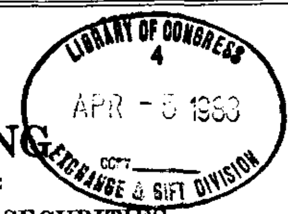
S. Hrg. 100-507

# THE INSIDER TRADING PROSCRIPTIONS ACT OF 1987




## HEARING

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

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

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

## S. 1380

TO AMEND THE SECURITIES EXCHANGE ACT OF 1934 TO PROHIBIT CERTAIN TRADING OR COMMUNICATIONS BY THOSE WHO POSSESS MATERIAL, NONPUBLIC INFORMATION

DECEMBER 15, 1987

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

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1 SEC. 3. EFFECTIVE DATE.

2 This Act shall take effect immediately upon enactment

3 of this Act.





## STATEMENT OF DAVID S. RUDER, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. RUDER. Chairman Riegle and members of the subcommittee: I am particularly pleased to be here today to testify concerning the Commission's revised proposal to define and prohibit insider trading. I ask that my written statement previously submitted to the subcommittee be included in the hearing record.

Senator RIEGLE. It will be done.

Mr. RUDER. At the outset, I would like to commend the subcommittee for its important leadership in working toward legislation to define and prohibit insider trading. Additionally, let me note my concurrence with those who continue to support a statutory definition even after the Supreme Court's decision in *United States* v. *Carpenter*. The Court's decision in that case was an important victory for the Government and for the Commission since it leaves standing the 2nd Circuit's affirmance of the misappropriation theory. Nevertheless, the Commission continues to support insider trading legislation in order to promote clarity and certainty in the law.

Prior to my becoming Chairman of the Securities and Exchange Commission, Chairman Riegle asked Harvey Pitt to form an ad hoc committee to draft insider trading legislation. The work of this ad hoc committee resulted in proposed legislation introduced by Chairman Riegle and Senator D'Amato previously referred to, S. 1380, introduced in June of this year.

At the subcommittee's request, the Commission submitted its own proposal for a statutory definition in early August. One of my first tasks when I became Chairman was to work through the Commission's staff with members of the ad hoc committee to produce a reconciliation draft between the draft submitted by the Commission in August and S. 1380, which could then be submitted to the subcommittee.

As a result of these efforts, the Commission has submitted a revised legislative proposal to the subcommittee on November 18. The Commission's proposal differs in only one significant respect from the reconciliation draft submitted by members of the ad hoc committee.

The Commission's support for its proposal depends in part upon the development of proposed legislative history which will amplify and describe certain provisions contained in its proposal. The Commission hopes shortly to submit that proposed legislative history to the subcommittee for its consideration.

I should note as important that the Commission's proposal has been formally adopted by the Securities and Exchange Commission, the agency charged with administration of the Nation's securities laws, and therefore represents the policy of that agency.

The Commission's written testimony sets forth at some length the provisions in the Commission's proposal. Let me highlight just a few of them.

### THEFT OF INFORMATION

First, it utilizes a wrongfulness approach in the general trading prohibition that reaches the theft of information and the use of

confidential information. It includes the terms "misappropriation and conversion," which are soundly based upon breach of duty theory. No violation will exist under our proposal unless the person knows or recklessly disregards that the information has been obtained wrongfully or that the purchase or sale would constitute a wrongful use.

Second, the Commission's proposal prohibits trading while in possession of material nonpublic information. The Commission rejects requiring the use of such information for trading since the use test makes enforcement extremely difficult. The possession test, which we advocate, is not harsh in view of the knowing or reckless disregard standard which appears in the general provision.

Third, the proposal contains a general tipping prohibition that expressly imposes liability based upon reasonably foreseeable trading.

Fourth, the proposal creates private rights of action for contemporaneous traders and additionally for other persons who can prove that they have been injured in their securities transactions by the insider trading violation.

Fifth, although the proposal does not contain an express exemption for communications made by or to analysts, it offers substantial protection for good faith communications. The Commission recognizes that an insider trading bill may interfere with the important analyst function of disseminating information to the market. To ensure that the analyst function is not impaired by the proposed legislation, the Commission's proposal contains both a wrongfulness concept and a foreseeability provision in the general tipping prohibition. An analyst must know that information has been communicated to him in a breach of duty, or the analyst must himself violate his duty in communicating the information.

The proposal contains a provision pursuant to which the Commission would have authority to exempt certain persons from the provisions of the bill. This provision is of particular importance to the Commission which anticipates, for example, that it will use the exemptive authority to exempt certain communications to and by market analysts that are consistent with the purposes of the act.

### POSSESSION OF CONFIDENTIAL INFORMATION

Finally, as I noted earlier, there is only one substantive area in which the Commission differs from the ad hoc committee. That area concerns communications relating to a person's own plans to acquire an issuer. The Commission's proposed legislation would continue existing law by generally codifying Commission rule 14e-3, a rule that makes it unlawful to trade while in possession of material nonpublic information relating to a tender offer. This provision does not depend upon wrongful conduct. By contrast, the ad hoc committee would extend the nonfault provisions to any acquisition or disposition of an issuer or a material portion of the issuer's securities or assets.

