

Securities Regulation By Enforcement: A Look Ahead At the Next Decade

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Slightly more than halfway through the past decade,¹ the effort

1. On May 12, 1986, federal prosecutors arrested Dennis Levine, a managing director of the investment banking firm of Drexel Burnham Lambert, Inc., charging him with insider trading activities allegedly dating back nearly to the beginning of the decade. SEC v. Levine, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,717 (S.D.N.Y. May 12, 1986). Levine was, at that time, one of the highest ranking Wall Street professionals to have succumbed to the temptation of insider trading. Thereafter, the numbers of professionals caught up in this scandal increased exponentially, and their stature increased commensurately. See, e.g., SEC v. Boesky, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,991 (S.D.N.Y. Nov. 14, 1986); SEC v. Siegel, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,123 (S.D.N.Y. Feb. 13, 1987); United States v. Freeman, No. 89 Cr.

of government regulators to enforce the arcane federal securities laws left the business pages, and assumed a prominent position of honor or ignominy (depending upon whether one was doing the writing, or being written about)² on the front pages of America's and the World's newspapers.³ For securities lawyers in particular, the 1980s were exciting and tumultuous.

Dubbed the "Roaring Eighties" by those with a cynical bent,⁴ and marred by a disturbing departure from ethical norms (in the form of a number of major corporate scandals, including a frightening increase in insider trading and defense contracting scandals⁵), this past decade saw a renewed interest in securities law enforcement on

615 (S.D.N.Y. Sept. 5, 1989). SEC charges related to Levine's trading were brought against Robert Wilkis, Ira Sokolow, David Brown, Ilan Reich, and Randall Cecola for furnishing Levine with some of the nonpublic information upon which his trades were based. SEC v. Wilkis, No. 86-5182 (S.D.N.Y. filed July 1, 1986); United States v. Wilkis, No. 86 Cr. 1112 (S.D.N.Y. Dec. 22, 1986); see *In re* Ira B. Sokolow, Exchange Act Release No. 23,386, 36 SEC Docket 6 (July 1, 1986); SEC v. Sokolow, No. 86-5193 (S.D.N.Y. filed July 1, 1986); United States v. Sokolow, No. 86 Cr. 762 (S.D.N.Y. Sept. 4, 1986); see *In re* David S. Brown, Exchange Act Release No. 23,698 36 SEC Docket 924 (Oct. 9, 1986); SEC v. Brown, Litigation Release No. 11,245, 36 SEC Docket 949 (S.D.N.Y. Oct. 9, 1986); United States v. Brown, No. 86 Cr. 741 (S.D.N.Y. Sept. 4, 1986); SEC v. Reich, Litigation Release No. 11,246, 36 SEC Docket 949 (S.D.N.Y. Oct. 9, 1986); United States v. Reich, 661 F. Supp. 371 (S.D.N.Y. 1987); SEC v. Cecola, Litigation Release No. 11,313, 37 SEC Docket 342 (S.D.N.Y. Dec. 22, 1986); United States v. Cecola, No. 86 Cr. 1113 (S.D.N.Y. Dec. 22, 1986). All of these individuals settled with the government.

2. Three reporters for the Wall Street Journal make this point graphically. Two—James Stewart and Daniel Hertzberg—received Pulitzer Prizes for their reportage of the insider trading scandal. See *Winners of Pulitzer Prizes in Journalism, Letters and the Arts*, N.Y. Times, Apr. 1, 1988, at B4, col. 1. The third—R. Foster Winans—received an eighteen month jail term for his illegal insider trading activities. See *Wall Street Journal Ex-Reporter Sentenced to 1 1/2 Years in Stock Fraud*, Wash. Post, Aug. 7, 1985, at A5, col. 3.

3. See *The Predator's Ball*, N.Y. Times, Aug. 14, 1988, § 7, at 29, col. 1; See also *Wall Street Trader Admits He is Guilty in Stock Price Case*, N.Y. Times, Aug. 31, 1989, at A1, col. 1; *Drexel Will Pay \$673 Million in Fines, Penalties*, Atlanta Constitution, Sept. 12, 1989, at A1; *Are RICO Seizures a Violation of Rights, as Critics Contend?*, Wall St. J., Feb. 15, 1989, at A1, col. 1; *The Bulldogs in Uncle Sam's Garden*, Fin. Times (U.K.), Aug. 8, 1987, § 1, at 1, col. 3; *Setback for US Insider Trading Probe*, Fin. Times (U.K.), May 14, 1987, § 1, at 1; Pitt & Shapiro, *The Revised Insider Trading Proscriptions Act of 1988: A Legislative Remedy for a Problem that Persists*, 26 AM. CRIM. L. REV. 7, 7 (1988) [hereinafter *A Legislative Remedy*].

The public's preoccupation with securities law enforcement was not restricted to the news media. One highly successful movie—*Wall Street* (Twentieth Century Fox Film Corp. 1987), an internationally acclaimed play—*Serious Money*, written by Caryl Churchill—and a series of *Doomesbury* cartoons by Gary Trudeau, transformed insider trading into a household concept.

4. See Brill, *The Roaring Eighties*, Am. Law., May 1985.

5. For a general description of these scandals, see Pitt & Groskaufmanis, *Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes of Conduct*, 78 GEO. L.J. — (1990) (forthcoming) [hereinafter *Corporate Codes*].

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the part of the Securities and Exchange Commission (the SEC or the Commission) and various federal and state prosecutors.⁶

The decade commenced with a seemingly pedestrian declaration of a return to the fundamentals of securities law enforcement, and the disavowal of the pursuit of so-called securities enforcement esoterica;⁷ it ended as a decade of vigorous securities law enforcement, by federal and state prosecutors, the SEC, securities industry self-regulators, and private plaintiffs.⁸ Perhaps more importantly, despite the agency's much publicized disavowal of certain of the attributes of the SEC's enforcement program in the 1970s, in fact, by the end of the decade, the SEC was expanding its authority, developing novel theories of law, enmeshing itself in corporate governance, and seeking unusual and extraordinary remedies in judicial proceedings.

6. While the Commission's enforcement of the federal securities laws receives the most prominent attention, authorities at the state level also play a significant role in regulating securities offerings. See L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 8-14 (1988). The Securities Act of 1933 (Securities Act) vests concurrent jurisdiction over its provisions in the state and federal courts, 15 U.S.C. § 77v (1982), thus enabling state regulators to enforce this Act's provisions in their own courts. The Securities Exchange Act of 1934 (Exchange Act), by contrast, expressly specifies exclusive jurisdiction in the federal courts. 15 U.S.C. § 78u(d)(1) (1982).

7. See, e.g., Noble, *The Dispute Over the S.E.C.*, N.Y. Times, Apr. 21, 1982, at D1, col. 3 ("Mr. Shad is focusing on [insider trading and manipulation] rather than on accounting practices and broader corporate governance, and he is supported by many in the securities community who have long argued that the enforcement division . . . needed to be reined in"). This perception remained, although one Shad-Fedders enforcement action raised fears of a return to the emphasis of the 1970s: "The [Paradyne] suit could have broad implications if it shows renewed SEC interest in management integrity—a concern that has been dormant under current SEC Chairman John S.R. Shad." *The SEC v. Paradyne: More at Stake than a Company's Reputation*, BUS. WK., Dec. 5, 1983, at 172, col. 1. Curiously, at the time the *Paradyne* suit was brought, Fedders already had asserted his intention to focus the Commission's enforcement efforts on traditional, fundamental principles of securities law, rather than the esoteric theories pursued during the 1970's. *Id.*

8. The Division of Enforcement of the Securities and Exchange Commission has been the focus of unprecedented attention and publicity during the past three years, as a result of the major insider trading cases brought by the Commission against a variety of leading Wall Street professionals, including investment bankers, arbitrageurs, and lawyers. The attention received by the Enforcement Division has not gone unnoticed by the Commission itself, which has sought a \$25.7 million budget increase for the 1989 fiscal year and a \$26.1 million budget increase for the 1990 fiscal year, much of which will apparently be channeled to the Enforcement Division. See Securities & Exchange Commission, *Budget Estimate Fiscal 1990*, Jan. 9, 1989, at i. In addition, remedies through civil, criminal, and administrative legal actions are sought as appropriate in the prevention and suppression of fraud. The number of investigations initiated, administrative proceedings opened, and injunctive actions commenced have increased steadily over the past three years. See *Budget of the United States Government, FY 1989*, at 1-288 (1988).

In the process, the SEC eschewed its traditional fear of Congressional handiwork,⁹ and proposed substantial securities legislation (largely but not exclusively devoted to the phenomenon of insider trading),¹⁰ which passed by a resounding margin.¹¹ And, fueled by the SEC or the media, relevant Congressional committees proposed, considered, and (in one case) adopted additional pieces of legislation, some of which have been revived in the current session of Congress.¹²

Although the onset of the Reagan Administration produced a flurry of criticisms by outspoken Congressional and other commentators regarding the future of securities regulation,¹³ by the end of the decade most members of Congress were praising a

9. As a general proposition, the SEC has often feared to propose legislation when it does not control the environment in which that legislation is considered. This is particularly true when the relevant Congressional committees are controlled by a political party other than that dominating the Commission.

10. The Insider Trading Sanctions Act of 1984 represented the Commission's first legislative assault on illegal insider trading. See Pub. L. No. 98-376, 98 Stat. 1264 (codified in scattered sections of 15 U.S.C. (Supp. IV 1986)).

11. See *Congress Talks Tough, But Fails to Speak Clearly on Insider Trading Issues*, Manhattan Law., Dec. 6-12, 1988, at 11 (Insider Trading and Securities Fraud Enforcement Act of 1988 passed by 410-0 vote in House, on a voice vote in Senate); *Insider-Trading Sanctions Bill Clears Congress*, Wall St. J., July 26, 1984, at 4, col. 2 ("The House voted unanimously to adopt the insider-trading sanctions bill").

12. Issues of insider trading and tipping regained the attention of Congress, resulting in rapid passage of the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA). See Pub. L. No. 100-704, 102 Stat. 4677 (codified as amended in scattered sections of 15 U.S.C. (Supp. IV 1986)). Another legislative proposal, the Insider Trading Proscriptions Act of 1987, was introduced in June 1987 as S. 1380, a bill drafted by an *ad hoc* committee of lawyers, chaired by Mr. Pitt, in response to a request by the Chairman of the Senate Securities Subcommittee. S. 1380, 100th Cong., 1st Sess., 133 CONG. REG. 58247 (daily ed. June 17, 1987). On January 18, 1989, the Commission submitted to Congress a legislative proposal to enhance its ability to enforce the provisions of the various federal securities regulatory statutes. See Memorandum of the Securities and Exchange Commission in Support of the Securities Law Enforcement Remedies Act of 1989, Jan. 18, 1989 (on file with authors). On March 1, 1989, the Commission submitted to the Senate Committee on Banking, Housing and Urban Affairs a legislative proposal, introduced as S. 646, to enhance its ability to secure from, and to provide to, foreign regulators cooperation in international securities law enforcement matters. See Memorandum of the Securities and Exchange Commission in Support of the International Securities Enforcement Cooperation Act of 1989, Mar. 1, 1989 (on file with authors).

13. Some of this criticism may have been self-inflicted. When John S.R. Shad assumed the Chairmanship of the Commission, he spent his first year touting the benefits of deregulation, see, e.g., *The SEC Under Shad: Can a Deregulator Protect the Public?*, BUS. WK., June 13, 1983, at 135; *SEC Chairman Notes Efforts to Streamline 50 Years of Rules, Statutes*, Daily Rep. for Exec. (BNA), Feb. 4, 1982, at A-1, and focusing his efforts on insider trading enforcement actions to the exclusion of other types of enforcement proceedings. See articles cited *infra* note 222. That did not play well in Congress. See *SEC's Shad, Fedders Deny Commission is Overemphasizing Insider Trading*, 14 Sec. Sec. & L. Rep. (BNA) No. 41, at 1785 (Oct. 22, 1982).

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vigorous SEC enforcement program, and seeking ways to facilitate the agency's law enforcement mission.¹⁴ Emboldened by its successes (particularly in the insider trading arena),¹⁵ favorable commentary from the press¹⁶ and academicians,¹⁷ and a number of significant litigation triumphs,¹⁸ the SEC's enforcement program shifted dramatically over the course of the decade, as the agency once again employed enforcement proceedings to develop new legal theories and remedies. This change promises to influence the future course of securities regulation during the next decade and beyond.

Unlike many of its sister agencies, the SEC consistently has maintained a vigorous, highly-visible, and largely successful enforcement profile.¹⁹ Indeed, the agency's enforcement proclivities have been so pronounced, that plaudits for the agency's effectiveness have, from time-to-time, shared the limelight with accusations that

14. See, e.g., *Reagan Asked to Name Vigorous Chief at S.E.C.*, N.Y. Times, Mar. 23, 1987, at D1, col. 1 (Congress urged President Reagan to appoint an SEC Chairman who would continue the agency's tough enforcement program, following Chairman Shad's resignation). By the end of his tenure, Mr. Shad had stopped speaking about deregulation, and started focusing on ethics. See Shad, *Business' Bottom Line: Ethics*, N.Y. Times, July 27, 1987, at A19, col. 1; *New Debate About Harvard Business School*, FORTUNE, Nov. 9, 1987, at 34; *Case Study in Caring*, THE ECONOMIST, Sept. 30, 1989, at 27 (reporting Mr. Shad's pledge to provide \$20 million to Harvard Business School to fund the teaching of business ethics). That not-so-subtle shift in emphasis produced a host of favorable commentary by former critics, see, e.g., *They Who 'Delivered' Boesky are Perplexed*, N.Y. Times, Jan. 2, 1987, at B6, col. 3 ("The Boesky case has indeed brought high praise to the S.E.C. from some of its most persistent critics. . ."), and even generated the preparation of a book about Mr. Shad's tenure as SEC Chairman. See *Inside New York*, Newsday, Feb. 6, 1989, at A1.

15. See, e.g., SEC v. Levine, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,717 (S.D.N.Y. May 12, 1986); SEC v. Boesky, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,991 (S.D.N.Y. Nov. 14, 1986); SEC v. Siegel, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,123 (S.D.N.Y. Feb. 13, 1987).

16. See *New Chairman Expected to Name Insider as Wall Street's Top Cop*, Reuter's Bus. Rep., Oct. 11, 1989 (BC Cycle) (LEXIS, NEXIS library, Wires file) (quoting favorable commentary regarding Commission's three acting Directors of Enforcement); *Futures Outrages Coming Home to Roost*, Wash. Post, Sept. 5, 1989, at E3, col. 1 (comparing SEC's superior performance to recent CFTC actions); *Nominee for S.E.C. Chairmanship Faces Heavy Sessions with Senators*, N.Y. Times, Sept. 4, 1989, at A9, col. 1 (praising quality of Commission's "highly skilled lawyers").

17. See Klein, *Insider Trading, SEC Decision-Making and the Calculus of Investor Confidence*, 16 HOFSTRA L. REV. 665 (1988).

18. See, e.g., *Carpenter v. United States*, 484 U.S. 19 (1987); SEC v. First City Fin. Corp., 688 F. Supp. 705 (D.D.C. 1988), *aff'd*, 890 F.2d 1215 (D.C. Cir. 1989); see also Pitt, *The Limits of Fraud: An Analysis of the Winans Case*, INSIGHTS, Jan. 1988, at 14.

19. See *infra* note 136 and accompanying text.

it indiscriminately uses its enforcement powers as a substitute for meaningful, orderly, and fair regulatory processes.²⁰

Depending upon the issues involved, and the timing of their presentation, that criticism is not without a modicum of merit. The SEC *has*, at times, resorted to *ad hoc* enforcement of the federal securities laws in particular contexts, in the absence of meaningful advance guidance (or warning) to those subject to the agency's jurisdiction, in large measure because of the agency's institutional fear that any specific regulations it might promulgate could prove underinclusive or susceptible of easy evasion.²¹

It is, understandably, far easier for SEC officials to defend and pursue individual enforcement actions, particularly if they are highly visible enforcement actions, than to attempt to develop and maintain comprehensive regulatory responses to difficult and technical industry and professional issues. To be sure, there are administrative benefits to such an approach—that is, to the approach of securities regulation by enforcement. Among other things,

- (i) the agency is not required to identify emerging issues before they actually arise;
- (ii) the agency is not required to chart out, explicate, maintain or perfect a comprehensive solution to identified issues, taking into account those circumstances where deviation from normative standards might be appropriate;
- (iii) the agency is able to react to specific facts, and tailor its responses to each new situation;
- (iv) the agency is not required to conform its actions to procedures that can both delay the articulation of new legal standards and can enable others to attack either the premises or the conclusions drawn by the agency; and

20. See, e.g., *Corporate Codes*, *supra* note 5, at 31 (quoting *The Corporate Rush to Confess All*, *BUS. WK.*, Feb. 23, 1976, at 22, col. 1 ("At some point . . . we end up trying to enforce everyone else's law, which is not our job to do") (statement of SEC Commissioner A. A. Sommer, Jr.)).

21. See *infra* note 68 and accompanying text.

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- (v) critics and overseers of the agency's activities are less likely to be able to detect inconsistent approaches by the agency to comparable problems, or even to ascertain guiding principles or policies employed by the agency to respond to certain types of situations.

Throughout most of its history, the SEC has consistently relied on this *ad hoc* enforcement approach to the development of certain regulatory standards. But, the SEC substantially changed the direction of its efforts with the advent of the 1980s. Turning away from so-called esoteric securities cases—that is, cases involving novel or unique investment instruments or activities whose connection to traditional securities law enforcement efforts may appear attenuated—the Commission embarked upon a dual program of deregulation and increased, main-stream enforcement of the federal securities laws. Despite a certain amount of initial cynicism and skepticism, the SEC's enforcement program over the past decade is now largely viewed as a success.²² In the course of this process, discernible trends began to develop in the agency's enforcement program.

Among other things, the SEC's focus on insider trading cases, while salutary, threatens to leave neglected critical other areas of securities enforcement that may be of less interest to the financial media. Similarly, the SEC's success with insider trading cases portends the likely expansion by the agency of the legal theories on which it will rely in other cases, and the remedies it will request in a variety of circumstances, in many instances beyond existing statutory provisions.²³

Finally, the development and maturation of the SEC's enforcement program during the past decade have brought with it the concomitant public scrutiny that ineluctably follows highly-visible government activities. Public scrutiny can enhance a regulatory agency's performance, and often does. Much of the criticism afflicting the Commission, however, has been directed toward

22. The agency (i) uncovered a massive insider trading scandal, which has prompted renewed self-policing by securities professionals, and the passage of significant and extensive new legislative powers for the agency; (ii) captured significant amounts in fines and penalties for the U.S. Treasury; (iii) scored some impressive litigation victories; and (iv) escaped the ravages of budget-cutting legislation.

23. While the SEC has done an admirable job in the area of law enforcement, this latter approach can take on some of the characteristics of "the ends justify the means."

questions of whether the agency is sufficiently aggressive, whether its sanctions are sufficient to deter future wrongdoing, and whether its settlement and litigation strategies are sufficiently rigorous and uncompromising. Scrutiny of this kind threatens to make the agency's enforcement staff more self-conscious about their judgments, and less self-confident about the wisdom of their choices.

In concrete terms, the same types of cases that are being brought today will likely continue to be brought over the course of the next decade. But the process by which those cases are resolved may well differ as a result of the Commission's activities and successes this past decade. Expansive theories of law, increased statutory authority, and novel theories of the remedies to which the agency is entitled, threaten to deprive the agency of some measure of its historical effectiveness. That effectiveness has been the product of an enforcement program that is perceived by lawyers, judges, and, perhaps most importantly, defendants, as both fair and credible. To the extent the agency strays from its traditional moorings, it runs a significant risk that more of its cases will be litigated and that, as a result, fewer cases can be brought.

Despite the difficulty that inheres in attempting to weave individual enforcement judgments into a cohesive and principled framework,²⁴ this Article attempts to chart the major themes of SEC regulation through enforcement during the 1980s, and to assess their implications for the next decade.²⁵

In particular, Part I assesses the predicates for an effective and meaningful SEC enforcement program, including an analysis of its limitations and its past origins. Through this analysis, we explicate the major facets of the SEC's approach to enforcement, and analyze the extent to which the actual attributes of the SEC's enforcement programs have conformed to the agency's ideals.

Part II discusses several of the major trends of the past decade, and the SEC's approach to enforcement throughout that period.

24. To a large extent, securities enforcement is serendipitous. First someone has to violate the law, and then someone in the government has to become aware of that violation. It is very difficult for the government to create a law enforcement program out of whole cloth and then "stock" it with cases brought in the ordinary course of its enforcement efforts. Rather, enforcement requires flexibility and responsiveness.

25. Scholars and practitioners who assess this Article undoubtedly will criticize its selectivity. It is, however, simply not possible to identify every significant enforcement development over the past decade, and it is even more difficult to discuss every significant enforcement development we are capable of identifying. We do not purport to do so. Instead, we attempt to identify a number of enforcement trends, and discuss those trends in the context of instances of enforcement initiatives.

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These trends evidence concrete directions and patterns assumed by the agency which are most likely to influence future enforcement initiatives. Given some of the responses to the agency's enforcement program, future institutional decisions may be easier to predict.

Finally, Part III identifies those aspects of the current enforcement program that are apt to have significant implications for future SEC enforcement initiatives, recognizing that any analysis, no matter how cogent, is circumscribed by the fact that the Commission itself is in the process of undergoing substantial changes in personnel.²⁶

I. The Predicates of an Effective Enforcement Program

The SEC has long (and consistently) been recognized as one of the most effective prototypes of federal enforcement powers.²⁷

26. The Commission has a relatively new Chairman, Richard C. Breeden. While Chairman Breeden has occupied this position for only a few months, some insight into his possible priorities may be gleaned from his responses to questions posed by members of the Senate Banking Committee, in connection with his confirmation hearings. See Breeden, *Response to Questions from Senate Banking Committee in Connection with Confirmation Proceedings for Richard C. Breeden as a Commissioner of the Securities and Exchange Commission*, Sept. 29, 1989 [hereinafter *Breeden Responses*]. In the *Breeden Responses*, Breeden identified as areas of especial interest or concern to him the need for (i) greater oversight of the international securities markets, see *id.* at 7-8, 35, 40, 82-3; (ii) increased use of criminal proceedings in egregious cases, particularly in the area of penny stock fraud, see *id.* at 13, 15, 29; (iii) the need for additional enforcement remedies, see *id.* at 37, 100; and (iv) a strong enforcement presence, see *id.* at 1, 49, 86, 104-5, while not over-regulating to the point of harming a competitive capital formation market, see *id.* at 93-4, 104.

In addition, as of this writing, the Commission's Director of Enforcement, William R. McLucas, a twelve-year veteran of the Enforcement Division, was only recently appointed. See *McLucas Is Named SEC Enforcement Chief, Its Second-Most-Influential Post*, Wall St. J., Dec 27, 1989, at A8, col. 2. Finally, additional vacancies on the Commission portend significant changes in its composition over the next year. While this Nation prides itself on being a government of laws, as opposed to a government of men, see J. Adams, *Original Draft of Mass. Const.*, (1779), the simple fact is that, with so much change, it is highly likely that the current enforcement program will undergo significant changes as well. This was certainly the case, for example, when the former Director of Enforcement, Stanley Sporkin (now Judge Sporkin), left the Commission and John M. Fedders succeeded him. See *infra* notes 215-19 and accompanying text.

27. See *A New Regulatory Framework: Report on Selected Independent Regulatory Agencies* by the President's Advisory Council on Executive Organization 102 (1971) [hereinafter *Ash Report*] ("The SEC is regarded as one of the ablest of the independent regulatory commissions"). See also *House Report Criticizes SEC for Slow Progress Toward National Market System, But Also Praises Agency*, Sec. Reg. & L. Rep. (BNA) No. 372, at A-5 (Oct. 6, 1976); Wolfson, *A Critique of the Securities and Exchange Commission*, 30 EMORY L.J. 119, 128-29 (1981) ("The SEC came to symbolize the need for and the value of the concept of the regulatory agency. Since the SEC was blessed not only by an admirable purpose, but by a remarkable staff, its reputation soon was pre-eminent among the agencies of government") (citing Ratner, *SEC: Portrait of the Agency as a Thirty-Seven Year Old*, 45 St.

Largely because of the importance of its mission,²⁸ the complexity of its tasks,²⁹ and the dedication and competence of its staff, the SEC has earned a significant level of respect and appreciation, even from normally severe critics.³⁰ Some observers have attributed this success to the early personnel of the agency,³¹ who set a standard for

JOHN'S L. REV. 583 (1971)).

28. The SEC was born out of the rubble of the Great Depression and the Market Crash. See J. SELIGMAN, *TRANSFORMATION OF WALL STREET* 1-2 (1982) [hereinafter *TRANSFORMATION OF WALL STREET*]. It was anticipated that the effects of the October, 1929 market crash would never be repeated, and perhaps could be prevented, by virtue of the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934. *Id.* at 2. It has become clear, however, that market crashes of the sort that gave rise to the Commission are not relics of the past, see, e.g., *The Villain in Volatility*, Newsweek, Nov. 6, 1989, at 58; *Fed Seeks to Reassure Markets; US Central Bank Ready to Inject Cash-United Reaction to Wall Street Losses*, Fin. Times (U.K.), Oct. 16, 1989, at 1, col. 3; *Legacies of '29*, Wash. Post, Oct. 23, 1987, at A21, col. 1; *Wall Street: The Wild Day After*, L.A. Times, Oct. 21, 1987, at 1, col. 5, and may occur with greater frequency in the future. Ironically, the appointment of the last two SEC chairmen, occurring in October 1987 and 1989, has coincided with market crashes.

29. Unlike many federal administrative agencies, the SEC is a lawyer-dominated organization. *Final Report of SEC Transition Team*, Sec. Reg. & L. Rep. (BNA) No. 587, at K-1, K-2 (Jan. 1, 1981) [hereinafter *Transition Team Report*]. It was not until some forty years after its establishment that the Commission recognized the value of policy planning, and increased the prominence of economic analysis in its regular operations. See *Transition Team Report*, *supra*, at K-2, K-3.

30. Professor Seligman, in *TRANSFORMATION OF WALL STREET*, *supra* note 28, observed that:

Even the critics of the SEC's mandated disclosure program paid homage to its popularity. Professor George Stigler, for example, in 1964 wrote:

It is doubtful whether any other type of public regulation of economic activity has been so widely admired as the regulation of the securities markets by the Securities and Exchange Commission. . . . The Commission has led a scandal-free life as federal regulatory bodies go. It has . . . enjoyed the friendship, or at least avoided the enmity, of both political parties.

In a similar vein, Professor [Homer] Kripke conceded fifteen years later, 'The Commission's approach to the content of disclosure has been accepted, with comparatively few exceptions . . . by the practicing professionals. . . .

Transformation Of Wall Street, *supra* note 28, at 561 (citations omitted).

31. The SEC has always been a breeding ground for important contributors to good government. Two senior SEC officials became Justices of the Supreme Court (William O. Douglas and Abe Fortas), at least two became federal appellate judges (Jerome Frank and William Timbers), at least three became federal district judges (Gerhardt Gesell, Kevin Duffy, and Stanley Sporkin), one is now serving as the senior Senator from Montana (Max Baucus), and at least three have thereafter served as higher ranking government officials (William Casey, John S.R. Shad, Stanley Sporkin). This is not intended to denigrate the countless numbers of SEC officials and staff members who have gone on to additional (if not greater) glory in the private sector. Indeed, the current Commissioner of Baseball is a proud SEC alumnus (Francis T. (Fay) Vincent).

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excellence that has continued throughout the agency's existence,³² while others credit the fact that the agency has nothing to give away, in the form of licensing power or monetary awards.³³

But, the mixture of enforcement and regulatory powers in a single agency often creates conflicts as well as policy choices,³⁴ although the courts have declined to upset this combination of functions.³⁵ Should the law be developed primarily through regulation or should it be developed primarily through enforcement?³⁶ How much regulatory specificity should precede enforcement activity?³⁷ How should the two functions complement one another?³⁸ Are they compatible?³⁹

32. See *supra* note 27.

33. The agency does, of course, have authority over securities professionals, such as securities brokers and dealers, and investment advisers. But, unlike licensing agencies, the SEC does not license such professionals; it merely registers them. Anyone with a minimal amount of capital, and a relatively consistent record of law compliance, can (and, indeed, must) be registered. See, e.g., Exchange Act § 15(b)(1), 15 U.S.C. § 78o(b)(1) (1982).

34. See generally Comment, *Prejudice and the Administrative Process*, 59 NW. U.L. REV. 216 (1966).

35. See, e.g., *Ash Grove Cement Co. v. Federal Trade Comm'n*, 577 F.2d 1368 (9th Cir.), *cert. denied*, 439 U.S. 982 (1978); cf. *Withrow v. Larkin*, 421 U.S. 35 (1975).

36. This issue has preoccupied the SEC, in particular, for many years. Indeed, in 1977, the agency convened a Major Issues Conference, attended by distinguished representatives of various private-sector organizations, to focus on four major issues confronting the agency. The very first issue denominated was the tension between regulation and enforcement. Not surprisingly, it was the consensus of the participants that the agency should regulate through regulation and not through enforcement. See FINAL REPORT OF THE SEC MAJOR ISSUES CONFERENCE 1-2 (1977) [hereinafter SEC MAJOR ISSUES CONFERENCE].

37. Particularly in the area of fraud, the tension between regulation and enforcement is significant. Long ago, the Commission asserted, and the courts recognized, that it was not possible, and perhaps counter-productive, to afford too much specificity regarding the content of fraud. See, e.g., *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961) ("the broad language of the anti-fraud provisions [should not be] circumscribed by fine distinctions and rigid classifications"); *Weiss v. United States*, 122 F.2d 675, 681 (5th Cir.) ("[f]raud . . . needs no definition; it is as old as falsehood and as versable as human ingenuity"), *cert. denied*, 314 U.S. 687 (1941).

By the same token, notions of due process require that an individual have fair warning of precisely what conduct the law proscribes, before that individual can be sanctioned for it. See, e.g., *Chiarella v. United States*, 445 U.S. 222, 235 n.20 (1980) (citing *Grayned v. City of Rockford*, 408 U.S. 104 (1972)).

38. The textual inquiry assumes that enforcement and regulation are not substitutes. Some commentators have criticized the SEC for not recognizing that fact. See generally R. KARMEL, *REGULATION BY PROSECUTION* 76 (1982) [hereinafter *REGULATION BY PROSECUTION*].

39. See *Withrow v. Larkin*, 421 U.S. 35, 51 (1975) ("Legislators . . . have given much attention to whether and to what extent distinctive administrative functions should be performed by the same persons. No single answer has been reached. Indeed, the growth, variety, and complexity of the administrative processes have made any one solution highly unlikely") (emphasis supplied); *Blinder, Robinson & Co. v. SEC*, 837 F.2d 1099, 1104 (D.C. Cir.) ("The APA prohibits agency staff from combining prosecutorial and adjudicative functions in the same

Although many, if not most, of these questions can be posed for other administrative agencies that also perform a combination of regulatory and enforcement powers, the issues raised by the SEC's approach to these issues are not necessarily the same as those confronted by other agencies. A recent glimpse at the enforcement process of the now-defunct Federal Home Loan Bank Board serves to underscore the point. In the unfolding story of that agency's internecine disputes between its San Francisco Regional Bank enforcers and its Home Office Enforcement staff,⁴⁰ arising out of the Lincoln Savings Bank's financial difficulties, it has become apparent that all federal enforcement agencies do not necessarily function comparably in analogous situations.

Thus, for example, the SEC has long promoted a spirit of cohesiveness and harmony between its home office staff and its regional office enforcement staff.⁴¹ The Bank Board, on the other hand, appears not to have enjoyed the same collegiality of spirit between home and regional offices, resulting in something less than appropriate aggressiveness in addressing questions about the legal sufficiency of a claim against Lincoln Savings Bank and its

case. *But it expressly exempts agency members from this prohibition of combined functions*") (emphasis in original) (citations omitted), *cert. denied*, 109 S. Ct. 177 (1988).

40. See *Savings Executive Won't Testify and Blames Regulators For Woes*, N.Y. Times, Nov. 22, 1989, at A1, col. 2, describing a bizarre exchange of accusations between regional and headquarters officials of the Bank Board:

[T]he bulk of the testimony amounted to finger-pointing by the Washington office to failures by the San Francisco office, with Mr. Wall and others asserting that the San Francisco office had not proved its case. . . . But the Washington officials did not go unchallenged. The committee called two of Mr. Wall's chief opponents from the San Francisco office. . . .

Id. See also *Lincoln Owner Refuses To Testify*, Wash. Post, Nov. 22, 1989, at E1, col. 2.

41. This does not mean, of course, that circumstances have not created the potential for strained relations between the home and regional offices. Indeed, the former head of the SEC's Atlanta Regional Office, Michael Wolensky, conducted an investigation of the private practice activities of the former Enforcement Division Director, John Fedders, in connection with Fedders' representation of Southland Corporation. See *SEC Probe Ties Southland to Kickbacks*, Wash. Post, Nov. 9, 1984, at B1, col. 3 ("Wolensky . . . was chosen to conduct the probe because he does not work directly with Fedders. 'Wolensky was trying to do a hatchet job [in describing Fedders's conduct in his report to the SEC],' [Fedders's lawyer, Peter] Bleakly said"). The Commission's inquiry ultimately exonerated Fedders. See *Fedders Cleared by S.E.C. Staff*, N.Y. Times, Nov. 19, 1984, at D7, col. 1. Significantly, this episode did not generate media reports of strained relations within the agency similar to those described as having prevailed at the Bank Board.

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Chairman, Charles Keating.⁴² While the existence of such questions is not unusual, even at an aggressive agency such as the SEC,⁴³ the two year hiatus during which these questions were pursued and resolved by Bank Board officials is atypical for an enforcement-minded agency like the SEC.⁴⁴

Equally atypical at the SEC is the degree to which other agencies permit political pressures to affect their enforcement and regulatory judgments. While the issues are still in the process of being sorted out in connection with the Lincoln Savings Bank case, early press and Congressional reports suggest that political influence may have played a role. That type of influence is exceedingly rare at the SEC.⁴⁵

In order to chart the likely course of securities law enforcement in the 1990s, it is essential to understand how the SEC's enforcement program functions (and, perhaps more importantly, how such a program *should* function), and what directions the SEC's

42. See *S&L's Phone Bugged, Gonzales Says*, Wash. Post, Oct. 27, 1989, at G1, col. 2 (former Regional Bank Board official "said the \$2 billion debacle 'need not have happened and would not have happened if the bank board had showed any backbone' "); *Savings Executive Won't Testify and Blames Regulators For Woes*, *supra* note 40, at A1 (Senior Bank Board officials "cited fear within the bank board's office that Mr. Keating could succeed in a legal challenge to any action taken against Lincoln"); *High Noon at S&L Hearings*, Wash. Post, Nov. 21, 1989, at C1, col. 2 ("[Regional Bank Board officials] have portrayed bank board officials in Washington as intimidated by Keating and unwilling to back up regional officials in taking action against Lincoln").

43. Questions of this sort arose during the 1970s, particularly with respect to the agency's vigorous pursuit of foreign and domestic questionable payments. See *Involuntary Disclosure*, Chemical Wk., June 2, 1976, at 16 (reporting on two companies' disclosure of questionable payments, publicized "over the objection of the [SEC], which claimed the information was not material . . ."). Those questions did not interrupt a steady flow of enforcement actions, however. Congress ultimately ratified much of the SEC's efforts by enacting the Foreign Corrupt Practices Act. See *infra* notes 189-192 and accompanying text.

44. Again, the SEC is not immune from similar scrutiny. In connection with a recommendation by the Enforcement Division staff to commence proceedings against Citicorp for its alleged failure to disclose currency violations, the Commission itself rejected the recommendation (with the support of Mr. Fedders who, in an unusual move, opposed his own Division's recommendation). See *S.E.C. Vote on Citicorp Questioned*, N.Y. Times, Mar. 1, 1982, at D1, col. 3 ("[v]arious S.E.C. officials, including John M. Fedders . . . had argued against the recommendation of the enforcement division staff"); see also *S.E.C. Overruled Staff on Finding that Citicorp Had Foreign Profits*, N.Y. Times, Feb. 18, 1982, at A1, col. 5.

45. An exception was the effort by Martin Sweig, Chief Administrative Aide to then House of Representatives Speaker John McCormack, to assist Nathan Voloshen in intervening on behalf of the Parvin/Dohrmann Corporation at the SEC. The end result was that Mr. Voloshen and a host of others were promptly sued by the SEC and federal criminal prosecutors when the facts were uncovered. See *United States v. Sweig and Voloshen*, 316 F. Supp. 1148 (S.D.N.Y. 1970) (Sweig and Voloshen indicted on 15 counts of defrauding United States government by exerting undue pressure and influence); *SEC v. Parvin/Dohrmann, Co.*, [1969-1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,500 (S.D.N.Y. Oct. 30, 1969).

enforcement program has pursued over the past years. In Part I, we outline some of the critical attributes a successful SEC enforcement program should exhibit; thereafter, we assess the SEC's adherence to this model.

A. Enforcement as Part of the Regulatory Process

The combination of regulatory and enforcement powers in a single agency, such as the SEC, is no longer novel;⁴⁶ preoccupation with that combination, however, is of somewhat more recent vintage.⁴⁷ Administrative agencies were established largely to develop and consolidate expertise in technical areas of societal interest.⁴⁸

46. The first regulatory agency, the Interstate Commerce Commission, was created in 1887. *See generally* J. LANDIS, *THE ADMINISTRATIVE PROCESS* (1938). Thereafter, a host of independent agencies was created during the New Deal. In the immediate aftermath of the agencies' creation, an assessment of their performance, undertaken at President Roosevelt's behest, asserted that these agencies properly and necessarily "act through exercise of a number of interrelated powers. These powers must be exercised consistently and, therefore, by the same body, . . . to realize the public purposes which the statutes are designed to further. . . ." *REGULATION BY PROSECUTION*, *supra* note 38, at 93 (quoting ATTORNEY GENERAL'S COMMITTEE ON ADMINISTRATIVE PROCEDURE, S. DOC. 8, 77th Cong., 1st Sess. 208 (Final Report 1941)).

47. The difficulties inherent in the combination of multiple functions led one court to observe that "[a]t the very least, quasi-judicial proceedings entail a fair trial. As the Supreme Court observed in [an]other context: . . . 'Fair trials are too important a part of our free society to let prosecuting judges be trial judges of the charges they prefer.'" *Amos Treat & Co. v. SEC*, 306 F.2d 260, 263 (D.C. Cir. 1962) (quoting *In re Murchison*, 349 U.S. 133, 136-137 (1955)).

One commentator has assessed at great length the combination of multiple functions within the SEC, observing that:

[a]fter several years of activity on the part of the New Deal regulatory agencies, there was considerable controversy about the problems inherent in the combination of [prosecutorial, rulemaking and adjudicative] functions . . . American law has long been opposed to letting anyone be a judge of his own cause, because this makes him 'incapacitated to appraise fairly and objectively the arguments advanced against the view espoused.'

See REGULATION BY PROSECUTION, *supra* note 38, at 92 (quoting W. GELLHORN, *THE ADMINISTRATIVE AGENCY—A THREAT TO DEMOCRACY?* (1941)).

48. To some extent, the textual description misstates the implicit assumption underlying the creation of regulatory agencies; administrative agencies, at least in theory, are not created to *develop* expertise, they are created to *exercise* it. Thus, by statute, if not by reality, administrative agencies are imbued with "instant expertise" from Congress. This can be seen through the development of administrative law concepts of deference to administrative expertise. *See, e.g.,* *Udall v. Tallman*, 380 U.S. 1, 16 (1965) ("When faced with a problem of statutory construction, this Court shows great deference to the interpretation given the statute by the officers or agency charged with its administration"); *see also* *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944). Similar presumptions of regularity apply to judicial review of challenged agency actions. *See, e.g.,* *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402, 420 (1971); *Hercules Inc. v. EPA*, 598 F.2d 91, 123

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Because Congress acts slowly at best, and lacks the necessary expertise to craft *narrow* specifications of normative conduct,⁴⁹ administrative agencies were intended to fill a legislative gap. Operating pursuant to broad, but reasonable, delegations of Congressional authority,⁵⁰ administrative agencies fill the interstices of Congressional pronouncements, at a level far beyond that which Congress is willing or able to provide.⁵¹

As part of this rubric, it is well-established that the adoption of a rule by an agency, acting in accordance with established legal standards,⁵² within its jurisdiction⁵³ and authority,⁵⁴ will be given virtually the same force and effect of law,⁵⁵ as if Congress had

(D.C. Cir. 1978).

49. In passing the Maloney Over-the-Counter Market Act, Pub. L. No. 75-719, 52 Stat. 1070 (1938) (codified as amended at 15 U.S.C. §§ 78o, 78o-3, 78cc, 78ff, 78q (1982)), the accompanying Senate Report observed that:

The brevity and generality of this treatment [of regulation of over-the-counter securities in the Exchange Act] arose from a realistic recognition of the *great difficulties of working out in any detail a suitable plan of regulation*. . . . But, though the Congress did not at that time have before it a sufficient record of data or experience to enable it to determine upon a detailed plan of regulation, it clearly set forth the objectives of and the standards for such regulation.

REGULATION OF OVER-THE-COUNTER MARKETS, S. REP. NO. 1455, 75th Cong., 3d Sess. 4 (1938).

50. *Id.* The lack of proper Congressional standards to guide administrative agencies in the performance of their assigned, quasi-legislative, tasks is unconstitutional. *See* A.L.A. Schechter Poultry Corp. v. United States, 295 U.S. 495 (1935).

51. *See, e.g.,* SEC v. Chenery Corp., 332 U.S. 194, 202 (1947).

52. The Administrative Procedure Act, 5 U.S.C. §§ 551-703, was adopted in 1946, Pub. L. No. 79-404, 60 Stat. 237 (1946), twelve years after the establishment of the SEC, to provide a uniform set of procedures for all agencies to follow in exercising their regulatory powers, and for the courts to consider in effecting meaningful judicial review of formal agency action. *See generally* Wong Yang Sung v. McGrath, 339 U.S. 33, *modified on other grounds*, 339 U.S. 908 (1950).

53. *See, e.g.,* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 213-214 (1976) (SEC can only enact a rule that complies with its statutory grant of authority and statutory mandate).

54. The determination whether an agency acted pursuant to an express or implied delegation of rulemaking authority dictates the degree of deference courts will accord to the resulting regulation. Thus,

[i]f Congress has [granted] . . . an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation[, s]uch legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute. . . . [Where] the legislative delegation . . . is implicit rather than explicit . . . a court may not substitute its own construction of a statutory provision for a reasonable interpretation . . . of an agency.

Chevron, U.S.A., Inc. v. Natural Resources Defense Council, 467 U.S. 837, 843-44 (1984).

55. *See, e.g.,* *Chrysler Corp. v. Brown*, 441 U.S. 281 (1979), in which the Court admonished:

enacted the provision itself.⁵⁶ In this vein, administrative agencies were perceived as stepchildren of the Congress, exercising quasi-legislative powers. But the New Deal's administrative agencies did not stop with quasi-legislative powers; most also were granted significant enforcement powers to complement their regulatory function.⁵⁷ Although this meant that the new alphabet agencies were vested with both quasi-legislative and quasi-executive authority,⁵⁸ the significance of the combination was apparently not readily manifest when the SEC came into being.⁵⁹

Since that time, however, a great deal of attention has been focused on the proper role of regulation and enforcement.⁶⁰ Put

It has been established in a variety of contexts that properly promulgated, substantive agency regulations have the 'force and effect of law.' This doctrine is so well established that agency regulations implementing federal statutes have been held to pre-empt state law under the Supremacy Clause.

Id. at 295-96 (citing *Batterton v. Francis*, 432 U.S. 416, 425 n.9 (1977)); *Paul v. United States*, 371 U.S. 245 (1963); *Free v. Bland*, 369 U.S. 663 (1962); *United States v. Mersky*, 361 U.S. 431, 437-38 (1960).

56. *Chrysler Corp. v. Brown*, 441 U.S. at 295-96. Regulatory provisions promulgated by the SEC are not quite on an absolute par with the statutory enactments pursuant to which those rules are established. It is a hornbook principle of criminal law that ignorance of the law is not a defense to a criminal charge. *See generally* J. HALL, GENERAL PRINCIPLES OF CRIMINAL LAW, ch. 11 (2d ed. 1960). Thus, an individual who is unaware of a legal requirement can still be convicted of a crime if he or she violates that requirement, provided that the acts that constitute the violation were committed knowingly. *See, e.g., United States v. Currier*, 621 F.2d 7 (1st Cir. 1980); *Morgan v. Dist. of Columbia*, 476 A.2d 1128 (D.C. 1984).

Congress chose to treat SEC rules somewhat differently; pursuant to Section 32 of the Exchange Act, 15 U.S.C. § 78ff (1982), any violation of any provision of the Exchange Act, or the rules thereunder, is a felony subjecting the actor to incarceration. If a defendant can show that he or she was unaware of the particular rule, however, a violation of that rule may be punishable only by fine. *See* Exchange Act § 32(a), 15 U.S.C. § 78ff(a) (1982) ("no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation"); *see also United States v. Dixon*, 536 F.2d 1388, 1395 (2d Cir. 1976) (although a person may be convicted of a violation of a Commission rule of which he was unaware, he may not be imprisoned).

57. The Supreme Court offered an extensive analysis of various government instrumentalities, including the SEC, empowered to conduct investigations in combination with legislative or quasi-legislative functions. *See Hannah v. Larche*, 363 U.S. 420, 444-52, 454-85 (1960).

58. In our tri-partite system of government, it is the duty of the executive to make certain that the laws are faithfully executed. *See* U.S. Const. art. II, § 3, cl. 3; L. TRIBE, AMERICAN CONSTITUTIONAL LAW § 4-2 (1978).

59. *See, e.g., R.A. Holman & Co. v. SEC*, 366 F.2d 446, 451-54 (2d Cir. 1966) (questioning participation of Commissioner in deciding petition concerning denial of broker-dealer registration, based upon Commissioner's earlier participation in matter at staff level), *cert. denied*, 389 U.S. 991 (1967).

60. *See supra* note 47 and accompanying text.

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succinctly, regulations prescribe, in advance of their application, normative standards of conduct to which persons subject to agency jurisdiction must adhere in the future.⁶¹ Enforcement powers apply existing rules to past facts, to assure compliance with regulatory standards, both by the entity subject to the standard (but accused of noncompliance) and by other entities similarly situated.⁶² In a proper context, an administrative agency should define normative standards first, offer interpretive guidance second (to the extent feasible), and compel obedience to those standards as a last resort, when it is clear that those standards have been well publicized and comprehended, but disregarded.⁶³

Not every rule of law, of course, is susceptible of embodiment in a formal regulation.⁶⁴ It is a tenet of our common law system that broad rules are laid down by legislatures and the courts may reasonably interpret the standards embodied in those laws. Nonetheless, it is equally a part of our legal system that notions of due process require ample, *advance* notification of precisely what types of conduct will be prohibited, before any person may be civilly or criminally prosecuted for a violation of those standards.⁶⁵

Drawing the proper balance between regulation and enforcement can be difficult for an administrative agency.⁶⁶ It is often easier for an agency to attack a practice after the fact, in the context of a concrete factual setting, the implications of which are relatively clearly perceived, than to engage in the often burdensome endeavor of quasi-legislative rulemaking (or standard setting).⁶⁷ And, it is simply human nature that a wrong once perceived should be redressed, if at all possible, rather than simply being utilized to define the scope of future regulations.⁶⁸

61. See generally *United States v. Darby*, 312 U.S. 100, 113-14 (1941).

62. See generally *SEC v. Chenery Corp.*, 332 U.S. 194 (1947).

63. See SEC MAJOR ISSUES CONFERENCE, *supra* note 36.

64. See *supra* note 37. Fraud is a good example of this phenomenon; the courts have long recognized that attempts to define fraud with too much specificity would encourage sharp characters with a venal bent to twist the law's specificity to their own advantage. See, e.g., *Weiss v. United States*, 122 F.2d at 681.

65. See *Chiarella*, 445 U.S. at 235 n.20.

66. See SEC MAJOR ISSUES CONFERENCE, *supra* note 36.

67. See generally Pitt, "The SEC and Corporate Governance," *Commentaries on Corporate Structure and Governance*, 1977-78 ALI-ABA SYMPOSIUMS (Schwartz, ed.) 185 (1979) ("The difficulties raised by *ad hoc* enforcement decrees, however, are that they obviate the need for thinking problems through to their logical conclusion").

68. Agencies are often afraid that, by adopting a specific regulation, they may allow certain misconduct, not presently perceived, to escape liability. The fact that regulations can be amended to include new examples of improper behavior is not always a comforting thought to government officials who take their mandate seriously.

Moreover, procedurally, the commencement of an enforcement action requires no delays, and imposes no obligations on an agency to consider carefully the views of various commentators.⁶⁹ Nor does the enforcement process permit political interference.⁷⁰ Those with alternative points of view have had very little difficulty finding the means to express them in the context of a quasi-legislative proceeding; history has taught the same individuals to refrain from such involvement in the context of a discrete adversarial enforcement proceeding involving other parties.⁷¹

Consequently, one of the dangers inherent in the administrative process is that agencies will eschew formal rulemaking for *ad hoc* enforcement actions, using discrete enforcement proceedings as a vehicle for developing new legal standards as the need arises.⁷² Particularly during the 1980s, when it became clear that government had, in a number of instances, been guilty of overregulating certain industries,⁷³ the balance between regulation and enforcement shifted markedly.⁷⁴ This shift occurred because deregulation inevitably brings with it a concomitant increase in governmental⁷⁵ and private⁷⁶ enforcement efforts.

69. Indeed, to the contrary, an agency is justified in shunning such input. *See, e.g., Pillsbury Co. v. FTC*, 354 F.2d 952, 963-65 (5th Cir. 1966).

70. *See, e.g., SEC v. Wheeling-Pittsburgh Steel Corp.*, 648 F.2d 118, (3d Cir. 1981) (quoting Parnell, *Congressional Interference in Agency Enforcement: The IRS Experience*, 89 Yale L.J. 1360, 1368 (1980)).

71. *See, e.g., Wheeling-Pittsburgh*, 648 F.2d 118 (3d Cir. 1981).

72. *See, e.g., NLRB v. Wyman-Gordan Co.*, 394 U.S. 759 (1974); *see also Remarks of Harvey L. Pitt Before the Learned Hand Award Dinner* (Mar. 31, 1988) [hereinafter *Remarks of Harvey L. Pitt*] (on file with authors).

73. *See Kahn, The Theory and Application of Regulation*, 55 ANTITRUST L.J. 177, 178 (1986).

74. *See infra* notes 201-14 and accompanying text.

75. Two reasons may explain this inverse relationship between regulation and enforcement. First, regulation often involves the setting of normative standards. *See generally United States v. Darby*, 312 U.S. 100, 113-14 (1941). Since most businessmen attempt to comply with the law, the establishment of normative standards puts those individuals on notice of the conduct to be followed, or avoided. Given normal success ratios, the greater the number of normative standards that exist, the less likely it is that enforcement will be required to produce adherence to those standards (unless the standards themselves are not reasonable or are not clearly articulated). Second, excessive regulation usually requires businesses to obtain advance governmental approvals or sanctions. If conduct cannot even be undertaken without advance governmental approvals, the requirement of such approvals will undoubtedly serve as a substitute for subsequent (or *post hoc*) government enforcement to require adherence to those standards.

76. *Cf. TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 444 (1976) (private actions vindicate the remedial purposes of the federal securities laws and are an important adjunct to the Commission's enforcement efforts); *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 381-83 (1970); *J. I. Case Co. v. Borak*, 377 U.S. 426, 430-33 (1964).

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In sum, an effective enforcement program is predicated upon a proper balance between *ex ante* rulemaking and regulation, on the one hand, and *ad hoc* enforcement actions, on the other. To the extent that an agency's program is unduly weighted in one direction or the other, it is apt to deviate from other standards of effectiveness discussed below, most notably the standards of perceived fairness⁷⁷ and ultimate success.⁷⁸

B. *The Influence of Politics on the Enforcement Process*

One of the difficulties confronted by an independent regulatory agency, such as the SEC, is that it is something of a political orphan.⁷⁹ Because it is a collegial agency, with members serving terms that exceed the four-year tenure of the Presidency,⁸⁰ it has been difficult, since the agency's initial creation and the years immediately thereafter⁸¹ for the Commission to be treated as anything but a mere nuisance by past administrations.⁸² Moreover, with a majority of its membership potentially reflecting the political party of the President,⁸³ possibly a party different from that in

77. See *infra* note 168 and accompanying text.

78. See *infra* notes 162-67 and accompanying text.

79. See *Ash Report*, *supra* note 27, at 103 (attributing the failure of the executive branch to assure adequate SEC manpower and funding to fact that "a President is not inclined to support an agency vigorously when he has little or no responsibility for its direction. For the same reason, Congress has not consistently allocated enough time and resources to help the SEC solve its complex problems").

