SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE CHAIRMAN

April 12, 1983

The Honorable Matthew J. Rinaldo
Subcommittee on Telecommunications,
Consumer Protection and Finance
2338 Rayburn House Office Building
Washington, D.C. 20515

Dear Congressman Rinaldo:

The enclosed memorandum prepared by the Office of the General Counsel addresses the questions raised in your letter of April 5, 1983.

As the memorandum points out, many of these suggestions and comments to which your letter alludes are thoughtful and responsible and merit consideration by the Commission and by the Congress.

If you would like any additional information, please do not hesitate to contact Ethel Geisinger, Director of Legislative Affairs for the Commission, at (202) 272-2500.

Sincerely,

John S.R. Shad

MEMORANDUM

April 12, 1983

TO: Chairman Shad

FROM: Office of the General Counsel

RE: The Insider Trading Sanctions Act of 1983 (H.R. 559); Letter from Congressman Matthew J. Rinaldo Dated April 5, 1983

Congressman Rinaldo's letter poses a number of questions based on submissions by several responsible commentators. Although the staff considered many of these points in drafting the proposed Act, some of the questions raise legitimate issues about its present form. This memorandum discusses these issues giving the principal arguments on both sides.

1. Is there a need for a statutory definition of the offense to which the new sanction would apply?

There is a substantial basis for the argument that, in the special context of this new penalty, there should be a precise definition of the offense to which the penalty applies. The magnitude of the new sanction creates much greater risks. Legitimate traders and analysts should be able to profit from their diligence without having to speculate, at the risk of substantial penalties, whether they violate a duty by trading while in the possession of material nonpublic information. So too should business executives planning major transactions that may raise questions about the possibility of the misuse of confidential information. Absent clarity concerning the conduct to which the penalty applies, legitimate activity may be foregone, and heavy compliance expenses incurred, all ultimately at costs borne by the investing public.

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 has been well-understood that "insiders" -- officers, directors or employees of an issuer -- are prohibited from trading on material nonpublic information about their companies. It is also clear that tippees of insiders are subject to the rule that they must disclose material inside information or abstain from trading.

The decision of the Supreme Court in Chiarella v. United States, 445 U.S. 222 (1980), created some uncertainty with respect to the law governing trading on so-called "market information" that is, information regarding the market for a company's securities. In 1980, the Commission resolved many of these uncertainties when it adopted Rule 14e-3, 17 C.F.R. § 240.14e-3. This rule made clear that persons with knowledge of an impending tender offer, which they know or have reason to know was obtained from a bidder, subject company, or their agents, (e.g., investment bankers, financial printers) are prohibited from trading while in possession of that information.

Recent judicial opinions have addressed other uncertainties with respect to market information. For example, in United States v. Newman, 664 F.2d 12 (2d Cir. 1981), 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).

Drafting a statutory definition of improper trading on material nonpublic information would be difficult, and could present difficulties in interpretation. However, if the Congress feels that it is desirable to create a statutory definition, it should be based upon the present state of the law but apply only to actions covered by the new sanction. It should not freeze the present state of the law as it may develop in the future on a case-by-case basis under Rule 10b-5.

2. Should there be a statutory definition for the phrase "profits gained or losses avoided" in order to clarify the measure of treble damages?

In SEC v. MacDonald, 699 F.2d 47 (1st Cir. 1983), the Commission took the position that the amount disgorged in an insider trading action should be the full amount of profit as measured by the difference between the purchase and sale prices. However, the court held that the price a reasonable time after dissemination of the information defined the profit to be disgorged for the insider trading.

The principal policy rationale for the broader measure is to maximize the deterrent effect of the proceedings, and this Office will continue to urge disgorgement of all profits in injunctive actions arising in other federal courts of appeal. The proposed Act would, however, obviate the need for "full" disgorgement as the appropriate measure of profit in civil penalty cases because the new treble penalty provision would provide a significant financial deterrent. Accordingly, for the purposes of the proposed Act, the measure of "profits gained or losses avoided" could probably be defined as the difference between the purchase price (or sale price) and the price a reasonable time after public dissemination of the information without substantially weakening the deterrent effect of the penalty.

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

The principal purpose for the language covering aiders and abettors is to make the sanction available against tippers as well as persons who trade on material nonpublic information. Although some commentators have argued that only those who trade should be penalized, to deter insider trading it is necessary to impose the sanction on tippers -- those persons who have been entrusted with material nonpublic information and who have abused that trust. Such persons do great harm when they selectively disseminate information. Imposition of a severe penalty based on the trading profits of tippees is an appropriate sanction for this harm.

It is true, however, that this language may be construed to give rise to liability for the penalty to those who aid and abet in ways other than as tippers. The questions posed focus on broker-dealer liability. Specific answers to these concerns follow:

(1) Where an employee is trading for his own account:

The proposed Act would not permit imposition of the penalty on the firm in this case. Absent other facts, the firm would not

have aided and abetted any violation, and the doctrine of respondeat superior would not apply to cause the firm to be liable for the employee's wrong since his misconduct is not within the scope of his employment.

(2) Where the employee makes a trade for a customer account:

If a registered representative executes a trade for a customer knowing that the customer has inside information, the registered representative could be held liable as an aider and abettor, and thus be subject to a penalty of three times the customer's profits. If the registered representative is neither a tipper nor a tippee, but merely executes the transaction, such a penalty seems unduly harsh. It might be more appropriate to limit the penalty to three times the registered representative's commission (and any other gain realized by him), while exacting the heavier penalty against the customer. It is likely that a court if faced with the facts as stated, would reach the balanced set of sanctions suggested.

The doctrine of respondeat superior could also attribute the employee's misconduct to the firm in such situations, since the employee's acts are within the scope of his employment. Imposing a treble penalty on the firm would not be appropriate in such a situation. Absent some other culpable involvement or notice to the firm, the Commission presumably would not seek, nor is it likely that a court would impose, a penalty on the firm. To the extent that there is any uncertainty, the Commission could clarify this point by means of a rule. Consideration might also be given to clarifying language in the proposed Act.

(3) Where an employee trades for the firm account:

Under the present language of the proposed Act, it would be appropriate for the Commission to seek disgorgement from the firm of the ill-gotten gains. Before seeking a treble penalty, the Commission would have to make a preliminary determination that the conduct of the firm was violative. Whether the firm's involvement in the trade merited imposition of the penalty would be for the court to determine, based on a case-by-case analysis of the firm's conduct or notice. The judge would be able to consider these facts in fixing the amount, if any, of the penalty.

(4) How would the proposed Act apply to such a firm if one employee possesses information but another employee, not knowing of the information, trades for the firm's account before it is made public?

In adopting Rule 14e-3 the Commission recognized that it was inappropriate to hold a firm responsible in such a situation, where an effective process in the nature of a so-called "Chinese Wall" prevents passage to a firm's trading desk of material nonpublic information known by others in the firm. At the time that the proposed Act was drafted, it was contemplated that the Commission would exercise its rulemaking authority under the proposed Act to adopt a similar rule. If such a rule is to be incorporated in the statute, the Office of the General Counsel would suggest the following language:

> For purposes of this section only, a person other than a natural person shall not be subject to a penalty under this section if such person shows that:
>
> (1) the individual(s) making the investment decision on behalf of such person to purchase or sell any security or to cause any security to be purchased or sold by or on behalf of others did not know the material nonpublic information; and
>
> (2) such person had implemented one or a combination of policies and procedures, reasonable under the circumstances, taking into consideration the nature of the person's business, to ensure that individual(s) making investment decision(s) would not engage in transactions giving rise to liability under this section, which policies and procedures may include, but are not limited to, (i) those which restrict any purchase, sale and causing any purchase and sale of any security or (ii) those which prevent such individual(s) from knowing such information.

This language, which is adapted from Rule 14e-3, could be added to Section 2 of H.R. 559 as (3) following line 3 on page 3.

4. The well accepted standard of proof for civil violations of the securities laws is proof by a preponderance of the evidence. E.g., Herman & MacLean v. Huddleston, 103 S. Ct. 683, 690 (1983). Should a higher burden of proof, such as proof by clear and convincing evidence, be applied in the special circumstances of treble damage actions under the proposed Act in light of the potentially severe penalties?

As noted, the burden of proof in Commission injunctive actions is proof by a preponderance of the evidence. Commentators have suggested that in light of the possibility of a

judge imposing a high sanction, a higher burden of proof should be required in actions seeking the proposed civil penalty.

On the other hand it should be noted that the proof in many of the Commission's insider trading cases depends heavily on circumstantial evidence. A higher burden of proof, such as a clear and convincing standard, would make it more difficult for the Commission to prove its case, particularly in insider trading cases where most cases are built on circumstancial evidence. A higher standard of proof would therefore substantially reduce the deterrent impact of the proposed sanction. Furthermore, confusion could arise if there was one trial with two different standards applicable to the same facts.

If there should be a higher standard of proof in actions which seek the treble penalty, that new standard should apply only to such actions, and should not "spill over" to change the standard of proof in traditional injunctive proceedings.

5. Should a statute of limitations apply to Commission actions under the proposed Act? If so, what should the limitation period be?

Currently there is no statute of limitations for Commission injunctive actions. There should be none because of the prospective nature of an injunction. However, because the new sanction would involve potentially large sums of money, a case can be made for adding a limitations period, but only for Commission actions which seek the penalty. This would have little effect on enforcement because the nature of most insider trading cases is such that the Commission becomes aware of the trading shortly after it occurs.

If a statute of limitations is necessary, five years is suggested. Anything less would result in the anomalous result that the Attorney General could bring a criminal action until five years after the violation and the Commission could bring an injunctive action, but could not seek the civil penalty during all of that period.

6. Does a defendant have the right to a trial by jury in an action seeking imposition of the penalty under the proposed Act? If so, would the jury merely determine whether or not the law has been violated or would the jury determine the damages and the penalty, if any?

Some cases suggest that the right to a jury trial is constitutionally mandated in civil penalty actions to determine whether the law has been violated. However, a judge rather than a jury would determine the amount of the penalty. E.g., 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). While these cases suggest that the right to a jury trial may be required, the Supreme Court has expressly reserved decision on this point. Atlas Roofing Co. v. Occupational Safety Commission, 430 U.S. 442, 449 n.6 (1977). The government argued in Atlas that the Seventh Amendment was not intended to apply to any government litigation, but was intended merely to assure the right to a jury trial in private suits for damages.

