

SEC ENFORCEMENT LEGISLATION

HEARING

BEFORE THE

SUBCOMMITTEE ON TELECOMMUNICATIONS,
CONSUMER PROTECTION, AND FINANCE

OF THE

COMMITTEE ON ENERGY AND COMMERCE
HOUSE OF REPRESENTATIVES

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

H.R. 559

A BILL TO AMEND THE SECURITIES EXCHANGE ACT OF 1934 TO IN-
CREASE THE SANCTIONS AGAINST TRADING IN SECURITIES WHILE IN
POSSESSION OF MATERIAL NONPUBLIC INFORMATION

APRIL 13, 1983

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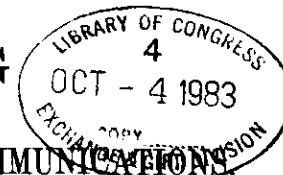


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INSIDER TRADING SANCTIONS AND SEC ENFORCEMENT LEGISLATION

WEDNESDAY, APRIL 13, 1983

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE,
SUBCOMMITTEE ON TELECOMMUNICATIONS,
CONSUMER PROTECTION, AND FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice at 9:40 a.m., in room 2123, Rayburn House Office Building, Hon. Timothy E. Wirth (chairman) presiding.

Mr. WIRTH. The subcommittee will come to order.

Today's hearing will consider legislation which would give the Securities and Exchange Commission additional enforcement tools to combat abuses in the securities markets. We are looking at this legislation at a time when SEC enforcement resources are decreasing, yet indications are that fraud in the marketplace is on the rise.

A shakeout from the worst recession in over 40 years may reveal still more serious problems in coming months. Today, as much as any other time in the Commission's history, it is important that the SEC maintain an effective enforcement presence with adequate deterrent capabilities.

The Federal securities laws were passed at a time when confidence in the Nation's financial markets was shattered. The purpose of the laws was to restore that confidence by protecting investors in a big, impersonal market. Existing laws were totally inadequate to serve that purpose.

Although the laws were passed to remedy the abuses of the day, the Commission has used those flexible laws to combat unique new problems in our changing markets. Indeed, the Supreme Court has repeatedly recognized that the antifraud provisions of the securities laws should not be construed "technically and restrictively," but "should be used flexibly to effectuate their remedial purposes."

Thus, there has not often been a need to change the substantive antifraud laws. The legislation before us today does not seek to change those laws, but proposes more effective remedies to address violations of those laws.

In past years, insider trading in the securities markets went largely undetected and unremedied. But when John Shad became Chairman of the SEC, he made insider trading a priority. His enforcement director, Mr. Fedders, called insider traders "thieves."

Chairman Shad promised to come down on insider traders with "hobnail boots."

The press, however, said the Commission was engaged in an "unwinnable war." Insider trading promises large rewards, but is risk free. Under existing law, all that a trader has to give up are the profits he makes.

The Commission acknowledged that it could not catch every violator, but promised to raise the level of risk for those it did catch. Last September, after months of development, the Commission recommended a statute that many believe is long overdue. The Commission's proposal provides for a civil monetary penalty of up to three times the amount of profit gained or loss avoided on an insider trading transaction. The Commission unanimously supported the legislation, and sent it to the Congress.

Chairman Shad, you should be praised for attacking this problem pragmatically. You cannot keep throwing the Commission's scarce resources at insider trading when there are so many other problems in the markets. We must provide a sufficient deterrent so that people will think twice before they engage in what all of us would call thievery.

Chairman Dingell and I introduced the bill H.R. 559 recommended by the Commission in January. Since then, the need for the legislation has reached the front pages in press accounts about the President's National Security Adviser, Thomas Reed, who turned a \$3,000 investment in options into a profit of more than \$400,000 in the space of 48 hours.

The Commission settled its case with Mr. Reed with an injunction and disgorgement of the profits he made. But that settlement left Mr. Reed essentially in the same position he was in prior to the trades. He in fact kept the profits of an earlier trade the Commission believed it could not prove with the evidence at hand.

Some have criticized the Commission's settlement with Reed. But at least the Commission took action. It brought the case. In that regard, I should note that my counterpart in the Senate, Senator D'Amato, held extensive hearings on the Commission's handling of the Reed case. He performed a great service in doing so.

