

Mr. LEVINE. I have not found them confusing and difficult to enforce. I do not think the Commission has—the cases where we utilized them are clear that there are major frauds and when you talk about overstatement of sales, fictitious inventory, capitalizing rather than expensing various items, you do not have a problem with the nuances which I think Mr. Fedders referred to.

I do want to emphasize in my belief the benefit to the corporation and to the auditors in having reliable books and records. I think that minimizes our necessity of going in and policing that area. And that, to me, is where the act is working.

Mr. WIRTH. Let me just end my questioning of this group by going back to a statement you made earlier, Mr. Fedders, about cooked books and enforcement being your top priorities. This goes to the question that we have talked about earlier, Mr. Chairman, about the resources available to the Commission.

Do you feel at this point that you have the adequate resources to carry out this responsibility, particularly with the growing instances of financial reporting fraud and the need to do perhaps more than bring on one gentleman from Peat, Marwick and Mitchell?

Mr. FEDDERS. Well, we have done more than that. I would just like to give Mr. Perry the credit he deserves for the enormous personal sacrifice he is making to come to the Commission. The question you have asked is very complex and it requires a lot of analysis and I hope you will bear with me a second.

First, I cannot do more with less, but I can do more with more. My job is a management job and the five people who report directly to me, we have set some goals and priorities for ourselves that I thought were unreachable this year. For instance, during last year we increased our caseload 30 percent, the enforcement actions we brought, with 6 percent fewer people.

People said we could not duplicate that this year. I frankly think it is unlikely that we can duplicate it, but I have got five people who tell me every day we are going to meet that goal. During the first half of the year I thought it was not likely that we could top the number of cases that we brought last year. We brought 112 cases in the first 6 months of last year. We have now brought 117 cases in the first 6 months of this year.

I know you said in a letter to Chairman Shad recently it would be truly remarkable, the Commission's enforcement effort, if you could judge it on quantity alone, and I am anxious to demonstrate to you and to the GAO, who is doing the study, that not only did we have quantity last year, we had quality of the highest order, and to say anything less is a poor reflection. Some have said that our quantity is up but our quality is down. There is no basis for that statement.

The integrity of the enforcement program is the strongest it has ever been. We are vigorous. The people are working hard now. As a manager, the first thing I want to know is what are my goals and objectives, and my goals are to sanction wrongdoers and to deter other people and to have a strong enforcement presence on a nationwide basis. We have maintained that.

Now we have had our staff cut this year. We are bringing more cases. I can do more with more and I cannot do more with less, but

the good thing for me—maybe I am a better person than my other division directors—is that the Division of Enforcement is being cut less than anybody else. I do not think that the cut that is being imposed upon us, as proposed, is going to have a telling effect on us.

We are going to sanction wrongdoers. We are going to serve as a strong deterrent out there, and the ever-presence of the Commission's enforcement program is going to be there day in and day out and nobody is running away from their responsibility and that does not have anything to do with John Fedders. That has a lot to do with the people who work in the Commission's enforcement program.

Mr. WIRTH. Well, we appreciate the dedication of people at the Securities and Exchange Commission and the fact that you have a very large responsibility. You remember the hearing we had in February when we discussed at length with the chairman and the other commissioners the support that the goals of the Commission are receiving in terms of the budget.

I do not want to go into that at this point but only to again reflect upon our concern on that front, and to reflect also, Mr. Chairman, our appreciation of the forthcoming nature of you and the other Commissioners in presenting to the subcommittee all of the data related to staffing and the priorities that were placed by a majority or all of the Commissioners on the need for beefing up to do more with more, and I appreciate that greatly.

Mr. Rinaldo.

Mr. RINALDO. Thank you, Mr. Chairman. I first of all want to compliment Chairman Shad and the other folks at the witness table. You have done an excellent job, in my opinion, in helping to point out some of the possible flaws in the law and also allowing us to focus in a little bit better on what has to be done.

I have one final question that I would like to ask, and that is to clarify for the record the Commission's position in regard to the situation in a multi service brokerage firm where one department has possession of nonpublic information but the person executing the transaction does not.

Would a transaction in such a situation be construed as insider trading?

Mr. SHAD. Well, we have the doctrine of the Chinese wall, and if there is a complete separation of the individual who has the inside information and the person who is engaged in trading, the firm would not be liable.

Mr. LEVINE. I think it is helpful to refer to the existing statute we have, which is rule 14(e)(3), which is an exception the Commission adopted which requires the person not to know and there be procedures at the institution so he cannot get the information.

If those two things are in place, which we already have built into an existing rule that we have adopted, then there would be no liability to the institution for the transaction. We both make sure that the person who does not know the information and that there are procedures in place.

The Chairman referred to the Chinese wall, which is insulating and preventing that person from having the information, and there would be no liability.

Mr. RINALDO. Are you saying, then, that there is no additional language that is necessary in this legislation in order to make sure that that is clear?

Mr. GOELZER. As I think we say in the letter that we sent over yesterday, at the time that we drafted the bill we contemplated that. The staff would recommend that the Commission exercise its rulemaking authority to put this Chinese wall provision in as a rule implementing the statute if it were enacted. That could, of course, also be accomplished by amending the legislation.

Mr. RINALDO. Which way would you prefer to have it done?

Mr. GOELZER. Well, I do not really think that it matters. They both would accomplish the same thing. The Commission certainly has the rulemaking authority, as Ted Levine has said, and has exercised that authority in the 14(e)(3) context, and I think would exercise it again in this area.

Mr. RINALDO. OK, fine. Once again I want to thank you. I think you have done an excellent job.

Mr. WIRTH. Fine, thank you, Mr. Rinaldo.

