

INSIDER TRADING AND SECURITIES FRAUD
ENFORCEMENT ACT OF 1988

SEPTEMBER 9, 1988.—Committed to the Committee of the Whole House on the State
of the Union and ordered to be printed

Mr. DINGELL, from the Committee on Energy and Commerce,
submitted the following

REPORT

[To accompany H.R. 5133]

[Including cost estimate of the Congressional Budget Office]

The Committee on Energy and Commerce, to whom was referred the bill (H.R. 5133) to improve the procedures and remedies for the prevention of insider trading, and for other purposes, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

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The amendment is as follows:

Strike out all after the enacting clause and insert in lieu thereof the following:

SECTION 1. SHORT TITLE.

This Act may be cited as the "Insider Trading and Securities Fraud Enforcement Act of 1988".

SEC. 2. FINDINGS.

The Congress finds that—

- (1) the rules and regulations of the Securities and Exchange Commission under the Securities Exchange Act of 1934 governing trading while in possession of material, nonpublic information are, as required by such Act, necessary and appropriate in the public interest and for the protection of investors;
- (2) the Commission has, within the limits of accepted administrative and judicial construction of such rules and regulations, enforced such rules and regulations vigorously, effectively, and fairly; and
- (3) nonetheless, additional methods are appropriate to deter and prosecute violations of such rules and regulations.

SEC. 3. CIVIL PENALTIES OF CONTROLLING PERSONS FOR ILLEGAL INSIDER TRADING BY CONTROLLED PERSONS.

(a) **AMENDMENT.**—The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended—

- (1) in section 21(d)—
 - (A) by striking out paragraph (2); and
 - (B) by redesignating subsection (d)(1) as subsection (d); and
- (2) by inserting after section 21 the following new section:

"CIVIL PENALTIES

"SEC. 21A. (a) AUTHORITY TO IMPOSE CIVIL PENALTIES.—

"(1) JUDICIAL ACTIONS BY COMMISSION AUTHORIZED.—Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information in, or has violated any such provision by communicating such information in connection with, a transaction on or through the facilities of a national securities exchange or from or through a broker or dealer, and which is not part of a public offering by an issuer of securities other than standardized options, the Commission—

"(A) may bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, a civil penalty to be paid by the person who committed such violation; and

"(B) may, subject to subsection (b)(1), bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, a civil penalty to be paid by a person who, at the time of the violation, directly or indirectly controlled the person who committed such violation.

"(2) AMOUNT OF PENALTY FOR PERSON WHO COMMITTED VIOLATION.—The amount of the penalty which may be imposed on the person who committed such violation shall be determined by the court in light of the facts and circumstances, but shall not exceed three times the profit gained or loss avoided as a result of such unlawful purchase, sale, or communication.

“(3) AMOUNT OF PENALTY FOR CONTROLLING PERSON.—The amount of the penalty which may be imposed on any person who, at the time of the violation, directly or indirectly controlled the person who committed such violation, shall be determined by the court in light of the facts and circumstances, but shall not exceed the greater of \$1,000,000, or three times the amount of the profit gained or loss avoided as a result of such controlled person’s violation. If such controlled person’s violation was a violation by communication, the profit gained or loss avoided as a result of the violation shall, for purposes of this paragraph only, be deemed to be limited to the profit gained or loss avoided by the person or persons to whom the controlled person directed such communication.

“(b) LIMITATIONS ON LIABILITY.—

“(1) LIABILITY OF CONTROLLING PERSONS.—No controlling person shall be subject to a penalty under subsection (a)(1)(B) unless the Commission establishes that—

“(A) such controlling person knew or recklessly disregarded the fact that such controlled person was likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent such act or acts before they occurred; or

“(B) such controlling person knowingly or recklessly failed to establish, maintain, or enforce any policy or procedure required under section 15(f) of this title or section 204A of the Investment Advisers Act of 1940 and such failure substantially contributed to or permitted the occurrence of the act or acts constituting the violation

“(2) ADDITIONAL RESTRICTIONS ON LIABILITY.—No person shall be subject to a penalty under subsection (a) solely by reason of employing another person who is subject to a penalty under such subsection, unless such employing person is liable as a controlling person under paragraph (1) of this subsection. Section 20(a) of this title shall not apply to actions under subsection (a) of this section.

“(c) AUTHORITY OF COMMISSION.—The Commission, by such rules, regulations, and orders as it considers necessary or appropriate in the public interest or for the protection of investors, may exempt, in whole or in part, either unconditionally or upon specific terms and conditions, any person or transaction or class of persons or transactions from this section.

“(d) PROCEDURES FOR COLLECTION.—

“(1) PAYMENT OF PENALTY TO TREASURY.—A penalty imposed under this section shall (subject to subsection (e)) be payable into the Treasury of the United States.

“(2) COLLECTION OF PENALTIES.—If a person upon whom such a penalty is imposed shall fail to pay such penalty within the time prescribed in the court’s order, the Commission may refer the matter to the Attorney General who shall recover such penalty by action in the appropriate United States district court.

“(3) REMEDY NOT EXCLUSIVE.—The actions authorized by this section may be brought in addition to any other actions that the Commission or the Attorney General are entitled to bring.

“(4) JURISDICTION AND VENUE.—For purposes of section 27 of this title, actions under this section shall be actions to enforce a liability or a duty created by this title.

“(5) STATUTE OF LIMITATIONS.—No action may be brought under this section more than 5 years after the date of the purchase or sale. This section shall not be construed to bar or limit in any manner any action by the Commission or the Attorney General under any other provision of this title, nor shall it bar or limit in any manner any action to recover penalties, or to seek any other order regarding penalties, imposed in an action commenced within 5 years of such transaction.

“(e) AUTHORITY TO AWARD BOUNTIES TO INFORMANTS.—Notwithstanding the provisions of subsection (d)(1), there shall be paid from amounts imposed as a penalty under this section and recovered by the Commission or the Attorney General, such sums, not to exceed 10 percent of such amounts, as the Commission deems appropriate, to the person or persons who provide information leading to the imposition of such penalty. Any determinations under this subsection including whether, to whom, or in what amount to make payments, shall be in the sole discretion of the Commission, except that no such payment shall be made to any member, officer, or employee of any appropriate regulatory agency, the Department of Justice, or a self-regulatory organization. Any such determination shall be final and not subject to judicial review.

“(f) DEFINITION.—For purposes of this section, ‘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.”.

(b) AMENDMENTS CONCERNING SUPERVISION.—

(1) BROKERS AND DEALERS.—Section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o) is amended by adding at the end thereof the following new subsection:

“(f) Every registered broker or dealer shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such broker’s or dealer’s business, to prevent the misuse in violation of this title, or the rules or regulations thereunder, of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer. The Commission, as it deems necessary or appropriate in the public interest or for the protection of investors, shall adopt rules or regulations to require specific policies or procedures reasonably designed to prevent misuse in violation of this title (or the rules or regulations thereunder) of material, nonpublic information.”.

(2) INVESTMENT ADVISERS.—The Investment Advisers Act of 1940 (15 U.S.C. 80b-1 et seq.) is amended by adding after section 204 the following new section:

“PREVENTION OF MISUSE OF NONPUBLIC INFORMATION

“Sec. 204A. Every investment adviser subject to section 204 of this title shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such investment adviser’s business, to prevent the misuse in violation of this Act or the Securities Exchange Act of 1934, or the rules or regulations thereunder, of material, nonpublic information by such investment adviser or any person associated with such investment adviser. The Commission, as it deems necessary or appropriate in the public interest or for the protection of investors, shall adopt rules or regulations to require specific policies or procedures reasonably designed to prevent misuse in violation of this Act or the Securities Exchange Act of 1934 (or the rules or regulations thereunder) of material, nonpublic information.”.

(c) COMMISSION RECOMMENDATIONS FOR ADDITIONAL CIVIL PENALTY AUTHORITY REQUIRED.—The Securities and Exchange Commission shall, within 60 days after the date of enactment of this Act, submit to each House of the Congress any recommendations the Commission considers appropriate with respect to the extension of the Commission’s authority to seek civil penalties or impose administrative fines for violations other than those described in section 21A of the Securities Exchange Act of 1934 (as added by this section).

SEC. 4. INCREASES IN CRIMINAL PENALTIES.

Section 32(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78ff(a)) is amended—

- (1) by striking “\$100,000” and inserting “\$1,000,000”;
- (2) by striking “five years” and inserting “10 years”;
- (3) by striking “is an exchange” and inserting “is a person other than a natural person”; and
- (4) by striking out “\$500,000” and inserting “\$2,500,000”.

SEC. 5. LIABILITY TO CONTEMPORANEOUS TRADERS FOR INSIDER TRADING.

The Securities Exchange Act of 1934 is amended by inserting after section 20 the following new section:

“LIABILITY TO CONTEMPORANEOUS TRADERS FOR INSIDER TRADING

“Sec. 20A. (a) **PRIVATE RIGHTS OF ACTION BASED ON CONTEMPORANEOUS TRADING.—**Any person who violates any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information shall be liable in an action in any court of competent jurisdiction to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class.

“(b) **LIMITATIONS ON LIABILITY.—**

“(1) **CONTEMPORANEOUS TRADING ACTIONS LIMITED TO PROFIT GAINED OR LOSS AVOIDED.—**The total amount of damages imposed under subsection (a) shall not exceed the profit gained or loss avoided in the transaction or transactions that are the subject of the violation.

“(2) **OFFSETTING DISGORGEMENTS AGAINST LIABILITY.—**The total amount of damages imposed against any person under subsection (a) shall be diminished by the

amounts, if any, that such person may be required to disgorge, pursuant to a court order obtained at the instance of the Commission, in a proceeding brought under section 21(d) of this title relating to the same transaction or transactions.

"(3) CONTROLLING PERSON LIABILITY.—No person shall be liable under this section solely by reason of employing another person who is liable under this section, but the liability of a controlling person under this section shall be subject to section 20(a) of this title.

"(4) STATUTE OF LIMITATIONS.—No action may be brought under this section more than 5 years after the date of the last transaction that is the subject of the violation.

"(c) JOINT AND SEVERAL LIABILITY FOR COMMUNICATING.—Any person who violates any provision of this title or the rules or regulations thereunder by communicating material, nonpublic information shall be jointly and severally liable under subsection (a) with, and to the same extent as, any person or persons liable under subsection (a) to whom the communication was directed.

"(d) AUTHORITY NOT TO RESTRICT OTHER EXPRESS OR IMPLIED RIGHTS OF ACTION.—Nothing in this section shall be construed to limit or condition the right of any person to bring an action to enforce a requirement of this title or the availability of any cause of action implied from a provision of this title.

"(e) PROVISIONS NOT TO AFFECT PUBLIC PROSECUTIONS.—This section shall not be construed to bar or limit in any manner any action by the Commission or the Attorney General under any other provision of this title, nor shall it bar or limit in any manner any action to recover penalties, or to seek any other order regarding penalties."

SEC. 6. INVESTIGATORY ASSISTANCE TO FOREIGN SECURITIES AUTHORITIES.

(a) DEFINITION OF FOREIGN SECURITIES AUTHORITY.—Section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)) is amended by adding at the end thereof the following:

"(50) The term 'foreign securities authority' means any foreign government, or any governmental body or regulatory organization empowered by a foreign government to administer or enforce its laws as they relate to securities matters."

(b) AUTHORITY TO PROVIDE ASSISTANCE TO FOREIGN SECURITIES AUTHORITIES.—Section 21(a) of such Act (15 U.S.C. 78u(a)) is amended—

(1) by redesignating subsection (a) as subsection (a)(1); and

(2) by adding at the end thereof the following:

"(2) On request from a foreign securities authority, the Commission may provide assistance in accordance with this paragraph if the requesting authority states that the requesting authority is conducting an investigation which it deems necessary to determine whether any person has violated, is violating, or is about to violate any laws or rules relating to securities matters that the requesting authority administers or enforces. The Commission may, in its discretion, conduct such investigation as the Commission deems necessary to collect information and evidence pertinent to the request for assistance. Such assistance may be provided without regard to whether the facts stated in the request would also constitute a violation of the laws of the United States. In deciding whether to provide such assistance, the Commission shall consider whether (A) the requesting authority has agreed to provide reciprocal assistance in securities matters to the Commission; and (B) compliance with the request would prejudice the public interest of the United States."

SEC. 7. SECURITIES LAWS STUDY.

(a) FINDINGS.—The Congress finds that—

(1) recent disclosures of securities fraud and insider trading have caused public concern about the adequacy of Federal securities laws, rules, and regulations;

(2) Federal securities laws, rules, and regulations have not undergone a comprehensive and exhaustive review since the advent of the modern international, institutionalized securities market;

(3) since that review, the volume of securities transactions and the nature of the securities industry have changed dramatically; and

(4) there is an important national interest in maintaining fair and orderly securities trading, assuring the fairness of securities transactions and markets and protecting investors.

(b) STUDY AND INVESTIGATION REQUIRED.—

(1) GENERAL REQUIREMENT.—The Securities and Exchange Commission shall, subject to the availability of funds appropriated pursuant to subsection (d), make a study and investigation of the adequacy of the Federal securities laws

and rules and regulations thereunder for the protection of the public interest and the interests of investors.

(2) **REQUIRED SUBJECTS FOR STUDY AND INVESTIGATION.**—Such study and investigation shall include an analysis of—

(A) the extent of improper trading while in possession of insider information, such as trading with advance knowledge of tender offers or forthcoming announcements of material financial information;

(B) the adequacy of surveillance methods and technologies of brokers, dealers, and self-regulatory organizations;

(C) the adequacy of cooperation between the Federal, State, and foreign enforcement authorities concerning securities laws enforcement; and

(D) impediments to the fairness and orderliness of the securities markets and to improvements in the breadth and depth of the capital available to the securities markets, and additional methods to promote those objectives.

