Securities and Exchange Commission Historical Society
Interview with Paul Gonson
Conducted on July 12, 2006, by Kenneth Durr

KD: This is an interview with Paul Gonson by Kenneth Durr, July 12, 2006, at Kirkpatrick & Lockhart in Washington, DC. Thank you for agreeing to meet with me today. I want to start with a little bit of background so we can get a sense of how you worked your way up into the Solicitor's job at the Commission.

PG: I came to the SEC in 1961 from private law practice in Buffalo and started in the old Division of Corporation Regulation, now called Investment Management. I did mostly bankruptcy reorganization work, which was an important part of the Commission's work at that time, and found that many of the cases that I worked on were going up on appeal. I was working with David Ferber, who then was SEC Solicitor and helping on the cases that I had handled in the lower court that were up on appeal, and argued some of those cases. There came a time when Dave Ferber asked if I would transfer to the General Counsel's Office and become primarily an appellate lawyer. That was attractive to me and I did that in 1967, and worked on many things--not just appellate work but a great deal on appellate work. When Dave Ferber retired in 1979, I took his job and was Solicitor from 1979 to 1998. At the end of that year, I retired from the SEC and then joined the firm of Kirkpatrick & Lockhart, where I still am today. So for that 20-year period from '79 to '98, I was in charge of the SEC's appellate practice and defense work, and that was of course the heyday of the cases that went to the courts, particularly the Supreme Court, in the insider trader area. I had also worked very extensively with the Division of Enforcement on enforcement cases, generally speaking. But as the insider trading cases, or program as it was called, started to develop, in addition to my appellate work, I also worked with the Division in formulating theories or principles that could be asserted in these cases. I worked with the trial lawyers with an eye toward developing a record that may end up in the appellate court. I not only handled the appellate process but was also involved in the formulation of policy.

KD: I was interested to hear you talk about an insider trading program--it sounds like rather than reacting and responding to things that were coming up, there was actually an attempt to pursue this thing systematically?

PG: Right.

KD: When would that have begun?

PG: My guess is in the '70s, but it really took traction in the early '80s when the wave of tender offers and mergers started to occur. By a program, I mean the SEC generally had a number of cases; I don't remember exactly what the figures are but I think that it's probably safe to say that the SEC brings some 500 or so law enforcement cases every year and of that amount, perhaps 10 percent or maybe 45 or 50 of them are insider trading cases. So it has a program in the sense that it focuses on a number of cases in the same category; it has a financial fraud program, for example. It has a program relating to false filing of documents, etcetera, so the insider training program was a program that was developed to try to stop what was considered abusive trading based on insider information. It was interesting because the SEC would not only go after the really big cases, and of course it would, but it would also make sure that it brought a few small cases. It would like everyone to know that, as we used to say when I was at the SEC, that you can't fly under the radar screen--that is don't try it even with just a little bit of trading because we're going to try to catch you also. Otherwise, people say "well if I trade small I probably won't be detected." There's some

merit in the stock watch systems. So the SEC generally would bring the bigger cases but it would also make sure that it would bring some smaller cases as well. I know it would bring them in a variety of areas as well to make its presence felt, generally speaking, in different areas of insider trading which I'll get to.

KD: So Enforcement would have been monitoring this overall insider trading program?

PG: Yes, it would be handled by the Division of Enforcement.

KD: Was there someone within that Division?

PG: There were some people who I think were prominent in that area. Gary Lynch was the Director of Enforcement in the 1980s when John Shad was SEC Chairman. Chairman Shad was Chairman in the Reagan Administration and he pushed forward a very vigorous insider training program. As a matter of fact, he had the phrase that he was going to stomp down with hobnailed boots on insider trading. One of the principal deputies was John Sturc--he was a former prosecutor--a very capable guy who handed a lot of these cases. Barry Goldsmith, who was then head of the Trial Unit and later went to the NASD and now is in a private law firm, was very active in that area. Tom Newkirk was Goldsmith's predecessor as head of the Trial Unit and very active in that area. When Gary Lynch left, Bill McLucas became Director and he continued that program. I think the SEC was fortunate in having such capable and dedicated people to run that program.

KD: I think we'll get into a lot of those specifics. But let's go back a little bit and talk about whether you can remember your earlier involvement with insider trading—the first significant case. I'd like to get a sense of the legacy of the '60s case -- *Cady, Roberts, Texas Gulf Sulphur* -- and what the context was.

PG: I think maybe a little historical background will explain *Cady, Roberts* and *Texas Gulf Sulphur*. Those were the first two cases. Insider trading is not defined in the federal securities laws; you can't look it up in a statute or rule and get a definition of it, nor is it made unlawful in expressed terms anywhere in the law. When one wants to learn about insider trading, one really has to read the cases that developed case-by-case and that's still true today, even after all these years and all these cases and several Congressional attempts. There's still no definition of insider trading even today; rather, it is a species of fraud mostly under the famous Section 10(b) and Rule 10b-5 under the Securities Exchange Act. That act says that it shall be unlawful to engage in manipulative or deceptive devices or contrivances in contravention of rules the SEC will promulgate in the public interest in connection with the purchase or sale of a security. You really can't tell very much from that language what it means, although that language has been upheld as not void for vagueness. You either need a manipulation or a deception in connection with the purchase or sale of a security. So those are the key words that are used. The first case that you referred to, which was *Cady, Roberts*, was a case in 1961 --this is before my time at the SEC—this was an administrative proceeding as distinguished from a court case that is brought by the SEC within its own building before an Administrative Law Judge. That case established a ground rule that business information was intended for business use and not the personal use of an individual; when an individual used it for his personal use it was an unfair use. I'm obviously glossing over much more technical language but that so far as I'm aware was the very first time that the SEC articulated a theory of insider trading.

KD: Is this where we get the fiduciary responsibility idea?

PG: It starts there; it really develops a little later in the *Chiarella* case which I will get to.

The *Texas Gulf Sulphur* case was around 1966 in Federal Court in New York City. That was the first case in which the SEC went to court, as distinguished from an administrative proceeding before an Administrative Law Judge, and sought an injunction and disgorgement of the insider trading profits, which means you have to give the money back. It also asked for disgorgement of the tippee's profit—the persons who were tipped that had to be made by the tippers, which was an interesting concept. That case hit corporate America like a tidal wave because many directors of big corporations believed that one of the prerequisites of being a director of a company was that you did get insider information and you were able to trade on it. Now the SEC is saying, no, you can't do that. I was at the SEC at that time; that was an enormous blow to corporate America. As a matter of fact in those days, there were some people who were directors of dozens of companies. Obviously, directors of dozens of companies can't devote sufficient time as a director to a particular company, so many times one thought the reason they were in so many companies was simply to get inside information and to make trading profits. That was a bombshell of a case.

The facts of that case are really quite interesting. Texas Gulf Sulphur, which was a mineral company, made a tremendous ore strike in Timmons, Ontario, a rural area up in Canada, and it wanted to keep secret that strike, understandably, because it wanted to go to the farmers in the immediate area of the strike and buy up more land. Of course, if it revealed the ore strike, the price of the adjoining land would zoom up in value. There was a legitimate business purpose to keep that secret, but many of the executives of Texas Gulf Sulphur bought stock knowing that eventually when the information would come out, the price of the stock would zoom up, which it did, and tipped others who also bought stock. The SEC brought action against all of these people in District Court. It was a novel case; it was tried by Frank Kennamer. In those days, there was not yet a Division of Enforcement, and the SEC's General Counsel's Office generally handled the trials of major cases.

KD: Did you know Frank Kennamer?

