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Note

Insider Trading Regulation of Law Firms: Expanding ITSFEA’s Policy and Procedures Requirement

by

PETER M.O. WONG*

I. Introduction

In the first half of the 1980s, public debate raged over the condition of America’s financial markets. Corporate takeovers dominated the headlines as battles were waged over the fate of major corporations.¹ The increased use of high-risk, high-leverage financing via “junk” bonds² caused uneasiness over whether such financial instruments were safe or appropriate for large transactions like corporate takeovers.³ Many financial analysts and legislators were concerned that the collapse of a major corporation as a result of enormous debt could create a chain reaction

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This Note won the 1992 Albert G. Evans Award in Private Enterprise. The award is given for the best published Note or Article in the area of governmental regulation or private enterprise.


2. The term “junk” bonds refers to bonds issued by companies with low credit ratings. To compensate for such high risk, and to attract investors, these debt instruments usually offer extremely high returns.

3. William Proxmire, What’s Right and Wrong about Hostile Takeovers?, 1988 WIS. L. REV. 353, 358-60. The former Chairman of the Senate Committee on Banking, Housing and Urban Affairs quotes then-SEC Chairman John Shad’s statement that “[t]he greater the leverage, the greater the risk to the company, its shareholders, creditors, officers, employees, suppliers, customers and others . . . . The more leveraged takeovers today, the more bankruptcies tomorrow.” Id. at 359 (quoting John Shad, The Leveraging of America, WALL ST. J., June 8, 1984, at 28).
that would cripple the nation's markets.⁴ Others were concerned about
takeovers because they produced huge movements in stock prices as in-
vestors speculated on the latest deals.⁵ Takeover-related stock price
movements created numerous opportunities for individuals with inside
information to "jump the gun" and trade prior to major corporate an-
nouncements, thereby profiting from the subsequent change in price.

As a result of takeover deals, many individuals intimately involved
in the negotiations were privy to confidential, material⁶ corporate infor-
mination. Among these individuals were the traditional corporate "insid-
ers,"⁷ such as a company's officers and directors, and "temporary
insiders"⁸ who acquired inside information through legitimate business
relations, such as members of investment banking firms and law firms
who had been hired as analysts and advisors to the deals.

At the height of the takeover craze large corporate law firms special-
izing in mergers and acquisitions performed legal services for the various
parties involved in these corporate acquisitions. In rendering their serv-
ices, the attorneys and employees of these law firms came into possession
of material, nonpublic information regarding impending corporate take-
overs. Often, this inside information proved lucrative to people willing to
disregard the federal securities laws concerning insider trading.

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⁴. See Securities Markets Oversight and Drexel Burnham Lambert: Hearings Before the
Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce,
100th Cong., 2d Sess. 2-3 (1988) ("The subcommittee is concerned about the liquidity of the
market in junk bonds in the event of an extended economic downturn.").

⁵. See Improper Activities in the Securities Industry: Hearing Before the Senate Comm.
on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 76 (1987). "[T]he substantial
increase in the number of takeovers, including hostile takeovers . . . [has] raised the rewards for
insider trading. The amount of money that you could make substantially increased and it . . .
raised the number of opportunities in which you could trade on inside information . . . " Id.

⁶. The Supreme Court first defined the term "material" in the context of SEC Rule 14a-
9, 17 C.F.R. § 240.14a-9 (1992), which pertains to proxy statements, in TSC Industries, Inc. v.
Northway, Inc., 426 U.S. 438 (1976). In TSC Industries, the Court stated:
An omitted fact is material if there is a substantial likelihood that a reasonable share-
holder would consider it important in deciding how to [act]. . . . Put another way,
there must be a substantial likelihood that the disclosure of the omitted fact would
have been viewed by the reasonable investor as having significantly altered the total
mix of information made available.

Id. at 449 (footnote omitted).

The Court later applied this standard to insider trading cases in Basic, Inc. v. Levinson,
485 U.S. 224 (1988). In Basic, the Court "expressly adopt[ed] the TSC Industries standard of
materiality for the § 10(b) [of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j(b)

In this Note, the terms "material, nonpublic information" and "inside information" will
be used interchangeably.

⁷. See infra note 63.

⁸. See infra notes 64-67 and accompanying text.
In 1984, Congress, intending to put some bite into the Securities and Exchange Commission's (SEC) arsenal of penalties, passed the Insider Trading Sanctions Act of 1984\textsuperscript{9} (ITSA). ITSA allowed the SEC to levy a penalty of up to three times the amount of profit gained or loss avoided from trading securities on material, nonpublic information. ITSA also increased the maximum fine for criminal violations from $10,000 to $100,000.\textsuperscript{10}

Despite the passage of ITSA, insider trading worsened. During the latter half of the 1980s, public confidence in Wall Street and the nation's financial markets was shaken by both the behavior of the market and the behavior of its participants. Inside dealing seemed to permeate the Wall Street community. It appeared that every major institution, including law firms, employed professionals who were involved in illicit trading, often in connection with intricate conspiracies. The professionals involved in these conspiracies included business journalists,\textsuperscript{11} stock brokers,\textsuperscript{12} and attorneys.\textsuperscript{13} Then, a series of highly publicized scandals concerning serious violations of the federal securities laws were prosecuted in the courts and widely reported in the press.\textsuperscript{14} These scandals involved very prominent members of the securities industry, representing nearly every major Wall Street securities firm.\textsuperscript{15}

The scandals also involved the legal community. For example, in 1987 a young partner at the firm of Wachtell, Lipton, Rosen & Katz was convicted for involvement in illicit trading.\textsuperscript{16} These scandals, including later reports of the sophisticated insider dealings of Michael Milken, in-

\textsuperscript{10} The Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA) increases this maximum to $1,000,000. 15 U.S.C. § 78ff(a) (1988).
\textsuperscript{11} R. Foster Winans, reporter for the \textit{Wall Street Journal}'s \textit{Heard on the Street} column, was convicted of participation in an insider trading scheme based on information misappropriated from a financial newspaper. U.S. v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), aff'd, 484 U.S. 19 (1987).
\textsuperscript{14} For an excellent account of the scandals, see JAMES B. STEWART, \textit{DEN OF THIEVES} (1991).
\textsuperscript{16} \textit{Lawyer Sentenced to 366 days For Role in Levine Scandal}, 19 Sec. Reg. & L. Rep. (BNA), No. 5, at 170 (Jan. 30, 1987). The lawyer was sentenced to 366 days in jail and received 5 years probation, and was fined $485,000 in civil penalties. \textit{Id.}
creased public skepticism about the fairness of the securities market with respect to the public at large.\textsuperscript{17}

In addition to the scandals, the crash of the stock market on October 19, 1987, shook public confidence. The crash caused a worldwide panic and raised questions about the stability of the American stock market and the propriety of the small investor's involvement in it.\textsuperscript{18}

Both the scandals and the market crash gave the investing public the impression that the U.S. financial markets were unsafe. Perhaps most troubling for the individual investor was the belief that the securities industry was ripe for fraud and abuse.