Whether an action is one in which a defendant has a right to a jury trial is a matter of constitutional law under the Seventh Amendment. If a jury trial is not constitutionally mandated, it would be possible for Congress to provide for one by statute. The justification for doing so would be that the new penalty could be as large as a criminal fine and that fairness to the defendant requires that he be afforded the opportunity to demand a jury. A jury trial provision would impose greater burdens on the Commission and the courts. Those burdens are unlikely, however, to be unacceptably severe.

It was intended that the use of the word "court" in the proposed Act would mean that in all actions, whether tried to the court or, if necessary to a jury, the judge would fix the amount of the penalty. If clarification is desired, the Office of the General Counsel would be pleased to suggest appropriate language.

Mr. RINALDO. I am also somewhat concerned about the liability for aiding and abetting a violation which the bill contains. In its response to my letter, the Commission stated that:

"The principal purpose for the language covering aiders and abettors is to make the sanction available against tippers as well as persons who trade on material information."

However, the language may be construed to impose liability for the triple damage penalty on aiders and abettors other than tippers, for example, on brokerage firms and their employees. The doctrine of respondeat superior could also be used to impose secondary liability on brokerage firms in some cases.

I am concerned that in such instances liability for the penalty could be imposed where there is no knowledge that the trade was based on insider information. Now, in addressing the liability of a brokerage firm for the damages penalty in such instances, the Commission stated that there could be liability, but that imposing a triple penalty on the firm would not be appropriate in such a situation.

What do you feel should be the liability of the firm in instances where an employee makes a trade for a customer who has inside information?

Mr. SHAD. None.

Mr. RINALDO. None?

Mr. SHAD. None on the part of the firm, if there is no knowledge that it is a transaction on inside information.

Mr. RINALDO. Do you feel that any clarifying language should be added to the bill to make that point clearer?

Mr. SHAD. I do.

Mr. RINALDO. Could you suggest some language?

Mr. SHAD. The general counsel, Dan Goelzer, has studied this area.

Mr. GOELZER. Well, where there is no knowledge on the part of the firm or the firm employee executing the trade, I do not think it is likely that the firm would be liable as an aider and abettor today, because that is one component of aiding and abetting.

That could be made clearer, however, by adding to the bill a provision that the person who merely executes a transaction and has no other connection with the violation is not liable.

Mr. RINALDO. Could you submit for the record the exact language that you feel should be included in the legislation to completely clear up this point so that there is no ambiguity or controversy about it in the future?

Mr. GOELZER. We would be happy to submit draft language.

Mr. RINALDO. Thank you.

Now, in the case of a registered representative who executes a customer's trade without knowing that that particular customer has inside information, the Commission stated that he could be held liable as an aider and abettor, and thus be subject to a penalty of three times the customer's profits. However, the Commission also added that "Such a penalty seems unduly harsh."

Mr. Shad or Mr. Goelzer, what do you feel is appropriate language, if any, in this situation?

Mr. GOELZER. Well, I am sorry. Perhaps I misunderstood your question.

Mr. RINALDO. Well, tell me about the appropriate liability and then the language.

Mr. SHAD. May I make sure I have the question? Was it without knowing that the customer was acting on inside information?

Mr. RINALDO. Without knowing that the customer had inside information.

Mr. SHAD. The account executive should not be liable.

Mr. GOELZER. And I do not think he would be liable under the provision as we have drafted it, because some knowledge of the underlying violation would be a requirement before aiding and abetting liability could be imposed.

However, I think the same kind of language that we spoke about a moment ago, exempting those who merely execute a trade, would clarify that point and would serve to exclude the registered representative from liability.

Mr. RINALDO. So would you submit language, then, to take care of both of those problems?

Mr. GOELZER. Again, I think it would be the same language.

Mr. RINALDO. OK. Now, it has also been suggested that the bill should define the violation as purchasing or selling a security based on material nonpublic information, rather than while in possession of such information. Which wording currently reflects the state of the case law regarding insider trading violations?

Mr. GOELZER. Well, the Commission's position, I think consistent position, has been that possession of material inside information is the test.

Mr. SHAD. But in terms of court decisions, I am not sure that we have always won on that ground. Is that a fair characterization?

Mr. FEDDERS. No, I know of no decision that refutes that point. We have lost cases based on circumstantial evidence, where the judge said that we did not meet the preponderance of evidence test. But I could stand corrected. I know of no decision where a court has abandoned the "in possession" theory.

Mr. SHAD. It has been held that it had to be "based on," as distinct from a "possession?"

Mr. FEDDERS. No, it has been held that you have to be "in possession of."

Mr. GOELZER. It would be an extremely difficult, if not impossible, thing to show that a person's motive was something else if they were in possession of the information.

Mr. WIRTH. If the gentleman would yield, counsel agrees with Mr. Fedders on that, is that correct?

Mr. FEDDERS. I think we are all in agreement.

Mr. SHAD. But I would clarify that "in possession"—where one member of a firm is in possession of inside information and somebody else in a different area of the firm engages in transactions, the firm is in possession but the trader that is actually buying the security may not be acting on inside information.

Mr. RINALDO. Well, let me followup with this question. Would the proposed change in your opinion affect your ability to prosecute insider trading cases?

Mr. FEDDERS. Yes, sir. I believe if you put a knowing standard in our ability to prosecute insider trading, that you have significantly impeded our ability. Insider trading cases are unlike cases dealing with corporate fraud. Corporate fraud cases frequently are based on empirical evidence, documents, recorded conversations and the like. I would say most of the insider trading cases, but not all, are based on largely circumstantial evidence, where you have records of telephone conversations, et cetera.

And to put a "knowing" standard in or that one has to—it has to be "based on material nonpublic information," rather than being "in possession of," you would not only have to establish that an individual has possession of the information, but you would have to get into his mind that the decision to affect a transaction was made knowingly and based on that.

So I would tell you that if you put the "knowing" standard in or if you put the "based on" standard in, you would be making our prosecutorial efforts much more difficult.

Mr. RINALDO. So in effect what you are saying is you are satisfied with the language, you feel that the language that should be in the proposed legislation is an improvement over what we now have?

Mr. FEDDERS. The proposed legislation in my view goes to a remedy. It does not at the present time at all impact the existing case law with regard to insider trading. It is strictly a remedy saying that if a person engages in this insider trading, however defined, that then the amount of disgorgement can be three times the ill-gained profit. And the proposed language that you have before you, presented by the Commission, does not impact the "based on," "in possession of," or a "knowing" standard at all.

It has been suggested by some thoughtful commentators—I have just told you that if it is drafted and approved by Congress in that fashion, you are going to impose a greater burden upon us in prosecution.

But one of the things that is being thought through—and you see this in some of the commentators; I have had the privilege of reading some of their testimony before they appear here today—is that the question of whether the underlying violation as we charge it now, let us say, under 10b–5, whether if any of these 10 points that have been made by the commentators, should it impact the underlying violation or should those kinds of criteria just come into place if we are seeking to impose the treble damages?

And there are some legitimate thoughts that are being expressed in that area.

Mr. RINALDO. So in effect, then, in summary—and I think you have given an excellent response to the question and cleared up an area that was a matter of some concern—what you are saying is that the violation would not be changed, that the violation would remain as defined in case law?

Mr. FEDDERS. That is correct, Congressman. But I also acknowledge that some of the commentators have said, hey, look, if you are going to move away from just a 10b–5 kind of violation where you are getting an injunction and ill-gained profit is being disgorged and you are going now for this severe remedy of a treble civil penalty, maybe with regard to that triple penalty alone, not the underlying violation, there ought to be some additional standards that are imposed, a definition, a higher burden of proof, and things of that nature.

And those are thoughtful commentaries, and I suggest that they place a great burden upon the Congress to think those things through.

Mr. RINALDO. My time has expired. Thank you very much for an excellent response.

Mr. WIRTH. Mr. Tauke.

Mr. TAUKE. Thank you, Mr. Chairman.

Mr. Shad, I just received a copy of the memo that you had sent to Congressman Rinaldo, but I have not really had an opportunity to review it. I guess that I am, first of all, intrigued by the notion that there seems to be some resistance to defining insider trading. But I do not think that I understand why there is resistance to defining that in the law.

It would seem to me from the discussion we have had already that there is some confusion about the definition of insider trading, and why not try to clarify that?

Mr. SHAD. Dan, would you want to respond?

The cases have not been clear in some aspects of this, particularly as it relates to market information. But I would ask Dan Goelzer to respond in more detail.

Mr. GOELZER. Well, I think one important reason for not trying to do a definition is that the range of potential conduct here is so broad that it is difficult to draft a definition that would cover what you wanted to cover and not cover what you did not.

If you just think of the kind of cases that the courts have confronted over the last 10 or 20 years, Chiarella involves a printer from materials he was given to set in print. Texas Gulf Sulphur involves employees of a company who knew that the company had a large mineral strike that had not been disclosed to the public.

There is just such a range in variation of conduct that it would be difficult to draft a perfect definition.

Mr. TAUKE. If I just might follow up, it seems that both of your responses in a sense argue in the other direction. Chairman Shad, you said the court cases are not clear. You suggested following up on that; that it is very difficult to define the scope, and it almost seems that that suggests that it is essential that we do so.

Mr. SHAD. It could be defined. It could be much narrower if defined than the broadest possible reach of current law, and I would suggest this: That, as Mr. Fedders concluded on his earlier comments, the possibility of leaving it to the courts on a case-by-case basis if merely an injunction or conventional disgorgement is pursued, but in cases where punitive sanctions are saught that you have a definition.

And it could be a very specific definition. It would be probably much narrower than where the courts—in the kind of cases we are bringing, because they do range over a very wide variety of areas. But in my opinion it would be possible to define who is an insider and what would be involved in both company and market information.

Mr. WIRTH. Would the gentleman yield?

Mr. TAUKE. I would be happy to yield.

