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News Release

Remarks of

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"Lawyers and Insider Trading"

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

I. Introduction

These last few years have not been easy ones for lawyers.

It has seemed to me --- though it is perhaps attributable to my peculiar sensitivity to such things --- that the lawyer jokes have increased in number --- ones comparing lawyers to sharks or laboratory rats, for example, or ones whose frequently genuinely funny punch lines depend on the gruesome and premature deaths of lawyers.

Journalists have delighted in pointing out our professional failings --- the greed, the bad judgments, the hunger for publicity, the ethical lapses and all the rest.

To some extent, lawyers added kindling to the bonfires of the vanities, and have been burned like the investment bankers by the conflagrations of the 1980's. One can only suspect that the morality plays of the financial institutions, which have begun unfold of late, will soon find, if they have not done so already, their lawyer villains. Surely the fact that disgraced or disgraceful public figures appear disproportionately to be attorneys has not added to the profession's luster.

Friends who are historians tell me not to be too disheartened -- - lawyers, they say, have always been held in terrible repute. Strangely, though, I take little comfort from this perspective.

What is the proper response of a professional to the misbehavior of fellow professionals? I will confess to probably not having thought much more about this question than most lawyers, prior to coming to the Commission.

My tenure at the Commission, however, has forced me to confront professional ethical issues considerably more than previously. I confess, quite frankly, to being shocked at the number of lawyers which the avenging angels of the Enforcement Division have brought before the Commission in recent months, alleging their participation in a variety of illicit schemes.

Every barrel inevitably will have its share of rotten apples, of course, and I am not sure anyone could persuasively demonstrate that there are more incidents of lawyer misbehavior in the world than incidents by, say, engineers, or opthalmologists, or registered nurses. Nor, as professionals, do I believe we need take personal responsibility for every lawyer who also happens to be a crook. Traits of honesty and good character are probably largely formed, for better or worse, long before entry into law school.

But there are, nonetheless, some aspects of professional behavior for which we do bear some collective professional responsibility. And, with your indulgence, I would like to explore for a few minutes today some aspects of that responsibility in one particular area of Commission concern --- insider trading cases.

II. SEC Releases and Cases

Let me begin with some history.

In 1977 the SEC issued a release disclosing that it had come to the Commission's attention that in certain instances law firm personnel, namely legal secretaries and what were then quaintly referred to as "stenotypists", had possibly either traded on inside information or passed such information on to others who traded.[1] The release urged firms to establish policies and procedures regarding confidential information and to take steps to ensure that all firm personnel were familiar with the procedures.

Three years later, in the first insider trading case against lawyers of which I am aware, the SEC sued partners and associates of a New Jersey patent law firm, alleging that they had purchased client securities while in possession of non-public information concerning client patent

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[1] Securities Exchange Act Release No. 13437 (Apr. 26, 1977).

applications.[2] The SEC issued a litigation release, stating that the anti-fraud provisions of the securities laws, as well as "the high ethical standards required of those engaged in the practice of law," mandated that all law firm personnel keep non-public information confidential, and not use such information as a basis for trading in securities. The release also re-emphasized the Commission's 1977 statement on the need for policies and procedures to protect confidential information.

Since that first case in 1980 the SEC and the Justice Department have brought, by my rough count, a total of sixteen separate insider trading cases involving 23 lawyers[3] --- and at least five other cases have

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[2] SEC v. Lerner, SEC Lit. Rel. No. 9049 (Apr. 2, 1980).

[3] SEC v. Bluestone, SEC Lit. Rel. No. 12589 (Aug. 22, 1990); SEC v. Glauberman, SEC Lit. Rel. No. 12574 (Aug. 9, 1990); SEC v. Singer, SEC Lit. Rel. No. 12523 (Jun. 28, 1990); SEC v. O'Hagan, SEC Lit. Rel. No. 12344 (Jan. 10, 1990); SEC v. Schreiber, SEC Lit. Rel. No. 12194 (Aug. 3, 1989); SEC v. Wolski, SEC Lit. Rel. No. 12092 (May 10, 1989); SEC v. Solomon, SEC Lit. Rel. Nos. 12000, 12243 (Feb. 21 and Sept. 8, 1989); SEC v. Atkinson, SEC Lit. Rel. No. 11567 (Sept. 30, 1987); SEC v. Grossman, SEC Lit. Rel. No. 11359 (Feb. 17, 1987); SEC v. David, SEC Lit. Rel. No. 11334 (Dec. 30, 1986); SEC v. Elliot, SEC Lit. Rel. No. 11335 (Dec. 30, 1986); SEC v. Reich, SEC Lit. Rel. No. 11246 (Oct. 9, 1986); SEC v. Florentino, SEC Lit. Rel. No. 10095 (Aug. 16, 1983); SEC v. Rubinstein, SEC Lit. Rel. No. 9861 (Jan. 10, 1983); SEC v. Cooper, SEC Lit. Rel. No. 9718 (Jul. 15, 1982); SEC v. Hall, SEC

been brought against law firm employees.[4] Even more troubling, nine of the sixteen cases have been brought since the Ivan Boesky and Dennis Levine scandals made insider trading a household term, assuming it had not already become one.