With the passage of time, Congress realized that the measures provided by ITSA were insufficient to deal with the mounting problems of insider trading. In 1988, the House Committee on Energy and Commerce (House Committee) noted that "[d]espite the stiffer penalties enacted by Congress in 1984, the [intervening years between the passage of ITSA and 1988] have seen a dramatic increase in insider trading cases, including cases against some of the most prominent officials in Wall Street investment banking firms."\textsuperscript{19} In response, Congress enacted the Insider Trading and Securities Fraud Enforcement Act of 1988 (IT-SFEA).\textsuperscript{20} Passed just four years after ITSA, ITSFEA was the second attempt by Congress to deal with the increased public perception that the nation's financial markets were unfair to the small investor.

ITSFEA provided a variety of measures to facilitate insider trading enforcement.\textsuperscript{21} For example, to aid in the detection of insider trading activity, ITSFEA authorized the SEC to offer bounties to persons who provided significant information about securities violations.\textsuperscript{22} ITSFEA also imposed liability on "controlling persons"\textsuperscript{23} for the insider trading


\textsuperscript{18} See "Black Monday," The Stock Market Crash of October 19, 1987, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 2d Sess. 1 (1988). "[A] basic principle [of our securities markets] is that we must preserve the confidence of investors in the integrity and stability of the market. How many roller coaster days on Wall Street can we have before investors, large and small, begin losing confidence in our securities markets?" Id. at 2 (statement of William Proxmire, Chairman of the Senate Committee on Banking, Housing, and Urban Affairs).


\textsuperscript{21} The two major obstacles to the prevention of insider trading are the SEC's lack of resources, and the difficulty of obtaining sufficient proof. See discussion infra Part II(A).


\textsuperscript{23} See infra notes 39-41 and accompanying text for the definition of a "controlling person."
activities of persons under their supervision. This aspect of ITSFEA shifted some of the burden of monitoring individuals from the SEC to employers.

This Note examines ITSFEA and the effect of the statute's definition of "controlling-person liability" on the legal profession. It analyzes the present state of the relevant law and suggests a proposal designed to effectuate the goals of ITSFEA and provide a clear and workable framework for practicing attorneys, law firms, and law firm employees.

Part II of this Note discusses the aspects of ITSFEA which are relevant to the legal profession, the problems that ITSFEA created, and the regulatory void that it left unfilled. Part III examines the current regulatory landscape. It focuses on regulations applicable to lawyers and law firms, including the securities fraud theories that most commonly affect law firm employees, the current regulations of the legal community by the SEC, and the most significant nationwide guidelines for attorney conduct. Finally, Part IV proposes that law firms should be required to adopt, maintain, and enforce policies designed to prevent insider trading by their employees. This proposal serves two purposes: (1) It establishes high standards sufficient to protect the confidentiality of corporate information; and (2) it provides law firms with clearer guidelines to give them a better understanding of their responsibilities.

II. The Problems of ITSFEA and the Need for Regulatory Clarity

A. The Insider Trading and Securities Fraud Enforcement Act of 1988

In 1988, Congress passed ITSFEA in an attempt to improve the detection and prevention of fraud in the trading of securities on secondary markets. The House Committee recognized two weaknesses in the SEC's battle against insider trading: a lack of resources and the difficulties involved in effectively prosecuting insider trading cases. IT- SFEA addressed these weaknesses by creating a bounty program to help discover and prosecute insider trading, and by creating controlli-
person liability\textsuperscript{28} to help spread the responsibility and cost of detecting insider trading violations.

The controlling-person scheme targeted firms participating in the securities field because Congress decided that they should assume a heightened responsibility to safeguard the integrity of the financial markets. Moreover, Congress delegated this responsibility and the imposition of costs to firms because they are in the best position to monitor their employees and detect any wrongdoing. The firm’s general duty to monitor their employees also includes the duties of specific individuals within these firms who have supervisory responsibilities. To this end, the House Committee stated, “In the view of the Committee, firms whose lifeblood is the continued public trust in our securities markets must do more to share in the responsibility for policing those markets and should be subject to considerable penalties for a shirking of that responsibility.”\textsuperscript{29} Thus, ITSFEA shifted some of the responsibility for the initial detection and prevention of securities fraud squarely onto the shoulders of securities businesses that directly benefit from the securities industry.

However, under ITSFEA, not all businesses bear the same responsibilities. ITSFEA provides a dual standard of care for controlling persons. For registered broker-dealers or investment advisers, liability attaches if it is established that (1) the controlling person knowingly or recklessly failed to establish, maintain, or enforce any policy or procedure reasonably designed to prevent the misuse of material, nonpublic information; and (2) the controlling person’s failure substantially contributed to or permitted the occurrence of the securities law violations.\textsuperscript{30}

Other controlling persons are subject to a penalty only if they “knew or recklessly disregarded the fact that” a person whom they controlled was likely to engage in securities fraud and “failed to take appropriate steps to prevent such acts before they occurred.”\textsuperscript{31} In other words, the failure to establish, maintain, or enforce an insider trading policy need not be the “but for” cause of the violation. Rather, it need only have allowed the violation to occur or have assisted in the violation.\textsuperscript{32} Serious penalties face controlling persons who do not fulfill their responsibilities

\textsuperscript{28} 15 U.S.C. § 78u-1(b).
\textsuperscript{32} House Report, supra note 19, at 18. Many self-regulatory organizations have already adopted similar rules requiring enforcement policies and procedures. See, e.g., American Stock Exchange Rules 320, 922, 1 Am. Stock Ex. Guide (CCH) ¶ 9374, 9722; NASD Rules of Fair Practice, Art. III, § 27, N.A.S.D. Manual (CCH) ¶ 2177; NYSE Rule 342, 2 N.Y.S.E. Guide (CCH) ¶ 2343. For a complete discussion on self-regulatory organizations see infra Part III.
as required by ITSFEA. Congress established the fine for an ITSFEA violation to be the greater of $1,000,000, or three times the amount of profit gained or loss avoided.33

(1) Confusion Over Law Firm Responsibility

The dual standards of liability for broker-dealers and investment advisers on the one hand, and controlling persons on the other, create doubt about how ITSFEA's general recklessness standard should be interpreted. The creation of two different standards indicates that Congress did not intend to require non-securities firms to establish written insider trading policies; instead, Congress subjected them to a less rigorous general recklessness standard.34 The House Committee provided distinct guidelines for the non-securities firms when it stated:

The risk involved must be such that to disregard it would constitute a gross deviation from the standard of care that a reasonable person would exercise in such a situation. For example, "recklessness" encompasses a heedless indifference as to whether circumstances suggesting employee violations actually exist. . . .

The controlling person is responsible under this subsection if it fails to take an appropriate action once it knew or was reckless in disregarding indications that its controlled person was engaging in insider trading.35

The language of the recklessness standard merely requires most firms to respond to evidence of wrongful action, while broker-dealers and investment advisers are required to actively prevent such situations from ever occurring. This House Committee report indicates that Congress intended two differing standards of controlling-person liability.

