# COMMENT

# The Insider Trading Sanctions Act of 1984: Did Congress and the SEC Go Home Too Early?

*Like much legislation, the Insider Trading Sanctions Act of 1984 (ITSA) raises more questions than it answers. While the ITSA increases penalties for insider trading and disclosure violations, it does not define insider trading, clarify secondary participant liability, or guide judicial decisionmaking. This Comment continues where the SEC and Congress left off by proposing additional legislation necessary to achieve the ITSA's deterrence objective.*

## INTRODUCTION

Congress enacted the Insider Trading Sanctions Act of 1984 (ITSA)[1] when the public perceived that the Securities and Exchange Commission (SEC) was fighting an unwinnable war against insider trading.[2] A former National Security Adviser had reaped over $400,000 purchasing options in a corporation he secretly learned was a takeover target.[3] The Secretary of Defense resigned when the SEC discovered that he had

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[1] Pub. L. No. 98-376, 98 Stat. 1264 (1984) (codified at various sections throughout 15 U.S.C. § 78) [hereafter ITSA].

[2] Landerman, Glaberson, Marcial, Philipps & Frank, *The Epidemic of Insider Trading*, BUS. WK., Apr. 29, 1985, at 78-92 [hereafter *Insider Trading Epidemic*]; Louis, *The Unwinnable War on Insider Trading*, FORTUNE, July 13, 1981, at 72-82; Pauly, Weathers, Ipsen & Bentley, *Crackdown on Insiders*, NEWSWEEK, Nov. 16, 1981, at 77-78.

[3] *See* United States v. Reed, 601 F. Supp. 685, 691 (S.D.N.Y. 1985); *see also* discussion in *Insider Trading Sanctions and SEC Enforcement Legislation: Hearing on H.R. 559 Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce*, 98th Cong., 1st Sess. 66-69 (1983) (statement of Rep. Bates) [hereafter *House Hearing*].

tipped confidential corporate information to his receptionist.[4] Congress feared that these stock market transactions undermined investor confidence, and thus discouraged investment.[5] However, restrained by practicalities,[6] Congress failed to enact far-reaching legislation to curb such abuses and restore investor confidence. Instead, Congress enacted only limited provisions to enhance the SEC's enforcement remedies.[7]

The ITSA's primary provision enables the SEC to seek treble damages against inside traders.[8] This treble penalty provision increases insider trading risks and should deter those who might have accepted the risks of previous sanctions.[9] The ITSA's second important provision authorizes the SEC to order individuals who cause reporting violations to comply with SEC regulations.[10] This administrative remedy should compel corporate officers, directors, and employees to comply with SEC reporting requirements.[11]

While these provisions enhance the SEC's enforcement capabilities, their uncertain application and scope undermine their deterrent effect. The treble penalty provision increases insider trading sanctions, but does not help the SEC identify insiders. The ITSA does not clarify which secondary participants are subject to treble penalties and which factors courts should examine when assessing treble penalties. While the administrative remedy enables the SEC to correct single reporting violations, it does not enable the SEC to deter repeat offenders. Failing to clarify the SEC's enforcement remedies will either permit repeat violations or induce the SEC to impose sanctions that exceed its adminis-

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[4] 130 CONG. REC. H7757-58 (daily ed. July 25, 1984) (statement of Rep. Dingell) (former Defense Secretary Paul Thayer resigned after allegedly tipping inside information he learned while chairman of the LTV Corporation); *Thayer, Others to Settle Case for $1 Million*, Wall St. J., May 8, 1985, at 3, col. 1.

[5] *The Insider Trading Sanctions Act of 1983: Hearing on H.R. 559 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 98th Cong., 2d Sess. 1-2 (1984) (statement of Sen. D'Amato) [hereafter *Senate Hearing*]; H.R. REP. NO. 355, 98th Cong., 1st Sess. 2 (1983), *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 2274, 2275 [hereafter *House Report*].

[6] Both congressional and SEC officials recognized that implying private causes of action or defining insider trading might delay or prevent the ITSA's passage. They feared that by attempting to enact broad legislation they would lose the opportunity to enact the ITSA's treble penalty provision. *Senate Hearing*, *supra* note 5, at 36 (statement of SEC Enforcement Director John M. Fedders); *House Hearing*, *supra* note 3, at 230 (statement of Rep. Wirth).

[7] ITSA §§ 2, 4.

[8] *Id.* § 2.

[9] *See infra* text accompanying notes 100-08.

[10] ITSA § 4.

[11] *See infra* text accompanying notes 109-18.

trative authority.

Because the ITSA's limited provisions fail to correct the abuses Congress and the SEC intended to address, this Comment proposes additional legislation. Part I analyzes regulatory gaps that permit insider trading and disclosure violations. Part II examines the ITSA's remedies and how Congress and the SEC expect these remedies to deter securities law violations. Part III demonstrates that the inefficacy of these remedies means that further legislation is necessary. This Comment proposes four amendments to define insider trading, clarify the scope and application of the ITSA's treble penalty, and augment the SEC's administrative authority. These proposals would effectuate the deterrent impact Congress and the SEC intended.

## I. Regulatory Gaps in Present Law

### *A. Insider Trading*

The SEC lacks adequate theories and remedies to prosecute and deter insider trading. To prosecute inside traders, the SEC must employ the broadly worded authority of rule 10b-5.[12] Rule 10b-5 prohibits using fraudulent or deceptive devices in connection with the purchase or sale of a security.[13] However, relying on common law fraud principles, the courts have fashioned narrow fiduciary duty theories under which the SEC must prosecute inside traders.[14] These theories' limited applications have created gaps in the regulation of insider trading.[15] Fur-

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[12] 17 C.F.R. § 240.10b-5 (1985). Rule 10b-5 derives from § 10(b) of the Securities Exchange Act of 1934. 15 U.S.C. § 78j(b) (1982). Although § 10(b) does not grant explicitly a private cause of action, courts assume that one exists. Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983) ("The existence of this private remedy is simply beyond peradventure.").

[13] 17 C.F.R. § 240.10b-5 (1985). Rule 10b-5 provides: "It shall be unlawful for any person, . . .

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact . . . ,

(c) To engage in any act, practice or course of business which operates or would operate as a fraud . . . ."

*See generally* A. Jacobs, Litigation and Practice Under Rule 10b-5 (rev. 2d ed. 1985).

[14] *See infra* text accompanying notes 17-71.

[15] An American Bar Association Task Force reached a similar conclusion after reviewing the insider trading case law. Committee on Federal Regulation of Securities, *Report of the Task Force on Regulation of Insider Trading Part I: Regulation Under the Antifraud Provisions of the Securities Exchange Act of 1934*, 41 Bus. Law 223, 247 (1985) [hereafter *ABA Report*].

thermore, even when the SEC identifies and prosecutes inside traders, it lacks effective sanctions to deter future violations.

1. Fiduciary Duty Theories

*a. Insiders*

One category of fiduciaries subject to prosecution includes corporate insiders, such as directors, officers, and controlling shareholders.[16] These insiders must either disclose nonpublic information or abstain from trading on the basis of that information.[17] Early cases held that the disclose or abstain obligation applied to all persons possessing nonpublic corporate information.[18] In *Chiarella v. United States*,[19] the Supreme Court reversed this trend and held that "mere possession" of corporate information does not impose a duty to disclose or abstain.[20] In *Chiarella*, and later in *Dirks v. SEC*,[21] the Court held that to be culpable the inside trader must owe the plaintiff a fiduciary duty.[22] In *Dirks* the Court added that a person may assume this fiduciary duty when she learns information that the corporation expects her to keep secret or when her relationship to the corporation indicates that she should not disclose the information.[23]

The *Chiarella* line of cases required a fiduciary relationship between

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[16] Strong v. Repide, 213 U.S. 419, 431-32 (1909); *In re* Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961); L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 830-31 (1983).

[17] L. LOSS, *supra* note 16, at 823-29. The SEC explained the policies underlying this disclose or abstain rule in *Cady, Roberts*, 40 S.E.C. at 912:

> [F]irst, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.

[18] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) ("anyone in possession of material inside information must either disclose it to the investing public, or, . . . abstain from trading . . . ."); *see also* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 236 (2d Cir. 1974).

[19] 445 U.S. 222 (1980).

[20] *Id.* at 235.

[21] 463 U.S. 646 (1983).

[22] *Dirks*, 463 U.S. at 654-55; *Chiarella*, 445 U.S. at 232.

[23] *Dirks*, 463 U.S. at 655 n.14. Dirks was a market analyst who learned from a corporation's former director that the corporation had misstated its assets. The Court held that Dirks did not have a fiduciary duty to disclose or abstain from tipping his employer's clients. Dirks did not induce others to repose trust in him, and the former director did not expect him to keep the information secret. *Id.* at 665.

the insider and the trading shareholder. In *Chiarella*, a printer correctly identified a corporation's merger targets when he processed some of the corporation's documents. The Court held that when the printer subsequently traded in the target's securities, he did so lawfully.[24] The printer did not owe the target's shareholders a fiduciary duty because he was not an officer, director, or controlling shareholder of the target and the target company had not placed its confidence in him.[25] In *Walton v. Morgan Stanley & Co.*,[26] an investment banking firm retained by the acquiring corporation purchased the target's shares for its own account. The Second Circuit held these purchases did not violate rule 10b-5 because the firm dealt with the target at arm's length and thus did not owe its shareholders a fiduciary duty.[27] In *SEC v. Switzer*,[28] a district court case, the defendant "overheard" a corporate insider tell his wife of an impending takeover. The court held that the defendant had no duty to refrain from purchasing the target's securities because the insider did not expect the defendant to keep the information secret.[29]

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[24] *Chiarella*, 445 U.S. at 232.

[25] The Court noted that Chiarella "was not a person in whom the sellers had placed their trust and confidence." *Id.*

[26] 623 F.2d 796 (2d Cir. 1980).

[27] *Id.* at 798-99. *Walton* appears inconsistent with a post-*Dirks* decision, SEC v. Lund, 570 F. Supp. 1397 (C.D. Cal. 1983). Defendant Lund learned material inside information from Horowitz, a business acquaintance. Horowitz had asked Lund to invest in a joint venture Horowitz' corporation was planning. Lund refused the offer, but instead purchased stock in Horowitz' corporation. The court held that Lund was a "temporary" insider and had violated the fiduciary duty he owed the corporation's shareholders. *Id.* at 1403; *see Dirks*, 463 U.S. at 655 n.14; *supra* note 23 and accompanying text. The court found that Horowitz expected Lund to keep the information confidential and had made the information available to Lund solely for corporate purposes. *Lund*, 570 F. Supp. at 1403.

*Walton* and *Lund* appear inconsistent because Lund, like Morgan Stanley, dealt with the corporate insider at arm's length. Arguably, this difference indicates that *Dirks* may have closed rather than created gaps in insider trading regulation. However, the difference also may be that the firm in *Walton* worked for the acquiring corporation and never had a working relationship with the target corporation. The corporate insider in *Lund* offered defendant an opportunity to enter the joint venture with the target corporation. Hiler, Dirks v. SEC — *A Study in Cause and Effect*, 43 MD. L. REV. 292, 340 (1984). Other commentators have criticized *Lund* for relying on a "tenuous temporary fiduciary relationship." Langevoort, *The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*, 37 VAND. L. REV. 1273, 1289 (1984); *see also* Freeman, *The Insider Trading Sanctions Bill — A Neglected Opportunity*, *reprinted in Senate Hearing*, *supra* note 5, at 77.

[28] 590 F. Supp. 756 (W.D. Okla. 1984).

[29] *Id.* at 765. Defendant Switzer overheard the conversation while sitting behind the

The fiduciary duty requirement creates regulatory gaps by focusing on the insider's relationship with the plaintiff, rather than on the nature of defendant's unlawful conduct. In *Chiarella* and *Walton*, for example, the defendants would have violated the securities laws if the merger target had retained their services because the target company would have expected them to keep the information secret.[30] Since the acquiring corporations retained their services, however, they owed no fiduciary duties to the plaintiffs who sold them the target corporation's shares.[31] Consequently, by focusing on the defendant's relationship with the plaintiffs, rather than the nature of the defendant's unlawful conduct, the fiduciary duty requirement allows defendants to capitalize on unfair informational advantages. Allowing these defendants to misuse confidential corporate information undermines investor confidence in the stock market as much as allowing traditional insiders to misuse such information.[32]

### *b. Tippees*

The fiduciary duty requirement also permits tippees of inside information to evade prosecution. A tippee's fiduciary duty is derivative: it arises when the tipper breaches a fiduciary duty and the tippee has reason to know of the tipper's breach.[33] A tipper breaches her fiduciary duty when she "will personally benefit, directly or indirectly," from the tip.[34]

Requiring that the tipper benefit and the tippee know of this benefit can create arguably unfair holdings. In *Dirks*, a corporate insider told a market analyst that the corporation had misstated its assets. The ana-

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corporate insider at a track meet. *Id.* at 762. The court held that Switzer had not acquired any "position of trust or confidence" with the target. *Id.* at 765.

[30] *See Dirks*, 463 U.S. at 655 n.14; *Lund*, 570 F. Supp. at 1403.

[31] Chiarella was "a complete stranger who dealt with the sellers only through impersonal market transactions." *Chiarella*, 445 U.S. at 232; *see also* Hiler, *supra* note 27, at 340.

