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A CRITIQUE OF THE INSIDER TRADING SANCTIONS ACT OF 1984

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Despite a significant increase in enforcement activity by the Securities and Exchange Commission,[1] insider trading[2] remains the most common violation of the federal securities laws.[3] The number of offenses suggests a failure of the existing regulatory system to deter insider trading.[4] In an attempt to remedy this perceived defect, Congress recently passed the Insider Trading Sanctions Act of 1984 (the ITSA or the Act).[5] The ITSA is intended to

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[1] See infra notes 78-92 and accompanying text.

[2] Insider trading is a difficult concept to define. In this note it is defined generally as conduct that violates the federal insider trading prohibition although this definition is admittedly circular and unsatisfactory.

The legal literature on insider trading is extensive. See, e.g., H. Manne, Insider Trading and the Stock Market (1966); B. Rider & H. Ffrench, The Regulation of Insider Trading (1979 & Supp. 1981); Brudney, Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws, 93 Harv. L. Rev. 322 (1979); Carlton & Fischel, The Regulation of Insider Trading, 35 Stan. L. Rev. 857 (1983); Dooley, Enforcement of Insider Trading Restrictions, 66 Va. L. Rev. 1 (1980); Heller, Chiarella, SEC Rule 14e-3, and Dirks: 'Fairness' Versus Economic Theory, 37 Bus. Law. 517 (1982); Karjala, Statutory Regulation of Insider Trading in Impersonal Markets, 1982 Duke L.J. 627; Levmore, Securities and Secrets: Insider Trading and the Law of Contracts, 68 Va. L. Rev. 117 (1982); Manne, In Defense of Insider Trading, Harv. Bus. Rev., Nov.-Dec. 1966, at 113; Schotland, Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market, 53 Va. L. Rev. 1425 (1967).

[3] See Dooley, supra note 2, at 7. There are no solid statistics on the incidence of insider trading. By the very nature of the activity, measurement of its frequency is probably impossible. Nevertheless, evidence indicates that its incidence is high. Studies of the investments made by corporate insiders indicate that they consistently outperform all other market actors. See, e.g., Finnerty, Insiders and Market Efficiency, 31 J. Fin. 1141 (1976); Givoly & Palmon, Insider Trading and the Exploitation of Inside Information: Some Empirical Evidence, 58 J. Bus. 69 (1985); Jaffe, Special Information and Insider Trading, 47 J. Bus. 410 (1974). These factors support the common perception that insider trading is widespread.

[4] See infra notes 46-47, 98-103 and accompanying text.

[5] Pub. L. No. 98-376, 98 Stat. 1264 (1984) (to be codified at 15 U.S.C. §§ 78c, 78o, 78t, 78u, 78ff). For commentary on the Act, see Insider Trading Sanctions Act 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. (1983) [hereinafter cited as House ITSA Hearing]; H.R. Rep. No. 355, 98th Cong., 1st Sess., reprinted in 1984 U.S. Code Cong. & Ad. News 2274 [hereinafter cited as House ITSA Report]; Flaherty, Should an 'Insider' Be Defined?, Nat'l L.J., Apr. 30, 1984, at 3, col. 1; Freeman, The Insider Trading Sanctions Bill--A Neglected Opportunity, 4 Pace L. Rev. 221 (1984); Junewicz, Insider Trading Act is Needed, but Without Defining the Term, Nat'l L.J., Apr. 30, 1984, at 24, col. 3; Stevenson, The Insider Trading Sanctions Act: Some Unfinished Business Ahead, Nat'l L.J., Oct. 15, 1984, at 18, col. 1.

increase the deterrent effect of the insider trading prohibition without changing the substantive common law governing insider trading cases. The Act creates a civil penalty of up to three times the profit gained, or loss avoided, through trading while in possession of material nonpublic information.[6]

This note examines the Act and considers its probable effect on insider trading. Part I outlines the development of the insider trading prohibition. Part II discusses the adoption of the Act and examines its provisions in the context of existing law. Part III criticizes the Act, suggesting that it will not have the deterrent effect anticipated by its drafters, and examines the possible effects of the ITSA on the development of the federal insider trading prohibition.

I. ORIGINS OF THE INSIDER TRADING PROHIBITION

A. State Common Law

State corporate law originally regulated insider trading. In the early 1900's, state courts adopted one of three approaches to the insider trading problem: the insider had no duty of disclosure and could buy freely regardless of any informational advantage; the insider had no duty in the absence of 'special circumstances' justifying the imposition of a duty; or the insider had a fiduciary duty to the shareholders and was required either to disclose any relevant inside information or to forgo trading.[7]

Prior to 1900 it was treatise law that '[t]he doctrine that officers and directors [or corporations] are trustees of the stockholders . . . does not extend to their private dealings with stockholders or others, though in such dealings they take advantage of knowledge gained through their offi-

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[6] The Act also increases the criminal fine applicable to securities violations, expands the SEC's administrative proceedings authority, and clarifies the prohibition on trading in derivative securities. See infra notes 129-39 and accompanying text.

[7] See infra notes 8-21 and accompanying text. For more thorough discussions of these approaches, see Berle, Publicity of Accounts and Directors' Purchases of Stock, 25 Mich. L. Rev. 827 (1927); Lake, The Use for Personal Profit of Knowledge Gained While a Director, 9 Miss. L.J. 427 (1937); Laylin, The Duty of a Director Purchasing Shares of Stock, 27 Yale L.J. 731 (1918); Smith, Purchase of Shares of a Corporation by a Director from a Shareholder, 19 Mich. L. Rev. 698 (1921); Walker, The Duty of Disclosure by a Director Purchasing Stock from his Stockholders, 32 Yale L.J. 637 (1923); Wilgus, Purchase of Shares of a Corporation by a Director from a Shareholder, 8 Mich. L. Rev. 267 (1910).

cial position.'[8] Liability in such dealings could arise only from actual fraud, such as misrepresentation or fraudulent concealment of a material fact. Liability therefore turned on whether the defendant said or did anything 'to divert or prevent, and which did divert or prevent, the plaintiff from looking into, or making inquiry, or further inquiries, as to the affairs or condition of the company and its prospects for dividends . . .'[9]

After 1900 most courts continued to reject any fiduciary duty on the part of corporate officers and directors in their private dealings with shareholders.[10] In 1903, however, the Georgia Supreme Court adopted a fiduciary duty rule, holding that the shareholder had a right to disclosure.[11] The court stated that ' w here the director obtains the information giving added value to the stock by virtue of his official position, he holds the information in trust for the benefit of the shareholders .'[12] Similarly, in 1904, the Kansas Supreme Court approved the notion that a director has a duty to all shareholders to disclose material information about the corporation.[13]

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[8] Wilgus, supra note 7, at 267 (quoting 21 The American and English Encyclopedia of Law 898 (2d ed. 1902)).

[9] Carpenter v. Danforth, 52 Barb. 581, 589 (N.Y. Sup. Ct. 1868), discussed in Wilgus, supra note 7, at 272-74. See also Grant v. Attrill, 11 F. 469 (S.D.N.Y. 1882) (holding that a sale of stock induced by the levy of an assessment was not so tainted with fraud as to render it void); Board of Comm'rs v. Reynolds, 44 Ind. 509 (1873) (holding over a strong dissent that there was no trustee relationship because directors did not have control, power, or dominion over the shares); Crowell v. Jackson, 53 N.J.L. 656, 23 A. 426 (1891) (liability only for active misrepresentation, no general duty of disclosure); Krumbhaar v. Griffiths, 151 Pa. 223, 25 A. 64 (1892) (shareholder cannot rescind sale of stock to secretary of corporation who discloses all information he has and conceals neither the condition of the corporation nor the value of the stock); Fisher v. Budlong, 10 R.I. 525 (1873) (liability solely because director was acting as an agent for the shareholder in the sale of the stock and abused that relationship to obtain the shares for himself at a price lower than their actual value); Deaderick v. Wilson, 67 Tenn. 108 (1874) (directors are free to purchase stock from a shareholder in the corporation on the same terms as others unless prohibited by legislative action); Hume v. Steele, 59 S.W. 812 (Tex. Civ. App. 1900) (liability based only on actual fraud); Haarstick v. Fox, 9 Utah 110, 33 P. 251 (1893) (no duty of disclosure absent active misrepresentation); Wilgus, supra note 7, at 267 (citing no pre-1900 cases calling for disclosure absent some special agency relationship outside of director-shareholder).

[10] See, e.g., Hooker v. Midland Steel Co., 215 Ill. 444, 74 N.E. 445 (1905); Walsh v. Goulden, 130 Mich. 531, 90 N.W. 406 (1902).

[11] Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232 (1903).

[12] Id. at 368-70, 45 S.E. at 234-35.

[13] Stewart v. Harris, 69 Kan. 498, 502, 77 P. 277, 279 (1904). Cf. Von Au v. Magenheimer, 126 A.D. 257, 110 N.Y.S.2d 629 (1908) (stockholder in nonpublic corporation who was induced to sell shares by misrepresentation on the part of management has action for damages). In Steinfeld v. Neilsen, 12 Ariz. 381, 100 P. 1094 (1909), rev'd, 224 U.S. 534 (1912), the lower court followed Oliver and Stewart but found no liability because the plaintiff had equal access to the information. On remand, the court appeared to follow Strong v. Repide, 213 U.S. 419 (1909), discussed infra notes 14-15 and accompanying text, but found no special circumstances justifying a duty of disclosure. Steinfeld v. Nielsen, 15 Ariz. 424, 139 P. 879 (1914).

In 1909, the United States Supreme Court introduced the special circumstances rule in Strong v. Repide.[14] In Strong, a director purchased shares from a stockholder at less than one-tenth of their potential value. In doing so, the director concealed both his identity and the imminent announcement of a profitable contract. The Court held that under such 'special circumstances' the stockholder was entitled to recission or damages for fraud.[15]

The no duty rule remained dominant in 1910, yet both the special circumstances and the fiduciary duty rules were gaining adherents. Between 1910 and 1921, every case that dealt with the question at least considered the two 'minority' rules.[16] No jurisdiction facing the question on first impression during this period adopted the older rule.[17]

The trend away from the no duty rule continued after 1921.[18] In 1937 one commentator argued that the special circumstances rule had become the majority, or at least the plurality, rule and that the fiduciary duty rule had been adopted in a substantial minority of jurisdictions.[19] Both the special circumstances and fiduciary duty rules, however, were more limited in application than in doctrine. These rules were applied only to face-to-face transactions with existing shareholders.[20] The uniform rule in exchange transactions remained one of no duty to disclose.[21]

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[14] 213 U.S. 419 (1909).

[15] Id. at 434-35.

[16] A 1921 updating of the Wilgus article identified 13 cases dealing with the duty to disclose inside information. Eight of these cases imposed liability for failure to disclose. Six cases, following the Strong special circumstances rule, found special facts justifying liability. The other two cases followed the fiduciary duty approach of Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232 (1903). See supra notes 10-11 and accompanying text. Of the five cases finding no liability, three cases said they would follow the older rule, but went out of their way to demonstrate that there were no special circumstances. The other two cases refused to adopt the older rule, but found no special circumstances justifying imposing a duty of disclosure. Smith, supra note 7, at 712-13.

[17] Smith, supra note 7, at 713.

[18] See, e.g., Brophy v. Cities Servs. Co., 31 Del. Ch. 241, 70 A.2d 5 (1949); Hotchkiss v. Fischer, 136 Kan. 530, 16 P.2d 531 (1932); Diamond v. Oreamuno, 24 N.Y.2d 494, 301 N.Y.S.2d 78, 248 N.E.2d 910 (1969) (creating a remedy for insider trading for the corporation whose stock was traded). But see Waller v. Hodge, 214 Ky. 705, 283 S.W. 1047 (1926); Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659 (1933).

[19] Lake, supra note 7, at 448-49. Professor Loss has suggested that the 'evolution of the common law toward the 'minority' view [the fiduciary duty rule] was aborted by the onslaught of Rule 10b-5.' L. Loss, Fundamentals of Securities Regulation 820 (1983).

[20] Conant, Duties of Disclosure of Corporate Insiders Who Purchase Shares, 46 Cornell L.Q. 53, 54-57 (1960).

[21] See, e.g., Goodwin v. Agassiz, 283 Mass. 358, 361, 186 N.E. 659, 660 (1933).

B. Federalizing the Prohibition

Although the federal securities laws do not preempt the state common-law rules on insiders, federal regulation under the 1934 Securities Exchange Act[22] has essentially superseded them. Although the SEC, the courts,[23] and Congress[24] have frequently contended that ' t he elimination of insider trading abuses was one of the goals of the Exchange Act,'[25] it is debatable whether Congress even intended to address insider trading in the 1934 Act.[26] Federal regulation of the abuse developed through administrative rulemaking and judicial interpretation rather than through legislative action, however, and the ITSA represents the first explicit congressional recognition of the prohibition against insider trading.

A close examination of the 1934 Act and its legislative history suggests that the statute was not intended to include the use of inside information, but only the use of manipulative devices such as market pools.[27] The conventional argument for inclusion is that Congress intended to prevent the use of nonpublic information by corporate insiders through section 16,

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[22] 15 U.S.C. §§ 78a-78kk (1982).

[23] See, e.g., Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 235 (2d Cir. 1974); Kohler v. Kohler Co., 319 F.2d 634, 637- 38 (7th Cir. 1963); SEC v. Lum's Inc., 365 F. Supp. 1046, 1057 (S.D.N.Y. 1973); Speed v. Transamerica Corp., 99 F. Supp. 808, 829 (D. Del. 1951).

[24] The House ITSA Report states:

> Congress condemned insider trading as being contrary to key national interests and, in an effort to curb such activity, adopted section 16(b) of the Exchange Act, which provides that profits earned by corporate officers, directors and controlling shareholders in certain short-term purchases and sales of securities 'shall inure to and be recoverable by the issuer. . . .' The express purpose of section 16(b) is 'preventing the unfair use of information' by such persons.
>
> However, the abuses sought to be remedied were not limited to actions of corporate insiders and large stockholders. Therefore, Congress included in the Exchange Act abroad [sic], general antifraud provision, section 10(b) and, in May 1942, acting under section 10(b), the Commission adopted Rule 10b-5.

House ITSA Report, supra note 5, at 3, reprinted in 1984 U.S. Code Cong. & Ad. News at 2276.

[25] Id. See also S. Rep. No. 1455, 73d Cong., 2d Sess. 55 (1934), quoted in House ITSA Report, supra note 5, at 3, reprinted in 1984 U.S. Code Cong. & Ad. News at 2276. ('Among the most vicious practices unearthed at the hearings . . . was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities.').

[26] See infra notes 27-45, 321-23 and accompanying text.

