STATEMENT OF DAVID S. RUDER,
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION,
BEFORE THE SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE OF
THE HOUSE COMMITTEE ON ENERGY AND COMMERCE

CONCERNING ADDITIONAL METHODS TO DETER AND PROSECUTE
INSIDER TRADING

July 11, 1988

STATEMENT OF DAVID S. RUDER,
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION,
BEFORE THE SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE OF
THE HOUSE COMMITTEE ON ENERGY AND COMMERCE

CONCERNING ADDITIONAL METHODS TO DETER AND PROSECUTE
INSIDER TRADING

July 11, 1988

Chairman Markey and Members of the Subcommittee:

Thank you for this opportunity to testify on proposals to provide additional methods for deterring and prosecuting insider trading under the federal securities laws. By letter dated June 14, 1988, the Subcommittee requested testimony on the adequacy of present laws on insider trading and, in particular, on a draft legislative proposal under consideration by the Subcommittee. Your letter also indicated certain specific substantive areas of particular concern to the Subcommittee. These areas are:

- The sufficiency of present laws in attacking insider trading and facilitating enforcement of insider trading cases;
- The need for greater responsibility by securities firms to supervise the trading activities of their employees and detect insider trading violations;
- The role of private litigation in the policing of insider trading;
- The desirability of increased penalties for insider trading violations; and

- o The advisability of alternative statutory methods of encouraging sources of information concerning securities law violations.

In response to the June 14 letter, this statement discusses the adequacy of existing law, and the areas of particular concern to the Subcommittee, addressing in that context those proposals for legislative action of which the Commission's staff has been made aware by the Subcommittee's staff.

SUMMARY OF THE TESTIMONY

The Commission currently has a variety of alternative enforcement remedies to deal with insider trading, and has continued to pursue an aggressive and successful program against it. Nevertheless, the Commission has supported appropriate initiatives to strengthen the Commission's enforcement efforts and increase the deterrence of insider trading. The Commission has proposed legislation to define insider trading, and to facilitate international cooperation in the enforcement of the securities laws. The Commission also supported a proposal for additional civil penalty authority.

My views on the areas of particular interest to the Subcommittee may be summarized as follows. Effective supervision by brokers and dealers is an important component of the federal regulatory scheme, and the duty to supervise employees is well established under the securities laws. While existing mechanisms for preventing individual insider trading

violations by employees have not presented unique supervisory problems, it may be appropriate to consider additional steps to promote sound procedures.

Private rights of action have traditionally served as an important supplement to Commission actions. The Commission's proposed insider trading legislation set forth its position on the proper scope of private actions in insider trading cases.

In my view, the most important criminal sanction is the five year prison term. Because of the range of other monetary remedies available for insider trading, and the possibility of multiple criminal fines in serious cases, the current maximum fines do not appear to be inadequate.

While these are potential benefits to an informant reward program, there are also disadvantages. This concept needs further examination and analysis before reaching a conclusion as to its advisability.

Finally, the proposed legislation also includes a provision authorizing the Commission to conduct investigations to collect information and evidence pertinent to a request for assistance from a foreign securities authority. This provision was included in a legislative proposal recently recommended by the Commission.

I. The Adequacy of Present Laws on Insider Trading

A. Source of Insider Trading Prohibitions

As the Subcommittee is aware, the law of insider trading has developed pursuant to judicial and administrative decisions

construing the antifraud provisions of the federal securities laws, especially Section 10(b) of the Securities Exchange Act and Rule 10b-5. Under this body of law, "insider trading" refers generally to the act of purchasing or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material nonpublic information relating to that security. The law prohibits such trading by corporate officers and directors and other persons having a relationship of trust and confidence with the issuer or its shareholders. 1/ Under a theory developed in the Second Circuit Court of Appeals, such trading by persons who misappropriate material nonpublic information from sources other than the issuer also is prohibited. 2/ Tipping -- the wrongful communication of material, nonpublic information -- by such persons is also

---

1/ The Commission first articulated the prohibition against such insider trading in Cady, Roberts & Co., 40 SEC 907 (1961), stating that corporate insiders have an obligation to abstain from trading in the shares of their corporation unless they have first disclosed to the shareholders any material nonpublic information known to them. The Cady, Roberts "abstain or disclose" doctrine was subsequently endorsed by the Second Circuit Court of Appeals in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d. Cir. 1968), cert. denied, 394 U.S. 976 (1969).