(3) **CONDUCT OF STUDY AND INVESTIGATION.**—In conducting the study and investigation required by this section, the Commission—

(A) may exercise any existing authority to gather information, including all power and authority the Commission would have if such investigation were being conducted pursuant to section 21 of the Securities Exchange Act of 1934;

(B) may consult with and obtain such assistance and information from other agencies in the executive and legislative branches of the Government (including the Department of Justice) as is necessary to enable the Commission to carry out this section;

(C) may appoint, without regard to the civil service laws, rules, and regulations, such personnel as the Commission deems advisable to carry out such study and investigation and to fix their respective rates of compensation without regard to such laws, rules, and regulations, but no such rate shall exceed the rate payable pursuant to section 5314 of title 5, United States Code; and

(D) may, on a reimbursable basis, use the services of personnel detailed to the Commission from any Federal agency.

(4) **SUPPORT FROM OTHER AGENCIES.**—(A) The head of any Federal agency—

(i) may detail employees to the Commission for the purposes of this section; and

(ii) shall provide to the Commission such information as it requires for the performance of its functions under this section, consistent with applicable law.

(B) The Comptroller General and the Director of the Office of Technology Assessment are authorized to assist the Commission in the performance of its functions under this section.

(c) **REPORTS AND INFORMATION TO CONGRESS.**—

(1) **GENERAL REPORT.**—The Commission shall report to the Congress on the results of its study and investigation within 18 months after the date funds to carry out this section are appropriated under subsection (d). Such report shall include the Commission's recommendations, including such recommendations for legislation as the Commission deems advisable.

(2) **INTERIM INFORMATION TO CONGRESS.**—The Commission shall keep the Committee on Energy and Commerce of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate, and the members thereof, fully informed on the progress of, and any impediments to completing, the study and investigation required by this section.

(d) **AUTHORIZATION OF APPROPRIATIONS.**—There are authorized to be appropriated \$5,000,000 to carry out the study and investigation required by this section.

(e) **DEFINITIONS.**—As used in this section—

(1) the term "Commission" means the Securities and Exchange Commission; and

(2) the term "Federal securities laws" has the meaning given the term securities laws by section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47)).

SEC. 8. COOPERATION WITH FOREIGN AUTHORITIES AND INTERNATIONAL ORGANIZATIONS IN ENFORCEMENT.

Section 35 of the Securities Exchange Act of 1934 is amended by adding at the end thereof the following new subsection:

"(c) Funds appropriated pursuant to this section are authorized to be expended—

"(1) for official reception and representation expenses, not to exceed \$10,000 per year; and

"(2) for the purpose of maintaining membership in and contributing to the operating expenses of the International Organization of Securities Commissions, not to exceed \$10,000 per year."

SEC. 9. EFFECTIVE DATE.

The amendments made by this Act, except for section 6, shall not apply to any actions occurring before the date of enactment of this Act.

PURPOSE AND SUMMARY

This legislation would augment enforcement of the securities laws, particularly in the area of insider trading, through a variety of measures designed to provide greater deterrence, detection and punishment of violations of insider trading. The bill would amend Section 21(d) of the Securities Exchange Act of 1934 ("Exchange Act") to expand the scope of civil penalties remedies to "controlling persons" who fail to take adequate steps to prevent insider trading; initiate a bounty program giving the Commission discretion to reward informants who provide it with valuable assistance; create a new Section 15(f) of the Exchange Act and Section 204A of the Investment Advisers Act to require broker-dealers and investment advisers to establish, maintain and enforce written policies "reasonably designed" to prevent misuse of material, nonpublic information by the firm or any of its employees or associated persons; amend Section 32 of the Exchange Act by increasing the maximum jail term and fines for those convicted of criminal securities law violations; create a new Section 20A of the Exchange Act to codify a private right of action for "contemporaneous traders;" enhance the Commission's authority to cooperate with foreign governmental authorities in the investigation of international securities law violations; and authorize a study of the adequacy of present securities laws.

BACKGROUND AND NEED FOR THE LEGISLATION

The Insider Trading and Securities Fraud Enforcement Act of 1988 represents the response of this Committee to a series of revelations over the last two years concerning serious episodes of abusive and illegal practices on Wall Street. In the view of the Committee, the present enforcement framework should be strengthened to curtail continuing insider trading and other market abuses. This legislation embodies a series of statutory changes the Committee views as necessary to enhance deterrence against insider trading, and where that deterrence fails, to augment the current methods of detection and punishment of this behavior. Particularly in the aftermath of the stock market crash of October 19, 1987, the Committee views these steps as an essential ingredient in a program to restore the confidence of the public in the fairness and integrity of our securities markets.

PARAMETERS OF INSIDER TRADING

"Insider trading" is not defined in the securities laws, but the term is used broadly to refer to the purchase or sale of securities while in possession of "material" information (generally, information that would be important to an investor in making a decision to buy or sell a security) that is not available to the general public

(that is, "nonpublic"). Insider trading can take a number of different forms. Possession of advance knowledge that a company is about to introduce a new product or issue a surprising earnings report can give the possessor of that knowledge tremendous advantages in the market for the equities being traded. The communication of that advance inside knowledge to others who trade while in possession of that information similarly poses serious problems for the fair and honest operation of our securities markets.

A modest number of economists and academics defend the practice of insider trading as promoting an efficient market. Some free market economists even favor legalizing insider trading. They argue that the faster the market price reflects the nonpublic information, the more smoothly the market functions. But the far greater number of commentators support efforts to curb insider trading, viewing such efforts as crucial to the capital formation process that depends on investor confidence in the fairness and integrity of our securities markets. Insider trading damages the legitimacy of the capital market and diminishes the public's faith. The investing public has a legitimate expectation that the prices of actively traded securities reflect publicly available information about the issuer of such securities. According to this view, the small investor will be—and has been—reluctant to invest in the market if he feels it is rigged against him.

Although there is no statutory "definition" of insider trading, this activity is proscribed by provisions of the securities laws, including Section 17(a) of the Securities Act, Sections 10(b) and 14(e) of the Securities Exchange Act of 1934, and Section 206 of the Investment Advisers Act, and the case law that has developed over time interpreting those provisions.

Section 10(b) of the Exchange Act, along with Rule 10b-5 promulgated by the Commission, has been subject to the most extensive judicial interpretation. These provisions broadly prohibit fraudulent practices in connection with the purchase or sale of any security, including trading while in possession of material, nonpublic information.¹

The general antifraud dictates of the securities laws prohibits a broad range of behavior included within the rubric of "insider trad-

¹ Section 10(b) reads as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility or any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5, promulgated by the Commission, further delineates the prohibition against fraudulent practices, and states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility or any national securities exchange,

- (1) to employ any device, scheme, or artifice to defraud,
- (2) to make any untrue statement of a material fact or to omit a material fact necessary in order to make the statements made, in light of circumstances under which they are made, not misleading, or
- (3) to engage in any act, practice, or course of business which operates as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

ing.”² Corporate directors, officers, employees, and other traditional “insiders” clearly have a fiduciary duty to shareholders to either *disclose* material nonpublic information about their corporation or *abstain from trading* in the securities of that corporation.³ And the development of case law in this area has made clear this duty extends beyond traditional corporate insiders to prohibit, in certain circumstances, misuse of material, nonpublic information by market professionals and others such as underwriters, investment analysts, lawyers, accountants and financial printers.

Despite the breadth of the statutory and regulatory framework for insider trading, several major court cases in recent years have established clear boundaries for prosecution of these violations. In *Chiarella v. United States*, 445 U.S. 222 (1980), the Supreme Court held that a duty to disclose under Rule 10b-5 does not arise from the mere possession of nonpublic market information. The Court held that under Rule 10b-5 a duty to disclose only arises from a fiduciary relationship or other relationship of trust and confidence between parties to the transaction. In the absence of such a relationship, a trader is not liable for injuries or damages suffered by the other party to the transaction who lacked the same information as the trader nor is he subject to criminal sanction, on a theory that the trader’s failure to disclose defrauded the other party to the transaction.

The Supreme Court followed a similar narrowing approach in *Dirks v. SEC*, 463 U.S. 646 (1983). In that case, a former officer of a company informed an analyst in a broker-dealer firm (Dirks) that the company’s assets were grossly overstated as a result of fraudulent corporate practices. Although Dirks did not own any shares in this company, he checked the officer’s information, confirmed its authenticity, and conveyed it to his clients and others. The Supreme Court accepted the SEC’s finding that Dirks had communicated the information to investors who traded in the company’s shares, but the Court held that recipients of material nonpublic information, such as Dirks, have a duty not to trade or communicate the information only when it has been improperly made available to them. The Court reasoned that to determine if an insider, in this case the former official, had breached a fiduciary duty to the shareholders, it would have to be established that the insider sought some “direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings.” The Court found that the former officer who had given Dirks the information intended to expose the fraud rather than gain from the disclosure of such information, and thus did not breach a duty.

The *Chiarella* and *Dirks* decisions established that there is no *general duty* to disclose material nonpublic information before trading on it. Traditional insiders and their tippees do have such a duty, and some individuals, although outsiders, become “temporary

² See Report of the House Committee on Energy and Commerce to accompany H.R. 559, the Insider Trading Sanctions Act, H. Rept. 98-355, 98th Congress, 1st Session 2-4 (1983) (hereinafter cited as “House ITSA Report”).

³ See, e.g., *Strong v. Repide*, 213 U.S. 419 (1909); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (en banc), cert. denied, 404 U.S. 1005 (1971); *In re Cady, Roberts & Co.*, 40 SEC 907 (1961).

insiders" by virtue of their relationship to the corporation, i.e., underwriters, accountants, lawyers, and assume a fiduciary duty of disclosure to the shareholders with whom they trade. But in cases where a trader did not have a duty to disclose material nonpublic information to the other party to the transaction, the SEC and the Department of Justice have pursued insider traders using an alternative theory: that individuals have a duty not to "misappropriate" information from their employers or otherwise in breach of fiduciary or other relationship of trust and confidence, and commit securities fraud when they trade in possession of misappropriated information or tip others who trade.⁴ Under current case law, the SEC must establish that the person misusing the information has breached either a fiduciary duty to shareholders or some other duty not to misappropriate insider information.

Within the court-developed parameters for insider trading, courts that have addressed the issue have also broadened the doctrine of insider trading to include trading and tipping by persons who misappropriate material nonpublic information from sources other than market participants. That was the theory underlying the case of *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).

The Supreme Court addressed the "misappropriation" theory of insider trading last November, in the appeal of the *Carpenter* case, and reached no definitive decision. The U.S. Attorney in that case had alleged a violation of Section 10(b) and Rule 10b-5 by R. Foster Winans, a former Wall Street Journal reporter, based on Winans' disclosure to others of information concerning various corporations which was later to appear in this column. After the columns appeared, the information contained in them would allegedly influence the price of the stock which was discussed. The Court divided on a 4-4 vote on the question of whether Winans' "misappropriation" of information rightfully belonging to his employer constituted insider trading, even absent any direct fiduciary duty owed from Winans to the issuers or purchasers and sellers of the securities. The Court's opinion contained no discussion of the issue. Thus the misappropriation theory clearly remains valid in the Second Circuit, the lower Court in the Winans case, but is unresolved nationally. In the view of the Committee, however, this type of security fraud should be encompassed within Section 10(b) and Rule 10b-5.

The Committee clearly has recognized the continuing concern over a definition of insider trading. The securities bar and the Congress have debated this issue for a number of years, including during consideration of the adoption of the Insider Trading Sanctions Act of 1984. During this Congress, such definitional questions have been the focus of much attention in Senate inquiries on this subject.⁵

⁴ See also *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).

⁵ See, e.g., Hearing on S. 1380, the Insider Trading Proscriptions Act of 1987, before the Senate Subcommittee on Securities, Committee on Banking, Housing, and Urban Affairs, December 15, 1987, 100th Congress, 1st Session.

While cognizant of the importance of providing clear guidelines for behavior which may be subject to stiff criminal and civil penalties, the Committee nevertheless declined to include a statutory definition in this bill for several reasons. First, the Committee believed that the court-drawn parameters of insider trading have established clear guidelines for the vast majority of traditional insider trading cases, and that a statutory definition could potentially be narrowing, and in an unintended manner facilitate schemes to evade the law. Second, the Committee did not believe that the lack of consensus over the proper delineation of an insider trading definition should impede progress on the needed enforcement reforms encompassed within this legislation. Accordingly, the Committee does not intend to alter the substantive law with respect to insider trading with this legislation. The legal principles governing insider trading cases are well-established and widely-known.

INSIDER TRADING SANCTIONS ACT OF 1984

Congress's most recent legislative response to concerns over insider trading was the Insider Trading Sanctions Act of 1984 (ITSA). This Act granted the SEC authority to seek imposition of a civil penalty against insider trading violators for up to three times the profit gained or loss avoided as a result of the unlawful purchase or sale of securities. It also increased the maximum fine for a criminal violation from \$10,000 to \$100,000, and gave the Commission authority to bring an administrative proceeding against persons who violate the proxy and tender offer reporting requirements under Section 14 of the Exchange Act. See 15 U.S.C. § 21(d)(2).

The enactment of ITSA reflected the intent of Congress to expand the range of tools available to the Commission in combating insider trading. As the Committee Report accompanying H.R. 559 stated: "[t]he principal, and often effectively only, remedy available to the Commission against insider trading is an injunction against further violations of the securities laws and disgorgement of illicit profits."⁶ The Commission requested statutory authorization for the creation of the new civil penalty sanction, and ITSA was a response to that request. The creation of a new civil penalty was intended to go beyond disgorgement of illegal profits to add the imposition of a significant fine as a needed deterrent. The Committee's expansion of ITSA in this legislation is a reaffirmation of the vital enforcement role of the civil penalties sanction.