Mr. Chairman and Mr. Longstreth, Mr. Fedders, all of you, thank you very much for your appearance and your great help to the subcommittee today as we addressed this important issue. We appreciate your help and look forward to working with you as we move on toward markup of the legislation.

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

Mr. SHAD. Thank you, Mr. Chairman.

[Testimony resumes on p. 105.]

[The following letter was received for the record:]



SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20540

June 29, 1983

The Honorable Timothy E. Wirth
Chairman
Subcommittee on Telecommunications,
Consumer Protection and Finance
House Committee on Energy and Commerce
Washington, D.C. 20515

Dear Chairman Wirth:

This is in response to questions raised during and subsequent to the April 13, 1983 Subcommittee hearing on H.R. 559, the proposed Insider Trading Sanctions Act of 1983. The Commission continues to support legislation which would increase the sanctions available against insider and other trading on nonpublic information. The Commission's views concerning the various questions are set forth below. In summary:

1. Secondary Liability: The Commission recommends amending the bill to limit the imposition of the new penalty to those who actually trade while in possession of material nonpublic information or who tip such information to others who trade. Employers, control persons, and aiders and abettors (other than tippers) of those who violate would not be subject vicariously to the new penalty, but would continue to be subject to existing sanctions, including injunctions, contempt proceedings, suspensions and revocations, and criminal sanctions.
2. Definition of Profit and Loss: The Commission recommends amending the bill to provide that the "profit gained" or "loss avoided" be based on the trading price of the securities a reasonable time after the information involved becomes public. Rarely would this limitation on the measure of profits or losses have any impact on the amount of the penalty assessed.
3. Statute of Limitation: The Commission does not oppose amending the bill to provide a five-year statute of limitation governing actions to impose the new penalty. Such a limitation would have a negligible effect on enforcement.

4. Burden of Proof: The Commission believes that "preponderance of the evidence" should be the requisite standard of proof in actions under the new treble penalty provision, as it is in civil actions under the other provisions of the federal securities laws.

5. Jury Trial: The Commission opposes amending the bill to provide a right to trial by jury. The availability of a right to a jury trial should be left to adjudication concerning the scope of the Seventh Amendment.

6. Insider Trading Definition: The Commission opposes adding a definition of insider trading to the bill. The Commission believes existing law is sufficiently clear to provide guidance as to prohibited transactions. A new statutory definition would necessarily incorporate new terms and concepts which would create new uncertainties and spawn future litigation.

Secondary Liability

The basic purpose of the proposed Insider Trading Sanctions Act is to increase the level of risk facing those who unlawfully trade while in possession of material nonpublic information, or who unlawfully communicate or "tip" such information to others. Traders, and those who tip them, currently face the risk of injunctions enforceable by contempt, disgorgement of illicit profits, and administrative or criminal proceedings. H.R. 559, by increasing their risk substantially, should have an important deterrent effect.

This objective does not, however, apply to secondary participants, such as aiders, abettors and control persons. Ample sanctions exist to address their conduct under the present securities laws. The aiding and abetting language of the bill was included to make clear that "tippers" would be subject to the new penalty. Under current law, tippers aid and abet the violation of their tippees when the latter trade on the tipped information.

The aiding and abetting provision of the bill would, however, subject to significant penalties a variety of persons involved in the trading process. In particular, this could include registered representatives and brokerage firms, the only involvement of which in the unlawful trading is to execute a

transaction for a customer who is trading on inside information. Where the registered representative or broker was on notice that insider trading was involved, his improper conduct may be subject to discipline under the Commission's administrative processes, in a civil injunctive action, or through criminal prosecution. Under the present language of the bill, however, a registered representative who knew or should have known that a customer's trades were motivated by material nonpublic information might also be held liable, as an aider and abettor, for up to three times the customer's profits, even though the registered representative neither tipped nor traded.

It is not necessary to seek the proposed penalty against such a broker or dealer because Section 15 of the Securities Exchange Act provides ample deterrence for such violations of the securities laws. Section 15 addresses the responsibility of trading professionals and authorizes the Commission to censure, suspend, or bar registered representatives or brokerage firms, or to impose suitable limitations on their activities.*/ Thus, in appropriate cases, firms in the securities industry and those who are employed in it can be expelled from the business.

Similarly, a securities firm might be held responsible under the bill for a violation by one of its employees who trades while in possession of material nonpublic information or who tips a customer. This result could follow from either Section 20 of the 1934 Act -- which makes controlling persons liable along with those they control -- or from the application of the doctrine of respondeat superior. Thus, where a person neither shares in the illicit profits of the inside trader nor tips such a person, the rationale of the bill does not apply, and exposure to a potential treble penalty based on

*/ In this context, it is also important to recognize that, under both existing law and the bill, a multiservice firm with an effective Chinese Wall would not be liable for trades effected on one side of the wall, notwithstanding inside information possessed by firm employees on the other side. At the time the Commission drafted the bill, it was contemplated that the Commission would adopt a rule similar to the Chinese Wall provisions of Rule 14e-3. The Commission would recommend recognition of that intent in the legislative history.

the trader's profit is inappropriate. Such a person's conduct does, of course, remain subject to a Commission injunctive action, an administrative proceeding, and criminal prosecution.

Accordingly, the Commission recommends that H.R. 559 be amended to reflect clearly that the treble penalty is available only against persons who trade on, or tip, inside information. The following language implements this suggestion:

No person shall be subject to a sanction under this subsection (d)(2) solely because that person aided and abetted a transaction covered by it in a manner other than by communicating material nonpublic information. Section 20 of this title shall not apply to actions brought under this subsection (d)(2). No person shall be liable under this subsection (d)(2) solely by reason of employing another person who is liable under such subsection.