[32] There is an "inherent unfairness involved where one takes advantage of information intended to be available only for a corporate purpose and not for the personal benefit of anyone." *Dirks*, 463 U.S. at 654 (quoting *In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933, 936 (1968)). Chiarella "misappropriated — stole to put it bluntly — valuable nonpublic information entrusted to him in the utmost confidence." *Chiarella*, 445 U.S. at 245 (Burger, C.J., dissenting). The victimized shareholders did not consider his trading more fair simply because the acquiring corporation, rather than the target, retained his services. *See infra* note 56.

[33] *Dirks*, 463 U.S. at 660.

[34] *Id.* at 662.

lyst's clients used this information to "unload" fifteen million dollars worth of stock before the news became public.[35] The Supreme Court did not hold the analyst liable because the insider conveyed the information to expose a fraud, not to obtain a benefit.[36] Furthermore, even when the tipper intends to benefit from the tip, the tippee may escape liability if she had no reason to know of the tipper's benefit.[37] Proving that the tippee knew of the tipper's benefit is particularly difficult when the tippee obtained the information through an intermediary.[38]

The fiduciary duty requirement allows tippees to capitalize on unfair informational advantages. Tippees may willfully profit from inside corporate information either if the tipper did not intend to benefit from the tip,[39] or if the tipper was not an insider.[40] Yet, trading shareholders suffer no less damage, and tippees are no less culpable, when these elements are not present.[41] Focusing on factors extraneous to the tip-

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[35] *Id.* at 670 (Blackmun, J., dissenting).

[36] *Id.* at 667. In *Switzer*, the defendant inadvertently overheard news of an impending takeover. *See supra* note 29. Since the SEC could not show that the insider intended the defendant to benefit, the court dismissed the suit. *Switzer*, 590 F. Supp. at 766-67. Similarly, in United States v. Reed, 601 F. Supp. 685 (S.D.N.Y. 1985), an insider tipped news of an impending tender offer to his son. The son used this information to acquire over $400,000 by trading during a 48 hour period. *Id.* at 690-91; *see supra* note 3. The government conceded that it could not prosecute the son as a tippee because the father did not convey the nonpublic information for his personal benefit. *Id.* at 698-99.

[37] State Teachers Retirement Bd. v. Fluor Corp., 592 F. Supp. 592, 595 (S.D.N.Y. 1984). *Fluor* states that the tippee must know the tipper benefited from the tip. *Id.* at 594. The SEC has criticized this language because under *Dirks* proof that the tippee had reason to know of the tipper's breach should suffice. SECURITIES AND EXCHANGE COMMISSION, REPORT TO THE HOUSE COMMITTEE ON ENERGY AND COMMERCE ON *Dirks v. Securities and Exchange Commission* 44 (Aug. 23, 1985) (on file with *U.C. Davis Law Review*) [hereafter SEC REPORT].

[38] *ABA Report, supra* note 15, at 247. As an example of an intermediary, the ABA describes a reporter who overhears two corporate officers discussing a lucrative contract that the corporation has just signed. The reporter then calls his brother-in-law *P*, and the two execute inside trades. As a remote tippee, *P* could not be liable because he had no reason to know that the officers had conveyed the information in breach of their fiduciary duties. *Id.* at 266-67.

[39] *Dirks*, 463 U.S. at 662.

[40] As noted, the tippee's fiduciary duty derives from the tipper's. *See supra* note 33 and accompanying text.

[41] It is difficult to discern any policy justification for resting the determination as to whether a securities fraud has been committed on the source of non-public information. Regardless of how the defendant received the information, his action is . . . equally dishonorable and despicable, and public investors are equally in need of protection.

pees' unlawful conduct, therefore, creates unfair regulatory gaps and undermines investor confidence.[42]

### *c. Misappropriators*

The SEC has attempted to close regulatory gaps by prosecuting inside traders under the misappropriation theory.[43] Misappropriators obtain confidential corporate information from third parties and trade on the basis of that information.[44] The theory's advantage is that it does not require a fiduciary relationship between the defendant and the trading shareholder. Rather, liability attaches because the defendant breached a fiduciary duty owed to the possessor of the misappropriated information.[45]

The misappropriation theory has helped the SEC prosecute defendants who would have escaped prosecution under insider and tippee liability theories. In *United States v. Newman*,[46] investment bankers violated rule 10b-5 by misappropriating impending takeover information from the bank's clients.[47] In *SEC v. Musella*,[48] a law firm's office manager violated rule 10b-5 when he misappropriated information concerning expected takeover targets from the law firm and its client.[49] And recently, in a case with facts identical to *Chiarella*,[50] the employee of a financial printing company who had access to a corporation's documents misappropriated confidential information.[51]

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Poser, *Misuse of Confidential Information Concerning a Tender Offer as a Securities Fraud*, 49 BROOKLYN L. REV. 1265, 1270 (1983); *see also* United States v. Reed, 601 F. Supp. at 699 (noting that the personal benefit requirement "present[s] this court with a troubling anomaly"); SEC v. Musella, 578 F. Supp. 425, 438 (S.D.N.Y. 1984).

[42] *See infra* text accompanying notes 160-62.

[43] Four Supreme Court Justices seemed to approve this theory in *Chiarella*, 445 U.S. at 238 (Stevens, J., concurring); *id.* at 239 (Brennan, J., concurring); *id.* at 239-43 (Burger, C.J., dissenting); *id.* at 245 (Blackmun, J., dissenting). The majority opinion did not address this issue because the trial court did not instruct the jury on this theory. *Id.* at 239 (Brennan, J., concurring).

[44] United States v. Newman, 664 F.2d 12, 17-18 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983); SEC v. Musella, 578 F. Supp. 425, 438 (S.D.N.Y. 1984).

[45] *Newman*, 664 F.2d at 17-18; *Musella*, 578 F. Supp. at 438.

[46] 664 F.2d 12.

[47] *Id.* at 17-18.

[48] 578 F. Supp. 425.

[49] *Id.* at 439.

[50] *See supra* notes 24-25 and accompanying text.

[51] SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 105 S. Ct. 2112 (1985). Like the defendant in *Chiarella*, Materia decoded the identity of merger targets from documents he printed. *Id.* at 202.

In each of these cases the defendants would have evaded liability under the tippee and insider liability theories: they were not insiders of the target,[52] they had not received information in confidence from target insiders,[53] and they were not tippees of target insiders.[54] The misappropriation theory allowed the courts to impose liability for the breach of a fiduciary duty owed to some party — not necessarily the trading shareholder.[55] Since the defendants owed fiduciary duties to their employers' clients, misappropriating confidential information subjected them to criminal and civil liability.[56]

While the misappropriation theory may help cure regulatory ills, the theory's flaws ensure that problems will persist. For example, the misappropriation theory does not obviate the 10b-5 requirement that the insider breach a fiduciary duty "in connection with" the purchase or sale of a security.[57] In *Newman*, the court found the "in connection with" requirement satisfied because the defendants' purpose in misappropriating the information was to purchase the target's shares.[58] But the court also found that these defendants breached fiduciary duties owed to their employers, not to the shareholders with whom they traded.[59] Arguably, therefore, the fiduciary duty breach was not "in connection with" the defendants' purchases of the shareholders'

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[52] The defendants in *Newman* were investment bankers, the tipper in *Musella* was a law firm office manager, and the defendant in *Materia* was a document printer. None of these defendants qualified as corporate insiders. *See supra* note 16 and accompanying text.

[53] The government based its claims against these defendants on the inside information they acquired while working for the acquiring corporations. *Materia*, 745 F.2d at 202; *Newman*, 664 F.2d at 15 n.1; *Musella*, 578 F. Supp. at 436 & n.8.

[54] Since the defendants did not obtain information from fiduciaries of the target they acquired no derivative fiduciary duties. *See, e.g.*, *Walton*, 623 F.2d at 796; *Musella*, 578 F. Supp. at 436.

[55] *See supra* note 45.

[56] "By endorsing the alternative misappropriation theory, . . . the Second Circuit gave legal effect to the commonsensical view that trading on the basis of improperly obtained information is fundamentally unfair, and that distinctions premised on the source of the information undermine the prophylactic intent of the securities laws." *Musella*, 578 F. Supp. at 438; *see also* United States v. Winans, 612 F. Supp. 827, 841 (S.D.N.Y. 1985) (sustaining reporter's conviction for misappropriating inside information after noting that he would have escaped liability under tippee and insider liability theories).

[57] Rule 10b-5 requires the defendant's fraud to be in connection with the purchase or sale of a security. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); 17 C.F.R. § 240.10b-5 (1985).

[58] *Newman*, 664 F.2d at 18; *see also Materia*, 745 F.2d at 203.

[59] *Newman*, 664 F.2d at 17.

securities.[60]

In addition, the misappropriation theory may not satisfy the 10b-5 manipulative device requirement. A 10b-5 violation must involve fraud.[61] Misappropriators may misuse information, but misusing information is not necessarily fraudulent.[62] Therefore, despite the Second Circuit's approval,[63] the misappropriation theory may be an insufficient basis for 10b-5 liability and may not withstand Supreme Court review.[64]

Even if the misappropriation theory survives Supreme Court scrutiny, regulatory gaps will persist. Private parties cannot employ the misappropriation theory to sue inside traders.[65] Consequently, private

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[60] *Id.* at 20 (Dumbauld, J., concurring and dissenting); *ABA Report*, *supra* note 15, at 236-37; Farley, *A Current Look at the Law of Insider Trading*, 39 BUS. LAW. 1771, 1776 (1984); Note, *Corporate Outsider May Be Liable for Failure to Disclose or Abstain Under Rule 10b-5 Based on Employer-Employee Fiduciary Relationship*, 13 SETON HALL L. REV. 178, 194-95 (1982) [hereafter Note, *Corporate Outsider*].

[61] Santa Fe Indus. v. Green, 430 U.S. 462, 473-74 (1977).

[62] *ABA Report*, *supra* note 15, at 237; Note, *Corporate Outsider*, *supra* note 60, at 195.

[63] *Materia*, 745 F.2d at 197; *Newman*, 664 F.2d at 17. As of the date of this Comment's publication, the authors found no other circuit court that had adopted the misappropriation theory. However, since most insider trading cases involve the New York Stock Exchange, the government may bring the cases in the Second Circuit. 15 U.S.C. § 78aa (1982).

[64] The Supreme Court has refused to review the theory on two occasions. SEC v. Materia, *cert. denied*, 105 S. Ct. 2112 (1985); United States v. Newman, *cert. denied*, 464 U.S. 863 (1983). Four Justices seemed to approve the theory in *Chiarella*. *See supra* note 43. On two subsequent occasions the Court mentioned the theory in dicta. In *Dirks*, the Court noted that the defendant did not "misappropriate" or illegally obtain the inside information. 463 U.S. at 665. More recently, the Court stated that defendants may violate rule 10b-5 when they misappropriate inside information. Eichler v. Berner, 105 S. Ct. 2622, 2630 n.22 (1985) (quoting *Dirks*, 463 U.S. at 665). The SEC argues that *Eichler* should foreclose arguments that misappropriation is not a 10b-5 violation. SEC REPORT, *supra* note 37, at 6, 13. Other commentators have argued that the theory will not withstand Supreme Court scrutiny. *SEC Enforcement, Financial Services Accounting Issues Dominate SRI Meeting*, 17 SEC. REG. & L. REP. (BNA) 210, 214 (Feb. 1, 1985) (statement of Prof. Schwartz); Fedders, *Senate Aides Express Doubts on Insider Trading Task Force Report*, 16 SEC. REG. & L. REP. (BNA) 1823 (Nov. 23, 1984) (statement of Richard Phillips, ABA Chairman, Section on Corporations, Banking and Business Law, Committee on Federal Securities Regulation).

[65] Moss v. Morgan Stanley, Inc., 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 464 U.S. 1025 (1984). In *Moss*, plaintiff claimed he sold shares to the defendants named in *Newman*. The court held that under the misappropriation theory the defendants breached fiduciary duties owed to their employer and employer's client, but not to the plaintiff. Since the defendants did not breach a fiduciary duty owed to the plaintiff, the

causes of action only supplement SEC enforcement in rare cases of insider and tippee liability.[66] Furthermore, the misappropriation theory still requires that the defendant breach a fiduciary duty.[67] This common law requirement[68] forces the government to base its prosecutions on such tenuous fiduciary relationships as father/son[69] and newspaper reporter/reader.[70]

As with the other fiduciary duty theories, the misappropriation theory ultimately creates gaps in insider trading regulations. Insider and tippee liability theories create regulatory gaps because they focus on the defendant's fiduciary relationship with the plaintiff, rather than on the nature of the defendant's conduct. The misappropriation theory improves enforcement because the defendant need not breach a fiduciary duty owed to the plaintiff. Yet, the misappropriation theory may not withstand Supreme Court review, does not permit private causes of action, and retains vague fiduciary duty concepts. With or without the misappropriation theory, regulatory problems persist.[71]

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court dismissed the suit. 719 F.2d at 13. One commentator has stated that the *Chiarella-Dirks-Moss* trilogy has sounded the "death knell" for private causes of action. *Senate Hearing*, *supra* note 5, at 156 (statement of Prof. Harrington).

[66] The SEC recognizes that private causes of action provide an important deterrent. J.I. Case Co. v. Borak, 377 U.S. 426, 432-33 (1964); Wachovia Bank & Trust Co. v. National Student Mktg., 650 F.2d 342, 352 (D.C. Cir. 1980), *cert. denied*, 452 U.S. 954 (1981); SEC REPORT, *supra* note 37, at 40.