POST-ITSA WALL STREET SCANDALS

Despite the stiffer penalties enacted by Congress in 1984, the last few years have seen a dramatic increase in insider trading cases, including cases against some of the most prominent officials in Wall Street investment banking firms. In a presentencing memorandum in the case against famed risk arbitrageur Ivan F. Boesky, the U.S. Attorney stated that Boesky's cooperation with the government "revealed that criminal conduct is at the heart of a substantial amount of market activity by established securities industry professionals."

⁶ House ITSA Report at 7.

The Commission's investigation of an insider trading group (the so-called "Yuppie Five") involving Michael David, a former associate of a New York law firm, led to a significant criminal insider trading prosecution against David and four others. On May 28, 1986, a federal grand jury indicted the five defendants for allegedly using confidential information misappropriated by David from his law firm to trade in the stocks and options of takeover targets. All subsequently pleaded guilty and were sentenced.

What would turn out to be a continuing scandal broke in May of 1986, when the SEC brought an action against Dennis Levine, then a managing director with Drexel Burnham Lambert, Inc., in New York. The Commission alleged that Levine made \$12.6 million by trading in the securities of at least 54 issuers while in possession of material nonpublic information about actual or proposed tender offers and mergers. Levine consented to a permanent injunction against future violations of the federal securities laws and agreed to disgorge \$11.6 million in illicit profits. Levine also pled guilty to one count of securities fraud, two counts of income tax evasion, and one count of perjury. Levine was sentenced to two years in prison and fined \$362,000. Levine's Bahamian broker copied some of Levine's trades and a default judgment was entered ordering that he disgorge his illegal profits and pay a fine on post-ITSA trades. In addition, five Wall Street professionals (Messrs. Wilkis, Sokolow, Brown, Reich and Cecola) were prosecuted for allegedly exchanging material nonpublic information with Levine and, except for Sokolow and Reich, for trading while in possession of such information.

On November 14, 1986, the Levine investigation resulted in the SEC settlement of insider trading charges against Ivan F. Boesky. The Commission alleged that companies controlled by Boesky made \$50 million in illicit profits by purchasing stock in corporations prior to the announcement of takeovers, while in possession of material nonpublic information often provided to him by Levine. Boesky consented to the entry of a permanent injunction and agreed to pay \$50 million in cash as disgorgement of profits and a \$50 million penalty. He also pleaded guilty to a criminal charge and was sentenced to three years in prison.

On February 13, 1987, the Commission filed an injunctive action against Martin A. Siegel, co-head of mergers and acquisitions at Drexel and formerly a top executive at Kidder, Peabody & Co., alleging that the disclosed confidential information concerning pending takeover deals to Boesky. Siegel agreed to pay the government more than \$9 million in a settlement and, in a related administrative proceeding, Siegel consented to an order barring him from the securities industry. He also pled guilty to two felony charges and is awaiting sentencing. He related proceedings, on June 4, 1987, Kidder consented to the issuance of a permanent injunction, disgorged \$13,676,101 in illicit profits and losses avoided and paid a civil penalty under ITSA of \$11,618,674. In administrative proceedings, Kidder was censured and ordered to retain an outside consultant to review its policies to prevent and detect violations of the federal securities laws and the rules of self-regulatory organizations, and to adopt any recommendations of the consultant. The Commission's complaint alleged that Kidder, for its direct or indirect benefit, traded in the securities of certain issuers while in possession of

material nonpublic information received through Siegel from a New York City arbitrageur under circumstances in which Kidder knew or should have known that the information was material and nonpublic and obtained through misappropriation or other wrongful acts. In exchange, Kidder, through Siegel, reciprocally disclosed to the arbitrageur material nonpublic information. *SEC v. Kidder, Peabody & Co., Inc.*, 87 Civ. 3869 (RO)(S.D.N.Y. filed June 4, 1987); *In the Matter of Kidder, Peabody & Co., Inc.*, Exchange Act Rel. No. 24543 (June 4, 1987).

Despite these high-profile cases and many others over the last few years, insider trading abuses have continued, through the time of this Committee's consideration of this legislation. Two recent cases have clearly demonstrated what many Wall Street observers and government regulators have known all along—that insider trading remains a serious problem in our securities markets.

In June of this year, the SEC filed civil charges in the second largest insider trading case ever, against Stephen Sui-Kuan Wang, Jr., a junior market analyst at the investment banking firm of Morgan Stanley & Co.; and Fred C. Lee, a Hong Kong-based investor who controlled trading accounts at Morgan, among other firms. The SEC has alleged that Lee made over \$19 million in illegal profits while in possession of material inside information provided to him by Wang. The information concerned potential takeover deals and other matters involving Morgan clients and at least part of the alleged illicit trades were made through accounts held at Morgan. The SEC alleges an elaborate information-funneling scheme based on a blatant disregard for the duties owed by an investment banking firm's employees to the firm, its clients and its shareholders. The complaint alleges illicit trading in stock of at least 25 companies, including Utah Power & Light Co., E.F. Hutton Group Inc., and Stop & Shop Cos., from July 1987 through April 1988.

Following a hearing on July 13, 1988, the U.S. District Court in Manhattan granted the Commission's motion for a preliminary injunction against further insider trading violations by Wang and Lee and a freezing and accounting of all allegedly ill-gotten assets of the defendants. On September 7, 1988, Wang pleaded guilty to several criminal charges. While all the facts in this case are far from completely established, the Committee remains concerned with the types of procedures Wall Street firms have in place to prevent insider trading violations given the great numbers of firm employees who have access to potentially invaluable confidential information and the apparent ease with which that information can be disseminated.

Shortly before the Committee's consideration of this legislation, new and disturbing allegations of insider trading surfaced, involving the trading of securities by brokers in possession of material, nonpublic information which the brokers obtained before its public dissemination in *Business Week* magazine. The most serious of these allegations were directed at William Dillon, a New London, Connecticut, stockbroker for Merrill Lynch. Dillon was accused of illegally obtaining nonpublic information from advance looks at the "Inside Wall Street" column in *Business Week*. Dillon acquired his advance copies from a pressman at the local R.R. Donnelly & Sons plant where *Business Week* is printed. Stocks mentioned in

this publication typically rose in value on the day of public dissemination. By the time of the Committee's consideration of this legislation, Dillon agreed to plead guilty to fraud charges, to return all profits, and to cooperate with the government in its investigation of similar trading schemes involving companies mentioned in Business Week.

CONGRESSIONAL RESPONSE

In the view of the Committee, the scandals of the last two years demand a legislative response. The Committee responded to several specific concerns raised in the course of oversight and legislative hearings.

Perhaps the greatest problem in the battle against insider trading is a lack of resources. At the legislative hearing before the Subcommittee on Telecommunications and Finance, both the Chairman of the SEC, David S. Ruder, and the United States Attorney for the Southern District of New York, Rudolph Giuliani, testified that their respective offices have been unable to pursue all potential insider trading investigations solely due to a lack of needed resources.

The Committee strongly believes that the agencies with responsibility for enforcing the laws against insider trading should be provided all the necessary resources to do their jobs. But the war against insider trading must be fought on many fronts. Consequently, in the view of the Committee there are a variety of statutory measures which should be implemented to enhance our enforcement framework, irrespective of the level of Commission resources.

The Committee has hoped that self-correcting mechanisms of the marketplace, and greater awareness among the self-regulatory organizations (SROs) and the firms themselves would curb abuses in the securities market without the need for legislation. The stock exchanges and the National Association of Securities Dealers (NASD) clearly serve a vital "watchdog" function of monitoring trading activity in the securities markets. Self-policing ranges from computer tracking of all trades by the exchanges, writing rules to govern members' conduct, and examining whether violations of SRO rules or the law have occurred. The SEC also has the computer capability to detect some unusual trading activity, but the SEC functions largely in an oversight capacity with respect to the day-to-day surveillance activity of the SROs. And partly in response to the Commission's Rule 14e-3, many firms have attempted to institute some type of supervisory systems to detect insider trading and other market abuses by their employees, and control the flow of information within a firm to prevent the misuse of such information. Despite these self-policing measures, however, evidence is mounting that existing safeguards to protect investors from insider-trading abuses should be enhanced.

The wave of insider trading cases in recent years has demonstrated the potential for abuse in even the largest and most prestigious of Wall Street securities firms. In the view of the Committee, the scandal represents far more than the transgressions of a few individuals. There is a clear need for an institutional, rather than

merely individual, response to this problem. In the view of the Committee, firms whose lifeblood is the continued public trust in our securities markets must do more to share in the responsibility for policing those markets and should be subject to considerable penalties for a shirking of that responsibility.

The recent wave of cases has cast serious doubt on the effectiveness of firm supervisory procedures. For example, questions have been raised about the efficacy of some firms "Chinese Walls", which are designed to erect a barrier between the sources of information in a multiservice securities firm (such as the corporate finance or mergers and acquisitions departments) and the traders of securities (such as the brokers). The mergers and acquisition departments of investment houses contain highly sensitive materials detailing the intricacies of corporate takeovers, invaluable information in the hands of skilled market professionals. In the view of the Committee, there is a need for an affirmative statutory obligation for every broker, dealer and investment advisor to design effective procedures to restrict and monitor access to such information and prevent insider trading. The Committee links this affirmative obligation to the ITSA penalties. The Committee believed it is necessary to expand the potential exposure to civil penalties under ITSA beyond the primary insider trading violators to securities firms and other "controlling persons" who knowingly or recklessly fail to take the appropriate measures to prevent insider trading violations by their employees.

It also came to the attention of the Committee that part of the problem in deterring and punishing insider trading violations is the difficulty of effectively prosecuting these cases. The biggest obstacle is making the vital connection between an investor and the possession of inside information (i.e., what he knew, when he knew it and how he found it out). Unless there is an obvious connection, which is rare, the success of the case usually depends on getting someone who knows about the insider trading to talk. According to the testimony of U.S. Attorney Giuliani, there are generally two people who can provide direct evidence that insider trading has occurred—the source of the information and the trader. It is very rare for one of these two persons to admit that they have engaged in insider trading. Most cases are based largely on circumstantial evidence. Because insider trading is so sophisticated and secretive, technical computer surveillance can only go so far in investigating crimes. In order to develop these cases effectively, information provided by other individuals who have relevant knowledge of the circumstances may prove essential.

In response to the difficulties in detection and prosecution, and recognizing the finite resources at the Commission and the Department of Justice, the Committee granted the Commission the authority to award bounty payments to persons who provide information leading to the successful prosecution of insider trading violations. The Committee's goal was to provide a clear and direct incentive for individuals to step forward with information that might be impossible to obtain in any other manner. As U.S. Attorney Giuliani noted in his Subcommittee testimony, the bounty program administered by the Internal Revenue Service has been extremely successful in providing the IRS with valuable information on tax

fraud. According to the IRS, the service received \$256 million in additional tax revenues as a result of paying only \$1.3 million in bounty payments in 1986.

Detecting and investigating insider trading originating in foreign countries is even more difficult. In 1987, approximately 18 percent of all transactions on U.S. equities markets originated through foreign investors. The Commission has entered into memoranda of understanding on enforcement issues with a number of foreign nations in recent years, but the Commission still lacks the much needed statutory authority to assist foreign governments in investigations concerning violations of securities laws and regulations in foreign countries. Consequently, the Commission has had difficulty gaining the full cooperation of foreign authorities for U.S. investigations. The Committee's response to this problem is in part to incorporate the provision granting the Commission authority to invoke its investigatory powers at the request of a foreign government seeking assistance in its securities investigations.⁷ The Commission testified before the Subcommittee that such authority is critical to its ability to obtain this cooperation from foreign authorities.

The Committee also believed it was extremely important to increase the maximum criminal penalties for those convicted of insider trading and other securities law violations. This was a response to the testimony of U.S. Attorney Giuliani, among others, who testified that "[t]here is non doubt that the longer the penalty that someone is anticipating, the greater the deterrence. * * * Congress could send an important message to the courts and society, that in cases of insider trading, the general rule must be that people go to prison at the conclusion of a criminal case." In the view of the Committee, increasing the certainty of a substantial prison term is the type of message white-collar criminals will understand the best. The enormous monetary scale of recent insider trading cases also led to the Committee's adoption of an increased ceiling for criminal fines.

SUMMARY OF LEGISLATION

(1) Civil Penalties for Violating Persons and Persons "Controlling" those Violators

The SEC already has authority granted through the Insider Trading Sanctions Act of 1984 ("ITSA") to seek civil penalties against persons—individuals and firms—who commit insider trading. Violators may be liable for up to three times the profit gained or loss avoided as a result of their trading while in possession of material, nonpublic information. As noted above, this provision has greatly expanded the tools at the Commission's disposal for combating insider trading. In fact, the Commission also voted recently to seek a statutory expansion of its authority to impose fines in cases of securities law violations that do not involve insider trading.

⁷ The Commission's comprehensive legislative package is contained in H.R. 4945, the International Securities Enforcement Cooperation Act of 1988, introduced upon request on June 29, 1988 by Reps. Dingell, Markey, Lent and Rinaldo. The Subcommittee on Telecommunications and Finance held a hearing on this proposal on August 3, 1988.

Under current law, ITSA (Section 21(d)(2) of the Exchange Act) permits the Commission in certain circumstances to seek a civil penalty against insider traders and tippers. Corporate entities and employers are directly liable for a penalty under circumstances in which the "corporate entity itself was the trader" or the tipper.⁸ But in the absence of trading or tipping by such an entity, ITSA did not extend liability for a penalty to corporate entities, employers or other control persons for violations by their employees or controlled persons. This legislation would expand the coverage of ITSA to include those broker-dealers, investment advisers and others who failed to take the appropriate steps to prevent such violations from occurring.