Three cases filed last year by the Commission illustrate the continuing nature of insider trading questions. In January of 1990 an action was filed by Division of Enforcement attorneys against James O'Hagan, a senior partner at Dorsey & Whitney, a major Minneapolis firm. The complaint alleges that O'Hagan discussed with his partners whether Dorsey & Whitney should represent a foreign corporation in its attempted hostile bid for one of Minnesota's largest corporations, the Pillsbury Company. Dorsey & Whitney ultimately gave up the

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Lit. Rel. No. 9013 (Feb. 22, 1980).

[4] SEC v. Hurton, SEC Lit. Rel. No. 12097 (May 16, 1989); SEC v. Aksler, SEC Lit. Rel. Nos. 11325, 11677 (Jan. 5, 1987 and Mar. 2, 1988); SEC v. Karanzalis, SEC Lit. Rel. Nos. 10325, 10558 (Apr. 5 and Oct. 10, 1984); SEC v. Madan, SEC Lit. Rel. No. 10063 (Jul. 7, 1983); SEC v. Musella, SEC Lit. Rel. No. 9862 (Jan. 11, 1983).

representation. However, before an offer for Pillsbury was made public, the complaint alleges, O'Hagan purchased 5,000 shares of Pillsbury stock and 3,000 out-of-the-money call options. O'Hagan's initial investment of $600,000 in Pillsbury stock and options ultimately yielded $4.3 million, for a profit of $3.7 million, in rough numbers. The complaint seeks disgorgement and ITSA penalties. O'Hagan is still litigating the case.

In August of 1990 the SEC filed an action against Steven Glauberman, a senior associate at Skadden Arps in New York. The complaint alleges that over a four year period Glauberman, in effect, sold non-public information to a broker concerning at least 29 corporate transactions worked on at Skadden. The broker made over $1.1 million from trades based on the information, and tipped others who also profited. Glauberman has pled guilty to criminal charges and settled with the SEC.

Also this past August, Division of Enforcement attorneys filed an action against five partners of a midwestern law firm. The complaint alleges that the partners sold their stock in a company after one of the partners learned the non-public information that the company had defaulted on a loan and would soon file for bankruptcy. According to the complaint, the five partners avoided losses of approximately $87,000 by trading on this inside information. This case also continues in litigation.

The recent cases against lawyers, assuming all the allegations are true, raise a number of questions: do lawyers as a group engage in insider trading more frequently than others? Is insider trading by lawyers more heinous than similar violations by others? Should lawyers be held to a higher standard in insider trading cases, either by the Commission or by others with the power to sanction them?

On the question of how often lawyers trade on inside information versus other groups, let me first state that I have no empirical data on insider trading by specific occupational groups. However, in thinking about recent cases brought by the SEC it appears that there are at least three groups that seem disproportionately to engage in insider trading.

The first two groups are securities professionals and lawyers. Both of these groups routinely obtain material, non-public information in the course of representing clients.

The third group consists of officers and directors of public companies. Their trading typically stems from corporate transactions involving the companies which they serve. Like lawyers and securities professionals, officers and directors of public companies routinely possess material, non-public information.

All others charged in insider trading cases comprise a variety of individuals from all walks of life who appear to take advantage of what they view as a once in a lifetime opportunity.

Let me return to the three groups of insider traders -- securities professionals, lawyers and officers and directors. Is there any reason why we in the legal profession should be more concerned about insider trading by a lawyer than about insider trading by an investment banker? Both investment bankers and lawyers receive confidential information from clients. Both groups are under an obligation not to misappropriate client information for their own benefit. Both groups are dependent on establishing and maintaining a reputation as safe repositories of confidential information to attract and retain clients.

Officers and directors of public companies have some similar obligations. They owe fiduciary duties to shareholders to act in their best interests. This duty prevents officers and directors from trading on material corporate information unless it is publically disseminated.