PG: Oh, very well. He was called the old gray fox. He was an older man; I suppose today I'm an older man but in those days I was a young man, so anybody with gray hair was an old man to me. He was a very fine trial lawyer and tried the case successfully and won it. The court held that there was a violation of the securities laws. The case then went to the 2nd Circuit on appeal. That's the Federal Appeals Court in New York City which affirmed in a very important opinion. The court there said that to the extent possible people in the market should have relatively equal access to the same information. This became known as the Equal Access Theory, and I'll get to this later. At some later point, the Supreme Court rejected it in favor of looking for fiduciary duties which you had mentioned a moment ago. But this relatively equal access of participants to information in the market was one of the landmarks of the *Texas Gulf Sulphur* decision in the 2nd Circuit. The 2nd Circuit also developed what became known as the Disclose or Abstain Rule, that is, that if you have this kind of information, you have to disclose it so that the other side of the trade in the market will have the same information you have that—this goes back to this relatively Equal Access Theory—or if you don't disclose or you cannot disclose it, then you have to abstain, that is, you cannot trade. Because many companies have business policies which prevent officials from disclosing business information, the Disclose or Abstain Rule really meant an Abstain Rule in *Texas Gulf Sulphur*.

Let me just go back if I can to give some sort of a general background so that when we get to some of the specific cases I think they will be perhaps better understood. There is a famous Supreme Court case that says that there is no such thing as Federal Common Law. This is a case called *Erie v. Tompkins* in 1938 and by that it means that in England, prior to this country becoming a nation, there was a system of common law where courts would develop the law case-by-case-by-case -- that's true in State Courts today where State Courts inherited that traditional British system. But the Federal Courts under the U.S. Constitution have only such jurisdiction as Congress gives them, so they're not supposed to develop case-by-case although up to 1938 they certainly did. Maybe I'm being a purist, but really an insider trading case is a statutory interpretation. The courts are construing the words manipulative and deceptive in connection with the purchase and sale of the security under Section 10(b) and Rule 10b-5 and materiality--it has to be material, it has to be non-public, those are the words that the courts are construing but they are nonetheless construing it case-by-case.

There are several theories which I'll get to in a minute. If you have a system of developing something on a non-statutory basis, you have to have some theory of law for it, because the statute doesn't give you a principle. And when one realizes that the SEC was created in 1934 and the statute that we're talking about is an act promulgated in 1934, these developments don't occur until the '60s. So for the first 30 years there was not really an insider trading program of the kind that we're talking about. So one might say, why did it take 30 years to develop, or why did it develop at all when it had not developed before? My own view is that it is a cultural phenomenon--society reaches a point where it starts to believe that there is a fundamental unfairness for some people who are in the know and who have access to insider information and trade on it when others in the market don't have that information. I think that there was a feeling that there had to be some kind of development of the law that would deal with that phenomenon. You wouldn't play poker in a rigged game because you'd know that the cards were stacked against you, and I guess it's a little bit like that

KD: While we're talking about antecedents, can you talk a little bit about the 1934 Act and another section that dealt specifically with insiders, people who owned 10 percent of a company?

PG: That's a very good question. That's Section 16(b) of the 1934 Act and that was one of the original sections in the 1934 Act and that section is a crude rule of thumb. It says that any person who is an officer or a director of a public company or has 10 percent or more of the stock of that company, if that person buys and sells or sells and buys within a six-month period, then the person is liable to a forfeiture or paying back the profits on that transaction. The SEC is given no role in that other than making rules, but the process by which the profit would be recaptured for the company is given to the company itself in another section. There have been many lawsuits seeking to recapture those trading profits.

Over the years, the SEC has promulgated very elaborate rules on how the section works and when it works. The Supreme Court decided a number of cases which construed the section very narrowly. What I call the rule of thumb is probably as crude as a thumb because it doesn't presuppose --you don't have to show fraud or you don't have any illegality--indeed the section does not make this conduct illegal; it simply provides a mechanism for recovery of the profits. There are very famous state court cases, which in effect do the same thing. They say that under state fiduciary duty law, corporations can recover trading profits from insiders who trade very similarly to this.

KD: Why wouldn't 16(b) have been appropriate to a case like *Texas Gulf Sulphur*?

PG: I guess 16(b) probably would have applied, assuming that they bought and sold within a six-month period, but it has its limitations in that it doesn't make the conduct unlawful, whereas Section 10(b) starts with it shall be unlawful to etcetera, etcetera, etcetera. So when one seeks to then impose other sanctions for insider trading, one has to go to a different kind of theory and there are a lot of draconian results or sanctions as a result of insider trading. Maybe I'm jumping ahead, but in addition to giving the money back which is called disgorgement, there is also a statute called the Insider Trading Sanctions Act that allows the SEC to request up to three times the profit obtained or the loss avoided as a penalty, and courts often do impose that. The reason for that statute was that it was felt that simply if we catch you with your hands in the cookie jar, you got to put the cookies back is not enough of a deterrent, so this up to three times penalty was considered an additional deterrent.

Also as we'll talk, many of these cases were brought as criminal cases because there is another statute, Section 32 of the 1934 Act, which criminalizes most of the conduct which is illegal under the '34 Act. If you can meet the criminalized standards, which are a higher degree of intent and seriousness, the case can be brought into criminal court and indeed of the four cases that went to the Supreme Court -- *Chiarella*, *Dirks*, *Carpenter* and *O'Hagan* -- three of them were criminal cases. Of the 45 or 50 cases a year that the SEC brings in the insider trading program, my guess is about 10 percent of those are criminal cases. The blockbuster cases tended to be brought in a criminal forum and in addition there could be a civil injunction against future violations. If the injunction is against a person, maybe a corporate director or a lawyer, it can have severe collateral consequences; one is enjoined for illegal conduct. An officer or director could be barred; a person can be barred from ever being an officer or director of a company again, so there's a lot of consequences that can ensue as a result of bringing insider trading as a species of fraud as distinguished from 16(b), which, as I say, merely allows the company to sue to recapture the trading profits.

KD: The question becomes how to define that fraud?

PG: It does, yes; that's really a question of definition. I would have to say that the SEC has been aggressive in developing these theories and pushing the envelope, as the cliché goes, in case-by-case-by-case broadening the reach of its insider trading program, which gets me back again to the criminal cases that I mentioned. The American Bar Association had a committee some years ago that was critical of the SEC bringing leading edge theory cases in the criminal forum. There is nothing wrong, legally speaking; the SEC certainly could do that if it wished or U.S. Attorneys could, but it was felt that as a matter of policy, if you were going to test a new theory, that new theory should be tested in a civil case where if the person loses, the person may have to give money back or pay a penalty, but not in a criminal case, where if the person loses, he may have to go to jail. This was the question posed on fairness. The SEC however has continued to bring many of these cases in a criminal forum and in more recent years has stepped up its criminal enforcement as you probably are aware--not only insider trading but in other areas of the law. So undeterred, they're still bringing leading edge cases in the criminal context.

KD: Can we move into some of those cases that you mentioned, starting with *Chiarella*? You would have gone into the Solicitor's position in time to have handled that.

PG: Yes.

KD: You were dealing at this point with Equal Access Theory coming into the appellate process on *Chiarella*.

PG: Right. The *Chiarella* case was the first insider case to reach the Supreme Court and it has an interesting history. The SEC had brought a bunch of cases against financial printers in the late 1970s. Some people in printing companies who were setting type--they were called mark-up men--that was the day of actual typesetting and they were preparing documents that were going to be filed with the SEC, like tender offer documents within a matter of a day or two. These printing companies took special pains to make sure that the information was kept secret. They would have signs all over the buildings; they would have signs on the pay slips that they would give to their people. I think that for the most part the names of the companies which were targets of these takeovers were coded or omitted, so that one would not know when one was typing who the company was.

The SEC brought a number of cases against financial printers and settled every one of those including *Chiarella*. Chiarella then was working for Pandick Press, a financial printer. Chiarella set type and he was a pretty savvy guy and was able, by reading the document in its entirety and his knowledge of the market generally, to be able to tell the name of these companies even though the company's name was not included in the material. He bought shares in the companies which were takeover targets shortly before these documents were filed and the takeovers made public, and then afterwards the price of the target stock would rise, and he would sell and make a profit. He made around $30,000 and he paid that money back in a civil settlement to the SEC.

