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Commentary

The Insider Trading Sanctions Bill — A Neglected Opportunity

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I. Introduction

The Securities and Exchange Commission (SEC) has proposed a bill, H.R. 559,[1] tripling the penalties for what it calls insider trading. The Bill, an additional enforcement tool which may be accepted by the Senate, has so far met no substantial objections. It has passed the House.

The Bill, however, proceeds on the basis that what the SEC views as "insider trading" is adequately dealt with by the Commission's existing Rule 10b-5.[2] It does not seek to amend or modify the substance of that Rule, but only to create an additional penalty for that which is illegal under the Rule.

It is submitted that this is an unduly narrow approach. Recent Supreme Court decisions have made it clear that section 10(b) of the Securities Exchange Act[3] and Rule 10b-5 were designed only to prohibit uses of nonpublic information that amount to fraud.[4] Yet many uses of nonpublic information may be unfair without amounting to fraud. The time has come to en-

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1. H.R. 559, 98th Cong., 1st Sess. (1983). The Bill has been denominated the "Insider Trading Sanctions Act of 1983."

2. 17 C.F.R. § 240.10b-5 (1983).

3. 15 U.S.C. § 78j(b) (1982).

4. *See* Dirks v. S.E.C., 103 S. Ct. 3255 (1983). *See also* Chiarella v. United States, 445 U.S. 222 (1980).

act a separate and specific statute broadening the class of activities outlawed. This statute would not be limited to frauds covered by Rule 10b-5, but rather would be designed to outlaw transactions involving unfair use of information, whether inside or outside,[5] and regardless of whether shareholders were defrauded. The objective would be to protect the reputation of the markets as fair places to deal and not as a gambling game where marked cards are permissible.

II. The Scope of Rule 10b-5 and Proposed Bill H.R. 559

Rule 10b-5 was adopted some forty years ago to deal with a case of fraudulent use of truly inside information.[6] The Rule was adopted because of a report that "the president of some company . . . is . . . buying up the stock from his own shareholders at $4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be $2.00 a share for this coming year."[7] That case involved not only direct misrepresentation but violation of a fiduciary obligation of disclosure owed by the president of the corporation to the shareholders in his own corporation, conduct plainly amounting to common law fraud.

As a result of the adoption of Rule 10b-5 purchasing or selling by corporate insiders on the basis of such inside information has been unquestionably illegal for more than forty years.[8] Such conduct has been subject to criminal penalties,[9] SEC injunctive

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5. "Inside" information is information coming from inside the corporation — such as earnings figures or new products — which is confidential information intended to be available only for a corporate purpose and not for the personal benefit of anyone. "Outside" or "market" information is information — such as the fact that a takeover is planned — which is likely to have an effect on the market for the company's stock. The Supreme Court has refused to draw a distinction between the two types of information for purposes of Rule 10b-5. *See* Dirks v. S.E.C., 103 S. Ct. at 3262 n.15; Chiarella v. United States, 445 U.S. at 241 n.1 (Burger, C.J., dissenting).

6. The author, in 1942, was co-draftsman of Rule 10b-5 in his capacity as Assistant Solicitor of the SEC.

7. Freeman, *Administrative Procedures*, 22 BUS. LAW 891, 922 (1967), *cited in* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212-13 n.32 (1976), *quoted in* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 767 (1975) (Blackmun, J., dissenting).

8. Likewise, outsiders who improperly receive inside information from insiders ("tippees") may acquire the same duties as an insider and may be prohibited from trading on that information. *See generally* Dirks v. S.E.C., 103 S. Ct. 3255 (1983).

9. Securities Exchange Act of 1934, § 32(a), 15 U.S.C. § 78ff (1982).

proceedings,[10] and to the right of the defrauded shareholder to recover civil damages.[11] The law on this point is unambiguous, and requires no clarification or amendment.

The SEC-sponsored Bill would increase the penalties for any person found to have violated section 10(b) and Rule 10b-5 "by purchasing or selling a security while in possession of material nonpublic information."[12] It does not purport to broaden the scope of what constitutes a violation under section 10(b) of the Act and Rule 10b-5. But the incentive for the Bill is the unfairness observed by the Commission in cases where persons have knowledge of impending tender offers or other similar developments and trade on that knowledge to their profit.[13] Typically in such cases, the persons sought to be punished are not officers, directors, or other insiders of the corporation, but rather outsiders obtaining "market" information from the outside tender offerors or persons related to those tender offerors. In my judgment it is extremely difficult to suggest that such persons owe the kind of fiduciary obligation to the persons with whom they deal, or commit the fraud that Rule 10b-5 was intended to deal with, or indeed fall within any possible extended scope of the Rule.