Accordingly, as developed by the courts, insider trading by investment bankers, lawyers and corporate officers alike, necessarily involves a breach of a duty to clients or constituents. Let me return to the original question: if insider trading by lawyers involves the same or a similar breach of duty as insider trading by other professionals, should we view violations by lawyers differently?

This is a difficult question but the answer, I believe, is "yes", and arises from the role that lawyers play in society. It starts with the oath we all took upon admission to the bar to the effect that we would uphold and defend the law. And it continues, because as officers of the courts, lawyers are called upon, on a daily basis, to interpret the law and act as intermediaries between private citizens and the processes of government and law enforcement.

Further, the legal profession remains largely self-governing. Although other professions are also self-governed, the legal profession has a special stake in remaining independent because its potential governmental regulators are often the subject of scrutiny by, and conflict with, the legal profession. Independence from government control is an important objective, for abuse of legal authority is more readily challenged by a profession whose members are not dependent upon government for the right to practice.

It is because of these special roles that violations of the law by lawyers merit increased attention. I do not suggest, however, that lawyers' conduct must be held to a higher standard by the Commission in making judgments about lawyers' liability for insider trading, though at a practical level it is simply harder for lawyers involved in insider trading cases to make arguments, such as, for example, that they didn't know there was anything wrong with trading on material, non-public information.

III. Available Sanctions Against Lawyers and Their Firms

A. Individual Liability

Even if you conclude that lawyers should be held to no higher standard than others in insider trading cases, one might still reasonably ask whether special sanctions should apply to lawyers found liable in such cases.

The potential individual liability for insider trading typically includes, of course, an injunction, disgorgement and payment of a penalty. In egregious cases, lawyers have gone to jail.

Two other remedies exist, however, that apply to lawyers' ability to continue to practice law. The first is a Rule 2(e) administrative proceeding brought by the Commission. Under Rule 2(e), the Commission may, of course, bar an attorney from practicing before it upon finding that the attorney has been enjoined or sanctioned administratively for violating the securities laws, or has had his license to practice law revoked or suspended. It is interesting to note that of the nearly two dozen attorneys sued for insider trading since 1980, I am told that no Rule 2(e) proceedings were subsequently filed.

One reason is that the Commission has tended only to bring Rule 2(e) proceedings against individuals whose securities law violations involved actual practice before the Commission, such as, for instance, participation in creation of a false filing, or making a false representation to the Commission.

However, the rule as written would literally seem to permit the Commission to bring a Rule 2(e) proceeding against a lawyer solely on the basis that the lawyer was found to have engaged in insider trading. Given the number of insider trading cases against lawyers, it is at least conceivable that some future Commission may look to Rule 2(e) proceedings as an additional sanction against insider trading by lawyers. I would counsel caution before such a step is taken; nonetheless, it is not in the realm of the impossible.

The second potential sanction for insider trading by a lawyer is a disciplinary proceeding by state bar authorities. In a case involving insider trading by a lawyer, the Commission staff, in addition to taking legal action on behalf of the Commission, routinely refers the matter to the lawyer's local bar association for its consideration.

I believe it is important that bar associations view insider trading as a serious violation warranting disciplinary action. In most cases involving lawyers and insider trading, the lawyer trades on misappropriated client information. Such actions may be in violation of the ABA's Model Rules of Professional Conduct, as well as individual state bar rules, which require, for example, that lawyers keep client information confidential, and not engage in transactions that conflict with a client's interests, as well as other ethical obligations.[5] To the extent bar associations fail adequately to sanction illegal and unethical conduct by their members, the risk to the legal profession is greater that

[5] See Model Rules of Professional Conduct and Code of Judicial Conduct, Rules 1.6 and 1.8, American Bar Association (1984). In addition, Model Rule 8.4 prohibits lawyers from engaging in conduct involving dishonesty, fraud, deceit or misrepresentation.

Government will take it upon itself to find ways to penalize attorneys for misconduct.

But the issue for the bar is not just how and when to discipline errant lawyers. There is a more practical effect of lawyer misbehavior on the firms in which dishonest lawyers practice.

B. Firm Liability

Law firms can be found liable for insider trading by partners or employees under the common law principle of respondeat superior, or pursuant to Section 20(a) of the Exchange Act, which imposes liability on controlling persons.

Respondeat superior liability generally is interpreted to require that the offending act by the employee be within the scope of his or her employment. However, courts have liberally construed this rule to cover conduct that is incidental to, or a foreseeable consequence of, the employee's activities. Under the right circumstances, insider trading by a lawyer or employee with frequent access to material, non-public information might pass the foreseeability test.