Mr. WIRTH. I think it might be helpful if we had counsel define how insider trading is enforced under the antifraud statute. There is a broad antifraud statute that has been used by the SEC and it might be helpful, I think, for the record at this point to identify clearly where that antifraud statute appears and why that broad definition is important, as you were pointing out earlier, given the changing nature of the marketplace.

Mr. GOELZER. Well, the bulk of insider trading enforcement is pursuant to rule 10b–5, the general antifraud prohibition in the 1934 act. Section 17(a) of the 1933 act is a similar antifraud prohibition, that prohibits fraud in the sale of securities. And the Commission has a rule, rule 14e–3, which prohibits trading on advance knowledge that a tender offer will be made.

So I would say those are the three provisions of the law that would be relevant. As John Fedders indicated earlier, insider trading really legally breaks down into two kinds of different activities, either trading with material nonpublic information that has been obtained from inside a corporation, where such trading violates a duty, a fiduciary duty to the shareholders of the corporation, or trading while in possession of material nonpublic information that you have misappropriated, obtained somehow in violation of a duty, not running to the corporation but to some other person, such as your employer.

Mr. TAUKE. Thank you, Mr. Chairman.

Just to follow up, Chairman Shad, do I understand that you or your staff have already submitted to the subcommittee a possible definition of insider trading?

Mr. SHAD. No, we have not.

Mr. TAUKE. Would it be possible for you to develop a possible definition of insider trading that we could at least review?

Mr. SHAD. Yes.

Mr. RINALDO. Would the gentleman yield?

Mr. TAUKE. Well, could I ask that that be submitted to the subcommittee?

Mr. RINALDO. I would like to clarify.

Mr. TAUKE. I would be happy to yield.

Mr. RINALDO. I want to clarify that point. Let me see if I can put it in perspective, because I think it is a very important issue, and it goes to the heart of the legislation.

What you are telling us is that under the present scheme of things, absent this legislation, no definition is necessary because in effect the only result, when a person is guilty of insider trading, can be disgorgement. There is no punitive penalty.

Mr. SHAD. There may be penalties even under the present law. Of course, a defendant could be subject to criminal prosecution by the Justice Department or other law enforcement agencies. But within the SEC, that is correct.

Mr. RINALDO. Under the present law you prefer not to have any definition, but just go along on a case-by-case basis. Is that correct?

Mr. SHAD. We have acknowledged serious questions raised by responsible parties, because going from remedial relief, which is the present form of enforcement in the Commission, to penalties——

Mr. RINALDO. There, when you change the law. So what you are saying is, when you go from the remedial stage to the punitive stage, that then there should be a definition, but that definition should apply only to actions under the new law, the new sanction.

Mr. SHAD. If that was the Congress' determination, yes.

Mr. RINALDO. Well, I am trying to obtain your view as to which is better. In other words, there are two ways of doing it, a broad definition, an all-inclusive definition, I would say, of insider trading that covers all insider trading, or a definition that is going to apply only to people to whom the punitive penalty would apply.

Mr. SHAD. Yes.

Mr. RINALDO. Well, which do you prefer? Do you prefer the all-inclusive definition that takes into account everything?

Mr. SHAD. I cannot express the Commission's view, because this has not been specifically discussed in that fashion of two types of sanctions, one for present injunctive actions and the other for penalties.

Mr. RINALDO. Let me go back a step further. Do you all feel that such a definition is necessary? Does anybody feel a definition is not necessary, even with the treble damages penalty?

Mr. FEDDERS. Well, that is difficult. As a prosecutor, I have got to tell you that specificity, lack of ambiguity, is something I embrace. The difficulty that we have, the time that is consumed in an enforcement context trying to establish whether there is a duty or whether there is a misappropriation in these cases, is very difficult. These are not easy cases.

You would think because we characterize them as stealing—and they are stealing—that these are easy determinations. They are quite difficult. I tend to agree with Justice Holmes that the tendency of the law must always be to narrow the field of uncertainty, and there is a lot of uncertainty in the insider trading area.

I happen to have confidence that we could come up with a definition, and I do not run away from it. I do not abandon that idea, but it is very difficult. One of the things I realize, though, is once I do a definition which I can live with and I hope my colleagues are proud of, that it is going to be subject to a lot of challenge in the Congress.

And what I do not want to see happen is that in these courses of conduct which I think is stealing and fraud that we come up with a definition that is so narrow that some misconduct becomes permissible. That would be bad.

Mr. WIRTH. Well, if I might intervene at this point, I do not understand, Mr. Shad, why you appear to be changing your position from that which was unanimously recommended by the Commission last fall, which was to stay with the broad antifraud statute. And now you are coming in and suggesting, well, maybe there is the need for narrowing this definition and moving away from the position the Commission had taken last fall.

Mr. SHAD. I would characterize the bill as submitted as being very specifically addressed to the treble damage proposal. Other areas were certainly discussed by the staff in the course of drafting it, but I think that since the bill has been introduced there have been very responsible parties that have now raised serious questions that I do think we should be responsive to.

Mr. WIRTH. When you say the staff drafted this legislation, the Commission was not involved in approving this legislation that came up?

Mr. SHAD. Yes, the Commission did approve it.

Mr. WIRTH. It was a Commission-approved piece of legislation, not a staff draft, is that correct?

Mr. SHAD. We did approve the legislation that the staff drafted, but we did not have a Commission discussion in the kind of detail that has been raised by very responsible members of the bar and the securities dealers.

Mr. WIRTH. Let me ask, Mr. Longstreth, if you might want to comment on this as well.

Mr. LONGSTRETH. Well, I think it is fair to say some Commissioners spent more time on this than others, and that is the way we often work. Barbara Thomas and I did work with the staff from the beginning in developing a legislative package, and because of the sunshine laws we were not able to have the other Commissioners there or we would have had to have a public meeting.

It seemed appropriate for the two of us to work with the staff to try to evolve a position, and then it was presented to the Commission at an open meeting and it was approved. And at that time there was not a great deal of discussion about the reasoning that went into the approach that we took.

We did take an approach of preferring to allow the common law under section 10(b) and rule 10b–5 to evolve, and we thought that that was a preferable way of going, that it would raise less problems. And what we were seeking was effectiveness through quick legislation, looking solely at the sanctions, because we felt that here we have an antifraud statute that has been well interpreted,

there are some uncertainties but there are a lot of certainties under that law, too.

At least in the area of the certainties, we hoped that we could improve the sanctions. Everybody felt they were inadequate. That was our position and I do not think we are changing that position.

But there have been questions raised now and it is—I suppose it is possible to draft a definition, and if we could come up with a good definition, which as John Fedders said, was not narrower than at least the well-known contours of the law, that might be a useful thing to do.

Mr. WIRTH. In other words, you could write a definition that is broad or you could write a definition that is so narrow that all the lawyers in town can drive trucks right through it and you do not get the deterrence that in fact is what you are after to begin with. That is what this whole issue is all about, is that not right? There are a number of people out there who are determined to make sure that if there are damages built into this, treble damages, that they therefore can constrain those in such a way that they can handcuff the SEC and make it impossible for you to enforce the law.

That is really fundamentally what this issue is all about, is that not right, Mr. Fedders?

Mr. FEDDERS. I think so.

Mr. WIRTH. That is what I thought.

If 20 years ago you had been asked to write a statute prohibiting insider trading where someone by virtue of special access to information not available to the general public purchases securities, what would you have written 20 years ago? Do you believe you would have written a statute broad enough to encompass the new frauds that we have seen developed in the last 20 years?

For example, in the *Thomas Reed* case, that involved Reed's purchasing options while he had information about a possible tender offer for Amax securities. Twenty years ago, do you believe you could have foreseen the tremendous impact of tender offers on insider trading and the growth of the options market and its impact on insider trading?

Mr. FEDDERS. Being a man of great wisdom, I probably could have.

I probably would have drafted rule 10b–5.

Mr. WIRTH. Which is the antifraud provision now used by the SEC to prosecute those cases. Thank you, Mr. Tauke.

Mr. TAUKE. Do I understand from all of this discussion, Chairman Shad, that I can expect that you will or see to it that someone from your staff drafts a possible definition which this subcommittee can review?

Mr. SHAD. Yes.

Mr. TAUKE. Thank you.

Mr. SHAD. I would like to ask if you want to give us any indication of how broadly you would like it defined, because that is the issue. The issue is how narrow or how broad the definition should be.

Mr. WIRTH. Well, I just might respond to that. Judges have said that "fraud is only limited by the genius of man." Is it not, therefore, necessary to have a general antifraud statute that can be broadly construed to meet new kinds of fraudulent conduct?

Does that not go right back to what you were suggesting in 10b–5, Mr. Fedders?

Mr. FEDDERS. Well, I do not resist a definition. Let me tell you quite candidly what I am concerned about. I think that the people at this table and this Commission have an ability to draft a definition that is comprehensive and that will cover all things possible in the fraud area known to man.

But I do fear the legislative process somewhat. I am concerned that the definition would come over here and that special interests would have the ability to narrow it. I am concerned about that.

Mr. WIRTH. I share that concern, Mr. Fedders.

Mr. SHAD. Well, let me suggest that we draft a definition which would certainly encompass the cases that we have brought. Those are the cases where we have sustained——

Mr. WIRTH. But again, we are trying to have that kind of foresight, Mr. Shad, in looking at 20 years, which is why the broad definition in 10b–5 is helpful.

Mr. SHAD. I lack some of Mr. Fedders' wisdom, but I think even I, could have drafted a bill. In fact, it would have been drafted in terms of securities which would have encompassed the subsequent development of options. So that just merely because options did not exist then in the standardized trading market as they do today, it would still have been caught by a definition 20 years ago.

Mr. TAUKE. I did not know that my simple questions would trigger such vigorous response.

Let me just observe, first of all, that all I am asking for is something that we can look at to see whether or not it makes sense.

Second, I might observe that if we want to cover everything we could just adopt a criminal code which says, we oppose all wrongdoing, and then let some courts decide what wrongdoing is. It seems to me there is from time to time some basis for making some definitions, so people know what they can and cannot do and how we see wrongdoing.

