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PROPOSED COMMENT LETTER OF THE CORPORATION, FINANCE AND SECURITIES LAW SECTION ON SEC PROPOSED RULES 10b5-1 AND 10b5-2

The SEC has proposed regulations (Rule 10b5-1 and Rule 10b5-2) to codify certain positions it has previously taken with respect to insider trading. A summary of the proposed comment letter is set forth below.

- The proposed rule provides that trading while in the possession of material non-public information will, with certain narrow exceptions, constitute insider trading. The comment letter expresses the view that before imposing on a person the severe sanctions associated with insider trading, a determination should be made that the person used the information in making the investment decision. The comment letter suggests, as a compromise, that the proposed Rule 10b5-2 could provide that trading while in the possession of material non-public information create a rebuttable presumption that the trading was on the basis of material nonpublic information or that an affirmative defense be added to negate liability if the information was not used when the investment decision was made.
- The comment letter suggests that the proposed Rule 10b5-1 be revised to expressly recognize the Chinese Wall defense (i.e., the trading department of a securities dealer can trade in a security even though the corporate finance department of the dealer has material nonpublic information, if the dealer has instituted an effective "Chinese Wall" between the two departments that ensures that the trading department does not have access to the information).
- Proposed Rule 10b5-2 would refine the misappropriation theory of insider trading so that it would apply (1) when there is an agreement by the recipient to keep the information confidential; (2) when there is an historic pattern or practice of sharing confidences that resulted in a reasonable expectation of confidentiality; and (3) when the recipient of the information is a family member unless there is an affirmative showing that the nature of the relationship gave rise to no reasonable expectation of confidentiality. The comment letter opposes the propose rule and suggests that it be limited to family relationships. The comment letter also observes that the recipient of information should not be liable on a misappropriation theory if the recipient reasonably believed that the information was not subject to a reasonable expectation of confidentiality.

The views expressed herein represent only those of the Corporation, Finance and Securities Law Section of the District of Columbia Bar and not those of the D.C. Bar or of its Board of Governors.

Draft 4/25/00

April ___, 2000

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: ***Proposed Rules Relating to Insider Trading (Release No. 33-7787, 34-42259, File No. S7-31-99)***

Dear Mr. Katz:

This letter is submitted on behalf of the Corporation, Finance and Securities Law Section of the District of Columbia Bar (the "Section") and was prepared by a task force formed by the Section's Committee on Broker-Dealer Regulation and SEC Enforcement. [1] The Section has a high concentration of attorneys who routinely counsel clients on questions involving the federal securities laws. Accordingly, we appreciate the opportunity to submit our views on the proposed Rule 10b-1 and 10b5-2. *See* Release No. 33-7787, 34-42259 (December 28, 1999) ("Proposing Release").[2] We respect and support the Commission's ongoing efforts to regulate the improper use of material, nonpublic information. In this letter, we attempt to offer a practitioner's perspective on how these proposed rules might be refined. Our single greatest concern with the proposed rules is that they could have marketplace consequences that were not intended by the Commission or its Staff.

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1 The views expressed herein represent only those of the Corporation, Finance and Securities Law Section of the District of Columbia Bar and not those of the D.C. Bar or its Board of Governors. The members of the task force who participated in the preparation of this letter include Daniel Anixt, James Day, Karl Grosskaufmanis, Neil Lang, Yoon-Young Lee, George Parizek, Philip Parker, Roger Patterson, John Sturc, Michael Trager, Harry Weiss, and Kenneth Winer. This comment represents the consensus of the participants as a whole and does not necessarily mirror the views of each individual participant or member of the Section.

2 The Proposing Release also included proposed rules concerning insider trading (Proposed Rule 10b5-1 concerning "use" v. "possession" of material non-public information). The Task Force is filing a separate comment letter addressing its concerns with Proposed Rule 10b5-1.

The proposed comment letter opposes the proposed rules and suggests a number of refinements in case the SEC nevertheless proceeds with adoption of the rules.