The Committee intends through the broadening of controlling person civil penalty liability to increase the economic incentives for such persons to supervise vigorously their employees. Effective supervision of securities firms of their employees and agents is a foundation of the federal regulatory scheme of investor protection. With respect to insider trading in particular, the necessity for appropriate supervision to prevent violations is evident in view of the special opportunities for abuse in this area.⁹

The expansion of the scope of civil penalties relies on the concept of "controlling person" currently contained in Section 20(a) of the Exchange Act. "Controlling person" may include not only employers, but any person with power to influence or control the direction or the management, policies, or activities of another person. See *Kersh v. General Council of Assemblies of God*, 804 F.2d 546, 548 (9th Cir. 1986), quoting *Christoffel v. E.F. Hutton & Co.*, 588 F.2d 665, 668 (9th Cir. 1978); *Richardson v. MacArthur*, 451 F.2d 35 (10th Cir. 1971); *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *Kennedy v. Tallant*, [1976-77] Fed. Sec. L. Rep. (CCH) paragraph 95,779 (S.D. Ga. 1976), *aff'd*, 710 F.2d 711 (11th Cir. 1983). Cf. SEC Rule 405; SEC Rule 12b-2; I Federal Securities Code 202(29) (ALI 1980). "Control" is inferred from possession of such power, whether or not it is exercised. See, e.g., *First Interstate Bank of Nevada v. National Republic Bank of Chicago*, [1984-85] Fed. Sec. L. Rep. (CCH) paragraph 91,994 (N.D. Ill. 1985). The Committee expects the Commission and courts to continue to interpret the term "controlling person" on a case-by-case basis according to the factual circumstances.

However, the Committee has adopted specific standards to govern when a controlling person will be liable for a penalty under Section 21A that differ from the defense provided under Section 20(a). Section 21A(b)(1)(a) would impose liability when a controlling person failed to take appropriate action once aware or in reckless disregard of circumstances indicating a likelihood that a controlled person was engaging in an ongoing insider trading or tipping violation or was about to engage in such a violation.

⁸ House ITSA Report at 10. The Committee Report cited the explanatory example that "if the board of directors of a corporation, while having material nonpublic information, directed an employee to trade for the corporation's account, the corporation itself would be liable for the penalty." *Id.*

⁹ 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).

Under Subsection (1)(A), the Commission must establish either "knowing" or "reckless" behavior on the part of the controlling person as a predicate for the imposition of a civil penalty against the controlling person. The statute does not define the terms "knowing" or "reckless." In order to seek imposition of a civil penalty, the Commission must establish that a controlling person objectively disregarded a risk that a controlled person was engaged in violations of the insider trading laws. The risk involved must be such that to disregard it would constitute a gross deviation from the standard of care that a reasonable person would exercise in such a situation.¹⁰ For example, "recklessness" encompasses a heedless indifference as to whether circumstances suggesting employee violations actually exist.¹¹ The Committee's concern in this context is with an objective standard of supervision which, if breached, will result in the imposition of substantial civil fines.

The controlling person is responsible under this subsection if it fails to take an appropriate action once it knew or was reckless in disregarding indications that its controlled person was engaging in insider trading or tipping. An aiding and abetting standard was specifically considered and rejected by the Committee.

Section 21A(b)(1)(B) operates in tandem with Section 159(f) of the Exchange Act and Section 204A of the Investment Advisers Act of 1940. These sections impose upon broker-dealers and advisers an affirmative duty to institute, maintain and enforce a reasonable and proper system of supervision, surveillance and internal control to protect against securities law violations. A penalty may be imposed under Subsection (1)(B) where the failure to establish, maintain and enforce an appropriate supervisory system has "substantially contributed to or permitted" the violation's occurrence. While the failure to establish, maintain, or enforce the policy or procedure must be relevant to the conduct leading to the controlled person's violations, this provision does not condition responsibility for possible sanction upon proof that but for the controlled person's breach the violation would not have occurred. It is sufficient that the breach thereby allowed the violation to occur, or that it provided some assistance to the controlled person's violations. Cf. *Henricksen v. Henricksen*, 640 F.2d 880, 887 (7th Cir. 1981).

The bill also would make a technical amendment to ITSA to reflect more accurately its original intent. The amendment would delete references in the statute that could be read to suggest that tippers are liable for the penalty only if their conduct, in addition to constituting a direct violation, also satisfies the elements of aiding and abetting a violation by the trader. ITSA was intended to permit penalties to be imposed upon both insider traders and tippers—"those persons most directly culpable in a violation."¹² ITSA sought "to increase the sanctions available under the law as it now exists and as it continues to evolve," and not to create new standards under which the liability of tippers or traders for a penalty would differ in any way from the standards of liability under the

¹⁰ See, e.g. Report of the Senate Committee on the Judiciary accompanying S. 1722, the Criminal Code Reform Act of 1979, S. Rep. No. 96-553, 95th Congress, 1st Session 64-65 (1979) ["Senate Judiciary Report"].

¹¹ See Senate Judiciary Report at 64-65.

¹² House ITSA Report at 9.

underlying substantive law.¹³ It is now clear under the existing body of case law that both traders and tippers are primary violators of the antifraud provisions, with independent liability.¹⁴ The amendment will thus clarify that the scope of liability for the penalty in cases involving the communication of material, nonpublic information is intended to conform to the substantive law of insider trading that has been developed by the courts.¹⁵

By removing any implication that tippers are subject to an ITSA penalty only when their tippers are also primary violators—a necessary element to establishing aiding and abetting—the legislation makes clear that a tipper cannot avoid liability by misleading his tippers about whether information conveyed was nonpublic or whether its disclosure breached a duty. In enacting ITSA, Congress intended to subject tippers to liability even where proof of all the elements of the tippers' violations is unavoidable. This amendment clarifies that intent. The amendment does not alter the substantive case law definition of what constitutes tipping. Therefore, the Committee does not intend, and does not believe this change will engender, any adverse affect on the legitimate flow of information to and from market analysts. The legislation is not intended to alter in any respect, however, the underlying standards for tipper and tippee liability. These standards, which are set forth in the Supreme Court's decision in *Dirks v. SEC*, were intended to ensure that the insider trading laws do not inhibit honest communication between corporate officials and securities analysts. The Committee recognizes that market analysts play a crucial role in facilitating the dissemination of information to the marketplace, and thereby promoting smoothly functioning markets. This legislation is not intended to interfere with those critical functions.

At markup, the Committee adopted an amendment concerning the extent of controlling person liability for violations by tippers. In actions brought by the Commission, the bill as amended would limit the extent of liability for persons who "control" tippers to three times the amount of profit gained or loss avoided by all of those "to whom the communication was directed." This language ensures that controlling persons are potentially liable for the profits made by indirect tippees (i.e., those who are tipped through a conduit) without subjecting them to potential liability for the profits of the possibly endless chain of persons who may trade on the information before it is public. For example, the Committee intends that a person who "controls" a tipper and otherwise meets the standards for imposition of a penalty should be liable for profits made by indirect tippees in a situation in which the tipper may communicate to one person, who does not trade and therefore re-

¹³ *Id.* at 14.

¹⁴ See *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299 (1985); *Dirks v. SEC*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980). The amendment does not of course foreclose the Commission from seeking in appropriate cases a penalty against any person who violated the Exchange Act by aiding and abetting a violation by communicating material, nonpublic information.

¹⁵ In clarifying that all persons whose violations of the underlying substantive law involve communicating material, nonpublic information are fully subject to the civil penalty, all statutory references to aiding and abetting have been deleted as unnecessary. Under the legislation, penalties would continue to be unavailable against persons who aided and abetted a violation in a manner other than by communicating material, nonpublic information.

ceives no direct profits, but who acts as a conduit and passes on the information to others who do trade.¹⁶

In determining the amount of the penalty to be imposed, under the new Section 21A, the legislation would retain the current language of the statutory definition of "profit gained or loss avoided" for purposes of ITSA—that is, the difference between the purchase or sale price of the security and the value of that security as measured by its trading price a reasonable period after public dissemination of the nonpublic information. It is clear this language embodies the standard applied in the court's decision in *SEC v. MacDonald*, 699 F.2d 47 (1st Cir. 1983).¹⁷ The Committee expects that in situations in which the information is never fully disseminated to the public, the profit gained or loss avoided would continue to be measured by the difference between the purchase or sale price and the value the security would have had at the time of the violation if the information had been publicly disseminated, based upon the facts and circumstances of the case.

(2) *Broker-Dealer and Investment Adviser Employee Supervision*

The general responsibility of broker-dealers and investment advisers to supervise their employees is well established under the securities laws. In recognition of this responsibility, a failure reasonably to supervise may subject a broker-dealer or investment adviser to sanctions when violations of law are committed by employees. For example, Section 15(b)(4)(E) of the Securities Exchange Act expressly authorizes the Commission to impose a range of administrative sanctions on violating parties. The Commission can 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 "has failed reasonably to supervise, with a view to preventing violations of [the securities and commodities laws], another person who commits such a violation, if such person is subject to his supervision," and the sanction is in the public interest.

The Commission possesses nearly identical disciplinary authority with respect to investment advisers under Section 203(e)(5) of the Investment Advisers Act.¹⁸

The obligation of broker-dealers to supervise their employees is also reflected in self-regulatory organization (SRO) rules. For example, the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) have rules providing that their members shall establish, maintain and enforce written procedures that will enable them to supervise properly their registered

¹⁶ The bill provides a similar clarification of the liability of tippees in a private action brought by a contemporaneous trader under the new Section 20A(a) of the Exchange Act, but the Committee chose not to apply this language in Commission actions directly against tippees. The public interest nature of Commission actions necessitates that the Commission's ability to obtain the full scope of equitable and other relief available in appropriate cases remain unimpaired. Thus, for example, if a tipper's communication resulted in profits to his direct tippee and to remote tippees as well, the Commission could obtain disgorgement from the tipper of the profits of both the direct and remote tippees, and could seek an ITSA penalty of up to three times that amount. This provision also would not affect in any way determinations as to those persons who may share in the distribution of a disgorgement fund established in a Commission enforcement action. See, e.g., *SEC v. Certain Unknown Purchasers*, 817 F.2d 1018 (2d Cir. 1987); *SEC v. Blavin*, 760 F.2d 706 (6th Cir. 1985).

¹⁷ See House ITSA Report at 11.

¹⁸ See also Section 15(b)(6) of the exchange Act (15 U.S.C. 780(b)); Section 17(j) of the Investment Company Act of 1940 (15 U.S.C. 80a-17(j)) and the rules promulgated thereunder.

representatives and associated persons to assure compliance with applicable securities laws, shall periodically review the activities of each office to detect and prevent irregularities and abuses, and shall investigate the qualifications of their employees.¹⁹

Despite the general supervisory requirements under existing law, the Committee believes it necessary to institute a new affirmative statutory requirement for broker-dealers and investment advisers to establish, maintain and enforce written supervisory procedures to prevent the misuse of material, nonpublic information. By complementing existing SRO supervisory requirements and the general duty to supervise reflected in Section 15(b)(4)(E) of the Exchange Act and Section 203(e)(5) of the Investment Adviser Act, these affirmative statutory requirements will promote more rigorous supervision of associated persons of broker-dealers and investment advisers who have access to confidential, market-sensitive information. As a result, they will help to combat market abuses that constitute the misuse of material, nonpublic information.

The legislation would add a new Section 15(f) to the Exchange Act and a new Section 204A to the Investment advisers Act. These sections would create a new explicit requirement for broker-dealers and investment advisers to establish, maintain, and enforce written policies and procedures "reasonably designed to prevent the misuse of material, nonpublic information" in violation of the Exchange Act and, in the case of advisers, the Advisers Act, by such entities or their associated persons.

The requirements of these new statutory provisions reflect the Committee's belief that broker-dealers and investment advisers must not only adopt and disseminate written policies and procedures to prevent the misuse of material, nonpublic information, but also must vigilantly review, update, and enforce them. The Committee believes that directly imposing such affirmative obligations in the federal securities statutes will underscore the significance of such policies and procedures and will also enhance the ability of the Commission and the SROs to monitor and promote the effectiveness of a firm's supervisory efforts. There would be direct statutory requirements for broker-dealers and investment advisers to have written policies and procedures, and those policies and procedures and their adherence to them would be subject to Commission and SRO inspection. Where a firm failed to comply with the statutory requirement to establish, maintain, or enforce reasonable written policies and procedures, it would be subject to a Commission or SRO action for violation of Sections 15(f) or 204A, and potentially subject to a fine under the new Section 21A of the Exchange Act.

The legislation does not set forth specific policies and procedures that are required of every broker-dealer or investment adviser. Rather, it recognizes that the question of what policies and proce-

¹⁹ NASD Rules of Fair Practice, Art. III, Sec. 27, NASD Manual (CCH) paragraph 2177; NYSE Rule 342, 2 NYSE Guide (CCH) paragraph 2343. See American Stock Exchange Rules 320, 922, 2 Am. Stock Ex. Guide (CCH) paragraphs 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); Chicago Board Options Exchange Rules 4.2, 9.8, Chi. Bd. Options Ex. Const. & Rules (CCH) paragraphs 2082, 2308 (stating obligation; requiring designation of appropriate official, written program for review of option accounts and orders, maintenance of customer records).

dures are reasonable for a particular firm may involve consideration of the differing business operations, organizational structure, scope and nature of a firm's business. Nevertheless, the Committee expects that institutions subject to the requirements of this provision will adopt policies and procedures appropriate to restrict communication of nonpublic information and to monitor its dissemination, such as restraining access to files likely to contain such information; providing continuing education programs concerning insider trading; restricting or monitoring trading in securities relating to which the firm's employees possess nonpublic information; and vigorously monitoring and reviewing trading for the account of the firm or of individuals. In this regard, the Committee does not consider the responsibility of a firm to be entirely released because an employee's illicit trading occurred in an account held at another firm. For example, the Committee would expect that a firm's supervisory system would include, at a minimum, employment policies such as those requiring personnel to conduct their securities trading through in-house accounts or requiring that any trading in outside accounts be reported expeditiously to the employing firm.

