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INSIDER TRADING: AN INTERNAL PROBLEM WITH INTERNATIONAL IMPLICATIONS

An Address
by
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It is a great pleasure for me to be here today at this gathering of such distinguished members of the international financial community. This afternoon, I will report to you on the initiatives recently taken by the Securities and Exchange Commission ("Commission" or "SEC") to thwart trading on "inside" information in the U.S. securities markets and to enlist your cooperation in our global effort to fight against this difficult problem.

I should make it clear from the outset, however, that I did not come to this European forum to attempt to export U.S. morality. I believe that each country may regulate, or not regulate, its own securities markets as it chooses; but we must acknowledge that the securities markets of most industrialized countries are increasingly international markets. Therefore, if those markets are to remain open for international use, we must recognize that legitimate regulation of internal markets has international implications. Although I have no simple answer to the question of how far any country may reach to protect its own internal -- although international -- securities markets, I do believe that a world-wide discussion of this question is an urgent necessity.

In the United States, a central premise of our auction-based securities market is that no buyer or seller should have a trading advantage over other users of the market by utilizing non-public information about a company received from the company itself, or from certain other parties, such as prospective bidders for the company's securities. Such activity is called "trading on inside information" or "insider trading" and is prohibited by our securities laws.

Insider trading is not trading on a more intelligent analysis of publicly known information about the issuer or the field in which it operates. It relates only to significant non-public information about the issuer that is, in general terms, derived from persons in a confidential relationship to the issuer or from a potential acquirer of the issuer's securities.

In our view, trading on inside information violates the public's legitimate expectation that honesty and fairness prevail in our securities markets. Individuals who convert confidential information into personal gain corrupt the core of the auction market. Thus, insider trading makes investors reluctant to invest in the stock market because it destroys their belief that they have an equal chance to profit. When investors are driven from the market, the market becomes less liquid, and thus less able to fuel the expanding capital demands of free enterprise.

The recent enactment in France of legislation expanding already existing insider trading prohibitions proves that the French, for their part, share our concern for the maintenance of honesty and integrity in the securities markets. Unfortunately, in many other countries, insider trading is not only legal, but is a usual form of conduct. Indeed, in some countries, it is often considered bad manners not to share non-public information with a friend so that he too can make a profit.

Of course, insider trading is not a new phenomenon. Today, however, we in America seem to be in the midst of an epidemic of such activity, in which the accounts that we read about in The New York Times and The Wall Street Journal represent only the most blatant cases.

Why has the problem become so acute? Probably because the potential rewards to these cheaters seem more alluring now than ever before. The current wave of mergers and tender offers in the U.S. -- with the precipitous price increases they generate -- often provide irresistable incentive to wrongdoers who seek enormous profits, virtually overnight, with little accompanying risk. This has been facilitated, in large measure, by the advent and development of formalized markets for options trading, both in the U.S. and here in Europe.

As most of you probably know, an option is the right to purchase or sell shares of stock in a particular company at a specified price within a limited period of time. What makes options, in particular, so attractive to insider traders is their low cost, typically a fraction of the price of the underlying security. If the price of the underlying security goes up dramatically, a purchaser of the options is able to magnify by many times the profit he would have made on the same investment in the stock itself.

Although, in general, insider trading has been an important focus of the Commission's enforcement program since at least the 1960's, the SEC's prosecution of insider traders in our own country has run up against three major roadblocks that continue to threaten our enforcement efforts. First, there seems to be a belief held by those who are tempted to trade illegally on inside information that the Commission cannot or will not prosecute them successfully, either because detection and proof are difficult or the law is unclear. The second roadblock is the absence of meaningful sanctions to punish those who are found to have violated the law and would deter others from such conduct. The third roadblock is the refuge insider traders often find behind bank secrecy and blocking laws of other countries that can be used to shelter both the identities of the perpetrators and their ill-gotten gains.

To eliminate these roadblocks, we at the Commission have recently undertaken three significant initiatives.

First, we are vigorously enforcing our own existing laws against insider traders. In this connection, the Commission, with my full support, has begun to bring insider trading cases at an unprecedented rate. Indeed, prior to 1978, the Commission had brought only 40 insider trading cases; since then, it has already brought more than 50 such actions, including 20 cases against 59 individuals in 1982 alone. In addition, I have recommended that the SEC refer insider trading cases to our Department of Justice for criminal prosecution on a much more frequent basis than we have in the past.

