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Insider Trading:
Are the Proposed Cures Appropriate for the Disease?

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The views expressed herein are those of Commissioner Peters and do not necessarily represent those of the Commission, other Commissioners, or the staff.

Insider Trading: Are the Proposed Cures Appropriate for
the Disease? 1/

Good afternoon ladies and gentlemen. I am very pleased to have been invited to join you today. As I focused on the title of your program, "The Annual Institute on Insider Trading, Securities Fraud and Fiduciary Duty," I did not take much comfort from the implication that fraud in the securities markets is, in fact or in perception, so pervasive and recurring that it warrants an annual day or two of study. On reflection, I concluded that the number of enforcement actions brought by the Commission during the last twelve to eighteen months charging violations of Section 10(b) of the Securities Exchange Act of 1934 in general and insider trading in particular, suggests that your Institute might do well to consider convening on a semi-annual or even monthly basis.

The Commission's recent efforts to enforce the antifraud provisions of the federal securities laws have resulted in landmark cases, such as the First Boston, Winans and Boyd Jeffries cases 2/ just to mention a few. Irrespective of these noteworthy accomplishments, or perhaps because of them, we must acknowledge that insider trading seems to be a bigger problem than one might

1/ These remarks were prepared by Commissioner Peters with the assistance of her legal counsel, Jacqueline P. Higgs.

2/ SEC v. The First Boston Corp., 86 Civ. 3524 (PNL) (S.D.N.Y. 1986); SEC v. Peter N. Brant, R. Foster Winans, Kenneth P. Felis, David W.C. Clark and David J. Carpenter, 84 Civ. 3470 (CBM) (S.D.N.Y. filed May 17, 1984); SEC v. Boyd L. Jefferies, 87 Civ. 1804 (S.D.N.Y. 1987).

have thought. Last year was a banner year at the Commission for high profile insider trading cases. In fiscal year 1986, the Commission initiated thirty-four cases involving insider trading as compared to twenty cases in 1985. The first six months of fiscal 1987 saw 22 more cases filed of which at least 17 have already been settled.

These enforcement initiatives have focused the attention of the securities industry, and indeed the world, on apparent weaknesses in the fabric of our current financial markets. We have had to face evidence of breached "Chinese Walls", to acknowledge the conflict between the perceived need for corporate secrecy and the public interest in having timely disclosure of material corporate events, and to deal with the tension created by regulatory restraint of the free market. The public is beginning to question the ethics and integrity of the capital markets and its participants. When questions and problems of this magnitude arise, you can be certain that answers and solutions will be sought. Generally, problems that generate turmoil and uncertainty provoke calls to do something. Not unexpectedly, today many are calling for a legislative response to the problem of insider trading.

For the next few minutes, I intend to address the broad issue of what, if any, new regulation would be appropriate as a response to the specter of pervasive insider trading by asking a few questions of my own. For example, would additional regulation in the tender offer area eliminate insider trading? Would enforcement efforts be enhanced by statutorily defining insider trading?

Would increasing the liability of brokerage and investment banking firms for their employees' fraudulent activities be a significant deterrent to insider trading by those employees?

As is obvious, my questions mirror proposed legislative initiatives currently being championed by various and sundry interested parties. How I have phrased the the questions probably gives you a clue as to how I would answer them. For my part, I have concluded that adoption of certain current legislative proposals would be ill-advised at this time.

Tender Offer Regulation

The notion that regulation of tender offers will solve our problems with respect to insider trading is born of the idea that there is a connection between insider trading and the recent proliferation of takeover activity. The correlation is not fabricated out of thin air. In recent testimony on insider trading, Chairman Shad referred to various studies indicating that the prices of target companies' shares often rise by over 25% of the potential premium prior to public announcements and suggesting that this pre-announcement price rise reflects unlawful trading on material nonpublic information. 3/ However, a recent study by the Office of the Chief

3/ Statement of John Shad, Chairman of the Securities and Exchange Commission before Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce Concerning Insider Trading (December 11, 1986).

