



U. S. Securities and Exchange Commission
Washington, D. C. 20549 (202) 272-2650

**News
Release**

**TO CATCH A THIEF:
RECENT DEVELOPMENTS IN
INSIDER TRADING LAW AND ENFORCEMENT**

Address to

The National Investor Relations Institute,
New York Chapter

Grand Hyatt Hotel
Ballroom D
New York, NY

June 20, 1986

Joseph A. Grundfest
Commissioner

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

TO CATCH A THIEF:
RECENT DEVELOPMENTS IN
INSIDER TRADING LAW AND ENFORCEMENT¹

The Securities and Exchange Commission has attracted widespread interest as a result of its recent insider trading enforcement actions. For a variety of reasons, speculation has emerged that the Commission has a hidden agenda designed to expand the scope of insider trading liability. The fear is that the Commission intends to reach persons who trade on the basis of material nonpublic information, regardless of whether that information is misappropriated or obtained in breach of a fiduciary duty.² Speculation has also emerged that the Commission has targeted Wall Street arbitrageurs, and is out "to get the arbs" by relying on novel and untested legal theories.³

I would like to put this speculation to rest, at least insofar as it relates to the thinking of one Commissioner.

The Focus Is On Thieves

Since I joined the Commission in October of 1985, every insider trading case authorized by the Commission has involved a clear misappropriation of material, nonpublic information.⁴

¹This speech was drafted with the assistance of Gerald J. Laporte and Ronald A. Schy, Counsel to Commissioner Grundfest.

²See, e.g., Bleiberg, "Those Hobnailed Boots: The SEC Has Put the Workings of the Market in Jeopardy," Barron's, June 2, 1986, at 11; Stewart & Gray, "SEC Insider Trading Case Could Clog Pipeline Between Bankers, Arbitrators," Wall St. J., May 19, 1986, at 3; Poser, "Shady Trading: The SEC's Case Against Levine May Be Shaky Under Present Law," Inv. Dealer's Digest, June 9, 1986, at 25; Kerwin, "Trading on a Tip: SEC Angles for Big Fish in Stock-Deal Leaks," The Detroit News, June 8, 1986, at 1B.

³See, e.g., Sherrid, "Wall Street's 'Arbs' on the Hot Seat," U.S. News and World Report, June 2, 1986, at 41-42.

⁴All of these cases have not, however, been pursued under a misappropriation theory.

Information is property.⁵ The taking of property without consent is theft, and theft is both immoral and inefficient.⁶ Theft is inefficient because it erodes the incentive to create and invest, and subverts the important price signaling mechanisms of a free-market system.⁷

This conclusion is consistent with well-accepted notions of morality and fairness. Indeed, this focus on market efficiency is, in the long run, more likely to promote investor

⁵E.I. duPont deNemours & Co. v. Christopher, 431 F.2d 1012 (5th Cir. 1970), cert. denied 400 U.S. 1024 (1971) (trade secret cannot be obtained by improper means, such as aerial photography); Smith v. Bravo Corp., 203 F.2d 369 (7th Cir. 1953) (trade secrets obtained while negotiating to purchase plaintiff's business may not be used to compete).

⁶See, e.g., Posner, "An Economic Theory of Criminal Law," 85 Colum. L. Rev. 1193, 1195 (1985) ("The major function of criminal law in a capitalist society is to prevent people from bypassing the system of voluntary, compensated exchange--the "market," explicit or implicit--in situations where, because transactions costs are low, the market is a more efficient method of allocating resources than forced exchange. Market bypassing in such situations is inefficient--in the sense in which economists equate efficiency with wealth maximization--no matter how much utility it may confer on the offender."); Shavell, "Criminal Law and the Optimal Use of Nonmonetary Sanctions as a Deterrent," 85 Colum. L. Rev. 1232 (1985).

⁷See authorities cited in note 6, supra. See also note 9, infra, for a summary explanation of how theft of information in the insider trading context harms market efficiency.

confidence than direct reliance on inherently subjective assessments of "fairness."⁸

The Commission has no interest in impeding the free and active flow of information on Wall Street. There are, however, sound economic reasons to draw a line at theft, and to prosecute vigorously all those who are thieves of information.⁹

⁸I have discussed this issue previously in "Enforcing the Securities Laws: A Search for Priorities," Address to the Sixth Annual Ray Garrett, Jr. Corporate and Securities Law Institute, in Chicago, Illinois (May 1, 1986).

⁹Some economists have argued that insider trading is beneficial because it is a desirable form of executive compensation and promotes market efficiency by helping prices adjust more rapidly to their true market levels. H. Manne, Insider Trading and the Stock Market (1966), is the seminal work in this school of thought. For citations to related works, see Carlton and Fischel, "The Regulation of Insider Trading," 35 Stan. L. Rev. 857 (1983). I am skeptical of these arguments.

