

April 28, 2000

Jonathan G. Katz, Secretary,
Securities and Exchange Commission,
450 Fifth Street, N.W., Stop 6-9
Washington, D.C. 20549.

Re: Proposed Rule 10b5-1 – File No. S7-31-99

Dear Mr. Katz:

The Securities Industry Association (“SIA”)¹ is pleased to submit this response to proposed Rule 10b5-1, contained in Release No.33-7787 (“Release”).²

The Commission’s proposing release states that the purpose of proposed Rule 10b5-1 is twofold: (i) to reconcile the views of different appellate courts so as “to define the scope of Rule 10b-5 as it applies to the use/possession issue,” and (ii) to “better enable insiders and issuers to conduct themselves in accordance with the law.”³ SIA applauds the Commission’s desire to provide clearer guidance to investors and their legal counsel as to when trading will be deemed to be “on the basis of” material nonpublic information (“inside information”). The basic approach taken by proposed Rule 10b5-1 of laying out certain specific affirmative defenses against liability would provide helpful guidance in an important area of law that has long generated uncertainty.

¹ SIA brings together the shared interests of more than 740 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of more than 50 million investors directly and tens of millions of investors indirectly through corporate, thrift and pension plans. The industry generates more than \$300 billion of revenues yearly in the U.S. economy and employs more than 600,000 individuals. (More information about SIA is available on its home page: <http://www.sia.com>.)

² SIA is commenting separately on the portion of the release proposing Regulation FD.

³ 64 Federal Register (“FR”) 72600 (Dec. 28, 1999).



However, we have two fundamental concerns with the proposed rule. First, the affirmative defenses need to be broadened and clarified in some respects to address additional situations where an investor should be permitted an opportunity to demonstrate that possession of inside information was not a factor in his or her investment decision. Second, and more importantly, the enumerated defenses should not be exclusive. By making these defenses exclusive, the proposed rule could lead to unjust results in some cases.

In the proposing release, the Commission expresses a fundamental principle that the rule should not create automatic liability where an investor had legitimate reasons for trading that predated acquiring inside information.⁴ Exclusive defenses, no matter how carefully crafted, cannot be reconciled with this principle because experience and logic show that the potential variations in circumstances cannot reasonably and accurately be predicted. There will invariably be circumstances that the drafter did not anticipate for which liability should not result but the narrowly drawn exclusive defenses do not cover. Without suggesting that selective enforcement is a sufficient answer to this problem, we believe that this inflexibility is especially worrisome where prosecutorial discretion does not apply, as in private actions. SIA believes that it is inappropriate for the Commission to excuse itself of the burden of proving a case of insider trading by adopting a rule that could inappropriately characterize innocent behavior as insider trading. Even if the rule was expanded to cover additional scenarios, undoubtedly other situations would arise that could cause the proposed rule to operate in an unduly harsh and inequitable manner.

Therefore, we recommend that, in addition to enumerated defenses to insider trading liability, the rule should provide defendants with the ability to proffer other evidence demonstrating that their investment decision was not made on the basis of inside information. Of course, under the *Adler* case, the Commission would be entitled to a presumption that trading made while in possession of inside information was made on the basis of that information, unless and until the defendant can rebut that presumption by demonstrating by a preponderance of the evidence that his or her trading was made for reasons other than that information.

The Affirmative Defenses Are Too Narrow.

Below we detail illustrative situations that we have identified that are not covered by the rule's defenses, but which in our view should not result in *per se* liability for insider trading. These illustrations demonstrate that reliance on *exclusive* defenses is not an equitable or workable approach for providing guidance in this area. Even if the

⁴ "[W]e recognize that an absolute standard based on knowing possession, or awareness, could be overbroad in some respects. Sometimes a person may reach a decision to make a particular trade without any awareness of material nonpublic information, but then come into possession of such information before the trade actually takes place. A rigid 'knowing possession' standard would lead to liability in that case. We believe, however, that for many cases of this type, a reasonable standard would not make such trading automatically illegal." 64 FR 72600.



exclusive defenses are adjusted to eliminate the shortcomings that we have identified, undoubtedly will be other situations outside the affirmative defenses that neither we nor the Commission have identified where *per se* liability will be unfair.