[67] Under the misappropriation theory the defendant owes a fiduciary duty to the person whose information the defendant misappropriated. *See supra* note 45 and accompanying text.

[68] L. LOSS, *supra* note 16, at 817.

[69] *Reed*, 601 F. Supp. at 685; *see* FEDERAL SECURITIES LAW COMMITTEE SECTION OF CORPORATIONS, BANKING AND BUSINESS LAW, AMERICAN BAR ASSOCIATION, REPORT OF THE TASK FORCE ON REGULATION OF INSIDER TRADING 20 (Oct. 30, 1984) (on file with *U.C. Davis Law Review*) [hereafter ABA DRAFT REPORT].

[70] United States v. Winans, No. 84 CR. 605 (S.D.N.Y. filed Aug. 28, 1984). The U.S. Attorney has indicated he is dropping this allegation. ABA DRAFT REPORT, *supra* note 69, at 20.

[71] The SEC also has attempted to close the gaps in insider trading regulations by drafting rule 14e-3. 17 C.F.R. § 240.14e-3 (1985). The SEC enacted the rule after the *Chiarella* decision. 45 Fed. Reg. 60412 (1980). Rule 14e-3 prohibits persons from trading in securities they have "reason to know" are the subject of a tender offer. 17 C.F.R. § 240.14e-3(a) (1985); *see ABA Report*, *supra* note 15, at 248-52. Commentators have questioned the SEC's authority to enact rule 14e-3. Heller, Chiarella, *SEC Rule 14e-3 and* Dirks*: "Fairness" Versus Economic Theory*, 37 BUS. LAW. 517, 542-43 (1982); Wang, *Recent Developments in the Federal Law Regulating Stock Market Inside Trading*, 6 CORP. L. REV. 291, 307-08 (1983). The SEC enacted rule 14e-3 relying on the authority of § 14(e) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78n(e) (1982); *see* 45 Fed. Reg. 60418 (1980). As does rule 10b-5, § 14(e)

2. Remedies

Besides providing inadequate theories to prosecute inside traders, the securities laws fail to provide effective sanctions. Courts limit monetary sanctions to the inside trader's profit gained or loss avoided.[72] Thus, inside traders risk nothing. If the SEC prosecutes them, insiders only lose their profits.[73] If they evade prosecution, insiders may keep the often valuable proceeds.[74] Therefore, the potential for reward vastly outweighs the risks of prosecution.[75]

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prohibits "fraudulent, deceptive, or manipulative" acts. 15 U.S.C. § 78n(e) (1982). Recently, the Supreme Court confirmed that § 14(e) prohibits fraudulent, not simply unfair, conduct. Schreiber v. Burlington Northern, Inc., 105 S. Ct. 2458, 2462-63 (1985); *see also* Santa Fe Indus. v. Green, 430 U.S. 462, 476-77 (1977). Rule 14e-3 may exceed the scope of the SEC's authority under § 14(e). *ABA Report*, *supra* note 15, at 251-52; Freeman, *supra* note 27, at 75 n.19; Heller, *supra*, at 542-45; Wang, *supra*, at 307-08. *But cf.* O'Connor & Assoc. v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179, 1190-93 (S.D.N.Y. 1981).

[72] Wilson v. Comtech Telecommunications Corp., 648 F.2d 88, 94-95 (2d Cir. 1981); Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 172 (2d Cir. 1980); *see also* Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977).

[73] "[C]urrent law is the equivalent of making a bank robber return the loot and then proceed on his merry way after signing a promise not to steal any more — without having to admit he stole in the first place." 130 CONG. REC. H7757 (daily ed. July 25, 1984) (statement of Rep. Dingell); *see also House Hearing*, *supra* note 3, at 26 (statement of SEC Chairman John Shad). Of course, simply bringing an SEC enforcement action may subject defendants to loss of employment, social disgrace, and costly legal fees. *House Hearing*, *supra* note 3, at 60 (statement of SEC Chairman John Shad).

[74] Recent developments have made insider trading particularly lucrative. The steady increase of tender offers and mergers has caused stock prices to fluctuate dramatically. The availability of options — permitting an investor to risk little capital with the potential for vast profits — also enhances the temptations and profits of insider trading. *House Hearing*, *supra* note 3, at 19-20 (statement of SEC Chairman John Shad); 130 CONG. REC. H7759 (daily ed. July 25, 1984) (statement of Rep. Wirth); *see, e.g.*, *supra* note 3 and accompanying text.

[75] *Senate Hearing*, *supra* note 5, at 17-18 (statement of SEC Chairman John Shad); 130 CONG. REC. H7759 (daily ed. July 25, 1984) (statement of Rep. Wirth) ("insider trading is virtually a no-risk practice"). The Supreme Court may have increased insider trading penalties when it decided Sedima, S.P.R.L. v. Imrex Co., 105 S. Ct. 3275 (1985). In *Sedima*, the Court held that private parties may sue rule 10b-5 violators under the Racketeering Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. §§ 1961-1968 (1982), without first proving a prior criminal conviction or a distinct racketeering injury. RICO violators may be liable for treble damages and attorneys fees. 18 U.S.C. § 1964(c) (1982). Members of Congress have introduced legislation designed to reverse *Sedima*. *Bill Imposing Conviction Requirement for Civil RICO Introduced by Boucher*, 17 SEC. REG. L. REP. (BNA) 1240 (July 12, 1985). The increased sanctions *Sedima* provides may be short-lived.

Criminal sanctions provide no additional deterrence. Congress established a $10,000 maximum criminal fine for inside traders in 1934; subsequent inflation has eroded this figure's deterrent effect.[76] Prosecutions are rare because proof of insider trading is circumstantial.[77] Satisfying the criminal "beyond a reasonable doubt" standard based upon such evidence is difficult.[78] Criminal prosecutions are also costly because rather than the SEC, the Attorney General's office processes them,[79] necessarily isolating the criminal proceeding from the SEC's civil proceeding. These separate civil and criminal procedures cause duplication of effort and expense.[80]

Injunctive relief also provides little deterrence because it only compels what the law expects — future compliance.[81] Thus, injunctions do not penalize inside traders for their past conduct.[82] Occasionally courts may use injunctions to order ancillary relief, such as the appointment of a receiver or a board of independent auditors.[83] However, these prospective remedies are usually more effective in requiring corporations to

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[76] 15 U.S.C. § 78ff(a) (1982); *House Hearing*, *supra* note 3, at 30 (statement of SEC Chairman John Shad).

[77] Unless a codefendant agrees to testify, the government must show the defendant's state of mind and knowledge of inside information from circumstantial evidence, such as telephone bills, timing of the trades, dates of meetings, etc. *See, e.g.*, SEC v. Musella, 578 F. Supp. 425, 441 (S.D.N.Y. 1984) (upholding preliminary injunction based on phone calls, timing of the trades, and large amounts invested). *But cf.* United States v. Winans, 612 F. Supp. 827, 829 n.1 (S.D.N.Y. 1985) (upholding conviction when one codefendant testified in return for a bargained plea).

[78] *Senate Hearing*, *supra* note 5, at 39 (statement of SEC Enforcement Director John M. Fedders). Before 1983 the courts had recorded only six criminal convictions for insider trading, and one of these was overturned. *House Hearing*, *supra* note 3, at 67 (statement of Rep. Bates).

[79] 15 U.S.C. § 78u(d) (1982).

[80] *House Hearing*, *supra* note 3, at 274-75 (statement of A.A. Sommer, Jr.).

[81] "An injunction orders a defendant to obey the law in the future. . . . As such, it presents no significant hardship to the defendant because '[c]ompliance is what the law expects.' " *Senate Hearing*, *supra* note 5, at 21 (statement of SEC Chairman John Shad) (quoting Walling v. Harnischfeger Corp., 242 F.2d 712, 713 (7th Cir. 1957)).

[82] *Id.* Arguably, injunctions deter insiders because a second securities law violation places the insider in criminal or civil contempt. 5C A. JACOBS, *supra* note 13, at 11-285. But again, this remedy is only effective if a second violation occurs. No penalty is imposed for the first violation.

[83] Once the SEC invokes the court's equitable jurisdiction, the court may impose a variety of ancillary remedies against the insider. *Materia*, 745 F.2d at 200-01; *see* Deckert v. Independence Shares Corp., 311 U.S. 282, 287-88 (1940) (giving trial court broad discretion to fashion equitable remedies to fit the Securities Act violation); *see generally* 5C A. JACOBS, *supra* note 13, at 11-287 to 11-307; Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 HARV. L. REV. 1779 (1976).

institute proper safeguards than in punishing specific wrongdoers.[84] They have little impact on individuals who are no longer associated with the corporation or who have fled with the profits.[85] Even when the SEC identifies and prosecutes inside traders, it lacks effective sanctions to penalize them for their actions.

### *B. Disclosure Requirements*

A second, more important set of securities laws that lacks effective enforcement remedies is the Exchange Act's disclosure requirements.[86] The Exchange Act and SEC regulations require comprehensive disclosure from qualifying large issuers.[87] These issuers must submit periodic financial statements to their shareholders and the SEC detailing earnings, expenses, and projected revenues.[88] When they intend to participate in a tender offer or proxy contest, they must disclose their plans.[89] Finally, issuers must notify the SEC when they repurchase a certain percentage of their own securities.[90]

The SEC may convene administrative hearings to review an issuer's compliance with these disclosure requirements.[91] If the Commission concludes that the issuer has not complied, it may order appropriate corrections.[92] If the issuer does not comply with this order, the SEC

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[84] Shad, *Who Pays for Executive Sins?*, N.Y. Times, Mar. 4, 1984, *reprinted in Senate Hearing*, *supra* note 5, at 54.

[85] *Id.* None of the defendants in *Newman*, *Musella*, or *Materia* were affiliated with the target corporations before or after they traded. *See supra* note 52. The threat of appointing a board of auditors to examine the target's financial circumstances would have little impact on these defendants.

[86] "Audited financial statements are the backbone of the disclosure system established under the federal securities laws." *SEC Oversight and Technical Amendments: Hearing on H.R. 4574 Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce*, 98th Cong., 2d Sess. 53 (1984) (statement of SEC Chairman John Shad) [hereafter *House Oversight Hearing*]. Misleading financial statements may undermine public confidence more than insider trading. *House Hearing*, *supra* note 3, at 85 (statement of SEC Commissioner James Treadway).

[87] The disclosure requirements apply to issuers having more than one million dollars in assets and 500 shareholders. 15 U.S.C. § 78l(g)(1) (1982); *see generally* McLucas & Romanowich, *SEC Enforcement Proceedings Under Section 15(c)(4) of the Securities Exchange Act of 1934*, 41 BUS. LAW. 145, 146 n.2 (1985).

[88] 15 U.S.C. § 78m (1982); *see also* 17 C.F.R. § 240.13a-1 (1985).

[89] 15 U.S.C. §§ 78m(d), 78n(c)(d) (1982); 17 C.F.R. §§ 240.13d-1, 240.14c-101 (1985).

[90] 15 U.S.C. § 78m(e) (1982); 17 C.F.R. § 240.13e-3 (1985).

[91] 15 U.S.C. § 78o(c)(4) (1982).

[92] *Id.*; *see generally* L. LOSS, *supra* note 16, at 495; McLucas & Romanowich,

may petition the district court for enforcement.[93]

While the SEC may order issuers to correct misleading disclosure documents, the SEC lacks inherent authority to order the responsible individuals to correct the misstatements.[94] Consequently, the SEC must seek separately a district court order to compel the responsible officer or director to correct the misstatements.[95] To obtain this order, the SEC must prove that the defendant is reasonably likely to repeat the violation.[96] Because it applies a higher standard of proof, the district court is less likely to grant the order as to these individuals than the SEC is to order action by the issuer.[97] The need for a district court order also forces the SEC to bifurcate its proceedings.[98] As with insider trading regulations, the SEC lacks appropriate remedies to deter the responsible individuals from causing disclosure violations.

## II. INSIDER TRADING SANCTIONS ACT OF 1984

Against this legal background Congress enacted the ITSA. Congress' objectives were to increase insider trading penalties and to enhance the SEC's administrative authority. Congress intended to achieve these goals by authorizing the SEC to seek treble damages against inside traders and to order individuals to comply with disclosure requirements. The treble penalty provision was designed to help deter insider trading because inside traders will risk more than disgorging their profits. The administrative remedy was included to enhance enforcement of the disclosure requirements by enabling the SEC to order the responsi-

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*supra* note 87, at 146-47.

[93] 15 U.S.C. § 78u(e) (1982); *House Oversight Hearing*, *supra* note 86, at 48 (statement of SEC Chairman John Shad).

[94] Section 15(c)(4) applies only to persons who have disclosure obligations under §§ 12, 13, or 15(d). These sections impose obligations on issuing corporations, not individuals. *In re* Spartek, Inc. [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶81,961, at 81,409 n.5 (Feb. 14, 1979) (Commissioner Karmel, dissenting); *House Hearing*, *supra* note 3, at 131-32 (statement of Dennis J. Block); *see also* Block & Barton, *Administrative Proceedings to Enforce the Foreign Corrupt Practices Act*, 7 SEC. REG. & L.J. 40, 44 (1979).

[95] *House Oversight Hearing*, *supra* note 86, at 346 (statement of SEC Chairman John Shad); Levine, *Insider Trading Act Broadens Enforcement Scope*, LEGAL TIMES, Sept. 10, 1984, at 17.