Proposed Rules 10b5-1 and 10b5-2 are not intended to create an overarching framework for insider trading regulation. Instead, the proposed rules reflect a patchwork approach intended to address issues on which the Commission has sustained setbacks in the courts. As outlined below, we do not believe that the Commission has articulated a need for either rule. To the extent that the Commission decides, nonetheless, to proceed with the adoption of these rules, we respectfully suggest that a limited number of refinements would limit the adverse market impact of these proposed rules.

I. Proposed Rule 10b5-1

Proposed Rule 10b5-1 stems from two federal appeals court decisions ruling that, in an insider trading prosecution, the government must establish the *use* of material, nonpublic information rather than merely its possession.[3] Under proposed Rule 10b5-1, a person trades "on the basis of" material, nonpublic information "if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale." This rule provides for certain, narrowly tailored affirmative defenses. Specifically, Rule 10b5-1 provides that a person may be liable when he trades while "aware" of material, nonpublic information unless the trade was made according to a preexisting contract, plan, or instruction. The awareness standard articulated in Rule 10b5-1 largely mirrors the Commission's prior "possession" standard which was rejected by two federal appeals courts.[4] The only significant difference between the two standards is that the awareness standard has a limited safe harbor for those defendants who can prove that their trades were conducted pursuant to a preexisting contract, plan, or instruction. We have three comments regarding this proposal.

A. Rule 10b5-1 Should Adopt a Use Standard

The Commission's proposing release suggests that federal appeals courts that have addressed the distinction between the use and possession standards "have reached different results."[5] Our review of the *Adler* and *Smith* opinions suggests that the Eleventh and

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3 *United States v. Smith,* 155 F.3d 1051, 1066-69 (9th Cir. 1998), *cert. denied,* 525 U.S. 1071 (1999); *SEC v. Adler*, 137 F.3d 1325, 1332-39 (11th Cir. 1998).

4 *Smith*, 155 F.3d at 1066-69; *Adler*, 137 F.3d at 1332-39.

5 Proposing Release at 72600.

Ninth Circuits reached consistent, well-reasoned opinions in favor of a use test. The Second Circuit's discussion in *United States v. Teicher* favoring a knowing possession standard has been explicitly discounted as dicta.[6] The proposing release identifies no evidence that the *Adler* and *Smith* opinions have limited the Commission's enforcement program in any way.

Before imposing the severe sanctions associated with a determination that a person illegally traded on the basis of material, nonpublic information, we believe that the SEC should be required to prove that the person actually used such information in formulating his investment decision.[7] A "use" standard, as opposed to mere awareness of the material, nonpublic information at the time of the trade, comports with the Supreme Court's repeated pronouncements on the scope of Section 10(b) of the Exchange Act. Section 10(b) proscribes fraud, and in order to prove fraud, the Supreme Court requires proof of manipulation or deception.[8] The Supreme Court has also stated that when a fiduciary misappropriates material, nonpublic information, he violates Section 10(b) by making "use" of such information to purchase or sell securities.[9]

In an insider trading context, the manipulation or deception element of Section 10(b) requires a corporate insider to exploit material, nonpublic information.[10] If a corporate insider has a preexisting plan to trade in his company's securities and subsequently acquires material, nonpublic information about his company, he does not engage in manipulation or deception by executing his preexisting trading plan. In such a situation there is no manipulation or deception because the corporate insider formulated his investment decision

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6 *United States v. Teicher*, 987 F.2d 112, 119 (2d Cir. 1993).

7 In insider trading cases, the Commission may seek disgorgement of the trader's profits or losses avoided and a civil monetary penalty of up to three-times the trader's profits or losses avoided. Section 21A(a)(2) of the Securities Exchange Act of 1934 ("Exchange Act"). In addition, insider trading is a criminal offense punishable by incarceration.

8 *See, e.g., United States v. O'Hagan*, 521 U.S. 642, 643 (1997) ("§ 10(b) is not an all-purpose breach of fiduciary duty ban, but trains on conduct that is manipulative or deceptive") (*citing Sante Fe Indus. v. Green,* 430 U.S. 462, 473-76 (1977)).

9 *Id.* at 652.