Unbeknownst to the SEC, an Assistant U.S. Attorney in the Southern District of New York heard about or read about this case and obtained a criminal indictment and prosecuted Chiarella to a conviction. At least, this was unbeknownst to me and I think unbeknownst to SEC people. The case then went to the 2nd Circuit on appeal and by that time, I became aware of the case. The 2nd Circuit affirmed the case essentially on an Equal Access Theory, and said that Chiarella was in the center of the business. The case talked about the relatively Equal Access Theory of *Texas Gulf Sulphur* and some of the other cases that had occurred at that time, and on that theory affirmed the conviction of Chiarella. The 2nd Circuit also talked about a theory which later became known as the Misappropriation Theory--that is, he had stolen the information or misappropriated the information that was entrusted to his employers for this specific secret purpose.

We have to also understand that as we talk about the *Chiarella* case, this is what's called a silence case as distinguished from a misstatement case, so when we talk about Section 10(b), Rule 10b-5 or fraud generally there are two kinds: one is an affirmative misrepresentation or a misstatement; and another species of fraud, which is you don't say anything at all. If you don't say anything at all and you know something and the other guy you're doing business with doesn't know that something, have you cheated him--is that a fraud? Here we get back to the common law of England which came down to the United States. There was a doctrine called Caveat Emptor, which meant let the buyer beware. Generally speaking, there was no duty to speak; if you had some information, there was no obligation for you to tell the other guy when you were negotiating with him. Now there were some exceptions. Let's say you had stolen the information and the other person couldn't get that information by diligence or by industry; he'd have to steal it too. Perhaps under that circumstance, you'd have to tell him.

This background of common law influences the *Chiarella* decision because where there is no statute saying what the duties are or what the definition of insider trading is, you have to look to some source to find whether there's some obligation to speak. This was referred to in the common law as the tort of deceit. There is a very illustrious group in the United States called the American Law Institute which has many books in which they restate the law as they call it. There's a restatement of the law of torts that deals with the law of deceit and if you look in there you'll see all kinds of examples of these so-called silence cases which came out of the common law. But those were almost always cases where there were face-to-face dealings. Here, we were dealing in an impersonal stock market so there was no inducement on the other side to come in. Some of these fraud cases, if they're misrepresentation cases, are where one person induces the other to trade based on a false statement. But in *Chiarella*, all these people were coming into the stock market based on nothing Chiarella was doing to them. They were coming in to sell stock to pay their kids' college tuition or take a vacation or buy a house. So the notion that there was some relationship between Chiarella's trade and their trades is really absent in the sense that there's no inducement.

So then the question arises: what is the theory under which Chiarella should be liable for insider trading in an impersonal stock market transaction? The Supreme Court rejected the Equal Access Theory that the 2nd Circuit used, and said there is no theory of law that would provide equal access to information under fraud.

KD: And you argued this case?

PG: No, I did not. This case was a criminal case and was argued by Steve Shapiro. Criminal cases were in those days and still today argued by either the Solicitor General or the senior people in the Solicitor General's Office; Steve Shapiro argued the case but I assisted him and oversaw the writing of the brief for the United States.

KD: Was your brief based on this Equal Access Theory?

PG: Our brief was based generally on two theories. One was the Equal Access Theory which was the theory under which Chiarella was convicted. There was a second theory as I mentioned a moment ago in the Court of Appeals decision that became known as the Misappropriation Theory. This Misappropriation Theory said that if somebody steals information or takes information to which he's been entrusted and then trades on it, then he breaches his duty to the source of the information. Now here's where we get into sort of complications of the theories; before I continue on *Chiarella* let me back up into what's called the classical theory of insider trading.

Do you remember years ago there used to be something called Classic Coke? They had a new Coke and the new Coke bombed and then they decided to call the old Coke Classic Coke.

KD: Right.

PG: So the first theory was never called the classic theory until there was a second theory and the first theory was simply *the* theory of insider trading. The theory of insider trading as exemplified in the *Cady, Roberts* SEC opinion and the Texas *Gulf Sulphur* 2nd Circuit opinion was essentially that officers and directors of corporations have fiduciary duties not

to disadvantage their shareholders. This comes from common law and state law. That theory applies certainly when the insider is trading with the shareholder; when the insider is buying stock on the stock market, necessarily he's buying from a shareholder. The theory loses substance when the insider is selling, because when an insider sells on bad news, the person he sells to is not a shareholder but he becomes a shareholder by virtue of that transaction. There was another case in the 2nd Circuit, a very famous case by Judge Learned Hand, that applied that same doctrine to insiders when they sell as when they buy and made it equivalent, so there grew up this doctrine of fiduciary duty not to disadvantage shareholders or would-be shareholders in transactions. That theory first was used with regard to officers and directors who had well-established fiduciary duties. Eventually the SEC extended that theory to anybody in the company on the theory that they were insiders of the company.

So, when the trade was made without disclosing the information the insider had, that of course was a violation of the fiduciary duty because you were then disadvantaging the shareholder by not putting that person on the same informational plane that you were on. That was the theory later called the Classical Theory and that theory was pretty good. It reached most of the cases because most cases were cases where officials were trading in their own stock, and that made sense.

Then there came a time when takeovers became very prominent in this country. This led to a law called the Williams Act in 1968, which was amended in 1970. The act gave the SEC authority to regulate tender offers and to pass rules governing their regulation. Around the same time, standardized options trading started to become okay in the U.S. Years earlier, if you wanted to buy options and stock, you had to go to something called a put and call dealer and get an option but there was no formal standardized options sold out of exchanges. The Chicago Board Options Exchange, the CBOE, came into being around that time and very gradually other exchanges started to deal in options, so it became possible to control a large amount of stock with only a small dollar investment. The margin requirements in this country for years have been 50-percent, so if you want to buy $10,000 worth of stock you have to put down $5,000, but if you buy options on those stocks and you're thinking the stocks are going to do well, you can buy an option and pay a premium for a much lower amount.

KD: Right.

PG: So the marriage or fortuitous combination of people who started to know about upcoming tender offers and who were then able to buy options on the stock of the target company fueled a tremendous boom**,** if you want to put it that way, in insider trading. But the Classical Theory which says that the fiduciary officer and director can't trade in his own company stock wouldn't apply because you weren't trading in your company stock; you were trading in a target company stock with whom you had no relationship at all.

So the Misappropriation Theory was a device that said if you were working in a brokerage firm and handling mergers and acquisitions and you got some information about upcoming tender offers and you traded yourself or you passed it on to cronies and they traded, you were entrusted with information and you had misappropriated that information. That theory was developed to try to reach that kind of phenomenon. There were arbitrageurs like the famous Ivan Boesky who would want to know tips about these upcoming tender offers, because it would be to the advantage of the prospective bidder to put stock in friendly hands, because at some point he's going to make an offer. The arbitrageur would want to be in

that position because the tender offer price would almost always be higher than the market price and the profit was pretty well assured.

So the symbiotic relationship led to many examples of persons who were tipping and trading. Two things developed: one was the creation of the Misappropriation Theory, and the other was a rule that the SEC promulgated, Rule 14(e)3, under the Williams Act. Section 14(e) is an anti-fraud section similar to 10(b) except it relates to tender offers only. There was a provision added in 1970 that allows the SEC to not only to define fraud in tender offers but also to prevent fraud from occurring,

The SEC promulgated a rule under Section 14(e), which was called 14-3, in which it said that if a person obtains information about an upcoming tender offer from a source connected either with the bidder or the target and then trades on it, then that person violates that rule. There was an exception for the bidder himself who of course can buy stock and is not obviously subject to that rule but it was intended to prevent warehousing, where stock was tipped and then put in friendly hands while the tender offer was going on.

KD: So misappropriation came about before *Chiarella*?

PG: The theory was being sort of nosed around before *Chiarella*--

KD: That's interesting.