[27] A number of commentators have argued that Congress did not intend to regulate insider trading under the 1934 Act except through the limited provisions of section 16, 15 U.S.C. § 78p (1982). See, e.g., Carlton & Fischel, supra note 2, at 884 n.90; Dooley, supra note 2, at 55-69; Easterbrook, Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information, 1981 Sup. Ct. Rev. 309, 317-20.

while addressing other abuses of inside information in section 10(b).[28] If so, then section 16 is oddly drafted because it does not prohibit trading on the basis of inside information, but simply requires that insider transactions be reported,[29] prohibits short sales by insiders,[30] and permits the issuer to recover insider short-swing profits.[31] The scope of section 16 as to insider trading is thus quite limited; it does not reach transactions occurring more than six months apart, nor does it apply to persons other than those named in the statute or to transactions in securities not registered under section 12.[32] These limitations, especially when considered in light of the 1934 Act's legislative history, suggest that in 1934 Congress did not intend to prohibit or even regulate insider trading through section 16.[33]

Although the SEC and the courts have created a much broader prohibition of insider trading using section 10(b)[34] and Rule 10b-5,[35] neither the section nor the rule explicitly regulates insider trading or prohibits nondisclosure of inside information in insider trades. Nothing in the legislative history of either provision suggests that Congress or the SEC intended such a prohibition. Indeed, section 10(b) received minimal attention during the hearings on the 1934 Act and was apparently seen simply as a grant of authority to the SEC to prohibit manipulative devices not covered by section 9.[36]

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[28] See, e.g., House ITSA Report, supra note 5, at 3, reprinted in 1984 U.S. Code Cong. & Ad. News at 2276 (quoted supra note 25).

[29] 15 U.S.C. § 78p(a) (1982).

[30] Id. § 78p(b).

[31] Id.

[32] See id. § 78p.

[33] As the SEC's solicitor recently observed, '[m]odern development of the law of insider trading is a classic example of common law in the federal courts. No statute defines insider trading; no statute expressly makes it unlawful.' Gonson & Butler, In Wake of 'Dirks,' Courts Debate Definition of 'Insider,' Legal Times, Apr. 2, 1984, at 16, col. 1.

The first version of section 16 (section 15 in draft) permitted corporate recovery of both insider and tippee short-swing profits, and prohibited the tipping of confidential information by insiders. Stock Exchange Regulation: Hearing on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 9-10 (1934) [hereinafter cited as Stock Exchange Regulation Hearing]. The House deleted both provisions, but the restriction on insider short-swing profits was restored in conference. S. Doc. No. 185, 73d Cong., 2d Sess. 16-17 (1934).

[34] 15 U.S.C. § 78j(b) (1982).

[35] 17 C.F.R. 240.10b-5 (1984).

[36] See Stock Exchange Regulation Hearing, supra note 33, at 115 (testimony of Thomas G. Corcoran, Reconstruction Finance Corp.) (Corcoran described the predecessor to section 10(b) as a prohibition on the invention of 'any other cunning devices').

The argument that neither section 10(b) nor rule 10b-5 originally prohibited insider trading, once made chiefly by academic opponents of the prohibition, has come to be recognized even by certain segments of the popular press. For example, as The Economist recently observed:

The 1934 act did not either specifically define or proscribe insider trading. Pre-1929, the biggest culprits of insider dealing were corporate officials. So the legislators laid down precise boundaries

Not until 1961 did the SEC or a court use either section 10(b) or Rule 10b-5 to regulate insider trading. In In re Cady, Roberts & Co.,[37] the SEC decided that Rule 10b-5 prohibited insider trading, holding that insider trading fit into the rule's proscription of 'a fraud or deceit . . . in connection with the purchase or sale of a security.'[38]

At the time it was unclear whether Cady, Roberts, which was an administrative proceeding against a regulated broker-dealer, presaged general application of Rule 10b-5 to insider trading.[39] In SEC v. Texas Gulf Sulphur Co.,[40] however, the Second Circuit removed that uncertainty, holding that 'anyone in possession of material inside information must either disclose it to the investing public, or . . . must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.'[41]

Although Cady, Roberts and Texas Gulf Sulphur represented a significant departure from SEC and judicial precedent,[42] they were followed

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within which directors, officers and large shareholders could deal in the stock of their companies. The principles were established by case law.

There was no attempt by the 1934 legislators to outlaw insider trading by stockbrokers, other insiders (and outsiders) who came into possession of privileged information. It was not until 1942 that the commission tackled the problem. It promulgated the so-called Rule 10B-5 under the section of the 1934 act which allowed it to lay down rules to protect the public. But again, there was no specific mention of insider trading. The rule simply forbad securities trading based on fraudulent activity. It was to be left to the courts to decide what was and was not fraudulent.

The Economist, June 30, 1984, at 68. See also Wayne, Insider Trading by Outsiders, N.Y. Times, May 27, 1984, § 3, at 2, col. 2 ('there is no statute that specifically defines and prohibits the activity'). One of the co-drafters of the rule, however, has argued that it 'was adopted . . . to deal with a case of fraudulent use of truly inside information.' Freeman, supra note 5, at 222.

[37] 40 S.E.C. 907 (1961).

[38] Id. at 913. See 17 C.F.R. § 240.10b-5(c) (1984).

[39] See, e.g., Recent Decision, 48 Va. L. Rev. 398, 403-04 (1962) ('in view of the limited resources of the Commission, the unfortunate existence of more positive and reprehensible forms of fraud, and the inherent problems concerning proof and evidence adhering to any controversy involving a breach of duty of disclosure, there is little prospect of excessive litigation evolving pursuant to [Cady, Roberts]'). But cf. Comment, Broker Silence and Rule 10b-5: Expanding the Duty to Disclose, 71 Yale L.J. 736, 747 (1962) ('While the SEC confined itself to a holding on the narrow situation in the present case, it is likely that the Cady, Roberts decision is a warning that it will move in the direction of expanding the scope of liability.').

[40] 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

[41] Id. at 848.

[42] Prior to Cady, Roberts, the SEC apparently did not view Rule 10b-5 as governing insider trading. See, e.g., Cook & Feldman, Insider Trading Under the Securities Exchange Act (pts. 1 & 2) 66 Harv. L. Rev. 385, 612 (1953) (a lengthy article on insider trading coauthored by then SEC Chairman Cook that does not even mention Rule 10b-5).

and refined in a line of cases that established a federal common-law prohibition of insider trading under Rule 10b-5.[43] The Supreme Court recently discussed the elements of a 10b-5 violation in Dirks v. SEC.[44] In Dirks, the Court held that an insider has a duty to disclose material nonpublic information only when there exists a fiduciary relationship that affords the insider 'access to inside information intended to be available only for a corporate purpose.'[45]

II. THE INSIDER TRADING PROHIBITION AND THE ITSA

Despite the establishment of the federal prohibition, the perceived incidence of insider trading continued to rise throughout the 1970's and early 1980's.[46] The frequency of violations has been attributed to the mildness of existing sanctions and the low level of SEC enforcement activity, which combined to produce a low-risk situation for inside traders.[47] The ITSA's principal purpose is to remedy the failure of the pre-ITSA enforcement regime to deter insider trading.[48] The federal common-law prohibition,

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[43] See, e.g., Dirks v. SEC, 103 S. Ct. 3255 (1983); Chiarella v. United States, 445 U.S. 222 (1980); Moss v. Morgan Stanley Inc., 719 F.2d 5 (2d Cir. 1983), cert. denied, 104 S. Ct. 1280 (1984); United States v. Newman, 664 F.2d 12 (2d Cir. 1981), cert. denied, 104 S. Ct. 193 (1983); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974). The full range of the Rule 10b-5 jurisprudence is beyond the scope of this note, but has been thoroughly explored elsewhere. See, e.g., L. Loss, supra note 19, at 799-946, 1125-52. This note discusses these portions of the federal common law of insider trading that are or may be affected by the ITSA. The most important way in which the federal prohibition differs from the state common law is through its applicability to exchange transactions. See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

[44] 103 S. Ct. 3255 (1983).

[45] Id. at 3260.

[46] See Blumstein, Insider Trading Hard to Measure, S.E.C. Suing More Often, N.Y. Times, Jan. 9, 1984, at D1, col. 4; Noble, S.E.C. Chief Plans Insider Trading Curb, N.Y. Times, Oct. 26, 1981, at D1, col. 1.

[47] See infra notes 93-103 and accompanying text. As Representative Wirth, author of the House version of the Act, has observed:

> [U]nder current law, insider trading is virtually a no-risk practice. . . .
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> . . . .PlaceHolderForCentered
>
> As we have seen by the increased incidences of insider trading, even the SEC's stepped up enforcement program against insider trading has failed to halt the abuses. The SEC simply must have the tools to deal with this problem effectively.
>
> Passage of [the ITSA] is a critical step in curbing insider trading.

130 Cong. Rec. H7759 (daily ed. July 25, 1984).

[48] See House ITSA Hearing, supra note 5, at 18 (statement of John S. R. Shad, SEC Chairman) ('Despite vigorous enforcement efforts, insider trading continues because it presents an opportunity to reap huge profits with little risk.'); House ITSA Report, supra note 5, at 8, reprinted in 1984 U.S. Code Cong. & Ad. News at 2281; 130 Cong. Rec. S8914 (daily ed. June 29, 1984) (remarks of Sen. Sarbanes) ('the Insider Trading Sanctions Act of 1984 is much needed legislation to deter insider trading'); 130 Cong. Rec. S8913 (daily ed. June 29, 1984) (remarks of Sen. D'Amato) (the ITSA 'would

however, will continue to play an important role as an ancillary enforcement mechanism.[49]

A. 'Strengthening' the Prohibition: Adoption of the ITSA

Before passage of the ITSA, the SEC had a number of enforcement mechanisms available for use in insider trading cases, including civil injunctions, administrative proceedings, and criminal prosecutions.[50] As noted, however, these tools have failed to control insider trading.

Section 21(d) of the 1934 Act empowers the SEC to seek an injunction whenever 'it shall appear to the Commission that any person is engaged or is about to engage in any acts or practices constituting a violation of' the Act or any rules promulgated thereunder.[51] Upon 'a proper showing, a permanent or temporary injunction or restraining order shall be granted' by the court against the commission of such acts.[52] The courts have not established very stringent standards for the granting of an injunction under section 21(d). A 'proper showing' requires merely that the SEC demonstrate a violation of the securities laws and a reasonable likelihood of future violations.[53] The SEC has not been required to meet traditional requirements for equitable relief such as irreparable harm.[54]

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amend the Securities and Exchange Act of 1934 to provide strong deterrence to the crime of insider trading'); 129 Cong. Rec. S3866 (daily ed. Mar 23, 1983) (remarks of Sen. D'Amato) ('This bill has a single purpose: the elimination of [insider trading,] one of the greatest harms to the integrity of our securities' markets.'); Flaherty, supra note 5, at 28, col. 1 ('There simply aren's sufficient disincentives to insider trading in our current remedies.') (quoting Gary Lynch, SEC Assistant Director for Enforcement); Blumstein, supra note 46, at D1, col. 4.

[49] See infra notes 282-323 and accompanying text.

[50] Other potential enforcement tools include prosecutions under the Mail Fraud statute, 18 U.S.C. § 1341 (1982), or the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. § 1962(b) (1982). For a comprehensive discussion of insider trading remedies, see Levine, Ferrigno & Mann, An Assessment of the Law Proscribing Insider Trading after Dirks, in The New Face of Insider Trading: Chiarella, Dirks, and Beyond 239, 268-81 (1983).

[51] 15 U.S.C. § 78u(d) (1982).

[52] Id.

[53] See SEC v. Commonwealth Chem. Sec., Inc., 574 F.2d 90, 99-100 (2d Cir. 1978). But cf. SEC v. Lund, 570 F. Supp. 1397, 1404 (C.D. Cal. 1983) (court denied an injunction on the grounds that the defendant's action was 'an isolated occurrence' and that his 'profession [was] not likely to lead him into future violations').

[54] See SEC v. Management Dynamics, Inc., 515 F.2d 801 (2d Cir. 1975); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082 (2d Cir. 1972).

Nor has the SEC been required to identify particular individuals who were wronged by the conduct; it is enough for the SEC to show that the insider traded in the security.[55]

The Second Circuit has observed that '[o]nce the equity jurisdiction of the district court has been properly invoked by the showing of a securities law violation, the court possesses the necessary power to fashion an appropriate remedy.'[56] Thus, in addition to or in place of injunctive relief, the SEC may seek disgorgement of profits, correction of misleading statements, disclosure of material information, or other special remedies.[57]

After the injunction, disgorgement is the most commonly used judicial enforcement tool.[58] Disgorgement requires the defendant to give up the profits he realized through the use of material nonpublic information. Courts have disagreed on the proper measure of the profits that must be disgorged. Some courts have required that the defendant disgorge potential, as well as actual, profits.[59] Other courts have required that non-trading tippers 'disgorge' an amount equal to the profits made by their tippees.[60] The SEC has supported these holdings, but has also argued that the amount of profits to be disgorged should be measured by the difference in the market prices on the actual dates of purchase and sale of the securities.[61] The First Circuit recently rejected this position in SEC v. MacDonald,[62] where the court held that the market price should be measured not on the actual date of sale, but by the price a reasonable time after the inside information was made public.[63]

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[55] See United States v. Naftalin, 441 U.S. 768 (1979).

[56] SEC v. Manor Nursing Centers, 458 F.2d 1082, 1103 (2d Cir. 1972).

[57] See House ITSA Report, supra note 5, at 7, reprinted in 1984 U.S. Code Cong. & Ad. News at 2280.

[58] See id. at 24, reprinted in 1984 U.S. Code Cong. & Ad. News at 2296 (memorandum of the Securities and Exchange Commission in Support of the Insider Trading Sanctions Act of 1982). The SEC first sought disgorgement in SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262 (S.D.N.Y. 1966), aff'd in part, rev'd in part, 446 F.2d 1301, 1307-08 (2d Cir.), cert. denied, 404 U.S. 1005 (1971). The SEC sought disgorgement in 12 of 37 cases initiated after Texas Gulf Sulphur and reported between 1966 and 1980. Dooley, supra note 2, at 14 n.69; see also House ITSA Report, supra note 5, at 7, reprinted in 1984 U.S. Code Cong. & Ad. News at 2280 ('The principal . . . remedy available to the Commission against insider trading is an injunction against future violations of the securities laws and disgorgement of illicit profits.').

[59] See, e.g., SEC v. Shapiro, 494 F.2d 1301, 1309 (2d Cir. 1974).

[60] See, e.g., SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301, 1308 (2d Cir.), cert. denied, 404 U.S. 1005 (1971).

[61] House ITSA Hearing, supra note 5, at 94-95 (letter from SEC Chairman John S. R. Shad to Rep. Wirth).

[62] 699 F.2d 47 (1st Cir. 1983).