10 Allan Horwich, *Possession Versus Use: Is There a Causation Element in the Prohibition on Insider Trading?*, 52 BUS. LAW. 1235, 1268-69 (1997) ("The essence of the prohibition, as expressed both in the common-law cases and in the seminal decisions under Rule 10b-5, is 'taking advantage' of information not known to those with whom one is trading. . . . At the very least, 'taking advantage of' implies conscious exploitation of inside information. One does not 'take advantage' of something which first comes to his attention after he has made his investment decision.").

based upon legitimate reasons. Liability should not be imposed simply because the corporate insider subsequently comes into possession of material, nonpublic information.[11] Therefore, it is appropriate that insider trading liability only attach to individuals who use material, nonpublic information, in breach of a fiduciary duty or similar duty of trust and confidence, in forming their investment decisions.

We recognize that in some instances, there may be practical difficulties in requiring the Commission to prove that an individual actually used material, nonpublic information in forming his investment decision. The Task Force believes that an appropriate compromise is the creation of a rebuttable presumption of use as articulated in the *Adler* case instead of limiting a defendant to a narrow safe harbor.[12] The *Adler* presumption permits the Commission to infer use when an individual trades while in possession of material, nonpublic information.[13] Such a presumption satisfies the requirement that insider trading liability only be triggered by actual use of material, nonpublic information while alleviating the Commission's evidentiary concerns by enabling the Commission to plead and present at trial a prima facie case without having to introduce direct evidence concerning the person's rationale for his trading.[14]

B. Rule 10b5-1 Should Explicitly Recognize a Chinese Wall Defense

Rule 10b5-1 provides that with respect to an entity, a trade will not occur "on the basis of" material, nonpublic information if the individual(s) making the investment decision are not aware of the sensitive information and the entity had adopted reasonable procedures "to ensure that individuals making investment decisions would not violate the laws prohibiting trading on the basis of material, nonpublic information." This recognition of internal Chinese Wall procedures is not implicit in the "awareness" standard proposed by the Commission. If Rule 10b5-1 is adopted in its current form, this provision will be critically important.

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11 *Id.*

12 As an alternative to the proposed safe harbor, the Commission could provide a non-exclusive list of situations wherein the presumption of use of material, nonpublic information can be rebutted (*e.g.* trading based upon a preexisting plan, contract, or instruction).

13 137 F.3d at 1337-38.

14 *See id.* at 1338.

In one respect, this provision is consistent with the SEC's prior rulemaking and *amicus* positions regarding Chinese Wall procedures.[15] Nonetheless, explicit regulatory recognition of a Chinese Wall defense in the proposed rule would be an important advance, particularly for members of the financial services industry. Many securities professionals, as part of a financial services complex, rely on the existence of Chinese Walls to continue to trade securities of issuers at the same time that other affiliated entities have become aware of material, nonpublic information regarding those issuers. While Chinese Wall procedures are commonplace in the securities industry, there is scant judicial authority that the existence of such procedures forecloses governmental or private claims alleging securities fraud violations. Rule 10b5-1 would place the Commission's imprimatur on the vitality of the Chinese Wall defense.

C. The Affirmative Defenses Identified in Rule Should Be Expanded

Rule 10b5-1, as presently drafted, includes a number of affirmative defenses identifying situations in which a person would not be deemed to be trading "on the basis" of

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15 The SEC directly addressed Chinese Wall procedures when it promulgated Rule 14e-3 (a rule that proscribed trading while in possession of material, nonpublic information relating to a tender offer) which codified a safe harbor for firms that screened individuals making investment decisions from information relating to the tender offer. 17 C.F.R. § 240.14e-3. In the adopting release for Rule 14e-3, the Commission specifically noted that the institution of effective Chinese Walls could satisfy the safe harbor. Tender Offers, Exchange Act Release No. 17120, 20 SEC-DOCKET 1241 (Sept. 4, 1980). Passage of the 1988 Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA"), which imposed controlling person liability when a firm's procedures for preventing the use of material, non-public information proves inadequate, spurred the SEC to review Chinese Walls. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988). Pursuant to this review, the SEC's Division of Market Regulation issued a report specifying the "minimum elements" of an adequate Chinese Wall: reviews of employee and proprietary trading, memorialization and documentation of firm procedures, substantive supervision of interdepartmental communications and specific procedures addressing proprietary information when the firm is in possession of material, nonpublic information. *Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Use of Material Nonpublic Information*, Report by the Division of Market Regulation, U.S. Securities and Exchange Commission, Mar. 1990.