However, some commentators believe that the two standards are not so different despite the language found in the legislative history of ITSFEA. During his tenure as director of the SEC's Division of Enforcement, Gary Lynch warned that "there could be a case where the mere fact that a firm failed to establish any policies and procedures whatsoever would be deemed to be reckless conduct."36 With respect to public corporations, which are only held to the recklessness standard, one commentator has recommended that

33. 15 U.S.C. § 78u-1(a)(3). In addition to a fine of up to $1,000,000 and/or 10 years in prison for "natural persons," section 32(a) of the Securities Exchange Act authorizes the imposition of criminal penalties on "non-natural persons," such as a company, of up to $2,500,000. 15 U.S.C. § 78ff(a) (1988).
34. The House Committee specifically rejected an aiding and abetting standard. House Report, supra note 19, at 18.
35. Id. (emphasis added).
[b]ecause the failure to adopt a policy is likely to be considered evidence of reckless disregard for purposes of 1988 Act controlling-person liability for employee insider trading, public corporations should promulgate and communicate a written policy against unlawful securities trading, monitor compliance with the policy, and enforce sanctions for noncompliance.\textsuperscript{37}

Under the present language of ITSFEA, law firms would do well to heed this advice. As a result of the uncertainty surrounding the responsibilities imposed on law firms by ITSFEA, a number of firms have implemented policies and procedures designed to satisfy the stricter standard.\textsuperscript{38} Whether these polices are sufficient is uncertain, since no official guidelines exist and no firms have yet been charged with ITSFEA violations due to inadequate prevention measures.

(2) Controlling-Person Liability

Law firms may be particularly susceptible to the vagaries found in ITSFEA because of their lack of formal internal structuring. Law firms rarely are organized along hierarchies common to most other corporate organizations. Consequently, the chain of command often is not clearly defined. Instead, law firms often are arranged into tiers of partners and associates, or into teams. As a result, senior members of law firms may be subject to liability under ITSFEA, but may not realize that they are considered a controlling person.

SEC Rule 405 defines “control” as “the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.”\textsuperscript{39} Thus, the definition of “controlling person” “include[s] not only employers, but any person with power to influence or control the direction or the management, policies, or activities of another person.”\textsuperscript{40} In fact, the House Committee equated “control” with the mere power to control, regardless of whether such power is actually exercised.\textsuperscript{41}

Under ITSFEA’s broad definition of control, lawyers and law firms could be exposed to liability from a number of angles. First, the law firm itself—the partnership or professional corporation—can be considered a controlling person for each attorney or staff member.\textsuperscript{42} Second, individual attorneys who directly supervise other firm employees, attorney or


\textsuperscript{39} 17 C.F.R. § 230.405 (1988).

\textsuperscript{40} HOUSE REPORT, supra note 19, at 17.

\textsuperscript{41} Id.

\textsuperscript{42} Id.
otherwise, are considered controlling persons for ITSFEA purposes. For example, the failure of a senior partner to properly prevent a subordinate from illegally trading on confidential client information could result in ITSFEA liability for both the law firm and that particular attorney. Third, a law firm’s management committee, which has the power to determine firm policy, could be considered a controlling person because it is responsible for making policies of each employee.

The potential liability for law firms and their individual members is enormous. The lack of guidance and the vagueness of ITSFEA’s language has created much confusion and has resulted in varied and disparate attempts at solutions. However, no uniform guidelines exist to settle the issue.

B. The Need for Improved Regulation of Attorney Conduct

Since lawyers and other law firm employees are often in a position to improperly use or reveal confidential corporate information or trade securities based on such information, there is abundant opportunity for the occurrence of insider trading violations. However, beyond heightened exposure to material, nonpublic corporate information, there are additional concerns about insider trading that support increased regulation over law firms. Commissioner Philip Lochner commented that insider trading violations by attorneys “should be viewed differently because of the role that lawyers play in society.” Lochner attributes this higher standard to a lawyer’s sworn duty to uphold and defend the law, her status as an officer of the court, and her role to act as an intermediary between private citizens and the government. In addition, Lochner believes that law firms may have an “ethical obligation” to report employees who engage in insider trading, even though the firms presently are not legally obliged to do so.

43. Id.
44. SEC Chairman Richard Breeden has warned that “senior members of law firms, who serve as ‘controlling persons,’ could be prosecuted under insider trading laws for failing to prevent insider trading and tipping by others within the firm.” SEC Finding Law Firms Lack Safeguards to Deter Insider Trading, Breeden Says, 22 Sec. Reg. & L. Rep. (BNA) No. 38, at 1375 (Sept. 28, 1990).
45. In 1991, SEC Commissioner Philip Lochner noted that while there is no data on insider trading by specific occupational groups, “recent cases brought by the SEC indicate that there are at least three groups that seem disproportionately to engage in insider trading. The first two groups are securities professionals and lawyers. Both of these groups routinely obtain material, nonpublic information in the course of representing clients.” Philip R. Lochner, Jr., Lawyers and Insider Trading, 11 BUS. LAW. UPDATE, May/June 1991, at 1, 2.
46. Id.
47. Id.
48. Law Firms May Have Ethical Obligation to Report Insider Trading, Lochner Says, 23 Sec. Reg. & L. Rep. (BNA) No. 6, at 168 (Feb. 8, 1991). Commissioner Lochner also noted that if local bar associations fail to properly regulate lawyers, the SEC may assume this respon-
The very nature of the legal profession and the role of lawyers in
general suggest that increased regulation is needed in the insider trading
context where the confidentiality of client information is particularly im-
portant. Information is the currency of power for lawyers. Attorneys
act as information gatherers during the discovery process. They also act
as information storers, as demonstrated by the need for the attorney-cli-
ent privilege. As an industry in which advertising is not an accepted
means of attracting clients, being “in the know” is vital to client develop-
ment. One way to make potential clients aware that attorneys and firms
are experienced and well-connected is the strategic leaking of
information.

Professor Helen Garten argues that in some instances insider trad-
ing by professionals may further the interests of the professional’s reputa-
tion or the reputation of her firm.49 Professor Garten notes that clients
may view securities lawyers as both information gatherers and informa-
tion storers:

That clients expect their professional advisers to be sources as well as
recipients of information alters the stakes involved in insider trad-
ing.... [I]f professional firms also serve as sources of valuable infor-
mation, then dealing in information, even inside information, may
further the goals of the firm by enhancing its reputation for knowledge
and expertise.50

Thus, clients will retain those law firms from which they receive expert,
knowledgeable legal advice. Attorneys are aware of this, and to attract
new clients they may reveal their involvement in particular transactions,
using “tipping . . . as a signal of knowledge and expertise in specific ar-
ees.”51 Furthermore, attorneys are aware that the revelation of this in-
formation would probably have a greater impact on a potential client if it
were leaked prior to public announcements, and, therefore, may be in-
clined to engage in illegal tipping.

Thus, because of the unique nature of the legal industry, heightened
regulation of employees of law firms may be necessary to prevent misuse
of material, nonpublic information. Placing responsibility on the firms to
properly supervise and instruct these employees may be the most effec-
tive method of enforcement of the securities laws, especially since current
regulation often fails to directly address the insider trading problem.