Unfair use of information by outsiders such as tender offerors should not be treated on the same basis as insider trading by corporation officials dealing with their own shareholders. The two categories of transactions are in practice and in legal theory completely different and require distinct treatment. Thus, it is a misnomer to call the proposal an "Insider Trading Sanctions

10. Section 21(d) of the 1934 Act authorizes the Commission to

> bring an action in the proper district court of the United States, the United States District Court for the District of Columbia, or the United States courts of any territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices [in violation of the securities laws], and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond.

Id. § 78u(d).

11. The right of defrauded shareholders to recover damages under Rule 10b-5 was recently reaffirmed in Herman & MacLean v. Huddleston, 103 S. Ct. 683, 686-87 (1983).

12. *See supra* note 1.

13. *See, e.g., Insider Trading Sanctions Act of 1983: Hearings on H.R. 559 Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy & Commerce*, 98th Cong., 1st Sess. 17, 19-20 (1983) [hereinafter cited as *Hearings*] (comments of SEC Chairman John S. R. Shad).

Act" when its motivation is, in fact, to deal principally with unfair use of information by outsiders.[14]

The fundamental legal obstacle is that in true insider trading, such as the case which occasioned the adoption of Rule 10b-5,[15] an officer of a corporation is trading in shares with one of his own shareholders to whom he owes a strong legal, indeed a fiduciary, obligation to advise truthfully as to the affairs of the corporation.[16] This behavior is properly covered by a rule against fraud because the conduct of the officer is clearly fraudulent under established common law standards, and his shareholder is a defrauded party.[17]

In comparison, an outsider not connected with the shareholder's corporation who knows that a third party intends to make an offer for the shares at a higher price, is under no obligation to disclose this knowledge to the shareholder or to dissuade him from selling. This was clearly established by the Supreme Court in *Chiarella v. United States*.[18] *Chiarella* involved a printer who obtained information about pending takeover offers while working for the purchasing companies. When he used that information to trade in the stock of the target companies and reap a profit, he was charged with defrauding the investors from whom he purchased. The Supreme Court held this charge could not stand — the sellers were not defrauded since Chiarella was a stranger to them and owed them no fiduciary duty of disclosure. In the absence of a finding of fraud, the Court held, section 10(b) and Rule 10b-5 would not apply.[19]

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14. The author has made this point in previous publications. *See* Freeman, *'Insider Trading' v. 'Unfair Use'*, Nat'l L.J., June 13, 1983, at 15; Freeman, *Legislative Action Called "Desirable" for Resolution of Insider Trader Problems*, N.Y.L.J., Dec. 14, 1981, *reprinted in* 10 SEC '82. He has also made this point in testimony before the House subcommittee conducting hearings on H.R. 559.

15. *See* Freeman, *supra* note 14 and accompanying text.

16. This obligation is owed both the existing shareholders from whom the insider is buying and to potential shareholders to whom the insider is selling. *See* Chiarella v. United States, 445 U.S. 222, 227 n.8 (1980); Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951).

17. *See, e.g.*, Strong v. Repide, 213 U.S. 419 (1909). This principle was recognized by the state courts as early as 1903. *See* Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232 (1903); Stewart v. Harris, 69 Kan. 498, 77 P. 277 (1904).

18. 445 U.S. 222, 231-35 (1980).

19. *Id.* at 234-35. Following *Chiarella*, the SEC attempted to cover the situation presented in that case by promulgating Rule 14e-3, 17 C.F.R. § 240.14e-3 (1983), which

The same principle — that, absent such a fiduciary obligation, Rule 10b-5 does not prohibit trading on nonpublic information — was reaffirmed by the Court this past term in *Dirks v. S.E.C.*[20] In *Dirks*, the Court reversed an SEC administrative censure issued against a stock analyst who, in the course of his work, learned about massive fraud at an insurance company from former employees at the company.[21] The analyst told a number of people in the investment community about his findings, some of whom subsequently sold their stock in the company. The SEC charged the analyst with aiding and abetting violations of Rule 10b-5 by causing these persons to trade on nonpublic material information.[22] In reversing the censure, the Court found that the information was not public, and assumed that it was material.[23] The Court held, however, that the analyst was an outsider of the company who owed no duty of disclosure to company shareholders. In the absence of any such duty, the Court held, there could be no fraud on the shareholders and no violation of Rule 10b-5.[24]

As was to be expected, the government has not willingly accepted the repeated judgments of the Supreme Court and is now seeking to avoid them by ingenious legal theories which may, in certain courts and for a period of time, be at least partially successful. For example, in *United States v. Newman*[25] the government has successfully prosecuted a stock trader who was in exactly the same position as Chiarella, trading stock in companies that were the targets of tender offers. Like Chiarella, the stock trader learned of the tender offers indirectly from an investment house working for the companies planning the takeovers.[26] And,

expressly prohibits trading on any nonpublic information concerning tender offers. The problem with this approach is that section 14(e) of the Securities Exchange Act, 15 U.S.C. § 78n(e) (1981), under which Rule 14e-3 was promulgated, is modeled on section 10(b) and, like that section, should probably only be read to prohibit acts which amount to fraud. Thus, Rule 14e-3 may well be no more applicable to outsider trading situations than Rule 10b-5 is.