First, I believe it can be rigorously demonstrated that any contract that allows insider trading as a form of compensation is, in economist's jargon, "strictly dominated" by alternative contracts involving stock options and/or cash incentive payments. In other words, I doubt that insider trading is ever an efficient method of executive compensation, and believe that there is a sound economic reason why the Mets pay Dwight Gooden \$1.32 million a year instead of saying, "Dwight, good buddy, why not just take \$600,000 and bet on some games to make up the rest." Other economists have developed extensive criticisms of this compensation rationale along this line. See, e.g., Scott, "Insider Trading, Rule 10b-5, Disclosure and Corporate Privacy," 9 J. Legal Stud. 801, 808 (1980); Easterbrook, "Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information," 1981 Sup. Ct. Rev. 309, 322; Ross, "Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signalling Theory," in Issues in Financial Regulation 177 (F. Edwards, ed. 1979); Levmore, "Securities and Secrets: Insider Trading and the Law of Contracts," 68 Va. L. Rev. 117, 149 (1982). But see Carlton & Fischel, supra this footnote, at 876-878 for criticisms of some of these arguments.

The argument that insider trading enhances pricing efficiency by moving securities prices more rapidly toward their true market values is, I believe, fundamentally flawed because it seeks to prove the wrong point. Sooner is not

And that's what we've done--we have gone after the thieves. Since October of 1985, we have brought solid cases that are well within the established parameters of insider trading law. None of our recently authorized actions suggests an extension of SEC jurisdiction beyond well-established bounds.

necessarily better when it comes to information disclosure. There is an optimal point at which information should be disclosed, and it can be inefficient if information is disclosed either too soon or too late.

Two examples underscore this point in nontechnical terms. In SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969), early disclosure of TGS's mineral find could have dramatically increased the price of acreage surrounding the drill site, but also could have sharply reduced the company's return on its exploration efforts. Similarly, in takeover contests, bidders often seek to accumulate "toe-hold" positions, and generally try to do so at the lowest possible cost. Insider trading that prematurely moves the price of the target stock to the bidder's reservation price decreases the bid's profitability, as well as its chances of success. Consequently, insider trading can reduce the incentive to mount a bid in the first place. In general, it seems that the owner of the information is the party best suited to determine the optimal time for disclosure, and insider trading that forces premature disclosure may well work against the larger interests of corporations and their stockholders. See Easterbrook, "Managers' Discretion and Investors' Welfare: Theories and Evidence," 9 Del. J. Corp. L. 540 (1984). I have discussed a related issue previously in "Carnation Revisited: Toward an Optimal Merger Disclosure and Rumor Response Policy," Address to the Federal Regulation of Securities Comm., American Bar Assoc., in Baltimore, Maryland (Apr. 5, 1986).

A more credible economic argument in defense of insider trading emanates, I believe, from the "contractarian" approach, which reasons that insider trading should be governed by private contract and should not be a subject of mandatory federal regulation. This argument is thoughtfully developed in Carlton and Fischel, supra this footnote. But here too, I believe the argument for government enforcement of insider trading laws is stronger than Carlton and Fischel suggest, in part because of the government's substantial comparative advantage in monitoring theft of intellectual property through stock market transactions. I hope to develop these arguments more fully and rigorously in a forthcoming article, if the burdens of Commission work permit.

True, there are many zones of gray in the law of insider trading. These areas of uncertainty are, perhaps, unavoidable in an evolving area of law that has imprecise statutory underpinnings and is essentially a creation of the courts.¹⁰ But none of the cases recently brought by the Commission slip over into these zones of gray. The Commission has managed, I think, to exercise its prosecutorial discretion quite responsibly. It has done so by focusing on crisp fact patterns that simply do not raise the difficult conceptual questions encountered in some previous insider trading actions.¹¹

The key to the Commission's reasonable exercise of prosecutorial discretion is, I think, a focus on misappropriated information or information used in breach of a fiduciary duty. As the Supreme Court has twice observed, traders owe no general duty of disclosure to the marketplace.¹² The market is not harmed, I believe, by trading on the basis of

¹⁰As Louis Loss so elegantly writes, "The 10b-5 story tempts the pen. For it is difficult to think of another instance in the entire corpus juris in which the interaction of the legislative, administrative rulemaking, and judicial processes has produced so much from so little. What is more remarkable is that the whole development was unplanned . . . [it is] Justice Rehnquist's 'judicial oak which has grown from little more than a legislative acorn'." L. Loss, Fundamentals of Securities Regulation 820 (1983), quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975). Indeed, the law in the area of insider trading and all of 10b-5 is based on the notion of "federal common law," and "when the statute and rule are, like [section] 10(b) and Rule 10b-5, virtually as vague as the Due Process Clause, the law is surely as much judge made as is the classic common law of the states." Loss at 822.