49. Helen A. Garten, Insider Trading in the Corporate Interest, 1987 Wis. L. REV. 573,
576 (“In some cases, the misuse of inside information by professionals may be the product not
of the triumph of self-interest over professional duty, but of a desire to further the interests of
the firm itself.”).
50. Id. at 594.
51. Id. at 606.
III. Current Regulation of Insider Trading and the Legal Profession

A. Theories of Liability

In the practice of law, attorneys are often placed in positions where they can intentionally or accidentally violate the federal securities laws concerning the use of confidential information. This problem is particularly acute for lawyers employed at large law firms with significant corporate practices because those firms tend to have larger corporate clients and are involved in larger transactions. In order to assess the measures a law firm must take to prevent such violations, we must first briefly examine the present regulatory landscape.52

The arguments over whether to restrict the trading of securities on the basis of material, nonpublic information are well settled.53 The decision to forbid insider trading is based on the public policy favoring fairness to each investor. This policy allows the investing public the opportunity to make informed decisions through comprehensive and equally accessible corporate information. In fact, one of the stated purposes of the Securities Exchange Act is to “insure the maintenance of fair and honest markets.”54

Although the term “insider trading” has never been legislatively defined, such activity is proscribed by the federal securities laws under Section 17(a) of the Securities Act of 193355 and Sections 10(b)56 and 14(e)57 of the Securities Exchange Act. The most extensive and prominent securities fraud theories have developed under Section 10(b) and SEC Rule 10b-5.58 Most of these theories are especially relevant to law firms and law firm employees.

52. For a more detailed analysis of securities fraud theories, see DONALD C. LANGEVOORT, INSIDER TRADING REGULATION (1990 ed.).
54. Securities Exchange Act § 2 (current version at 15 U.S.C. § 78(b) (1988)). This section acknowledges the necessity for regulation because “transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest.” Id.
58. Rule 10b-5, promulgated by the SEC pursuant to Congress's grant of authority under section 10(b) of the Securities Exchange Act, is the SEC's primary antifraud statute. Rule 10b-5 states:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or
(1) Abstain or Disclose Rule

Insider trading case law requires an insider to disclose any material, nonpublic information in her possession, or to abstain from trading. This concept was originally formulated when the stock market involved face-to-face transactions. Presently, however, the large impersonal nature of financial markets necessitates disclosure of nonpublic information to the entire investing public prior to an insider’s trading. An insider of a corporation must either announce the nonpublic material information through a press release or press conference, or refrain from trading while the information is still confidential. Failure to do so will violate the corporate insider’s duty to the company’s shareholders.

By contrast, an attorney or other employee of a law firm hired by a corporation and entrusted with sensitive, inside information does not have the option of revealing confidential client information. Both the attorney-client privilege and the attorney’s duty of loyalty to the client mandate nondisclosure. As a result she cannot trade in that company’s securities while the information remains nonpublic because she also has an insider’s fiduciary duty to the client’s shareholders.

This theory of liability is based on an expanded definition of who is an insider. Although the term “insider” originally referred to officers and directors of a publicly traded company, case law has broadened the definition to encompass other persons. In many instances, in the course
of a business relationship confidential information is passed to other individuals. The persons who receive sensitive information with the understanding that it is to remain confidential have the same fiduciary duty to the company's shareholders as the insiders themselves. In the leading case of Dirks v. SEC, the Supreme Court acknowledged that a member of a law firm can possess a corporate insider's fiduciary duty to abstain from trading on material, nonpublic information. The Dirks case established that a member of a law firm retained to act as a corporation's legal counsel in a public offering or a corporate merger or acquisition is considered a temporary insider. Temporary insiders owe the same fiduciary duties to a corporation as traditional corporate insiders.

(2) Tipper/Tippee Liability

In SEC v. Texas Gulf Sulphur Co., the Second Circuit Court of Appeals prohibited both trading of securities and recommending securities for purchase while in possession of inside information, without disclosure of such information. Thus, a "tipper," an insider who has made a gift of confidential information to a trading relative or friend, of inside information is as liable for securities violations as she would be if she had placed the trade herself. In Dirks, the Supreme Court recognized that a "tippee," a person who receives inside information with the knowledge that the insider is breaching a fiduciary duty, is also liable for insider trading when they trade on inside information. According to the Court in Dirks, the securities laws are violated when an insider makes a gift of confidential information to a relative or friend because "[t]he tip and trade resemble trading by the insider himself followed by a gift of the

64. 463 U.S. 646 (1983).
65. The Court stated:
   Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes . . . . For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty.
Id. at 655 n.14 (emphasis added) (citations omitted).
66. Id.
67. Id.
68. 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).
69. Id. at 848 (interpreting Rule 10b-5).
70. See Dirks, 463 U.S. at 664.
71. Dirks, 463 U.S. at 659-60 n.19. "Tippees" of corporate insiders have been held liable under § 10(b) because they have a duty not to profit from the use of inside information that they know is confidential and know or should know came from a corporate insider. Chiarella v. United States, 445 U.S. 222, 230 n.12 (1980) (citation omitted).
profits to the recipient.\textsuperscript{72} The Court recognized that the personal benefit that an insider receives from tipping is not limited to pecuniary gain, but may also include intangible gains such as enhancement of reputation.\textsuperscript{73} Thus, law firm employees who leak confidential client information in breach of their fiduciary duty will be subject to tipper liability for any trading by their tippees. Tipper liability will attach even if the tipper leaked only to enhance the firm’s reputation.

\textbf{(3) Misappropriation}

A less widely accepted theory imposes liability based on the misappropriation of information. This theory equates insider trading to theft in that an individual who profits from improperly using insider information is considered to have stolen information from his employer or client. Under this theory, misappropriators of an employer’s entrusted information defraud their employers “[b]y sullying the reputations of [their] employers as safe repositories of client confidences.”\textsuperscript{74} Although the Supreme Court has not yet adopted the misappropriation theory,\textsuperscript{75} it has been accepted in the Second,\textsuperscript{76} Third,\textsuperscript{77} Seventh,\textsuperscript{78} and Ninth\textsuperscript{79} Circuits.

The misappropriation theory is especially relevant to law firms. Attorneys and staff members can easily access information regarding a public offering or a tender offer by a corporate client and use it for an illegitimate purpose—insider trading. Law firm employees already have been prosecuted for insider trading in these situations.\textsuperscript{80}

\textsuperscript{72} Dirks, 463 U.S. at 664.
\textsuperscript{73} Id. at 663.
\textsuperscript{75} In Carpenter v. United States, 484 U.S. 19, 24 (1987), an evenly divided Court affirmed securities fraud convictions brought pursuant to the misappropriation theory. “An affirmation by an evenly divided court is ‘not entitled to precedential weight.’” United States v. Chestman, 947 F.2d 551, 566 n.3 (2d Cir. 1991) (citing Neil v. Biggers, 409 U.S. 188, 192 (1972)).

The misappropriation theory has been forwarded by Chief Justice Burger. In \textit{Chiarella}, he stated in dissent, “\textit{Chiarella . . . misappropriated—stole to put it bluntly—valuable nonpublic information entrusted to him in the utmost confidence. He then exploited his ill-gotten informational advantage by purchasing securities in the market. In my view, such conduct plainly violates § 10(b) and Rule 10b-5}.” \textit{Chiarella}, 445 U.S. at 245 (Burger, C.J., dissenting) (emphasis added).


\textsuperscript{78} \textit{See} SEC v. Cherif, 933 F.2d 403, 409 (7th Cir. 1991).
\textsuperscript{79} \textit{See} SEC v. Clark, 915 F.2d 439, 443 (9th Cir. 1990).
The new "controlling person" liability theory established in IT-SFEA attempts to address misappropriation by requiring certain employees to reasonably anticipate and deter the misappropriation of client information by instituting preventative insider trading policies and procedures. Interestingly, prior to the development of controlling-person liability and ITSFEA, law firms were considered *victims* of the misappropriation and insider trading of its employees. Now, however, firms may be held liable for the insider trading of their employees if they are reckless in failing to take preventative measures.