The legislation also provides the Commission with additional broad rule-making authority to emphasize that the Commission may require specific policies or procedures if it deems such actions necessary or appropriate in the public interest or for the protection of investors. In the regard, the Commission's authority extends to adopting rules "reasonably designed to prevent" misuse of material, nonpublic information.²⁰ The Commission has indicated the importance of providing flexibility to an institution to tailor its policies and procedures to fit its own situation.²¹ However, if the Commission is dissatisfied with the overall quality of procedures in place, or become aware of particular areas of concern, its ability to address these concerns should be clear. This legislation would make clear that the Commission has the authority to deal with such situations as they arise.

(3) Bounty Provision

This section grants authority to the Commission to award payments to persons who provide information concerning insider trading violations. At the sole discretion of the Commission, the individual can receive up to ten percent of the penalty imposed or settlement reached. Neither the decision whether to reward an informant nor a decision on the amount of any such award is subject to judicial review. The purpose of this provision is to encourage more sources of information to come forward, and assist the Commission and the Department of Justice in developing better information in their investigation and prosecution of insider trading cases.

The bounty provision explicitly excludes payments to members, officials and other employees of the Commission, the Department of Justice or a self-regulatory organization due to their unique re-

²⁰ The inclusion of the "reasonably designed to prevent" language, which is similar to language in the rule-making provisions of Sections 14(e) and 15(c)(2) of the Exchange Act, is designed to ensure that the Commission's ability to adopt rules in this area extends beyond the specific requirements of the section.

²¹ See Securities Exchange Act Release No. 17120 (September 4, 1980).

sponsibilities to enforce the securities laws. The Committee rejected the inclusion of language which would have expressly excluded a broad class of employees in the securities industry due to concerns that any such statutory exemption would have eliminated the possibility to payment to many persons who may be in the best position to supply valuable information to the Commission. Nevertheless, the Committee expects that bounty payments would not be made to supervisory and compliance officers of securities firms in situations in which a reward would undermine substantially the compliance programs within such firms. The Committee's adoption of an affirmative statutory obligation to supervise employees indicates the importance the Committee places on the internal compliance programs at these firms. The Committee is sympathetic to the concern that bounty payments, if indiscriminately awarded, would substantially undermine the ability of broker-dealer firms to carry out their supervisory duties to detect and prevent insider trading. On the other hand, there may be circumstances in which it would be appropriate to award a bounty to a broker-dealer employee. Thus, the bill gives the Commission discretion to award bounties to broker-dealer firm employees in appropriate cases.

(4) Increases in Criminal Penalties

This section increases the maximum jail term for criminal securities law violations from 5 years to 10 years and increases the maximum criminal fine for individuals from \$100,000 to \$1,000,000 and the maximum fine for non-natural persons from \$500,000 to \$2,500,000. Furthermore, this section changes current law by making all non-natural persons subject to the higher criminal penalty; current law imposes the higher burden only on exchanges.

The Committee's interest in the maximum jail term is an explicit congressional statement of the heightened seriousness with which insider trading and other securities fraud offenses should be viewed. Although the legislation does not include an explicit mandatory minimum sentence the Committee believes in the strongest possible manner that courts should impose jail terms for the commission of these crimes, and expects that raising the ceiling will increase the certainty of substantial prison sentences.

This provision concerning jail terms was adopted by voice vote as an amendment during the markup by the Subcommittee on Telecommunications and Finance. This amendment was designed to provide a greater jail deterrent for these white-collar criminals, reflecting the input of witnesses before the Subcommittee who stressed that a jail term was the most important deterrent for these types of criminals.

Although jurisdiction over criminal jail terms rests with the Committee on the Judiciary pursuant to clause 1(m) of Rule X of the Rules of the U.S. House of Representatives, Chairman Rodino of that Committee agreed to waive that Committee's right to a referral on this occasion due to the late date of the legislative session and the desire for expeditious consideration of this legislation. An exchange of letters confirming this agreement follows:

HOUSE OF REPRESENTATIVES,
 COMMITTEE ON ENERGY AND COMMERCE,
 Washington, DC, August 8, 1988.

Hon. PETER W. RODINO, Jr.,
 Chairman, Committee on the Judiciary,
 House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: Thank you for your letter of August 4, 1988, indicating that the Committee on the Judiciary will waive its right to a referral of the bill H.R. 5133, the Insider Trading and Securities Enforcement Act of 1988. As amended in Subcommittee, the bill would increase the maximum jail term under section 32(a) of the Securities Exchange Act of 1934 for criminal violations of the federal securities laws from five to ten years (copy enclosed).

Your gracious assistance and cooperation with this Committee are appreciated. The Committee will meet in open markup session tomorrow at 10:00 a.m. in Room 2123 to consider, among other bills, H.R. 5133. It is our present intention to take this bill to the floor in early September. As requested, a copy of your letter will be included in the Committee report and we would be pleased to have you speak in support of the bill should you desire to do so.

Many thanks again.

Sincerely,

JOHN D. DINGELL, *Chairman.*

Enclosure.

HOUSE OF REPRESENTATIVES,
 COMMITTEE ON THE JUDICIARY,
 Washington, DC, August 4, 1988.

Hon. JOHN D. DINGELL,
 Chairman, Committee on Energy and Commerce,
 House of Representatives, Washington, DC.

DEAR CHAIRMAN DINGELL: Thank you for your letter requesting that the Judiciary Committee waive its right to a referral of the bill H.R. 5133, the "Insider Trading and Securities Enforcement Act of 1988." In your letter dated August 3, 1988, you state that you are considering an amendment to the bill which would increase the maximum jail term for criminal securities law violations from five to ten years. As you correctly point out adding a criminal penalty amendment would call for the bill to be referred to the Judiciary Committee.

The Judiciary Committee has a longstanding interest in the issue of white collar crime. For example, last term the Committee's Subcommittee on Crime conducted extensive hearings on securities violations by the investment firm of E. F. Hutton. Earlier this session, the full Committee voted out a bill to increase the criminal penalties for defense procurement fraud. Currently, the Subcommittee on Criminal Justice is considering several white collar crime bills including amendments to the mail and wire fraud statutes, amendments to the federal racketeering statute (RICO), and a bill to provide criminal penalties for businesses who fail to disclose known safety defects.

The Subcommittee on Criminal Justice is also currently considering H.R. 1238, the "Insider Trading Prevention Act," introduced by Mr. Conyers, Chairman of that Subcommittee. That bill would spe-

cifically define the type of insider trading conduct which should be subject to criminal prosecution. The Subcommittee has held hearings on the bill.

I share the sentiment expressed in your letter that strong criminal penalties are essential if we are to deter insider trading. And, in view of the close consultations and work between the staff of both Committees on this important issue and the lateness in the session, the Committee will waive the Judiciary Committee's jurisdiction on this one occasion. I would request that a copy of this letter be included in any report accompanying the "Insider Trading and Securities Enforcement Act of 1988."

With warm regards,
Sincerely,

PETER W. RODINO, Jr.
Chairman.

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE,
Washington, DC, August 3, 1988.

Hon. PETER W. RODINO, Jr.,
Chairman, Committee on the Judiciary,
Rayburn House Office Building, Washington, DC.

DEAR MR. CHAIRMAN: Yesterday, we introduced the "Insider Trading and Securities Fraud Enforcement Act of 1988," a comprehensive attempt to strengthen the securities laws concerning insider trading. We are sure that you share our goal of improving the mechanisms for investigation, detection and prosecution of serious white-collar offenses, and are thus writing to you in connection with an amendment that would be of common interest.

As introduced, our legislation would enhance the enforcement of the securities laws in several ways. Securities firms would for the first time be subject to treble damages civil penalties for failing to take adequate steps to supervise their employees and prevent insider trading violations; the Securities and Exchange Commission would be permitted to award bounty payments to individuals who provided valuable information leading to the imposition and penalties; private rights of action would be codified for those injured as a result of insider trading; monetary penalties for criminal securities violations would be increased; and the Commission would be granted greater authority to cooperate with foreign securities authorities.

We are considering attaching an amendment to this legislation which would raise the maximum jail term for criminal securities law violations from five to ten years, similar to action taken by the Senate Banking Committee in S. 1323. This provision would send a clear and strong signal that if you commit this type of white-collar crime, you will go to jail. Our staffs have discussed the substance of this proposal with the staff of your Committee and the Subcommittee on Criminal Justice, and fully taken those views into account in determining how to proceed.

While we would very much like to move forward on this proposal, we recognize that laws concerning jail sentences generally fall

within the jurisdiction of the Committee on the Judiciary. Under normal circumstances, such a provision could trigger a sequential referral to the Committee on the Judiciary. Given the extremely late date of this congressional session, any such referral would likely doom this most-important legislation. Consequently, consistent with discussion and understanding among staff, we would propose the following procedure.

The provision on jail terms would be included as an amendment at the markup of this legislation before the Subcommittee on Telecommunications and Finance tomorrow, and we would welcome your participation at the markup should you so desire. Following the full Committee's reporting out of the bill, the Committee on the Judiciary would waive its right to referral of this bill and thus avoid any delay in consideration of this legislation by the full House. Despite such a waiver, this letter is intended as a firm acknowledgment that your Committee properly has jurisdiction on a matter such as this concerning criminal jail terms. The agreement to avoid delay of this legislation is necessary solely as a result of the date of this session and our mutual desires to move expeditiously towards passage.

Please let us know as quickly as possible if our approach to moving forward is amendable to you in your capacity as the Chairman of the Committee on the Judiciary. Thank you for your attention to this matter.

Sincerely,

JOHN D. DINGELL,
Chairman.

EDWARD J. MARKEY,
Chairman,

*Subcommittee on
Telecommunications and Finance.*

(5) Express Private Rights of Action

Although the courts have recognized an implied private right of action in insider trading cases, this section would codify an express right of action against insider traders and tippers for those who traded the same class of securities "contemporaneously" with and on the opposite side of the market from the insider trader. The value of this provision is evident in the testimony of SEC Chairman Ruder, who stated on July 11, 1988, before the Subcommittee on Telecommunications and Finance, that "private rights of action have traditionally served as an important supplement to the Commission's enforcement of the federal securities laws."

In particular, the codification of a right of action for contemporaneous traders is specifically intended to overturn court cases which have precluded recovery for plaintiffs where the defendant's violation is premised upon the misappropriation theory. See e.g., *Moss v. Morgan Stanley*, 719 F.2d 5 (2d cir. 1983). The Committee believes that this result is inconsistent with the remedial purposes of the Exchange Act, and that the misappropriation theory fulfills appropriate regulatory objectives in determining when communicating or trading while in possession of material nonpublic information is

unlawful. The bill does not define the term "contemporaneous," which has developed through case law.²²

The legislation provides that persons who violate the law by communicating information shall be liable in the new express action for contemporaneous trades jointly and severally with, and to the same extent as, persons "to whom the communication was directed." This language, which parallels that used in the penalty provisions of the bill, ensures that the communicator would not be subject to potential liability for the profits gained or losses avoided by all persons who may have ultimately learned of the information. This provision is intended to ensure that the potential liability of communicators is not so enormous that it would chill legitimate communication.

At the full Committee markup, the Committee accepted an amendment which clarified that the liability of controlling persons in private rights of action brought by contemporaneous traders is governed by Section 20(a) of the Exchange Act. Thus, the bill would reaffirm the continued application of Section 20(a) to private actions. The express private right of action would impose liability for a variety of violations by controlled persons. However, the bill rules out the use of respondeat superior theory in private actions for insider trading by contemporaneous traders.²³

At the full Committee markup, the Committee also accepted an amendment to delete the paragraph containing an express private right of action for parties other than contemporaneous traders. The Committee's intention in this amendment was to avoid creating an express private cause of action which might have the unintended effect of freezing the law or in any way restricting the potential rights of action which have been implied by the courts in this area. Rather, the Committee wanted to give the courts leeway to develop such private rights of action in an expansive fashion in the future.

Despite the absence of explicit statutory language for private rights of action outside of the contemporaneous trader plaintiff situation, the Committee recognized that there clearly are injuries caused by insider trading to others beyond contemporaneous traders. In the view of the Committee, Section 10(b), Rule 10b-5, and other relevant provisions of the Exchange Act have sufficient flexibility to recognize and protect any person defrauded, or harmed by a violation of any provision of this title or the rules or regulations thereunder by another person's purchasing or selling a security

²² See, e.g., *Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88 (2d Cir. 1981); *Shapiro v. Merrill, Lynch Pierce, Fenner and 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).

²³ Section 20A(b)(3), to be added by the legislation, states that no person shall be liable in a private action "solely by reason of employing another person who is liable * * *." The legislation does not affect the applicability of the respondeat superior theory in Commission actions or under the federal securities laws generally. See, e.g., *In re Atlantic Financial Management, Inc.*, 784 F.2d 29 (1st Cir. 1986), cert. denied, 107 S. Ct. 2469 (1987); *Henricksen v. Henricksen*, 640 F.2d 880 (7th Cir.), cert. denied, 454 U.S. 1097 (1981); *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); *Holloway v. Howerdd*, 536 F.2d 690 (6th Cir. 1976). *Contra Rochez Brothers, Inc. v. Rhoades*, 527 F.2d 880 (3d Cir. 1975); *Christoffel v. E.F. Hutton & Co.*, 588 F.2d 665 (9th Cir. 1978). Similarly, it does not affect the availability of any other theories of liability, such as aiding and abetting or the failure to supervise, in appropriate circumstances.

while in the possession of material, nonpublic information, or communicating such information to others.

