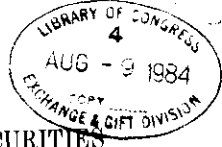


THE INSIDER TRADING SANCTIONS ACT OF 1983



HEARING

BEFORE THE
SUBCOMMITTEE ON SECURITIES

OF THE

**COMMITTEE ON
BANKING, HOUSING, AND URBAN
AFFAIRS**

UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

SECOND SESSION

ON

H.R. 559

TO AMEND THE SECURITIES EXCHANGE ACT OF 1934 TO INCREASE THE
SANCTIONS AGAINST TRADING IN SECURITIES WHILE IN POSSESSION
OF MATERIAL NONPUBLIC INFORMATION

APRIL 3, 1984

Printed for the use of the
Committee on Banking, Housing, and Urban Affairs



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THE INSIDER TRADING SANCTIONS ACT OF 1983

TUESDAY, APRIL 3, 1984

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, D.C.

The subcommittee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Alfonse M. D'Amato (chairman of the subcommittee) presiding.

Present: Senators D'Amato and Proxmire.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. The hearing on the Insider Trading Sanctions Act will come to order in the Securities Subcommittee.

Today's hearing will consider legislation formulated to deter insider trading. There are two approaches before us. One is H.R. 559, a bill passed by the House which authorizes the imposition of up to a triple penalty for insider trading. H.R. 559 does not include a definition of insider trading. Instead, it relies on case law growing out of SEC antifraud rule 10b-5. The second approach is included in a draft which I offer for discussion. The draft before you is derived from an idea presented by Milton Freeman in his testimony last April before the House Subcommittee on Telecommunications, Consumer Protection and Finance. My bill would abandon the rule 10b-5 requirement that the SEC prove fraud and show that the trader intended to deceive or defraud investors to whom he owed a duty. Instead, it would create a new section in the securities laws to supplement rule 10b-5 which would simply proscribe the unfair use of inside information. The SEC would no longer be required to prove that the insider had a special relationship with the person he was trading with or that the insider intended to defraud the other party.

Insider trading is a blight on our capital markets. I concur wholeheartedly with John Fedders, the Director of the SEC's Division of Enforcement that insider traders are thieves. I also concur with Mr. Fedders' statement that insider trading is not a victimless crime. Even if the person who deals with the insider trader would have traded anyway the integrity of the market is the victim since it is seriously undermined.

The capital markets in the United States are noted internationally for their efficiency and integrity. Because of this, municipal and corporate borrowers from around the world rely heavily on our markets as a major source of capital. The perception that U.S. markets are relatively free from fraud and abuse fosters investor confi-

dence, which in turn increases the depth and liquidity of our capital markets. Failure to preserve the integrity of our markets could ultimately increase the cost of borrowing as investors seek investment alternatives which they perceive as fair.

SEC rule 10b-5 has been the Commission's basis for barring insider trading. The rationale is that corporate insiders owe a fiduciary duty to the shareholders and that the use of inside information to profit in stock transactions is a fraud against the shareholders. The Supreme Court, however, has narrowly construed the term "insider." Under rule 10b-5, various classes of traders fall through the cracks and are permitted to benefit from trading while in possession of material nonpublic information. Arguably current law doesn't cover most forms of options trading.

Clearly, the corporate executive who knows of record earnings and purchases stock before corporate earnings are publicized is an insider within the reach of the SEC under rule 10b-5. But what about the financial printer who uses the confidential information he obtains after breaking a secret code? According to the Supreme Court's 1980 *Chiarella* opinion, the financial printer is not guilty of insider trading because he is not an insider within the meaning of rule 10b-5. He did not owe any fiduciary duty to the corporation's shareholders. In *SEC v. Dirks* (1983), the Supreme Court ruled that there is no violation of the rule if the person using the information is not an insider and if he did not receive the information from an insider who received a personal benefit and breached a fiduciary obligation. This opinion leaves the door open to the unscrupulous to obtain material nonpublic information and to benefit without the fear of civil or criminal penalties, it also makes the SEC's job more difficult by requiring them to show that the tipper received a benefit. Finally, in recent weeks, we have seen insider trading involving outsiders and outside market information in the *Searle* case, and the *Wall Street Journal* case. The SEC has announced formal investigations of these cases, but I question whether the current law is adequate to deal with these situations.

In addition to not reaching all insider traders current law lacks deterrence. The harshest remedy the SEC may currently seek against an insider trader is disgorgement of the ill-gotten gain or loss avoided, and an injunction mandating that the violator observe the securities laws in the future. Clearly this provides little in the way of deterrence since violators only risk is being returned to their original position. I fully support a triple penalty for insider trading as well as an increase in the fine for criminal violations of the securities law from \$10,000 to \$100,000. My only question is how should we apply the penalty.

Since the House concluded their hearings last April I have attempted to sort out this problem. I solicited input from the Securities and Exchange Commission and even requested a draft of a definition of insider trading. My staff has discussed these issues with the SEC, the securities bar, the securities industry, and other concerned parties.

It is my hope that the dialog started last year will continue today and these hearings will provide a record for deciding the following issues:

One, whether the current law is adequate to preserve investor confidence by deterring or punishing those who trade while in possession of inside information?

Two, if we decide that the current law is inadequate, can we find a workable definition?

Three, if we decide not to create a definition, how do we apply a triple penalty to the existing law?

I thank all of the people who have contributed their time and effort in the last year in pursuit of a legislative solution which would protect investors and preserve the integrity of our capital markets.

[Bill H.R. 559 and draft of legislation proposed by Senator D'Amato follows:]

include, but are not limited to, (i) those which restrict any purchase, sale of any such security or (ii) those which prevent such individuals from knowing such information.

(d) It shall not be necessary to establish a violation of this Section 16(f) that the acts made unlawful be proved to be done with any purpose to deceive, manipulate or defraud investors but only that the use of information was unfair as violating an express or implied obligation.

(e) Any person violating this section shall forfeit the amount of the profit gained or the loss avoided and shall pay an amount determined by the court in light of the facts and circumstances up to three times the amount of the profit gained or the loss avoided into the Treasury of the United States upon order of a United States District Court in an action commenced by the Commission under Section 21(a).

For purposes of this paragraph "profit gained" or "loss avoided" is the difference between the purchase or sale price of the security and the value of that security as measured by the trading price of the security a reasonable period after public dissemination of the nonpublic information.

(f) This section is in addition to any other provision of law and, particularly, shall not be deemed in any way to restrict the scope of sections 10(b) and 14(e) of this Act and the rules promulgated thereunder.

SEC. 1

Section 13 of the Securities Exchange Act of 1934 is amended by striking "10(b) (3)" from subsection (a), and inserting in lieu thereof "10(b)(3)".

Senator D'AMATO. Before we turn to our first panel, which is Chairman Shad, Mr. Fedders, and Mr. Goelzer, my distinguished colleague, Senator Proxmire, is here and I wonder if he has an opening statement.

Senator PROXMIRE. No, thank you very much, Mr. Chairman. This is a very, very important hearing and I am glad you're calling it and I look forward to the testimony.

Senator D'AMATO. Thank you.

Chairman Shad.

STATEMENT OF JOHN S.R. SHAD, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, ACCOMPANIED BY JOHN FEDDERS, DIRECTOR, SEC DIVISION OF ENFORCEMENT; AND DANIEL L. GOELZER, SEC GENERAL COUNSEL

Mr. SHAD. Thank you, Chairman D'Amato. It is requested that our formal statement be included in the record.

Senator D'AMATO. It shall be.

Mr. SHAD. Chairman D'Amato, Senator Proxmire, and other members of the subcommittee: With me here today are John Fedders, the SEC's Enforcement Division Director, and Dan Goelzer, who is the SEC's General Counsel.

The Securities and Exchange Commission appreciates this opportunity to testify on S. 910 and H.R. 559 today, the Insider Trading Sanctions Act, passed by the House in September 1983.

This legislation would permit civil penalties of up to three times the profits gained or losses avoided when a person unlawfully purchases or sells a security while in possession of material nonpublic information.

