NEWS

SECURITIES AND EXCHANGE COMMISSION
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INSIDER TRADING REVISTED

Remarks of
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Association of the Bar
of the City of New York
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Introduction

I am delighted to be here tonight at the end of my second year at the Commission and to have the opportunity to speak to this distinquished group, which includes so many of my personal and professional friends. Two years may not seem like a long time but I have now served longer than all but one of the other Commissioners. I have come home tonight to describe the initiatives recently taken by the Securities and Exchange Commission in its effort to thwart the all-too-frequent occurrence of trading on "inside" information and to enlist your support for the Commission's efforts. These initiatives are, I believe, at least as important in fulfilling our statutory mandate to protect investors and maintain the integrity of our capital markets, as are our controversial efforts to streamline market access through the innovations of the integrated disclosure system and Rule 415.

Happily, however, I am in complete agreement with our insider trading initiatives, so you will suffer nó 37 page dissent here tonight. Unlike the overly broad Rule 415, our insider trading initiatives are carefully tailored to solve specific problems and run no risk of upsetting the traditional effectiveness of our American capital market system.

But before I go on to tell you what we are doing, let me tell you why we are doing it. Here in this grand room of this venerable institution, surrounded by honorable colleagues from prestigious law firms and corporations, you may forget --

or simply not know -- that securities fraud still lives on in the land and has even infected areas previously thought immune. The current wave of mergers and tender offers provides the green fertilizer that makes it thrive. Some of you may be incredulous, I know. Not so in our firms, not among our clients, you say -- and you may have been right in earlier days but now you are wrong. Even institutional law firms and Fortune 500 companies have recently been found to harbor insider traders, and more are found elsewhere, with no reputations to lose, with no traditions of fair play to maintain, and, until now, with little to risk by playing fast and loose with our securities laws.

The spectacular -- and tragic -- cases we read about in the N.Y. Times and the Wall Street Journal are but the jagged tip of the iceberg. The Commission now has more cases of insider trading under active investigation than ever before. Of course, proper proof and procedural requirements will keep many cases from being brought or won despite the conviction of our staff that wrongdoing on somebody's part is likely. In those cases we may not be able to prove the extent of the fire; but we can see a great deal of smoke. We all know the frequency of sudden price jumps just before an announcement of a big merger or tender offer. Even the most naive among you cannot believe these jumps are merely a coincidence or just good guess work by daredevil investors.

The law governing insider trading, from Texas Gulf Sulphur and Chiarella, to Newman and Lund, is intellectually fascinating and full of policy paradoxes and theoretical thickets, but, although I am trained as a securities lawyer, I have not come here tonight to expound upon the fine legal distinctions between trading on inside information and trading on market information, nor to consider who owes what duty to whom. Although the Commission will undoubtedly play an important role in the unravelling of these issues in the courts, I will leave them for another time. Instead, I am here tonight to discuss the action the Commission is currently taking, and will in the future take, with respect to the great preponderance of the cases in which there is no question that the conduct is wrongful and that the perpetrators should be punished.

The Commission's recent initiatives are aimed at dealing specifically with three major roadblocks which continue to threaten our enforcement of our insider trading prohibitions.

First, there seems to be a widely held cynical view that the Commission cannot or will not prosecute insider traders successfully, either because the proof is difficult or the law is unclear.

The second roadblock is the refuge insider traders often find in foreign bank secrecy laws and blocking statues which have historically sheltered both the identities of the perpetrators and their ill-gotten gains.

The third roadblock is the lack of meaningful sanctions with which to punish those who are found to have violated the law and to deter others from such conduct. The Commission's traditional enforcement arsenal -- highly effective in other contexts -- simply lacks the firepower necessary to deal with this problem.

To address these three difficult roadblocks, we at the Commission have formulated the three significant initiatives I intend to discuss tonight.

Vigorous Enforcement

First, vigorous enforcement of our existing laws should help to convince those who would attempt to profit on inside information that henceforth they will not do so with impunity. Accordingly, under the strong leadership of John Fedders and with my full suppport and that of my fellow Commissioners, the SEC has brought insider trading cases at an unprecedented rate. Early in my term I recognized that among the numerous violations of the securities laws to come before the Commission, none appeared more widespread -- or more detrimental to the historic confidence placed in our markets -- than insider trading. I resolved, therefore, to make its attack my number one enforcement priority. Interestingly, this view has, I believe, been adopted by each of the new Commissioners as they came aboard and it is now the view of the Commission as a whole. As a result, we have agreed to

focus a large portion of our enforcement efforts on ferreting out and prosecuting these market cheaters.