Definition of Profit and Loss

In SEC v. MacDonald, 699 F.2d 47 (1st Cir. 1983), the Commission took the position that the amount to be disgorged in an insider trading action should be the full amount of the defendant's profit, as measured by the difference between the purchase and sale prices of the security traded, even though the sale occurred many months after public disclosure of the inside information. The court rejected the Commission's position, holding that the price a reasonable time after dissemination of the information defined the profit to be disgorged. The Commission based its position on the importance of maximizing the deterrent effect of the Commission's enforcement actions.

The same reasoning need not, however, apply under the Insider Trading Sanctions Act. The ability of a court under the bill to impose a penalty up to three times the profit gained would eliminate the necessity to include profits after public dissemination of the inside information in order to assure that the defendant did not retain the benefit from his wrongful purchase. And, in any event, since inside traders seldom hold their securities long after announcement of the nonpublic

information on which they purchased, the MacDonald issue rarely arises. Accordingly, the Commission recommends including in the bill a definition of "profit gained" and "loss avoided" based on the price of the stock a reasonable time after the information in question becomes public.

The following language incorporates this suggestion:

For purposes of this subsection: "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.

Statute of Limitation

As proposed, the Insider Trading Sanctions Act, like the Securities Exchange Act, contains no statute of limitation applicable to Commission actions. See, e.g., SEC v. Penn Central Co., 425 F. Supp. 593, 599 (E.D. Pa. 1976). The usual reason for a statute of limitation is that, after the passage of a significant period of time, the defendant should not be put to the task of defending against charges concerning which witnesses' memories may be dim and relevant documents unavailable. Because of the potentially heavy penalty under the bill, similar reasoning may justify a statute of limitation for these special penalty actions.

As a practical matter, the addition of a reasonable statute of limitation would not be consequential to Commission penalty actions because, in most instances, insider trading is discovered, if at all, soon after it occurs. Accordingly, the Commission would not object to the addition of a statute of limitation applicable to the penalty provision. A five-year statute of limitation would be adequate and would conform to the criminal statute of limitation for Exchange Act violations.

Burden of Proof

The Commission opposes suggestions that a higher burden of proof, such as a clear and convincing standard, should apply in actions to impose the new sanction. The burden of proof in injunctive actions brought by the Commission is proof by a

preponderance of evidence. SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 355 (1943). This standard also applies in private actions. Herman & MacLean v. Huddleston, 103 S. Ct. 683, 690 (1983). A higher burden of proof would make the prosecution of insider trading actions more difficult and thus would reduce the number of actions commenced and successfully maintained under the statute. Most insider trading cases are, by their nature, based largely on circumstantial evidence. The strength of the inferences drawn from that evidence would not always be sufficient to meet the higher evidentiary standard. Moreover, the use of a special standard in Commission penalty actions would raise the possibility that the factfinder would be put in the awkward position of having to apply simultaneously two different standards of proof to the same evidence -- the higher "clear and convincing" standard in determining the fact of violation for purposes of the penalty, and the lower "preponderance" standard in determining the fact of violation for purposes of injunctive relief.

The Supreme Court has expressly approved the use of the "preponderance of the evidence" standard in governmental actions for civil penalties. United States v. Regan, 232 U.S. 37, 48-49 (1914). The Court cited Regan with approval in Herman & MacLean v. Huddleston, 103 S. Ct. at 691-92, noting that the higher "clear and convincing" standard is reserved for cases "where particularly important individual interests or rights are at stake," for example, proceedings to terminate parental rights, Santosky v. Kramer, 455 U.S. 745, 769 (1982); involuntary commitment proceedings, Addington v. Texas, 441 U.S. 418, 427 (1979); and deportation proceedings, Woodby v. INS, 385 U.S. 276, 285-86 (1966). Monetary damages, although they may be heavy in certain cases, do not rise to the level of such individual interests.

Huddleston holds that a preponderance of the evidence is the appropriate standard in damage actions under Rule 10b-5. H.R. 559 would increase the penalty in actions which are, in essence, Rule 10b-5 cases. Since no change is being made to existing law, no new language is necessary in order to have the preponderance standard apply. The Commission recommends, however, that the legislative history indicate that the intent of Congress is that the preponderance of the evidence standard is to apply to penalty actions.

Jury Trial

The law is not settled concerning whether the defendant in an action under the Insider Trading Sanctions Act would have a constitutional right to a jury trial. This issue turns on the historical question of whether a government penalty action is analogous to an action to collect a debt, which at common law was triable to a jury. Some case authority, including two older Supreme Court decisions and a 1974 Second Circuit opinion, indicates that a defendant in a civil penalty action, like that created by the bill, would have a Seventh Amendment right to a trial by jury on the question of whether the law had been violated. */ However, a defendant would not appear to have a right to a jury trial on the amount of the penalty to be assessed. **/

The Supreme Court in Atlas Roofing Co. v. Occupational Safety Comm., 430 U.S. 442, 449 n.6 (1977), expressly reserved judgment on the question of whether the Seventh Amendment applied in any respect to government actions for a civil penalty. In Atlas Roofing the Solicitor General contended, on the basis of a review of historical authorities, that the Seventh Amendment was "never meant to burden government [civil] litigation with the requirement of a jury trial." (Brief of United States at 61).

The Commission opposes the addition of a jury trial provision. A statutory right to a jury trial could burden and prolong Commission actions for a penalty and complicate settlement negotiations. Moreover, the right to a jury trial in penalty actions may interfere with the successful prosecution of Commission injunctive proceedings. Potential problem areas include the effect of the doctrine of collateral estoppel, the consolidation and order of proceedings, and the possibility of inconsistent judgments. If the Subcommittee determines to add a jury trial provision to H.R. 559, the Commission

*/ See United States v. Regan, 232 U.S. 37, 47 (1914) (dictum); Hepner v. United States, 213 U.S. 103, 115 (1909) (dictum); United States v. J.B. Williams Co., 498 F.2d 414, 421-24 (2d Cir. 1974) (collecting cases).