It also increases the fines for most criminal violations of the Exchange Act from \$10,000 as established in 1934 to \$100,000.

INSIDER TRADING UNDERMINES PUBLIC CONFIDENCE

Insider trading undermines public confidence in the fairness of the securities markets. It victimizes not only individual and institutional investors, but also securities firms, corporations, and others. Option writers have incurred multimillion-dollar losses as a result of insider trading. Insider trading has also caused corporate tender offers to be modified, trading in securities to be suspended, and newspaper articles and investment adviser recommendations to be withdrawn and modified.

The reputations of leading law firms, securities firms, corporations, publications and others have been impugned by unscrupulous employees who have abused their positions of trust to take advantage of inside information.

As a result of the record volume of tender offers since mid-1981, the Commission has brought over 50 insider trading cases. They represent over 40 percent of all such cases that have ever been brought by the Commission.

Defendants have included corporate executives, attorneys, accountants, brokers, bank officers, members of their families, and many others.

The expanding options market and volume of tender offers have increased the opportunities to reap extraordinary profits with little

risk. Because of the leverage afforded by options, over hundredfold profits have been realized within 48 hours on inside information.

The Commission's principal enforcement remedy is a civil injunction against future violations and disgorgement of the illegal gains. Inside traders may also be subject to criminal prosecution, imprisonment and fines, civil suits by defrauded parties, disbarment, and license revocations, the loss of employment, and social opprobrium. However, these have not been adequate to deter those tempted by extraordinary profit opportunities.

The proposed legislation would dramatically increase the risk of insider trading. For example, under the present law, if A conveys inside information to B who realizes a \$100,000 profit, A or B can be compelled to disgorge the whole \$100,000. Under the proposed bill, in addition to disgorging the \$100,000 profit B could be compelled to pay a fine of \$300,000. A could also be fined \$300,000. Thus, the total disgorgement and penalties could be increased in this example by sevenfold and in fact it could be much more than that if there were more parties involved—from \$100,000 to \$700,000 in my example.

On the other hand, the bill is not intended to inhibit legitimate corporate activities for the benefit of shareholders, or to increase compliance costs, which investors ultimately bear.

As passed by the House, H.R. 559 contains several amendments suggested by the SEC.

AMENDMENTS SUGGESTED BY SEC

First, penalty fines would be limited to those who trade while in possession of material nonpublic information or who tip such information.

Second, penalty fines would not apply to those whose liability is secondary or vicarious. For example, those who aid and abet insider trading other than by tipping would not be subject to the penalty, but they would continue to be subject to the SEC's present sanctions.

Third, the fine would be based on the price of the security a reasonable time after public dissemination of the information and would not take into account subsequent profits.

Fourth, Commission actions seeking imposition of the fine would be subject to a 5-year statute of limitations.

The Commission recommends that the bill be further amended to incorporate a present Commission rule that provides that multiservice firms that have effective Chinese walls are not liable for trades by employees shielded by such walls from information possessed by other employees.

The House bill would also grant the Commission the same administrative authority to address false and misleading proxy and tender offer filings as it has in the case of other filings.

The Commission has recently proposed similar legislation that also includes the authority to name the individuals who caused such violations.

The Commission was advised last week that the subcommittee has under consideration an alternative approach to the Insider Trading Sanctions Act that includes a definition of the conduct

that would be subject to the penalty. The Commission applauds Chairman D'Amato for his efforts to resolve the difficult issues raised by proposals to define insider trading. Some members of the SEC staff favor the amended version of H.R. 559 rather than the alternative approach, but the full Commission has not as yet had an opportunity to make a comparative analysis of the new approach with the existing state of the law, and some of the preliminary conclusions vary. Some would argue that the new approach is much simpler, has greater specificity, and in some ways is narrower; and yet others would contend that it's much broader and would bring into play a whole host of new charges and prospective defendants.

The Commission would like to have the opportunity to do a serious comparative analysis of the new approach with the present state of law and then submit pros and cons and its conclusions for your consideration, Mr. Chairman, and the subcommittee's consideration.

The other area that has been raised for today's discussion is waiver by conduct, which is an excellent concept. It has not as yet been considered by the full Commission. Questions can be raised concerning the cost and benefits of any new legislation. I raise this proposal for consideration in order to gain greater foreign support and cooperation for it. While some might characterize it as an extraterritorial application of our laws, it includes a reciprocal provision in which the United States would give similar treatment to foreign countries who are soliciting information concerning trades in their countries and many others in the United States. Also I think we would benefit from broad public exposure and the solicitation of comments.

Thank you very much. I'd be glad to respond to any questions.

PRESENT STATE OF THE LAW

Senator D'AMATO. Thank you very much, Mr. Chairman.

Let me pose a problem to you as I see it and it's a very disturbing one. Let's look at the present state of the law with respect to insider trading. In the *Chiarella* case, you had a financial printer who uncovered the name of a target of a tender offer and he purchased the stock prior to the tender offer. Even though he devised the scheme to crack the code and then profited from the information, the Supreme Court said that he wasn't guilty under our present law.

The Court reasoned that *Chiarella* was not a so-called insider within the meaning of rule 10b-5 and since he owed no duty to the shareholders he was exempt from that provision of the law.

Now in light of that, don't you see a glaring loophole? Here is a person who comes in and cracks the code, who takes this information, who profits by this information. Isn't there a need to proscribe this conduct?

Mr. SHAD. The Commission believes that we could sustain such an action today, but I'd like the General Counsel to comment. In fact, there's some helpful language in the *Chiarella* case, notwithstanding the bottom line in the case—some helpful language relating to the misappropriation theory which has been upheld in subsequent cases.

Mr. Goelzer, would you like to comment?

Mr. GOELZER. I think John Fedders may also have some comments about these issues since he's responsible for actually bringing the enforcement actions in this area, but just concerning *Chiarella* generally, let me say this. I think the reason that the Supreme Court overturned Mr. Chiarella's criminal conviction was that the theory that had been presented in the charge to the jury in this case was not sustainable. It was one based on equal access to information. The misappropriation theory was not presented to the jury in the *Chiarella* case.

We believe, therefore, and we've brought a number of cases since *Chiarella* based on this proposition, that misappropriation of inside information is illegal under existing law. We have a case right now before the second circuit which is almost identical to *Chiarella*.

Senator D'AMATO. Well, the fact is that the Supreme Court has not reversed itself in that particular case, have they? It's still the law.

Mr. GOELZER. They have not. However, they have—

Senator D'AMATO. You have taken the case up to the second circuit and what you're saying is you hope that maybe they will come out with a new ruling on it.

Mr. GOELZER. Well, the Supreme Court did deny certiorari in a case called *Newman* subsequent to *Chiarella* in which the Government had charged the jury and prosecuted the case on the misappropriation theory that the concurring and dissenting opinions in *Chiarella* suggest it might be OK.

Senator D'AMATO. Mr. Fedders, you understand this Senator's concern? The concern is that if you're going to simply permit a narrow definition of insiders, then everything that takes place thereafter will be legal, people finding information or being given

information from someone who breaches a duty. To have a situation resulting like *Chiarella*, will cause people to be hurt. There are people who are losing profits. There is money that's being taken away from someone, as you testified.

Mr. FEDDERS. I think we effectively plead the misappropriation theory that Chairman Shad and Dan Goelzer talked about. As Dan has said, the Supreme Court, although holding that Mr. Chiarella was innocent of the charges brought against him, said the defect was one in pleading. It was not a case initiated by the Commission. It was a case initiated by the criminal prosecutor.

In a concurring opinion, Justice Stevens and Chief Justice Burger in his dissent, gave creditability to the misappropriation theory and the so-called conversion theory. The Commission has effectively used that theory since then, and criminal prosecutors have used it effectively in the case of *United States v. Newman*.

Now this theory is that an employee who misappropriates information from his employer that is subsequently used to profit in stock trading is guilty of securities fraud.