¹¹Examples of prior enforcement actions that raise obvious conceptual questions include Dirks v. SEC, 463 U.S. 646 (1983) and SEC v. Brant et al., No. 84 Civ. 3470 (S.D.N.Y. filed May 17, 1984). Some of the conceptual problems raised in the Brant case were discussed in the Second Circuit's opinion in the companion criminal case, United States v. Carpenter, 1985-86 Fed. Sec. L. Rep. (CCH) para. 92,742 (2d Cir. 1986), (hereinafter cited as Winans), discussed at length below.

¹²Dirks v. SEC, 463 U.S. 659, 657-58 (1983) ("recipients of inside information do not invariably acquire a duty to disclose or abstain"); Chiarella v. United States, 445 U.S. 222, 235 (1980) (duty to disclose under section 10(b) "does not arise from the mere possession of nonpublic market information").

nonpublic information, provided that the information is not obtained through a breach of fiduciary duty or otherwise misappropriated. This point was recently echoed by the Second Circuit when, in its Winans decision, it observed that:

Obviously, one may gain a competitive advantage in the marketplace through conduct constituting skill, foresight, industry, and the like. Certainly, this is as true in securities law as is antitrust, patent, trademark, copyright, and other fields. But one may not gain such advantage by conduct constituting secreting, stealing, purloining or otherwise misappropriating material nonpublic information.¹³

Put quite simply, the race in the stock market is to the swift, not to the thief. As long as the law draws that distinction, and as long as the Commission acts responsibly by focusing its efforts on cases where the evidence of misappropriation or breach is compelling, our insider trading enforcement program can draw broad-based support and enhance the efficiency of the marketplace.

The Arbitrageurs

As for concerns that the Commission is targeting Wall Street arbitrageurs simply because they are arbitrageurs, it's interesting to place these charges in historical perspective. For years, critics of our enforcement program claimed that we operate only on the periphery of the market. They said that we don't have the ability to go to the heart of Wall Street.

The Commission's recent enforcement actions clearly debunk the notion that the SEC pursues only the small fry, and that the Commission has neither the ability nor the inclination to take on tough cases involving major players. Our recent actions demonstrate not only that we are willing to go to the heart of Wall Street, but that we will do cardiac surgery whenever the evidence so warrants. Indeed, given the Commission's prior pursuit of Mr. Thayer¹⁴ and Mr. Reed,¹⁵ I

¹³United States v. Carpenter, 1985-86 Fed. Sec. L. Rep. (CCH) para. 92,742, at 93,608, 93,613 (2d Cir. 1986).

¹⁴See SEC v. Thayer, No. 84-0066 (S.D.N.Y. filed Jan. 5, 1984); SEC Litigation Rel. No. 10251, 1983-84 Fed. Sec. L. Rep. (CCH) para. 99,607 (1984).

¹⁵See SEC v. Reed, 1982-83 Fed. Sec. L. Rep. (CCH) para. 99,207 (S.D.N.Y. 1983). Reed, who had been Special Assistant to the President for National Security Affairs, agreed to

think it is crystal clear that prestige, reputation, and position will not deter us if we have the evidence necessary to make out a case.

The speculation that the Commission is targeting arbitrageurs, or that it is prepared to launch a vendetta against the arb community, is as baseless as the claim that the Commission is unwilling to pursue cases against Wall Street professionals. The Commission follows the evidence wherever it leads. If it leads to a printer, proofreader, law firm associate or partner, arbitrageur, managing director, or Deputy Secretary of Defense, we will pursue it. The Commission holds no grudge against arbitrageurs and understands full well the efficiency-enhancing benefits generated by arbitrageurs, who help reallocate risk and legitimately ferret out information that is not widely known in the market.

I will repeat that, as the Supreme Court observed in the Chiarella and Dirks cases, traders have no general obligation to disclose material nonpublic information before trading in the market. There is no general principle of informational equality in the securities laws, and I do not believe the Commission should seek to impose one. Indeed, absolutely nothing that has happened in recent months should, I think, cause concern to arbitrageurs, investment bankers, or anyone else who has not traded on the basis of misappropriated information, or information used in breach of a fiduciary duty. On the other hand, if an arb has traded on the basis of inside information, and if the arb knew or should have known that the information was misappropriated, or used in breach of a fiduciary duty, then the arb, or anyone else in his position, has good reason to be concerned, and all I can do is encourage such concern.