**/ See United States v. Reader's Digest Ass'n, 662 F.2d 955, 967 (3d Cir. 1981), cert. denied, 455 U.S. 908 (1982); J.B. Williams Co., 498 F.2d at 438 n.28; United States v. Duffy, 550 F.2d 533, 534 (9th Cir. 1977).

requests that the Subcommittee consult with the Commission's staff in the drafting of such a provision so that potential impediments to Commission injunctive actions can be minimized.

Insider Trading Definition

As proposed, H.R. 559 does not define insider trading. It looks to existing law prohibiting trading while in possession of material nonpublic information. Although there is some merit to arguments in support of the formulation of a definition applicable to the proposed new penalty provision, the Commission opposes incorporation of a definition in the bill. */

In the majority of insider trading cases, it is clear what the law proscribes. Since SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969), it is well-understood that "insiders" -- officers, directors, or employees of an issuer -- are prohibited from trading while in possession of material nonpublic information about their company. The same legal obligation applies to tippees of insiders. Tippees, who do not themselves engage in prohibited trading, are liable as aiders or abettors of the trader's fraud.

*/ The Commission does urge that the legislative history of the bill cite behavior to which the statute is not intended to apply. It should be clear that, under present law and the proposed bill, legitimate business communications, undertaken for the benefit of corporate shareholders by officials having no knowledge or reason to believe that the information will be used for trading purposes, would not be unlawful tips under Rule 10b-5. One area of concern is the situation faced by a corporate executive who, in good faith, discusses material, nonpublic information with outsiders in order to obtain their advice and assistance for the benefit of his corporation's shareholders. An executive should not be inhibited from pursuing the interests of his shareholders or incur needless compliance costs out of fear that he may be subject to substantial personal penalties, if the persons that he consults subsequently trade and the executive had no knowledge or reason to believe that the information would be so used. While such officials would not be liable as aiders and abettors under existing law, the Commission believes it would be useful for the legislative history to emphasize this point. The General Counsel's staff would be pleased to provide suggested language in this and other areas.

In 1980, the Commission adopted Rule 14e-3 which clarified the obligations of those in possession of nonpublic tender offer information. Enacting Rule 14e-3 into statutory law would provide no added clarity. The regulation has been in force for the past three years. Similarly, recent judicial opinions have addressed other uncertainties. In United States v. Newman, 664 F.2d 12 (2d Cir. 1981), on remand, 534 F. Supp. 1109 (S.D.N.Y. 1982), aff'd, No. 82-1273 (2d Cir. Feb. 8, 1983) (mem.), petition for cert. filed, 51 U.S.L.W. 3759, (U.S. Apr. 8, 1983) (No. 82-1653), the Second Circuit found that the law was sufficiently clear in the market information area that it would support the imposition of criminal liability. See also O'Connor & Associates v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179 (S.D.N.Y. 1981); SEC v. Lund, [1981-82] Fed. Sec. L. Rep. (CCH) ¶ 98,428 (C.D. Cal. 1982).

Two insider trading cases are presently before the Supreme Court. */ Resolution of these cases may change the contours of insider trading law -- either to broaden or narrow the scope of the offense -- in ways which those drafting a statutory definition could not now foresee. In order to reach unforeseen fact patterns, any definition would have to be very broad. The flexibility which is gained by basing the imposition of the penalty on existing case law avoids the problems of freezing into law either a definition which is too broad, or too narrow to deal with newly-emerging issues.

Thus, existing law provides a sound legal framework for judicial analysis and review of new and unforeseeable trading devices and strategies. Decades of legal thinking have contributed to the development of existing antifraud law under Rule 10b-5. The Commission is opposed to abandoning those principles for an untried definition of insider trading. Any definition would incorporate new terms and concepts which would have to be interpreted in subsequent litigation. Thus, a definition would not provide the clarity sought; to the contrary, it would inevitably create new uncertainties.

*/ Dirks v. SEC, 681 F.2d 824 (D.C. Cir. 1982), cert. granted, 103 S. Ct. 371 (1982) (No. 82-276); United States v. Newman, 664 F.2d 12 (2d Cir. 1981), on remand, 534 F. Supp. 1109 (S.D.N.Y. 1982), aff'd, No. 82-1273 (2d Cir. Feb. 8, 1983) (mem.), petition for cert. filed, 51 U.S.L.W. 3759 (U.S. April 8, 1983) (No. 82-1653).

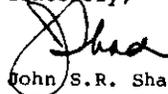
In response to inquiries during the Subcommittee's hearing, the staff formulated various definitions of insider trading for Commission consideration. In addition, a variety of sample definitions have been proposed by commentators. A comparison of these definitions, which vary greatly in approach and scope, reflects the difficulties inherent in drafting a definition that is both clear and flexible. Nevertheless, the Commission's staff can provide your staff with copies of the various internal definitions and discuss the pros and cons of each approach, if desired by the Subcommittee.

* * *

In summary, the Commission continues to believe that greater sanctions are needed to inhibit insider trading. A treble damage penalty will increase the risk to illicit traders and tipsters, and achieve added deterrence. At the same time, the Commission seeks enactment of a bill which will not unduly inhibit legitimate activity nor impose undue compliance costs at the expense of public investors. Attached to this letter is a revised version of H.R. 559 which the Commission believes meets this objective.

If you have any additional questions, or if we may assist you or your staff in any way, please contact me.

Sincerely,


John S.R. Shad

Attachment

cc: The Honorable Matthew J. Rinaldo

Amended Bill to Accompanying
Letter to the Honorable
Timothy E. Wirth

A Bill

To amend the Securities Exchange Act of 1934 to increase the sanctions against trading in securities while in possession of material nonpublic information.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. This Act may be cited as "The Insider Trading Sanctions Act of 1983."

