TO: Members and Staff, Senate Banking Committee

FROM: Steven B. Harris and Richard S. Carnell

DATE: June 15, 1987

SUBJECT: Insider Trading

On June 17, 19, and 30, the Securities Subcommittee will hold hearings on clarifying the law of insider trading.

As used in this memorandum, "insider trading" refers to securities trading by persons who wrongfully use material, nonpublic information, even if those persons are not officers, directors, or controlling shareholders of the issuer.

This memorandum will briefly discuss (1) the SEC's Rule 10b-5, the principal prohibition against insider trading; (2) the problems arising from recent Supreme Court decisions narrowing the scope of Rule 10b-5; and (3) the upcoming hearings.

1. Rule 10b-5

Insider trading as such is not specifically prohibited by statute. The law of insider trading has developed from the antifraud provisions of the Securities Exchange Act of 1934 ("Exchange Act"), particularly section 10(b), which prohibits the use of "any manipulative or deceptive device or contrivance", in connection with the purchase or sale of any security, in violation of rules prescribed by the SEC "in the public interest or for the protection of investors."

SEC Rule 10b-5, issued in 1942 pursuant to section 10(b), forbids any person:

"(1) to employ any device, scheme, or artifice to defraud,

"(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

"in connection with the purchase or sale of any security."

Under section 32 of the Exchange Act, violators of Rule 10b-5 are subject to imprisonment for up to five years and fines of up to $100,000.

Under the Insider Trading Sanctions Act of 1984, anyone who violates the Exchange Act or regulations issued under that Act (such as Rule 10b-5) "by purchasing or selling a security while in possession of material, nonpublic information" is subject to a civil penalty of up to three times the profit gained or loss avoided.

2. The Judicial Expansion and Contraction of Rule 10b-5

During the 1960s and 1970s, through a process of administrative and judicial interpretation, Rule 10b-5 became a formidable weapon against insider trading. Trading on the basis of material, nonpublic information was held to be fraud for purposes of Rule 10b-5 even if traditional elements of fraud (such as a misrepresentation of fact by the defendant) were absent. Anyone who possessed material, nonpublic information was required either to disclose it or to refrain from trading on it.

Recently, however, the Supreme Court has rejected that approach and cut back the scope of Rule 10b-5. The Court's Chiarella (1980) and Dirks (1983) decisions have made it difficult to apply 10b-5 to persons who are not corporate insiders and who do not otherwise owe a fiduciary duty to the corporation and its shareholders. The difficulty is particularly acute in the case of "tippees" -- persons who use tips of inside information to buy and sell securities.

The fundamental weakness of current law has been aptly described as follows:

> "[T]he foundation of insider trading prohibitions -- the general antifraud provisions of Section 10(b) and Rule 10b-5 -- is poorly suited to serve as the basis for controls over tippee trading. By their very terms, Section 10(b) and Rule 10b-5 are not directed at insider trading per se, but at fraud. The Dirks and Chiarella decisions rigidly conform the insider trading doctrine to this fraud context by holding that trading on the basis of material, nonpublic information constitutes fraud only where there is a duty to speak, and by limiting that duty largely to those who owe a fiduciary duty to the issuer of the securities being traded and its shareholders. In so doing, these decisions confirm the use of that doctrine as a control over insider misconduct. Yet the federal securities laws are investor protection statutes, and their primary purpose is not to police insiders, but to protect market participants from

> unfair trading and other abuses. This goal cannot be met as long as the insider trading doctrine is confined to fraud. Accordingly, legislation designed to strip insider trading restrictions from the rubric of fraud, and to place them on a new foundation, is needed if the doctrine is to serve effectively as a control over tippee trading on the basis of material, nonpublic information."
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> Phillips & Zutz, The Insider Trading Doctrine: A Need for Legislative Repair, 13 Hofstra L. Rev. 65, 70-71 (1984).

In seeking to satisfy the requirements of the Chiarella and Dirks decisions, the SEC and the Department of Justice have developed various legal theories, notably the "misappropriation theory". That theory was the basis of the Winans case, which involved trading based on tips about articles that were about to appear in the Wall Street Journal's "Heard on the Street" column. But the Supreme Court's decision to review the Winans case casts doubt on the Government's prosecutorial theories.

3. The Subcommittee's Hearings

The Subcommittee's hearings will focus on the need to clarify the law of insider trading and, in particular, on a proposal prepared by a group of distinguished securities lawyers at the request of Senators Riegle and D'Amato. That proposal will be available at 5 p.m. tomorrow from Ms. Mary Kusin in SD 546.

A witness list for the June 17 hearing is attached.

The witnesses tentatively scheduled to appear on June 19 are the Honorable Beryl W. Sprinkel, Chairman of the President's Council of Economic Advisors; the Honorable Charles C. Cox, a member of the SEC; and a representative from the Department of Justice.

SUBCOMMITTEE ON SECURITIES
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
Hearing on the definition of insider trading

WITNESS LIST

Wednesday, June 17, 1987, 10:30 a.m., Room SD-538 Dirksen Senate Office Building

PANEL 1

HARVEY L. PITT, ESQ.
Partner
Fried, Frank, Harris, Shriver & Jacobson
Washington, DC

JOHN F. OLSON, ESQ.
Partner
Gibson, Dunn & Crutcher
Washington, DC

HENRY G. MANNE
George Mason University
School of Law
Arlington, Virginia

GARY L. TIDWELL
Associate Professor
Business Administration
College of Charleston
Charleston, South Carolina