80. See Exchange Act § 4, 15 U.S.C. § 78d(a) (1982) (specifying five-year term for Commissioners).

81. In its infancy, the SEC's appointees were close to President Roosevelt, during whose administration the agency initially was created. See TRANSFORMATION OF WALL STREET, *supra* note 28, at 103-23. Thereafter, the agency drifted into its status as a friend of no one and a part of no branch of government. See *Ash Report*, *supra* note 27, at 102-03. The appointment of Richard C. Breeden as Chairman of the SEC, with acknowledged close ties to President Bush and the current White House administration could change this situation. See *Nominee for SEC Has Made Career as GOP Loyalist*, *Newsday*, Aug. 16, 1989, at 54, col. 4; *President Bush Names Key Aide SEC Chairman: Richard C. Breeden Helped Formulate White House's Plan to Bail Out S&P's*, *L.A. Times*, Aug. 15, 1989, § 4, at 1, col. 5; *Bush Picks Savings Crisis Adviser to Succeed Ruder as S.E.C. Chief*, *N.Y. Times*, Aug. 15, 1989, at A1, col. 1.

82. See, e.g., *Ash Report*, *supra* note 27, at 14 ("[the independent commissions] constitute a headless 'fourth branch' of the [g]overnment, a haphazard deposit of irresponsible agencies and uncoordinated powers") (citations omitted). See also Letter from Elliot L. Richardson to Senator William Proxmire (June 11, 1976), *reprinted in* PLI, EIGHTH ANNUAL INSTITUTE ON SECURITIES REGULATION 343, 358 (1976) (questioning propriety of SEC enforcement actions involving improper corporate payments).

83. Pursuant to Section 4 of the Exchange Act of 1934, 15 U.S.C. § 78d(a) (1982), no more than three members of the Commission may be from the same political party. Each commissioner serves for a five year term, or until his or her successor is appointed

control of either the House of Representatives or the Senate, or both, and particularly because its Chairman is perceived as an agent of the President,⁸⁴ the SEC also has often found itself without much support from Congress. On other occasions, the Commission has found itself with unsolicited congressional support for programs of great interest to Capitol Hill.⁸⁵

In these circumstances, it is not surprising that, from time to time, members of various administrations, or members of Congress (or their staffs), have sought to influence the results of administrative agency deliberations.⁸⁶ As a general proposition, an enforcement program must be seen as free from political influence.⁸⁷ To the extent the courts have been confronted with the issue, they generally have reacted negatively to administrative agency enforcement efforts that have been, or even appear to have been, tainted by political influence.⁸⁸ The SEC has been remarkably free from such controversy, and is widely respected for an enforcement program that will not yield to political pressures and, indeed, may react to the detriment of those seeking to apply such pressure.⁸⁹

and confirmed by Congress. *Id.*

84. This perception probably arises, at least in part, from the power of the President to designate the agency's chairman. See Reorganization Plan No. 10 of 1950, 5 U.S.C. §§ 901-913 (1982). See also articles cited *supra* note 81. Cf. Statement of Senator William Proxmire, Nomination of William J. Casey, S. REP. NO. 4, 92d Cong., 1st Sess. 5 (Mar. 19, 1971) ("The President does not have the right to have 'his man' at the SEC any more than does the Congress").

85. Compare *Ash Report*, *supra* note 27, at 102-03 ("Various studies have recommended increasing the funding and manpower of the SEC, but neither the President nor Congress has given full support to these proposals") with INSIDER TRADING AND SECURITIES FRAUD ENFORCEMENT ACT OF 1988, H.R. REP. NO. 910, 100th Cong., 1st Sess. 14 (1988) ("The [House] Committee strongly believes that the agencies with responsibility for enforcing the laws against insider trading should be provided all the necessary resources to do their jobs") (emphasis supplied).

86. See, e.g., SEC v. Wheeling-Pittsburgh Steel Corp., 648 F.2d 118 (3d Cir. 1981).

87. See, e.g., *Breeden Responses*, *supra* note 26, at 1.

88. See, e.g., SEC v. Wheeling-Pittsburgh Steel Corp., 648 F.2d 118 (3d Cir. 1981).

89. See *supra* note 45.

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C. The Need for Efficiency, Visibility, and Success in an Enforcement Program

Since the government's enforcement resources are limited,⁹⁰ it cannot hope to ferret out every instance of wrongdoing.⁹¹ Moreover, even if it could, the government lacks the necessary resources to prosecute every such case. As a result, an effective governmental enforcement program is, and must be, predicated upon a significant deterrent effect. To that end, an effective enforcement program must be efficient, visible, and successful.

1. Efficiency

One of the most important concepts in administrative law enforcement is the notion of efficiency. Since, as noted, the SEC cannot investigate every case of which it becomes aware, and since it cannot litigate every case as to which it conducts an investigation, the agency must pick its cases carefully. The SEC has employed several devices quite successfully to promote its enforcement efficiency.

a. Selection of Targets

An important way in which an agency can achieve enforcement efficiency is through the careful selection of targets. The Commission has always attempted to select its targets carefully, with a view toward discouraging violations by others similarly situated.

For example, in the 1970s, the Commission's staff embarked upon what it referred to as the "access" theory of securities law enforcement.⁹² Cognizant of the agency's limited resources, and desirous of achieving the maximum (or most efficient) enforcement impact from its available resources, the Commission's staff served notice on the public that the "keys" to the securities marketplace are often controlled by a limited number of well-positioned

90. See generally *Drexel Will be Fined \$650 Million, But SEC Won't Get a Cent*, Assoc. Press, Feb. 2, 1989 (PM Cycle) (LEXIS, NEXIS library, Wires file) ("the Securities and Exchange Commission—considered chronically understaffed and underfunded—isn't even allowed to spend the money it raises through routine stock licensing fees, which amounted to twice its budget last year").

91. See, e.g., *Heckler v. Chaney*, 470 U.S. 821, 831 (1985) ("An agency generally cannot act against each technical violation of the statute it is charged with enforcing").

92. See Burton, *SEC Enforcement and Professional Accountants: Philosophy, Objectives and Approach*, 28 VAND. L. REV. 19 (1975).

individuals—securities professionals, accountants, and lawyers.⁹³ By vigorously enforcing the federal securities laws against such individuals, the Commission felt that it could prevent many more violations of law than simply by proceeding against wrongdoing principals.⁹⁴

Relying on concepts of secondary and vicarious liability,⁹⁵ the SEC commenced a series of proceedings against securities professionals,⁹⁶

93. *Id.*

94. *Id.* at 19-20.

95. Vicarious, or secondary, liability has been described as the burden imposed by law upon those persons who have not committed the principal wrongful act but who bear responsibility for the act by virtue of either assistance to, or a relationship with, the primary violator. See Kuehnle, *Secondary Liability Under the Federal Securities Laws—Aiding and Abetting, Conspiracy, Controlling Person, and Agency: Common-Law Principles and the Statutory Scheme*, J. CORP. L. 313, 318-320 (1988). See also Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, in Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597 (1972).

A noted commentator has suggested that the principle of vicarious liability first emerged in medieval times, when strict liability was imposed upon masters for the misdeeds of their servants:

The modern notion started to develop at the end of the seventeenth century because of the 'growth of England's industry and commerce' The streams of doctrine that fed the new development [of vicarious liability] were 'firstly a Roman influence which filtered through the court of Admiralty and mercantile custom, and secondly an English influence derived from the medieval modifications of the common law principle governing the master's liability.'

2 W. HOLDSWORTH, HISTORY OF ENGLISH LAW 46-47 (4th ed. 1936). Compare Wigmore, *Responsibility for Tortious Acts*, 7 HARV. L. REV. 315 (1894) (pointing to ancient German origin of principle of vicarious liability).

96. See, e.g., *In re* Edward J. Blumenfeld, Exchange Act Release No. 16,437, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,396 (Dec. 19, 1979); *In re* Richard O. Bertoli, Exchange Act Release No. 16,220, 18 SEC Docket 486 (Sept. 25, 1979); *In re* Robert A. Podesta, Exchange Act Release No. 16,209, 18 SEC Docket 404 (Sept. 18, 1979); *In re* Robert T. O'Donnell, Exchange Act Release No. 15,869, 17 SEC Docket 743 (May 24, 1979); *In re* Thomson McKinnon Sec., Inc., Exchange Act Release No. 15,768, 17 SEC Docket 419 (May 3, 1979); *In re* E.F. Hutton & Co., Exchange Act Release No. 15,538, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,938 (Jan. 30, 1979); *In re* G.H. Sheppard & Co., Exchange Act Release No. 15,179, 15 SEC Docket 1123 (Sept. 21, 1978); *In re* Shearson Hayden Stone, Inc., Exchange Act Release No. 14,918, 15 SEC Docket 191 (July 3, 1978); *In re* FDI Securities, Inc., Exchange Act Release No. 14,875, 15 SEC Docket 96 (June 22, 1978); *In re* First Georgetown Sec., Inc., Exchange Act Release No. 14,790, 14 SEC Docket 1165 (May 22, 1978); *In re* Powell Sec., Inc., Exchange Act Release No. 14,668, 13 SEC Docket 814 (Apr. 17, 1978); *In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., Exchange Act Release No. 14,149, 14 SEC Docket 646 (Nov. 9, 1977); *In re* R.L. Whitney Sec., Inc., Exchange Act Release No. 13,813, 12 SEC Docket 1419 (Aug. 1, 1977); *In re* Investors Diversified Serv., Inc., Exchange Act Release No. 13,768, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,241 (July 19, 1977); *In re* Stifel, Nicolaus & Co., Exchange Act Release No. 13,307, 11 SEC Docket 1877 (Feb. 28, 1977); *In re* AmSwiss International Corp., Exchange Act Release No. 13,011, 11 SEC Docket 1054 (Nov. 26, 1976); *In re* Brooks - Hamburger Sec. Co., Exchange Act Release No. 12,695, 10 SEC

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auditors,⁹⁷ and attorneys,⁹⁸ with a predictable outcry from

Docket 214 (Aug. 6, 1976); *In re Stearns & Co.*, Exchange Act Release No. 12,405, 9 SEC Docket 550 (May 3, 1976); *In re Bache & Co.*, Exchange Act Release No. 11,957, 8 SEC Docket 898 (Dec. 29, 1975); *In re Pilgrim Sec. Corp.*, Exchange Act Release No. 11,730, 8 SEC Docket 71 (Oct. 14, 1975); *In re Barrett & Co.*, Exchange Act Release No. 11,457, 7 SEC Docket 101 (June 4, 1975); *In re Gilliam & Co.*, Exchange Act Release No. 11,171, 6 SEC Docket 53 (Jan. 9, 1975); *In re Western Funding, Inc.*, Exchange Act Release No. 11,126, 5 SEC Docket 669 (Dec. 9, 1974); *In re Alessandrini & Co.*, Exchange Act Release No. 11,041, 5 SEC Docket 246 (Oct. 10, 1974); *In re Midwestern Sec. Corp.*, Exchange Act Release No. 10,992, 5 SEC Docket 67 (Aug. 29, 1974); *In re Edward F. Henderson & Co.*, Exchange Act Release No. 10,727, 4 SEC Docket 80 (Apr. 10, 1974); *In re First Hudson Sec. Corp.*, Exchange Act Release No. 10,652, 3 SEC Docket 571 (Feb. 22, 1974); *In re Blyth, Eastman, Dillon & Co.*, Exchange Act Release No. 10,565, 3 SEC Docket 255 (Dec. 19, 1973); *In re Saunders, Stiver & Co.*, Exchange Act Release No. 10,341, 2 SEC Docket 290 (Aug. 14, 1973); *In re Sanford Sec., Inc.*, Exchange Act Release No. 10,225, 2 SEC Docket 6 (June 19, 1973).

97. See, e.g., *In re Martin E. Davis*, Acctg. Series Release No. 267, [1937-1982 Accounting Series Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,289 (July 2, 1979); *In re Gerald J. Flannely*, Exchange Act Release No. 15,181, [1937-1982 Accounting Series Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,277 (Sept. 22, 1978); *In re Ernst & Ernst*, Acctg. Series Release No. 248, [1937-1982 Accounting Series Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,720 (May 31, 1978); *In re Haskins & Sells*, Exchange Act Release No. 14,450, [1937-1982 Accounting Series Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,263 (Feb. 10, 1978); *In re Paul N. Conner*, Exchange Act Release No. 14,382, 13 SEC Docket 1397 (Jan. 16, 1978); *Litigation Involving Price Waterhouse & Co.*, Acctg. Series Release No. 238, [1937-1982 Accounting Series Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,260 (Jan. 16, 1978); *In re Norman A. Weiner, C.P.A.*, Exchange Act Release No. 14,249, [1937-1982 Accounting Series Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,255 (Dec. 12, 1977); *In re Phillip J. Wolfson*, Exchange Act Release No. 13,521, [1937-1982 Accounting Series Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,237 (May 9, 1977); *In re S.D. Leidesdorf & Co.*, Exchange Act Release No. 13,268, [1937-1982 Accounting Series Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,231 (Feb. 16, 1977); *In re Touche Ross & Co.*, Exchange Act Release No. 12,851, 10 SEC Docket 655 (Oct. 1, 1976); *In re Seidman & Seidman*, Exchange Act Release No. 12,572, 10 SEC Docket 327 (Sept. 1, 1976, amended Dec. 3, 1976); *In re Peat, Marwick, Mitchell & Co.*, Exchange Act Release No. 11,517, [1937-1982 Accounting Series Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,195 (July 2, 1975); *In re Touche Ross & Co.*, Exchange Act Release No. 10,654, 3 SEC Docket 594 (Feb. 25, 1974); *In re Benjamin Botwinick & Co.*, Exchange Act Release No. 11,176, [1937-1982 Accounting Series Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,190 (Jan. 13, 1975); *In re Westheimer, Fine, Berger & Co.*, Exchange Act Release No. 11,153, [1937-1982 Accounting Series Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,190 (Dec. 24, 1974).

98. See, e.g., *In re Paul H. Brumley, Esq.*, Exchange Act Release No. 16,558, 19 SEC Docket 503 (Feb. 6, 1980); *In re Bernard J. Coven*, Exchange Act Release No. 16,448, 19 SEC Docket 12 (Dec. 21, 1979); *In re Richard D. Hodgins*, Exchange Act Release No. 16,225, 18 SEC Docket 458 (Sept. 27, 1979); *In re Stephen R. Gilliland, Esq.*, Exchange Act Release No. 16,046, 17 SEC Docket 1381 (July 26, 1979); *In re Melvan M. Jacobs*, Exchange Act Release No. 15,556, 16 SEC Docket 1029 (Feb. 8, 1979); *In re Robert A. Petralia*, Exchange Act Release No. 15,087, 15 SEC Docket 722 (Aug. 25, 1978); *In re Robert D. Nielsen*, Exchange Act Release No. 14,803, 14 SEC Docket 1225 (May 26, 1978); *In re Mary Jane Melrose*, Exchange Act Release No. 14,720, 14 SEC Docket 974 (May 1, 1978); *In re Robert E. Porges*, Exchange Act Release No. 13,975, 13 SEC Docket 118 (Sept. 20, 1977); *In re Plotkin, Yolles, Siegel & Turner*, Securities Act Release No. 5841, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,236 (July 5, 1977); *In re C. Wayne*

commentators and representatives of the affected professional groups.⁹⁹ By the early 1980s, the Commission abandoned this approach, particularly with respect to lawyers, as its General Counsel announced a return to more fundamental, and somewhat less aggressive, secondary liability concepts.¹⁰⁰

Although the attack on securities professionals, accountants, and attorneys may have abated, the underlying premises of the access theory remained intact throughout the 1980s. The Commission and its staff recognized that the agency's enforcement efficiency depends on an expansive approach toward vicarious liability. In the form of actions against corporations and other employing institutions,¹⁰¹ as

Litchfield, Exchange Act Release No. 13,678, 12 SEC Docket 1016 (June 4, 1977, amended Sept. 26, 1977) (permanently barred from practice before SEC as attorney or certified public accountant); *In re* Edward C. Jaegerman, Exchange Act Release No. 13,513, 12 SEC Docket 372 (May 6, 1977); *In re* Donald R. Bernard, Exchange Act Release No. 13,283, 11 SEC Docket 1778 (Feb. 22, 1977); *In re* William N. Levy, Exchange Act Release No. 13,124, 11 SEC Docket 1352 (Dec. 30, 1976); *In re* Alvin Lester Sitomer, Exchange Act Release No. 12,501, 9 SEC Docket 784 (June 1, 1976); *In re* Morton Schimmel, Esq., Exchange Act Release No. 12,254, 9 SEC Docket 262 (Mar. 25, 1976); *In re* Lloyd Feld, Exchange Act Release No. 11,775, 8 SEC Docket 291 (Oct. 30, 1975); *In re* Stanley T. Traska, Exchange Act Release No. 11,662, 7 SEC Docket 864 (Sept. 18, 1975); *In re* McLaughlin & Stern, Ballen and Miller, Exchange Act Release No. 11,553, 7 SEC Docket 465 (July 25, 1975); *In re* Gerald H. Cahill, Exchange Act Release No. 11,304, 6 SEC Docket 474 (Mar. 20, 1975); *In re* Donald R. Hunter, Exchange Act Release No. 11,253, 6 SEC Docket 304 (Feb. 18, 1975); *In re* John A. O'Toole, Exchange Act Release No. 11,169, 6 SEC Docket 50 (Jan. 8, 1975); *In re* Jo M. Ferguson, Securities Act Release No. 5523, 5 SEC Docket 37 (Aug. 21, 1974); *In re* Robert E. Lee, Securities Act Release No. 5462, 3 SEC Docket 600 (Feb. 27, 1974); *In re* George Mariscal, Securities Act Release No. 5442, 3 SEC Docket 101 (Nov. 30, 1973); *In re* Paul Gerstner, Exchange Act Release No. 10,458, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,610 (Oct. 26, 1973); *In re* Emanuel Fields, Securities Act Release No. 5404, [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,407 (June 18, 1973).

99. See, e.g., Note, *SEC Disciplinary Proceedings Against Attorneys Under Rule 2(e)*, 79 MICH. L. REV. 1270, 1286 (1981) (criticizing SEC's use of Rule 2(e) proceedings against attorneys instead of bringing proceedings in federal district court); Marsh, *Rule 2(e) Proceedings*, 35 BUS. LAW. 987, 1010-15 (1980) (raising question whether Rule 2(e) is constitutional, as Commission applies it to attorneys and accountants); Downing & Miller, *The Distortion and Misuse of Rule 2(e)*, 54 NOTRE DAME L. REV. 774, 777-81 (1979) (Commission's application of Rule 2(e) to attorneys and accountants exceeds the agency's statutory authority); *When Accountants Fail to Spot Fraud's Liability*, BUS. WK., Mar. 15, 1976, at 74, col. 1 (criticizing SEC's application of Rule 2(e) to accountants); Daley & Karmel, *Attorneys' Responsibilities: Adversaries at the Bar of the SEC*, 24 EMORY L.J. 747, 780-93 (1975) (criticizing, among other things, the SEC's attempts to obtain *de facto* licensing authority over securities counsel).

100. See Greene, *Lawyer Disciplinary Proceedings Before the Securities and Exchange Commission* (remarks to the New York County Lawyers' Association) (Jan. 13, 1982), reprinted in 14 Sec. Reg. & L. Rep. (BNA) No. 13, at 168 (Jan. 20, 1982).

101. See, e.g., SEC v. Oak Indus., Civ. Action No. 85-1507, 33 SEC Docket 694 (S.D. Cal. June 25, 1985); SEC v. PepsiCo, Inc., Litigation Release No. 10,807, 33 SEC Docket 861 (S.D.N.Y. July 1, 1985); SEC v. E.F. Hutton Group, Litigation Release No. 10,915, 33 SEC Docket 588 (D.D.C. Oct. 29, 1985).

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well as efforts designed to preclude certain violators of the federal securities laws from reassuming high corporate office,¹⁰² the SEC of the 1980s has practiced enforcement efficiency with a more recent variation of the access theory.

b. The Heightened Possibility of Criminal Prosecution

The SEC also has been the beneficiary of criminal law enforcement authorities' renewed interest in securities law violations. Prior to the 1970s, the SEC enjoyed a relatively arms-length relationship with most criminal law authorities. The Commission would prepare cases for formal submission to the Department of Justice, as originally contemplated by statute.¹⁰³ This would entail the preparation of a detailed Criminal Reference Report, including an analysis of the evidentiary predicates for the staff's view that criminal prosecution was warranted, as well as a detailed legal analysis of the merits of criminal prosecution and the theories on which the prosecution should rest. Finally, the Commission itself would review the Report. After a formal Commission vote approving the criminal reference, the appropriate referral would occur.¹⁰⁴

102. See, e.g., *In re Michael R. Maury*, Exchange Act Release No. 23,067, [1982-1987 Accounting and Auditing Enforcement Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,493 (Mar. 26, 1986); *In re Thomas C. Runge*, Exchange Act Release No. 23,066, 35 SEC Docket 432 (Mar. 26, 1986).

103. Securities Act Section 20(b) provides that "[t]he Commission may transmit such evidence as may be available concerning such acts or practices to the Attorney General who may, in his discretion, institute the necessary criminal proceedings under this subchapter." 15 U.S.C. § 77t(b) (1982). Exchange Act § 21(d)(1) contains a virtually identical provision. See 15 U.S.C. § 78u(d) (1982); see also 17 C.F.R. § 202.5(b) (1988).

104. The Commission has described its formal criminal reference process as follows:

[A] formal criminal reference . . . involves the preparation of a written report by Commission staff members. Such reports generally set forth a detailed statement of the information developed during the course of the Commission's investigation keyed to the available evidence, an analysis of applicable law, an analysis of strengths and weaknesses of the case, and recommendations as to who should be prosecuted and for what offenses.

Memorandum of the SEC, *Amicus Curiae* at 11-12, *United States v. Fields*, 592 F.2d 638 (2d Cir. 1978) (No. 77-1342), cert. denied, 442 U.S. 917 (1979) [hereinafter *SEC Amicus Brief (Fields)*]. This process comports with a clear Congressional mandate to maintain such channels of communication. See H.R. REP. NO. 640, 95th Cong., 1st Sess. 10 (1977) ("Traditionally, there has been a close working relationship between the Justice Department and the SEC. The Committee [on Interstate and Foreign Commerce] fully expects that this cooperation between the two agencies will continue. . . .") (quoted in *SEC Amicus Brief (Fields)* at 8, n.21).

Although it was not the exclusive method by which cases were brought to the attention of criminal prosecutors,¹⁰⁵ the criminal reference process survived through the early 1970s, but proved far too cumbersome a procedure to warrant its continued longevity. By the early 1970s, the Commission's staff had begun working out informal relationships with various United States Attorneys Offices around the country, particularly those located in the same cities as SEC Regional and Branch offices. As a result, prosecutors' requests for access to Commission files became more frequent, and the preparation of formal criminal reference reports began to dwindle.¹⁰⁶

In 1978, the SEC's criminal reference process changed. Knowledgeable practitioners understood that the SEC staff could not, and would not, bind criminal law enforcement authorities regarding the possibility of criminal prosecutions. Nevertheless, the interest (or lack of interest) of criminal prosecutors was relevant to settlement discussions, and the agency was quite successful in utilizing that interest, or lack of interest, to assist it in the pursuit of negotiated settlements of enforcement proceedings.

In *United States v. Fields*, counsel for a settling defendant asserted that settlement was procured by SEC staff officials only upon the promise that no criminal prosecution would ensue.¹⁰⁷ When criminal prosecution proceeded, the defendant's counsel argued that the "government," a phrase claimed to include the SEC,¹⁰⁸ should be estopped from proceeding with the prosecution, since the defendant's settlement with the government allegedly was conditioned upon an oral promise of non-prosecution.¹⁰⁹ The SEC

105. Throughout the Commission's history, various law enforcement officials have sought to obtain access to information about securities law enforcement initiatives of the Commission and its staff. Thus, it was not unusual during this period for a United States Attorney to learn of an SEC investigation (despite its nonpublic status), and request access to the Commission's files regarding that investigation. Although the Commission itself was required to approve each such request for access to its files, requests of this nature were routinely granted.

106. See, e.g., *United States v. Fields*, 592 F.2d 638, 646 (2d Cir. 1978), *cert. denied*, 442 U.S. 917 (1979).

107. *Id.* at 643.

108. It is useful to note, in this context, that the defendant's argument assumes the existence of a single government. The SEC, of course, has always relied upon its status as an independent regulatory agency to thwart any attempt to lump it with other elements of the government. This has caused the agency to confront other branches of the government with seeming regularity. See generally REGULATION BY PROSECUTION, *supra* note 38, at 86-91.

Indeed, within a year of its creation, the Commission launched an effort to break away from the control of the Department of Justice, seeking approval for its right to try its own cases before the lower federal courts. See *SEC v. Robert Collier & Co.*, 76 F.2d 939, 940-41 (2d Cir. 1935).

109. See *Fields*, 592 F.2d at 643.

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ultimately explained its criminal reference procedures to the United States Court of Appeals for the Second Circuit, advising the Court that its staff had many ways in which to refer information concerning investigations to criminal prosecutors, and that the SEC never apprised settling defendants of the likelihood of criminal prosecution.¹¹⁰

Although the SEC denied that its officials had misled counsel for the defendant in *Fields*, the court found that issue of little relevance. It quite properly suggested that, if counsel were claiming that the Commission lulled his client into settling with a promise of no criminal prosecution, the court would simply reopen the SEC proceeding, and allow the criminal prosecution to proceed.¹¹¹ From that point on, however, the SEC amended its organizational rules, to make explicit that its Director of Enforcement had the authority to make informal references of cases to criminal prosecutors without the involvement of the Commission itself.¹¹² After the adoption of these internal rules, the Commission's involvement in the formal criminal reference process markedly declined.¹¹³

In the 1980s, criminal prosecutors began to recognize the value of securities law indictments. Led by the United States Attorney for the Southern District of New York, the Department of Justice and individual United States Attorneys began paying closer attention to the SEC and its law enforcement activities. As a result, the heightened prospect of criminal prosecution by Justice Department officials has become a more potent weapon in the SEC's enforcement arsenal.

110. See *SEC Amicus Brief (Fields)*, *supra* note 104, at 8-13.

111. See *Fields*, 592 F.2d at 647.

112. Compare 17 C.F.R. § 202.5(b) (1987) (authorizing Commission to refer matters to Department of Justice for criminal prosecution) with 17 C.F.R. § 200.30-4(a)(7) (1987) (expressly delegating to the Director of Enforcement the authority to grant access to Division investigative files to other government agencies).

113. An interview with John M. Fedders, two years into his tenure as SEC Director of Enforcement, demonstrates the degree to which the criminal reference process had become a function of informal contact below the Commission level:

Statistics of how many criminal references there have been, how many prosecutions have come out of those references is [sic] good, but it's not entirely reflective of their attitude of cooperation and support. That's the key . . . Bob Ogren, who's in charge of Justice's fraud section, meets with us here on almost a monthly basis to review our inventory of cases to discuss possible references and to obtain information from us.

SEC Should Consider Revised Policy on Modifying Injunctions, Fedders Says, 15 Sec. Reg. & L. Rep. (BNA) No. 46, at 2143, 2147 (Nov. 25, 1983) (emphasis supplied).

By jointly pursuing a number of investigations,¹¹⁴ the SEC has benefited from the subtle, and not so subtle, pressures brought to bear by criminal prosecutors. For example, in the recent Drexel Burnham Lambert, Inc. (Drexel) case, the United States Attorney was able to effect a settlement with Drexel, a prime condition of which was that the firm resolve its difficulties with the SEC, which had commenced separate proceedings against Drexel and certain of its officials.¹¹⁵ Drexel, which claimed it was unfairly compelled to settle with the United States Attorney,¹¹⁶ was in turn persuaded to settle with the SEC, after lengthy and, apparently, acrimonious negotiations.¹¹⁷ The SEC has thus achieved a certain amount of efficiency in its enforcement program by taking advantage of the current aggressive criminal prosecution environment.¹¹⁸

114. The law places limitations on the extent to which the SEC and criminal prosecutors can collaborate on investigations. By virtue of Rule 6(e) of the Federal Rules of Criminal Procedure, grand jury information cannot be shared with persons outside the grand jury or the United States Attorney's office directing the work of that grand jury. *See* FED. R. CRIM. P. 6(e). Accordingly, information sharing efforts usually involve the furnishing of information by the SEC to various Justice Department officials (Rule 6(e) does not prohibit that type of information sharing), or involves the sharing of non-grand jury materials by the Justice Department with the SEC. To facilitate the work of the Justice Department, the SEC frequently details enforcement personnel to a United States Attorney's office to assist in the development of a criminal case. *See Concern Over Congressional Reactions Affects SEC Decisions, Longstreth Says*, 15 Sec. Reg. & L. Rep. (BNA) No. 11, at 566, 568 (Mar. 18, 1983) (Commissioner Longstreth discusses benefits of detailing SEC staffers to Department of Justice).

115. *See Drexel Reaches S.E.C. Accord in Civil Charges*, N.Y. Times, Apr. 14, 1989, at A1, col. 2; SEC v. Drexel Burnham Lambert, Inc., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,474 (S.D.N.Y. June 20, 1989); *In re Drexel Burnham Lambert, Inc.*, Exchange Act Release No. 27,236, 44 SEC Docket 907 (Sept. 11, 1989).

116. Drexel stated that the threat of the pre-trial forfeiture provisions of the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. §§ 1961-68 (1988) compelled it to settle and abandon its defenses to the United States Attorney's allegations. *Debate Rages Over the Long Arm of RICO*, L.A. Times, Aug. 13, 1989, at 1, col. 4; *see also Justice Restricts*, Reuters, Bus. Rep., Oct. 24, 1989 (LEXIS, NEXIS library, Wires file); *Can Fred Joseph Save Drexel?*, FORTUNE, May 8, 1989, at 18; *Justice Dept. Revises Rules on RICO Cases*, L.A. Times, Oct. 24, 1989, at 1, col. 2; *U.S. Moves to Limit Racketeering Law in Business Cases*, N.Y. Times, Oct. 24, 1989, at A1, col. 3; *Justice Dept. Limits Pretrial Freezes of Assets Under RICO*, Newsday, Oct. 21, 1989, at 13, col. 3.

117. For example, a major point of contention between the Commission and Drexel appears to have been the agency's insistence that Drexel relocate its junk bond operations to New York from Los Angeles, a demand that was apparently abandoned. *See Drexel Settles Charges, Faces Stiff Supervision*, L.A. Times, Apr. 14, 1989, § 1, at 1, col. 2 ("The Drexel lawyer said the SEC had dropped a demand to move the junk bond department back to New York"); *Drexel Junk Bond Unit Reportedly to Stay in Southland*, L.A. Times, Feb. 22, 1989, § 4 at 1, col. 5 ("[T]he [SEC] had demanded that Drexel move the high-yield junk bond operation back to the firm's headquarters in New York . . . But Drexel strongly resisted").

118. Ironically, the increased interest of criminal prosecutors in securities law violations may make it more difficult to settle some cases. In earlier times, a settlement with the SEC might discourage criminal prosecutorial interest in the same case. Today, such

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c. Settlements

Traditionally, the SEC has relied most effectively on a high volume of settlements to keep its enforcement program efficient and vigorous.¹¹⁹ As long as defendants are prepared to settle cases, the SEC's enforcement program should thrive. Conversely, if the SEC were required (or chose) to litigate a substantial number of cases each year, its enforcement program would become less efficient, less successful and ultimately less visible.

The SEC has managed to promote settlements, among other things, by (i) catching defendants in egregious situations for which there is no likely successful defense;¹²⁰ (ii) offering to negotiate the terms of the charges that will be brought against a proposed defendant;¹²¹ (iii) permitting the proposed defendant to negotiate the terms of any relief to be obtained by the SEC's staff;¹²² (iv) saving the proposed defendant the cost and burdens of litigating the action;¹²³ and (v) deploying the threat of exposure to possible

settlements often pique the interest of prosecutors. As a result, counsel must carefully weigh the ramifications of whether, and on what terms, to settle cases with the SEC where criminal prosecution is still a live possibility.

119. See, e.g., *Shore v. Parklane Hosiery Co.*, 565 F.2d 815 (2d Cir. 1977), *aff'd*, 439 U.S. 322 (1979).

120. Since virtually all cases are settled with the defendant(s) neither admitting nor denying the allegations of the Commission's complaint, see 17 C.F.R. § 202.5(e) (1987); see also *SEC v. Drexel Burnham Lambert, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,474 (S.D.N.Y. June 20, 1989); *In re Link-Up [Plus] 1 Securities, Inc.*, Exchange Act Release No. 20,940, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,625 (May 8, 1984); *In re Thomas L. McGhee*, Exchange Act Release No. 20,852, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,605 (Apr. 12, 1984), it is not possible to tell which cases are settled simply because the defendant(s) recognized the futility of their position, and which cases reflect different judgments. See *infra* notes 125-26 and accompanying text.

121. In virtually every case, the SEC is prepared to negotiate some form of both its charges and the relief it will seek. Many of the concessions the SEC is willing to offer a prospective defendant in exchange for settling the proposed action (for example, not alleging fraud in an accounting case, but limiting the charges to a failure to comply with the SEC's filing requirements) are more a matter of perception than reality. Nevertheless, the avoidance of certain charges may benefit a proposed defendant in connection with anticipated (or pending) shareholder litigation. See Rauch, *Practical Perspectives on Advising Clients in Responding to Insider Trading Investigations*, PLI, NINETEENTH ANNUAL INSTITUTE ON SECURITIES REGULATION 351, 375 (1987) [hereinafter *Practical Perspectives*].

122. *Id.*

123. This is the usual rhetoric employed by many settling defendants: A, the President and Chief Executive Officer of XYZ Corporation stated that the Company had decided to settle, rather than contest, the SEC's charges in order to avoid the expense and burden of litigation. See, e.g., *SEC Bars Local Financial Adviser*, *Sacr. Bee*, Aug. 22, 1989 at D1, col. 2 ("The settlement was one of 'economic expediency,' to save Mason the cost of litigation, he said"); *Carl's Jr. Founder Agrees to Settle, Pay Lump Sum in Insider Trading Case*, *L.A. Times*,

criminal sanctions for the same conduct as a friendly persuader of the need to settle the SEC's enforcement action.¹²⁴

In order for the SEC's enforcement program to remain successful, the agency must continue to encourage early settlements by the overwhelming preponderance of those persons against whom the Enforcement Division's staff proposes to commence enforcement actions.¹²⁵ The SEC's capacity to encourage early settlements is a function of the strength of its proposed cases and its flexibility in

L.A. Times, May 3, 1989, at 1, col. 4 ("Karcher's attorney, Wes Howell, said the 72-year old founder and chief executive . . . chose to settle the case to avoid both the emotional and financial costs of trial").

In many cases, this may, in fact, be an accurate portrayal of the circumstances. Congress has recognized some of the difficulties inherent in this situation, and attempted to redress those difficulties by enacting the Equal Access to Justice Act of 1980 (EAJA), Pub. L. No. 96-481, 94 Stat. 2325 (codified as amended in scattered sections of 5, 26, 28, 41 U.S.C. (1982)). The statute provides, in pertinent part, that "a court shall award to a prevailing party other than the United States fees and other expenses, . . . unless the court finds that the position of the United States was substantially justified or that special circumstances make an award unjust." 28 U.S.C. § 2412(d)(1)(A) (1982). The EAJA was designed to "press[] the agency to address the problem of abusive and harassing regulatory practices" and "to caution agencies to carefully evaluate their case and not to pursue those which are weak or tenuous." H.R. REP. NO. 1418, 96th Cong., 2d Sess. 14, *reprinted in* 1980 U.S. CODE CONG. & ADMIN. NEWS 4953, 4993.

Courts have demonstrated no reluctance in enforcing this provision against the Commission. *See, e.g., SEC v. Kluesner*, 834 F.2d 1438, 1440 (8th Cir. 1987) (SEC not substantially justified in pursuing defendant who did not act with *scienter*); *SEC v. Comserv Corp.*, 698 F. Supp. 784, 788-89 (D. Minn. 1988) (SEC action not substantially justified where agency introduced no evidence of recklessness in establishing system of internal controls; defendant's invocation of Fifth Amendment privilege does not constitute a special circumstance rendering unjust an award of fees and costs).

124. As noted above, *see supra* notes 103-04 and accompanying text, in past decades, the SEC made formal criminal references to the Department of Justice, or one or more of the various United States Attorneys, although it moved away from formal criminal references in the late 1970s, particularly after the *Fields* decision, *supra* note 106. Concomitantly, criminal prosecutions for violations of the federal securities laws appear to have risen substantially during the past ten years. *See Criminal Prosecutions, Insider Trading Questions Are Probed by Panelists at ABA*, 18 Sec. Reg. & L. Rep. (BNA) No. 33, at 1202, 1202 (Aug. 15, 1986) ("There have been more criminal prosecutions under the federal securities laws over the past two-to-five years than previously, Securities and Exchange Commission Enforcement Director Gary Lynch acknowledged . . . 'It is a trend,' Lynch said . . . [that] 'has grown out of the realization that civil enforcement alone really isn't effective for some types of violators, chronic violators . . .'").

125. *See generally* Brief of SEC as *Amicus Curiae* at 16, *Parklane Hosiery Co. v. Shore*, 439 U.S. 322 (1979) (No. 77-1305) [hereinafter *SEC Amicus Brief (Parklane)*].

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offering would-be defendants meaningful incentives to enter into a settlement agreement, among other factors.¹²⁶

126. As a general proposition, the SEC advances the law through settlements that build on the various enforcement remedies in the agency's arsenal of weapons. Surprisingly, for a highly effective agency, the SEC has long labored without a broad variety of meaningful enforcement remedies. Under the Exchange Act, for example, the SEC can

- (i) issue a public report of investigation, pursuant to Section 21(a) of the Act, 15 U.S.C. § 78u(a) (1982);
- (ii) commence an administrative proceeding to determine whether any person subject to the requirements of Sections 12, 13, 14 or 15(d) of the Act, 15 U.S.C. §§ 78l, 78m, 78n, or 78o(d) (1982), have committed violations of those provisions, or whether any *other* person *caused* such a violation;
- (iii) commence an administrative proceeding to determine whether any regulated person or entity (specifically, securities market professionals) violated any provision of the federal securities laws and, if such violations occurred, either suspend such person from functioning as a market professional for up to one year, bar such person permanently from serving as a market professional, or impose some other form of limitation on the nature of the activities such market professional can continue to pursue;
- (iv) commence an action in federal court seeking to enjoin any person from violating any provision of the federal securities laws; and
- (v) refer a matter to the Attorney General of the United States for criminal prosecution, pursuant to Section 20(b) of the Securities Act, 15 U.S.C. § 77t(b) (1982); and Section 21(d) of the Exchange Act, 15 U.S.C. § 78u(d) (1982).

In 1984, at the Commission's request, Congress authorized the Commission to seek (but not to impose itself) a monetary civil penalty in insider trading cases, in an amount up to three times the illicit profits obtained (or losses avoided) from insider trading by a defendant found to have violated the law. In addition, at various times during the Commission's history, some courts have confirmed the Commission's *implied* authority to seek ancillary relief in the form of (i) disgorgement of ill-gotten gains, *see, e.g.*, SEC v. Blatt, 583 F.2d 1325 (5th Cir. 1978); (ii) appointment of a receiver for a public enterprise, *see, e.g.*, SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082 (2d Cir. 1972); (iii) requirement of a special investigation, or the appointment of a special committee to perform certain specified tasks, *see, e.g.*, Handler v. SEC, 610 F.2d 656 (9th Cir. 1979); and (iv) an order precluding certain recidivist officers and/or directors from resuming their positions with publicly held companies, *see, e.g.*, SEC v. Coastal States Gas Corp., Litigation Release No. 6054, 2 SEC Docket 451 (S.D. Tex. Sept. 12, 1973).

The SEC is attempting to alleviate this dearth of enforcement remedies by proposing the creation of sweeping new administrative powers. *See infra* note 410 and accompanying text. For the present, when the SEC staff comes upon a novel activity that it believes violates the law, it will often attempt to settle the first several cases of that nature, so that it can establish its own set of precedents. Thus, the first person accused of certain novel violations of the law may be offered the opportunity to settle the matter for a public report (a device utilized less frequently today than prior to the late 1970s) or an order under Section 15(c)(4) of the Securities Exchange Act. The advantage to the Commission of these

d. *Encouragement of Private Rights of Action*

Given the inherent limitations on the government's capacity to mount an effective enforcement program, an agency will often seek to improve its efficiency by encouraging private rights of action. Early in the Commission's history, it supported the creation and use of such implied rights of action¹²⁷ as a necessary supplement to its own enforcement activities.¹²⁸ Such actions have been consistently used ever since.¹²⁹

forms of settlement is that the Commission can issue a lengthy description of the conduct it finds objectionable, and its rationale for finding that conduct violative of the law. See Exchange Act § 15(c)(4), 15 U.S.C. § 78o(c)(4) (1982 & Supp. 1986) ("If the Commission finds . . . that any person . . . has failed to comply with any such provision, rule, or regulation in any material respect, the Commission may publish its findings and issue an order . . .") (emphasis supplied).

After one or two of these relatively lenient settlements, the SEC will then increase the "penalty" for similar violations seeking administrative orders against professionals or injunctive relief against corporations and their officers and directors. Compare *In re Woods Corp.*, Exchange Act Release No. 15,337, 16 SEC Docket 166 (Nov. 16, 1978) (administrative proceedings against issuer for inadequate disclosure in proxy materials; issuer consented to various undertakings), with *In re Spartek, Inc.* and John K. Cable, Exchange Act Release No. 15,567, 16 SEC Docket 1094 (Feb. 14, 1979) (administrative proceeding against issuer and its chairman for inadequate disclosure in proxy materials, citing *Woods*, *supra*, as precedent; issuer and chairman consented to various undertakings). See also *In re Revlon, Inc.*, Exchange Act Release No. 23,320, 35 SEC Docket 1148 (June 16, 1986); *In re George C. Kern, Jr.* (Allied Stores Corporation), [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342 (Nov. 14, 1988), discussed *infra* at notes 496-522 and accompanying text. In the wake of the controversy surrounding the *Kern* case, the Commission has dramatically circumscribed the Staff's ability to craft creative settlements under Section 15(c)(4).

127. Indeed, the legislative history of the Exchange Act demonstrates that the Commission's support of such actions comported with the intentions of the authors of the legislation. Thomas G. Corcoran, in his testimony concerning the inclusion of private remedies in the Exchange Act, pointed out that

The principle of civil liability for the damage . . . is moreover not only a matter of justice to the person injured but is also the surest way of guaranteeing that there will be some compliance. . . . In other words, there is no policeman so effective as the one whose pocketbook is affected by the degree to which he enforces the law.

*Senate Committee on Banking and Currency, Stock Exchange Practices: Hearings on S. Res. 84 (72d Cong.) and S. Res. 56 and S. Res. 97 (73d Cong.), pt. 15, National Securities Exchange Act of 1934, 73d Cong., 1st Sess. 6518 (1934), quoted in Pitt, Standing to Sue Under the Williams Act: A Leaky Ship on Troubled Waters, 34 Bus. Law. 117, 163 (1978) [hereinafter *Standing to Sue*].*

128. See, e.g., *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964).

129. An example of the Commission's ongoing support for private vindication of the remedial purposes of the federal securities laws is embodied in its enthusiasm for the express and implied private remedy provisions of ITSFEA. See *infra* note 131.

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Of course, the establishment of a broad private right to sue for alleged securities law violations can be problematic at times. Private plaintiffs are not as likely as the Commission to be circumspect about the theories they pursue in private litigation, and the law established in such actions can redound to the distinct disadvantage of the Commission.¹³⁰

Nonetheless, properly circumscribed private rights of action serve as a valuable adjunct to an agency's own enforcement program, and the Commission has attempted to foster such rights at every available opportunity.¹³¹ It is one of the hallmarks of the Commission's enforcement program that, through the years, it has adopted a decidedly hospitable approach to private litigation, in contrast to the posture sometimes assumed by other law enforcement agencies.¹³²

130. See, e.g., Pitt, *An SEC Insider's View of the Utility of Private Litigation under the Federal Securities Laws*, 5 SEC. REG. L.J. 3 (1977). There are, to be sure, differences between private causes of action (particularly those implied by the judiciary) and government causes of action. Nevertheless, since the same statutes are usually involved, judicial interpretations of the statute in a private implied action can have a decidedly negative impact on the SEC. *Id.* See also *Sante Fe Indus. v. Green*, 430 U.S. 462 (1977).

131. Thus, the Commission consistently has supported the implication of private rights of action in amicus curiae briefs before the Supreme Court and other federal courts. See *SEC Amicus Brief (Parklane)*, *supra* note 125, at 2; INSIDER TRADING AND SECURITIES FRAUD ENFORCEMENT ACT OF 1988, H.R. REP. NO. 910, 100th Cong., 1st Sess. 26 (1988) [hereinafter HOUSE ITSFEA REPORT] (quoting then-SEC Chairman David Ruder's testimony that "private rights of action have traditionally served as an important supplement to the Commission's enforcement of the federal securities laws"); See generally *Standing to Sue*, *supra* note 127. In addition, upon the passage of new securities legislation, the Commission has, from time to time, issued releases indicating the agency's position that courts should imply a private remedy under the provisions in question; see, e.g., Notification of Enactment of Foreign Corrupt Practices Act of 1977, Exchange Act Release No. 14,478, [1937-1982 Accounting Series Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,264 (Feb. 16, 1978). Finally, in connection with the adoption of recent insider trading enforcement legislation, the Commission strongly supported both the creation of an express private right of action by persons who trade contemporaneously with, but on the opposite side from, insider traders, see Exchange Act § 20A(a), 15 U.S.C.A. § 78t-1(a) (West Supp. 1989); HOUSE ITSFEA REPORT, *supra*, at 26, and the creation of an express implied remedy for anyone else who can demonstrate actual injury resulting from insider trading by another, see Exchange Act § 20A(d), 15 U.S.C.A. § 78t-1(d) (West Supp. 1989); see also *Insider Trading: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 100th Cong., 2d Sess. 3 (July 11, 1988) (statement of David S. Ruder, SEC Chairman).

132. See generally *Commodity Conferees Examine Implied Rights, CFTC Enforcement*, 14 Sec. Reg. & L. Rep. (BNA) No. 38, at 1696, 1696 (Oct. 1, 1982) (discussing status of private rights of action under Commodities Exchange Act).

2. Visibility

An essential predicate for any effective enforcement program is its visibility.¹³³ In essence, a law enforcement agency like the SEC seeks to create "the illusion of three dimensions";¹³⁴ that is, that the agency is omnipresent, and is more likely than not to detect illegal behavior if someone is foolish enough to attempt it.¹³⁵ When required to choose between proceeding against a relatively nondescript target and a highly visible one, therefore, an enforcement agency generally is apt to choose the highly visible target if it wants to achieve the greatest deterrent effect for its enforcement efforts. Free advertising is often available to the SEC by dint of the targets it selects, and through certain other endeavors described below.

Accordingly, the SEC and its enforcement staff will often consider the public relations value of a case in deciding whether, when and how to pursue it.¹³⁶ A case of smaller dimensions (in terms of the magnitude or complexity of the illegal conduct alleged) with a more visible target may be deemed to be more appropriate than a larger case with a less visible target.¹³⁷ The SEC selects its targets carefully; particularly given its freedom from political influence,¹³⁸ it has been unusually adept at tackling prominent individuals in the domestic political,¹³⁹ religious,¹⁴⁰ entertainment,¹⁴¹ medical,¹⁴² legal,¹⁴³ cor-

133. See *infra* note 136 and accompanying text.

134. See *Suddenly, A Sleepy S.E.C. is Wide Awake*, N.Y. Times, Nov. 23, 1986, § 4, at 5, col. 1 ("The S.E.C. needs to maintain the illusion of being three-dimensional. . . . It has to appear to be everywhere at the same time, which it is not").

135. See Dannen, *The SEC's Insider Trading Quandary*, Institutional Investor, Oct. 1986, at 237 ("We want to create an environment where the downside is so staggeringly painful, it's not worth even a million bucks to take the risk," says [then Associate Director (now Director) of Enforcement William R.] McLucas"); Egan, *The War on Wall Street's Inside Dopesters*, N.Y. Mag., Mar. 28, 1983, at 41 ("We're out to cover a lot of ground," says John Fedders, the S.E.C.'s enforcement chief. "We want to get the butcher, the baker, and the candlestick maker").

136. See generally Moore, *The SEC on the Beat*, 19 Nat'l J., Jan. 3, 1987, No. 1, at 22, col. 1 ("The SEC has sought to achieve more enforcement with fewer troops by highlighting major cases that are designed to deter illegal activity. . . . We try to provide . . . a very visible presence through the publicity of these outrageous cases . . . to inhibit others from engaging in the activity," [SEC Chairman] Shad told the House Energy and Commerce Subcommittee . . .).

137. See, e.g., *infra* note 264 and accompanying text.

138. See *supra* note 45 and accompanying text.

139. See, e.g., SEC v. Thayer, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,718 (S.D.N.Y. Mar. 16, 1984); SEC v. Reed, Litigation Release No. 9537, 39 SEC Docket 1001 (S.D.N.Y. Dec. 23, 1981).

140. See, e.g., SEC v. Ambassador Church Fin./Dev. Group, Inc., 788 F.2d 1208 (6th Cir. 1986).

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porate,¹⁴⁴ arbitrage,¹⁴⁵ investment banking,¹⁴⁶ junk bond,¹⁴⁷ tender offer,¹⁴⁸ print media,¹⁴⁹ and marketmaking¹⁵⁰ fields.

Similarly, the SEC has not been shy about tackling well established and large business enterprises in those fields as well.¹⁵¹ Nor has the SEC restricted its efforts to the United States; the Commission has shown itself equally adept at pursuing prominent individuals and entities abroad.¹⁵²

Apart from the visibility of its targets, the SEC has employed other methods to create a public awareness of its enforcement

141. See, e.g., *In re De Laurentiis Ent. Group*, Exchange Act Release No. 24,786, 38 SEC Docket 1343 (Aug. 10, 1987).

142. See, e.g., *SEC v. Moore*, Litigation Release No. 11,013, 35 SEC Docket 230 (D. Conn. Mar. 3, 1986).

143. See, e.g., *SEC v. Grossman*, Litigation Release No. 11,359, 37 SEC Docket 919 (S.D.N.Y. Feb. 17, 1987); *SEC v. Elliott*, Litigation Release No. 11,335, 37 SEC Docket 477 (N.D. Ill. Dec. 30, 1986); *SEC v. Reich*, Litigation Release No. 11,246, 36 SEC Docket 949 (S.D.N.Y. Oct. 9, 1986); *SEC v. Madan*, Civ. Action No. 83-5053, 34 SEC Docket 1434 (S.D.N.Y. Mar. 24, 1986); *SEC v. Florentino*, Civ. Action No. 81-5903, 23 SEC Docket 958 (S.D.N.Y. Sept. 23, 1981).

144. See, e.g., *SEC v. PepsiCo, Inc.*, Litigation Release No. 10,807, 33 SEC Docket 861 (S.D.N.Y. July 1, 1985); *SEC v. General Dynamics Corp.*, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,293 (E.D. Mo. Feb. 27, 1980); *In re American Express Company*, Exchange Act Release No. 23,332, 35 SEC Docket 1163 (June 17, 1986).

145. *SEC v. Marcus Schloss & Co.*, 88 Civ. No. 88-0755 (S.D.N.Y. Feb. 9, 1988); *SEC v. Boesky*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,991 (S.D.N.Y. Nov. 14, 1986).

146. See, e.g., *SEC v. Levine*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,717 (S.D.N.Y. May 12, 1986); *SEC v. Siegel*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,123 (S.D.N.Y. Feb. 13, 1987).

147. See, e.g., *SEC v. Drexel Burnham Lambert, Inc.*, Litigation Release No. 11,859, 41 SEC Docket 1047 (S.D.N.Y. Sept. 7, 1988) (including charges against junk bond trader Michael Milken).

148. See, e.g., *SEC v. Bilzerian*, Litigation Release No. 12,144, 43 SEC Docket 1950 (D.D.C. June 29, 1989); *SEC v. First City Fin. Corp.*, 688 F. Supp. 705 (D.D.C. 1988), *aff'd*, 890 F.2d 1215 (D.C. Cir. 1989).

149. See, e.g., *SEC v. Ruderman*, Litigation Release No. 12,109, 43 SEC Docket 1492 (S.D.N.Y. May 25, 1989); *SEC v. Brant*, Litigation Release No. 10,908, 34 SEC Docket 511, 512 (S.D.N.Y. Oct. 21, 1985) ("Southern District of New York has entered a Final Judgment of Permanent Injunction and Other Equitable Relief by Consent against R. Foster Winans, Jr.").

150. See, e.g., *SEC v. Jefferies*, Litigation Release No. 11,370, 37 SEC Docket 1286 (S.D.N.Y. Mar. 19, 1987); see also *United States v. Jefferies*, No. 87 Cr. 339 (S.D.N.Y. Apr. 16, 1987) (LEXIS, Genfed library, Dist file).

