Introduction

Daniel L. Goelzer
In recent years, the Securities and Exchange Commission’s increased enforcement presence with respect to insider trading has prompted a growing body of legal and public commentary. It is important to keep in mind, however, that concern about the occurrence and consequences of insider trading is by no means a recent phenomenon. Indeed, the elimination of insider trading abuses was one of the goals of the Securities Exchange Act of 1934.1

Much of the recent commentary on insider trading has centered on the type of conduct that the law should proscribe. The federal securities laws do not contain an express definition of insider trading. Instead, liability for insider trading has grown out of the antifraud provisions of these statutes. The articulation of the scope of the pro-

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** General Counsel, Securities and Exchange Commission.

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hibition has evolved through case-by-case adjudication, consistent with the purposes of the securities laws and in recognition of established principles of common law. Existing law strikes an appropriate balance in prohibiting the abuse of confidential information without detracting from the benefits to the markets resulting from individual initiative in ferreting out and analyzing information.

Concern about insider trading has come into sharp focus in recent years as a result of the increasing size and number of mergers and tender offers, and the expansion of trading in standardized options. Persons with advance knowledge of a merger or tender offer announcement have an opportunity to profit substantially in a short period of time with little risk of loss. Such opportunities for illegal profits can be greatly maximized in the options market because the value of an option contract after the announcement of a significant event, such as a proposed merger, tends to increase by a much greater percentage than does the value of the underlying stock. The effect of these developments on the liquidity, efficiency and fairness of capital markets was an important factor in the Commission's recommendation, and Congress' adoption, of the Insider Trading Sanctions Act of 1984 (ITSA) as a means of increasing the risks of, and therefore deterring, insider trading.

Some commentators have challenged the predicates for this concern and, most particularly, have disputed that individual investors are actually harmed by insider trading. But public reaction to press accounts of insider trading suggests that individual investors do not share this perception. Congress and the courts, too, have taken a contrary view. Moreover, other substantial policy concerns support the prohibition of insider trading. One fundamental and widely recognized basis for the prohibition is the fear that insider trading threatens to erode the critical role of public investors and market professionals in the nation's economy. Capital formation and national economic growth are dependent on liquid, efficient and fair markets. These conditions, in turn, depend upon investor confidence in the fairness and integrity of the capital markets. Insider trading


threatens these markets by undermining the expectations of fairness and honesty that are the foundation of public confidence. Public investors may be less willing to place their money at risk in securities if they believe that persons in possession of confidential information will take unfair advantage of them. Insider trading also threatens the orderliness and stability of the markets by exposing market professionals to substantial losses and potential insolvency. Market specialists, for example, obligated to maintain a fair and orderly market, may be unable to make rational pricing or investment decisions in the face of insider trading.

Congress has provided the Commission with a variety of tools to carry out its enforcement responsibilities. Insider traders can be enjoined, required to disgorge profits, and subjected to other appropriate ancillary sanctions.\(^4\) In addition, the ITSA authorizes the Commission to seek a civil penalty of up to three times the amount of profit gained or loss avoided;\(^5\) the Act also prevents circumvention of existing prohibitions by explicitly making it illegal to trade in derivative securities such as options while in possession of nonpublic material information.\(^6\) These provisions will prove to be strong deterrents to insider trading, but deterrence can be further strengthened with increased attention to private policing mechanisms.

The private sector can and should contribute to the deterrence of insider trading by adopting procedures to make employees aware of their organization's policies in this area. Issues such as who should have access to confidential information, how to protect against improper use or disclosure of such information, and when to do so, are questions that must be resolved within the organizational structure and procedures of individual private entities.

Corporations, law firms, brokerage houses, investment bankers and others who are involved in the securities business, or who otherwise have access to confidential information, should desire and indeed may be obligated by business commitments to protect confidential information disclosed to them during the normal course of business. Those who possess confidential information that may affect the securities markets have an affirmative obligation to safeguard such information.

Other compelling reasons support the adoption of appropriate procedures to prevent employee misuse of confidential material.

Since clients generally expect their information to be handled with the strictest confidentiality, implementing appropriate procedures will reassure the client and enhance the organization’s reputation. Because efforts to complete a transaction may be frustrated by the premature disclosure of nonpublic information, firms have an added incentive to safeguard such information.

While appropriate procedures will depend upon such factors as the nature of the business, the organization’s structure, and other factors unique to a particular entity, several general categories of procedures can be identified. An organization can adopt educational procedures aimed at informing employees about its policy regarding the use of confidential information. A manual explaining that policy and describing the firm’s rules regarding securities transactions should be distributed to all employees; a signed statement from all employees to the effect that the manual was received, read and understood could be required to stress the importance of the policy and rules. An explanation of the legal consequences of insider trading and illustrations of what constitutes the prohibited conduct should be included in the manual. Furthermore, someone should be appointed to provide further guidance as needed, and that person’s availability should be publicized.