2/ United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), aff'd on securities law counts by an equally divided court, 108 S. Ct. 316 (1987); SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), cert. denied, 471 U.S. 1053 (1985); United States v. Newman, 664 F.2d 12 (2d Cir. 1981), aff'd after remand, 722 F.2d 729 (2d Cir.), cert. denied, 464 U.S. 863 (1983). The "misappropriation" theory was previously discussed in the concurring and dissenting opinions in Chiarella v. United States, 445 U.S. 222 (1980).

prohibited, and tippees of tippees are also prohibited from trading or tipping. 3/

B. Enforcement of Insider Trading Prohibitions

The Commission currently has a variety of alternative enforcement remedies to deal with insider trading and other fraudulent or unlawful activities. The Commission's principal enforcement remedy is a federal court injunction prohibiting future violations of the securities laws. Under Section 21(d)(1) of the Exchange Act, the Commission may bring an action for injunctive relief "[w]henever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices" constituting a violation of the Act. Upon a "proper showing," the court shall grant a permanent or temporary injunction or restraining order. Courts have interpreted "proper showing" to require proof of a past violation and a reasonable likelihood of future violations. In such an action, once the equity jurisdiction of a court has been invoked on a showing of a securities violation, the court may fashion an appropriate remedy. 4/ In insider trading cases, one commonly invoked

---

3/ See Dirks v. SEC, 463 U.S. 646 (1983); SEC v. Texas Gulf Sulphur Co., supra, 401 F.2d at 852.

4/ SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082 (2d Cir. 1972); SEC v. Commonwealth Chemical Securities, Inc., 574 F.2d 90 (2d Cir. 1978).

equitable remedy is the disgorgement of a defendant's illegal profits. 5/

The enactment of the Insider Trading Sanctions Act ("ITSA") in 1984, provided the Commission with an additional important remedy against insider trading. ITSA provides the Commission with the authority to seek, in addition to an injunction and disgorgement, civil monetary penalties against insider traders and tippers up to three times the amount of profit gained or loss avoided as a result of the violation.

In addition to these judicial remedies, the Exchange Act authorizes the Commission to bring administrative proceedings against a broker-dealer and its associated persons for violations of the federal securities laws, including insider trading. The Commission may impose sanctions, including a censure, limitations on activities, and suspension or revocation of the registration of a broker-dealer or suspension or bar of a person associated with a broker-dealer.

In recent years, the Commission has continued to pursue an aggressive enforcement program against insider trading. Fiscal year 1987 was the most productive year in the Commission's history in this respect. In 1987, the Commission instituted 40 insider trading cases and obtained over $130 million in disgorgement and penalties under ITSA. Criminal law enforcement authorities also have been devoting substantial resources to

---

5/ See, e.g., SEC v. Materia, supra; SEC v. Tome, 638 F. Supp. 596 (S.D.N.Y. 1986), aff'd, 833 F.2d 1086 (2d Cir. 1987), cert. denied, 108 S. Ct. 1751 (1988).

prosecuting insider trading cases. In 1987, at least seven criminal actions based upon insider trading were brought by United States criminal law enforcement authorities. The Commission believes that the overall success of its enforcement program, the civil penalties provided by ITSA, and the increase in criminal prosecutions of insider trading and related offenses all represent significant deterrents to those who may consider committing such violations.

C. Recent Commission Proposals to Improve Existing Law

Notwithstanding the past success of the Commission's enforcement program, the increasing complexity of the nation's financial markets and the growth of international securities transactions, among other trends, highlight the need for continued vigilance in the detection, prosecution and deterrence of insider trading. The Commission has supported initiatives to promote the clarity and enforcement of the insider trading proscriptions. On November 18, 1987, the Commission submitted to the Senate Banking Committee proposed legislation on insider trading. This legislation would statutorily define and prohibit insider trading, utilizing and clarifying concepts of breach of duty and misappropriation embodied in existing law. The legislation also would, among other things, provide an institutional trading defense for institutions that have adopted certain reasonable procedures, address the issue of derivative liability for controlling persons and employees, provide express

private rights of action for certain persons, and clarify ITSA. A copy of that legislative proposal, accompanying analysis, and proposed accompanying legislative history are attached to this testimony.