Economist of the Commission ("OCE"), which examined successful tender offers for 172 companies during the period from 1981 to 1985, revealed that in each case stock prices made major upward moves about seventeen trading days before the buyout announcements. Averaged over all cases, trading volume doubled its historical norm ten days before public announcement. 4/ Notwithstanding these statistics, OCE was unable to conclude that illegal use of insider information was the sole (or even principal) explanation of the pre-announcement price increases. The OCE study cites takeover speculation in the media and heavy stock buying by the acquiring company as possible (and presumably equally likely) factors fueling the price run up. 5/ Thus, proposed regulatory measures, such as restricting the use of junk bond financing of tender offers and extending tender offer offering periods, designed to tighten the reins on takeover activity are unlikely to address adequately our insider trading concerns because the relationship between the two activities is not necessarily one of cause and effect.

That is not to say that legislation designed to tighten regulation of tender offers would have no effect on illegal trading activity in the market prior to the announcement of a tender offer. Clearly, restrictions placed on takeover bids are

4/ Office of the Chief Economist, U.S. Securities and Exchange Commission, Stock Trading Before the Announcement of Tender Offers: Insider Trading on Mutual Anticipation? (February 24, 1987) at 33 (study).

5/ Id. at 34.

likely to reduce the number of such bids and perhaps the success rate of those made. If such is the case, logic suggests that fewer takeovers will mean fewer opportunities to make a profit based on inside information. However, this seems to be an inefficient solution to the problem. I cannot help but think that we would be cutting off our nose to spite our face if we tried to eliminate the abuse by eliminating the sound economic activity being abused.

That is not to say that certain legislative changes would not be helpful in curbing, albeit indirectly, insider trading abuses. For example, I do believe that the ten-day window provided in Section 13(d) of the Securities Exchange Act for anyone acquiring more than 5% of a company's stock to publicly disclose that fact should be closed. 6/ In my view, the purpose of such legislation would be to provide shareholders and the market with earlier notice of large scale stock purchases that may lead to a takeover or otherwise affect the value of stock prices, not to control insider trading. An incidental, although beneficial, side effect would be to reduce the opportunity for persons to abuse the process by using their informational advantage in violation of the securities laws.

Similarly, prompt disclosure by issuers of accurate material information concerning business transactions would help to limit the opportunity for insider trading. As you will recall, in 1985,

6/ See, e.g. S.2830, 100th Cong., 1st Sess. (1987); S.227, 100th Cong., 1st Sess. (1987); H.R. 1601, 100th Cong., 1st Sess. (1987).

the Commission considered the Carnation case 7/ in which an official of Carnation, who was not privy to discussions about the company's takeover by Nestle, publicly denied that the company was engaged in merger discussions. In a 21(a) report, the SEC stated that under the current state of the law, companies have no general duty to speak, but those who choose to speak must speak truthfully. The Commission added, however, that a company could respond to questions with "no comment."

The Commission's opinion in Carnation was discussed in a recent news article with the following observation:

In one sense, the Carnation rule with its strictures against misleading statements, serves the cause of maximum disclosure. On the other hand, some executives faced with the choice of either saying nothing or taking a chance on saying something that might later be construed as misleading choose to say nothing. 8/

Quite frankly, such statements make me wonder how the art of communication can be perceived to be so primitive in this age of advanced technology and electronic wizardry. Be that as it may, in my view, Carnation should not have the chilling effect on disclosures attributed to it, since it is a "what can you say," not a "when do you say it" case.

In any event, Carnation is not to be last word in this area. On February 23, 1987, the Supreme Court granted certiorari in

7/ In re Carnation Corp., Exchange Act Release No. 22214, 33 S.E.C. Dkt. 1025 (July 8, 1985).

8/ Melloan, Someone There Is Who Does Like The SEC, Wall St. J., Mar. 10, 1987 at 31.