The most prominent example of the non-contemporaneous trader suit which came to the attention of the Committee involved a suit filed by Anheuser-Busch Companies, Inc. against Paul Thayer, a former director of the corporation. See *Anheuser-Busch Companies, Inc., v. Thayer, et. al.*, CA3-85-0794-R (N.D. Texas 1986). In that case, the plaintiff alleged that it was defrauded not as a result of trading with the defendant, but by having information secretly stolen and by having the subsequent trading on the information concealed. According to the complaint in this case, prior to public dissemination, the tipper disclosed to several parties the plans of Anheuser-Busch to acquire Campbell Taggart, Inc. The alleged misappropriation of Anheuser-Busch's confidential information proximately caused a significant increase in the market price of Campbell Taggart stock before Anheuser-Busch announced its offer. This forced Anheuser-Busch to raise its tender offer price, and the company eventually paid approximately \$80 million more as a result of the illegal insider trading. Clearly, in such a case, the plaintiff corporation was a victim of the defendant's misappropriation. In the view of the Committee, where the plaintiff can prove that it suffered injury as a result of the defendant's insider trading, the plaintiff has standing to sue in this circumstance, and the remedial purposes of the securities laws require recognition of such an action.

In the view of the Committee, it was also important to note that in situations such as the Anheuser-Busch case and others, the potential harm to the plaintiff from the defendant's insider trading or tipping may be far greater than the profit gained or loss avoided by that defendant. The Committee recognizes that where the plaintiff demonstrates that he was defrauded by the defendant's insider trading and suffered actual damages proximately caused by the defendant's behavior, a cap of profit gained or loss avoided by the defendant, which is applicable for actions by contemporaneous traders, is not appropriate. Rather, in such an implied private cause of action, the plaintiff should be able to recover the full extent of those actual damages.

The section on private rights of action explicitly states that nothing in this section may be construed in any fashion to limit or condition the right of any person to bring an action to enforce a requirement of the Exchange Act, or the availability of any cause of action implied under the Exchange Act. The Committee in fact expressly recognizes the implied right of action under the securities laws for cases including but not limited to the situations such as that noted above in the Anheuser-Busch case.

(6) Enhancement of SEC Authority to Cooperate with Foreign Governmental Authorities

Given the ever-increasing incidence of insider trading violations carried on through off-shore entities (the Dennis Levine case being the oft-cited example), the SEC has sought ways to gain the cooperation of foreign authorities whose secrecy laws in many instances make the pursuit of off-shore violations of U.S. securities laws exceedingly difficult. In this regard, the Commission has entered into

Memoranda of Understanding with nations such as Switzerland, Canada, the United Kingdom, Japan and Brazil in an attempt to improve the basis for this cooperation. The United States is a party to mutual assistance treaties with Switzerland, the Netherlands, Turkey and Italy. Additionally, the Commission has utilized certain Conventions to obtain evidence and testimony and serve judicial documents, and has relied also on limited informal case-by-case arrangements.

The Commission's existing statutory authority, however, does not permit full cooperation between the Commission and foreign authorities in international investigations. In return for promises of more openness by foreign government authorities in investigation of U.S. securities law violations, the Commission has sought statutory authority to permit it to invoke its investigatory powers at the request of foreign governments who are seeking to enforce their own securities laws. Thus, the Commission is seeking an amendment to Section 21(a) of the Exchange Act as contained in this legislation.

This legislation would expand the Commission's authority under Section 21 of the Exchange Act to allow a Commission investigation for the purpose of assisting a foreign authority to determine whether a violation of the laws it administers has occurred, is occurring, or is about to occur. The Commission's discretion to open the investigation to assist a foreign authority would be governed by the same standards as a domestic case. As a result, the proposal brings into play the full range of investigative procedures and remedies at the Commission's disposal, including the issuance and enforcement of subpoenas. By utilizing the investigative framework which already is in place, the proposal provides a vehicle with which the Commission and the legal community is familiar for assisting foreign authorities.

The legislation would give the Commission the discretion to issue a formal order of private investigation to assist in gathering information regarding alleged violations of foreign laws relating to securities matters. To protect against the possibility that the Commission might assist in an unfocused or unbounded foreign investigation, it is expected that a foreign authority seeking the Commission's assistance will submit a request stating the facts which constitute a potential violation of its laws. The Committee intends that the Commission carefully examine this request and make a determination whether to issue a formal order. If a formal order is issued, the investigation will be conducted in the U.S. by those persons appointed as officers of the Commission and the evidence will be gathered pursuant to normal procedures. Thus, Commission control over the investigation and the application of the Commission's investigative procedures will apply to the investigation in the U.S.

Because the legislation relies upon established procedures for conducting investigations, it provides witnesses with the same protections and remedies that are afforded to witnesses in purely domestic Commission investigations. Accordingly, a witness who is subpoenaed in a proceeding pursuant to this legislation will be able to obtain a copy of the formal order identifying the basis and subject of the investigation and will be able to rely upon established means for challenging the subpoena. See, e.g., *SEC v. Dresser In-*

dustries, 628 F.2d 1368 (D.C. Cir. 1980). The Committee believes that, by providing a witness with the same rights and protections provided to witnesses in Commission investigations, the proposed legislation resolves any constitutional due process and Fourth Amendment concerns which could be raised.²⁴

The legislation restricts assistance requests to "foreign securities authorities." That term is defined in the bill as "any foreign government, or any governmental body or regulatory organization empowered by a foreign government to administer or enforce its laws as they relate to securities matters." This definition recognizes that countries have different approaches to securities law enforcement. In some countries—the United Kingdom, for example—jurisdiction over securities law enforcement has been assigned by statute to a government authority. In other countries, a private agency is authorized to act as the primary administrator or enforcer for securities matters. The Committee intends that this term encompass:

(a) foreign independent regulatory agencies similar to the Commission, such as the Commission des Operations de Bourse in France and the Canadian provincial securities commissions, as well as foreign Executive agencies, such as the British Secretary of State for the Department of Trade and Industry, which hold express statutory authority to enforce securities laws;

(b) general police entities, such as the Swiss Federal Department of Justice and Police, which enforce commercial, corporation and financial laws or other generalized fraud statutes; and

(c) self-regulatory organizations ("SROs"), such as the U.K. Securities and Investment Board (as of April 1988), to the extent that SRO is not merely a membership organization but also "administers" or "enforces" securities laws.

The legislation requires that the Commission, in deciding whether to grant assistance, consider whether the requesting authority has agreed to provide the Commission with reciprocal assistance. The amendment does not, however, require that, as a condition to the Commission assistance, the requesting authority must commit to granting reciprocal assistance to the Commission. The Committee does not expect that the Commission would grant assistance to foreign authorities who would be unwilling to reciprocate to the extent permitted by that authority's domestic law. However, there may be cases in which the Commission might decide that assistance to foreign authorities will spur the development of a mutual assistance relationship.

The legislation does not require that the matter under investigation would constitute a violation of U.S. law if it had occurred here. Such a dual criminality requirement would inhibit the Commission's ability to be responsive to foreign requests. Moreover, be-

²⁴ Because testimony would be taken pursuant to existing investigative procedures, a witness would be entitled to assert all relevant rights and privileges of the United States. In addition, a witness would be entitled to assert privileges available in the country seeking the evidence even as to those matters which are not privileged under U.S. law. Issues of privilege would be preserved on the record of the investigative proceedings for later consideration by a court of the requesting authority. The Committee expects that foreign countries providing reciprocal assistance to the Commission will follow a familiar procedure.

cause U.S. securities laws are broader than those in most other countries, the imposition of a dual criminality requirement by other countries could seriously restrict the Commission's ability to obtain assistance from foreign countries in many cases.

The legislation would also bolster SEC international regulatory efforts by authorizing the appropriation of Commission expenditures for participation in the International Organization of Securities Commissions.

(7) *Securities Laws Study*

This section directs the Commission to study the adequacy of present securities laws in meeting their goal of protection of investors, including an examination of the extent of insider trading, the adequacy of surveillance methods of brokers, dealers and self-regulatory organizations, and other deficiencies in the fairness and orderliness of the securities markets. The Committee viewed this study as necessary in light of the sweeping changes in the securities markets since the last similar study in this area, conducted by the Cohen Commission in 1963.²⁵

At the full Committee markup, the Committee adopted an amendment to this section which includes two key provisions. The first puts this study in greater effective control of the Commission, following the model of the Cohen Commission study. The second makes clear that the directive to the Commission to conduct this study is contingent upon the availability of the funds authorized to be appropriated by this Act.

In 1961, Congress passed legislation directing the SEC to make a study and investigation of the rules of national securities exchanges and national securities associations (i.e., the National Association of Securities Dealers, Inc.) and their disciplinary authority over member firms to determine whether those rules adequately protected investors.²⁶ Congress wanted to ensure that the SEC did not have to divert resources from other activities to complete the study, and authorized a separate appropriation for the task.

To discharge its responsibility, the SEC created a Special Study task force. That group produced a massive and comprehensive study of the securities markets. It served as the basis for the 1964 amendments to the securities laws. It also became the text book for generations of investment bankers, securities lawyers, academics, legislators, regulators, and the general public.

While the Special Study was (and some of its remains) an extremely useful document, much of its has become obsolete. Since the early 1960s, the securities markets have undergone major changes, such as: the development of NASDAQ; the growth of standardized options; unfixing of commission rates; immobilization of securities certificates; and the development of index options, financial futures, and index arbitrage. In addition, in recent years, the vigorous law enforcement efforts of the SEC and the Department of Justice have revealed troubling insider trading and other securities frauds, as described *supra*.

²⁵ Report of the Special Study of Securities Markets of the Securities and Exchange Commission, House Document no. 95, Pts. 1-6, 88th Congress, 1st Session (April 3, 1963).

²⁶ P.L. 87-196; 75 Stat. 465.

Accordingly, the Committee believes that the Congress should direct the SEC to undertake a new Special Study of the securities markets. While the Congress and its Committees have directed the SEC to study certain topics in the intervening years, the Commission has not completed a comprehensive examination of the securities markets in 25 years. The Committee believes that the Commission should undertake a comprehensive and far-reaching securities study. This study shall include an analysis of trading on insider information and the adequacy of means to police insider trading and of cooperation between federal, state and foreign enforcement authorities.

However, the Committee intends that this study go well beyond an examination of the problems of securities fraud. The study shall include an examination of impediments to the fairness and orderliness of securities markets and of improvements to the breadth and depth of capital available to the securities markets, and additional methods to promote those objectives. The Committee intends that the Commission shall use its discretion to examine a broad range of topics from legal, economic, or public policy perspectives. For example, the Commission could decide to examine the effects of mergers and acquisitions on the economy and the efficacy of federal and state laws in regulating them. The Commission also could study investment activities, whether or not they are regulated currently by federal and state law. The Committee intends that the SEC include in its study the issue of the role of institutional fund managers and their impact on the market, given the increasing trend of institutional holdings in the market and the growing power of fund managers in determining the outcome of proxy contests. The study is intended to be broad in scope and in method of analysis, commensurate with the amount of the appropriation and the extensive expertise of the SEC's attorneys, accountants, economists, and other professional staff.

The study may also include recommendations for new legislation, as the Commission deems appropriate. The Committee notes that the Commission may make any recommendation for legislation in its interim reports. Moreover, the Committee notes that it will not hesitate to recommend to the Congress legislation that it independently has deemed appropriate during the pendency of the study.

HEARINGS

On March 5, May 5, and June 4, 1987, the Subcommittee on Telecommunications and Finance held oversight hearings which in part concerned the insider trading issue. Witnesses included then-Chairman John S. R. Shad of the Securities and Exchange Commission and Commissioners Charles C. Cox, Edward H. Fleischman and Joseph A. Grundfest, as well as the following SEC officials: Kenneth A. Fogash, Deputy Executive Director; Richard Ketchum, Director, Market Regulation; George Kundahl, Executive Director; Gary Lynch, Director, Enforcement; and Linda C. Quinn, Director, Corporate Finance. Testimony was also received from Rudolph W. Giuliani, United States Attorney Southern District of New York; Stephan L. Hammerman, Executive Vice President, Merrill Lynch,

John J. Phelan, Chairman, New York Stock Exchange; and David Marcus, Executive Vice President, New York Stock Exchange.

The Committee's Subcommittee on Telecommunications and Finance held a legislative hearing on H.R. 5133 on July 11, 1988. Testimony was received from the Honorable David S. Ruder, Chairman, Securities and Exchange Commission; Mr. Rudolph W. Giuliani, United States Attorney, Southern District of New York; Mr. John W. Bachmann, Chairman, Securities Industry Association; and Professor James D. Cox, Duke University School of Law.

COMMITTEE CONSIDERATION

On August 4, 1988, the Subcommittee on Telecommunications and Finance met in open session and ordered reported the bill H.R. 5133, as amended, by voice vote, a quorum being present. At this markup, the Subcommittee adopted one amendment, by voice vote, to H.R. 5133 as originally introduced. This amendment, offered by Mr. Markey, increased the maximum jail term for those convicted of a criminal securities law violation from 5 years to 10 years.

On August 9, 1988, the Committee met in open session and ordered reported the bill H.R. 5133 with amendment, a quorum being present. The Committee adopted one package of amendments offered by Mr. Dingell. This block of amendments was approved by voice vote, and included the following: clarification of damage liability for "tippers" of material, nonpublic information; deletion of "other actions" language concerning private rights of action for litigants other than contemporaneous traders; clarification of controlling person liability for private rights of action; and changes to the study commission which will put it more firmly in control of the Commission and prevent implementation in the absence of a separate appropriation and available funds. These amendments are described in greater detail in the Summary of Legislation.

COMMITTEE OVERSIGHT FINDINGS

Pursuant to clause 2(1)(3)(A) of Rule XI of the Rules of the House of Representatives, the Committee makes oversight findings as contained in this report.

COMMITTEE ON GOVERNMENT OPERATIONS

Pursuant to clause 2(1)(3)(D) of Rule XI of the Rules of the House of Representatives, no oversight findings have been submitted to the Committee by the Committee on Government Operations.

COMMITTEE COST ESTIMATE

In compliance with clause 7(a) of rule XIII of the Rules of the House of Representatives, the Committee states that the reported bill is not expected to incur any significant costs or savings.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, September 6, 1988.