Options Exercise. The affirmative defenses do not adequately protect holders of options who elect to exercise their existing option positions. Suppose that an investor buys an option, and subsequently comes into possession of inside information. Subparagraph (c)(1)(i)(A) as written would protect the writer of the option because he or she has “entered into a binding contract to purchase or sell the security in the amount, at the price, and on the date which the person purchased or sold the security.” It is not clear that this language would protect the buyer of the option, since he or she can elect whether or not to exercise an in-the-money option. Further, brokers commonly exercise automatically an in-the-money option for their customers. This means that unless the buyer specifically instructs his or her broker not to exercise the in-the-money option, which itself could strongly telegraph a “tip” to the recipient, a purchase or sale will occur and the customer may not have the benefit of the affirmative defense.

In these situations the economically relevant investment decision was made when the option was purchased, not when it was exercised.⁵ As long as the buyer was not aware of inside information when the option was purchased, he or she should be permitted to exercise the option.

Firm Trading Activities and Chinese Walls. Another hazard of precluding any defense outside of a preset exclusive list is that some legitimate trading activity by securities firms may be swept up, even though the trading is not actually being conducted on the basis of inside information. The Commission seeks to avoid impacting normal trading functions of broker-dealers by providing a defense if the firm has implemented “Chinese Wall” procedures. While the basic Chinese Wall defense addresses certain situations relating to traditional investment banking activities, it would not address many trading related strategies now commonly employed by broker-dealers in their own trading, as well as in trading for issuers and their affiliates.

Specifically, we have identified problems that could arise with firms' "dynamic hedging" strategies, and with passive trading activities while trying to work a block trade for an institutional customer. The common thread running through these concerns is the inflexibility of only countenancing trading activity where formal “Chinese Wall” protections are in place. As the examples below illustrate, there are times when a firm's trading desk, in the course of providing liquidity to the marketplace, might in hindsight be viewed as having possessed material nonpublic information. The examples below

⁵ E.g., Rule 16b-6(a) and (b) provide that a purchase or sale generally occurs when the option at the time the option is bought or sold, rather than when the option is exercised to purchase or sell the underlying stock.



illustrate trading activities that serve useful and important capital market and risk management functions,⁶ and that could not be performed effectively if information was entirely withheld from the trading desk. It is reasonable to place the burden of proof on the firm to show that inside information was not the basis for any trading decision. However, legitimate and desirable trading functions should not be disrupted, either by labeling these activities as *per se* violations of the insider trading restrictions, or by requiring firms to impose formal Chinese Wall procedures in contexts in which they do more harm than good.

1. Dynamic Hedging and Risk Management. Broker-dealers often conduct trading activities to manage risk rather than to seek to profit on the economic fundamentals underlying a security. A broker-dealer conducting hedging or trading activities designed to maintain a market-neutral or other risk adjusted position could run into problems that would not be covered by the affirmative defenses. A broker-dealer might come into possession of inside information about a security as to which it has taken offsetting hedges in order to remain within certain risk tolerances with regard to that security's value. Since the firm is not seeking to profit from the information, but only to stay market-neutral or comply with its risk adjusted trading protocols, existing practice might not necessarily require that the trader managing the hedge be formally segregated by a Chinese Wall, and such a segregation may in fact be impractical.

