PRELIMINARY DRAFT 042787
PRIVILEGED AND CONFIDENTIAL
FOR DISCUSSION PURPOSES ONLY

BRIEF EXPLANATORY MEMORANDUM

I. Purposes of, and Need for, the Proposed Legislation

Recently, there has been considerable criticism of the development of the law on so-called "insider trading." Among other things, concern has been voiced that the actual parameters of existing law are unknown, and the theories by which those parameters might be applied or extended in the future remain ambiguous. In addition, the government itself has suffered two significant setbacks in the Supreme Court that have served to contort the search for principled theories of law to apply. The Supreme Court's recent grant of a writ of certiorari in U.S. v. Carpenter (often referred to as the Winans case)1/ presages additional concerns about the continued viability of at least certain of the government's prosecutorial theories.2/

The need for greater certainty in the development and application of the law is a direct result of these recent Supreme Court decisions. All those who deal with questions of securities fraud and insider trading on a daily basis recognize the impracticality of attempting to define too rigidly or too precisely the nature of the conduct that is prohibited. The SEC and the Department of Justice have done a commendable job of molding their theories to changing judicial constructs. But the cost of such a process is the reduction of clarity in the theories of law that ought to be applied by the courts in responding to instances of alleged illegal trading conduct.

At present, for example, the government cannot prosecute illegal tips of inside information absent a showing that the tipper communicated the information in order to receive some form of "personal benefit," or that the tippee had an independent duty to speak before trading on the basis of the information so communicated. These theories were articulated in passing by the Supreme Court in the Dirks decision, but have no statutory antecedents. Indeed, the search for "personal benefits" has plagued the government in a number of cases, as

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1/ 791 F.2d 1024 (2d Cir.), cert. granted, 107 S. Ct. 666 (1986).

2/ [citation to be supplied].

has the search for independent duties requiring a tippee to speak before trading on the basis of a tip of inside information.

In addition, the major linchpin on which virtually all governmental insider trading cases are predicated today -- the misappropriation theory -- is itself a judicially-created construct, the parameters of which have never been addressed by either Congress or the Supreme Court. It is entirely possible that, in attempting to ascertain whether, and to what extent, the misappropriation theory will provide a viable basis for future government prosecutions, the government will be disabled from bringing certain cases Congress believes should be pursued.

Moreover, even if the government is successful in preserving a broad scope to the misappropriation theory, it is nonetheless anomalous to permit the law to develop without the benefit of some guidance from the Congress as to the principles to be applied, and the standards that should obtain. The Winans case is an example of this phenomenon, since the prosecution depended, at least in part, upon the fortuity of the adoption of a Code of Conduct by the Wall Street Journal, upon which a breach of duty by Mr. Winans was predicated. It seems evident that the law should be based on statutory principles, even if those statutory principles do no more than affirm the principles upon which Mr. Winans' conviction rested.

Beyond these concerns, it is manifest that the courts have been struggling with the development of rational principles to govern insider trading cases, in large part because Congress has never identified the reasons that insider trading should be prohibited, or the persons who are injured by such conduct. It may seem unthinkable that, more than fifty years after the adoption of the Securities Exchange Act, the Congress is first now addressing these important questions, but it is only after reviewing the results of much of the confusion engendered by recent judicial decisions that the need for such an identification of statutory purposes and statutory beneficiaries seems clear.

Finally, it should be noted that, under current law, the ambiguities that have been created by what is, in effect, judicial legislation, leave far too many questions not only unanswered, but unstructured for appropriate response. These include:

(i) the extent, if any, to which institutions that employ persons who engage in illegal insider trading should bear any liability for the wrongful acts of their employees outside the scope of employment;

(ii) whether, and on behalf of whom, a private right of action may exist;

(iii) the extent to which persons who engage in insider trading can be held liable for civil damages (in addition to the disgorgement of ill-gotten gains at the behest of the SEC, and the imposition of treble civil penalties under the Insider Trading Sanctions Act of 1984);

(iv) the extent to which trading while in possession of inside information will, in and of itself, result in insider trading liability;

(v) the statute of limitations applicable to any private right of action for alleged insider trading; and

(vi) the extent, if any, of the Commission's authority to exempt certain transactions from the reach of any insider trading prohibition.