151. See, e.g., *SEC v. Kidder, Peabody & Co.*, Litigation Release No. 11,452, 38 SEC Docket 647 (S.D.N.Y. June 4, 1987); *SEC v. First Boston Corp.*, No. 86-3524 (S.D.N.Y. May 5, 1986).

152. See, e.g., *SEC v. Tome*, 833 F.2d 1086 (2d Cir. 1987), *cert. denied*, 108 S. Ct. 1751 (1988); *SEC v. Certain Unknown Purchasers of the Common Stock of and Call Options for the Common Stock of Sante Fe Int'l Corp.*, 817 F.2d 1018 (2d Cir. 1987), *cert. denied*, 108 S. Ct. 1013 (1988); *SEC v. Banca Della Svizzera Italiana*, 92 F.R.D. 111 (S.D.N.Y. 1981); *SEC v. Collier*, Litigation Release No. 11,817, 41 SEC Docket 711 (C.D. Cal. July 26, 1988).

presence. A principal device utilized by the agency is the issuance of a Litigation Release every time the agency takes or commences formal enforcement action.¹⁵³ These releases are catalogued and disseminated to the news media as well as to those on the SEC's mailing list. Even though the mere filing of an action is not, in and of itself, a true precedent for future enforcement action, by cataloging and publicizing its enforcement activities, the Commission has been able both to deter similar conduct by others and, perhaps more importantly, to utilize its prior enforcement activities, even if in the form of a settled action, as precedent in a subsequent contested enforcement proceeding.¹⁵⁴

Through these litigation releases, as well as through speeches by Commissioners and staff officials, the agency disseminates information regarding its enforcement agenda. The financial press is well attuned to the SEC's activities and gives substantial attention to SEC litigation releases. The language of these releases can be negotiated as part of the settlement process, within limits, thus giving the SEC additional leverage over alleged violators.¹⁵⁵

153. In 1942, the Commission issued its first litigation release, an untitled document dealing with joint SEC and Department of Justice charges of failure of an issuer to register securities pursuant to the Securities Act and failure of a broker-dealer to comply with the Exchange Act's registration requirements. See Litigation Release No. 1 (Aug. 5, 1942) (LEXIS, Securities library, Releases file). Even prior to the SEC's formation, in 1934, the Federal Trade Commission (which administered the Securities Act prior to the SEC's existence) had already developed the practice of issuing announcements relating to the agency's enforcement efforts. See, e.g., Securities Act Release No. 186 (July 2, 1934) (LEXIS, Securities library, Releases file) (entry of a temporary restraining order against Carleton Saunders & Co.). The Commission adopted this approach within the first year of its existence. See, e.g., Securities Act Release No. 273 (Jan. 4, 1935) (LEXIS, Securities library, Releases file) (entry of temporary restraining order against Plymouth Consolidated Gold Mines, Ltd.).

154. See *In re Allied Stores and George C. Kern*, Exchange Act Release No. 24,648, 38 SEC Docket 987 (June 29, 1987), discussed *infra* notes 496-522 and accompanying text.

155. The Commission will allow its staff to negotiate the content of a litigation release, but the staff will seek to obtain the same rights with respect to the defendant's press release. Although a settling defendant is not required to admit wrongdoing as part of the price of settling an enforcement proceeding with the SEC, as a matter of formal policy, the Commission will not accept a settlement from any person or entity unless that person neither admits nor denies the allegations of the Commission's complaint or order for proceeding. See 17 C.F.R. § 202.5(e) (1987). In some cases, individuals have settled with the SEC and then issued statements denying any wrongdoing. The agency has reacted negatively to such denials and, in one instance, reopened the proceedings and obtained additional judicial relief. See *SEC v. Fashion Two Twenty, Inc.*, Litigation Release No. 8701, 17 SEC Docket 146 (N.D. Ohio Mar. 23, 1979) (without admitting or denying SEC's allegations, defendants consented to injunction against further inadequate disclosure in proxy materials); *SEC v. Fashion Two Twenty, Inc.*, Litigation Release No. 8739, 17 SEC Docket 465 (N.D. Ohio May 1, 1979) (announcing court order requiring defendant to resolicit shareholders' proxies for annual meeting, based on alleged violation of final judgment; defendant had circulated memorandum to certain shareholders stating that SEC's

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This free publicity is one method by which the agency can promote the visibility of its activities, although it is difficult to ascertain the degree to which publicity of this sort successfully deters similar acts by other persons.¹⁵⁶ More recently the SEC also has begun announcing its enforcement efforts with a formal press conference. This procedure has long been utilized by various criminal prosecutors, at both the federal and state levels, although the SEC has only recently adopted it.

Another device by which the SEC has assured visibility for its enforcement efforts is by attracting attention to anticipated, rather than consummated, enforcement actions. Termed a program approach to law enforcement, this approach involves the identification of a type, or class, of reprehensible behavior and the subsequent creation of a program to combat such activity. Developed prominently during the 1970s and particularly as an outgrowth of the Watergate scandal,¹⁵⁷ the Commission has devised programs for

allegations were baseless). *See also* Opening Statement of the Honorable Harold N. Williams, Chairman, Securities and Exchange Commission, at the Commission's Consideration of the Staff's Proposal Concerning Public Statements Inconsistent With Terms of Settlement (June 5, 1979) (unpublished speech on file with authors).

The above cited example is not the only instance of defendants denying SEC allegations after entering into a consent agreement. *See President of First Jersey Signs S.E.C. Decree*, N.Y. Times, Nov. 21, 1984, at D1, col. 1 ("Even though Mr. Brennan consented to the decree without admitting or denying the charges, Mr. Brennan took the view that the court order 'completely vindicates me and my firm' "); *First Jersey Settlement Said "Unique,"* Wash. Post, Nov. 22, 1984, at B1, col. 3 ("He can say whatever he wishes. The documents speak for themselves," retorted [SEC New York Regional Administrator Ira] Sorkin . . . The SEC is angry that Brennan put out a release claiming vindication a few hours before the decree was signed . . .").

156. A graphic example of the lack of success achieved by the SEC's publicity program occurred when the Commission brought charges in June, 1988 against Stephen Sui-Kuan Wang, Jr., a twenty-four year old financial analyst in the Mergers and Acquisitions Department of Morgan Stanley & Co., Inc. *See SEC v. Wang*, Litigation Release No. 11,780, 41 SEC Docket 384 (S.D.N.Y. June 27, 1988). The Commission accused Wang of tipping material, nonpublic information concerning transactions by at least 25 Morgan Stanley clients to Fred C. Lee, generating for Lee some \$19 million in illegal profits. The amount of illegal proceeds, however, pales in comparison to the brazenness of carrying out such a scheme *after* the filing of civil and criminal charges against Dennis B. Levine and Ivan F. Boesky, and the attendant publicity which emphasized that insider traders do get caught and prosecuted.

157. A particularly effective program of the 1970s was the Commission's Voluntary Disclosure Program. In the wake of Watergate and the resulting barrage of news reports of illegal or undisclosed use of corporate funds for political purposes, the Commission announced that the conviction of an officer or director of a public company for an illegal payment was material, and must be disclosed to the public and to the issuer's shareholders. *See Securities Act Release No. 5466*, 3 SEC Docket 647, 648 (Mar. 8, 1974) ("Such a conviction is material to an evaluation of the integrity of the management of the corporation as it relates to the operation of the corporation and the use of corporate funds").

many illicit securities activities, including its highly prominent crackdown on insider trading initiated during Chairman Shad's term.¹⁵⁸ Most prominent among the activities currently subject to this programmed approach is the Commission's crackdown on illegal activities in the Penny Stock markets.¹⁵⁹

Few agencies have developed visibility for their enforcement programs as well as the Commission has. Although the targets of such publicity often find it unbecoming,¹⁶⁰ the Commission's publicity may in fact deter some individuals from violating the law, and certainly puts the public on notice of the conduct the Commission believes will constitute a violation of the law.¹⁶¹ It also has the

The Voluntary Disclosure Program was, in a sense, an SEC offer of amnesty—the Commission let it be known that it would not likely investigate or prosecute companies that cleaned their own house, by conducting a thorough internal investigation, announcing the cessation of such payments, and disclosing the findings of its internal investigation. *See* SENATE BANKING, HOUSING AND URBAN AFFAIRS COMM., 94th Cong., 2d Sess. (1976); REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES (Comm. Print 1976), *reprinted in* Sec. Reg. & L. Rep. (BNA) No. 353, at 2 (May 19, 1976). As noted below, over 450 public companies came forward and admitted such wrongdoing. *See infra* note 192 and accompanying text.

158. *See S.E.C. Chief Plans Insider Trade Curb*, N.Y. Times, Oct. 26, 1981, at D1, col. 1 ("Mr. Shad said . . . 'We're going to come down with hobnail boots [on insider trading]'"); *see also Insider Cases and the S.E.C.*, N.Y. Times, Jan. 25, 1983, at D2, col. 1 ("In an oft-quoted remark, John S.R. Shad, the Chairman of the Securities and Exchange Commission, has promised that his agency is 'going to come down with hobnail boots' on anyone who dares engage in insider trading"). The Commission's insider trading enforcement program is discussed *infra* notes 215-440 and accompanying text.

159. The Commission's penny stock enforcement program is discussed *infra* notes 523-44 and accompanying text.

160. There is an apocryphal story about a fellow who was indicted for market manipulation at the behest of the SEC. Upon learning of the indictment, he protested his innocence to several SEC officials and pleaded that they undo a grievous wrong. The response, as expected, was a bureaucratic reliance on the wisdom of the criminal process, and an assurance that, if the fellow was truly innocent, no jury would convict him. After a trial on the merits, and an acquittal, the successful defendant happened upon the same SEC officials from whom he had sought assistance. Despite the loss, these officials had the presence to remind their former prey that the system had indeed worked, and he had been acquitted. To their amazement, he responded angrily by pointing to the headline in his hometown newspaper, which reported his victory under the headline: "Market Manipulator Acquitted!"

161. Indeed, a recent "tongue-in-cheek" letter to the Wall Street Journal provides an amusing depiction of the effect upon the public of the considerable media attention focused on the enforcement of the securities laws:

I was quite concerned when I saw your Oct. 26 article about Anheuser-Busch's recent price cut and drop in demand.

A friend of mine and I might be in big trouble. We're afraid the Justice Department and the SEC will soon be after us for manipulating stock prices by using inside information. I hope this letter will explain the situation and at least be some evidence of my contrition.

Recently, I went to see my doctor for a checkup. As soon as he saw my weight he insisted I lose some poundage immediately. Since beer has been my

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salutary purpose of assuring investors that the Commission is effectively monitoring the United States securities markets.

3. *Litigation Success*

A successful enforcement program is one that is credible both to those who are confronted with the government's enforcement initiatives, and those who must evaluate their validity. To the extent the government is perceived as an effective litigator, with the capacity to prevail should it commence an enforcement proceeding, targets of proposed government enforcement action will be more likely to settle cases. If the government is perceived as an ineffective or unsuccessful litigator, it will have to litigate many more cases, straining its limited resources, or it will be forced to settle cases on less favorable terms.

The success of a litigation strategy can be measured in a number of ways. The first is whether the SEC prevails more often than not in its litigation. This may be more important to the object of the SEC's proceeding than to the SEC itself. It is not a sign of weakness, or failure, if the government loses a fair percentage of the cases it actually litigates. In the SEC's enforcement program, there is a Darwin-like process of natural selection in terms of which cases it actually litigates. Typically, the most difficult cases for defendants will be settled rather than litigated.¹⁶² Those cases that defendants do

sin of choice for years and is the main source of my non-nutritional calories (at least according to my wife), it seemed like a good idea to stop drinking beer until my weight got on the south side of 200 pounds. I enlisted a friend—another large consumer of beer—to go on this diet with me. He stopped drinking beer, too. I can assure you and your readers that it never occurred to either of us that this would have such an effect on the beer market or that it would cause Anheuser-Busch such problems.

One source of hope: Rudolph Giuliani is no longer the U.S. attorney for the Southern District of New York. I just hope neither his successor nor any other district attorney will see fit to indict us.

Every investor in the U.S. should be aware that I hope to reach 200 pounds very soon, and that when that happens my beer consumption will resume. I hope that by making my plans public knowledge I can now buy beer-company shares—knowing as I do that the demand for Budweiser will soon surge—without any fear of trading on inside information.

Geo. Thomas Davis, Jr.
Swan Quarter, N.C.

See Inside Trader Sees Trouble Brewing, Wall St. J., Nov. 21, 1989, at A19, col. 2.

162. This is not intended to convey the impression that every case that is settled reflects a judgment by the defendant (or defense counsel) that the defendant would have

litigate most likely are those in which the government's position is weakest, or where the stakes are highest.¹⁶³

Of greater significance to the government is whether its legal theories are accepted by the court. While the government may not prevail in a specific enforcement action, it often advances or sustains the basic legal theories upon which that action was predicated.¹⁶⁴ In such circumstances, the government's loss is often illusory, because legal theories will be established or advanced for use in future actions.

The failure of an agency to sustain its legal theories in an enforcement proceeding, however, may seriously affect its enforcement program. Losing a case because the government fails to meet its burden of proof is of minimal concern to a government enforcement agency.¹⁶⁵ Similarly, if the legal theories of the government are rejected because the regulations currently in place do not comprehend the theories alleged, the loss is likely to be of less concern to the government, since the agency can often amend a rule or regulation to ameliorate the effects of an adverse decision.¹⁶⁶ However, a serious setback may occur where a court

lost the proceeding had it been litigated. In some circumstances, cases are settled despite a good faith belief by the defendants that they could have prevailed, because the outcome of the case is simply not sufficiently important to them to warrant the burden and expense of litigation. This is most often the case when the government seeks an injunction or some other similar type of order.

In other cases, a settlement reflects the defendant's assessment that the risks of losing enforcement litigation outweigh the benefits of winning. This is the case, for example, where the government offers not to seek treble damages under the provisions of RICO, in return for the defendant's agreement to settle the matter on a less dramatic basis. The mere lodging, not to mention the loss, of a governmental RICO claim carries with it significant implications for the defendant, both within the context of the government's action, and in connection with the private litigation that inevitably follows.

163. It is not surprising to see defendants litigate where the government seeks to impose criminal sanctions (in the form of a jail term), or where the relief sought by the government approximates the realistic risk of losing should the case actually be litigated.

164. See, e.g., *SEC v. Switzer*, 590 F. Supp. 756 (W.D. Okla. 1984).

165. Many cases are lost on this basis, particularly where there is a jury trial. See, e.g., *Jury Clears Reed in Amax Case*, N.Y. Times, Dec. 17, 1985, at D1, col. 6. From the government's perspective, a loss on that basis does no permanent damage to its program, unless the court indicates that the government's theory could not have succeeded on any set of facts.

166. Legislative grants of SEC rulemaking (and rule amending) authority speak in very broad, general terms, see, e.g., Securities Act § 19(a), 15 U.S.C. § 77(a) (1982) ("The Commission shall have authority from time to time to make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of this title . . ."); Exchange Act § 23(a)(1), 15 U.S.C. § 78w(a)(1) (1982) (granting similar authority). Nevertheless, an agency regulation may not purport to exceed the bounds of the statutory provision pursuant to which the regulation was promulgated. See, e.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 213-14 (1976).

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rejects the government's legal theories because the controlling statute will not accommodate the government's interpretations: only Congress can remedy such a statutory disability.¹⁶⁷

In short, an effective enforcement program is one which generates considerable concern on the part of prospective defendants that the government is more than likely to prevail in the event of litigation, and that the risks of refusing an offer of settlement and losing the subsequent litigation outweigh the chance that the defendant will prevail and be absolved of guilt.

The foregoing discussion delineates some of the more important predicates of an effective enforcement program.¹⁶⁸ Throughout the past several decades, the SEC's enforcement program has embodied most of these attributes. We now turn to a retrospective evaluation of the Commission's enforcement program during the 1980s, to assess how well that program—which reflected a departure from prior years' enforcement policies—conforms to the model we have articulated.

II. Securities Law Enforcement During the 1980s

A. Background of the 1970s

The Commission's enforcement presence in the late 1960s and the 1970s personified the agency's tenacity and energy. Certainly the

167. See, e.g., *Lowe v. SEC*, 472 U.S. 181, 211 (1985) (rejecting Commission's interpretation of an exclusion to antifraud provision of Advisers Act); *Dirks v. SEC*, 463 U.S. 646, 665-667 (1983) (rejecting SEC's assertion that Exchange Act § 10(b) and Rule 10b-5 reached the agency's theory of tippee liability); *Chiarella v. United States*, 445 U.S. 222 (1980) (rejecting government's interpretation of Exchange Act Section 10(b) and Rule 10b-5 as applied to alleged insider trading); *American Bankers Ass'n v. SEC*, 804 F.2d 739, 743-54 (D.C. Cir. 1986) (rejecting SEC's claim of authority to regulate banks as broker-dealers).

168. The importance of "fairness" to an enforcement program should not be overlooked. A key ingredient for the success of any enforcement program is a perception that the program operates fairly. In this context, fairness embodies

- (i) the cases that are discarded, as well as those that are initiated;
- (ii) the theories that are pursued (and, in particular, whether prosecutors can avoid the temptation to pursue attenuated theories of law in the context of a case that virtually assures them of the likelihood they will prevail on other, more standard theories of law);
- (iii) the persons who are targeted as defendants; and
- (iv) the remedies and sanctions that are sought.

The government is, and should be, held to a higher standard than other litigants, since its mission is to protect the public interest, and not simply to achieve a businessman's result.

events of the 1970s required creativity and tenacity to deal with the regulatory implications of events such as Watergate, the foreign and domestic payments scandals and the like. We highlight various of the Commission's responsive enforcement programs, below, as they portray the tenor of the Enforcement Division to which the Reagan administration, which dominated most of the 1980s, responded.

B. *Enforcement Programs of the 1970s*

1. *Unconventional Securities*

From its inception, the Commission has been confronted with the question of whether novel investment-related offerings that do not fit the typical mold of corporate equity or debt instruments should be treated as securities. The Commission opted for an expansive view of its jurisdiction—a not uncommon trait of many regulatory agencies—and, in a progression of cases beginning in the early 1940s, continuing through the end of the 1960s, the Commission scored a series of impressive litigation victories in the Supreme Court. Each of these cases vindicated the Commission's position that atypical investment instruments offered for public sale through the means or facilities of interstate commerce were securities for purposes of the registration¹⁶⁹ and antifraud¹⁷⁰ provisions of the federal securities laws.¹⁷¹

During the 1970s, the Commission elevated its ingrained fascination with novel and atypical securities interests virtually to an art form, bringing a number of enforcement actions against the

169. Pursuant to Section 5 of the Securities Act, 15 U.S.C. § 77e (1982), it is unlawful for any person to offer for sale, or sell, any securities through the means and instrumentalities of interstate commerce or the mails, unless those securities have first been registered with the SEC, and meaningful disclosure is made available to investors. Although there are a number of securities and transactions that are exempted from this registration requirement, *see* Securities Act §§ 3-4, 15 U.S.C. §§ 77c, 77d (1982), the burden is on the person claiming entitlement to an exemption to prove such entitlement. *See, e.g., SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953). The public distribution of non-exempt unregistered securities imposes absolute liability on the issuer of those securities. *See* Securities Act § 12(1), 15 U.S.C. § 77l(1) (1982).

170. *See generally* Securities Act §§ 11, 12(2), 17, 15 U.S.C. §§ 77k, 77l(2), 77q (1982); and Exchange Act § 10(b), 15 U.S.C. § 78j(b) (1982).

171. *See, e.g., SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943) (sale of assignments of portions of oil drilling leases); *SEC v. W.J. Howey Co.*, 328 U.S. 293 (sale of packages consisting of deeds to a portion of an orange grove and a ten-year service contract to operate the grove); *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959) (variable annuity insurance policies); *cf. Tcherepnin v. Knight*, 389 U.S. 332 (1967) (withdrawable capital shares of a savings and loan institution).

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promoters and issuers of such various and sundry instruments as: self-improvement courses,¹⁷² cosmetic distributorships,¹⁷³ franchising agreements,¹⁷⁴ resort condominiums,¹⁷⁵ cattle herds,¹⁷⁶ oil and gas limited partnerships,¹⁷⁷ real estate limited partnerships,¹⁷⁸ call options for silver bullion,¹⁷⁹ undivided fractional working interests in oil and gas wells,¹⁸⁰ personal promissory notes,¹⁸¹ and, for good measure, interests in foreign sex centers for prostitutes.¹⁸²

The SEC, however, did not limit itself to enforcement proceedings. It also issued releases alerting the investing public to some of the scams that had arisen in connection with some of these atypical securities.¹⁸³ And, the Commission filed *amicus curiae* briefs with a variety of courts, in favor of private plaintiffs seeking to expand the reach of the federal securities laws to such atypical "securities" as pension plan interests,¹⁸⁴ shares in a cooperative housing project,¹⁸⁵ and life insurance policies.¹⁸⁶ Although this effort

172. See, e.g., SEC v. Glenn W. Turner Enter., Inc., 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

173. See, e.g., SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974); SEC v. Isis Indus., Litigation Release No. 8844, 18 SEC Docket 178 (S.D.N.Y. Aug. 20, 1979).

174. See, e.g., SEC v. Futuristic Foods, Inc., Litigation Release No. 8636, 17 SEC Docket 464 (S.D.N.Y. Apr. 30, 1979).

175. See, e.g., SEC v. Cal-Am Corp., Litigation Release No. 8216, 20 SEC Docket 963 (C.D. Cal. Dec. 14, 1977).

176. See, e.g., SEC v. Southern Star Land & Cattle Co., Litigation Release No. 6895, 7 SEC Docket 52 (S.D. Fla. May 20, 1975); see also United States v. Schwartz, Litigation Release No. 5741, 1 SEC Docket 23 (S.D.N.Y. Feb. 13, 1973); United States v. Pitts, Litigation Release No. 7304, 9 SEC Docket 173 (N.D. Tex. Mar. 9, 1976).

177. See, e.g., SEC v. Income Properties of America Investment Management Co., Litigation Release No. 8768, 17 SEC Docket 794 (D.D.C. May 30, 1979); SEC v. DiGiorno, Litigation Release No. 8278, 14 SEC Docket 130 (N.D. Tex. Feb. 6, 1978); SEC v. Garfinkle, Litigation Release No. 6687, 6 SEC Docket 95 (S.D.N.Y. Jan. 15, 1975).

178. See, e.g., SEC v. Barnwell Indus., Litigation Release No. 6873, 6 SEC Docket 886 (D.D.C. May 8, 1975).

179. See, e.g., SEC v. Tex-A-Chief, Inc., Litigation Release No. 7205, 19 SEC Docket 65 (N.D. Tex. Dec. 11, 1975).

180. See, e.g., SEC v. Big D Oil & Gas Co., Litigation Release No. 8960, 19 SEC Docket 65 (N.D. Tex. Dec. 26, 1979).

181. See, e.g., United States v. Ginter, Litigation Release No. 8839, 18 SEC Docket 148 (D. Or. Aug. 15, 1979).

182. See SEC v. Globus Anlage-vermittlungsgesellschaft MBH, Litigation Release No. 6229, 3 SEC Docket 523 (D. Md. Feb. 4, 1974); SEC v. Globus, Litigation Release No. 6490, 5 SEC Docket 60 (D. Md. Aug. 22, 1974).

183. See, e.g., Securities Act Release No. 5347, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,163 (Jan. 18, 1973); Securities Act Release No. 6051, 17 SEC Docket 190 (Apr. 5, 1979).

184. See Int'l Brotherhood of Teamsters v. Daniel, 439 U.S. 551 (1979).

185. See United Housing Found., Inc. v. Forman, 421 U.S. 837 (1975).

186. See Grainger v. State Sec. Life Ins. Co., 547 F.2d 303 (5th Cir. 1977), *cert. denied*, 436 U.S. 932 (1978).

was largely unsuccessful,¹⁸⁷ it evidenced the expansive position the Commission was prepared to espouse.¹⁸⁸

2. Questionable Payments

For much of the 1970s, questionable payments by public companies, to foreign and domestic business and government officials, occupied the SEC's agenda.¹⁸⁹ Congress, too, involved itself in the issue, launching an investigation into whether International Telephone and Telegraph Corp. (ITT) had offered a contribution to the 1972 Republican Presidential Campaign in an effort to settle an antitrust action against ITT.¹⁹⁰

The Commission's investigations into corporate slush funds led to a steady progression of cases revealing the use of these unaccounted-for funds for illegal domestic political contributions, domestic and foreign bribes, questionable payments to foreign agents and the like.¹⁹¹ The Commission's inquiries revealed that over 450

187. The Commission's position was rejected in both the *Forman* and *Daniel* cases, *supra* notes 184-85.

188. By the early 1980s, the Commission's position in the Supreme Court had changed dramatically, as it affirmatively opposed treating bank-issued certificates of deposit, and collateral agreements, as securities for purposes of the federal securities laws. See *Marine Bank v. Weaver*, 455 U.S. 551 (1982).

189. One theory underlying the Commission's questionable corporate payments enforcement program turned on the premise that, since a contract procured by bribing the agent of one party is voidable at the instance of the affected principal, see CORBIN ON CONTRACTS § 228 (1963), then an issuer's financial statements were false and misleading if a contingency had not been noted with respect to a material contract procured in that fashion. See generally COMM. OF CONF., FOREIGN CORRUPT PRACTICES, H.R. REP. NO. 831, 95th Cong., 1st Sess. (1977) (Joint Explanatory Statement of the Committee of Conference at § A(2)(a)); HOUSE COMM. ON INTERSTATE & FOREIGN COMMERCE, UNLAWFUL CORPORATE PAYMENTS ACT OF 1977, H.R. REP. NO. 640, 95th Cong., 1st Sess. (1977). Other theories included the notion that public companies impliedly represent that they (1) obtain and retain business solely on the merits of their goods or services, and (2) maintain accurate books and records for which there is full corporate accountability.

190. See TRANSFORMATION OF WALL STREET, *supra* note 28, at 446.

191. See, e.g., SEC v. J. Ray McDermott & Co., [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,740, at 90,594 (D.D.C. Oct. 6, 1976) (secret payments to foreign consultants and domestic business officials; accumulation of off-books slush fund for political contributions); SEC v. Foremost-McKesson, Inc., Litigation Release No. 7479, 9 SEC Docket 1074 (D.D.C. July 7, 1976) (undisclosed payments to foreign officials to influence unspecified foreign government actions; undisclosed payments to retailers and wholesalers to induce purchases of defendant's products); SEC v. Gen. Tire & Rubber Co., [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,542, at 99,730 (D.D.C. May 6, 1976) (illegal payments to officials and employees of foreign governments to "obtain removal from the Arab boycott list"); SEC v. Lockheed Aircraft Corp., [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,509, at 99,569 (D.D.C. Apr. 13, 1976) (secret payments to foreign government officials to procure contracts and permits); SEC v. United Brands Co., [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,357, at 98,775 (D.D.C. Apr. 10, 1975)

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issuers had tampered with their accounting records or concealed the payment of illegal gratuities in foreign or domestic transactions.¹⁹²

3. Corporate Accountability

Related to, although distinct from, the questionable payments issue was the larger issue of corporate accountability to shareholders and, in particular, the conduct of directors of public companies in overseeing the business affairs of their companies. In cases where the Commission believed that the board of a public company had failed to carry out its responsibilities, it made public its views of the nature of the lapse and the actions that should have prevented it.

Perhaps in recognition of the new ground that was broken by measuring the conduct of directors against federal law rather than state law,¹⁹³ the Commission did not commence enforcement proceedings in many of these cases, but chose to invoke its publication authority under the Exchange Act to publish reports of its investigations.¹⁹⁴

Thus, the 1970s saw corporate directors taken to task publicly for a variety of misdeeds ranging from neglecting the affairs of their company,¹⁹⁵ to permitting an issuer to issue unduly optimistic press

(undisclosed payments to Honduran and European government officials "in the course of its business"); *SEC v. Northrop Corp.*, Litigation Release No. 6842, 6 SEC Docket 712 (D.D.C. Apr. 17, 1975) (undisclosed unlawful political contributions).

192. See TRANSFORMATION OF WALL STREET, *supra* note 28, at 449. This information gave rise to the passage of the Foreign Corrupt Practices Act of 1977, which both proscribed certain types of payments and required that public companies keep sufficiently accurate books and records to reveal the nature of all such payments. See COMM. OF CONF., FOREIGN CORRUPT PRACTICES, H.R. REP. NO. 831, 95th Cong., 1st Sess. (1977) (Joint Explanatory Statement of the Committee of Conference at § A(2)(a)); HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, UNLAWFUL CORPORATE PAYMENTS ACT OF 1977, H.R. REP. NO. 640, 95th Cong., 1st Sess. (1977).

193. Corporate governance has long reposed in the domain of state law. See, e.g., *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69, 88-89 (1987).

194. The Commission's publication authority derives from Exchange Act Section 21(a), 15 U.S.C. § 78u(a) (1981), which provides, in pertinent part, that "[t]he Commission is authorized in its discretion, to publish information concerning any . . . violations" of the federal securities laws uncovered in its investigations.

The Commission has described its publication authority as a device to "advise the public with respect to the obligations imposed by the securities laws." See The Commission's Practice Relating to Reports of Investigations and Statements Submitted to the Commission Pursuant to Section 21(a) of the Securities Exchange Act of 1934, Exchange Act Release No. 15,664, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,014, at 81,557 (Mar. 21, 1979).

195. See, e.g., SECURITIES AND EXCHANGE COMM'N STAFF REPORT ON THE FINANCIAL COLLAPSE OF THE PENN CENTRAL COMPANY, H.R. DOC. NO. 12,128, 92d Cong., 1st Sess. (1972), in which the Commission's investigation revealed that the inattention of the issuer's

releases in spite of its knowledge that the company was in grave financial distress.¹⁹⁶

4. *Novel Theories of Ancillary Relief*

As the Commission continued to advocate novel legal theories and sought to apply the securities laws to forms of conduct not previously recognized as falling within the ambit of federal law, it found that the traditional equitable remedy of the civil injunction was no longer adequate for a variety of the cases brought by the agency. Thus, the SEC devised creative new forms of ancillary equitable relief to tailor the remedy to address the wrong more closely.

Particularly in cases of public companies whose officials had been accused of corporate mismanagement, the Commission designed creative forms of relief, tailored to the particular facts uncovered in the investigation, such as (1) the designation of special counsel, sometimes referred to as a "special review person," to conduct an investigation of the issuer or the suspect transactions,¹⁹⁷ (2) the appointment of new independent directors to the issuer's board,¹⁹⁸ (3) the establishment of an Audit Committee or Executive Committee

board of directors was, at a minimum, partly responsible for the chief financial officer's successful misappropriation of at least \$4 million. *Id.* at 158-63.

196. See, e.g., *In re* National Telephone Company, Exchange Act Release No. 14,380, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,410 (Jan. 16, 1978). Other matters of director responsibility were also addressed by the Commission in Section 21(a) reports during this period. See, e.g., *In re* Gould, Inc., Exchange Act Release No. 13,612, 12 SEC Docket 773 (June 9, 1977) (failure of the board to inquire into a corporate transaction tainted by management self-dealing); Report of Investigation *In re* Stirling Homex Corp., [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,219 (July 2, 1975) (failure of outside directors to learn details of company's financial condition permitted fraudulent securities offering).

197. See, e.g., *SEC v. Westgate-California Corp.*, Litigation Release No. 6142, 3 SEC Docket 30 (S.D. Cal. Nov. 9, 1973), in which the court, among other things, appointed a special counsel to investigate the issuer's activities, appointed a new board of directors, and required former directors to resign from any other directorships with public companies, based upon allegations that the defendants had misappropriated substantial assets of the issuer and falsified the issuer's books and records.

198. See, e.g., *SEC v. Coastal States Gas Corp.*, Litigation Release No. 6054, 2 SEC Docket 451 (S.D. Tex. Sept. 12, 1973), in which the Commission alleged that the issuer omitted from various of its public filings information concerning its ability to meet its business commitments. Particularly during the energy crisis resulting from the oil embargo of that period, the Commission expected oil and gas companies to disclose information concerning their reserves. The issuer settled the matter by consenting to an injunction and ancillary relief in the form of the appointment of independent members to its board, implementing a new disclosure policy concerning its reserves and submitting to a special review of specified financial transactions by the company's auditors. *Id.*

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of the issuer's board, to assure appropriate review of certain items of business,¹⁹⁹ and (4) the incorporation into an injunction of a series of undertakings by the defendant designed to cure the particular problems revealed by an investigation.²⁰⁰

C. Deregulation in the 1980s

The Reagan Revolution arrived in Washington, amid great fanfare, in 1981.²⁰¹ The new administration quickly announced that regulatory relief would play a prominent role in its economic policy.²⁰² Deregulation was soon heralded as a tonic, if not a panacea, for the country's sluggish, listless economy.²⁰³

The regulatory (or deregulatory) reform movement was driven by the conviction that "incentives, not rules, should guide business conduct and that negotiation among the principals, not litigation

199. *Id.*

200. A consent injunction issued against a public accounting firm exemplifies creative relief designed to remedy with precision a specific set of circumstances. The Commission charged an issuer's auditors with certifying and distributing materially false and misleading financial statements concerning the performance of an investment firm. See *Accounting Firm Agrees to Consent Decree Providing for Independent Investigation of its Practices*, Sec. Reg. & L. Rep. (BNA) No. 204, at A-1 (May 30, 1973). The Commission alleged that the auditing firm was unqualified to prepare certified financial statements because certain firm personnel "during the period of time when they were working on the preparation of such financial statements, received payments from the general partners of [the client] totalling approximately \$17,000 in the guise of profits from participation in the purchase and sale of hot issues." *Id.*

The auditors consented to a set of undertakings that included the adoption of internal controls procedures, cooperation with an independent investigation to determine whether the new procedures were adequate and whether the auditors were complying with them, a one-year agreement not to merge with, or acquire, another accounting firm without the consent of the SEC's Chief Accountant, and a five-day bar from accepting new public accounting engagements. *Id.*

201. Ronald Reagan was elected President of the United States in 1980, in a landslide, on a platform of restoring conservative values, and a promise to "get the government off the backs of the people." *Reagan: Putting His Philosophy to Work Fast*, BUS. WK., Nov. 17, 1980, at 154, col. 1; see also *Justice and Mr. Thurmond*, The Christian Science Monitor, Nov. 19, 1980, at 24, col. 1.

202. See generally Fix & Eads, *The Prospects for Regulatory Reform: The Legacy of Reagan's First Term*, 2 YALE J. ON REG. 293 (1985) [hereinafter *Prospects for Regulatory Reform*] (describing administration's plan to eliminate unnecessary agency regulations, revise regulatory statutes, and abolish certain regulatory agencies).

203. One commentator has attributed to the early 1970s' framework of regulation such ill effects as: suppression of innovation; limitation of variety in the price and quality of goods; and such price distortions as, for example, the overpricing of long-distance telephone service and the underpricing of crude oil and natural gas. See Kahn, *The Theory and Application of Regulation*, 55 ANTITRUST L.J. 177, 178 (1986).

between the lawyers, should determine disputes."²⁰⁴ The Reagan administration eagerly embraced this credo; the President empaneled a Task Force on Regulatory Relief whose mandate was the coordination of the overall regulatory reform initiative.²⁰⁵

The SEC was not excluded from the administration's regulatory reforms: The President's SEC Transition Team saw the Commission as a potential hindrance to effective capital formation and an impediment to the administration's goals of economic growth and increased productivity.²⁰⁶ Not surprisingly, then, the SEC Transition Team advised President Reagan that, among other things, the staff and budget of the Commission could be cut by 30% over three years, "without any compromise in the mission of the Agency."²⁰⁷ Despite its grudging admiration for the Commission,²⁰⁸ and, in particular, its crown jewel, the Enforcement Division,²⁰⁹ the Transition Team nonetheless urged that regulatory reform be visited upon the agency in the form of, among other things, a four-fold reduction of Enforcement Division personnel, from 200 to 50.²¹⁰

The notion that the dismantling of multiple layers of regulation should be accompanied by a comparable reduction in enforcement worked at cross-purposes with the axiomatic correlation between decreased regulation and increased supervision and enforcement.²¹¹

204. McGarity, *Regulatory Reform in the Reagan Era*, 45 MD. L. REV. 253, 254 (1986) [hereinafter *Regulatory Reform*].

205. *Id.* at 261 (citing remarks by President Reagan (Jan. 22, 1981)).

206. *Final Report of SEC Transition Team*, Sec. Reg. & L. Rep. (BNA) No. 587, at K-1 (Jan. 21, 1981) [hereinafter *Transition Team Report*].

207. See *Transition Team Report*, *supra* note 206, at K-1.

208. The *Transition Team Report* stated that, over the course of its history, the Commission "has become known as an agency which is tightly run, . . . a vigorous enforcer of esoteric securities laws, and a jealous guardian of its reputation as a highly independent agency." *Id.* at K-2.

209. In evaluating for the President the various divisions and offices of the SEC, the Transition Team reported that "[t]he integrity, dedication and zeal of the staff of the SEC's Enforcement Division is [sic] the envy of government. . . . The technique of investigation and litigation and the enthusiasm which the staffers of [the Division] bring to their work is [sic] truly a model for all of government." *Id.* at K-8.

210. *Id.* at K-9. This recommendation fell at the midpoint of the range of recommendations concerning the staffing of the Enforcement Division. At opposing ends of the spectrum were the alternatives of (1) preserving the size and centralized management of the Division; and, conversely, (2) eliminating the Division in Washington, in favor of a coordinated regional enforcement program. *Id.* Similar recommendations were offered as a means for reforming the other divisions and offices of the Commission, as well as many of the agency's regulatory programs. *Id. passim*.

211. Not long after the initial deregulatory efforts were recommended for the SEC, the Enforcement Division's new director, John M. Fedders, admonished the audience of the Securities Industry Association Legal and Compliance Seminar that, notwithstanding the agency's commitment to prudent deregulatory initiatives, the securities industry should not

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Nevertheless, the regulatory reformers were convinced that economic incentives, rather than government enforcement, would motivate compliance with a pared-down regulatory framework.²¹²

Chief among the substantive, enforcement-oriented recommendations of the SEC Transition Team was the need to return to the pursuit of traditional forms of securities fraud, such as insider trading and manipulation.²¹³ The Transition Team urged Reagan to appoint a new SEC Chairman and evaluate future appointments to the Commission with a view toward assuring that the new Chairman be able to achieve voting control.²¹⁴

D. Insider Trading: Centerpiece of the Enforcement Program of the 1980s

With the arrival of Ronald Reagan and deregulation came a new Chairman of the SEC, John S.R. Shad, and, shortly thereafter, the newly appointed Director of Enforcement, John M. Fedders.²¹⁵ As subsequent events amply demonstrate, Shad and Fedders had read the SEC Transition Team's Report and heeded its essential message.

Following, and to a large extent, in response to, the dramatic expansion of the federal securities laws during the 1970s,²¹⁶ the Shad-Fedders regime set out to restore to the Commission a philosophy of strict construction of the federal securities laws.²¹⁷ In particular, Shad announced promptly upon his confirmation that insider trading would become the object of heightened attention, proclaiming that the Commission would "come down with hobnail boots" on those who abused informational advantages.²¹⁸

misread broker-dealer regulatory reform. *See Fedders Urges More Criminal Prosecution of Market Manipulators, Insider Traders*, 14 Sec. Reg. & L. Rep. (BNA) No. 8, at 795, 795-96 (May 7, 1982). Fedders called upon the industry to step up its self-regulatory efforts, underscoring his readiness to recommend proceedings to criminal prosecuting authorities and to increase the use of the remedies available to the Commission. *Id.*

212. *See generally Prospects for Regulatory Reform*, *supra* note 202, at 305-06.

213. *See Transition Team Report*, *supra* note 206, at K-9.

214. *Id.* at K-28.

215. Prior to their appointment, Shad had been the vice-chairman of E.F. Hutton, while Fedders, a litigator, had been a partner at a Washington, D.C. law firm. *See The Man From Wall Street: John Shad's Reign at the SEC*, Wash. Post, Feb. 5, 1989, at A1, col. 1.

216. *See supra* notes 169-200 and accompanying text.

217. *See supra* note 213 and accompanying text. In this context, the concept of strict construction embodied a decision to return to the fundamentals of securities law enforcement and to eschew cases involving novel instruments and novel theories of law.

218. *See S.E.C. Chief Plans Insider Trade Curb*, N.Y. Times, Oct. 26, 1981, at D1, col. 1. Indeed, the agency speedily announced a significant victory in an insider trading case. *See Profits on Santa Fe Trading Frozen*, N.Y. Times, Oct. 27, 1981, at D1, col. 3 (court froze \$5.2 million in illegal proceeds from insider trading in Santa Fe stock and options).

During the early 1980s, while the SEC focused on insider trading cases, Shad and Fedders spoke out loudly and often against the evils of this particular brand of illicit securities trading.²¹⁹ Even with their focus on insider trading, however, it seems safe to say that no one anticipated the turn of events that would thrust insider trading into the headlines, where it would remain for the rest of the decade.²²⁰ In a sense, the Commission's insider trading enforcement program of the 1980s reflects, in a microcosm, certain overarching themes of the last decade of SEC enforcement.

1. *Back to Fundamentals*

As noted earlier, the Shad-Fedders team proclaimed that their mission was to restore to the Commission's enforcement program an emphasis on fundamental principles of securities fraud, abandoning the 1970s' approach of finding, and defining, the outer limits of fraud.²²¹

Although Shad and Fedders emphasized that their program merely reflected a return to conservative legal principles, some saw the deregulation of the early 1980s as benefiting big business, while leaving the full force of the Commission's enforcement arsenal to descend upon individuals.²²² Insider trading cases provided a ready

219. See, e.g., *Insider Trading: Why it Can't be Stopped*, DUN'S BUS. MONTH, June 1984, at 48; *Insider Trading by Outsiders: The SEC Strives to Widen Its Net But Major Rulings Have Held It Back*, N.Y. Times, May 27, 1984, at C1, col. 2; *Insider Cases and the S.E.C.*, N.Y. Times, Jan. 25, 1983, at D2, col. 1; *The Dispute Over the S.E.C.*, N.Y. Times, Apr. 21, 1982, at D1, col. 3.

220. See *supra* note 2. Ironically, and sadly, at the moment of the SEC's greatest triumphs involving insider trading, Fedders was no longer at the agency. See *Fedders Resigns as SEC Chief of Enforcement, Apologizes to Agency*, L.A. Times, Feb. 27, 1985, § 4, at 1, col. 5.

221. See article cited *supra* note 211. In an interview with *Forbes* magazine, Fedders extracted from a pick-up game of basketball with his predecessor, Stanley Sporkin, an apocryphal analogy to the two men's differing approaches to enforcing the federal securities laws:

I noticed Stanley shot outside shots At midcourt, he'd just be chucking them away. Every time I got the ball, I was very slow and patient. I'd work the ball in close, then I'd go up and stuff it. Stanley's a guard, and I'm a center. I'm not going for long shots.

Dunk Shot, FORBES, Dec. 7, 1981, at 148.

222. For example, in a speech on the topic of whether the failure of issuers to disclose their unasserted illegal conduct constitutes a violation of the federal securities laws, Fedders explained his disinclination to bring certain of those cases against issuers:

[A]bsent (1) self-dealing, (2) a mandated disclosure requirement or (3) an untrue statement of material fact or a statement rendered misleading by the omission of

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vehicle for pursuing individuals rather than issuers, since it was thought that, only in the rare case, if at all, would a company play a role in insider trading other than as the source or object of the information in question.²²³

a material fact, law enforcement judgments based on the general antifraud provisions of the securities laws generally should be made in terms of *quantitative* materiality.

See J. Fedders, Speech Before the Federal Regulation of Securities Committee of the American Bar Association (Nov. 19, 1982), *reprinted in* 14 Sec. Reg. & L. Rep. (BNA) No. 46, at 2059, 2059 (Nov. 26, 1982) (emphasis supplied); *see generally Fedders Says Commission Less Likely to Go After Some Corporate Misconduct*, 14 Sec. Reg. & L. Rep. (BNA) No. 46, at 2037, 2037 (Nov. 26, 1982). This represented a departure from the prior decade's emphasis on qualitative materiality during the management integrity disclosure program of the prior decade. *Id.* at 2058-59.

And, in connection with the Commission's later emphasis on financial fraud, *see infra* notes 474-83 and accompanying text, Fedders explained his views on the relative responsibility of corporate officers and their subordinates for securities laws violations. In a speech before the Second Annual Financial Executives Institute Conference on Current Financial Issues, Fedders observed that, although top management might exert pressures to perform that created the environment leading midlevel personnel to carry out a financial fraud, it was the midlevel people who would be named in the enforcement action, since senior officials were unlikely to possess the requisite degree of scienter necessary to sustain a fraud charge. *See SEC Beefing Up Financial Fraud Work, Fedders Tells Conference of Executives*, 15 Sec. Reg. & L. Rep. (BNA) No. 48, at 2234, 2235 (Dec. 9, 1983).

Not surprisingly, this redirection of the Commission's enforcement efforts downward from issuers and their senior officers provided a lightening rod for Congressional criticism. Representative John Dingell, whose Oversight and Investigations Subcommittee monitored the Commission's activities, accused the agency of "a fundamental shift in [its] attitude toward its responsibilities." *See SEC's Shad, Fedders Deny Commission Is Overemphasizing Insider Trading*, 14 Sec. Reg. & L. Rep. (BNA) No. 41, at 1785, 1785 (Oct. 22, 1982). Fedders denied the accusation, asserting, "There has been no conscious effort to avoid certain areas of the law." *Id.*

Nevertheless, at least one securities law practitioner observed two years later that a then-recent financial fraud case, in which the issuer was not named as a defendant, comported with Chairman Shad's practice of suing individuals and not companies in certain cases. *See SEC Enforcement, Financial Services, Accounting Issues Dominate SRI Meeting*, 17 Sec. Reg. & L. Rep. (BNA) No. 5, at 210, 211 (Feb. 1, 1985) (remarks of Arthur F. Mathews, Esq.).

223. The Commission under Chairman Shad's tenure was consistent in its determination to hold individuals responsible for securities law violations encountered by the agency. In a rejection of the so-called "Good Soldier" defense, the Commission ruled that middle and lower level corporate personnel who violate the federal securities laws by following the directives of their superiors should be sanctioned as principal wrongdoers. *See, e.g., In re Michael R. Maury*, Exchange Act Release No. 23,067, [1982-1987 Accounting and Auditing Enforcement Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,493 (Mar. 26, 1986) [hereinafter *Maury*], in which the Commission charged the Respondent, a vice president and controller of a public company, with causing the issuer's violations of Exchange Act § 13(a), 15 U.S.C. § 78m(a) (1982), and Rules 12b-20, 13a-1, and 13a-13 thereunder, 17 C.F.R. §§ 240.12b-20, 240.13a-1, 240.13a-13 (1989). In finding Respondent culpable for causing those violations, the Commission admonished that

Concerns about selective enforcement of the federal securities laws by the Commission are not new.²²⁴ During the 1980s, however, those issues resurfaced, and at least one court showed an interest in seeing the issue fully ventilated by the Commission before the court would affirm the agency's choice of sanctions.²²⁵

2. *Inadequate Statutory Framework*

Having identified its principal mission as ferreting out and prosecuting illegal insider trading, the Commission and its Enforcement Staff were confronted with several anomalies in the federal securities laws:

- (a) the federal securities laws do not expressly prohibit insider trading;
- (b) the crime of insider trading was not defined in any of the statutes or rules administered by the SEC;²²⁶ and

[a]lthough Maury may have made the appropriate recommendations to his corporate supervisors, when those recommendations were rejected, Maury acted as the 'good soldier,' implementing their directions which he knew or should have known were improper. . . . Maury's actions clearly failed to fulfill the duty Maury owed as corporate Controller.

Maury, at 63,334.

224. See, e.g., *Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 182 (2d Cir. 1976), *cert. denied*, 434 U.S. 1009 (1978); *Hiller v. SEC*, 429 F.2d 856, 859 (2d Cir. 1970) ("A finding of a 'gross abuse of discretion' might be supported by proof of the suggestion emphasized by counsel at oral argument that the Commission has consistently applied a different standard to the violations of 'large and powerful Wall Street establishments,' and thus exercised its powers discriminatorily"); *Winkler v. SEC*, 377 F.2d 517, 518 (2d Cir. 1967).

SEC Chairman Hamer Budge had espoused the view that the Commission should not selectively bring to bear the enforcement weapons at its disposal, and insisted that small securities firms be no more heavily sanctioned for their misdeeds than larger firms responsible for similar misconduct. See *TRANSFORMATION OF WALL STREET*, *supra* note 28, at 441.

225. See *Blinder, Robinson & Co., Inc. v. SEC*, 837 F.2d 1099, 1112 (D.C. Cir. 1988) ("we would be less than candid if we did not flag for the Commission our concern that petitioners have mounted a non-frivolous claim that they have been singled out for disproportionately harsh treatment") (emphasis supplied), *cert. denied*, 109 S. Ct. 177 (1988).

226. See *infra* note 245 and accompanying text. See generally *A Legislative Remedy*, *supra* note 3, at 9. As noted below, the remedies available to the Commission were significantly expanded in two legislative enactments. See *infra* notes 313-29, 371-407, and accompanying text.

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- (c) the federal securities laws provided only one express remedy for so-called insider trading: an injunction against future violations.²²⁷

Indeed, the Commission's principal weapon was the broad, catch-all antifraud provision of Section 10(b) of the Exchange Act²²⁸ (and Rule 10b-5 promulgated thereunder),²²⁹ which provided the basis for a series of judicial and administrative opinions inferring from those provisions a prohibition against trading securities while in possession of, or on the basis of, material, nonpublic information affecting the securities.²³⁰

This lack of statutory authority raised at least two questions for the insider trading enforcement program: First, precisely what conduct would, or perhaps more significantly, would not, provoke a government enforcement action for insider trading (or, from the opposite perspective, what conduct gave rise to a case that could be won)? And, second, if the government brought and won such an action, could courts fashion a remedy that would both properly address the conduct at issue, and deter others from similar misconduct in the future?

A war strategy that directs soldiers to battle against an undefined target is bound to suffer a measure of failure and frustration. The government's insider trading enforcement program of the early 1980s was no exception. While the government achieved some impressive victories, these victories were largely confined to the lower courts.²³¹ In the Supreme Court, the SEC suffered some significant defeats, which threatened to undermine the agency's war on insider trading.²³²

227. See Exchange Act §§ 21(d)-21(e), 15 U.S.C. §§ 78u(d)-78u(e) (1982).

228. 15 U.S.C. § 78j(b) (1982).

229. 17 C.F.R. § 240.10b-5 (1989).

230. See, e.g., SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (*en banc*), *cert. denied sub nom.* Coates v. SEC, 394 U.S. 976 (1969); *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961); *In re Ward La France Truck Corp.*, 13 S.E.C. 373 (1943).

231. See, e.g., United States v. Newman, 664 F.2d 12 (2d Cir. 1981) (upholding validity of misappropriation theory in government insider trading cases), *cert. denied*, 464 U.S. 863 (1983); SEC v. Musella, 678 F. Supp. 1060, 1063 (S.D.N.Y. 1988) (conscious avoidance of knowledge that information conveyed to defendants was from an unlawful, insider source does not defeat liability); SEC v. Lund, 570 F. Supp. 1397, 1402-03 (C.D. Cal. 1983) (person who becomes fiduciary of issuer by accepting confidential information will be treated as temporary insider for purposes of assessing Section 10(b) liability).

232. See *Dirks v. SEC*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980). *Chiarella* was technically a criminal prosecution and *not* an SEC enforcement action. Nevertheless, the SEC's lawyers took the lead in preparing the government's brief in the Supreme Court.

