Gave input were able to effect some changes but we were not satisfied,

WRITTEN STATEMENT OF THE HONORABLE JOHN S.R. SHAD, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, BEFORE THE SUBCOMMITTEE ON TELECOMMUNICATIONS, CONSUMER PROTECTION AND FINANCE OF THE HOUSE ENERGY AND COMMERCE COMMITTEE CONCERNING THE INSIDER TRADING SANCTIONS ACT

April 13, 1983

## I. Introduction

The Securities and Exchange Commission appreciates this opportunity to testify in support of H.R. 559, the Insider Trading Sanctions Act of 1983. The bill would maximize the deterrent effect of enforcement actions brought against those who engage in insider trading, and thereby prevent violations that injure the investing public and undermine the integrity of the securities markets.

The bill would amend the Securities Exchange Act of 1934 by authorizing the Commission to seek civil money penalties of up to three times the profit gained or loss avoided when it appears to the Commission that any person has unlawfully purchased or sold a security while in possession of material non-public information. The proposed legislation would also increase the fines for most criminal violations of the Exchange Act from $10,000 to $100,000. The latter fines have not been increased in nearly 50 years.

## II. The Nature of the Problem

"Insider trading" is the term used to describe the act of purchasing or selling securities while in possession of material non-public information about an issuer or the trading market for an issuer's securities. Such conduct undermines the expectations of fairness and honesty that are the foundation of public confidence in our nation's securities markets.

The term "insider" includes corporate officers and directors and any other person who has a fiduciary or similar relationship of trust or confidence to the corporation or its shareholders as well as persons who, through some act or course of conduct, misappropriate material non-public information. As used herein, "inside information" includes information concerning the corporation, its activities or performance, or events related to the market for the corporation's securities, such as a proposed tender offer.

Abuses by insiders and their tippees erode investor confidence in the securities markets. Public investors may be less willing to place their money at risk in securities if they believe that insiders, with access to material non-public information, will utilize that information to victimize those without such access.

Insider trading also has a substantial adverse impact upon market professionals. Market makers and specialists are exposed to substantial losses when trading with persons who possess confidential inside information because they cannot make rational pricing decisions. Recently, several option writers have incurred multi-million dollar losses because they had to honor commitments to persons who purchased options while in possession of inside information concerning an impending acquisition.

The perceived gravity of the insider trading problem is illustrated by a 1981 editorial in Barron's entitled "Want a Hot Tip? There's No Way to Prevent Trading on Insider Information." Shortly thereafter, a Fortune article was entitled "The Unwinnable War on Insider Trading." These perceptions demand an effective response.

In order to curtail and deter insider trading, the Commission has sharply increased the number of enforcement actions against such conduct. In fiscal 1982, the Commission brought 20 cases involving insider trading (including one report of investigation pursuant to Section 21(a) of the Exchange Act). This number compares with a total of 50 insider trading cases brought since 1977 and 97 since 1949. Respondents in enforcement actions brought during fiscal 1982 included corporate executives, attorneys, accountants, bank officers, members of their families and others who purchased securities while in possession of material non-public information concerning proposed tender offers, or other significant developments.

Despite vigorous enforcement efforts, insider trading continues because it presents an opportunity to reap huge profits with little risk. Active markets in standardized option contracts and major tender offers permit several hundred thousand dollar profits to be realized within a few weeks on modest investments. The existing risks are not sufficiently great, given the opportunities for gain, to deter insider trading.

## III. The Need for an Additional Remedy to Deter Insider Trading

(a) Reasons for the recent increase in insider trading.

The large number of mergers and tender offers has been an important factor in the increased incidence of insider trading because the reaction of the market to the announcement of a proposed acquisition is predictable: the price of the stock generally moves close to the merger or tender offer price. Thus, persons with advance knowledge of a proposed tender offer or merger announcement have an opportunity to obtain substantial profits in a short period of time without great risk of loss.

Another important reason for the increase in insider trading is the expansion of trading in standardized option contracts. Call option contracts for the purchase of common stock are issued in series fixing the month of expiration and the price at which the option contracts can be exercised to purchase the common stock. Each option contract in a series represents the right to purchase 100 shares of stock. Thus, a single contract for "October 25" would entitle the holder to purchase 100 shares of an issuer's common stock for $25 per share until a specified date in the latter part of October, after which they would expire and become worthless.