[63] Id. at 54-55. For more detailed discussion, see infra notes 192-96 and accompanying text. In addition to disgorgement and injunctions, the SEC may also seek special forms of equitable relief. These include requiring the cancellation of stock options and adoption of internal controls on the use of nonpublic information. See House ITSA Report, supra note 5, at 7, reprinted in 1984 U.S. Code Cong. &

The SEC may also punish insider trading by regulated market professionals through administrative proceedings. Under section 15(b)(4) of the 1934 Act, the SEC may censure, limit the activities of, suspend, or revoke the registration of a broker or dealer who 'willfully' violates the insider trading prohibition.[64] Similar sanctions may be imposed on those associated with the broker or dealer in such activities.[65] The SEC may still issue a report of its investigation of the incident if it decides not to pursue judicial or administrative proceedings.[66]

Finally, the SEC may request that the Attorney General institute criminal proceedings against violators.[67] Under section 32(a), 'any person who willfully violates' the securities laws 'shall upon conviction be fined not more than $10,000, or imprisoned not more than five years.'[68] Criminal sanctions, however, may only be imposed where the trader violates a fiduciary duty.[69]

Although these responses would appear to provide substantial penalties for insider trading, Congress,[70] the SEC,[71] academics,[72] and the press[73] generally agreed that pre-ITSA sanctions failed to deter insider trading. This lack of deterrence was commonly blamed on opportunities created

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Ad. News at 2280. These remedies are rarely sought or imposed in practice, however. See Dooley, supra note 2, at 74-83 (summarizing the results of 37 insider trading cases between 1966 and 1980).

[64] 15 U.S.C. § 78o(b)(4) (1982).

[65] Id. § 78o(b)(6).

[66] Id. § 78u(a); see also SEC Exchange Act Release No. 15,664, reprinted in Fed. Sec. L. Rep. (CCH) ¶82,014, at 81,557 (Mar. 21, 1979) (setting forth the Commission's policy with regard to issuance of such reports).

[67] 15 U.S.C. § 78u(d) (1982).

[68] Id. § 78ff(a).

[69] Chiarella v. United States, 445 U.S. 222, 235 (1980).

[70] See House ITSA Report, supra note 5, at 5-6, reprinted in 1984 U.S. Code Cong. & Ad. News at 2278-79; see also 130 Cong. Rec. H7757 (daily ed. July 25, 1984) (remarks of Rep. Dingell); 129 Cong. Rec. S3865-66 (daily ed. Mar. 23, 1983) (remarks of Sen. D'Amato).

[71] See House ITSA Report, supra note 5, at 24-25, reprinted in 1984 U.S. Code Cong. & Ad. News at 2296-97 (memorandum of the Securities and Exchange Commission in Support of the Insider Trading Sanctions Act of 1982); see also House ITSA Hearing, supra note 5, at 18-27 (statement of John S. R. Shad, SEC Chairman) (discussing reasons and remedies for the increase in insider trading); Goelzer, SEC General Counsel's Speech on Insider Trading, Legal Times, Nov. 7, 1983, at 28 (discussing the limited deterrent effect of SEC enforcement).

[72] See, e.g., Carlton & Fischel, supra note 2, at 858-59; Dooley, supra note 2, at 1.

[73] See, e.g., Barron's, July 24, 1978, at 7; The Economist, June 30, 1984, at 67; Flaherty, supra note 5, at 3, col. 1; Lewin, Defining Insider Trades, N.Y. Times, May 17, 1983, at D2, col. 1; Louis, The Unwinnable War on Insider Trading, Fortune, July 13, 1981, at 72; Newsweek, Nov. 16, 1981, at 77.

by the increasing number of tender offers and takeovers[74] and the recent growth of the options market.[75]

A merger or acquisition provides an opportunity for individuals with advance knowledge of the transaction to reap enormous profits. Because target share prices almost always rise toward the bid price once an offer is made public, corporate insiders and associated parties such as lawyers, investment bankers, accountants, financial printers, and their employees can use their informational advantage to buy target shares at the pre-bid price with little risk of financial loss.

The use of option contracts has also increased the profitability of insider trading. Call option contracts for the purchase of common stock typically give the holder of the option the right to purchase 100 shares of common at a fixed price. Because the price of the option is typically a small fraction of the actual share price, very little capital is at risk.[76] The insider, anticipating a substantial rise in share price once the information is made public, can buy an option with an exercise price at or close to the current pre-announcement market price and exercise his option once the information is made public and the share price has risen. By promptly selling the purchased shares, he covers his outlay immediately and reaps a sizeable profit.[77]

Recognizing that this enormous potential for profit had contributed to an increase in the incidence of insider trading, the SEC in 1979 substantially increased its enforcement activities. Between 1979 and 1981 the SEC charged thirty-three individuals with insider trading violations.[78]

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[74] The number of tender offers and takeovers increased from 1889 in 1980 to 2533 in 1983. The Economist, June 30, 1984, at 68. Chairman Shad argues that '[t]he large number of mergers and tender offers has been an important factor in the increased incidence of insider trading.' House ITSA Hearing, supra note 5, at 19 (statement of John S. R. Shad, SEC Chairman).

[75] See House ITSA Hearing, supra note 5, at 19 (statement of John S. R. Shad, SEC Chairman); The Economist, June 30, 1984, at 68; Williams, Insider Trading and Options, N.Y. Times, Apr. 13, 1983, at D1, col. 3. The growth in the tender offer and options markets, however, cannot by itself explain the insider trading phenomenon. This growth has increased opportunities for gain, but some other factor must account for the willingness of insiders to take advantage of these opportunities. One explanation may be a perception, based on the low probability of detection, that insider trading is a no-risk offense. See supra note 47 and accompanying text.

[76] House ITSA Hearing, supra note 5, at 19-20 (statement of John S. R. Shad, SEC Chairman); The Economist, June 30, 1984, at 68.

[77] For example, when Thomas C. Reed, a former special assistant to President Reagan, learned of a proposed takeover of Amax, Inc., he allegedly purchased $3125 of Amax options. The next day the bid was announced and Mr. Reed exercised his options, yielding a profit of $427,000. Lewin, supra note 73. See also Williams, supra note 75, at D7, col. 1 (discussing an illustrative example).

[78] The Economist, June 30, 1984, at 67.

The emphasis on insider trading increased further with the 1981 appointment of John Shad as Chairman of the SEC.[79] Chairman Shad promised to make insider trading a top priority of his administration and 'to come down with hobnail boots to give some startling examples to inhibit' insider trading.[80] Since 1982, forty-nine individuals have been charged with insider trading offenses, almost one-third of all those prosecuted in the SEC's history.[81] Moreover, the SEC has initiated a vigorous enforcement campaign to expand the scope of the prohibition[82] to include not only true corporate insiders but also outsiders such as a financial printer,[83] an investment analyst,[84] investment bankers,[85] a football coach,[86] and a Wall Street Journal reporter.[87]

The SEC has obtained only mixed results in these recent cases.[88] Yet in addition to producing an important new strategy (a misappropriation theory) for including outsiders within the prohibition,[89] these cases represent a new SEC approach to deterring insider trading--the 'big bang' enforcement theory.[90] Faced with limited enforcement resources, the SEC has chosen to prosecute high visibility cases to maximize the publicity and the resulting deterrence from each case.[91] Indeed, the ultimate outcome of the case is probably less important to the 'big bang' approach than the publicity surrounding the prosecution.[92]

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[79] Id. See also Noble, supra note 46, at D1, col. 1 (discussing recent SEC plans to curb insider trading).

[80] Id.

[81] The Economist, June 30, 1984, at 67.

[82] Bonner, The Legal Questions in Journal Case, N.Y. Times, May 19, 1984, at 31, col. 3.

[83] Chiarella v. United States, 445 U.S. 222 (1980).

[84] Dirks v. SEC, 103 S. Ct. 3255 (1983).

[85] United States v. Newman, 664 F.2d 12, 19 (2d Cir. 1981), cert. denied, 104 S.Ct. 193 (1983).

[86] SEC v. Switzer, 590 F. Supp. 756 (W.D. Okla. 1984).

[87] SEC v. Brant, Fed. Sec. L. Rep. (CCH) ¶91,571 (S.D.N.Y. July 12, 1984). Former SEC Director of Enforcement John M. Fedders has described these cases as seeking to bring '[e]veryone including the butcher, baker and the candlestick makers' within the prohibition. Wayne, supra note 36, § 3, at 1, col. 3.

[88] The SEC lost Dirks v. SEC, 103 S. Ct. 3255 (1983); Chiarella v. United States, 445 U.S. 222 (1980); and SEC v. Switzer, 590 F. Supp. 756 (W.D. Okla. 1984); and won United States v. Newman, 664 F.2d 12 (2d Cir. 1981), cert. denied, 104 S.Ct. 193 (1983). SEC v. Brant, Fed. Sec. L. Rep. (CCH) ¶91,571 (S.D.N.Y. July 12, 1984), is still in litigation.

[89] The misappropriation theory was first suggested by Chief Justice Burger in Chiarella v. United States, 445 U.S. 222, 239 (1980) (Burger, C.J., dissenting), and adopted by the Second Circuit in United States v. Newman, 664 F.2d 12, 12 (2d Cir. 1981), cert. denied, 104 S. Ct. 193 (1983).

[90] Wayne, supra note 36, § 3, at 21, col. 3.

[91] Id.

[92] For example, the Wall Street Journal case forced many newspapers to review their rules on employee ownership of stock and handling of unpublished information. Id.

The increased profitability of insider trading only partly explains its growing frequency. The small deterrent effect of the SEC's pre-ITSA enforcement tools also accounts for increased violations. Indeed, disgorgement, the SEC's principal non-injunctive remedy,[93] creates almost no deterrence.[94] Because disgorgement is not a penalty, but the mere giving up of gains, 'the prospect of compelled disgorgement alone is not sufficient to dissuade people from violating the law.'[95] Because injunctions under section 21(b) of the 1934 Act only forbid future violations and do not punish past violations, they too fail to penalize inside traders.[96] Criminal actions and administrative proceedings can result in penalties, but until recently such penalties were rarely sought or were lenient if imposed.[97]

The inadequacy of the pre-ITSA sanctions was compounded by the SEC's propensity to settle insider trading cases.[98] Between 1966 and 1980 the SEC settled, in whole or in part, eight of eleven reported administrative proceedings and seventeen of twenty-six reported court cases.[99] A recent press report reached a similar conclusion, stating that 'in 90% of the cases brought, the alleged insider trader settles before trial.'[100] The more drastic penalties were rarely sought or imposed, probably account-

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[93] See supra notes 58-63 and accompanying text.

[94] See Flaherty, supra note 5, at 3, col. 1 ('Returning illicit profits . . . means the inside trader can suffer 'no net loss' from his violations.'); Goelzer, supra note 71, at 29, col. 4 (arguing that disgorgement is of limited utility).

[95] 129 Cong. Rec. S3867 (daily ed. Mar. 23, 1983) (remarks of Sen. Sarbanes); see also House ITSA Report, supra note 5, at 7-8, reprinted in 1984 U.S. Code Cong. & Ad. News at 2280-81 (discussing insufficiency of disgorgement remedy).

[96] Flaherty, supra note 5, at 3, col. 1.

[97] Id. at 28, col. 1; Noble, Business and the Law, Insider Cases and the S.E.C., N.Y. Times, Jan. 25, 1983, at D2, col. 1.

Admittedly, private damage suits and non-SEC penalties such as disbarment in the case of lawyers supplement SEC remedies to create a higher level of deterrence. In many areas of securities law, such private actions are an important means of enforcement and deterrence. See generally L. Loss, supra note 19, at 1007-1216; Dooley, The Effects of Civil Liability on Investment Banking and the New Issues Market, 58 Va. L. Rev. 776 (1972) (discussing the role of private 10b-5 actions in determining the risks of underwriting public offerings). According to one commentator, however, in the insider trading area 'the Commission has a virtual monopoly. The private actions actually brought are largely parasitic . . .. [P]rivate parties are surprisingly reluctant to bring claims. On the basis of the reported cases, damage actions were brought in only nine of the thirty-five insider trading incidents that were the subject of SEC enforcement.' Dooley, supra note 2, at 16-17 (footnote omitted). Furthermore, individuals generally do not bring private actions without prior SEC actions; hence, their deterrent effect in this area is minimal. Id.

[98] Dooley, supra note 2, at 12-13.

[99] Id. at 13.

[100] The Economist, June 30, 1984, at 68.

ing in part for the high settlement rate.[101] Furthermore, most of the injunctions obtained were narrowly drawn and required the insider trader merely to abstain from future inside trading in the security actually traded.[102] Because insider trading is difficult to detect and expensive to prove,[103] the low level of enforcement and the SEC's tendency to settle these cases can also be explained by an effort to conserve enforcement resources.

Given the limited return on its enforcement resources and the inadequacy of its traditional weapons of injunction and disgorgement, the SEC concluded that an increase in the penalties for insider trading was necessary.[104] On September 1, 1982, the commissioners unanimously approved a request to Congress for legislation increasing the penalties for insider trading.[105] On September 27th, the SEC forwarded a draft bill to Congress that would impose a civil treble damage penalty and increase the criminal fine for securities violations.[106]

The House opened subcommittee hearings on the bill, H.R. 559, on April 13, 1983.[107] During the hearings, the principal point of contention was not the desirability of the penalty but whether the statute should define insider trading.[108] There was a consensus for the need for some legislation in this area.[109] On July 27, 1983, the subcommittee approved the bill,[110] which was amended to include provisions insulating from liability brokers who unknowingly executed orders for clients trading on in-

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[101] No criminal penalties or license revocations were imposed between 1966 and 1980, and injunctions were the only relief sought in nine cases. See Dooley, supra note 2, at 13.

[102] Id. at 13-14.

[103] See id. at 18-20. Establishing an insider trading violation is even more difficult when, as often happens, the transactions in question are conducted through foreign banks in countries with strong bank secrecy laws, as often happens. For a discussion of the United States government's efforts to counter foreign secrecy laws, see Levine, Ferrigno & Mann, supra note 50, at 281-311; Note, Banking Secrecy and Insider Trading: The U.S.-Swiss Memorandum of Understanding on Insider Trading, 23 Va. J. Int'l L. 605 (1983).

[104] Former Commissioner Thomas observed that '[i]nsider trading has been proliferating at an alarming rate, and we need a new weapon in our arsenal to stem this tide.' Noble, Securities Sale Rule Extended, S.E.C., 2 to 1, Backs Shelf Registration, N.Y. Times, Sept. 2, 1982, at D1, col. 6 (quoting SEC Commissioner Barbara Thomas). Although Chairman Shad is similarly supportive of the ITSA, he cautions that one should not overexaggerate the incidence of insider trading, which he suggests is minimal in comparison to the volume of trading. Noble, supra note 46, at D1, col. 1.

[105] Noble, supra note 104, at D1, col. 6.