In essence, the Supreme Court's approach to the first insider trading cases with which it was confronted at the onset of the 1980s reflected a continuation of the Court's decidedly hostile approach to the SEC's expansive interpretation of the federal securities laws during the 1970s.²³³ The Court's antipathy toward the agency's use of Rule 10b-5 represented a potentially crippling blow to the SEC's insider trading program. In *Chiarella*,²³⁴ and again in *Dirks* some

233. During the 1970s, in a series of cases involving a variety of attempts to expand existing interpretations of the federal securities laws (mostly initiated by private plaintiffs), the Supreme Court:

1. Restricted the ability of lower courts to recognize new implied rights of action by private parties. *See, e.g.*, *TransAmerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979); *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979); *Cannon v. Univ. of Chicago*, 441 U.S. 677, 699 n.24 (1979) (citing with approval, *Standing To Sue*, *supra* note 127); *Piper v. Chris-Craft Indus.*, 430 U.S. 1 (1977);
2. Restricted the categories of persons deemed to have standing for previously recognized implied private rights of action. *See, e.g.*, *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); *cf. Piper v. Chris-Craft Indus.*, 430 U.S. 1 (1977);
3. Substituted a philosophy of literalism in interpreting the meaning and scope of various provisions of the federal securities laws, *see, e.g.*, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Blue Chip Stamps*, 421 U.S. 723 at 756-57 (Powell, J., concurring), for the Court's previously enunciated directive to the lower courts that they broadly construe the federal securities laws to accomplish their remedial purposes. *See, e.g.*, *Superintendent of Ins. v. Bankers Life and Casualty Co.*, 404 U.S. 6, 12 (1971);
4. Curtailed and limited the scope of the government's and private parties' causes of action under Section 10(b) and Rule 10b-5 thereunder, the principal weapon against insider trading. *See, e.g.*, *Aaron v. SEC*, 446 U.S. 680 (1980); *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Blue Chip Stamps*, 421 U.S. 723 (1975); and
5. Substituted great disdain, in place of its previously articulated respect and deference, for the SEC. *See, e.g.*, *SEC v. Sloan*, 436 U.S. 103 (1978); *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977); *Piper*, 430 U.S. 1 (1977); *Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232, 259-60 (1976) ("the Commission has not appeared as an amicus in this case. In any event . . . we would not afford [the Commission's views] the deference to which the views of the agency administering a statute are usually entitled . . ."); *Ernst & Ernst*, 425 U.S. 185 (1976); *Blue Chip Stamps*, 421 U.S. 723 (1975).

For a general review of the Supreme Court's attitude toward the federal securities laws and the SEC during the 1970s, *see* Pitt, *An SEC Insider's View of the Utility of Private Litigation under the Federal Securities Laws*, 5 SEC. REG. L.J. 3 (1977).

234. *Chiarella*, 445 U.S. 222 (1980).

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three years later,²³⁵ the Court expressed great concern about applying a generic *fraud* statute to most modern day insider trading cases—cases in which

- (a) the two parties to the securities transaction have never met, and do not know of each other's existence;
- (b) the alleged insider trader trades through an impersonal stock exchange, rather than face-to-face;
- (c) the alleged insider trader does not induce the other party to the trade to buy or sell the stock in question, and does not communicate with the other party to the trade in any manner whatsoever.²³⁶

Most insider trading during the late 1970s and the early 1980s reflected certain market trends that conformed the cases to this pattern.²³⁷ As a result, the SEC's war on insider trading seemed destined for significant curtailment or failure, at least in the absence of the legislative action the Court in *Chiarella* had exhorted Congress to take.²³⁸

Given the Supreme Court's suggestion that Congress make clear its intent with respect to the types of cases the Commission had begun to pursue, it would have been logical for the agency to prepare legislation to resolve any ambiguities in the law in favor of the agency's program. But, as noted above,²³⁹ the Commission's traditional distrust of, and uncertainty with, the legislative process caused it to refrain from seeking a legislative solution. Instead, the agency resorted to self-help in two discrete ways.

235. *Dirks*, 463 U.S. 646 (1983).

236. See Pitt, *After the Fall: The Ins and Outs of Rule 10b-5*, PLI, TWELFTH ANNUAL INSTITUTE ON SECURITIES REGULATION 603, 641-45 (1980).

237. *Insider Trading: Hearings Before the Subcommittee on Telecommunications, Consumer Protection and Finance of the House of Representatives Committee on Energy and Commerce*, 99th Cong., 2d Sess. 67-78 (1986) (testimony of Harvey L. Pitt).

238. The Court directed Congress to make its intentions clear, if insider trading legislation was to have its full force and impact. *Chiarella*, 445 U.S. at 227, 230, 234. The Court pointed to the lack of clear guidance from Congress with respect to the intended application of Section 10(b) to the conduct under review. *Id.* at 234.

239. See *supra* note 9 and accompanying text.

First, the Commission adopted a rule—Rule 14e-3²⁴⁰—designed to address some of the difficulties the Supreme Court pointed out in *Chiarella* with respect to Rule 10b-5. In order to extricate itself from some of the potential limitations of Rule 10b-5 and its governing statute, Exchange Act Section 10(b), the Commission adopted its new rule under Section 14(e) of the Exchange Act,²⁴¹ an arguably broader antifraud provision than Section 10(b),²⁴² but nonetheless a section with a more limited focus—namely, tender offers. As events during the 1980s subsequently proved, the adoption of Rule 14e-3 gave the Commission a potent new weapon that covered most, albeit not all, of the insider trading cases that were to arise.

Second, picking up on bits and scraps in the *Chiarella* and *Dirks* decisions, the SEC began developing new theories to circumvent the restrictions those decisions imposed on the agency's insider trading enforcement efforts. Principal among these was the development of the so-called misappropriation theory—that is, the theory that a person who misappropriates information for personal use when that information was made available to him or her (if in fact it was made available at all and not merely stolen) for another, legitimate purpose, breaches Rule 10b-5.

The agency's adoption of the misappropriation theory was not perceived as necessarily troubling as a substantive matter; indeed, some commentators concluded that there was merit to this approach.²⁴³ But, the adoption of this theory on an *ad hoc* basis, and in the absence of any legislative predicate for it, troubled scholars and commentators, irrespective of their overall support for the

240. 17 C.F.R. § 240.14e-3 (1989); Adoption of Tender Offer Fraud Policy, Exchange Act Release No. 17,120, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,646 (Sept. 4, 1980) [hereinafter SEC Rule 14e-3 Release] (adopting Rule 14e-3).

241. 15 U.S.C. § 78n(e) (1982).

242. Section 10(b) authorizes the Commission to adopt rules designed to prohibit manipulative or deceptive conduct. Section 14(e), by contrast, authorizes the Commission (i) to adopt rules designed to prohibit manipulative, deceptive or *fraudulent* conduct; and (ii) to adopt rules reasonably calculated to prevent such conduct. The Commission believed that the inclusion of the term "fraudulent" in Section 14(e) might give it greater power than a statute limited solely to manipulative and deceptive devices and contrivances. See SEC Rule 14e-3 Release, *supra* note 240, at 83,454. Those hopes were dashed when the Supreme Court ruled that Section 14(e)'s inclusion of the term "fraudulent" did not extend its coverage beyond conduct that was either deceptive or manipulative. See *Schreiber v. Burlington Northern*, 472 U.S. 1, 6-12 (1985).

243. See, e.g., Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101, 102 (1984) (misappropriation theory provides "convincing rationale for finding that outsiders violate Rule 10b-5").

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agency's enforcement program.²⁴⁴ Particularly as the agency's insider trading program began to gather momentum, and to attract the attention and involvement of criminal prosecutors, concerns were expressed that the agency had an obligation first to define the predicate offense of insider trading, expose that definition to public scrutiny and comment, and only then to pursue prosecutions based on such a definition.²⁴⁵

As the agency's self-help approach began to take shape, it was tested in the lower courts, and met with great success.²⁴⁶ For whatever reason, the lower courts were not troubled that the validation of the SEC's new theories required judges to embrace the inherent assumption that the SEC's ends—in this case, the curtailment of insider trading—somehow justified the agency's means, that is, the creation of theories of law without a proper statutory foundation or predicate, in order to meet the exigencies of specific cases and to evade the restrictions of negative precedents.²⁴⁷

Despite the problems caused by a lack of clear statutory law in the area, the Commission told Congress it was in no hurry to develop a legislative definition of insider trading.²⁴⁸ In particular, the agency expressed the fear that it might be impossible to craft a definition that could embrace all forms of wrongful insider trading and that, even if such a legislative definition could be achieved, a clear, bright-line definition might only assist potential wrongdoers to devise schemes designed to fall just beyond the reach of the prohibition.²⁴⁹ Not surprisingly, the Commission was willing to trade off uncertainty over the precise contours of the offense in exchange for retaining the flexibility to pursue new varieties of wrongdoing not yet within the contemplation of the lawmakers. For those subject to the agency's jurisdiction and enforcement program, this flexibility for the SEC came encumbered with a very heavy price—uncertainty about the parameters of the law.

244. See, e.g., *Definition of Insider Trading (Part I): Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 1st Sess. 17 (1987) (testimony of Harvey L. Pitt and John F. Olson) ("in so important an area of the law, 'judicial legislation' is . . . inappropriate"); see also Pitt, Olson & Shapiro, *1987 Insider Trading Proscriptions Act*, N.Y.L.J., June 25, 1987, at 5.

245. See *A Legislative Remedy*, *supra* note 3, at 7, 8.

246. See, e.g., *SEC v. Tome*, 638 F. Supp. 596 (S.D.N.Y. 1986), *aff'd*, 833 F.2d 1086 (2d Cir. 1987), *cert. denied sub nom. Combarfin v. SEC*, 108 S. Ct. 1751 (1988); *SEC v. Musella*, 678 F. Supp. 1060 (S.D.N.Y. 1988); *SEC v. Lund*, 570 F. Supp. 1397 (C.D. Cal. 1983).

247. See *Remarks of Harvey L. Pitt*, *supra* note 72.

248. See *infra* note 317 and accompanying text.

249. *Id.*

Despite these gaps, the Commission's program began bearing success. More insider trading cases were being settled, and those that were being litigated were largely, but by no means exclusively, resolved in the Commission's favor.²⁵⁰ Adopting a philosophy that the risks of insider trading should be substantially increased, the Commission attempted to compensate for the inherent limitation of its organic statutes by seeking the disgorgement of insider trading profits by those found guilty of illegal insider trading. This was not a new development: in the 1965 landmark *Texas Gulf Sulphur* case,²⁵¹ the Commission sought the disgorgement of ill-gotten gains by those whose trading was deemed illegal, and by those whose illegal tips enabled others to benefit.²⁵²

The difficulty with this approach, of course, is that the Exchange Act does not expressly provide for such a remedy.²⁵³ Moreover, even if courts universally were to adopt the Commission's theory that, by invoking the equitable jurisdiction of the court to consider the need for an injunction in light of its substantive insider trading charges, the SEC was also entitled to obtain a variety of equitable remedies including disgorgement,²⁵⁴ there were no statutory guidelines for the courts to follow.

For example, how should the profits gained by the defendant be measured?²⁵⁵ At what point should the nondisclosed information utilized by the defendant be deemed to have been made sufficiently

250. Compare SEC v. Reed, Litigation Release No. 9537, 24 SEC Docket 442 (S.D.N.Y. Dec. 23, 1981) (Reed disgorged profits from transactions in takeover target's options) with SEC v. Switzer, 590 F. Supp. 756 (W.D. Okla. 1984) (SEC litigated, and lost, case against hometown college football coach).

251. See SEC v. Texas Gulf Sulphur Co., Litigation Release No. 3196 (S.D.N.Y. Apr. 19, 1965) (LEXIS, Securities library, Releases file) (announcing filing of complaint seeking injunctive and ancillary equitable relief).

252. *Id.*

253. See *supra* note 227 and accompanying text.

254. The Supreme Court has never ruled on the Commission's entitlement to disgorgement under the Exchange Act, or other ancillary remedies under that Act. The agency has relied on New Deal-related Supreme Court decisions involving other agencies, see, e.g., *Porter v. Warner Holding Co.*, 328 U.S. 395 (1946), and on the language of the Exchange Act § 28: "The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity . . ." 15 U.S.C. § 78bb(a) (1982).

The lower courts have uniformly supported the agency's claim of entitlement to ancillary relief. Indeed, a recent decision by the United States Court of Appeals for the District of Columbia resoundingly affirmed the Commission's right to seek the full panoply of equitable remedies inherent in the equity jurisdiction of the federal courts set forth in the Exchange Act. See *infra* note 471. In light of the various amendments to the Exchange Act in 1984 and 1988, designed principally to deal with the phenomenon of insider trading, this issue may well be moot. See *infra* notes 314, 379-80, and accompanying text.

255. See *infra* notes 470-71 and accompanying text.

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public so that no further illegal profits would be realized by the defendant?²⁵⁶ What should happen to the funds disgorged or, put another way, who should be deemed to have a valid claim to those funds?²⁵⁷ These are substantive, not technical, issues involving important questions of policy.

To the extent that individuals profit from the misuse of inside information, few critics of the SEC would doubt the propriety of depriving those persons of their ill-gotten gains. But, the questions posed by such an approach reflect fundamental decisions best left to Congress, and not the judicial or administrative branches of government. Nonetheless, the SEC effectively seized the initiative on these issues: as the decade progressed, the SEC's entitlement to disgorgement began to be taken for granted.²⁵⁸

While disgorgement adequately separated these wrongdoers from their windfall gains, however, the number of insider trading cases that followed suggested that the threat of disgorgement had failed to deter other insider traders from abusing their informational

256. As long ago as 1968, the courts had asked the SEC to define when information is deemed to have been made public. *See SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 854 n.18 (2d Cir. 1968) (*en banc*) (urging Commission to specify when information becomes public, "to provide some predictability . . . for the business community"), *cert. denied sub nom.*, *Coates v. SEC*, 394 U.S. 976 (1969). The SEC attempted to do so, *see SEC Inquiry into Use of Undisclosed Material Information in Connection With Purchase or Sale of Securities*, Exchange Act Release No. 10,316, 2 SEC Docket 229 (Aug. 1, 1973), but ultimately abandoned the effort because of its difficulty. *See Pitt & Shapiro, New Act May Help Clarify Law*, 198 N.Y.L.J. 21, 27 (1987).

257. In most cases involving the disgorgement of ill-gotten insider trading profits, the defendants have settled with the SEC and have attempted to work out a formula for the disposition of those monies. At times, the Commission failed to provide adequately for the distribution of disgorged funds, including any monies remaining after the initial class of beneficiaries of the agency's settlement had been satisfied. *See, e.g., SEC v. Flight Transp. Corp.*, 699 F.2d 943, 945 n.2 (8th Cir. 1983) ("The SEC has not clearly stated to whom it wishes the 'disgorged' money to be paid"), *cert. denied*, 108 S. Ct. 1113 (1988); *SEC v. Gen. Host Corp.*, 438 F. Supp. 105, 108-09 (S.D.N.Y. 1977) (disgorged funds were not exhausted by private claimants and settlement agreement did not provide for disposition of remainder, so funds were returned to defendant). As a result, the Commission has been careful to make certain that under any and all circumstances, once funds have been disgorged by a settling defendant, those monies can never return to that defendant. Nonetheless, disputes still arise regarding the disposition of these monies, and the agency is still embroiled in litigation over the issue. *See, e.g., SEC v. Levine*, 881 F.2d 1165 (2d Cir. 1989) (prescribing allocation of disgorged funds among competing claimants, including defrauded investors and Internal Revenue Service).

258. Indeed, courts have upheld the Commission's entitlement to disgorgement even though they would not grant the injunctive relief the agency sought. *See SEC v. Ingram*, Litigation Release No. 11,739, 40 SEC Docket 1292 (C.D. Cal. May 16, 1988); *SEC v. Lund*, 570 F. Supp. 1397, 1403-04 (C.D. Cal. 1983) (court ordered disgorgement of profits from insider trading, but denied injunction upon finding that trade was an "isolated occurrence," unlikely to be repeated); *cf. SEC v. First City Fin. Corp.*, 688 F. Supp. 705 (D.D.C. 1988), *aff'd*, 890 F.2d 1215 (D.C. Cir. 1989).

advantages.²⁵⁹ More onerous penalties were thought appropriate, since a judicial order for disgorgement, requiring the defendant to "put the cookies back in the cookie jar,"²⁶⁰ no longer seemed adequate.

3. *The Commission's Evolving Response to Insider Trading*

While the Enforcement Division under the Shad-Fedders leadership had abandoned the pursuit of esoterica in favor of insider trading, a mainstream variety of fraud, great creativity and imagination were needed to develop a strategy to combat this wrong. One such response was the SEC's so-called Small Dollar program. In the past, some commentators had expressed the view that only greedy insider traders caught the eye of the regulators.²⁶¹ Because of the Commission's scarce resources, this impression was quite plausible.

The announcement, then, in March 1988, that the Commission had filed a civil injunctive action against two foreign insider traders, whose allegedly ill-gotten gains amounted to a relatively trifling \$9,156 and \$17,747, respectively,²⁶² seemed somewhat surprising.²⁶³ The Commission, however, pointed out that its selection of the case turned, in part, on the very paucity of the unlawful proceeds, observing that, "[i]n some cases people don't make a lot of money by design to try to avoid being detected. That is why [the SEC feels]

259. See articles cited *supra* note 3.

260. This phrase was used by one federal judge who refused to sign a consent decree in an SEC insider trading case, based on his dissatisfaction with the seemingly lenient terms of the defendants' proposed settlement. See *Judge Refuses Plea Settlement for Second Time*, Assoc. Press, Apr. 18, 1983 (AM Cycle) (LEXIS, NEXIS library, Wires file).

Judge William Orrick . . . rejected a proposed [SEC insider trading] settlement . . . calling for repayment of profits, saying it was an 'outrageous disposition' and a mere 'slap on the wrist.' . . . The penalty, Orrick said, 'seems to be no more than telling a person caught stealing cookies that he must return them to the cookie jar and agree never to do it again.'

Id.

As noted below, the Commission soon acquired the authority to seek from the federal district courts greater penalties in insider trading cases. See *infra* notes 314-15 and accompanying text.

261. See, e.g., *Insider Trading: Why It Can't be Stopped*, DUN'S BUS. MONTH, June 1984, at 48, 54.

262. See SEC v. Kerherve, Litigation Release No. 11,643, 40 SEC Docket 43 (S.D.N.Y. Jan. 13, 1988).

263. See *SEC Gains Settlement in Egyptian Case*, Wash. Post, Mar. 4, 1988, at B3, col. 1.

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it is important to pursue cases where the dollars are not large."²⁶⁴ The Commission has since brought a series of small dollar cases, confirming its initial admonition that minimal cupidity offers no assurance of escaping detection or enforcement action.²⁶⁵ The small dollar program should dissuade illicit behavior in situations where the stakes are relatively low and the costs of defending, or even quickly settling, an insider trading enforcement case vastly exceed the potential benefit of the wrongdoing.

There are, however, at least two perspectives from which to view the SEC's small dollar program. On the one hand, as noted, it could be viewed as an ingenious effort to discourage violations of insider trading by creating the impression that no violation of the federal securities laws is too insignificant to go unpunished. Particularly given the agency's limited resources, however, such an approach could not be maintained indefinitely; if it did not produce immediate success, it might well have to be curtailed in favor of a more efficient allocation of scarce enforcement resources.

On the other hand, the small dollar program may also reflect a different trend on the part of the Commission and its enforcement program. As the agency pursued its insider trading leads, its cases produced enormous visibility and, through the process of disgorgement and other remedies, meaningful monetary returns. An aggressive program of insider trading prosecutions is one way to deflect criticism from Congress and the media, and another way to generate favorable commentary. Those who practice before the agency noted a remarkable shift in the agency's enforcement efforts during the decade of the 1980s. Despite the agency's protestations to the contrary,²⁶⁶ the distinct impression emerged that agency personnel were affirmatively searching for insider trading cases, even in investigations largely devoted to other matters.

264. *Id.* The Commission also advanced another of its program goals with the successful resolution of an insider trading case against two foreigners trading securities in the United States markets. The ability of the agency to collect a one-times ITSA penalty from foreign investors was of significance to the Commission. *Id.*

265. *See, e.g.,* SEC v. Horwitz, Litigation Release No. 12,236, 44 SEC Docket 754 (C.D. Cal. Aug. 31, 1989) (disgorgement and penalty of \$1,696 and \$1,386, respectively); SEC v. Passov, Litigation Release No. 12,174, 44 SEC Docket 218 (N.D. Ohio July 24, 1989) (disgorgement of between \$4,950 and \$25,456, and range of up to "one-times" ITSA penalty); SEC v. Sparks, Litigation Release No. 11,916, 42 SEC Docket 396 (N.D. Tex. Nov. 21, 1988) (tipper paid penalty of \$1,919.50; trader disgorged \$1,919.50 and paid penalty in same amount).

266. *See SEC's Shad, Fedders Deny Commission Is Overemphasizing Insider Trading*, 14 Sec. Reg. & L. Rep. (BNA) No. 41, at 1785 (Oct. 22, 1982).

This is not surprising. There is an inherent appeal to cases arising out of trading in advance of important news about a security. And, apart from the high visibility and publicly-favorable response to insider trading cases, these cases are not always as intellectually challenging as other types of law enforcement cases brought by the SEC, such as complex market manipulations or financial frauds,²⁶⁷ or even technical and detailed broker-dealer compliance issues (as are extant in most of the so-called Penny Stock cases presently being pursued by some members of the Enforcement Division).²⁶⁸

4. *International Aspects of the SEC's Insider Trading Program*

The 1980s saw a significant movement toward globalized trading in interlinked capital markets. This development was accompanied by an increase in suspicious securities transactions originating outside the United States.

Historically, the SEC's Enforcement Division staff has always been skeptical about the *bona fides* of foreign cultural mores, foreign statutory schemes, foreign officials, and foreign courts.²⁶⁹ And, as a matter of sheer presumptive intuition, the existence of a foreign bank account, for instance, much like the invocation of the privileges accorded a witness under the Fifth Amendment,²⁷⁰ always has been

267. Indeed, early in the Commission's insider trading program, Fedders observed that insider trading cases could be concluded in far less time than was needed for complex financial fraud cases. See *SEC Should Consider Revised Policy on Modifying Injunctions*, Fedders Says, 15 Sec. Reg. & L. Rep. (BNA) No. 46, at 2143, 2145 (Nov. 25, 1983) ("insider trading cases can be brought in three or four months. The financial fraud cases take a lot more energy, resources, and time to bring in . . .").

268. This is not meant to denigrate the enormous effort some of these insider trading cases require; see *The Mysterious 'Coincidences' in Insider Trading Cases*, BUS. WK., Sept. 8, 1986, at 76, col. 1. Put another way, though, insider trading cases often require more in the way of the skills of Sherlock Holmes than of Oliver Wendell Holmes!

269. See generally Pitt, Hardison & Shapiro, *Problems of Enforcement in the Multinational Securities Market*, 9 U. PA. J. INT'L BUS. L. 375 (1987) [hereinafter *Problems of Enforcement*].

270. Through the 1970s, a witness' decision to invoke his or her Fifth Amendment right against self-incrimination was believed invariably to lead the Enforcement Division staff to recommend the institution of an enforcement proceeding against that person. Today, with the increasingly frequent involvement of criminal prosecutors in securities law cases, the invocation of Fifth Amendment rights is no longer a reason, *in and of itself*, for the staff to recommend an enforcement proceeding, although the majority of cases in which the Fifth Amendment is invoked will still produce that result. See, e.g., *SEC v. Comserv Corp.*, 698 F. Supp. 784 (D. Minn. 1988), in which the Commission sought to defend a claim against the agency for attorney's fees and expenses, pursuant to the EAJA. The Commission argued that the action brought against an officer of Comserv Corporation was justified solely by reference to the officer's assertion of his Fifth Amendment privilege during the agency's initial investigation. See *Comserv Corp.*, 698 F. Supp. at 789. The court ruled against the Commission, holding that, absent other evidence, the assertion of the Fifth Amendment

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viewed as a hallmark of fraud by the SEC staff.²⁷¹ This, in part, explains some of the SEC's difficulty during its foreign payments program of the 1970s, when the agency found itself at odds with the Department of State.²⁷²

In that context, the Commission's insider trading program was potentially an open invitation to similar international disputes. It quickly dawned on many with a venal bent that insider trading most effectively could be performed from abroad.²⁷³ Through the use of a Swiss Bank Account, or a bank account in a variety of other foreign bank secrecy jurisdictions, and by utilizing Panamanian corporations²⁷⁴ or Liechtenstein Anstalts,²⁷⁵ Americans and foreign

privilege "[was] not a sufficient basis for the SEC's action." *Id.* See also *Pagel, Inc. v. SEC*, 803 F.2d 942, 946-47 (8th Cir. 1986) (citing *Baxter v. Palmigiano*, 425 U.S. 308, 317 (1976)).

271. See generally *Problems of Enforcement*, *supra* note 269.

272. See, e.g., *SEC v. Lockheed Aircraft Corp.*, 404 F. Supp. 651 (D.D.C. 1975).

273. See *Problems with the SEC's Enforcement of U.S. Securities Laws in Cases Involving Suspicious Trades Originating from Abroad: Hearing Before a Subcomm. of the House Comm. on Government Operations*, 100th Cong., 2d Sess. 75, 83-85 (1988) (testimony of Harvey L. Pitt).

274. Prior to the political crises resulting from the charges of corruption leveled against Panama's president, Manuel Noriega, Panama was regarded as "the Western Hemisphere's primary financial and trading tax haven." 3 W. DIAMOND & D. DIAMOND, *TAX HAVENS OF THE WORLD*, at Panama-1 (1989) [hereinafter *TAX HAVENS*]. Panamanian corporations have no minimum capital requirement, and shares, if registered, need not be fully paid in. Ownership in the corporation can be evidenced by bearer shares (in which case, the shares must be fully paid in). *TAX HAVENS* at Panama-21. There must be at least two shareholders for the purpose of electing a board of directors of three to eleven persons, who need not hold shares in the company. After incorporation, the number of shareholders may be reduced to one. There are no citizenship requirements except for the appointment of a resident statutory agent, who is generally the incorporating attorney. *Id.*

Bearer shares of a Panamanian corporation allow ownership to be kept confidential; these shares are freely transferable from one individual to another merely by transferring possession of the share certificates. Other features of Panamanian incorporation include: (i) banking secrecy laws, (ii) no taxation of income produced from sources outside the country, and (iii) investment and capital incentives. See *TAX HAVENS* at Panama-2, 6; *Banking Law of Panama*, Law No. 16, Arts. 2-4 (Jan. 28, 1959).

For examples of instances where Panamanian corporations have been involved in violations of the federal securities laws, see, e.g., *SEC v. Levine*, Civ. Action No. 86-3726 (S.D.N.Y. filed May 12, 1986) (alleging defendant Levine made securities trades based on inside information through two Panamanian corporations beneficially owned and controlled by Levine) (a copy of this Complaint is on file with authors); *In re Joseph A. Lugo*, Admin. Proc. File No. 3-6740 (LEXIS, Securities library, Releases file) (May 10, 1988) (Panamanian bearer stock corporation involved in scheme to defraud investors); *SEC v. Palmer Fin. Corp.*, Litigation Release No. 12,082, 43 SEC Docket 1230 (D.D.C. May 3, 1989) (violations of Sections 13(d) and 16(a) of the Exchange Act).

275. A Liechtenstein Anstalt or Establishment is a special type of corporation which in practice serves as an international holding company (holding financial or controlling interests in foreign corporations) with its residence in Liechtenstein. 2 *TAX HAVENS*, *supra* note 274, at Liechtenstein-5. The Anstalt may be formed with only one founder or promoter, who may be a Liechtenstein representative acting for an anonymous owner. *Id.* at Liechtenstein-17. Features of the Liechtenstein Anstalt include: (i) no restrictions on

nationals alike could attempt to conceal their identities while pursuing illegal securities trades predicated upon inside information. As a result, early in the decade, the Commission's insider trading program confronted the formidable combination of foreign bank secrecy or blocking statutes,²⁷⁶ foreign entities organized to mask the true identities of their owners, and illegal insider trading, often immediately in advance of the announcement of a takeover.²⁷⁷

If anything, the difficulties presented by foreign trades dwarfed the legislative and remedial difficulties confronted by the SEC *vis-a-vis* domestic insider trading.²⁷⁸ Not only was there no law regulating many of the details of this activity, but the Commission had to confront a host of cultural,²⁷⁹ procedural,²⁸⁰ jurisdictional,²⁸¹

debt-equity ratio, (ii) low taxation rates, and (iii) the option of concluding a contract with the Liechtenstein tax authorities guaranteeing the entity's present tax rate for a period of up to thirty years. *Id.* at Liechtenstein-5 to -6. Recently, the United States assets of Finacor Anstalt, a Liechtenstein firm, were frozen by a federal district court in connection with charges of insider trading brought by the SEC. See *Finacor's U.S. Assets Frozen as SEC Files Insider-Trading Suit*, Wall St. J., Nov. 29, 1989, at A3, col. 4.

276. Generally speaking, bank secrecy laws protect an individual's right to confidentiality of information relating to the individual's banking relationships. The confidentiality of this information is a personal right that can be waived by the true account holder. Some countries have adopted blocking laws, either in addition to, or in the absence of, bank secrecy statutes, which address national interests in preserving the confidentiality of specified types of information. No individual can waive the application of these statutes even as to personal information. Only the sovereign can waive the barrier to disclosure of this information. See *Problems of Enforcement*, *supra* note 269, at 402-14.

277. See *supra* note 273 and accompanying text.

278. See *supra* notes 226-27 and accompanying text.

279. In many foreign jurisdictions, at the beginning of the 1980s, insider trading was simply not illegal. See *Problems of Enforcement*, *supra* note 269, at 390-92. Indeed, in some foreign jurisdictions, insider trading was viewed as an affirmative right of corporate insiders. Tunc, *A French Lawyer Looks at American Corporation Law and Securities Regulation*, 130 U. PA. L. REV. 757, 762 (1982) (tipping considered "a social duty . . . expected of relatives and friends" in France); Akashi, *Regulation of Insider Trading in Japan*, 89 COLUM. L. REV. 1296, 1296 (1989) (until recently, Japanese investors were "allowed, and sometimes even encouraged, to act upon inside information"); *Insider Trading in New Zealand, 'Deplorable' But Legal*, Wall St. J., May 28, 1987, at 26, col. 1 (insider trading "is considered a way of life [in New Zealand]" says founder of Insider Trading Hotline).

280. The United States is a signatory to the Hague Convention on the Taking of Evidence Abroad in Civil or Commercial Matters (Convention) which provides for three of the most common methods of foreign discovery: by letters rogatory, evidence-taking by a consular official, and evidence taking by private commissioners. The Convention is of no assistance to the SEC during an investigation, however, as it is only available for use in actual litigation.

281. The federal securities laws authorize the SEC to subpoena evidence from anywhere in the world, so long as service has been properly effected in the United States. See, e.g., *SEC v. Minas de Artemisa, S.A.*, 150 F.2d 215 (9th Cir. 1945). United States administrative agencies, however, generally do not have the power to compel persons outside the United States, who have no contacts with the United States, to produce evidence for an investigation or to appear in court. See, e.g., *Commodity Futures Trading Comm'n*

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and substantive²⁸² restrictions on its efforts to pursue an insider trading investigation or prosecution.

The Commission showed remarkable dexterity in tackling these obstacles. The agency invoked a bifurcated approach to the problem, and developed legal theories designed to assist at least one aspect of these efforts. Thus, the SEC quickly concluded that, since insider trading reflects a crime of greed, it should respond in a manner most calculated to get the attention of those whose greed had caused the violation. Since most of the trades at the beginning of the 1980s were effected in the United States,²⁸³ and since the SEC could ascertain the identity of the agent that had placed and executed the orders for the illegal trades, the Commission began to apply pressure to the foreign banks with assets in this country, and United States brokerage firms at which those banks held their accounts.²⁸⁴

With assistance from a receptive federal judiciary, principally courts in the Southern District of New York, which took a dim view of the conduct necessitating the agency's claims for extraordinary relief, the SEC sought to assert jurisdiction over foreign nationals and foreign banks, using foreign assets present in New York as an effective lever for obtaining the attention of those foreign nationals

v. Nahas, 738 F.2d 487 (D.C. Cir. 1984). Even if the SEC were aware of the identity of an insider trading violator, that person might not be physically present in the United States. Obtaining jurisdiction over such persons became a major problem for the agency. *See, e.g., SEC v. Tome*, 833 F.2d 1086 (2d Cir. 1987), *cert. denied*, 108 S. Ct. 1751 (1988).

282. The SEC's capacity to obtain information from abroad was subject to a number of restraints including, among other things, foreign nondisclosure principles and restrictions on the agency's ability to obtain testimony and other discovery from foreign nationals. *See, e.g.,* Article 28 of the Swiss Civil Code (authorizing individuals whose privacy has been invaded to sue for damages and injunctive relief) and Article 47 of Switzerland's Banking Law of 1934 (prescribing criminal penalties for the disclosure of confidential information acquired in the course of providing banking services, as well as attempts to induce bank personnel to disclose such information). For a more detailed survey of various foreign nondisclosure laws, *see Problems of Enforcement, supra* note 269, at 402-15; *see also* Internationalization of the Securities Markets, Report of the Staff of the U.S. Securities and Exchange Commission to the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Energy and Commerce, at VII-31 to VII-38 (1987).

283. By the latter part of the decade, global trading had arrived, and with it the opportunity to trade United States securities on foreign exchanges. *See Fraud Overseas Will Force Action on Secrecy Laws, Lynch Says*, 17 Sec. Reg. & L. Rep. (BNA) No. 43, at 1927 (Nov. 1, 1985); *see also Global Investing More Complex as Markets End Wild Year*, N.Y. Times, Jan. 4, 1988, at D3, col. 1 ("Global investing is here to stay, experts say . . ."). Nonetheless, most of the trading in New York Stock Exchange-listed securities is still conducted in the United States. *See PROBLEMS WITH THE SEC'S ENFORCEMENT OF U.S. SECURITIES LAWS IN CASES INVOLVING SUSPICIOUS TRADES ORIGINATING FROM ABROAD*, H.R. REP. NO. 1065, 100th Cong., 2d Sess. 3 (1988).

284. *See, e.g., SEC v. Certain Unknown Purchasers*, No. 81-Civ-6553 (S.D.N.Y. July 25, 1983); *SEC v. Banca Della Svizzera Italiana*, 92 F.R.D. 111 (S.D.N.Y. 1981).

and entities caught up in the SEC's investigative efforts.²⁸⁵ At the same time, the agency began direct negotiations with foreign governments to develop a methodology by which the SEC's investigations could continue.²⁸⁶ The result was a series of so-called Memoranda of Understanding (MOUs), pursuant to which the SEC could seek to invoke the cooperation of foreign nondisclosure jurisdictions.²⁸⁷

Much of the SEC's efforts to bypass procedural and jurisdictional impediments in foreign matters involved the same creativity in devising legal theories as did the agency's development of theories

285. See cases cited *supra* note 284; see also *Finacor's U.S. Assets Frozen as SEC Files Insider-Trading Suit*, Wall St. J., Nov. 29, 1989, at A3, col. 4 (noting recent freeze placed on U.S. assets of Finacor); *SEC v. Levine*, No. 86-3726 (S.D.N.Y. May 12, 1986) (order freezing assets).

286. See generally *Problems of Enforcement*, *supra* note 269.

287. See Understanding Regarding the Establishment of a Framework for Consultations Between the Securities and Exchange Commission and the Commission des Operations de Bourse (Dec. 14, 1989) (France); Agreement Between the United States of America and the Kingdom of the Netherlands on Mutual Administration Assistance in the Exchange of Information in Securities Matters (Dec. 11, 1989); Communiqué on Exchange of Information Between the United States Securities and Exchange Commission and the Commissione Nazionale per La Società e La Borsa (Sept. 20, 1989); Memorandum of Understanding and Comissão De Valores Mobiliários (Brazil) (July 1, 1988); Memorandum of Understanding Between the United States Securities and Exchange Commission and Ontario Securities Commission, Commission Des Valeurs Mobilières Du Québec and British Columbia Securities Commission (Jan. 7, 1988); Memorandum of Understanding on Exchange of Information Between the United States Securities and Exchange Commission and the United Kingdom Department of Trade and Industry In Matters Related to Securities and Between the United States Commodities Future Trading Commission and the United Kingdom Department of Trade and Industry In Matters Relating to Futures (Sept. 23, 1986); Memorandum of the United States Securities and Exchange Commission and the Securities Bureau of the Japanese Ministry of Finance on the Sharing of Information (May 23, 1986); Memorandum of Understanding Between the Government of the United States of America and the Government of Switzerland (to establish mutually acceptable means for improving international law enforcement cooperation in the field of insider trading) (Aug. 31, 1982) [hereinafter *Swiss MOU*].

The Swiss MOU was designed to fill a gap in a treaty of broader application, governing law enforcement in criminal cases. This treaty provided that the two countries would provide investigative and certain other assistance with respect to conduct that was subject to criminal prohibitions in both countries. See *Treaty on Mutual Assistance in Criminal Matters Between the Swiss Confederation and the United States*, May 25, 1973 (effective 1977), 27 U.S.T. 2019 [hereinafter *Swiss Treaty*]. This dual criminality requirement, however, cast insider trading cases beyond the scope of the Swiss Treaty since, until recently, insider trading was not prohibited in Switzerland. Thus, the SEC's ability to gather information was frustrated by Switzerland's bank secrecy laws when the agency sought to investigate suspicious securities transactions directed through Swiss accounts.

The Swiss MOU overcame that obstacle; the agreement was drafted to expire, by its own terms, upon the effective date of Swiss legislation prohibiting insider trading. The Swiss criminal prohibition on insider trading became effective on July 1, 1988, thus triggering the expiration of the Swiss MOU. See the Swiss Penal Code, Art. 161; see also Hermann, *Prompt Disclosure Can Pre-empt Insider Trading*, *Fin. Times* (U.K.), Aug. 18, 1988, at 23, col. 5.

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to circumvent the absence in the Exchange Act of any definition of the offense of insider trading. The SEC's foreign-based activities, however, did not produce the same outcry that its domestic endeavors did. In large measure, the SEC's efforts produced a slow (sometimes tedious), but generally successful, process by which foreign-based trading became less problematic for the agency.²⁸⁸

The MOU mechanism has proven to be a valuable tool for the Commission. The most visible product of these agreements has been in the area of enforcement actions.²⁸⁹ It should, however, be anticipated that the 1990s will see an increase in reciprocal assistance with inspection, market surveillance, and other preventive functions that will both reduce the incidence of securities law violations and streamline the smooth operations of an increasingly globalized capital market.

5. Heightened Emphasis on the Criminal Components of Insider Trading

From 1942, when Rule 10b-5 was first promulgated,²⁹⁰ until 1978, when an indictment was handed down in the *Chiarella* case,²⁹¹ there had been a total of thirty-six insider trading actions brought by the SEC,²⁹² but absolutely no criminal prosecutions for insider trading by federal criminal prosecutors.²⁹³ Although the public record is devoid

288. See, e.g., *Financial Analyst, Father Settles Charges of Inside Trading on RCA Stock*, 18 Sec. Reg. & L. Rep. (BNA) No. 32, at 1157 (Aug. 8, 1986) (assistance under the Swiss MOU); see also *Liechtenstein Firm Faces SEC Charges of Inside Trading*, Wall St. J., Nov. 20, 1989, at A11, col. 3; *Rules for the Global Market*, Fin. Times (U.K.), Nov. 17, 1987, at 20, col. 3 (describing the SEC's assistance, pursuant to the United Kingdom MOU, in the United Kingdom prosecution of insider trading in connection with the Guinness-Distillers transaction). This is not to say that the SEC is without its critics in the international sphere. Oddly, however, much of its criticism stems from Congressional concerns that the agency is still not sufficiently effective when it comes to foreign-based trading in United States securities. See PROBLEMS WITH THE SEC'S ENFORCEMENT OF U.S. SECURITIES LAWS IN CASES INVOLVING SUSPICIOUS TRADES ORIGINATING FROM ABROAD, H.R. REP. NO. 1065, 100th Cong., 2d Sess. 2-6 (1988). See also *infra* note 438 and accompanying text. Legislation currently pending before Congress would improve the Commission's bargaining position with foreign governments, as it seeks additional agreements for mutual cooperation. See *infra* notes 423-28 and accompanying text.

289. See, e.g., SEC v. Katz, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,867, at 94,226 (S.D.N.Y. Aug. 7, 1986) (information obtained pursuant to terms of Swiss MOU); see also articles cited *supra* note 88.

290. See Exchange Act Release No. 3230 (May 21, 1942) (LEXIS, Securities library, Releases file).

291. See *United States v. Chiarella*, 445 U.S. 222 (1980).

292. See *SEC Defends Enforcement Rate*, Wash. Post, Oct. 20, 1982, at D8, col. 1 ("Since 1978, 50 [insider trading] cases have been brought, compared with 36 in all the years since 1934").

293. See *Chiarella*, 445 U.S. at 235 n.20.

of a definitive explanation for this lack of criminal insider trading prosecutions, these statistics do speak for themselves, and may reflect the fact that insider trading was not perceived as an attractive subject for criminal prosecution.

Moreover, there is some reason to believe that the infirmities in the statutory authority discussed above²⁹⁴ may have been more disconcerting to criminal prosecutors than to the SEC, in part reflecting the different prosecutorial standards each must meet.²⁹⁵ Indeed, so diverse were the SEC's and the Justice Department's perceptions of the law of insider trading at the beginning of the decade, that the Department of Justice affirmatively opposed the SEC's defense of its administrative decision on the subject of insider trading in the *Dirks* case before the Supreme Court,²⁹⁶ forcing the Court to resolve the differences between the two government agencies, with predictable support for the Department of Justice from Mr. *Dirks*,²⁹⁷ and with predictable results from the Court.²⁹⁸

When prosecutors for the Southern District of New York finally did take an interest in insider trading cases, they did not meet with immediate success. Apart from the *Chiarella* decision,²⁹⁹ the *Reed* case reflected a significant setback in the criminal portion of the insider

294. See *supra* notes 226-27 and accompanying text.

295. The SEC is able to prevail in its cases if it can prove its allegations by a preponderance of the evidence adduced. See, e.g., *Herman & McLean v. Huddleston*, 459 U.S. 375, 390 (1983). Criminal prosecutors, however, must prove their charges beyond a reasonable doubt. See, e.g., *In re Winship*, 397 U.S. 358 (1970). Since most litigated insider trading cases do not involve objective evidence or confessions of wrongdoing, criminal prosecutions must confront an "explanation" by the defendant for his or her securities trades that may satisfy the jury that a reasonable doubt exists. See, e.g., *Jury Clears Reed in Amex Case*, N.Y. Times, Dec. 17, 1985, at D1, col. 6.

296. "The Solicitor General is of the view that the holding of the court of appeals is in conflict with this Court's decision in *Chiarella v. United States*, . . . [and] that the decisions of the SEC and the court of appeals have a potential adverse effect on federal criminal law enforcement." Brief of the SEC in Opposition at 17-18, *Dirks v. SEC*, 463 U.S. 646 (1983) (No. 82-276) (dissenting footnote of the Solicitor General).

297. "The views of the Solicitor General that the position of the SEC and the decision below are not only wrong and inconsistent with this Court's ruling, but are potentially harmful to federal criminal law enforcement, amply demonstrate that this case should be reviewed by the Court." Petitioner's Reply Brief in Support of Petition for Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit at 3, *Dirks v. SEC*, 463 U.S. 646 (1983) (No. 82-276).

298. The Court, of course, sided with the Department of Justice. See *Dirks*, 463 U.S. at 665 n.25. Under the circumstances, it would have been difficult for the Court to do anything else. If the Justice Department could not agree with the SEC on what the laws against insider trading covered, how could Mr. *Dirks* be expected to comply with those laws? See Pitt & Ain, '*Dirks*' Deals Blow to SEC Insider Program, *Legal Times*, July 11, 1983, at 10.

299. See *supra* note 37 and accompanying text.

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trading program, as juries seemed ready to believe almost any explanation for alleged wrongdoing.³⁰⁰ Nevertheless, criminal prosecutions were to become an important part of the SEC's renewed focus on insider trading. To accomplish this result, the agency actively publicized its own insider trading activities,³⁰¹ and renewed its relationships with both the Department of Justice and the United States Attorney's Office for the Southern District of New York.³⁰² Eventually, the number of criminal prosecutions for illegal insider trading increased exponentially.

Having developed a renewed interest in securities law enforcement, the Department of Justice and various United States attorneys began to pay closer attention to the SEC's enforcement program, with the concomitant result that more and more activities ferreted out by the SEC are of greater interest to criminal law enforcement authorities. This has prompted some to decry the criminalization of the federal securities laws, and to claim that the SEC now is dominated by criminal law enforcement authorities.³⁰³

The simple response, however, is that the SEC's insider trading program led it to uncover a significant scandal on Wall Street, which greatly interested not only the SEC but criminal law enforcement authorities as well. Given the severity and magnitude of the alleged wrongdoing, it is not surprising that more criminal prosecutions

300. The jury apparently was prepared to credit Mr. Reed's explanation that he decided to purchase stock options for the first time in his life, and that there was nothing untoward about the facts that (i) those options covered the securities of the company on whose board of directors his father sat, (ii) the options were purchased immediately following a telephone call to Reed from his father, and (iii) the call came immediately after the board of directors meeting at which material, nonpublic, inside information relating to the issuer of the stock underlying the options was communicated to the board and Reed's father. For a full exposition of the facts in *Reed*, see *United States v. Reed*, 601 F. Supp. 685 (S.D.N.Y.), *rev'd*, 773 F.2d 477 (2d Cir. 1985).

301. Prosecutors do look at public perceptions. As the Commission's insider trading program gained substance and popular acclaim, it appeared to become more attractive to criminal authorities as a vehicle for securities law prosecutions.

302. See *Supreme Court Double Jeopardy Ruling May Affect SEC Enforcement, Lynch Says*, 21 Sec. Reg. & L. Rep. (BNA) No. 29, at 1104, 1104 (July 21, 1989) ("As a result of the [Court's] decision, [Lynch] said the SEC Enforcement Division will have to increase its coordination with the Justice Department").

303. See *U.S. Attorney Giuliani to Step Aside; Deadline on Drexel Settlement Extended*, 21 Sec. Reg. & L. Rep. (BNA) No. 2, at 63, 63 (Jan. 13, 1989) ("Under Giuliani, the U.S. Attorney's office helped 'criminalize' many securities law violations"); *Insider Trading, Internationalization, Rule '144A' Discussed at ABA Conference*, 19 Sec. Reg. & L. Rep. (BNA) No. 33, at 1242, 1243 (Aug. 14, 1987) ("Other 'mischief that has resulted [from the insider trading scandal] is the criminalization of things that up to now have been viewed as technical violations of the securities laws, such as 'net capital violations, § 13(d) violations, parking . . . books and records'").

would arise.³⁰⁴ The result of the Commission's renewed effort to attract the attention of criminal law enforcement authorities has not always been salutary, however.

For one thing, the SEC cannot, and will not, give assurances regarding the possibility of criminal prosecution should a defendant settle with the agency.³⁰⁵ Consequently, defendants who are enmeshed in SEC enforcement investigations must decide whether a settlement with the agency will produce greater or lesser interest on the part of criminal authorities in commencing their own prosecution of the defendant.³⁰⁶ Undoubtedly, some will conclude that a settlement with the SEC will produce greater criminal interest, and thus the SEC may find itself forced to litigate more insider trading cases in the future.

304. Some of the criticism directed at the SEC and the United States Attorney's Office for the Southern District of New York is decidedly misplaced. Both have been attacked for making trivial or technical securities law violations the subject of criminal prosecutions. Particular reference is made to prosecutions for the evils of "parking" and noncompliance with net capital requirements. *See Has the SEC Abdicated Its Role as Cop?*, Nat'l L.J., Apr. 6, 1987, at 3 ("In the last 30 or 40 years not one practitioner would have even guessed that a net capital violation would result in a criminal prosecution") (citations omitted).

Parking connotes circumstances in which the true ownership of securities is masked by nominee arrangements. *See Champion Parts, Inc. v. Oppenheimer & Co.*, 878 F.2d 1003, 1005 (7th Cir. 1989). Parking is not a trivial violation of the federal securities laws, however. The essence of virtually every provision of the federal securities laws is stock ownership. If stock ownership can be masked, the application of many of the provisions of the federal securities laws, including the ban against insider trading, will be undermined.

In order to ensure the safety of customer funds and securities, and to protect other securities brokers and dealers, every brokerage firm must meet certain minimum net capital requirements. *See Exchange Act* § 15(c)(3), 15 U.S.C. § 78o(c)(3) (1982). Prior to 1975, the net capital requirements were one of the few provisions of the federal securities laws the violation of which did not give rise to criminal liability. *See Securities Exchange Act of 1934*, Pub. L. No. 73-291, 48 Stat. 881 (1934). In 1975, however, Congress amended the Exchange Act, and, among other things, specifically provided that the violation of *any* requirement under the Act could give rise to the assertion of criminal liability. *See Securities Act Amendments of 1975*, Pub. L. No. 94-29, 89 Stat. 97 (1975). While net capital requirements are technical, their impact on other broker-dealers and on customers is not highly technical. *See, e.g., Blaise D'Antoni Assoc. v. SEC*, 289 F.2d 276, 277 (5th Cir. 1961) ("The net capital rule is one of the most important weapons in the Commission's arsenal to protect investors"); *see also In re Hankoff*, Exchange Act Release No. 24,390, 38 SEC Docket 220 (Apr. 24, 1987); *In re Sloan*, Exchange Act Release No. 11,376, 6 SEC Docket 772 (Apr. 28, 1975). Moreover, the cases in which net capital violations have been charged criminally have all been settled actions, in which it is more likely than not that negotiations between the defendant and the prosecutors limited the charges to net capital violations. *See, e.g., United States v. Davidoff*, No. 87 Cr. 78 (S.D.N.Y. Jan. 28, 1987) (Davidoff consented to permanent injunction against further violations of net capital requirements); *United States v. Lewis*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,479 (S.D.N.Y. June 15, 1989); *United States v. Jefferies*, No. 87 Cr. 339 (S.D.N.Y. Apr. 16, 1987).

305. *See supra* note 110.

306. *See Practical Perspectives, supra* note 121, at 375-77.

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Similarly, because the Commission has been so successful in attracting the attention of criminal prosecutors, defendants can assume that, increasingly, they will be prosecuted criminally regardless of whether they settle with the SEC. To the extent that the Commission is prepared to proceed first,³⁰⁷ and that discovery against the SEC is broader than discovery against criminal law enforcement prosecutors,³⁰⁸ the agency may also find that an increased litigation burden is a logical outcome of its persuasiveness with criminal prosecutors.

6. Legislative Initiatives and Responses

Ultimately, the most enduring legacy of the Commission's war on insider trading will be the fruits of its various legislative initiatives. During the 1980s, the Commission embarked upon an active and largely successful campaign of legislative advocacy, proposing a number of bills to expand its authority and clarify the law.

As noted above,³⁰⁹ prior to the 1980s, the Commission had traditionally eschewed Congress' assistance, in the form of legislation, particularly where the party dominating Congress is not the party

307. As a practical matter, if both the SEC and the criminal authorities are prepared to bring an action at the same time, only the criminal prosecution will be allowed to proceed. *See generally* United States v. LaSalle Nat'l Bank, 437 U.S. 298 (1978) (holding that a civil summons issued during the pendency of a parallel criminal proceeding will not be enforced).

308. Civil discovery is significantly broader than criminal discovery. *See* FED. R. CIV. P. 26 (scope of discovery includes any non-privileged matter relevant to the subject matter involved in the pending action). *Cf.* FED. R. CRIM. P. 16 (defendant only entitled (i) to examine and copy any relevant written statements of defendants, (ii) to learn the substance of any oral statement of defendant to be offered into evidence, and (iii) to inspect and copy any books, papers, photographs, and tangible objects within the control of the government which are material to preparation of defendant's defense or constitutes the prosecution's evidence in chief). Of course, if the SEC's enforcement proceeding is brought before an administrative law judge, the amount of discovery the defendant will receive is more limited than civil discovery, although still broader than criminal discovery. *See* 17 C.F.R. § 201.8(d) (1987). The rule provides in pertinent part:

[T]he hearing officer, at the request of any party or upon his own motion, . . . may in his discretion and with due regard for the convenience and necessity of the parties or their attorneys, order a party, including the interested division, to furnish where practicable any or all of the following: An outline of its case or defense; the legal theories upon which it will rely; the identity of the witnesses who will testify on its behalf; and copies of or a list of documents which it intends to introduce at the hearing.

Id.

309. *See supra* note 239 and accompanying text.

comprising a majority of the SEC. There are a number of reasons for this phenomenon.

First, the Commission is reluctant ever to admit that it does not possess all the legislative authority it needs. The agency seems to fear that, by seeking legislation, it will be deemed to have conceded that it lacked the authority it sought in the first place.³¹⁰

Second, the Commission is skeptical about the legislative process. Since the agency has generally lacked political acumen,³¹¹ it has worried that, once the process starts, others will wield greater influence with Congress than the Commission will, resulting in a final legislative product that will not meet the agency's needs.

Finally, the Commission has always been concerned that the legislative process will produce substantially greater scrutiny for the subject of the particular legislative proposal than would otherwise be the case, and that, upon closer examination, Congress may not approve of the Commission's various approaches to the issues involved.³¹²

The insider trading enforcement program, however, prompted reciprocal interest by the Commission and Congress in closer scrutiny of the agency's program. From the Commission's perspective, the growing success of its program in the early part of the decade suggested the timing was right to seek additional remedies with which to attack the problem. This, in the long run, would enhance the agency's capacity to pursue its program with even greater effectiveness. By the same token, the high degree of visibility garnered by the SEC's insider trading program made it a

310. The SEC has rational basis for this fear. *See, e.g.*, *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 732-33 (1975) (Congress' failure to adopt legislation requested by the SEC is evidence that the existing statutes administered by the agency do not extend to cover the conduct for which legislation was sought).