The purchase of such options, rather than the underlying securities, enables a person in possession of material non-public information to maximize potential profits because the option price is generally a tiny fraction of the price of the underlying stock. Thus, a minimal amount of capital is placed at risk. However, once a tender offer or merger is announced, the value of an option contract tends to increase at a much greater percentage than the rise in the price of the stock.

(b) Recent Enforcement Actions

Enforcement actions with respect to insider trading have involved information relating to corporate events and the market for an issuer's securities. Corporate events have included increases or decreases in corporate earnings; increases or reductions in dividends; significant corporate transactions such as ore strikes, approval of patents, joint ventures, settlement of litigation and entry into the casino gambling business. External factors which impact the prices of publicly traded securities have included mergers and tender offers; rates of government issued securities; recommendations by analysts and financial writers; and potential enforcement action by the Commission.

The Commission has instituted enforcement actions against different classes of persons for trading while in possession of material non-public information. These include issuers, officers, directors, and employees; principal shareholders; attorneys, accountants and investment bankers who trade in securities of their clients; officers and directors of bidders in tender offers; investment analysts; and financial printers and others.

On October 26, 1981, for example, the Commission filed an action for injunctive relief in the United States District

Court for the Southern District of New York entitled Securities and Exchange Commission v. Certain Unknown Purchasers of the Common Stock of and Call Options for the Common Stock of, Santa Fe International Corporation. The Commission's complaint alleged that certain unknown persons purchased securities, and options to purchase the securities, of Santa Fe International Corporation (Santa Fe) while in possession of material non-public information relating to merger negotiations between Santa Fe and Kuwait Petroleum Corporation (KPC). It alleged that, between September 21, and October 1, 1981, the defendants purchased 3,000 call option contracts, at a total cost of $384,206; the options could be exercised to purchase 300,000 shares of Santa Fe common stock. The Commission also alleged that the unknown purchasers acquired 27,000 shares of Santa Fe securities at a cost of $340,000. Following the announcement of a merger between Santa Fe and KPC on October 5, 1981, the value of the option contracts increased by $5,344,763 and the value of the securities increased by $335,000. All of the shares and most of the option contracts were sold in the two week period following the announcement.

A named defendant in the Santa Fe case was Faisal Al Massoud Al Fuhaid. The Commission's complaint alleged that Mr. Fuhaid purchased 500 option contracts at a cost of $49,700, which were sold after the announcement. The complaint alleges that he realized profits of $843,719 as a result of his transactions.

On September 29, 1982, the Court entered a Final Judgment of Permanent Injunction against Darius Keaton. Mr. Keaton, who was one of the unknown purchaser defendants and a director of Santa Fe, purchased 10,000 shares of Santa Fe at a cost of $235,000. According to the complaint, Mr. Keaton sold the securities, after announcement of the merger, for a profit of $278,750. Mr. Keaton consented, without admitting or denying the Commission's allegations, to the entry of the Final Judgment enjoining him from violating the anti-fraud provisions of the Federal securities laws and ordering him to disgorge $278,750. The litigation is continuing as to the other unknown defendants.

On April 7, 1982, the Commission filed a second enforcement action involving transactions in options or securities of Santa Fe prior to the Santa Fe-KPC merger announcement. Gary L. Martin and various entities controlled by Martin were named as defendants in this action.

The Commission's complaint alleged that Martin is a Certified Public Accountant and financial adviser whose clients include an outside director of Santa Fe and various businesses related to the director. The complaint further alleged that, commencing on or about August 20, 1981, Martin obtained material non-public information concerning the forthcoming merger from the Santa Fe director and used or misappropriated this information to purchase 800 Santa Fe options for the accounts of entities he controlled. These options, which could be exercised to purchase 80,000 shares of Santa Fe common stock, cost approximately $54,000. According to the complaint, Martin sold or exercised the 800 options, following the October 5 announcement of the Santa Fe-KPC merger agreement, for a total profit of approximately $1.11 million.