SECTION 2. Section 21 of the Securities Exchange Act of 1934 is amended by redesignating subsection (d) as subsection (d)(1), and adding at the end thereof the following new paragraph:

"(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 ~~(A)~~ (i) on or through the facilities of a national securities exchange or from or through a broker or dealer, and ~~(B)~~ (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

and internal controls provisions of Section 102 of the Foreign Corrupt Practices Act of 1977, newly added Section 13(b)(2) of the 1934 Act. Thus, it would be broader than present Section 15(c)(4) proceedings both in range of respondents -- individuals would be included -- and in conduct and filings covered.

I do not support fines and penalties for officers and directors, broker-dealers, or other persons subject to the securities laws. The remedy of an injunction, once thought to be a "mild prophylactic", is now acknowledged by the Supreme Court and other courts to have harsh and grave consequences, both legal and stigmatic.

Furthermore, I think much more effective use of existing remedies, such as criminal contempt proceedings and criminal references for prosecution, can be achieved through the use of deputized SEC attorneys as Assistant U.S. Attorneys, and through more careful surveillance of repeat violators of the securities laws. Several years ago, there were some noteworthy examples of corporations and some individuals who reportedly had repeat injunctions for additional securities violations. I think a well-publicized crackdown on such violators by invoking criminal contempt sanctions, as the SEC recently did, would impress upon people the need to respect the securities laws.

I want to thank the Panel for hearing my views.

STATEMENT OF MILTON V. FREEMAN

Mr. FREEMAN. Thank you, Mr. Chairman, for inviting me. I should also state that I am appearing personally, whatever description there may be of me in the listing, and my statement will explain the capacity in which I appear.

Some 40 years ago, when I was an assistant solicitor of the Securities and Exchange Commission, I participated in the drafting of rule 10(b)(5). The occasion for the drafting of that rule was an insider trading case and I am not before this committee in any way to suggest that rule 10(b)(5), my participation in the drafting of which I am very proud of, should in any way be diminished.

I think the rule should continue in effect and should be given the broadest possible scope by the courts. I am here suggesting a definition which is designed to provide the Commission with an additional remedy in cases where the courts have said that 10(b)(5) does not reach the transaction, and that comes from the difference between two kinds of things which have been called insider trading.

It is clear that insider trading of the kind that rule 10(b)(5) was meant to deal with were cases where corporate officials were taking advantage of inside information to buy shares from their own shareholders. That is a case of inside information where the corporate official is cheating his own shareholder, to whom he owes a fiduciary duty.

There is no question that that has been illegal since rule 10(b)(5) was adopted and will continue to be and should be illegal. There has been developed, however, a new theory, dealing with somebody who is not an insider, not an official of the company, but somebody who is outside who wants to make a tender offer, Judge Pollack in the District Court of the Southern District of New York, who is one of our leading judges, specifically pointed out in a case where a suit was brought that the defendant purchased stock on the basis of information that was obtained from a source outside of the issuer.

While the information that led to the purchase was not public, it was outside, not inside information. And in the case of outside information, such as the *Chiarella* case, where a printer got information about proposed tender offers in his job as a printer, the Supreme Court of the United States said that that is not a fraud because Mr. Chiarella owed no obligation to the people from whom he purchased the securities.

Now I think that is something which we can all accept, but it does not mean that when we accept the fact that it is not fraudulent, we accept the fact that it must continue to be permitted. I suggest and I have drafted a proposed rule which would say that Mr. Chiarella, if he were to do this tomorrow or after Congress passed the rule, would be guilty of a violation of law. It could not be made a fraud because there is nobody who is being defrauded.

But it is inappropriate conduct which should be condemned. It should be made a crime and it is easy to do that. You just leave out the word fraud and say it shall be unlawful to do what Mr. Chiarella did.

I have drafted such a rule. It presents a problem. It would relieve the Commission of some obligation, because if they operate under 10(b)(5) they have to prove an intention to deceive or defraud inve-

tors. My suggestion is that under this new rule where we are not speaking in terms of fraud but merely make unlawful Mr. Chiarella's type of conduct, that there should be some lesser standard which would relate to the unfair or inappropriate or corrupt use of information, or obtaining information in violation of some duty.

The issue of whether that would violate 10(b)(5) and the mail fraud statute is now before the Supreme Court in the *Newman* case which has been mentioned. I think we should not wait for the outcome of the *Newman* case to see whether you can get around the *Chiarella* case, but that Congress should clearly define that the *Chiarella* kind of conduct is unlawful, even if it may not be a fraud, and to say that people who engage in that kind of activity should be subject to injunction, should be subject to fine, and should be subject to jail.

Whether there should be single, double, or triple damages, I have no concern except that I think that Congress should say to a judge: You must follow the following standards in adopting what the punishment should be.

The difference between the *Chiarella* kind of case and the kind of case that is truly insider trading rather than outsider trading is because in the insider trading case for which rule 10(b)(5) was adopted you have an insider taking advantage of his own shareholders, and that is a statute and a rule that is designed to protect the individual investor.

Here it has been clearly stated that there is more concern with the outsider trading kind of thing which affects the integrity of the market and the question is whether you are playing with marked cards. And since in that case it does not make any difference that there is or is not an individual investor who is a victim and whether it is or is not a victimless crime, it should not be subject to argument about whether a victim is necessary as in a case which is phrased in terms of fraud. You should just have a simple law saying that if people abuse information of the kind that Mr. Chiarella did, that they should be subject to sanctions because of the effect on the integrity of the markets and not because they cheated an individual investor.

Again, thank you very much.

[Testimony resumes on p. 196.]