In two recent legislative proposals, the Commission has not hesitated to state that it seeks new authority. *See infra* notes 408-09, 423-24, and accompanying text. In documents accompanying the two proposals, however, the Commission does indicate that certain of its proposals are intended to clarify existing agency authority. *See* Memorandum of The Securities And Exchange Commission In Support of The International Securities Enforcement Cooperation Act of 1989, at 2 (Mar. 1, 1989) [hereinafter SEC Memorandum In Support (ISECA)] (proposing, among other things, a statutory provision "making clear that the Commission, by rule, may provide for the disclosure of nonpublic documents"); Memorandum of The Securities And Exchange Commission In Support of The Securities Law Enforcement Remedies Act of 1989, at 2 (Jan. 18, 1989) [hereinafter SEC Memorandum In Support (SLERA)] (proposing legislation to "clarify" the authority of federal courts to bar persons from serving as an officer or director of a public company upon application of SEC).

311. *See supra* note 9.

312. This is something akin to the theory about sleeping dogs.

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logical subject for even higher visibility hearings by both Congressional oversight committees and those committees with authority over securities legislation. As a result, the last six years of the 1980s produced a flurry of legislative hearings, proposals, and enactments.

a. Insider Trading Sanctions Act of 1984

The Insider Trading Sanctions Act of 1984 (ITSA or the Sanctions Act)³¹³ represented the Commission's first foray into the insider trading legislative arena. The Sanctions Act authorizes the federal district courts to impose a penalty, in addition to any amounts ordered to be disgorged, of up to three times the wrongful profits gained, or losses avoided, by illegal insider trading.³¹⁴

Additionally, the Sanctions Act increased the criminal penalty set forth in Exchange Act Section 32(a) from \$10,000 to \$100,000 for each violation of the Exchange Act. The Commission also acquired expansive new administrative enforcement powers over individuals alleged to have caused certain specified violations of the Exchange Act.³¹⁵

The Commission easily overcame its natural reluctance to seek Congressional assistance in connection with ITSA. Under no imaginable set of circumstances could the SEC have claimed it already had the authority to seek, and that courts had the authority to impose, a civil fine of up to three times the amount of the profits gained, or losses avoided, from insider trading. Similarly, it took little political acumen to recognize that most, if not all, Congressmen

313. Pub. L. No. 98-376, 98 Stat. 1264 (1984) (codified as amended in scattered subsections of 15 U.S.C. § 78 (Supp. IV 1986)).

314. See former Exchange Act § 21(d)(2)(A), 15 U.S.C. § 78u(d)(2)(B) (Supp. IV 1986). This provision has been superseded by the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), Pub. L. No. 100-704, reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS (102 Stat. 4677) (1988) (codified as amended in scattered sections of 15 U.S.C.). See *infra* notes 371-83 and accompanying text.

As amended, this treble damage provision implicitly ratifies the Commission's authority to seek disgorgement in insider trading cases. See Exchange Act § 21(d)(2)(A), 15 U.S.C.A. § 78u(d)(2)(A) (West Supp. 1989) ("[T]he actions authorized by this paragraph may be brought in addition to any other actions that the Commission . . . [is] authorized to bring) (emphasis supplied); see also Exchange Act Section 20A(b)(2), 15 U.S.C.A. § 78t(b)(2) (West Supp. 1989) ("The total amount of damages imposed against any person [in related private litigation] shall be diminished by the amounts, if any, that such person may be required to disgorge, pursuant to a court order obtained at the instance of the Commission, in a proceeding brought under section 21(d) of this title . . .") (emphasis supplied).

315. See generally McLucas & Romanowich, *SEC Enforcement Proceedings Under Section 15(c)(4) of the Securities Exchange Act of 1934*, 41 BUS. LAW. 145 (1985).

would naturally oppose insider trading, and that the imposition of increased penalties for insider trading violations was itself not a highly controversial proposition. And finally, the Commission was at little risk that the initiation of the legislative process would either produce legislation with which it could not live, or that Congress would not approve of the agency's enforcement program.³¹⁶

Perhaps the most noteworthy feature of the Sanctions Act, however, was the provision that was not included. Conspicuously absent from the Sanctions Act was a definition of the offense that would invoke ITSA's new treble penalty.³¹⁷

The Sanctions Act nevertheless marked a significant turning point in the Commission's insider trading enforcement program. Prior to this legislation, the law provided little, if any, deterrence to an insider trader—at most, after a lengthy delay during which the Commission first had to detect and investigate a suspicious transaction, the defendant would merely be ordered to disgorge his ill-gotten gains, as ancillary relief to a civil injunction. As previously noted, this penalty hardly constituted a significant disincentive, particularly when balanced against the possibility that the wrongdoing might go undetected.³¹⁸

316. In fact, the agency actually came close to being saddled with a definition of "insider trading" that might have restricted future enforcement efforts. As noted below, however, the agency was able to fend off those initiatives. See *infra* note 317 and accompanying text.

317. This omission was no mere oversight. See Levine, *Recent Insider Trading Sanctions*, 19 Rev. Sec. & Comm. Reg. 185, 186 (1986) ("ITSA took so long to pass [partly because of] the extensive debates at the Commission, in the securities bar, and in the securities industry over whether the legislation should include a definition of insider trading . . .").

During congressional hearings on ITSA, Fedders presented arguments illustrating both sides of the debate. Apparently, his arguments against a definition were more persuasive than his arguments in favor of one—in pointing out the reasons that a definition could be disadvantageous, Fedders observed, among other things, that (1) the offense could not be defined in a way that would embrace all forms of wrongful insider trading; and (2) if such a legislative definition were attainable, a clear, bright-line definition would only pave the way for the development of schemes designed to fall just beyond the reach of the prohibition. See *The Insider Trading Sanctions Act of 1984: Hearing Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 98th Cong., 2d Sess. 35-37 (1984) (testimony of John M. Fedders). As noted, a definition was not included in the statute.

318. Indeed, since all insider traders would enjoy the use of any illegal proceeds during the time spent on the investigation, there may have been some room to profit from wrongdoing even after disgorging the ill-gotten gains. This anomaly may have played a role in a recent development at the SEC. Chairman Breeden is insisting that insider trading settlements include the payment of pre-judgment interest. See *Issue of Cease and Desist Authority May Be Reexamined, Fienberg Indicates*, 21 Sec. Reg. & L. Rep. (BNA) No. 43, at 1631, 1631 n.43 (Nov. 3, 1989) (Breeden has indicated to the SEC staff that full disgorgement of insider trading profits must include pre-judgment interest); see also *SEC Accuses Two of Breaking Trading Rules*, Wash. Post, Dec. 15, 1989, at F3, col. 2 ("Lindberg

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The adoption of the Sanctions Act substantially altered the balance between the potential cost of insider trading and its potential benefit. The Commission's ability to seek disgorgement of any illegal profits plus a civil penalty of up to three times the amount disgorged created significant disincentives against insider trading. Furthermore, by applying this considerable penalty to those persons who illegally tipped inside information to others, who used the information to trade the affected securities,³¹⁹ the Commission expected that these sources of inside information would be somewhat more circumspect in their communications. As with any law enforcement program, it is impossible to determine the precise number of people who have been deterred from illegal insider trading since the adoption of the Sanctions Act.

The passage of ITSA was not entirely an unmixed blessing, however. In its wake came the concomitant pressure for the agency to develop an approach to future insider trading cases and the circumstances under which the SEC would seek the payment of a civil penalty, as well as the amount of such civil penalties. While the agency's approach is subject to change, and a variety of circumstances, it has become relatively clear that the SEC would seek an ITSA penalty in virtually every insider trading case arising after the effective date of the statute.³²⁰ Moreover, the minimum amount the SEC apparently will accept in settlement is (i) disgorgement of all ill-gotten gains and (ii) at least a one-times ITSA penalty.³²¹ If the agency litigates, however, it invariably seeks an injunction, disgorgement, and a three-times ITSA penalty.³²²

The establishment of this approach comports with the Commission's original intent in seeking the legislation—namely, it enables the Commission to increase the stakes for those who engage

settled the matter by paying the SEC about \$114,000.00—representing his illegal trading profits plus interest . . .").

319. See H.R. REP. NO. 355, 98th Cong., 1st Sess. 9 ("The [treble civil] penalty would also be imposed upon persons who aid and abet violations by communicating ('tipping') material nonpublic information, even if they do not trade").

320. If the defendant is impecunious, the agency may forego seeking some or all of the ITSA penalty. See, e.g., *Levine Settles Insider Trading Charges, Pleads Guilty to Perjury, Tax Evasion*, 18 Sec. Reg. & L. Rep. (BNA) No. 23, at 793 (June 6, 1986) (Dennis B. Levine, who allegedly reaped \$12.6 million in insider trading profits, disgorged only \$11.6 million).

321. See, e.g., SEC v. Levine, Civ. Action No. 86 Civ. 3726 (filed May 12, 1986).

322. Thus, if a defendant engaged in illegal insider trading, and made a profit of \$1 million, the SEC could commence an injunctive action against the defendant and seek disgorgement of all ill-gotten profits (in this hypothetical, \$1 million) and a civil penalty in an amount up to three times the illegal profits (or another \$3 million), for a total of \$4 million.

in illegal insider trading. The only problem with this result is that money (as opposed to injunctive relief) is something over which many defendants may be willing to fight. As a result, the passage of ITSA portends an increase in the number of insider trading cases the SEC may be compelled to litigate.

Directly related to the possibility that the passage of ITSA might ultimately produce more contested insider trading litigation for the SEC are the conditions under which that litigation will be required to take place. Shortly after the passage of ITSA, a Supreme Court decision in an unrelated area of the law made it mandatory that SEC cases seeking some form of ITSA civil penalties be litigated before a jury, if the defendant so requests.³²³ Since the SEC was not an active litigator prior to the passage of the statute,³²⁴ it most assuredly lacks familiarity with the nuances and strategies of jury trials. Even in the midst of the heightened media attention on insider trading generated by the Dennis Levine insider trading scandal, surveys of average Americans—the kind of individuals most likely to serve on juries—suggested less than an unqualified condemnation of insider trading.³²⁵

As a result, the requirement that the SEC try cases before a jury, combined with the likelihood that those trials would not take place in Washington, D.C.,³²⁶ suggests that the passage of ITSA may produce some highly particularized constraints for the SEC's

323. See *Tull v. United States*, 481 U.S. 412 (1987) (where monetary penalty is at stake constitutional guarantee of trial by jury attaches).

324. As noted, see *supra* notes 119-26 and accompanying text, the Commission settles the overwhelming percentage of its enforcement cases.

325. Indeed, a survey taken in the aftermath of the Levine and Boesky insider trading settlements suggested an interesting contrast. On the one hand, a comparison of August 1986 and November 1986 population samples showed that, by the November time period, a larger percentage of the sample believed insider trading *should* be illegal (66% in November, *up* from 52% in August), and a smaller percentage believed most people would trade if they had a tip (78% in November, *down* from 82% in August), thus lending some measure of credence to the general deterrent effect resulting from the recent high-profile insider trading cases. See *Business Week/Harris Poll: Outsiders Aren't Upset by Insider Trading*, BUS. WK., Dec. 8, 1986, at 34, col. 2.

On the other hand, however, there was a slight *increase* in the November percentage of the sample who said they personally *would* trade if they had a tip on a stock (55% in November, *up* from 53% in August). More significant, however, is the conclusion that, in both periods, more than half of the sample population would have succumbed to the temptation of insider trading if they thought they had a sure thing in the form of a tip. *Id.*

326. Venue for most of these cases will be in the defendant's hometown, see 28 U.S.C. § 1391 (1982), with a greater likelihood that the defendants will benefit from a trial at home. See, e.g., *SEC v. Switzer*, 590 F. Supp. 756 (W.D. Okla. 1984).

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enforcement program. The SEC's experience with ITSA, thus far, suggests a mixed record in trying its cases in a different locale.³²⁷

However ITSA is characterized, some prominent members of the securities industry apparently were not deterred by the ITSA civil penalties.³²⁸ As the Wall Street insider trading scandal unfolded in the wake of the May 12, 1986 arrest of Dennis B. Levine, the co-head of mergers and acquisitions at Drexel, it became apparent that insider trading had infected persons at the highest echelons of the securities industry.

These revelations precipitated a renewed Congressional interest in strengthening the government's enforcement capabilities against insider trading and tipping.³²⁹ The ensuing legislative initiative sought to enhance the government's ability to prosecute these cases by clearly defining and prohibiting insider trading and tipping.

b. *Insider Trading Proscriptions Act of 1987*

While the Sanctions Act demonstrated a congressional determination that illegal insider trading must be deterred, as noted above, no consensus had emerged on a workable definition of the offense or even on the desirability of such a definition.³³⁰ The Wall Street insider trading scandal, however, changed the views of some members of Congress (and, eventually, a majority of the Commission) as to the propriety of criminally prosecuting an offense that was neither expressly defined nor specifically prohibited.³³¹ As a result of the drafting efforts of an *ad hoc* committee of private sector lawyers,³³² in June 1987, Senators Riegle and D'Amato jointly

327. Compare SEC v. Clark, Litigation Release No. 12,111, 43 SEC Docket 1574, 1574 (W.D. Wash. May 31, 1989) ("The order by Judge Thomas S. Zilly is the first ITSA penalty ordered paid by a defendant after trial of an insider trading case"), with SEC v. Ingram, Litigation Release No. 11,739, 40 SEC Docket 1292, 1292 (C.D. Cal. May 16, 1988) ("The court ordered Ingram to disgorge the commissions . . . [but] declined to impose penalties under the Insider Trading Sanctions Act and to enjoin Ingram from violating the securities laws in the future on a finding that there was no reasonable likelihood of future securities laws violations"). Other Commission ITSA cases are still in litigation. See, e.g., SEC v. Peters, Litigation Release No. 11,950, 42 SEC Docket 789 (D. Kan. Dec. 28, 1988).

328. See *supra* note 1 and accompanying text.

329. See *Dingell Spins Yarn About Caracas Connection in Levine Case*, SEC. WK., Dec. 15, 1986, at 10 ("we must make the punishment fit the crime," said committee chairman John Dingell . . . "Clearly, the unbelievable greed of some was not sufficiently deterred").

330. See *supra* note 317 and accompanying text.

331. See *Definition of Insider Trading: Hearing Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, Part I*, 100th Cong., 1st Sess. 107 (1987) [hereinafter *S. 1380 June Hearings*] (remarks of Subcomm. Chairman Riegle).

332. The *ad hoc* committee was chaired by Mr. Pitt, at the request of Senators Riegle

introduced the Insider Trading Proscriptions Act of 1987 (Proscriptions Act or S. 1380) to remedy this deficiency.³³³

Congress' initiation of the drafting of the Proscriptions Act,³³⁴ combined with the processes by which that proposed legislation was considered,³³⁵ are instructive of the marked changes in SEC

and D'Amato. Its members included: Lewis Black (then Chairman of the Committee on the Federal Regulation of Securities of the American Bar Association's (ABA's) Section on Corporate and Banking Laws); Theodore A. Levine (Chairman of the ABA's Subcommittee on Civil Liability); Sam Scott Miller (Chairman of the ABA's Subcommittee on Broker-Dealer Regulation); John F. Olson (Vice-Chairman of the ABA's Committee on the Federal Regulation of Securities); Richard M. Phillips (Past Chairman of the ABA's Federal Regulation of Securities Committee, and Chairman of the New York Stock Exchange's Legal Advisory Committee Task Force on Insider Trading); Irving M. Pollack (former Commissioner and Director of Enforcement of the SEC); and the Honorable Stanley Sporkin (United States District Judge for the District of Columbia and former Director of the SEC's Division of Enforcement). Ms. Shapiro served as the Reporter for the *Ad Hoc* Senate Committee. See *Oversight of the Securities & Exchange Commission and the Securities Industry: Hearing Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 100th Cong., 1st Sess. 3 (1987) (remarks of Subcomm. Chairman Riegle).

333. In a shift of position, see *supra* note 317, the SEC endorsed the desirability (but not the necessity) of a definition, and its Director of Enforcement conceded that S. 1380 was an improvement over existing law. See *Definition of Insider Trading (Part II): Hearing Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 100th Cong., 1st Sess. 19 (1987) [hereinafter *S. 1380 August Hearings*] ("I think [S. 1380] would put us in a stronger position than current law") (testimony of Gary G. Lynch). On August 3, 1987, the Commission submitted a revised legislative proposal to the Securities Subcommittee to define and prohibit insider trading and tipping. *Id.* at 9-12 (Memorandum of the Securities and Exchange Commission in Support of the Insider Trading Proscriptions Act of 1987). Ultimately, two reconciliations of the Commission's draft and the *Ad Hoc* Committee's draft were prepared. For the text of these documents, see *A Legislative Remedy*, *supra* note 3, at app. 1-2.

334. It is significant that the Senate initiated consideration of a legislative definition for insider trading. Responding to two critical concerns, Senators Riegle and D'Amato made plain their concern that (i) Congress address the problems identified by the Supreme Court in its *Chiarella* decision, see *supra* notes 232-36 and accompanying text, so that future SEC enforcement prosecutions could proceed unhampered; and (ii) the intensity with which both the SEC and the criminal law enforcement authorities were pursuing insider trading cases necessitated the development by Congress of a plain-English definition of the crime for which individuals were being heavily fined and sentenced to increasingly longer jail terms. See *S. 1380 June Hearings*, *supra* note 331, at 3 (Sen. D'Amato emphasizing the need to respond to the Court's opinion in *Chiarella*); *Id.* at 2 (Sen. Riegle advocating plain-English definition as a means of deterring insider trading abuses).

335. It was important to the Senate that the *Ad Hoc* Committee it established be fairly representative of a diversity of viewpoints. See *S. 1380 June Hearings*, *supra* note 331, at 1-2. In addition to the individuals who were actual members of the Committee, see *supra* note 332, senior staff members of the SEC, *id.* at 12, and senior staff members of the Senate Subcommittee on Securities attended and participated in the Committee meetings. *Id.* In addition, once the Committee crafted a plain-English draft, it circulated copies of the proposed legislative language to a wide variety of interested persons in the fields of practicing lawyers, academics, banking, securities, accounting, and investment companies. *Id.* at 12 (describing *Ad Hoc* Committee's methodology); *id.* at 43-44 (identifying persons who commented on draft of S. 1380).

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enforcement practices that had occurred by 1987. Indeed, while the legislation has not yet been reintroduced in the current session of the Congress, portions of the proposed Proscriptions Act already have been incorporated into law,³³⁶ and Senator Riegle (who now chairs the full Senate Committee on Banking, Housing, and Urban Affairs) has indicated his intention to reintroduce the Proscriptions Act during the current legislative session.³³⁷ Moreover, the high degree of visibility garnered by the SEC's insider trading program made it logical and appropriate that Congress would itself review the Commission's activities as well as the courts' responses thereto, and then reach its own conclusions regarding the wisdom of various approaches and the need for various pieces of legislation.

Accordingly, although still only in the proposal stage, the Proscriptions Act is an important indicant of both how Congress has perceived the SEC's enforcement program and the principal component thereof over the last decade, and what possible changes in the Commission's governing statutes may lie ahead over the next decade that could have an important influence on the future directions of the agency's enforcement program.

The introduction of the Proscriptions Act signaled Congress' support for, and direction to continue, the agency's emphasis on insider trading enforcement actions.³³⁸ In addition, the effort to define and expressly prohibit insider trading served both to respond to judicial uncertainty regarding the proper interpretation of insider trading prohibitions and to disavow the notion that insider trading promotes market efficiency³³⁹

336. Compare S. 1380, 100th Cong., 1st Sess. § 16A(a) with Pub. L. No. 100-704, 102 Stat. 4677 (1988) (codified as amended in scattered sections of 15 U.S.C.) (ITSFEA) § 2 (congressional findings to enable courts to ascertain the goals of securities legislation) and compare S. 1380 Proposed Section 16A(d) with ITSFEA § 21A(B)(2) (limitation on derivative liability of person whose sole nexus to the insider trading of another is the employment relationship); and compare S. 1380 Proposed Section 16A(e) with ITSFEA § 21A(c) (Commission rulemaking authority to implement legislation); and compare S. 1380 Section 16A(f) with ITSFEA § 20A (private right of action).

337. It is unclear, however, whether the Commission will continue to support the effort to enact a legislative definition of insider trading. Compare *Breeden, the SEC Hopeful, Just Breezes In*, NAT'L L.J., Oct. 2, 1989, at 8, col. 2 ("Mr. Breeden made it clear that he supports a [legislative] definition [of insider trading], saying enforcement targets should have had 'some fair appreciation . . . the conduct they were engaging in was across the line'" with *Breeden Responses*, *supra* note 26, at 4 (stating he was no longer certain that a legislative definition is necessary, in view of success of insider trading enforcement program).

338. This mandate later would be reinforced with the adoption of the Insider Trading and Securities Fraud Enforcement Act of 1988, discussed below. See *infra* notes 371-407 and accompanying text.

339. See, e.g., Wu, *An Economist Looks at Section 16 of the Securities Exchange Act of 1934*, 68 COLUM. L. REV. 260 (1968); H. MANNE, *INSIDER TRADING AND THE STOCK MARKET*

The eventual structure and substance of the Proscriptions Act embodied several major predicates. First, the Act was intended to serve as a vehicle for Congress to articulate precisely its assessment of insider trading, and to give direction to the judiciary on how insider trading prosecutions should be addressed. In essence, as noted above,³⁴⁰ this offered Congress the opportunity to address (and redress) the concerns expressed by the Supreme Court in *Chiarella*,³⁴¹ and to articulate the theories on which insider trading should be prohibited.³⁴² A principal feature of the statute, in this regard, was its treatment of insider trading *not* as a species of fraud, but as a species of wrongful conduct deemed detrimental to the marketplace as a whole and unfair to those who trade in the marketplace.³⁴³ While some have since taken issue with this approach,³⁴⁴ it responded to the major difficulty the Supreme Court has had in resolving the two principal insider trading cases presented to it at the beginning of the decade by the SEC—the *Chiarella* and *Dirks* cases—that trading on the basis of an unfair informational advantage, in which the person with inside information neither induces anyone to trade the stock in issue nor in any way misleads anyone concerning the value of that stock, does not look or sound like a traditional fraud, and is tantamount to a victimless crime.³⁴⁵

(1966).

340. See *supra* notes 333 and accompanying text.

341. See *Chiarella v. United States*, 445 U.S. 222, 224 (1980).

342. Much of this was accomplished in a series of Congressional findings set forth at the beginning of the Proscriptions Act. This technique, although to a different effect, was utilized in connection with ITSFEA. See *infra* note 372 and accompanying text.

343. See S. 1380, 100th Cong., 1st Sess. § 16A(a)(1) (1987) ("The fairness, honesty, and integrity of the Nation's securities markets are impaired [by insider trading]"); see also *A Legislative Remedy*, *supra* note 3, at 11 ("this legislation would remove insider trading from the rubric of fraud . . .").

344. See *Need for Insider Trading Definition Has Diminished*, *Grundfest Says*, SEC. WK., Feb. 1, 1988, at 6; *Grundfest Expresses Preference for Case Law Insider Trading Definition*, 20 Sec. Reg. & L. Rep. (BNA) No. 4, at 136 (Jan. 29, 1988).

345. See *Post-Winans Insider Trading Law Debated by Lawyers at ALI-ABA Seminar*, 20 Sec. Reg. & L. Rep. (BNA) No. 9, at 329 (Mar. 4, 1988) ("Is insider trading really securities fraud? . . . [I]n *Winans* and cases like it, investors are not defrauded into making trading decisions. Rather, their claim is that they did not have information to which they were not, in fact, entitled"). As reprehensible as insider trading is, the persons who trade contemporaneously with the insider trader are not truly the "victims" of that insider trader. This is so because the information to which the insider trader is privy is not information to which any investor was entitled. Moreover, those who trade contemporaneously with a *Chiarella* or *Dirks* do so volitionally, not because anyone induced them to trade, but because it was their judgment, or economic necessity, that compelled them to trade the securities they traded, at the price they traded, at the time they traded. As a result, those people who trade contemporaneously with an insider trader are not really injured by his or her act; they really are complaining that the insider trader achieved a windfall to which

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Second, the Proscriptions Act sought to codify precisely what theories could be employed by the government in pursuing insider trading cases. Congress had never considered or ratified the misappropriation theory that was created out of whole cloth by the government and endorsed by the lower courts.³⁴⁶ Although the theory has become widely accepted, it was felt that the Congress should formally embrace it in order to legitimize the existing process by which insider trading cases are prosecuted.³⁴⁷ The Proscriptions Act started with the essential premise, moreover, that no insider trading case that the government could legitimately have brought at the time of the introduction of that statute should be foreclosed by the adoption of S. 1380.³⁴⁸

Third, the Proscriptions Act was intended to craft a plain-English definition of the crime of insider trading, so that all persons subject to its terms could fairly understand what was prohibited and what was not.³⁴⁹ A major concern of many securities professionals was that the growing use of the misappropriation theory, without any indication of its ultimate contours, exposed such professionals to a variety of lawsuits at the behest of the government and others, without fair warning or notice of all the conduct that might be deemed illegal.³⁵⁰ A concomitant concern of many lawyers was that the failure to articulate with precision the contours of an insider trading violation might subject future criminal prosecutions to constitutional challenge.³⁵¹

Fourth, the Proscriptions Act reflected an attempt to structure the prohibition against insider trading in a manner that would enable the government to adapt its theories to a changing marketplace, without sacrificing clarity or appropriate notice of the conduct intended to be proscribed. Thus, the Proscriptions Act stated its essential prohibitions in terms of wrongful trading and wrongful tipping by persons with access to material nonpublic information, and expanded the class of information that might constitute so-called

he or she was not entitled, by virtue of special access to material nonpublic information.
Id.

346. See *supra* note 244 and accompanying text.

347. See *S. 1380 June Hearings*, *supra* note 331, at 18 n.5, 23-26, 30, 36 (joint statement of Harvey L. Pitt and John F. Olson).

348. *Id.* at 17.

349. *Id.* at 16-17; see also *A Legislative Remedy*, *supra* note 3, at 10-11.

350. See *S. 1380 June Hearings*, *supra* note 331, at 23-26. The achievement of this goal would cure an area of potential vulnerability on the criminal side of the insider trading enforcement program by precluding due process arguments flowing from criminal prosecutions of an undefined offense. *Id.* at 16.

351. See, e.g., *Chiarella v. United States*, 445 U.S. 222, 235 n.20 (1980).

inside information beyond information about a single company's securities to information about a class or group of securities, or the market for such securities.³⁵²

Fifth, the proposed legislation specifically codified the dual evils inherent in insider trading—wrongful trading and wrongful tipping. In statutorily addressing the problem of wrongful tipping of information for the first time, the draft statute attempted to place liability for illegal tipping on a sounder and express statutory footing, and to correct the problems that had arisen by virtue of the *Dirks* decision's adoption of the nettlesome and ill-conceived "personal benefits" test.³⁵³

Sixth, the Proscriptions Act attempted to respond to the phenomenon of takeover-related trading, by adopting special

352. See S. 1380, 100th Cong., 1st Sess. § 16A(b)(2) (1987). A simple hypothetical demonstrates the reach of this concept:

Assume that A is a lawyer, and that his firm specializes in bankruptcy work. A's firm is asked to handle the still-secret proposed bankruptcy filing of XYZ Corp., a major widget manufacturer. A is assigned to work on the project. A is an astute follower of the widget industry, and recognizes immediately that the bankruptcy filing of XYZ will leave only PQR Corp. as the major domestic source of widgets. A buys PQR stock before any announcement of XYZ's intention to file a bankruptcy petition.

Under current law, there exists significant doubt whether the Commission could prosecute A for illegal insider trading, since current concepts of materiality are restricted to the particular stock in question. See *A Legislative Remedy*, *supra* note 3, at 19. Under the Proscriptions Act, this conduct would be clearly prohibited. S. 1380, 100th Cong., 1st Sess. § 16A(b)(2) (1987).

353. In addressing tippee liability, the Supreme Court in *Dirks* set forth the following standard: "the test is whether the insider personally will benefit, directly or indirectly, from his breach. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach [by the tippee]." 463 U.S. at 662. Thus, to prevail under the rule of *Dirks*, the government must prove that the tippee (a) "tipped" the information in order to receive a personal benefit; or (b) was bound by an independent duty to speak before trading on the basis of the tipped information.

In order to meet this burden, the government has been forced to include rather titillating allegations in its complaints. See, e.g., *United States v. Winans*, 612 F. Supp. 827, 849 (S.D.N.Y. 1985), *aff'd*, 791 F.2d 1024, 1026 (2d Cir. 1986) (discussing the "private, personal, non-business relationship" between two male co-defendants); see also *SEC v. Thayer*, Litigation Release No. 10,251, 29 SEC Docket 730 (S.D.N.Y. Jan. 5, 1984) (allegations of "private personal relationship" to support charge that tipper benefited from his mistress/tippee's trades); and undertake a search for independent duties. See, e.g., *SEC v. Switzer*, 590 F. Supp. 756, 766-67 (W.D. Okla. 1984) (corporate outsider who overhears an insider discuss material, nonpublic information has no relationship with, and therefore owes no duty to, shareholders of insider's company).

The Proscriptions Act would relieve this problem by establishing as the predicate for tipper liability the facts that the insider conveyed the material, nonpublic information and that the tippee's trade was reasonably foreseeable. See *A Legislative Remedy*, *supra* note 3, at 21-22.

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prohibitions against the selective tipping of tender offer-related information for the purpose of facilitating the successful acquisition of the target company.³⁵⁴

Seventh, the Proscriptions Act attempted to address the difficult problem of vicarious liability by distinguishing between employers who were, in effect, victimized by errant employees and those employers who failed adequately to supervise their employees or establish a meaningful set of guidelines and procedures to preclude illegal trading. Thus, the statute expressly recognized that the mere existence of an employer-employee relationship, without more, could not give rise to vicarious liability for an employer who had the misfortune of employing a venal employee who engaged in illegal insider trading.³⁵⁵ Nonetheless, the Proscriptions Act embodied the SEC's philosophy that greater liability must apply to those who employ or control individuals with access to inside information, to stimulate increased vigilance in the business community and to promote more effective self-regulation in the securities industry.³⁵⁶

Finally, the Proscriptions Act sought to clarify the murky area of private rights of action by providing an express cause of action for persons who trade contemporaneously with, but on the other side of, an insider trader.³⁵⁷ Although long endorsed by the Commission (and accepted by the courts) as a necessary supplement to the Commission's own enforcement program,³⁵⁸ private remedies were relegated to second-class status by virtue of the fact that they were required to be implied by the judiciary, instead of emanating from express directives of Congress. In the four decades following the first judicial recognition of a private remedy for violations of Rule 10b-5,³⁵⁹ the Supreme Court first expanded and encouraged such remedies, and then changed direction and began to curtail and restrict them.³⁶⁰ Particularly in the absence of a meaningful

354. See S. 1380, 100th Cong., 1st Sess. § 16A(c)(2) (1987). Section 16A(c)(2) was designed to prohibit what was perceived as the practice of corporate raiders (or their allies) tipping information about their plans to put companies "into play." See S. 1380 *June Hearings*, *supra* note 331, at 32 (joint statement of Harvey L. Pitt and John F. Olson).

355. See S. 1380, 100th Cong., 1st Sess. § 16A(d) (1987).

356. The legislative process provided the Commission with the forum for advocating its position that controlling persons and employers of insider traders should be derivatively liable for those violations unless the only nexus between the two parties was the circumstance of employment or control.

357. See S. 1380, 100th Cong., 1st Sess. § 16A(f) (1987).

358. See, e.g., *J.I. Case Co. v. Borak*, 377 U.S. 426, 434 (1964).

359. The first private right of action for a violation of Rule 10b-5 was recognized in 1946. See *Kardon v. Nat'l Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946).

360. Compare *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972)

delineation of the precise wrong inflicted by insider trading, the courts experienced difficulty in articulating a coherent approach to the question of private remedies.³⁶¹

The Proscriptions Act did not become law. Although strongly supported in the Senate, two separate events relegated the legislation to continued proposal status. First, Congressman John Dingell, Chairman of the House Committee on Energy and Commerce (which has jurisdiction over the SEC and the federal securities laws), opposed a definition of insider trading. According to Congressman Dingell, such a definition would only enhance the ability of clever lawyers to argue that the insider trading of their clients did not violate the law.³⁶²

(Section 10(b) applied to actions of bank employees who failed to disclose to sellers that they were in a position to obtain financial gain from sales of stock in corporation managing assets of American Indian tribe); *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971) (corporate receiver allowed to pursue private cause of action under Section 10(b) of the Securities Act against officer who perpetrated a fraud against the corporation); *Surowitz v. Hilton Hotels Corp.*, 383 U.S. 363 (1966) (derivative suit brought by shareholder based on violations of the federal securities laws by corporation's officers and directors); *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964) (right of action exists for private parties under Section 14(a) of the Exchange Act) *with* *TransAmerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979) (limited private right of action exists under Investment Advisers Act of 1940 for rescission; that Act does not allow for the implication of additional private remedies); *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979) (no implied private cause of action arises from violations of Section 17(a) of the Exchange Act); *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977) (defeated tender offerors have no right to maintain a private cause of action under Section 14(e) of the Exchange Act even where the fraudulent actions of successful offeror may have frustrated efforts of defeated offeror); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977) (breach of fiduciary duty by majority shareholder in absence of deception, misrepresentation or nondisclosure, does not violate Section 10(b) of Exchange Act or Rule 10b-(5)); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (Section 10(b) liability may not be imposed on the basis of negligent conduct alone); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (offeree defrauded out of contractual right to purchase securities has no standing to bring a private cause of action).

361. The companion cases of *Moss v. Morgan Stanley*, 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984), and *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983) illustrate this point. These cases were both decided by the same court, and both arose out of the same conduct. In the former case, the court held that Mr. Newman could be incarcerated and fined for illegally misappropriating material, nonpublic information about a variety of stocks for his personal trading purposes. In the latter case, however, the court held that those persons who traded contemporaneously with Newman lacked standing and so could not recover any of the alleged losses they suffered, or any alleged windfall Newman received as a result of his trades. It thus became the law in the Second Circuit that it was easier to send a man to jail for insider trading than it was to require him to recompense those individuals who traded contemporaneously with him.

362. See *Enactment of Insider Trading Bill Unlikely this Year*, SEC Official Says, 20 Sec. Reg. & L. Rep. (BNA) No. 9, at 324, 324 (Mar. 4, 1988) ("Dingell opposes legislation to define insider trading because he believes it would narrow the SEC's ability to bring enforcement actions, [SEC Chairman Ruder's Executive Assistant Linda] Feinberg said").

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This opposition did not abate after the Proscriptions Act received the endorsement of the United States Attorney for the Southern District of New York,³⁶³ the Director of the SEC's Division of Enforcement³⁶⁴ and, ultimately, the Commission itself.³⁶⁵ In essence, Congressman Dingell's opposition ran directly counter to, and gave further fuel for, the arguments in favor of adopting a plain-English definition, since Congressman Dingell's stated concern was that a plain statement of the offense would put people on notice of precisely what conduct was, and what conduct was not, violative of the law.

The second major event that eviscerated the urgency prompting consideration of the Proscriptions Act was the Supreme Court's resolution of the so-called *Winans* case.³⁶⁶ R. Foster Winans, a reporter and columnist for the *Wall Street Journal*, was indicted by the government for tipping collaborators about forthcoming *Journal* articles on specific companies in the widely-read and followed "Heard on the Street" column that Winans principally authored. The case was seen as a major challenge to the misappropriation theory, and the Supreme Court's decision to review Winans' conviction created an air of expectation that the conviction might be reversed and the misappropriation theory circumscribed or rejected.

Instead, dividing four-to-four, the Court ultimately expressed no view on that theory *vis-a-vis* the federal securities laws.³⁶⁷ Justice Powell, who was widely expected to oppose the application of the misappropriation theory to securities fraud cases, did not participate in the decision, and the remaining justices split evenly, without elaboration on the subject. The principal conclusion drawn from this decision, however, was a weakened perception that legislation was

363. See *SEC Counsel Says Commission to Offer Legislation to Define Wrongful Information Use*, Daily Rep. for Exec. (BNA), at A-10 (June 25, 1987) ("Speaking at the annual dinner of the New York Financial Writers Association, . . . Giuliani said, 'From a criminal point of view, [S. 1380] would—unless I'm missing something—it would embrace all the things that we think we have to do'").

364. See *S. 1380 August Hearings*, *supra* note 333, at 19 (testimony of Gary G. Lynch).

365. See *The Insider Trading Proscriptions Act of 1987: Hearing Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 100th Cong., 1st Sess. 17 (Dec. 15, 1987) (SEC Memorandum in Support of Legislation).

366. *Carpenter v. United States*, 484 U.S. 19 (1987).

367. The Court did embrace the misappropriation theory for purposes of the mail and wire fraud statutes. *Id.* at 28. Its willingness to do so left open the possibility that the theory might apply to securities fraud as well, although its different treatment of securities fraud suggested that at least four members of the Court perceived a difference between securities fraud on the one hand, and mail and wire fraud on the other. See Pitt, *Winans Case: The Limits of Securities Law*, Legal Times, Nov. 23, 1987, at 18.

needed to assist the SEC, a perception that, in part, may have motivated the Commission's own support for the Proscriptions Act.³⁶⁸

The Commission's misappropriation theory thus survived a major Supreme Court challenge. While not endorsed by the Court, the theory also was not rejected. As a result, the Commission remained free to pursue cases on the basis of the misappropriation theory until another Supreme Court challenge could be mounted.³⁶⁹ Given the high degree of visibility and acclaim for the Commission's insider trading program that had evolved, Congress was unlikely to adopt insider trading legislation unless it would enhance the Commission's enforcement efforts. Since there was no longer any compelling fear that the courts would require such legislation, the Proscriptions Act faded from public attention, and Congress turned to other legislative proposals more directly supportive of the Commission's program.³⁷⁰

c. The Insider Trading and Securities Fraud Enforcement Act of 1988

Against the backdrop of a continuous stream of headlines about the Wall Street scandal, insider trading and tipping continued to preoccupy Congress, resulting in the introduction and rapid passage of the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA).³⁷¹ Despite Congress' reluctance to define the crime

368. See SEC Submits Draft Legislative History to Accompany Insider Trading Proposal, 20 Sec. Reg. & L. Rep. (BNA) No. 7, at 252, 252 (Feb. 19, 1988) ("Grundfest conditioned his support for the SEC's November proposal on the SEC submitting acceptable language that could serve as legislative history for an insider trading definition bill"); Grundfest Expresses Preference for Case Law Insider Trading Definition, 20 Sec. Reg. & L. Rep. (BNA) No. 4, at 136, 136 (Jan. 29, 1988) ("Securities and Exchange Commissioner Joseph Grundfest . . . said that he is leaning strongly in favor of relying on case-by-case development of insider trading law rather than enacting either of the two major pending legislative proposals to define insider trading offenses").

369. See Pitt, *The Limits of Fraud: An Analysis of the Winans Case*, INSIGHTS, Jan. 1988, at 14.

370. While the Commission's new Chairman has advised the Senate that he supports the adoption of the Proscriptions Act, he also has expressed reservations about the need for such legislation at this time. See Confirmation of Nomination for Chairman of the Securities and Exchange Commission Before the Senate Banking Committee, 101st Cong., 1st Sess. 24 (1989) (statement of Richard C. Breeden). But see Breeden Responses, *supra* note 26, at 4, in which Breeden observed that it was no longer clear to him whether, in view of the Commission's great success in recent insider trading cases, a legislative definition was, in fact, necessary.

371. Pub. L. No. 100-704, 102 Stat. 4677 (1988) (codified as amended in scattered sections of 15 U.S.C.). The bill was introduced in the House of Representatives on August 2, 1988, see H.R. 5133, 100th Cong., 2d Sess., 134 CONG. REC. E2583-E2585 (daily ed. Aug. 2, 1988), and was passed by a vote of 410 to 0, on September 13, 1988. See H.R. 5133, 100th Cong., 2d Sess., 134 CONG. REC. H7570 (daily ed. Sept. 14, 1988). The Senate first considered the bill, on October 21, 1988, in the waning hours of the 100th Congress, and voted to approve the next morning. See H.R. 5133, 100th Cong., 2d Sess., 134 CONG.

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of insider trading, ITSFEA reflected that body's absolute lack of hesitation to increase the sanctions associated with this as yet undefined crime.³⁷²

ITSFEA reflects Congress' overriding concerns about insider trading, that is, that (1) harsher deterrents were needed to prevent insider trading and other illegal securities transactions; and (2) expanded secondary liability would promote increased supervision and self-regulation, both among regulated securities professionals, and in the business community and related service industries that generate or otherwise control confidential business information.

ITSFEA's most dramatic changes to the laws governing insider trading include: substantial increases in the civil and criminal penalties associated with the offense;³⁷³ the imposition of an affirmative obligation on registered securities professionals to put into place and enforce policies to "prevent" the "misuse" by their employees of material, nonpublic information concerning publicly traded securities;³⁷⁴ the expansion of the derivative liability of persons who employ or otherwise "control" persons who have violated the federal securities laws;³⁷⁵ and the creation of both an express private remedy on behalf of persons who traded contemporaneously with an insider trader,³⁷⁶ and an express invitation to the judiciary to imply additional causes of action as appropriate.³⁷⁷ ITSFEA also broadens the SEC's ability to facilitate investigations by foreign enforcement authorities.³⁷⁸

As noted, the penalty provisions of ITSFEA reflect Congressional concern that, notwithstanding the treble civil penalty provision of the Sanctions Act, the potential risk associated with insider trading did not sufficiently outweigh the perceived benefits.³⁷⁹ To address this

REC. S17218-S17222 (Oct. 21, 1988). The law became effective January 3, 1989, *see* 135 CONG. REC. H29 (daily ed. Jan. 3, 1989).

372. *See generally A Legislative Remedy, supra* note 3, at 7.

373. *See* Exchange Act §§ 21A(a)(1), 32(a), 15 U.S.C.A. §§ 78uA(1), 78ff(a) (West Supp. 1989).

374. *See* Exchange Act § 15(f), 15 U.S.C.A. § 78o(f) (West Supp. 1989); Advisers Act § 204A, 15 U.S.C.A. § 80b-4A (West Supp. 1989).

375. *See* Exchange Act § 21A(a)(2), 15 U.S.C.A. § 78u-1(a)(2) (West Supp. 1989).

376. *See* Exchange Act § 20A(a), 15 U.S.C.A. § 78t-1(a) (West Supp. 1989).

377. *See* Exchange Act § 20A(d), 15 U.S.C.A. § 78t-1(d) (West Supp. 1989).

378. *See* Exchange Act § 21(a)(2), 15 U.S.C.A. § 78u(a)(2) (West Supp. 1989).

379. In other words, Congress sought to assure that the risk of detection, disgorgement of profits and payment of a penalty, would sufficiently outweigh, and therefore deter, the potential benefits of an undetected violation, that is, the substantial profits that flow from the use of an unfairly gained informational advantage.

concern, ITSFEA preserves the treble penalty framework first introduced in the Sanctions Act.³⁸⁰

Perhaps the most significant deterrent effect of the law, however, appears in the criminal penalties for insider trading, which were increased tenfold, from \$100,000 to \$1,000,000, for individuals, and five times, from \$500,000 to \$2,500,000, for entities.³⁸¹ ITSFEA also doubles the maximum term of imprisonment for criminal violations of the Exchange Act from five to ten years.³⁸²

In addition, ITSFEA substantially increases the civil and criminal penalties that courts may impose upon those who employ persons who have engaged in insider trading and tipping. Thus, it authorizes the federal district courts, at the request of the SEC, to impose upon such employers a civil penalty of up to \$1,000,000, or three times the profit gained or loss avoided as a result of the employee's violation, whichever is greater.³⁸³

380. See Exchange Act § 21A(a)(1), 15 U.S.C.A. § 78u-1(a)(1) (West Supp. 1989).

381. See Exchange Act § 32(a), 15 U.S.C.A. § 78ff(a) (West Supp. 1989). The Commission was also required by this section of the bill to submit to each house of Congress any recommendations the agency believes appropriate concerning the extension of its authority to impose civil penalties or administrative fines. See ITSFEA § 3(c). The agency's responsive proposal, the Securities Law Enforcement Remedies Act of 1989, is discussed *infra* notes 408-22 and accompanying text.

382. See Exchange Act § 32(a), 15 U.S.C.A. § 78ff(a) (West Supp. 1989). This sanction is applicable to *any* violation of the Exchange Act, and its express purpose was to persuade judges to increase their sentences. See HOUSE ITSFEA REPORT, *supra* note 131, at 23 (emphasis supplied), which states that

The Committee's interest in the maximum jail term is an explicit congressional statement of the heightened seriousness with which insider trading and other securities fraud offenses should be viewed. Although the legislation does not include an explicit mandatory minimum sentence *the Committee believes in the strongest possible manner that courts should impose jail terms for the commission of these crimes, and expects that raising the ceiling will increase the certainty of substantial prison sentences.*

383. See Exchange Act § 21A(a)(3), 15 U.S.C.A. § 78u-1(a)(3) (West Supp. 1989). For a court to impose a penalty upon a controlling person, the Commission must establish that the controlling person (i) knew or recklessly disregarded that the controlled person "was likely to engage in the act or acts constituting the violation[,] and [(ii)] failed to take appropriate steps to prevent" the conduct. Exchange Act § 21A(b)(1), 15 U.S.C.A. § 78u-1(b)(1)(A) (West Supp. 1989). This language may encourage a fair degree of hindsight judgments.

The legislation purports to carve out a safe harbor from this stringent derivative liability by providing that

[n]o person shall be subject to a penalty under [this provision] solely by reason of employing another person who is subject to a penalty under such subsection, unless such employing person is liable as a controlling person under paragraph (1) . . .

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This provision underscores Congress' intent to impose greater accountability on employers and controlling persons for the violations of subordinates, suggesting that the 1990s will witness a redoubled effort toward self-imposed codes of conduct, either by affirmative obligation (for regulated entities) or in an effort to build a record showing that the employer took every reasonable step to safeguard, and prevent the misuse of, information in its custody.³⁸⁴

The heightened focus on vicarious liability further evidences the severely circumscribed ability of controlling persons to defend against liability for the alleged violations of their controlled persons. The new provision, which apparently eliminates the so-called good faith defense for controlling persons as set forth in Section 20(a) of the Exchange Act,³⁸⁵ now would prevent controlling persons from escaping secondary liability, if the Commission can show that the person "knew or recklessly disregarded the fact that such controlled person was *likely to engage in the act or acts constituting the violation and*

Section 78t(a) of this title shall not apply to actions under subsection (a) of this section.

Exchange Act § 21A(b)(2), 15 U.S.C.A. § 78u-1(b)(2) (West Supp. 1989). In fact, it is not clear how helpful this safe harbor will actually prove to be, since it does permit someone who supervises or employs a wrongdoer to be held liable if the employer recklessly disregards the fact that the employee was likely to violate the law, and if the employer failed to take appropriate steps to prevent the violation before it occurred. *See* Exchange Act § 21A(b)(1), 15 U.S.C.A. § 78u-1(b)(1)(A) (West Supp. 1989).

In the case of brokers and dealers or investment advisers registered with the SEC, a controlling person can be fined severely if the SEC establishes that the employer knowingly or recklessly failed to implement procedures otherwise required under the federal securities laws, where the failure to do so "substantially contributed to or permitted the occurrence of the act or acts constituting the violation." Exchange Act § 21A(b)(1)(B), 15 U.S.C.A. § 78u-1(b)(1)(B) (West Supp. 1989). And, regardless of whether an insider trading violation has taken place, registered brokers, dealers, and investment advisers are required to maintain procedures "to prevent the misuse . . . of material, nonpublic information" by their employees. *See* Exchange Act § 15(f), 15 U.S.C.A. § 78o(f) (West Supp. 1989); Advisers Act § 204A, 15 U.S.C.A. § 80b-4a (West Supp. 1989).

384. *See generally Corporate Codes, supra*, note 5. It should also be noted that a controlling person can be an individual well below the level of an actual employer. Consistent with the origins of ITSFEA, the critical term "controlling person" is not defined in the statute, but apparently is intended to include "any entity or person with the power to influence or control the activities of another person." *See* H.R. REP. NO. 910, 100th Cong., 2d Sess. 17 (1988). This suggests that mid- and lower-level supervisors may be liable for the conduct of those who report to, and are influenced by, them.

385. *See* Exchange Act § 21A(b)(2), 15 U.S.C.A. § 78u-1(b)(2) (West Supp. 1989) ("Section 20(a) of this title shall not apply to actions under subsection (a) of this section"). Exchange Act § 20(a), 15 U.S.C. § 78t(a) (1982), provides that controlling persons are subject to joint and several liability for the Exchange Act violations of their employees (or other "controlled" persons), "unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation"

failed to take appropriate steps to prevent such act or acts before they occurred"³⁸⁶

This language, however, could plausibly be construed to hold a controlling person accountable for many actions taken by an employee; in the case of broker-dealers, portfolio managers, and other securities professionals, the trade itself arguably comprises the "act . . . constituting the violation." So construed, this provision could render broker-dealers and similarly circumstanced employers virtual insurers of their employees' acts. Such a reading would depart from the prior statutory framework, which permitted a good faith defense for controlling persons.³⁸⁷

Moreover, it is unclear precisely what would constitute "appropriate steps" to prevent a violative act before it occurred. This provision could, for example, be construed as imposing a heavy obligation to prevent insider trading and tipping violations by controlled persons. That goal is unattainable. The imposition of substantial monetary penalties might incrementally improve the performance of some controlling persons, but could not prevent all violations. If the term "appropriate steps" is read expansively, effectively requiring the complete prevention of insider trading by subordinates, liability for employers and controlling persons under ITSFEA would be greatly expanded.

However these provisions are construed, they fundamentally misperceive the role of most employers who have been involved in the insider trading scandal to date. Far from being responsible for their employees' violations of the law, and far from failing to take steps to prevent those violations, most of the employers who have had the unfortunate experience of employing someone who trades on inside information are in fact the only true victims, in an otherwise victimless crime, of their employee's defalcations.³⁸⁸

386. Exchange Act § 21A(b)(1)(A), 15 U.S.C.A. § 78u-1(b)(1)(A) (West Supp. 1989).

387. As previously noted, *supra* note 385, ITSFEA does specify that controlling persons shall not be liable to private plaintiffs based *solely* upon employment or control of a person who violates the Exchange Act. In the context of private litigation, controlling persons may still invoke the good faith defense contained in Section 20(a) of the Exchange Act. See Exchange Act § 20A(b)(3), 15 U.S.C.A. § 78t-1(b)(3) (West Supp. 1989).

If such a corporation is found not to have taken "appropriate steps" to prevent the violation, however, liability will ensue, and the good faith defense contained in Section 20(a) of the Exchange Act is *not* available in government prosecutions. (This provision will only be relevant, of course, when someone already has violated the law; an employee's violation could be asserted by zealous prosecutors, however, as evidence of whether "appropriate steps to prevent" the violations were in fact taken).

388. Ironically, ITSFEA might well have altered the results in the *Winans* case. The Supreme Court went to great lengths to indicate that the *Wall Street Journal* (the *Journal*)

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Consistent with the Congressional goal of imposing greater accountability on those who employ insider traders, ITSFEA imposes on registered brokers, dealers, and investment advisers a new obligation to "establish, maintain, and enforce written policies and procedures reasonably designed . . . to prevent the misuse . . . of material, nonpublic information" by their employees.³⁸⁹ Similarly, new Section 204A added to the Advisers Act by ITSFEA would impose an analogous obligation upon registered investment advisers.³⁹⁰

These provisions reflect an increased emphasis on self-regulation, by imposing substantial liability on those regulated employers who fail to carry out their new supervisory responsibilities. Presumably, these provisions are enforceable in administrative proceedings and may, in addition to other remedies available to the SEC, result in limitations on the business activities these entities are allowed to perform, if they are found not to have developed adequate mechanisms to prevent insider trading violations by errant employees.³⁹¹

Apart from SEC enforcement powers, ITSFEA also adopts the idea, first developed in the Proscriptions Act,³⁹² of granting private litigants an express right of action against persons who engage in

had been victimized by Winans and his cohorts, and that proprietary information belonging to the *Journal* had wrongfully been purloined by the *Journal's* employees. See *Carpenter v. United States*, 484 U.S. 19, 24 (1987). For his part, Winans indicated that he really did not know the *Journal* had a policy against misuse of the *Journal's* inside information, and if such a policy existed, it was not enforced. See R. Foster Winans, Remarks at the National Joint Conference on White-Collar Crime, Aug. 31, 1987, at 5 ("seeing the policy in black and white . . . might have sensitized me to the issue so that when the offer was made [to sell information concerning his impending Wall Street Journal columns], maybe I would have hesitated just long enough for the temptation to pass"). If Winans' statements were credited, under ITSFEA both Winans and the *Wall Street Journal* could be prosecuted for illegal insider trading.