On June 3, 1988, the Commission submitted to Congress the "International Securities Enforcement Cooperation Act of 1988," draft legislation to facilitate international cooperation in the enforcement of the securities laws, which would be particularly useful in the Commission's efforts to enforce the insider trading prohibitions. This legislative package would permit the Commission to assist foreign securities authorities by conducting investigations on their behalf. It also would amend the Exchange Act to enable the Commission to maintain the confidentiality of records produced under reciprocal arrangements with foreign securities authorities. The proposed legislation also would clarify the Commission's rulemaking authority to provide access to Commission records by foreign officials, and permit the Commission to institute administrative proceedings based upon a finding of a foreign court or securities authority. The Commission's proposal was introduced by Chairman Dingell on June 29, 1988 (H.R. 4945).

The Commission also has determined to support the recommendation of the National Commission on Fraudulent Financial Reporting that the Commission be provided with the authority to impose civil monetary penalties in administrative proceedings, and that courts be authorized to impose such penalties in

Commission injunctive actions. 6/ However, the Commission continues to believe that there are several issues that should be examined before specific legislation regarding civil monetary penalties is proposed. Among these issues are whether civil monetary penalties are appropriate in Rule 2(e) proceedings, whether such penalties should be imposed against corporate issuers under circumstances where shareholders bear the costs of the penalty, and the procedures by which standards governing the size of civil monetary penalties should be established. The Commission's staff is currently developing specific proposals for consideration by the Commission.

The Commission continues to support appropriate initiatives relating to insider trading. Improvements in the clarity and enforcement of current law, and in the Commission's ability to gather relevant evidence, would strengthen the Commission's enforcement efforts and increase the deterrence to insider trading.

II. Legislative Areas Under Consideration

A. Need for Greater Responsibility by Securities Firms to Supervise the Trading Activities of Employees and to Detect Insider Trading Violations

---

6/ See Statement of David S. Ruder, Chairman of the Securities and Exchange Commission, Before the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce, Concerning the Recommendations of the National Commission on Fraudulent Financial Reporting 24 (May 2, 1988).

The responsibility of broker-dealers to supervise their employees is well established under the securities laws. A failure reasonably to supervise will subject a broker-dealer to sanctions, as under principles of secondary liability, for violations of law committed by employees. Section 15(b)(4)(E) of the Securities Exchange Act expressly authorizes the Commission to censure, place limitations on the activities of, suspend, or revoke the registration of any broker or dealer if it finds that the broker or dealer, or any person associated with the broker or dealer, "has failed reasonably to supervise, with a view to preventing violations of [the securities and commodities laws], another person who is subject to his supervision," and the sanction is in the public interest. The section provides that no person shall be deemed to have failed reasonably to supervise if

> (i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and
>
> (ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

The Commission possesses the same disciplinary authority with respect to investment advisers under Section 203(e)(5) of the Investment Advisers Act. Analogous obligations to prevent violations by employees or agents have been recognized in civil

actions, under the controlling person provisions of Section 20(a) of the Exchange Act. 7/

Where the unlawful activity of employees or agents is on behalf of the broker-dealer or otherwise constitutes the conduct of the firm, the firm itself is liable as a primary violator of the law. The operation of this principle is reflected in Commission Rule 14e-3, which prohibits insider trading in connection with a tender offer. Under the terms of that rule, a firm could be found liable for insider trading even where one department of the firm engages in trading for the firm's account without possessing any material nonpublic information, if another department of the firm did possess such information. For this reason, Rule 14e-3 includes a defense to liability under the rule for non-natural persons that can show that:

> (1) the individual(s) making the investment decision on behalf of such person to purchase or sell any security described in paragraph (a) or to cause any such security to be purchased or sold by or on

---

7/ See, e.g., Marbury Management, Inc. v. Kohn, 629 F.2d 705 (2d Cir.), cert. denied, 449 U.S. 1011 (1980); Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111 (5th Cir. 1980).