(4) SEC Rule 14e-3

The SEC promulgated Rule 14e-3 (the Rule),\(^1\) under section 14(e) of the Securities Exchange Act,\(^2\) to address the specific problem of insider trading in connection with tender offers. Rule 14e-3 is particularly significant to attorneys and law firms because the language of the Rule specifically covers the function of attorneys and law firms. The Rule prohibits a person from trading in the securities of a company which is the target of a tender offer once the bidder company has taken a substantial step toward executing the bid, if the person knows or has reason to know that the information is nonpublic and acquired from the bidder or target company, their insiders, or "any other person acting on [a company's] behalf.\(^3\) Furthermore, the Rule prevents insiders, a company's "advisors," or persons acting on behalf of insiders, from "communicat[ing] material, nonpublic information relating to a tender offer to any other person under circumstances in which it is reasonably foreseeable that such communication is likely to result in [an insider trading] violation.\(^4\)

Thus, attorneys or other employees of a law firm which has been hired by a corporation to perform legal services in connection with a


\(^{3}\) 17 C.F.R. § 240.14e-3(a) (1992). The validity of the SEC's power to promulgate this rule was affirmed by the Second Circuit in an *en banc* proceeding. United States v. Chestman, 947 F.2d 551, 563 (2d Cir. 1991).

tender offer would violate Rule 14e-3 if, while in possession of information relating to the tender offer, they trade in securities of any companies involved. In addition, they would be liable under the Rule if they provide other persons with the tender offer information, and these “tippees” trade while in possession of the information. Considering the frequency with which large law firms perform these kinds of services for their corporate clients, Rule 14e-3 violations are clearly foreseeable.

(5) Respondeat Superior

The doctrine of vicarious liability or “respondeat superior” is the common-law equivalent to controlling-person liability. Presently, most of the federal circuits have held that controlling-person liability supplements, but does not supplant, common-law respondeat superior doctrine. Under this doctrine, an employer is held liable for the actions of its employee while the employee is acting within the scope of her employment. Respondeat superior may be applicable to law firms whose employees execute securities transactions based upon confidential information they received through their employment. However, some courts have ruled that trading on the basis of material, in this situation, the law firm employees would almost certainly be charged with the knowledge that the information came from an insider and was nonpublic.

85. In this situation, the law firm employees would almost certainly be charged with the knowledge that the information came from an insider and was nonpublic.

86. See, e.g., Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1576-78 (9th Cir. 1990); In re Atlantic Fin. Management, Inc., 784 F.2d 29, 32-34 (1st. Cir. 1986), cert. denied, 481 U.S. 1072 (1987); Commerford v. Olson, 794 F.2d 1319, 1322-23 (8th Cir. 1986); Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1115-19 (5th Cir. 1980); Marbury Management v. Kohn, 629 F.2d 705, 712-16 (2d Cir.), cert. denied, 449 U.S. 1011 (1980); Holloway v. Howerdd, 536 F.2d 690, 694-95 (6th Cir. 1976); Kerbs v. Fall River Indus., Inc., 502 F.2d 731, 740-41 (10th Cir. 1974). The Seventh, Eleventh, and District of Columbia Circuits have not directly addressed this issue.

In Sharp v. Coopers & Lybrand, 649 F.2d 175, 182-83 (3d Cir. 1981), cert. denied, 455 U.S. 938 (1982), the Third Circuit allowed respondeat superior liability against broker-dealer and accounting firms because of their positions in the public trust. However, the court cautioned that the doctrine “should not be widely expanded in the area of federal securities regulation.” Id. The Fourth Circuit is split on the issue. Compare Carras v. Burns, 516 F.2d 251, 259 (4th Cir. 1975) (holding that brokerage firm’s liability for churning does not depend solely on lack of effective supervision, but arises from employer’s vicarious liability) with Carpenter v. Harris, Upham & Co., 594 F.2d 388, 394-95 (4th Cir.) (refusing to hold brokerage firm liable as “controlling person” after broker left firm, without evidence that broker acted at firm’s direction), cert. denied, 444 U.S. 868 (1979).

87. See generally RESTATEMENT (2D) OF AGENCY §§ 228, 229, 257, 258, 261, 262, 265 (1958) (defining scope of employment and misrepresentation leading to principal’s liability). For an example of conduct held to be outside the scope of employment, see Lundberg v. State, 255 N.E.2d 177, 179-80 (N.Y. 1969) (absolving state as employer from liability for accident caused by state employee driving to worksite eighty miles from home).

88. Some commentators believe that respondeat superior increases law firm liability to third party investors because it is easier to prove than controlling person liability. David B. Parker et al., Law Firm Liability Under the Federal Securities Laws, INSIGHT, Mar. 1992, at 19.
nonpublic information necessarily exceeds the scope of the insider's employment, thus absolving the employer of vicarious liability.  

B. Regulation by the SEC

(1) SEC Rule 2(e)

The SEC presently has the power to sanction lawyers and law firms. Historically, however, the agency has exercised this power over the profession infrequently. SEC Rule 2(e) gives the SEC authority to temporarily or permanently suspend an attorney from practicing before it. Imposition of these sanctions prevents an attorney from participating in any preparation of materials to be filed with the SEC. Furthermore, while the SEC has stated that Rule 2(e) generally applies to individual attorneys, it has also warned that "a firm may itself be enjoined 'by name' and thus come within the terms of the Rule." The language of the Rule provides additional support for the proposition that a firm can be penalized. Rule 2(e)(1) does allow for the denial of the privilege of practice before the SEC of "any person." In the following two subsections, the Rule refers to "any attorney." The use of both "attorney" and "person" in the Rule suggests that 2(e)(1) can apply to non-natural "persons" such as law firms. Thus, it appears that a law firm can be enjoined from practicing before the Commission.

Under the current formulation of the Rule, insider trading has rarely, if ever, been the primary focus of a 2(e) proceeding. This result may be due to the SEC's harsh view of misrepresentations made in the


90. One commentator estimates that only 121 attorneys were prosecuted under Rule 2(e) proceedings between 1972 and 1989. Robert W. Emerson, Rule 2(e) Revisited: SEC Disciplining of Attorneys Since In re Carter, 29 AM. BUS. L.J. 155, 176 (1991). Of this number, only twenty-six were prosecuted during the 1980s. Id. However, Emerson argues that the dearth of 2(e) proceedings is only temporary, since the fundamental conflict over the SEC's use of Rule 2(e) remains unsettled. Id. at 166.


92. Rule 2(e) grants the SEC the power to deny persons the privilege of practicing before the Commission. Rule 2(g) defines "practice" to include "(1) transacting any business with the Commission; and (2) the preparation of any statement, opinion or other paper by any attorney, ... filed with the Commission in any registration statement, notification, application, report or other document with the consent of such attorney." 17 C.F.R. § 201.2(g).


94. Id. ("Partners and associates of a disqualified firm, of course, may not practice before the Commission so long as they remain members of or associated with the firm.").