The Commission believes that Congress should endorse the approach of rule 14e-3. Experience has shown that trading and the potential for trading while in possession of confidential information relating to tender offers can result in significant market disruption



and abusive practices. However, the Commission does not believe that there has been a demonstration that similar express prohibitions are necessary for other types of transactions. In most cases that will arise involving transactions other than tender offers, the persons obtaining material nonpublic information will owe duties of confidentiality; and, thus, their trading or tipping would be prohibited by the general trading and tipping proscriptions in the Commission's proposal, and a nonfault provision is not necessary in that regard.

Mr. Chairman, the task which you and this subcommittee have undertaken is an important and challenging one, and I look forward to continuing to work with this subcommittee in its efforts to develop insider trading legislation.

If I may, Mr. Chairman, I would like to respond to your question regarding Commission resources.

Senator RIEGLE. Please do.

Mr. RUDER. Between 1980 and 1987, the securities markets experienced phenomenal growth. For example, trading volume on U.S. securities markets during that period more than quadrupled. During that same period, registered brokers increased from 6,750 to 13,000. The number of investment advisers increased from 4,580 to 13,000. The number of investment companies increased from 1,461 to 3,300. And the number of initial public offerings increased from 710 to 2,220.

Additionally, during that period, the enforcement efforts of the Commission have increased markedly.

Nevertheless, during these same years, from 1980 to 1987, the Commission's personnel resources shrank by 111 staff years, from 2,041 to 1,930. At present, in addition to the Commission's ongoing regulatory responsibilities, it is engaged in a series of major initiatives relating to strengthening the integrity of our capital markets. Those include not only the insider trading and other enforcement efforts, but also internationalization of the securities markets, and analysis of the causes and implications of the October market break.

President Reagan has recommended a fiscal year 1988 Commission budget of $145 million, a significant increase over the Commission's $114.5 million 1987 appropriation. Both the Senate and the House have passed appropriations approximating $142 million. An appropriation in this range, while still not ideal, would permit the Commission to keep pace with the increasing scope of its responsibilities. It would also continue the Commission's status as a Government profit center, since $142 million of spending would only absorb approximately ½ of the fee revenues generated by the Commission.

I am, however, deeply concerned that as a result of the ongoing budget negotiations, the Commission's 1988 appropriation may be significantly less than the President's request—funding which would result in a level of Commission activity, as we understand mandatory expenditures which we must make, at or below 1987 levels. This level would be extremely unfortunate in light of the dramatic growth of our responsibilities.

For these reasons, I urge that the 1988 budget legislation appropriate at least $142 million for the Commission and that the Com-

mission be authorized to reprogram certain funds appropriated for certain purposes to other pressing agency obligations.

Chairman Riegle, I appreciate the opportunity to address these budget considerations. I recognize that my suggestions in this regard represent somewhat of a deviation from my predecessor's, but I would tell you that I came to the Commission and found a Commission which is well-staffed and able to meet its regulatory duties. The problem is that we have now reached the limit of our ability to deal with the expanded securities markets and the matters which are before us, and it is essential that we be able to expand our resources in order to meet our new responsibilities.

Thank you.

[The complete prepared statement of David S. Ruder follows:]

STATEMENT OF DAVID S. RUDER,
CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION,
BEFORE THE SUBCOMMITTEE ON SECURITIES OF THE
SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE

CONCERNING THE COMMISSION'S REVISED PROPOSAL
TO DEFINE INSIDER TRADING

December 15, 1987

Chairman Riegle and Members of the Subcommittee:

The Securities and Exchange Commission is pleased to testify concerning its revised proposal for a statutory definition of insider trading, which was transmitted to the Subcommittee on November 18, 1987. The Commission's Proposal would expressly define and prohibit insider trading through provisions carefully crafted to preserve and protect the fairness, integrity, and efficiency of the nation's securities markets. This statement describes the Commission's Proposal, discusses significant differences between that proposal and S. 1380, legislation introduced on June 17, 1987 by Chairman Riegle and Senator D'Amato, and discusses the one substantive difference between the Commission's Proposal and the "Reconciliation Draft" recently submitted by Harvey L. Pitt, Chairman of the Ad Hoc Legislative Committee to Define Insider Trading (the "Ad Hoc Committee").

I. Background

During an oversight hearing before the Subcommittee on February 24, 1987, Chairman Riegle requested Harvey Pitt to form a committee of securities law practitioners to draft statutory language to define and prohibit insider trading. The work of this group, the Ad Hoc Committee, resulted in proposed legislation that was introduced by Chairman Riegle and Senator D'Amato as S. 1380, the "*Insider Trading Proscriptions Act of 1987,*" on June 17, 1987.

The Commission testified before the Subcommittee on June 19, 1987, concerning the desirability of a statutory definition of insider trading, and in particular, the merits of the approach adopted in S. 1380. In general, the Commission stated that it could support a definition that preserved its authority and flexibility, although it did not believe a statutory definition was necessary for the continued success of its enforcement program. With respect to S. 1380, the Commission stated that, although there was much in the bill that the Commission could endorse, it could not recommend adoption of the proposed legislation due to concerns about certain of its provisions. Therefore, the Commission stated that it would develop and submit to the Subcommittee its own proposal for a statutory definition of insider trading.