Hon. JOHN D. DINGELL,
*Chairman, Committee on Energy and Commerce,
House of Representatives, Washington, DC.*

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the attached cost estimate for H.R. 5133, the Insider Trading and Securities Fraud Enforcement Act of 1988.

If you wish further details on this estimate, we will be pleased to provide them.

Sincerely,

JAMES L. BLUM,
Acting Director.

CONGRESSIONAL BUDGET OFFICE COST ESTIMATE

1. Bill number: H.R. 5133.
2. Bill title: Insider Trading and Securities Fraud Enforcement Act of 1988.
3. Bill status: As ordered reported by the House Committee on Energy and Commerce, August 9, 1988.
4. Bill purpose: H.R. 5133 contains language aimed at preventing stock trading based on insider information. Specifically, the bill would clarify the categories of illegal insider trading, authorize the Securities and Exchange Commission (SEC) to pay bounties to persons who provide information concerning insider trading violations, and increase criminal penalties for securities law violations. In addition, the bill would require the SEC to assemble a panel of experts to study the adequacy of present securities laws in protecting investors, and would authorize \$5 million in fiscal year 1989 for this purpose.
The bill also contains language aimed at facilitating cooperation between the United States and foreign countries in securities law enforcement. The SEC would be permitted to provide investigatory assistance at the request of a foreign country, provided that country grants reciprocal assistance to the SEC.
5. Estimated cost to the Federal Government:

[By fiscal year, in millions of dollars]

	1989	1990	1991	1992	1993
Study of present securities laws:					
Authorization level.....	5.0				
Estimated outlays.....	4.6	0.4			

The costs of this bill fall within budget function 370.

Basis of estimate: This estimate assumes that the full amounts authorized will be appropriated prior to the beginning of fiscal year 1989. Outlays are based on historical spending patterns of similar programs at the SEC.

Other provisions of the bill are not expected to result in significant additional cost to the federal government.

6. Estimated cost to State and local governments: None.

7. Estimate comparison: None.
8. Previous CBO estimate: None.
9. Estimate prepared by: Douglas Criscitello.
10. Estimate approved by: James L. Blum, Assistant Director for Budget Analysis.

INFLATIONARY IMPACT STATEMENT

Pursuant to clause 2(1)(4) of rule XI of the Rules of the House of Representatives, the Committee makes the following statement with regard to the inflationary impact of the reported bill: H.R. 5133 would have no inflationary impact.

SECTION-BY-SECTION ANALYSIS, INSIDER TRADING AND SECURITIES FRAUD ENFORCEMENT ACT OF 1988

SECTION 1—SHORT TITLE

Section 1 cites the title of the Act as the "Insider Trading and Securities Fraud Enforcement Act of 1988".

SECTION 2—FINDINGS

The findings in Section 2 expressly recognize that the rules and regulations of the Securities and Exchange Commission under the Securities Exchange Act of 1934 ("Exchange Act") governing trading while in possession of material, nonpublic information are necessary and appropriate for the Commission to carry out its responsibilities to act in the public interest and for the protection of investors. Furthermore, the findings recognize that, while the Commission has enforced such rules and regulations vigorously, effectively and fairly, additional methods are required to deter and prosecute violations of such rules and regulations. These findings are intended as an expression of congressional support for these regulations.

SECTION 3—CIVIL PENALTIES AND LIABILITY OF CONTROLLING PERSONS FOR ILLEGAL TRADING BY SUBSIDIARIES AND EMPLOYEES

This section creates a new Section 21A of the Exchange Act, which replaces and expands the present Section 21(d)(2) of the Act concerning the imposition of civil penalties on persons who commit insider trading violations and persons who controlled them at the time of the violation. Congress originally granted the Commission authority to seek the imposition of such civil penalties in the Insider Trading Sanctions Act of 1984.

Authority To Impose Civil Penalties

Subsection (a) of the new Section 21A authorizes the Commission to bring an action in United States district court to impose a civil penalty on persons who violate the securities laws by "purchasing or selling a security while in possession of material nonpublic information," or "by communicating such information in connection with a transaction." The Commission may similarly seek a civil penalty against persons who, at the time of the violation, "controlled" the violating person.

Paragraphs (2) and (3) of subsection (a) set the amount of civil penalties for persons who commit insider trading violations and the controlling persons. For the violating party, the amount of the civil penalty could be as high as three times the profit gained or loss avoided as a result of the unlawful activity. For controlling persons, the limit would be the greater of \$1 million or three times the amount of the profit gained or loss avoided as a result of the controlled person's violation. If the controlled person is a tipper, however, then the profit gained or loss avoided would be limited to profits or losses made by those to whom the tipper's communication was directed. In all instances, the actual amount of the penalty would be determined by the court in light of appropriate facts and circumstances.

Limitations of Liability

Subsection (b) of Section 21A provides several limitations on liability under subsection (a). Paragraph (1) delineates alternative requirements for the imposition of liability against controlling persons. "Controlling persons" in the insider trading context are likely to include broker-dealers and investment advisers, but may also include other employers and individuals who exercise effective control over the activities of a violator. This paragraph imposes liability on any controlling person who "knew or recklessly disregarded" facts that would give that person reason to believe that the person under this control was engaging in insider trading. In addition, broker-dealers and investment advisers are also subject to liability if they have "knowingly or recklessly" failed to establish, maintain or enforce adequate procedures reasonably designed to prevent insider trading violations by their employees. These supervisory procedures are by this Act affirmatively required of all broker-dealers through the new Section 15(f) of the Exchange Act and Section 204A of the Investment Advisers Act of 1940.

This subsection also makes clear that the breakdown in a firm's system of surveillance must have been related to the violation committed by the controlled person. Paragraph (1) of subsection (b), in combination with subsection (a), fundamentally changes current law by extending liability for civil penalties beyond primary violators of the law to those who violate their duty to take reasonable steps to prevent that behavior.

Paragraph (2) of subsection (b) contains additional restrictions on liability. First, it would prohibit the imposition of a penalty under subsection (a) based solely on the doctrine of *respondeat superior*. An employing person would be subject to a penalty, however, if found liable as a "controlling person" under paragraph (1). Second, this paragraph makes clear that the liability of controlling persons for the penalty would be governed by the specific standards embodied in Section 21A. The differing standards in existing Section 20(a), which governs the general responsibility of controlling persons in the event of violations of the securities laws by their controlled persons, would not apply in penalty actions.

Exemptive Authority of the Commission

Subsection (c) of Section 21A grants the Commission authority to exempt any persons or transactions from any of the provisions of

this section, as the Commission considers necessary or appropriate in the public interest or for the protection of investors.

Procedures for Collection

Subsection (d) of Section 21A includes several provisions relating to the procedures for bringing actions under this section. Paragraph (1), which continues current law, specifies that any penalty under Section 21A is payable into the Treasury of the United States.

Paragraph (2) of subsection (d) states that in the event a person fails to pay a civil penalty under a court order, the Commission may seek the judgment itself through court proceedings or refer the matter to the Attorney General.

Paragraph (3) of subsection (d) states that Section 21A is not an exclusive remedy for insider trading violations and would not preclude the Commission or the Attorney General from bringing any other actions to which they are legally entitled. This continues present law in Section 21(d)(2)(A) of the Exchange Act, and permits the Government to litigate insider trading cases based on other provisions of the securities laws and of the general mail and wire fraud statutes, which served as a basis for the insider trading conviction of Wall Street Journal reporter R. Foster Winans, among others, in *Carpenter v. U.S.*

Paragraph (4) of subsection (d) states that actions under Section 21A will be treated as actions "to enforce any liability or duty created by this title," which is necessary for purposes of clarifying proper jurisdiction and venue under Section 27 of the Exchange Act. This continues present law in Section 21(d)(2)(A) of the Exchange Act.

Paragraph (5) of subsection (d) imposes the same statute of limitations as included in present law in Section 21(d)(2)(D) of the Exchange Act. No action may be brought under Section 21A more than five years after the date of the transaction that forms the basis of the violation.

Bounty Provision

Subsection (e) grants authority to the Commission to award bounty payments to persons who provide information concerning insider trading violations. At the discretion of the Commission, such person can receive up to ten percent of the penalty imposed through litigation or settlement. Neither the decision to award an informant nor a decision on the amount of such an award is subject to judicial review. This provision is intended to encourage additional sources of information to come forward, thus assisting the Commission in its investigation and development of insider trading cases.

Definition

Subsection (f) of Section 21A defines the terms "profit gained" or "loss avoided," which are used to determine the amount of the civil penalty. The definition is identical to present law in Section 21(d)(2)(C), and is the difference between the purchase or sale price of the security paid or received by the violating party and the real

value of that security as measured by the trading price a reasonable time after public dissemination of the nonpublic information.

Supervisory Requirements for Broker-Dealers and Investment Advisers

Subsection (b) of Section 3 of this Act includes amendments to the securities laws which establish affirmative obligations on regulated securities firms to supervise their employees. Both broker-dealers and investment advisers must establish, maintain and enforce written policies "reasonably designed" to prevent misuse of material, nonpublic information by the firm or any of its employees or associated persons. Thus, a multiservice securities firm would have to establish a supervisory system to oversee trading of securities in both firm accounts and employee accounts. The adequacy of the system would be considered in the context of the nature of the firm's business. This is a significant change from current law, which contains no affirmative statutory obligation on a securities firm to adopt procedures designed to prevent insider trading and other misuse of material, nonpublic information.

This subsection also specifically authorizes the Commission, consistent with its statutory responsibility to act in the public interest and for the protection of investors, to adopt rules or regulations to specify the policies and procedures which would be in compliance with the dictates of these statutory requirements.

Recommendations for Additional Civil Penalty Authority

Subsection (c) of Section 3 of this Act mandates that, within 60 days after the enactment of this Act, the Commission submit to Congress appropriate recommendations with respect to the extension of the Commission's authority to seek civil penalties or impose administrative fines in areas beyond insider trading. The Commission recently approved a proposal on this subject and directed staff to prepare proposed legislation. This provision is intended to set a deadline for that process.

SECTION 4—INCREASES IN CRIMINAL PENALTIES

This section amends Section 32 of the Exchange Act by raising the maximum jail terms for securities law violations from 5 to 10 years, and by increasing criminal monetary penalties from an individual maximum of \$100,000 to \$1,000,000 and a maximum for non-natural persons from \$500,000 to \$2,500,000. The section also changes current law by making all non-natural persons subject to the higher criminal penalty; current law imposes the higher burden only on exchanges.

SECTION 5—LIABILITY TO CONTEMPORANEOUS TRADERS FOR INSIDER TRADING

Subsection (a) of this Section would create a new Section 20A of the Exchange Act and provide express private rights of action for those who traded securities contemporaneously with, and on the opposite side of, a transaction from the insider trader. This codification of a right of action for all contemporaneous traders is intended, in part, to overturn court cases which have precluded re-

covery by plaintiffs who were victims of misappropriation. See, e.g., *Moss v. Morgan Stanley*, 719 F.2d (2d Cir. 1983).

Limitations on Liability

Paragraph (1) of subsection (b) would limit the total amount of damages awarded to contemporaneous traders to the profit gained or loss avoided in the transaction that is the subject of the violation. Furthermore, under paragraph (2), the total amount of damages imposed in an action brought by a contemporaneous trader must be diminished by any amount the violating person was required to disgorge pursuant to a court order in a Commission action. Paragraph (3) provides that the doctrine of *respondeat superior* would not apply in private rights of action by contemporaneous traders, but reaffirms that Section 20(a) of the Exchange Act, governing the liability of controlling persons, would continue to apply. Finally, paragraph (4) dictates that no action pursuant to this section may be brought more than 5 years after the date of the last transaction that formed the basis of the violation.

Joint and Several Liability

Subsection (c) imposes liability on tippers of inside information to the same extent as persons liable under Subsection (a) of paragraph (1).

No Restriction of Implied Rights of Action or Public Prosecutions

Subsection (d) states that the explicit authority for persons to pursue private rights of action under this section is not intended to limit or condition any other express or implied private rights of action under any other section of the Exchange Act. Subsection (e) also makes clear that this section is not intended to bar or limit any other court action by the Commission or the Attorney General.

SECTION 6—INTERNATIONAL ENFORCEMENT COOPERATION AUTHORITY

This section amends Section 21(a) of the Exchange Act by providing the Commission with expanded statutory authority to assist foreign governments in investigations concerning violations of foreign securities laws and regulations. The Commission would have the discretion to assist foreign governments upon a request for such assistance, but would have to consider the following factors in making a determination whether to cooperate: (1) whether the requesting foreign authority has agreed to provide reciprocal assistance to the Commission on U.S. securities matters; and (2) whether compliance with the request would "prejudice the public interest of the United States."

This section closely follows one section of the Commission's recent proposal (H.R. 4945, introduced by request on June 29, 1988) for expanded statutory authority to bring its domestic investigatory powers to bear in assisting foreign governmental authorities in cases involving foreign securities laws. Such assistance is considered crucial to gaining the cooperation of foreign governments when necessary for investigations of U.S. securities laws when the evidence exists outside of the U.S.

SECTION 7—SECURITIES LAWS STUDY

This section directs the Commission to embark upon a study of the adequacy of present federal securities laws in meeting the goal of protecting the investing public. This study is in no way intended as an impediment to any needed efforts to reform the securities markets and assure the fair and honest operation of those markets and in no way should be construed to sanction any delay in enacting further legislation dealing with the financial markets prior to completion of the study.

SECTION 8—COOPERATION WITH FOREIGN AUTHORITIES AND INTERNATIONAL ORGANIZATIONS IN ENFORCEMENT

This section amends Section 35 of the Exchange Act by authorizing the appropriation of funds, not to exceed a total of \$20,000 per year, for official expenditures, as well as membership fees incurred through the Commission's participation in the International Organization of Securities Commissions (IOSC). As the Commission has noted in previous congressional testimony, the IOSC is the major international forum for securities market regulators. The facilitation of SEC participation in this organization provides an opportunity for U.S. regulators to join with high-level delegations from other nations to further their common goals in the effective regulation of international securities markets.