95. Id.

96. Emerson, supra note 90, at 211 n.278. According to Professor Emerson's research,
form of filings and documents related to the Commission's internal processes. These actions are often absent in attorney insider trading cases. In addition, the SEC has made a practice of bringing 2(e) proceedings against attorneys who already have been enjoined or convicted for securities law violations by a court.97 "[The SEC], as a matter of policy, generally refrains from using its administrative forum to conduct de novo determinations of the professional obligations of attorneys."98 Consequently, Rule 2(e) proceedings have not been used as an initial mechanism for determining liability in the past decade.99

In a few instances, Rule 2(e) has been used to effect policy and procedure changes in law firms. In one case, In re Keating, Muething & Klekamp,100 the SEC sanctioned a law firm for failing to disclose material information in documents it had prepared for a client and filed with the Commission.101 In imposing sanctions pursuant to Rule 2(e), the Commission ordered the firm to "adopt, maintain, and implement additional internal and supervisory procedures . . . reasonably designed to ensure that respondent has adequate procedures with respect to representation in matters involving the federal securities laws . . . and to avoid recurrence of [securities violations]."102 However, the Commission did not dictate what procedures should be instituted.103

In SEC v. Lerner, David, Littenberg & Samuel,104 another proceeding prior to the passage of ITSFEA, the SEC again sanctioned a law firm. Lerner involved allegations of insider trading of information regarding a client's patent by all of the partners of the firm, an associate, their family members, their friends, and other firm clients. The SEC ordered the firm to "comply with its undertaking to adopt, implement and maintain policies and procedures designed to prevent the use or dissemination of any material, nonpublic information received by any member or employee of [the firm] by virtue of, or during the course of, their employment."105

In 1977, the Commission issued a release warning law firms of their responsibility to preserve the confidentiality of material, nonpublic infor-

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97. *Id.* at 213.
98. *Id.* at 214.
99. *Id.*
100. 47 S.E.C. 95 (1979).
101. *Id.* at 97. Interestingly, this case involved the former law firm of Charles H. Keating, Jr., who would later emerge as a major figure in the Savings and Loan scandals of the late 1980s.
102. *Id.* at 108.
103. *Id.* at 107.
105. *Id.*
mation.\textsuperscript{106} The release stated that "[l]aw firms, like others which have confidential information in their possession that may affect the securities trading markets, have an affirmative obligation to safeguard such information."\textsuperscript{107} In what could be seen as a precursor to the ideas formally stated in \textit{ITSFEA}, the release also stated that "law firms are encouraged to establish policies and procedures regarding confidential information and take steps to ensure that all firm personnel are familiar with those policies, including the serious consequences that may result from conduct violating such policies."\textsuperscript{108}

Through these proceedings, the SEC has demonstrated that it can and will exert its authority to effect the internal policies and procedures of law firms in situations in which the lack of such measures have impinged on the internal processes of securities regulation. In general, however, Rule 2(e) has been a little-used enforcement mechanism for influencing law firm governance.

(2) Self-Regulatory Organizations

The SEC currently delegates the first level of enforcement and surveillance to self-regulatory organizations (SROs\textsuperscript{109}).\textsuperscript{110} Ten national securities exchanges, including the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD), are SROs. SROs are responsible for monitoring the activities of their own members and assuring that they comply with the federal securities laws. Each of these SROs must adopt rules "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, . . . and, in general, to protect investors and the public interest."\textsuperscript{111} SROs must also provide fair disciplinary procedures for their members.\textsuperscript{112} SRO rules, although entitled to considerable respect, are not binding on the courts or the SEC.\textsuperscript{113} In fact, the SEC has extensive oversight and supervisory power over the SROs, and must approve all SRO rules, policies, practices, and interpretations prior to their implementa-

\textsuperscript{108} \textit{Id.}
\textsuperscript{113} See Silver v. NYSE, 373 U.S. 341, 357 (1963); see also Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 181-82 (2d Cir. 1966).
tion. The SEC may also add or abrogate such rules as it deems necessary.\textsuperscript{114}

ITSFEA builds upon the regulatory relationship between the SEC and the SROs by requiring certain controlling persons to establish and enforce written policies aimed at preventing the misuse of material, non-public information.\textsuperscript{115} As mentioned previously, ITSFEA makes registered broker-dealers and investment advisors liable for "knowingly or recklessly fail[ing] to establish, maintain or enforce" policies and procedures designed to prevent insider trading.\textsuperscript{116} The statute increases the SRO members' responsibility to prevent and detect securities fraud. ITSFEA also extends a certain degree of that responsibility to entities which are not presently regulated by the SEC's SRO regulatory scheme because ITSFEA provides controlling-person liability for nonregistered entities which knowingly or recklessly disregard probable securities trading violations.\textsuperscript{117}

C. Other Regulation of Attorney Conduct

Much of the current regulation of attorney conduct comes from local and state bar associations. While each jurisdiction has a distinct body of local statutes and case law governing ethical conduct by attorneys, this Note focuses on ethical rules and guidelines which attempt to provide a uniform national standard of conduct for the legal profession. There are two such bodies of standards: the American Bar Association's (ABA) Model Code of Professional Responsibility (ABA Code or Code), and the ABA Model Rules of Professional Responsibility (Model Rules or Rules).

The ABA Code was promulgated in 1969 and was adopted by many states as the official standard of conduct for attorneys. In 1983, the ABA sought to replace the Code by promulgating the Model Rules as a new framework for ethical conduct in the legal profession. While many states have adopted new ethics standards based on the Model Rules, some still retain aspects of the ABA Code.\textsuperscript{118} Neither set of standards, however, independently carries any binding legal effect; they are intended only as models for the individual states to follow.

\begin{itemize}
\item \textsuperscript{114} Securities Exchange Act § 19(c) (codified at 15 U.S.C. § 78s(c) (1988)).
\item \textsuperscript{116} Id.
\item \textsuperscript{117} 15 U.S.C. § 78u-1(b)(1)(A).
\item \textsuperscript{118} The following jurisdictions have adopted new legal ethics rules based on the Model Rules of Professional Conduct since the Rules were promulgated by the ABA in 1983: Alabama, Arizona, Arkansas, Colorado, Connecticut, Delaware, District of Columbia, Florida, Idaho, Indiana, Kansas, Kentucky, Louisiana, Maryland, Michigan, Minnesota, Mississippi, Missouri, Montana, Nevada, New Hampshire, New Jersey, New Mexico, North Dakota, Oklahoma, Pennsylvania, Rhode Island, South Carolina, South Dakota, Texas, Utah, Wash-
The Code of Professional Responsibility attempted to provide ethical guidelines that would prohibit insider trading by members of the legal profession. Disciplinary Rule 4-101 states that an attorney may not reveal a client’s confidence or secret, use a confidence or secret to the client’s disadvantage, or use a confidence or secret to the advantage of the attorney or a third party without the client’s consent upon full disclosure. Subsection (3) is most relevant to insider trading because in most insider trading situations an attorney who trades while in possession of confidential information acts to her own advantage, not to her client’s disadvantage. Furthermore, an attorney need not reveal any confidential information in order to personally benefit from insider trading.

Controlling-person liability is more relaxed under the Code than under ITSFEA. Attorneys are required merely to exercise reasonable care in preventing their employees or associates from disclosing or using client confidences or secrets. The ABA Code contains no other requirements regarding a lawyer’s supervisory responsibilities for her subordinates.

