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Remarks of

David S. Ruder
Chairman
Securities and Exchange Commission

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Recent Developments in Insider Trading Law and Enforcement

The views expressed herein are those of Chairman Ruder and do not necessarily reflect those of the Commission, other Commissioners or the staff.

RECENT DEVELOPMENTS IN
INSIDER TRADING LAW AND ENFORCEMENT

The dramatic stock market events of October 1987 have already resulted in the initiation of a number of studies regarding the dramatic fall in stock prices. The Securities and Exchange Commission has its own review underway, and I hope that we will soon be able to offer suggestions for improving the operation of our nation's capital markets.

Although that task is important, I also think it important that you know we are continuing to concentrate on other areas of regulation intended to improve the capital formation process. The regulation of insider trading is one of those areas and it remains a very high priority for Commission action.

I. INTRODUCTION

"Insider trading" refers generally to the act of purchasing or selling securities, in breach of a fiduciary duty, by persons who possess material, non-public information about the issuer or its securities. Unless the Supreme Court holds to the contrary in the recently argued Carpenter case, 1/ trading while in possession of information that has been misappropriated also amounts to insider trading.

Insider trading prohibitions are extremely important to the operation of our securities markets. Although they rest on

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1/ U.S. v. Carpenter, et al. 791 F.2d 1024 (2d Cir.), cert. granted, 107 S.Ct. 666 (1986). The Supreme Court heard oral argument on this matter on October 7, 1987.

legal concepts of breach of fiduciary duty and misappropriation, they also serve to improve confidence in the fairness and integrity of the securities markets. The investing public has a legitimate expectation that the prices of actively traded securities reflect publicly available information about the financial condition and prospects of issuers, and that persons with access to material, non-public information will not abuse their trust by trading before such information is publicly disclosed. 2/

II. THE EVOLUTION OF INSIDER TRADING LAW

A. Trading by Corporate Insiders

The starting point for insider trading analysis is a long standing doctrine that corporate officers, directors, and controlling persons who trade in a corporation's shares have an obligation to disclose to the corporation's shareholders any material, non-public information that they know about their corporation. 3/

2/ Like many other types of fraud, the offense of "insider trading" is not specifically defined by the securities laws. The Commission has brought insider trading cases under Section 10(b) of the Securities Exchange Act of 1934, and Commission Rule 10b-5, which generally prohibit fraudulent practices "in connection with" the purchase or sale of a security. In some cases, violations of Section 17(a) of the Securities Act of 1933 have been alleged in actions against insider traders, and, more recently, Section 14(e) of the Exchange Act and Rule 14e-3 have been relied upon to reach insider trading in the tender offer context.

3/ *See* *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

In a 1961 Commission administrative proceeding, William Cary, then Chairman of the Commission, described the insider trading doctrine as follows:

> ... the obligation [consists of] two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. 4/

In 1968, a federal circuit court held in the famous Texas Gulf Sulphur 5/ litigation that those persons having access to information "intended to be available only for a corporate purpose, and not for the benefit of anyone" must observe the "abstain or disclose" principal. 6/ They must either abstain from trading or disclose the information in their possession to the investing public.

Although the Cady, Roberts opinion, like Texas Gulf, was based upon breach of a duty to the corporation, it also introduced another concept. Chairman Cary's thoughtful

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4/ Cady, Roberts, 40 S.E.C. at 912. In Cady, Roberts the director of a public company divulged material non-public information to his partner in a brokerage firm. The Commission held that the partner was under an obligation to disclose the information or abstain from trading, even though the Commission accepted the director's contention that he had believed the information to be public at the time he divulged it to his partner.

5/ SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

6/ SEC v. Texas Gulf Sulphur, 401 F.2d at 848.

opinion suggested that trading based on non-public information should be prohibited because of the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to the other party to the transaction.

This "equal access" to information theory was tested in a 1980 Supreme Court case, Chiarella v. U.S. 7/ In that case Vincent Chiarella, an employee of a financial printer, had deduced the identities of corporate takeover targets from information contained in documents delivered to the printing firm. He purchased securities of the target companies before the takeover bids were announced. In reversing Chiarella's criminal conviction, the Supreme Court stated that an affirmative duty to disclose or abstain does not arise merely from the possession of material information, but depends instead upon the existence of a fiduciary or other relationship of trust and confidence on the part of the trader. 8/ The Court found that Chiarella owed no such duty to the persons from whom he purchased securities.