He and other members of the Senate Banking Committee called for Mr. Reed's prompt resignation. In contrast, the White House gave Mr. Reed its full support. It is not my role to be judge and jury with respect to Mr. Reed, but I have to share some of the feelings expressed by my colleagues.

The White House's handling of this matter raises serious questions in my mind about how this administration views violations of the Federal securities laws. I think it becomes even more important, if we want to deter the kind of activity engaged in by Mr. Reed, that we demonstrate that the Congress, at least, views insider trading and other violations of the Federal securities laws as thievery and as serious frauds, which merit tough sanctions.

In addition to the insider trading bill, we are circulating drafts of other proposed enforcement tools. Many have said that insider trading is not the greatest abuse in the securities markets, and I agree. These other proposals are intended to serve the same purpose as the insider trading sanctions. We want to give the SEC ade-

quate deterrent capabilities and flexibility in using its resources to combat all serious market abuses.

I should mention two other aspects of our enforcement efforts that go hand in hand with these "tools." First, it will not help to give the SEC additional tools if the SEC does not have the personnel to use them. Chairman Shad and I have discussed this before.

Second, we must make sure that the SEC is directing its resources to those areas where investors suffer the greatest losses, and where investor confidence in the markets is most affected. Insider trading may represent a significant abuse. But we must be sure that, in devoting substantial resources to this area, the SEC does not neglect other activity that potentially does greater harm to investor confidence in our markets.

The SEC should be praised for coming forward with the insider trading bill and for working to make its enforcement activities more effective. Senator D'Amato has introduced a similar bill in the Senate, and I am hopeful that we can work together to pass this legislation quickly.

I would also like to insert in the record at this point a letter we received this morning from Mr. D'Amato on making available to the subcommittee and the House all of the material they developed on the Senate side, with respect to the SEC's handling of the Reed matter.

[The text of H.R. 559, the letter referred to, and the staff drafts follow:]

Mr. WIRTH. Before proceeding to our witnesses, I would ask the ranking minority member, Mr. Rinaldo, and other members of the committee if they have any statements they would like to make at this point. Mr. Rinaldo.

Mr. RINALDO. Thank you, Mr. Chairman. I do have a statement.

First of all, I want to welcome Chairman Shad, and I also want to commend you, Mr. Chairman, for holding this important hearing on what I consider an extremely urgent bill, the Insider Trading Sanctions Act. The legislation has been drafted by the SEC, as you mentioned, to address the need for greater deterrence of insider trading violations of the securities laws.

I am pleased that the subcommittee is taking up this priority bill. Insider trading has been characterized as "thievery." It enables those with material nonpublic information to reap huge profits at the expense of investors without the benefit of such information. By violating fundamental expectations of fairness and honesty, it undermines public confidence in our Nation's securities markets, which are the best in the world.

I commend the SEC, and Chairman Shad in particular, for giving insider trading violations a higher enforcement priority and for initiating an increased number of cases. I would hope that increased enforcement emphasis has had some deterrent effect on the marketplace.

But the problem we are facing with insider trading is that present sanctions available to the Commission do not serve as a real deterrent when compared to the vast profits which can be gained so rapidly by trading with inside information. The most that the Commission can do at the present time is enjoin an inside trader from future violations and require him to disgorge his illegal profits.

Clearly, neither of these remedies penalizes the trader's illegal conduct. Disgorgement of profits simply puts him back in the position he would have been in if he had obeyed the law in the first place.

The legislation we are considering today will provide an increased deterrent for insider trading by allowing the SEC to go to court to seek a civil penalty of up to three times the profit gained or loss avoided. Such a penalty would serve as a real deterrent by greatly increasing the risk of engaging in insider trading. It would also underscore the significance of this offense.

The bill also increases the fine for criminal violations from the present \$10,000, established in 1934, to \$100,000. This increased fine would enhance the level of deterrence for all Exchange Act violations.

A number of issues, however, that are clearly related to this legislation have been raised by representatives of the securities industry and the securities bar. These include whether the bill should include a definition of insider trading, the extent of secondary liability under theories of aiding and abetting and respondent superior, and whether a knowing or willful violation should be required.

In addition, the procedural questions of the appropriate burden of proof, the right to trial by jury, and statute of limitations have been raised. I feel that these issues should be looked at carefully by

the subcommittee, and I expect that we will hear them discussed today in detail.