The ABA Code appears to adequately prohibit insider trading by individual attorneys. However, the Code fails to address the supervisory responsibility of law firms or senior attorneys. Thus, states that currently follow the ABA Code provide no additional obligations on law firm policies and procedures beyond the minimal requirements of ITSFEA’s recklessness standard.

There is no equivalent to Disciplinary Rule 4-101(B)(3) in the Model Rules. Unlike the ABA Code, the Model Rules fail to directly address the possibility of insider trading on behalf of attorneys. However, two rules partially address revelation of client information by an attorney.


119. MODEL CODE OF PROFESSIONAL RESPONSIBILITY (1980).
120. MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 4-101(B) (1980). “Confidence” refers to any information protected by the attorney/client privilege, and “secret” is defined as any information that would be embarrassing or detrimental to the client, or that the client has requested to be kept private. DR 4-101(A) (1980). An attorney has discretion to reveal confidential information, however, if revelation (1) has been consented to by the client after full disclosure, (2) is required by law or court order, (3) is necessary to prevent the client from committing a crime, or (4) is necessary for the attorney to collect his fee or to defend against any allegations of wrongdoing. DR 4-101(C) (1980).
121. DR 4-101(D) (1980).
attorney. Model Rule 1.6 prevents a lawyer from revealing information that relates to the representation of a client without that client's consent, but is silent on the attorney's responsibility regarding the use of such information. Rule 1.8(b) also partially addresses attorney misuse of client information. It states: "A lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client consents after consultation . . . ."\textsuperscript{123}

Taken together, these two Rules do not prohibit the execution of securities trades based on confidential information resulting from the attorney-client relationship when such trades do not disadvantage the client. While illegal insider trading may theoretically injure the company whose securities are being traded,\textsuperscript{124} such harm is considered highly speculative.\textsuperscript{125} Therefore, in most cases, attorneys who trade on information they receive during the course of a client relationship do not violate the Model Rules. While insider trading that does not disadvantage the client is clearly prohibited by the federal securities laws, the Model Rules fail to expressly prohibit such activity.

The Model Rules provide stronger guidelines than the Model Code regarding attorney supervision of subordinates. Rule 5.1 addresses the responsibilities partners or supervisory individuals in law firms have with regard to subordinates.\textsuperscript{126} Under Rule 5.1, partners, attorneys with intermediate supervisory responsibility, and shareholders of a professional (legal) corporation are responsible for making "reasonable efforts to ensure that the [law] firm has in effect measures giving reasonable assurance that all lawyers in the firm conform to the rules of professional conduct."\textsuperscript{127} The Model Rules also specifically address an attorney's responsibility regarding nonlawyer assistants.\textsuperscript{128} They acknowledge that

\textsuperscript{122} However, an attorney may reveal confidential information if (1) the lawyer believes that revelation of such information is necessary to prevent the client from committing a crime resulting in imminent death or substantial bodily harm; or (2) such information is needed to exonerate the attorney from allegations made by the client or other party. \textit{Model Rules of Professional Conduct} Rule 1.6(b) (1993).

\textsuperscript{123} \textit{Model Rule} 1.8(b) (1993) (emphasis added).

\textsuperscript{124} See \textit{Marc Steinberg & William K. S. Wang, Regulation of Insider Trading} § 2.3.2 (forthcoming 1994) (discussing and criticizing arguments that insider trading will impair management performance or increase the cost of capital).

\textsuperscript{125} See \textit{Wang, supra} note 53, at 1230 (questioning argument to this effect by New York Court of Appeals in Diamond v. Oreamuno, 248 N.E.2d 910, 912-13 (N.Y. 1969)).

\textsuperscript{126} \textit{Model Rule} 1.10 cmt. 1 (1993) (defining "firm" to include lawyers in a private law firm, lawyers in a legal department of a corporation or other organization, or in a legal services organization).

\textsuperscript{127} \textit{Model Rule} 5.1(a) (1993).

\textsuperscript{128} \textit{Model Rule} 5.3 (1993). The comment accompanying Rule 5.3 states that "[a] lawyer should give such assistants [as secretaries, investigators, law student interns, and paraprofessionals] appropriate instruction and supervision concerning the ethical aspects of their employment, particularly regarding the obligation not to disclose information relating to representation of the client." \textit{Model Rule} 5.3 cmt. (1993).
the measures required of each law firm will vary depending on the firm's structure and the nature of its practice.\textsuperscript{129} The duties enumerated under Rule 5.1 appear similar to the supervisory duties required under IT-SFEA. However, these seemingly stringent guidelines are tempered by the fact that supervisors only have a duty to seek conformity with the rules of professional conduct as delineated by the Model Rules. Since, as discussed above, the Model Rules themselves do not adequately address insider trading, the requirement to adequately supervise subordinates to comply with the Rules still fails to directly address the insider trading problem.

At face value, allowing an industry to determine its own rules of professional conduct appears to be a conflict of interest. The ABA's most recent attempt to regulate attorney ethics, the Model Rules, has resulted in lower ethical standards in the context of attorney confidentiality. The legal profession lacks a powerful, independent entity to set sufficient guidelines for attorney conduct in relation to the problems identified by ITSFEA. Furthermore, the enforcement of ethical guidelines by various local bar associations is irregular and often criticized.\textsuperscript{130}

One commentator has observed with respect to the disciplining of securities lawyers:

\begin{quote}
For all [of the bar's] emphasis on self-regulation and state control, the bar has not shown much concern with the Commission's need for cooperation from state bar overseers. According to Commission personnel, the SEC has referred attorney misconduct to various [boards of bar overseers], but in most cases these boards—without notifying the Commission—took no action whatsoever.\textsuperscript{131}
\end{quote}

The lack of adequate legislation on insider trading in the legal profession, and the apparent lack of interest in enforcing the existing structures, suggest that the current self-regulatory bars are inappropriate entities for regulating attorney and law firm conduct for security violations.

In contrast, the SEC has attempted to expand its regulatory reach in the name of improved professional conduct and fairness to the investing public.\textsuperscript{132} Despite this attempt, the language of ITSFEA is ambiguous regarding the responsibilities of law firms. The inherent ambiguities found in ITSFEA only add to the potential ambiguities facing every law firm. A more precise definition of lawyer and law firm responsibility under ITSFEA would benefit the investing public by creating better securities trading surveillance. It would also benefit the legal profession by informing those in the profession what safeguards must be taken, and what activities they can engage in without inadvertently violating the federal securities laws.

\begin{enumerate}
\item[129.] Model Rule 5.1 cmt. 2 (1993).
\item[130.] See Emerson, supra note 90, at 232-34.
\item[131.] Id. at 208.
\item[132.] Id.
\end{enumerate}
IV. Proposal

The foregoing discussion demonstrates that the current regulatory landscape for insider trading regulation of law firms is fraught with peril. Under the current regulatory system, consisting of the federal securities laws, rules promulgated by the SEC, and rules of professional conduct, law firms are neither expressly required to establish written procedures to prevent insider trading, nor given sufficient guidance for implementing appropriate procedures if they desire. The dual standards of liability found in ITSFEA have led to a debate over the specific responsibilities of law firms. The unique organizational structure of most law firms and the ambiguity over the definition of a “controlling person” add to the difficulties of interpreting the statute. Finally, there is an increased chance that “violations” will occur in this undefined area of doubt because attorneys are constantly entrusted with confidential information. Consequently, firms are forced to speculate whether their attempts to comply with the law are sufficient enough to avoid the sting of controlling-person liability.\(^\text{133}\) As a result of this uncertainty, many firms lack the proper safeguards necessary to prevent certain instances of insider trading.

