SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHAIRMAN

November 18, 1987

The Honorable Donald W. Riegle, Chairman
Securities Subcommittee of the Committee on
Banking, Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510

The Honorable Alfonse M. D'Amato
Securities Subcommittee of the Committee on
Banking, Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Riegle and Senator D'Amato:

By letter dated August 11, 1987, you requested that the Commission assist the Subcommittee in its efforts to develop a consensus proposal for legislation to define insider trading. That letter followed the Commission's August 7 testimony before the Subcommittee at which Commissioner Cox explained the insider trading bill which the Commission proposed on August 3, and outlined the differences between the Commission's proposal and S. 1380, legislation drafted by the Ad Hoc Legislative Committee chaired by Harvey L. Pitt.

In response to your 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 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. The enclosed bill represents a proposal for compromise legislation that would be acceptable to a majority of the Commission, provided that certain interpretive positions described below are clearly set forth in the legislative history accompanying the bill. */ With the exception of one substantive

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*/ Transmittal of this legislation was approved, following deliberation, pursuant to formal Commission action. Commissioner Grundfest's position on the proposed legislation is contingent on the contents of the as yet uncompleted legislative history that the Commission will propose to accompany the bill. Commissioner Fleischman did not join in accepting the proposed legislation or the proposals for legislative history.

area in which it was not possible to reach agreement, and certain differences as to language believed to be technical in nature, it is my understanding that this bill would also be acceptable to the Ad Hoc Committee.

The compromise proposal retains many important aspects of the Commission's original proposal. Among other things, it retains a "wrongfulness" approach in its general trading prohibition that reaches both the theft of information and the use of information in breach of a duty; it prohibits trading while "in possession of" material, nonpublic information, rather than requiring the "use" of such information for trading; it includes a tipping prohibition that expressly imposes liability based on reasonably foreseeable trading by direct and indirect tippees; and it creates broad private rights of action for contemporaneous traders and other persons injured in their securities transactions by insider trading violations.

The compromise bill also includes certain provisions adapted from S. 1380 that would be acceptable to a majority of the Commission, provided the legislative history resolves certain interpretive issues in the manner described below. First, like S. 1380, and unlike the Commission's August 3 proposal, the compromise bill includes the terms "misappropriation" and "conversion" in the basic prohibitions against wrongful trading and tipping. Similarly, the trading prohibition section in the compromise bill does not specifically enumerate sources to whom a breach of duty must be owed for liability to arise. Finally, the compromise bill does not include express exemptions for communications made by or to analysts, or communications made to disseminate information publicly, as did the Commission's proposal. Instead of the analyst exemption, the compromise embodies a "wrongfulness" concept in the general tipping prohibition.

The one substantive area in which it was not possible to reach agreement with the Ad Hoc Committee concerns the issue of communications relating to a person's own plans to acquire an issuer. The enclosed bill, which would continue existing law in this area, generally codifies Commission Rule 14e-3 by making 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. Tipping by specified persons, including the offering person, the target, or their agents, also would be prohibited (with the exception of certain good faith communications). S. 1380, by contrast, would prohibit a person planning to acquire or dispose of an issuer or a material block of its securities or assets from communicating its plans, if the purpose of the communication is to influence or encourage

trading; exceptions are made for communications 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. A majority of the Commission believes it preferable to retain the approach of Rule 14e-3. The demonstrated potential for insider trading abuses in the tender offer area warrants maintaining the substance of the protections afforded by current law. The Commission does not believe, however, that such provisions, which go beyond the "wrongfulness" rationale as defined in the proposal's principal prohibitions, are warranted when transactions other than tender offers are involved.

As noted above, the Commission's support for the enclosed compromise proposal is contingent on the proper resolution of several important interpretive issues in the bill's legislative history. In particular, if the Committee determines to report this legislation to the full Senate, the Committee report should clarify the following issues:

- o The Commission's authority to exclude particular sources -- The compromise bill does not include the enumerated sources provision contained in the Commission's proposal. However, the legislative history should state that it is not the intent of the legislation to reach conduct lacking a significant relationship to the securities markets. Moreover, the legislative history should specifically state that the Commission could use the broad exemptive authority provided in the bill to exempt persons whose information is obtained from sources whose nexus to the securities markets is remote or insubstantial. Hence, the Commission could, by rule, provide that misappropriation from particular sources with no regular nexus to the securities markets would not violate the statute.