There may be good and legitimate reasons for not in this case defining how we see that wrongdoing, but I think we should at least take a look at the issue, especially since it has been raised by so many people. I would appreciate it if you would submit a suggested definition.

Mr. WIRTH. Well, I thank the gentleman for raising the question. I think this is a very important issue, and we have brought out what some of the problems are here, and that kind of a submission from the Commission to the subcommittee I think would be very helpful.

I thank the gentleman from Iowa.

Mr. RINALDO. If the gentleman would yield, I think it is important too that since this is being submitted for our evaluation, perhaps we should look at it both ways. I am just as concerned as anyone else that you might get a definition that is so narrow that it will hamper the prosecution of legitimate cases.

What I would like is perhaps one broad definition, and then, second, a definition that would apply only to the new sanctions, so in effect you could continue along on a case-by-case basis for 10b–5.

Mr. FEDDERS. That is a very thoughtful approach. I like that.

Mr. SHAD. I do, too.

Mr. RINALDO. I think that might solve the problem, because I appreciate the concerns of the chairman, and on the other hand I understand what Congressman Tauke is saying. I think you have been very helpful in delineating the problems.

So perhaps that second approach—and I do not want to take away from what Mr. Tauke is requesting.

Mr. TAUKE. I think that is a very fine suggestion.

Mr. WIRTH. Mr. Leland.

Mr. LELAND. Thank you, Mr. Chairman.

Mr. Shad, it might be useful to ask you some questions about what the legislation does not do. If we passed the legislation or other legislation giving you enforcement remedies we may develop, that does not mean you would stop using the remedies you already have, does it?

Mr. SHAD. No. In fact, it adds to our available remedies.

Mr. LELAND. In other words, you are not asking that we repeal anything, are you?

Mr. SHAD. No, we are not.

Mr. LELAND. You still intend to use all of the weapons in your arsenal?

Mr. SHAD. All that we presently have, plus this additional heavy penalty.

Mr. LELAND. This bill, the insider trading bill, does not create any new sanction, does it?

In other word, it does not change the substantive law but just adds another remedy for the SEC to use in pursuing violations?

Mr. SHAD. That is correct.

Mr. LELAND. The bill does not say that a court in every instance will assess a penalty of three times the profit, does it?

Mr. SHAD. No, it does not. It is up to three times the profit.

Mr. LELAND. In fact, the court will look at all of the facts and circumstances in making the determination; is that not correct?

Mr. SHAD. Well, within the pleadings, yes.

Mr. LELAND. Do you want to expound on that?

Mr. SHAD. Do I see a problem with it?

Mr. LELAND. Yes.

Mr. SHAD. No.

Mr. LELAND. In 1972 the SEC's advisory committee on enforcement policies and practices recommended the use of money penalties or fines as a sanction to be used by the SEC in broker-dealer proceedings. This was recommended in an effort to give the Commission more flexibility in fashioning a suitable remedy in certain cases.

Mr. Fedders, do you see any value in civil money penalties?

Mr. FEDDERS. I see some values, and I see some shortcomings in it. In November 1981 I, with the concurrence of the Commission, undertook to begin a study of Commission enforcement procedures, as well as the possibility of recommending to Congress expanded remedies and sanctions. That staff study has now been completed. It has not been reviewed by the Commission.

One thing that we learned during that study is that we do not possess all of the wisdom in this area, and that each of these new potential remedies has some shortcomings associated with it. With regard to the civil penalties, we have thought and considered whether we might use civil penalties in both civil injunctive actions against individuals and/or against corporations and in the administrative context against brokerage firms. Brokerage firms are regulated entities.

The shortcoming of that is that it may cause our enforcement effort to slow down, it might serve as an impediment to settling a number of our cases, and I would not want to impose any sanction or remedy that served as a deterrent to the effective and swift law enforcement that we can provide today.

This is something that I hope that the Commission will consider over the ensuing months. It will then be discussed with Congress, but, quite frankly, after a year and several months of study, it is a more difficult issue and it is tougher to reach a determination than I thought it would be in November 1981.

Mr. LELAND. Thank you. Thank you, Mr. Chairman.

Mr. WIRTH. Mr. Oxley.

Mr. OXLEY. Thank you, Mr. Chairman.

Mr. Fedders, there has been some discussion about adding a statute of limitations, particularly if we change the law and provide for a more punitive area of the criminal law. Do you agree with that basic concept?

Mr. FEDDERS. I would not disagree with it, save several caveats. First of all, as long as the statute of limitations was reasonable. Second, I would not want any statute of limitations to have a spillover effect into other provisions of enforcement in the Federal securities laws. At the present time we do not have a statute of limitations in a number of our areas.

If because this is a treble penalty, and because it is so severe, if Congress decided that a statute of limitations of several years was appropriate, I would not resist that. I would not advocate against it, but I would hope that there would be no other spillover effect.

I am aware that there are several bills pending in both the House and the Senate that have been thoughtfully introduced suggesting that all Government agencies ought to be subjected in civil context to a 4-year statute of limitations. I would like to have the opportunity at some time to comment on that, but I do not think a statute of limitations per se in the narrow area of the treble damages would be destructive or obstructive.

Mr. OXLEY. I gather, then, that you think perhaps 4 years may be too short in that context?

Mr. FEDDERS. No, I think that is just about right, frankly, in this context. It does not trouble me. I have discussed with my colleagues 3, 4, 5, or 6 years, and at some time maybe it would be appropriate to give the Congress some of our thoughts in this area. You know that the criminal statute of limitations today in most crimes is 5 years.

Mr. OXLEY. There is some question, when we are dealing with this rather inexact, if I can use that term, inexact crime, as to when that particular crime may have taken place and when in fact the statute of limitations would toll. I am thinking specifically of a course of conduct. For example, if something may have gone on for some time, is that something that we should deal with in the legislation, or something that perhaps would best be left to the courts to define exactly when that statute may have tolled?

Mr. FEDDERS. That is a very good point, Congressman. Insider trading is not an open and notorious event, such as a murder or an airplane catastrophe or something like that. It is a course of conduct engaged in fraud, and generally it is done in silence, so the question is, when does the statute of limitations begin to run? When we discover it? Or does it run from its inception? That is a very important point that you must address.

Mr. OXLEY. And you would think that that is our responsibility to address and to try to define the matter a little further, as opposed to simply imposing the statute and then sitting back and letting the courts work their will as far as the definition is concerned?

Mr. FEDDERS. If there is a statute of limitations at all, I suggest you also address the question of when it begins to run.

Mr. OXLEY. Thank you. One question for Mr. Goelzer. You had talked about a fiduciary duty, It has been a long time since I got out of law school, and that was really my only brush with that particular part of the law. I wonder if you could further describe for me and perhaps for my colleagues what exactly the fiduciary responsibility is. You mentioned, I think, the fiduciary responsibility in the corporate area, and particularly to the stockholders. I wonder if you could expand on that a little bit for my own edification.

Mr. GOELZER. Well, I do not know that I can give a complete lecture on the law of fiduciary duty.

Mr. OXLEY. I do not want one.

Mr. GOELZER. In this context, I think the concept arises from the *Chiarella* decision, which analyzes the insider trading violation as being a breach of the duty that corporate officers and executives owe to the shareholders to deal fairly with them and to not take advantage of the shareholders.

The analysis is that if a corporate insider has knowledge about the corporation because of his position and then goes out and trades in the securities markets and the corporation stock based upon that information, he is in essence profiting off of the shareholders of the corporation, and that is a breach of the duty that he owes to deal fairly with the shareholders.

Mr. OXLEY. As I read over some of the material last night prior to this meeting, it struck me, as Mr. Fedders indicated, that there are a lot of things that are in a very massive gray area as far as violations are concerned. Where does that chain end or how do we best get a handle on it?

I guess that goes back to the questions that the chairman and Mr. Tauke raised as far as definition of insider trading, and that is something that is somewhat troubling, because in many cases it is probably more than a breach of fiduciary duty. Do you agree with that?

Mr. GOELZER. Well, when you talk about where does the chain end, of course, in this area, it is likely to be that the officer does not trade himself, but tells someone else, who in turn tells someone else, who tells someone else, and ultimately, at the end of the chain, there is a securities transaction.

Mr. OXLEY. Whether at the end of that chain there is in fact a prosecutable offense, and whether in fact the degree of privity between the initial insider and the individual at the end of the chain has been broken, or whether it continues is a very, very confusing area of the law for me, and I am sure that it contributes to some of the problems we have.

I would be glad to yield to the gentleman who has the microphone.

Mr. GOELZER. Let me just add, I think in the *Chiarella* opinion, in a footnote, the court refers to the trader as a participant after the fact in the insider's breach. I think that is the nature of the offense.

Mr. LEVINE. I think the *Chiarella* decision talked about someone who has a fiduciary relationship or a relationship of trust or confidence to someone else who then because of the relationship would have a duty to that entity or to the shareholders in the case of the corporate executive. And that is well established in common law, not to take advantage of, or in that case of *Chiarella*, to disclose before one traded. All it says is, if you are in the position where you have a fiduciary relationship or a position of trust and confidence—and that goes back to the basic law that you were referring to earlier—you cannot trade, buy securities from that person or sell to that person, without disclosing the information you have if it is material.

In terms of the tippee down the line, there are standards that the courts have imposed, and at the Commission there are decisions which do not say anyone who learns of it may have to give up profits. But you have to know where it came from. You may assume the duty of the person who told you the information. In other words, there are finite limits. It does not just go on down the line without limit.

And I think the Commission is very careful in trying to assure that when we bring a case, in interpreting the courts' decisions, it is only within those limits, and it does not expand all the way down the line.

Mr. OXLEY. Thank you.

Thank you, Mr. Chairman.

Mr. WIRTH. Mr. Dingell.

Mr. DINGELL. Thank you, Mr. Chairman.

Mr. Shad, I would like to thank you and your associates for being here before the committee today. I would like to commend the Commission for its support of H.R. 559, which I regard as an extremely important piece of legislation, and for that reason I am particularly pleased to see you here before the committee in support of that legislation.