PG: --and it was pursued. In the majority opinion, the Court said that Chiarella was not an insider; that is under the traditional theory he wasn't an officer or director of the company; he was a stranger to those companies; he owed no duty to anybody in the marketplace to tell them about it and consequently he didn't violate the law. The government in its brief had pushed hard this Misappropriation Theory. Justice Powell, writing for the majority, said we can't reach the Misappropriation Theory because the Misappropriation Theory in this criminal case was not presented to the jury. And we can only reach theories that were presented to the jury. I digress to give a little lecture on appellate procedure: in criminal cases, which must be tried under a beyond a reasonable doubt standard of proof, there's no such thing as a directed verdict--that is the Court can't say to the jury you have to find for the government or find for the defendant when there is a conviction and the conviction goes up on appeal. The Court can only look at the jury instructions; what was the theory under which the government prosecuted? In this case, the government had not prosecuted under the Misappropriation Theory and so the Court said—well the majority said--we're not going to overrule this case.

But interestingly, there were a number of dissenting and concurring opinions that said, I think the theory is pretty good. Justice Stevens concurred in the view that there was no liability but he thought the Misappropriation Theory had some merit to it. Justice Brennan concurred only on the inadequate jury charge, but he too thought that the Misappropriation Theory had some merit. Chief Justice Burger at that time dissented; he thought in fact it had been well presented to the jury but he said that when a person trades on the basis of undisclosed information "obtained not by superior experience, foresight, or industry, but by some unlawful means then he does have an obligation to tell the other side of the trade," and he also had a theory that there was a duty to the marketplace which was never subsequently adopted by any other Court. And Justice Blackman, joined by Justice Marshall dissented; they would have affirmed the case on the theory that was presented and they too thought that the Misappropriation Theory wasn't a very bad theory at all. So here

you had four or what I would call four and a half concurring or dissenting opinions giving some validity to this theory even though the Court doesn't accept it. It's one of these kinds of cases where the SEC or the government loses; on the other hand you get a win indirectly because the Court suggests that this theory has some validity.

The next case that's brought is *U.S. v. Newman,* which is in the 2nd Circuit. Newman is a stockbroker and he has friends who are with several big investment bankers and these investment bankers are tipping Newman about upcoming tender offers.

KD: Just looking at *Chiarella*, you were working with Steve Shapiro who was arguing this case; and you argued it in front of the Supreme Court and then you got this message from the Court. At this point did you actually sit down and look through everything and say "aha, they want us to go here," or "this is an opportunity--misappropriation is an opportunity?"

PG: Absolutely. As a matter of fact at that time, there was a young lawyer named Donald Langevoort who is working in the General Counsel's Office and we dispatched him to New York to work with the United States Attorney in drafting an indictment based on this theory in what later became the *Newman* case. It was a very carefully orchestrated effort to capitalize on this.

KD: So the *Newman* case didn't just happen?

PG: No, no, the *Newman* case was created in the wake of the *Chiarella* case. As a matter of fact, Langevoort since that time became a very famous law professor and now is at Georgetown Law School; he is the author of probably the best known treatise on insider trading; I have it in my office. His early start was helping the United States in New York draft the indictment in the *Newman* case so it would past muster because we knew that would be the first big test case out of the box after *Chiarella*, which indeed it was.

KD: So now the SEC at this point then is actually working with Justice--

PG: The Justice Department --the prosecutor in New York.

KD: --to bring just the right charges.

PG: Right, and the right kind of a case of course. This was a good case; two fellows from different brokerage firms were in effect stealing information from their brokerage firms about upcoming tender offers and passing it onto a cadre of people. Newman was the stockbroker in the case. They were buying stock and then selling it after the tender offerings were announced and making a profit. Judge Haight, of the Southern District dismissed the indictment as a matter of law. He said it was insufficient and the 2nd Circuit reinstated it and said, this is our day; the Supreme Court left open the question of misappropriation and now we reach it for the very first time and we hold that it is a good theory and on that basis Mr. Newman can be prosecuted. He then was prosecuted and he was sent to jail. He did appeal to the Supreme Court, but the Supreme Court denied cert and did not take his case.

Later when Dirks was argued, Newman and his lawyer were in the audience listening to the argument.

KD: Why would the Supreme Court have denied it?

PG: Probably because the issue wasn't "well percolated." We opposed the cert in Newman as we do in all cases generally in which we won below--we again being the Government. And generally speaking, it isn't always true, but sometimes when a new theory is developed, the Supreme Court would like to have a number of lower Federal Appeals Courts deal with it and sometimes they use the phrase percolation, like coffee percolates, in the lower courts before it's ripe for review. My guess is that's why. Newman was also convicted for mail fraud and wire fraud as well as for securities fraud. It's very hard to go to the Supreme Court and test a securities fraud case when you have a mail fraud conviction which is hard to overturn, so as a practical matter, the Supreme Court--I'm guessing now; it's just speculation--might say "well why should we take a case and maybe reverse the securities part of it when there's a mail fraud part of it" and the guy is going to go to jail anyway. So maybe that was part of it; I don't know. I'm just guessing at that.

KD: So misappropriation worked itself through the Circuit Courts and I guess at this point are you the Solicitor for the SEC?

PG: Yes, I was Solicitor for the SEC at that point.

KD: What was your most notable case coming in early at this point?

PG: There were so many of them it's hard to say. There were a number of cases that were brought again on the Misappropriation Theory. In other Courts there was *Clark* in the 9th Circuit that I argued. I'm trying to remember the name of the case in the 7th Circuit that Jacob Stillman argued but I had worked on with him, which were all varieties of the same thing. We were trying to establish in other Circuits the Misappropriation Theory and indeed we did. In the 7th Circuit case, the person had worked for a large investment bank and then was fired or left, but he managed to persuade the personnel department to allow him to keep his access card to the building. He would come in in the dead of night by using his access card and he'd rifle through everybody's inbox to try to get information about upcoming deals, and then he would trade on these deals. I guess he was pretty smart in some respects but wasn't smart enough to realize that he was leaving an electronic record every time he pushed his card in; it recorded the fact that he had come into the building. So it wasn't very hard to catch him and the 7th Circuit adopted the Misappropriation Theory. *Clark* was a case that I had argued where the Court also adopted in the 9th Circuit-- the Appeals Court for the West Coast of the United States --they adopted the Misappropriation Theory. In that case the SEC had also sued the broker who was a tippee of the insider and the broker was found not to have violated the law and was exonerated by the jury in that case, although the insider was not. We had asked that the insider pay back the broker's profits and he said, why should I pay the broker's profits when the jury found the broker didn't violate the law? But the Court said you've got to pay it anyway and the 9th Circuit affirmed that. So it was a pretty vigorous program. We were attempting to establish Misappropriation Theory elsewhere and these were some of the cases that went to the Appeals Courts but there were many cases in Lower Courts that were brought--many of them were settled under the same theory. The very famous cases against Siegel, Levine, Ivan Boesky, Michael Milken--these cases were all based on the Misappropriation Theory so the Misappropriation Theory became a very important theory in which to proceed on the SEC's insider trader program.

KD: While we're talking about tippees, were you involved with the *Dirks* case?

PG: Yes, I was. *Dirks* was decided in 1983. *Dirks* was really a very interesting case. I had argued that case to the Supreme Court and *The New York Times* wrote a big article about the oral argument and started by saying it was great theater--which it was; it was a really interesting case. Dirks was a very well known analyst in the insurance industry. There was a company called Equity Funding Corporation of America which was a darling of Wall Street, a high-flying company that was very successful selling a combination of life insurance and mutual funds. A former mid-level executive of Equity Funding came to Dirks and said to Dirks that this entire operation is a fraud. This was inherently unbelievable; it would be like somebody coming to an analyst who follows automobile companies and saying Chrysler doesn't put engines in their automobiles; they use big rubber bands. I would have thrown the guy out of my office if he had come to see me and tell me that. But Dirks, being sort of a tenacious guy, a little idiosyncratic guy, decides to investigate so, on his own time and expense, he goes to Los Angeles where Equity Funding is located and he interviews people and makes an investigation and he concludes that this guy – Secrist -- was right. The thing is a giant fraud. As a matter of fact, in the dead of night, Equity Funding would have what they called parties where they would create fictitious people that they would issue insurance policies on and occasionally they would kill off these fictitious people and collect on the proceeds and they would even reinsure by selling these policies which were completely phony to reinsurance companies and getting some part of the premiums for it.