[106] See House ITSA Report, supra note 5, at 19-21, reprinted in 1984 U.S. Code Cong. & Ad. News at 2292-94.

[107] House ITSA Hearing, supra note 5.

[108] See infra notes 133-44 and accompanying text.

[109] See Flaherty, supra note 5, at 3, col. 1.

[110] Noble, Insider Bill Advances in House, Panel Backs Stiff Penalties, N.Y. Times, July 28, 1983, at D20, col. 1.

side information, establishing a definition of profit and loss, and creating a statute of limitations applicable to the penalty.[111] The bill was reported out of committee on August 3[112] and was passed without objection by the House on September 9.[113]

Senator D'Amato introduced the SEC draft as Senate Bill 910.[114] Although the House version never seriously deviated from the original SEC proposal, the Senate bill underwent a number of amendments and proposed revisions. The Senate bill that passed was similar to H.R. 559, but with three amendments. The Senate version expanded the SEC's administrative proceedings power to include takeover and proxy violations,[115] made liability for the use of inside information on options or other derivative securities coextensive with liability for such use with regard to the underlying security,[116] and gave the SEC power to exclude violators of commodity market rules from the securities market.[117] The House adopted all three amendments,[118] and the bill was passed on July 25, 1984,[119] and signed into law by President Reagan on August 10, 1984.[120]

The ITSA increases both the civil and the criminal penalties for insider trading.[121] The Act amends section 21(b) of the 1934 Act to give the SEC authority to seek a civil monetary penalty of up to 'three times the profit gained or loss avoided' by a person who violates the prohibition 'by

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[111] See H.R. 559, 98th Cong., 1st Sess. § 2, 129 Cong. Rec. H7011 (daily ed. Sept. 19, 1983) [hereinafter cited as H.R. 559].

[112] N.Y. Times, Aug. 4, 1983, at D9, col. 4.

[113] N.Y. Times, Sept. 20, 1983, at D13, col. 1.

[114] S. 910, 98th Cong., 1st Sess., 129 Cong. Rec. S3865-66 (daily ed. Mar. 23, 1983).

[115] S. 910, 98th Cong., 1st Sess. § 4, 130 Cong. Rec. S8911-12 (daily ed. June 29, 1984).

[116] Id. § 5.

[117] Id. § 6.

[118] 130 Cong. Rec. H7760 (daily ed. July 25, 1984).

[119] Id.

[120] Stevenson, supra note 5, at 18, col. 1. The Senate subcommittee considered an alternative bill proposed by Senator D'Amato that would have outlawed the 'unfair' use of inside information in trading. See generally Flaherty, supra note 5, at 28, col. 1 (discussing the merits of including a definition of insider trading). Under the proposal, the SEC would not have to show fraud but simply a breach by the actor of some duty he owed, whether to the other trading party or someone else. Noble, Securities Industry Backs Bill Defining Insider, N.Y. Times, Apr. 4, 1984, at D2, col. 1. The bill would have defined insider trading, increased the criminal fine, and included a civil treble damage penalty. Id.; Flaherty, supra note 5, at 28, col. 1. The bill was never formally introduced. For similar proposals by Milton Freeman and Michael Klein, see House ITSA Hearing, supra note 5, at 159-95 (statement of Milton V. Freeman, Esq.); Klein, Outsider Proposes Changes in Insider Trading Bill, Legal Times, Dec. 12, 1983, at 8, col. 1.

[121] See 130 Cong. Rec. H7758 (daily ed. July 25, 1984) (remarks of Rep. Dingell). A fourth change made by the Act is the amendment of section 15(c)(4) to permit the SEC to conduct administrative proceedings against violators of section 14 of the 1934 Act. ITSA, § 4, 98 Stat. 1264, 1265 (to be codified at 15 U.S.C. § 78o).

purchasing or selling a security while in the possession of material nonpublic information.'[122] This action may be brought in addition to or in lieu of any other actions that the SEC or Justice Department is entitled to bring.[123] The SEC's other civil, as well as its administrative and criminal remedies,[124] remain available.[125]

Because the SEC may seek both disgorgement and treble damages, the inside trader now faces a potential civil liability of up to four times the profit gained.[126] The SEC is not required, however, to seek the maximum penalty in every case.[127] Moreover, the court is given 'discretion to determine the amount of the penalty, within the maximum amount, in light of the facts and circumstances' of the case. The court may consider factors such as the violator's level of culpability and the amount of proof demonstrated by the SEC in establishing its case.[128]

The ITSA also increases the maximum criminal fine from $10,000 to $100,000.[129] Moreover, the Act amends section 20 to provide that the use

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[122] The Act provides, in part:

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

'(2) (A) Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material nonpublic information . . . the Commission may bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, a civil penalty to be paid by such person, or any person aiding and abetting the violation of such person. The amount of such penalty shall be determined by the court in light of the facts and circumstances, but shall not exceed three times the profit gained or loss avoided as a result of such unlawful purchase or sale, and shall be payable into the Treasury of the United States. . . . The actions authorized by this paragraph may be brought in addition to any other actions that the Commission or the Attorney General are entitled to bring. . . . The Commission, by rule or regulation, may exempt from the provisions of this paragraph any class of persons or transactions.

ITSA, § 2, 98 Stat. 1264, 1264 (to be codified at 15 U.S.C. § 78u).

[123] In appropriate insider trading cases, the SEC may seek a court order enjoining the individual from again violating the prohibition, disgorgement of of 'ill-gotten' gains, and the imposition of the new civil penalty. House ITSA Report, supra note 5, at 8, reprinted in 1984 U.S. Code Cong. & Ad. News at 2281.

[124] See supra notes 50-69 and accompanying text.

[125] See House ITSA Report, supra note 5, at 8-9, reprinted in 1984 U.S. Code Cong. & Ad. News at 2281-82.

[126] Goelzer, supra note 71, at 29, col. 4.

[127] House ITSA Report, supra note 5, at 8, reprinted in 1984 U.S. Code Cong. & Ad. News at 2281.

[128] Id. at 8-9, reprinted in 1984 U.S. Code Cong. & Ad. News at 2281- 82. Although it is not clear from the Act or the legislative history, the language of the Act implies that courts are not bound by the SEC's request but may set a higher or lower figure at their discretion.

[129] ITSA, § 3, 98 Stat. 1264, 1265 (to be codified at 15 U.S.C. § 78ff). This increase applies to all securities violations, including but not limited to insider trading. It was justified as necessary to account for inflation since passage of the 1934 Act, which had 'eroded the deterrent effect of the fine.' House ITSA Report, supra note 5, at 12, reprinted in 1984 U.S. Code Cong. & Ad. News at 2285.

of material nonpublic information in connection with the 'purchase or sale of a put, call, straddle, option, or privilege' in a way that would violate the insider trading ruled if used with respect to the underlying security is also a violation of the rules and will result in 'comparable liability.'[130] This provision is intended to 'make clear that it is not possible to insulate oneself from the prohibition of insider trading by restricting activity to securities that are derivative of the securities to which the material nonpublic information relates.'[131]

The Act significantly increases the stakes for inside traders. Unlike under the pre-ITSA regime, the potential inside trader must consider the possibility of substantial civil and criminal penalties. Yet deterrence is not merely a function of penalties, and it remains to be seen whether the ITSA will in fact deter insider trading.[132]

B. Elements of the Prohibition

1. Defining the Prohibition

A major issue in drafting the ITSA was whether to include a definition of insider trading.[133] A number of witnesses at the House hearing on the Act favored including a definition that would at least apply for purposes of the treble damage sanction. They suggested that the decisions did not provide clear boundaries between acceptable and unacceptable conduct, and in fact, represented a case-by-case approach to the question that was unsuitable for such a drastic penalty.[134] The SEC strongly opposed the inclusion of a definition,[135] arguing that 'in the majority of insider trading cases, it is clear what the law proscribes.'[136] The SEC asserted its

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[130] ITSA, § 5, 98 Stat. 1264, 1265 (to be codified at 15 U.S.C. § 78t).

[131] 130 Cong. Rec. H7758 (daily ed. July 25, 1984) (written explanation submitted by Rep. Dingell) (analyzing the ITSA as amended by the Senate).

[132] See infra notes 248-81 and accompanying text (discussing probable deterrent value of the ITSA).

[133] See Flaherty, supra note 5, at 3; Junewicz, supra note 5, at 24, col. 3; Lewin, supra note 73, at D2, col. 1.

[134] See, e.g., House ITSA Hearing, supra note 5, at 106-07, 122-23 (statement of Dennis J. Block, Esq.); id. at 149-51 (statement of David M. Brodsky, Esq.). But see id. at 196 (testimony of Arnold S. Jacobs, Comm. on Securities Regulation, New York City Bar Ass'n).

[135] During testimony on the Act, Chairman Shad appeared willing to reconsider the SEC's opposition to inclusion of a definition, see id. at 51-56 (testimony of John S. R. Shad, SEC Chairman), but there was no change in the SEC's position.

[136] House ITSA Hearing, supra note 5, at 98 (letter from SEC Chairman John S. R. Shad to Rep. Wirth).

satisfaction with the common-law definition[137] because 'existing law provides a sound legal framework for judicial analysis and review of new and unforeseeable trading devices and strategies.'[138]

Ultimately, and for similar reasons, both the House and Senate decided not to include a definition in their respective versions of the Act,[139] but chose instead to rely on the common-law definition.[140] The House committee asserted that the common law was sufficiently developed to warn traders of what was wrongful and that the problem of drafting a workable definition was so complex that 'any effort to define insider trading would result in, at best, a slightly less generalized rule than 10b-5 and, at worst, a rule that leaves gaping holes 'large enough to drive a truck through.''[141] The committee also feared that any definition would have to be either so broad as to be unworkable or so narrow as to reduce the SEC's and the courts' flexibility to address new forms of trading. Moreover, it was concerned that any definition, even if limited to the treble damage penalty, would ultimately control all situations.[142]

The Senate chose not to include a definition because of its acceptance of the SEC's testimony that it was satisfied with existing law and because of its concern that a statutory definition would produce a substantial amount of interpretive litigation and limit the SEC's flexibility. The legislative history in the Senate indicates that an additional concern was 'the complexity of the undertaking, and the necessity for prompt action on the bill.'[143] On several occasions Senator D'Amato noted that he was reluctant to delay consideration of the bill solely to provide a statutory definition of insider trading.[144]

2. Applying the Prohibition

The Act's treble damage provision may be imposed on any individual who violates the insider trading prohibition by purchasing or selling a se-

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[137] 130 Cong. Rec. S8912-13 (daily ed. June 29, 1984) (remarks of Sen. D'Amato).

[138] House ITSA Hearing, supra note 5, at 99 (letter from SEC Chairman John S. R. Shad to Rep. Wirth). The SEC also argued that '[a]ny definition would incorporate new terms and concepts which would have to be interpreted in subsequent litigation.' Id.

[139] 130 Cong. Rec. H7758 (daily ed. July 25, 1984) (written explanation submitted by Rep. Dingell).

[140] See infra notes 161-82 and accompanying text.

[141] House ITSA Report, supra note 5, at 14, reprinted in 1984 U.S. Code Cong. & Ad. News at 2287.

[142] Id. at 13, reprinted in 1984 U.S. Code Cong. & Ad. News at 2286.

[143] 130 Cong. Rec. S8913 (daily ed. June 29, 1984) (remarks of Sen. D'Amato).

[144] See, e.g., 130 Cong. Rec. S8912-13 (daily ed. June 29, 1984) (remarks of Sen. D'Amato); N.Y. Times, April 30, 1984, at A14, col. 4 (letter to the editor from Sen. D'Amato).

curity while in possession of material nonpublic information.[145] The occurrence of a violation is determined by reference to the common-law prohibition[146] unless the individual or entity involved falls within a statutory exemption.[147] With respect to transactions, the Act expressly spells out those to which the sanction applies.[148]

a. Individuals

The federal common-law insider trading prohibition is potentially applicable to a large class of individuals who do not actually trade securities. Liability is imposed on such individuals under the doctrine of respondeat superior or under a theory of aiding and abetting a violation.[149] The initial draft of the Act applied the sanction to such non-traders.

The securities industry opposed extension of the treble damage sanction to individuals who did not actually trade securities or tip inside information.[150] The SEC subsequently agreed, arguing that the deterrent objective underlying the Act did not require the imposition of the sanction on secondary actors.[151] In response to these concerns, the bill was amended to provide the following exemption:

> No person shall be subject to a sanction [under the Act] solely because that person aided and abetted a transaction covered by [the Act] in a manner other than by communicating material nonpublic information. Section 20(a) of this title [which makes controlling persons liable for violations committed by their agents] shall not apply to an action brought under [the Act]. No person shall be liable under [the Act] solely by reason of employing a person who is liable under [it].[152]

Thus, although the House committee endorsed application of the SEC's other civil and criminal remedies to controlling persons and to aiders and abettors, the treble damage provision will not apply to such actors unless

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[145] ITSA, § 2, 98 Stat. 1264, 1264 (to be codified at 15 U.S.C. § 78u). The problems posed by the statute's use of 'while in possession of material nonpublic information' are discussed infra notes 310-15 and accompanying text.

[146] See supra text accompanying note 140.

[147] See infra notes 149-84 and accompanying text.

[148] See infra notes 185-90 and accompanying text.

[149] House ITSA Report, supra note 5, at 9-11, 28, reprinted in 1984 U.S. Code Cong. & Ad. News at 2282-84, 2300-01.

[150] Stevenson, supra note 5, at 18, col. 2.

[151] House ITSA Hearing, supra note 5, at 92-94 (letter from SEC Chairman John S. R. Shad to Rep. Wirth).

[152] ITSA, § 2(B), 98 Stat. 1264, 1264 (to be codified at 15 U.S.C. § 78u).

they also engage in illegal trades.[153]

This exemption limits a financial firm's liability in several important ways. First, a brokerage firm will not be liable if an employee learns inside information legitimately released to the firm and then uses it to trade for his own account.[154] Second, the firm would be insulated from liability where an employee trades for a customer's account without the firm's knowledge or approval.[155] Third, the firm is not liable where it executes trades for an insider without trading on the information for its own account or tipping it to other customers.[156] Fourth, the firm is not liable if an adviser working for an investment company trades on the firm's account without the company's knowledge or approval.[157] Last, the committee believed that the firm would not be liable under the Act where one employee possesses inside information and another trades for the firm without knowing the information.[158] Although an express 'Chinese Wall'[159] provision was deleted from the bill, both Congress and the SEC believed that the Act and existing law implicitly provided this protection. Congress also intended that the SEC use its rulemaking authority under the ITSA to create such an exemption.[160]

Although the Act is by its terms limited to primary actors, its failure to define the limits of insider trading liability leaves the question of which such actors are reached to be answered by the common law.[161] Liability does not arise under current law solely because one trades on the basis of inside information.[162] Rather, liability arises only when the trader's use of

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[153] House ITSA Report, supra note 5, at 10, reprinted in 1984 U.S. Code Cong. & Ad. News at 2283.