Basic Incorporated v. Levinson 9/ to review two issues, one of which is the proper standard for assessing the materiality of merger negotiations in determining when such negotiation must be disclosed to the public. I am confident that you have discussed or will discuss Basic and the Commission's amicus brief during your working sessions and therefore, I will not discuss it here. I would note in passing that although the Commission's probability/magnitude standard is an appropriate test of materiality 10/ in determining when merger discussions must be disclosed as a matter of law, the question of when they should be disclosed as a matter of policy remains. John Phelan, Chairman of the New York Stock Exchange, believes that insider trading could be reduced significantly by forcing companies to tell the public quickly when a deal is under consideration. As such, the "window of opportunity" for making money from secret information would be swiftly closed. 11/

For my part, I am sympathetic to Mr. Phelan's concerns but, I am still wrestling with the implications of his suggestion. It could mean that the price of ensuring prompt and adequate disclosure is to conduct merger negotiations and other business transactions in a fishbowl. However the balance is struck between the

9/ Basic Incorporated v. Levinson, S. Ct. No. 86-279, cert. granted (Feb. 23, 1987).

10/ SEC v. Texas Gulf Sulphur Company, 401 F.2d 833, 849 (2nd Circuit 1968), cert. denied, 394 U.S. 976 (1969).

11/ Rosenblatt, Remedies For Insider Trading Offered, Los Angeles Times, Dec. 12, 1986 at 1.

corporation's right to confidentiality and the public investor's right to know, I find it interesting that some who argue that the market is the best evaluator of deals also argue strenuously against requiring early disclosure of business negotiations. Apparently, they do not trust the efficient market to evaluate properly the contingencies associated with negotiations. In any event, for our purposes today the truly important question to ask is whether an early disclosure rule would eliminate insider trading or significantly reduce it. I think the answer is not so clear, which is a plus for the proposal. That is more than I can say for proposals to restrict junk bond financing and to lengthen the offer period for tender offers. There the answer is clearly no, whatever merit these ideas may have for other reasons and purposes.

Definition of Insider Trading

In the minds of some, what is really needed is a definition of insider trading. Some have suggested that, although the SEC has been successful in pursuing variations of the "misappropriation" theory to support insider trading allegations, a definition is needed because "legitimate businessmen face a fair amount of uncertainty in ascertaining the precise reach of the law and what steps they should take to assure compliance with it." 12/

12/ See Senate Panel Asks Securities Bar to Consider Insider Trading Definition, 19 Sec. Reg. & Law Report 283 (Feb. 27, 1987) (quoting former SEC General Counsel Harvey Pitt of Fried, Frank, Harris, Shriver & Jacobson).

I am curious about this rationale for urging that insider trading be defined. As former Commissioner James Treadway noted recently, lawyers will agree 80 to 90% of the time on whether a particular situation constitutes insider trading. 13/ I believe most businessmen can as well. Moreover, the Commission's most recent insider trading cases do not reflect efforts to expand the law on insider trading beyond recognizably reprehensible behavior. Where is the uncertainty?

Another argument frequently offered in support of the proposition that unlawful insider trading should be defined is that the conduct has been criminalized. It is suggested that a defendant is entitled to specific notice of the precise conduct for which he may be criminally prosecuted. This suggestion ignores the fact that in our system of justice, criminal fraud has been broadly defined for generations. For example, the federal statute prohibiting mail fraud does so in very general terms.

Whoever, having devised or intending to devise any scheme or artifice to defraud, ... for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service, ... any such matter or thing, shall be fined not more than \$1,000 or imprisoned not more than five years, or both. 14/

13/ Id.

14/ 18 U.S.C. §1341.

Wire fraud is defined in similarly broad terms.

Whoever, having devised or intending to devise any scheme or artifice to defraud, ... transmits or causes to be transmitted by means of wire, radio, or television communication in interstate or foreign commerce, any writings, signs, signals, pictures, or sounds for the purpose of executing such scheme or artifice, shall be fined not more than \$1,000 or imprisoned not more than five years, or both. 15/

Is Section 10(b) of the Securities and Exchange Act much different?

I think not.