The Commission submitted its original proposal for a definition on August 3, 1987, and the Subcommittee held hearings on this proposal on August 7, 1987. At that hearing, and thereafter by letter, the Subcommittee requested that the Commission assist in the process of developing a consensus proposal for legislation defining insider trading. In response to that request, members of the Commission's staff met with representatives of the Ad Hoc Committee to discuss a potential compromise. Following those meetings, and as a result of further Commission consideration of the definition, the Commission, acting by a majority, determined that it could support legislation that differs in certain respects from the Commission's original proposal and includes certain provisions adopted from S. 1380. On November 18, 1987, the Commission submitted to the Subcommittee its revised proposal for compromise legislation. 1/ It bears emphasis that, although the Commission's Proposal differs from the Ad Hoc Committee's in only a few areas, the Commission's endorsement extends only to its own proposal.

II. Purpose of the Commission's Proposal

The law of insider trading has developed pursuant to judicial and *administrative decisions construing* the antifraud provisions of the federal securities laws, especially Section 10(b) of the Securities Exchange Act and Rule 10b-5. Under this body of law, "insider trading" refers generally to the act of purchasing or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material

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1/ Chairman Ruder's letter of November 18, 1987, transmitting the Commission's Proposal, stated that the proposal would be acceptable to the Commission, provided that certain interpretive positions are clearly set forth in the legislative history. (A copy of that letter is attached as Appendix A.) Chairman Ruder's letter set forth those areas in which the Commission believed clarifying legislative history was necessary and indicated that the Commission's staff had been requested to prepare suggested Committee Report language addressing these issues. This report language will be transmitted to the Subcommittee as soon as it is completed.

Commissioner Grundfest's position on the Commission's Proposal is contingent on his approval of this legislative history. Commissioner Fleischman did not join in accepting the proposed legislation or the proposals for legislative history.

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nonpublic information relating to that security. The law prohibits such trading by corporate officers and directors and other persons having a relationship of trust and confidence with the issuer or its shareholders. 2/ Under a theory developed in the Second Circuit Court of Appeals, such trading by persons who misappropriate material nonpublic information from sources other than the issuer also is prohibited. 3/ Tipping -- the wrongful communication of material, nonpublic information -- by such persons is also prohibited, and the tippees of such persons are also prohibited from trading or tipping. 4/

The prohibitions against insider trading play an extremely important role in the proper functioning of the securities markets. Although they rest on legal concepts of breach of fiduciary duty and misappropriation, they also serve to improve confidence in the fairness and integrity of the securities markets. The incentives for legitimate information gathering, analysis, and dissemination, activities that are essential to the efficient operation of the nation's securities markets, are diminished when others may wrongfully obtain or use confidential information. Insider trading may undermine investor confidence in the fairness and integrity of the markets, and thereby impair the markets' ability to further capital development and economic growth. The Commission recognizes that market participants will naturally seek an informational edge and that it is desirable for securities prices to reflect value in light of all relevant information. The Commission is not, however, prepared to condone the exploitation of informational advantages dishonestly acquired.

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2/ The Commission first articulated the prohibition against such insider trading in Cady, Roberts & Co., 40 S.E.C. 907 (1961), stating that corporate insiders have an obligation to abstain from trading in the shares of their corporation unless they have first disclosed to the shareholders any material nonpublic information known to them. The Cady, Roberts "abstain or disclose" doctrine was subsequently endorsed by the Second Circuit Court of Appeals in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

3/ United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), aff'd on securities law counts by an equally divided court, 56 U.S.L.W. 1073 (November 16, 1987); SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), cert. denied, 471 U.S. 1053 (1985); United States v. Newman, 664 F.2d 12 (2d Cir. 1981), aff'd after remand, 722 F.2d 729 (2d Cir.), cert. denied, 464 U.S. 863 (1983). The "misappropriation" theory was previously discussed in the concurring and dissenting opinions in Chiarella v. United States, 445 U.S. 222 (1980).

4/ See Dirks v. SEC, 463 U.S. 646 (1983); SEC v. Texas Gulf Sulphur Co., 401 F.2d at 852.



The Commission's Proposal is a carefully tailored insider trading prohibition that will promote the fairness, efficiency, and integrity of the securities markets, without impeding the important functions of those markets or the free flow of information to the marketplace. While the Commission would not support legislation intended to impose a "parity of information" standard, 5/ the Commission believes it is essential that the law continue to prohibit persons from gaining informational advantages in the securities markets through wrongful conduct. The Commission's Proposal, supplemented by its proposed legislative history, is designed to distinguish such wrongful conduct from legitimate activities, and thereby to protect the integrity of the securities markets.

## III. Discussion of the Commission's Proposal

The Commission's Proposal would add a new Section 16A to the Securities Exchange Act and make related conforming amendments to that Act. Section 16A would expressly prohibit conduct commonly referred to as "insider trading," utilizing and clarifying the concepts of breach of duty and misappropriation embodied in the existing law of insider trading. By making use of existing theories, the Commission's Proposal avoids the interpretational uncertainties that a definition based on more novel notions would inevitably entail.