Thus, the proposed legislation, drafted at the request of the Senate Subcommittee on Securities, and its Chairman, Senator Riegle, is an attempt to provide meaningful guidance to the government, the courts, and legitimate businessmen, concerning the principles that will be applied in the future to test securities trading conduct for possible abuses in cases involving informational advantage.

At the outset, it should be noted that this proposal is not intended completely to supplant existing law. Thus, there will be no basis for the fear expressed by some that a statutory definition of insider trading will limit the government's ability to prosecute novel frauds not caught by the new definition. It is contemplated, however, that the new statute will be the exclusive definition for the improper use or communication of material, nonpublic information. Sections 10(b) and 14(e) of the Exchange Act will continue to provide possible avenues for government enforcement, and SEC rulemaking, in other types of frauds including market manipulations. It is expected, however, that proposed Section 16A will replace the use of Rule 10b-5 in "insider trading" cases, and that Rule 14e-3 will be withdrawn by the Commission as superfluous in the face of the new statute.

This provision specifically rejects the notion that federal law mandates equality of information in securities trading. The fact that various participants in the securities markets do not have equal information at any given time is not, in-and-of-itself, a basis for the institution of an enforcement action by the government. Nor does the proposed statute mandate an absolute equality of access to stock-related information in order to avoid legal liability.

There are many legitimate reasons that certain persons might have earlier and better access to material, nonpublic information, and might even be able to trade on such information, without violating existing or proposed law. A case in point is the role of stock exchange specialists, who often have better information about the market for any particular security than the public-at-large or even other securities professionals. Similarly, under present law, companies that intend to launch a tender offer for a publicly held company's stock can purchase up to five percent of the target company's stock without violating any laws. The proposed statute would not change these present rules. Instead, the proposed legislation addresses its proscriptions to the wrongful use or communication of material, nonpublic information.

Thus, as noted above, a prospective purchaser could make purchases of target stock up to the Section 13(d) disclosure threshold without informing the marketplace. However, if an employee of, or an advisor to the proposed bidder, with full and proper access to that information, were to convert that information to his or her own personal use, and trade on the information, or tip someone else who then trades the affected securities, the policies underlying the laws against insider trading would be implicated, and the proposed statute would expressly prohibit that conduct.

Unlike the present law, in fact, the proposed statute would set forth three basic purposes the new law against insider trading would be designed to foster. Many commentators, and the courts, have expressed difficulty in ascertaining the precise purposes behind the laws against insider trading. It is anticipated that the inclusion of express Congressional findings will serve to enhance judicial interpretation, the establishment of governmental enforcement policies, and the ability of private sector lawyers and businessmen to understand the full extent and reach of the law.

Moreover, the Commission's rulemaking authority is intended to be channelled by the Congressional findings set forth in the proposed statute. Unbridled rulemaking power might be detrimental to the continued liquidity and efficiency of our markets; unduly circumscribed rulemaking power might leave the Commission unable to address clear abuses. The proposed statute strikes a meaningful balance between these two extremes.

Nevertheless, it should be noted that no statute can delineate with precision the entire spectrum of conduct that might violate the law. The proposed statute provides a framework for governmental prosecutions and judicial resolutions, but trusts to our common law system, and the unquestionable expertise of the Securities and Exchange Commission in implementing Congressional directives through rulemaking, the ultimate evolution and development of the outer reaches of the proscribed conduct.

II. Overview of the Proposed Legislation

The legislation starts with a statement of Congressional findings. It cannot be gainsaid that there are daily instances in which persons buy or sell securities without knowledge of material, nonpublic information that might have influenced their trading decisions had it been disclosed. The proposed statute, as noted above, does not effect a change to current law in that respect. Instead, the legislation makes clear that the gravamen of insider trading abuses is the perceived unfairness and loss of integrity in our market place when an informational advantage is abused or wrongly obtained. The Congressional findings balancing the needs for both a fair marketplace and a prompt, unfettered flow into that market of properly obtained information, set the framework for future judicial interpretations and Commission rulemaking.