The legal foundation for our assault on insider trading is solid. From Cady Roberts through Texas Gulf Sulfur and its progeny, we witnessed almost two decades of virtually uninterrupted expansion of the legal basis for our prosecution of insider traders. Although the Chiarella decision in 1980 appeared to cloud our enforcement efforts, at least as against certain types of trading on non-public information, subsequent decisions, including the much publicized Newman case in the Second Circuit, and the Lund case in California, have demonstrated, as many had suggested from the outset, that Chiarella was merely a jury charge case, whose significance should be limited to its facts and procedural history. We at the Commission believe that the recent cases, together with our timely adoption of Rule 14e-3, have continued to strengthen the legal foundation for our enforcement efforts against insider trading.

As a result of our increased resolve to combat this problem, and the positive judicial response to our post-Chiarella initiatives, the Commission has redoubled its emphasis in this area. From the adoption of the '34 Act through 1978, the Commission brought only 40 insider trading cases. Since then, we have brought approximately 50, including some 20 cases in fiscal year 1981 alone. These statistics, of course, only demonstrate those

instances in which we have actually filed a complaint or brought an administrative proceeding. They do not reflect the large number of investigations we have conducted, or the regular surveillance procedures we have in place and are developing, which are designed to alert us to insider trading activity at the earliest possible moment.

Even more important than these statistics, however, is the determination behind them. In driving insider traders from the marketplace, we shall use all the weapons of deterrence available to us. Insider traders had better beware, the Commission stands united in its commitment to find you, prosecute you and punish you. Even when the facts are hard and the proof seems elusive we are going to forge ahead and bring the cases nevertheless.

Indeed, when professionals are involved, we're going to hit them where it hurts: their professional standings. For attorneys who trade on inside information -- and especially those who use their professional relationships to gain and exploit such information -- I will urge that we bring these cases to the attention of the appropriate state or local disciplinary bodies for remedial action. In addition, other professionals -- accountants in particular -- who depend upon certification for their livelihood should also know that information relating to their participation in illegal insider trading will be made available to their respective professional licensing and cer-

tifying authorities. Of course, where securities professionals such as investment bankers and broker-dealers are involved, I will not hesitate to support permanent bars from the business in appropriate cases.

Moreover, as you know, violators of the Exchange Act can be prosecuted criminally in addition to any civil action which may be brought by the Commission. As part of our no-holds barred approach, we will refer insider trading cases to the Department of Justice much more frequently than we have done in the past. For my part, I firmly believe that criminal prosecution of securities law violators is a highly effective and underutilized resource and one which should be relied upon to a greater extent in our fight against all securities frauds, and in particular insider trading.

Although our enforcement initiative was a logical and necessary first step, it is not, in itself, a panacea. Indeed, we are acutely aware that without bringing about certain other fundamental changes in the environment in which insider traders operate -- particularly with respect to where they hide and how they are punished -- meaningful control of insider trading cannot be achieved. With this in mind, we set out to, and have gone a long way towards, piercing the veil of the Swiss bank secrecy laws, and making insider trading far more costly to its perpetrators.

Swiss Agreement

As many of you know, the SEC has encountered formidable obstacles in its war against insider trading as a result of

Swiss laws that prohibit Swiss banks from disclosing to anyone the identity of their customers. These secrecy laws have provided traders on inside information with a mechanism by which to trade securities in the American markets without fear of identification. Recently, however, we reached an historic agreement with the Swiss government that will greatly facilitate the Commission's ability to penetrate Swiss bank secrecy.

In achieving this agreement with the Swiss, we were greatly aided by the Commission's stunning victory in the Banca Della Svizzera case, which involved the purchase of options and stock in St. Joe Mineral Corporation by foreign purchasers through a Swiss bank prior to the public announcement of the Seagram's tender offer for St. Joe. In ordering the Swiss bank to answer the Commission's interrogatories and to reveal the identity of its customer, Judge Pollack, in the Southern District of New York, stated that the Swiss secrecy laws must yield to our "vital national interest in maintaining the integrity of the securities markets...."

This case and the pendency of the Santa Fe case, which involves the purchase of options and stock in Santa Fe International prior to the announcement of its acquisition by the Kuwait Petroleum Corporation, highlighted to both Swiss and U.S. officials the urgent need to work together to arrive at a solution to the problem.