In 1990, Richard Breeden, chairman of the SEC, remarked that there are a “surprising number of law firms that [do] not have formal procedures [for dealing with insider trading] in place.”\(^\text{134}\) For some firms, ITSFEA may have its intended deterrent effect, but the resulting regulatory procedures that have been implemented are either overly restrictive or inadequately preventative. Clearer guidelines are needed.

Under the current language of ITSFEA’s dual standards of controlling person liability, only firms which are registered with the SEC, namely broker-dealers and investment advisers, are specifically required to establish, maintain and enforce insider trading procedures and policies.\(^\text{135}\) All other firms, including law firms, are held to a “reckless disregard” standard that imposes liability on those firms which recklessly disregard the fact that their employees are likely to violate the securities laws by failing to take appropriate preventative measures.\(^\text{136}\)

This Note proposes that Congress amend ITSFEA to include lawyers and law firms with broker-dealers and investment advisers under

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\(^{133}\) Harvey L. Pitt et al., *Law Firm Policies Regarding Insider Trading and Confidentiality*, 47 Bus. Law. 235, 239 (1991). The Subcommittee on Civil Litigation and Enforcement Matters of the ABA’s Section of Business Law Federal Securities Law Committee surveyed law firms that already have insider trading policies in order to provide all firms with some guidance in crafting a policy because so many law firms appear to have decided, on their own, to adopt such policies based on their own interpretation of what safeguards are sufficient. *Id.* The survey set forth a variety of sample policies to provide some much needed guidance.


ITSFEA’s requirement to establish, maintain, and enforce policies and procedures aimed at preventing insider trading. This amendment would address several problems under the current system. First, increased oversight of law firms through the imposition of an insider trading policy and procedures requirement would help regulate a profession that, by its nature, has the opportunity and the propensity to trade or advise others to trade securities while in possession of nonpublic information. Second, the legal profession is so intimately involved with the functioning of the securities industry that law firms serving investment banks, corporations, or other securities-related entities should assume heightened responsibility for detecting and preventing securities law violations by monitoring their employees’ use of inside information. Third, legislative action is needed because the present system of self-regulation in the legal profession inadequately protects the investing public from illicit trading. Finally, the legal profession needs better guidance to allow it to properly achieve ITSFEA’s original goals. The overriding concern in a proposal to increase regulation of law firms by a government agency should be to spread the cost and burden of securities surveillance to the firms that derive a significant and direct benefit from the securities industry.138

In conjunction with amending ITSFEA, Rule 2(e) should be modified to grant the SEC additional authority over attorneys to manage and enforce the new policy and procedures requirement. Authorizing the SEC to oversee law firm compliance with the proposed policy and procedures requirement would provide a second level of regulation over law firm confidentiality. Furthermore, the SEC would give firms guidance as to the limits and extent of their controlling person duties. As a well-respected federal agency, the SEC is in an excellent position to oversee nationwide regulation of securities fraud prevention measures. Through Rule 2(e) the SEC already has the ability to sanction lawyers, and even law firms. This proposal would expand this preexisting power.

As to the specific requirements of law firm policies, the House Committee provided some guidance regarding which procedures should be included in any insider trading policy. These suggestions, found in the House Report accompanying ITSFEA but not binding on its interpretation,139 should serve as the SEC’s basic foundation for industry-wide policy. In the report, the Committee designated three areas of importance: (1) restraining access to confidential information, (2) providing continuing education programs concerning the sensitivity of certain information,

137. See supra notes 45 & 80.


139. HOUSE REPORT, supra note 19, at 22.
and (3) restricting or monitoring the securities trading of employees. All three of these procedures should be incorporated into a system of guidelines that the SEC would provide for law firms under an expanded version of Rule 2(e) and ITSFEA.

The SEC should set up a three-level program of policy and procedure requirements. On the first level, firms that have practices involving little or no contact with the securities industry or public corporations would essentially only be held to the current recklessness standard. On the second level, firms that have corporate clients would be responsible for a basic system of antifraud measures similar to those suggested by the House Committee. At the third and highest level, additional procedures and policies should be ordered for firms that are major players in the securities arena. The specific nature of these tougher standards should be based on the present regulatory practices found in the securities industry.

Like other securities professionals, securities lawyers and firms falling into the third category should be required to register with the SEC in order to practice before it. Those lawyers and firms registering with the SEC would have to agree to be subject to the proposed criteria of the new ITSFEA.

The SEC also has the expertise and experience to adjust the specific criteria of law firm policies and procedures to account for differences in the nature of various law firm business. To this end, the House Committee clearly stated that in the context of broker-dealer and investment adviser regulation under ITSFEA, the SEC has broad authority to enforce the statute's provisions. Under the amendments proposed here, such enforcement power would allow the SEC to tailor the enforcement of ITSFEA to the unique problems found in the legal profession.

Just as the NASD, the NYSE, and the other SROs are the first level of enforcement in the securities regulation pyramid, law firms are in the best position to monitor and inform their employees of the responsibilities and consequences of possessing material, nonpublic corporate information. The legal profession should essentially act like a de facto SRO. This role would minimize the amount of time and expense the SEC would need to expend on securities enforcement of the legal community.

Of course, any increased oversight of the legal profession must be carefully delineated. Regulation of the legal profession by the SEC must be narrowly restricted. The SEC is a federal agency with the primary purpose of monitoring the securities markets; inappropriate expansion of its control of law firms could lead to abuse. By focusing SEC regulation

140. Id.

141. Id. The Committee stated that ITSFEA "provides the Commission with additional broad rule-making authority . . . and may require specific policies and procedures if it deems such action necessary or appropriate in the public interest or for the protection of investors." Id.
on law firms that directly practice before and participate in the processes of the SEC, this legislative proposal can achieve the goal of regulating while restricting the SEC's control. Former SEC Chairman Harold Williams expressed a similar position with regard to the disciplining of individual attorneys:

Rule 2(e) should not be utilized as an enforcement tool against those who violate the federal securities laws and happen coincidentally also to be lawyers or accountants. But where such individuals engage in professional misconduct which impairs the integrity of the Commission's processes, the Commission has an obligation to respond through the application of Rule 2(e).142

The problem of insider trading by lawyers and law firm employees straddles two industries which have distinctly different systems of administration and management. The securities industry has been highly regulated by the government to insure fairness in a business susceptible to fraud. On the other hand, the legal profession has remained largely self-regulated, free from governmental reach. This proposal strikes a balance between the legal profession's concerns about incursions on its independence and the government's desire to protect inequitable behavior.

Allowing the government to regulate any part of the legal profession will result in protest by the bar. The legal community has long resisted any outside oversight of the profession's practices and has opposed any attempt to create specialized sections of the bar. However, the time has come for the legal community to share in the costs of securities regulation just as it shares in the benefits of the market. In the specific context of insider trading, clarification of law firm and attorney responsibility would benefit the legal profession as well.

142. In the Matter of Keating, Muething & Klekamp, 47 S.E.C. 95, 120 (1979) (Williams, Chairman, concurring).