Definitions designed to label specific activities as fraudulent do not clarify but rather limit. What troubles me about the move to define insider trading is the prospect that such a definition will limit the scope of Section 10(b) to the extent that we ultimately may increase the incidence of non-redressable fraud in the marketplace. Distilled to its essence, insider trading is just that -- fraud. There are many many ways in which fraud may be committed, as is evidenced by the creative and inventive schemes and practices regularly uncovered by the SEC. Therefore, I am loathe to provide a road map to those who would exceed the specified boundaries if given the opportunity. The federal courts have recognized this danger and have held, in the criminal context, that:

The fraudulent aspect of the scheme to "defraud" is measured by a nontechnical standard. Law puts its imprimatur on the accepted moral standards and condemns conduct which fails to match the "reflection of moral uprightness, of fundamental honesty, fair play and right dealing in the general and business life of members of society."

15/ 18 U.S.C. §1343.

This is indeed broad. For as Judge Holmes once observed, "[t]he law does not define fraud; it needs no definition; it is as old as falsehood and as versable as human ingenuity." [citations omitted] 16/

Securities Industry Association President Edward I. O'Brien, was recently quoted as stating that "while Rule 10b-5 of the Securities Exchange Act is a clear and basic antifraud provision, its application is not always so precise. Therefore, any definitions should be carefully drafted to avoid inadvertently halting legitimate activities." 17/ To that statement, I would add the warning that any definition should be carefully drafted to avoid inadvertently excluding illegitimate activities. I have strong doubts about the feasibility of such a task.

Some time ago, Harvey Pitt, a proponent of the need to define insider trading and one of the persons assigned that task by Senator Riegle, and I agreed to disagree about the desirability of defining insider trading. However, during this morning's session I was surprised by Harvey's description of his Committee's efforts to formulate a suitable definition of insider trading. If I understood Harvey correctly, his Committee's efforts are focused on defining the purposes of the prohibition, the persons to whom the prohibition is directed and those it is designed to

16/ See Louisiana Power and Light Company v. United Gas Pipe Line Company, 642 F. Supp. 781, 802 (E.D. La. 1986) (quoting Blachly v. United States, 380 F.2d 665, 671 (5 Cir. 1967)).

17/ See SIA Urges Insider Trading Definition, Seeks More Surveillance By SRO's Firms, 19 Sec. Reg. & Law Report 439 (March 27, 1987).

protect. If indeed the Pitt Committee's approach is something other than to specify what constitutes insider trading, then perhaps we can reach a meeting of the minds on this issue.

Liability of Broker-Dealers

A more productive approach to enhanced enforcement of the laws against insider trading, would be to direct our energies to raising the consciousness of the securities firms, among others, about the need to tackle the problem. As you know, multi-service securities firms which may consist of investment banking, broker-dealer, arbitrage, and research departments, all under the same roof, are repositories for confidential information from corporate clients. As a general matter, resources and expertise may be shared throughout the various departments of the firm which in turn could lead to potential abuses of such information.

A recent case, SEC v. The First Boston Corporation, 18/ demonstrates the danger of abuse. In that action, a First Boston insurance analyst obtained confidential information about a client of the firm and communicated the information to the firm's traders who then traded on that information. The Commission alleged that such conduct violated Rule 10b-5 and First Boston consented to the entry of a permanent injunction and other relief without admitting or denying the Commission's allegations. The

18/ SEC v. The First Boston Corp., 86 Civ. 3524 (PNL) (S.D.N.Y. 1986).

facts underlying this case demonstrate how important it is for investment banking firms to adopt and monitor procedures to prevent misuse of confidential nonpublic information.