KD: Getting back to the tippee a minute ago?

PG: Yes.

KD: You said his last name. Who was that--Secrist?

PG: Secrist was the tipper. He was the former mid-level executive from Equity Funding who spilled the beans.

KD: Do you remember the first name?

PG: I don't remember it; but I have the opinion here and I could probably find it. I don't know his first name.

KD: That's okay; I can get that.

PG: To some extent, Dirks was a folk hero. The SEC earlier had taken a look at the company on some tip that something was wrong and didn't find anything. And even during that time when Dirks was now persuaded that it was a fraud, Dirks went to the Los Angeles office of *The Wall Street Journal* and urged them write a story exposing the fraud. He spoke to a reporter who was very interested in it but felt that it was too much of a risk for the *Journal* to do this because they would expose themselves to libel laws--unless they had a more solid basis. So the *Journal* started to make its own investigation; they did write a tremendous story and the guy who wrote it, I think, was nominated for the Pulitzer Prize. But in any event, while Dirks is doing this, he has clients who hold Equity Funding securities; now he knows that the whole thing is a huge fraud and at some point that's going to be exposed and he's trying to expose it but he's not successful doing it. So he tells his clients that they better get rid of their securities because when this all comes out the securities are going to hit the floor and they do, and I forgot the figure now but there were quite a few million dollars worth of securities that were then sold. When this all becomes known, the SEC

immediately steps in and the company goes into receivership and a lot of these officials go to jail. The question is, well what do we do with Dirks because Dirks is both a hero in the sense that he exposes the fraud and on the other hand he tips his clients to get out of their securities before everything is known. So the SEC agonizes over what to do about it.

KD: Tell me about that process. Are you sitting in meetings talking back and forth and taking different positions?

PG: The SEC's New York Office was the one that investigated this and the head of that Office was a fellow named Donald Malawsky and the guy who was actually working the case was Roger Dietz. They finally came with a recommendation to the SEC Commissioners that the SEC Commissioners bring an administrative proceeding--an in-house proceeding against Dirks, who of course is a registered stockbroker or associated with a stockbroker, to sanction him for insider trading. The Commissioners of course are agonizing about this--well should we do it or shouldn't we do it because this is a guy who exposed the fraud? On the other hand he probably shouldn't have done what he did which was to tip off his clients. So they finally agreed to go ahead with the proceeding but they imposed the least possible sanction which is a reprimand--that is they don't throw him out of the business, they don't suspend him, they don't fine him; they simply put a bad letter in his file. Now Dirks is a man of great self-esteem and wants to vindicate his name even with just a reprimand. He appeals to the Court of Appeals in the District of Columbia Circuit and the DC Circuit comes out with this very unusual kind of opinion in which they affirm the SEC, but they do it in a very odd way. Judge Wright I recall later writes an opinion in which no one else joins and then another judge concurs but does not write an opinion and a third judge dissents but does not write an opinion dissenting. So you have the one judge's opinion and another judge agreeing or concurring making it two to one affirming. Then Dirks appeals to the Supreme Court. The SEC opposes it but the Supreme Court then takes the case. The case goes to the Supreme Court and the SEC's theory is a pretty simple theory which went something like this: Secrist himself obviously was an insider; Secrist could not himself have sold Equity Funding securities; he would have violated what you'd call the Classical Theory, right?

KD: Right.

PG: He would have disadvantaged whoever was on the other side of the trade. So the SEC said that when he tipped Dirks, Dirks stood in his shoes or putting it another way, Dirks inherited his disability so whatever disability Secrist has he conveys it to whoever he tips. The Supreme Court rejected that line of argument; the Supreme Court said that Secrist was trying to expose the fraud. He wasn't doing anything wrong and that tippee liability is derivative; that is a tippee is liable only if the tipper is liable, so you have to look to see whether the tipper has done something wrong. If the tipper is getting paid by the tippee for the information or is getting a quid pro quo, some monetary benefit why yes he's probably done something wrong, or if the tipper is getting some reputational benefits or some benefit even if by giving information to a friend that might be considered a benefit to the tipper. What grew out of that was a so-called Benefits Test. There could not be tippee liability unless you could show that the tipper somehow benefits from the tip in some way. Some are obvious--if he gets paid or if there is a financial quid pro quo there certainly is a benefit but there can also be so-called intangible benefits that could result from that. So the *Dirks* case was very interesting in the sense that it resulted in this rejection of an Equal Access Theory; the Court refers to its opinion in *Chiarella* and again rejects the notion of Equal Access. The case is also notable because there was a disagreement with the Solicitor

General in this case. In every Court except the Supreme Court, the SEC goes to Court with its own lawyers and does not need the approval of the Solicitor General or anybody else in the Government. However, when the case is in the Supreme Court, the SEC does need the approval of the Solicitor General. Rex Lee, the Solicitor General, took the position that there should be an encouragement of what he called private law enforcement--that is, the kind of activity that Dirks did should be encouraged and not discouraged. And so he disagreed with the SEC's conclusion that Dirks should be penalized. Then there was some disagreement between myself and the Solicitor General. The Solicitor General had indicated that he was not going to let the SEC file a brief in this case because he disagreed with its position. I said that the SEC is an independent agency which has a very strong view about insider trading and it ought to be able to present its views to the Supreme Court without the administration stultifying that or preventing that. I said that if he would not permit it, he has to endorse the brief, on the bottom saying I approve the filing of this brief; if he would not do that the SEC would consider the possibility of filing a brief directly with the Supreme Court. He said, if that would happen the Clerk of the Court would not accept it because he would look to see whether I had approved it and he would see no endorsement that approves it. I then said, if the Clerk would not accept it we would then consider bringing a common law mandamus petition to the nine Justices which is an old common law writ which asks the Court to direct a Clerk to perform a ministerial act like accepting a document for filing--that would then raise the question as to whether the SEC is an independent agency and would have the right to bring its views to the Supreme Court. On reflection at some point, Solicitor General Rex Lee decided to let the SEC file the brief; I guess he didn't want to go through that test and did endorse it but he endorsed it in a way which made clear his disagreement when we filed the brief. When the SEC filed the brief he said on the brief I authorized the filing of this brief but see brief for the United States as Amicus Curiae in support of reversal filed December 30, 1982 and then he filed a brief on behalf of the United States in which he disagreed with the SEC's view in the Supreme Court.

The Court decided the case as I say on this different benefit theory--not on the Solicitor General's theory which it didn't pay any attention to one way or the other. It's also interesting that when the case came down, just like the *Chiarella* case, it had some very good language and some concurring opinions about the Misappropriation Theory. The old cliché about how the SEC then made lemonade out of lemons; there was a similar thing happening in *Dirks*. In *Dirks* there was Footnote 14. Footnote 14 said essentially that under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, attorney or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The theory was that they would become what we would call temporary insiders and the analysis would then not be that they would be tippees like Dirks was a tippee; they would be tippers. They would be equivalent to corporate officials. So this temporary Insider Theory which then lets the SEC now reach underwriters--that is stockbrokers, accountants, lawyers, and consultants -- was a very important breakthrough along the way even though the case was lost on the merits largely. This was, the SEC thought, a very helpful footnote. I was doing a lot of speaking at that time and of course including insider trading. After the case came down I had a debate before an American Bar Association group with Milton Freeman. Milton Freeman was a senior partner at Arnold & Porter. R. David Bonderman from Arnold & Porter had argued the case and that law firm was very interested in the case. I remember that I emphasized that Footnote 14 was very important to the SEC's enforcement program. Milt Freeman said the trouble with SEC lawyers is that they never know when they've lost a case because they always are reading the footnotes instead of the text.