On September 28, 1982, the Commission filed a civil injunctive action against Ronald A. Feole, the General Counsel and a Vice President of of Santa Fe Minerals Inc., which is a wholly-owned subsidiary of Santa Fe International Corporation. Other defendants were also named. The Commission's complaint alleged that Feole, in connection with his employment, learned material, non-public information concerning the Santa Fe-KPC merger agreement, that he communicated such information to his wife, and that Feole and his wife directly and indirectly communicated such information to friends and relatives. The complaint alleged that, while in possession of such information, Feole and other defendants purchased 585 call options and 1,390 shares of Santa Fe at a total cost of $64,861.58. The complaint alleges that after the public announcment of the merger agreement, the defendants sold the call options and shares for a total profit of $750,376.

On September 30, 1982, the Commission filed a civil action for injunctive and other equitable relief against James H. Randolph, a Vice President of a wholly-owned subsidiary of Santa Fe and Charles Blackard, another employee of the subsidiary. The Commission's complaint alleged that, while in possession of material non-public information, Blackard purchased 20 Santa Fe options at a cost of $1,940.00 which he exercised after the public announcement of the merger with KPC. Blackard received 2000 Santa Fe shares which he tendered pursuant to the merger agreement. According to the complaint, he realized profits of $40,060 as a result of his transactions.

The Commission also alleged that Randolph recommended the purchase of Santa Fe options to his father-in-law, who subsequently purchased 65 Santa Fe options over two days at a total cost of $1,059.52. According to the complaint, Randolph's father-in-law sold his Santa Fe options following the merger agreement for a profit of $76,647.

The Commission alleged that substantial profits were also realized by persons in possession of material non-public information in connection with a tender offer by Whittaker Corporation for the common stock of Brunswick Corporation. The Commission alleged that J. Robert Fabregas, an employee of a lender involved in the Brunswick acquisition, purchased 100 Brunswick call options at a total price of $6,693, sold the options following the announcement at a price of $60,194 and realized a profit of $53,471. In addition, the Commission alleged that Fabregas caused 100 Brunswick call options to be purchased in the account of his wife at a price of $4,256 and that these options were sold after the announcement for $59,637, resulting in a profit of $55,381. Fabregas settled the suit, without admitting or denying the Commission's allegations, was enjoined from engaging in further violations, and required to disgorge illicit profits.

The cases described above illustrate the opportunities for profit inherent in the recent conjunction of increased tender offers and acquisitions with the availability of trading in standardized option contracts. These circumstances have fundamentally altered the risk-reward equation with respect to potential insider trading and demonstrate the need for a new enforcement remedy to deter such conduct.

(c) The Need for a Civil Penalty to Deter Insider Trading

The Commission's principal enforcement remedy is a civil injunctive action against persons who have traded securities while in possession of material nonpublic information. 1/ An order of the court enjoining a defendant from further violations of the provisions proscribing insider trading is punishable by contempt proceedings. In addition, in virtually every instance in which the Commission has sought an injunction against a person for trading on inside information, it has also sought disgorgement of illicit profits.

In recommending enactment of the Insider Trading Sanctions Act, which would authorize civil money penalties of up to three times the profit gained or the loss avoided by persons who purchase or sell securities while in possession of material non-public information, the Commission pointed out that its existing remedies are not adequate:

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1/ The Commission has also instituted administrative proceedings against persons subject to its regulatory authority who have traded on inside information or who have aided and abetted persons who have traded on inside information. In addition, the Commission, pursuant to the authority conferred by the Securities Exchange Act, has made evidence of insider trading available to the Department of Justice for determinations as to possible criminal prosecution.