Mr. Shad, I have observed in the press and have observed in the comments of our very able chairman, whom I want to commend for holding these hearings today, that the war on insider trading is called essentially an unwinnable war, one where the prospects for having, as Gilbert and Sullivan say, the punishment fit the crime is really not very good under current law.

I am very much troubled that, even if you catch somebody engaged in insider trading, the penalty is so small as to provide no significant deterrent toward future actions of the same sort either by that individual or by any other person. It is for that reason that I find particularly pleasing the action of the Commission in sup-

porting the bill, which I have introduced and of which Chairman Wirth and I are cosponsors.

I hope as the Commission proceeds forward in its consideration of this matter, that the Commission will not only most diligently implement existing law, but will continue to very strongly support the provisions of H.R. 559 as introduced, or perhaps as strengthened if you and the Commission feel that would be appropriate or you can suggest any strengthening amendments to us on this matter.

Mr. SHAD. Do you want me to comment?

Mr. DINGELL. I do indeed.

Mr. SHAD. Well, I think what is coming out of the hearing is a request for greater specificity, or at least for language that could be considered, and we will be glad to provide it. You know, I think that it has been widely publicized in the press and the media that if a person engages in insider trading, he either gets to keep the profits, or if he gets caught, he only has to give the profits back. I think one of the problems, and perhaps this hearing could help amplify it, is that the public by and large does not appreciate the host of other sanctions in addition to those available to the Commission.

In fact, the Commission's action often triggers a whole chain of events that responsible commentators have also noted, in terms of disbarment proceedings against people who have engaged in this activity, and loss of licenses by broker-dealers or others, criminal proceedings by the Justice Department and other law enforcement agencies.

There is the loss of employment, social opprobria, heavy legal fees. There is a whole series of other sanctions that do in fact come to bear on insiders, but unfortunately, I do not believe that the public is aware of those, and how severely, even under present law, they can be prosecuted.

Mr. DINGELL. Can you name any instance in your experience where these other sanctions have come to bear on any person who has been involved in insider trading?

Mr. SHAD. The most widely publicized would be Thomas Reed.

Mr. DINGELL. I beg your pardon?

Mr. SHAD. The most widely publicized case would be Thomas Reed.

Mr. DINGELL. The only thing that happened in the Reed case was that Mr. Reed had to give back some $425,000.

Mr. SHAD. But he is now—there is a grand jury that has been investigating possible criminal sanctions. He is being sued by the brokers that were on the other side of the transactions that were involved. He is being discharged from his present position on the National Security Council.

Mr. DINGELL. Well, that is yet to be seen.

Mr. SHAD. But these accurred in just this one case, and I would say that I could give you some even more flamboyant situations involving others.

Mr. DINGELL. Well, there has been no action taken by the Commission against the broker dealer.

Mr. SHAD. That is true.

Mr. DINGELL. And there has been no action taken by the Commission in connection with the falsification of documents which has been alleged in this matter, has there?

Mr. SHAD. Well, we could respond in detail, but I would like—I thought your initial question was, do these additional sanctions ever come to bear, and I would say the generalization is in most cases they do. Victims sue for civil damages, and there have been criminal prosecutions, and there has certainly been disbarment or reference to bar associations and others to bring sanctions against people that have engaged in these activities.

Mr. DINGELL. In the Reed case, however, all of these matters are quite inchoate, are they not?

Mr. SHAD. Yes, as far as I am aware, that is true.

Mr. DINGELL. No action has been taken against the broker dealer. No action has been taken against Mr. Reed for the alleged falsification of documents. The grand jury was rather slow in convening. The entire matter dangled for a goodly period of time, until finally something did occur. The trade press indicates some rather remarkable things. The trade press says that the Commission is engaged in an "unwinnable war" in this matter.

Mr. SHAD. That was dated 1981, and certainly I think the evidence since then demonstrates that the Commission is very vigorously enforcing this area of the law.

Mr. DINGELL. Well, I am not going to contest with you whether the Commission is doing that at this particular time, but the law has not been changed so as to make the climate better from the standpoint of Commission enforcement action during that interim period, has it?

Mr. SHAD. No, it has not.

Mr. DINGELL. And as I observe, Mr. Fedders has properly termed inside traders as thieves. That is a fair characterization of their behavior, is it not?

Mr. SHAD. I embrace it.

Mr. DINGELL. Well, I am concerned now about the suggestions of changes in the legislation that I find very, very troublesome. If the standard of proof suggested by the securities bar had been in place, could the Reed case have been brought to a successful conclusion before the Commission?

Mr. SHAD. You are suggesting clear and convincing evidence as distinct from a preponderance of the evidence?

Mr. DINGELL. That is correct.

Mr. SHAD. It would be difficult, because that, like most of these cases, was built on circumstantial evidence.

Mr. DINGELL. Now, could not the same statement be made——

Mr. SHAD. Just a second. I am being told by Mr. Fedders that he would not agree with what I just answered.

Mr. DINGELL. Well, I think we ought to hear from Mr. Fedders then.

Mr. FEDDERS. I have too much respect for Chairman Shad to tell him I disagree with him, so I would put it a little differently, but circumstantial evidence comes in various degrees, and I believe judges when they go into their chambers can make a decision, or juries go into the jury room—and I have only been there one time—make determinations with regard to guilt and innocence,

and although we use words like "preponderance of evidence" and "clear and convincing" and "beyond a reasonable doubt," I believe the course of conduct was such in that case that if we had to meet such a burden, whether it be preponderance of evidence or clear and convincing, we could have brought the case and we would have been successful.

Now, that does not mean——

Mr. DINGELL. You can only speculate on that point, though.

Mr. FEDDERS. That is one of the advantages of being a prosecutor. You get to speculate. But, yes, I am only speculating, but I am telling you that I think that our circumstantial evidence in that case was strong enough that we would have met a clear and convincing burden.

I am also telling you, as I told Senator D'Amato and his committee, that there were substantial litigation risks in that case. We could have lost it.

Mr. DINGELL. Well, that is precisely the point. You remember now, Mr. Fedders, you cannot have it both ways. You cannot tell the committee that you could have lost the case, and yet you could have met a stronger burden of proof. Now, you can take one position or you can take the other, and I leave you the election of that on which you wish to stand.

Mr. FEDDERS. Well, I think I can take them both. I have been at this litigation business for about 18 years, and there is no case that is not loseable, and there is no case that is not winnable.

Mr. DINGELL. Well, the chances, though, of losing under clear and convincing would have been much larger than the chances of winning under the preponderance. Is that not so?

Mr. FEDDERS. That is indeed correct, because it is a higher standard of proof.

Mr. DINGELL. Let us just talk about this thing as lawyers, because we are concerned as lawyers. It is fair to observe that in the case of matters of this sort, speaking now theoretically as lawyers, that clear and convincing requires a much higher level of proof than does a preponderance of the evidence. Is that not true?

Mr. FEDDERS. That is correct. When the judge charges a jury or when he reads the technical requirements of the three, either preponderance of the evidence, clear and convincing, or beyond a reasonable doubt, the charge to a jury or the definition of each is different, and they go up in levels of requirement.

Mr. DINGELL. That is right, and let it be understood that, when you are talking about large sums of money, potential criminal prosecution, and further private litigation, that whoever is involved in this kind of thing is going to get himself the best lawyers he can to assure that the judge will instruct with the greatest of clarity to the jury with regard to the burden of proof that the prosecution or the Government bears in this particular matter. Is that not so?

Mr. FEDDERS. That is true.

Mr. DINGELL. And it would also be true that were this to occur, the prospects of catching closer cases or retrieving the moneys that should be retreived from persons who, as you have described them, are "thieves" becomes much more difficult, and the universe of those who would escape through this larger mesh is much larger. Is that not true?

Mr. FEDDERS. I only disagree with some of the adjectives you have used. Whether it is much more difficult or not, as I began to say before, I think that when a jury goes into its chambers, or a judge, that basically, whether it is preponderance, clear and convincing, they make a determination of innocence or guilt, did the guy do it or did he not do it.

Mr. DINGELL. You regard, then, the difference between the two as being simply a matter of technicality?

Mr. FEDDERS. No, not at all. I am too wise to make that foolish statement.

Mr. DINGELL. Then I am not quite clear on how you purport to distinguish between the two. If the words mean what they say, and if they mean what, for example, Black's Law Dictionary says, then we must assume that they in fact differ in meaning, that those differences have significance, and that folks who might escape under one would not escape under the other. Now, am I in error?

Mr. FEDDERS. No, you are not in error, but I have read some of the psychology of juries and judges and things of that nature. I want to preface this remark by saying I am—with the preponderance of evidence, I am not advocating—besides, we are getting into an intellectual discussion right now that is important, but I am an advocate for preponderance of evidence where we are.

Mr. DINGELL. I am happy to hear that.

Mr. FEDDERS. Now, if with regard to the civil treble penalty, that extraordinary burden that we are going to sanction these with, Congress says, look, with regard to that treble amount, we are going to raise the burden of proof, that is more acceptable, but if this Congress ever begins to tamper with preponderance of evidence with regard to the underlying violations in 10b–5 and in other areas of the Federal securities laws, or if there is a spillover from raising the burden of proof in the treble area to underlying violations and other areas of the securities laws, you are going to hurt our prosecution, and you cannot do that, and I do not think you intend to.

Mr. DINGELL. I think you are absolutely correct on that point, and that is something I think we should be very much fearful of. You have here a rather arcane, obscure, and difficult field of the law. You have cases which you often have to prove through circumstantial evidence, and those cases involve fraud which threatens the faith of the entire universe of investors in the securities market.

And I am curious about how the Congress can seriously consider weakening on the one hand while we purport to strengthen on the other the laws against something which you have described as thievery. That there are parties here this morning advocating that, and changes with similar effect, is something which I find enormously troublesome. I just feel very strongly that there should be no weakening of this particular statute, and I hope the Commission does not this morning make or support any such amendments, particularly the suggestion that the proposal with regard to the burden of proof in connection with the treble damages should be in any fashion weakened. Am I in any error on that statement?

Commissioner Longstreth, do you have any comment?

Mr. LONGSTRETH. I think that we are getting a little twisted around here on the burden of proof. The Commission submitted a bill which said that we have a set of violations that have been defined by the courts and accepted by not only this country's securities markets and the public here but in every other country that has looked at insider trading. They have said it is wrong.