Our second initiative in the battle against insider trading in our securities markets is the Commission's recent submission to our Congress of the Insider Trading Sanctions Act ("Sanctions Act"). 1/ This proposed legislation is necessary to make our

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1/ H.R. 559, 98th Cong. 1st Sess. (1983).

increased enforcement efforts more potent. It provides for greatly enhanced civil and criminal penalties against those who violate our Federal securities laws by trading on inside information.

The need for greater sanctions against insider traders is obvious. The SEC's principal weapons against all fraud, including insider trading, are legal actions for an injunction that requires a defendant to obey the law in the future, and actions for additional relief in the form of disgorgement of profits.

At most, an injunction subjects a defendant to possible contempt proceedings if he violates the law again. It is, in effect, merely a wrist slap -- a warning to behave in the future. Similarly, disgorgement -- although a useful remedy in general because it deprives violators of the fruits of their violation -- does not penalize defendants for their past actions and, therefore, does not provide adequate deterrence. Indeed, because disgorgement does not subject a violator to any monetary net loss, it places an insider who is caught profiting from the illegal use of inside information in no worse a position than an honest person who refuses to violate the law in the first place.

The proposed Sanctions Act is designed to raise the stakes of the game. Without making changes in the current substantive law, it would make two alterations in the sanctions to which illegal traders are exposed.

First, it would increase the criminal fines for most violations of the Securities Exchange Act of 1934 ("Exchange Act"), including insider trading, from their present level of $10,000 to $100,000.

Second, and much more important, the Sanctions Act would authorize the SEC to bring an action in court to seek a civil penalty in an amount, to be determined by the court, that does not exceed three times the profit gained or loss avoided by the insider trader. Significantly, this sanction differs from the $100,000 criminal fine in that treble damages can be assessed only with respect to insider trading violations.

Although a breakthrough in U.S. securities regulation, this kind of multiple monetary penalty for insider trading is not new. Indeed, right here in France, a fine of up to four times the amount of the insider trader's profit on his illegal deal has been the law since 1970.

I firmly believe that our proposed Sanctions Act, by providing both the increased criminal fine and the potentially very costly treble damages provision, will greatly alter the risk analysis that an insider trader employs when determining whether to trade on inside information, and thus will offer a realistic and effective deterrent to such illegal action.

Our enforcement initiative was a logical and necessary first step, and the proposal for increased sanctions is an essential supplement to it. Without one further initiative, however, meaningful control of the problem of insider trading in our capital markets cannot be achieved. Our war against insider traders has been made increasingly difficult by foreign bank secrecy laws that prohibit the disclosure of customers' identities, and blocking statutes that are designed to limit the effect of U.S. foreign discovery procedures. Indeed, the use of such statutes to protect these wrongdoers was strongly criticized by the Federal District Court in New York in the recent Banca Della Svizzera case. In this landmark decision ordering the Swiss bank to reveal the identity of its customer, the Judge noted that "[i]t would be a travesty of justice to permit a foreign company to invade American markets, violate American laws if they were indeed violated, withdraw profits and resist accountability for itself and its principals for the illegality by claiming their anonymity under foreign law." Accordingly, our third initiative is to engage in international negotiation and discussion in an effort to persuade other countries to permanently deprive insider traders of the foreign hiding places they traditionally have used when seeking to avoid enforcement of U.S. laws with respect to trading in the U.S. securities markets.

I emphasize here that we are not attempting to deal with regulation, or non-regulation, of the securities markets outside the United States, only with the regulation of our own securities markets as they are used by non-U.S. traders.

Our first major accomplishment in this area was the historic accord reached last summer between the United States and Switzerland. On August 31, 1982, our two governments -- after only six months of cordial consultations -- executed a Memorandum of Understanding that represents an important achievement in international cooperation and is certain to improve our ability to discover and thwart insider trading through Swiss bank accounts.

The Memorandum of Understanding is not a binding international agreement. Rather, it is a declaration of each nation's commitment to battle insider trading and to rely whenever possible upon the 1977 U.S. - Swiss Treaty of Mutual Assistance in Criminal Matters ("Treaty"). That Treaty provides for the exchange of law enforcement information on matters that are criminal in both nations. Unfortunately, insider trading, although a crime in the U.S., is not a crime as such in Switzerland. Consequently, unless the conduct falls within more general Swiss proscriptions against fraud or unfaithful management, the mutual criminality standard is not satisfied, and the Treaty cannot be invoked. As the Swiss Federal Tribunal indicated in its recent decision in the Sante Fe case, it appears that these provisions cannot be used against certain insider trading activity.