> An injunction orders a defendant to obey the law in the future and subjects a defendant to the threat of contempt proceedings if he violates the law again. As such, it presents no significant hardship to the defendant because "[c]ompliance is just what the law expects." In view of this and the fact that they are prospective in operation, injunctions do not penalize the defendant for the illegal conduct for which the injunction was imposed. 2/

The Commission also noted that, while it may seek disgorgement of illegal profits, this remedy merely "strips the defendant of the fruits of his illegal conduct and returns him to the position he was in before he broke the law." Thus, the Commission concluded, "it is necessary to raise the level of risk that potential insider traders face if insider trading is to be effectively deterred." 3/

The Commission recognizes that there are factors, in addition to Commission enforcement actions, that tend to deter persons from engaging in insider trading. For example, insider trading may subject a person to criminal prosecution by the Justice Department; imprisonment and criminal fines; civil suits by defrauded parties; disbarment, license revocation and other proceedings by professional and self-regulatory organizations; the loss of employment; substantial legal

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2/ The Commission memorandum in support of the bill is reprinted in 14 Securities Regulation & Law Report 1704, 1706-1707 (October 1, 1982). The Commission quotes Walling v. Harnischfeger Corp., 242 F.2d 712, 713 (7th Cir. 1957).

3/ Id.

expenses; and social opprobria. Nevertheless, these factors have not provided a sufficient measure of deterrence to prevent insider trading because of the unusual opportunities for gain inherent in using material non-public information.

The proposed legislation would dramatically increase the risks associated with insider trading by authorizing the Commission to seek a court order requiring offenders to pay the Treasury of the United States a sum up to three times the profits gained or losses avoided through illicit transactions. The Commission would be authorized to seek this remedy directly, and would not be required to first obtain an injunction.

IV. An Explanation of the Insider Trading Sanctions Act of 1983

Section 2 of the proposed legislation would authorize the Commission to bring a civil action in federal district court, based upon insider trading, and seek relief in the form of a civil money penalty payable to the Treasury. The amount of the penalty would be in the court's discretion, but would be limited to a maximum of three times the profits gained or losses avoided through insider trading.

The new remedy could be used in lieu of, or as a supplement to, traditional Commission injunctive and administrative remedies. Thus, in an appropriate case, the Commission could decide to seek an "obey the law" injunction, disgorgement of illicit profits, and a civil penalty of up to three times the amount of illicit profits. The court could exercise its broad discretionary powers in determining the disposition of disgorged funds (e.g. putting the money in an escrow account which could be used to compensate victims of the insider trading), but any civil penalty imposed would always be paid to the Treasury.

If a person upon whom a civil penalty is imposed fails to pay the penalty within the prescribed time, the Commission could refer such failures to the Attorney General, who could recover the penalty in a separate action in the appropriate United States district court. Alternatively, the Commission could seek enforcement of the court order through contempt proceedings, as in the case of other court ordered remedies available to the Commission.

V. Ancillary Issues

As proposed, H.R. 559 contains the essential elements needed to deter inside trading. Since the Bill was introduced, responsible parties have submitted thoughtful comments on certain issues.

Heretofore, the Commission's sanctions have been remedial. In view of the penalties now proposed, such parties have queried:

1. whether the right to a trial by jury should be granted;

2. whether the court or a jury should determine the amount of any penalty;

3. whether the penalty should be based on all profits subsequent to execution of a transaction based on inside information, or be limited to the profits within a reasonable period (e.g., two business days) after dissemination of such information;

4. whether there should be a statute of limitations for such penalty actions;

5. whether the Bill should include a definition of insider trading;

6. whether the burden of proof should be "clear and convincing evidence" rather than a "preponderance of the evidence"; and

7. whether the extent of potential liabilities under <u>respondeat</u> <u>superior</u>, aiding and abetting and control person theories of liability should be defined.

Most of the foregoing were discussed by members of the staff and Commission prior to the proposal of this legislation.

Nevertheless, the Commission appreciates that responsible corporations, professional organizations, securities firms and others incur significant direct and indirect expenses in order to assure compliance with securities laws. In order to avoid the imposition of unintended compliance expenses, which are ultimately borne by the investing public, the Commission recognizes the need for legislation to be clear, unambiguous and predictable in its interpretation and application.

The challenge is to evaluate legitimate concerns and appropriately clarify ambiguities. If the Subcommittee feels the areas cited should be clarified, the Commission will be pleased to submit language for your consideration.

VI. <u>The Need for an Increase in the Maximum Criminal Fine for Violations of the Securities Exchange Act</u>

Section 3 of the proposed legislation would raise the maximum criminal fine for most violations of the Exchange Act from $10,000 to $100,000. 4/ The increased criminal fines would not be limited to cases involving insider trading.

