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December 22, 1988

Steven B. Harris, Esquire
Senate Banking Committee
Dirksen Senate Office Building
Room 546
Washington, D.C. 20510

Dear Steve:

You have asked that we prepare a draft introductory statement for the "repackaged" draft of S. 1380, the "Insider Trading Proscriptions Act of 1989," with a view to preparing for its introduction in the next session of Congress. We are enclosing under cover of this letter a draft statement which we believe highlights the important issues that would be addressed by this legislation.[1/]

We have also prepared a brief analysis of the Senate Legal Counsel draft of the bill, pointing out several material differences between that version and the Revised Reconciliation

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1/ The proposed opening statement to announce the introduction of the new bill appears at Tab 1.

Draft, which we submitted to Senator Riegle on July 12, 1988. Since you have advised us that the Senate Legal Counsel version was not intended to effect any substantive changes to the bill, we have included a mark-up of that draft, suggesting language to restore the original intent of the Revised Reconciliation Draft.[2/]

* * *

ANALYSIS OF SENATE LEGAL COUNSEL VERSION OF THE INSIDER TRADING PROSCRIPTIONS ACT OF 1989

As noted, the Senate Legal Counsel version of the Insider Trading Proscriptions Act of 1989 (the "Senate Legal Counsel Version") differs in several material respects from the Revised Reconciliation Draft of S. 1380.[3/] The following outline identifies those significant points of divergence that we believe should be resolved prior to introduction of the bill.

* * *

2/ The marked version of the Senate Legal Counsel version reflecting our proposed revisions ("SLC Mark-up") appears at Tab 2.

3/ A marked copy of the Revised Reconciliation Draft of S. 1380 (the "Revised Reconciliation Draft Mark-up"), reflecting the differences between the two versions, appears at Tab 3.

Congressional Findings

1. The Senate Legal Counsel Version deletes from the Congressional Findings, in the Revised Reconciliation Draft Section/16A(a)(2), the underscored language as follows:

> Even when the wrongful trading in securities while in possession of material, nonpublic information relating thereto (or relating to the market therefor), * * *.4/

1.1 This is probably a typographical error, because the language seems incongruous as written.

1.2 We propose restoring the deleted language to the Senate Legal Counsel Version.5/

2. The Senate Legal Counsel Version deletes from the exclusivity finding the underscored language as follows:

> It is appropriate to, and this section does, establish exclusive statutory standards * * *.6/

4/ Compare Revised Reconciliation Draft Mark-up at page 2, line 25 with Senate Legal Counsel Version at page 3, line 3.

5/ See SLC Mark-up at page 3, line 3.

6/ Compare Revised Reconciliation Draft Mark-up at page 3, line 14 with Senate Legal Counsel Version at page 3, line 19.

2.1 This deletion may have the unintended effect of confusing the issue of whether this statute would unequivocally establish the desired exclusive standards.

2.2 We believe that the principle of exclusivity is far too important to leave to chance. We therefore propose restoring the deleted language to the Senate Legal Counsel Version.[7/]

Wrongful Communications

3. The Senate Legal Counsel Version reflects a deletion from Section 16A(c)(1), as shown by the underscoring as follows, that would do considerable damage to the statutory scheme:

> It shall be unlawful for any person whose own purchase or sale of a security would violate paragraph (b) * * * wrongfully to communicate information relating thereto (or to the market therefor) that such person knows (or recklessly disregards) is material and nonpublic to any other person * * *.[8/]

The issues implicated by this modification will be discussed in turn:

7/ See SLC Mark-up at page 3, line 19.

8/ Compare Revised Reconciliation Draft Mark-up at page 4, lines 24-25 with Senate Legal Counsel Version at page 5, line 16.

3.1 **Elimination of the scienter/recklessness requirement** - Technically, the deletion of any standard of intent could render this provision a strict liability statute.

3.1.1 It is unclear whether the retention of the "wrongfulness" requirement would cure this problem.

3.1.2 Taken to its most extreme application, such a provision could render liable a person who negligently communicated information to another person, in a case where the second person thereafter traded the securities that were the subject of the information.

3.1.3 We propose that the scienter/recklessness language be reincorporated into the bill.9/

3.2 **Elimination of the requirement that the communicated information be material and nonpublic** - This deletion could give rise to liability for any communication of the most trivial

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9/ See SLC Mark-up at page 5, line 16.

information about a public company or its securities, even if the information has already been publicly disseminated, if the recipient of the information thereafter traded the affected securities.

3.2.1 This would be a radical departure from the current law of insider trading, and significantly departs from the standards that permeate the federal securities laws. Careful thought should be given to such a change.

3.2.2 As a practical matter, it would be virtually impossible for securities analysts, investment bankers and a host of others who are exposed to corporate and market information to function within such a regulatory framework, without incurring substantial liability.[10/]

10/ This is of particular concern in view of the draconian new penalties that may be applicable under the Insider Trading and Securities Fraud Enforcement Act.

3.2.3 We propose that these important qualifiers be reinstated in this provision.[11/]

4. The Senate Legal Counsel Version deletes from the more narrowly tailored prohibition against tipping, contained in Section 16A(c)(2), the underscored language as follows:

> It shall be unlawful for any person planning an acquisition or disposition of an issuer, a material portion of the issuer's securities or its assets (herein the "transacting person"), or any person acting on behalf of such a person <u>for the purpose of influencing or encouraging the purchase or sale of the securities of such issuer</u>, to communicate * * *.[12/]

4.1 Particularly in view of the absence of any "wrongfulness" language in this subsection, it seems that the elimination of any provision addressing purpose or intent would effectively remove from this provision any notion of a standard of intent.