[Mr. Freeman's prepared statement follows:]

STATEMENT OF MILTON V. FREEMAN
BEFORE THE HOUSE TELECOMMUNICATIONS,
CONSUMER PROTECTION AND FINANCE SUB-
COMMITTEE OF THE UNITED STATES HOUSE OF
REPRESENTATIVES' ENERGY AND COMMERCE
COMMITTEE SCHEDULED FOR APRIL 13, 1983

My name is Milton V. Freeman. I am a partner in the Washington, D.C. firm of Arnold & Porter. My career has been largely in the practice of securities law.

From 1934, when I graduated from the Columbia Law School, until 1946, I was employed by the Securities and Exchange Commission and its predecessor, the Securities Division of the Federal Trade Commission. From January 21, 1946 to date, I have been with my present law firm, variously styled Arnold and Fortas, Arnold, Fortas & Porter and Arnold & Porter.

I am currently and have for some years been Chairman of the American Bar Association Subcommittee on SEC Practice and Enforcement Matters. I want to make it clear that the views I express are purely personal -- they have not been submitted to or cleared with the American Bar Association. I am not authorized to, nor do I purport to, speak for that organization or any part of it, nor indeed for my partners or for any client. The views I express are my personal views

which I commend to this Committee only for such consideration as they may deserve on their merits.

While I was employed by the Securities and Exchange Commission, in the year 1942, I participated in the drafting of Rule 10(b)(5), which has been the principal provision under which the Securities and Exchange Commission and the Department of Justice have brought litigation against the unfair use of information.

The occasion for the adoption of Rule 10(b)(5) was a case of trading unfairly on the basis of inside information. The rule was adopted because of a report that "the president of some company . . . is . . . buying up the stock from his own shareholders at \$4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be \$2.00 a share for the coming year." Freeman, 22 Bus. Law. 922 (1967).¹

That case involved not only direct misrepresentation but violation of a fiduciary obligation by the president of the corporation to the shareholders in his own corporation.

¹ See also, Justice Powell's opinion in Ernst & Ernst v. Hochfelder, 425 U.S. 185 at 213, n.32 and Justice Blackman's dissent in Blue Chip Stamps, 421 U.S. 723 at 767.

There is no question that as a result of the adoption of the rule, for over 40 years purchasing on inside information has been illegal. Such conduct has been subject to criminal penalties and to the right of the shareholder imposed on to the recovery of civil damages. The law on this subject is clear, it requires no clarification or amendment. Indeed the SEC's concern in connection with the proposed bill is not principally and perhaps not at all with such insider trading.

The Commission instead has made a proposal that is concerned more with the recent phenomenon of tender offers for the stock of companies in which an opportunity exists for unfair use of information to make profits. This is an entirely different matter. In my judgment the Commission has made a major error in trying to treat unfair use of information by outsiders such as tender offerors on the same basis as insider trading by corporation officials dealing with their own shareholders.

It is my belief that the two types of transactions are in practice and in legal theory entirely different and require separate treatment. Thus it is fundamentally false labeling to call the proposal an Insider Trading Sanctions Act when its purpose is in fact to deal

principally with unfair use of information by outsiders. It is just as inappropriate to use tools designed for insider trading to apply to tender offer outsider trading as it would be to use indoor house paint for the outside of a house.

I shall try to set forth the differences between insider trading and outsider trading from a legal point of view, and thus to show why it is necessary to define by legislation what conduct is being outlawed and what the penalty shall be. I shall attempt to show here not only why such a legislative definition is necessary but also, contrary to suggestions from some Commission staff personnel, that it is both possible and relatively simple. I have expressed this basic philosophy in an article published in the New York Law Journal on December 14, 1981, and reprinted in SEC '82, entitled "Legislative Action Called Desirable for Resolution of Insider Trading Problem." A copy of that article is attached.²

² The article requires supplement in only one respect. That is, I had assumed that the further test of the Supreme Court's views would be presented in 1982. Instead it has been delayed, and I am informed that a petition for certiorari raising the entire issue of the application of the securities laws to outsider trading has first been presented to the court. This case, treated in my cited article, is called Newman v. United States, Supreme Court Docket No. 82-1653, petition filed April 9, 1983.

The basic legal point is that in true insider trading such as the case which occasioned the adoption of Rule 10(b)(5), an officer of a corporation was buying shares from one of his own shareholders. In that situation he owed an obligation to his shareholder to reveal that earnings had improved and the shares were more valuable than the shareholder believed. There the officer of the corporation was cheating somebody to whom he owed a strong legal, indeed a fiduciary, obligation to advise truthfully as to the affairs of the corporation.

This is properly covered by a rule against fraud because the conduct of the officer is clearly fraudulent by normal standards of the common law, and his shareholder is a defrauded party. It is also clear that at common law in a suit for fraud the shareholder could recover as the injured party. Strong v. Repide, 213 U.S. 419 (1919).

On the other hand, in the case of an outsider who is not connected with the shareholder's corporation and who knows that a third party proposes to make an offer for the shares at a higher price, he owes no obligation to the shareholder to tell him what he knows

or to dissuade him from selling. It was clearly established by the Supreme Court in Chiarella v. United States, 445 U.S. 222 (1980) that the investor is not a defrauded person. Chiarella involved a printer who got his information improperly on the job and traded on that information to his profit. He was charged with defrauding the investors from whom he purchased. The Supreme Court held this charge would not stand -- that the investors were not defrauded, that Chiarella was a stranger to them and owed them no obligation.

There is now being brought to the Supreme Court a criminal case in which the government, accepting that the investor is not defrauded, has charged that fraud exists nonetheless in a tender offer situation because employees of an investment banking concern were faithless to their obligations to their employers (not to the investors) when they used information obtained from the employer for their personal trading profit. In such a case not only has the Supreme Court said that the investor is not injured, but one of our most distinguished judges, experienced in the securities field, has said that the investor who sold his shares has no claim for damages. See Moss v. Morgan Stanley, 553 F. Supp. 1347 (S.D.N.Y. Jan. 10, 1983), decided

by Judge Milton Pollack. He pointed out that the defendant there "purchased stock on the basis of information that was obtained from a source outside of the issuer. While the information that led to the purchase was not public it was outside not inside information." Accordingly he held that the selling shareholders had no claim against anybody.