I look forward to hearing from all of the witnesses today. And Chairman Shad, I hope you are wearing those hobnail boots.

Mr. WIRTH. Thank you, Mr. Rinaldo.

Mr. Tauke.

Mr. TAUKE. I have no statement, Mr. Chairman.

Mr. WIRTH. Fine.

Mr. SHAD, again welcome to you and to the members of your staff. I think this is very important, and again I want to commend you and Mr. Fedders for raising the issue of insider trading some time ago.

This committee, as you know, has long been concerned about this issue. In January of this year, Mr. Dingell and I introduced the legislation unanimously suggested by the Commissioners. Mr. D'Amato is moving on the Senate side. And clearly the whole *Thomas Reed* case has raised this to a level of public awareness, so that people in the country I think understand the very important service that you have rendered in raising this issue and putting forward the legislation.

So we are delighted to have you with us today. Please proceed in whatever way is appropriate, and then we will get into what I think will be quite extensive questioning to you, Mr. Fedders, and others.

You might start by introducing the members of your staff at the table.

STATEMENT OF HON. JOHN S. R. SHAD, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, ACCOMPANIED BY JOHN M. FEDDERS, DIRECTOR, DIVISION OF ENFORCEMENT; THEODORE A. LEVINE, ASSOCIATE DIRECTOR, DIVISION OF ENFORCEMENT; FREDERICK B. WADE, CHIEF COUNSEL, DIVISION OF ENFORCEMENT; DANIEL GOELZER, GENERAL COUNSEL, OFFICE OF THE GENERAL COUNSEL; AND BEVIS LONGSTRETH, COMMISSIONER (SEC)

Mr. SHAD. Thank you, Chairman Wirth and Congressmen Rinaldo and Tauke and members of the subcommittee.

The people with me at the table, starting on my far right, are: Ted Levine, who is the Associate Director of the Enforcement Division; John Fedders, the Division Director; Dan Goelzer, General Counsel; and Fred Wade, also Associate Director of the Enforcement Division.

The Securities and Exchange Commission appreciates this opportunity to testify in support of H.R. 559, the Insider Trading Sanctions Act of 1983. The bill would amend the Securities and Exchange Act of 1934 by authorizing the Commission to bring an action in a U.S. district court to seek civil penalties up to three times the profits gained or losses avoided when it appears to the Commission that any person has unlawfully purchased or sold a security while in possession of material nonpublic information.

The proposed legislation would also increase the fines for most criminal violations of the Exchange Act from \$10,000 to \$100,000. Such criminal fines have not been increased in nearly 50 years.

Insider trading undermines investors' confidence in the fairness of the Nation's securities markets. It victimizes not only the investing public, but also securities firms and professionals, particularly in options transactions. Some options sellers have incurred multi-million dollar losses on transactions with persons who are alleged to be acting on material nonpublic information.

In fiscal 1982 the Commission brought 20 insider trading cases, which represents 40 percent of all such cases since 1977. Defendants have included corporate executives, attorneys, accountants, bank officers, members of their families, and others.

Despite vigorous enforcement efforts, insider trading continues because active options markets and major takeovers permit several hundred thousand dollar profits to be realized within a few weeks on modest investments. For example, on October 1, 1981, the last day Santa Fe International traded prior to an announcement of a proposed merger with Kuwait Petroleum, Santa Fe closed at 24¾. Under the terms of the merger, Santa Fe shareholders would receive \$51 a share.

Following the announcement Santa Fe resumed trading at 42½. Because of the leverage—as you can see, that is less than a doubling in price—but because of the leverage afforded by options, various parties who had purchased Santa Fe options shortly before the announcement realized ten to twentyfold profits aggregating several million dollars.

Some of these individuals were closely associated with Santa Fe or relatives of such individuals. Similar cases have involved the securities of Brunswick, Marathon Oil, Amax, St. Joe Mineral, and many other companies.

The Commission's principal enforcement remedy is presently a civil injunctive action. Relief typically consists of an injunction against future violation and disgorgement of the illicit profits.

However, it should be noted that defendants may also be subject to criminal prosecution by the Justice Department, imprisonment and criminal fines, civil suits by defrauded parties, disbarment, license revocation, and other proceedings by professional and self-regulatory organizations, the loss of employment, legal fees, and social opprobria.