On August 31 of this year, after only six months of negoti-

ations, we executed a Memorandum of Understanding with the Swiss Government that is certain to improve our ability to discover and thwart insider trading through Swiss bank accounts.

As part of this historic accord, the Swiss Bankers' Association has agreed to submit a proposed "private convention" to its members that would permit 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 request through the 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 profits realized in the transaction under investigation.

It is important to note that since 1977, there has existed a Treaty of Mutual Assistance between the United States and Switzerland pursuant to which both countries have agreed to exchange information in connection with various types of criminal activity. The problem in applying this treaty to insider trading cases is that in order to invoke it, the activity involved must be criminal on both sides of the ocean; and unfortunately, although insider trading is a crime here, it is not a crime as such in Switzerland. The Swiss have, however, agreed to enact a statute, which is anticipated within the year, making

insider trading a crime in their country so that thereafter the treaty itself can be used and the private convention will no longer be needed.

I have no illusions, however, that the Swiss agreement will solve all of the problems of insider traders using the shield of foreign accounts, secrecy laws and blocking statutues to keep their identity hidden. It is likely that these rogues will merely shift their action to other jurisdictions fortified with secrecy statutes and blocking laws. The problem is further compounded by the fact that, in many countries, insider trading is not only legal, but an expected form of conduct. Indeed, in those countries, it is often considered bad manners not to share non-public information with a friend so that he too can make a profit.

I, therefore, believe that a global solution is required. In crafting such a solution, I am keenly aware of the fact that the SEC has little or no jurisidiction over securities traded in foreign markets or over accounts of U.S. brokers in foreign countries. We do have jurisdiction, however, over trading in our own securities markets regardless of who trades in them, and it is the integrity of these markets that we must fight to maintain.

One idea that has been considered is the imposition of a requirement that all purchases and sales consummated in our domestic markets -- no matter where they originated -- be subject to some identity requirement. Under such a rule,

no broker-dealer would be permitted to execute a trade in a U.S. market without ascertaining the identity of the ultimate beneficiary of the trade. The Commission would be permitted to obtain such information, after a threshold indication of illegal trading. A rule similar to this was proposed in 1976, but met with great opposition. The problem is that such a solution may operate to deter legitimate and needed foreign investment in our securities market. Obviously a careful balancing is required in this area between the desire not to discourage such foreign investment and the need for maintaining an honest marketplace.

I have spoken and written frequently about the problems arising from the internationalization of the capital markets and the need for uniformity in disclosure and accounting standards. Consistent with these statements I believe the SEC should try to execute agreements similar to the Swiss one with the other countries that have active securities markets as well as to continue to work with international organizations such as the OECD and the EEC to develop uniform prohibitions against insider trading and guidelines for cooperation in investigating and prosecuting such violations.

Indeed, one of my personal projects since I have been at the Commission has been the establishment of an international committee of securities regulators which would meet periodically to discuss problems of mutual interest and importance. I believe that this face to face contact will operate, as it

has with the Cook Committee in the banking field, to facilitate personal solutions to international problems. I am gratified to be able to say that the first meeting is now in the planning stage, and that our prime topic for discussion at that meeting is how to deal with the issue of international insider trading. Perhaps this will be the garden in which a global solution could grow.

Sanctions Act

Our third initiative in the battle against insider trading is one that will make our enhanced enforcement efforts more potent, and our achievement with the Swiss more rewarding. It is our submission to Congress on September 27 of The Insider Trading Sanctions Act of 1982.

The need for new legislation in this area was apparent to the Commission when insider trading did not abate despite the excellent judicial and regulatory developments to which I have referred. The existing law was simply not providing an adequate deterrent. From a financial point of view the illegal trader risked only the loss of profits gained, at virtually no investment risk. Threats of criminal prosecution and damage to reputation are apparently not great enough to offset the temptations of tremendous profits.

We, therefore, determined to augment the statutory law in this area. The question was how extensive should our legislative proposal be. Although many changes in the current law

would be useful in our efforts to win the war against insider trading, our one overriding consideration was the desire to take some action quickly. We did not want our proposal to suffer the fate of the long-ago proposed, and still-unenacted, ALI Securities Code. We therefore reasoned that the less comprehensive and controversial the proposal, the faster we could expect action.

The path of increased sanctions was deemed by the Commission to be the one of least resistance. Accordingly, with the aid of our highly skilled staff, we prepared and fully considered the Insider Trading Sanctions Act, which we believe is a valuable and viable legislative proposal.