There's both good news and bad news. The good news is that the lower Federal courts seem to agree with the theory. The bad news is that the Supreme Court of the United States has rejected certiorari in the *Newman* case. The conviction of Newman does stand. Until the Supreme Court confirms the misappropriation theory, there's always some concern on our part in pleading cases using the misappropriation theory.

So I share the reluctance you have. So does the Chairman and so does Mr. Goelzer. But yet, at the present time, when we plead the misappropriation theory we are bringing to these specific pleadings intellectual meticulousness under the Chief Justice's dissent and Justice Stevens' concurring opinion, I think we are on viable and solid ground.

Senator D'AMATO. Let me ask you this. Would you describe the strengths and the weaknesses of the current law in layman's terms so the people can understand why we are at these crossroads in attempting to define the conduct that we find abhorrent and prompt this legislative hearing?

Mr. SHAD. Do you want me to start on that one? That's a very big question.

Senator D'AMATO. Whether you or Mr. Fedders would like to make an analytical comment.

WEAKNESSES OF THE PRESENT LAW

Mr. SHAD. I could comment and then he could amplify.

In terms of the weaknesses of the present law, I would say our concerns are that the long-term trend of the courts has been to steadily refine the definition and in doing so in some respects to narrow the application of the provisions of the securities laws that enable us to bring these cases. The most recent case is *Dirks*, where the Supreme Court introduced another refinement, if you will, in the law requiring that we be able to prove that the tipper had a direct or indirect benefit from making the information available to others who traded.

Each time that these cases have come up, the Supreme Court has tended to narrow the definition, but, the other side of the coin is that if we go to an entirely new definition, as proposed under the alternative to be discussed today, the problem that some are concerned about is that all of these new words and terms will have to be relitigated. Instead of bringing an increased certainty you're going to have perhaps a decade of new litigation because of such a dramatic change in the law itself. I would ask Mr. Goelzer to amplify on the weaknesses of the present law.

Mr. GOELZER. Well, I think you and John Fedders have given a good summary. Probably the main weakness is the fact that, as all of you have said, we don't know whether the Supreme Court will definitely sustain the misappropriation theory. We have had good luck with it in the lower courts since the *Chiarella* case, but the Supreme Court hasn't considered it.

I'd say that the other principal defect is the fact that at least one court of appeals has held that, in the misappropriation context, the injured investors have no private right of action to recover. That's the *Moss* case. I think that is a change in existing law that resulted from *Chiarella* and that is not favorable to those affected by insider trading.

Senator D'AMATO. Well, let me ask you simply, the rationale behind the misappropriation theory is that someone has converted and misused information, isn't this theory akin to the draft legislation before you that is based on use proscribing the unfair use of nonpublic information?

In light of that fact, wouldn't this bill supplement rule 10b-5?

Mr. SHAD. Yes; it could.

Senator D'AMATO. Wouldn't that be an additional strength in spelling out clearly the kind of conduct we wish to proscribe?

Mr. SHAD. My understanding is that the latest version of the proposal would fully incorporate rule 10b-5 so that all the actions and rights that the Commission has to suppress this activity under rule 10b-5 would be preserved. In addition, for purposes of this penalty, which obviously is a dramatic escalation of the costs of violating the law, there would be specific categories of individuals who could be charged, and the Commission would not have to prove fraud. It would suffice that if an officer or director of a corporation who is in possession of inside information purchased securities and made a profit, he would be subject to the penalty.

In my view—although the full Commission again hasn't formally considered it—in my view, such a proposal would add specificity and simplicity subject to the necessity to relitigate all of these new provisions over a period of years.

Senator D'AMATO. Mr. Fedders, would you care to elaborate on this? As I suggested, doesn't the proposed legislation supplement rule 10b-5 and make it easier for the Commission or the Justice Department to go after those people who are taking advantage of this information?

Mr. FEDDERS. I think you're correct, Senator. Whether it makes it easier or not, I don't know. In anticipation of this hearing, I have very carefully considered the pros and cons of the definition and I have prepared, if you want me to do it here or I can provide it to

you by letter, six very compelling reasons for a definition and six very compelling reasons against a definition.

Senator D'AMATO. You should truly seek public office.

Mr. FEDDERS. No, thank you. I have had enough sunshine in 2½ years.

At the same time, I have these six pros and cons and I will provide them either in this testimony or by letter.

Senator D'AMATO. I think it's important if you touch on them briefly.

SIX REASONS FOR A DEFINITION

Mr. FEDDERS. First, when considering a definition, it depends on how you approach it. There could be a codification of existing insider trading case law under section 10b of the 1934 act. That's one way. A second way would be an attempt to narrow or to broaden existing case law in the context of section 10b. The third way would be the approach you refer to as the Milton Freeman approach, which is to supplement rule 10b-5 and the antifraud provisions of the Federal securities laws.

Let me tell you what I think the six reasons are supporting a definition of insider trading.

First, Congress is our lawmaker. It has not taken the opportunity to define insider trading. This misconduct is generally prosecuted under the antifraud provisions of the 1934 act. Consideration of the Insider Trading Sanctions Act gives Congress an opportunity to establish the law prohibiting this course of misconduct.

Second, by defining insider trading, Congress would establish the parameters of the illegal conduct: namely, (a) whether an information parity law is desirable, (b) whether it agrees with the Supreme Court's application of the antifraud provisions in the *Chiarella* and *Dirks* decision, and (c) to address a host of other complex issues decided by the Federal district and appellate courts relating to trading while in possession of material nonpublic information about an issuer or the trading market for an issuer's securities by insiders, tippees, and remote tippees. The definition would permit Congress to prohibit the conduct it wants to make illegal.

Third, and I think this is the most compelling reason in favor of a definition, a definition would permit Congress to clarify the law for the benefit of the investing public as well as the Commission and criminal prosecutors. Justice Holmes has said that the tendency of the law must always be to narrow the field of uncertainty. Commentators have said that uncertainty remains in the law of insider trading, particularly the law relating to conduct by tippees. In my view, justice is too important to be left solely to judges and lawyers acting on a case-by-case ad hoc basis. Congress is our lawmaker. Clarification of the law by Congress would permit investors to chart their course of conduct confident in their obligations.

Fourth, the current state of the insider trading case law places an enormous burden on the Commission as prosecutor to determine whether a particular course of tipping or trading conduct is illegal. Insider trading by insiders and tippees, as I said, is prosecuted under the antifraud provisions, and the courts have developed a number of complex theories which must be met by the Commission and criminal prosecutors. For example, when initiating an insider trading case we must consider such diverse theories as (a) breach of duty, (b) misappropriation or conversion of information, (c) con-

structive or temporary insiders, and (d) communication of information for personal pecuniary or reputational gain or to confer a gift of trading information. These legal theories make application of law to facts difficult. These legal theories developed by the courts do not necessarily have anything to do with the harm to the public caused by conduct of insider trading.

Now I'm not criticizing the courts. They have a difficult task applying the general antifraud provisions to this wrongful conduct. As a result of the development of these complex legal theories, the Commission has had to allege in its insider trading complaints facts concerning the relationships of the parties which have little direct bearing on the act of insider trading by insiders or tippees. But the expansive allegations were necessary to meet the legal test established by the courts.

If Congress defines this prohibited course of conduct, it could make it easier on law enforcers to investigate and plead their cases without such theories as (a) duty, (b) misappropriation, (c) conferring a benefit, et cetera.

A fifth reason supporting a definition would be it is difficult to argue against any insider trading legislative proposal which would supplement the Commission's enforcement tools to prosecute insider trading and their tippees. I refer to the proposal that you have called the Freeman proposal. My understanding is that this new law would not infringe upon the Commission's ability to prosecute insider traders under the antifraud provisions or rule 14e-3.

Sixth, some have also argued that if Congress adds the triple civil money penalty for violation of the insider trading law, investors deserve greater clarity of the prohibited conduct.

Having given six advantages to be a good politician, I have six disadvantages as well.

SIX REASONS FOR NOT DEFINING PRESENT LAW FURTHER

My greatest fear—and I wouldn't want to minimize this a bit—is that Congress will turn its attention to a definition of insider trading and it will further delay the enactment of this important piece of legislation. Indeed, I fear it may kill the legislation.