The Dog Ate My Homework

Another concern that has been bandied about is that the Commission will pursue individuals who trade on the basis of innocently overheard inside information. Typically, the hypothetical is put something like this: "I'm in an airport waiting lounge, or bar, or elevator of an office building, and

disgorge his profits in an SEC civil action, but was subsequently acquitted in a criminal proceeding. See Berton, "Reagan Ex-Adviser Cleared of Charges of Insider Trading," Wall St. J., Dec. 17, 1985, at 12.

overhear these two guys talking about the big deal they're going to announce on Friday. If I trade on that information, will I get sued by the SEC?"¹⁶

Realistically, if that's what actually happened, the odds are that you're safe from enforcement action. Unfortunately, these stories are often designed to cover clear misappropriations or breaches of fiduciary duty. In fact, the story that "I heard it in a bar, elevator, or airport" is up there with "the dog ate my homework" as a credible explanation for trading in many of our investigations.¹⁷

Let me give you a couple of examples. In one investigation, the wife of a defendant who was found guilty of insider trading had purchased the same stocks on the same dates as her husband. When asked about the reasons for the trading, she claimed that she overheard some good advice in the beauty parlor.

In another case, a defendant claimed to have overheard talk about a major deal in the lobby of an investment banking firm. There, the defendant eventually admitted that he overheard no such information, and that he had traded on the basis of information he clearly knew was confidential.

On occasion, however, the story works. In 1983 the Commission instituted civil proceedings against Barry Switzer, football coach at the University of Oklahoma, alleging that Mr. Switzer had been tipped material inside information. Because he was Oklahoma's head football coach, Mr. Switzer could not, of course, claim to have overheard the information in a beauty parlor. Instead, he explained that he overheard the tip at a high school track meet while lying on the bleachers directly behind the source of the information. The source denied any recollection of discussing the transaction at the track meet. The judge ruled that even though the Commission had introduced substantial circumstantial evidence of illegal insider trading, Coach Switzer's explanation that he overheard it at the track meet was more credible.¹⁸

¹⁶See, e.g., Marcus, "Murky Inside-Trading Rules Often Point to Outsiders," Wash. Post, June 1, 1986, at F1.

¹⁷The S.E.C. is not the only enforcement authority that encounters difficulties with alibis. See, e.g., B. Cosby, *Fatherhood* 83 (1986) ("On one occasion he said the dog ate his book report; and another time he said he was robbed of his homework. The thief took no money, just the homework.").

¹⁸SEC v. Platt, 565 F. Supp. 1244 (W.D. Okla. 1983).

At its roots, however, any such casual encounter story is fundamentally implausible. How many of you would really invest a substantial portion of your net worth in highly volatile stocks or options based on something overheard from two total strangers? How many of you would overhear such chats more than once, and invest more than once?

In a word, if you're going to claim "the dog ate your homework," it's probably a good idea to at least own a dog. Many defendants we encounter with this story don't.

Recent Developments

That, in a nutshell, sums up my response to some of the more popular concerns prevalent in the press. There are, however, some other recent developments that deserve close scrutiny. To put these developments in perspective it helps to review a remarkable string of eight events that have come to light since February of this year. Not all of these events involve insider trading actions brought by the Commission, but together they make some significant points and raise some interesting questions about the direction of insider trading law and the focus of the Commission's enforcement activities.

1. The Santa Fe Case. The string of remarkable developments began on February 26, when the Commission announced a settlement in the Santa Fe case.¹⁹ Eight foreign investors who had traded through secret Swiss bank accounts agreed to disgorge \$7.8 million in profits obtained as a result of insider trading based on a tip from a corporate director. Among those who agreed to disgorge profits were residents or nationals of Lebanon, Liechtenstein, England, Iraq, and Kuwait, including a high-ranking Kuwaiti government official. At the time, the \$7.8 million recovery was a record in the Commission's 52-year history. What was not known then was that this record would stand for less than three months.

2. First Boston. On May 5, ten weeks after the Santa Fe settlement, the Commission instituted proceedings against The First Boston Corporation alleging that it illegally traded in securities of CIGNA Corporation in violation of First Boston's

¹⁹SEC Litigation Rel. No. 11012, 1985-86 Fed. Sec. L. Rep. (CCH) para. 92,484 (1986). See also Ingersoll, "Foreign Investors to Give Up \$7.8 million in Santa Fe International Insider Case," Wall St. J., Feb. 27, 1986, at 3; Sterngold, "8 to Repay \$7.8 Million in SEC Insider Case," N.Y. Times, Feb. 27, 1986, at D-1; Behr, "SEC Probe Ends in Big Recovery," Wash. Post, Feb. 27, 1986, at E1.