389. See Exchange Act § 15(f), 15 U.S.C.A. § 78o(f) (West Supp. 1989) (emphasis supplied), and Advisers Act § 204A, 15 U.S.C. § 80b-4A (West Supp. 1989). Yet, while seeking to expand the accountability of such persons, new Section 15(f) of the Exchange Act may in fact narrow the class of persons within its reach; in mandating that registered brokers, dealers, and investment advisers establish, maintain, and enforce procedures to prevent the misuse of material, nonpublic information in violation of this title, this provision could impose on the government the burden of having to prove that a wrongdoer subjectively "used" material, nonpublic information, rather than having traded while in possession of such information.

390. See Advisers Act § 204A, 15 U.S.C.A. § 80b-4A (West Supp. 1989).

391. Cf. Exchange Act § 15(b)(4), 15 U.S.C. § 78o(b)(4) (1982) (authorizing the Commission to censure, limit the activities of, suspend or bar registered brokers and dealers for failure reasonably to supervise their employees with a view to preventing violations of the Exchange Act); Advisers Act § 203(e), 15 U.S.C.A. § 80b-3(e) (West Supp. 1989) (same as to investment advisers with respect to employee violations of the Advisers Act).

392. See *supra* notes 357-61 and accompanying text.

insider trading, provided that the private plaintiffs traded the affected securities contemporaneously with, and on the opposite side of, the alleged insider trader.³⁹³ This express right of action gives private litigants a potent weapon against which there appear to be few limiting defenses.³⁹⁴

In an effort to encourage even broader judicial recognition of implied remedies for alleged insider trading, ITSFEA also contains a provision negating any inferences that its legislative scheme precludes private plaintiffs from successfully maintaining other, implied causes of action to recover damages sustained by virtue of a violation of *any* provision of the Exchange Act.³⁹⁵ This broad recognition of other, implied rights of recovery is intended to enhance the deterrents to illegal insider trading by encouraging active private litigation.³⁹⁶

Significantly, Congress did not limit its attention to domestic enforcement issues or the creation of domestic private rights of actions. ITSFEA also broadens the Commission's ability to conduct investigations on behalf of, and for the sole benefit of foreign securities authorities, without regard to whether the conduct at issue would constitute a violation of United States law.³⁹⁷ As noted above, the Commission increasingly has promoted cross-border cooperation in securities law enforcement and oversight matters among nations that share an interest in fostering honest capital markets.³⁹⁸ Heretofore, the Commission has largely been the recipient of cooperative efforts by foreign governments.³⁹⁹ This provision of ITSFEA ensures that the Commission will have the capability to respond to reciprocal requests.

393. See Exchange Act § 20A(a), 15 U.S.C.A. § 78t-1(a) (West Supp. 1989).

394. For example, there is no requirement that the injury sustained as a result of the alleged violation breach any duty owed to the plaintiff. Moreover, the provision authorizing the court to award "appropriate equitable relief" offers no guidance as to what is contemplated, and so could be read as an extremely broad grant of authority to impose civil liability.

395. See Exchange Act § 20A(a), 15 U.S.C.A. § 78t-1(d) (West Supp. 1989).

396. Private rights of action under ITSFEA are governed by a five-year statute of limitations. See Exchange Act § 20A(b)(4), 15 U.S.C.A. § 78t-1(b)(4) (West Supp. 1989).

The SEC recently filed an *Amicus Brief* in *Lebman v. Aktiebolaget Electrolux* (U.S. June 26, 1989) (No. 88-1114), asserting that all Rule 10b-5 private actions should be governed by a five-year statute of limitations, consistent with the statute of limitations applicable to SEC penalty actions, see Exchange Act § 21(d)(2)(D), 15 U.S.C.A. § 78u-1(d)(2)(D) (1982 & West Supp. 1989), and the newly-created private rights of action, see Exchange Act Section 20A(b)(4), 15 U.S.C.A. § 78t-1(b)(4) (West Supp. 1989).

397. See Exchange Act § 21(a)(2), 15 U.S.C.A. § 78u(a)(2) (West Supp. 1989).

398. See *supra* notes 286-89 and accompanying text.

399. See *supra* note 287 and accompanying text.

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Plainly, the Commission's continued ability to seek helpful information from other countries in international market oversight and law enforcement matters will likely correspond to its ability to extend such cooperation to other countries. Prior to the adoption of this provision, the Commission did not possess the authority to conduct investigations or otherwise gather information for the sole benefit of foreign securities regulators. Thus, this section of ITSFEA not only fills an important gap in the SEC's power and recognizes the benefit of reciprocal assistance among financial regulators, but assures that the agency can continue to expand its efforts in the international arena well into the future.

While the grant of additional enforcement authority to the SEC may prove salutary, ITSFEA suffers from its failure to adopt a definition of the underlying offenses of insider trading and tipping. This omission is particularly troublesome in view of the significant increase in penalties authorized by ITSFEA. The failure to include a definition of the underlying substantive offenses disregards the conclusions of a report commissioned by Congressman Dingell, Chairman of the House Committee on Energy and Commerce, and issued by the General Accounting Office (GAO). The report examined the insider trading enforcement programs administered by the Commission, the Department of Justice (Justice), and the various self-regulatory organizations (SROs) that oversee member broker-dealers.⁴⁰⁰

After analyzing evidence secured by, and interviewing personnel from, the SEC, other federal law enforcement agencies, and selected SROs,⁴⁰¹ the GAO concluded that "[a]dditional investigative methods . . . along with changes in the securities laws, *such as defining insider trading*, may be necessary if the goal is stronger penalties for this violation."⁴⁰² Indeed, the GAO Report further observed that a statutory definition of insider trading might be

400. See UNITED STATES GENERAL ACCOUNTING OFFICE, REPORT TO THE CHAIRMAN, SUBCOMM. ON OVERSIGHT AND INVESTIGATIONS COMM. ON ENERGY AND COMMERCE, HOUSE OF REPRESENTATIVES: SECURITIES REGULATION—EFFORTS TO DETECT, INVESTIGATE, AND DETER INSIDER TRADING [hereinafter GAO REPORT] 14-17 (1988).

The GAO REPORT resulted from hearings before the House Subcommittee on Oversight and Investigations in December 1986 concerning the then-recent revelations of significant insider trading schemes. See *Securities and Exchange Commission and Insider Trading: Hearing Before the House Subcomm. on Oversight and Investigations of the Comm. on Energy and Commerce*, 99th Cong., 2d Sess. (1986). The GAO's mandate was "to review the approaches used to deal with insider trading and identify alternatives that might lead to improved detection, investigation, and prosecution." GAO REPORT, *supra*, at 2.

401. *Id.* at 17.

402. *Id.* at 3 (emphasis supplied).

required in order for the "relevant provisions of the Securities Exchange Act of 1934 [to] meet the constitutional principle of 'specificity' required of criminal law."⁴⁰³

Viewed in its entirety, ITSFEA moves the federal securities regulatory framework in a direction that is both dangerous for the unwary and unforgiving of those who suffer the misfortune of employing an insider trader. In essence, the new securities regulatory scheme increases supervisory responsibilities for employers and supervisors,⁴⁰⁴ and fortifies these provisions with steep increases in the applicable civil⁴⁰⁵ and criminal⁴⁰⁶ penalties. At the same time, the legislation erodes certain defenses formerly available to those persons who, by definition, may be secondarily liable for the acts of other persons over whom they may in fact exercise little, if any, meaningful control.⁴⁰⁷

d. *The Securities Law Enforcement Remedies Act of 1989*

On January 18, 1989, the Commission submitted to Congress a legislative proposal to enhance its ability to enforce the provisions of the various federal securities laws. This proposal responded to the

403. *Id.* at 58; *see also id.* at 61, 63. The authors endorse the GAO's conclusion in this regard.

404. *See supra* notes 384-91 and accompanying text.

405. *See supra* notes 379-80 and accompanying text.

406. *See supra* notes 381-82 and accompanying text.

407. *See supra* note 383. In a sense, the company that employs a truly venal person exercises virtually no *meaningful* "control" over his wrongdoing. For example, the investment banker who calls his Bahamian broker from pay phones and conceals his illicit trades (based, of course, upon information pilfered from his place of business and his clients) simply cannot be thwarted by even the best compliance department.

Yet, the employer firm could well face onerous penalty proceedings should the government choose to pursue the matter. (Of course, the firm would not be subject to penalty liability in private claims since ITSFEA preserves the peculiarly governmental feature of that provision). Thus, if a firm employs a broker who executes a small illegal trade, for a total profit of \$2,500, the firm could be held liable for up to \$1 million in civil penalties, and \$2.5 million in criminal fines. While the likelihood that such a fine and penalty would actually be imposed is remote, it is certainly possible and unnecessarily harsh.

Nevertheless, even if substantial civil and criminal liability (at the behest of the government) is not necessarily a preordained result in insider trading cases under ITSFEA, the ramifications of private litigation should not be overlooked, in light of the adoption of ITSFEA. As previously noted, private plaintiffs now have their choice between an express action (for contemporaneous traders) and/or an implied action (expressly sanctioned by Congress). *See* Exchange Act § 20A(a), 15 U.S.C.A. § 78t-1(a) (West Supp. 1989) (express private remedy for contemporaneous traders); Exchange Act § 20A(d), 15 U.S.C.A. § 78t-1(d) (West Supp. 1989) (other express or implied private remedies not prohibited). This facilitation of private litigation necessarily encompasses the likelihood that private litigation, even if not meritorious, will have a settlement value to busy corporations and their senior executives.

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directive in ITSFEA that the Commission review, and forward to Congress recommendations for enhancing, its enforcement capabilities.⁴⁰⁸

The resulting proposal, the Securities Law Enforcement Remedies Act of 1989 (Remedies Act),⁴⁰⁹ represented a bold effort by the Commission to expand its enforcement powers. If this measure had been enacted as originally drafted, the Commission would have acquired sweeping authority over corporate officials that would effectively have permitted the Commission to decide who could, and who could not, serve as an officer or director of a public company. Additionally, the Act would have authorized the imposition of substantial civil and administrative fines that would have been applicable to any violation of the four securities statutes affected by the Remedies Act.⁴¹⁰

408. See H.R. 5133, 100th Cong., 2d Sess. § 7(b)(2), (c)(1).

409. H.R. 975, 101st Cong., 1st Sess., 135 CONG. REC. H270 (daily ed. Feb 9, 1989).

410. The proposed legislation included the following broad categories of provisions that would have amended the Securities Act, Exchange Act, Company Act, and Advisers Act:

1. Authorization for the Commission to seek, and the federal district courts to impose, against any person found to have violated *any* provision of the federal securities laws (or any rule or regulation promulgated thereunder), a bar against serving as an officer or director of a public company. *Id.* at § 101 (Proposed Securities Act Amendment), § 202(1) (Proposed Exchange Act Amendment), § 302(1) (Proposed Company Act Amendment), § 402(1) (Proposed Advisers Act Amendment);
2. Authorization for the Commission to seek, and the federal district courts to impose, civil penalties in connection with *any* violation of the federal securities laws or any rule or regulation promulgated thereunder. *Id.* at § 102(a) (Proposed Securities Act Amendment), § 202(a) (Proposed Exchange Act Amendment), § 302(a) (Proposed Company Act Amendment), § 402(2) (Proposed Advisers Act Amendment). The various fine provisions specify a maximum of the greater of \$100,000 for individuals (\$500,000 for entities) or the gross amount of pecuniary gain associated with the violation; *see id.* at §§ 102, 202, 302, 402. The statute does not define the concept of pecuniary gain;
3. Authorization for the Commission to impose in administrative proceedings pursuant to Exchange Act Section 15(c)(4), against any person found to have violated specified provisions of the federal securities laws or any rule or regulation promulgated under those provisions, a bar against serving as an officer or director of a public company. *Id.* at § 201, *see supra* note 315 and accompanying text; and
4. Authorization for the Commission to impose in administrative proceedings a monetary penalty against any person found to have

On February 1, 1990, the Securities and Exchange Commission submitted proposals to amend S. 647 which, if adopted, would grant the Commission (i) administrative authority to issue cease-and-desist orders, including temporary orders; (ii) the right to obtain grand jury information, upon judicial application by a prosecutor, if the information sought relates to potential securities law violations; (iii) administrative authority to impose equitable remedies, such as disgorgement of ill-gotten gains and an accounting, against any person; and (iv) the authority to compel a federal district court to impose minimum fines for noncompliance with certain insider reporting requirements under the Exchange Act. In return for these new powers, the Commission concomitantly proposed to (i) delete those portions of S. 647 that would have enabled the agency administratively to bar certain persons from serving as officers or directors of public companies; (ii) limit the power of the federal courts to bar persons from serving as officers and directors of public companies to situations in which those persons had been found to violate a scienter-based fraud statute; and (iii) modify its proposal to obtain the authority to impose monetary fines administratively.

If enacted in either form—as originally introduced, or as the Commission now proposes to amend it—the Remedies Act would substantially increase the sanctions confronting respondents in SEC enforcement proceedings. One significant alteration to the remedies framework would be the *de facto* shift from remedial to punitive sanctions. The new authority sought in this bill, which could, in many cases, be invoked even in response to the most minor, technical violations of the securities laws, suggests an effort by the government to amass an enforcement arsenal of excessive proportions.

Perhaps the most significant aspect of this proposed legislation is the prospect that, if adopted, it would in almost every case allow the Commission, at its own discretion, to bypass the federal courts altogether, thereby bypassing many of the safeguards currently protective of respondents' rights in the judicial system. In view of the many highly technical requirements specified in the federal securities laws, some of which operate as strict liability provisions

violated any provision of the federal securities laws or any rule or regulation promulgated thereunder. *Id.* at § 203(a) (Proposed Exchange Act Amendment), § 301(a) (Proposed Company Act Amendment), § 401(a) (Proposed Advisers Act Amendment).

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that arguably do not require any showing of scienter,⁴¹¹ this remedies framework could permit the imposition of extraordinarily harsh punishment for seemingly trivial misconduct. This result is, at best, inconsistent with the remedial purposes of the federal securities laws.⁴¹²

These new penalties are disproportionately harsh in several respects. For example, a violation of the net capital rules of the Exchange Act does not necessarily bear a relationship to the violator's qualifications to serve as an officer or director of a public company. We have serious doubt that the SEC requires this authority to carry out its mission;⁴¹³ moreover, regardless of whether the SEC requires this authority, the grant of such authority would intrude the SEC into the proper domain of state law and shareholder rights.⁴¹⁴ Of course, even if such a measure were

411. For example, Exchange Act § 13(a)(2), 15 U.S.C. § 78m(a)(2) (1982), and Rules 13a-1 and 13a-13 thereunder, 17 C.F.R. § 240.13a-1, 240.13a-13 (1989), prescribe the requirements of, and time periods for, filing annual and quarterly reports for issuers having securities registered pursuant to Exchange Act § 12. If a required report is filed one day late, these provisions have been violated, even if the issuer acted without scienter. See, e.g., Rule 13a-1 ("annual reports *shall be filed* within the period specified in the appropriate form . . .") (emphasis supplied).

412. See, e.g., SEC v. Savoy Indus., 587 F.2d 1149, 1169 (D.C. Cir. 1978) ("The principal purpose of . . . [an] injunction is, of course, to deter future violations, and *not to punish the violator*") (emphasis supplied), cert. denied, 440 U.S. 913 (1979); SEC v. Geon Indus., 531 F.2d 39, 56 (2d Cir. 1976) ("The historic injunctive process was designed to *deter, not to punish*") (emphasis supplied); SEC v. Parklane Hosiery Co., 422 F. Supp. 477, 487 (S.D.N.Y. 1976) (same), *aff'd*, 558 F.2d 1083 (2d Cir. 1977).

413. Our views in this regard are reflected in the American Bar Association's Section on Corporations' comment letter on this proposed legislation. See Letter from Jean Allard to The Honorable Donald W. Riegle, Jr. (Apr. 9, 1990) [hereinafter ABA Letter] (on file with authors). The ABA Letter was drafted by a comment team chaired by Mr. Pitt.

It is conceivable that the SEC might be confronted with a situation in which it genuinely requires a court order enjoining someone from serving as an officer or director of a public company, for example, where an individual has looted one public company and is about to do the same with another public company. But, those instances in which the SEC needs this authority are quite rare. Indeed, to the best of our knowledge, this relief has only been granted once in a litigated case. See SEC v. Techiculture, Inc. [1973-74 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,501 (D. Ariz. Apr. 2, 1974). Presumably, if the SEC has the authority to seek disgorgement and other equitable remedies, it may be able to obtain an extraordinary writ from a federal judge, enjoining someone from serving on a board, when a true emergency so requires. See generally Exchange Act § 21(d)(1), 15 U.S.C. § 78u(d)(1) (1982) (general authority for the federal district courts to issue injunctive relief upon application of SEC).

414. See generally CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69, 89 (1987) (corporate governance is properly a function of state law). The times when such a remedy will be needed by the SEC is likely quite small, since the SEC's effectiveness over the past fifty-five years has not been impaired by the absence of this authority. In light of the lack of any demonstrable need for this authority, Congress should not attempt to vest such authority in the SEC given the dangers this legislation poses as a potential usurpation of legitimate state law functions.

appropriate on rare occasions, a more narrowly-tailored provision should limit the availability of this sanction.⁴¹⁵

The new monetary penalties sought by the Commission also raise concerns over their potentially excessive applicability. Particularly in the wake of ITSFEA's sharply increased monetary penalties,⁴¹⁶ the need for an additional layer of civil and administrative fines has not been shown.⁴¹⁷

And, this civil fine authority would be a non-exclusive remedy, available "in addition to any other actions that the Commission or the Attorney General is entitled to bring."⁴¹⁸ If this non-exclusivity feature is retained, particularly with respect to insider trading allegations that may be charged under Exchange Act Section 10(b) (with the attendant Exchange Act civil penalties), Securities Act Section 17(a), and the Racketeer Influenced and Corrupt Organizations Act (RICO),⁴¹⁹ the pecuniary sanctions available to the government would reach a maximum of

- (i) *seven times* the profit gained (or loss avoided) in the transaction;
- (ii) a civil fine pursuant to this provision;
- (iii) if the defendant is a securities professional registered with the Commission, one or more administrative fines pursuant to other provisions of the Remedies Act; and

415. At a minimum, the Commission should be required to show that the offender was an officer or a director of a public company at the time of the violation and that the violation bears on the offender's ability to carry out the responsibilities attendant to the corporate office. An additional benefit of narrowing this sanction would be the resulting limitation of the Commission's ability to extract settlement concessions from defendants faced with the ultimate sanction—a bar against remaining with his or her present, or any other, public company.

416. See *supra* note 381 and accompanying text.

417. These large fines could apply to cases in which the alleged wrongdoer reaped no pecuniary gain, such as the late filing of a Form 3 or 4. See *infra* note 460 and accompanying text. This seems particularly ill-advised in light of the Supreme Court's recent ruling that excessive civil fines in government proceedings, the amounts of which bear no rational relationship to compensating the government for its losses or the costs of detecting and prosecuting the matter, may in fact constitute punishment rather than a remedy. In such cases, the constitutional guarantee against double jeopardy would preclude subsequent criminal prosecution of the offense. See *United States v. Halper*, 109 S. Ct. 1892 (1989).

418. See Exchange Act § 21(d)(2)(A), 15 U.S.C.A. § 78u-1(d)(2)(A) (West Supp. 1989).

419. 18 U.S.C. §§ 1961-68 (1982).

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- (iv) an order banning the individual defendants from ever serving as officers or directors of a public company.

This “piling-on” of sanctions seems both vindictive and unnecessary.

The administrative fine provisions, however, suggest even more troublesome failings, possibly of constitutional dimensions. Presumably, the imposition of these fines would follow a trial before a Commission administrative law judge, who would act in the dual capacity of trier of fact and trier of law. Yet, the Seventh Amendment to the Constitution guarantees the right to a jury trial in actions seeking monetary penalties.⁴²⁰ This provision, however, would permit the Commission to avoid that requirement, as no other litigant could, simply by instituting an administrative proceeding.

Other significant issues of fairness permeate the question whether the Commission should be permitted to assess monetary fines in an administrative proceeding. These questions arise largely because the Commission has the choice, at its complete discretion and without any express or implied standards, to proceed in an administrative or judicial forum. If the Commission chooses to institute an administrative proceeding before one of its administrative law judges (ALJs), there is no right to remove the case for a hearing before an independent federal district court.⁴²¹

In sum, the Remedies Act would vest in the Commission considerable procedural and strategic advantages, to the detriment of assuring fairness to potential respondents and defendants. Taken

420. See *Tull v. United States*, 481 U.S. 412, 417-25 (1987) (Seventh Amendment to the United States Constitution guarantees right to jury trial in cases where the government seeks a monetary penalty).

421. See *Touche Ross & Co. v. SEC*, 609 F.2d 570 (2d Cir. 1979). From the point of view of the respondent, a federal district court proceeding includes a right to a trial before an independent federal judge, the right to immediate relief by motion to dismiss, summary judgment or other means, a right to discovery under the Federal Rules of Civil Procedure, see *supra* note 308, a right to subpoena witnesses without special permission of the trial judge and the imposition of the burden on the Commission to prove its case by a preponderance of the evidence. In contrast, in a Commission administrative proceeding, the respondent may subpoena evidence only upon the approval of the ALJ, preliminary dispositive motions are prohibited, and there are no rights of discovery, notwithstanding the considerable advantage the Commission enjoys by virtue of the compulsory process available to the Staff in the investigations that precede administrative proceedings. The authors believe that, at a minimum, the Commission should not be permitted to assess the substantial penalties provided in the Enforcement Remedies Act without assuring the protections inherent in the level playing field established by the federal rules of civil procedure.

in conjunction with the higher penalties prescribed in ITSFEA, these two bills portend a trend toward potentially draconian, punitive enforcement of the federal securities laws.⁴²²

e. The International Securities Enforcement Cooperation Act of 1989

As the Commission continued to seek law enforcement information from foreign securities regulators, it sought an expansion of its authority to permit the extension of reciprocal assistance to foreign regulators. To that end, the Commission submitted to Congress proposed legislation entitled "The International Securities Enforcement Cooperation Act of 1989" (ISECA). This legislation contemplates empowering the Commission to exchange certain types of information with foreign securities regulators, subject to assurances that the confidentiality concerns of each nation will be addressed.⁴²³ Additionally, ISECA would authorize

422. Among other concerns engendered by the Commission's proposed amendments to S. 647 are the following:

1. The Commission's proposal to ease its access to grand jury matters (i) virtually eliminates the current assurance of secrecy essential to protecting respondents' rights in the grand jury process and contains no express sanctions for abuse of the grand jury information obtained, and (ii) would further perpetuate the unfairness of the present administrative process and would inject into federal court actions enhanced discovery for the Commission without a reciprocal enhancement for the respondent.
2. An extraordinary remedy, such as civil fining authority should be granted only on a section-by-section basis, and only after the Commission demonstrates, as it did when requesting ITSA, that the remedy is essential to enforcing a specific section of the securities laws.
3. Under the civil penalty provisions of the proposed legislation, federal courts and (with respect to regulated entities) the Securities and Exchange Commission would be empowered to impose huge fines for violation of the federal securities laws, with virtually no requirement for determining whether a fine is appropriate or, if so, in what amount.
4. The SEC's proposal for cease-and-desist authority contains ambiguous language that might authorize the SEC to act administratively to inhibit zealous representation by counsel, and might impose severe (perhaps crippling) monetary sanctions without the intercession of a court, and without the benefit of a stay of the SEC's order pending such judicial review as may be obtainable.

A copy of the Commission's proposed amendments to S. 647 is on file with the authors.

423. See ISECA § 6(b), H.R. 1396, 101st Cong., 1st Sess., 135 CONG. REC. H5870, H5872 (1989). As noted above, Congress has already expanded the Commission's authority to gather and provide information to foreign securities regulators. See *supra* note 397 and accompanying text.

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the Commission to rely on the findings of foreign tribunals as the basis for imposing administrative sanctions on securities professionals registered, or applying for registration, in the United States.⁴²⁴

ISECA would cure numerous problems impeding the Commission's ability to deal with investigations extending beyond the territorial limits of the United States. For example, the SEC thus far has been unable to assure foreign securities authorities that any documents they provide to the Commission will not be disclosed; the Freedom of Information Act (FOIA) mandates disclosure of investigative records in the Commission's possession unless, among other reasons, a current enforcement interest requires preserving the confidentiality of the requested information.⁴²⁵

The agency's inability to offer that assurance may well inhibit foreign securities authorities from providing information to the Commission.⁴²⁶ Granting the Commission the authority to offer these assurances comports with the purposes of FOIA,⁴²⁷ since affected documents would likely never have found their way to the Commission's files (thus rendering them subject to FOIA requests) absent assurances of confidentiality.⁴²⁸

In seeking a form of reciprocity for foreign sanctions against securities professionals, however, the Commission's proposal stands on less sure footing. By these provisions, the Commission seeks authority to invoke the findings of foreign tribunals, concerning certain violations of foreign law, as a basis for imposing administrative sanctions upon securities professionals registered, or seeking registration, to do business in the United States securities markets.⁴²⁹ Thus, securities professionals found by a competent

424. See *id.* at §§ 3, 5. The bill also includes certain housekeeping details, such as definitions, *id.* at §§ 4, 6, and provisions relating to the expenses of covered investigations, *id.* at § 7.

425. See 5 U.S.C. §§ 552a(a)(3), 552a(b)(7) (1982); 17 C.F.R. § 200.80(b) (1988).

426. For a discussion of foreign nondisclosure principles, see generally *Problems of Enforcement*, *supra* note 269, at 381.

427. The legislative history of the FOIA demonstrates that the purpose of the Act is to assure "[t]he right of the individual to be able to find out how his Government is operating" H.R. REP. NO. 1497, 89th Cong., 2d Sess., *reprinted in* 1966 U.S. CODE CONG. & ADMIN. NEWS 2418, 2423.

428. Of course, the availability of such confidential treatment may encourage foreign authorities to request it, even when there may be no clear obligation under foreign law for them to do so. Nevertheless, the benefit of increased cooperation in international law enforcement, particularly in the face of the impediments presented by foreign nondisclosure laws that might otherwise prevent the SEC from obtaining needed information, should outweigh the inconvenience of testing the occasional unwarranted request for confidential treatment.

429. See ISECA §§ 3, 5, H.R. 1396, 101st Cong., 1st Sess., 135 CONG. REC. H5879

foreign tribunal to have engaged in conduct that violates foreign law that is the "substantial equivalent" of an analogous SEC prohibition, would be subject to the full panoply of SEC administrative sanctions, based solely upon foreign misconduct.⁴³⁰

The Commission is of the view that, since certain of the statutory predicates for the administrative sanctions that may be imposed upon brokers and dealers do not *preclude* basing those sanctions upon foreign misconduct, the Commission currently enjoys, at least impliedly, the authority to impose sanctions on brokers and dealers registered (or seeking registration) in the United States based upon a violation of certain foreign prohibitions.⁴³¹

Nevertheless, rather than waste scarce time and resources litigating the question,⁴³² it seems sensible to vest the Commission

(1989).

430. See Exchange Act §§ 15(b)(4), 15(b)(6), 15 U.S.C. §§ 78o(b)(4), 78o(b)(6) (1982) (authorizing the Commission to censure, limit the activities of, suspend, or revoke the registration of any broker or dealer, or person associated with a broker or dealer, respectively, upon a finding of specified violations of law).

Thus, for example, the Commission is empowered to so proceed against any broker or dealer that: has made (or caused to be made) a false filing with the Commission, *see* 15 U.S.C. § 78o(b)(4)(A) (1982); has been convicted, within 10 years before its application for registration, of any felony or misdemeanor (a) found by the Commission to involve a securities transaction, a false oath or report, bribery, perjury or burglary (or conspiracy to commit these offenses, *see* 15 U.S.C. § 78o(b)(4)(B)(i) (1982); (b) that arises from the business of the securities or commodities industry, insurance, banking, investment advisory services, fiduciary or transfer agency, *see* 15 U.S.C. § 78o(b)(4)(B)(ii) (1982); (c) involving the wrongful obtaining of funds or securities, *see* 15 U.S.C. § 78o(b)(4)(B)(iii) (1982), or involving concealment of assets or other offenses in a bankruptcy proceeding, mail or wire fraud, counterfeiting, forgery or other federal fraud or false statements, *see* 15 U.S.C. § 78o(b)(4)(B)(iv) (1982); (d) has been permanently or temporarily enjoined from conducting securities, commodities, banking or insurance business or from any conduct or practice in such industry, *see* 15 U.S.C. § 78o(b)(4)(C) (1982); (e) has willfully violated, or is unable to comply with, any provision of the Securities Act of 1933, the Exchange Act, the Advisers Act, the Company Act, the Commodity Exchange Act, the rules or regulations under any of the Acts or the rules of the Municipal Securities Rulemaking Board, *see* 15 U.S.C. § 78o(b)(4)(D) (1982); (f) has willfully aided, abetted or otherwise induced or procured a violation of the above statutes by another person, or failed to adequately supervise a person who violates one of the above statutes, *see* 15 U.S.C. § 78o(b)(4)(E) (1982); or (g) is subject to an order of the Commission barring or suspending the person from association with a broker or dealer, *see* 15 U.S.C. § 78o(b)(4)(F) (1982).

431. See SEC Memorandum in Support (ISECA), *supra* note 310, at 13 (citing *In re R.P. Clarke & Co.*, 10 S.E.C. 1072 (1942) (revoking United States registration of Canadian broker-dealer based on conviction in Canadian court for crimes in connection with securities transactions, without discussion of jurisdiction)).

An important distinction exists between imposing sanctions for foreign conduct that violates domestic law, and imposing sanctions for foreign conduct that does *not* violate domestic law (regardless of whether it violates foreign law). See generally *Problems of Enforcement*, *supra* note 269, at 393-97.

432. In the context of *settled* proceedings, the Commission recently brought a civil injunctive action against a foreign national for insider trading in non-United States securities

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with explicit authority to protect the integrity of the United States securities industry by preventing the specified class of wrongdoing foreign securities professionals from conducting business in the domestic securities markets.

This legislative proposal should ease the Commission's ability to provide the type of international cooperation governed by MOUs, by permitting the agency the flexibility to address the concerns of securities regulators in jurisdictions with nondisclosure laws. This, in turn, should help to encourage a community of interest among nations with developed capital markets in coordinated market surveillance and law enforcement, to advance the shared goal of honest securities markets.

listed on a foreign securities exchange, without encountering any jurisdictional obstacle. The broker and brokerage account through which the transactions were ordered provided the sole nexus to the United States. *See SEC v. Collier*, Litigation Release No. 11,817, 41 SEC Docket 711 (C.D. Cal. July 26, 1988).

It is unclear, however, whether the Commission's assertion of jurisdiction would have succeeded had the action been contested. Well-settled principles of international law demonstrate that, under the "conduct" test for determining whether a sovereign may prescribe rules governing actions:

A state has jurisdiction to prescribe a rule of law

(a) attaching legal consequences to conduct that occurs within its territory, whether or not such consequences are determined by the effects of the conduct outside the territory, *and*

(b) *relating to a thing located, or a status or other interest localized, in its territory.*

Restatement (Second) of Foreign Relations Law of the United States § 17 (1965) (emphasis supplied).

It is also unclear whether a court would interpret Restatement Section 17(b), as precluding the exercise of prescriptive jurisdiction over domestic transactions by a foreign citizen in securities of a foreign issuer traded on a foreign exchange, where the effects of the wrongful conduct do not impinge upon any interest *located in the United States*. Despite numerous judicial opinions suggesting that the federal securities laws can be applied beyond the United States borders, *see, e.g., IIT v. Vencap, Ltd.*, 519 F.2d 1001, 1017 (2d Cir. 1975) ("We do not think Congress intended to allow the United States to be used as a base for manufacturing fraudulent security devices for export . . ."); *SEC v. Kasser*, 548 F.2d 109, 114 (3d Cir.) ("We are . . . skeptical that Congress wished to preclude all SEC suits for injunctive relief where the victim of a fraudulent scheme [carried out in the United States] happens to be foreign or where there was insubstantial impact on the United States"), *cert. denied*, 431 U.S. 938 (1977), some cases imply that certain limitations nevertheless constrain the extraterritorial reach of the antifraud provisions of the federal securities law. *Cf. Tamari v. Bache & Co. (Lebanon) S.A.L.*, 730 F.2d 1103, 1108 (7th Cir.) (fraudulent transactions from abroad *on United States exchanges* cause sufficient harm to invoke United States jurisdiction), *cert. denied*, 469 U.S. 871 (1984); *IIT v. Cornfeld*, 462 F. Supp. 209, 223 (S.D.N.Y. 1978) (in predominantly foreign transaction, facts that defendants were American and offering circulars were prepared in United States are insufficient for prescriptive jurisdiction), *aff'd in part, rev'd in part*, 619 F.2d 909 (2d Cir. 1980).

f. Congressional Oversight

Apart from Congress' consideration of specific legislative proposals either submitted by the SEC or initiated in Congress, the Commission has always been subject to an extensive amount of general Congressional oversight, directed at a review of how the agency functions and whether improvements in its processes can be effected.⁴³³ The success of the agency's insider trading program, combined with its high degree of visibility, however, exponentially increased the amount of oversight devoted to the SEC,⁴³⁴ and expanded the scope of that oversight in a direction that has had, and will have, implications for the Commission's enforcement program.

Despite the overall success of the SEC's insider trading program—a success crafted in the face of significant obstacles relating to the lack of a precise statutory definition of the crime of insider trading and the lack of express remedies for that conduct⁴³⁵—a great deal of the Congressional oversight of the 1980s has been devoted to a variety of criticisms of the agency's performance. Much of the remainder of that oversight has reflected the efforts of members of Congress to enmesh themselves in a popular, highly-visible, SEC enforcement effort, in a desire to become a part of the process and contribute to its effectiveness.

Thus, during the past decade, Congress principally focused on:

- (i) ascertaining whether the agency's settlements of various insider trading cases were too lenient;⁴³⁶

433. See, e.g., *SEC Lets Some Firms Skirt Disclosures on Dubious Payoffs, House Study Shows*, Wall St. J., May 25, 1976, at 2, col. 3. During the SEC's foreign payments program, Congressman Dingell's predecessor, Congressman John E. Moss, conducted a review of the effectiveness of the SEC's program, and singled out for special criticism eight cases (out of the hundreds in which the Commission either brought enforcement action or compelled affirmative disclosures) in which the Commission, on the advice of its General Counsel, Chief Accountant, and Director of Corporation Finance, had declined to institute enforcement proceedings against companies that did not disclose questionable foreign payments. Report on Questionable and Illegal Corporate Payments and Practices issued by SEC on May 12, 1976, cited in H.R. REP. NO. 640, 95th Cong., 1st Sess. 241, 246 (1977).

434. By way of comparison, the SEC testified before Congress once in 1977, see 43 SEC ANN. REP. 26 (1977) and ten times in 1987, see 53 SEC ANN. REP. 67 (1987).

435. See *supra* notes 226-27 and accompanying text.

436. See, e.g., *Companies, Securities Firms Enlist Top Lobbyists for Showdown Over Bid to Tighten Takeover Law*, Wall St. J., Mar. 9, 1987, at 50, col. 1 (Congress conducting its own investigation into conduct of insider trading enforcement proceedings); see also *Democrats' Hold on Senate Banking Panel Augurs Tougher Stance With Banking, Securities Sectors*, Wall St. J.,

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- (ii) exploring allegations that the agency's response to, and follow-up on, referrals of insider trading cases from the various stock exchanges and the National Association of Securities Dealers, Inc. was inadequate;⁴³⁷
- (iii) assessing whether the Commission's ability to deal with foreign-based insider trading violations was, as charged, woefully inadequate;⁴³⁸ and
- (iv) conducting a public investigation to ascertain whether the targets of SEC insider trading investigations had committed other violations of the law not being investigated by the SEC.⁴³⁹

There is little doubt that hearings of this nature have had, and will continue to have, an effect on the agency's approach to enforcement. The SEC is sensitive to Congressional or media criticism.⁴⁴⁰ When its settlements are criticized, the SEC responds first, by defending itself against the charges, and second, by ensuring that such criticism is not repeated in future cases. This suggests that, over time, the SEC's requirements to settle insider trading cases are apt to become even more aggressive than is presently the case.

Similarly, the mere assertion of the claim that the Commission has not diligently pursued leads from various self-regulatory organizations, or pursued foreign-based insider trading cases more effectively, no matter how poorly founded, may well cause the

Jan. 12, 1987, at 52, col. 1 (further Congressional attention to be given to securities issues).

437. See, e.g., GAO REPORT, *supra* note 400, at 27-38.

438. See, e.g., COMM. ON GOVERNMENT OPERATIONS, PROBLEMS WITH THE SEC'S ENFORCEMENT OF U.S. SECURITIES LAWS IN CASES INVOLVING SUSPICIOUS TRADES ORIGINATING FROM ABROAD, H.R. REP. NO. 1065, 100th Cong., 2d Sess. 2 (1988) ("The [Committee's] hearing and investigation disclosed serious problems with the SEC's ability to enforce U.S. securities laws in cases involving suspicious foreign originated trading").

439. See, e.g., *Milken Pleads Fifth to Questions on Drexel Officials' Personal Bond Deals*, 20 Sec. Reg. & L. Rep. (BNA) No. 17, at 640 (Apr. 29, 1988) (House Committee investigation extending to matters not included in SEC investigation of Milken and Drexel); *House Subcommittee Plans Hearings Today on Pacific Lumber Takeover*, SEC. WK., Oct. 5, 1987, at 4.

440. See, e.g., *Dingell: Woe to Those Whose Interests Conflict*, Wall St. J., Feb. 17, 1989, at 14, col. 3 ("Securities and Exchange Commission enforcement chief, Gary Lynch, implicitly criticized Mr. Dingell's committee recently as the source of a leaked internal memo that suggested tardiness in the Boesky investigation").

agency to exercise less discretion as to whether to abandon *de minimis* violations of the law that are brought to its attention, and may prompt the Commission to expand programs like the "small dollar" program, which focus on very small violations of the law. Despite the fact that the Commission cannot pursue every claim that comes to its attention, the agency is particularly responsive to Congressional criticism, and can be expected to adopt policies designed to avoid it where possible.

E. Other Enforcement Programs of the 1980s

1. Manipulation

The pervasive problem of market manipulation was a principal focus of the SEC Enforcement Division in the 1980s. Consistent with the agency's stated intention of returning to a strict construction of the federal securities laws, Shad and Fedders communicated to the marketplace that mainstream types of securities fraud, particularly market manipulation, would attract renewed attention, in both civil and criminal proceedings.⁴⁴¹ By the end of the decade, the Commission, albeit under new leadership,⁴⁴² gave credibility to its promise to place greatest enforcement emphasis on mainstream securities fraud, as demonstrated by the fact that its market manipulation case against a prominent corporate "raider," was accompanied by a criminal prosecution.⁴⁴³

Information developed by the SEC during its insider trading investigation⁴⁴⁴ has apparently also resulted in several criminal

441. See, e.g., *Acquisitions, Rule 415, Disclosure Dominate 15th PLI Securities Institute*, 15 Sec. Reg. & L. Rep. (BNA) No. 45, at 2104, 2105 (Nov. 18, 1983) ("the Commission is monitoring the aftermarket trading activity of penny stocks [which can be the subject of manipulations]"); *SEC's Shad, Fedders Deny Commission is Overemphasizing Insider Trading*, 14 Sec. Reg. & L. Rep. (BNA) No. 41, at 1785 (Oct. 22, 1982) (Fedders tells press conference that he is "surprised" by the low volume of market manipulation cases brought in fiscal 1982 but anticipates that the number will increase in 1983); *Fedders Urges More Criminal Prosecution of Market Manipulators, Insider Traders*, 14 Sec. Reg. & L. Rep. (BNA) No. 18, at 795 (May 7, 1982) (Fedders warns the Securities Industry Association's Legal and Compliance seminar that brokerage firms must adopt stringent self-policing measures, as he predicts an increase in criminal enforcement of the securities laws).

442. By 1985, Fedders had departed the agency, succeeded by Gary G. Lynch. In 1987, Shad was succeeded by David S. Ruder.

443. See *SEC v. Bilzerian*, Litigation Release No. 12,144, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,491 (June 29, 1989); *United States v. Bilzerian*, Cr-88-962-01 (S.D.N.Y. Sept. 27, 1989); see also *United States v. GAF Corp.*, 884 F.2d 670 (2d Cir. 1989).

444. See *Another Wall Street Defendant Changes Mind, Pleads Guilty*, Assoc. Press, Aug. 31, 1989 (PM Cycle) (LEXIS, NEXIS library, Wires file) which reported that: "The second

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prosecutions—market manipulation charges involving the securities of Fireman's Fund Corp.⁴⁴⁵ and Union Carbide Corp.⁴⁴⁶ have thus far resulted in settlements in the former case,⁴⁴⁷ and, after two mistrials, a conviction in the latter case.⁴⁴⁸ The progression of these two cases points up two recurring themes that have emerged from the 1980's SEC enforcement program.

The first case, in which a decision was made to settle criminal securities fraud charges late in the trial, reflects the different strategic decisions that must be considered in the current, more criminalized environment of securities law enforcement.⁴⁴⁹ Unlike the

big-time Wall Street securities professional in two weeks [Salim B. Lewis] has reversed position and pleaded guilty to fraud charges that stem indirectly from the Ivan Boesky insider trading scandal." See also *Third GAF Trial Set for Today*, N.Y. Times, Oct. 24, 1989, at D6, col. 6 ("The GAF case was the first securities fraud trial stemming from the Ivan F. Boesky insider trading scandal"); *Crimes and Lying Get Bilzerian Four Years*, Newsday, Sept. 28, 1989, at 53, col. 1 ("Boyd Jefferies, who was implicated by Boesky . . . in turn testified against Bilzerian and others").

445. The defendants in this case were charged with purchasing shares of Fireman's Fund Corp. (FFC) stock, in trades that violated federal rules governing the extension of credit in securities transactions, to establish a closing price for FFC stock that would be a factor in pricing a pending secondary offering of FFC stock. See *United States v. Lewis*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,479 (S.D.N.Y. June 15, 1989).

446. The government alleged that the defendants in this case "conspir[ed] to manipulate the price of Union Carbide stock during GAF's negotiations to sell its block of Union Carbide stock in October 1986." *GAF Corp.*, 884 F.2d at 671.

447. Although defendants Salim B. Lewis and his firm had initially contested the charges, an unfavorable ruling on their motions to dismiss the government's allegations, see *United States v. Lewis*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,479 (S.D.N.Y. June 15, 1989), was soon followed by guilty pleas. See *A Prominent Trader Admits He Schemed to Rig a Stock Price*, N.Y. Times, Aug. 31, 1989, at A1, col. 1; *Top Wall Street Speculator Pleads Guilty to Three Counts; Lewis Admits '86 Scheme was 'Wrong'*, L.A. Times, Aug. 31, 1989, § 4, at 1, col. 4; *'Blueblood' Trader Admits Price Rigging*, Newsday, Aug. 31, 1989, at 47. S.B. Lewis & Co. subsequently settled SEC administrative proceedings arising from the same activities that gave rise to the guilty pleas described above. See *Brokerage Firm Is Censured*, N.Y. Times, Dec. 8, 1989, at D7, col. 5 (SEC censured S.B. Lewis & Co. based on its "role in . . . [the] manipulation of the stock price of the Fireman's Fund Corporation in May 1986").

448. See *Stock Fraud Conviction Another Notch In Government's Belt*, Assoc. Press, Dec. 14, 1989 (PM Cycle) (LEXIS, NEXIS library, Wires file); *N.Y. Stock Manipulation Verdict In Third Trial*, Fin. Times (U.K.), Dec. 14, 1989, at 3, col. 7.

449. See *Case of Sandy Lewis Points Up Dilemma About Clients Who Seek to Plead Guilty*, Wall St. J., Sept. 13, 1989, at B9, col. 1, which notes that Lewis "reportedly is second-guessing his attorneys" and wondering whether an earlier plea would have secured a more favorable settlement with prosecutors; see also *Bad Week for Wealthy Fraud Suspects; Pressure Builds on Holdout Milken*, Assoc. Press, Sept. 1, 1989 (BC Cycle) (LEXIS, NEXIS library, Wires file), which reports that the conviction in Leona Helmsley's tax evasion trial and the sentence in attorney Alfred Elliott's insider trading case "showed that judges and juries are quite willing to punish white-collar felons as harshly as suspects convicted for violent crimes. That fact may have played a role in the decision by [Salim B.] Lewis to strike a deal with federal prosecutors in New York and plead guilty to three felonies for stock manipulation. Lewis originally had asserted innocence and his lawyers had called his

decision to contest a civil enforcement proceeding, in which the potential consequences involve an injunction⁴⁵⁰ and perhaps a monetary penalty,⁴⁵¹ the stakes in a criminal trial are much higher, since courts have not hesitated to impose increasingly longer jail terms, along with substantial fines, in criminal securities cases.⁴⁵² The apparent trend toward increased criminal prosecutions will make the job of defense counsel all the more challenging as the difficult decisions that emerge from these cases arise.⁴⁵³

The so-called GAF manipulation case, in which the government proceeded through two mistrials, to a third full trial on the merits and a conviction,⁴⁵⁴ illustrates the relentlessness with which the government has pursued securities fraud cases, and will likely pursue them in the future. This tenacity bears out Fedders' admonition that deregulation should not be mistaken for weak enforcement.⁴⁵⁵

In pursuing a criminal prosecution of alleged stock parking by Paul Bilzerian,⁴⁵⁶ many commentators noted that the government broke new legal ground in its ongoing efforts in the Wall Street

indictment a 'piece of garbage.'"

450. See Exchange Act § 21(d), 15 U.S.C.A. § 78u(d) (1982 & West Supp. 1989).

451. See Exchange Act § 21A(a), 15 U.S.C.A. § 78u-1(a)(1) (West Supp. 1989).

452. See Exchange Act § 32(a), 15 U.S.C.A. § 78ff(a) (1982 & West Supp. 1989); see also *Bilzerian Sentenced, Parole Called 'Unlikely'*, Nat'l L.J., Oct. 9, 1989, at 6, col. 1 (Bilzerian sentenced to six concurrent four-year jail terms and fined \$1.5 million for stock parking); *Bad Week for Wealthy Fraud Suspects; Pressure Builds on Holdout Milken*, supra note 449 (insider trader Alfred Elliott sentenced to five years in prison); *Key Dates in Wall Street Scandals of Levine-Boesky Era*, Assoc. Press, Aug. 17, 1989 (AM Cycle) (LEXIS, NEXIS library, Wires file) (Dennis B. Levine sentenced to two years in prison and fined \$362,000; Ivan F. Boesky sentenced to three-year jail term); but see *Court Gives Stock Firm Founder Jefferies Suspended 5-Year Sentence, \$250,000 Fine*, Daily Rep. for Exec. (BNA) No. 129 (July 7, 1989); *Probation and Fine for Jefferies*, N.Y. Times, July 7, 1989, at D1, col. 3 ("As he announced his sentence, Judge Lasker said he believed that Mr. Jefferies was a good man who had made serious mistakes, but that there was little reason to send him to prison. 'Mr. Jefferies has by now earned his way, through agony and effort, to a suspended sentence.'").

453. For example, permitting a defendant to testify in his own behalf at trial incurs the risk that the court will consider the credibility of that testimony at sentencing. See *Bilzerian Gets Four Years in Jail and is Fined \$1.5 Million*, N.Y. Times, Sept. 28, 1989, at D1, col. 1 (the sentencing judge observed that "I do believe that if Mr. Bilzerian had not testified at all at the trial, his sentence would not be what it was." The judge further explained that, while he did not take issue with Bilzerian's posture of maintaining his innocence, he believed Bilzerian had perjured himself during his testimony).

454. See supra note 448 and accompanying text.

455. See supra note 211 and accompanying text.

456. The defendant in this case was convicted of seeking to avoid the reporting requirement of Schedule 13D, 17 C.F.R. § 240.13d-101 (1989), by placing in friendly hands portions of his stock holdings in various public companies.

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insider trading scandal.⁴⁵⁷ While it is well-established that the surreptitious accumulation of more than five percent of a public company's stock, without the requisite disclosure, violates the law,⁴⁵⁸ the criminal prosecution of these cases departs from past practice, and further underscores the heightened criminalization that should be anticipated in the next decade.

2. *Delinquent Filing Program*

In 1983, the SEC briefly joined the ranks of much of corporate America when it became the object of an attack by the country's leading consumer advocate, Ralph Nader.⁴⁵⁹ Nader conducted a survey of a number of major domestic corporations and concluded that at least half of the officers and directors of those companies were not reporting transactions in their company's stock, as required by Section 16 of the Exchange Act.⁴⁶⁰ In a letter to Fedders, Nader charged that the Commission had failed "to bring enforcement actions to stem this tide of executive law breaking," and asserted that the results of his study "reflect a dismal enforcement record that will further breed disrespect for the laws governing corporations and their executives."⁴⁶¹ Pointing to the Commission's highly publicized war on insider trading which, in his view, was waged at the expense of the previous regime's corporate accountability program, Nader charged that Fedders' efforts to enforce Section 16(a) "[fell] far short of [his] words."⁴⁶² Reflecting the agency's sensitivity to public criticism of this nature, yet another SEC

457. See, e.g., *Financier Sentenced to Four Years' Jail for Fraud*, Fin. Times (U.K.), Sept. 28, 1989, at 3, col. 7; *Bilzerian Gets Four Years in Jail and is Fined \$1.5 Million*, N.Y. Times, Sept. 28, 1989, at D1, col. 1; *Crimes and Lying Get Bilzerian Four Years*, Newsday, Sept. 28, 1989, at 53, col. 1.

458. See, e.g., *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 57 (1975); *Wellman v. Dickenson*, 682 F.2d 355, 363-367 (2d Cir. 1982), *cert. denied*, 460 U.S. 1069 (1983); *SEC v. Savoy Indus.*, 587 F.2d 1149, 1187 (D.C. Cir. 1978), *cert. denied*, 440 U.S. 913 (1979); *GAF Corp. v. Milstein*, 453 F.2d 709 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972); *SEC v. First City Fin. Corp.*, 688 F. Supp. 705, 722 (D.C. Cir. 1988), *aff'd*, 890 F.2d 1215 (D.C. Cir. 1989).

459. See *Nader Charges Directors, Officers Not Reporting Stock Purchases to SEC*, 15 Sec. Reg. & L. Rep. (BNA) No. 48, at 2237 (Dec. 9, 1983).

460. *Id.* Section 16(a) of the Exchange Act requires that officers, directors, and 10% beneficial owners of public companies report to the Commission and the exchange on which the securities are traded (1) their ownership of the company's stock, and (2) for any month in which their holdings of company stock changes, an updated statement of their holdings plus the number of shares bought or sold and the price at which they were traded. See 15 U.S.C. § 78p(a) (1982); 17 C.F.R. §§ 249.103-04 (1989).

461. See *Nader Charges Directors*, *supra* note 459, at 2237-38.

462. *Id.* at 2238.

enforcement effort of the 1980s, the delinquent filings program, was created.⁴⁶³

Beyond the initial spurt of coverage that followed the public release of the results of Nader's study, the Commission's delinquent filings program did not attract the publicity surrounding its insider trading cases.⁴⁶⁴ Nevertheless, the delinquent filings program has resulted in a fairly steady stream of successful cases.⁴⁶⁵ And, for good measure, the Commission's response to Nader's criticism has included a proposal to give the agency authority administratively to bar officers and directors who fail to file timely reports of their securities trades from serving as officers or directors of any publicly-held company.⁴⁶⁶

3. *Expanded Ancillary Relief*

The Commission's success in extracting ancillary relief, such as disgorgement, in insider trading cases broadened into a plan to secure similar equitable relief in other contexts. In so doing, the agency achieved an impressive victory in a type of case that previously was not thought amenable to any remedies other than curative disclosure and an injunction against future violations of the same sort.

An alleged stock parking arrangement formed the basis for the Commission's complaint in *Securities & Exchange Comm'n v. First City Financial Corp. (First City)*.⁴⁶⁷ While the Commission's theory of

463. In his letter, Nader observed that the Commission had discontinued its practice of sending warning letters to delinquent filers. Moreover, Nader noted that an SEC staffer had advised him that no activity in the delinquent filings area had been undertaken until the agency received Nader's letter. *Id.* at 2237.

464. It is ironic that the delinquent filings program, which found its origin in Exchange Act Section 16(a), the only statutory provision of the federal securities laws that expressly addresses itself to insider trading, faded into relative obscurity in the presence of the noteworthy allegations that surfaced in connection with the cases based upon the prohibition against insider trading implied from Exchange Act Section 10(b).