The integrity of our markets requires this law to deter potential wrongdoers from this course of misconduct.

The second is a very important reason which was acknowledged by the House of Representatives. It is the House view that the law prohibiting insider trading has been sufficiently well developed by the courts to provide adequate guidance. They, and many commentators, are of the view that there are not great ambiguities in the law of insider trading. Their view is that the law works well and that the courts have properly restrained the Commission when it applies the antifraud provisions to courses of conduct which are not fraudulent and do not jeopardize the integrity of our markets.

Third, there is the legitimate concern that a definition with new terms and its legislative history would create new ambiguities, thereby increasing rather than limiting uncertainty. This will mean a decade of vigorous and expensive litigation over the new terms used by Congress. This concerns me. I am resource-oriented and believe that we have to have a cost-benefit analysis when we

consider this kind of undertaking. I am hopeful that, if Congress insists upon a definition, it will give great deference to the Commission and its views on what the definition should include.

Fourth, a definition of insider trading for purposes of enforcement actions under rule 10b-5 may reduce the Commission's flexibility to prosecute evolving types of misconduct. Who would have thought in 1934 about some of the kinds of insider trading that are being perpetrated on the public today? And any definition that ruins our flexibility is going to be a substantial burden on the Commission protecting the integrity of our markets. Maintaining flexibility rather than being locked into a definition that might prove too rigid to address currently unperceived abuses that might develop is desirable.

Fifth, a poorly drafted definition may unduly restrict brokerage firms in block trading, arbitrage, and other types of legitimate brokerage activity. Any carveouts in the definition for such activities would inevitably make legal some conduct Congress wants to prohibit.

Sixth and finally, drafting a comprehensive definition is enormously difficult. My colleague, Dan Goelzer, has said it is the greatest cottage industry in Washington, D.C., at the present time. The Commission staff can attest to this. Dan, myself, and our colleagues have been at the task for 5 months, and we haven't reached agreement. It is impossible to figure out all the alternatives and millions of permutations and combinations. All these cannot be addressed in a definition. This is why the antifraud provisions work so well. They provide the Commission the flexibility on a case-by-case basis.

I'm sorry to have taken so much of your time, but I think each of the six pros and cons are worthy of your consideration.

Senator D'AMATO. In recent weeks, we've had much attention on the SEC's inquiry with respect to CBS and the story that came out on Nutrisweet and the events surrounding that as well as the events of the reporter from the Wall Street Journal.

Under the present law, what theory do you proceed in terms of this action? I'm not asking you to get into the details.

Mr. FEDDERS. Senator, I think it would be inappropriate for me to even confirm the existence of a Commission investigation with regard to any of the matters to which you referred. I would answer only by saying that our surveillance of the market is more comprehensive than it has ever been. The insider trading program is something that is receiving 8 percent of our resources, both in fiscal years, 1982 and 1983, and in the present fiscal year.

If the words over the door of the Supreme Court mean anything, "Equal Justice Under Law," to begin to take specific fact circumstances and discuss them at this time, if I did that, I'm not worthy of holding this job. We will be vigorous and we will do anything, even on circumstantial evidence, to prosecute people who jeopardize the integrity of our markets.

Senator D'AMATO. Well, obviously you feel that you have sufficient tools under the present law to become involved in a case like this. Let me put it to you this way. If you had the definition before you which supplements rule 10-5, would that make your case easier or more difficult?

Mr. FEDDERS. Senator, that's a very difficult question. I would address it this way, which is going to be intentionally evasive. I have not studied—

Senator D'AMATO. Well, if you were to apply my definition to these types of cases—let's put aside the CBS issue and the Wall Street Journal—but that kind of situation, what would that do? Would that give you additional tools and resources? Would it make your case more difficult?

Mr. FEDDERS. If the hypotheticals you talked about were prosecuted today, I would probably not prosecute them under the definition. I would use the expansive language of the antifraud provisions of the Federal securities laws.

I have studied this definition for the weekend, and I've thought about what you've said and the way you've asked the questions. I have six principal concerns with the definitions proposed. I am not pooh-poohing on the definition. The man who drafted it was my mentor and he was my former partner. I have great respect for him, but, notwithstanding that, I have to bring my own independence to this.

DEFINITION AS DRAFTED MAY BE DEFENSE LAWYER'S MECCA

First, the definition as drafted may be a defense lawyer's mecca. It is filled with ambiguities which are correctible, but I don't want any definition that will provoke years of litigation. Every time the Commission has to litigate, it uses valuable resources.

Second, I'm not sure that the definition is sufficiently broad to cover certain illegal insider trading acts to which the treble penalty should apply. It addresses a narrower category of unlawful conduct than H.R. 559.

Third, if we're going to go to a definition, let's abandon some of these complex theories that the Supreme Court has given us in *Dirks* such as duty. Consequently, there is no real benefit of clarity of law to investors and the Commission.

Fourth, addressing tippee cases, as I read the definition, the tippee liability has been narrowed from that under rule 10b-5.

A fifth concern relates to the so-called safe harbor or Chinese wall tests. The attempt to recite what is presently embodied in rule 14e-3 are phrased in the disjunctive and, consequently, do not provide a sufficient breadth of investigator protection.

The sixth concern is probably the one that troubles me the most, and that's proof. My concern is that the proof of tippee's knowledge of a tippee's breach of fiduciary duty appears in the proposed definition to be higher than the scienter requirement in section 10(G).

Now section 10(G) presently includes recklessness, and I'm not so sure that the definition permits us to use recklessness as a proof standard.

So those are six concerns after a weekend of work, but at the same time, I think you can tell by the way I have the pros and the cons that I do think there are some benefits of a definition. I don't want to give the impression that I'm simply throwing the definition out. My job is to make sure that I have a tool that I can effectively prosecute with and I'm going to be free—doing it respectfully—to criticize it, only to improve it, not to kill it.

Senator D'AMATO. Senator Proxmire.

Senator PROXMIRE. Thank you very much, Mr. Chairman.

Mr. Shad, you obviously recognize insider trading as a serious, serious problem and you indicated it will be a more serious problem as time goes on due to mergers and so forth and I think Mr. Fedders called those who engage in insider trading thieves. Yet I'm wondering about the severity of the recommendations that you make to us here and whether or not the bill that comes from the House is really strong enough.

First, this is an evil that's been going on for a long, long time and I notice on page 3 of your statement, Mr. Shad, you indicate that there's been—using the arithmetic that you give us—that there's been about 140 cases brought against people who have been involved in insider trading.

Mr. SHAD. Yes.

Senator PROXMIRE. Mr. Fedders, as the head of the Enforcement Division, how many successful criminal prosecutions for insider trading have there been in the 50 years the SEC has been in operation?

Mr. FEDDERS. Less than 10, Senator.

Senator PROXMIRE. When was the last successful prosecution that required a fine or penalty?

Mr. FEDDERS. Certainly within the last 2½ years. I can't be specific. I have a couple cases in mind, but I can't be specific when the last one was. Certainly in the last 2½ years.

Senator PROXMIRE. Here you have a situation, as you say, where those who engage in insider trading are thieves and yet the chances of being prosecuted and penalized seem very, very slim—approximately 1 in 14, according to your own figures—and if you are prosecuted and convicted, you don't go to the slammer. The severest penalty is that you pay a fine of some kind.

Mr. FEDDERS. Let me explain to you what I consider to be the rationale for that if I could.

Senator PROXMIRE. Yes.

Mr. FEDDERS. In my view, no insider trading case has been prosecuted using direct, uncontroverted evidence. It's probably better to say it the other way. All insider trading cases are prosecuted on circumstantial evidence. No one leaves a paper trail saying that he's engaged in insider trading. We put these cases together by putting material nonpublic information in someone's possession and then you deal with phone conversations of one person to another. Those are all evidentiary problems that we have based on circumstantial evidence.

Now the burden of proof the Commission must meet is the preponderance of the evidence, and the Supreme Court has said in the *Herman MacLean* case in footnote 30, that circumstantial evidence is adequate to meet a preponderance of evidence test.