[96] *House Hearing*, *supra* note 3, at 123-24 (statement of Dennis J. Block); Block & Barton, *supra* note 94, at 42; *see, e.g.*, SEC v. Commonwealth Chem. Sec., Inc., 574 F.2d 90 (2d Cir. 1978).

[97] Block & Barton, *supra* note 94, at 42.

[98] *House Oversight Hearing*, *supra* note 86, at 346 (statement of SEC Chairman John Shad); Levine, *supra* note 95, at 17.

ble individuals to correct misleading documents without district court action.[99]

### *A. Treble Penalty Provision*

The ITSA grants district courts discretion to impose a penalty of three times the inside trader's profit gained or loss avoided.[100] The ITSA defines profit gained or loss avoided as the difference between the securities' purchase price and their trading price a reasonable time after the inside information is publicly disseminated.[101] The treble penalty provision applies only when parties violate the Exchange Act[102] by

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[99] *See* 103 CONG. REC. H7757-59 (daily ed. July 25, 1984) (statement of Rep. Dingell).

[100] Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material nonpublic information in a transaction (i) on or through the facilities of a national securities exchange or from or through a broker or dealer, and (ii) which is not part of a public offering by an issuer of securities other than standardized options, the Commission may bring an action in the United States district court to seek, and the court shall have jurisdiction to impose, a civil penalty to be paid by such person, or any person aiding and abetting the violation of such person.

ITSA § 2(A). The language and legislative history clarify that only the SEC, not private parties, may sue to obtain treble damages. *House Hearing*, *supra* note 3, at 258 n.6 (statement of Ted J. Fiflis); 5C A. JACOBS, *supra* note 13, at 11-408.

Inside traders must pay treble penalties in addition to disgorging their profit gained or loss avoided. *House Hearing*, *supra* note 3, at 27 (statement of SEC Chairman John Shad). The treble penalties are payable into the U.S. Treasury, but the court may establish an escrow fund with the disgorged monies to compensate the trading victims. *Id.* at 27-28.

[101] ITSA § 2(C). In prior cases the SEC argued unsuccessfully that it could disgorge an insider's total profits if the stock continued to rise after the inside information was disseminated. SEC v. MacDonald, 699 F.2d 47 (1st Cir. 1983). Treble penalties provide sufficient deterrence, making it unnecessary for the SEC to disgorge the insider's full profits. *House Hearing*, *supra* note 3, at 42-43, 94-95 (statement of SEC Chairman John Shad).

[102] The ITSA applies to violations of "this title" — the Securities Exchange Act. ITSA § 2(A). Consequently, the SEC may not obtain treble damages for violations of § 17(a) of the Securities Act of 1933. 5C A. JACOBS, *supra* note 13, at 11-410; Levine, *supra* note 95, at 17.

An open question is whether the ITSA applies when the inside trader violates provisions of both the Securities Act and the Exchange Act. In Herman & MacLean v. Huddleston, 459 U.S. 375 (1983), the Supreme Court held that a plaintiff could state a claim under § 10(b) even though defendant's conduct also violated § 11 of the Securities Act. The Court noted that treating securities laws remedies as cumulative "furthers their broad remedial purposes." *Id.* at 386.

committing inside trades through a national securities exchange or a broker or dealer.[103] Public offerors are not subject to treble penalties unless they sell options.[104] The ITSA also increases the maximum criminal fine to $100,000.[105]

Treble penalties should enhance the deterrent effect of insider trading regulations. The ITSA resolves prior deficiencies by authorizing district courts to penalize inside traders, rather than simply forcing them to disgorge profits.[106] Increasing the maximum criminal fine will also augment insider trading penalties.[107] These sanctions should enhance the SEC's ability to restore investor confidence in the stock market.[108]

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[103] ITSA § 2(A)(i). Consequently, the treble penalty does not apply to over-the-counter trading unless a broker or dealer executes the transaction. 5C A. JACOBS, *supra* note 13, at 11-413.

[104] ITSA § 2(A)(ii). The ITSA does not clarify whether shareholder offerings are subject to the treble penalty provision. Consequently, if a registration statement includes public offerings by issuers and shareholders, the shareholders, but not the issuers, may be subject to treble penalties. 5C A. JACOBS, *supra* note 13, at 11-413 to 11-414. Congress denied the public offeror exemption to option sellers because of the abuse inherent in selling and purchasing options. Options permit inside traders to place a small sum of money at risk and create the opportunity for vast profits once the public learns the inside information. *House Hearing*, *supra* note 3, at 19-20 (statement of SEC Chairman John Shad); *see, e.g.*, *supra* note 3. Curbing these abuses also persuaded Congress to include a section in the ITSA to clarify that insider trading in derivative instruments, such as options, puts, calls, and straddles, exposes the defendant to treble penalties. ITSA § 5; *House Report*, *supra* note 5, at 26 n.51. This section eliminates the confusion that prior case law created. *Compare* Laventhall v. General Dynamics, 704 F.2d 407, 413-15 (8th Cir.), *cert. denied*, 464 U.S. 846 (1983), *with* O'Connor & Assocs. v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179, 1188 (S.D.N.Y. 1981).

[105] ITSA § 3.

[106] *House Report*, *supra* note 5, at 7-8; 130 CONG. REC. H7757-58 (daily ed. July 25, 1984) (statement of Rep. Dingell); 130 CONG. REC. S8913 (daily ed. June 29, 1984) (statement of Sen. D'Amato).

[107] *House Report*, *supra* note 5, at 26.

[108] This theme recurs throughout the ITSA's legislative history. *See Senate Hearing*, *supra* note 3, at 17 (statement of SEC Chairman John Shad); *House Report*, *supra* note 5, at 2-3, 22-23.

Though the ITSA is unclear, Congress intended that district judges assess the treble penalty. *House Report*, *supra* note 5, at 16. Authorizing the judge rather than a jury to impose a civil penalty complies with the case law. United States v. ITT Continental Baking Co., 420 U.S. 223, 229 n.6 (1975); United States v. Duffy, 550 F.2d 533, 534 (9th Cir. 1977); United States v. J.B. Williams Co., 498 F.2d 414, 438 n.28 (2d Cir. 1974).

Two procedural issues the ITSA does not address are the right to a jury trial and the burden of proof. Congress opposed granting defendants the right to a jury trial, but left

### *B. Administrative Remedy*

The ITSA also enhances SEC enforcement efforts by authorizing the SEC to proceed administratively against individuals who cause reporting violations.[109] If the SEC finds that an issuer has not complied with its reporting requirements, it may order the responsible individual to correct the misstatements.[110] The SEC can issue the order only after providing notice and an opportunity to be heard.[111] The order applies to all persons who "knew or should have known" that their acts or omissions contributed to the noncompliance.[112]

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the issue to judicial interpretation. *House Report*, *supra* note 5, at 16. The issue will depend on whether a court would have granted the defendant the right to a jury trial at common law. Parklane Hosiery Co. v. Shore, 439 U.S. 322, 344-45 (1979) (Rehnquist, J., dissenting); Dimick v. Schiedt, 293 U.S. 474, 476 (1935); U.S. CONST. amend. VII; *see generally* Jorde, *The Seventh Amendment Right to Jury Trial of Antitrust Issues*, 69 CALIF. L. REV. 1, 7-8 (1981). Case law suggests that defendants have the right to a jury when the government seeks to impose a civil penalty. The Sarah, 21 U.S. (8 Wheat) 391, 394 (1823) (right to jury trial granted in government action to seize property); United States v. Anderson, 584 F.2d 369, 373-74 (10th Cir. 1978) (jury trial granted in action brought by the Internal Revenue Service to collect delinquent taxes); *J.B. Williams*, 498 F.2d at 424 (right to jury granted in action brought by Federal Trade Commission to enforce civil penalty). The Supreme Court has reserved ruling on this issue. Atlas Roofing Co. v. Occupational Safety & Health Review Comm'n, 430 U.S. 442, 449 n.6 (1977).

With respect to the burden of proof issue, courts should apply the preponderance of the evidence standard. First, Congress considered and rejected arguments that courts find clear and convincing evidence before imposing treble penalties. *House Report*, *supra* note 5, at 15-16. Second, the Supreme Court has employed the clear and convincing standard only when more important individual interests were at stake. *See, e.g.*, Santosky v. Kramer, 455 U.S. 745 (1982) (termination of parental rights); Addington v. Texas, 441 U.S. 418 (1979) (involuntary commitment proceedings); Woodby v. INS, 385 U.S. 276 (1966) (deportation proceedings). Third, courts have exclusively applied the preponderance of the evidence standard to securities violations, *see, e.g.*, Herman & MacLean v. Huddleston, 459 U.S. 375 (1983) (private rule 10b-5 actions); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 355 (1943) (SEC injunctive actions), even when the action threatens more than civil penalties, *see, e.g.*, Steadman v. SEC, 450 U.S. 91, 106 (1981) (Powell, J., dissenting) (preponderance of the evidence standard applied to SEC administrative proceeding seeking to suspend broker's registration).

[109] ITSA § 4.

[110] *Id.*

[111] *Id.*

[112] *Id.* The ITSA also closes other administrative gaps. Section 4 extends the SEC's administrative authority to order corrections to reports filed under § 14 of the Exchange Act. Under prior law, the SEC could order any person to comply with the reporting requirements listed in §§ 12, 13, and 15(d) of the Exchange Act. Securities Acts Amendments of 1964, Pub. L. No. 88-467, § 6(c)(4), 78 Stat. 565 (codified at 15 U.S.C. § 78o(c)(4) (1982)). Congress inserted § 14's reporting requirements after this

This provision should facilitate enforcement of the disclosure requirements. The SEC need not bifurcate administrative and district court proceedings[113] and may proceed administratively against both issuers and individuals.[114] The ITSA also reduces the SEC's burden of proof.[115] The SEC may obtain compliance orders without proving that the defendant is reasonably likely to commit future violations.[116] Thus, the ITSA gives the SEC flexibility in selecting between administrative compliance orders and injunctive relief.[117] Most importantly, the SEC can apply the order to the individual officer, director, or employee responsible for the violation.[118]

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administrative remedy became effective. Consequently, the SEC had no authority to seek administrative sanctions for failure to comply with § 14's reporting requirements. Williams Act, Pub. L. No. 90-439, 82 Stat. 455 (1968) (codified at 15 U.S.C. § 78n(d)-(f) (1982)); *House Hearing*, *supra* note 3, at 128-29 (statement of Dennis J. Block); *House Report*, *supra* note 5, at 8; 130 CONG. REC. S8913 (daily ed. June 29, 1984) (statement of Sen. D'Amato).

Section 14 is particularly important because it includes reports that issuers must file in connection with proxy fights and tender offers. 17 C.F.R. §§ 240.14c-101, 240.14d-1 (1985). Commissioner Treadway plans to use the ITSA to supervise takeovers more closely. *SEC Should Have Power to Bar Executives from Public Firms for Securities Violations, Commissioner Treadway Says*, DAILY REP. FOR EXECUTIVES (BNA) No. 180, at C-1 (Sept. 17, 1984) (available Mar. 22, 1986, on LEXIS, Nexis library, Gov't file) [hereafter *Power to Bar Executives*].

The ITSA closes another hole in administrative regulations by permitting the SEC to suspend brokers and dealers and their associates when they violate the Commodity Exchange Act, 7 U.S.C. §§ 1-26 (1982). ITSA § 6. Under prior law, the SEC could suspend such persons for violating a series of companion securities laws. 15 U.S.C. § 78o(b)(4)-(6) (1982). However, because of apparent legislative oversight, this administrative remedy did not extend to violations of the Commodity Exchange Act. 130 CONG. REC. S8913 (daily ed. June 29, 1984) (statement of Sen. D'Amato).

[113] *See supra* notes 95, 98 and accompanying text.

[114] *House Oversight Hearing*, *supra* note 86, at 346 (statement of SEC Chairman John Shad); Levine, *supra* note 95, at 17.

[115] *House Oversight Hearing*, *supra* note 86, at 346.

[116] ITSA § 4. Under prior law the SEC either had to prove that the defendant was a controlling person of the issuer or that she was reasonably likely to commit future violations. *House Oversight Hearing*, *supra* note 86, at 346; Block & Barton, *supra* note 94, at 42, 48 n.28. The SEC need not meet either of these standards in an administrative proceeding after the ITSA.

[117] The ITSA allows the SEC to obtain an order requiring compliance when injunctive relief, with its concomitant costs, is inappropriate. *House Report*, *supra* note 5, at 12-13; 130 CONG. REC. S8913 (daily ed. June 29, 1984) (statement of Sen. D'Amato).

[118] *House Oversight Hearing*, *supra* note 86, at 345-46; 130 CONG. REC. S8913 (daily ed. June 29, 1984) (statement of Sen. D'Amato); Levine, *supra* note 95, at 17.

## III. Legislative Proposals

While the ITSA may assist SEC enforcement efforts, Congress neglected to pass legislation to effectuate the deterrence needed in insider trading regulation. The ITSA increases penalties for insider trading, but fails to define "inside trader"; thus, its ability to facilitate SEC prosecutions is limited. It also lacks guidelines for assessing treble penalties and imposing secondary participant liability. The administrative remedy enables the SEC to correct single violations, but does not deter repeat offenders. These omissions require further legislation to enhance the SEC's enforcement of insider trading and disclosure laws.