So, we have a core of violations, and we are trying to enforce the law against the violators, and we have found, and I think it is generally accepted, that our sanctions are inadequate to deter anyone who would be classified as a risk taker. He is just going to take the risk because the slap on the wrist that he gets is inadequate.

So, we submitted a bill which focused on sanctions for this well-known violation. It has some uncertainties out at the periphery, but the core of it is well-known. A guy with inside information trading on that information. It is a sure thing. I think that if the Congress were now to increase the burden of proof for this violation that we are talking about, you simply move the ground underneath the Commission, and since these cases are all rooted in circumstantial evidence, you are going to make it far more difficult for the Commission to succeed in a case.

And I do not know the minds of the jury or the judge as well as John Fedders does, because I have not been a litigator as he has for so many years, but I do know the mind of at least one Commissioner, and we take our responsibilities in deciding whether to bring a case, whether to go out and involve our powers, subpena powers and so on, very seriously, and we try to comply with what the Supreme Court has told us is the burden of proof that we have to meet to bring a case.

So, I can say if you raise the standard, it is going to change my attitude. It has to change my attitude about the cases I am willing to bring.

Mr. DINGELL. Or the cases that you can refer to the courts for appropriate action, either civil or criminal.

Mr. LONGSTRETH. What I am saying is, we will not be investigating the same cases, because if we do not feel that we can make the case with clear and convincing evidence, we will not be bringing the case. So there is going to be a difference, and I find it ironic that here we submitted a bill saying we need better sanctions for an existing violation, and there is an idea that we are going to change the existing violation to make the burden of proof higher. There are a lot of legitimate comments that have been made, but I find that one simply off the wall.

Mr. SHAD. The statement was made that——

Mr. WIRTH. If the gentleman would yield for just a moment, I mean, I find Mr. Longstreth's statement just excellent on this whole subject. As Chairman Dingell, is pointing out, we have a piece of legislation that was sent up to us by the SEC, unanimously agreed to by the Commissioners, and now it seems to me that we are seeing some potential backsliding or, as you said, Commissioner Longstreth, some shifting of the ground.

We had extensive discussion earlier about the definition of insider trading which is rife with the possibility for enormous loopholes being driven through the legislation, and now we are getting into an area of changing the evidence from preponderance of evidence to clear and convincing evidence.

I do not understand why there would be support for that when just recently the Supreme Court in the *Huddleston* case supported the use of the preponderance of evidence test in cases for damages under the Federal securities law antifraud provisions. The Court noted very recently that the preponderance of the evidence standard allows both parties to share the risk in roughly equal fashion. Any other standard expresses a preference for one side's interests.

In going to the Chairman's questions on this, it seems to me that staying with what we have in the statute as proposed by the Commission, and not moving away from it, is in the best public interest, going right to what you were saying, Mr. Longstreth.

I thank the Chairman for yielding.

Mr. FEDDERS. Congressman Wirth, that *Huddleston* case is terribly important to us in the insider trading area, not only what they said on preponderance of evidence, but what they said in footnote 30, which relates to circumstantial evidence, and the Supreme Court said that circumstantial evidence generally ought to be satisfactory to meet the preponderance of evidence test, and we are in an area dealing with circumstantial evidence. So *Huddleston* is very important to us in pleading our insider trading cases.

Mr. DINGELL. Well, Mr. Chairman, I see that red light down there, and I know my time is up, but I do not want anybody to walk out of this room with misunderstandings about what is involved here. Chairman Shad, is it fair to say that you have no way of knowing what percentage of the insider trading cases you catch down there at SEC?

Mr. SHAD. That is correct. As is true with all securities law violations, we do not know the cases that we do not identify. That is true of all law enforcement.

Mr. DINGELL. There is a fair prospect that a goodly number of insider trading cases are going on that you never catch. Is that not correct?

Mr. SHAD. That is correct. And as to all violations.

Mr. DINGELL. And those insider trading cases could affect not only the earnings of particular persons, but also the overall confidence of the trading public in the marketplace. Is that not so?

Mr. SHAD. Well, I would have some reservations about the impact of unknown violations on the market in general. If they are not ventilated in any way, I would think that the market might not give much weight to them.

Mr. DINGELL. There are certainly some rogues out there taking unfair advantages and behaving, as Mr. Fedders has described, as thieves.

Mr. SHAD. Yes. I would like to try to put it in perspective in terms of the order of magnitude of insider trading in one man's opinion. I believe that it is a very tiny fraction of the billions of dollars of securities that change hands daily. I believe that a huge portion is just based on the usual motivations of investors, based on publicly available information.

Mr. DINGELL. Well, I am constrained here on time, and I am already transgressing the rules here. But am I fair in my observation

that the Commission still stands in favor of H.R. 559 as introduced and as submitted by the Commission?

Mr. SHAD. We support the bill.

Mr. DINGELL. Is there any change of position on the part of the Commission in that regard?

Mr. SHAD. We have tried to ventilate in this hearing the serious issues that have been raised by responsible parties since the bill was introduced which had not been considered or reacted to by the full Commission prior to submission of the legislation.

Mr. DINGELL. But the Commission still supports H.R. 559 as introduced?

Mr. SHAD. Yes. We have raised the questions that we think——

Mr. DINGELL. I have no objection to the questions being raised. I find them singularly lacking in merit. But I have no objection to having them raised.

Mr. Chairman, I thank you for your courtesy to me, and Commissioner Longstreth, I want to commend you and have you know that I think you have made a very valuable contribution to our discussion this morning.

Mr. Chairman, I thank you.

Mr. WIRTH. I thank the chairman for joining us, and want to associate myself with his remarks, and wish that I had used the term "rogue" as carefully as the chairman had, and I also want to thank you, Mr. Longstreth, for your contributions to that discussion, as well as you, Mr. Fedders.

We have a vote on the floor now with about 10 minutes to go, a vote on the Journal, and we all must go over and strengthen the fabric of the Republic by voting yes or no on the Journal of yesterday's proceedings. Consequently, if we could be in recess until 20 minutes after 11, and we will come back with further questions for this panel. I thank you for your forebearance. We will be back at 20 minutes after 11.

[Brief recess.]

Mr. WIRTH. The subcommittee will come back to order.

We are asking questions of the witnesses in order of appearance. The gentleman from California, Mr. Bates.

Mr. BATES. Thank you, Mr. Chairman. I appreciate the chance to be able to ask questions today.

I am a relative newcomer to this subcommittee, so I hope you will bear with me. I have a number of questions in determining whether the changes in the law would be sufficient or perhaps would actually deter criminal prosecution. I would like to read from an article that I hope is accurate, and perhaps you can comment on that before I go on, and it reads as follows:

> Insider trading is illegal because it is unfair to the rest of the investing public. It is like playing with marked cards, says one Wall Street securities attorney. But that is not the only problem. Insider trading also threatens the foundations of the securities market which are key to raising capital for industry here and abroad.

And that is a point that I would like to focus a little more on and have you comment.

The SEC is worried that if enough people play with marked cards, honest investors will not join the game with the larger implications of insider trading very serious, and the consequences for those charged with doing it have been surprisingly light. Although insider trading can be both a civil and criminal offense, [illegible] prosecution is all but unknown. Only six people have ever been convicted on criminal charges, and one conviction was overturned.

The SEC says U.S. attorneys are usually just not interested in bringing criminal cases to court because they are tough to prove and are not high priority, and I think in using the *Thomas Reed* case, and I apologize for using that—that is the only one I am familiar with—I do not wish to create for him personally any additional hardship, but in this particular case it has received considerable media coverage, which would give the average investor, it seems to me, the impression that there are a lot of people playing with marked cards, and that is perhaps just circumstantial evidence.

But I have a letter here from Richard Rosenblatt, who is a good friend of mine, not a constituent, but a neighboring—he is from the higher income district next to mine, and he has written me that he has had some involvement with this particular case, and I would like for the record to read some of his letter, and ask his questions, and I may be taking a broader approach to this than the specific legislation before us, and if I am, the Chairman could narrow my focus.

But if I could just take a minute here to read the letter and give you the kind of perspective that I am coming from as a nonattorney who has been contacted by a citizen, it says:

> I spoke to you briefly the other day concerning my reading an article on the Thomas Reed affair which was featured on Sixty Minutes on CBS last Sunday night. In the event we do not reach each other, I am sending you some of the information on the matter which I uncovered more than a year ago.
>
> You will find here a copy of Common Cause Magazine containing an article by Julie Kosterlitz on the matter. At the time of that article, most of the events had not yet taken place. Additionally, there has been a good deal of research since. The article is based on a letter I wrote to Archibald Cox several months before.
>
> In March of 1981 I retained the prominent attorney Louis Nizer to investigate some suspicious occurrences at Amax, a public mining company in which I had an interest. The press got wind of this, and there were numerous articles about my having taken this step. At that time it was discovered that a son of one of the directors had made a killing in the market.
>
> At that time, this was not particularly my concern, and the matter was dropped when Mr. Nizer determined that legal action would, given the information we had at the time, be unproductive, but months later, I saw an announcement in the newspapers that the son of Reed, Thomas Reed, had been appointed to the National Security Council in the White House. I was very much concerned that we would have someone with such a questionable background in so high and sensitive a position.
>
> In March of 1982, I wrote to Judge Clark, chairman of the National Security Council, calling to his attention Mr. Reed's background and the stories I had read a year earlier about his questionable dealings. A number of months later, I read in William Safire's column in the New York Times that Thomas Reed was to be the next chairman of the National Security Council, and this is the job formerly held by Kissinger and Brzezinski.
>
> In view of Reed's irrational behavior at the time of the insider trading affair and other news which was beginning to surface, I contacted Archibald Cox and Common Cause. They obtained a Freedom of Information order, and got to the closely guarded records of the examinations under oath of the witnesses in the insider trading investigation, including sworn statements of Reed which resulted in Reed paying $427,000 back.
>
> Actually, it would appear that he made several million dollars at that time, and the reason I am providing this background is to let you know that I have some basis for these questions in trying to get to some of what appears to be a much broader issue than this legislation, that it does not address that I think undermines the entire Securities and Exchange Commission.