In view of the existence of these shortcomings in the Treaty, the Swiss Bankers' Association has submitted to its members a "private convention" that permits signatory banks, without violating Swiss secrecy laws, to furnish information to the SEC in connection with customers suspected of trading on inside information. We may now request through our Justice Department and the Swiss Police Department that a three member commission appointed by the Swiss Bankers' Association investigate and report to us the identity of traders involved in questionable transactions (which must relate to either a business combination or the acquisition of at least 10% of a company's shares). The bank will also freeze the suspects' assets up to the amount of the illegal gains in the transaction under investigation. As of this date, I am happy to report, the private convention is operational.

The private convention, however, is only a provisional measure. Once legislation is enacted that makes insider trading a crime in Switzerland, the convention, by its terms, will be terminated, and enactment of such legislation is anticipated by late this year or early next year.

While the execution of the Memorandum, as well as Switzerland's own efforts toward limiting the damaging impact of its bank secrecy laws on international law enforcement are to be applauded, they will, by no means, solve the problem of insider traders in the U.S. market using the shield of foreign laws to hide their identities. Rather, with one of their traditional hiding places exposed, it is likely that these illegal traders will merely shift their base of operations to other jurisdictions fortified with secrecy laws and blocking statutes; and unfortunately such jurisdictions abound.

Turning first to bank secrecy, my research has shown that at least 32 countries have bank secrecy laws that keep bank accounts and depositors shielded from foreign scrutiny. Moreover, the number is increasing, not decreasing. In Switzerland the bank secrecy law, which is of lessened significance to the Commission in light of the Memorandum of Understanding, nevertheless reflects a relationship between the government and its citizens that is deeply rooted in history, and is aimed at preventing government intrusion into the private sector.

The secrecy laws of some smaller nations are less rooted in a historical fear of government intrusion, and may be the result of cynical attempts to attract business of any sort to those countries. These nations may become the next major refuge for insider traders in the U.S. markets. In the Bahamas, for example, there are two statutes that offer substantial incentives for maintaining the confidentiality of customer information. 2/ Like the Bahamas, the Cayman Islands also offer the allure -- to both the honest and the dishonest -- of a disclosure-free banking environment. 3/

Of course, the Caribbean is not the only locale where promises of secrecy may attract illicit insider traders. Right here in Europe there are a number of laws that can be used to prevent disclosure of banking information to legitimate foreign investigative authorities.

2/ One of these laws, the 1965 Act to Regulate Banking Business and Trust Companies, provides for a fine, imprisonment, or both, for disclosure to anyone of information with respect to a bank or its customers, if such information was acquired in the course of the violator's relationship with the bank. There is an exception, however, for disclosure made pursuant to a court order or in connection with the day-to-day responsibilities of bank employees. A second law, the 1974 Act to Provide For The Establishment of a Central Bank, subjects anyone who divulges banking information to a similar fine, and imprisonment. This latter statute differs from the first in that it applies only to the disclosure of information to a governmental authority without bank or court authorization, and does not apply to general business relationships.

3/ The Cayman statute, the Confidential Relationships (Preservation) Law of 1976, provides criminal penalties of fine and imprisonment for disclosure of confidential information with respect to virtually all business activities, including banking. Pursuant to 1979 amendments to that law, any person who requests disclosure of confidential information must first make an application to the Grand Court of the Caymans (a trial-type court) for authorization and direction.

In West Germany, for example, the Banking Act 4/ imposes a duty of secrecy on employees of the Federal Bank, and a similar duty is imposed in the Netherlands by its banking laws. 5/ Although I firmly believe that these laws were enacted to further the legitimate national interests of those nations, and not to harbor those who trade on inside informatin in the U.S. markets, nevertheless, their effect is to make foreign investigations of such violations more difficult.

Like secrecy laws, blocking statutes are prevalent, and can impede the SEC's ability to discover such insider traders. As most commonly enacted, these statutes prohibit the production of information pursuant to foreign administrative or judicial requests. In addition, certain blocking laws are designed to minimize the impact of foreign court judgments. These statutes reflect a determination that enforcement of a foreign order is inconsistent with local legal or financial principles, or is a threat to sovereignty or national interest.

Indeed, even France has enacted a blocking law. 6/ The French statute is one of the most recent, and, in my view, one of the most stringent of these laws. Although technically an amendment to a statute regulating communications with respect to maritime commerce, it relates directly to the SEC's ability to acquire information about activity that violates U.S. statutes but that occurs in France.

4/ See Section 9 of the Banking Act of 1963, as amended.