SECTION 9—EFFECTIVE DATE

This section clarifies the prospective application of this statute. With the exception of section 6 of this Act, none of the amendments made by this Act shall apply to any action occurring before the date of enactment.

CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3 of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

SECURITIES EXCHANGE ACT OF 1934

* * * * *

TITLE I—REGULATION OF SECURITIES EXCHANGES

* * * * *

DEFINITIONS AND APPLICATION OF TITLE

SEC. 3. (a) When used in this title, unless the context otherwise requires—

(1) * * *

* * * * *

(50) *The term "foreign securities authority" means any foreign government, or any governmental body or regulatory orga-*

nization empowered by a foreign government to administer or enforce its laws as they relate to securities matters.

REGISTRATION AND REGULATION OF BROKERS AND DEALERS

SEC. 15. (a) * * *

* * * * *

(f) Every registered broker or dealer shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such broker's or dealer's business, to prevent the misuse in violation of this title, or the rules or regulations thereunder, of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer. The Commission, as it deems necessary to appropriate in the public interest or for the protection of investors, shall adopt rules or regulations to require specific policies or procedures reasonably designed to prevent misuse in violation of this title (or the rules or regulations thereunder) of material, nonpublic information.

* * * * *

LIABILITY TO CONTEMPORANEOUS TRADERS FOR INSIDER TRADING

SEC. 20A. (a) PRIVATE RIGHTS OF ACTION BASED ON CONTEMPORANEOUS TRADING.—Any person who violates any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information shall be liable in an action in any court of competent jurisdiction to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class.

(b) LIMITATIONS ON LIABILITY.—

(1) CONTEMPORANEOUS TRADING ACTIONS LIMITED TO PROFIT GAINED OR LOSS AVOIDED.—The total amount of damages imposed under subsection (a) shall not exceed the profit gained or loss avoided in the transaction or transactions that are the subject of the violation.

(2) OFFSETTING DISGORGEMENTS AGAINST LIABILITY.—The total amount of damages imposed against any person under subsection (a) shall be diminished by the amounts, if any, that such person may be required to disgorge, pursuant to a court order obtained at the instance of the Commission, in a proceeding brought under section 21(d) of this title relating to the same transaction or transactions.

(3) CONTROLLING PERSON LIABILITY.—No person shall be liable under this section solely by reason of employing another person who is liable under this section, but the liability of a controlling person under this section shall be subject to section 20(a) of this title.

(4) STATUTE OF LIMITATIONS.—No action may be brought under this section more than 5 years after the date of the last transaction that is the subject of the violation.

(c) *JOINT AND SEVERAL LIABILITY FOR COMMUNICATING.*—Any person who violates any provision of this title or the rules or regulations thereunder by communicating material, nonpublic information shall be jointly and severally liable under subsection (a) with, and to the same extent as, any person or persons liable under subsection (a) to whom the communication was directed.

(d) *AUTHORITY NOT TO RESTRICT OTHER EXPRESS OR IMPLIED RIGHTS OF ACTION.*—Nothing in this section shall be construed to limit or condition the right of any person to bring an action to enforce a requirement of this title or the availability of any cause of action implied from a provision of this title.

(e) *PROVISIONS NOT TO AFFECT PUBLIC PROSECUTIONS.*—This section shall not be construed to bar or limit in any manner any action by the Commission or the Attorney General under any other provision of this title, nor shall it bar or limit in any manner any action to recover penalties, or to seek any other order regarding penalties.

INVESTIGATIONS; INJUNCTIONS AND PROSECUTION OF OFFENSES

SEC. 21. (a)(1) The Commission may, in its discretion, make such investigations as it deems necessary to determine whether any person has violated, is violating, or is about to violate any provision of this title, the rules or regulations thereunder, the rules of a national securities exchange or registered securities association of which such person is a member or a person associated with a member, the rules of a registered clearing agency in which such person is a participant, or the rules of the Municipal Securities Rulemaking Board, and may require or permit any person to file with it a statement in writing, under oath or otherwise as the Commission shall determine, as to all the facts and circumstances concerning the matter to be investigated. The Commission is authorized in its discretion, to publish information concerning any such violations, and to investigate any facts, conditions, practices, or matters which it may deem proper to aid in the enforcement of such provisions, in the prescribing of rules and regulations under this title, or in securing information to serve as a basis for recommending further legislation concerning the matters to which this title relates.

(2) *On request from a foreign securities authority, the Commission may provide assistance in accordance with this paragraph if the requesting authority states that the requesting authority is conducting an investigation which it deems necessary to determine whether any person has violated, is violating, or is about to violate any laws or rules relating to securities matters that the requesting authority administers or enforces. The Commission may, in its discretion, conduct such investigation as the Commission deems necessary to collect information and evidence pertinent to the request for assistance. Such assistance may be provided without regard to whether the facts stated in the request would also constitute a violation of the laws of the United States. In deciding whether to provide such assistance, the Commission shall consider whether (A) the requesting authority has agreed to provide reciprocal assistance in securities*

matters to the Commission; and (B) compliance with the request would prejudice the public interest of the United States.

* * * * *

(d) [(1)] Whenever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of this title, the rules or regulations thereunder, the rules of a national securities exchange or registered securities association of which such person is a member or a person associated with a member, the rules of a registered clearing agency in which such person is a participant, or the rules of the Municipal Securities Rulemaking Board, it may in its discretion bring an action in the proper district court of the United States, the United States District Court for the District of Columbia, or the United States courts of any territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. The Commission may transmit such evidence as may be available concerning such acts or practices as may constitute a violation of any provision of this title or the rules or regulations thereunder to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this title.

[(2)(A)] Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material nonpublic information in a transaction (i) on or through the facilities of a national securities exchange or from or through a broker or dealer, and (ii) which is not part of a public offering by an issuer of securities other than standardized options, the Commission may bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, a civil penalty to be paid by such person, or any person aiding and abetting the violation of such person. The amount of such penalty shall be determined by the court in light of the facts and circumstances, but shall not exceed three times the profit gained or loss avoided as a result of such unlawful purchase or sale, and shall be payable into the Treasury of the United States. If a person upon whom such a penalty is imposed shall fail to pay such penalty within the time prescribed in the court's order, the Commission shall refer the matter to the Attorney General who shall recover such penalty by action in the appropriate United States district court. The actions authorized by this paragraph may be brought in addition to any other actions that the Commission or the Attorney General are entitled to bring. For purposes of section 27 of this title, actions under this paragraph shall be actions to enforce a liability or a duty created by this title. The Commission, by rule or regulation, may exempt from the provisions of this paragraph any class of persons or transactions.

[(B)] No person shall be subject to a sanction under subparagraph (A) of this paragraph solely because that person aided and abetted a transaction covered by such subparagraph in a manner other than by communicating material nonpublic information. Section 20(a) of this title shall not apply to an action brought under

this paragraph. No person shall be liable under this paragraph solely by reason employing another person who is liable under this paragraph.

[(C) 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.

[(D) No action may be brought under this paragraph more than five years after the date of the purchase or sale. This paragraph shall not be construed to bar or limit in any manner any action by the Commission or the Attorney General under any other provision of this title, nor shall it bar or limit in any manner any action to recover penalties, or to seek any other order regarding penalties, imposed in an action commenced within five years of such transaction.]

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CIVIL PENALTIES

SEC. 21A. (a) AUTHORITY TO IMPOSE CIVIL PENALTIES.—

(1) *JUDICIAL ACTIONS BY COMMISSION AUTHORIZED.*—Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information in, or has violated any such provision by communicating such information in connection with, a transaction on or through the facilities of a national securities exchange or from or through a broker or dealer, and which is not part of a public offering by an issuer of securities other than standardized options, the Commission—

(A) may bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, a civil penalty to be paid by the person who committed such violation; and

(B) may, subject to subsection (b)(1), bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, a civil penalty to be paid by a person who, at the time of the violation, directly or indirectly controlled the person who committed such violation.

(2) *AMOUNT OF PENALTY FOR PERSON WHO COMMITTED VIOLATION.*—The amount of the penalty which may be imposed on the person who committed such violation shall be determined by the court in light of the facts and circumstances, but shall not exceed three times the profit gained or loss avoided as a result of such unlawful purchase, sale, or communication.

(3) *AMOUNT OF PENALTY FOR CONTROLLING PERSON.*—The amount of the penalty which may be imposed on any person who, at the time of the violation, directly or indirectly controlled the person who committed such violation, shall be determined by the court in light of the facts and circumstances, but shall not exceed the greater of \$1,000,000, or three times the amount of the profit gained or loss avoided as a result of such controlled person's violation. If such controlled person's viola-

tion was a violation by communication, the profit gained or loss avoided as a result of the violation shall, for purposes of this paragraph only, be deemed to be limited to the profit gained or loss avoided by the person or persons to whom the controlled person directed such communication.

(b) LIMITATIONS ON LIABILITY.—

(1) LIABILITY OF CONTROLLING PERSONS.—No controlling person shall be subject to a penalty under subsection (a)(1)(B) unless the Commission establishes that—

(A) such controlling person knew or recklessly disregarded the fact that such controlled person was likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent such act or acts before they occurred; or

(B) such controlling person knowingly or recklessly failed to establish, maintain, or enforce any policy or procedure required under section 15(f) of this title or section 204A of the Investment Advisers Act of 1940 and such failure substantially contributed to or permitted the occurrence of the act or acts constituting the violation.

(2) ADDITIONAL RESTRICTIONS ON LIABILITY.—No person shall be subject to a penalty under subsection (a) solely by reason of employing another person who is subject to a penalty under such subsection, unless such employing person is liable as a controlling person under paragraph (1) of this subsection. Section 20(a) of this title shall not apply to actions under subsection (a) of this section.

(c) AUTHORITY OF COMMISSION.—The Commission, by such rules, regulations, and orders as it considers necessary or appropriate in the public interest or for the protection of investors, may exempt, in whole or in part, either unconditionally or upon specific terms and conditions, any person or transaction or class of persons or transactions from this section.

(d) PROCEDURES FOR COLLECTION.—

(1) PAYMENT OF PENALTY TO TREASURY.—A penalty imposed under this section shall (subject to subsection (e)) be payable into the Treasury of the United States.

(2) COLLECTION OF PENALTIES.—If a person upon whom such a penalty is imposed shall fail to pay such penalty within the time prescribed in the court's order, the Commission may refer the matter to the Attorney General who shall recover such penalty by action in the appropriate United States district court.

(3) REMEDY NOT EXCLUSIVE.—The actions authorized by this section may be brought in addition to any other actions that the Commission or the Attorney General are entitled to bring.

(4) JURISDICTION AND VENUE.—For purposes of section 27 of this title, actions under this section shall be actions to enforce a liability or a duty created by this title.

(5) STATUTE OF LIMITATIONS.—No action may be brought under this section more than 5 years after the date of the purchase or sale. This section shall not be construed to bar or limit in any manner any action by the Commission or the Attorney General under any other provision of this title, nor shall it bar or limit in any manner any action to recover penalties, or to

seek any other order regarding penalties, imposed in an action commenced within 5 years of such transaction.

(e) *AUTHORITY TO AWARD BOUNTIES TO INFORMANTS.*—Notwithstanding the provisions of subsection (d)(1), there shall be paid from amounts imposed as a penalty under this section and recovered by the Commission or the Attorney General, such sums, not to exceed 10 percent of such amounts, as the Commission deems appropriate, to the person or persons who provide information leading to the imposition of such penalty. Any determinations under this subsection, including whether, to whom, or in what amount to make payments, shall be in the sole discretion of the Commission, except that no such payment shall be made to any member, officer, or employee of any appropriate regulatory agency, the Department of Justice, or a self-regulatory organization. Any such determination shall be final and not subject to judicial review.

(f) *DEFINITION.*—For purposes of this section, “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.

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PENALTIES

SEC. 32. (a) Any person who willfully violates any provision of this title (other than section 30A), or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this title, or any person who willfully and knowingly makes, or causes to be made, any statement in any application, report, or document required to be filed under this title or any rule or regulation thereunder or undertaking contained in a registration statement as provided in subsection (d) of section 15 of this title, or by any self-regulatory organization in connection with an application for membership or participation therein or to become associated with a member thereof, which statement was false or misleading with respect to any material fact, shall upon conviction be fined not more than ~~[\$100,000]~~ \$1,000,000, or imprisoned not more than ~~[five]~~ 10 years, or both, except that when such person ~~[is an exchange]~~ is a person other than a natural person, a fine not exceeding ~~[\$500,000]~~ \$2,500,000 may be imposed; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.

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AUTHORIZATION OF APPROPRIATIONS

SEC. 35. (a) * * *

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(c) *Funds appropriated pursuant to this section are authorized to be expended—*

(1) for official reception and representation expenses, not to exceed \$10,000 per year; and

(2) for the purpose of maintaining membership in and contributing to the operating expenses of the International Organization of Securities Commissions, not to exceed \$10,000 per year.

* * * * *

SECTION 204A OF THE INVESTMENT ADVISERS ACT OF 1940

PREVENTION OF MISUSE OF NONPUBLIC INFORMATION

SEC. 204A. Every investment adviser subject to section 204 of this title shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such investment adviser's business, to prevent the misuse in violation of this Act or the Securities Exchange Act of 1934, or the rules or regulations thereunder, of material, nonpublic information by such investment adviser. The Commission, as it deems necessary or appropriate in the public interest or for the protection of investors, shall adopt rules or regulations to require specific policies or procedures reasonably designed to prevent misuse in violation of this Act or the Securities Exchange Act of 1934 (or the rules or regulations thereunder) of material, nonpublic information.

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