I have called the Sanctions Act "a rifle shot at a broad target" both because of what it does and because of what it does not do. Stated simply, it would increase the maximum criminal fines for most violations of the Exchange Act, including insider trading, from $10,000 to $100,000, and it would authorize the Commission to seek a treble damage-type of civil penalty in insider trading cases. Whether enactment of such greatly enhanced sanctions will be sufficient to eradicate insider trading remains to be seen. Perhaps a shotgun approach will ultimately be required; but a broader gaged approach would clearly be more difficult to enact quickly.

Before limiting our first shot to increased sanctions we did, however, agonize over a number of other possible choices.

First and most fundamentally, we considered proposing an

amendment to Section 10(b) to provide a general statutory proscription against trading on specific types of non-public information and to provide a meaningful definition of the prohibited conduct. This, it was argued, would help to remove the legal uncertainty that often results when a body of law develops, as did the law of insider trading, from judicial and Commission decisions interpreting broad statutory language. This approach was rejected because it was certain to be especially controversial within the Commission and thereafter to provoke a long siege of scholarly and Congressional debate.

Furthermore, it did not seem necessary. The existing law is not now presenting any real obstacles to our enforcement efforts. The few judicial decisions handed down since Chiarella have been favorable. Indeed, as I mentioned earlier, the Newman and Lund decisions, coupled with the judicial support of Rule 14e-3, have established what we believe is a sound body of law. Fine distinctions remain to be drawn, but the basic ground rules on insider trading seem to be fairly clear in most situations. Accordingly, we took the view that a legislative proposal defining the violation was not our best course of action.

Second, we looked at the possibility of creating an explicit private right of action in insider trading cases. The Commission continues to believe that private actions provide a valuable and appropriate addition to Commission enforcement actions. In this connection, as you know, an implied cause of action for money damages under Rule 10b-5 has been firmly embedded in the

scheme of the Federal securities laws for more than 35 years, and despite recent rumblings by the Supreme Court, I believe it is still alive and well.

The law is more uncertain, however, with respect to damage suits under Rule 10b-5 for insider trading. The Sixth Circuit has held that a specific claimed loss by a plaintiff who traded in an impersonal stock market is generally not causally related to a defendant's act of trading while in possession of inside information. Therefore, if the Sixth Circuit rule were followed, no liability for insider trading could be imposed in the bulk of private insider trading cases. The technical legal issue of causation has always been a difficult one, and in the insider trading area in particular, it has been a subject of extensive debate. Such debate would undoubtedly have continued within the legal community and Congress if the explicit creation of a private right of action for insider trading were proposed. Thus, we again deferred to our desire for swift action and left that issue for subsequent consideration.

Having rejected both an attempt to codify the definition of illegal insider trading and an attempt to provide specific private rights of action, we focused on the imposition of greater sanctions that would increase the risk to which insider traders are exposed.

The need for greater sanctions is glaringly apparent. The SEC's principal weapons against all fraud, including insider trading, are actions for an injunction requiring a defendant to

obey the law in the future, and actions for additional equitable relief in the form of disgorgement of profits. Both have simply proved inadequate to stem the tide of insider trading.

At most, an injunction subjects a defendant to possible contempt proceedings if he violates the law again. As such, an enjoined insider trader is hardly burdened, because, as the Seventh Circuit has observed "compliance is just what the law expects." 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 violations --does not penalize defendants for their actions and therefore does not provide adequate deterrence. Indeed, as a 1972 report prepared for the Administrative Conference noted in highlighting the inadequacy of the disgorgement remedy, "an insider who is caught improperly profiting from the use of material information is placed in no worse position than the honest man who refuses to act."

The Sanctions Act is designed to raise the stakes of the game. Technically the Act is relatively simple; it makes no changes in the current substantive law. Rather, as its name implies, it makes two alterations in the sanctions to which illegal traders will be exposed.

First, as I mentioned earlier, the Act would increase the criminal fines for any violation of the Exchange Act (except the bribery provisions of the foreign corrupt practices Act)

from their present level of $10,000 to $100,000. Although seemingly a hefty increase at first blush, the increased fine in reality does little more than reflect inflation. Since 1934, when the $10,000 fine was first enacted, the dollar in real terms has fallen to one-seventh of its former value.