Enactment of this legislation would emphasize the significance of proscriptions against insider trading in the regulation of the nation's securities markets and would represent express Congressional approval of the important principles underlying these prohibitions. The Commission's Proposal would set forth within one provision of the securities laws the law governing this conduct. It would provide the investing public and securities industry with additional guidance in ordering their conduct. It also would resolve certain questions that may interfere with effective enforcement of the law.

One of the proposed legislative findings would reflect the intention that proposed Section 16A be the exclusive provision in the federal securities laws under which conduct known as "insider trading" will be addressed. Of course, the fact that insider trading cases would be brought under Section 16A would not affect the application of the securities laws to other types of violations that may involve similar conduct. For example, cases

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5/ See generally, Chiarella v. United States, 445 U.S. at 233; Dirks v. SEC, 463 U.S. at 657.





involving manipulation or false or misleading corporate disclosure could still be brought under Section 10(b) or other appropriate provisions of the securities laws, where the elements of such other violations are met, even if trading in securities also occurred. Further, proposed Section 16A would be exclusive only with respect to the federal securities laws. Actions currently cognizable under state law, or other federal statutes, such as the mail and wire fraud statutes, would be unaffected.

### A. General Prohibition Against Trading -- Subsection 16A(b)(1)

Subsection (b)(1), which contains the basic trading prohibition, is targeted against the wrongful trading abuses that have a direct, significant effect on our securities markets. This provision would make it clear that a person is prohibited from purchasing or selling a security while in possession of material nonpublic information relating to the security, if that person knows or recklessly disregards that the information has been "wrongfully obtained," or that such purchase or sale would constitute a "wrongful use" of the information. 6/

The prohibition would clearly reach not only any person who purchases or sells a security for his own account, but also any person who "causes" another person's purchase or sale of a security in these circumstances. The concept of "causing" a purchase or sale, which is not included in S. 1380, would, among other things, clarify the application of the prohibition to the situation where one person makes an investment decision for the account of another person -- for example, a broker exercising discretionary investment authority for a client, a trustee acting for the account of a beneficiary, or an investment adviser making investment decisions for its clients. In this situation, the person who "caused" the trade to be made would be a primary violator of the law -- i.e.,

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6/ One of the proposed legislative findings would reflect the intention to exercise federal jurisdiction in this area to the fullest extent possible, in light of the substantial effect insider trading has on interstate commerce. Thus, as under existing law, subsection (h) would provide that the prohibitions against trading and tipping apply to any transaction in connection with which use is made of any means or instrumentalities of interstate commerce, or of the mails, or of the facilities of any national securities exchange, or of the facilities of any automated quotation system maintained for the trading of securities.



the broker, trustee or investment adviser. 7/ The person for whose account the transaction was made would not be a violator of the prohibition, assuming such person did not otherwise participate in the violative conduct. 8/

The critical element of the prohibition would be that the information has been "wrongfully" obtained or used. Two separate categories of such "wrongful" conduct would be set forth, encompassing those activities by which persons improperly obtain or use information. The first category, in subsection (b)(1)(A), would cover four specific types of wrongful conduct by which confidential information is obtained or used -- theft, bribery, misrepresentation, or espionage. Thus, for example, if a competitor were to obtain material, nonpublic information about an issuer by industrial espionage, he would be precluded from trading that issuer's securities. 9/ Moreover, a third person who possesses such information and knows or recklessly disregards that it was obtained as a result of another's theft, bribery, misrepresentation or espionage, would also be precluded from trading.

The second category of wrongful conduct, in subsection (b)(1)(B), would address those situations in which information is obtained or used in violation of some express or implied obligation of confidentiality. The wrongful conduct covered by this category would include conversion, misappropriation, and any other breach of a fiduciary duty, a personal or other relationship of trust and confidence, or a contractual or employment relationship. Thus, for example, if material, nonpublic information relating to an issuer is properly disclosed to a person, such as a lawyer or an accountant, with the reasonable expectation that it will be kept confidential, and that person trades the issuer's securities, liability would result under this provision. In addition, if that person tips the information, and the tippee trades, the tippee would be liable if he knew or recklessly disregarded that

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7/ For example, where an adviser to an investment company directs trades on behalf of the investment company while in possession of material nonpublic information, the adviser, not the investment company, would be the violator. Cf. H.R. Rep. No. 355, 98th Cong., 1st Sess. 11 (1983).

8/ However, under well-established principles of equity, such person would in most cases be required to disgorge any profits gained or losses avoided from the trading.

9/ Cf. Investors Management Co., Inc., 44 S.E.C. 633, 642 & n. 18 (1971).

the information was obtained as a result of the tipper's breach of duty. Similarly, any subtippees who know or recklessly disregard that the information was wrongfully obtained would be liable for trading.

The broad provisions of subsection (b)(1)(B) would expressly prohibit all conduct that is unlawful under existing principles of liability, including traditional insider trading doctrine and the "misappropriation" theory. By employing the terms "misappropriation" and "conversion," the provision would reach situations in which information is used in a manner inconsistent with a duty of trust and confidence owed to the person providing the information. Under the Commission's Proposal, cases could be premised not only upon the breach of formal fiduciary duties, but also upon the breach of duties that may arise from personal or other relationships, 10/ or the breach of any contractual or employment relationship.