The statements included admissions by Reed—the statements included admissions by Reed of forgery and other falsifications of federal documents. I asked a mutual friend of mine and of Judge Clark's to intercede to make sure that Mr. Reed would not receive the position and that he would be removed from the National Security Council. This resulted in no action whatsoever, and I wrote to Clark again in strong terms.

I received a reply from Clark's assistant at the National Security Council and the chief security officer who had cleared Reed for the highest top secret and top nuclear clearances. He denied any improper acts on the part of Reed and openly denied everything which Reed had admitted in his deposition and including other statements of other people involved.

Having received that letter, which was an outright set of lies, I sent my White House file, including a letter to the head of enforcement at the SEC, and to others at the SEC.

And I guess you received these.

Mr. FEDDERS. I have corresponded with Mr. Rosenblatt. Indeed, my conversations and communications with him were the subject of questions in an exchange between members of the Senate Securities Subcommittee and myself.

Mr. BATES. I got no reaction except an acknowledgement from the chief of enforcement at the SEC, but someone leaked the file to Mike Wallace.

Mr. FEDDERS. I never communicated——

Mr. BATES. No; I am not accusing you.

Mr. FEDDERS. No, I neither leaked the file nor did I write Mr. Rosenblatt. That is the point.

Mr. BATES. Whoever leaked the file, I want to publicly thank them.

It appears he went to Chairman Dingell, Chairman of the House Energy and Commerce Committee, who went marching into the White House with my White House file. The reaction of the White House was to start an investigation on who leaked the file to Mr. Dingell. At present they are conducting lie detector tests to find out.

There are a number of prominent people involved in this, including former President Gerald Ford, who is also a director of Amax, presumably appointed by Reed's father, and who had conversations with Reed at the same time, and all of these raise questions which I would like to address to you.

I have got to answer these questions, so I will ask them now, and hopefully you might have some answers.

How do people get clearances at the White House? How do people get appointed to the highest jobs at the White House? How corrupting are campaign donations? He gave $1,270,000 to Reagan's campaign. What is the process by which people get elected to the board of directors of public companies? What influence does the White House have over the SEC? If insider trading is a crime, why is not the maximum penalty a consent decree and paying back of the improperly acquired profit? To what extent has the White House adopted lying as its normal way of answering questions? Should we be increasing our first strike nuclear capability if it is to be placed in the hands of inept, incompetent, and greedy political appointees lacking judgment?

So, that is the letter. But the question I have with respect to whether in these cases the possibility exists that people can be appointed to extremely high and sensitive positions, that when there is an allegation or an investigation, and when it is settled, that that official record be the official response rather than the one sent by the White House, which reads as follows:

Dear Mr. Rosenblatt: William P. Clark has referred to me your letter of January 31 recalling your earlier letter complaining of the association of Thomas Reed with the National Security Council following disclosure of the Securities and Exchange Commission investigation of Mr. Reed's Amax option transactions.

It is certainly understandable that any person aware of circumstances appearing in media accounts of the Amax transactions would entertain the concerns expressed by you. However, the charges were fully investigated by the SEC, and after an investigation and the taking of depositions of all concerned parties and agencies, the charges were dismissed, notwithstanding their rather damning circumstantial evidence.

There is no direct evidence that Mr. Reed used insider information. He has not confessed to the entry of any decree, and none has been entered. He has not paid $432,000, and he has consistently maintained his innocence. He has no beneficial interest in profits made in the transaction, and while he paid for the purchase of the options, he purchased them for the benefit of other persons, employees, associates, and family members. The $432,000 you mentioned in your letter are other personal funds which Mr. Reed has transferred in trust for designated charitable and other purposes.

An independent investigation by the NSC has failed to disclose any improper conduct by Mr. Reed, and the investigating staff officers concluded that Mr. Reed's association with the NSC posed no risk of breach of the national security and expressed confidence in his integrity and judgment.

It thus appears that detailed, objective investigations have failed to sustain the circumstantial inferences of improprieties. Thank you for your interest. Sincerely, Richard C. Morris, Special Assistant to William P. Clark, The White House.

So, I guess after laying that groundwork my first question really would be, is it true that all charges were dismissed against Mr. Reed as claimed in this letter from the White House?

Mr. SHAD. The case was settled, and we then terminated the case.

Mr. BATES. Terminated and settled? I have not heard you use the word "dismissed." "Dismissed" I thought was a legal term. I campaigned on the slogan that I was not an attorney and I have never had legal background. Is there a difference between being dismissed and terminated or settled?

Mr. FEDDERS. The document that was the ultimate resolution of the matter bore several titles. I think it was called Stipulation Order and Dismissal. "Termination" was the fourth word in the caption. As we have explained several times, the case was—if it was dismissed at all, it was dismissed with an order, which is punishable if it violated—is punishable by criminal contempt that Mr. Reed not trade on material nonpublic information, again, insider trading.

There was a total disgorgement, too, that was put in escrow for distribution to those people who were deemed to be the beneficiaries or to have been defrauded by the transactions.

So, if there was a dismissal, that term was used, correct, in the caption of the pleading, but it was dismissed with a court order and with disgorgement. The case was not—the connotation that has been put on the word "dismissal" is that it was dropped without any resolution at all, and that is incorrect.

Mr. BATES. And that is the point I am trying to make, that I think it is a real disservice to this gentleman and others in the public to give the impression that everything is fine.

Now, I do not want to get into the case and pass any judgments, but I think this is an extremely misleading letter to receive, and I am wondering to the extent that the article and the other documents indicate that these kinds of incidents of insider trading are not done by the single party or the beneficiary, that you have members of the boards of directors and others that are in the posi-

tion to have this information that is passed on to someone who would purchase these options.

So, my first question really is, is there not a way where we have people in very high places, and there are these kinds of incidents that we cannot include in the law, that the official statement include the facts that occurred, and not a letter that attempts to completely dismiss this, and I think if we were talking about just an ordinary employment, that might not be necessary, but I think where you have top security and nuclear clearances, that might be in order.

And I would ask your response to that point.

Mr. SHAD. Well, that does go well beyond the SEC's area of jurisdiction, and that would be a matter for your colleagues. It would be unusual to add that to this bill.

Mr. WIRTH. If the gentleman would yield, I think the gentleman raises a very significant issue and a very real one in terms of the integrity of the political process and the clear explanation of what is going on, and Chairman Shad is correct. I think the issue goes far beyond the SEC, and is probably more appropriately raised with our colleagues on the Committee on Government Operations, and Mr. Brooks, to really focus on this issue.

Mr. BATES. Well, I appreciate that clarification, and I thought that might be the case, so that is why I hesitated bringing this up, but I think the underlying point for me is, if these changes in the law were to occur, would they be vigorously enforced, and do you think they would be effective, or do we need to broaden them?

It just seems to me that we have had an incident that has been publicized and it has been brought to our attention, and we are kind of grappling to try and get what I think everyone would agree is necessary, stronger penalties, but then can you in light of the statement with six convictions on criminal sanctions, can you go out and do the job, and if this does not do the job, what will do the job? Because what I am seeking is a much tougher criminal sanction. I think that the whole process has been undermined, and it has got to really be serious. We have been toughening up burglaries and robberies, and armed robbery and everything else across the country. Drunk driving is starting to get some attention, and yet these white collar crimes, we are just getting around to, and what are the tools you need to do the job?

Mr. FEDDERS. Congressman, you raise a number of very interesting issues, one of them being what are we doing? We survey the market as carefully as we can. We are vigorously investigating these things. We are prosecuting as diligently as we can even on circumstantial evidence. We are here because we think that the deterrent level has to be raised. That is why we are seeking this bill.

One other area you raise is what can we do to increase the criminal prosecution of insider trading. I think there is a potential fallout that should this bill be approved and passed and signed into law, that there will be less criminal prosecution of insider trading.

In my rationale—I have never shared this with anyone else, but my view is that the criminal prosecutors may very well decide that enough is enough. The chap has been enjoined. He has been required to disgorge his ill-gained profits. He has been required to pay treble damages. And does the criminal process then have to impose itself on the individual? I foresee that as a potential fallout.

Mr. BATES. Let me just add, when my constituents go to jail for stealing a few thousand dollars, it is hard for me to reconcile your statement that paying back the profits, in other words, losing the gain, much less paying any penalty for your actions, is fair. I simply cannot accept that.

Mr. FEDDERS. I am not suggesting that.

Mr. BATES. I am asking you, please, if you will tell me how to toughen this so that it is tougher penalties.

Mr. FEDDERS. Pass the bill as promptly as possible.

Mr. BATES. Thank you.

Mr. WIRTH. Thank you, Mr. Bates. And we will be happy to have the staff work with you in any suggestions or approaches you might want to make to Mr. Brooks and the Committee on Government Operations. I might also add, as I think Mr. Fedders noted, or Mr. Shad noted, that this correspondence and this issue was examined in great detail with Senator D'Amato's subcommittee. As we said at the opening of the hearing, Senator D'Amato has written to the Subcommittee and very generously offered to us all of the material and correspondence and findings of that set of hearings which we look forward to examining.

Mr. Broyhill.

Mr. BROYHILL. Mr. Chairman, thank you.

Due to a delay in air travel, I was unable to be here at the beginning of this hearing, and I want to welcome the Chairman and his able staff to the hearing this morning.

Mr. Chairman, could you enlighten me as to what definition is in the law presently with respect to the knowledge that is required for a violation of this proposed law or the present law respecting insider trading? Is there a standard in the law?

Mr. SHAD. Under the present law, we have to prove scienter.

Mr. BROYHILL. You have to prove knowledge? There is no statutory definition of the knowledge that is required?

Mr. SHAD. Yes.

Mr. FEDDERS. What we do is, we prosecute under rule 10b-5. The Supreme Court has said that you must prove scienter in establishing a violation of rule 10b-5. We do that, we believe, on circumstantial evidence by meeting the test that the person traded while in possession of material nonpublic information. We do not have to meet the burden of trading "based on" material nonpublic information, so the distinction is, yes, we must meet the scienter standard, but we meet the burden "while in possession of" material nonpublic information as opposed to "trading" based on material nonpublic information.