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

A major question to be addressed is whether persons who merely possess material, nonpublic information about a security which they have traded (or the market therefor), violate the law, or whether it must also be shown that such persons traded on the basis of that information. The proposed statute resolves this controversy by providing that the mere possession of material nonpublic information will give rise to an irrebuttable presumption that an individual, or natural person, possessing the information used that information in deciding to buy or sell the security in question, if such a use would be wrongful. The term "wrongful" has been defined expansively to encompass any theft, conversion, material misuse, or use of such information in breach of any "fiduciary, contractual, employment, personal or other relationship of trust and confidence." This provision is intended to provide a basis in the federal securities laws for proscribing the types of conduct seen in United States v. Carpenter, United States v. Reed, and other cases brought by the government which, under current case law, have required tortured analyses of business, personal and other relationships in order to find a common law breach of a fiduciary duty.

In a limited class of cases, it is possible that an individual who possesses material, nonpublic information should not be presumed to have used that information wrongfully -- for example, where a pre-existing dividend reinvestment plan of many years' duration is not interrupted by an individual who wrongfully obtains material, nonpublic information. It is anticipated that those situations are so limited, that the general presumption that individuals have used such information should apply, but the SEC should develop rules to exempt from the terms of the statute those situations in which the statute should not apply.

In the case of a person other than a natural person, this presumption of use will not be irrebuttable, but may be overcome upon a showing that the decision to buy or sell the security in question was not influenced by such material, nonpublic information. Among other things, it is intended that this provision will satisfy the legitimate concerns of the brokerage industry, and other financial institutions, that decisions to buy or sell a stock will not be tainted merely because someone in the organization possessed material nonpublic information about the security. As long as the institution involved could sustain the burden of demonstrating that the person who directed the trade did not know of the information, and was not influenced in any way by another employee's possession of that information, liability would not attach to the institution, even though the trade might be for its account. Thus, in the case of a multifaceted financial institution, the statute clearly provides that the demonstration of reasonable policies and procedures, properly implemented and maintained, to prevent employees from violating this statute will be relevant to the factfinder's determination whether the trading employee in fact did not possess the material, nonpublic information that was otherwise properly in the possession of the institution.

Additionally, as discussed above, no liability will attach to trading while in possession of material, nonpublic information concerning a person's own plans to acquire or dispose of an issuer, a material block of its securities, or its assets. Thus, the proposed legislation preserves the regulatory scheme of Section 13(d) of the Exchange Act, which allows the accumulation of up to 5% of any class of an issuer's equity securities before the stock ownership and plans of the owner must be disclosed.

Both of the principal prohibitions of this statute limit their reach to trading while in possession of information that is both nonpublic and material. The standard for determinations as to materiality remains unchanged; the test articulated by the Supreme Court in TSC Industries, Inc. v. Northway, whether "there is a substantial likelihood that a reasonable investor would consider [the omitted fact] important in [making his or her decision,]"3/ continues to apply in cases brought under the proposed legislation. Further guidance in assessing materiality should be drawn from decisions that looked to whether the information in question was "reasonably certain to have a substantial effect on the market price of a security."4/

In the case of multifaceted financial services firms, a legitimate concern of the Commission has been anticipated and is addressed by this formulation. Thus, the burden will clearly be on the party who traded on the material, nonpublic information to demonstrate that the information was not used directly or indirectly when the institution effected the challenged stock trade or trades.

As noted above, trading while in possession of material, nonpublic information concerning that security does not, standing alone, constitute a violation of this statute. There must be shown an element of "wrongfulness" in the means by which such information was obtained or used.

This test precludes the government from relying on the existence of corporate policies as a basis for prosecution, as occurred in the so-called Winans case, but would permit the

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3/ 426 U.S. 438, 450 (1976).

4/ Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 166 (2d Cir. 1980), citing with approval Securities & Exchange Comm'n v. Bausch & Lomb, Inc., 565 F.2d 8, 15 (2d Cir. 1977).

government to pursue such a case by demonstrating that Winans had some fiduciary or other legal duty not to use the information for his own personal benefit or gain. (Additionally, a case like Winans could be pursued on an alternative theory not involving the jurisprudence of insider trading, such as a market manipulation under Section 10(b) of the Securities Exchange Act.)

