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News Release

IS THE SKY REALLY FALLING? THE STATE OF INSIDER TRADING LAW AFTER THE WINANS DECISION

Federal Bar Association Luncheon
National Lawyers' Club
Washington, D.C.

January 26, 1988

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

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The Supreme Court's split decision on the securities issue in Winans[1] has provoked substantial concern from many commentators. For example, Harvey Pitt has suggested that the split decision "leaves the Commission's own enforcement tools in a state of limbo."[2] Professor James Cox of Duke University Law School, in testimony before the Senate, claimed that the Winans decision "casts a menacing shadow on the continued effective enforcement of insider trading rules."[3] Concern over the implications of the split Winans decision has

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[1]Carpenter v. United States, _____ U.S. _____; 108 S.Ct. 316 (1987).

[2]Letter dated November 19, 1987, from Harvey L. Pitt to the Honorable Alfonse M. D'Amato, transmitting a Reconciliation Draft of S. 1380, the Insider Trading Proscriptions Act of 1987.

[3]Testimony of Professor James D. Cox before the Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs Concerning Legislation to Define Insider Trading (Dec. 15, 1987).

also added fuel to the calls for a statutory definition of insider trading.[4]

Contrary to the suggestion of these observers, Winans does not mean the sky is falling on the Commission's insider trading program. The Commission's insider trading program is not in limbo, nor is it living under a menacing shadow or any other shadow, for that matter. From a criminal and civil standpoint, the mail and wire fraud convictions in Winans may well have strengthened the insider trading laws far more than a free standing affirmance of Winans' securities law conviction ever could have.

The suggestion that the Winans decision adds urgency to the need for a statutory definition of insider trading is also, I think, incorrect and seriously overstated. Indeed, the evidence I see strongly suggests that the common law process, with all its infirmities, is preferable to either of the statutory insider trading definitions now pending before Congress. The more prudent course of action may therefore be to allow the courts to continue to develop the law of insider trading on a case-by-case basis, and put efforts aimed at a statutory definition on the legislative back burner.

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[4] See, e.g., Taylor, Justices, 8-0, Back Winans Conviction on Misuse of Data, N.Y. Times, Nov. 11, 1987, at 1; Nash, "Insider" Definition In New Law Urged, N.Y. Times, Nov. 11, 1987, at D-10; Knight, Winans Ruling Leaves Major Question Open, Wash. Post, Nov. 11, 1987, at 10.

The Misappropriation Theory

We must remember that Winans is not a garden-variety misappropriation case. It is an exotic case that tests the outer limits of the securities law. Foster Winans, you may recall, co-authored the Wall Street Journal's popular "Heard on the Street" column, a market gossip feature that had a short-term impact on the prices of the stocks it discussed. The official policy at the Journal was that prior to publication, the contents of the column were the Journal's confidential information. Despite that rule, Winans entered into a scheme with two stockbrokers to provide advance information about the timing and contents of the column. This permitted the stockbrokers to buy or sell stock based on the column's probable market impact. These facts are unusual because the victim of the fraud, the Journal, was not a buyer or seller of the stocks written about in the column, nor was it otherwise a market participant.

The vast majority of misappropriation cases encountered by the Commission look nothing at all like Winans. Instead, they involve misappropriation from takeover bidders, investment bankers, lawyers, or others who either are themselves, or are agents of, a buyer, seller, or market participant. These garden-variety misappropriation cases are at the heart of the Commission's insider trading enforcement program. They stand in stark contrast to the exotic facts of Winans.