DIFFICULTY OF USING CIRCUMSTANTIAL EVIDENCE

Now when you go into the criminal forum you meet the burden of proof beyond a reasonable doubt, and to take circumstantial evidence and meet that burden is difficult for criminal prosecutors. That's why I think Chairman Shad's initiative with the civil penal-

ty is correct. We know that it's going to continue to be circumstantial evidence that we act on. We're going to meet the preponderance of evidence test. We're not only going to require disgorgement of ill-gained profits but—because of his, and your, and other Senators, and House initiatives—we're going to have the treble money penalty. But meeting the test of beyond a reasonable doubt in a criminal court is difficult.

Senator PROXMIRE. Let me just go back a little bit. Over the last 50 years there have been about three cases brought a year and about once every 5 years on the average, somebody has to pay some kind of a fine or some kind of financial penalty.

How many have been referred to the Department of Justice for prosecution?

Mr. FEDDERS. I can't give you a specific number, but I can tell you this—

Senator PROXMIRE. Will you give us the number that have been prosecuted for the record and indicate briefly a summary of each one, and the number in which a penalty has been paid?

Mr. FEDDERS. I think that number is readily available. I would say in the past couple years insider trading has become so prominent that there's not an insider trading case we filed where there is not an inquiry from a criminal prosecutor as to whether or not we believe that it might meet the beyond a reasonable doubt burden. None of them are neglected.

Senator PROXMIRE. Except wouldn't you agree that in view of the temptation for people who are insiders to trade on inside information that there have probably been close to several hundred or maybe several thousand infractions a year, but only about three a year have been prosecuted and only a tiny, tiny fraction of those have resulted in any kind of penalty, and there's never been a jail penalty.

Mr. FEDDERS. There could be a jail penalty under the criminal prosecution.

Senator PROXMIRE. Well, there never has been anybody who has gone to jail.

Mr. FEDDERS. To my knowledge, that's correct.

[The following information was subsequently submitted for the record:]



DIVISION OF
ENFORCEMENT
STOP 4-1

SECURITIES AND EXCHANGE
COMMISSION
WASHINGTON, D. C.

The Honorable Alfonso J.
Chairman
Subcommittee on Securities
Committee on Banking
Urban Affairs
United States Senate
Washington, D. C.

The Honorable William
Subcommittee on Securities
Committee on Banking
Urban Affairs
United States Senate
Washington, D. C.

Dear Senators:

During a recent hearing
on Securities and Exchange
Urban Affairs Committee
Act, Senator [Name]
with information regarding
trading and
investigation.

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Mr. SHAD. No. I said you misquoted me. In fact, what you did was quote a partial statement without the amplification which I just made. As far as Commissioner Treadway is concerned, you're absolutely accurate, and I would also add that Commissioner Treadway would be the first to say that when I informally solicited the views of the other Commissioners and senior staff in this area he had no expectation that that statement was going to be in the press or aired in Congress. I agree with his bottom line. In fact, if you review the testimony in the House on the same point, there was concurrence by all three Commissioners on how to deal with these kinds of problems and basically it's on a case-by-case basis.

I was characterized in the New York Times as having said we should only bring action against employees, never against the company. That's outrageous. I have never said that and that was the implication also, I believe, in your opening characterization. I've never said that.

Mr. FEDDERS. Senator, could I comment on that?

Senator PROXMIRE. Sure.

Mr. FEDDERS. I've learned in 2½ years that the Commission is a place of great intellectual nudity. It's not a place where anyone should ever fear of raising a question—the most junior staff member to the most senior person, Chairman Shad—should ever be concerned in raising an issue. This issue was raised with great integrity and I would tell you that after having heard every Commissioner, every staff member discuss this at length, that the difference of opinion is almost razor thin. I do think certain statements have been taken out of context. There is no message in any place of the Commission to go soft on anyone. We target no one. We elect to go soft on no one.

The great thing that has happened is that there is intellectual nudity. People are free to raise issues, to question old ideas, to try to make it a healthy and vital place. Today if there is any disagreement on this very issue, it's razor thin.

Senator PROXMIRE. I don't question any of that. I just wanted to quote Mr. Treadway who seems to take a different position, and you respect that position.

Mr. SHAD. I do.

Senator PROXMIRE. Now you testify that you agree with him in part.

Mr. SHAD. I concurred with him, and we have talked about it.

Senator PROXMIRE. Let me proceed then and get back to what Chairman D'Amato was asking about. Mr. Shad, you testified in the House that inside trading could be defined. You said, "it could be a very specific definition" and you said, "It would be possible to define who is an insider." And you suggested that "in cases where punitive sanctions are sought that you have a definition." Later you changed your position and opposed adding a definition in the bill concluding,

The Commission believes existing law is sufficiently clear to provide guidance as to prohibited transactions. A new statutory definition would necessarily incorporate new terms and concepts which would create more uncertainties and spawn future litigation.

Why the flip-flop? It almost sounds as if you're running for President.

Mr. SHAD. I think the first statement was my personal opinion. The second was the Commission's position. I think everyone who has addressed this area initially feels intuitively and emphatically that we should have a definition. We don't want to have ambiguity and uncertainty that's going to cause corporate executives, for instance, to inhibit desirable conduct for the benefit of shareholders for fear of exposing themselves to enormous penalties. We don't want to put high compliance costs on the securities industry because a fear that a broker executing transactions in the pell-mell of daily trading activities may later be deemed an aider and abettor of an insider trader. The huge liability and fines will in turn simply be passed through to the investing public; they will be borne in the final analysis by investors. So we would be greatly reducing the benefits we are trying to confer on investors if we inhibit desirable conduct or impose heavy compliance costs to their detriment. So that's where I started. I felt that if we had a specificity it would not have a tendency to increase the compliance costs or inhibit desirable conduct.

COMPLEXITY OF DEFINING ALL THE ISSUES

But as I've gotten into this issue, I've appreciated more and more its complexity, and the big risks of not coming out with a bill, of tying this thing up in a definition debate that could go on forever. It's so complex. A recurring issue is whether it should be narrower or broader. Should we attempt to codify the present state of the law and risk undue rigidity? There are those who would argue that preserving the flexibility of the courts to deal with the evolving problems and new techniques is better than adopting a rigid codification.

Senator PROXMIRE. Then, as I understand your position, you're against a definition in the bill because it would delay the bill and for other reasons.

Mr. SHAD. Well, no; I won't accept that. What I have said today is on behalf of the three sitting Commissioners, and, I hope, two more soon, we have not had an opportunity to formally sit down and look at, on a comparative basis the present state of the law and the subcommittee's proposed approach. I think it's got a lot of appeal. So before you sign me off, I think I'd like to get all full evidence and make a careful consideration of the new approach.

Senator PROXMIRE. At any rate, you come down on the side of no definition.

Now, Mr. Fedders, you testified in the House—

Mr. SHAD. Wait—

Senator PROXMIRE. Did you not? Didn't you say you came down on the side of no definition?

Mr. SHAD. No, damn it. [Laughter.]

Senator PROXMIRE. Now I'm really puzzled.

Mr. SHAD. I thought I said it clearly.

Senator D'AMATO. You got 6 for and 6 against.

Senator PROXMIRE. I'm going to deal with Mr. Fedders on that, but it would be nice if you fellows said you want the definition or don't want a definition. If you want one, what is it?

Mr. SHAD. I think the more you appreciate the problem, the more difficult it is to say flatly that you're opposed to a definition or you're in support of it.

Senator PROXMIRE. You want us to feel the same kind of deep intestinal pain that you feel?

Mr. SHAD. Thank you.

Senator PROXMIRE. Now with that in mind, Mr. Fedders, you testified in the House,

I happen to have confidence that we could come up with a definition, and I do not run away from it. I do not abandon that idea, but it is very difficult. One of the things I realize is once I do a definition that I can live with and I hope my colleagues are proud of, that it is going to be subject to a lot of challenge in the Congress.