B. Trading by Misappropriators

The Supreme Court's holding in Chiarella presented serious securities law policy problems. While traditional duty concepts are effective in cases involving corporate officers trading in the securities of their own companies, they are not applicable

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7/ Chiarella v. U.S., 445 U.S. 222 (1980).

8/ Chiarella v. U.S., 445 U.S. at 235.

in cases where persons breach duties to other persons and entities when trading based upon non-public material information. For instance, they do not reach breaches of duties to the federal government, to courts, to self-regulatory agencies, to broker-dealers, or to news gathering entities. In an effort to reach these situations, the "misappropriation theory" of liability has been developed. Under this theory, an individual may be engaged in insider trading based on non-public information that the individual obtained or used in breach of a duty to another person, even if that duty is owed to someone other than the issuer of the securities traded or its shareholders. 9/

For instance in SEC v. Materia, 10/ a case similar in its facts to Chiarella, an employee of a financial printing house purchased takeover stocks that he was able to identify from tender offer documents being printed by his employer. The Second Circuit in that case held that "one who misappropriates

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9/ The misappropriation theory was first expressed as an alternative basis for insider trading liability in the Second Circuit's Chiarella opinion. See Chiarella, 588 F.2d at 1368, n.15. The Supreme Court reversed Chiarella's conviction on the grounds that he had not had prior dealings with the persons who sold securities to him, and hence owed them no duty. Although the government argued the misappropriation theory before the Supreme Court, the Court declined to address the theory in its majority opinion. However, the concurring and dissenting opinions in Chiarella commented favorably upon the theory, thereby laying the groundwork for reliance upon the theory in subsequent cases.

10/ SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), cert. denied, 471 U.S. 1053 (1985). See also U.S. v. Newman, 664 F.2d 12 (2d Cir. 1981), aff'd after remand, 722 F.2d 729 (2d Cir.), cert. denied, 464 U.S. 863 (1983).

non-public information in breach of a fiduciary duty and trades on that information to his own advantage" violates the law. 11/

Within the next few months, the Supreme Court may rule on the validity and scope of the misappropriation theory in the Carpenter case. 12/ As you probably know, this case, popularly known as the Winans case, involves the criminal convictions of a reporter for the Wall Street Journal and his confederates on charges that the contents and timing of items that were to appear in the Journal's "Heard on the Street" column were misappropriated from the Journal and used as a basis for insider trading.

C. Rule 14e-3

In addition to the corporate fiduciary duty and the misappropriation theories, a third theory has emerged, designed as a means of dealing with abuses in the takeover area. In this area, the problem is that a bidder may distribute to others non-public information about its takeover plans. The bidder's motivation may be to reward others or perhaps to encourage accumulation of the target's securities in the hands of persons willing to tender when the bidder's offer is made. This activity does not involve a breach of duty, but it has characteristics of unfairness to the market that justify regulation.

11/ Materia, 745 F.2d at 203.

12/ U.S. v. Carpenter, 791 F.2d 1024.

In response to this potential for abuse the Commission has promulgated Rule 14e-3. 13/ That rule prohibits any person who possesses material, non-public information about a tender offer from trading, or causing others to trade, securities of the target company if the person knows or has reason to know that the information has been obtained directly or indirectly from the bidder or the target. The prohibitions of Rule 14e-3 apply even if the person charged with a violation does not owe a fiduciary or other duty to the issuer or its shareholders and even if no prohibition against misappropriation has been violated. 14/

D. Tipping

Another question stemming from the basic insider trading prohibition has been whether a person who receives non-public information from someone who is subject to the prohibition

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13/ Securities Exchange Act Release No. 17120 (Sept. 4, 1980); see also Securities Exchange Act Release No. 16385 (Nov. 29, 1979) (proposing release). Rule 14e-3 was promulgated pursuant to the Commission's authority under Section 14(e) to "define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative" in connection with a tender offer. See Schreiber v. Burlington Northern, Inc., 472 U.S. 1 (1985).

14/ The Commission has alleged violations of Rule 14e-3 in a number of recent cases. See, e.g., SEC v. Levine, 86 Civ. 3726 (RO) (S.D.N.Y. filed May 12, 1986); SEC v. Siegel, 87 Civ. 0963 (S.D.N.Y. filed Feb. 13, 1987); SEC v. Boesky, 86 Civ. 8767 (RO) (S.D.N.Y. filed Nov. 14, 1986); SEC v. Vaskevitch, 87 Civ. 1620 (RWS) (S.D.N.Y. filed Mar. 11, 1987).

against insider trading would also be subject to the "abstain or disclose" prohibitions. The 1968 Texas Gulf Sulphur case addressed this issue and the court held that not only were transactions by the person receiving the information unlawful, but that the person communicating the information would also be violating the law.