I had a second debate with him maybe a week or two later before another group also about the *Dirks* case which then was quite fresh. He referred to the previous statement that he had made about Gonson not knowing that he had lost a case because he always reads the footnotes instead of the text. He says, now I have documentary evidence. and he waves a piece of paper in the air that this is uniform among SEC lawyers -- a letter from Theodore Levine. The letter said something like this: "Dear Milt, I received your outline of the *Dirks* opinion for use in the program in San Diego but I looked in the footnotes and I didn't see in the footnote any statement that your firm had represented Dirks. Don't you think it's only fair that you would say in a footnote that your firm had represented Dirks in the Supreme Court?" I wrote back to him and said: "Dear Ted, the reason that we didn't put in a footnote is because we said so in the text. And if you would have read the text you would have seen it. The trouble with the SEC lawyer is you never read the text; you're always reading the footnotes."

KD: Did you initiate a process similar to what happened then after *Chiarella* where you started looking around for another case that would advance the program?

PG: The answer is yes and we did bring some cases and the SEC came out with a rule called Regulation FD which to some extent dealt with it. But the process was a much longer process than the filing of the *Newman* case in New York fairly shortly after the *Chiarella* decision because in the *Dirks* opinion the Court emphasized the value that analysts bring to the securities markets. There got to be quite a discussion at the SEC and some difficulty in conceptualizing ways in which the SEC could bring lawsuits against analysts. The SEC brought many lawsuits against tippees and those were not a problem. One of the most interesting to me anyway was the case against Paul Thayer. Paul Thayer was, I think, Deputy Secretary of Defense and the SEC was investigating him for insider trading. He had an affair with a young aerobics instructor; there was another fellow who was a stockbroker in the case who also was having some relationship with another young aerobics instructor, and Thayer apparently had been giving stock tips to his friend the aerobics instructor. Trying to use the theory of the *Dirks* benefits test to the tipper, we had to formulate in a way that was not too salacious, what the benefit to Thayer was as a result of his giving the stock tips to this tippee. I was involved. I ordinarily was not involved in drafting District Court complaints but I was involved in this case at the request of the then head of Enforcement, John Fedders, because of my involvement in *Dirks*. I would try to work on a language that would be felicitous and I think we came up with something like "close personal relationship" or something like that which was the *Dirks* required benefit to the tipper for the information given to the tippee. That insider trading case eventually attenuated because during the investigation Thayer obstructed justice and eventually went to jail not for insider trading but for obstruction of justice. This is sort of the early Martha Stewart analogy where Martha Stewart went to jail for obstruction of justice and not for insider trading.

But that was an example. There was another example of --well I guess I shouldn't mention his name -- a very well known person on Wall Street, a household name. His wife had gone to a psychiatrist and the wife was revealing information to the psychiatrist that had of course come from her husband and the psychiatrist was then trading and the SEC then sued the psychiatrist. Taxi drivers, policemen, word processors in law firms -- many, many lawsuits were being brought on the theory --all were tippees. But when you came to the analyst community it was very hard to bring actions against analysts.

There were two cases that the SEC did bring. One was *Fox-Pitt Kelton, Inc*. This was 1996; a stockbroker and an analyst received information during an issuer conference call. They are in their brokerage conference room with the speakerphone. Several other salespersons from Fox-Pitt are walking in and out of this room during the time that this conference call is going on. Why the door wasn't bolted shut we don't know and then the salespersons traded in the stock on behalf of the firm's clients before a public disclosure based upon what they overhead as they walked through this conference room. A second Fox-Pitt analyst who overheard the call himself trades in the account and then some senior employees traded in personal accounts. The SEC didn't charge insider trading there but it did charge a violation of the Securities Exchange Act that requires broker/dealers to have in place procedures designed to prevent the use of inside information. As I mentioned there were some statutes that were passed and one of the statutes requires that broker/dealers have procedures to prevent insider trading. And so the theory here wasn't a 10b-5 fraud theory; the theory was you didn't have procedures in place at the brokerage firm to prevent this insider trading.

And there was another case after *Dirks*--1991--called *SEC v. Philip J. Stevens* --this was in the Southern District of New York. At a much earlier time, Stevens who was head of this company had a negative report from an analyst about his company and several years later the company realized it was going to have another disappointing quarter. Before Stevens disclosed this bad information, he made a series of calls to analysts before he informed the market as a whole and two of these analysts then tipped their clients who then dumped their shares before the bad news came out. The benefit that the SEC said that Stevens had obtained by tipping-- to show a benefit to the tipper to protect and enhance his reputation--was trying to create favor with the analysts and that was the benefit to the company. The case was settled so that theory was never tested in court. So these were the sort of the kinds of cases the SEC brought after *Dirks*.

KD: But you're on your way to *O'Hagan* here?

PG: I think we've got to talk about *Carpenter* before we go to *O'Hagan*.

There was an effort in the 1980s in Congress to develop a definition of insider trading. This has to do in a way with the *Dirks* case and the *Carpenter* case, also with the fact that Boesky was quoted in telling some class that greed was good and that greed should be encouraged. That greatly offended John Dingell who then was head of the SEC's Oversight Committee in the House. There was some efforts made over quite a period of time to develop a statutory definition of insider trading.

While this was going on, the Department of Justice with the SEC brought a criminal case against a reporter for *The Wall Street Journal* named F. Foster Winans. Winans wrote a column called *Heard on the Street* which was a column about companies and he would write about companies that seemed to be doing well or companies that weren't seeming to be doing well. *The Wall Street Journal* has this enormous circulation around the country and many people who read that column will sometimes buy stock of companies that are reported favorably or sell short companies that are reported unfavorably. Winans had, with a group of people including stockbrokers, set up a scheme where he would leak in advance to these people what he was going to write about in his columns; if he was going to write something good about a company, those people then would buy shares in that company and then after the article came out, the buying pressure of the people who read that article would raise the price of the stock and these people would make a lot of money. The Government

brought a criminal case against Winans and others, including Carpenter, Winans's roommate. When the case goes to the Supreme Court, it's called *Carpenter* but we always referred to it as the Winans case. In the District Court, Winans gets convicted and the case goes to the 2nd Circuit and the 2nd Circuit affirms the conviction. The Supreme Court grants certiorari in Winans.

The case is captioned *Carpenter v. U.S.* in the Supreme Court. The rules provide that in the lower courts the name of the person who brings the lawsuit goes first in the caption of the case, and the rules also say that when a case goes up on appeal then the Court of Appeals has to keep the same caption that was in the District Court. The Supreme Court has its own rules; the Supreme Court says that the party that petitions for review goes first. If the Government loses, it would be *United States* versus; that would seem to make sense. But when the Government wins, it's the guy who loses, he goes first. So the case is called *Carpenter v. U.S.* in the Supreme Court. Why the lawyers decided to put Carpenter's name first rather than Winans--it's Carpenter et al which means and others--is beyond me. I don't know but the case is called *Carpenter* in the Supreme Court.