It is anticipated that, as under current law, the application of the prohibition would focus on activities with a significant relationship to the securities markets. The Commission's Proposal is intended to proscribe wrongful conduct in connection with the nation's securities markets, but not otherwise to enforce duties of trust and confidence or to reach conduct that is remote from the securities markets. To the extent this provision, which would also provide a basis for private actions, would inappropriately extend to cases in which a substantial nexus to the securities markets is lacking, the Commission would expect to use the broad exemptive authority provided by subsection (f)(1).

Under subsection (b)(1), proof of trading "while in possession of" material nonpublic information would establish a violation where the other elements of the prohibition are met. This provision thus would not require proof that a defendant "used" the nonpublic information for trading, or traded "on the basis of" such information. The "possession" test would represent a significant difference from S. 1380, which would require "use" of the information and create a rebuttable presumption that a person who traded "while in possession of" material, nonpublic information had "used" that information. The Commission supports the "possession" standard. The Commission's experience demonstrates that individuals who have actually traded on the basis of inside information frequently

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10/ See United States v. Reed, 601 F. Supp. 685 (S.D.N.Y. 1985).



attempt to invent arguments that they have traded for other reasons. Under a "possession" standard, such post hoc rationalizations would be irrelevant, and could not be used to impede enforcement of the law. Concerns that the "possession" standard would lead to inappropriate liability are unwarranted, in view of the fact that the prohibition would require knowing or reckless conduct as a predicate to any violation.

The Commission's Proposal would continue existing law by encompassing within its proscriptions "material, nonpublic" information "relating" to a security. The terms "material" and "nonpublic" are not separately defined in the Commission's Proposal. These terms have been the subject of much judicial interpretation, and are best left to development on a case-by-case basis. In general, information relating to a security is material "if there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision or if it would have "significantly altered the 'total mix' of information made available" to the shareholder. 11/ The Commission's Proposal is intended to reaffirm this standard, and would neither broaden nor narrow the scope of what is material information in the context of an insider trading case.

Moreover, the language of the Commission's Proposal -- information "relating" to a security -- is consistent with this standard, and would not alter existing law concerning "market" information and "corporate" information. "Corporate inside information" is information from within a corporation bearing on its expected earnings or assets. "Market information" concerns events and transactions outside of the corporation that could affect the price of corporate securities. 12/ It is well settled under current law that certain types of information external to a corporation -- for example, information about an impending tender

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11/ TSC Industries Inc. v. Northway, 426 U.S. 438, 449 (1976) (footnote omitted). Although Northway involved proxy violations, that test has been applied in insider trading cases as well. See, e.g., United States v. Carpenter, 791 F.2d at 1032 n.9.

12/ See Dirks v. SEC, 463 U.S. at 660 n.15. See generally Brudney, Insiders, Outsiders and Informational Advantages Under the Federal Securities Laws, 93 Harv. L. Rev. 322, 329-330 (1979).





offer -- may be material for purposes of trading in the corporation's securities. 13/

Information must also be "nonpublic" for a violation to occur. It is well established that information is nonpublic if it has not been disseminated in a manner making it available to investors generally. 14/ No liability would result under the Commission's Proposal where a person engaging in a face-to-face transaction discloses material information to the other party to the transaction. In such a case, the information would be known to both parties and thus would not be nonpublic for purposes of the particular transaction.

B. Institutional Trading Defense -- Subsection 16A(b)(2)

The Commission's Proposal would provide a defense for institutions, such as multiservice securities firms, in circumstances in which one individual in the firm has material, nonpublic information about a security and another individual in the firm trades in that issuer's securities for the firm's account. The defense would be similar to the defense contained in Commission Rule 14e-3, regulating transactions in securities while in possession of tender offer information. That rule contains an institutional defense from its trading prohibitions when the institution can demonstrate: (1) that the individual or individuals making the trade did not know the information; and (2) that the firm has implemented reasonable procedures, such as Chinese Walls and restricted lists, to ensure that individuals making investment decisions do not violate the trading prohibition in the rule. 15/

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13/ S. 1380 and the Reconciliation Draft refer to material nonpublic information relating to the security "or the market therefor." The Commission's Proposal does not include this additional language.

14/ See, e.g., Investors Management Co., Inc., 44 S.E.C. 633, 643 (1971).

15/ The substance of the institutional safe harbor in Rule 14e-3 currently applies equally to insider trading cases brought under Section 10(b) of the Securities Exchange Act and Rule 10b-5. See Letter from Chairman John S.R. Shad to Honorable Timothy E. Wirth (June 29, 1983), reprinted in H.R. Rep. No. 355, 98th Cong., 1st Sess. 28 (1983).