Section 20(a) provides that "[e]very person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." "Controlling person" includes not only employers, but any person with power to influence or control the direction of the management, policies, or activities of another person.

behalf of others did not know the material, nonpublic information; and

(2) such person had implemented one or a combination of policies and procedures, reasonable under the circumstances, taking into consideration the nature of the person's business, to ensure that individual(s) making investment decision(s) would not violate paragraph (a), which policies and procedures may include, but are not limited to, (i) those which restrict any purchase, sale and causing any purchase and sale of any such security or (ii) those which prevent such individual(s) from knowing such information. 8/

The obligation of broker-dealers to supervise their employees is also reflected in self-regulatory organization ("SRO") rules, the violation of which may lead to a range of sanctions. For example, the Rules of Fair Practice of the National Association of Securities Dealers ("NASD") provide that members shall establish, maintain and enforce written procedures that will enable them to supervise properly their registered representatives and associated persons to assure compliance with applicable securities laws, periodically review the activities of each office to detect and prevent irregularities and abuses, and investigate the qualifications of their employees. 9/

8/ The substance of the institutional safe harbor in Rule 14e-3 currently applies equally to insider trading cases brought under Section 10(b) of the Securities Exchange Act and Rule 10b-5. See Letter from Chairman John S.R. Shad to Honorable Timothy E. Wirth (June 29, 1983), reprinted in H.R. Rep. No. 355, 98th Cong., 1st Sess. 28 (1983).

9/ NASD Rules of Fair Practice, Art. III, Sec. 27, NASD Manual (CCH) ¶ 2177. See New York Stock Exchange Rule 342, 2 NYSE Guide (CCH) ¶ 2342 (stating obligation; requiring designation of appropriate official, who must provide for appropriate procedures and a separate system of follow-up and review); American Stock Exchange Rules 320, 922, 2 Am.

(continued...)

Effective supervision by brokers and dealers of their employees and agents is an important component of the federal regulatory scheme of investor protection. The Commission has emphasized, in a number of recent administrative actions, the need for both the adoption and enforcement of adequate policies and procedures. 10/ With respect to insider trading in particular, the necessity for appropriate supervision to prevent trading violations by the firm is evident in view of the special opportunities for abuse in this area. 11/

Under consideration by the Subcommittee are two proposals to strengthen the law in this area. One proposal would authorize the Commission to seek civil penalties against controlling persons of persons who violate the insider trading prohibitions. The second proposal would impose an affirmative obligation on

---

9/(...continued)
Stock Ex. Guide (CCH) ¶¶ 9374, 9722 (same requirements as NYSE; with respect to options trading, requiring designation of appropriate official, written program for supervision of accounts and orders, maintenance of customer records); and Chicago Board Options Exchange Rules 4.2, 9.8, Chi. Bd. Options Ex. Const. & Rules (CCH) ¶¶ 2082, 2308 (stating obligation; requiring designation of appropriate official, written program for review of option accounts and orders, maintenance of customer records).

10/ See, e.g., In the Matter of Prudential-Bache Securities, Inc., et. al., Securities Exchange Act Rel. No. 22755 (January 2, 1986); In the Matter of Victor G. Matl, Merrill Lynch, Pierce, Fenner & Smith, Inc., et. al., Securities Exchange Act Rel. No. 22395 (September 10, 1985).

11/ See, e.g., SEC v. Kidder Peabody and Co. Inc., Civil Action No. 87-3869 (S.D.N.Y.), Litigation Rel. No. 11452 (June 4, 1987); SEC v. The First Boston Corporation, Civil Action No. 86-3524 (S.D.N.Y.), Litigation Rel. No. 11092 (May 5, 1986).

brokers and dealers to establish written policies and procedures to prevent violative conduct.

Liability of Controlling Persons for Civil Penalties

Currently, the Insider Trading Sanctions Act authorizes the Commission to seek civil penalties against any person who has violated the insider trading prohibitions through trading or tipping, i.e., those persons who were deemed "most directly culpable" in a violation. 12/ The statute expressly excludes from liability for penalties persons whose violations are predicated on theories of aiding and abetting, respondeat superior, or controlling person liability under Section 20(a). 13/

The draft Subcommittee proposal would amend ITSA to authorize the Commission to seek civil penalties against controlling persons. A defense to liability would be provided to a broker or dealer that could meet the standards of the defense currently provided in Section 20(a) and also show that it had implemented an appropriate system of supervision and control over the conduct of its controlled persons. 14/ The Commission would

---

12/ See H.R. Rep. No. 355, 98th Cong., 1st Sess. 9 (1983).