### *A. Defining Insider Trading*

#### 1. The Need for a Legislative Definition

The ITSA's primary failing is the omission of an insider trading definition. Defining insider trading would help close the gaps created by judicial reliance on fiduciary duty concepts.[119] The fiduciary duty requirement focuses on the defendant's relationship with the trading shareholders, rather than on the nature of the defendant's unlawful conduct.[120] This approach undermines investor confidence because it permits unscrupulous individuals to capitalize on unfair informational advantages.[121] A straightforward definition focusing on the defendant's unfair conduct would close these regulatory gaps and restore the investor confidence Congress and the SEC intended to foster.[122]

Defining insider trading would produce other benefits. A definition would provide needed clarity for the SEC when it prosecutes enforcement actions.[123] Currently the SEC selects from a variety of complex

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[119] This recognition prompted Sen. D'Amato to introduce a definition of insider trading during the ITSA's Senate hearings. *Senate Hearing*, *supra* note 5, at 2, 8-10. An ABA Task Force also has proposed legislation to close insider trading regulatory gaps. *ABA Report*, *supra* note 15, at 259-64.

[120] *See supra* text Part I(*A*).

[121] The victim of unfair trades that "fall through the [regulatory] cracks" is the "integrity of the market." *Senate Hearing*, *supra* note 5, at 2 (statement of Sen. D'Amato).

[122] Milton Freeman proposed a definition during the ITSA's legislative hearings that would prohibit the unfair use of nonpublic information. *House Hearing*, *supra* note 3, at 175-76, 180-84 (statement of Milton Freeman). The definition's objective was "to protect the reputation of the markets as fair places to deal." Freeman, *supra* note 27, at 73. Sen. D'Amato proposed a substantially similar version during the ITSA's Senate hearings. *Senate Hearing*, *supra* note 5, at 8-10.

[123] *Senate Hearing*, *supra* note 5, at 35-36 (statement of SEC Enforcement Director

theories of tippee, insider, and misappropriator liability.[124] Each theory has its own elements and applications.[125] These overlapping and conflicting elements confuse SEC prosecutions and hamper enforcement.[126] Defining insider trading would assist the SEC in identifying and prosecuting violators.[127]

A legislative definition would also make clear to the investing public what is prohibited conduct.[128] For example, under current law, before using their research, market analysts need be sure of the following: that the insider providing the information did not intend a benefit;[129] that the analysts did not owe the insider a fiduciary duty;[130] and that the insider did not convey the information in confidence.[131] These elements provide little guidance for analysts or the investing public to distinguish lawful from unlawful conduct.[132] This lack of guidance either restricts valuable market research[133] or invites noncompliance.[134] Because of the ITSA's stiff treble penalty provision,[135] it needs to make painstakingly clear the kinds of activity it encompasses.

### 2. Proposed Insider Trading Definition

Congress should enact a definition of insider trading that prohibits the unfair use of nonpublic corporate information. This definition should balance the underlying objectives of insider trading regulations: the need to maintain investor confidence while ensuring efficient and active market research.[136] A definition explicitly protecting these values

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John M. Fedders).

[124] *Id.*; see the theories discussed in Gonson & Butler, *In Wake of* Dirks, *Courts Debate Definition of Insider*, LEGAL TIMES, Apr. 2, 1984, at 16.

[125] Gonson & Butler, *supra* note 124, at 16, 21.

[126] *Senate Hearing*, *supra* note 5, at 35-36 (statement of SEC Enforcement Director John M. Fedders).

[127] *Id.*

[128] *Id.* at 35; Karsch, *The Insider Trading Sanctions Act: Incorporating a Market Information Definition*, 6 J. COMP. BUS. & CAP. MARKET L. 283, 291 (1984).

[129] *Dirks*, 463 U.S. at 662; *see supra* notes 33-34 and accompanying text.

[130] If the analyst owed the source of information a fiduciary duty, she might be liable as a misappropriator. *See supra* note 45.

[131] *Dirks*, 463 U.S. at 655 n.14.

[132] *ABA Report*, *supra* note 15, at 248.

[133] *Id.* at 225.

[134] Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 554 (1970).

[135] *Senate Hearing*, *supra* note 5, at 36 (statement of SEC Enforcement Director John M. Fedders); *ABA Report*, *supra* note 15, at 224.

[136] Here the balancing act is between the need to maintain investor confi-

would close the gaps in insider trading regulations.

Congress should add the following subsection to section 16 of the Exchange Act.

Section 16(f):[137]

> It shall be unlawful, by use of any means or instrumentalities of interstate commerce, or the mails, or any facility of a national security exchange, for misappropriators or tippees to sell or buy a security while possessing material nonpublic information,[138] or to communicate such information to another person who is likely to trade, with an intent to deceive, defraud, or manipulate.[139] Private parties may sue persons who violate this provision and recover all remedies provided by this title.
>
> (1) Misappropriators shall include persons who unlawfully or unfairly obtain material nonpublic information.
>
> (a) Misappropriators act unfairly when they breach an implied or express obligation or use an unerodable informational advantage[140] without helping to disseminate market information.
>
> (2) Tippees shall include persons who learn material nonpublic information from persons they have reason to know are misappropriators or tippees.

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> dence, the integrity of the securities markets and on the other hand the need to have the functioning of securities analysts and other professionals who seek out and bring to the market the information which makes it vital and efficient.

*Senate Hearing*, *supra* note 5, at 115 (statement of Faith Colish).

[137] The proposal adds a separate subsection to § 16 of the Exchange Act because this section strictly prohibits insiders from effecting sale and purchase transactions within six months of each other. 15 U.S.C. § 78p(b) (1982). Since the proposal does not rely on common law fiduciary and fraud principles, this section is more appropriate than § 10(b). *ABA Report*, *supra* note 15, at 253. Inserting the proposal in this section also clarifies that the proposal complements but does not replace § 10(b). The SEC could still employ § 10(b) to prosecute traditional insider trading violations. A new insider trading definition would embroil the SEC in lengthy litigation designed to clarify the definition's application. *Senate Hearing*, *supra* note 5, at 36-37 (statement of SEC Enforcement Director John M. Fedders).

[138] The definition of these terms is left to existing judicial interpretation. They have not caused the regulatory gaps discussed *supra* text Part I(*A*).

[139] The proposal preserves the rule 10b-5 scienter requirement. The imposition of treble damages requires a high level of awareness. Furthermore, the Supreme Court has reduced the SEC's burden of proving scienter by permitting the use of circumstantial evidence. Herman & MacLean v. Huddleston, 459 U.S. 375, 390 n.30 (1983).

[140] An "unerodable" informational advantage is one that the public cannot lawfully overcome or offset. Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 360 (1979).

### 3. Protecting Competing Values

The definition's purpose is to harmonize the competing objectives of maintaining investor confidence and ensuring active market research. The definition per se prohibits trading by persons who unlawfully obtain nonpublic information because they undermine both of these objectives. Examples of persons who unlawfully obtain confidential corporate information include printers who decode secret documents[141] and employees who break into office cabinets. These individuals undermine investor confidence in the stock market because investors perceive trading by persons who steal inside information as unfair.[142] Nor do such persons encourage active market research. Instead, they preserve the information's secrecy to maximize their profit.[143]

Although the definition per se prohibits the unlawful use of inside information, it only requires persons who unfairly use inside information to abstain from trading when they breach an obligation, use an unerodable informational advantage, and do not help disseminate market information. Basing liability on these factors helps preserve the competing values of insider trading regulations.[144] Individuals who

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[141] Thus, the printer in *Chiarella* would have violated the proposal. *See supra* notes 24-25 and accompanying text.

[142] *Chiarella*, 445 U.S. at 241-42 (Burger, C.J., dissenting). One commentator has noted that a "trader who uses surreptitious means to obtain information is unreachable under rule 10b-5. . . . Such activity clearly falls outside traditional notions of fairness, however, and thus may be curtailed by a statute prohibiting unfair activity." Comment, *Inside Information and Outside Traders: Corporate Recovery of the Outsiders' Unfair Gain*, 73 CALIF. L. REV. 483, 510 (1985) [hereafter Comment, *Inside Information*]. Another commentator agreed that when "one simply steals information from a stranger," she does not violate rule 10b-5 because she had no "fiduciary or similar obligation to the possessor." Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101, 122 (1984).

The Supreme Court has left this issue open. In *Dirks*, the Court noted that Dirks did not misappropriate "or illegally obtain" the inside information. 463 U.S. at 665. Two SEC officials have concluded that trading on stolen inside information violates rule 10b-5. Gonson & Butler, *supra* note 124, at 16, 21. The definition removes this uncertainty by focusing on whether the defendant's unlawful conduct undermines the objectives of insider trading laws. *See Chiarella*, 445 U.S. at 241-42 (Burger, C.J., dissenting) (indicating that the disclose or abstain obligation should arise "whenever a party gains an informational advantage by unlawful means").

[143] *House Hearing*, *supra* note 3, at 267 (statement of Ted J. Fiflis); Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425, 1448-49 (1967). *But cf.* Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217, 1228 (1981).

[144] For comparison, consider the factors listed in Comment, *Inside Information*,

breach the confidence of those who provide them with corporate information or who capitalize on privileged access to such information undermine investor confidence in the stock market.[145] Investors consider this trading unfair because they do not have the same access to inside information.[146] Alternatively, persons who actively research the value of particular securities and distribute that information to clients help to allocate resources efficiently.[147]

This definition also should help close the gaps caused by judicial reliance on fiduciary duty principles. The case of *United States v. Reed*[148] provides a good example of how the proposed definition improves upon present judicial construction. In *Reed*, the defendant traded on the basis of secret takeover information learned from his father, a director of the target company.[149] The government attempted to prosecute Reed on the theory that he breached a fiduciary duty owed to his father and misappropriated inside information.[150] Though the district court denied Reed's motion to dismiss, it noted the government's heavy burden of proving that Reed breached a confidential relationship.[151]

Reed's liability would be clear under the proposed definition. He capitalized on an unerodable informational advantage:[152] no one else had special access to his father. Reed did not help disseminate useful market information. He maintained the information's secrecy to maximize his own profits.[153] The definition's factors explicitly prohibit this type of unfair use of inside information in a manner superior to present fiduciary duty principles.

The proposed definition would distinguish between fair and unfair insider trading in other circumstances. It would not prohibit analysts

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*supra* note 142, at 511.

[145] Aldave, *supra* note 142, at 122-23; Brudney, *supra* note 140, at 346.

[146] The unfairness of insider trading "is not a function merely of possessing more information — outsiders may possess more information than other outsiders by reason of their diligence or zeal — but of the fact that [the insider] has an advantage which cannot be competed away." Brudney, *supra* note 140, at 346.

[147] Market professionals who research and obtain material nonpublic information are "necessary to the preservation of a healthy market." *Dirks*, 463 U.S. at 658.

[148] 601 F. Supp. 685 (S.D.N.Y. 1985); *see supra* note 3.

[149] *Reed*, 601 F. Supp. at 690.

[150] *Id.* at 699.

[151] *Id.* at 718.

[152] *See supra* note 140.

[153] Reed kept the information secret as long as possible. The government is also accusing him of perjury in denying the use of inside information. *Reed*, 601 F. Supp. at 692, 720.

who learn inside information from making recommendations to their clients.[154] If the insider knows the analyst will recommend the purchases, then the analyst does not breach an express or implied obligation.[155] The analyst's recommendation distributes important market information,[156] and the insider may prefer this method of selective distribution.[157] The analyst's recommendations will not inflate the securities' price and will not educate competitors.[158] Nor have the analyst's clients used an unerodable informational advantage. Unlike the filial relationship in *Reed*, investors can compete with the analyst's clients by hiring their own analyst. Recognition that the analyst's clients have a temporary informational advantage will not undermine investor confidence in the market.[159]

The proposed definition also preserves the underlying values of insider trading laws by eliminating the personal benefit requirement for tippee liability. Under present law, before successfully prosecuting the tippee the SEC must prove that the tipper intended to benefit.[160] However, tippees who unfairly use inside information undermine investor confidence regardless of the tipper's motive.[161] The tippee also is not more likely to disseminate the inside information when the tipper benefits. Since protecting the underlying values of insider trading laws does not depend upon whether the tipper benefited, the definition eliminates this requirement.[162]

The definition further protects the values of insider trading regulations by implying a private cause of action. Present law authorizes pri-

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[154] *Cf. ABA Report*, *supra* note 15, at 256 (exempting liability for analysts who obtain inside information through "their own efforts").

[155] Aldave, *supra* note 142, at 121-22.

[156] The ABA's exclusion for analysts who obtain information through their own efforts "squarely recognizes the strong public policy reasons for . . . encouraging market analysis and the flow of information from analysts to the marketplace." *ABA Report*, *supra* note 15, at 256.

[157] Fischel, *Insider Trading and Investment Analysts: An Economic Analysis of* Dirks v. Securities and Exchange Commission, 13 HOFSTRA L. REV. 127, 141-42 (1984).

[158] *Id.* at 142.

[159] Aldave, *supra* note 142, at 123; Brudney, *supra* note 140, at 360-62.

[160] *See supra* notes 33-34 and accompanying text.

[161] *See supra* note 41; *see also Dirks*, 463 U.S. at 674 (Blackmun, J., dissenting) ("It makes no difference to the shareholder whether the corporate insider gained or intended to gain.").