Leave the challenge to us. What is the definition you would come up with? You gave us six on the one hand and six on the other and, like Harry Truman, I'm looking for someone to give me one-handed advice.

Mr. FEDDERS. Well, it pains me to tell you this, Senator. My advice would be to accept from the Commission—

Senator PROXMIRE. I'm sorry. What was that again?

Mr. FEDDERS. To accept from the Commission a law that would not be a codification of existing case law, that would not attempt to narrow or restrict the law, but that would be a supplement to the antifraud provisions.

I don't see how anyone who wants to attack this form of misconduct can ever attack something that supplements the enforcement remedies available to the Federal Government. Consequently if we had a supplemental rule, that's essentially what's in the Freeman definition here, I see no reason—how can anyone attack something that is supplemental to law enforcement to help us do our job? But I don't want a definition that causes me problems in other litigation. I don't want your definition, Senator. Frankly, I want my definition because I'm the guy who has to do the prosecuting. I say that obviously respectfully and very quickly respectfully.

Senator PROXMIRE. Thank you. I have other questions but I yield back to you.

Senator D'AMATO. What is your definition? Now you've got me going round and round.

Mr. FEDDERS. After 5 months of work, we're close. This is a difficult task. If we're asked to continue to work, I'm sure we can come up with something. But at the present time, I don't have anything, Senator, that I would be proud to hand to you.

The reason you put the work in at this end is once it becomes law, then you have two decades of litigation, and we don't want that.

Senator D'AMATO. But again, in terms of supplementing the existing law, I think quite clearly that it's necessary, that in certain cases we've got people driving trailer trucks through loopholes. So I think your effort is important and I think the fact that we've got this bill up in this manner to focus in on this issue is important. We simply can't take the position that because we may get litigation with respect to a new definition that we shouldn't go forward. I don't think it's going to impede prosecution since it will supple-

ment the existing law and it certainly isn't going to cause us to lose any cases.

SEC'S INVESTIGATION OF TOM REED

Let me focus on something else. Last year we held hearings on the SEC's investigation of Mr. Tom Reed. That's the case where the fellow traded with the options and he wanted to put all his options in his friends' names and give them a wonderful charitable gift.

The Commission ended up entering into a consent agreement with Mr. Reed in which he promised to behave in the future—I couldn't believe that—and that he'd return the profits. Now had it been necessary to litigate, wouldn't the fact that Mr. Reed had purchased options and not common stock been a problem for the Securities and Exchange Commission in pursuing litigation against him?

Mr. FEDDERS. I can confidently say to you, Senator, that I don't think so. I am aware of some cases that are of the point of view that rule 10b-5 covers it and the way we use it in our insider trading program covers only equities securities and there are some points of view out there that says it does not cover the options market. I think they are wrong. I think we can sustain our point of view, but, yes, I recognize the point that you make.

Senator D'AMATO. But isn't this a gray area that needs some clarification. Wouldn't it help to have more clearly defined language to insure that options trading is included in insider trading laws?

Mr. FEDDERS. Any time Congress can clarify a law on a cost-benefit analysis, it's helpful to us.

Senator D'AMATO. Do you have a suggestion in that regard?

Mr. FEDDERS. At this time I don't, Senator, but certainly—

Senator D'AMATO. I was going to say don't give me six reasons for and six against.

Mr. FEDDERS. The language that Mr. Goelzer and I and his colleague, Diane Sanger, whom I think you're familiar with, who has just done an absolutely marvelous job in working with some of Dan's colleagues who have just done a terrific job on working with this, but we're not done. If we send something over, it will be Tiffany in every respect.

Senator D'AMATO. How long can I wait for Tiffany?

Mr. FEDDERS. Some great diamonds take a very long time, but we hope you don't have to wait much longer. It will be good when you get it.

Senator D'AMATO. Mr. Fedders, I understand that you believe insider trading has increased because of the enormous increase in tender offers and mergers and the necessity to put less capital at risk when investing in the options market and the ease with which individuals can execute transactions in the U.S. capital markets from foreign jurisdictions with secrecy and blocking laws have created some very real problems.

Could you please explain for the record exactly what the secrecy and blocking laws are doing and how they have created this problem?

SECURITY AND BLOCKING LAWS

Mr. FEDDERS. These laws, Senator, are impeding the efforts of the Commission to protect investors and to police our capital markets. Secrecy laws exist in about 14 foreign nations, countries such as the Bahamas, Cayman Islands, Hong Kong, and Switzerland. Secrecy laws are confidentiality laws which prohibit the disclosure of business records and the identity of bank customers.

Blocking laws are quite different. They grew out of the alleged extraterritorial application of our antitrust laws. The two prominent blocking statutes that we frequently confront are in the United Kingdom and in France. Blocking statutes generally embody national interests and prohibit the disclosure, copying, inspection or removal of documents located in the territory of the enacting state in compliance with orders of foreign authorities. There are about 15 foreign jurisdictions which have blocking statutes.

Senator D'AMATO. Let me ask you something. Am I correct that your insider trading prosecutions involving the *St. Joe's* Mineral Corp. and the October 1981 announcement of the merger of Santa Fe and Kuwait Petroleum were impeded by the Swiss secrecy laws?

Mr. FEDDERS. You're right in both cases, Senator. Both of those cases illustrate the problems that we've encountered in policing our international capital markets and confronting foreign secrecy and blocking laws. In each case, we alleged that wrongdoers executed transactions through foreign banks in our capital markets and then when we attempted to learn their identity the foreign banks said, "I'm sorry, but there's a secrecy law applicable here and we cannot provide you the identity of the customer."

In the *St. Joe* case, we eventually brought a rule 37 motion to compel. After about an 8-month delay we received the name of Giuseppe Tome. We can now continue with our prosecution. In October 1981, after the announcement of the Kuwait Petroleum-Santa Fe transaction, we could tell from our market surveillance that a number of people had executed transactions through five different Swiss banks. We immediately brought an action in the Southern District of New York, froze assets, and since that time, 2½ years, have been working with the Swiss Government to get the identity of these individuals.

But law enforcement can only be effective if it's swift and economical. Unfortunately, here we have been impeded in our progress. We are hopeful. The Swiss have worked with us. We are hopeful that we will obtain the identities of the individuals in the late spring of this year.

Senator D'AMATO. Well, let me ask you something. How does this kind of transactions that you suspect were taking place—how does that hurt the little fellow right out there in the marketplace? Can you describe that, and what's the solution to this problem?

Mr. FEDDERS. Well, it does hurt the little guy substantially. It hurts everyone in our capital markets. I think what has happened by reason—

Senator D'AMATO. What did you suspect was taking place in that particular case, the *St. Joe's* case or the case you just referred to?

Mr. FEDDERS. Well, the *Santa Fe* case, because the market surveillance unit in the Division of Enforcement showed that pur-

chases of deep out of the money options had occurred immediately preceding the announcement of the Kuwait-Santa Fe transaction, it was likely that someone had inside information. The striking price of the options had nothing to do with the then market price of the stock. Then 3 days later there's an announcement of the transaction. The stock took an enormous jump and these people made millions of dollars.

Senator D'AMATO. You're talking about millions. How much?

Mr. FEDDERS. Well, in the \$10 million area.

Senator D'AMATO. \$10 million?

Mr. FEDDERS. Yes; we froze a little less than that. We still have under freeze the money before Judge Connor in the Southern District of New York.

Senator D'AMATO. That's \$10 million that people lost?

Mr. FEDDERS. Not only that they lost, but there were naked options written on the Pacific Stock Exchange and some of those folks have gone bankrupt because of this.

Senator D'AMATO. So people are out of business and a lot of people lost profits they would have otherwise made.

Mr. FEDDERS. Most were options so I don't know that they would have had profits, but they were naked. They wrote naked options and, consequently, they had to buy into the market because they were naked.