Nevertheless, these have not been adequate deterrents, because the opportunity for profit is so exceptional. In addition to traditional injunctions and the disgorgement of illicit profits, H.R. 559 would permit the Commission to seek court-imposed civil penalties payable to the Treasury of up to three times the illicit gains or losses avoided.

By way of an example, under the present law if a tippee realizes a \$100,000 illicit profit the Commission may be able to obtain an aggregate disgorgement of \$100,000 from the tippee, the tipper, and any aiders or abettors. Under the act as proposed, the Commission may be able to obtain an aggregate disgorgement of \$100,000 plus up to \$300,000 in penalties from each of the foregoing offenders.

To put that in perspective, in other words, the escalation of the penalties involved could be say in the area of tenfold if there were several people involved and if the full penalty was sustained in the courts, in other words, going from \$100,000 disgorgement to, say, in the area of \$1 million. So it is not just a threefold increase in the

penalty. Thus H.R. 559 may be expected to inhibit significantly insider trading.

Since the bill was introduced, responsible parties have submitted thoughtful comments on certain issues. Heretofore the Commission sanctions have been remedial. In view of the penalty now proposed, such parties have questioned:

Whether the right to a trial by jury should be granted; whether the court or a jury should determine the amount of any penalty; whether the penalty should be based on all profits subsequent to execution of the violative transaction or limited to the profits within a reasonable period after public dissemination of the inside information; whether there should be a statute of limitations on such penalties; whether the proposed act should include a definition of insider trading; whether the burden of proof should be clear and convincing evidence rather than a preponderance of the evidence; whether the extent of potential liabilities under respondent superior, aiding and abetting, and control person theories of liability should be defined or limited; whether the inside information covered by the statute should be limited to corporate as opposed to market information; whether the Commission should have to prove that a person acted knowingly in order to establish a violation; and whether the legislation should be limited to trading on the basis of, rather than while in possession of, inside information.

The SEC staff considered many of these points when drafting the proposed act. The Commission recognizes the need for legislation to be clear, unambiguous and predictable in its interpretation and application. The challenge is to evaluate legitimate concerns and appropriately clarify uncertainties.

If the subcommittee feels the areas cited should be clarified, the Commission will be pleased to submit language for your consideration.

Thank you.

[Testimony resumes on p. 33.]

[Mr. Shad's prepared statement follows.]

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

April 13, 1983

I. Introduction

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

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

II. The Nature of the Problem

"Insider trading" is the term used to describe the act of purchasing or selling securities while in possession of material non-public information about an issuer or the trading

market for an issuer's securities. Such conduct undermines the expectations of fairness and honesty that are the foundation of public confidence in our nation's securities markets.

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

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

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

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

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

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

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

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

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

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

The purchase of such options, rather than the underlying securities, enables a person in possession of material non-public information to maximize potential profits because the option price is generally a tiny fraction of the price of the

underlying stock. Thus, a minimal amount of capital is placed at risk. However, once a tender offer or merger is announced, the value of an option contract tends to increase at a much greater percentage than the rise in the price of the stock.

(b) Recent Enforcement Actions

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

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

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

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

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

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

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

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

Martin sold or exercised the 800 options, following the October 5 announcement of the Santa Fe-KPC merger agreement, for a total profit of approximately \$1.11 million.

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

On September 30, 1982, the Commission filed a civil action for injunctive and other equitable relief against James H. Randolph, a Vice President of a wholly-owned subsidiary of Santa Fe and Charles Blackard, another employee of the subsidiary. The Commission's complaint alleged that, while in possession of material non-public information, Blackard purchased 20 Santa Fe options at a cost of \$1,940.00 which he

exercised after the public announcement of the merger with KPC. Blackard received 2000 Santa Fe shares which he tendered pursuant to the merger agreement. According to the complaint, he realized profits of \$40,060 as a result of his transactions.

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

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

The cases described above illustrate the opportunities for profit inherent in the recent conjunction of increased tender

offers and acquisitions with the availability of trading in standardized option contracts. These circumstances have fundamentally altered the risk-reward equation with respect to potential insider trading and demonstrate the need for a new enforcement remedy to deter such conduct.