(footnote continued)



S. 1380 would afford a defense when the firm could prove that the purchase or sale was not influenced by material, nonpublic information, and that the individual effecting the trade did not know the information. The presence of institutional procedures designed to prevent violations would not be an essential element of the defense. Rather, such procedures are stated to be "relevant evidence" in this regard. This provision apparently would broaden the institutional defense by not requiring the implementation of reasonable procedures as an element of the defense. 16/

The Commission's Proposal adopts a more rigorous standard. Under subsection (b)(2) of the Commission's Proposal, an institution would have to sustain the burden of proof on two issues. First, it would have to show that "no individual involved in making the investment decisions" on behalf of the institution knew or was influenced by the information. This language recognizes that more than one individual may be involved in making a decision to trade for the firm. In such a case, none of those individuals would be permitted to know or be influenced by the information. 17/ Second, the firm would have to show that it had implemented reasonable procedures designed to

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(footnote continued)

The question of what procedures are "reasonable" depends on the nature and scope of the person's business. See Securities Exchange Act Release No. 17120, [1980] Fed. Sec. L. Rep. (CCH) ¶ 82,646 at 83,461 (September 4, 1980). Entities which do not regularly come into possession of material, nonpublic information but which do have investment portfolios (e.g., colleges, charitable foundations) would not be expected to maintain "Chinese Walls" or "restricted lists" such as a multiservice securities firm might. In some circumstances, no procedures at all could be reasonable.

16/ See Statement of Charles C. Cox, Commissioner, Securities and Exchange Commission, Before the Subcommittee on Securities of the Senate Banking, Housing and Urban Affairs Committee at 8 (June 19, 1987) ("Cox Testimony").

17/ Only the individuals actually involved in making the investment decision are covered by this language. It would not reach persons with purely supervisory authority with respect to investment decisions, or a compliance officer who, in the proper exercise of the firm's procedures governing exceptions to trading restrictions, authorizes a trade initiated by another person in the firm.

prevent the persons making the type of investment decision at issue from possessing the information. Under this provision, the firm would meet this element of the defense if it could demonstrate that it had established and maintained reasonable procedures relevant to the particular violation. The availability of the defense would not be affected by evidence that other unrelated aspects of the firm's procedures were flawed.

C. General Prohibition Against Tipping -- Subsection 16A(c)

Subsection (c) contains the general prohibition against tipping material nonpublic information. As the Supreme Court has recognized, tipping, as well as insider trading, must be prohibited in order to protect the securities markets. 18/ The Commission's Proposal endorses the important principle that a tipper is liable for the trading of reasonably foreseeable tippees and subtippees. Subsection (c) would expressly prohibit a person whose own trading of a security would be prohibited from wrongfully communicating information relating to the security, which the person knows or recklessly disregards is material and nonpublic, to another person who trades or causes trading, if the trading is reasonably foreseeable. In addition, if the tippee communicates the information to subtippees who engage in reasonably foreseeable trading or cause such trading, the original tipper would be liable. 19/

Significantly, this provision would make it clear that "personal benefit" is not a required element of tipper liability. Under existing law, it has been necessary to demonstrate that a tipper anticipated or received a direct or indirect "personal benefit" from the disclosure. 20/ However, the "personal benefit" test, by requiring inquiry into the subjective motives of the tipper through the aggregration of circumstantial evidence, has introduced unnecessary issues and complexities in insider trading cases.

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18/ Dirks v. SEC, 463 U.S. at 659.

19/ The Commission's Proposal would not define "communicating." Since a "communication" for purposes of the tipping proscription would continue to include conveying material nonpublic information or its import, by verbal or other conduct, the application of this concept would be essentially a factual question requiring a flexible approach best left to case-by-case development.

20/ Dirks v. SEC, 463 U.S. at 662.



Instead of "personal benefit," the Commission's Proposal would focus on the "wrongful" communication of a tipper. In requiring a "wrongful" communication as an element of the violation, the Commission's Proposal would recognize that certain communications made for a proper purpose are not unlawful and should not result in tipping liability even if those communications lead to trading. One example of this is a communication properly made by a corporate official to a market analyst. Market analysts play a crucial role in facilitating the dissemination of information to the marketplace, and thereby promoting healthy and efficient markets. The Commission Proposal would protect routine communications to and from analysts (i.e., communications not in breach of duty), 21/ or communications otherwise made to publicly disseminate information. Indeed, given the importance of their activities, the Commission would consider instituting rulemaking proceedings to ensure that the legitimate functions of analysts will not be inhibited.

Consistent with current law, the Commission's Proposal would impose liability upon a tipper for the trades of tippees who are not themselves liable. For example, if a tippee neither knows nor recklessly disregards that information was wrongfully conveyed, then the tippee would not violate the statute by trading while in possession of the information. The tipper would nevertheless be liable for making a wrongful communication of information that resulted in reasonably foreseeable trading. The Commission's Proposal thus recognizes that a tipper's liability must not depend on whether the tippees broke the law. S. 1380 does not clearly impose liability upon the tipper in such a case. 22/ The Commission's Proposal also would not require that a person who communicates information be liable in order for the recipient of the information to be prohibited from wrongfully trading while in possession of that information. Thus, if a person communicates material nonpublic information under circumstances in which trading by the recipient is not reasonably foreseeable, the recipient would be liable if his trading (or tipping) were wrongful, although the person who provided the information is not liable for making the communication.