Carpenter goes up to the Supreme Court and the issue that's being raised is that, unlike all these other misappropriation cases, the tipper or the person disadvantaged is not in the securities business. Is a theft from a newspaper actionable as an insider trading violation? Also, I think the Reporters Committee for a Free Press filed a brief as a friend of the Court and said there shouldn't be a conviction here either and you got a little bit of a First Amendment overtone to this case, too. However, Carpenter and Winans and the others were convicted not only of insider trading; they were convicted of mail fraud and wire fraud and so they appeal both sets of convictions. While the case is pending, the Supreme Court comes out with a mail fraud case called *McNally v. United States* in which the Supreme Court rejects the conviction in that case and says that the theory under which United States attorneys or other Federal Officials proceed against judges, governors and other officials for not giving loyal services to their constituents is not reached under the Mail Fraud Statute which speaks only of money and property. You have to take money or property and so Governor Marvin Mandel from Maryland, who had earlier been convicted under that mail fraud section, gets out of jail. So now this Carpenter insider trading case becomes a huge important mail fraud case because it's the next case to go to the Supreme Court on mail fraud after the Court's *McNally* decision. Later on the Congress reversed legislatively the Supreme Court by coming out with a new law called the McNally Act that in effect reinstated the law before the McNally decision but that hadn't happened yet. This is the next case after *McNally* so it becomes sort of an important mail fraud case too and of course the argument is made both in the securities case and the mail fraud case that this isn't property; this is ephemeral, in the air. The Supreme Court splits four to four on the securities count and unanimously affirms the mail fraud count distinguishing *McNally*. So it's sort of a big win for the Government because it puts the mail fraud program back on track but it leaves the securities issue of the Misappropriation Theory up in the air. Under Supreme Court rules, when the Supreme Court is evenly divided, whatever the Lower Court decision was stands because it's not reversed. In this case the Lower Court had of course affirmed the conviction so the securities conviction stands.

I mentioned a moment ago that there was this effort on the Hill to try to get a definition and the Senate was pushing pretty hard on that; Harvey Pitt and Dick Phillips were very active and working with the Senate Committee developing it. The SEC generally did not like the idea of a definition at all because they thought a definition was going to hamstring them, not

help them. But reluctantly under pressure when David Ruder was SEC Chairman—which should be 1987, '89—

KD: It's '87.

PG: Right. The SEC did endorse, in a lukewarm way, one version. But the conventional wisdom around town was that the SEC was going to lose the Winans case in the Supreme Court and it was necessary after that loss to resurrect the program by coming out with a definition. But when the Court split four to four and the SEC did not lose the case but the 2nd Circuit was affirmed, then all the starch and steam went out of the idea of a definition and it never happened. The thing just fell flat; so to this day there's still no definition but that was an interesting period in which that happened.

There's also something which to me as a litigating lawyer that's just very fascinating in the Winans case, and that is when we were doing the briefing in the *O'Hagan* case which I'm going to get to next, we sent a lawyer over to the Library of Congress to look through Justice Marshall's papers. Justice Marshall had died and he had left his papers to the Library of Congress but without any restriction on use. The Supreme Court, particularly at that time under Chief Justice Rehnquist, was somewhat offended because they felt that there should be a long period of time that would elapse between the time that a Justice who passes away leaves papers and those papers become public because there might still be things in those papers that might apply to current matters. But Justice Marshall had not restricted that in his deed of gift to the Library of Congress. So the Library would allow scholars to come in and do research. Adam Pritchard, who was a lawyer at that time in the General Counsel's Office went over to the Library of Congress to rummage through Justice Marshall's papers--for no particular reason --just to see if there was something in there that might be useful to us as we were briefing the *O'Hagan* case. He came upon this remarkable document, where Justice Powell has a draft which he had circulated to other Justices on December 10, 1986 that dissents from the denial of certiorari in *Carpenter*. But in *Carpenter* cert was granted and they took the case, so what does this document mean? Justice Powell's dissent was joined the next day on December 11 by Chief Justice Rehnquist and Justice O'Connor; those three Justices were now dissenting from the denial of cert, but this document was never published and it was in Marshall's file because Justice Powell had circulated this to all the Justices.

Justice Brennan and Justice Scalia then switched their votes and voted to grant certiorari. By voting to grant certiorari, this proposed dissent from the denial of certiorari never saw the light of day. After certiorari is granted, but before the *Carpenter* case gets argued, Justice Powell retires from the Supreme Court and his successor, Justice Anthony Kennedy, was not confirmed until after the argument. So there's this hiatus; there's only eight Justices and Kennedy did not participate in the case. The Court then splits four to four and they issue no opinion nor do they indicate which Justice votes for or votes against, so we don't know how the lineup is. But in *O'Hagan*, we see later that Justice O'Connor and Kennedy voted with the majority to uphold the Misappropriation Theory, so if Kennedy had been confirmed in time and there were nine Justices, its likely he probably would have voted to uphold it in this case, too in which it would have been a five to four and we would have had the law of the land at that point.

Now in Justice Powell's draft dissent, he says a comparison of the Court of Appeals opinion in this case, referring to the Winans or *Carpenter* case--with the Supreme Court's then recent precedents, referring to *Chiarella* and *Dirks*--demonstrates the need for

examination by the Court of the Misappropriation Theory. He talks about the *Dirks* and *Chiarella* cases and he says, in applying these principles to this case, it is difficult to understand how any of the petitioners were guilty of criminal securities fraud. So had he not retired and voted, then there would have been a five to four decision overruling the Misappropriation Theory and if Kennedy had been seated it would have been five to four approving it. So you see how the vagaries of who happens to be on the Court when it splits five to four often depends on that one swing vote.

KD: There's a lot of chance here?

PG: There was. Adam Pritchard then wrote a wonderful article about this and subsequently has written articles on Justice Powell and Justice Powell's role in the Supreme Court.

Before we come to *O'Hagan*, just to finish the *Dirks* epilogue, the SEC in August 2000 adopts Regulation FD which stands for Fair Disclosure; that was designed roughly speaking to legislatively overrule the *Dirks* decision in which it had all the problems, even though as I mentioned in the *Stevens* and *Fox Kelton* cases, it had a lot of difficulty in bringing cases against analysts. So when you had corporate insiders whisper in the ears of analysts before the information became public, the SEC decided to pass a rule to deal with that. When I was at the SEC in my last year there, I started to work a little bit on this rule and it was a rule that was based on 10b-5; but after I left, the thinking obviously switched and they adopted a rule not under Section 10(b) which applies to any person in any security but they adopted it under Section 13 of the Exchange Act which is the section that deals with filing reports with the SEC, so that the reach of the rule isn't any person, any security like the insider trading is based on 10(b); rather it applies only to issuers with securities that are registered and/or who have to file reports with the SEC. I'm not going to go through the detail, but essentially it sets up a system where if an issuer is going to give non-public material information about the company, then it has to also simultaneously find a way to issue that to the stock market. In a sense that's what it does and there are some other aspects which would be very interesting, but that was a way in which the SEC was then dealing with the long-term fallout. After all, *Dirks* was '83 and this rule is 2000, so it took a long, long period of time for the SEC to get its act together.

One other thing I may mention too was there was an episode where there was a big fight with the IRS that I was involved in. The SEC was grabbing the profits from insider trading to try to get them back to the investors who were defrauded and the IRS was trying to grab these profits for unpaid taxes, penalties and interest. Of course, guys like Dennis Levine didn't pay taxes. I think Boesky did; some did and some did not. And the SEC negotiated with the IRS and the Justice Department at great length to try to work out an arrangement, not with much success. There was some litigation in court between the two agencies and there was a case in the 2nd Circuit that I was going to argue and I showed up in New York City at the 2nd Circuit ready to argue against the IRS and the IRS lawyer was there and the presiding Judge of a three-Judge panel said is this true? Are my eyes deceiving me; we have two agencies of the Federal Government that are arguing and they want the Court to decide this? They said, you two guys go out in the lawyers lounge and settle this case. You come back here after we've heard all the arguments this morning and tell us that you settled it and how you settled it. So we go to the lawyers lounge and I call back and he calls back to Washington and we settle it, but there was this tiff that went on for a while. I wrote an article about that--interesting to look at that.

KD: Why did it get to that point?

PG: I don't know. There are inter-agency disagreements about things. The law is pretty clear that the IRS thought that whether the income is legal or illegally earned, it's still income and you have to pay taxes on it, and if you didn't pay taxes on it then of course interest runs on the unpaid taxes and if you intentionally didn't do it penalties run too. So when you start adding the penalties and interest over a period of time you pretty much consume the whole thing. The SEC meanwhile is trying to give the money back to the victims; that's the whole theory of disgorgement—your get the money back and you try to give it back to the victims. You had two blue chip agencies really with different theories--each one made sense and we tried to work out an accommodation which took quite a while to do.