In addition, organizations can adopt procedures aimed at protecting information from inadvertent or premature disclosure. Such safeguarding procedures could include disclosing information only on a need-to-know basis; using code names, numbers or decoys; storing information in restricted files; and shredding documents that are no longer needed. In the case of an issuer, requests for information should be handled by a designated person who is responsible for disclosing appropriate information. Numbering both original documents and copies and requiring employees to sign for them is one tool that would better control disclosure of highly sensitive information.

In multi-service organizations, transfers of personnel between departments and communication between departments should be monitored to prevent potential conflicts of interest. The effectiveness of these and similar procedures should be tested, perhaps by planting phony information to discover leaks in the system.

Organizations also can impose reporting requirements aimed at identifying potential problems or apparent conflicts of interests. New employees could be asked to report securities ownership, including that of close family members, and periodic updates of changes in ownership could be required. An alternative approach would require
post-transaction notification within specified periods of time.

Finally, organizations may choose to restrict or prohibit trading activity by employees. Trading could be restricted to transactions completed through mutual funds or blind trusts. A total trading prohibition with respect to a corporation's own stock or that of its clients also might be imposed. Such a prohibition could be permanent or temporary, as required by the circumstances. Short-sales and options transactions in the securities of the organization or those of its clients could be prohibited. Another approach would be to require written permission from designated persons before transactions are completed. Such clearance procedures could allow for specified periods during which employees would not be allowed to trade if the organization is in possession of material nonpublic information.

While such protections, consistently and firmly enforced, are likely to deter insider trading, debate will continue regarding the legal parameters of insider trading and the limits of the conduct to be proscribed. This Symposium issue of the Hofstra Law Review addresses these issues.

The first Article, by Jonathan R. Macey, traces the intellectual history of Rule 10b-5 and concludes that the Supreme Court, in Chiarella v. United States and Dirks v. SEC, grounded tippee liability "on a theory that recognizes the value to society of protecting property rights in inside information." The Supreme Court's test falls short, the author argues, because it does not provide a standard for determining when one has a legally recognized property right in information, and fails to provide damages to the party actually injured by information misappropriation. Discussing the economic function of property rights in information, Professor Macey suggests that a better approach would protect information that is the "proper subject of contract." Under this test, liability would accrue for misappropriation of such information through trading or disclosure. Professor Macey proposes that the owners of the information be given standing to sue, and that the measure of damages be determined by the harm caused to the owner.

Richard M. Phillips and Robert J. Zutz begin their Article by reviewing the historical standards for tippee liability under Rule 10b-5, criticizing what the authors view as the Supreme Court's re-

8. Id. at 39.
turn to the “fiduciary duty” standard of liability. The authors argue that the misappropriation theory of liability, the theory of “constructive insiders,” and Rule 14e-3 are all insufficient to close the gaps created by the Dirks decision. Instead, they propose a new statutory foundation, building liability upon “trading in securities based upon unfair informational advantages.” The proposed standard would require possession of material, non-public information and evidence that the trader acquired such information through the use of business, personal or other special relationships not available to the public.

Barbara Aldave, too, criticizes the Chiarella/Dirks approach, finding fault with the Supreme Court’s “expansive view of what constitutes a fiduciary relationship.” A more realistic approach, she argues, is the misappropriation theory, which focuses on the misappropriator’s actual obligation to the person who entrusted information to him, rather than on his fictional relationship to the parties with whom he trades. Professor Aldave proposes that instead of grounding liability on the fiduciary relationship between trading parties, liability should be conditioned on “a party’s deception of those who have given him privileged access to confidential information.” She concludes her Article with the suggestion that SEC sanctions be employed to deter Rule 10b-5 violations, since the difficulties of identifying and compensating injured parties in an impersonal market militate against any private right of action.

An essay by Daniel R. Fischel rounds out the Symposium with an economic analysis of the Dirks decision. Professor Fischel argues that insider trading may benefit rather than harm investors, and that investment analysts in particular serve an important social function by reducing the problem of asymmetric information in the purchase and sale of securities. As a result, this author concludes, the law “should not equate the existence of fiduciary duties with a prohibition against insider trading,” and investment analysts “should be free of legal rules restricting the use of inside

10. Id. at 99.
12. Id. at 124.
14. Id. at 129.
information.”¹⁵

These Articles raise provocative questions about the prosecution of insider trading. While I do not agree with all that is said,¹⁶ I believe that the evolution of the law will be influenced by these well-reasoned commentaries.

¹⁵. Id. at 130.

¹⁶. Despite the criticisms several of the authors level at the Supreme Court’s reasoning in Dirks and Chiarella, it is difficult to dispute that the Commission’s enforcement program has continued to fair well since those decisions. See, e.g., SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), cert. denied, 105 S. Ct. 2112 (1985).