[154] House ITSA Hearing, supra note 5, at 43-44 (memorandum attached to letter from SEC Chairman John S. R. Shad to Rep. Matthew J. Rinaldo).

[155] See House ITSA Report, supra note 5, at 11, reprinted in 1984 U.S. Code Cong. & Ad. News at 2284.

[156] Id. at 10, reprinted in 1984 U.S. Code Cong. & Ad. News at 2283.

[157] Id. at 11, reprinted in 1984 U.S. Code Cong. & Ad. News at 2284.

[158] Id.

[159] A Chinese Wall is a procedure used by multi-service business to keep confidential information obtained by one group within a firm physically segregated from the rest of the firm. The purpose is to prevent the appearance of a conflict of interest within a business. See generally W. Carey & M. Eisenberg, Corporations 781-82 (5th ed. 1980); Lipton & Masur, The Chinese Wall Solution to the Conflict Problems of Securities Firms, 50 N.Y.U. L. Rev. 459 (1975).

[160] House ITSA Report, supra note 5, at 11, reprinted in 1984 U.S. Code Cong. & Ad. News at 2284. In addition to the statutory exclusion and the planned Chinese Wall exemption, the Act authorizes the SEC to exempt by rule such other classes of individuals or transactions that it sees fit. ITSA, § 2, 98 Stat. 1264, 1264 (to be codified at 15 U.S.C. § 78u).

[161] See supra text accompanying notes 140, 146.

[162] See Dirks v. SEC, 103 S. Ct. 3255, 3260 (1983) ('there is no general duty to disclose before trading on material nonpublic information').

the information violates some fiduciary duty.[163] True corporate insiders such as directors and managers fall within the prohibition because of their fiduciary duties to the corporation and its shareholders.[164] Outsiders to whom corporate information is released with an express or implied duty of confidentiality are also treated as fiduciaries of the shareholders.[165] When they misappropriate the information for their own use, these 'constructive insiders'[166] also violate the prohibition.

The misappropriation theory also extends to employees of such individuals, even if the employees do not themselves owe a duty to the shareholders. Their liability arises instead from the violation of their duty to their employer not to misuse confidential information.[167] The House committee approved this extension of liability,[168] but the Supreme Court has not yet directly addressed the issue. Chief Justice Burger has argued that insider trading liability should extend to any individual who obtains an 'informational advantage . . . by some unlawful means.'[169] In Dirks v. SEC,[170] a majority of the Court rejected liability in the absence of a fiduciary relationship,[171] but observed that Dirks did not 'misappropriate or illegally obtain the information.'[172] Dirks therefore leaves open the status of the misappropriation theory.

The common law also prohibits insiders from tipping information to outsiders who then trade on it.[173] Dirks limits tipper/tippee liability to cases where the tip violates the insider's duty to the corporation.[174] The Dirks

test is whether the insider personally will benefit, directly or indi-

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[163] Id. at 3261; Chiarella v. United States, 445 U.S. 222, 227-35 (1980). This assumes that the other elements of the violation, which are discussed in L. Loss, supra note 19, at 818-946, are also met.

[164] Dirks v. SEC, 103 S. Ct. 3255, 3261 (1983).

[165] Id. at 3261 n.14. Among the classes of individuals who fall within this group are underwriters, lawyers, accountants, financial printers, and consultants. The basis for this duty is the confidential relationship entered into between these individuals and the corporation and the fact that they were given the information solely for a corporate purpose. See id.

[166] Gonson & Butler, supra note 33, at 16, col. 1.

[167] See United States v. Newman, 664 F.2d 12, 15-16 (2d Cir. 1981), cert. denied, 104 S. Ct. 193 (1983).

[168] House ITSA Report, supra note 5, at 4-5, reprinted in 1984 U.S. Code Cong. & Ad. News at 2277-78.

[169] Chiarella v. United States, 445 U.S. 222, 240 (Burger, C.J., dissenting).

[170] 103 S. Ct. 3255 (1983).

[171] Id. at 3261.

[172] Id. at 3267.

[173] House ITSA Report, supra note 5, at 4-5, 9-11, reprinted in 1984 U.S. Code Cong. & Ad. News at 2277-78, 2282-84.

[174] 103 S. Ct. at 3263-66.

> rectly, from his disclosure [to the outsider]. Absent some personal gain, there has been no breach of duty to the stockholders. . . .
>
> . . . This requires courts to focus on objective criteria, i.e., whether the insider receives a direct or indirect benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings

for the insider.[175] Even upon such a breach, the outsider is liable only if he knows or should have known of the breach.[176]

The ITSA applies to all individuals who trade on or tip inside information in violation of the common-law prohibition. Whether it extends to those who trade on the basis of nonpublic market information, however, is less clear.[177] The House committee commented that trading on such information is 'no less reprehensible than the outright theft of nonpublic information.'[178] Nevertheless, the Supreme Court held in Chiarella v. United States[179] that trading on either inside or market information violated the prohibition only if the trader had some fiduciary relationship with the corporation or shareholders such that he had a duty to disclose;[180] Dirks reaffirmed that holding.[181] Even the committee's condem-

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[175] Id. at 3265-66. The Court observed:

> There are objective facts and circumstances that often justify such an inference [of benefit to the insider]. For example, there may be a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the particular recipient. The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend. The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.

Id. at 3266.

[176] Id. at 3264.

[177] Market information is commonly defined as 'information about events or circumstances which affect the market for a company's securities but which do not affect the company's assets or earning power.' Fleischer, Mundheim & Murphy, An Initial Inquiry into the Responsibility to Disclose Market Information, 121 U. Pa. L. Rev. 798, 799 (1973). See also United States v. Chiarella, 588 F.2d 1358, 1365 n.8 (2d Cir. 1978) (market information is information that affects the price of a firm's securities without affecting its earning power or assets), rev'd on other grounds, 445 U.S. 222 (1980); cf. In re Oppenheimer & Co., SEC Exchange Act Release No. 12,319, reprinted in Fed. Sec. L. Rep. (CCH) ¶80,551, at 86,415 n.2 (Apr. 2, 1976) (defining market information as information that 'emanates from non-corporate sources and deals primarily with information concerning or affecting the trading markets for a corporation's securities').

[178] House ITSA Report, supra note 5, at 4-5, reprinted in 1984 U.S. Code Cong. & Ad. News at 2277-78.

[179] 445 U.S. 222 (1980).

[180] Id. at 231-35. Indeed, Chiarella could be read as barring any liability for trading on 'market information' as the term is commonly defined. See id. at 231-35. But a better reading is probably that trading on market information in a way that breaches a fiduciary duty is still a violation.

[181] Dirks v. SEC, 103 S. Ct. 3255, 3261 (1983).

nation of the use of market information appears to be limited to cases where the market information is leaked by an insider or is misappropriated.[182] Moreover, the committee stated that it did not intend the bill to 'in any way inhibit legitimate analytical activities,'[183] which often include the gathering and use of market information.[184] Trading on nonpublic market information therefore falls within the scope of the Act only when the information is leaked by an insider or misappropriated by the trader.

b. Transactions

Rule 10b-5 potentially applies to all transactions affected 'by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange.'[185] Despite the emphasis in the 1934 Act on 'transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets,'[186] the broad language of Rule 10b-5 has been used in private insider trading cases to apply the prohibition to all securities transactions.[187]

In contrast, the ITSA applies only to transactions 'on or through the facilities of a national securities exchange or from or through a broker or dealer, and . . . which [are] not part of a public offering by an issuer of securities other than standardized options.'[188] This definition appears to exclude face-to-face transactions and most public offerings. Unfortunately, the legislative history fails to explain this limitation.

Three explanations may account for the omission. First, the legislative history indicates that Congress was primarily concerned with deterring 'insider trading in publicly traded securities' to protect the 'integrity' of the public markets.[189] This emphasis on the protection of the markets

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[182] See House ITSA Report, supra note 5, at 4-5, reprinted in 1984 U.S. Code Cong. & Ad. News at 2277-78.

[183] Id. at 5, reprinted in 1984 U.S. Code Cong. & Ad. News at 2278.

[184] In explaining the final bill, Representative Dingell observed:

We anticipate that the courts in applying Section 10(b) of the Act and Rule 10b-5 thereunder will be mindful of the necessity, in light of the substantial penalty herein imposed, to avoid unduly inhibiting traders from generating and acting upon valid research information of the sort upon which efficient markets necessarily depend.

130 Cong. Rec. H7758 (daily ed. July 25, 1984).

[185] 17 C.F.R. § 240.10b-5 (1984).

[186] 15 U.S.C. § 78b (1982).

[187] B. Rider & H. Ffrench, supra note 2, at 73-74.

[188] ITSA, § 2, 98 Stat. 1264, 1264 (to be codified at 15 U.S.C. § 78u).

[189] See House ITSA Report, supra note 5, at 2-6, 16, reprinted in 1984 US. Code Cong. & Ad. News at 2274-79, 2289; 130 Cong. Rec. H7759 (daily ed. July 25, 1984) (remarks of Rep. Wirth); id. at H7758 (remarks of Rep. Dingell); 129 Cong. Rec. S3866-67 (daily ed. Mar 23, 1983) (remarks of Sen. Sarbanes); id. at S3865-66 (remarks of Sen. D'Amato).

rather than individual investors would at least explain the failure to regulate face-to-face transactions, where insider trading can not undermine the public's confidence in the markets. Second, Congress may have chosen to leave face-to-face transactions to state common-law fraud or to private 10b-5 actions. Third, Congress may have recognized that the 1934 Act was primarily intended to regulate market transactions, not face-to-face transactions or public offerings.[190] If this latter explanation is correct, Rule 10b- 5's broad application in private actions exceeds its statutory authority and the rule should be restricted to market transactions.

3. The Rest of the Prohibition

Congress considered several other questions in preparing the ITSA including the appropriate definition of profit and loss, the standard of proof, the right to a jury trial, and the impact of Dirks[191] on SEC enforcement activity. A final issue that received only minimal consideration was whether a private treble damage action should be expressly or impliedly granted under the Act.

a. Profit and Loss

As noted above, disagreement exists over how to measure the profit gained or loss avoided by the violator when calculating the amount to be disgorged.[192] For example, assume that the insider illegally bought stock at four dollars per share and that throughout the month following the announcement of the information on which his purchase was based, the stock sold at five dollars per share.[193] If he sells during that month, there is general agreement that he may be required to disgorge one dollar of profit per share. If the share price later declines to three dollars, he can still be required to disgorge one dollar per share under the line of cases holding insiders liable for any profits they could have realized.[194] If the share price rises to ten dollars but then falls to three dollars, at which point the insider sells, the SEC will only request disgorgement of one dollar of profit per share, despite the 'could have realized' line of cases.[195] Where the insider sells at ten dollars, however, the SEC will demand that

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[190] See supra text accompanying note 186.

[191] Dirks v. SEC, 103 S. Ct. 3255 (1980).

[192] See supra notes 59-63 and accompanying text.

[193] This example is taken from SEC v. MacDonald, 699 F.2d 47, 52-53 (1st Cir. 1983).

[194] See supra note 59 and accompanying text.

[195] SEC v. MacDonald, 699 F.2d 47, 52-53 (1st Cir. 1983). There the court noted, 'in passing, that inconsistencies do not bother the Commission.' Id. at 53.

he disgorge six dollars per share.[196]

The SEC argued in SEC v. MacDonald[197] that the appropriate standard was the difference between the purchase and sale prices, no matter how far distant in time or how much subsequent events may have affected the price.[198] In the SEC's view, it was necessary to include profits realized after public dissemination of the inside information to maximize deterrence.[199] The First Circuit rejected the SEC's position, holding that the correct definition of profit gained was the difference between the purchase price and the market price a 'reasonable time' after the information was generally disseminated.[200] The court saw 'no legal or equitable difference' between the inside trader's decision to retain the stock 'with the hope of further profit and a decision to sell it and invest in something else. In both cases the subsequent profits are purely a new matter.'[201] A reasonable time was defined as ending on 'the date by which the news had been fully digested and acted upon by investors,' as indicated by the volume and the price at which the shares were traded following disclosure.[202]

The SEC's argument is even less persuasive when applied to the ITSA. The treble profits penalty should erase any subsequent profits made by the defendant. Moreover, because most inside traders sell shortly after disclosure, the MacDonald issue rarely arises in practice. Recognizing this, the SEC recommended that the MacDonald standard be adopted in the ITSA,[203] and the House committee agreed.[204]

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[196] Id. at 52.

[197] 699 F.2d 47 (1st Cir. 1983).

[198] Id. at 52-54; House ITSA Hearing, supra note 5, at 94-95 (letter from SEC Chairman John S. R. Shad to Rep. Wirth).

[199] House ITSA Hearing, supra note 5, at 94-95 (letter from SEC Chairman John S. R. Shad to Rep. Wirth).

[200] SEC v. MacDonald, 699 F.2d 47, 55 (1st Cir. 1983).

[201] Id. at 54.

[202] Id. at 55. Cf. SEC v. Texas Gulf Sulphur Co., 312 F. Supp. 77 (S.D.N.Y. 1970) (insiders required only to disgorge those profits accrued prior to the time the inside information was disclosed), modified on other grounds, 446 F.2d 1301 (2d Cir.), cert. denied, 404 U.S. 105 (1971).

[203] House ITSA Hearing, supra note 5, at 94-95 (letter from SEC Chairman John S. R. Shad to Rep. Wirth).

[204] The Act defines "profit gained' or 'loss avoided' [to be] the difference between the purchase or sale price of the security and the value of the security as measured by the trading price of the security a reasonable period after public dissemination of the nonpublic information.' ITSA, § 2, 98 Stat. 1264, 1264 (to be codified at 15 U.S.C. § 78u).

b. Standard of Proof

To obtain equitable relief under section 10(b), the SEC must establish the violation by a preponderance of the evidence.[205] The same standard is applicable to other civil actions under the federal securities laws.[206] The potentially expansive liability imposed by the ITSA led a number of witnesses at the House hearings to suggest that the ITSA adopt the more rigorous 'clear and convincing evidence' standard.[207]

Where Congress has not expressly prescribed a standard of proof, courts will establish one based on congressional intent[208] and a balancing of interests.[209] The courts have required clear and convincing evidence where important liberty interests such as parental rights,[210] involuntary commitment,[211] or deportation[212] are involved, while permitting a preponderance standard where severe civil penalties that do not implicate such interests are imposed.[213] Although it may be difficult to determine ex ante when an interest is protected, purely monetary liability appears not to be a protected interest.[214] In light of the 'intent of Congress that the preponderance of the evidence standard be applied to penalty actions brought under the ITSA ,'[215] the courts will probably not require proof by clear and convincing evidence before imposing the sanction.