For example, suppose that a firm has a proprietary position consisting of a security, and/or call options on that security, partially hedged by an offsetting short position, or put options, on that security or a basket of securities that trade similarly to that issuer's securities. Due to other changes in its overall portfolio, the firm might need to rebalance its net position because the firm's exposure exceeds its internal risk control tolerances. Suppose further that, at the moment the firm is reducing its net long position in that security, the trading desk possesses potentially material nonpublic information (e.g., that a separate effort to sell a block of the securities for the issuer is not going well). We do not think that such a scenario necessarily should be illegal, as long as the broker-dealer can demonstrate that it is following its general trading risk strategy with regard to the security, rather than trading for the purpose of profiting on the economic fundamentals of the issuer. A federal rule that preemptively labels such conduct as *per se* unlawful could create many unforeseen complications for firms' internal risk management policies and procedures, and might impede the ability of firms to fully manage their risk exposure.

⁶ The Commission in other contexts has been sensitive to the need to exempt passive market-making from regulatory requirements so as not to impede market liquidity, both in U.S. as well as foreign markets. See, e.g., Rule 103 of Regulation M. See also letter to Dan Sheridan, London Stock Exchange, from Nancy J. Sanow, Assistant Director, Division of Market Regulation (August 5, 1997) (exempting passive market-making in certain securities in the United Kingdom from the restrictions of Regulation M based on the representation of the London Stock Exchange "that, in order to maintain depth and liquidity in the U.K. securities market, it is imperative that Exchange member firms be able to engage in market making activities at all times")(id. at 7).



2. Block Transactions. The exclusive defenses of Rule 10b5-1 could unintentionally impede market liquidity and have other significant complications when broker-dealers participate in shelf take-downs and other block transactions. A broker-dealer that agrees to conduct a block transaction may nevertheless wish to hold itself open to facilitate transactions in that security to the same extent as it did prior to the solicitation, especially if it is a market-maker in that security. Indeed, if it ceased to perform “passive market-making” and similar functions, liquidity in the issue could be impaired, and the market might be tipped that the broker-dealer is handling an unusual order.

As written, Rule 10b5-1 would create legal uncertainty about whether broker-dealers can continue to conduct passive market-making and similar activities while working a block trade. None of the affirmative defenses of Rule 10b5-1 appear to protect this legitimate and lawful activity. The provision in the rule for institutional Chinese Wall procedures would not apply since the trading desk by necessity could not be walled off from the information about the block trade. The firm would have a strong argument that its actions violated no duty to the client (and in fact to have withdrawn entirely would have hurt completion of the client’s block trade) and therefore did not violate Rule 10b-5. Whether or not the Enforcement Division would accept that argument would be impossible to predict with certainty. The dealer might therefore feel less comfortable about continuing to passively provide market liquidity while working the block trade. This result is both undesirable and unnecessary.

3. The “Chinese Wall” Defense. As a drafting matter, we note an apparent problem resulting from the circularity in the articulation of the proposed “Chinese Wall” defense is set out in the rule. The exception in (c)(2)(ii) only applies if the policy ensures that investment decisions are not made “on the basis of” inside information. But paragraph (b) defines “on the basis of” to mean any purchase or sale made while in possession of information unless the affirmative defenses in (c)(1)(i) apply. Unless a firm’s trading activity falls within the enumerated defenses of (c)(1), (b) would seem to treat it as being *per se* on the basis of inside information. Therefore, even if procedures were in place and were followed to ensure that the trading desk did not know the inside information, that might not satisfy a very technical reading of the (c)(2)(ii) exemption. To make the Chinese Wall defense work as intended, the Commission might consider moving the (c)(2)(ii) exemption into (c)(1).

Deviation from Prior Plan Due to Mistake. The affirmative defenses make no allowance for someone who deviates from a plan due to a mistake. For example, what if trading deviates from a written plan as a result of clear operational or human error? The rule makes no allowance for this scenario, and would treat such a transaction as being *per se* violation if the trader possessed such information at the time the error occurred. Again, it may be appropriate to accord the Enforcement Division a rebuttable presumption in such



as case, but to deny the trader any opportunity to show evidence of an innocent mistake seems unnecessary as a matter of policy and unduly harsh.