13/ These exclusions from the penalty provisions do not affect the availability of any other remedies against such persons.

14/ This provision would also apply to investment companies required to register under Section 8 of the Investment Company Act and investment advisers subject to Section 204 of the Investment Advisers Act.

be authorized to adopt rules requiring the implementation of specific procedures. Any other controlling persons would be afforded a defense equivalent to that presently provided in Section 20(a).

While the proposed amendment would apply to any person found to be a controlling person within the meaning of the existing language of Section 20(a), it is apparently directed primarily at concerns about the adequacy of broker-dealer supervisory processes over insider trading violations by employees. It has not been the Commission's experience that existing mechanisms for preventing individual insider trading violations by employees have presented unique supervisory problems. Existing incentives in this area are already substantial.

Nevertheless, it is necessary to assure that reasonable policies and procedures continue to be implemented to prevent and detect employee violations. While the imposition of civil penalties on firms in the event of employee insider trading violations would undoubtedly increase incentives to compliance, as discussed below, it may be more desirable to address any perceived inadequacies in broker-dealer supervisory processes on a more comprehensive basis. In this regard, the Commission recently approved various amendments to the rules of the New York Stock Exchange codifying and making explicit certain supervisory and compliance obligations of NYSE members and member organizations. 15/ These amendments require members and member

---

15/ Securities Exchange Act Release No. 25763 (May 27, 1988).

organizations to subject to review procedures trades for their own accounts, and those of employees and others, in New York Stock Exchange-listed securities and related financial instruments. 16/ The rules also require members and member organizations to conduct an internal investigation into any reviewed trade that appears to have violated the provisions against insider trading and other practices. 17/ These rules should enhance efforts to detect activities that violate the securities laws, including the prohibitions against insider trading.

Affirmative Obligation to Adopt Procedures

While brokers and dealers clearly are under a duty reasonably to supervise employees, with a view to preventing violations both by its employees and the firm itself, current law does not mandate specific means through which this duty must be fulfilled. As noted, the Exchange Act provides for the imposition of sanctions against broker-dealers for the failure reasonably to supervise employees, and the SRO rules generally require each broker-dealer to adopt those written procedures necessary to enable the firm to prevent securities law violations.

Brokers and dealers may be subject to a range of regulatory requirements at both the federal and state level as well as

---

16/ NYSE Rule 342.21(a).

17/ NYSE Rule 342.21(b).

fiduciary obligations to customers, clients, and shareholders. The steps appropriate to prevent violations may depend in large part on such factors as the nature of a firm's business and customers, the number and types of services it performs, and the structure and size of the organization.

For this reason, when the Commission adopted Rule 14e-3, and its defense to liability for non-natural persons, the Commission determined that the defense should require the implementation of policies and procedures that are reasonable under the circumstances, taking into consideration the nature of the person's business, and not require the implementation of any specific policies and procedures.

This approach is intended to provide flexibility to each institution to tailor its policies and procedures to fit its own situation. 18/ Such flexibility continues to be a desirable feature of the regulatory scheme. However, particularly in light of certain recent Commission actions, including several involving insider trading on the part of firms, it may now be appropriate to consider additional steps to promote sound supervisory processes.

The Subcommittee proposal would require that every registered broker and dealer adopt written policies and procedures, reasonably designed, taking into consideration the nature of its business, to prevent the misuse of nonpublic

---

18/ See Securities Exchange Act Release No. 17120 (September 4, 1980).

information. 19/ The Commission would be authorized to adopt rules to require specific policies or procedures. This proposal would enhance existing regulatory structures governing broker-dealers. Its effect would be to establish an affirmative obligation on the part of broker-dealers to codify and enforce a comprehensive system of supervision and control over their operations and employees. It is highly desirable that any additional regulatory requirements in the area of supervision recognize the full scope of obligations to which broker-dealers are subject and promote a rational and integrated approach to compliance. At the same time, the proposal would recognize the important role that the circumstances of a particular broker or dealer play in the formulation of an appropriate system of control. 20/

B. Role of Private Litigation

Private rights of action have traditionally served as an important supplement to the Commission's enforcement of the federal securities laws. In the area of insider trading, courts have permitted some private rights of action under Section 10(b) and Rule 10b-5, but also have imposed certain limitations on the

---

19/ This requirement would also be imposed on investment advisers, and possibly other regulated persons.