The second major limitation of the proposed legislative proscriptions against "insider trading" is the requirement that proposed defendants know (or be shown to have been reckless in not knowing) that

(i) the information in question was material;

(ii) the information in question was nonpublic;

(iii) the information in question was wrongfully obtained, used or communicated.

This more clearly defines the liability of tippees and eliminates the troublesome "personal benefit" test set forth in Dirks v. SEC. It also precludes liability for good faith communications made for a proper purpose, thus preserving the protections accorded by Dirks to analysts and the corporate officials from whom they seek information. Similarly, corporate officials' communications to shareholders that might inadvertently convey material, nonpublic information do not constitute an illegal "tip" under the federal securities laws if such communications are made in good faith for a proper purpose.5/

Conspicuously absent from both the language of the statute, and this report, is the concept of fraud. This omission is intended to reject any suggestion that the jurisprudence of insider trading still may require analysis under the former antifraud approach. Not every case of misused or improperly obtained material, nonpublic information will contain each element of a common-law fraud claim; this statute will nevertheless prohibit conduct that constitutes a wrongful use of material, nonpublic information. As previously noted,

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5/ It is implicit in this requirement of a proper purpose that scienter must be shown for an allegation of an improper purpose to be sustained. The current definition of scienter is not altered by this legislation.

cases that fall outside this proscription for lack of an essential element may constitute fraud of a variety other than "insider trading," and will continue to be within the reach of the appropriate antifraud provisions of the Securities Act of 1933 and the Exchange Act.

The proposed statute limits the application of the principle of respondeat superior, by providing a safe harbor for employers and controlling persons upon a showing that such persons have not participated in the violation by the employee or controlled person, and have taken reasonable steps to prevent and detect conduct proscribed by the proposed statute. This provision assures that public companies, law firms, financial printers, and other entities and persons that have taken proper precautions, are not held accountable for the misdeeds of an employee who has deliberately circumvented the safeguards of his employer.

As previously noted, the proposed statute gives the Commission rulemaking power to avoid ambiguities in the reach of the law in two discrete ways. First, the Commission may implement the prohibitions of this statute, so long as the Commission's rulemaking is consistent with the statement of Congressional findings at the outset of the section. Second, the Commission may exempt transactions or persons (or classes thereof) from the reach of the proposed statute that the Commission finds were not intended to be within the reach of this legislation.

Finally, the proposed legislation explicitly provides a private right of action for investors injured by a violation of the statute. This provision both recognizes that private, as well as public enforcement of such legislation is necessary to vindicate its remedial purposes, and assures that those persons whom the statute is intended to protect possess a mechanism by which they may invoke that protection.

The provision for a private right of action is intended to replace the standard set forth by the Court of Appeals in Moss v. Morgan Stanley Inc.[6/] for ascertaining the class of persons in whom that right reposes. The most readily identifiable persons injured by a violation of this statute are those who traded contemporaneously with the violator but did not possess that person's informational advantage. Because the statute goes beyond the Chiarella[7/] -- Dirks[8/] fiduciary

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6/ 719 F.2d 5 (2d Cir. 1983).

7/ United States v. Chiarella, 445 U.S. 222 (1980).

8/ Dirks v. Securities and Exchange Comm'n, 463 U.S. 646 (1983).

duty analysis in defining the violation of insider trading, a decisional principle that predicates upon that analysis the standing of a private plaintiff no longer is required and, indeed, now seems inappropriate. This approach would preserve the standing requirements articulated in Birnbaum v. Newport Steel Corp.[9] and Blue Chip Stamps v. Manor Drug Stores.[10]

The incorporation by reference of the damages and statute of limitations provisions of the Insider Trading Sanctions Act of 1984 ("ITSA" or the "Act") is intended to preserve, but not expand the scope of the Act. Thus, as is currently the case under ITSA, a person adjudged to have committed an insider trading violation would face a maximum financial sanction of four times his profit gained or loss avoided, representing disgorgement plus a treble penalty which latter remedy would continue to be available only to the government. Any actual damages assessed in private civil litigation arising out of the same set of facts would be offset by the amount, if any, disgorged by the individual pursuant to the related proceedings brought by the Commission.

9/ 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952).

10/ 421 U.S. 723 (1975).