restricted list and Chinese Wall procedures.²⁰ This case represents the Commission's first proceeding against a brokerage firm on charges that it traded for its own account while in possession of material nonpublic information received from an investment banking client.²¹ First Boston settled these proceedings by agreeing to disgorge profits of \$132,138 plus a penalty of \$264,276 obtained under the Insider Trading Sanctions Act of 1984.²²

3. Dennis Levine. Less than a week after First Boston, on May 12, in what is perhaps the most publicized insider trading case since Texas Gulf Sulphur,²³ the Commission instituted proceedings against Dennis Levine who, at the time, was a managing director of Drexel Burnham Lambert.²⁴ The Commission alleged that Levine misappropriated confidential information, and through a secret account at a Swiss branch bank in the Bahamas, illegally made \$12.6 million by trading in the shares of at least 54 issuers. On June 5, Levine pleaded guilty to one count of securities fraud, two counts of income tax evasion, and one count of perjury. Together, these pleas carry a maximum penalty of 20 years imprisonment and \$610,000 in fines. Mr. Levine also agreed to disgorge \$11.6 million in trading profits and additional assets, including a red Ferrari sports car and shares in Drexel Burnham.

4. Winans. Just two weeks after the Levine case was announced, and while major events in that case were still breaking, a split panel of the Second Circuit Court of Appeals upheld the criminal conviction of R. Foster Winans and his colleagues on charges that Winans, formerly a reporter for the Wall Street Journal, misappropriated information from his employer, and thereby violated the securities laws, when he

²⁰SEC v. The First Boston Corp., 86 Civ. 3524 (PNL) (S.D.N.Y. filed May 5, 1986); SEC Litigation Rel. No. 11092, 1985-86 Fed. Sec. L. Rep. (CCH) para. 92,712 (1986).

²¹But cf. Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933 (1968) (finding that investment banking firm had passed on confidential information relating to a client to favored brokerage customers who traded while in possession of the information).

²²Pub. L. No. 98-376, 98 Stat. 1264 (1984).

²³SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

²⁴SEC v. Dennis Levine, 86 Civ. 3726 (RO) (S.D.N.Y. 1986); SEC Litigation Rel. No. 11095, 1985-86 Fed. Sec. L. Rep. (CCH) para. 92,717 (1986).

traded on the basis of the Journal's "Heard on the Street" column before publication.²⁵ Mr. Winans and his colleagues earned \$690,000 as a result of this trading. The dissenting judge reasoned that the federal securities laws were never intended to protect a publisher's interest in maintaining the integrity or reputation of a publication.²⁶ The dissenting judge therefore would have found the defendants innocent on the securities law counts, but agreed that they had violated the mail and wire fraud statutes even though they did not violate the securities laws.²⁷

5. "Yuppie-Scam." On May 28, the day after the Winans decision was announced, a federal grand jury indicted five young upwardly mobile professionals on charges that they had engaged in illegal insider trading.²⁸ One New York paper quickly labelled the case "Yuppie-Scam." At the center of the group stood Michael David, a former associate of a prestigious New York law firm, who allegedly misappropriated from the firm secret information regarding potential takeovers. Mr. David traded on the basis of this information and shared it with his four colleagues. On June 5, Mr. David's four colleagues pleaded guilty to charges arising out of the indictments. Two of these defendants also pleaded guilty to giving perjured testimony to the Commission or to obstructing Commission investigations. At the time of arraignment, the two oldest defendants were 27. The three youngest were 23.

6. Tome. The week after "Yuppie-Scam," on June 3, in another case involving foreign trading, a court found that Mr. Guisepppe B. Tome, an Italian national, together with an Italian business associate, had illegally traded on inside information regarding a takeover of St. Joe Minerals Corporation.²⁹ The trading occurred through Swiss banks, and the court found Mr. Tome potentially liable for \$5.8 million on the basis of his

²⁵U.S. v. Carpenter, 1985-86 Fed. Sec. L. Rep. para. (CCH) para. 92,742, at 93,608 (2d Cir. 1986), aff'g, 612 F. Supp. 827 (S.D.N.Y. 1985).

²⁶Id. at 93,616 (Miner, J., dissenting).

²⁷Id. at 93,617.

²⁸U.S. v. Michael David, 86 Cr. 454 (JFK) (S.D.N.Y. 1986); U.S. v. Andrew Solomon, 86 Cr. 451 (CLG) (S.D.N.Y. 1986); U.S. v. Daniel J. Silverman, 86 Cr. 452 (CLG) (S.D.N.Y. 1986); U.S. v. Robert Salsbury, 86 Cr. 453 (CLG) (S.D.N.Y. 1986); U.S. v. Morton Shapiro, 86 Cr. 455 (CLG) (S.D.N.Y. 1986).