Every indication we have from the Supreme Court regarding its views on garden-variety misappropriation cases suggests that the misappropriation theory is on solid ground in the vast majority of cases in which it is important. In Chiarella v. United States,[5] for example, four justices addressed the validity of the misappropriation theory in a garden-variety context and concluded that "a person violates § 10(b) whenever he improperly obtains or converts to his own benefit nonpublic information which he then uses in connection with the purchase and sale of securities."[6] In Dirks v. SEC,[7] the Court found that a tippee was not liable for trading on inside information because the tippee did not misappropriate or illegally obtain the information.[8] Further, in Bateman Eichler, Hill Richards, Inc. v. Berner,[9] the Supreme Court implicitly endorsed the misappropriation theory when it observed in a footnote that tippee liability under Section 10(b) may arise not only from participation in an insider's

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[5]445 U.S. 222 (1980).

[6]Id. at 239 (Brennan, J., concurring in the judgment). See also id. at 239 (Burger, C.J. dissenting); id. at 245 (Blackmun, J., with whom Marshall, J. joins, dissenting). The government argued, inter alia, that Chiarella's conviction could be sustained on the theory that he violated Rule 10b-5 by misappropriating nonpublic information and purchasing securities on the basis of that information. The majority, however, declined to address the misappropriation theory because it had not been presented to the jury.

[7]463 U.S. 646 (1983).

[8]Id. at 665.

[9]472 U.S. 299 (1985).

breach of fiduciary duty, but also where a tippee "otherwise misappropriate[s] or illegally obtain[s] the information."[10]

Lower court decisions have also consistently upheld application of Section 10(b) and Rule 10b-5 in garden-variety misappropriation cases. In two cases, United States v. Newman,[11] and SEC v. Materia,[12] the Supreme Court, significantly, did not grant certiorari. In Newman, the first case to adopt the misappropriation theory after Chiarella, the Second Circuit held that two employees of investment banking firms breached their duties to both their employers and their employers' clients by passing information to others who then traded on the information. In so holding, the court clarified that, in the context of enforcement proceedings brought by the Commission or the Department of Justice, the persons defrauded need not have been purchasers or sellers of securities from the defendants. In Materia, which involved facts similar to Chiarella, the Second Circuit reaffirmed the misappropriation theory, holding that "one who misappropriates nonpublic information in breach of a fiduciary duty and trades on that information to his own advantage violates Section 10(b) and Rule 10b-5."[13] Both of these cases, for which certiorari was

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[10] Id. at 313 n.22.

[11] 664 F.2d 12 (2d Cir. 1981), aff'd after remand, 722 F.2d 729 (2d Cir.), cert. denied, 464 U.S. 863 (1983).

[12] 745 F.2d 197 (2d Cir. 1984), cert. denied, 471 U.S. 1053 (1985).

[13] Id. at 203.

denied, involved garden-variety misappropriation from a buyer, seller, or market participant. They did not pique the Court's curiosity. Winans did.

The Court's carefully worded description of the facts in Winans, the Court's decisions in Chiarella and Dirks, the misappropriation footnote in Berner, and the Court's refusal to grant certiorari in Materia and Newman strongly suggest that the misappropriation theory is alive and well in the vast majority of insider trading cases. Although, taken alone, none of these factors might provide great comfort, taken together they signal that the Court would have little problem with a misappropriation case in which information was purloined or converted from a buyer, seller, or other market participant.

The Court split in Winans, I believe, only because the case involved misappropriation from the Wall Street Journal, which was not a buyer, seller, or market participant. Thus, the addition of a ninth justice who might have voted against the government's insider trading theory would not have rung the death knell for the misappropriation theory. At worst, it would have limited the application of the theory to garden-variety misappropriation cases. The Ivan Boeskys, Dennis Levines, and Martin Siegels of this world fit nicely into this category. The cases that would be excluded involve more exotic fact patterns in which reporters, researchers, or others, who are relatively remote from the operation of the market, misappropriate material nonpublic information from someone whose nexus to the market is again sufficiently remote that he is not a buyer, seller or participant with regard to any of the purloined information.