465. See, e.g., *SEC v. Palmer Fin. Corp.*, Civ. Action No. 88-305 (D.D.C. Aug. 18, 1988) (LEXIS, Genfed library, Dist file) (holding individual in contempt for failure to file accurate Forms 3 and 4); *SEC v. Read*, Litigation Release No. 11,620, 39 SEC Docket 1001 (D.D.C. Dec. 10, 1987) (enjoining defendant, by consent, from failing, *inter alia*, timely to file Forms 3 and 4); *SEC v. Lee*, Litigation Release No. 11,191, 36 SEC Docket 371 (D.D.C. Aug. 11, 1986); *SEC v. Michael Indus.*, Litigation Release No. 11,191, 36 SEC Docket 371 (D.D.C. Aug. 11, 1986); *SEC v. Ziegler*, Litigation Release No. 11,191, 36 SEC Docket 371 (D.D.C. Aug. 11, 1986); *SEC v. Agron*, Litigation Release No. 10,543, 31 SEC Docket 580 (D.D.C. Sept. 28, 1984).

466. See *supra* note 410 and accompanying text.

467. 688 F. Supp. 705 (D.D.C. 1988), *aff'd*, 890 F.2d 1215 (D.C. Cir. 1989). Defendants First City Financial Corp. (First City) and Marc Belzberg, a principal of First

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liability in *First City* broke no new ground, the remedy requested was novel under the circumstances. The Commission's prayer for injunctive relief, which the court ultimately granted, generated no controversy. Injunctive relief, in addition to corrective disclosure, is a familiar remedy in Section 13(d) cases.⁴⁶⁸

In requesting the court to order disgorgement of the illegal profits defendants derived from concealing their accumulation of greater than five percent of Ashland's stock, however, the Commission sought to expand the limited universe of remedies previously thought to be applicable to Section 13(d) violations.⁴⁶⁹

The court ruled favorably upon the Commission's claim that the defendants' concealment of their statutorily material ownership of Ashland securities had enabled them to reap wrongful profits from continued purchases of the stock in an uninformed market.⁴⁷⁰ Thus, by litigating what seemed to be a garden variety case involving an untimely Schedule 13D filing, the Commission won an important victory, extending the applicability of disgorgement beyond the traditional boundary of insider trading cases to, perhaps, any violation of the federal securities laws.⁴⁷¹

City, were accused of secretly accumulating shares in Ashland Oil Corporation (Ashland) by means of an undisclosed arrangement with their broker, Bear Stearns, Inc. (Bear Stearns). The Commission alleged, and the court found, that Belzberg entered into an unwritten agreement by which Bear Stearns would purchase shares of Ashland for the benefit of First City and Belzberg. Although the shares were nominally held in a Bear Stearns account, the court found that both Belzberg and the chairman of Bear Stearns understood that any profit or loss generated by the purchases would accrue to Belzberg and First City. *Id.* at 714-16.

468. See, e.g., *SEC v. Savoy Indus.*, 587 F.2d 1149 (D.C. Cir. 1978), *cert. denied*, 440 U.S. 913 (1979); *SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90 (2d Cir. 1978); *SEC v. National Student Mktg. Corp.*, 457 F. Supp. 682 (D.D.C. 1978).

469. If practitioners had ever been tempted to view Section 13(d) as a mere technical reporting requirement, that inclination should be ignored, in view of the opinion of the Court of Appeals in *First City*. See *First City*, 890 F.2d 1215, 1230 ("Section 13(d) . . . is the pivot of the entire Williams Act regulation of tender offers").

470. See *First City*, 688 F. Supp. at 726. The court applied to this case the measure of calculating disgorgement in insider trading cases prescribed in *SEC v. MacDonald*, 699 F.2d 47 (1st Cir. 1983). See *First City*, 688 F. Supp. at 727.

471. The District Court in *First City* offered expansive dicta on this issue, observing that "*MacDonald* supports the Commission's theory of disgorgement. While the case involved violations of Section 10(b) of the 1934 Act, the Court's analysis of disgorgement is relevant to all securities law violations." *First City*, 688 F. Supp. at 727 (emphasis supplied). The opinion of the Court of Appeals offers an even more generous view of the applicability of the entire array of equitable remedies to violations of the Exchange Act, proclaiming that "[u]nless otherwise provided by statute, all the inherent equitable powers of the District Court are available for the proper and complete exercise of that jurisdiction." *We see no indication in the language or the legislative history of the 1934 Act that even implies a restriction on the equitable remedies of the district courts.*" *First City*, 590 F.2d at 1230 (emphasis supplied) (citations omitted). The Court of Appeals thus concluded that there was no basis for distinguishing

The Commission has further demonstrated its desire for broader and more flexible remedies, as noted earlier, in its consent decrees⁴⁷² and by its proposal of the Securities Law Enforcement Remedies Act.⁴⁷³ This suggests that, by a variety of mechanisms, the Commission will continue to seek to expand its enforcement arsenal.

4. *Financial Fraud*

Early in 1983, Fedders estimated that insider trading cases would comprise no more than eight percent of enforcement actions that year, with sixty to seventy percent of the Division's cases focusing on financial fraud, or "cooked books."⁴⁷⁴ This new emphasis would be supported by the Division's hiring of its first Chief Enforcement Accountant, a highly experienced practitioner from the private sector.⁴⁷⁵ Throughout 1983, the Commission continued to sound this theme,⁴⁷⁶ as its Enforcement Staff labored over complex accounting and financial issues to build its cases.⁴⁷⁷

between insider trading and Section 13(d) violations in applying the disgorgement remedy. *Id.* at 1232.

472. See, e.g., *In re M.D.C. Holdings, Inc.*, [Current Accounting and Auditing Enforcement Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,714, at 63,273 (Sept. 1, 1989) (M.D.C. to retain independent accountants to evaluate internal accounting controls, comply with certain procedures for major corporate transactions and new corporate governance procedures); *SEC v. Florafax*, Litigation Release No. 10,617, 31 SEC Docket 1038 (N.D. Okla. Nov. 27, 1984) (Florafax to recalculate compensation paid to corporate officers involved in wrongdoing and seek repayment if appropriate); *In re Prudential-Bache Sec., Inc.*, Exchange Act Release No. 22,755, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,948, at 87,930 (Jan. 2, 1986) (Prudential-Bache required to retain outside consultant to make recommendations regarding supervision of compliance and sales personnel).

473. See *supra* notes 408-09 and accompanying text. Among other things, the Commission has sought the authority to bar persons who have violated the securities laws from serving as officers or directors of public companies. See *supra* note 410 and accompanying text.

474. See *NASAA Adopts Oil & Gas, Cheap Stock, Leasing Guidelines, Postpones ULOE*, 15 Sec. Reg. & L. Rep. (BNA) No. 17, at 844, 847 (Apr. 29, 1983).

475. *Id.*

476. See, e.g., *SEC Should Consider Revised Policy on Modifying Injunctions, Fedders Says*, 15 Sec. Reg. & L. Rep. (BNA) No. 46, at 2143, 2145 (Nov. 25, 1983) [hereinafter *Revised Policy*] (Fedders describes Enforcement Division's increased talent pool for carrying out complicated financial fraud investigations); *SEC Beefing Up Financial Fraud Work, Fedders Tells Conference of Executives*, 15 Sec. Reg. & L. Rep. (BNA) No. 48, at 2234 (Dec. 9, 1983) (Fedders advises the Second Annual Financial Executives Institute Conference on Current Financial Issues that the Commission is establishing a greater presence with increase in financial fraud cases).

477. See *Revised Policy*, *supra* note 476, at 2145 (explaining that financial fraud cases are more complex and take longer to complete than other types of cases). Indeed, Fedders took great pride in the work of the Division in that area: "I think the 'cooked book' area is one that we're going to prove ourselves in in the next six months. At the end of the next

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The Commission's financial fraud program uncovered a wide variety of schemes to inflate the earnings disclosed by issuers including, among other things: (1) juggling reserves to create the appearance of steady growth;⁴⁷⁸ (2) failure to take appropriate write-downs of corporate assets;⁴⁷⁹ (3) pre-recognition of income by improper recordation of sales;⁴⁸⁰ (4) improper accounting treatment of research and development costs;⁴⁸¹ (5) falsification of expenses and inventory items;⁴⁸² and (6) window dressing, or the creation of fictitious year-end transactions that were reversed at the opening of the new reporting period, to create a better year-end snapshot of an issuer's financial condition.⁴⁸³

5. Disclosure Issues—The MD&A Program

The debate over qualitative versus quantitative materiality re-emerged as the Commission turned its attention to the quality of corporate disclosures. As the agency backed away from qualitative materiality issues,⁴⁸⁴ and placed greater emphasis on quantitative, or

six months, there will be a lot of people sitting back and saying: 'Whew, they did a hell of a job.' " *Id.*

SEC Commissioner James C. Treadway also spoke out frequently on the need for tighter standards and increased self-regulation. When he and Fedders addressed a securities conference in the latter part of 1984, Treadway observed that it was the "rare week" when an accounting matter was not brought before the Commission in an enforcement proceeding. He noted that "[a]ccounting is under a microscopic examination with a relatively critical focus." See *Accounting Issues Addressed by Fedders, Treadway at Rocky Mountain Conference*, 16 Sec. Reg. & L. Rep. (BNA) No. 42, at 1707, 1707 (Oct. 26, 1984).

478. See, e.g., SEC v. Oak Indus., Litigation Release No. 10,801, 33 SEC Docket 694 (S.D. Cal. June 25, 1985).

479. See, e.g., SEC v. The Charter Co., Litigation Release No. 11,135, 35 SEC Docket 1284 (July 9, 1986).

480. See, e.g., *In re Stewart Parness*, Exchange Act Release No. 23,507, [1982-1987 Accounting and Auditing Enforcement Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,508 (Aug. 5, 1986).

481. See, e.g., SEC v. Savin Corp., Litigation Release No. 10,928, 34 SEC Docket 706 (D.D.C. Nov. 12, 1985).

482. See, e.g., SEC v. PepsiCo, Inc., Litigation Release No. 10,807, 33 SEC Docket 861 (S.D.N.Y. July 1, 1985).

483. See SEC v. Schreiber, Litigation Release No. 12,170, 44 SEC Docket 518 (S.D. Fla. July 20, 1989).

484. Early on in his tenure as Enforcement Director, Fedders made it clear that he was not interested in qualitative materiality issues, such as management integrity, that had captured the interest of his predecessor, admonishing that the Commission should not employ "the antifraud provisions of the securities laws where there is a failure to disclose conduct which may be considered qualitatively material." See *Fedders Says Commission Less Likely to Go After Some Corporate Misconduct*, 14 Sec. Reg. & L. Rep. (BNA) No. 46, at 2037, 2037 (Nov. 26, 1982) (speech before the Federal Regulation of Securities Committee of the American Bar Association).

so-called financial statement, materiality, there developed a corresponding effort to improve the quality of the disclosures still required. In 1981, for example, the Commission took the first of several steps designed to guide public companies toward improved disclosure, in its release captioned "Management's Discussion and Analysis of Financial Condition and Results of Operations" (MD&A), identifying performance information that would be meaningful to shareholders.⁴⁸⁵

The Commission revisited the adequacy of MD&A disclosure in 1986 after leading members of the accounting and auditing profession submitted a recommendation to the American Institute of Certified Public Accountants (AICPA Paper),⁴⁸⁶ calling for increased business risk disclosure to appear outside the MD&A portion of periodic reports.⁴⁸⁷

After receiving responses to a concept release⁴⁸⁸ seeking comments on the adequacy of current MD&A requirements,⁴⁸⁹ the Commission launched what has become known as the MD&A Project, to review the adequacy of MD&A disclosure by issuers in selected industries, to determine whether revisions to the MD&A requirements were necessary.⁴⁹⁰ The MD&A Project progressed in two phases: Phase One involved the review of 218 issuers in twelve industries.⁴⁹¹ The review in Phase Two included 141 issuers in an additional twelve

485. MD&A disclosure calls for a discussion of liquidity, capital resources, results of operations, and other current information necessary to an investor's understanding of a registrant's financial condition and results of operations. See Securities Act Release No. 6349, [1937-1982 Accounting Series Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,321 (Sept. 28, 1981). The MD&A requirement was instituted to provide investors "with a realistic management assessment of corporate objectives and numerical results." *Id.* at ¶ 62,946.

486. See Concept Release on Management's Discussion and Analysis of Financial Condition and Operations, Securities Act Release No. 6711, 38 SEC Docket 138 (Apr. 17, 1987) [hereinafter Concept Release].

487. The AICPA Paper, which had been prepared by the managing partners of seven major accounting firms, followed by Coopers & Lybrand's to the Commission's Chief Accountant, which recommended that issuers increase the business risk disclosure *within* the MD&A and that auditors follow certain proposed procedures to test this new disclosure. *Id.* at 141-42.

488. See Concept Release, *supra* note 486.

489. The Commission reported that "[v]irtually all the 196 commentators opposed the proposals initiated by members of the accounting profession, and most took the position that there was no need to change the MD&A requirements." Interpretive Release on Management's Discussion and Analysis of Financial Condition and Results of Operations: Certain Investment Company Disclosures, Securities Act Release No. 6835, 43 SEC Docket 1330, 1331 (May 18, 1989) [hereinafter Interpretive Release].

490. *Id.*

491. *Id.*

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industries.⁴⁹² Based on the results of this review, the Commission determined that, while new MD&A requirements were not necessary, further guidance should be given as to how public companies should comply with existing disclosure obligations.⁴⁹³

The Commission issued a forty-five page release describing and discussing the results of its progress to date in the MD&A Project.⁴⁹⁴ The thoroughness of the MD&A Project review process and the resulting guidance published in the May 1989 release show that, while perhaps having backed away from some of the more novel disclosure theories pursued in the 1970s, the Commission remains committed to fundamental principles of qualitative disclosure. Whether by interpretive guidance, such as the MD&A Project, or enforcement investigations and prosecutions in selected cases, the SEC clearly will continue to promote a high quality of disclosure on the part of issuers of securities.⁴⁹⁵

6. Attorneys

It remains unclear whether the Commission's commencement of administrative proceedings pursuant to Exchange Act Section 15(c)(4) in *In the Matter of Allied Stores Corporation and George C. Kern (Kern)*,⁴⁹⁶ reflects the agency's readiness to litigate enforcement cases, or if it portends a revitalized effort to pursue securities attorneys in enforcement actions. In either case, the filing of the *Kern* Order Instituting Proceedings sent shock waves through the securities bar.⁴⁹⁷

492. *Id.* at 1332. Phase Three, looking at 12 additional industries, is currently under way. *Id.*

493. *Id.* at 1331.

494. See Interpretive Release, *supra* note 489.

495. The Commission has brought two enforcement actions involving, among other things, inadequate MD&A disclosure since the inception of its MD&A Project. While the events forming the basis of these actions predated the MD&A Project, it is likely that the MD&A-oriented allegations can be attributed to the Commission's heightened scrutiny of this important disclosure device. See *In re John M. Schulzetenberg*, Exchange Act Release No. 26,103, [Current Accounting and Auditing Enforcement Release Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,669 (Sept. 23, 1988); *In re American Savings & Loan Assoc. of Fla.*, Exchange Act Release No. 25,788, 41 SEC Docket 78 (June 8, 1988).

496. Order Instituting Proceedings and Notice of Hearing, Exchange Act Release No. 24,648, 138 SEC Docket 987 (June 29, 1987) [hereinafter Order Instituting Proceedings].

497. See *Securities Bar Frets Over SEC Sanctions; Sullivan & Cromwell is Focus*, Nat'l L.J., July 13, 1987, at 3, col. 1; *SEC Accuses Leading Wall Street Lawyer Over Disclosure in Allied Stores Takeover*, Wall St. J., June 30, 1987, at 3, col 2.

The Commission authorized the institution of this action to determine (1) whether Allied Stores Corporation (Allied) violated Exchange Act Section 14(d)(4),⁴⁹⁸ and Rule 14d-9 thereunder⁴⁹⁹ by failing promptly to amend a Schedule 14D-9⁵⁰⁰ previously filed with the Commission; (2) whether Kern caused Allied's violation; and (3) if so, whether prospective relief should be granted against Kern, as the individual who allegedly caused the issuer's disclosure violation.⁵⁰¹

A proceeding charging a director of a public company with causing the principal violation of an issuer would not, in itself, necessarily command the attention of the securities bar. However, the respondent director in this case, George C. Kern, was also the issuer's counsel and the head of the Mergers and Acquisitions Department of a major Wall Street law firm.⁵⁰²

498. 15 U.S.C. § 78n(d)(4) (1982).

499. 17 C.F.R. § 240.14d-9(b) (1988). Rule 14d-9 provides, in pertinent part, that:

If any material change occurs in the information set forth in the Schedule 14D-9 required by this section, the person who filed such Schedule 14D-9 shall:

- (1) File with the Commission eight copies of an amendment on Schedule 14D-9 disclosing such change promptly . . . ;

. . . and

- (3) Promptly disclose and disseminate such change in a manner reasonably designed to inform security holders of such change.

Id. (citations omitted).

500. See Reproduction of Schedule 14D-9, 17 C.F.R. § 240.14d-101 (1988).

501. Exchange Act Section 15(c)(4) provides, in pertinent part, that:

If the Commission finds, after notice and opportunity for a hearing, that any person subject to the provisions of sections [12], [13], [14], . . . or subsection (d) of [section 15 of this title] or any rule or regulation thereunder has failed to comply with any such provision, . . . the Commission may publish its findings and issue an order requiring such person, *and any person who was a cause of the failure to comply due to an act or omission the person knew or should have known would contribute to the failure to comply*, to comply, or to take steps to effect compliance, . . . as the Commission may specify in such order.

15 U.S.C.A. § 78o(c)(4) (1982 & West Supp. 1989) (emphasis supplied).

502. The Kern proceedings emerged from Allied's failure to amend its Schedule 14D-9 to reflect developments at the Company while it was the subject of an unsolicited takeover bid by Campeau Corporation (Campeau). In order to remain independent from Campeau, Allied had begun negotiations with a potential white knight, and had reached a preliminary merger agreement. Allied's board of directors had approved the agreement. Kern, acting alone on behalf of Allied and its board, decided that these developments did not call for an amendment to Allied's Schedule 14D-9, since Allied and its white knight had not yet reached an agreement as to the price and terms of the

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The SEC Administrative Law Judge disagreed with Kern's analysis of Allied's disclosure obligations.⁵⁰³ The Judge cited the Commission's opinion issued in *Revlon, Inc.*, a settled administrative proceeding pursuant to Exchange Act Section 15(c)(4),⁵⁰⁴ in support of the proposition that Allied's negotiations with a white knight were more than merely exploratory and would have been considered important by a reasonable investor.⁵⁰⁵ The Administrative Law Judge ruled that Allied's failure to amend its Schedule 14D-9 violated Rule 14d-9 and that Kern caused Allied's violation. Imposition of prospective relief was denied since Kern was no longer able to cause further actions by Allied (which had since been acquired in the transaction that gave rise to the administrative proceedings).⁵⁰⁶

The *Kern* proceeding is significant for at least three reasons. *First*, as noted, the Commission's zealous pursuit of a case against a lawyer, based upon his legal advice to a client, raises the possibility of continued SEC intrusion into the office practice of securities counsel. *Second*, since a negotiated consent order is not subject to the procedural rulemaking requirements of the Administrative Procedure Act,⁵⁰⁷ the Staff's use of an articulation of legal principles set out in a negotiated consent order as precedent in a contested

transaction. See *In re Allied Stores Corp. and George C. Kern, Jr.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342 (Nov. 14, 1988) [hereinafter *Kern Initial Decision*].

503. Neither the Order Instituting Proceedings nor the Initial Decision specified whether Kern was subjected to this action by virtue of his role as a director of Allied or as its counsel. Rather, both documents focused on his acting alone to effect the determinations concerning Allied's disclosure obligations. Nevertheless, as noted herein, the commencement of such proceedings against a prominent securities lawyer, regardless of his dual capacity in this matter, has caused great discomfort within the bar.

504. Exchange Act Release No. 23,320, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,006 (June 16, 1986).

505. See *Kern Initial Decision*, *supra* note 502, at 89,582-83, 89,585. The Administrative Law Judge emphasized that: "The *Revlon* decision, even though issued in a consent matter, should have alerted Kern to the disclosure philosophy of the Commission and to the need for securities practitioners to be aware that the Commission favors a liberal interpretation of Rule 14d-9." *Id.* at 89,593.

506. Thus, Kern was not ordered to cause Allied to undertake corrective disclosure. And, since this was an administrative, rather than civil, action, Kern did not face the prospect of conducting a legal practice under the cloud of an injunction prohibiting further violations. Had the Commission filed an action against Kern in the federal courts, which one Commissioner believed to be the only appropriate forum for this matter, see Order Instituting Proceedings, *supra* note 496 (dissenting opinion of Commissioner Edward Fleischman), Kern could have been subject to an injunction pursuant to Exchange Act Section 21(d), 15 U.S.C. § 78u(d) (1982). Although neither party appealed the *Initial Decision*, the Commission, on its own motion, has taken up the matter for review. See *In re George C. Kern, Jr.*, SEC Admin. Proc. No. 3-6869 (Jan. 4, 1989) (order for review).

507. 5 U.S.C. § 553 (1982).

matter portends an aggressive agency posture as to what constitutes a binding rule of law. *Third*, the utilization of the agency's relatively new authority under Section 15(c)(4) of the Exchange Act⁵⁰⁸ to pursue an attorney who allegedly *caused* a corporate issuer's noncompliance with regulatory requirements, was reminiscent of the "access" theory of enforcement employed during the 1970s.⁵⁰⁹ These issues are discussed below.

a. Attorneys' Ability to Counsel Clients

The *Kern* proceeding resurrected the spectre of an earlier Commission administrative proceeding charging two prominent Wall Street lawyers with improper professional conduct in connection with their representation of National Telephone Company (National) during the period leading to National's petition for reorganization under the protection of the bankruptcy court.⁵¹⁰ Those proceedings were commenced during the 1970s, pursuant to Rule 2(e) of the Commission's Rules of Practice.⁵¹¹ Consistent with the Commission's "access" theory of enforcement,⁵¹² the SEC staff charged, and the Administrative Law Judge found, that, among other things, the two attorneys had aided and abetted National's violations of the Exchange Act's financial reporting requirements by failing to prevent National's optimistic statements about its business prospects in its public reports and press releases.⁵¹³

508. 15 U.S.C.A. § 78o(c)(4) (1982 & West Supp. 1989). In 1984, with the passage of ITSA, the Exchange Act was amended to give the SEC authority to bring administrative proceedings under Section 15(c)(4) against persons who *cause* a corporate issuer to violate various specified provisions of the federal securities laws.

509. See *supra* notes 92-100 and accompanying text.

510. During the year preceding National's petition, National's filings and press releases emphasized the steady increase in National's new orders for telephone system leases. None of these public statements, however, reflected the fact that, due to the nature of National's business, each new order the company accepted required a considerable cash outlay by National, while the resulting income stream trickled in over initial lease terms from 60 to 125 months. Thus, the substantial increase in new orders in fact operated as a negative financial indicator for a company in National's precarious financial condition. See Report of Investigation *In re* National Telephone Co., Relating to Activities of the Outside Directors of National Telephone Co., Exchange Act Release No. 14,380, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,410 (Jan. 16, 1978).

511. 17 C.F.R. § 201.2(e) (1988). Rule 2(e) provides, in pertinent part, that: "[t]he Commission may deny, temporarily or permanently, the privilege of appearing or practicing before it in any way" *Id.*

512. See *supra* notes 92-100 and accompanying text.

513. See *In re* Carter & Johnson, Exchange Act Release No. 17,597, 22 SEC Docket 292 (Feb. 28, 1981).

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Amidst a storm of controversy from the bar, the two lawyers appealed this decision to the Commission, which dismissed the proceedings. The Commission determined that the attorneys' conduct did not lie within clear, generally accepted standards of conduct in the profession and, therefore, should not first be sanctioned in an enforcement proceeding.⁵¹⁴

In the wake of the *Carter and Johnson* matter, few actions were brought against lawyers based upon the good faith rendering of legal advice.⁵¹⁵ Thus, the Commission's Section 15(c)(4) action against Kern rekindled great concern that the agency had once again established the securities bar as the target of an enforcement program. While the Commission's broader intentions in this regard are, as yet, unknown, even the possibility of such a program could chill attorneys' exercise of judgment in advising their clients.

b. Commission Bootstrapping of Consent Orders into Substantive Rules of Law

The Division of Enforcement Staff supported its charges against Kern with the assertion that he knowingly breached the standards for disclosure in Schedule 14D-9 since he was familiar with the Commission's interpretation of that obligation in the context of control contests as set forth in the *Revlon* consent order.⁵¹⁶ Despite a brief disclaimer of the precedential value of the *Revlon* order,⁵¹⁷

514. The Commission observed that: "elemental notions of fairness dictate that the Commission should not establish new rules of conduct and impose them retroactively upon professionals who acted at the time without reason to believe that their conduct was unethical or improper." *Id.* at 319.

515. Of course, periodically, persons accused of deliberate fraud may be attorneys. See, e.g., *SEC v. Elliott*, Litigation Release No. 11,335, 37 SEC Docket 477 (Dec. 30, 1986) (entry of injunction in consent proceedings). Such cases, however, do not raise the concerns that stemmed from the *Carter and Johnson* case, as they involve principal liability for an offense which requires proof of *scienter*. See also *United States v. Elliott*, No. 88 Cr. 645 (N.D. Ill. Sept. 13, 1989) (LEXIS, Genfed library, Dist file) (conviction in related insider trading criminal prosecution).

The *Kern* case, however, does not involve allegations of principal fraud by the respondent. Rather, this use of the Commission's relatively new Section 15(c)(4) authority to pursue an attorney who allegedly caused an issuer's noncompliance with regulatory requirements is very reminiscent of the "access" theory of enforcement employed during the 1970s. See *supra* notes 92-100 and accompanying text.

516. See *supra* note 504 and accompanying text.

517. The Initial Decision accords recognition to the minimal weight that should be ascribed to articulations of legal principles set forth in consent orders:

The consent orders are not considered to have precedential value in determining the proper interpretation of the Section 15(c)(4) language in question since there

the Administrative Law Judge nevertheless cited the order no less than four times in support of various propositions of law, including the materiality of the information that Allied did not disclose in an updated Schedule 14D-9.⁵¹⁸

The Commission's staff thus succeeded in "bootstrapping" a negotiated articulation of an advocate's legal position into a substantive rule of law. The application of such a negotiated position as precedent in future proceedings effectively bypassed the notice and hearing requirements of the Administrative Procedure Act (APA) for agency rulemaking.⁵¹⁹ The *de facto* elevation of the Commission's position in *Revlon* to a substantive rule of law in *Kern* stands in sharp contrast to the policies underlying the notice and public comment requirements of the APA. Commission investigations are, with very few exceptions, nonpublic. Thus, only the potential respondent and the Commission, through its Enforcement Staff, have any ability to influence the articulation of the legal principles included in consent orders such as *Revlon*.

Clearly, the Commission's advocates enjoy the greater "bargaining power" in conducting settlement negotiations. Once potential respondents have decided to settle, rather than litigate, an SEC administrative proceeding, they are likely to focus on only two issues: (1) the remedy they will have to give up to the Commission, that is, undertakings for corrective measures to prevent future violations; and (2) the recitation of the facts that gave rise to the

is no indication in those cases whether the Commission considered if it had the authority to impose a requirement of future compliance as a matter of law.

Kern Initial Decision, *supra* note 502, at 89,593 n.45.

518. See Kern Initial Decision, *supra* note 502, at 89,582-83, 89,585, 89,593.

519. See 5 U.S.C. § 553 (1982). Section 553(c) of the APA provides that interested parties may participate in agency rulemaking through a written submission. 5 U.S.C. § 553(c) (1982).

The notice and comment provisions of the APA were designed to assure the participation of persons affected by rulemaking on the part of agencies that operate outside of, and are thus unaccountable to, the electoral process. As one court observed: "when an agency action has 'palpable effects' upon the regulated industry and the public in general, it is necessary to expose that action to 'the test of prior examination and comment by the affected parties.'" *National Helium Corp. v. Federal Energy Admin.*, 569 F.2d 1137, 1146 (Temp. Emer. Ct. App. 1977) (quoting *Nat'l Motor Freight Traffic Ass'n v. United States*, 268 F. Supp. 90, 96 (D.D.C. 1976) (three judge court), *aff'd per curiam*, 393 U.S. 18 (1968)). Moreover, these procedures implement the determination by Congress that agency rulemaking procedures should operate in a fully informed fashion, a function that is greatly enhanced by broad exposure to public scrutiny and comment. See, e.g., *Brown Express, Inc. v. United States*, 607 F.2d 695 (5th Cir. 1979).

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alleged violation,⁵²⁰ with a view to limiting the amount, and characterization, of information made available to potential private litigants. Consequently, the Commission's articulation of the rule of law applied in consent orders may well go completely unchallenged if the respondent has struck a good bargain in the remainder of the order. This procedure is perfectly appropriate if a settlement is nothing more than a contractual arrangement between consenting adults. But, this process is entirely antithetical to the goals sought to be advanced by the APA if consent decrees are anything more than two-party agreements.

It should be noted that the *Kern* proceeding is not an isolated example of SEC "bootstrap" rulemaking. The Commission has carried out similar *de facto* rulemaking via consent orders in failure to supervise cases against securities broker-dealer firms.⁵²¹ The *Kern* case, however, differs significantly from these supervision cases, in which one *consent* order was cited as precedent in a later *consent* proceeding. The Commission's staff in the *Kern* matter has, with apparent success, applied the purported rule from a consent order in a *contested* proceeding, a case in which the application of the law is the sum and substance of the dispute. The agency's stance in that regard represents a significantly more aggressive legal posture than has usually been seen in Commission actions.

In view of the Commission's recent successes, whether the *Kern* proceeding stands for anything beyond the proposition that the Commission will more readily litigate matters involving advice of counsel in the future, remains to be seen. Clearly, one action against one attorney, in which an aggressive legal position on the applicable precedent was asserted, hardly constitutes conclusive evidence of new substantive trends in the Commission's enforcement efforts.⁵²² Nevertheless, these two areas are worth watching, to determine whether further developments offer a clearer picture of the agency's future direction.

520. See 17 C.F.R. § 202.5(e) (1989) (providing that parties may settle enforcement actions while neither admitting nor denying allegations therein).

521. See, e.g., *In re Prudential-Bache Sec., Inc.*, Exchange Act Release No. 22,755, 34 SEC Docket 1094 (Jan. 2, 1986), relying on the legal standard set forth in *In re Bache Halsey Stuart Shields, Inc.* and *Loren Lyon*, Exchange Act Release No. 19,725, 27 SEC Docket 1049 (May 3, 1983).

522. As we noted at the outset, it is unclear whether the Commission pursued *Kern* in the capacity of board member or legal counsel. One commentator observed that "[t]he Order [for Proceedings] has led many to wonder whether Kern was named as a lawyer, or as a director, or as both. The best guess is both." Klein, *SEC Reopens Old Wounds With Its Proceeding Against George C. Kern, Jr.*, INSIGHTS, Sept. 1987, at 32, 34 (emphasis supplied).

7. Penny Stocks

Bucket shops, boiler rooms and the like formed the basis for one of the more recent Commission enforcement initiatives of the 1980s. In the securities arena, seemingly outmoded scams eventually have a way of being recycled and sold to a new generation of consumers. Penny stock operations, which had a boom in the late 1950s and early 1960s, when investors snapped up shares in dubious uranium and gold mines,⁵²³ reemerged with a vengeance in the 1980s.⁵²⁴

While the sale of so called penny stocks—inexpensive high risk securities that typically are neither traded on an exchange nor listed with NASDAQ⁵²⁵—is not in itself illegal, the manner of their sale is highly susceptible to fraud. According to the North American Securities Administrators Association, fraudulent sales of penny stock are “the biggest threat facing the average investor.”⁵²⁶

A typical penny stock scam might begin with the registration of shares in a shell corporation for the stated purpose of making a “blank check offering”—one in which the only disclosed business purpose is to search for suitable investment opportunities. An unscrupulous promoter may then tout the shell corporation as having acquired the exclusive rights to a novel or revolutionary property, such as the technology to extract gold from sand.⁵²⁷ In order to create the illusion of a market and inflate the price of the securities, the promoter will enlist the aid of brokers to trade the shares among nominee accounts which they control. With the trap thus baited, smooth talking brokers armed with sophisticated telecommunications equipment engage in a high-pressured sales campaign targeted at unwary investors who ultimately discover, to

523. See Sontag, *SEC Targets Penny Stocks; Haven for Swindlers?*, NAT'L L. J., Apr. 3, 1989, at 1.

524. In the words of Joseph Goldstein, who heads a Commission task force on penny stock fraud, “[t]he telecommunications revolution has made penny stock fraud easier and it's becoming more and more profitable. . . . There are more penny stock broker dealers than ever before.” *Penny Stock Fraud Costing Consumers Billions*, Reuter Bus. Rep., May 9, 1989 (LEXIS, NEXIS library, Wires file). According to one estimate, with computerized dialing a broker can place more than 200 telephone calls each day. See *The War on Penny Stocks*, NEWSWEEK, Apr. 10, 1989, at 52, col. 1.

525. The market for such securities is primarily quoted in the Pink Sheets,TM the daily listings of the National Daily Quotation Service.

526. *Penny Stock Fraud: Battling the Boiler-Rooms*, Assoc. Press, Aug. 20, 1989 (LEXIS, NEXIS library, Wires file).

527. See, e.g., SEC v. Goldcor, Inc., Litigation Release No. 11,847, 41 SEC Docket 960 (M.D. Fla. Aug. 24, 1988) (extracting gold from Costa Rican beaches).

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their sorrow, that the market in their shares is virtually nonexistent.⁵²⁸

In response to the high growth penny stock industry,⁵²⁹ the Commission established a Penny Stock Task Force in October, 1988. The goal of the task force was to coordinate Commission enforcement, regulatory, and educational efforts aimed at the problem of widespread misconduct by broker-dealers in connection with low-priced securities.⁵³⁰ As a result of its efforts, the Commission adopted a new rule on August 22, 1989, that imposes sales practice requirements on broker-dealers who recommend purchases of certain low-priced, non-NASDAQ, over-the-counter securities to persons who

528. Typically, potential purchasers are drawn from telephone lists and other directories; consequently, many have little investment experience. Salespersons are trained to close the sale before ending the conversation and usually are compensated solely from any commissions they generate. See Sales Practice Requirements for Certain Low-Priced Securities, 54 Fed. Reg. 35,468 (1989) [hereinafter SEC Penny Stock Rule Release].

529. In 1988, the Commission initiated over 25 enforcement actions involving fraud or abuse in connection with penny stock offerings; since 1986, the Denver Regional Office alone had initiated over 30 such cases. By August 1989, the Commission had already initiated 40 enforcement actions and was investigating many other cases involving penny stock abuse. See 54 Fed. Reg. 6693, 6694 n.4 (1989) (proposed Feb. 14, 1989) [hereinafter Penny Stock Comment Release].

Investor complaints are also on the rise. In fiscal year 1988, the Commission received approximately 1500 complaints regarding broker-dealer misconduct in connection with the sale of penny stocks. By mid-1989, it had logged approximately 2400 complaints. *Id.* See also SEC v. Brownstone-Smith Sec. Corp., Litigation Release No. 12,126, 43 SEC Docket 1748 (S.D. Fla. June 12, 1989) (scheme involved manipulation of trading prices, sales of securities at excessive mark-ups, and failure to disclose to customer broker-dealer's domination and control of market for securities); *In re* The David-Maxwell Company, Inc., Exchange Act Release No. 26,823, 43 SEC Docket 1636 (May 15, 1989); *In re* The Stuart-James Co. Inc., Exchange Act Release No. 26,700, 43 SEC Docket 966 (Apr. 5, 1989) (excessive mark-ups in connection with trading of new issues underwritten by broker-dealer); SEC v. Hughes Capital Corp., Litigation Release No. 11,939, 42 SEC Docket 630 (D.N.J. Dec. 13, 1988) (scheme to manipulate price of Hughes securities included dissemination of false and misleading prospectus; charging of undisclosed excessive mark-ups, arbitrary price increases, and dissemination of false and misleading newsletters and press releases); SEC v. Goldcor, Inc., Litigation Release No. 11,847, 41 SEC Docket 960 (M.D. Fla. Aug. 24, 1988) (scheme involving sale and distribution of shares in entity ostensibly engaged in business of refining gold from black sand beaches in Costa Rica); *In re* Bradley E. Bohling, Exchange Act Release No. 25,346, 40 SEC Docket 228 (Feb. 11, 1988) (sale of unregistered securities of inactive shell corporation).

530. See SEC News Release, Remarks of David S. Ruder, Chairman, U.S. Securities and Exchange Commission, Before the Twenty-First Annual Rocky Mountain State-Federal-Provincial Securities Conference, Denver, Colorado (Oct. 21, 1988). Even prior to the creation of the Penny Stock Task Force, the Commission had apparently anticipated the need for a concerted effort to combat this particular variety of fraud. See NASAA *Adopts Oil & Gas, Cheap Stock, Leasing Guidelines, Postpones ULOE*, 15 Sec. Reg. & L. Rep. (BNA) No. 15, at 844, 847 (Apr. 29, 1983) (Felders tells NASAA gathering that the SEC and NASD are coordinating efforts to be ready for next surge of activity in Denver penny stock market).

are not established customers.⁵³¹ New Rule 15c2-6⁵³² requires broker-dealers to make certain suitability determinations regarding potential purchasers and to obtain certain written agreements from new purchasers.⁵³³

The new requirements attempt to implement these objectives by establishing account opening procedures that must be followed by broker-dealers in making suitability determinations regarding prospective customers, and by requiring broker-dealers to obtain confirmation of certain purchases in writing.⁵³⁴

Rule 15c2-6 prohibits a broker-dealer from selling a "Designated Security"⁵³⁵ to, or to effect the purchase of a Designated Security by any person, unless (a) the transaction falls within one of the Rule's enumerated exemptions or (b) prior to the transaction, the broker-dealer has approved the purchaser's account for transactions in the Designated Security and has received written approval for the transaction by the purchaser.⁵³⁶

531. See SEC Penny Stock Rule Release, *supra* note 528. The effective date of the Rule has been set for January 1, 1990, in order to allow broker-dealers time to implement compliance procedures. *Id.*

532. See 17 C.F.R. § 240.15c2-6 (1989).

533. The promulgating release accompanying Rule 15c2-6 states that the Commission sought to deter high-pressured, unscrupulous sales methods by

imposing objective and readily reviewable requirements that condition the process by which new customers are induced to purchase low-priced stocks. The requirements are intended to assist investors in protecting themselves from fraudulent sales practices, and also to reinforce a broker-dealer's suitability obligations, which historically have been an important standard constraining indiscriminate high pressure sales tactics by broker-dealers.

SEC Penny Stock Rule Release, *supra* note 528, at 35,740 (citations omitted).

534. *Id.* at 35,472.

535. See *infra* note 536 and accompanying text.

536. In promulgating the Rule, the Commission was concerned that it not adversely affect legitimate small business capital formation. See SEC Penny Stock Rule Release, *supra* note 528, at 35,471-72. To accommodate this concern, the Rule is limited to transactions in Designated Securities, which are defined as securities *other than* those that are (i) registered or approved for registration upon a stock exchange; (ii) authorized or approved for authorization for quotation in the NASDAQ system; (iii) issued by a registered investment company; (iv) options issued by The Options Clearing Corporation; or (v) offered by an issuer with net tangible assets in excess of \$2,000,000. See 17 C.F.R. § 240.15c2-6(d)(2) (1989). Exemptions are also provided for (i) transactions in which the price of the security is five dollars or more; (ii) transactions in which the purchaser is an accredited investor or an established customer of the broker-dealer; (iii) transactions that are not recommended by the broker-dealer; and (iv) transactions by a broker-dealer who is not a market maker in the Designated Security and whose sales-related revenue from transactions in Designated Securities does not exceed five percent of its total sales-related revenue from securities transactions. See 17 C.F.R. § 240.15c2-6(c) (1989).

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Prior to engaging in a transaction that falls within the scope of the Rule, broker-dealers must (i) obtain, orally or in writing, information from the customer concerning the customer's financial situation, investment experience, and investment objectives; (ii) reasonably determine the customer's suitability for, and capability of evaluating the risks of, transactions in Designated Securities; (iii) deliver to the customer a written agreement setting forth the basis of the determination; and (iv) receive from the customer a manually signed and dated copy of the suitability statement.⁵³⁷ Thus, Rule 15c2-6 attacks the problem of fraudulent transactions by addressing the sales practices of broker-dealers actively involved in selling low-priced securities to new customers.

The Commission has recognized that only comprehensive action will successfully reduce wide-spread fraud in the penny stock market. Accordingly, in addition to adopting Rule 15c2-6, the Commission has asserted its intention to continue ongoing efforts in enforcement, public education, and regulatory initiatives.⁵³⁸ In this regard, the Commission has embarked on a public education campaign designed to inform investors of the risks in the low-priced securities market.⁵³⁹ The Commission also plans to propose an amendment to existing Rule 15c-11⁵⁴⁰ which will emphasize the responsibility of market makers to review information concerning non-NASDAQ, over-the-counter securities.⁵⁴¹ It has also encouraged self-regulatory initiatives designed to curb fraud and market manipulation.⁵⁴² As part of this effort, the NASD has implemented a program requiring broker-dealers to report volume and price information concerning transactions in non-NASDAQ, over-the-counter securities.⁵⁴³

Increased criminal actions and stiff prison sentences may also be in store for broker-dealers caught in fraudulent penny stock scams. Joseph Goldstein, chairman of the Commission's penny stock task force, told the House Subcommittee on Telecommunications and Finance that the Commission will be referring an increasing number

537. 17 C.F.R. § 240.15c2-6(b) (1989).

538. SEC Penny Stock Rule Release, *supra* note 528, at 35,468.

539. See *id.* SEC Information for Investors, Penny Stock Telephone Fraud, SEC Press Release No. 89-58 (Aug. 1989); SEC Information for Investors, Beware of Penny Stock Fraud! (Nov. 1988) (*cited in* SEC Press Release No. 89-58).

540. 17 C.F.R. § 240.15c2-11 (1989).

541. See SEC Penny Stock Rule Release, *supra* note 528, at 35,468.

542. See *id.*

543. See Schedules to the By-Laws, NASD Manual (CCH) ¶ 1932-33 (Oct. 1989) (Schedule H).

of penny stock cases to the Justice Department for criminal prosecution.⁵⁴⁴

Whether Rule 15c2-6 will operate effectively to deter the free wheeling fraud rampant in the low-priced securities market is still a matter of conjecture. Adoption of the Rule, however, along with the Commission's stepped up enforcement actions and cooperation with other regulatory agencies and organizations, signifies a significant new emphasis on an area that had received too little attention for a number of years.

8. *Corporate Governance Issues*

Despite the Commission's determination to back away from the 1970s' enforcement actions directed at improving corporate governance,⁵⁴⁵ a number of enforcement initiatives during the 1980s looked surprisingly similar to those very actions. Thus, for example, during the 1980s, the Commission continued the practice of seeking to extract, in appropriate settlements, corporate self-investigations and the appointment of independent directors, special counsel, and the like.⁵⁴⁶ In addition, the Commission endeavored to influence whether certain persons could continue to serve as officers and

544. Goldstein testified that

[t]oo often the Commission's experience is that the people responsible for organizing, financing and executing stock manipulations in penny stocks are not deterred by the civil remedies that are currently available to the Commission, . . . These civil remedies are viewed as part of the cost of doing business. Therefore, to deter more effectively penny stock fraud, the Commission is actively seeking to enlist the help of criminal prosecutors.

See States News Service, Aug. 21, 1989 (LEXIS, NEXIS library, Wires file). A number of cases in which the Commission has cooperated with federal and state authorities and self-regulatory organizations have already resulted in criminal prosecutions. See, e.g., *United States v. Kimmes*, Litigation Release No. 12,211, 44 SEC Docket 468 (D. Nev. Aug. 9, 1989); *United States v. Hansen*, Litigation Release No. 12,094, 43 SEC Docket 1692 (D. Utah May 15, 1989); *United States v. Gleave*, Litigation Release No. 12,024, 43 SEC Docket 108 (D. Utah Mar. 8, 1989).

545. See *supra* notes 193-96 and accompanying text.

546. See, e.g., *In re M.D.C. Holdings, Inc.*, [Current Accounting and Auditing Enforcement Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,714, at 63,264 (Sept. 1, 1989) (evaluation by independent accountants and institution of special procedures for major corporate transactions required for a certain time period); *SEC v. Florafax*, Litigation Release No. 10617, 31 SEC Docket 1038 (Nov. 27, 1984) (Florafax required to (i) establish an Audit Committee, (ii) restate prior financial statements, and (iii) submit restatements to independent audit).

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directors of public companies, once they had been found, or had consented to be branded as, violators of the federal securities laws.⁵⁴⁷

9. *Unconventional Securities*

Similarly, during the 1980s, the Commission maintained a fairly active vigil against promoters and issuers of novel securities.⁵⁴⁸ Reminiscent of the agency's program of the 1970s, the SEC also was required to confront the question whether it could and should regulate hybrid and unusual securities. Since most of these new instruments are derivative in nature, the Commission has been compelled to consider whether it wants to compete for regulatory venue: Both the Commission and the Commodity Futures Trading Commission (CFTC) asserted that many of these instruments fell within their respective jurisdictions.⁵⁴⁹ Having decided to enter the fray, the Commission lost the two major litigations in which the issue was raised, and the CFTC's position was vindicated.⁵⁵⁰

547. See, e.g., *In re Michael R. Maury*, Exchange Act Release No. 23,067, [1982-1987 Accounting and Auditing Enforcement Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,493 (Mar. 26, 1986) (in consent proceeding, Vice President/Corporate Controller of Oak Industries barred from serving as officer or director of public company based on carrying out "directions [of his superiors] which he knew or should have known were improper . . ."); *In re Thomas C. Runge*, Exchange Act Release No. 23,066, 35 SEC Docket 432 (Mar. 26, 1986) (in consent proceeding, Treasurer of Oak Industries barred from serving as officer or director of public company for failure to prevent Oak's violation of reporting provisions); *SEC v. Florafax*, Litigation Release No. 10,617, [1982-1987 Accounting and Auditing Enforcement Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,444, at 63,161 (N.D. Okla. Nov. 27, 1984) (former officer barred from servicing directly or through a nominee as officer of the company for three years).

548. See, e.g., *SEC v. Enerdine Int'l Corp.*, Litigation Release No. 9775, 26 SEC Docket 439 (D.D.C. Oct. 6, 1982) (resort condominiums); *United States v. Griggs*, Litigation Release No. 11,215, 36 SEC Docket 737 (W.D. Va. Sept. 15, 1986) (limited partnership interests in government subsidized housing projects); *SEC v. Professional Assoc.*, 731 F.2d 349 (6th Cir. 1984) (joint venture interests with passive investors); *SEC v. Crowder*, Litigation Release No. 11,575, 39 SEC Docket 553 (C.D. Cal. Oct. 3, 1987) (real estate limited partnerships); *SEC v. Schreiber*, Litigation Release No. 12,170, 44 SEC Docket 47 (S.D. Fla. July 20, 1989) (real estate limited partnerships); *SEC v. McGuire*, Litigation Release No. 11,753, 41 SEC Docket 62 (S.D. Tex. May 31, 1988) (limited partnerships in oil and gas interests); cf. *United States v. Center Art Galleries, Inc.*, 89 Cr. No. 00125 (D. Haw. Jan. 26, 1989) (U.S. Attorney brought criminal indictment for securities laws violations regarding fraudulent misrepresentations of investment potential of Salvador Dali lithographs).

549. See Exchange Act Release No. 26,709 (Apr. 11, 1989) (LEXIS, Securities library, Releases file) (SEC granting request of exchange to begin trading in index participation contracts).

550. See *Chicago Mercantile Exchange v. SEC*, 883 F.2d 537 (7th Cir. 1989) (index participation held to be futures contract under exclusive jurisdiction of CFTC); *Chicago Bd. of Trade v. SEC*, 677 F.2d 1137 (7th Cir. 1982) (GNMA options held not to be securities).

Ultimately, the two agencies resolved one impasse with an agreement for new legislation that was promptly adopted.⁵⁵¹

F. Overview

The Commission's enforcement program in the 1970s was controversial but quite successful. Tackling a variety of establishment targets, the Commission expanded its jurisdiction by relying on creative, and sometimes unsupported, statutory interpretations and practices. The Commission's enforcement program of the 1980s, under Shad and Fedders, promised to be different. And, it was. But it was not different in concept. The 1980s saw the agency prosecuting insider trading cases without explicit statutory authority for all its theories, or direct support for many of its prayers for relief. In addition, questions of qualitative materiality continued to surface during the course of the 1980s, particularly as the agency aggressively reviewed management's discussion and analysis of soft, or qualitative, and forward-looking information. Topics like novel securities and corporate governance remained equally high on the Commission's enforcement priority list.

In sum, the Commission did articulate a different direction in the 1980s, and it did pursue different types of cases from those pursued in the 1970s. But the more the Commission's enforcement program purported to change, the more it resembled the program put together by the predecessors of Shad and Fedders.

III. Expectations for the SEC's Enforcement Program in the 1990s

A. Preliminary Issues

1. *Inherent Limitations Affecting the Predictability of the Commission's Future Enforcement Initiatives*

As we noted at the outset,⁵⁵² it is difficult for anyone to attempt to predict what the future configuration of the SEC's law enforcement activities will be. Nonetheless, we set forth below some of the logical extensions of the enforcement program crafted by the

551. See S. REP. NO. 384, 97th Cong., 2d Sess. 21-24 (1982), cited in *Chicago Mercantile*, 883 F.2d at 544.

552. See *supra* notes 24-25 and accompanying text.

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Commission during the 1980s. In doing so, however, certain *caveats* are in order.

First, any projection of future SEC enforcement trends is highly dependent upon the accuracy of prognostications about the prevailing political climate. Through at least the first two years of the next decade, a moderately conservative Republican Administration will influence the direction of governmental policy in general, and the Commission in particular.⁵⁵³ As far as law enforcement is concerned, the Bush Administration has made it abundantly clear that the premises of the Reagan Administration are not *necessarily* the same premises that will govern the Bush agenda.⁵⁵⁴ It is, of course, not possible to predict whether the current Administration will be renewed for a second four-year term, although based solely on historical precedents that is likely to be the case. Should history's precedents be confirmed, that would take the SEC to 1996, at which time the same issues regarding a possible change in Administration would once again arise. Accordingly, any projections about likely SEC enforcement initiatives are apt to be valid for about five years, under the best of circumstances.

Second, and as a corollary of the first *caveat*, the 1990s will more than likely see at least one, and possibly several, changes in the SEC's chairman. This is likely to occur for several reasons, not the least of which is that, historically, the average tenure of SEC chairmen has been relatively brief.⁵⁵⁵ Moreover, if the current Administration continues in office, it is more than likely that the current SEC Chairman, Richard Breeden, will be considered for other government positions as time passes.⁵⁵⁶ Finally, if the current

553. Although, as a general proposition, the Commission is oblivious to political pressures, for the first time in its history the Commission's Chairman is a confidante of the incumbent President. See *supra* note 81. As a result, he is likely to channel the Commission's agenda in a direction or directions that are compatible with those of the President, either intuitively, or with the assistance of relatively frequent communications.

554. See, e.g., Nash, *Stronger U.S. Antitrust Action Vowed*, N.Y. Times, Nov. 4, 1989, at A33, col. 5 ("The [C]hairman of the Federal Trade Commission and the head of the Justice Department's antitrust division, [both Bush appointees] who took office last summer, indicated . . . that the antitrust enforcement policies of the Reagan administration would be changed").

555. The average tenure for the 21 past SEC Chairmen (not including acting chairmen or Messrs. Shad and Ruder) has been approximately 26 months. See Longstreth, Book Review, *The SEC After Fifty Years: An Assessment of its Past and Future*, 83 COLUM. L. REV. 1593, 1607 (1983) (reviewing J. SELIGMAN, *THE TRANSFORMATION OF WALL STREET* (1982)). With Mr. Shad's unusual six-year service, and Mr. Ruder's two year stint, the average for 23 chairmen is approximately 28 months. If Mr. Shad's tenure is excluded, the average drops to under 26 months.

556. The SEC has been a springboard for other high-level government offices. For

Administration is not re-elected in 1992, the incumbent Chairman almost certainly would depart from the agency.⁵⁵⁷

Third, the future of the SEC's enforcement program will be influenced to a very meaningful extent by the agency's Director of Enforcement,⁵⁵⁸ and some of the Director's immediate subordinates.⁵⁵⁹ As of this writing, there is little discernible indication precisely how new Director of Enforcement McLucas will react to a number of the issues likely to confront the Enforcement Division over the next few

example, William Casey left the SEC after approximately two years as its Chairman, and became Undersecretary of State, and thereafter President of the Export-Import Bank. Similarly, John S.R. Shad was appointed Ambassador to Norway after he served nearly six years as the SEC's Chairman.

557. Pursuant to Section 4 of the Securities Exchange Act, 15 U.S.C. § 78d(a) (1982), each member of the Commission is nominated for a five-year term; once confirmed, a member of the Commission cannot be removed without cause. *See Humphrey's Ex'r v. United States*, 295 U.S. 602, 629 (1935) ("The authority of Congress, in creating [independent] agencies . . . includes, as an appropriate incident, power to . . . forbid [members'] removal except for cause. For it is quite evident that *one who holds his office only during the pleasure of another, cannot be depended upon to maintain an attitude of independence against the latter's will*") (emphasis supplied).