²⁹SEC v. Tome, 81 Civ. 1836 (S.D.N.Y. June 3, 1986).

own trading, the trading of his associates, and the trading of certain still unknown investors who traded on Mr. Tome's tips.³⁰

7. GNP Leaks. On June 12, the Department of Commerce announced that it had fired three employees on charges that they had tipped or traded on the basis of confidential GNP data.³¹ The investigation was not, however, able to determine who had leaked September 1985 flash GNP estimates that became widely known on Wall Street and sparked a bond price rally well before their scheduled release.

8. The Gramm-Rudman Leak. A leak of information that does not involve the stock market, but could have, may have emanated from the Supreme Court over the weekend of June 14-15, 1986. Sometime during that weekend, ABC News learned, possibly as a result of a tip from a Supreme Court source, that the Supreme Court had decided to hold a portion of the Gramm-Rudman-Hollings Act unconstitutional. Consider for a moment what the reaction would be if there was a leak and it related to the outcome of a pending case with obvious stock market implications--such as the 1975 decision regarding antitrust litigation between IBM and Telex that was settled before any Supreme Court decision was publicly announced³²--and if the leak actually led to stock market trading. Or, consider the issue posed if a jury member in the Pennzoil-Texaco litigation bought Pennzoil shares or sold Texaco stock before that \$12 billion verdict was announced.

For the remainder of this address, I would like to step back and observe some broad patterns that emerge from these eight case studies, and dwell on just one of the tough questions that these fact patterns raise.

³⁰Id.

³¹Gutfeld, "Commerce Department Says 3 Employees Misused Prior Knowledge of GNP Report," Wall St. J., June 3, 1986, at 2; Berry, "3 Commerce Employees Fired for Profiting From Data," Wash. Post, June 13, 1986, at A1. The Commerce Department has reportedly submitted to the Office of Management and Budget draft legislation that would impose civil and criminal penalties on those who illegally disclose or trade on confidential government economic data. Id. at A12.

³²Telex Corp. v. IBM, 510 F.2d 894 (10th Cir.), cert. dismissed, 423 U.S. 802 (1975).

International Trading

First, it should be clear that the SEC can successfully trace illegal foreign trading, even if it occurs through accounts located in bank secrecy jurisdictions. Santa Fe, Levine, and Tome involved recoveries aggregating more than \$25 million, and in each case the defendants traded through accounts located in jurisdictions with bank secrecy laws. The reason for this success is, I think, much more fundamental than any one bilateral agreement, or improvements in the Commission's or the exchanges' monitoring abilities.

The world's capital markets are highly internationalized, and they are becoming more so each day. Financial institutions located in secrecy jurisdictions want to participate in the international capital markets. To do so, however, they must accommodate the legitimate interests of other nations in seeing that their domestic laws are not violated through subterfuges involving foreign bank secrecy.³³ There are many legitimate reasons for bank secrecy, but I doubt that violation of criminal laws that raise no substantial exogenous moral concerns is one of them. Indeed, as Attorney General Adderley of the Bahamas so aptly observed, the bank secrecy laws "were never intended to protect fraud, never intended to protect a thief."³⁴ Thus, as the world's financial system becomes increasingly linked, bank secrecy is likely to become an ever more porous shield.

Monitoring Ability

It should also be clear that the Commission's ability to track violations of the insider trading laws has improved substantially. Much of the credit in this regard goes to the securities exchanges and NASD which, with improved audit trails and computerized filtering and matching methods, regularly monitor market activity for patterns that suggest insider

³³See Templeman et al., "Why the Swiss Are So Interested in Cleaning Up Their Vaults," Bus. Week, June 3, 1986, at 48-49; Zanker & Scherschel, "Why It's Getting Tougher to Hide Money," U.S. News & World Rep., June 9, 1986, at 43; Putka, "Those Famed Swiss Bank Accounts Aren't Quite As Impenetrable As They Use to Be," Wall St. J., June 20, 1986, at 21.

³⁴Penn, "Bahamas Official Suggests He May Waive Bank Secrecy Laws Again in Insider Cases," Wall St. J., May 28, 1986, at 12.

trading.³⁵ Many other sources are also responsible for our recent success, but, for reasons I am sure you understand, it is not in the public interest to set forth all the details of how these cases are uncovered.

Where Does Winans Lead?

Finally, it is apparent that even though recent Commission enforcement actions fall well within the accepted bounds of existing insider trading law, many tough issues are either already with us or lurk just over the horizon. For example, in the Santa Fe, First Boston, Levine, "Yuppie-Scam," and Tome cases, it is possible to trace trades to information obtained from either a classic or temporary insider.³⁶ Winans, however, is different because the alleged violation of the insider trading laws did not hinge on any information emanating from a classic or a temporary insider.³⁷ Instead, the information at issue was misappropriated from an "outsider" that did not even intend to trade on the basis of the information, the Wall Street Journal.