A DE FACTO DOUBLE STANDARD

But one thing I don't want to miss mentioning. You asked the question about how is the little guy hurt. What these secrecy and blocking laws have done to our market is they've created a de facto double standard. One standard of law enforcement for those who choose to effect such transactions from beyond our borders through intermediaries secrecy or blocking jurisdictions, and another strict standard for those who trade within our country. We have easy access to those individuals and can certainly enforce our laws, but we are impeded when confronting individuals hiding behind secrecy and blocking laws.

Senator D'AMATO. Do you have any suggested approach to deal with this problem?

Mr. FEDDERS. Well, Senator, there are three possible approaches that we could take. We could take a bilateral approach on a country-by-country basis. That would take an enormous amount of time. We could take a multinational approach, but I suggest that that would take years and I don't think the integrity of our market can wait for that. The third approach is a unilateral approach. At your request and Chairman Dingell's request, I wrote each of you on March 30 discussing possible legislation that I characterize, and John Shad spoke of in his introductory statement, as the waiver by conduct idea.

The rationale of this concept is that individuals and financial institutions who effect securities transactions in our markets make a deliberate and a voluntary decision to engage in conduct within this Nation. They do so in order to take advantage of what John Shad calls the fairness, the most efficient, and the cheapest markets in the world.

If a waiver by conduct law were enacted, foreigners would automatically waive the protections of secrecy laws as a precondition for engaging in securities transactions in the United States. Such waivers would be implied by the fact that the transaction took place in our markets. The United States could require that foreign investors make an explicit choice—either forego the investment opportunities available here, or give up the protection of foreign laws that might be used to conceal the identity of the investor and the circumstances of the transaction.

This concept is not an extritorial application of U.S. laws or an infringement on the sovereignty of other nations. People who conduct transactions through foreign institutions in our markets are engaging in conduct in the United States. They are making a direct and intentional decision to take advantage of our markets. Those availing themselves of this privilege thereby submit to the jurisdiction of the United States and leave the protection of secrecy and blocking laws behind. Indeed, it is the extritorial assertion of foreign laws that impedes the SEC's efforts to police our markets.

It's not a panacea. There are both pros and cons, and I set out about a dozen pros and cons in my letter to you.

Senator D'AMATO. Is there any administrative burden on the firms with regard to your proposal?

Mr. FEDDERS. In my view, as I say in my March 30 letter to you, I think they are minimal. Yes. Nothing is free in this society. The administrative burden I think would be minimal—by putting an extra sentence or two in their confirmation orders.

Senator D'AMATO. Before we go to the second panel, Senator Proxmire, do you have any other questions?

Senator PROXMIRE. Yes, I have just a couple and I apologize because I realize we have a very distinguished panel coming up.

Mr. SHAD, Christopher Demuth, the Office of Management and Budget's regulatory chief, in an analysis prepared for the Cabinet Council on Economic Affairs on the administration's 1984 regulatory agenda, is reported to have recommended rewriting the securities laws. Specifically he is reported as recommending the elimination of restrictions on insider trading and tender offers. Is that correct?

Mr. SHAD. I'm sorry. I didn't hear a couple of those words.

Senator PROXMIRE. Christopher Demuth—you know who he is—is reported to recommend rewriting the securities laws specifically recommending the elimination of restrictions on insider trading and tender offers.

Mr. SHAD. Yes, I'm familiar with that.

Senator PROXMIRE. He did make that recommendation?

Mr. SHAD. Well, I've never actually seen—I've never had direct communication that he made it. I have heard it reported. I have been told that it has been proposed and actually to be accurate, I haven't been told that there was any proposal on tender offers but on insider trading, yes. I heard there were suggestions, I would say, more in opposition to the proposal of the triple penalty.

Senator PROXMIRE. Is this an administration position in favor of eliminating restrictions on insider trading?

Mr. SHAD. I don't believe so. Dan, do you have anything on that?

Mr. GOELZER. As far as I know, the administration is not proposing that.

Senator PROXMIRE. You don't contest the assertion of Mr. Demuth. It seems to me when he speaks he speaks for the administration.

Mr. SHAD. I don't know. I guess you'd have to ask him to be sure whom he's speaking on behalf of, whether himself or the administration or OMB. But I want to make it clear that all I've heard—and I haven't seen anything in writing and have had no official communication—was the expression of reservations about the proposed triple penalty that we are now here supporting. I've heard that there are people within OMB and others who have serious reservations concerning the imposition of the triple penalty on insider trading, and I could amplify as to the reason if you wish me to do so.

Senator PROXMIRE. Has the administration or OMB expressed to you, as Chairman of the SEC, any position on regulatory reform in the Securities and Exchange Commission?

Mr. SHAD. I know of none, no. We get various forms of communication from OMB, principally concerning our budget, of course. I don't recall any on this subject—although they also require reports under the Regulatory Flexibility Act and other things.

Senator PROXMIRE. This is a very, very serious charge against the SEC I'm going to ask you about and I ask it recognizing that the SEC is still, in my judgment, the best agency in Washington and that you're a man of great integrity and ability and I think you've done your very best as Chairman of the SEC. Nevertheless, I'm disturbed by this statement by a highly respected former Commissioner, Bevis Longstreth, who wrote the following in the New York Times:

There's a growing risk the SEC would be seen on Wall Street as a paper tiger. This risk is rapidly becoming a reality. Its consequences will be adverse and long term. The SEC's effectiveness over the years has been on creating and sustaining the belief among issuers, securities professionals, their lawyers, and accountants that violations will not go undetected, that there is indeed a cop on the beat along Wall Street. If that belief fades, it will not be restored easily or overnight.

Now again, I want to repeat the fact that I have great respect and admiration for the SEC. It's been a fine agency and it is a fine agency.

IS THE SEC BECOMING A PAPER TIGER?

How do you respond to the assertion that the Commission is rapidly becoming a paper tiger by an insider, a former Commissioner, a man of the integrity and ability of Bevis Longstreth?

Mr. SHAD. Well, I certainly share your high regard for Bevis Longstreth. I think he's an extraordinary person. I strongly disagree with the paper tiger characterization, but that's certainly his privilege.

How can one say that the SEC is becoming a paper tiger when, over the emphatic opposition of virtually the entire securities industry we adopted a shelf registration rule? Why? Because we knew it was saving hundreds of millions of dollars for the benefit of corporations, and, ultimately, investors. We've consistently taken action guided by one principle as far as I'm concerned as a

Commissioner and as an individual, and that's what's in the best interest of the investing public.

Last month, we proposed changes in the tender offer area. We have reviewed the recommendations of our Tender Offer Advisory Committee, and we've testified in support of certain changes in the tender offer rules. On the other hand, we stated that, while the Advisory Committee recommended that we continue to honor, of course, and support the business judgment rule, the Commission's position is that shareholders would be better protected if the courts, in applying the business judgment rule, recognized potential conflicts of interest between management and shareholders. I don't make a one-inch concession to critics that say we are not trying to do an absolutely effective job. I think this is the best Commission the SEC has ever had in terms of the results over the past 2½ years. I'm proud of this Commission. No matter what we do, we're going to get criticism. I accept that; it goes with the territory; but I don't think it's just and I think we're doing a first rate job in protecting investors.

Senator PROXMIRE. How do you answer the criticism then that the SEC has been weakened because you have recommended cutting enforcement funds?

Mr. SHAD. Nobody has recommended cutting the enforcement program. In fact, the enforcement program under my direction has been one of the largest—

Senator PROXMIRE. Don't you have a smaller staff now than you had before in enforcement?

Mr. FEDDERS. It's smaller in relation to 1979, but the support that Chairman Shad has given the enforcement program since he's been there and since I've been there since July 1981 is unqualified. Statistically—

Senator PROXMIRE. That's a nice term of rhetoric but one way you measure that is by the manpower you have in enforcing the law.

Mr. FEDDERS. Senator, if you measure my manpower, then let's measure us by results also. The statistics are as follows: The first fiscal year, fiscal year 1982, 6 percent reduction in staff, 30 percent increase in enforcement actions, 254. Last year, virtually a flat enforcement staff, and a further increase from 254 enforcement actions in fiscal year 1982 to 261 enforcement actions last year. And I accept the thunderous applause.