New Technology. The proposed list of affirmative defenses also may impair the use of some new technologies and trading strategies that investors may desire. For example, we understand that some firms are starting to offer computer programs to investors that automatically execute transactions for investors' accounts based on pre-established parameters (e.g., automatically buy or sell a given security or group of securities based on specified movements in share price, or in benchmark indicators such as market indices, interest rates, etc.). Trading that is executed by an investor using such technology does not seem to fall within any of the affirmative defenses provided in the proposal. Under the proposal, an investor could run afoul of the insider trading laws if he or she comes into possession of inside information about an issuer, and the investor's trading program, taking no account of that information, happens to automatically execute a trade in that issuer's securities for the investor's account. We think that the Commission should try to avoid writing any regulations that unnecessarily limit investor access to new technology.

Does Partial Noncompliance Unravel the Affirmative Defenses? It is unclear to what extent the affirmative defenses apply to trading pursuant to a plan that falls partially within and partially outside any of the defenses. For example, suppose that John Doe adopts a written plan specifying dates, amount and prices at which he will purchase securities of Issuer X. Doe comes into possession of inside information about merger negotiations. The negotiations remain secret for several months. He continues to make purchases strictly in adherence to the plan. However, on one occasion Doe diverges from his plan, either deliberately or due to some mistake. Would the deviating transaction invalidate the protection of the affirmative defenses for all of Doe's other purchases pursuant to his plan while he was in possession of the inside information? We think that it should not, but the rule does not make this clear.

Compelling Personal Hardship. Another shortcoming of the proposed affirmative defenses is their lack of recognition that in some situations a securities transaction may be motivated by compelling personal or fiduciary considerations, rather than on the basis of inside information that the investor happens to possess. It is very easy to think of situations where someone in possession of inside information might be compelled to sell securities that they otherwise had no intention of selling in order to meet a financial emergency. A person might be compelled to sell in order to meet a personal emergency, such as a family member's medical needs that might not be covered by health insurance. One might also be forced to sell in order to meet a margin call or other creditor demand, particularly if one is otherwise faced with a severe financial repercussion such as a mortgage foreclosure or personal bankruptcy. It does not take too much imagination to think of other situations where a person might be compelled to sell securities.

Perhaps the Commission is reluctant to permit a defense of personal hardship because of the prospect that some defendants will try to assert the defense speciously.



Indeed, such a defense should not be entertained by the factfinder where other reasonable financial alternatives are available. However, it seems preferable to allow a judge or jury to assess a claim of personal hardship, rather than to foreclose the ability of any defendant to ever offer evidence that he or she made an investment decision on the basis of personal hardship rather than on the basis of inside information.

The Affirmative Defenses Should Not be Exclusive.

As the situations described above illustrate, it is extremely difficult to write a rule that details every situation where an investor might legitimately purchase or sell securities while in possession of material non-public information. We are no more prescient than the Commission, and undoubtedly there are circumstances that no one has thought of that could come to light once the rule is in place involving innocent conduct.⁷ Situations are bound to arise outside the scope of any affirmative defenses where a trading decision was unaffected by an investor's possession of inside information. It would be unjust to deprive such an investor of any opportunity to put on a defense merely because the Commission, SIA and other commenters suffer from a human inability to foresee every circumstance that might arise.

In order for the rule to operate fairly and avoid injustice, we think it is essential that the rule permit a general defense that a defendant's investment decision was not on the basis of inside information. In the context of proposed Rule 10b5-2 the Commission recognizes that it does not have the ability to enumerate every conceivable "duty of trust and confidence" and therefore provides that the duties enumerated in 10b5-2(d) are not exclusive. It would be inconsistent to recognize that exclusivity is impractical in a setting where that recognition empowers the Commission, but to turn away from this recognition when it might inconvenience the Commission in performing a prosecutorial function.