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[205] House ITSA Hearing, supra note 5, at 95-96 (letter from SEC Chairman John S. R. Shad to Rep. Wirth).

[206] See, e.g., Herman & MacLean v. Huddleston, 459 U.S. 375 (1983) (private civil action under 10b-5); Steadman v. SEC, 450 U.S. 91 (1981) (SEC administrative proceedings under § 9(b) of the 1940 Investment Company Act and § 203(f) of the 1940 Investment Advisers Act); SEC v. C. M. Joiner Leasing Co., 320 U.S. 344 (1943) (SEC civil action under §§ 5(a) and 17(a) of the 1933 Act).

[207] See, e.g., House ITSA Hearing, supra note 5, at 205 (statement of Sam Scott Miller, Securities Industry Ass'n); id. at 227-28 (letter of Saul S. Cohen, chairman, Federal Regulation Comm., Securities Industry Ass'n); id. at 316 (memorandum in support of resolution by Council of the Section of Corporation, Banking and Business Law, American Bar Ass'n). But see id. at 249- 50 (statement of Ted J. Fiflis, Professor of Law, Univ. of Colorado Law School).

[208] See Steadman v. SEC, 450 U.S. 91, 95-96 (1981).

[209] See Herman & MacLean v. Huddleston, 459 U.S. 375, 389-90 (1983).

[210] E.g., Santosky v. Kramer, 455 U.S. 745 (1982).

[211] E.g., Addington v. Texas, 441 U.S. 418 (1979).

[212] E.g., Woodby v. Immigration & Naturalization Serv., 385 U.S. 276 (1966).

[213] Herman & MacLean v. Huddleston, 459 U.S. 375, 389-90 (1983); see also United States v. Regan, 232 U.S. 37 (1914) (preponderance standard applies to civil actions even if they involve a penalized or criminal act).

[214] For example, in the analogous situation of treble damage actions for antitrust violations, the standard of proof is preponderance of the evidence. See Ramsey v. United Mine Workers, 401 U.S. 302 (1971).

[215] House ITSA Report, supra note 5, at 16, reprinted in 1984 U.S. Code Cong. & Ad. News at 2289.

c. Right to a Jury Trial

Several witnesses at the House hearings suggested that because of the potential liability involved, the ITSA should provide alleged violators with a right to a jury trial.[216] The SEC feared that this suggestion would 'burden and prolong Commission actions for a penalty and complicate settlement negotiations.'[217] Another witness testified that the expense and delay inherent in jury trials argued against their imposition unless constitutionally mandated.[218]

Whether jury trials are constitutionally required in government civil penalty actions is an open question. Although the Supreme Court reserved judgment on the issue in Atlas Roofing Co. v. Occupational Safety & Health Review Commission,[219] some older Court dicta and lower court holdings would require jury trials in such cases,[220] although the juries need not determine the amount of the penalty.[221] The American Bar Association's Section on Corporation, Banking and Business Law and several other witnesses argued at the House hearings that these authorities were binding.[222]

The House committee refused to provide a right to a jury trial under the Act, leaving the issue to the courts. Although it expressed no view on the resolution of the constitutional issue, the committee noted that the statutory provision of such a right would tax an already overburdened SEC and federal court system.[223]

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[216] Id.

[217] House ITSA Hearing, supra note 5, at 97 (letter from SEC Chairman John S. R. Shad to Rep. Wirth). The SEC also argued that a right to jury trials might 'interfere with the successful prosecution of Commission injunction proceedings. Potential problem areas include the effect of the doctrine of collateral estoppel, the consolidation and order of proceedings, and the possibility of inconsistent judgments.' Id.

[218] Id. at 249.

[219] 430 U.S. 442, 449 n.6 (1977).

[220] United States v. Regan, 232 U.S. 37, 47 (1914); Hepner v. United States, 213 U.S. 103, 115 (1909); United States v. J. B. Williams Co., 498 F.2d 414 (2d Cir. 1974).

[221] United States v. Reader's Digest Ass'n, 662 F.2d 955 (3d Cir. 1981), cert. denied, 455 U.S. 908 (1982).

[222] House ITSA Hearing, supra note 5, at 153-57 (statement of David M. Brodsky, Esq.); id. at 316-17 (memorandum in support of resolution by Council of the Section of Corporation, Banking and Business Law, American Bar Ass'n).

[223] House ITSA Report, supra note 5, at 16, reprinted in 1984 U.S. Code Cong. & Ad. News at 2289. The American Bar Association argued that a failure to provide for a jury trial would burden the courts with litigation over the constitutional issue. House ITSA Hearing, supra note 5, at 317 (memorandum in support of resolution by Council of the Section of Corporation, Banking and Business Law, American Bar Ass'n). Congress apparently decided that a greater burden would be imposed by a statutory requirement, probably a correct assessment given the cost and delay inherent in jury trials.

d. Impact of Dirks

The House committee also considered overruling Dirks v. SEC[224] in the Act. Immediately following the Dirks decision, a number of commentators suggested that the case would seriously impede the Commission's enforcement efforts.[225] Nevertheless, the decision's limited practical impact on enforcement,[226] its unique facts,[227] and its focus on objective criteria[228] convinced the committee that Dirks would not adversely affect enforcement if construed narrowly by the courts.[229]

Yet the committee remained concerned with the long-term impact of Dirks on the development of the prohibition. It therefore ordered the SEC to monitor the effect of Dirks on insider trading litigation for at least two years and to report on that effect annually.[230]

e. Private Actions

The House committee raised the possibility of a private treble damage remedy under the ITSA. One witness suggested that a private remedy was desirable but noted that the need for prompt action on the bill and the complexity of drafting a private action provision militated against including such a provision in the Act.[231] In contrast, the American Bar Association argued for an express exclusion of a private remedy, while supporting the use of the proceeds from an SEC action to compensate victims.[232] Congressman Wirth also asked two other witnesses to comment on the issue. Both stated that the bill already dealt with a number of complex issues and that consideration of the private remedy question should be delayed so the legislation could be promptly enacted.[233] Wirth

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[224] 103 S. Ct. 3255 (1983).

[225] See, e.g., Bernstein, Dirks Case: Is Small Investor Fair Game?, N.Y.L.J., Sept. 28, 1983, at 1, col. 1; Noble, The Dirks Ruling: Insiders' License?, N.Y. Times, July 16, 1983, at 29, col. 4; Pitt & Ain, 'Dirks' Deals Blow to SEC Insider Trading Program, Legal Times, July 11, 1983, at 10, col. 1.

[226] Despite the commentators' pessimism, an SEC review of the 34 insider trading cases preceding Dirks indicated that only one would have been affected by the decision. House ITSA Report, supra note 5, at 15, reprinted in 1984 U.S. Code Cong. & Ad. News at 2288.

[227] Id. at 14, reprinted in 1984 U.S. Code Cong. & Ad. News at 2287.

[228] Id. at 15, reprinted in 1984 U.S. Code Cong. & Ad. News at 2288.

[229] Id.

[230] Id.

[231] House ITSA Hearing, supra note 5, at 257-59 (statement of Ted J. Fiflis, Professor of Law, Univ. of Colorado Law School).

[232] Id. at 317 (memorandum in support of resolution by Council of the Section of Corporation, Banking and Business Law, American Bar Ass'n).

[233] Id. at 197-98 (testimony of Arnold S. Jacobs, Comm. on Securities Regulation, New York City Bar Ass'n); id at 230 (testimony of David M. Brodsky, Esq.). But see id. at 231 (testimony of Dennis J. Block, Esq.).

agreed that 'we do not want to get this bill bogged down with a lot of baggage.'[234] Consequently, neither the bill nor the report addressed the issue of a private right of action.

Under current law, judicial implication of a private action under the ITSA is highly unlikely. Although private actions have long been implied under section 10(b) and other sections of the 1933 and 1934 Acts,[235] the trend has been away from implying additional remedies. The Supreme Court stated the test for determining when a private action will be implied in Cort v. Ash:[236]

> First, is the plaintiff 'one of the class for whose especial benefit the statute was enacted,'--that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law?[237]

In Touche Ross & Co. v. Redington,[238] the Court refined the test to emphasize the first three Cort factors.[239] After Touche Ross, implication of a private cause of action depends primarily upon legislative intent as evidenced by the plain language of the statute and by the legislative history.[240]

Under the Cort test, the ITSA does not provide for a private right of action. First, the legislative history indicates that the Act is intended to provide an exclusive SEC remedy. Second, there is no evidence of congressional intent to create a private action. Recent congressional practice

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[234] Id. at 230 (statement of Rep. Wirth).

[235] The private 10b-5 action was first enunciated in Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). It was recently reaffirmed by the Supreme Court in Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983) ('The existence of this implied remedy is simply beyond peradventure.'). A number of other private actions have been implied under various sections of the 1933 and 1934 Acts. See, e.g., J.I. Case Co. v. Borak, 377 U.S. 426 (1964) (section 14(a) of the 1934 Act); Dan River, Inc. v. Unitex Ltd., 624 F.2d 1216 (4th Cir. 1980) (section 13 of the 1934 Act), cert. denied, 449 U.S. 1101 (1981); Kirshner v. United States, 603 F.2d 234 (2d Cir. 1978) (section 17(a) of the 1933 Act), cert. denied, 442 U.S. 909 (1979).

[236] 422 U.S. 66 (1975).

[237] Id. at 78 (citations omitted).

[238] 442 U.S. 560 (1979).

[239] Id. at 575-76.

[240] See Landry v. All Am. Assurance Co., 688 F.2d 381, 388-89 (5th Cir. 1982).

has been to state expressly that a private remedy should be inferred where Congress intends for the courts to do so. For example, in its report on the Small Business Investment Incentive Act of 1980, the House committee reporting the bill stated that it 'wishe[d] to make plain that it expects the courts to imply private rights of action under [the Act], where the plaintiff falls within the class of persons protected by the statutory provision in question.'[241] The absence of such language in the legislative history of the ITSA suggests that Congress intended to limit the Act's treble damage penalty to the SEC.

The ITSA also fails to satisfy the third Cort factor, that an implied private remedy be consistent with the purposes of the legislation. Although a private remedy might increase deterrence,[242] the paucity of private insider trading cases[243] suggests that the effect would be minimal. More importantly, section 28(a) of the 1934 Act explicitly provides that 'no person permitted to maintain a suit for damages under the provisions of this chapter shall recover . . . a total amount in excess of his actual damages.'[244] This section precludes punitive damages in 10b-5 cases.[245] Because a private action under the ITSA would be governed by section 28(a), and because Congress failed to modify that section when the Act was adopted, a private action for treble damages under the ITSA would create a statutory conflict. Together 'with the Supreme Court's conservative interpretation of the Cort test in recent years,'[246] this analysis suggests that no private action should be implied under the ITSA.[247]

III. A CRITIQUE OF THE ACT

The ITSA reflects a congressional judgment that the social costs of insider trading are too high. The congressional response was simply to increase the sanction for engaging in the activity. Yet questions remain as to whether this action appropriately minimizes the social losses from in-

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[241] H.R. Rep. No. 1341, 96th Cong., 2d Sess. 29 (1980).

[242] House ITSA Hearing, supra note 5, at 258 (statement of Ted J. Fiflis, Professor of Law, Univ. of Colorado Law School).

[243] See supra note 97.

[244] 15 U.S.C. § 78bb(a) (1982).

[245] See deHaas v. Empire Petroleum Co., 435 F.2d 1223 (10th Cir. 1970); Green v. Wolf Corp., 406 F.2d 291 (2d Cir. 1968), cert. denied, 395 U.S. 977 (1969).

[246] Landry v. All Am. Assurance Co., 688 F.2d 381, 391 (5th Cir. 1982).

[247] The fourth Cort factor, the role of state law, does support implication because insider trading is not a matter solely relegated to state law. However, this factor has assumed far less importance in the Court test than the other factors. See supra text accompanying note 240.

sider trading, and whether its ancillary effects on the federal common law prohibition will be significant.[248]

A. Probable Deterrent Effect of the ITSA

Although punishment serves a number of purposes, its most widely accepted function is the deterrence of the harmful activity giving rise to the sanction.[249] Following Jeremy Bentham,[250] many modern deterrence theorists assume that man is a rational calculator of costs and benefits and that if the costs of an activity exceed its benefits he will choose not to engage in it.[251] This approach to deterrence is particularly suitable for the insider trading problem. Individuals prosecuted for insider trading have included 'officers, directors and employees of issuers; the issuer itself; attorneys; law firm paralegals; principal shareholders; business consultants and investment analysts; merger partners; finders; underwriters; brokers; accountants for corporate directors; newspaper columnists; government officials . . .; and friends and relatives of the above individuals.'[252] The rational calculator model of deterrence seems especially appropriate for these groups, who are likely to be relatively well- educated and to be acting for pecuniary gain.[253]

Deterrence therefore attempts to minimize the social loss resulting from some harmful activity by persuading potential offenders that the costs of the activity are greater than the rewards.[254] This social loss can

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[248] This question assumes, arguendo, that insider trading does in fact impose social costs. For a contrary argument, see H. Manne, supra note 2, at 15.

[249] See generally P. Low, J. Jeffries & R. Bonnie, Criminal Law: Cases and Materials 1-30 (1982) (discussing the rationales for punishment).

[250] See J. Bentham, The Rationale of Punishment (London 1830).

[251] See P. Low, J. Jeffries & R. Bonnie, supra note 249, at 8-11 ('an important segment of the current research being conducted on deterrence is based on an economic model that predicts behavior based on a rational calculus of costs and benefits').

The notion of the criminal as a rational calculator will strike many readers as highly unrealistic, especially when applied to criminals having little education or to crimes not committed for pecuniary gain. But . . . [a] growing empirical literature on crime has shown that criminals respond to changes in opportunity costs, in the probability of apprehension, in the severity of punishment, and in other relevant variables, as if they were indeed the rational calculators of the economic model . . ..

R. Posner, Economic Analysis of Law 164-65 (2d ed. 1977).

[252] House ITSA Report, supra note 5, at 24 n.36, reprinted in 1984 U.S. Code Cong. & Ad. News at 2296 n.36 (memorandum of the Securities and Exchange Commission in Support of the Insider Trading Sanctions Act of 1982).

[253] Although the 'economic' theory of deterrence is thought by some to apply 'regardless of whether the crime is committed for pecuniary gain or out of passion, or by well or by poorly educated people,' R. Posner, supra note 251, at 165, it seems particularly apt in the case of well-educated persons acting for monetary gain, such as the typical inside trader.