In substance the Commission has accepted this point for it is no longer insisting that the selling public shareholder is injured by unfair trading. It no longer seeks to give the investor a claim but its proposed legislation instead provides for a penalty to be paid to the Treasury.

As stated, in the criminal case now being brought before the Supreme Court, the question presented is whether, even though investors were not defrauded, nevertheless the user of the unfairly obtained inside information can be sent to jail because he stole or misappropriated the information and abused his obligations to his employer by misusing the information.

The issue is doubtful. Justice Stevens of the Supreme Court, speaking in the Chiarella case and stating that he was not passing on the matter, said that in

his view "arguments of equal force could be made on both sides" of the question. Certainly it is a new and different position from that provided by insider trading. We can, of course, await the outcome of the Supreme Court's decision as to whether the Chiarella case can be avoided by saying that the securities laws prohibit unfair use of information even where no investor is injured.

I suggest that it is inappropriate to rely on the uncertain outcome of litigation. I believe that the Commission has properly sought legislation as I indicated in my article I believed it should.

I believe that legislation is appropriate now, but I believe it should not be in the form suggested by the Commission. Rather, it should define what is outlawed in specific terms and should deal with outside information in tender offer situations differently from the abuse of inside information, and that it should deal with the matter specifically in a separate section.

Plainly, the conduct of persons making unfair use of inside information in tender offers should be outlawed. It should be done specifically and clearly with precise legislative definition of the kind of conduct

regarded as improper. It should not be phrased in terms of fraud which normally connotes a victim, a defrauded party, which as we have seen may be very difficult to find in the outsider trading cases. It should not place upon the Commission or the other enforcement agency the obligation to establish willful and deliberate intention to deceive, manipulate and defraud, which would undoubtedly be necessary if the matter were treated as fraud under Rule 10(b)(5) or 14(e) of the Securities Exchange Act. See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199, holding that Rule 10(b)(5) requires proof of "intentional or willful conduct designed to deceive or defraud investors." On the other hand it should have a clear definition of the amount of knowledge of the wrongdoing that is required to make the trader subject to the law, a subject which requires careful consideration by this Committee but is unfortunately not touched on by the Securities and Exchange Commission's proposal.

There should be a clear form of prohibition which declares unlawful the improper use of information illegally obtained. It should make it a crime. It should make it subject to penalties of whatever amount the Congress believes appropriate.

The Commission has proposed to increase the penalty for what it calls insider trading. It purports not to change existing law as to what is illegal and relies on two rules phrased in terms of fraud, Rule 10(b)(5) and new Rule 14(e)(3). It seems to me, however, that the proposal is approaching a desirable objective in the wrong way.

I agree with the Commission's objective to punish those who make unfair use of information to make a profit without exercising independent analysis or judgment. However, the legislation proposed by the Commission will not do what it was intended to and will have many undesirable side effects. I believe that the Commission has wrongly refused to request that the Congress set forth a definition of the acts it proposes to outlaw. Instead its proposal would leave present uncertainties as to the meaning of the law unchanged, when in fact they cry out for legislative definition.

I have attached a proposed draft of legislation entitled "To Make Unlawful Unfair Use of Information." Such a bill would carry out the Commission's objectives in the Commission's own words, as set forth in one of the Commission's own rules. The proposed new section would make unlawful the practice of which the Commission,

and indeed everybody else, disapproves, i.e., the practice of making unfair use of information belonging to others to make profits without effort and without analysis. It does so by legislative definition of the acts prohibited and avoids serious legal questions pending in the courts arising from the fact that present law is phrased in terms of fraud.

My proposed revision is a slight modification of the Commission's existing Rule 14(e)(3), revised in such a way as to avoid legal doubts as to whether it is authorized by the Congress, by making the conduct unlawful without characterizing it as fraud. I have chosen this form not because I believe the Commission's rule is necessarily desirable in precise form, but merely to show that definition is possible as well as necessary. By accepting the substantive standards of the Commission's rule, I can concentrate on the legal issues that my approach solves and the Commission's proposal does not. I leave to the judgment of this Committee and the Congress the examination of the substance of the rule to determine whether as a matter of policy it believes that that substance should be accepted, rejected or modified. My only point is that definition is necessary and that it is demonstrably possible.

One point remains, clarification of the standard of impropriety. The evil that is sought to be reached is unfair and improper or corrupt use of information. Perhaps there could be a definition of purpose using one or more of these words. For example, the Chief Justice, in the Chiarella case, was offended that Chiarella had, in his words, "stolen" the information.

As I have suggested in my article, while this fact may not help in determining whether someone has been defrauded, it clearly is a proper consideration in legislative outlawing of such conduct.

If the appropriate standard of unfair, improper or corrupt use is not set forth, the legislation will be subject to abuse. For it would then be easy for plaintiffs, governmental or private, to mischaracterize fair and proper use of information as improper. See for example Walton v. Morgan Stanley, 623 F(2d) 796 (2d Cir. 1980). I suggest the Committee consider whether the standard of misconduct should be that the use of the information was in violation of some express or implied obligation not to use the information for personal profit. Or the Committee may consider that the language of Rule 14(e)(3) modified as in my proposed bill, is

sufficient, with perhaps some expansion of the good faith exception in the rule. In this connection it should be noted that I have felt it necessary in using the model of Rule 14(e)(3) to strike out the phrase "reason to know" at the four points in which it appears in the rule. This is because it would create great uncertainty. Not only is it vague in content, it is inappropriate for use in a statute condemning conduct as immoral and unethical. The phrase "reason to know" if it means anything sounds more in absolute liability or negligence than unethical conduct. It is puzzling that the Commission should have employed such a test in a rule adopted under a section giving it power only over "fraudulent, deceptive or manipulative practices." In any event I believe the question requires consideration by this Committee.