Mr. SHAD. Senator, could I respond?

Senator PROXMIRE. Yes, sir. The reason I don't give thunderous applause is that I'm not sure the number of enforcement actions brought is the one and only measure of your record.

Mr. SHAD. It certainly isn't, and by all other criteria, we've seen record results. But I think the question is sort of a derivative question based on other things. The other things are that, in the course of budget hearings, I supported the administration's recommendation that we only receive a 3-percent increase in our budget. Actually, if you look at a list of the various agencies, the SEC has had by far one of the largest increases of any of the regulatory agencies. Looking at the budget in 1981 versus the budget that the administration approved for 1985, we've gone up over 33 percent in

that period of time. Most independent agencies have been cut. I'm talking about dollars now.

But it's a matter of record that when OMB proposed our initial budget they made some concessions to us but not enough and we got further increases. We ended up with a 3-percent increase in the budget which necessitated a 6-percent reduction in personnel because of other inflationary costs.

Now everyone in this room I believe—and certainly in the Congress—is very concerned about the size of the Federal deficits. Yet it troubles me that so often after the first breath of criticizing the huge deficits the next breath is, "But I need more. I want more for my agency, my district, my area."

Senator PROXMIRE. Chairman Shad, your agency in the past—and I haven't been associated with this in the Appropriations Committee recently—has been financed in large part by industry registration and administrative fees. Isn't that correct?

Mr. SHAD. We earned a profit in 1983.

Senator PROXMIRE. You bring in more money than you cost?

Mr. SHAD. Yes.

Senator PROXMIRE. So that the argument that you balance the budget by cutting the enforcement staff of the SEC, or the enforcement funding of the SEC, or holding it down to 3 percent does not seem to me a sensible fiscal move, or very persuasive.

PERFORMANCE OF SEC IMPROVED BY NEW TECHNOLOGY

Mr. SHAD. Well, I don't think in fact you want to balance the budget that way. If you eliminated the entire cost of the SEC, we would still be generating transfer and filing fees, so it would be a 100-percent profit. But I by no means advocate that obviously. I made the statement that, because of ongoing productivity improvements we could maintain our present level of activity despite a 6-percent reduction in personnel. We've more than done that. In every major division, we have achieved record results or the highest levels in several years in each of the last 2 years despite a 3-percent reduction in personnel over that period. We're doing, I think, a terrific job in improving performance through productivity by going to computers, by upgrading the speed and the efficiency of our entire activity, and we've got much bigger and exciting things in prospect. We are dramatically improving the productivity, efficiency, and effectiveness of this Commission.

Senator PROXMIRE. Let me ask just one more question, Mr. Chairman, and again I apologize for taking so long.

Mr. Shad, how do you respond to the assertion of Michael Kline of the law firm of Wilmer, Cutler, and Pickering and others, and I quote:

The additional appropriations and oversight may be more significant than amending the substantive statute. Instead of amending the law, you need more resources to enforce the law you have.

Mr. SHAD. We don't know the extent of undetected crime and that's true whether it's SEC, FBI, or anybody. It's true that, if we had more resources, we would bring more cases, we would pursue more wrongdoing. That's a judgment for Congress. It's a very difficult one. Where do you draw the line? I don't think there's any

question that if we doubled our budget there would still be areas in which we could still go beyond that. So do you triple it, quadruple it, or conclude that the SEC already has a very visible presence that is having a dramatic inhibitory effect on securities fraud. I believe we have. Judging by lineage in newspaper articles, it's gone up dramatically in the past 2 years. You can't pick up an issue of the Wall Street Journal today without seeing a story about the SEC's charging somebody with either securities fraud, or insider trading, or manipulation. The same is true of the New York Times, a general news publication.

So the SEC with this limited budget and this small staff is having a dramatic impact and visible impact because it's those stories that inhibit people from engaging in questionable conduct.

Mr. FEDDERS. Senator, could I just comment on one thing? I think my friend, Bevis Longstreth, wasn't calling us a paper tiger today. He just feared that we could become one.

Senator PROXMIRE. He said the danger of becoming one.

Mr. FEDDERS. We all have to be concerned with whether we might become one. The goal right now for the enforcement program is not to target it in one area. Insider trading gets enormous publicity because people can understand it and even people in the press can understand it and they can write about it.

Senator PROXMIRE. You said even the press?

Mr. FEDDERS. I don't know that I said that. We can check that. Eight percent of our resources—the goal today in the enforcement program is breadth and presence and seeking new ideas, new ways to attack different problems on the street, and that's really where we're being successful. I don't look to the insider trading book as a success or financial fraud, but are we successful in breadth and presence of the program; and that's the thing where it's a credit to all the enforcement attorneys, not to John Shad or myself or the other Commissioners or soon to be Commissioners. It's to the credit to these young people who are there day in and day out. When people criticize us, they're not really hurting us. The talismans are there. But it's hurting the staff people and that's the thing that I feel bad about.

Senator PROXMIRE. Thank you, Mr. Chairman.

Senator D'AMATO. I want to thank the Chairman, Mr. Fedders, and Mr. Goelzer. I'd ask you, if you would attempt to get some suggested legislative language to us. My inclination certainly is not to impede the enactment of the treble damages provision which I think is absolutely essential. I'll confer with the entire committee, particularly with my distinguished colleague, Senator Proxmire, with respect to just how we should continue to move this. We don't want to get bogged down in a situation where we have no legislation. There's no pride of authorship; but by the same token, I am not satisfied with the language that comes over from the House bill. I think that while it does address important areas with respect to seeing to it that those who do engage in insider trading pay an appropriate penalty—and I'm not so sure that that penalty is even large enough, it doesn't include a definition—however, it certainly is a step in the right direction. I think that we've got to work toward seeing to it that those gray areas are no longer gray and

enact legislation that will deal comprehensively with the problem. It's absolutely essential.

So while I'm not saying to you the language which has come over from the House side won't be amended to include a definition, I am pledging one thing, we're not going to get this mired down to the extent that we don't have any legislation on it at all. I think that would be a terrible shortcoming on our part. We are definitely going to get some legislative action this year. Both Senator Proxmire and I feel very strong in that regard.

Mr. SHAD. May I make a very brief statement?

Senator D'AMATO. Certainly.

Mr. SHAD. First of all, I want to applaud Chairman D'Amato for raising two critical new areas and ventilating some very desirable concepts. But I also want to say to Senator Proxmire how much I respect him and appreciate the tough questions he was advancing because it did give me an opportunity to respond, and I appreciate that, Senator.

Senator PROXMIRE. Thank you, sir.

Senator D'AMATO. Thank you very much.

Let me apologize to our second panel for the amount of time we took with our first panel, but obviously, as you saw, with the interest in the questions, we couldn't do anything less. I want to thank all of you for participating not only here today but also in terms of your communications and contact with the committee and indeed the effort and thought that you have given to this most important matter.

Why don't we start it off and we will take all of your testimony for the record in its entirety. You can summarize that which you feel is important and the Chair is not going to attempt to put any restrictions on you with regard to time because we think that this is a rather important issue.

STATEMENT OF MILTON V. FREEMAN, ESQ., PARTNER, ARNOLD & PORTER, WASHINGTON, D.C.

Mr. FREEMAN. Mr. Chairman, thank you for the opportunity to testify. My statement has all that I wish to say on the merits of the matter. I want to thank you for your kind reference to the proposal and the association of my name with it. I'm pleased and proud to be associated with it.

More than 40 years ago I was Assistant Solicitor for the Securities and Exchange Commission and dealing with the question of insider trading. In one day we adopted a rule to prohibit purchases on the basis of insider trading, now known as rule 10b-5. And 40 years later, when I suggested in House testimony last year an extension of that rule be made to deal with outsider trading, not unexpectedly, it did not receive similar unanimous and immediate approval. However, I was very pleased today to hear the testimony of the Securities and Exchange Commission. Although I had understood that they might be opposed to the matter, I'm pleased that today they indicated they are not opposed to adopting legislation which supplements rule 10b-5 and gives the Commission additional powers which I think they should have.