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21/ Although the Commission's Proposal would eliminate the "personal benefit" test, the Commission does not believe it would reverse the result in a case such as Dirks v. SEC, supra. Dirks did not receive information from a person breaching a duty.

22/ See Cox Testimony at 10.





D. Prohibition Against Trading and Tipping While In Possession of Material, Nonpublic Information Relating to a Tender Offer -- Subsection 16A(d)

The Commission's Proposal includes a separate provision addressing insider trading and communication in the context of a tender offer. Subsection (d) would reaffirm existing law in this area by generally codifying the prohibitions contained in Commission Rule 14e-3. The separate treatment of this category of transactions continues to be warranted, in light of the special opportunities for abuse they present, and the substantial impact to the market that can result from them. 23/ The Commission's Proposal would make it unlawful, after substantial steps have been taken to commence a tender offer, to trade while in possession of material, nonpublic information relating to the tender offer, if the trader knows or recklessly disregards that the information has been acquired directly or indirectly from the offering person, the target, or their agents. Communications of material, nonpublic information relating to a tender offer by specified persons, including the offering person, the target, or their agents, also would be prohibited (with the exception of certain good faith communications).

Both S. 1380 and the Reconciliation Draft, by contrast, depart from current law. These proposals include a special provision that would apply in the context of any acquisition or disposition of an issuer or a material portion of its securities or assets -- not only in connection with tender offers. Under these proposals, a person planning such a transaction would be prohibited from communicating material nonpublic information concerning such plans for the purpose of influencing or encouraging trading, except if the communication is made to members of the person's group (within the meaning of Section 13(d)(3) of the Exchange Act) or in the course of a good faith solicitation to join such a group. These provisions would prohibit only the communication, and would not prohibit the recipient of the communication from trading.

The Commission believes Congress should endorse the approach of Rule 14e-3. Security holders who purchase from or sell to

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23/ Unlike the general prohibitions against tipping and trading, subsection (d) would not require a showing that there has been a breach of a duty. Consequently, although in many cases liability might arise under both the general prohibition and subsection (d), in some cases liability could arise only under the latter provision.



persons in possession of information relating to a tender offer are effectively denied the protections of the Williams Act. Moreover, recent experience has shown that trading and the potential for trading while in possession of confidential information relating to a tender offer can result in significant market disruption and abusive practices. Such consequences have a detrimental impact on shareholder protection, tender offer practices, and the securities markets. Accordingly, the Commission continues to believe that the communication, and trading while in possession of such information should be prohibited by the federal securities laws. The Commission does not believe, however, that similar prohibitions are warranted when transactions other than tender offers are involved. In most cases that will arise involving these other transactions, persons obtaining material nonpublic information will owe duties of confidentiality to a party involved in the transaction, and their trading or tipping would give rise to liability under the general prohibitions of Section 16A. In addition, the broad application of the prohibitions of S. 1380 would extend to transactions such as block purchases of securities, which could create uncertainties as to the status of ordinary market transactions and expose market participants to potential liability in the absence of impropriety.

E. Derivative Liability -- Subsection 16A(e)

Subsection (e) would address the issue of derivative liability for controlling persons and employers of other persons who violate Section 16A. The subsection would state that, except as provided in Section 20(a) of the Exchange Act, 24/ no person is liable solely by reason of employing or controlling another person who violates the section, "if such controlling person or employer did not participate in, profit from, or directly or indirectly induce the acts constituting the violation."

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24/ Section 20(a) provides that "[e]very person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." "Controlling person" includes not only employers, but any person with power to influence or control the direction of the management, policies, or activities of another person.

The Commission's Proposal differs from S. 1380 on this issue. S. 1380 provides that an employer or controlling person would be derivatively liable only if it has participated in, or directly or indirectly induced the violation. However, S. 1380, as the exclusive prohibition of insider trading, could be interpreted to exclude controlling person liability under Section 20(a). Therefore, the Commission's Proposal expressly provides that Section 20(a) will continue to be applicable to insider trading cases.

The imposition of derivative liability on employers and controlling persons under Section 20(a) provides an incentive for employers and controlling persons to take reasonable steps to prevent violations by persons acting on their behalf and within their direction or control. It is also appropriate that controlling persons and employers who participate in or profit from a violation be subject to liability. The Commission's Proposal would not, however, expose an employer or controlling person to potential litigation or liability in the event of insider trading violations by errant employees or agents which cannot reasonably be prevented and do not operate to benefit them. Thus it would rule out causes of action based on respondeat superior in insider trading cases. 25/

F. Exemptions -- Subsection 16A(f)

Subsection (f)(1) would give the Commission authority to exempt, by rule or order, any person, security, or transaction (or class of person, security, or transaction), from the provisions of the legislation, where such exemption is not inconsistent with the purposes of the section. As noted above, the Commission's experience after enactment of this legislation may indicate that it is necessary to consider exemptions in certain areas -- for example, for certain communications to and by market analysts -- and the proposal would give the Commission sufficient flexibility to address such issues as they arise.

The Commission's Proposal would not specifically grant the Commission authority to make general regulations under Section 16A. Such authority is unnecessary in view of the Commission's existing authority under the Exchange Act. For example, Section 23(a) of the Act provides broad general rulemaking authority, and Section 3(b) of the Act provides authority to define terms.