Clearly, the misappropriation was theft, and there is, I think, no economically viable rationale that could defend such theft. I am quite comfortable with the prospect that a thief of information can go to jail for his actions. Nonetheless, a sticky legal issue remains: Is this the type of theft or breach of duty that is properly within the scope of the insider trading laws? Was it Congress' intent to allow section 10(b) of the '34 Act to reach that conduct? In amicus briefs filed in the Winans case, the Commission has forcefully argued that the securities laws most certainly reach that conduct.³⁸ The

³⁵See, e.g., "SEC Using New Means to Track Insider Trading," Los Angeles Times, June 6, 1986, sec. 4, at 5 (of 10,000 "exceptions" per year noticed by New York Stock Exchange's automated systems, 640 are investigated further by Exchange, and 65 are passed on to SEC for investigation).

³⁶The "temporary insider" concept was first developed in footnote 14 of Justice Powell's opinion for the Court in Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983).

³⁷The fact pattern in Winans is not, however, unique. See Zweig v. Hearst Corp., 521 F.2d 1129 (9th Cir.), cert. denied, 423 U.S. 1025 (1979) (newspaper acting in good faith is not vicariously liable for employee's laudatory article about a company in which he hold shares).

³⁸See Brief of the Securities and Exchange Comm., Amicus Curiae, at 11-23, United States v. Carpenter, 1985-86 Fed. Sec. L. Rep. (CCH) para. 92,742 (2d Cir. 1986); Memorandum of the

Commission, in its brief, argued, among other things, that "[t]he integrity of the securities markets is undermined when . . . persons trade on fraudulently misappropriated information."³⁹ The majority in the case agreed, and observed that the statute "was designed as a catchall clause to prevent fraudulent practices"⁴⁰--it is "intended to be broad in scope, encompassing all 'manipulative and deceptive practices which have been demonstrated to fulfill no useful function.'"⁴¹ The majority said it perceives "nothing useful about defendants' scheme." I wholeheartedly agree.

Judge Miner, in his dissent in the Winans case, did not frame the issue quite the same way. He concluded that, "while the proscription of fraudulent and deceptive practices in connection with the purchase and sale of securities is a broad one, it never was intended to protect the reputation, or enforce the ethical standards of a newspaper."⁴² Judge Miner agreed, however, that Winans had violated the mail and wire fraud statutes. Therefore, even if Winans isn't guilty of a violation of the securities laws, he can be incarcerated for violation of other statutes.⁴³

The question naturally arises as to where the potential for such liability might stop. Suppose the Commerce Department employees involved in the GNP leak case traded in markets subject to SEC jurisdiction. Could it then be argued that their breaches of Commerce Department confidentiality policies are sufficient to sustain a criminal conviction under the

Securities and Exchange Comm., Amicus Curiae, in Opposition to Defendants' Motions for Acquittal at 3-8, United States v. Winans, 612 F. Supp. 827 (S.D.N.Y. 1985).

³⁹Brief of the SEC, supra, n.38, at 18.

⁴⁰Winans, slip op. at 12, quoting Chiarella, 445 U.S. at 226 (citing Ernst & Ernst, 425 U.S. 185, 202, 206) (1976).

⁴¹Id. SEC v. Materia, 745 F.2d 197, 201 (2d Cir. 1984), cert. denied, 105 S. Ct. 2112 (1985), and its quotation from S. Rep. No. 792, 73d Cong. 2d Sess. 6 (1934).

⁴²United States v. Carpenter, 1985-86 Fed. Sec. L. Rep. (CCH) para. 92,742, at 93,608, 93,617 (2d Cir. 1986) (Miner, J., dissenting).

⁴³As a result of a petition for rehearing en banc filed July 10 by one of Winan's colleagues, this controversy is now before the full Second Circuit.

securities laws?⁴⁴ If a graduate student trades on the basis of his professor's secret formula for beating the stock market then, would he also have violated the securities laws and would he face jail on a securities count? Similarly, assuming there was a leak from the Supreme Court, could the person responsible be prosecuted for a violation of the securities laws, had the information been material to the market and had it been the basis of a purchase or sale of securities?⁴⁵

The answer to each of these questions may well turn out to be "yes," and that may not be a bad conclusion from many public policy perspectives, but it is not a conclusion that flows inexorably from the language of the statute. Society has at its disposal numerous private, state, and federal causes of action that can deter misappropriation of property rights and breaches of fiduciary duty.⁴⁶ To what extent is it prudent, necessary, or proper to supplement these remedies with federal securities law sanctions? That question has significant implications for the future scope of the federal securities