The maximum $10,000 criminal fine provided in the Exchange Act has not been changed since it was enacted, nearly fifty years ago. In the intervening period, inflation, as measured by the Consumer Price Index, has been nearly 700%. Thus, the deterrent effect of a $10,000 fine has been significantly eroded by the passage of time. By raising the maximum to $100,000 the Act will counter the effects of inflation, and enhance the potential deterrent effect of criminal fines.

In fiscal 1982, the Commission issued litigation releases reporting that $357,500 in criminal fines were imposed by federal district courts in cases involving violations of the federal securities laws. 5/ An increase in the maximum criminal fine will emphasize the importance of deterring securities law violators, assure the availability of remedies that will have a greater deterrent effect, and thereby prevent future violations of the law. In addition, larger fines will benefit the public by allowing the federal government to recoup a

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4/ The only violations exempt from this increase are violations of Section 30A of the Exchange Act (the Foreign Corrupt Practices provisions). These latter violations are treated separately by Section 32 of the Exchange Act and provide for maximum criminal fines of $1,000,000 for issuers, and up to $10,000 for individuals.

5/ This figure includes cases involving multiple counts in which defendants were also convicted of such crimes as mail, wire, or banking fraud, tax code violations, or perjury.

greater portion of the cost of detecting and prosecuting securities law violators.

## VII. Consideration of the Adequacy of Other Sanctions and Remedies Available to the Commission

The Commission has not considered, and is not prepared to propose, any additional sanctions or remedies at this time. The following are preliminary facts and opinions. No attempt has been made to assess cost-effectiveness or unintended compliance expenses that these remedies may impose on responsible parties that are not the intended targets of such sanctions.

The Division of Enforcement has been reviewing the adequacy of the sanctions and remedies available to the Commission. This review has involved three distinct inquiries:

1. Whether there are ways to increase the level of risk for those who violate the securities laws;
2. Whether the Commission should have greater ability to tailor remedies in administrative proceedings to the circumstances of a case; and
3. Whether it is possible to enhance the ability of the public to distinguish between violations of the federal securities laws.

### (a) Civil Money Penalties

There are different types of civil penalties and different purposes for which they can be established. One rationale, which is reflected in the Commission's recommendation of the Insider Trading Sanctions Act, is increased deterrence. On the other hand, civil penalties might be used to mitigate the potential harshness of license suspensions.

A civil money penalty may be imposed, depending on a statute, by either a court or an administrative agency. Most provide for relatively small penalties for common and repetitive offenses. There are some, however, which provide for fines in excess of $25,000 per violation.

The Commission has not considered whether it would be desirable to seek legislation authorizing any civil penalties in addition to the Insider Trading Sanctions Act. The federal securities laws have always been viewed as remedial rather than punitive. Additional civil penalties might change the character of the Commission's enforcement program, inhibit settlements of Commission enforcement actions and cause the judiciary to be less receptive to Commission actions designed to protect the investing public. Accordingly, the relative merits of other civil penalties will require careful consideration by the Commission.

(b) Cease and Desist Authority

Cease and desist authority would permit the Commission to issue an administrative order, once a violation is found, that directs a person to refrain, or cease and desist, from engaging in violative conduct. Such a remedy would:

1. Increase flexibility in tailoring remedies to the circumstances of a case;

2. Eliminate gaps in the Commission's administrative authority; and

3. Establish a remedy for violative conduct that might otherwise escape redress.

On the other hand, there is a question whether the Commission should spend its enforcement resources in pursuit of incidental cases that do not warrant the entry of an injunction, particularly since cease and desist orders would not be enforceable through contempt proceedings.

(c) Expansion of the Commission's Authority Under Section 15(c)(4) of the Securities Exchange Act

The staff is also reviewing whether the Commission's authority under Section 15(c)(4) should be expanded to include violations of Section 14. This change would make it possible to deal with violations of the tender offer requirements and the proxy provisions in an administrative forum. Additional perspective in this area is expected from the Commission's Advisory Committee on Tender Offers which is expected to recommend proposed improvements by July 8 in the regulations and laws which govern changes in corporate control.