25/ This provision does not address the general applicability of the respondeat superior theory under the federal securities laws, and does not affect the availability of any other theories of secondary liability, such as aiding and abetting or the failure to supervise, in appropriate circumstances.



Subsection (f)(2) provides that the prohibitions of Section 16A will not apply to agents acting at the direction of, and solely for the account of, their principals, when the transaction or communications would be lawful under the Section if done directly by the principal while in possession of the information. It is evident in today's complex markets that the execution of investment plans requires the assistance of others acting on one's behalf. Thus, for example, a tender offeror's agent who possesses material nonpublic information with respect to the planned tender offer would not violate Section 16A by effecting, or authorizing subagents to effect, trades in the offeree's stock for the account of the principal. However, the exemption applies only when the trades would be lawful for a principal who actually possessed the nonpublic information. Further, this exemption would not apply to an agent acting on behalf of the principal when the agent has otherwise wrongfully obtained the information.

G. Private Rights of Action -- Subsection 16A(g)

The Commission's Proposal would provide express private rights of action for two classes of persons: persons who have traded contemporaneously with the violators, and other persons who are injured by a violation in connection with their securities trading. The victims of insider trading may suffer substantial economic losses, and should be afforded a direct and effective means of redress for their injuries. Private rights of action have traditionally served as an important supplement to the Commission's enforcement of the federal securities laws.

First, the Commission's Proposal would provide contemporaneous traders a right of recovery against inside traders or tippers. It thus would reverse cases that have precluded such recovery in misappropriation cases, 26/ and even in traditional insider trading cases where the plaintiffs neither dealt with the defendants nor were influenced in their trading decision by the defendants' trading. 27/ However, the liability of a violator to contemporaneous purchasers or sellers would be limited to the profit gained or the loss avoided as a result of the violation. Damages imposed against a defendant in such a case would be diminished by the amount that the defendant has paid as disgorgement in a Commission injunctive action relating to the same violation.

26/ Moss v. Morgan Stanley, Inc., 719 F.2d 5 (2d Cir. 1983), cert. denied, 465 U.S. 1025 (1984).

27/ Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977).





Second, the Commission's Proposal affirms existing cases that provide standing to any other persons, such as tender offerors, injured by insider trading in connection with their securities transactions. Unlike contemporaneous traders, such plaintiffs would be required to prove that their damages were caused by the violation. However, their damages would not be limited to the amount of profit gained or loss avoided by the defendants. Further, other issues associated with this type of case, such as the type of injury covered and the measure of damages, would be addressed on a case-by-case basis. S. 1380 does not expressly provide a private right of action to any plaintiff other than a contemporaneous trader and would likely be interpreted to preclude such an action. 28/

H. Other Amendments

1. Amendments to Subsection 21(d)(2) of the Securities Exchange Act

Section 21(d)(2) of the Exchange Act, added by the Insider Trading Sanctions Act of 1984, provides that the Commission may bring an action to seek civil penalties against any person who illegally trades while in possession of material nonpublic information or tips such insider information. Section 3 of the Commission's Proposal would amend Section 21(d)(2) to conform its scope to the scope of proposed Section 16A. The Commission's Proposal would make clear that civil penalties are available for any primary violation of Section 16A -- whether predicated on purchasing or selling securities while in possession of material nonpublic information, causing a purchase or sale while in possession of such information, or communicating such information. 29/ The proposal would not, however, affect the provisions of Section 21(d)(2)(B) that state that civil penalties are not available against persons who are derivatively liable for violations as control persons, employers, or otherwise as aiders and abettors.

28/ See Cox Testimony at 13.

29/ The proposal also would delete language in Sections 21(d)(2)(A) and (B) that categorizes tipping as an aiding and abetting violation for purposes of the penalty provision. It thus would conform the analysis of tipping under the provisions to that utilized to determine the underlying violations: tipping would be treated as a primary violation.



2. Amendments to Subsection 20(d) of the Securities Exchange Act

Section 20(d) of the Exchange Act currently provides that when the communication of confidential information, or the purchase or sale of a security while in possession of confidential information would be illegal, such conduct also is illegal with respect to "a put, call, straddle, option, or privilege with respect to such security or with respect to a group or index of securities including such security." Section 4 of the Commission's Proposal would amend Section 20(d) to clarify that such conduct also is illegal with respect to debt securities (i.e., any note, bond, debenture, evidence of indebtedness or similar debt security) of the issuer of a security, if the material nonpublic information would be material with respect to such debt securities, and with respect to securities convertible into or exchangeable for the securities of the issuer. In addition, consistent with the purpose of providing the exclusive standards for insider trading in Section 16A, Section 20(d) would be recodified by the legislation as Section 16A(i) of the Exchange Act.

IV. Conclusion

The Commission appreciates the opportunity to testify on its proposal for legislation to define insider trading. The Commission believes that its proposal would effectively address the prohibition of insider trading and promote the integrity of the securities markets. The Commission would be pleased to provide any further assistance to the Subcommittee in its consideration of this important issue.