20/ See Statement of David S. Ruder, Chairman of the Securities and Exchange Commission, Before the Subcommittee on Securities of the Senate Banking, Housing and Urban Affairs Committee, Concerning the Commission's Revised Proposal to Define Insider Trading 9-10 (December 15, 1987).

class of persons to whom such actions are available. Under the existing case law, persons who have traded in the market contemporaneously with (and on the other side of the transaction from) the violator in a traditional insider trading case have been granted a right to recovery; 21/ however, contemporaneous traders in a misappropriation case have been denied the right to bring such an action. 22/ Recently, there have also been several cases brought by persons such as tender offerors who have claimed that they were injured by insider trading in the stock of a tender offer target. 23/

The Commission's position on the proper scope of private rights of action in insider trading cases was set forth in its legislative proposal to define insider trading. The Commission's proposal provided express private rights for two classes of persons: those who have traded contemporaneously with (and on the other side of the transaction from) the violators, and others

---

21/ See Wilson v. Comtech Telecommunications Corp., 648 F.2d 88 (2d Cir. 1981); Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); O'Connor & Associates v. Dean Witter Reynolds, Inc., 559 F. Supp. 800 (S.D.N.Y. 1983); Backman v. Polaroid Corp., 540 F. Supp. 667 (D. Mass 1982). But see Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977) (denying recovery where plaintiffs neither traded with the defendants nor were influenced in their trading decision by the defendants' trades).

22/ Moss v. Morgan Stanley Inc., 719 F.2d 5 (2d Cir. 1983), cert. denied, 465 U.S. 1025 (1984).

23/ See, e.g., Anheuser-Busch Co. v. Thayer, No. CA3-85-0794-R (N.D. Tex. Apr. 26, 1985); Litton Industries, Inc. v. Lehman Bros. Kuhn Loeb, Inc., No. 86-6447 (S.D.N.Y. Aug. 19, 1986).

who are injured by a violation in connection with their securities trading. With respect to the first class, contemporaneous traders, the Commission's proposal would reverse those cases that have precluded recovery by contemporaneous traders in misappropriation cases, 24/ and even in traditional insider trading cases when the plaintiffs neither dealt with the defendants nor were influenced in their trading decision by the defendants' trading. 25/ As under existing law, the liability of a violator to contemporaneous traders would be limited to the amount of profit gained or loss avoided by the defendant as a result of the violation. 26/ Damages imposed against a defendant in such a case would be diminished by the amount that the defendant has paid as disgorgement in a Commission injunctive action relating to the same violation. With respect to the second class of plaintiffs, the Commission's proposal would affirm existing cases that provide standing to any other persons, such as tender offerors, who may be injured by insider trading in connection with their securities transactions. Unlike contemporaneous traders, such plaintiffs would be required to prove that their damages were caused by the violation. However, recovery of any damages that were proved would not be limited to the amount of profit gained or loss avoided by the defendant.

24/ Moss v. Morgan Stanley Inc., supra.

25/ Fridrich v. Bradford, supra.

26/ See Elkind v. Liggett & Myers, Inc., supra, 635 F.2d at 172-73.

The proposed legislation under consideration by the Subcommittee would incorporate many aspects of the Commission's proposal, including a right of recovery for contemporaneous traders and a right of action for any other person injured by an insider trading violation. The proposed provisions relating to contemporaneous traders would differ from the Commission's, however, in two important respects. First, unlike the Commission's proposal, the legislation would change existing law by eliminating any cap on the defendant's liability in these cases. 27/ Current law seeks to achieve proportionality between the total recovery and the seriousness of the misconduct, generally imposing liability only for the amount of profit gained or loss avoided as a result of the violation. In contrast, under the Subcommittee's draft proposal, the scope of liability in any particular case would depend upon such factors as the overall volume of trading at the time of the violation or the number of plaintiffs in the case, rather than upon the magnitude of the defendant's transaction. Thus, the Subcommittee's proposal could produce arbitrary and inconsistent results in cases involving roughly equivalent violations. Therefore, this change in existing law is not advisable.