- o The import of "misappropriation" and "conversion" -- The compromise bill includes these terms. The legislative history should make clear, however, that, as under existing case law, "misappropriation" and "conversion" refer to possession or use of information in breach of a pre-existing duty of confidentiality or non-use arising from the expectations of the parties thereto, or from law. The proposed Section 16A(b) per se does not create such duties, nor would Section 29 of the Securities Exchange Act invalidate otherwise lawful agreements to waive any such pre-existing duties.

- o The scope of the bill's exclusivity -- The compromise bill contains a legislative finding on exclusivity. The legislative history should clarify two important points. First, the statute is only exclusive with

respect to the federal securities laws; actions brought under state law, or the federal mail and wire fraud or other statutes, are unaffected. Second, the exclusivity provision would not affect the Commission's ability to proceed under Section 10(b) and other provisions of the federal securities laws in cases involving manipulation, false or misleading corporate disclosure, or other violative conduct, where the elements of such other violations are met, even though insider trading also exists.

- o The application of the prohibitions to market information -- The compromise bill governs certain communications, and trading while in possession of, material nonpublic information "relating" to a security. The legislative history should state that the bill is intended to reaffirm existing law concerning "market" information and "corporate" information, and regarding what constitutes "material nonpublic information," including the Supreme Court's disavowal in Chiarella v. United States, 445 U.S. 222 (1980), that a "parity of information" theory is intended.

- o The application of the bill to communications leading to public disclosure -- The compromise bill does not include the Commission's proposed exemptions for communications made by or to analysts, or made to disclose information publicly. However, it does include the concept of "wrongfulness" in the general proscriptions against tipping. The legislative history should emphasize the crucial role played by market analysts in the dissemination of information to the marketplace and in the promotion of healthy and efficient markets. It should make clear that the inclusion of a wrongfulness element is intended to assure that routine communications (i.e., not in breach of duty) to and from analysts are not prohibited, and communications properly made to disseminate information publicly also are not prohibited. The legislative history should further indicate that, in view of the importance of such activities, further clarification of, or exemptive relief from, the provisions of the bill may be appropriate and should be carefully considered. Thus, it should state that the Committee intends that the Commission consider rulemaking proceedings addressing these important and difficult issues.

- o The scope of derivative liability -- The compromise proposal preserves controlling person liability under Section 20(a) of the Securities Exchange Act in insider trading cases, but rules out respondeat

superior liability except when the employer has participated in, profited from, or induced the violation. The legislative history should state that Congress expresses no view on whether the respondeat superior theory is applicable to other securities law violations. It should also make clear that this provision does not affect the Commission's ability to bring cases against employers or controlling persons under such theories as aiding and abetting or the failure to supervise, where appropriate.

- o The application of the bill to private transactions -- The legislative history should state that no liability would result under the bill where a person engaging in a face-to-face transaction disclosed material nonpublic information to the person on the other side of the trade; in such a situation, the information would be known to both parties and thus would not be nonpublic for purposes of the particular transaction.

The Commission's staff has been requested to prepare specific suggested report language addressing these issues, which will be transmitted to you as soon as possible.

I look forward to working further with you and the Subcommittee on this important matter. I am also sending a copy of this letter to Mr. Pitt. I understand that he is sending you a letter reflecting his committee's views of the compromise legislation.

Sincerely,

David S. Ruder

David S. Ruder
Chairman

Enclosure

cc: Office of Management and Budget */
Harvey L. Pitt, Esq.

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*/ The enclosed legislative proposal represents the views of a majority of the Commission, and does not necessarily represent the views of the President. By copy of this letter, the enclosed proposal is also being transmitted to the Office of Management and Budget.