Controlling person liability under Section 20(a) of the Exchange Act provides that a control person is jointly and severally liable for the violations of controlled persons, unless the controlling person acted in good faith and did not directly or indirectly induce the violative act.

Under ITSFEA, good faith may no longer be a defense for a law firm. A controlling person must now take appropriate action once he knows a controlled person is about to engage in a violation. More importantly for most firms, a control person is also potentially liable if it recklessly disregards circumstances indicating a likelihood that a controlled person will engage in insider trading or tipping. Thus, ITSFEA can be viewed as imposing an affirmative obligation on law firms to take appropriate action to prevent insider trading.

Some leading members of the securities bar have suggested that in light of the recklessness standard contained in ITSFEA, it is conceivable that a law firm which routinely has access to material, non-public information could be found reckless for failing to adopt appropriate policies and procedures to prevent insider trading.[6]

Thus, notwithstanding the fact that law firms are not statutorily required to adopt policies and procedures, firms that routinely come into possession of material, non-public information should seriously consider adopting policies and procedures aimed at protecting confidential information, and preventing insider trading.

IV. Policies and Procedures to Prevent Insider Trading

I have emphasized, to this point, some reasons why lawyers may be viewed as being required to have higher standards than others --- reasons relating to their special role in the community. I have also

[6] T. Levine & A. Mathews, Law Firm Policies and Procedures to Prevent Insider Trading, 10th Annual Southern Securities Institute (Jan. 11, 1990).

indicated some special sanctions which may be applied to lawyers and, more relevantly for you, their partners, in cases of insider trading. These arguments, if you will, force us to deal with our brethren even if we believe ourselves to be pure of heart. Now I would like to turn the coin over and ask what law firms can or should do to cope with these circumstances.

In turning to specific policies and procedures that law firms might consider implementing, it might be useful briefly to review the policies and procedures securities firms maintain to deal with insider trading risks. ITSFEA specifically requires that securities firms establish, maintain, and enforce written policies and procedures reasonably designed to prevent misuse of material, non-public information. Securities firms which fail to implement the required policies and procedures may be liable under ITSFEA for violations of employees if the absence of policies and procedures contributed to the occurrence of the violations.

Securities firms typically restrict securities transactions by employees in some of the following ways: employees may not maintain a brokerage account outside the firm; all securities transactions must be pre-approved; short term trading, short sales and options trading are prohibited; and transactions in deal or rumor stocks are not permitted. Chinese walls, restricted lists and watch lists are also common components of procedures implemented by securities firms.

All these procedures may not be appropriate for law firms. In fact, none of these procedures may be appropriate. The very fact that ITSFEA suggests special obligations for securities firms may lead one to conclude that Congress intended no such special obligations to fall on law firms. Such an approach by law firms, however, carries with it obvious risks.

Assuming a law firm wishes to establish procedures relating to insider trading for its employees and partners, how should it proceed?

Before adopting any set of procedures to deter or prevent insider trading, a law firm must first examine whether procedures make sense in light of all the facts and circumstances of its practice. In some cases, depending on the size of the firm and the nature of its business, the best procedure may be no set procedure. What is important, in my view, is not the adoption of any specific policies, but the conscious consideration of policies.

Even if a firm adopts procedures, of course, there is no guarantee that the firm will be insulated from liability. If it establishes procedures and then fails to follow them, it will surely increase the likelihood that it will be held liable. Unfortunately, in addition, at least one federal Court of Appeals has suggested, in another context, that the mere enactment of procedures may serve to bring illegal conduct by employees within the scope of their employment, because the adoption of procedures demonstrates that the illegal acts of employees were foreseeable.[7] Such a rule, I believe, would be unfortunate if it deterred firms from taking reasonable precautions to prevent lawlessness.

There is also the risk that at some point the maintenance of policies and procedures by law firms may become so widespread as to create, in the view of the courts, a minimum standard of care within the profession. Thus, any firm that failed to adopt these minimum procedures, no matter what its size or the nature of its practice, might face the charge that an absence of policies and procedures caused the firm to fall below the recognized standard of care in the profession. This, too, would appear to me to be an unfortunate result.

Even with these risks, however, I believe firms must consider prophylactic measures to prevent insider trading. Such measures appear to fall into three categories: general education; protecting

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[7] See Yates v. Avco Corp., 819 F.2d 630, 636 (6th Cir. 1987).

confidential information from disclosure; and trading restrictions.

Education, may be the least costly, and yet quite effective. One educational step, for example, would be to have a written statement, acknowledged in writing by all firm employees and partners, concerning the need to preserve the confidentiality of client information.