KD: You just needed some judges to help you focus.

PG: Needed some judges to say, go in the backroom and settle this thing.

KD: Let's get to the *O'Hagan* case then.

PG: I had mentioned to you that the 2nd Circuit, the 7th Circuit and the 9th Circuit had all found that the Misappropriation Theory was valid. A number of circuits had also upheld 14(e)3 against challenge as well; this was the Insider Trading Rule and Tender Offers I had mentioned. But there came a time when the 4th Circuit in Richmond, the Appeals Court for the Mid-Atlantic States, disagreed with the Misappropriation Theory. This involved the West Virginia Lottery. The fellow who was running the West Virginia Lottery was supposed to select a company to run the lottery for the state and he knew which company was going to be selected, so he bought stock in that company before the award was given. He then was prosecuted by Federal authorities under mail fraud and under securities fraud--it's a puzzle to me why they had to add securities fraud but they did. He gets convicted; the case goes to the 4th Circuit; the 4th Circuit affirms the mail fraud but reverses on the securities fraud rejecting in a very lengthy scholarly opinion the Misappropriation Theory. The SEC then says to itself, should we appeal this or should we not appeal it? We now have a conflict in Circuits which is one of the bases upon which the Supreme Court will accept a case but the facts weren't really too good. The guy is going to go to jail anyway, and so the SEC and the Justice Department decided not to seek Supreme Court review in that case.

Later, in *O'Hagan*, it happens again; the 8th Circuit which is in St. Louis also rejects the Misappropriation Theory. Now we have two cases; so we have the split of three that have accepted and two that have rejected that theory.

O'Hagan was a fascinating case. O'Hagan was a securities lawyer in the very well known Minneapolis firm of Dorsey & Whitney. He had himself litigated 10b-5 cases and certainly knew the securities law. At that time Dorsey & Whitney was representing a company named Grand Met, which was secretly preparing to make a tender offer bid for Pillsbury. This was kept secret, of course. O'Hagan was not working on this case, but he was a very senior partner in the firm and he was nosing around and he went to the lawyer who was working on it and he got a lot of information about this upcoming tender offer. He then took that information and he bought stock and options on stock in Pillsbury. When the tender offer was announced he made $4,000,000—a lot of money--and it also came out that he had been taking clients' funds. When Justice Blackman was at Dorsey & Whitney, the Mayo Clinic was Blackman's client and now the Mayo Clinic was O'Hagan's client and O'Hagan was taking money from the Mayo Clinic. It was just a very, very bad

scene. O'Hagan gets disbarred and he gets prosecuted criminally by the Federal authorities for insider trading and he gets convicted. His case goes to the 8th Circuit and the 8th Circuit reverses the conviction. They say they don't approve of his conduct, obviously, but they make an analysis and they don't think the Misappropriation Theory is sound. They also reject as invalid Rule 14(e)3; he was also charged under that because there was a tender offering and of course he was violating the rule that says you can't use insider information on a tender offer. He had obtained the information from the source connected with the bidder, which is the law firm. The case goes to the Supreme Court and the Supreme Court reverses the 8th Circuit and reinstates the conviction and upholds the Misappropriation Theory in a very strong opinion. It also upholds the validity of Rule 14(e)3 in a strong opinion. It becomes a very big win for the Government to finally get after *Carpenter* refused to reach it and Congress didn't ever approve it legislatively. Finally, the Supreme Court in the *O'Hagan* case affirms the Misappropriation Theory. It was a case with good facts; I second chaired it. The case was argued by what we call the Criminal Deputy, Michael Dreeben. Criminal Deputy doesn't mean he's a criminal; it means he's a Deputy Solicitor General who handles the criminal cases and he argued the case. He's an old friend of mine and we handled many cases together over the years in the Supreme Court. I sat with him at counsel table.

We had prepared the case elaborately. We had two moot Courts, you know moot Court is where he gives his argument and you ask a million questions, and held three conferences that were not moot Courts and had many late-night phone calls before the oral argument. We tried to anticipate every and any question that might be asked by a Justice during the argument. We also tried to circumscribe or delimit or put a fence around the scope of the argument as to not make it too broad, because if you make it too broad it's hard to sell. The Government argues first and then O'Hagan's lawyer argues and then Dreeben has rebuttal. Dreeben asked me what should he say in rebuttal and the answer was, I don't think you have to say anything because there wasn't one question that was asked that we had not rehearsed the answer to. When you read the transcript of the oral argument, while it's mostly question and answer, every Justice except Justice Thomas asked a question. The oral argument reads seamlessly as if he's anticipating these questions and it doesn't read in a disjointed way; it reads like a coherent argument which he would go back to and then go back to and go back to interweaving answers to his questions. It was a brilliant argument.

KD: When you're doing something like that do you think "well Justice so and so might ask something like this?"

PG: Yes, indeed, we do. We thought we knew what Justice Scalia was going to ask; we thought we knew what Justice O'Connor was going to ask, and we were pretty dead-right; we knew what Chief Justice Rehnquist was going to ask and I can't say we got it all right but we anticipated many of those questions based upon their previous decisions and based upon generally the fact that if you read Supreme Court decisions you see certain trend lines out of these Justices' votes. We were surprised that the case was six to three in favor of the Misappropriation Theory and Chief Justice Rehnquist, Justice Thomas, and Justice Scalia dissented, but Justice Scalia's dissent refers to a doctrine in the criminal law called the Doctrine of Lenity that says that if you have a close question in a criminal case, you give the benefit of that doubt to the criminal Defendant and this is a criminal case. He seemed to be saying we think that if this had been a civil case brought by the SEC rather than a criminal case brought by the Department of Justice he probably would have gone along with it. So while it doesn't make any difference, because the Court in a very strong majority opinion upholds the theory, it adds a little gloss to it because even conservative Justice Scalia is

signaling that in civil SEC cases under this, probably he would go along with it too. He also went along with the validity of Rule 14(e)3. That was seven to two with Scalia then in the majority agreeing on the validity of the rule, so that was a very important win for the SEC because that was the theory upon which these big blockbuster cases in the '80s were brought. If that theory had been undermined by the Supreme Court then, I think the SEC would have had to go to Congress and get a definition because then they would have had no real alternative but to do that. But we didn't have to do that. Today, as I said when we started, if you looked in the law you will find no definition of insider trading and nothing that makes it unlawful. You just have to read the cases.

KD: But are those who want to prosecute on much more solid ground than they once were?

PG: Yes they are. I've been at this law firm for seven and a half years and I tell everybody that I used to, for many years, prosecute stock brokers and now I defend them--still I have to say that the SEC has had a very formidable and successful insider trading program. There is an analogy where private investors can bring lawsuits to recover damages of insider trading. There is a specific section of the Insider Trading Sanctions Act that permits that but limits the recovery to the disgorgement measure which means that the injured investor can only recover that amount which the insider trader gained which might be less than his total amount of damages, so in general while that private lawsuit is permitted, specifically it's not the best kind of lawsuit because of the limitations.

KD: Anything else we haven't talked about?

PG: I guess to say that right now I'm on the outside looking in and so far as I can tell the SEC still continues a pretty vigorous insider trading program. I might observe as an old-timer having lived through this program particularly in the late '70s and '80s that it recycles again, so maybe it's part of the larger lesson of life that younger people don't learn from the abuses of their elders but the same kinds of improprieties that got young investment bankers and other people on Wall Street into trouble are getting them again into trouble, and the SEC is cracking down again the same way it did 20--25 years ago, and so one wonders why people won't learn from the problems that their fathers and mothers had.

KD: Well human nature being what it is I guess there will always be the need for that sort of enforcement.

PG: I guess that's right.

KD: Well thanks very much.