It will be noted that my proposed draft deals only with tender offer cases. It is true that there may be cases of misuse of information in other contexts, but if so, the Commission has not specified them, and all its major cases relate to tender offers. As to any other cases, the Commission will of course retain the right to prosecute wherever it can establish fraud. My proposal limited to tender offers gives the Commission

broader powers than it has itself requested and relieves it of the limitations of proof inherent in a fraud remedy in the principal area (tender offers) in which it has brought its cases.

It is in my judgment the function of the Congress to clarify the matter by legislation and to make it unequivocally a matter of law that one who unfairly uses outside information shall not be allowed to keep his ill-gotten gains, that he should be punished by such additional financial penalty, including perhaps two or three times the gain, if that is regarded by the Congress as an appropriate standard.

Some employees of the Commission in various public fora have denied that its proposed bill would seek to circumvent the Supreme Court opinion in Chiarella by indirection.

It is my suggestion that the Commission and this Committee although they must accept the Chiarella decision, should say that Chiarella's conduct, while it may not now be illegal, must be made clearly illegal in the future. The conduct of Mr. Chiarella in using information obtained in a confidential capacity as a printer to make money for himself, may not have been

a "fraud" but it was clearly morally unjust and should be outlawed. Even Mr. Chiarella's counsel did not seek to justify his conduct on moral grounds before the Supreme Court, but succeeded only in persuading the Court that he had not engaged in activity which was a "fraud" on those from whom he bought.

Certainly, even if Mr. Chiarella did not defraud anyone within the meaning of the statute, this does not mean that a future Chiarella should be immune from condemnation by a clear outlawing of his type of conduct, properly designated not as fraud, but as unfair use of information belonging to others.

Indeed, the thrust of the criticism of Chiarella's conduct and the similar conduct of others sued by the Commission is not that they have defrauded individual investors, but that they have discovered a device of getting money by unfair means and without working for it, which undermines public confidence in the integrity of the securities markets. So it is the integrity of the securities markets that we are trying to protect against unfair outsider trading and not the interests of any particular investors. Since the purpose is different from that normally the object of the antifraud provisions of the law, it requires a different and

separate statutory prohibition. Indeed, in new Rule 14(e)(3) the SEC itself has considered the matter and has defined what it regards as inappropriate in a tender offer situation.

Unfortunately this Rule 14e-3 was adopted under a statute, Section 14(e), which, like Section 10(b), speaks in terms of fraud. Nevertheless, the conduct the Commission sought to outlaw has been clearly defined and it can easily be altered by leaving out reference to fraud and merely declaring the conduct unlawful. By this method the conduct can be subject to criminal prosecution. In addition, the Commission may be authorized to sue for a penalty as their proposal suggests in amounts greater than the gain.

Another problem remains -- if the penalty is to be more than the amount of the gain, the Congress should not leave the penalty to the unfettered discretion of the judiciary. It should either set the multiple itself to be applied in every case like triple damages under the antitrust laws, or it should set up standards by which the courts may decide the extent of the penalty. It is not appropriate, and it may indeed be subject to constitutional question, for the courts to be granted unfettered power to set their own multiple of a penalty on no specified basis.

One other aspect of the proposed SEC bill is subject to criticism. It states that a penalty up to three times the profit shall be applied to persons buying or selling a security "while in possession of material nonpublic information." This language is not in any part of the securities law but would insert into law a rejected SEC litigation theory of a vague nature. This theory is not only unclear but it has been specifically rejected by the Supreme Court of the United States in the Chiarella case. There the court said that the Commission's argument that there must be some kind of equality of information between the purchaser and the seller was not supportable under the statute. It found that a duty "does not arise from the mere possession of nonpublic market information." Yet the Commission proposes to insert the fact of "possession" of such information as somehow relevant to an existing violation of law. Such language can only result in confusion as to whether the Congress is seeking to reverse by indirection some or all of the Chiarella case. In addition, how such a rule would work, if it were at all possible, is not clear.

It flies in the face of the fact, as Justice Powell pointed out, that under SEC regulations a tender

offeror may buy up to 5 percent of the shares without letting the sellers know the "material nonpublic information" in his possession to the effect that he intends to make a tender offer. Obviously an officer, director or employee of the tender offeror who obtains and without permission uses this information to buy for himself is unfairly using the information and is properly subject to criticism for using the nonpublic material information. This is not because he "possesses" the material nonpublic information but because he has obtained it in an improper manner and is using it for personal advantage, as opposed to the tender offeror himself who is using it for legitimate business purposes.

Accordingly, the test is vague, it has been rejected by the Supreme Court, and would cause confusion and cast doubt upon the legitimacy of perfectly proper business transactions by prospective tender offerors.

The objectionable practice is not the possession of material nonpublic information and its use, but only unfair use by appropriation of information belonging to others.

The proposed draft that I have prepared takes care of this objection in the words of the SEC Rule

14(e)(3) where it is at least reasonably clear that the offense is in the improper acquisition of the information rather than its mere possession, and where the tender offeror himself is specifically exempted from the prohibition. Certainly as indicated above it may be improved by precise definition of what constitutes unfair use of information e.g., violation of an expressed or implied obligation.

CONCLUSION

Legislation is required. It should be a separate provision of law outlawing specified unfair uses of information. It should not be phrased in terms of fraud. The penalty should be clear and specific. The attached draft shows that it can be done.