20. 103 S. Ct. 3255 (1983).

21. *Id.* at 3250.

22. *Id.* at 3259.

23. *Id.* at 3260-61.

24. *Id.*

25. 664 F.2d 12 (2d Cir. 1981), *aff'd after remand*, No. 82-1273 slip op. (2d Cir. Feb. 8, 1983), *cert. denied*, 52 U.S.L.W. 3266 (U.S. Oct. 4, 1983) (No. 82-1653).

26. *Id.* at 15.

like Chiarella, the trader did not owe any fiduciary duties of disclosure to the shareholders of the target companies.[27] The conviction was achieved nonetheless by an instruction to the jury that they need not consider whether any investor was defrauded, but could find the defendant guilty if the information had been obtained or used in violation of duties of confidentiality owed to the investment house.

An even more unusual approach was proposed by the SEC, and adopted by the federal district court in California, in *S.E.C. v. Lund*.[28] That case involved an individual who was approached by the president of a company with an offer to participate in a joint venture which the company was planning with a third party. Although Lund did not join in the venture, he did purchase stock in the company, reaping a profit after the joint venture was announced.[29] In finding Lund liable under Rule 10b-5, the court held that although Lund was not an officer, director, or employee of the company, he became, simply by receiving nonpublic information about the company, a "temporary insider" of the company.[30] This theory is at best problematic. The court cited as authority a footnote in *Dirks* in which the Supreme Court noted that certain outsiders who "have entered into a special confidential relationship in the conduct of the business of the [company]" may acquire the same duties insiders have.[31] But that footnote only stated that certain persons — such as "an underwriter, accountant, lawyer, or consultant working for the corporation" — might become subject to an insider's duties as a result of being retained by a corporation.[32] There was

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27. That the trader owed no duty to the shareholders was affirmed in a related civil suit brought by the shareholders under Rule 10b-5. Moss v. Morgan Stanley, [Current] Fed. Sec. L. Rep. (CCH) ¶ 99,478 (2d Cir. 1983).

28. [Current] Fed. Sec. L. Rep. (CCH) ¶ 99,495 (C.D. Cal. 1983).

29. *Id.* at 96,872.

30. *Id.* at 96,874. The Commission had originally pressed the theory that Lund was a "tippee" of a corporate insider, since he had received information about the venture from the company's president. In the wake of *Dirks*, however, the Commission abandoned that theory since it was apparent that the president had breached no duty in disclosing this information to Lund during legitimate business discussions. Under *Dirks*, finding of such a breach would be a predicate to finding "tippee" liability. *Id.* at 96,873.

31. *Id.* at 98,874 (quoting Dirks v. S.E.C., 103 S. Ct. at 3261 n.14).

32. Dirks v. S.E.C., 103 S. Ct. at 3261 n.14. The footnote is in fact adopted from a part of the argument of Dirks' counsel in the Supreme Court. *Cf.* Brief for Appellant at 31-34, Dirks v. S.E.C., 103 S. Ct. 3255 (1983).

absolutely nothing to suggest that a person who was not retained by the firm, and who acquired information in arms-length discussions about a possible business transaction, became a common law fiduciary towards the company with which he was negotiating.[33] Indeed, it is hard to see how such a duty can be conjured up out of *Dirks* in light of the Court's favorable reading of the Second Circuit's decision in *Walton v. Morgan Stanley & Co.*[34] In *Walton*, an investment banking firm, on behalf of a client, approached a corporation viewed by its clients as a possible takeover target. In the course of discussions with the target, the firm acquired confidential earnings figures. The investment banking firm traded on the information, reaping a profit when the figures were disclosed.[35] As the *Dirks* Court noted with approval, the firm did not acquire fiduciary duties simply because it acquired confidential information from a company in an arms-length negotiation with the company.[36] Yet based on nothing more than the fact that Lund acquired confidential information in an arms-length business discussion with a company's president, the *Lund* court found that he *did* acquire fiduciary duties.[37]

III. Analysis and Recommendations

The Commission may, of course, continue to be successful in pressing such theories. It is suggested here that whether or not the Commission is successful in partially circumventing the *Chiarella v. United States*[38] and *Dirks v. S.E.C.*[39] cases, it is