Despite the four-four split in Winans, I would therefore argue that the misappropriation theory is quite alive and well in the vast majority of cases we see, and in essentially all cases that involve "big time" traders. The theory is in doubt only in exotic cases. The four-four split signals only that, in bringing the Winans case, the government has found the cusp of the law, and has pushed its argument just to the point where it can evenly split an eight member court. The split carries, I think, no ominous implications for the vast majority of misappropriation cases and no ominous implications for the big cases that involve substantial market participants.

Criminal Liability

Indeed, even if my previous analysis is incorrect, and even if the Winans decision suggests some more basic weakness in the misappropriation theory, the scope of the Court's mail and wire fraud ruling is so broad that it effectively fills any void that may have been created by the securities law decision on the criminal side.

In the wake of Winans it seems clear that insider trading violations are, as a practical matter, also violations of the mail and wire fraud statutes. Thus, if the Commission ever encounters a situation in which it finds suspicious trading, it will always be able to conduct an investigation under Section 21(e) of the '34 Act.[14] If the investigation suggests that a person traded while in possession of material nonpublic information, but breached a fiduciary obligation in a manner that does not give rise to a claim under the securities laws, the Commission then simply phones the U.S. Attorney's Office and delivers a mail and wire fraud case, all neatly wrapped. The Commission is therefore not shut out of investigating exotic cases, because the Commission has the right to investigate suspicious trading, at least to a point where it is satisfied that the suspicious trading, which could be a violation of traditional insider trading law or of other antifraud principles, was in fact misappropriation conducted in a manner that does not breach a duty that gives rise to securities law liability.

From the defendant's perspective, it doesn't make much of a difference at all whether he is prosecuted under the mail fraud, wire fraud, or securities statutes. The new sentencing guidelines use the same monetary tables for mail and wire fraud as for insider trading violations, and consider the same aggravating factors. The only difference is the base level:

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[14] 15 U.S.C. 78u(e).

mail and wire fraud has a base offense level of 6,[15] while insider trading has a base offense level of 8.[16]

From Foster Winans' perspective it doesn't make a hill of beans difference whether he goes to jail for 18 months for mail and wire fraud or securities fraud. There are no special cells or tennis courts for securities law offenders as opposed to mail and wire defrauders.

Therefore, if the common law evolves in such a way as to avoid imposing 10b-5 liability on exotic cases such as Mr. Winans', that does not mean that Foster Winans and his imitators will have carte blanche to roam the securities markets free of the fear of criminal prosecution. Hardly.

Civil Liability

On the civil side, we shouldn't forget RICO, the Racketeer Influenced and Corrupt Organization[17] law, which provides for a treble damage remedy plus attorney's fees for persons injured by reason of a violation of the statute. RICO prohibits any person from investing in, acquiring, owning or conducting an "enterprise" by means of a pattern of racketeering activity. "Racketeering activity" is defined to include mail fraud and wire fraud.[18] A "pattern of

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[15]United States Sentencing Commission, Guidelines Manual, § 2F1.1 (Oct. 1987).

[16]Id. at § 2F1.2.

[17]18 U.S.C. §§ 1961 et seq.

[18]Id. at § 1961(1).

racketeering activity" is defined as two acts of racketeering activity occurring within ten years of one another.[19] Thus, if there is a future Foster Winans-type situation, and if one can satisfy RICO's requirements, there is the prospect of collecting treble damages from the violator. These damages would conceivably be available even though the trading does not give rise to private liability under the securities laws, or violate the securities laws at all. Further, in contrast to treble penalties assessed under the Insider Trading Sanctions Act of 1984,[20] which are paid into the federal treasury, the treble damages potentially available under RICO are paid directly to the injured private litigant. This is a difference with a major distinction to any plaintiff counsel who may be sitting in the audience.

U.S. Attorney Rudolph Giuliani has also recently announced that his office is considering more aggressive use of RICO on the criminal side as part of its insider trading enforcement program.[21] Obviously, the bag of tricks available to federal prosecutors, and private plaintiffs, is not limited to one rule under one section of one law.

I recognize that the potential availability of a statutory treble damage action under civil RICO for violations

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[19]Id. at § 1961(5).