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

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

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

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

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

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

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

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

3/ Id.

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

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

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

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

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

which could be used to compensate victims of the insider trading), but any civil penalty imposed would always be paid to the Treasury.

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

V. Ancillary Issues

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

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

1. whether the right to a trial by jury should be granted;
2. whether the court or a jury should determine the amount of any penalty;
3. whether the penalty should be based on all profits subsequent to execution of a transaction based on inside information, or be limited to the profits within a reasonable period (e.g., two business days) after dissemination of such information;

4. whether there should be a statute of limitations for such penalty actions;
5. whether the Bill should include a definition of insider trading;
6. whether the burden of proof should be "clear and convincing evidence" rather than a "preponderance of the evidence"; and
7. whether the extent of potential liabilities under respondeat superior, aiding and abetting and control person theories of liability should be defined.

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

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

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

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

Section 3 of the proposed legislation would raise the maximum criminal fine for most violations of the Exchange Act

from \$10,000 to \$100,000. 4/ The increased criminal fines would not be limited to cases involving insider trading.

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

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

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

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

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

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

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

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

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

(a) Civil Money Penalties

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

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

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

(b) Cease and Desist Authority

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

1. Increase flexibility in tailoring remedies to the circumstances of a case;
2. Eliminate gaps in the Commission's administrative authority; and
3. Establish a remedy for violative conduct that might otherwise escape redress.

should spend its enforcement resources in pursuit of incidental cases that do not warrant the entry of an injunction, particularly since cease and desist orders would not be enforceable through contempt proceedings.

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

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

Mr. WIRTH. Thank you very much, Mr. Chairman.

I note that Commissioner Longstreth is here as well, and he may want to come up and join the table and participate in the discussions.

Mr. Fedders, did you have a statement?

Mr. FEDDERS. I do not.

Mr. WIRTH. Do we have comments from any of the other members of the staff as an opening statement?

[No response.]

Mr. WIRTH. Commissioner Longstreth, do you have any comments you might like to make at the start?

Mr. LONGSTRETH. No.

Mr. WIRTH. Perhaps we might start, Mr. Shad or Mr. Fedders, with the basic question: What is insider trading?

Mr. SHAD. I would like to refer to I think a well-considered memorandum that was prepared by the general counsel, and copies were sent at the request of Congressman Rinaldo, and it was suggested that it be incorporated, if Congressman Rinaldo does—

Mr. RINALDO. Yes. Mr. Chairman, if you would yield, I was going to move a little later to introduce into the record the letter I sent Chairman Shad and his response.

Mr. SHAD. I am going to highlight the definition as provided by the general counsel in response to the question by Congressman Rinaldo, if that is all right.

There is substantial basis for the argument that, in the special context of the new penalty, there should be a precise definition of the offense to which the penalty applies. Legitimate traders and

analysts should be able to profit from their diligence without having to speculate as to the risk of a substantial penalty, whether they will violate a duty by trading while in possession of public information—

Mr. WIRTH. Mr. Shad, maybe we could just get a simple description of insider trading.

Mr. SHAD. There are two categories of insider trading. One would involve the improper use of corporate information, such as the company's earnings prospects, prospective dividend actions, and those sort of things. There is a second category which involves market information, such as knowledge that a tender offer is about to be made for a company's stock at a substantial premium.

Those are the two principal categories, and it would consist of people who are aware of such information and take action on it, that it is not generally known to the public.

Mr. WIRTH. Mr. Fedders, would you agree that when we talk about insider trading we are talking about a term of art to describe trading while in possession of material nonpublic information, both the categories that the Chairman suggested, about a company or the trading market for its securities, and it is the nonpublic nature of the information that is important?

Mr. FEDDERS. I do not disagree with that.

Mr. WIRTH. You would agree with that?

Mr. FEDDERS. Correct.

Mr. WIRTH. When we say that the information not only has to be nonpublic, but also has to be material, what does that mean?

Mr. FEDDERS. There is an enormous amount of information that is available to insiders that is nonpublic. All of that information is not necessarily material. If disseminated, it would not affect the market price of the stock. And what we are talking about is not only that the information is nonpublic, but that it also be material.

The best definition of materiality is by the Supreme Court in the *TSC v. Northway* case.