In 1983, the Supreme Court limited the scope of both tipper and tippee liability in its decision in Dirks v. SEC. 15/ In that case, Dirks, an investment analyst, learned about a massive financial fraud from a company officer and transmitted that information to some of his clients, who sold the issuer's securities before the information was publicly disclosed. The Supreme Court held that a tippee assumes a fiduciary duty to shareholders when the insider communicating the information breaches a fiduciary duty by tipping the material non-public information, and the tippee knew or should have known about the breach. 16/ The Court added that whether the insider breaches a duty by disclosing non-public information depends in large part on the purpose of the disclosure, and that the test is whether the insider seeks a direct or indirect personal benefit from the disclosure. 17/ The result of the Dirks case was to limit tippee liability to those cases where (1) the tipper

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15/ Dirks v. SEC, 463 U.S. 646 (1983).

16/ Dirks v. SEC, 463 U.S. at 660.

17/ Id.

breached a fiduciary duty by tipping, and (2) the tippee knew or should have known of the tipper's breach.

E. Temporary Insiders

In a key footnote in Dirks, the Court endorsed a theory that has the effect of enlarging the primary group owing fiduciary duties to the corporation. It stated that "where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders." 18/ This "temporary insider" theory is not based simply on the fact that such persons acquired non-public corporate information, "but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes." 19/

III. SEC ENFORCEMENT

Within this evolving legal framework, the Commission continues its aggressive pursuit of insider trading violations. We have brought insider trading cases not only against traditional insiders, but also against professionals, such as investment bankers, risk arbitrageurs, brokers, attorneys, other

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18/ Dirks, 463 U.S. at 655 n.14.

19/ Id.

law firm employees, accountants, and bank officers. We have also actively pursued cases involving tipping of associates, relatives, and friends.

The beginning of a remarkable series of cases occurred in May of 1986, when the Commission filed an insider trading action against Dennis Levine, a New York investment banker. The Commission alleged that Levine made huge profits over a six year period by trading in the securities of at least 54 issuers while in possession of material, non-public information about actual or proposed tender offers, mergers, and other business combinations. The Commission alleged that in many instances Levine learned of these impending transactions through his employment as an investment banker.

On June 5, 1986, Levine consented to a permanent injunction against future violations of the federal securities laws and agreed to disgorge $11.6 million in illicit profits from his insider trading. Levine also agreed to the issuance of an administrative order permanently barring him from the securities industry. In a related criminal action, Levine pled guilty to one count of securities fraud, two counts of income tax evasion, and one count of perjury, for which he was sentenced to two years in prison and fined $362,000.

Over the following five months, the Commission's investigation led to a series of cases against several other professionals who participated in Levine's insider trading scheme. 20/ On November 14, 1986, the Commission instituted the largest insider trading case in the Commission's history, the case against Ivan F. Boesky, a New York broker and arbitrageur. The Commission alleged that Boesky caused certain affiliated entities to trade in securities while in possession of material non-public information provided to him by Levine. As part of the settlement of that action, Boesky consented to the entry of a permanent injunction and agreed to pay $50 million in cash as disgorgement of profits obtained by his affiliated entities, and to pay a penalty consisting of securities having an estimated aggregate value of $50 million. Boesky also consented to the entry of an administrative order permanently barring him from the securities industry and agreed to plead guilty to a federal felony charge arising from the insider trading violation.

Ivan Boesky continues to cooperate with the Commission's ongoing investigation. The investigation has already resulted in additional significant cases, including one in which a major brokerage firm consented to pay $25 million in disgorgement and civil penalties. 21/ The Commission is still investigating, and you may rest assured that it will bring additional

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20/ See SEC v. Wilkis, 86 Civ. 5182 (S.D.N.Y. 1986); SEC v. Sokolow, 86 Civ. 5183 (S.D.N.Y. 1986); SEC v. Brown, 86 Civ. 7774 (S.D.N.Y. 1986); SEC v. Cecola, 86 Civ. 9735 (S.D.N.Y. 1986).