4.1.1 As noted above at ¶ 3.1, this provision would likely become a strict liability

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11/ <u>See</u> SLC Mark-up at page 5, line 16.

12/ <u>Compare</u> Revised Reconciliation Draft Mark-up at page 5, lines 17-18 <u>with</u> Senate Legal Counsel Version at page 6, line 17.

standard, as to which no reasonable defenses would be available.

4.1.2 At the least, this revision probably would create an inordinately broad proscription that could reach unintended classes of persons.

4.2 We propose restoring the deleted language to the Senate Legal Counsel Version.[13/]

Effective Date

5. Finally, as a technical matter, the Senate Legal Counsel Version eliminates the Effective Date provision.

5.1 We propose restoring the deleted provision to the Senate Legal Counsel Version.[14/]

* * *

13/ See SLC Mark-up at page 6, line 17.

14/ See SLC Mark-up at page 11, lines 23-24.

We appreciate the opportunity to continue working with the Securities Subcommittee on this matter, and remain available should you wish any further assistance.

Very truly yours,

Harvey L. Pitt

3854s/3856s

Draft Introductory Statement for
S. , the Insider Trading
Proscriptions Act of 1989

Today, the Securities Subcommittee again turns its attention to the continuing problem of insider trading. Recent events have amply demonstrated that, in spite of all the media publicity surrounding the convictions and jail sentences imposed on insider traders over the last several years, the integrity of the nation's capital markets continues to be marred by the blatantly unlawful actions of those who would exploit their access to material, nonpublic information in their quest for a quick profit in the stock market.

The Securities and Exchange Commission's case last year against a young securities analyst at a major Wall Street investment banking firm, who tipped off one of his customers about imminent takeovers and other major market transactions, underscores the intractable nature of the insider trading problem. Cases like this have made it increasingly clear that the government must be given every law enforcement mechanism that we can provide, to better arm those at the front line of the war on insider trading.

Congress took an important first step in the process of enhancing the government's enforcement arsenal with the passage in the last session of the "Insider Trading and

Securities Fraud Enforcement Act of 1988." This legislation dramatically increases the monetary penalties and prison sentences that can be imposed on insider traders.

The bill also gives the Commission the authority to conduct investigations for foreign securities enforcers, even if the conduct being investigated would not violate United States law. This important provision should assist the Commission in achieving mutual assistance agreements with foreign governments that have not already entered into such an agreement.

But, the new law was merely the first step on the road to a legislative response to the insider trading phenomenon -- it is now time to define in plain English the offenses of insider trading and tipping that trigger the strengthened penalties. The Subcommittee is extremely concerned that a definition be made an integral part of this legislation. Prosecutions under the new law must not be permitted to falter merely because defendants and their lawyers argue that Congress failed adequately to specify the conduct it intended to be punished.

The Supreme Court has twice told us, in the Chiarella and Dirks cases, that if people are going to be held accountable for insider trading, then it must be clear that the prohibition against insider trading does indeed reach the conduct being challenged -- that due process and fundamental

fairness do not permit people to be found guilty of an offense that has not explicitly been prohibited.

The Chairman of the SEC and the Director of the Commission's Enforcement Division both testified during this Subcommittee's hearings on insider trading legislation that a legislative definition of insider trading was desirable. Earlier, the United States Attorney for the Southern District of New York told this Subcommittee that such a definition would be a clear improvement in the law, observing that:

> [I]f there was a clear, precise definition of [insider trading] enacted by Congress, it could help to end a lot of the irrelevant debate about whether insider trading or what forms of insider trading actually constitute crimes.

A specific legislative definition of insider trading, which as yet does not exist in the federal securities laws, is absolutely essential if the government's prosecutions are to be protected against technical legal attacks. We must not allow insider traders to escape well-deserved punishment. We must, in a word, respond to the Supreme Court's call for a legislative clarification of the law in this area.

This Subcommittee has long advocated the adoption of a precise definition of the offenses of insider trading and tipping. Senator D'Amato has provided strong leadership in this effort, first suggesting that a legislative definition be enacted during the hearings on the Insider Trading Sanctions Act of 1984.

More recently, in the last Session of Congress, Senator Riegle, then the Chairman of this Subcommittee, requested that a group of experienced securities lawyers, from a wide variety of backgrounds, draft a precise, plain-English definition of these offenses. The result of that group's efforts, the "Insider Trading Proscriptions Act of 1987," was introduced in June of 1987 as S. 1380.

Although the busy legislative calendar of the last eighteen months prevented us from bringing this proposed legislation to fruition, we now stand ready to resume that important task. Our goal is to enact a clear, comprehensive definition of what constitutes unlawful insider trading and tipping.

To that end, today I, with Senator(s) _____, introduce S. _____, the "Insider Trading Proscriptions Act of 1989." This bill, containing substantially the same provisions as S. 1380, will accomplish the following important tasks upon its enactment:

- Clear Congressional findings will articulate the purposes to be served by this legislation, thus assisting the courts in interpreting and applying the operative provisions of the Act.
- For the first time, the federal securities laws will provide a clear, plain-English definition of what conduct constitutes illegal insider trading

and tipping. The standards provided in the bill will be the exclusive standards for determining insider trading liability under federal law, thus promoting clarity and certainty in the application of the law.

- The liability of employers and controlling persons under this bill will be clarified, assuring that liability is not imposed upon those who could neither know of nor prevent the wrongdoing of their employees or controlled persons.
- The Commission will be granted exemptive authority, and those who act solely at the behest, and for the benefit, of others will be exempted from liability under the bill.
- Finally, express private remedies will be provided for persons injured by an insider trading or tipping violation.

* * *

I look forward to this Subcommittee's continued efforts to bring clarity to this important area of the federal securities laws.