[162] The ABA Task Force also recommends eliminating the personal benefit requirement for imposing tippee liability. *ABA Report*, *supra* note 15, at 259, 272 (Alternative A), 264 (Alternative B).

vate causes of action only under the narrow circumstances of tippee and insider liability.[163] Authorizing private causes of action will provide an important supplement to insider trading enforcement.[164] Private parties also should recover treble damages. Treble damages are necessary to encourage private parties to accept the high costs and proof difficulties associated with insider trading actions.[165]

The definition will not eliminate all uncertainty in insider trading regulations. Persons who inadvertently "overhear" inside information may or may not violate securities laws. They probably do not breach an

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[163] *See supra* notes 65-66 and accompanying text.

[164] *See supra* note 66; Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975) (implying private cause of action was "entireley consistent with the Court's recognition . . . that private enforcement of Commission rules may provide a necessary supplement to Commission action") (quoting J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964)); *see also* Fridrich v. Bradford, 542 F.2d 307, 314 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977) (noting that implying a private cause of action for rule 10b-5 encourages enforcement); Ratner, *Federal and State Roles in the Regulation of Insider Trading*, 31 BUS. LAW. 947, 954-55 (1976) (discussing the utility of private cause of action as a supplement for SEC enforcement actions).

[165] *House Hearing*, *supra* note 3, at 258 (statement of Ted J. Fiflis); *see* Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 20 (1980); *Insider Trading Epidemic*, *supra* note 2, at 80, 81, 88. However, granting private parties the right to obtain treble damages may encourage frivolous and extortionate strike suits. *See, e.g.*, *Blue Chip Stamps*, 421 U.S. at 740-47 (limiting standing for bringing private 10b-5 actions because of a perceived need to protect the courts from a deluge of unwarranted private damage claims); *House Hearing*, *supra* note 3, at 259 (statement of Ted J. Fiflis); Comment, *Inside Information*, *supra* note 142, at 515; Comment, *Fashioning a Lid for Pandora's Box: A Legitimate Role for Rule 10b-5 in Private Actions Against Insider Trading on a National Stock Exchange*, 16 UCLA L. REV. 404 (1969). Encouraging such suits might restrict lawful, beneficial activity and subject defendants to ruinous liabilities. *Fridrich*, 542 F.2d at 318 (criticizing imposing "Draconian" civil damages against insiders); *House Hearing*, *supra* note 3, at 294-95 (statement of New York State Bar Association); Ratner, *supra* note 164, at 956; Comment, *Inside Information*, *supra*, at 515.

The Supreme Court may have mooted this issue by authorizing private parties to obtain treble damages against securities violators under RICO. Sedima, S.P.R.L. v. Imrex Co., 105 S. Ct. 3275 (1985). Even if Congress overturns *Sedima*, *see supra* note 75, private parties should still be able to obtain treble damages. The difficulty in detecting insider trading makes frequent strike suits unlikely, and the existence of a private cause of action will free the SEC to perform its other duties. *House Hearing*, *supra* note 3, at 258-59 (statement of Ted J. Fiflis); Karjala, *Statutory Regulation of Insider Trading in Impersonal Markets*, 1982 DUKE L.J. 627, 638 n.38; Ratner, *supra* note 164, at 954-55. One of the draft proposals submitted by the ABA Task Force recommended that private parties be able to obtain treble damages. ABA DRAFT REPORT, *supra* note 69, at 76.

obligation, but they also do not help disseminate market information.[166] However, while the scope of prohibited conduct is not precise, the courts need flexibility to address new fraudulent schemes.[167] Most significantly, the definition explicitly recognizes and protects the underlying values of insider trading regulations: investor confidence and market efficiency. The definition should close the gaps in insider trading regulations and protect these values in ways superior to present fiduciary duty principles.[168]

### *B. Treble Penalty Guidelines*

#### 1. Unguided Judicial Discretion

The ITSA's second principal weakness is that it grants district judges wide discretion when imposing treble penalties. The ITSA provides that judges shall fix the penalty amount "in light of the facts and circumstances."[169] The ITSA does not state what judges should consider when assessing treble penalties. This uncertainty requires further legislation to clarify the factors for imposing treble penalties.

The ITSA's legislative history provides no more guidance than the statutory language concerning the factors judges should consider. The House report states that district judges should examine the amount of proof introduced and the defendants' level of awareness.[170] Thus, Congress apparently intended district judges to concentrate on insiders' past activities, rather than on the likelihood of future violations. Yet, Con-

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[166] This hypothetical has no easy resolution. The ABA Task Force's Alternative B would prosecute persons who inadvertently overhear nonpublic information because they did not acquire the information through their own efforts. *ABA Report*, *supra* note 15, at 266-67, 268. Other commentators argue that trading on inadvertently overheard information should be permissible. *Senate Hearing*, *supra* note 5, at 119 (statement of Faith Colish); Aldave, *supra* note 142, at 122-23; Comment, *Inside Information*, *supra* note 142, at 513.

[167] *Senate Hearing*, *supra* note 5, at 37 (statement of SEC Enforcement Director John M. Fedders); *House Hearing*, *supra* note 3, at 197 (statement of Arnold S. Jacobs).

[168] The proposal should improve clarity by narrowing the category of prohibited actors. Presently, the SEC may prosecute defendants as traditional insiders, temporary or constructive insiders, tippers, etc. *See* Gonson & Butler, *supra* note 124, at 16. The wide range of theories into which the SEC must fit violations complicates SEC prosecutions. *Senate Hearing*, *supra* note 5, at 35-36 (statement of SEC Enforcement Director John M. Fedders); *see supra* text accompanying notes 123-27. Proscribing the unfair use of information based on enumerated factors should reduce this confusion.

[169] ITSA § 2(A).

[170] *House Report*, *supra* note 5, at 9.

gress inserted the treble penalty in the same subsection of the Exchange Act that authorizes the SEC to obtain injunctive relief.[171] This placement indicates that judges must find a reasonable likelihood of future violations before assessing treble penalties.[172]

Congress' purpose in enacting the ITSA further confuses the assessment of treble penalties. Congress and the SEC intended to deter insider trading by penalizing insiders for past conduct.[173] They concluded that injunctive relief and disgorging of profits were inadequate remedies because they only demand future compliance.[174] Congress' purpose indicates that judges should consider factors relating to the insider's past conduct, not her future conduct.[175]

Confusion about the factors for imposing treble penalties will produce inconsistent judgments and unfair punishments. Unless judges have common guidelines, they will reach different results on identical facts.[176] Investors cannot be confident of engaging in legitimate conduct because they do not know what conduct will subject them to multiple penalties. Consequently, assessing treble penalties without guidelines may deprive defendants of due process rights.[177]

This lack of clarity persuaded certain commentators to suggest that Congress eliminate judicial discretion in imposing treble penalties.[178] They recommended that courts automatically impose a multiple penalty

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[171] 15 U.S.C. § 78u(d)(2)(A) (Supp. II 1984).

[172] One commentator has suggested that courts will apply the same factors used in deciding whether or not to impose an injunction in SEC enforcement actions. 5C A. JACOBS, *supra* note 13, at 11-415 & n.46. This interpretation conflicts with the SEC's position that it can obtain treble penalties directly without first obtaining an injunction. *House Report*, *supra* note 5, at 21.

[173] *Senate Hearing*, *supra* note 5, at 2 (statement of Sen. D'Amato); *House Hearing*, *supra* note 3, at 25-27 (statement of SEC Chairman John Shad); *House Report*, *supra* note 5, at 8; 130 CONG. REC. H7757-58 (daily ed. July 25, 1984) (statement of Rep. Dingell).

[174] *Senate Hearing*, *supra* note 5, at 2 (statement of Sen. D'Amato); *House Hearing*, *supra* note 3, at 25-27 (statement of SEC Chairman John Shad).

[175] Under this approach, the court should not consider the following factors: whether the defendant has an opportunity to commit future breaches; whether she admitted her guilt; and whether she disclaimed an intent to trade in the future. *See* 5C A. JACOBS, *supra* note 13, at 11-415.

[176] *House Hearing*, *supra* note 3, at 184 (statement of Milton Freeman).

[177] Vesting district judges with such "absolute discretion" is "of doubtful legality." *Id.* at 176, 184 (statement of Milton Freeman). *But cf.* United States v. Guterma, 189 F. Supp. 265 (S.D.N.Y. 1960) (characterizing as "thoroughly shopworn" the defense that Exchange Act was unconstitutionally vague for supporting a criminal prosecution).

[178] *House Hearing*, *supra* note 3, at 170 (statement of Milton Freeman); *id.* at 151 (statement of David Brodsky).

for any violation.[179] However, automatic multiple penalties might encourage judges to raise the corresponding standard of proof.[180] A higher standard of proof would burden SEC enforcement actions.[181] Thus, while Congress needs to clarify the factors for imposing treble penalties, it must strive to preserve judicial flexibility.

### 2. Factors for Imposing Treble Penalties

Congress should add a separate subsection to the ITSA clarifying the factors for imposing treble penalties. The factors should preserve Congress' intent by focusing on defendants' past conduct and ability to pay. The factors should clarify the bases for treble penalties and reduce inconsistent judicial decisionmaking.

Section 21(d)(2)(E):[182]

> In assessing treble penalties, district judges[183] should intend to penalize the offender. Relevant factors include but are not limited to: the amount of proof introduced; the level of the defendants' awareness; the defendants' financial resources; and the availability of other penalties.

### 3. The Benefits of Guidelines

This proposal should achieve a number of important objectives. The listed factors should ensure that judges effectuate Congress' intent to deter insider trading. Considering the amount of proof and defendants' awareness requires judges to evaluate defendants' past rather than likely future conduct. Also, by evaluating defendants' wealth and the availability of other penalties, judges will focus on the penalty's deterrent impact. The proposal further enhances the ITSA's deterrent impact by clarifying when inside traders will be subject to treble

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[179] Brodsky and Freeman cited the antitrust laws and False Claims Act as examples of laws that impose multiple penalties once the court finds a violation. *Id.* at 151 (statement of David Brodsky); *id.* at 176 (statement of Milton Freeman).

[180] As previously discussed, Congress opposed applying the clear and convincing standard to SEC enforcement actions. *House Report*, *supra* note 5, at 15-16; *see supra* note 108. Congress conceded, however, that the district judge should consider the amount of proof introduced in assessing the treble penalty. *See supra* note 170 and accompanying text. An automatic multiple penalty might deprive judges of this flexibility and encourage them to raise the standard of proof.

[181] *House Hearing*, *supra* note 3, at 46 (statement of SEC Chairman John Shad).

[182] The new subsection would appear in the same Exchange Act section in which the ITSA's treble penalty provision appears. 15 U.S.C. § 78u (Supp. II 1984).

[183] This language clarifies that judges, not juries, will impose treble penalties. *See supra* note 108.

penalties.[184]

Listing the factors for imposing treble penalties should produce other benefits. By directing judges to penalize insiders and by listing specific factors, the proposal should reduce judicial inconsistency and arbitrariness. It will also clarify unlawful conduct. Consequently, parties will be more aware of their bargaining positions, and thus will more likely settle before litigation.[185] This is a salient factor because the SEC's limited resources compel it to settle most enforcement actions.[186]

Arguably, the proposal unnecessarily restricts the judicial fact-finding process. The listed factors may not always apply or may not be significant. However, the proposal does not limit judicial discretion. It merely provides needed clarity to judges, parties, and the public by listing certain factors. These factors should achieve Congress' intent to deter by directing judges to punish defendants for their past conduct.

### *C. Secondary Participant Liability*

#### 1. Treble Penalty's Uncertain Scope

The ITSA's third major failing is that it does not clarify the liability of secondary participants. Subsection 2(A) imposes treble penalties on inside traders,[187] tippers,[188] and on "any person aiding and abetting" the inside trader.[189] Subsection 2(B), however, states that district courts may not impose treble penalties on secondary participants who "solely" aid and abet, employ, or control inside traders.[190] Inserting one subsec-

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[184] *House Hearing*, *supra* note 3, at 151 (statement of David Brodsky).

[185] *Id.* at 145 (statement of David Brodsky).

[186] The SEC, for example, settles nearly every administrative proceeding filed against professionals. Siedel, *Rule 2(e) and Corporate Officers*, 39 BUS. LAW. 455, 460-61, 470 (1984); *see* Touche Ross & Co. v. SEC, 609 F.2d 570, 580-81 (2d Cir. 1979).

[187] Subsection 2(A) applies to persons who violate the Securities Exchange Act "while in possession of material nonpublic information." This language does not modify substantive law, but clarifies that the ITSA's treble penalty provision applies to present judicial definitions of inside traders. *House Hearing*, *supra* note 3, at 244-46 (statement of Ted J. Fiflis); *House Report*, *supra* note 5, at 13.

[188] Subsection 2(B) imposes liability on persons who communicate material nonpublic information to traders. 130 CONG. REC. S8913 (daily ed. June 29, 1984) (statement of Sen. D'Amato).

[189] ITSA § 2(A).

[190] No person shall be subject to a sanction under subparagraph (A) of this paragraph solely because that person aided and abetted a transaction covered by such subparagraph in a manner other than by communicating material nonpublic information. Section 20(a) of this title shall not apply to an action brought under this paragraph. No person shall be liable

tion providing and a second subsection excluding secondary liability obfuscates congressional intent. This confusion requires a legislative amendment to clarify secondary participant liability.