A second type of prophylactic measure is to restrict the flow of confidential information within the firm. Many firms have procedures designed to limit dissemination within the firm of material non-public information.

Let me add that it would be a mistake to view the problem of restricting the flow of confidential information as a problem solely of law firms principally engaged in mergers and acquisitions work. Bankruptcies, corporate earnings data, new technology and management changes, to name a few matters, can all have a significant impact on a company's stock price. Accordingly, a law firm must look beyond M&A to determine what policies and procedures are needed.

Turning now to the third type of prophylactic measure, trading restrictions, I'll start by mentioning the most restrictive rule possible, which is a complete ban on all securities ownership by law firm employees and partners, except through mutual funds, blind trusts or similar mechanisms. This is an admittedly draconian measure, but some have argued that given the number of confidential matters a law firm may be working on at any one time, the risk of an inadvertent purchase by an employee or partner and the resulting reputational harm to the firm outweigh the benefits of allowing securities trading by firm personnel.

A somewhat less restrictive approach would be to require pre-clearance of all trades, though this approach is not without material administrative costs.

Firms might alternatively require that employees and partners only execute trades through a designated broker that automatically would report all trades to the management committee, or allow the firm access to brokerage records upon request.

Another approach would be to distribute a list of clients and their affiliates to law firm partners and employees, and prohibit trading in their securities. Such a list should also include parties on the opposite side of a corporate transaction and, under certain circumstances, even adverse parties in litigation.

Depending on the nature of a firm's practice, distribution of an updated list of prohibited securities may be an unattractive solution because it highlights material matters the firm is working on, and such information may have the effect of providing inside information rather than concealing it.

Limitations could also be placed on the type of trading law firm employees could engage in. For instance, options trading or short sales could be prohibited. Also, firms might require that securities purchased by employees be held for a certain minimum period of time before sale.

There are, no doubt, other procedures or variations on the procedures I've just described that would be effective.

At the risk of repeating myself, I do not believe any single procedure is necessarily required to avoid liability. What is important, I believe, is that firms consider such issues with some care.

V. Obligations of Law Firms Upon Discovering a Violation

Before closing, let me briefly mention a law firm's obligation upon discovering insider trading by an employee. While there may be no specific obligation under the Commission's rules to report the employee, there may be an ethical obligation under the Model Rules and its local variants. Model Rule 5.1 states that: "A lawyer shall be responsible for another lawyer's violation of the Rules of Professional Conduct if the lawyer is a partner in the law firm in which the other lawyer practices, or has direct supervisory authority over the other lawyer, and knows of the conduct at a time when its consequences can be avoided or mitigated but fails to take reasonable remedial action."

Furthermore, Rule 8.3 requires that "[a] lawyer having knowledge that another lawyer has committed a violation of the Rules of Professional Conduct that raises a substantial question as to that lawyer's honesty, trustworthiness or fitness as a lawyer in other respects, shall inform the appropriate professional authority."

Once an SEC investigation begins, what is a firm's obligation to cooperate with a Commission inquiry? I would hope that firms would cooperate fully and not engage in dilatory tactics. I do not mean to suggest that firms aren't entitled to use the law, in good faith, to defend themselves --- if it comes to that. But, unfortunately, in my experience at the Commission, full cooperation is not always the rule, and this has led to some question as to whether all firms have the commitment to preventing insider trading which they profess.

What obligations does a firm have if, despite the presence of policies and procedures, employees engage in insider trading? At a minimum, these firms should re-examine the operation and enforcement of their procedures, and consider what additional means might be more effective than the ones in place at the time of the original violation.

VI. Conclusion

In conclusion, I would note that no set of procedures can absolutely prevent insider trading. The best we can hope for from a set of procedures is to make all firm personnel aware that trading on confidential information is unacceptable, and perhaps make it a little more difficult for the dishonest or careless employee or partner to engage in unacceptable behavior. As important, the existence of procedures will demonstrate to the public the institutional unacceptability to the profession and to firms of illegal behavior.

I think a further solution might be found at the local bar level. Continuing legal education programs can help, and disciplinary committees should severely sanction transgressions involving misappropriation of client information and related behavior.

We are, after all, a self-policing profession. Accordingly, we all bear some responsibility for the illegal acts of our colleagues. It is up to all of us to make serious efforts to prevent violations from occurring, and to sanction appropriately those who engage in violations.

In the long term, the unpleasant alternative to professional self-regulation may be further governmental intrusion into the governance of the profession. That result, I believe, bears a serious risk of doing more lasting harm than good.

Thank you.