We have two suggestions for how the Commission might make its defenses non-exclusive. One approach would be to provide an additional affirmative defense allowing a defendant to demonstrate by a preponderance of the evidence that his or her trading was made on the basis of information or circumstances other than possession of inside information. Alternatively, the Commission might simply state in 10b5-1(b) that the defenses set out in paragraph (c) are non-exclusive.

We recognize that both of these suggestions are closer to the approach of *SEC v. Adler* than the Commission might prefer to go. The proposing release rejects the presumption or "strong inference" approach adopted in *SEC v. Adler* because the

⁷ We have identified at least two other areas that may not be adequately addressed by the affirmative defenses as proposed. One area concerns issuer stock repurchase programs. See comment letter of LeBoeuf, Lamb, Greene & MacRae, L.L.P. (March 29, 2000). The second concerns employee purchase plans. These plans are carefully structured to comply with Section 16 of the Securities Exchange Act. The requirements of Rule 10b5-1 may conflict with the structures that have developed in practice under Section 16.



Commission thinks that approach would not provide sufficient clarity and certainty to market participants.⁸ As one of the principal voices of market participants, we do not share that view. Market participants find specific but nonexclusive safe harbors laid out by the Commission to be very helpful guidance to ensure that they stay well within the law. In fact, such regulatory approaches often become true operating benchmarks and define the scope of behavior absent particular detailed review customarily involving specific legal advice. Our suggestion would therefore meet the Commission's stated objectives, while reducing the risk that the rule might lead to inflexible and unjust results.

Impact of Rule 10b5-1 on Private Actions.

The concerns that we express above about the inflexible application of exclusive defenses in SEC enforcement actions are vastly greater in the context of private actions. Market participants may be able to take comfort that the SEC's own exercise of prosecutorial discretion, coupled with the ability of prospective defendants to address the Commission in pre-litigation "Wells" proceedings, may mitigate excessively harsh application of the rule. However, private litigants have no incentive or reason to be restrained by any sense of discretion or fairness.

Private insider trading cases should only be permitted under the current legal precedents, rather than permit some private litigants to use the affirmative defenses as a club to wield against defendants in cases that the Commission itself would choose not to bring.⁹ However, this limitation by itself, while somewhat helpful, would not sufficiently address our concerns. Even if private actions are expressly excluded from Rule 10b5-1, private plaintiffs may still seek to benefit from the rule in important ways, such as by using the rule to argue against dismissal motions, or to resist sanctions for spurious claims. Moreover, the possibility would remain that SEC enforcement actions might be brought under a standard of *per se* liability against conduct that would be otherwise defensible. Therefore, while the application of the rule in private actions provides an additional reason for making the defenses contained in the rule nonexclusive, our concern cannot be addressed merely by limiting the application of Rule 10b5-1 to SEC actions.

Conclusion

We appreciate the opportunity to comment on proposed Rule 10b5-1. We hope that the comments offered above will help the Commission to shape the rule so that it

⁸ 64 FR at 72600.

⁹ While the Commission generally has not attempted to regulate private litigation under Rule 10b-5, there is respectable opinion that it could do so if it chose. See Grundfest, Disimplifying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority, 107 Harv. L. Rev. 961 (1994). Moreover, limiting Rule 10b5-1 to Commission actions would not create a new restriction on private actions, but would merely preserve the *status quo* for private civil liability.



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more effectively separates innocent conduct from the scourge of insider trading, which the Commission should continue to zealously prosecute. If we can be of further assistance, please do not hesitate to contact the undersigned, or George R. Kramer of the SIA staff at 202/296-9410.

Sincerely,

Stuart J. Kaswell
Senior Vice President and
General Counsel

Cc: The Honorable Arthur Levitt, Chairman
The Honorable Norman S. Johnson, Commissioner
The Honorable Isaac C. Hunt, Jr., Commissioner
The Honorable Paul R. Carey, Commissioner
The Honorable Laura S. Unger, Commissioner
David Becker, General Counsel, Office of General Counsel
Richard A. Levine, Assistant General Counsel
Sharon Zamore, Senior Counsel
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