[20]Pub. L. No. 98-376, 98 Stat. 1264.

[21]Ricks, Giuliani Would Use Racketeering Law If Warranted in Wall Street Inquiries, Wall St. J., Jan. 25, 1988, at 12; Insiders and RICO, Wash. Post, Jan. 23, 1988, at D-1.

of federal laws that previously either had allowed no private actions, or had allowed private actions limited to actual damages, raises significant concerns. The evolution of civil RICO into "something quite different from the original conception of its enactors"[22] has prompted calls for reform of the statute. According to its critics, private civil RICO litigation threatens to undermine established federal statutory schemes and permits legitimate business enterprises to be charged with racketeering in ordinary business disputes.[23] Whether one agrees or disagrees with RICO critics, as a practical matter, until Congress sees fit to amend the statute, its remedies are available to any private litigant who can satisfy the statute's requirements. Thus, it does not seem that the Winans decision has materially weakened the criminal or civil deterrent against insider trading. Nor does it seem that the criminal or civil deterrent against Winans-type behavior has been materially weakened even if it doesn't constitute insider trading.

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[22]Sedima, S.P.R.L. v. Imrex Co., Inc., 473 U.S. 479, 500 (1985).

[23]See, e.g., Salomon & Aiston, Fix the Antiracketeering Law, N.Y. Times, Apr. 28, 1987, at A-31; Earle III, The Fantasy of Life Without Risk, Time, Feb. 16, 1987, at 113; House Passes Bill on Rackets, N.Y. Times, Oct. 9, 1986, at A-24; Shad, Why RICO Needs Reforming, Fortune, March 3, 1986, at 109.

Legislation

Now, because the Winans decision does not, as a practical matter, cut back very much, if at all, on the criminal or civil deterrence applied to traditional insider trading, or to Winans-type behavior, what implications does that have for the statutory definition of insider trading? It's useful to address that question by reviewing the major reasons put forward in favor of a statutory definition, and then measuring how well the proposed statutory language achieves those goals.

First, people wanted a "plain English" definition of insider trading. People wanted a simple, concise definition free of legalistic metaphysics that could be easily stated and readily understood. Well, given the statutory language floating around Capitol Hill, I'm afraid you can forget plain English as a rallying cry for legislation. The Commission's bill is not plain English, the Pitt bill is not plain English, and I don't think you can write a full blown definition that is plain English. These bills are as plain English as the 1986 tax act was a tax simplification act. Thus, if plain English is one goal of a statutory definition, that's strike one against the pending legislation.

Second, people wanted a definition that clarified the current state of the law. The Commission and Pitt bills, however, dramatically expand the current state of the case law and lead to conclusions that have no legal precedent as of today. The bills also do not clarify many of the ambiguities that people have complained about most vigorously and add new ambiguities of their own. For example, the bills add no clarity to the definition of "materiality," they do not define "nonpublic information," and they do not give clear meaning to the notion of "fiduciary duty," the breach of which constitutes a basis for a violation. Thus, the Commission and Pitt bills do not clarify the current state of the law, and if that's the second goal of the legislation, that's strike two.

The third reason for a statute was concern that the Winans case would be decided against the government and that the misappropriation theory would be seriously gutted. Well, that hasn't happened. For the reasons I've explained, the misappropriation theory is alive and well and is now clearly buttressed and expanded by the Court's expansive interpretation of the mail and wire fraud statutes. So, if fear of Winans is the third reason to adopt a statute, that's strike three.

Where I come from, three strikes and you're out.

Perhaps then it makes sense to step back for a moment and question whether the current statutory proposals are preferable to the common law as it now stands. Based on such an analysis of the pending statutes and evolving case law, I lean strongly to the conclusion that the law of insider trading may well be best left alone and allowed to evolve on a case-by-case basis in the courts, as it has to date--particularly if the alternative is one of the two statutes that are now being considered.