The second strengthening of the available sanctions, and by far the more important, is the Act's civil penalty provision. Drafted as an addition to Section 21 of the Exchange Act, the provision authorizes the Commission to bring an action in Federal 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 illegal insider trader. This sanction differs from the $100,000 maximum criminal fine, in that it can be sought only with respect to Exchange Act violations committed by purchasing or selling a security while in possession of material non-public information. The Sanctions Act does not define when trading on non-public information is illegal. It simply provides that its sanctions apply to trading on material non-public information if such trading violates other provisions of or Rules under the Exchange Act. The other provisions principally applicable would, of course, be Section 10(b) and Rule 10b-5.

The idea of a civil penalty, although a breakthrough in the context of the Federal securities laws, is hardly novel. On the contrary, this type of provision has been part of our regulatory framework since the nineteenth century.

It is interesting to note that the civil penalty which would be imposed by the Sanctions Act is quite different from a private action for treble damages, such as may be maintained under the antitrust laws. For one thing, under the proposed Act, only the Commission, and not private plaintiffs, may bring an action under the penalty provision. For another, the measure of relief under the Act is based on the defendant's profit gained or loss avoided, and not, as in treble damage actions, on the amount of the plaintiff's loss.

The civil penalty would apply only to public secondary market activity. It would not apply to negotiated private transactions, trades in the securities of closely held corporations or public offerings of securities by issuers. The statute as proposed also grants the Commission broad rulemaking power to exempt any other transactions it considers appropriate.

Our decision to exempt private transactions and public offerings by issuers reflects the Commission's determination that these transactions are simply not the type in which we tend to find insider trading abuses. Negotiated private transactions are typically accomplished by sophisticated investors whose strong bargaining positions make informational imbalances less likely. Moreover, even if overreaching does occur in these contexts, detection is likely, and private damage actions for fraud are easily brought. In addition, it is axiomatic that insider trading in private transactions and in the stock of closely held companies will not undermine investor confidence

in the public securities markets because the public markets are not involved.

The exemption of primary offerings of securities also reflects our judgment that adequate deterrence is provided by the existing regulatory scheme. In view of the well-developed and normally effective disclosure system provided for under the Securities Act of 1933 (the significance of which I discussed extensively in my recent dissent to the extension of Rule 415), as well as the private remedies available under Section 11, we felt it was not necessary to complicate the proposed Sanctions Act by including initial public offerings.

The proposed Act does, however, cover any secondary market trading by those in possession of material, inside information with respect to primary offerings. In addition, the Act expressly applies to all options trading, which is probably the single greatest source of insider trading activity.

One more aspect of the proposed Sanctions Act that I might mention is the provision for the payment of the civil penalty into the U.S. Treasury, a provision which follows most other Federal penalty statutes. I was, however, interested in considering an innovative approach for the Sanctions Act. Under such approach, the court would be granted the authority to require that the amount of the penalty assessed be applied to the establishment of a fund or escrow account against which victims of insider trading could make claims, or from which judgments obtained by such persons could be satisfied.

Upon closer examination, however, certain administrative problems with the penalty-fund approach became apparent. Most compelling among these was the strong view of some that the creation of such a fund would lead inevitably to a rush of claimants, some legitimate and some not, with the attendant bureaucratic or judicial nightmare of sorting out the differences.

In the end, however, the principal reason for choosing the Treasury as the sole beneficiary of the collected penalties was again the desire for prompt legislation. Rather than continue to debate within the Commission, and then perhaps within the bar and Congress, the authorization for a court-supervised fund was, like the other good but complicated ideas, left for another day.

We at the Commission hope that we can count on this prestigious Bar Association to support legislative efforts in this area in both your collective and individual capacities so that our expectations of timely action can in fact be realized.

Conclusion

In summary, the Commission has adopted a three-pronged attack on insider trading. Through vigorous enforcement of our present laws we intend to disabuse those who violate their positions of trust of their vain hope that they won't be caught. Through our agreement with the Swiss and our continuing efforts at international cooperation we intend to deny wrongdoers their hiding places. And through new domestic legislation, The Insider Trading Sanctions Act, we intend to make wrongdoing

not only not pay, but cost the wrongdoer a great deal.

In these various ways we at the Commission have tried to still the siren call of greed that has long tempted some to steer a crooked course through our capital market waters. We know that, all too often, these wrongdoers have encountered only smooth sailing. The Commission's recent initiatives, however, are intended to place large and treacherous rocks in their course, so that all who would respond to the alluring call to trade on inside information will suffer a profitless journey through unforgiving waters.