One uncertainty created by the contradictory subsections is whether Congress intended to exclude from liability all secondary participants except tippers. The ITSA seemingly excludes from liability only certain types of secondary participants — employers, controlling persons, and aiders and abettors. Because it failed to exclude beneficial owners[191] and conspirators[192] from secondary liability, Congress may have intended to impose treble penalties on these secondary participants. Attaching the adverb "solely" to the exclusions for aiders, abettors, and employers creates further uncertainty. The ITSA's legislative history includes statements that treble penalties should apply to those who share in the profits.[193] If secondary participants share the insider's profits, the subsection 2(B) exclusion may not apply because they will

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> under this paragraph solely by reason of employing another person who is liable under this paragraph.

ITSA § 2(B). Section 20(a) of the Exchange Act imposes liability on those who control, "directly or indirectly," others who commit securities law violations. 15 U.S.C. § 78t(a) (1982); *see* Carpenter v. Harris, Upham & Co., 594 F.2d 388, 393 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979); Rochez Bros. v. Rhoades, 527 F.2d 880, 889 (3d Cir. 1975).

[191] Courts have employed this theory to impose liability on inside traders whose spouses purchased shares on their behalf. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 841 n.4 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); *see* 5 A. JACOBS, *supra* note 13, at 2-379. The absence of its specific exclusion and the close relationship it requires between the insider and secondary participant suggest that courts may impose treble penalties on beneficial owners. The only legislative history on this point is a statement by the New York State Bar Association. It concluded that courts would interpret the ITSA to impose treble penalties on beneficial owners. *House Hearing*, *supra* note 3, at 301. Yet, this interpretation contradicts SEC and congressional statements limiting the treble penalty's application to tippers and traders. *Senate Hearing*, *supra* note 5, at 25 (statement of SEC Chairman John Shad); *House Report*, *supra* note 5, at 9.

[192] Civil conspiracy requires proof of an unlawful act and an agreement to commit the unlawful act. 5 A. JACOBS, *supra* note 13, at 2-363. No valid reason exists for imposing treble penalties on conspirators but not on aiders and abettors. The legislative history does not suggest that Congress considered any possible distinction. This question would never have arisen if Congress had drafted one provision clarifying secondary participant liability.

[193] *House Report*, *supra* note 5, at 28-29 (statement of SEC Chairman John Shad). The New York State Bar Association also concluded that aiders and abettors who share the insider's profits should be subject to treble penalties. *House Hearing*, *supra* note 3, at 301.

be doing more than "solely" employing, aiding, or abetting.[194]

Alternatively, Congress may have inserted subsection 2(B) expressly to exclude secondary participants other than tippers. Legislative history supports this interpretation.[195] However, while this reading removes the subsection's ambiguity, it undermines the ITSA's deterrent impact. It would exclude secondary participants who may be more culpable than the inside trader. For example, insiders might use their influence to help others gain access to secret corporate information and then split the profits with them.[196] Such persons may profit as much from the

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[194] Strictly construed, the exclusion is valueless because a plaintiff can always show that the defendant did more than "solely" employ or aid the inside trader. For example, an investment banking firm may be liable for a dealer's inside trades if, besides "solely employing" the dealer, it failed to institute proper safeguards. *Senate Hearing*, *supra* note 5, at 130 (statement of Sam Scott Miller on behalf of the Securities Industry Association).

Additionally, the exclusion for secondary participants creates ambiguity because Congress did not attach the adverb "solely" to controlling person liability. Instead, Congress simply stated that § 20(a), which provides the basis for controlling person liability, does not apply when the SEC seeks treble penalties. ITSA § 2(B). Possibly, the absence of "solely" from the controlling person exclusion suggests that Congress never intended to impose treble penalties on controlling persons irrelevant of their degree of participation or share in the profits. Alternatively, the absence of "solely" from the controlling person exclusion may represent legislative oversight. When reviewing the bill, Congress also attached the adverb "solely" to the controlling person exclusion. *House Report*, *supra* note 5, at 9.

Another possible unintended effect of the specific exclusions for secondary liability is that it may approve the validity of these theories. The Supreme Court has not determined whether rule 10b-5 applies to aiders and abettors. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 191 n.7 (1976). The specific exclusions for aiders, abettors, and employers may imply congressional approval of these theories. 5C A. JACOBS, *supra* note 13, at 11-421 to 11-422. Furthermore, Congress encouraged the SEC to apply these theories when the SEC does not seek a treble penalty. *House Report*, *supra* note 5, at 10.

This last point is particularly important in light of the two recent Supreme Court decisions in Herman & MacLean v. Huddleston, 459 U.S. 375 (1983), and Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353 (1982). In both cases, the Court held that congressional silence suggested approval of judicial interpretation. *Huddleston*, 459 U.S. at 385-86 (congressional silence indicates approval of the overlap between § 10(b) of the Exchange Act and § 11 of the Securities Act); *Curran*, 456 U.S. at 381-82 (congressional inaction suggests approval of a private remedy under the Commodity Exchange Act). In this case, the specific exclusions for secondary liability and the legislative history suggest congressional approval of these theories.

[195] *House Hearing*, *supra* note 3, at 92 (statement of SEC Chairman John Shad); *House Report*, *supra* note 5, at 9.

[196] *See, e.g.*, SEC v. Washington County Util. Dist., 676 F.2d 218 (6th Cir. 1982) (insider convinced board to use underwriter for public distribution of municipal bonds, knowing underwriter would commit inside trades and split profits with him); United

transaction as the individual who purchased the shares.[197] Furthermore, a broad exclusion for secondary participants may encourage technical evasions on the ground that the defendant did not "tip" or "trade."[198]

These contradictory subsections have created uncertainty and have hampered effective deterrence. One possible interpretation is that the ITSA exempts all secondary participants other than tippers. A second interpretation is that the ITSA imposes liability on all secondary participants that do more than "solely" aid, abet, or employ the inside trader. These contradictory and equally undesirable interpretations require a legislative amendment clarifying secondary participant liability.

### 2. Applying Treble Penalties to Willful Violators

To clarify secondary participant liability, Congress should delete subsection 2(B) because it only creates confusion by seemingly contradicting subsection 2(A). In addition, Congress should amend subsection 2(A) to read as follows:

Section 21(d)(2)(A):

> Whenever it shall appear to the Commission that any person has violated any provision of this title, except Section 20(a), or the rules or regulations thereunder by purchasing or selling a security while in possession of material nonpublic information . . . the court shall have jurisdiction to impose a civil penalty to be paid by such person, or any person willfully aiding and abetting such a person . . . .

### 3. Clarifying Secondary Participant Liability

The proposal would clarify secondary participant liability by replacing the existing contradictory subsections with one clear rule. Liability would not depend on whether the defendant was an "insider" or "tipper." Alternatively, evading liability would not require the defendant to prove she was in one of the excluded categories for aiders, abettors, or

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States v. Winans, 612 F. Supp 827 (S.D.N.Y. 1985) (brokers used access to stock exchange to trade for the account of a person whom they knew utilized material nonpublic information and then shared the profits with this person).

[197] *See Winans*, 612 F. Supp. 827 (brokers shared profits amounting to $690,000 with the person who misappropriated the inside information).

[198] Suppose an investment firm tells its junior brokers to make trades for the firm account when they learn inside information about a security. Though management never learns the details of the insider trading, it profits from the trades. Can the firm be held liable for treble damages as a tipper? *See* Langevoort, *supra* note 27, at 1284-85.

employers. Instead, the proposal would base liability on whether the defendant willfully assisted the inside trader.[199] This clear standard of secondary liability would provide needed guidance to litigants, judges, and investors.[200]

Thus, persons who knowingly help inside traders transfer funds out of the country would be subject to treble penalties, even though they did not technically trade or tip.[201] Similarly, persons who knowingly use their influence to help others gain access to inside information would be subject to treble penalties.[202] While neither person would be subject to treble penalties under the ITSA, they are both just as culpable as those who actually trade. By extending secondary liability to include all willful aiders and abettors,[203] the proposal achieves the SEC's

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[199] The phrase "willfully aiding and abetting" requires proof that the secondary participant knowingly assisted the principal in committing the inside trade. *See* Harmsen v. Smith, 693 F.2d 932, 943 (9th Cir. 1982), *cert. denied*, 464 U.S. 822 (1983); 5 A. JACOBS, *supra* note 13, at 2-356 to 2-357.

[200] Applying treble penalties only to traders and tippers may encourage courts to expand the definition of "trader" and "tipper" to include culpable participants who do not fit neatly within these categories. Such judicial construction may produce inconsistency, arbitrariness, and unpredictability.

[201] *See, e.g.*, United States v. Newman, 664 F.2d 12, 15 (2d Cir. 1981), *cert denied*, 464 U.S. 863 (1983).

[202] *See supra* note 196.

[203] Legislative history supports imposing secondary liability on all willful aiders and abettors. The SEC's draft bill imposed aider and abettor liability. The Insider Trading Sanctions Act of 1982, *reprinted in House Hearing, supra* note 3, at 318 (submitted Sept. 27, 1982). Commentators complained that courts might employ controlling person, respondeat superior, or other secondary participant theories to impose treble penalties on those who neither knowingly participated in, nor profited from, the transaction. *House Hearing*, *supra* note 3, at 209-10 (statement of Sam Scott Miller on behalf of the Securities Industry Association). Instead of drafting appropriate language, the SEC eliminated the liability of all secondary participants except tippers. Amended Bill Accompanying Letter to the Honorable Timothy E. Wirth (June 29, 1983), *reprinted in House Hearing*, *supra* note 3, at 101-03. The SEC's rationale was that secondary participants already were subject to adequate administrative sanctions. *House Hearing*, *supra* note 3, at 92-94 (statement of SEC Chairman John Shad); *Senate Hearing*, *supra* note 5, at 103-04 (statement of Arnold S. Jacobs). This rationale does not apply, however, to secondary participants who are not brokers or dealers and are thus not subject to administrative sanctions. Other commentators suggested instead that the SEC amend the ITSA to impose treble penalties on all those who "knowingly cause" violations. *Senate Hearing*, *supra* note 5, at 132, 141 (statement of Sam Scott Miller on behalf of the Securities Industry Association).

The Securities Industry Association also feared that the phrase "while in possession of material, nonpublic information" would impose no-fault treble liability on brokerage houses. ITSA § 2(A); *House Hearing*, *supra* note 3, at 208-10 (statement of Sam Scott Miller on behalf of the Securities Industry Association). One department of a multi-

and Congress' intended deterrence and punishes those most responsible for insider trading.

Arguably, the ITSA already provides sufficient deterrence by imposing treble penalties on traders and tippers. These parties usually share the profits and conceive the insider trading scheme.[204] However, by technically categorizing defendants, the law invites sly traders to avoid liability by artifice that on a literal level keeps them in a legitimate category.[205] Since Congress and the SEC intended to deter the most culpable participants, they should have done so directly by using the proposal's language to proscribe the undesirable activity.

### *D. Administrative Remedy*

#### 1. Uncertain Administrative Remedy

The ITSA's final shortcoming is its failure to clarify the SEC's administrative remedies. Under the ITSA, the SEC may order individuals to comply with the reporting requirements "upon such terms and con-

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service brokerage firm might recommend a stock purchase while persons in another department might possess inside information concerning the stock. *Id.* at 208. Courts might impose treble damages against the firm because it recommended purchases while possessing material nonpublic information. *Id.* at 208-09. The Senate drafted language allowing firms to implement reasonable procedures to avoid this result. S. 910, 98th Cong. 2d Sess., 130 CONG. REC. S8911 (daily ed. June 29, 1984). The Senate deleted this provision to allow the SEC flexibility in drafting such provisions. *Id.* at S8913-14 (statement of Sen. D'Amato).

Finally, the proposal expressly excludes § 20(a) because that section imposes liability on controlling persons. Controlling persons are liable if they "culpably participate" in the unlawful transaction. 5 A. JACOBS, *supra* note 13, at 2-370; *see* cases cited *supra* note 190. The proposal expressly excludes controlling person liability to clarify that only willful aiders and abettors are liable for treble damages. However, defendants who willfully assist the inside trader will not escape liability by arguing that they qualify as a controlling person.

[204] *House Hearing*, *supra* 3, at 93 (statement of SEC Chairman John Shad) (noting that the ITSA's rationale does not apply to controlling persons because they do not share in the illicit profits and do not tip those who unlawfully profit); *see also House Report*, *supra* note 5, at 9 ("the new civil penalty would be imposed upon those persons most directly culpable").

[205] An insider may pay another person to register the shares in her name. The SEC could not punish the trader unless the trader knew or was reckless in not knowing the trades were based on material nonpublic information. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976); Hoffman v. Estabrook & Co., 587 F.2d 509, 516 (1st Cir. 1978). The insider would evade punishment under a strict construction of the ITSA's language. *See, e.g.*, *Winans*, 612 F. Supp. at 831-32 (reporter purchased shares under friend's name without friend's knowledge).

ditions . . . as the Commission may specify."[206] The ITSA's failure to specify the SEC's administrative sanctions against individuals who repeatedly violate disclosure requirements undermines the ITSA's intended deterrent effect and creates the need for further legislation.