Mr. WIRTH. And that term has been construed to mean information that a reasonable investor would consider important in making a decision whether or not to buy securities, significant information?

Mr. FEDDERS. That is correct.

Mr. WIRTH. It has been noted that insider trading is in a sense a victimless crime. Of course there are exceptions. It is said, however, that if a person with inside knowledge buys on the open market, he may be buying securities that people without that knowledge would have sold anyway. Therefore, although the insider gains, there may be no identifiable investor who loses.

Do you agree with that? And what is then the real harm of insider trading?

Mr. FEDDERS. I do not necessarily believe that it is a victimless crime. Some of the insider trading might be characterized as a victimless crime, but certainly those brokers on the Pacific Stock Exchange who wrote the naked options in connection with the Santa Fe transactions in the cases we have brought, they certainly are victims. Some of them have lost upwards of \$10 million and their firms have gone bankrupt because of the transaction.

Some have said that with regard to insider trading in the equities market that the seller, assuming that a person is buying on potential good news, that the seller was going to trade anyway, and why should he reap the profits when he would have sold whether or not there was this information? Well, there it may be a victimless crime, but certainly the integrity of the marketplace is seriously jeopardized.

You began your statement earlier by talking about different kinds of violations and their impact on investors, some monetarily, some dealing with the psychology, the confidence of investors in the securities markets. And if we permit this kind of conduct to go on I think it would erode investor confidence in the marketplace and they may very well flee the marketplace and choose other investments, which would hurt the liquidity of the exchanges, the liquidity of the marketplace, and eventually the capital structure of our country.

Mr. WIRTH. I think that is an excellent statement, Mr. Fedders. I think that is really what this is all about. We are really going to the question of investor confidence and the feeling that markets are square, that the markets are honest, the markets are straightforward, and that people do not have to worry about the fact that others in the marketplace may benefit from information they cannot compete with. That is the broad public issue that we are after here, is that not right?

Mr. FEDDERS. Absolutely.

Mr. WIRTH. And that is what the Commission, Mr. Chairman, was attempting to do in unanimously proposing this legislation to the Congress?

Mr. SHAD. That is correct.

Mr. WIRTH. Now, what we are also saying is that insider trading undermines confidence. And is it the fact that all market participants are not equal in access to information?

Mr. FEDDERS. That is correct.

Mr. WIRTH. That is what would undermine the confidence?

Mr. FEDDERS. I am not suggesting that all market participants, all investors, analysts, have to have equal access to information. I think the Supreme Court addressed that question in the *Chiarella* case. But that is not inconsistent with the statement that you made.

There is not equal access to information. The question is, do investors have equal access to material nonpublic information, and we go back to things such as Texas Gulf Sulphur, where the Court in a sense said: Abstain or disclose, and if you have this material nonpublic information and you have the temptation to trade on that information, the Court was saying that then you have an obligation to disclose it.

Mr. WIRTH. The point is, if someone has a special advantage because of his special access to information, the public cannot fairly compete with that advantage.

Mr. FEDDERS. That is correct.

Mr. WIRTH. And therefore you have undermined market confidence, you have undermined the integrity of the markets and the hope that people are going to invest long term in those markets.

Mr. FEDDERS. Right.

Mr. WIRTH. Does that special advantage or special access necessarily have to come from within a corporation? For example, if an investment banker represents a company about to make a tender offer for another company and employees of the investment banker buy the target company's stock while in possession of that information about the upcoming tender offer, they would have an unfair advantage over public shareholders generally; would they not?

Mr. FEDDERS. They would. That issue has been addressed in both civil proceedings and in criminal proceedings, and I cite you to the case of *U.S. v. Neuman*, a decision by the second circuit court of appeals which is now—cert has been requested of the Supreme Court, in a case that falls within the parameters of what you just said, that is, generally characterized as market information as opposed to corporate information.

Mr. WIRTH. So insider trading can occur as a result of market information as well as corporate information?

Mr. FEDDERS. That is correct.

Mr. WIRTH. For example, if an employee of a bank knows the bank's trust department is going to unload a large block of stock in a company and the bank employee sells short the company's stock, is that the kind of unfair access to information that we are talking about?