The Commission has not prescribed any specific procedures which firms must implement to prevent insider trading abuses. The closest it has come to doing so was the adoption of Rule 14e-3 19/ which forbids trading in securities sought in tender offers by persons in possession of material nonpublic information concerning the tender offer. Rule 14e-3(b) provides a safe harbor for institutional traders provided that the institution can demonstrate that it had in effect policies and procedures, such as Chinese Walls, to control the flow of material nonpublic information within the firm so that individuals making investment decisions do not trade while possessing material nonpublic information. Unfortunately, Chinese Walls are like honor systems, they work only if the people maintaining them want them to work. Our recent enforcement cases show that Chinese Walls can be easily breached where there is the incentive to do so. 20/

19/ See 17 C.F.R. §240.14e-3 (1985).

20/ A Chinese Wall forbids disclosure of confidential client information to persons within or without the firm except as necessary to serve a client. A restrictive list is used to prohibit certain research and trading activities in securities on the list. See Weiss and Spolan, Preventing Insider Trading, 19 Review of Sec. and Comm. Reg. 233, 237-239 (Nov. 5, 1986).

However, useful measures can be taken to remedy this problem. In fact, the Securities Industry Association recently made specific proposals in this regard.

I think securities firms would be more motivated to find effective ways to curb insider trading by their employees if the Commission brought a few "failure to supervise" cases in instances where a firm has failed reasonably to monitor the activities of its employees who have traded on inside information obtained from the firm. 21/ I hope to see increased use of the "failure to supervise" vehicle in the insider trading context. My prediction is that firms will become much more cognizant of and responsive to their obligations in the insider trading area as a result, particularly, if the Commission had the ability to fine where such violations occur.

This brings me to the legislative proposal that would make broker-dealers subject to suit by the public in cases of insider trading by their employees. Since broker-dealers do have a statutory duty to supervise which imposes an obligation to monitor employees' activities in all respects to avoid violations of the securities laws and consequent liability, I see no need to create a private right of action under Section 10(b) based on notions of secondary liability to achieve that result.

21/ See Report by the Trading Practices Committee to the Chairman of the Securities Industry Association (March 25, 1987).

The Commission currently has the authority to require disgorgement of ill-gotten gains in those instances where the firm knew or should have known of its employees unlawful conduct. Perhaps our authority goes even further. Therefore, legislation is not necessary for that purpose. Moreover, if the Commission were granted the authority to impose fines, we would have an additional economic deterrent without the "in terrorem" effect of class action suits. Finally, it seems to me that there are already sufficient legal theories in place, such as Section 20(a) of the Securities Exchange Act of 1934 (controlling person liability) and the aiding and abetting doctrine, 22/ to permit private plaintiffs to sue for damages in appropriate cases.

I have spent the last thirty minutes or so giving you my views on what should not be done in response to the current scandal tainting the markets. You may be asking what does she think should be done, if anything. Prepare yourselves to utter a collective groan. Apart from continuing vigorous enforcement efforts, I would join Harvey Pitt and Milton Cohen in asking for a special study of the markets. There have been fundamental changes in our capital markets during the twenty-four years since the last general study. These changes have been not only in where, how and from whom capital is raised, but also have

22/ To the extent broker-dealer conduct amounts to direct violations or aiding and abetting, the Insider Trading Sanctions Act of 1984 would apply. See Pub. L. No. 98-376, 98 Stat. 1264 (1984).

occurred with respect to where, how and by whom securities are traded. Many of our problems may well be rooted in these changes. We are trying to regulate a 1980's world from a 1960's perspective. It is time to adjust our focus. Once that is done, we will have a better idea of what to do about our problems, and then well-considered legislation can be proposed.

In concluding, I refer to a recent Washington Post article concerning insider trading which suggests that greed is a basic tenet of our capitalist system and therefore should not be "outlawed," but rather should be channeled into "more productive outlets." 23/ If that is the case, and I believe it is, (although it could be more eloquently put), then I submit that a concerted effort on the part of the regulators and the regulated is needed to emphasize that, notwithstanding the acceptability of greed, illegal and unethical behavior in the securities industry cannot and will not be tolerated. This should help to "channel" if not modify some of that greed so that it does not erode the basic fairness which is essential to the integrity of our markets.

Thank you.

23/ Kinsley, Wall Street's Other Scandal, Washington Post March 5, 1987 at A27.