[254] For a technical exposition of the analysis used in this section, see Becker, Crime and Punishment: An Economic Approach, 76 J. Pol. Econ. 169 (1968); see also R. Posner, supra note 251, at 164-72 (also analyzing deterrent theory within an economic framework). This method of analysis was

be viewed as a function of the loss created by the activity itself (activity loss), the cost of enforcing a prohibition against the activity (enforcement loss), and the cost of imposing sanctions against the activity (penalty loss).[255] Any attempt to minimize social loss must attempt to minimize the sum of all three factors, and not merely activity losses.[256]

Activity loss is a function of the number of offenses and of the loss resulting from each offense. The number of offenses reflects the expected benefits and sanctions. Where potential offenders perceive that the potential gains from the activity are greater than the potential penalties, offenses will increase. In contrast, offenses will be reduced when the expected sanction exceeds the expected benefit.[257] The expected benefit depends on the probability of success and the likely gain. Similarly, the expected sanction is a function of the nominal penalty and the probability of conviction or settlement.

If activity losses were the only factor in determining social loss, the social loss could be minimized simply by increasing the nominal sanction or the probability of conviction until the expected sanctions far outweigh the expected benefits.[258] An increase in enforcement activity, however, requires increased enforcement expenditures and increases the enforcement loss to society. Similarly, an increase in nominal sanctions increases the externalities associated with imposing the sanction--such as deterrence of beneficial activities--thereby increasing the penalty loss to society.[259]

Enforcement and penalty losses are distinguished primarily by the stage of the deterrence process where they occur. Enforcement loss is the cost to society of detecting and convicting wrongdoers. Penalty loss is the cost of subsequent punishment. The sum of the costs to society and to the individual resulting from the imposition of the sanction and from any externalities created is the net penalty loss to society.[260] The penalty loss imposed by fines like those imposed by the ITSA is essentially zero, absent externalities, because the monetary gain to society is approximately equal to the loss to the offender. Although the fine imposes a monetary loss on the offender, society obtains an equivalent monetary gain, less any

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applied to the insider trading problem in the House ITSA Hearing, supra note 5, at 236, 268-77 (statement of Ted J. Fiflis, Professor of Law, Univ. of Colorado Law School).

[255] Becker, supra note 254, at 181; Schwartz, Baxter & Ryan, The Duel: Can These Gentlemen Be Acting Efficiently?, 13 J. Legal Stud. 321, 334-35 (1984).

[256] Becker, supra note 254, at 182.

[257] See R. Posner, supra note 251, at 165.

[258] See id. at 166 (discussing why such an approach is undesirable even in the absence of other costs).

[259] See Becker, supra note 254, at 172-80.

[260] See id.

costs of collecting the fine, through payment of the fine to the government.[261]

In contrast to the penalty loss associated with the ITSA, enforcement losses under the Act are more difficult to measure and may in fact increase. As discussed, prior to the ITSA the SEC frequently settled insider trading cases.[262] The high settlement rate may be explained by the offender's low incentive to litigate when the SEC offered to settle for disgorgement. This reduced the SEC's litigation costs, thereby minimizing the enforcement losses. Because the treble damage provision of the Act is merely an upper limit on the sanction, it may be difficult for offenders to decide whether a settlement offer is realistic. The courts have discretion under the Act to impose sanctions ranging from simple disgorgement to disgorgement plus three times the profits realized.[263] Because the Act does not delineate the fine to be imposed under a given set of circumstances, the offender may litigate in the hope that the court will impose a sanction less onerous than the offered settlement. If the rate of settlement decreases under the ITSA, enforcement losses will increase, assuming the SEC brings the same number of actions.[264]

For two reasons, however, enforcement losses may not increase under the ITSA. First, an offender faced with a settlement decision might litigate hoping for a court-imposed penalty less than the settlement offer, but he also risks a higher penalty. The courts' increasing hostility toward mild insider trading sanctions,[265] coupled with their freedom to impose an amount greater than the settlement offer, may encourage offenders to settle. Second, enforcement losses are counterbalanced by any monetary recovery resulting from enforcement. Civil penalties serve a compensatory as well sa a deterrent function;[266] in a sense, the fine compensates the government for the cost of imposing the sanction and enforcement losses are reduced thereby.[267] Thus, even if enforcement costs increase under the Act, the net enforcement loss may be minimal.

If neither penalty losses nor enforcement losses increase under the

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[261] Gary Becker has made an elaborate proof of this conclusion. See id. at 190-98. But see R. Posner, supra note 251, at 167.

[262] See supra notes 98-101 and accompanying text.

[263] See supra notes 121-28 and accompanying text.

[264] John M. Fedders, formerly the SEC's enforcement director, has admitted that he expects at least an initial decline in the rate of settlements under the ITSA. See 15 Sec. Reg. & L. Rep. (BNA) 2144-45 (1983).

[265] See, e.g., SEC v. Randolph, 564 F. Supp. 137 (N.D. Cal. 1983) (district court refused to approve a settlement because the penalty was too light), rev'd, 736 F.2d 525 (9th Cir. 1984).

[266] This rationale for civil penalties is suggested in Diver, The Assessment and Mitigation of Civil Money Penalties by Federal Administrative Agencies, 79 Colum. L. Rev. 1435, 1456 (1979).

[267] See Becker, supra note 254, at 192.

ITSA, its deterrent effect will be determined by the increase in the expected sanction.[268] A determination of the expected sanction requires an estimate of the probability of conviction, which in turn necessitates knowledge both of the number of convictions and of the number of offenses. Given the difficulty of actually measuring the incidence of insider trading, estimating the probability of conviction with any confidence may be impossible. It is reasonable to assume, however, that the eighty-two cases brought between 1979 and mid-1984[269] represent a small fraction of the actual number of violations.

Although there is little hard evidence, insider trading is generally recognized as the most common securities violation.[270] The observation that prices of securities in publicly held companies rise immediately prior to the disclosure of material information appears to confirm this intuition.[271] Furthermore, there is a general perception that insider trading carries a low probability of detection and a small punishment for thsoe detected.[272] What little hard evidence exists suggests this perception is accurate.[273]

The increased enforcement activity under SEC Chairman Shad has no doubt increased the probability of conviction, but the extent to which it has increased can be questioned. Assuming that the number of offenses is equal to the number referred to the SEC by the stock exchanges,[274] and that that number has remained constant, the eighty-two cases brought in the last five years represent a probability of conviction of 17.6 percent. Even this figure may significantly overstate the probability of conviction.[275]

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[268] In his comments on the draft ITSA, Michael Klein argued that the Act was unlikely to provide significant deterrence of insider trading 'because the laws already provide for society's ultimate sanction: imprisonment.' House ITSA Hearing, supra note 5, at 288 (letter from Michael R. Klein, Esq. to Reps. Dingell and Wirth). This argument fails to recognize that the nominal sanction is not merely the greatest of applicable sanctions, but the sum of all those imposed. The ITSA in fact significantly increases the nominal sanction in insider trading cases. See supra notes 121-32 and accompanying text. Klein was correct in stating, however, that increased enforcement activity would make the Act more effective. See infra notes 269-77 and accompanying text.

[269] See supra text accompanying notes 78, 81.

[270] See supra text accompanying note 3.

[271] House ITSA Hearing, supra note 5, at 271 (statement of Ted J. Fiflis, Professor of Law, Univ. of Colorado Law School).

[272] See supra note 47 and accompanying text.

[273] For example, between 1974 and 1976, the major stock exchanges and the National Association of Securities Dealers referred 186 suspected cases of insider trading to the SEC. Only one case in 20 was actually investigated, and only one in 60 resulted in the filing of an action. See 412 Sec. Reg. & L. Rep. (BNA) A-5 (July 30, 1977).

[274] See supra note 273.

[275] First, the number of offenses is widely believed to have risen since 1976. See supra text accompanying note 46. Second, the number of offenses during that period is believed to have been much larger than the number of referrals. See Dooley, supra note 2, at 6 n.17. Third, the SEC did not obtain

If the probability of conviction is in fact low, the expected sanction will remain relatively small even under the ITSA. Assume for example that the offender's expected gains are $100. Under the Act, the maximum monetary penalty is disgorgement plus treble gains, or $400. Unless the probability of conviction is at least twenty-five percent, the expected benefits will still outweigh the expected sanction, and the rational actor would proceed with the trade. But even the liberal estimate the probability of conviction, 17.6%, is more than seven percentage points less than the minimum necessary.

The expected sanction can be stregnthened by increasing the probability of conviction, but this approach would require further increases in the SEC's detection and prosecution efforts. The SEC's current resources do not permit a significant increase in enforcement activity. Several witnesses[276] and the House committee itself[277] recognized this, yet the bill provided for no increase in enforcement.

This note has argued that the ITSA enforcement regime is unlikely to achieve significant deterrence of insider trading without a substantial increase in the SEC's enforcement activity. This contention, however, rests on several assumptions that may not hold in practice. For example, it assumes that actors are risk-neutral, indifferent as between the certainty of being penalized one dollar and a ten percent chance of being penalized ten dollars.[278] A risk-averse individual would prefer the smaller certain penalty. The greater the nominal sanction, the more such individuals will

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convictions or settlements in every case. The probability of conviction is therefore probably substantially less than 17%.

[276] See, e.g., House ITSA Hearing, supra note 5, at 288-89 (letter from Michael R. Klein, Esq. to Reps. Dingell and Wirth) (arguing that an increase in the risk of detection may deter more insider trading than would treble damages, and that additional appropriations for SEC enforcement are therefore necessary).

[277] See House ITSA Report, supra note 5, at 6, reprinted in 1984 U.S. Code Cong. & Ad. News at 2279.

[278] The person who is risk neutral between the loss of one dollar and a 10% chance of losing $10 may not, however, be risk neutral between, for example, a loss of $10 and a 10% chance of losing $100.

Compliance with a legal standard is also affected by uncertainty about enforcement, about the penalty that will be assessed if the standard is enforced, and about the contours of the standard itself. For example, a potential inside trader will not only have to estimate the amount of the potential penalty and the chance that it will be enforced, but must predict what a court or the SEC will define as an illegal act. See supra notes 133-44 (ITSA does not define insider trading). To the extent that uncertainty causes potential actors to overcomply with the legal rule, efficient behavior may be deterred. If uncertainty causes undercompliance, on the other hand, inside traders will commit offenses at a higher than optimal rate. See generally Calfee & Craswell, Some Effects of Uncertainty on Compliance with Legal Standards, 70 Va. L. Rev. 965 (1984).

be deterred. The large nominal sanction imposed by the ITSA and the recent publicity given to it and to the SEC's enforcement program should deter such actors.

This analysis also ignores the effect of criminal and non-monetary civil penalties. Because the SEC may seek both the ITSA sanction and these other penalties, the expected sanction is greater than suggested above. The difficulty of estimating the monetary equivalent of such penalties makes it difficult to predict whether they would raise the expected sanction sufficiently to exceed expected benefits. Moreover, the use of these penalties significantly increases social costs through an increase in enforcement and penalty losses.[279] Without increased enforcement resources, such sanctions may thus provide only limited deterrence.

The Act, however, suggests how to increase enforcement activity with the resources available. Proceeds from enforcement of the ITSA are payable to the United States Treasury.[280] The SEC's enforcement resources may be increased by earmarking fines under the Act for SEC enforcement efforts against insider trading. Such a system would take advantage of the compensatory nature of the fine and would permit the SEC to increase the probability of conviction enough to deter insider trading.[281]

This analysis does not suggest that insider trading cannot be deterred; rather, it intends to show that deterrence is a complex problem involving many interrleated variables. Changing one variable, such as the nominal sanction, will not necessarily deter wrongdoing. Moreover, adjusting one variable frequently affects other variables, changing in turn the net deterrence calculus. A more complete approach would attempt to adjust all the variables to minimize the overall social loss from insider trading. This note suggests that the ITSA is a useful but not a complete step towards significant deterrence of insider trading. The next step must be an increase in SEC enforcement efforts.

B. Effect of the ITSA on the Federal Common-Law Insider Trading Prohibition

In analyzing the impact of the ITSA on the common law of insider trading, a recognition that the Act's drafters did not intend to change the substantive common law is crucial.[282] Congress made this intent clear in

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[279] Dooley, supra note 2, at 26-27.

[280] ITSA, § 2, 98 Stat. 1264, 1264 (to be codified at 15 U.S.C. § 78u).

[281] There is substantial empirical support for the proposition that 'an increase in the probability of apprehension and conviction is more effective than an increase in the sentence in detering crimes.' Easterbrook, Criminal Procedure as a Market System, 13 J. Leg. Stud. 289, 295 (1983).

[282] See infra notes 316-20 and accompanying text.

its failure to define insider trading[283] and by numerous statements in the Act's legislative history disclaiming any intent to modify the common-law prohibition.[284] Therefore, if properly interpreted, the ITSA should have only a minimal effect on the core judicial definition of insider trading.

Nevertheless, the Act can be expected to exert some limited influence on the development of the common law.[285] For example, in adopting the MacDonald disgorgement-context definition of profit and loss,[286] the House committee expressly stated that it was not endorsing the MacDonald holding as to disgorgement.[287] Despite this disclaimer, the Act's adoption of the MacDonald standard for the meaning of profit and loss may establish it for disgorgement as well. One reason for the refusal to adopt a statutory definition of insider trading was the fear that a definition limited to the ITSA would inevitably become the common-law definition.[288] The profit and loss definition appears equally prone to such a development. Because the MacDonald situation arises infrequently,[289] however, this effect is likely to be minimal.

Similarly, the use of the term 'aiding and abetting' in the Act will provide statutory support for the use of that theory as a basis for liability in injunctive or disgorgement actions. Although rarely used in insider trading cases, the SEC has long used 'aiding and abetting' as a ground for imposing such penalties on secondary actors in other cases.[290] Al-

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[283] See supra notes 133-44 and accompanying text. This failure can be criticized as a violation of the proposition that 'the determination of penalties should be guided by reasonably clear, complete, and objective policies' and standards. Diver, supra note 266, at 1457. It is mitigated, however, by the Act's grant of rule-making authority to the SEC to exclude such classes of individuals or transactions as it sees fit from coverage, see supra note 160 and accompanying text, and by the SEC's general definitional authority, see 15 U.S.C. § 78w(a) (1982).

[284] See, e.g., House ITSA Report, supra note 5, at 13, reprinted in 1984 U.S. Code Cong. & Ad. News at 2286; 130 Cong. Rec. H7759-60 (daily ed. July 25, 1984) (remarks of Rep. Wirth). The SEC has also stated that the common-law definition would be unaffected by the Act and should continue to evolve despite passage of the ITSA. House ITSA Hearing, supra note 5, at 48-56 (testimony of John S. R. Shad, SEC Chairman, John M. Fedders, Director, Div. of Enforcement, SEC, and Daniel Goezler, Office of General Counsel, SEC); House ITSA Hearing, supra note 5, at 98-100 (letter from SEC Chairman John S. R. Shad to Rep Wirth).

[285] It is argued infra p. 497 that it is not inconsistent to expect some changes in the nondefinitional portions of the common law while also suggesting that the ITSA will not substantially affect the definitional aspects.

