in this situation?

The answer to this question is set forth in my answer to hypotheticals c) and d) above. In sum, it depends upon whether there was an improper tip ala Dirks and whether the entity can establish its “good faith” defense under the controlling person standard as well as that its “tipping employee” was acting outside the scope of his employment.

f). An entity receives insider information from another person and trades securities on the basis of that information: When should the entity be liable?

My response to this question is the same as that to question c). It should be emphasized that the information in this hypothetical must be material, that the trading defendant or its employees must know it was material and knowingly trade for the employer’s account or otherwise within the scope of their employment trade while the themselves are in possession of said information.

This concludes my response to the questions. I very much appreciate this opportunity to serve the Subcommittee and you. Please do not hesitate to give me a call if I can be of any further use; as life would have it, I am in Washington fairly frequently and I would be happy on such a trip to meet with you or your staff to be of whatever service I can.

Best regards,

James D. Cox  
Professor of Law