Mr. FEDDERS. That is a category that could come under the definition of market information. What you are beginning to develop is something that I loosely characterize from time to time as "front-running." I have never heard it in the hypothetical which you have just posed by a bank officer knowing of a particular source of information, but where it does come, and the exchanges have rules prohibiting it, let us suppose this hypothetical:

An exchange or a brokerage firm has just received an enormous block order and therefore it goes into the options market and front-runs the transaction because of that block order which is overhanging the market and is not generally known to the public. When it is executed, it will have an effect on the market price.

The person goes into the options market, front-runs the transaction and takes advantage of it. There are specific rules of the various exchanges prohibiting that. So technically you could say that there is corporate information, there is market information, and there is this sort of category called front-running.

I would tell you that the law in the whole area of front-running I consider to be considerably more ambiguous than in the corporate and in the market information context.

Mr. WIRTH. The broad point is that the public policy goal we are after is to achieve fairness in the market for the purpose of maintaining confidence in the market, and therefore it should not matter whether the material nonpublic information comes from inside or outside the corporation, right?

Mr. FEDDERS. That is correct.

Mr. WIRTH. Mr. Rinaldo. And I will be coming back, but please, Mr. Shad and Mr. Longstreth and others of you, please jump in where you think it might be appropriate, as you all may have comments that you would like to make as we go along.

Mr. Rinaldo.

Mr. RINALDO. Thank you, Mr. Chairman.

Mr. Chairman, last week, as I mentioned earlier, I wrote to Chairman Shad concerning a number of points raised about the legislation by various commentators and requested the Commission's views on these issues. A copy of this letter and the Commission's response has been furnished to your staff.

I would like at this point to request unanimous consent to include both of these documents in the record.

Mr. WIRTH. Without objection, they will be included in the record.

[The material referred to follows:]

MATTHEW J. RINALDO
Securities, New Jersey
Telephone Office
2222 Rayburn House Office Building
Washington, D.C. 20515
(202) 555-4361
OFFICE OFFICE
1081 Thomas Avenue
Cherry Hill, New Jersey 08002
(609) 663-4338

Congress of the United States
House of Representatives
Washington, D.C. 20515

COMMITTEE
ENERGY AND COMMERCE
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ON ASHING
SUBCOMMITTEE
HUMAN SERVICES

April 5, 1983

The Honorable John S.R. Shad
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Insider Trading Sanctions Act of 1983 (H.R. 559)

Dear Chairman Shad:

On April 13, 1983, the Subcommittee on Telecommunications, Consumer Protection, and Finance will hold hearings on the proposed Insider Trading Sanctions Act. The Act would create a treble damage civil penalty which could be requested by the Commission in insider trading cases. In viewing this proposed new sanction, commentators have suggested the desirability of adding certain procedural protections and clarifying amendments to H.R. 559. I would appreciate receiving the Commission's views on the desirability of these proposed changes with respect to Commission actions brought under the new penalty provision. Specifically:

- (1) Is there a need for a statutory definition of the offense to which the new sanction would apply?
- (2) Should there be a statutory definition for the phrase "profits gained or losses avoided" in order to clarify the measure of treble damages?
- (3) Under what circumstances could the aiding and abetting provision of the proposed Act or other theory of secondary liability result in the imposition of the treble damage penalty provision on an employer or controlling person? For example, would the new sanction be available for use against a broker-dealer (1) where an employee is trading for his own account; (2) where the employee makes a trade for a customer account; or (3) where the employee traded for the firm's account? How would the proposed Act apply to such a firm if one employee possesses information but another employee, not knowing of the information, trades for the firm's account before it is made public?

- (4) The well accepted standard of proof for civil violations of the securities laws is proof by a preponderance of the evidence. E.g., Herman & MacLean v. Huddleston, 103 S. Ct. 683, 690 (1983). Should a higher burden of proof, such as proof by clear and convincing evidence, be applied in the special circumstances of treble damage actions under the proposed Act in light of the potentially severe penalties?
- (5) Should a statute of limitations apply to Commission actions under the proposed Act? If so, what should the limitation period be?
- (6) Does a defendant have the right to a trial by jury in an action seeking imposition of the penalty under the proposed Act? If so, would the jury merely determine whether or not the law has been violated or would the jury determine the damages and the penalty, if any?

In light of the April 13 hearing, I would appreciate the Commission's early attention to these questions.

Sincerely yours,



MATTHEW J. RINALDO
Member of Congress