Second, unlike existing law, the right of recovery would not be expressly limited to persons on the other side of the

---

27/ Like the Commission's legislation, the proposal would provide that a defendant's liability be reduced by the amount the defendant has paid as disgorgement in a Commission injunctive action based on the same violation.

defendant's transaction, that is, purchasers in cases in which the defendant sold, and sellers in cases in which the defendant bought securities. Current law permits recovery only to contemporaneous traders on the opposite side of the defendant's transactions. This proposal could be read to permit the anomalous result that every person trading in the market contemporaneously with the defendant could be entitled to recovery. Again, this change could lead to arbitrary results. In addition, since traders on the same side of the market as the violation ordinarily would not in fact be injured, any recovery arguably would simply constitute a windfall. 28/ This change in existing law also is not advisable.

C. Increased Criminal Penalties

While the Commission does not, of course, enforce the criminal provisions of the securities laws, criminal prosecution of insider trading violations is a significant adjunct to an effective civil enforcement program. The number of insider trading prosecutions over the past eight years has increased dramatically and substantial sanctions have been assessed in some cases.

Section 32(a) of the Exchange Act currently provides penalties for criminal violations of the statute, including

---

28/ For the same reason, it is also unclear on what basis an appropriate measure of recovery could be determined.

insider trading violations, in the amount of a maximum fine of $100,000 and a maximum term of 5 years in prison. The maximum fine was raised from $10,000 in 1984 by the Insider Trading Sanctions Act. 29/ However, the maximum fines applicable to criminal securities law violations were effectively increased by the enactment of subsequent legislation. The Criminal Fine Improvements Act of 1987, adopted on December 11, 1987, imposes a maximum fine of $250,000 ($500,000 in the case of an organization) for the commission of a felony. 30/ The maximum fines imposed in any particular case would depend upon the number of counts on which the defendant was convicted.

The Subcommittee's proposal would amend Section 32(a) of the Exchange Act to increase the maximum penalties for criminal violations of the Act to $1,000,000. In my view the most important criminal penalty in this area is the five year prison term. Because of the range of the other monetary remedies available for insider trading, and the possibility of multiple criminal fines in serious cases, the current maximum fines do not appear to be inadequate.

29/ Under Section 32(a), criminal violations by an exchange are subject to a maximum fine of $500,000.

30/ See 18 U.S.C. 3571(b) & (c) (1987). See also the alternative fine provisions of 18 U.S.C. 3571(d). This statute provides that these maximums apply unless another statute specifying a lesser fine specifically states that the provisions of 18 U.S.C. 3571 do not apply. See 18 U.S.C. 3571(e) (1987); H.R. Rep. No. 100-390, 100th Cong., 1st Sess. 6 (1987).

D. Alternative Methods to Encourage Sources of Information

The Subcommittee's proposed bill would also amend the Exchange Act to authorize the Commission to pay rewards to persons who provide information that leads to the imposition of a civil monetary penalty under the Insider Trading Sanctions Act. These rewards, which could not exceed 10 percent of the penalty, would be made in the sole discretion of the Commission. The Commission's determination would not be reviewable by a court.

Members of the Commission and its staff have considered in the past whether to recommend that Congress authorize an informant reward program. For example, at a Commission roundtable on insider trading in 1986, several members of the Commission expressed the view that the proposal deserved serious consideration. The Commission never developed such a recommendation, however, largely because its resources were then devoted to prosecuting the many insider trading actions that stemmed from the Levine case. Many of these actions were based upon information provided by cooperating witnesses.

There are several potential benefits to be derived from an informant reward program. Although the Commission already initiates many investigations as a result of information received from informants, it is possible that the Commission would receive helpful information in more cases if informants had a monetary incentive. Such a program might also provide added deterrence, as the existence of a reward program might deter potential violators from pursuing their schemes because of the increased

risk that another participant would provide information to the Commission. Finally, to the extent that informants are available to testify, the Commission would be able to present direct evidence of a violation rather than rely upon circumstantial evidence.