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33. The court in *Lund* suggested that it was sufficient that Lund acquired this information because he was a longtime friend and business associate of the president of the company. This, the court said, gave him a "special relationship" with the company. S.E.C. v. Lund, [Current] Fed. Sec. L. Rep. (CCH) ¶ 99,495, at 96,874. But it is clear that Lund was not given this information as a favor from a friend — if that had been the case he would be a "tippee" under *Dirks*. *See* Dirks v. S.E.C., 103 S. Ct. at 3265. And while Lund, as a likely business partner, did enjoy special access to information about the joint venture that other investors did not enjoy, that is insufficient to establish a duty under Rule 10b-5. Just such a "special access" rule was proposed by the dissenters in Chiarella v. United States, 445 U.S. at 251 (Blackmun, J., dissenting), and rejected by the majority in that case. *Id.* at 230.

34. 623 F.2d 796 (2d Cir. 1980).

35. *Id.* at 797.

36. Dirks v. S.E.C., 103 S. Ct. at 3265 n.22.

37. S.E.C. v. Lund, [Current] Fed. Sec. L. Rep. (CCH) ¶99,495, at 96,874.

38. 445 U.S. 222 (1980).

pursuing a myopic and unnecessarily restrictive course in attempting to do so. It also faces years of litigation, with the outcome uncertain, by trying to fit the conduct of such outsiders into a fraud mold. The SEC is so accustomed to the use of Rule 10b-5 as a be-all and end-all that it has not adequately recognized that the problem it is facing is of a different character, larger than can readily be managed within that narrow compass. There is an easier answer, as I have repeatedly pointed out:[40] specific legislation addressed to the problem of outsider trading.

For the problem the Commission faces today is a result of the proliferation of tender offers by outsiders and the creation of an option market in which the traders are not insiders and owe no fiduciary obligation to shareholders. Accordingly, the problem is not one that can be handled within the scope of a standard and a rule designed to protect the individual from fraud.

Instead, the concern the Commission does have and should have is that persons unfairly using information about coming events, such as tender offers, are engaged in socially unacceptable and publicly condemned conduct. For example, Chiarella's counsel did not seek to defend the morality of his actions even in the Supreme Court, but contended successfully only that it was not covered by the anti-fraud Rule designed to protect investors. Similar condemnation of the conduct of Chiarella was voiced by almost all members of the Supreme Court in that case, the majority and dissenters alike.[41] In the legislative considerations of the SEC-endorsed insider trading sanctions Bill, the Congressional Committee joined in the broad condemnation of the kind of conduct involved there. Indeed it was one of the members of the committee who suggested the analogy used above to playing with marked cards.[42]

In other words, Congress and the courts are sufficiently of-

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39. 103 S. Ct. 3255 (1983).

40. *See supra* note 14.

41. All members of the Court implicitly recognized that Chiarella's conduct was "unfair." Chiarella v. United States, 445 U.S. at 232, 241, 252 (1980).

42. *See Hearings, supra* note 13, at 66-67 (remarks of Jim Bates, member of Comm. on Energy & Commerce). Industry witnesses were concerned with other problems. Nevertheless they endorsed the suggestion presented by the writer that a new and separate bill be adopted outlawing the kind of conduct in which Chiarella engaged, independent of any concept of fraud.

fended by this type of conduct that they would consider adopting a standard outlawing outsider trading involving unfair uses of information without limiting the enforcing agency to a fraud concept. This standard could outlaw purchases of securities or options trading or any other means which allow persons in possession of this unfair advantage to make money as Chiarella did.

Such legislation would be easily adopted if supported on an institutional basis. If the SEC were to make such a suggestion, there would be no difficulty in having it promptly adopted by both houses of the Congress, since there is no constituency opposed to legislation outlawing unfair use of information in the markets.

Problems about the precise definition and scope of such a law would have to be addressed, but these issues should be easily resolved. The SEC is in a position to take the leading role and to secure congressional approval for which it would and should get credit.

To date, it has been reluctant to take this initiative and has not accepted the suggestion for such legislation which the writer put forth in testimony on H.R. 559.[43] However, the setback that the Commission has since received in the decision against it by the Supreme Court in the *Dirks* case has caused it to reconsider. There is a reasonable possibility that it may, after such reconsideration, seek to introduce and support legislation to this end. If it does so, it will meet no opposition in the Congress or in the financial industry, and it will be welcomed by the courts which are outraged by the immoral conduct involved, but have not yet been given the tools to deal with it. Such legislation could be readily adopted as stated.

43. *Hearings, supra* note 13, at 159-60.