[286] See supra text accompanying note 204.

[287] House ITSA Report, supra note 5, at 12, reprinted in 1984 U.S. Code Cong. & Ad. News at 2285.

[288] See supra text accompanying note 142.

[289] See supra text accompanying note 203.

[290] Stevenson, supra note 5, at 20, col. 1.

though most courts have upheld the SEC's position,[291] there is no statutory support for this practice in the 1934 Act,[292] and a number of commentators have therefore opposed the imposition of 'aiding and abetting' liability.[293] Although the ITSA applies only to insider trading and limits 'aiding and abetting' treble damage liability to tipping, the use of the term in the statute and the express House committee approval of its use in injunctive actions implies a statutory basis for its use in noninsider trading cases.[294]

A final change may result from the legislative history's emphasis on protecting securities firms with strong Chinese Walls between their trading and investment banking departments.[295] This emphasis may influence courts to protect these firms in injunctive actions as well as in proceedings under the ITSA. The SEC has suggested that these firms are already protected under current law,[296] and the legislative history of the ITSA should further strengthen this exemption.

In addition to the expected changes in the common law, some modification of the federal common law may result if the Act or its legislative history are read improperly. For example, lower courts might read the Act to limit Dirks[297] and Chiarella[298] to their facts. Although such action would be contrary to congressional intent,[299] portions of the statute and the legislative history, if misinterpreted, may support such attempts to circumvent Dirks and Chiarella.[300] Most importantly, the ITSA appears

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[291] See id.; see, e.g., Harmsen v. Smith, 693 F.2d 932 (9th Cir. 1982), cert. denied, 104 S. Ct. 89 (1983); Sirota v. Solitron Devices Inc., 673 F.2d 566 (2d Cir.), cert. denied, 459 U.S. 838 (1982).

[292] The 1934 Act uses the terms 'aiding and abetting' only once: in regard to administrative sanctions against brokers. 15 U.S.C. § 78o(b)(4)(E) (1982); see Stevenson, supra note 5, at 20, col. 1.

[293] See, e.g., Fischel, Secondary Liability Under Section 10(b) of the Securities Act of 1934, 69 Calif. L. Rev. 80, 94-102 (1981).

[294] Stevenson, supra note 5, at 20, col. 1.

[295] See supra notes 158-60 and accompanying text.

[296] See House ITSA Hearing, supra note 5, at 93 n.*(letter from SEC Chairman John S. R. Shad to Rep. Wirth). The emphasis on such protection in the legislative history of the ITSA should further strengthen this exemption.

[297] See supra notes 169-76 and accompanying text.

[298] See supra notes 179-80 and accompanying text.

[299] It must be recognized that the House committee implicitly suggested that Dirks be limited to its facts. See House ITSA Report, supra note 5, at 15, reprinted in 1984 U.S. Code Cong. & Ad. News at 2288. The committee also 'implied that if [Dirks] was taken by the lower courts as a mandate to narrow the scope of insider-trading liability, the committee would reconsider the desirability of broadening the definition of insider trading by statute.' Stevenson, supra note 5, at 20, col. 4. Nonetheless, the main point is that Congress left Dirks intact. See infra text accompanying note 318.

[300] See infra notes 301-15 and accompanying text.

to impose the treble damage penalty 'whenever . . . any person has violated the prohibition by purchasing or selling a security while in possession of material nonpublic information.'[301] The plain meaning of this provision may suggest a congressional intent that the common-law definition of insider trading, as stated by Dirks,[302] be replaced by a test that punishes any trading while in possession of material nonpublic information.[303]

Because a 'mere possession' test is inconsistent with several provisions of the 1934 Act and the insider trading common law, inferring such an intent from the ITSA would be improvident. First, it would revive the parity of information theory rejected by Dirks and Chiarella.[304] Second, because violations of the provisions under the 1934 Act and other securities statutes relating to short sales, margin purchases, or foreign corrupt practices arguably fall within a mere possession test, this interpretation would subject such violations to the ITSA's treble gains penalty[305] in contravention of Congress' intent. A clarifying amendment might be desirable to avoid judicial extension of the Act to non-insider trading portions of the federal securities laws. Third, this interpretation would undermine the Chinese Wall protection that the Act provides. Under a mere posses-

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[301] ITSA, § 2, 98 Stat. 1264, 1264 (to be codified at 15 U.S.C. § 78u).

[302] See supra text accompanying note 45.

[303] Furthermore, the ITSA may permit courts to avoid Dirks and Chiarella by implicitly affirming the misappropriation theory. Both cases were principally concerned with the duties owed to the corporation and its shareholders. See Dirks v. SEC, 103 S. Ct. 3255, 3261 (1983); Chiarella v. United States, 445 U.S. 222, 227-36 (1980). In contrast, the misappropriation theory is mainly concerned with the employment relationship between the trader and his employer, who may be but need not be a corporate agent. See, e.g., United States v. Newman, 664 F.2d 12 (2d Cir. 1981), cert. denied, 104 S. Ct. 193 (1983). Where Congress revises a statute without reversing prior on point judicial holdings, that failure has been taken as evidence of congressional approval of those holdings. See, e.g., Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353 (1982). Taken together with the House committee's implicit approval of the theory, see House ITSA Report, supra note 5, at 4-5, reprinted in 1984 U.S. Code Cong. & Ad. News at 2277-78, this analysis suggests that the misappropriation theory should be considered an established part of the prohibition, despite the Supreme Court's failure to address it to date.

[304] The parity of information theory asserts that the federal securities laws were intended to create 'a system providing equal access to information necessary for reasoned and intelligent investment decisions.' United States v. Chiarella, 588 F.2d 1358, 1362 (2d Cir. 1978), rev'd, 445 U.S. 222 (1980). This theory could make any informational imbalance a violation of the prohibition, but was explicitly rejected by the Supreme Court in Chiarella, 445 U.S. at 232, and Dirks v. SEC, 103 S. Ct. 3255, 3262-63 (1983). It continues to receive some congressional support, see, e.g., 129 Cong. Rec. S3865 (daily ed. Mar. 23, 1983) (remarks of Sen. D'Amato), but was not made an explicit basis for the ITSA.

[305] See House ITSA Hearing, supra note 5, at 296 (letter from Richard R. Howe, chairman, Comm. on Securities Regulation, New York State Bar Ass'n, to Sen D'Amato and Rep. Wirth).

sion test, a multi-service firm with inside information in its investment banking division would be liable for trades in that stock by its brokers even with a Chinese Wall in place, because the firm had traded 'while in possession of' inside information.[306]

Similarly, the 1934 Act permits market professionals to enjoy significant informational advantages because of the importance of their activities to the functioning of the markets.[307] Finally, a company contemplating a tender offer is permitted to buy up to five percent of the target's stock without disclosing its intentions, even though it is technically trading on market information.[308] This rule is essential to the effective functioning of the market for corporate control.[309] All of these socially beneficial activities, permitted by provisions of the securities law, would be threatened by a mere possession test.

Because the courts have broadly read the 'material' and 'nonpublic' aspects of the prohibition to include a wide range of information,[310] the mere possession test might also impede the activities of analysts and other market professionals. Analysts gather information not possessed or understood by the investing public and trade or recommend trading on such information, a function essential to efficient markets.[311] Moreover, corporate managers often have a 'symbiotic relationship with financial analysts and other professional advisors of large institutional investors. . . . Both management and financial advisers thus face powerful inducements to disclose selectively and to utilize inside information in every borderline case.'[312]

In addition to benefiting the corporation and the professionals, this ac-

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[306] Id. at 296-97; id. at 315-16 (memorandum in support of resolution by Council of the Section of Corporation, Banking and Business Law, American Bar Ass'n). Both groups suggested that the use of the terms 'on the basis of' instead of 'while in possession of' in the statute would solve the difficulties in the statutory language.

[307] See Memorandum Amicus Curiae of the Securities Industry Association 14, Chiarella v. United States, 445 U.S. 222 (1980).

[308] See 17 C.F.R. § 240.14d-3 (1984) (tender offer statement need not be filed unless bidder owns more than five percent of target).

[309] See generally Gilson, Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense, 35 Stan. L. Rev. 51 (1982) (discussing importance of open market for corporate control).

[310] Although much of the information used in the examples given in the text may fall into the category of market information, the SEC and the courts have often tried to include at least some categories of market information within the prohibition and uncertainty over whether the information falls within the prohibition will also deter this type of beneficial activity. Moreover, not all information used in such contexts falls within the market information category.

[311] House ITSA Hearing, supra note 5, at 315 (memorandum in support of resolution by Council of the Section of Corporation, Banking and Business Law, American Bar Ass'n).

[312] Dooley, supra note 2, at 11-12.

tivity also helps maintain the efficiency of the markets. As the analysts and their clients trade on the basis of the information, the stock price will move in the direction indicated by the information, allowing the market to account for the information prior to its public release.[313] Because this use of information might fall within a mere possession test, the ITSA's treble damage provision might deter risk-averse market professionals, not only injuring their clients but also reducing the efficiency of the securities markets.[314]

A mere possession test would also raise important fairness issues. In the absence of clear standards, it might be unfair to impose liability on an individual who lawfully obtains information and who owes no duty to the corporation not to use it, or even on someone who did not know the source or nature of the information when trading.[315] Yet a mere possession test would permit such liability.

Fortunately, the legislative history shows that the ITSA's drafters did not intend to create a mere possession test.[316] Where Congress adopts or revises a statute without reversing prior pertinent judicial holdings, congressional approval of those holdings is presumed.[317] Congress could have overruled Dirks instead of merely ordering a study of its effects.[318] The

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[313] Id. at 12.

[314] For an excellent summary of the importance of market professionals and their activities to the efficient functioning of the securities markets, see Gilson & Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549, 569-79 (1984).

Penalty regimes characterized by high sanctions but low probabilities of enforcement, such as the ITSA or the antitrust laws, pose a serious risk of deterring socially beneficial activity by risk-averse individuals acting close to the line between legal and illegal conduct. See generally Block & Sidak, The Cost of Antitrust Deterrence: Why Not Hang a Price Fixer Now and Then?, 68 Geo. L.J. 1131 (1980).

[315] House ITSA Hearing, supra note 5, at 298 (letter from Richard R. Howe, chairman, Comm. on Securities Regulation, New York State Bar Ass'n, to Sen D'Amato and Rep. Wirth).

[316] If a statute's plain language is unambiguous, that language must control its interpretation. However, where the plain language is ambiguous, raises serious constitutional problems, or leads to injustice, oppression, or an absurd consequence, the court must seek the legislature's true intent. The legislative history of a statute is perhaps the most important tool in that search. See generally W. LaFave & A. Scott, Handbook on Criminal Law 69-83 (1972) (describing how the judiciary ascertains legislative intent in the criminal law).

[317] See supra note 303.

[318] In explaining the final ITSA draft, Representative Dingell stated that:

By the use of the language '[w]henever 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,' the Congress [does not intend] to define the elements of the underlying violation, or to restrict the existing flexibility of the courts in determining what constitutes a violation of Section 10(b) of the Act, Rule 10b-5 thereunder, or any other provision.

130 Cong. Rec. H7758 (daily ed. July 25, 1984).

mere possession test therefore should be rejected as inconsistent with congressional intent.

The argument that the ITSA should not affect the definitional aspect of the insider trading prohibition may appear inconsistent with the preceeding suggestions that the Act will affect certain non-definitional portions of the common law. The effects on those non-definitional aspects, however, will merely reinforce trends in the existing development of judicial precedent. This is consistent with the basic argument that the Act leaves the definition of insider trading to the common law.

A likely explanation for the use of 'while in possession' is that Congress wanted to avoid using language that might constrict the existing definition. A major concern in drafting the Act was to preserve the courts' flexibility to address new developments in insider trading.[319] Congress may have used broad language to avoid any suggestion that the Act was intended to narrow the prohibition.[320]

The ITSA's most likely effect on the common law has received little attention. Prior to the adoption of the ITSA, a number of commentators argued that the common-law prohibition was without statutory authorization and contrary to Congress' actual intent in the 1934 Act.[321] This argument is often used as support for the economic arguments that the prohibition be abolished or substantially restricted.[322] Regardless of the merits of the economic arguments against the prohibition, the ITSA is an ex-

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[319] See supra text accompanying note 142.

[320] A more malign hypothesis is that the Congress was misled by the SEC. In testimony before the House committee, representatives of the Commission stated that 'while in possession of' was an accurate statement of the federal common-law definition. See House ITSA Hearing, supra note 5, at 48-49 (testimony of John S. R. Shad, SEC Chairman, John M. Fedders, Director, Div. of Enforcement, SEC, and Daniel Goezler, Office of General Counsel, SEC). Indeed, Mr. Fedders stated that he knew of no 'decision where a court has abandoned the 'in possession' theory.' Id. at 49. If by this he meant mere possession of either market or inside information, he ignored Dirks, which rejected that test as to both types of information. Dirks v. SEC, 103 S. Ct. 3255, 3263 (1983). Several witnesses at the hearing apparently thought that 'while in possession of' was in fact not the current common-law definition. See House ITSA Hearing, supra note 5, at 196-97 (testimony of Arnold S. Jacobs, Comm. on Securities Regulation, New York City Bar Ass'n); id. at 297 (letter from Richard R. Howe, chairman, Comm. on Securities Regulation, New York State Bar Ass'n, to Sen D'Amato and Rep. Wirth). It is therefore difficult to reconcile Congress' use of 'while in possession of' and its apparent intent not to change to the common-law definition of insider trading, unless Congress relied on the SEC's assertions or the discussion in the text is correct.

[321] See supra note 27.

[322] A number of scholars have suggested that the insider trading prohibition is economically undesirable and should be eliminated, weakened, or otherwise modified. See, e.g., H. Manne, supra note 2; Carlton & Fischel, supra note 2; Dooley, supra note 2, at 29-55; Manne, supra note 2. This debate is beyond the scope of this note.

press congressional statement that insider trading should be prohibited. Thus, the most important effect of the Act may be its establishment of a statutory basis for the prohibition.[323]

IV. CONCLUSION

The Insider Trading Sanctions Act of 1984 is one of the most important recent developments in federal securities law. It provides an essential first step toward the goal of deterring insider trading. This note has attempted, however, to show that the ITSA suffers from a number of defects. If not addressed, these problems threaten to prevent the Act from achieving its purpose of deterring insider trading without injuring the efficiency and integrity of the securities markets. The note therefore proposed ways in which the effective sanction against insider trading can be increased without incurring these problems. With these modifications the Act can be the weapon Congress desired to give the SEC.

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[323] Although the ITSA establishes a basis for the prohibition, neither it nor the legislative history establishes a statutory structure for the prohibition. Congress intended that the law continue to develop in this area. See supra text accompanying note 319. The courts are therefore free to evolve the prohibition towards a more rational structure.