21/ SEC v. Kidder, Peabody & Co., Inc., 87 Civ. 3869 (RO) (S.D.N.Y. 1987).

enforcement actions if its investigation reveals that violations have occurred.

Other recent insider trading cases include an action against a lawyer who utilized information obtained from his law firm, 22/ an action against a public relations executive who traded on information that his firm obtained when it was retained in connection with a proposed acquisition, 23/ and an action against an employee of a financial printer who misappropriated information contained in tender offer documents being printed by his employer. 24/ These cases, as well as the Levine, Boesky and related cases, have a very disturbing common element. They involve deliberate misuse of confidential information by persons placed in special positions of trust. Market professionals, lawyers, public relations executives, financial printers and many others play crucial roles in our market system. It is enormously disturbing that persons either directly or indirectly involved in the securities markets show so little respect for concepts of fairness and integrity. The eradication of insider trading by such persons will continue to have the highest priority in the Commission's enforcement program.

22/ U.S. v. Michael David, 86 Cr. 454 (JFK) (S.D.N.Y. 1986).

23/ SEC v. Franco, Civ. Action No. 86-2382 (D.D.C. 1986).

24/ SEC v. Materia, 745 F.2d 197 (2d Cir. 1984).

Although I have just strongly condemned insider trading activities by those closely associated with a market system this attitude is not intended to indicate lack of concern when corporate insiders engage in such activities. Moreover, I believe it is improper for friends and relatives of persons possessing inside information to use that information for their own financial benefit. It is a disturbing indictment of our society's moral values to hear reports of friends and relatives of insiders placing hurried calls to their brokers in order to take advantage of confidential information communicated to them. 25/ Neither insiders nor their friends and families are entitled to ignore the proscription against insider trading simply because opportunities to trade reach them infrequently. Let me assure you that the Commission will continue vigorously to pursue violations by these casual traders as well as by other persons who unfairly trade while in possession of material non-public information.

IV. DEFINING INSIDER TRADING

A. Legislative Action

Recently, at the request of the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs,

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25/ The Commission has recently considered a number of cases involving complicated familial networks through which such information was being passed. *See, e.g. SEC v. Aksler*, No. 86-9811 (S.D.N.Y. December 23, 1986) (a former law librarian and eight of his relatives charged with trading on non-public information misappropriated from the law firm of Skadden, Arps, Slate, Meagher & Flom).

a group of securities law practitioners assisted in drafting a statute to define and prohibit insider trading. The resulting bill, S. 1380, "The Insider Trading Proscriptions Act of 1987," was introduced in the Senate by Senators Riegle and D'Amato on June 17, 1987. The bill adopts and builds upon existing case law regarding both traditional insider trading and the misappropriation theory. It would prohibit the use of inside information that is "wrongfully" obtained or used, and would broadly define such "wrongful" conduct.

On August 3, 1987, before I was sworn in as Chairman, the Commission presented its own draft bill to the Securities Subcommittee. The Commission is currently engaged in examining S. 1380 in light of the legislation it proposed on August 3. In so doing I believe the Commission should support a definition of insider trading that is broad enough to reach not only insider trading by corporate employees, but also insider trading by persons associated with the market, by friends and relatives, and by other persons who knowingly violate relationships of trust and confidence by utilizing inside information for their own benefit. The new legislation should remove the Dirks requirement that in tipping cases a personal benefit to the tipper must be found in order to charge the tipper or the tippee.

I also believe that the principle embodied in Commission Rule 14e-3 prohibiting use of tender offer information should be continued. Even if no breach of trust or confidence would be involved, it is unfair to permit those planning a tender offer to spread that highly material information to others in advance of the tender offer.

Additionally, I believe it appropriate for the legislation to provide an express private right of action for contemporaneous traders against the persons illegally trading on inside information to recover an amount equal to the profit obtained or loss avoided.

Notwithstanding the desirability of new legislation of the type described, there should also be some limitations on insider trading law in order to protect legitimate activities by market professionals and others. For instance, entities that institute reasonable policies and procedures to protect against insider trading should not be subject to a presumption that confidential information has been transmitted throughout the entity. Additionally, communications of information by market analysts to their customers should not be prohibited unless the analyst knows that the information was wrongfully obtained.

V. CONCLUSION

If adopted, the insider trading legislation I have described will recognize that it is wrong to benefit oneself by breaching a duty to keep information confidential. When this breach threatens the honesty and integrity of our securities markets, a legitimate federal interest in regulation arises.