The SEC has also issued *amicus* positions supporting the use of Chinese Walls by firms. The Commission's *In re: Federated Stores* (a bankruptcy proceeding involving Federated Department Stores) *amicus* brief took the position, along with the ICI, that Fidelity Management should be permitted to trade Federated securities while serving on the formal creditor's committee for Federated so long as effective Chinese Wall procedures prevented the flow of information from the committee to Fidelity's traders. *Amicus* Brief, Memorandum in Support of the Securities and Exchange Commission in Support of the Motion of Fidelity Management & Research Co. at 6, *In re: Federated Department Stores, Inc.*, No. 1-90-00130 (Bankr. S.D. Ohio 1991).

certain market-sensitive information. Since these defenses are narrowly defined, they may not capture every situation in which there is no misuse of confidential information. We suggest adding a catch-all affirmative defense that would be applicable when the record demonstrates that the information was not used when the investment decision was made.

In many respects, this additional provision reflects a principle that runs throughout Subsection (i) of proposed Rule 10b5-1. We believe that, in the normal course, there will arise a number of situations involving decisions to trade that do not involve the formality presently suggested by the affirmative defenses. It seems to us, for example, that a middle manager might implement a sales program, but because it is not a "written plan specifying purchases and sales," it may not, in theory, be eligible for the affirmative defense identified in Subsection (c)(i)(C). That is an anomaly that should be corrected.

II. Proposed Rule 10b5-2

Proposed Rule 10b5-2 is intended to refine the application of the misappropriation theory of insider trading liability within the context of family and personal relationships. Proposed Rule 10b-5 would apply if (i) there is an agreement by the recipient to keep the information confidential, (ii) there is a history, pattern, or practice of sharing confidences that resulted in a reasonable expectation of confidentiality, and (iii) when the recipient of the information is a spouse, child, or sibling of the person who provided the information unless it is affirmatively shown that the nature of the relationship gave no reasonable expectation of confidentiality. We do not believe that the Commission has outlined a compelling need for this rule. To the extent it is needed, proposed Rule 10b5-2 should be limited to family relationships.

The proposing release indicates that proposed Rule 10b5-2 is largely the product of the "restrictive analysis" in *United States v. Chestman*.[16] Specifically, *Chestman* held strictly, in a criminal insider trading prosecution, that a family relationship must be the functional equivalent of a fiduciary relationship if the breach of that relationship is to serve as the basis for a prosecution under the misappropriation theory. While this opinion could serve to limit the SEC under certain circumstances, we are not aware of any significant setbacks to the SEC's enforcement program as a result of the opinion. The need for proposed Rule 10b5-2 appears tenuous.

If the Commission determined that this need exists, we recommend that Rule 10b5-2 be limited to the family contacts at which it was aimed. The proposing release discusses this rule exclusively in the context of family relationships. There is no express

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16 *United States v. Chestman*, 947 F.2d 551, 568 (2d Cir. 1991).

intention to use the proposed rule to define fiduciary-like relationships outside the family context (and indeed, the rule as drafted would not fairly reflect how such relationships are found in the marketplace). The potential adverse impact of proposed Rule 10b5-2 is limited significantly if its scope is restricted to the family relationships at which it was aimed.

Should the Commission adopt a broader version of proposed Rule 10b5-2, covering the panoply of personal relationships described in the release, it should provide certain safeguards for recipients of material, nonpublic information. Under such a measured approach, the recipient would not be liable under Rule 10b5-2 unless the following two conditions are met: (i) the person providing the information to the recipient has a reasonable expectation that the recipient will keep the information confidential and will not trade on the basis of it and (ii) the recipient understands that the person providing the information has a reasonable belief that the recipient will keep the information confidential and will not trade on the basis of it. Such an approach to Rule 10b5-2 would help achieve the objective of proscribing illegal insider trading without unfairly penalizing innocent recipients of material nonpublic information.

Respectfully Submitted,

Corporation, Finance and Securities Law
Section, District of Columbia Bar

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