⁴⁴Such an application of the securities laws would not be totally without precedent. See In re Blyth & Co. 1967-69 Fed. Sec. L. Rep. (CCH) para. 77,647 (1969) (use of material nonpublic information about interest rates affecting market conditions wrongfully obtained from a Treasury Department employee)

⁴⁵Apparently, there is no written policy binding Supreme Court law clerks to a duty of confidentiality. Would that make a difference in the wake of Winans? This fact pattern also is not without precedent. Essentially the same hypothetical was suggested in L. Loss, Fundamentals of Securities Regulation 851, 852 n.74 (1983), and suspicions were reported in early 1985 that a Montana Supreme Court decision regarding the Montana Power Company was leaked to select traders prior to public announcement. Johnson, "SEC Probes Report of Warning of MPC Ruling," Great Falls Tribune, Feb. 8, 1985, at 1.

⁴⁶In the Winans case, the court observed that "theft or embezzlement of certain information is a statutory crime in some states." United States v. Carpenter, 1985-86 Fed. Sec. L. Rep. (CCH) para. 92,742, at 93,608, 93,614 n.10 (2d Cir. 1986), citing N.Y. Pen. L. sec. 165.07 (McKinney's 1975) (unlawful use of secret scientific information); Mass. Gen. Laws chap. 266, sec. 30(4) (1985 Supp.) (theft of secret scientific material). The court went on to observe that "the victim of such theft or embezzlement may have a common law action for conversion against the misappropriator." Id. at 93,614 n.10. The court also observed that the "general tort of breach of a duty of confidentiality to an employer is, of course, well-settled." Id. at 93,611 n.5, citing Franke v. Wiltschek, 209 F.2d 493, 495 (2d Cir. 1953).

laws, even though Winans may not be the cleanest set of facts for its resolution because of the independent basis for conviction on mail and wire fraud charges.

Indeed, in light of recent personnel changes at the Supreme Court, the resolution of this question, should it get that far, is quite interesting to ponder.

In 1975, the Commission argued before the Supreme Court in favor of a more expansive interpretation of Rule 10b-5 that would have dramatically increased the class of plaintiffs allowed to sue under the securities laws.⁴⁷ In an opinion authored by Justice Rehnquist, whom the President has recently announced will be nominated to serve as the new Chief Justice, the Court rejected the Commission's argument. There Judge Rehnquist observed that he might narrowly interpret section 10(b) and Rule 10b-5.⁴⁸

Judge Antonin Scalia, President Reagan's nominee to fill the expected vacancy on the Supreme Court, also has a reputation as somewhat of a strict constructionist when it comes to the interpretation of statutes. Indeed, Judge Scalia construes strictly even when he may disagree with the

⁴⁷See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

⁴⁸Justice Rehnquist observed that:

It would be disingenuous to suggest that either Congress in 1934 or the Securities and Exchange Commission in 1942 foreordained the present state of the law with respect to Rule 10b-5. It is therefore proper that we consider . . . what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither Congressional enactment nor the administrative regulations offer conclusive guidance. Id. at 737.

If a case like Winans ever reaches Chief Justice Rehnquist, I suspect there will be no shortage of "policy issues" to consider, including the federalization and securitization of a reporter's duty of confidentiality to a newspaper. That issue, raises interesting questions even if one strongly believes that insider trading law reflects a sound economic policy designed to deter the theft of information. See pp. 2-3, supra.

fundamental economic policy underlying a particular statute.⁴⁹ Here again, it is fascinating to consider what a jurist with Judge Scalia's attention to legislative detail would make of a statute like section 10(b), a fact pattern like Winans, and a doctrine like insider trading.

Moreover, it is also noteworthy that Chief Justice Burger, who will soon be stepping down, appears to be one of the stronger proponents of the misappropriation theory currently sitting on the Court.

These are interesting times for the law of insider trading, and the issues may well get tougher before the air is finally cleared. The progress we are making now, however, is at the core of the law and well away from the hazy issues that inevitably reside at the fringe of a statute as amorphous as section 10(b). There's plenty for us to do, at the core of the law, and we intend to do it.

⁴⁹Thus, in 1984, in a dissenting opinion reviewing an order of the Interstate Commerce Commission, Judge Scalia wrote:

I think it not the function of . . . the court to assure that the principal goal of a statute is pursued with maximum efficiency, but rather to assure that it is pursued with that degree of efficiency that Congress intended--which may well be less than the maximum, in order to accommodate other interests [If the statutory] language does not bear the meaning the Commission has assigned it, I think [that] decision ultimately frustrates rather than furthers the full purpose of the legislation.

Illinois Commerce Commission v. Interstate Commerce Commission, 749 F.2d 875, 887 (D.C. Cir. 1984) (Scalia, J., dissenting) (emphasis in original).