One potential disadvantage to such a program is that the Commission might receive a large number of unproductive or misleading leads. It is possible that, each time a tender offer or some other significant event were announced, the identity of persons who purchased prior to the announcement would be brought to the Commission's attention by potential claimants. The Commission's existing surveillance capabilities already permit it to determine all purchasers of a stock prior to the public dissemination of material information. Thus, the mere identification of a purchaser would not be useful to the Commission unless the informant provided additional information concerning the purchaser's access to the nonpublic information.

It should also be noted that the testimony of a witness who has applied for a reward may be less credible than that of a witness who appeared without such incentive. Although such testimony would nonetheless supplement circumstantial evidence, and to that extent would be helpful, it is difficult to predict whether a trier of fact would choose to believe the testimony of the informant. Finally, it would be necessary to establish clearly that an informant could not use such a program to obtain immunity from criminal or civil prosecution for violations of the

securities laws. Immunity for information is already covered by the Organized Crime Control Act, 31/ pursuant to which the Commission may request the Attorney General to grant criminal immunity to particular persons. The Department of Justice has cooperated with Commission requests, and we believe the current system is sufficient to meet our needs in this area.

This area is one which needs further examination and analysis before reaching a conclusion regarding its advisability.

E. Investigatory Assistance to Foreign Securities Authorities

The proposed legislation under consideration by the Subcommittee also would amend the Exchange Act to authorize the Commission to conduct investigations to collect information and evidence pertinent to a request for assistance from a foreign securities authority. Under the proposal, the matter under investigation for the foreign authority need not constitute a violation of United States law. In deciding whether to provide assistance, the Commission, under the proposal, would be required to consider whether the requesting foreign authority has agreed to provide reciprocal assistance, and whether the request would prejudice the public interest of the United States.

31/ See 18 U.S.C. 6001 et seq. (1985).

This amendment was included as part of the Commission's proposed "International Securities Enforcement Cooperation Act of 1988" that was recently transmitted to the Congress and introduced by Chairman Dingell. The Commission recommended this provision because it believes it will enhance the Commission's foreign enforcement capabilities. Foreign authorities will be more likely to enter into bilateral assistance agreements with the Commission, and agreements in effect and under negotiation may be expanded, if the Commission has the authority to provide such investigative assistance to foreign authorities.

The Commission's proposed legislation also included several other provisions. The Commission's proposal also would amend the securities laws to permit the Commission to assure confidential treatment for records produced under reciprocal arrangements with foreign securities authorities. This is significant because, in some cases, negotiations for bilateral agreements with foreign authorities have been frustrated by the Commission's inability to provide assurances that documents and testimony transmitted to the Commission by foreign authorities will be kept confidential. The Commission cannot provide assurances of confidentialty because of its disclosure obligations under the Freedom of Information Act ("FOIA"). The Commission's proposed legislation would exempt from the FOIA documents furnished to the Commission if a foreign authority represented that the disclosure of such documents would violate confidentiality requirements of that country's laws.

In addition, the Commission's proposal would make explicit the Commission's rulemaking authority to provide documents and other information to foreign authorities, as well as to provide such materials to domestic authorities. Finally, the Commission's proposal would amend the federal securities laws to permit the Commission to institute an administrative proceeding against a securities professional based upon a finding of a foreign court or foreign securities authority that the professional engaged in illegal or improper conduct.

The Commission appreciates the inclusion of a provision for investigatory assistance to foreign authorities in the Subcommittee's proposed bill. Although it would be preferable if the additional provisions contained in the Commission's proposal were also enacted, this provision is the most critical component of the Commission's proposal. Its passage would enhance the Commission's ability to enter into information sharing agreements by providing impetus for foreign countries and securities authorities to expand their cooperation with the Commission in protecting the integrity of the securities markets.

III. Conclusion

I appreciate the opportunity to testify on proposals for additional methods for deterring and prosecuting insider trading. The prohibitions on insider trading play an important role in protecting the fairness, integrity, and efficiency of the

nation's securities markets. Vigorous enforcement of these prohibitions remains a high Commission priority. The Commission would be pleased to provide any further assistance to the Subcommittee in its efforts to enhance the law in this area.