As noted, the ITSA allows the SEC to order responsible individuals to correct misleading disclosure documents.[207] While this provision authorizes the SEC to correct single disclosure violations, it does not provide sanctions against repeat violators.[208] If the individual fails to comply with an SEC administrative order requiring correction or amendment of disclosure documents, the SEC may petition the district court to order compliance.[209] However, once the individual has complied with the administrative order, she is not subject to additional administrative remedies if she later causes another disclosure violation.[210] Unless the SEC accepts the burdens of seeking injunctive relief, the SEC's only remedy is to issue another order compelling the repeat offender to correct the new reporting violation.[211] As a result, individuals can cause repeated disclosure violations without fear of any additional sanctions except another administrative order.[212]

The lack of an effective administrative remedy may continue to undermine SEC enforcement efforts. Alternatively, it may cause the SEC to extend its administrative authority unlawfully. The SEC General Counsel has concluded that the ITSA's broad language authorizes the SEC to bar repeat offenders from serving as directors and officers.[213]

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[206] ITSA § 4.

[207] *See supra* notes 109-18 and accompanying text.

[208] *Peters Says SEC May Need New Authority, More Weapons Against Repeat Offenders*, DAILY REP. FOR EXECUTIVES (BNA) No. 42, at A-7 (Mar. 4, 1985) (available Jan. 13, 1986, on LEXIS, Nexis library, Gov't file) [hereafter *New Authority*].

[209] *See supra* note 93.

[210] *New Authority*, *supra* note 208, at A-7; *Power to Bar Executives*, *supra* note 112, at C-1.

[211] Instead of proceeding administratively, the SEC can petition the district court to enjoin the individual from future securities law violations. 15 U.S.C. § 78u(d) (1982). Obtaining injunctive relief is difficult because the SEC must show that the defendant is reasonably likely to commit a future violation. *See supra* note 96; *House Hearing*, *supra* note 3, at 123-24 (statement of Dennis J. Block).

[212] Unlike with injunctions, noncompliance with an administrative order does not subject the defendant to contempt proceedings. *House Hearing*, *supra* note 3, at 126 (statement of Dennis J. Block).

[213] Noble, *Tougher Talk from SEC*, N.Y. Times, Dec. 3, 1984, at D2, col. 1. SEC General Counsel Dan Goelzer stated that Commissioner Treadway agrees that the ITSA grants the SEC this suspension authority. *Id.* In an earlier interview, Treadway stated that legislation would be necessary to authorize the SEC to obtain this remedy. *Power to Bar Executives*, *supra* note 112, at C-1. Other officials have concluded that

Because the ITSA does not explicitly grant the SEC this remedy, employing it may exceed the agency's authority.[214] Also, if the SEC applies such a severe remedy under the ITSA, the SEC may ultimately circumvent more stringent requirements in other parts of the securities laws. Because the ITSA does not include a scienter requirement, for example, the SEC might employ this remedy without proving the mental element required for other securities remedies.[215] Additionally, the SEC might use this authority to bar officers and directors for acts unrelated to disclosure documents.[216] Allowing the SEC to supervise corporate actions other than the submission of disclosure documents would exceed congressional limitations on the federal regulation of corporate management.[217]

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the ITSA does not grant the SEC this suspension authority. Noble, *supra*, at D2, col. 1 (statement of Theodore Levine, former Associate Director of Enforcement). *See also Commissioners Debate Delaware Poison Pill Case at 'SEC Speaks'*, 17 SEC. REG. & L. REP. (BNA) 400 (Mar. 8, 1985) (statements of Commissioners Marinaccio, Treadway).

[214] In Wallach v. SEC, 202 F.2d 462 (D.C. Cir. 1953), for example, the court denied the SEC's attempt to extend the administrative remedy of § 15(b) to parties not expressly covered by the statute. Similarly, in SEC v. Sloan, 436 U.S. 103 (1978), the court denied the SEC's attempt to extend the administrative authority of the Exchange Act § 12(k). 15 U.S.C. § 781(k) (1982). This section permits the SEC to suspend trading in any security for 10 days if necessary to protect investors. In *Sloan*, the SEC issued consecutive 10-day suspension periods. The Supreme Court held that imposing the sanctions without notice or hearing exceeded the scope of the SEC's administrative authority. The Court declined to read § 12(k) more broadly than its language and the statutory scheme reasonably permit. *Sloan*, 436 U.S. at 121; *see* Touche Ross & Co. v. SEC, 609 F.2d 570, 580 n.16 (2d Cir. 1979).

[215] To prosecute rule 10b-5 violators, the SEC must prove that the defendant knew or was reckless in not knowing she was employing material nonpublic information. *See supra* note 205; Aaron v. SEC, 446 U.S. 680 (1980). Suspending officers and directors without a similar finding of scienter would allow the SEC to impose serious remedies without appropriate safeguards. Siedel, *supra* note 186, at 471.

[216] Siedel, *supra* note 186, at 468-69. Courts should limit the SEC's authority to prohibiting actions that threaten the integrity of its own processes, such as submitting false reports. *Id.* at 468.

[217] Santa Fe Indus. v. Green, 430 U.S. 462, 479 (1976) (" 'Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement.' ") (quoting Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971)); *see* H.R. REP. NO. 1838, 73d Cong., 2d Sess. 35 (1934) (omitting provision stating SEC has no right to interfere in corporate management because "it is not believed the bill is open to misconstruction in this respect"); Siedel, *supra* note 186, at 469.

2. Barring Repeat Offenders

Congress should add a subsection authorizing the SEC to bar repeat offenders from preparing disclosure documents. This remedy would enhance the SEC's ability to ensure compliance with the disclosure requirements. The remedy also would ensure that the SEC does not exceed congressional limitations on its authority. The new subsection should read as follows:

Section 15c(4)(b):[218]

> If, after notice and an opportunity to be heard, the Commission finds that any corporate officer, director, or employee repeatedly has caused failures to comply with the reporting requirements of sections 12, 13, 14, or subsection (d) of section 15 of this title or any rule or regulation thereunder, due to acts or omissions the person[219] knew or should have known would contribute to the failures to comply, the Commission may censure, suspend, or bar the person from helping draft documents required under the above sections.

3. Vesting Discretion in Commissioners

The proposal purposefully gives the SEC discretion to impose the remedy. The Commissioners reviewing each case should examine a variety of factors before reaching their decision.[220] Though the repeated violations need not be willful, Commissioners should consider the individual's level of awareness when deciding the length of the suspension. Commissioners should also consider the individual's participation in preparing the documents. Individuals who carelessly misstate facts should receive longer suspensions than individuals who unreasonably rely on erroneous information provided by others.

Commissioners also should consider other factors. They should weigh the number of violations and the time between violations. The similarities between the violations are also relevant because the similarity tends to demonstrate willfulness. Commissioners should assess the damage caused by the misstatement. Erroneous disclosure documents can induce banks to advance millions in uncollectible loans, cause suppliers to advance unworthy credit, and defraud private investors of needed

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[218] The proposal will renumber the present § 15c(4) as § 15c(4)(a) and add § 15c(4)(b).

[219] The Exchange Act broadly defines "person" to include a natural person, company, or political subdivision. 15 U.S.C. § 78c(a)(9) (1982).

[220] Many of the factors are similar to the ones courts examine when determining whether to grant an injunction. 5C A. JACOBS, *supra* note 13, at 11-415.

funds.[221] If the individual did not willfully misrepresent facts, but had reason to know that misstatements would cause severe damages, Commissioners should treat her carelessness more harshly.

Critics may argue that the proposal has a low scienter requirement. Suspension can result when the officer, director, or employee negligently ignores disclosure violations on two occasions. The SEC currently has similar suspension authority over broker-dealers, lawyers, and accountants. However, the SEC cannot suspend these professionals unless they act willfully.[222] The proposal authorizes suspension absent a similar finding of willfulness.

Nevertheless, disclosure violations warrant a lower scienter requirement: When the SEC suspends broker-dealers or professionals, it deprives them of their livelihood.[223] But in this situation, officers, directors, and employees who do not prepare disclosure documents can still perform other functions within the corporation. Furthermore, unlike the broker-dealer and professional provisions,[224] the proposal only imposes suspension after the individual has been the subject of a previous compliance order. Finally, while the proposal has a low scienter requirement, Commissioners should consider the individual's willfulness in deciding the length of the suspension.

The proposal limits the SEC's authority to matters within its administrative capacity. The SEC will be able to ensure compliance with the disclosure requirements without deciding which individuals govern public corporations. The proposal provides a solid legislative foundation for preventing repeat offenders from participating in corporate disclosures.[225] This administrative remedy should achieve the deterrent

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[221] These are only examples of the entities or persons injured by misleading disclosure documents. *See* Remarks to Institute for Corporate Counsel (Mar. 11, 1983), *reprinted in House Hearing*, *supra* note 3, at 81-82 (speech of SEC Commissioner James Treadway); *see also Power to Bar Executives*, *supra* note 112, at C-1.

[222] 15 U.S.C. §78o(b)(4)(A) (1982); 17 C.F.R. § 201.2(e)(3)(iii) (1985).

[223] *See* Steadman v. SEC, 450 U.S. 91, 106 (1981) (Powell, J., dissenting) (suspension barring investment advisor from practicing his profession); Marsh, *Rule 2(e) Proceedings*, 35 BUS. LAW. 987, 994-95, 997 (1980) (noting that rule 2(e) suspensions deprive lawyers and accountants of their livelihood).

[224] 15 U.S.C. § 78o(b)(4)(A) (1982); 17 C.F.R. § 201.2(e) (1985).

[225] Arguably, the SEC need not rely on Congress, but could enact a rule giving it suspension authority against officers and directors. The Second Circuit previously upheld the SEC's power to include similar suspension authority in rule 2(e). 17 C.F.R. § 201.2(e) (1985); Touche Ross & Co. v. SEC, 609 F.2d 570 (2d Cir. 1979). Rule 2(e) authorizes the SEC to suspend professionals who lack the requisite qualifications or moral character or who willfully violate the securities laws. *Touche Ross* held that the SEC validly exercised its rulemaking authority when it enacted rule 2(e). The court

impact Congress and the SEC intended.[226]

## CONCLUSION

When working on the ITSA, the SEC and Congress feared that attempting to enact far-reaching legislation would delay or prevent the enactment of the ITSA's treble penalty provision.[227] Consequently, Congress confined its attention to passing the treble penalty and administrative provisions.

While these provisions should help deter insider trading and disclosure violations, primarily they demonstrate that additional legislation is necessary to make SEC enforcement effective. The ITSA's treble penalty provision does not deter because it does not apply to unfair users of

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noted that the SEC was not planning to use rule 2(e) as an additional enforcement tool. 609 F.2d at 579. The court also distinguished inconsistent case law on the ground that in those cases the SEC attempted to exceed legislative authority. *See supra* note 214. "Here, however, the Commission relies on its general rulemaking authority." 609 F.2d at 580 n.16. Consequently, the relevant standard is whether the rule is " 'reasonably related to the purposes of the enabling legislation.' " *Id.* at 579 (quoting Mourning v. Family Publications Serv., Inc., 411 U.S. 356, 369 (1973)). The court cited case law that upheld the drafting of administrative regulations necessary to protect the organization's processes. Goldsmith v. Board of Tax Appeals, 270 U.S. 117, 122 (1926) (Board has authority to regulate attorneys practicing before it); Koden v. United States Dep't of Justice, 564 F.2d 228 (7th Cir. 1977) (Immunization and Naturalization Service has authority to discipline attorneys appearing before it); Herman v. Dulles, 205 F.2d 715, 716 (D.C. Cir. 1953) (International Claims Commission has authority to discipline attorneys who fail to comply with the Commission's regulations).

Subsequent commentators have criticized the reasoning in *Touche Ross*. Downing & Miller, *The Distortion and Misuse of Rule 2(e)*, 54 NOTRE DAME LAW. 774 (1979); Siedel, *supra* note 186, at 464. *Touche Ross* may not apply to regulations enacted pursuant to the ITSA's authority because the SEC has clarified that it will use the ITSA as an additional enforcement weapon. 609 F.2d at 579; *see House Oversight Hearing*, *supra* note 86, at 344-46 (statement of SEC Chairman John Shad). However, the ITSA provides a more solid foundation for an enabling regulation than the broad language used in enacting rule 2(e). *Compare* 15 U.S.C. § 78w(a)(1) (1982); *Touche Ross*, 609 F.2d at 577-78.

[226] Similar to broker-dealers who are subject to administrative suspensions, corporate officers will have the authority to appeal to the entire Commission and then to the court of appeals. L. LOSS, *supra* note 16, at 702-03; Mathews, *The SEC and Civil Injunctions: It's Time to Give the Commission an Administrative Cease and Desist Remedy*, 6 SEC. REG. & L.J. 345, 353 (1979). Also, suspended officers will have the right to petition the Commission for reinstatement similar to rule 2(e). 17 C.F.R. § 201.2(e)(3)(ii) (1985).

[227] *Senate Hearing*, *supra* note 5, at 36 (statement of SEC Enforcement Director John M. Fedders); *House Hearing*, *supra* note 3, at 230 (statement of Rep. Wirth); *see also House Hearing*, *supra* note 3, at 197-98 (statement of Arnold S. Jacobs).

confidential corporate information. Similarly, administrative orders are ineffective because issuers can cause repeated violations without fear of additional sanctions. This Comment remedies these deficiencies by defining insider trading, expanding and clarifying secondary participant liability, and authorizing the SEC to bar repeat violators. Implementing these provisions would achieve the deterrence the SEC and Congress intended.

*Tammy L. O'Leary*
*Timothy F. O'Leary**

*Timothy F. O'Leary is a 1984 graduate of Boalt Hall, currently an associate attorney at the San Francisco law firm of Cooley, Godward, Castro, Huddleson & Tatum.