5/ See Section 46 of the Banking Act of 1978.

6/ Law No. 80-538 of July 16, 1980.

The primary purpose of the French blocking law is to ensure that foreign lawyers comply with the judicially supervised French discovery procedures. To achieve this result, as I understand it, the provision not only prohibits any disclosure of documents or information that would threaten the sovereignty, security or essential economic interests of France, or the public order, but also makes the very act of requesting any documents or information without following judicial procedures an offense. Specifically covered by the statute are matters of an economic, commercial, industrial, or technical nature, intended for use as evidence in connection with pending or prospective foreign judicial or administrative proceedings.

As originally enacted, the French blocking law appeared to create serious obstacles to our ability to investigate insider trading in the U.S. markets that involved activity in France. In this connection, it also threatened to undermine the traditional cooperation between the SEC and the Commission Des Operations de Bourse ("COB"), a prospect which, I am sure, troubled that distinguished agency as much as it troubled us. Happily, however, I understand that pursuant to recent amendments to the blocking law, the COB will once again be able to assist the SEC in investigations involving activities occurring in France.

In direct contrast to the strictness of the French statute, the British blocking law 7/ confers wide discretionary authority on the Secretary of State to allow or prohibit foreign discovery requests. Under that law, if a person carrying on business in Great Britain is requested to produce information concerning conduct occurring outside the requesting country's jurisdiction, whether or not such activity took place in Britain, he may be required to give notice to the Secretary of State. If the Secretary determines that the request threatens Great Britain's trading interests, infringes on its jurisdiction, or prejudices its sovereignty or security, he may prohibit compliance with the foreign order.

It should be noted that although the Act was motivated by what the British perceive as unreasonable and chauvinistic extraterritorial applications of the United States antitrust laws, the actual scope of the Act is not so limited. By its terms the Act may apply to any foreign measure affecting the trading interests of Great Britain. It is clear, therefore, that the Act can be used to block enforcement of foreign laws that, according to the tenor of the times, may be considered unfair or unpopular by the British government.

In the face of all of these obstacles to enforcement of our securities laws with respect to trading in our markets, we in the U.S. are keenly aware that international solutions are needed. Toward this end, I believe that significant progress

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7/ The Protection of Trading Interests Act of 1980 (Eliz II).

has been made. One important initiative has been the negotiations that our Department of Justice has conducted and is currently conducting with many nations aimed at procuring treaties of mutual assistance in criminal matters that do not contain the kind of dual criminality requirement that have proved so troubling in our treaty with the Swiss. Such negotiations have recently been concluded successfully between our country and Colombia, the Netherlands, and Turkey, respectively, and similar accords are expected in the near future.

Even more significant, I believe, from a global perspective, was the gathering together last week in Amsterdam of an informal group of international securities regulators. This almost entirely European gathering discussed various regulatory issues of common interest to all of the participants. The establishment of this group as a continuing entity, without U.S. leadership or domination, has been one of my personal projects since I have been at the Commission. I was inspired in this regard by Dean Robert H. Mundheim of the University of Pennsylvania Law School, and other members of the International Faculty for Corporate and Capital Market Law, a standing group of academics concerned with the health of the world's capital markets. I was also encouraged by the outstanding results achieved by the Basle Committee, an international working group of bank supervisory authorities originally led by W. Peter Cooke, with whom I consulted at the outset of my efforts. It is my strong belief that the face-to-face contact fostered by such a group will operate to facilitate personal solutions to international problems. I am extremely optimistic about the role of informal discussions in bridging the transnational gaps in cooperation in all matters relating to the world's capital markets, and in particular, to the problem of insider trading.

Conclusion

I have attempted today to outline the measures we at United States Securities and Exchange Commission have taken, as well as the obstacles we still face, in our ongoing battle against insider trading in the U.S. securities markets. It is clear to us, however, that our efforts to date are only small attacks in what must be a global battle.

Although my mission today is to outline our own struggles in keeping the U.S. securities markets free from insider traders from all countries, the problem of insider trading is an international one. Isolated unilateral or bilateral efforts are salutary and may relieve temporary discomforts, but they cannot bring about long-term recovery. A lasting cure can only be developed through cooperation by all nations engaged in multinational commerce.

It is therefore of the utmost importance that groups such as this one, and the informal group of international securities regulators that I discussed briefly, pledge themselves to establishing a continuing dialogue on this issue. It is only by continuation of such a dialogue that members of the international community, through both formal and informal means, can accommodate their own national interests while promoting our common international objectives.