Mr. BROYHILL. Are there any guidelines for a person who is in a management position—obviously they know more about what is going on in that company than an average investor. Is there any procedure that that person can follow in order to legally dispose of all or any part of his stockholdings in that company?

Mr. FEDDERS. Sure. As long as there is no trading while in possession of material nonpublic information. There is a rule 16-b that is a specific rule arbitrarily drafted with regard to short swing profits, there not being buying and selling nor vice versa in any 6-

month period, so a person who is an insider must both obey the rule 16-b by not engaging in short swing purchases or sales, and, second, he or she may not trade while in possession of material nonpublic information.

But I believe that the parameters of these rules are consistent with good law enforcement and good corporate management, fulfillment of fiduciary responsibilities, and provide a person in these positions an effective opportunity to dispose of their interest in these corporations.

Mr. BROYHILL. There is a requirement that these trades be disclosed to the public. Is that not correct?

Mr. FEDDERS. That is correct. Insiders must file initially a form 3 and then a form 4 with regard to transactions.

Mr. BROYHILL. Does that mean advance notice that they are going to trade?

Mr. FEDDERS. It does not. After the fact.

Mr. BROYHILL. What would be your reaction to a proposal saying that there should be advance notice?

Mr. FEDDERS. I have never personally thought it through. If a person has lettered stock and is dribbling those into the marketplace in accordance with rule 144, there is advance notice by the filing of a form 144, but let us put legended stock aside. I think that does not occur with the frequency of an insider selling unlegended securities. That would place an enormous burden upon the individual to make determinations. The concept is easier to grab than the mechanics. How long in advance does he have to file this report? If he files the report, is he compelled to sell or buy the shares? So there is an awful lot of mechanics that are associated with it. I have never thought it through.

Mr. LEVINE. Could I offer one suggestion? The violation is failing to disclose information that he has. By putting in the fact he is selling, it would not cure the defrauding of the shareholder who is buying or vice versa necessarily, because that person would not know unless you also required him to disclose the information he had. Remember, the violation is not the selling, but the failure to disclose the information he possesses which the other people do not possess, so you would have to go further if you did it and actually put information out, which is the whole purpose here. It is either abstaining from trading or disclose what you know. Have I made myself clear?

Mr. BROYHILL. I understand that. I am really thinking perhaps of cases where persons—it might be alleged because they are in a management position they may have knowledge that others do not have. However, they may for whatever reasons have need to dispose of all or a portion of their holdings in that particular company.

Mr. FEDDERS. The rule, the prohibition on insider trading does not relate to knowledge of just any kind of information. Certainly an insider would have much more information than an outsider with regard to the mechanics of the corporation and other aspects of it, but what we are talking about here is material nonpublic information, material information that falls within the definition of *TSC* v. *Northway*. That has been very carefully defined by the Supreme Court.

Mr. BROYHILL. This bill permits the Commission to bring action in district court to seek civil penalties for violations of this law. Could we go beyond this? Has the Commission ever considered asking the Congress for other authority, more general authority to seek civil penalties for violations of various parts of the securities laws?

Mr. GOELZER. Well, I do not believe we have ever sought such authority. As Mr. Fedders mentioned earlier in this hearing, that is something that his staff has had under consideration for the last year or so, while the report has been prepared or is in the process of being prepared, which will be submitted to the Commission. The Commission itself has not considered that issue at this time.

Mr. BROYHILL. You say that a report is being prepared and you will address this point?

Mr. FEDDERS. In November of 1981, I undertook with the Commission's approval to study the question of whether the Commission needed additional enforcement remedies available to it to be effective in fulfilling its law enforcement responsibilities. We studied at that time a number of kinds of remedies. Included in that was administrative or civil fines; second, the possibility of utilizing cease and desist orders; and third, the expansion of administrative proceedings under rule 15C.

We have concluded some of this study, and we are working on a memorandum to the Commission at this time.

Mr. BROYHILL. Could you inform us as to when this might be forthcoming?

Mr. FEDDERS. The most important priority I have right now is law enforcement. This is ancillary to that. It is an important ancillary responsibility. I cannot give you a fixed time, but whenever we have law enforcement responsibilities that need to be met, we take people off of projects like that and we prosecute our cases. But we are hopeful that over the next several months we will be able to get it to the Commission and the Commission will have time to study it. It is very, very complex. I thought when I began this maybe a bit cavalierly on my own part that we could come to some easy resolution in this area, that as you studied it, there would have been an idea that was worthy, and that you would immediately grab onto it.

As I said earlier in testimony, I find the question much more difficult today than I did in November of 1981.

Mr. BROYHILL. Thank you, Mr. Chairman.

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

Just summarizing on that, Mr. Shad or Mr. Fedders, on the civil fine, cease and desist and administrative proceedings, when do we anticipate hearing from the Commission on these subjects?

Mr. SHAD. Well, the first—the memo has to come up, of course, and then the areas that have not yet been addressed are the cost-benefit aspects of such legislation.

Mr. WIRTH. Let me ask the question again. When could we expect to hear from the Commission on this?

Mr. SHAD. The summertime, late summer probably.

Mr. WIRTH. Let me just turn to a bit of a different topic, if I might. In a recent speech, Commissioner Treadway talked about the problem that he called cooked books, meaning false financial

Mr. WIRTH. The Commissioner went on to say that eradication of cooked books deserves the highest priority. Would you like to comment on that, Mr. Shad or Mr. Fedders or Mr. Longstreth?

Mr. SHAD. Well, it is an area that we are very active in right now. The recession has brought out more of those cases than we have seen in the past and we have brought some very important proceedings under the present law. We have not raised the issue of whether we need more authority in that area.

Mr. FEDDERS. I concur entirely in what Commissioner Treadway has said. Whether it is my predecessor or my successor, I think it is a top priority of the Commission and will always be—fraud by financial reporting companies. We have over the past year taken steps to improve our capabilities in this area.

One of the most significant was the hiring of one individual, Glenn Perry, who sits four or five rows behind me now, who was a senior partner at the firm of Peat, Marwick & Mitchell, a man of enormous capabilities and integrity in the whole area of financial fraud and how public companies operate, and he has brought new skills and new management techniques to us to improve our capabilities in this area.

We are working on a broad number of cases in this area and I think those that we have already brought this year and what we will bring for the remainder of the year will demonstrate that this is our top priority.

Mr. WIRTH. The cooked books activity even being more important than the insider trading?

Mr. FEDDERS. Insider trading has been ballyhooed by the press and made bigger than life. I do not think it is an unwinnable war. I think we are doing a hell of a job in the area. We are getting the butcher, the baker and the candlestick maker, and we are not going to eradicate insider trading, and we are not going to eradicate corporate fraud.

But the press has brought this enormous publicity to insider trading. Last year, it consumed 8 percent of 250-plus cases that we brought—only 20 cases. Sure it consumed a bit more time, about 15 percent of our time with regard to resources, but it was a top priority. But there is no way that you can compare insider trading as a priority to two other areas, that being cooked books, or—broaden the terms—fraud by financial reporting companies, which is what cooked books is all about, and, second, our enforcement program against regulated entities, broker dealers, brokerage firms.

Insider trading or any other priority that comes about will never replace those two as number one and number two because that is the business we are in.

Mr. WIRTH. If you agree that the cooked books issue is very significant, and the evidence seems to be from everything that I have read that this is a problem that is growing in its occurrence and in the size and scope of the problem, when would we expect to hear from you back on the question of cooked books?

Mr. FEDDERS. I think you have seen some cases in the past several months. You have seen them all the time. We have had an enormous number of cases that we brought under the Foreign Corrupt Practices Act, the accounting provisions, and Mr. Wade can always give you the exact number. How many Foreign Corrupt Practices Act cases have we brought in the last 18 months?

Mr. WADE. I am sorry I do not have the exact number at this time, but it is approximately 24 altogether have been brought since the Act was enacted, and I would say approximately two-thirds of those in the last 18 months.

Mr. WIRTH. Perhaps it is appropriate to get into the question of those accounting provisions. Mr. Levine, at a recent SEC conference you spoke about the importance of the Foreign Corrupt Practices Act accounting provisions passed by this committee in 1977 and the relationship of those provisions to the Commission's current activities in accounting cases.

Can you tell the committee how you have used these provisions in recent accounting cases?

Mr. LEVINE. I think they serve an important—they have important utilization both in our enforcement action and also in the discipline in the corporate governmenance system. Number one, it helps the independent auditors who the Commission relies upon to look at the financial condition and books and records of the company and then they have to certify to us about the accuracy of them.

It makes that job easier because it makes the records more reliable—the requirement to have accurate books and records and a good system of internal controls—and I think that is a benefit in terms of what we see. It makes the auditor's job easier in terms of the enforcement action. It gives us the ability to pursue a breakdown in books and records or internal controls with an allegation in a complaint other than simply a failure to disclose. It also gives us the ability to proceed where there is, and we are talking about a large breakdown in either internal controls or inaccurate books and records, such as overstatement of sales, fictitious inventory, some of the problems we are seeing now.

When you couple those together, those are the benefits that I see, one, from the point of view of the self-discipline in the system for the corporations and the auditors looking at them and, two, from the point of view of when we prosecute the case.

Mr. WIRTH. So these provisions have been helpful both for the auditors and in terms of your enforcement activities at the SEC?

Mr. LEVINE. In my judgment, they have been and we have utilized them, as Mr. Fedders just indicated.

Mr. SHAD. But may I add that, of the cases we have brought under those provisions of the Foreign Corrupt Practices Act, I believe without exception we could have brought the cases because of other associated violations. That is, they were not based solely on those provisions. Is that correct?

Mr. FEDDERS. Yes. There is only one case that the Commission has brought where the Foreign Corrupt Practices Act charge was not a companion to some other charge.

Mr. WIRTH. It is a helpful tool, though, as Mr. Levine would suggest. Is that not correct?

Mr. FEDDERS. It is a very helpful tool. That does not mean that there are not some ambiguities. You and I have had the pleasure of discussing that before.

Mr. WIRTH. Have you found these provisions confusing or difficult to enforce, Mr. Levine?