Pursuant to Section 3 of Reorganization Plan No. 10 of 1950, however, the President has the exclusive authority to designate one of the Commissioners to serve as the agency's Chairman. *See* 15 Fed. Reg. 3175, 64 Stat. 1265. The Chairman of the SEC serves as such solely at the pleasure of the President. As a practical matter, no Chairman of the SEC has ever continued to serve as Chairman after a change in the political composition of the incumbent Administration.

558. There are some limitations on precisely how much influence the SEC's Director of Enforcement can exert on the contours of an ongoing enforcement program. Among other things, many of the cases the Commission pursues are mainstream fraud cases which a government official would be hard-pressed to justify quashing. Moreover, as noted earlier, *see supra* note 24, much of the enforcement work of the agency is serendipitous; the Commission is essentially a partial captive of the prevailing business environment.

It is, however, undoubtedly the case that the Director of Enforcement at the Commission can, and will, have far more influence over the Commission's enforcement program than any member of the Commission, or the five Commissioners as a body. This is so because the Commission has delegated vast discretion and authority to its Director of Enforcement. *See* 17 C.F.R. § 200.30-4 (1989) (delegating powers of the Commission to the Director of Enforcement). In brief, the Director of Enforcement controls work assignments, and determines which cases should be pursued and which cases should be halted mid-stream (or earlier). Most of the judgmental factors relevant to an ongoing enforcement program never reach the Commission, and are largely incapable of review by the Commissioners. In essence, the role of a Chairman (or the Commission as a body) is limited to (i) delineation of policies of cases to be pursued; (ii) establishment of enforcement policies and priorities (for example, *vis-a-vis* the types of cases that will be brought, the types of defendants who will be pursued, the types of relief that may be sought, and the types of settlements that will be acceptable); and (iii) review of concrete enforcement recommendations brought to the Commissioners for approval.

559. The Director of Enforcement is the chief enforcement officer for the Commission, but certainly has little of the day-to-day responsibility for the management of the Division's caseload. That function falls to four Associate Directors (including one for International Enforcement Matters) and the Division's Chief Counsel and Chief Trial Attorney.

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years. Moreover, there is apt to be some turnover in the Director's position during the coming decade as well, regardless of whether the Administration changes at some point during that time.⁵⁶⁰

Fourth, any enforcement program must be flexible enough to respond to changes in economic and other ambient circumstances. The Commission has shown the capacity, the flexibility and the creativity to respond to a variety of developments outside the normal ambit of securities law enforcement in the past,⁵⁶¹ and is likely to do so through the coming decade. The difficulty for prognosticators is that it is not possible to determine in advance of some of these scandals and other developments precisely what ambient circumstances the Commission may be called upon to address.

Fifth, the Commission's enforcement program will be influenced, to a large extent, by the effects of the ongoing Congressional oversight to which the agency routinely is subject. It is not now possible to predict precisely what the effects of that oversight will be, but it can be foreseen that those effects will be a significant factor in shaping the future directions of the agency's enforcement program. In particular, for every Congressional prod of the Commission (or *vice-versa*) for more far-reaching enforcement powers and remedies, there will be a direct effect on the Commission's enforcement program.⁵⁶²

2. Administrative Considerations

Two misperceptions, somewhat contradictory in nature, confront those who attempt to assess or evaluate enforcement programs. These are (i) the tendency to view such programs as *solely* the product of one or two individuals; and (ii) the inability to view such programs as more than the product of a monolithic entity devoid of human qualities and frailties. It is important to avoid both misperceptions.

First, while it is true that the Commission's enforcement program is guided by a limited number of individuals,⁵⁶³ it is implemented by

560. The position of Enforcement Division Director is a highly visible one, and is not likely to serve as the final professional stopping point for any incumbent.

561. The Commission's responses to the Watergate scandal and the deluge of improper foreign corporate payments during the 1970s, *see supra* note 157 and accompanying text, and the defense contractors' scandal of the 1980s, *see supra* note 5 and accompanying text, typify this flexibility.

562. *See infra* notes 652-53 and accompanying text.

563. *See supra* notes 558-59 and accompanying text.

a much wider circle of persons.⁵⁶⁴ The enforcement process carries with it more than just the establishment of broad policies. It also necessitates difficult judgments about the weight of evidence, the credibility of witnesses, the need for certain forms of relief in precise factual contexts, and similar judgments.⁵⁶⁵ These judgments are the product of the field work done by the SEC Enforcement Division Staff, and it is that work on which the senior officials of the Division of Enforcement, and ultimately the members of the Commission, heavily rely.

To the extent that the agency succeeds in attracting qualified individuals, and furnishes them with the necessary resources to do their jobs well, the judgments ultimately made by the agency will be sharper and withstand inevitable judicial and congressional scrutiny.⁵⁶⁶ To the extent the agency is unsuccessful in attracting bright young attorneys, and experienced lateral attorneys seeking to acquire some experience in government, the agency's enforcement program will suffer materially. There are several components of this equation.

The Commission has always been a young agency, populated by youthful and sometimes inexperienced lawyers in many of its offices and divisions.⁵⁶⁷ This is a function of

564. See *supra* note 559 and accompanying text.

565. Indeed, the overarching principle that must be remembered in this highly judgmental aspect of the Commission's mandate is that "[t]he power to investigate carries with it the power to defame and destroy." Canons of Ethics for Members of the Securities and Exchange Commission, 17 C.F.R. § 200.66 (1989).

566. See *Hearing Before the Securities Subcomm. of the Senate Banking, Housing and Urban Affairs Comm. Regarding the Securities and Exchange Commission*, 100th Cong., 1st Sess. 17-20 (1987) (written statement of Harvey L. Pitt) [hereinafter *Pitt Testimony*].

567. Youth and inexperience are not the same, however, and do not always go hand-in-hand. From the earliest days of the agency, many of its leaders were relatively young, although extremely accomplished, a trend that seems to be continuing today. William O. Douglas, who was later to become a Justice of the Supreme Court, was considered a leading authority on corporate finance as a young Yale law professor before accepting a top staff position at the SEC. See *TRANSFORMATION OF WALL STREET*, *supra* note 28, at 110-111. Mr. Douglas also served as a Commissioner, and from March 1938 to April 1939, was Chairman of the SEC. *Id.* at 155. Almost fifty years later, Richard Breeden, the current SEC Chairman, is only 39 years of age and already has spent several years in private law practice in between stints of government service as an executive assistant to the Undersecretary of the Department of Labor, deputy counsel to then Vice-President George Bush, and a number of troubleshooting roles, most notably regarding the Administration's position regarding the thrift crisis, as assistant for issues analysis to President Bush. Singer, *Richard Breeden: True But Not Tried*, *AM. LAW.* at 50, 52-53 (Nov. 1989).

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- (i) lower, and often inadequate, compensation for professionals;⁵⁶⁸
- (ii) rapid turnover of professionals;⁵⁶⁹
- (iii) an inability, at times, to “sell” the nature of the Commission’s workproduct to the brightest attorneys graduating from law schools;⁵⁷⁰
- (iv) the difficult working conditions to which young attorneys in the government often must acclimate themselves;⁵⁷¹ and

568. The Commission has compensated its personnel on the Civil Service scale since its inception. See 15 U.S.C. § 78d(b) (1982). These salaries are far lower than competing salaries offered to professionals in the private sector. See *1989 16th Annual AICPA National Conference on Securities and Exchange Commission Developments* [hereinafter *SEC Developments*], Federal News Service, Jan. 10, 1989 (LEXIS, NEXIS library, Wires file) (remarks of then SEC Chairman David S. Ruder). No matter how committed an individual may be to the ideal of public service, it is very difficult to compare a \$27,172 starting salary for SEC attorneys with an \$80,000 starting salary for starting attorneys in the private sector, particularly in cities such as Washington, D.C., New York, Los Angeles, and Chicago. It becomes even more difficult to make such comparisons when many young lawyers emerge from law schools burdened with the debt of an expensive law school education.

The problem is less acute at senior levels of the government, where the high visibility, and the promise, ultimately, of a prominent private sector position serve to encourage some individuals to sacrifice short-term compensation for long-term rewards. See *Breeden Cites Competitive Challenge of Growing International Marketplace*, Daily Rep. for Exec. (BNA) Nov. 21, 1989 (Breeden stated that “the pay of the Commission and the Chairman is not as critical [as the pay at the staff level] because people are always willing to fill these positions for a limited time”). It is ironic, but revealing, to compare the Commission’s Fiscal 1989 Budget of \$142.6 million to the \$167.5 million allocated that year to military bands. See *Drexel Will Be Fined \$650 Million, But SEC Won’t Get a Cent*, Assoc. Press, Feb. 2, 1989 (PM Cycle) (LEXIS, NEXIS library, Wires file).

569. Most staff attorneys stay an average of two to three years at the SEC. That number is even smaller when looked at solely from the perspective of the Enforcement Division. See *SEC Developments*, *supra* note 568.

570. “Selling” the agency is not difficult when the agency’s work is well understood by law students. In earlier times, securities laws were thought of as relatively arcane; indeed, until fairly recently, many law schools did not offer a formal course on securities regulation. Today, it is the rare exception if a law school does not offer several securities law courses, and many schools have developed graduate programs in the specialty of securities law.

571. It is not possible in this article to catalogue all of these problems, but they include the following: (i) lack of adequate training; (ii) inadequate *per diem* and travel allowances; (iii) inadequate office space (both in terms of the cramped quarters the Commission historically has had to endure, and the lack of adequate facilities to house the lawyers the agency is able to hire); (iv) inadequate paralegal and non-professional help; and (v) inadequate resources, in the form of computers and other facilities that enable lawyers to focus on professional issues rather than function at both the professional and non-professional levels. See *Pitt Testimony*, *supra* note 566.

- (v) the fact that many young lawyers interested in some exposure to government service choose to start with the government and then rotate into the private sector, rather than starting in the private sector, and rotating into the government.⁵⁷²

Heading into the 1990s, the SEC is well-positioned to attract bright lawyers to government service. Its enforcement program has been highly visible and many young lawyers are interested in participating in a law enforcement program upon graduating from law school, particularly a program that promises the opportunity to confront successful and famous individuals in a variety of public and private preoccupations. No longer an arcane subject on a crowded law school agenda, securities law has become a prominent feature of the law school curriculum, and the SEC's ability to recruit able lawyers should improve by virtue of the success of its enforcement program during the past decade.⁵⁷³

Beyond the visibility and relevance of the agency and its work is its current campaign to remove the restrictions of the Civil Service salary cap.⁵⁷⁴ Unlike certain of the banking agencies, which long ago were relieved of the necessity of conforming attorney salaries to civil service salary limitations,⁵⁷⁵ the SEC has been saddled with an outmoded system of compensation, predicated upon different

572. Needless to state, there is no one "right" approach to government service. But the realities of the private sector may promote the choice referred to in the text. Most attorneys interested in government service see it as a vehicle for earlier and better responsibility for matters than they may receive in private practice, and believe that government service may afford them an opportunity to develop a specialty in the law before it would be possible to accomplish the same result at most law firms. Those intent on partnership at a law firm are aware that most firms make their judgments about partnership in a lawyer's fifth through eighth years out of law school. That suggests for many attorneys that a two or three year apprenticeship at a government agency will not unduly restrict their chances for a partnership with a private law firm. Those who start at a private law firm usually decide to seek out government service in their second through fourth years, enabling them to return to the private sector and permit their law firms an opportunity to evaluate their partnership qualifications.

573. The SEC's other divisions and offices are highly attractive as well. Moreover, the shock of several market crashes, and the lure of international securities regulation, should make the SEC an exciting agency for many law students.

574. Unless otherwise specified in another statute, all federal employees must be classified according to a class and grade, for purposes of applying uniform levels of compensation. See 5 U.S.C. § 5107 (1982).

575. See, e.g., Federal Reserve Act of 1913, § 11(1), 38 Stat. 251, 262-63 (codified as amended at 12 U.S.C. § 248(l) (1982)).

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considerations for vastly different agencies.⁵⁷⁶ The current SEC Chairman has advocated removing the Commission from the Civil Service salary limitation system, and putting the agency on an equal footing with its sister agencies in the banking field.⁵⁷⁷ The prospects for such a change in SEC compensation levels appear positive and, coupled with proposals to make the agency a self-funding operation,⁵⁷⁸ suggest that the agency may subsequently acquire more latitude in the direction of its program.⁵⁷⁹ But, even if there is little prospect of removing the existing Civil Service salary cap, the broad publicity given to the mere possibility of more money may, itself, do wonders for the SEC's recruitment program, at least in the short term.

The factors identified above, combined with a broadly anticipated malaise in private sector law practice, suggest that the caliber of SEC professionals should rise markedly during the 1990s. This should

576. The Civil Service salary cap is a function of comparing government service with the private sector. This approach is meaningful when the positions and duties being compared bear some relevance to each other. For example, it is logical and relevant to compare the salary of a government secretary with that of a private sector secretary. The figures used to evaluate government salaries, however, do not adequately take account of specialized professional training such as in law, science, and the like. See COMMISSION ON EXECUTIVE, LEGISLATIVE AND JUDICIAL SALARIES, FAIRNESS FOR OUR PUBLIC SERVANTS 11-12 (1989). A recent Presidential review panel found that the current Civil Service salary scale is detrimentally behind the levels applicable in the private sector, and recommended a substantial pay raise for all government employees. *Id.* Notwithstanding that finding, amply supported by a detailed analysis, Congress has refused to raise government salaries because the current Civil Service pay scale statutorily ties the pay for government civil servants and federal judges with the salary received by Congress. Since the Congress has been unable, politically, to justify to itself raising salaries for future Congresses (by Constitutional limitation, the Congress cannot raise its own salary, U.S. CONST., art. I, § 6, cl. 2), there is great pessimism whether the salaries of government employees will be raised meaningfully under the current system.

577. See generally *Breeden Responses*, *supra* note 26, at 47.

578. The SEC historically has taken in more funds each year, generated by its fee structure for processing registration statements, etc., than it has expended in its annual budget. The Commission's operation as a so-called profit center has led some commentators to suggest that the agency's budget should be funded by the profits it generates. See *Drexel Will Be Fined \$650 Million, But SEC Won't Get a Cent*, Assoc. Press, Feb. 2, 1989 (PM Cycle) (LEXIS, NEXIS library, Wires file) (former SEC Chairman David Ruder and Rep. John Dingell propose SEC self-funding, based on the agency's fee generation of approximately twice its annual budget); see also *Breeden Responses*, *supra* note 26, at 46-47.

579. An agency that is not funded through the appropriations process must, by definition, have greater control over its own programs. When an agency is dependent upon the normal budget processes for its funding, it must justify its programs first to the Administration and then to the Congress, and it is likely to be affected by general budgetary trends and deficits. While the SEC has often fared better than many of its sister agencies because of its mission and performance, it has nevertheless felt the sting of government budget cuts. Needless to state, of course, although putting the SEC on a self-funding basis would not relieve the agency of justifying its programs or its expenditures, the process would be less onerous, and the agency would derive greater autonomy.

have a decidedly positive effect on the quality and creativity of the agency's enforcement program.⁵⁸⁰

B. General Attributes of the SEC's Enforcement Program that can be Anticipated in the 1990s

1. Modifying the Trend Toward Deregulation

Although the Bush Administration seems less militant about proving its commitment to deregulation than did the Reagan Administration at a comparable period in the life of the first Reagan Term, there is no doubt that the current Administration does favor rational deregulatory initiatives.⁵⁸¹ The SEC can be expected to embrace the general principle that deregulation should be pursued wherever possible.⁵⁸² Nevertheless, early indicia suggest that the Breeden Commission may be more receptive to some forms of regulation than the Shad Commission, particularly in such areas as the financial soundness of broker-dealers,⁵⁸³ penny stock market practices,⁵⁸⁴ disclosures related to LBO practices,⁵⁸⁵ private placement

580. See *Business and the Law: Downturn Crimps Large Law Firms*, N.Y. Times, Apr. 2, 1990, at D2, col. 1. The private bar has long supported efforts to improve the caliber of the SEC's professional staff, through more generous budgets, higher salaries, and self-funding. See, e.g., *Oversight of the Securities and Exchange Commission and the Securities Industry: Hearing Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 100th Cong., 1st Sess. 87 (1987) (statement of Milton H. Cohen) ("the adequacy of the Commission's resources to carry out its responsibilities . . . are inadequate, and seriously so"); *id.* at 102 (statement of Harvey L. Pitt) ("the political and public concerns about increasing the size of the agency's budget and the take-home pay of its employees can be allayed by a simple expedient—placing the Commission on a self-sustaining basis, and relieving the Commission of the constraints that presently limit the salary scale to Civil Service-prescribed amounts"); *id.* at 119 (statement of James C. Treadway) ("I can think of no reason why the SEC's fee schedule . . . should not make the SEC self-supporting in virtually all years"). The reason for this support is simple: Private practitioners are apt to be more successful in their representation of clients before the SEC, both in the enforcement context and in the regulatory and disclosure contexts, if they are facing capable attorneys who have developed a certain amount of job maturity. Heavy turnover and poor recruitment are thus detrimental to the interests of the private sector.

The Commission's new Chairman has also taken up the cause for self-funding as a means to obtain higher salaries for the Commission's Staff. See *Breeden, Cites Competitive Challenge of Growing International Marketplace*, Daily Rep. for Execs., Nov. 21, 1989, at 223 ("Many people are willing to engage in public service," Breeden stated, "but we don't need to ask them to commit financial suicide").

581. See, e.g., *Bush May Try to Revive Some Industry Controls*, L.A. Times, Feb. 5, 1989, § 1, at 1, col. 3 ("the new [Bush] Administration, less ideological than the old, will probably seek to reinstate federal controls in some areas even as it relaxes regulations elsewhere").

582. See, e.g., *Breeden Responses*, *supra* note 26, at 93-94, 101, 104.

583. *Id.* at 16-17, 37-38.

584. *Id.* at 13, 99-100.

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abuses,⁵⁸⁶ and the regulation of multiservice financial institutions if the Glass-Steagall Act is repealed.⁵⁸⁷

As we have seen, to the extent the Commission continues to pursue deregulation as an operating philosophy, the likelihood will increase that the Commission will be required,⁵⁸⁸ and in any event will opt,⁵⁸⁹ to step up the pace of its enforcement efforts. Moreover, the Commission's enforcement program almost certainly will become more aggressive than it has been in the past. These conclusions stem from several considerations.

First, deregulation generates pressure to step up enforcement: absent sufficient regulatory controls, the government will not be available to screen potential violations of the law before they occur. Moreover, individuals are more likely to run afoul of broad, generic legal standards than detailed regulatory requirements. In addition, the competition facing this country's securities markets itself demands an improved enforcement presence and aggressiveness. As competition between marketplaces increases, market share will likely be determined by the most efficient marketplaces and those that are deemed to be the fairest and best policed. Chairman Breeden has confirmed the essential accuracy of these conclusions at an early stage in his tenure. Drawing analogies to the thrift crisis, Breeden

585. *Id.* at 5-7, 63, 70-71, 84-85, 94-96, 103-04, 108-09.

586. *Id.* at 21-22.

587. *See Breeden Responses*, *supra* note 26, at 42. The Glass-Steagall Act, 48 Stat. 162, is codified as amended at 12 U.S.C. § 24 (1982) and scattered sections of 18 U.S.C.

588. *See supra* notes 329-32 and accompanying text.

589. That certainly is the flavor of new SEC Chairman Breeden's comments to the Congress. For example, Chairman Breeden advised the Senate that he

would support efforts to reduce U.S. regulatory disincentives to extending offers to U.S. holders on equal terms with those of other shareholders, where the home country's regulatory scheme is adequate to protect investors and the percentage of shares held by U.S. persons is not significant. However, in any such system jurisdiction over fraudulent conduct that has an effect on U.S. persons should be retained.

Breeden Responses, *supra* note 26, at 68. *See also id.* at 13 (emphasizing need for continued vigorous insider trading enforcement program, international law enforcement cooperation, and increased criminal referrals, *inter alia*); *id.* at 49 ("[a]n effective and aggressive enforcement program will continue to be essential to deter wrongdoers, preserve the integrity of the securities markets and thereby maintain the investor confidence that is vital for capital formation"); *id.* at 86 ("[o]ne of the most effective means to increase individual investor confidence . . . is for the Commission . . . to enforce aggressively rules against insider trading, front-running, and other manipulative practices that compromise the integrity and fairness of the markets").

has indicated that an effective enforcement program must be aggressive, assured, non-tentative, and expeditious.⁵⁹⁰

2. *Using Enforcement Proceedings as a Substitute for Regulation*

Because of the prominence of enforcement programs in a deregulatory environment, there remains a possibility that enforcement proceedings will become a substitute for formal regulation. This presents an omnipresent problem with respect to fraud prosecutions, and there even exists a danger in connection with proceedings designed to improve the quality and caliber of corporate disclosures by publicly-owned companies. Despite safeguards designed to prevent the misuse (or abuse) of enforcement proceedings from substituting for regulation, the agency's emphasis on high profile enforcement makes regulation through enforcement a continuing possibility.

3. *Increased Publicity for the Enforcement Program*

Particularly during the past two decades, the SEC incorporated publicity into the agency's enforcement strategy.⁵⁹¹ This trend is likely to continue in the decade ahead: the Commission almost certainly perceives publicity as an important component of the deterrent effect of its enforcement program, and that deterrence is a major policy goal of the program.⁵⁹² As a result, the agency can be expected to emphasize its enforcement initiatives, and continue the trend toward greater publicity of the agency's activities. Moreover, as a result of the high visibility of the Commission's program over the past decade, the Commission could not decrease the publicity given to SEC cases even if it desired to do so. Most of the financial media have increased their coverage of the SEC, and in particular its enforcement program; even publications that ordinarily would not be covering the Commission have followed its exploits.⁵⁹³

The financial and news media, however, are not the only sources of publicity regarding the efforts of the SEC's enforcement program. Congress has increased its oversight of the Commission's activities, which is a direct product both of the high visibility of the

590. See *Breeden Responses*, *supra* note 26, at 86.

591. See *supra* notes 133-60 and accompanying text.

592. See *supra* note 154 and accompanying text.

593. See, e.g., *SEC Probe of Farley Recalls a Charge Raised in WPP Suit*, *Women's Wear Daily*, Feb. 10, 1989, at 8; *Those Wild Stock Swings*, 11 *WORKING WOMAN* 50 (1986).

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Commission's enforcement activities during the past decade,⁵⁹⁴ and the Commission's decision to seek additional powers from Congress.⁵⁹⁵ Given the Commission's continued requests of Congress for additional legislative powers, this trend of Congressional involvement in, and publicity for, the SEC's enforcement program is sure to continue.

Finally, it should not be overlooked that the increasing internationalization and interdependence of securities markets makes the Commission's enforcement program a likely candidate for increased publicity, not just in the United States, but throughout the capital markets of the world. The Commission's program is already perceived as a model for other countries that aspire to develop sophisticated capital markets.⁵⁹⁶ Moreover, as more and more international offerings, takeovers, and other activities occur over the next decade, the SEC's enforcement efforts will extend well beyond United States nationals to implicate important individuals and entities overseas as well.

4. Increased Enforcement Authority

The success of the Commission's insider trading enforcement program, combined with the agency's flourishing efforts to increase the penalties for illegal insider trading, have encouraged the agency to seek additional remedies and enforcement tools for use outside the area of insider trading.⁵⁹⁷ Thus, even prior to the recent change in the leadership of the Commission, the agency had submitted to Congress far-reaching, and somewhat controversial, proposals to increase the Commission's authority to assist foreign governments and entities in their enforcement activities.⁵⁹⁸ Additionally, pursuant to the directive contained in ITSFEA,⁵⁹⁹ the Commission had proposed significant additional enforcement powers.⁶⁰⁰

594. When the Commission's enforcement program became a public preoccupation, Congress became more active in reviewing the agency's efforts, evaluating them, and deciding what role properly should be played by the legislature in this context.

595. See *supra* notes 408-22 and accompanying text.

596. See, e.g., Behr, *Trade Link Promises Regulatory Headaches*, Wash. Post, Oct. 26, 1986 at D1, col. 3 ("In Tokyo, where a market for U.S. stocks is expanding, trading is governed by securities law patterned after American statutes").

597. See *supra* notes 408-22 and accompanying text.

598. See *supra* note 378 and accompanying text.

599. See ITSFEA § 3(c), H.R. 5133, 100th Cong., 2d Sess. § 3(c) (1988).

600. See *supra* notes 409-10 and accompanying text.

The SEC's new Chairman has made manifest his support for the grant of additional authority to the Commission in this regard, including the power to impose fines in a wide variety of cases (including the imposition of such fines directly by the agency in administrative proceedings), and, perhaps, the power to seek cease and desist orders when someone has violated the federal securities laws.⁶⁰¹ Although the new Chairman has recently expressed the view that the Commission may in fact not need the administrative power to bar certain persons from serving as officers or directors of publicly-held companies,⁶⁰² the legislative proposal to that effect submitted by the Commission to Congress remains pending.⁶⁰³

Given the current climate surrounding the Commission's enforcement program, one may reasonably predict that, in the absence of a change in Commission philosophy, and perhaps even in spite of such a change,⁶⁰⁴ the Commission will receive new powers to sanction violations of the federal securities laws. If this new authority and power is granted to the Commission, its enforcement program could change dramatically.

5. *Increased Development of Aggressive Enforcement Remedies*

A major tenet of the Commission's enforcement program throughout the past decade has been an insistence on greater deterrence.⁶⁰⁵ This emphasis on deterrence explains why the agency has frequently sought from Congress during the past decade additional grants of enforcement authority and stiffer sanctions: the

601. See *Breeden Responses*, *supra* note 26, at 13-14.

602. See *SEC For First Time Asks Congress To Grant It Cease-and-Desist Powers*, 22 Sec. Reg. & L. Rep. (BNA) No. 5, at 155 (Feb. 2, 1990) ("[The SEC] has decided to drop a controversial request for authority to bar officers and directors through administrative proceedings, SEC Chairman Breeden told the Senate Banking Securities Subcommittee"); see also *supra* notes 408-22 and accompanying text.

603. Securities Law Enforcement Remedies Act of 1989, H.R. 975, 101st Cong., 1st Sess., 135 CONG. REC. H270 (daily ed. Feb. 9, 1989).

604. ITSFEA was not a Commission creation. It emanated from the oversight function performed by the Chairman of the House Subcommittee on Telecommunications and Finance. Nevertheless, after the legislation developed its own momentum, and eliminated some of its more objectionable features (such as a proposed Qui Tam provision), the Commission enthusiastically supported the legislation. See *Insider Trading: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, H.R. REP. NO. 225, 100th Cong., 2d Sess. 20-21 (1988) (remarks of SEC Chairman David S. Ruder).

605. See, e.g., *Grundfest Calls for Enhanced Detection in Deterring Securities Law Violations*, 21 Sec. Reg. & L. Rep. (BNA) No. 5, at 204 (Feb. 3, 1989).

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essential theory is that heavier sanctions will deter more violations of the federal securities laws.⁶⁰⁶

By the same token, ever since the 1970s, the Commission has been consistently aggressive in its pursuit of ancillary remedies once it detects a violation of the federal securities laws. Despite the agency's efforts to effect helpful legislation, it has never been reluctant to assert the authority to seek and obtain from some courts a broad range of ancillary remedies, including some of the specific remedies the agency is currently seeking from Congress.⁶⁰⁷ Because of the agency's conviction that increased penalties effectively deter potential violators of the federal securities laws, the SEC can be expected to continue, and perhaps increase, its efforts to expand the range of implied sanctions it can seek in courts or negotiate in settlements.⁶⁰⁸

Finally, as a corollary to these propositions, the SEC can be expected to seek harsher sanctions in connection with its enforcement program. To the extent that the agency continues to

606. The logic of this rationale is not subject to empirical testing. One could compare the number of insider trading cases detected and pursued prior to 1984, before sanctions for insider trading increased dramatically, as against the number of similar cases detected and brought after 1984. The fact is that there were more prosecutions for insider trading after Congress provided for increased penalties than before. A review of selected SEC Annual Reports through 1987 shows that the Commission brought 121 insider trading cases prior to 1984, *see* 52 SEC ANN. REP. 3 (1986); 48 SEC ANN. REP. 3 (1982); 49 SEC ANN. REP. 3 (1983), while the number of SEC cases brought since then is only slightly smaller, or 105. *See* 50 SEC ANN. REP. 3 (1984); 51 SEC ANN. REP. 3 (1985); 53 SEC ANN. REP. 10 (1987). Thus, in the three years following the enactment of ITSA, the Commission had approached the number of insider trading cases brought in the previous fifty years; when the numerous other insider trading cases brought by the Commission in 1988 and 1989 are added, *see* cases cited *supra* at notes 327-28, there is no doubt that more insider trading cases have been brought *after* the sanctions for insider trading were substantially increased.

That does not mean, however, that the adoption of heavier penalties did not serve as a deterrent. All that can be said is that the opportunities and motivation for illegal insider trading increased after 1984, *see Problems with the SEC's Enforcement of U.S. Securities Laws in Cases Involving Suspicious Trades Originating from Abroad: Hearing Before a Subcomm. of the House Comm. on Government Operations*, 100th Cong., 2d Sess. 75, 83 (1988) (testimony of Harvey L. Pitt), and the Commission's ability to detect and pursue illegal insider trading also improved during that time. *Id.* at 75, 86-87.

607. *See supra* notes 408-10 and accompanying text.

608. This has already been demonstrated to some extent. The agency developed the notion of disgorgement, as an equitable remedy for insider trading violations, during the 1960s. *See, e.g., SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 855 (2d Cir. 1968) (disgorgement and rescission consistent with underlying policies of federal securities laws), *cert. denied sub nom., Coates v. SEC*, 394 U.S. 976 (1969). The Commission's theory was that a court of equity could deprive an adjudicated wrongdoer of the ill-gotten gains derived from his or her illegal conduct. By the end of the 1980s, this theory, which has a logical nexus to insider trading violations, also had been applied, successfully, to violations of the reporting requirements of the Williams Act. *See First City*, discussed *supra* at note 470-73 and accompanying text.

find widespread illegality in various aspects of the domestic securities markets, the internal and external pressure to raise the stakes for securities violators will increase. Given the SEC's historical predilection towards increasing sanctions when the standard of the law becomes better established and more widely recognized, the next decade should witness a concerted effort by the agency to increase the level of penalties imposed for various violations of the federal securities laws.

6. *Increased Criminalization of the Federal Securities Laws Enforcement Process*

As noted previously,⁶⁰⁹ the 1980s ushered in an era of increased criminalization of the federal securities laws enforcement process. This trend is demonstrated by the increased number of highly-visible criminal prosecutions emanating from SEC enforcement cases. However, it would be misleading not to point out that this supposed increased criminalization of the federal securities laws was not a wholly independent phenomenon.

For one thing, these highly visible SEC enforcement cases of the 1980s were of a sufficient magnitude to have warranted criminal prosecution under any set of circumstances.⁶¹⁰ Beyond that, counsel for the defendants involved in such cases recognized the inherent criminality of the conduct involved, and decided with their clients to pursue criminal resolutions of these cases on their own initiative. Perhaps most importantly, however, is the invalidity of the concern expressed by some attorneys that trivial securities law violations are now becoming the targets of criminal prosecutions.⁶¹¹ One must keep in mind exactly how the SEC enforcement process works. If the SEC is interested in counsel's client, counsel must assess whether the case

609. See *supra* notes 301-04 and accompanying text.

610. From the outset, it is clear that Congress intended truly egregious violations of the Exchange Act to be criminally prosecuted. See Herlands, *Criminal Law Aspects of the Securities Exchange Act of 1934*, 21 VA. L. REV. 139 (1934), in which it was opined that Congress apparently expected that "reliance will be placed chiefly upon administrative and injunction proceedings for enforcing the statute; and that . . . only viciously fraudulent cases will draw the fire of federal prosecutors." *Id.* at 196-97 (emphasis supplied).

611. See generally Coffee, *The 'Tip' of the Bunny's Nose: Sniffing Out Crime Where None Exists*, Legal Times, Sept. 25, 1989, at 34, col. 1 ("The problem of redefining the boundaries of criminal law in ways that make it virtually coextensive with civil regulatory law is that it ignores the advantages of having a gray penumbra of civil violations surrounding an inner core of more egregious criminal violations").

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carries with it a criminal component.⁶¹² Once a judgment is made that the case will not likely escape the attention of criminal prosecuting authorities, judgments must be made whether to settle or litigate the anticipated proceedings.

Where a decision is made to settle an anticipated criminal proceeding, counsel often finds it wise to bargain for a variety of benefits on behalf of his or her client in return for settling the action. Two major components of any criminal settlement are the number of charges to which a plea of some kind will be required,⁶¹³ and the nature of the charge (or charges) to which a guilty plea will be entered.⁶¹⁴ It is not surprising, therefore, to find a variety of esoteric charges suddenly surfacing as violations of the federal securities laws.⁶¹⁵ Such an occurrence is not an indication that prosecutors have elevated those esoteric charges to the level of commonplace criminal conduct; rather, it is a pragmatic reflection of the settlement process.

Nevertheless, the high-profile securities law enforcement program of the 1980s has kept securities violations very much on the minds of criminal prosecuting authorities around the country. Accordingly, one may anticipate that, during the next decade, more securities law cases that are being pursued by the SEC also will be referred, or selected, for criminal prosecution.

7. Increase in Private Rights of Action

Private rights of action have always served as a necessary supplement to the Commission's own enforcement program.⁶¹⁶ In connection with Congress' prior consideration of legislation to define the crime of insider trading⁶¹⁷ and its self-initiated, but

612. That is, counsel must determine whether, in his or her judgment, a given set of facts implicates not only civil violations of the federal securities laws, but also a possible interest by criminal prosecuting authorities. Once that judgment is made, counsel must determine how to approach the case so as to maximize the client's chances either of litigating the cases successfully, settling the SEC action without arousing the interest of criminal authorities, or attempting to settle both the SEC and criminal proceedings likely to arise, without undue prejudice to client's interests.

613. The pleas that are acceptable depend on the magnitude of the conduct involved. Pleas of *nolo contendere*, however, are becoming more difficult to achieve, as prosecutors insist upon, and obtain, guilty pleas to felony allegations.

614. See *Practical Perspectives*, *supra* note 121, at 380-81.

615. This presumably explains settlements in which defendants have consented to plead guilty to violations of the SEC's net capital rules. See, e.g., *United States v. Davidoff*, No. 87 Cr. 78 (S.D.N.Y. Jan. 28, 1987).

616. See *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964); see *supra* notes 358-59.

617. See *supra* notes 330-33 and accompanying text.

SEC-supported, effort to increase the sanctions for insider trading in 1988,⁶¹⁸ the Commission formally embraced the concept that the theretofore *implied* right of action for insider trading under the federal securities laws should be made *express*. Congress accepted the Commission's view in this regard, and added both an express remedy for insider trading and potential additional implied remedies as well.⁶¹⁹

One may reasonably expect, then, that the next decade will see an increase in private enforcement actions, particularly for insider trading. Congress' handiwork may reflect a determination that, in the absence of an express statement to that effect, no private right of action should be implied. By the same token, it may also reflect the view that Congress has endorsed private remedies and wishes to see them fostered.

8. *Decreased Flexibility in the Implementation of the Commission's Enforcement Program*

For the reasons discussed below, the SEC's enforcement program in the 1990s is not likely to allow staff members as much flexibility in the implementation of the program as in prior years.

First, as noted previously,⁶²⁰ the SEC's enforcement program has become far more visible. As a result, the Commission's enforcement decisions tend to be analyzed, reviewed, dissected, and criticized by more people than ever before, particularly by those in the press and in Congress. This phenomenon is the natural outgrowth of the SEC's decision to use the press to publicize its enforcement efforts (as part of its deterrent program),⁶²¹ and to seek increased enforcement powers from Congress.⁶²² Because the SEC has shown a sensitivity to criticism,⁶²³ it is likely to permit less flexibility in the

618. See ITSFEA, *supra* note 371.

619. See Exchange Act §20A(a), 15 U.S.C.A. § 78t-1(a) (West Supp. 1989) (express private remedy) and § 20A(d), 15 U.S.C.A. § 78t-1(d) (West Supp. 1989) (authority not to restrict other express or implied rights of action).

620. See *supra* notes 133-61 and accompanying text.

621. See *supra* notes 153-56 and accompanying text.

622. See *supra* notes 408-10 and accompanying text.

623. See *Hill Hears from SEC Tomorrow on Int'l Enforcement*, Wall St. Letter, Mar. 20, 1989, at 6 ("SEC officials said the agency has become more sensitive to criticism that it has fallen down on the job concerning oversight of foreign-oriented trading . . ."); *SEC, Stung by Criticism, Seeks Stiffer Insider Penalties*, L.A. Times, Feb. 18, 1987, § 4, at 1, col. 2 ("sleuths at the Securities and Exchange Commission were still smarting from accusations that they had been too lenient in penalizing [Martin] Siegel's co-conspirator, confessed inside trader Ivan F. Boesky").

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exercise of its prosecutorial discretion than might otherwise have been the case.

Second, once the SEC succeeds in obtaining new enforcement powers and remedies, either by virtue of new legislation, or favorable judicial decisions, the agency will be expected to use them (and likely will be taken to task for any failures in that regard). Rather than willingly confront that type of scrutiny, the agency will likely develop programs to use more effectively any new powers or remedies it is granted.

Third, the Commission's ability to settle cases in the future may diminish markedly as a result of a number of the factors described below:

(i) *Settlement is a function of pragmatics and leverage.* Under the Commission's old enforcement program, which emphasized injunctive relief, and permitted defendants to walk away from litigation by promising to do what the law already required those defendants to do (namely, to obey the law), without any acknowledgement of wrongdoing, the prospects of settlement were quite high.

But, while defendants may not care excessively about the adverse publicity that normally accompanies a court order requiring them to obey the law, they normally do, and will, care about serving time in jail, or about paying substantial monetary fines. By definition, early settlements may be discouraged by excessive governmental demands for monetary or ancillary relief,⁶²⁴ and increased pressure for criminal sanctions.⁶²⁵

In this sense, the SEC's greatest successes over the past decade—in the arena of insider trading—may have significantly adverse consequences for its future law enforcement efficiency. As more and more insider trading cases arose, and as Congress was persuaded to adopt the Sanctions Act, and its provision for treble

624. See generally Andre, Jr., *The Collateral Consequences of SEC Injunctive Relief: Mild Prophylactic or Perpetual Hazard?* 1981 U. ILL. L. REV. 625 (1981). The Commission's insistence upon injunctive relief usually is not an obstacle to the settlement of most enforcement cases. To be certain, there are some significant collateral consequences that can attend the entry of an injunction against an individual or an entity, not to mention the adverse publicity that flows from the settlement. Nevertheless, most prospective defendants see the entry of an injunction as merely a command that the defendant do what he, she or it already was required to do—that is, obey the law. See *SEC v. Bausch & Lomb, Inc.*, 82 F.R.D. 50, 53 (S.D.N.Y. 1979). It is only when the government ventures beyond the arena of simple injunctive relief that most defendants feel compelled to think carefully about settlement.

625. See, e.g., *Bad Week for Wealthy Fraud Suspects; Pressure Builds on Holdout Milken*, Assoc. Press, Sept. 1, 1989 (BC Cycle) (LEXIS, NEXIS library, Wires file).

civil penalties in SEC insider trading actions, the SEC's demands for higher monetary penalties also increased.⁶²⁶

This is particularly likely to be the case as the civil and criminal enforcement processes become more and more entwined. Law enforcement officials are not normally oblivious to the activities of one another. If the SEC presses a proposed defendant for an excessive or harsh settlement, involving components other than injunctive relief, the mere fact of settlement may whet the appetite of criminal prosecutors to pursue the same case. Given the different standards that prevail in criminal and civil cases,⁶²⁷ however, criminal prosecutors can be expected to exercise greater discretion in the selection of criminal prosecution targets.⁶²⁸

(ii) *The SEC's ability to settle its cases is also a function of its flexibility.* As noted above, the greater the SEC's flexibility, the more likely it will be able to settle its matters and avoid the burdens of litigation.⁶²⁹ During the 1980s, the enormous visibility of the SEC's enforcement program persuaded Congressional oversight committees to explore the wisdom of individual SEC settlements, producing unusually harsh criticism of certain settlements.⁶³⁰

626. See, e.g., *SEC Nails Drexel Dealmaker*, DUN'S BUS. MONTH, June 1986, at 19 ("The SEC is seeking treble penalties against [Dennis B.] Levine for alleged profits earned after August 10, 1984, the effective date of the Insider Trading Sanctions Act of 1984").

627. See *supra* note 295.

628. The burden of proof in a given case is one of the many factors weighed in the determination whether to commence a criminal prosecution. Courts have demonstrated great reluctance in interfering with the exercise of prosecutorial discretion. See, e.g., *Inmates of Attica Correctional Facility v. Rockefeller*, 477 F.2d 375, 380-81 (2d Cir. 1973) ("we believe that substitution of a court's decision to compel prosecution for the U.S. Attorney's decision not to prosecute, even upon an abuse of discretion standard of review and even if limited to directing that a prosecution be undertaken in good faith, . . . would be unwise") (citation omitted).

629. See *supra* note 324 and accompanying text.

630. A case in point occurred in connection with the Thomas Reed case during the early part of the past decade. There, the SEC settled civil injunctive insider trading charges against Reed, a member of the President's National Security Agency, and obtained over \$400,000 in disgorgement of allegedly ill-gotten gains. See *SEC v. Reed*, Litigation Release No. 9537, 24 SEC Docket 442 (S.D.N.Y. Dec. 23, 1981). Members of a congressional oversight committee immediately criticized the SEC for a settlement that was too lax, see *Commission Denies Special Treatment in Settling Thomas Reed Insider Case*, 15 Sec. Reg. & L. Rep. (BNA) No. 12, at 602 (Mar. 25, 1983), even though the disgorgement largely recouped the monies allegedly gained improperly by Reed. It should be noted in this context that, at the time of the violative activities, Congress had not, as yet, passed the Insider Trading Sanctions Act. Although SEC officials defended themselves vigorously, the oversight committee was skeptical. Thereafter, the United States Attorney for the Southern District of New York commenced a criminal prosecution of Reed for precisely the same conduct that formed the predicate for the SEC's charges and ultimate settlement. Reed was acquitted. See *Jury Clears Reed in Amax Case*, N.Y. Times, Dec. 17, 1985, at D1, col. 6.

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Congressional criticism is nothing new for the Commission; it has followed the agency throughout most of its existence.⁶³¹ Nevertheless, this criticism appears to have achieved its intended effect, at least to the extent that the Commission often seems to consider whether its proposed activities will generate criticism for having acted too weakly in the face of egregious violations of law.⁶³² Moreover, during the 1980s, it became fairly clear that the Commissioners themselves were reviewing with uncharacteristic detail staff-negotiated settlements presented to the Commission for approval.⁶³³

631. For a sampling of such criticisms in recent years, see *Regional Exchanges Urge Delay in Expanded Multiple Options Trading*, 21 Sec. Reg. & L. Rep. (BNA) No. 40, at 1534, 1534 (Oct. 13, 1989) ("The [C]ommission's handling of the multiple trading issue has drawn sharp criticism from some congressmen, including Rep. John Dingell . . ."); *Ruder Says Drexel Case Does Not Imply that Entire Securities Industry has Problems*, 20 Sec. Reg. & L. Rep. (BNA) No. 36, at 1394, 1394 (Sept. 16, 1988) ("[t]he SEC came under criticism from Rep. Howard Nielson (R-Utah), who contended the Commission should have brought the charges against Drexel sooner . . ."); *SEC Could Adopt Audit Committee Rule with Small Firm Exception*, *Ruder Says*, 20 Sec. Reg. & L. Rep. (BNA) No. 18, at 672, 672 (May 6, 1988) ("the SEC was criticized sharply by Subcommittee Chairman John Dingell (D-Mich.) for not fully supporting an antifraud Commission's recommendation . . ."); *Dingell Warns SEC to Take Action Soon On Curbing Program Trading Volatility*, 19 Sec. Reg. & L. Rep. (BNA) No. 7, at 221 (Feb. 13, 1987); *SEC Efforts to Uncover Levine Scheme Hurt by Perjured Testimony*, *Lynch Says*, 18 Sec. Reg. & L. Rep. (BNA) No. 49, at 1769 (Dec. 12, 1986) (Congressmen accuse SEC of failing to pursue leads from New York Stock Exchange that later were attributable to illegal trading by Dennis B. Levine); *Troubled Banks Still Must Report on Collectibility of Loans*, *FASB Says*, 18 Sec. Reg. & L. Rep. (BNA) No. 18, at 648, 649 (May 2, 1986) ("Subcommittee Chairman John Dingell (D-Mich.) chastised the SEC for not investigating the financial statements of Columbia First after the March 28 letter from the FASB staff"); *House Members Split with SEC, Treasury Over U.S. Securities Dealers Regulation*, 17 Sec. Reg. & L. Rep. (BNA) No. 25, at 1098, 1100 (June 21, 1985) ("SEC recommendations came under sharp attack by Wirth and Rinaldo, who were especially critical of the idea of granting Treasury rulemaking authority over government securities dealers"); *FASB Conceptual Framework Criticized*, *Dingell Discusses Accounting Hearings*, 17 Sec. Reg. & L. Rep. (BNA) No. 22, at 973, 973 (May 31, 1985) ("Dingell chastised the Securities and Exchange Commission for its reluctance to use its considerable authority over accountants . . .").

632. The authors are not aware of any instance in recent times where the Commission was criticized by Congress for extracting too harsh a settlement.

633. In response to a Freedom of Information Act request by the authors, the Commission produced a 578-page printout of a computerized database maintained by a former Commissioner for purposes of comparing proposed sanctions to prior similar matters. (A copy of the request, and the authors' appeal from a partial redaction to the database, are on file with authors). This database, entitled "Sanctions Project" includes the following categories of information: Name of Settlor; Date Decided; Case Name; File; Related Settlor; Sections Violated; Rules Violated; Nature of Case; Party; Recidivist; Prior Sanctions; Litigation or Settled; Customer Losses; Relief Obtained; Notes. (A copy of the Sanctions Project materials released to the authors by the SEC is on file with authors).

The Commission's current processes are not overly conducive to the flexible resolution of nascent enforcement proceedings. Prior to the late 1960s, the Commission's enforcement staff was authorized to alert potential defendants of the staff's likely recommendation that enforcement proceedings be instituted, and to solicit any interest in settling the action prior to presentation to the Commission. During the tenure of Chairman Hamer Budge, however, a certain amount of mistrust of the enforcement staff prevailed, and the staff was instructed

Because different Commissioners may have different ideas about the settlement process, this effective second-guessing by individual Commission members tends to make the staff somewhat more cautious about approaching the settlement process with flexibility, imagination and, on occasion, compassion.

(iii) *As the SEC expands its arsenal of securities enforcement weapons, it also potentially increases the rights of defendants who choose to litigate with the agency.* For example, it is now well-accepted that the agency's decision to seek civil monetary penalties carries with it the defendant's right to try the case to a jury of his or her peers.⁶³⁴ This may not work to the defendant's advantage in some cases, but the Commission's experience in litigating jury trial cases is limited.⁶³⁵

(iv) *The SEC's willingness to develop new legal theories in response to the exigencies of particular cases may promote less receptivity to settlement.* The more aggressively the SEC pursues novel legal theories, the more likely it is that settlements will be more difficult to achieve. New legal theories create new avenues for defense, and defendants who perceive themselves as beneficiaries of additional legal argumentation are apt to seize the opportunity.⁶³⁶

that it could not thereafter solicit indications of interest in settlement prior to the presentation to, and approval of, enforcement recommendation to the Commission. See SEC, REPORT OF THE ADVISORY COMMITTEE ON ENFORCEMENT POLICIES AND PRACTICES 34-35 (1972) [hereinafter WELLS REPORT]. This restriction tends to work against defendants who are represented by attorneys not familiar with the SEC's enforcement processes, since those persons do not know that, under the current enforcement policy (which has not formally changed since the Chairmanship of Hamer Budge), the staff will ordinarily not initiate settlement discussions until it has obtained approval from the Commission to do so, but will respond to such discussions if initiated by counsel for a prospective defendant.

This restriction also has the capacity to affect adversely the SEC staff's ability to continue its heavy reliance on settlements. At a minimum, it means that the Commission's decision to pursue a case will be predicated largely upon the staff's analysis and any countervailing arguments submitted by the proposed defendants in the form of a so-called "Wells Submission." See Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigations, Securities Act Release No. 5310, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,010 (Sept. 27, 1972). That analysis tends to take on the trappings of an adversarial presentation by the time the staff has determined to recommend formal enforcement proceedings. As a result, the staff often finds that the Commissioners, if they have approved a recommendation for enforcement action, are not receptive to later importunings to accept settlements that do not comport with the staff's original description of its proposed enforcement action.

634. See *Tull v. United States*, 481 U.S. 412 (1987); *supra* note 323 and accompanying text.

635. Nevertheless, the Commission's victory in litigating its first ITSA jury trial, see *SEC v. Clark*, Litigation Release No. 12,111, 43 SEC Docket 1574 (W.D. Wash. May 31, 1989), demonstrated the agency's readiness to take appropriate cases to trial.

636. Chairman Breen already be leading the Commission in that direction, as he seeks to extract pre-judgment interest from settling (or non-settling) defendants in insider trading cases. See *supra* note 318.

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C. Specific SEC Enforcement Initiatives Likely to Surface in the 1990s

1. Insider Trading

Given the high visibility of the Commission's insider trading enforcement program in the past decade and the popular attention it garnered, as well as the likelihood that increased sanctions will not deter a significant amount of insider trading,⁶³⁷ one may logically assume that a renewed, increased emphasis on insider trading will mark the Commission's enforcement program over the coming decade.⁶³⁸ In addition, it can be anticipated that the Commission will resume its aggressive enforcement of related violations, such as stock parking⁶³⁹ and similar misdeeds.

2. Penny Stock Abuses

The Commission's Task Force on Penny Stock Abuses is of relatively recent vintage. Chairman Breeden has recently reaffirmed his intention to continue the program and enforce it vigilantly.⁶⁴⁰ Having publicized the program and having witnessed extensive

637. See, e.g., SEC v. Wang, Litigation Release No. 11,780, 41 SEC Docket 384 (S.D.N.Y. June 27, 1988) discussed at *supra* note 156.

638. The process already has started. See SEC v. Lynch, Litigation Release No. 12,311, 44 SEC Docket 1768 (S.D.N.Y. Nov. 30, 1989) (SEC filed motion seeking temporary restraining order to freeze defendant's assets based on allegations of insider trading); SEC v. Finacor Anstalt and Certain Purchasers of Call Options Contracts for the Common Stock of Combustion Engineering, Inc., Litigation Release No. 12,296, 44 SEC Docket 1686 (S.D.N.Y. Nov. 20, 1989) (court entered order freezing assets of foreign entity based on allegations of insider trading).

639. One court has described stock parking as the practice in which "shares of stock are held by someone other than the true owner for the purpose of lowering the apparent amount of stock owned by that person" *Champion Parts v. Oppenheimer & Co.*, 878 F.2d 1003, 1005 (7th Cir. 1989).

640. See *Breeden Responses*, *supra* note 26, at 13.

publicity for it,⁶⁴¹ combined with an active state enforcement program,⁶⁴² the Commission will not let this program falter.

3. *Market Manipulation Cases*

Toward the end of the past decade, the Commission began pursuing market manipulation cases with greater frequency.⁶⁴³ In light of the greater volatility of the markets since the 1987 Crash, the Commission can be expected to seek to regulate market phenomena with which it disagrees through the vehicle of enforcement.⁶⁴⁴

4. *Disclosures in Change of Control Contexts*

In view of the Commission's reluctance to regulate further in the takeover or leveraged buyout arena, and given the agency's concerns about precluding foreign issuers from making bids within this country, the Commission is likely to promote a hospitable environment for change of control transactions, but police vigorously failures to comply with disclosure requirements. Indeed, it is even conceivable that this is one area in which the Commission may, advertently or inadvertently, entirely substitute the enforcement process for regulation.

641. See, e.g., *The Penny Stock Scandal*, BUS. WK., Jan. 23, 1989, at 74, col. 1.

642. New Jersey, Florida, Utah, and Georgia are increasing their supervision and enforcement efforts. See *id.* at 77, 79-80. See also *Sartore v. Buder*, 759 P.2d 785 (trustee liable to beneficiary for improperly investing in penny stocks), *aff'd en banc*, 774 P.2d 1383 (Colo. 1989).

643. As early as 1982, the Commission had proclaimed its intention to pursue market manipulation cases. See *SEC's Shad, Fedders Deny Commission is Overemphasizing Insider Trading*, 14 Sec. Reg. & L. Rep. (BNA) No. 41, at 1785, 1785 (Oct. 22, 1982) ("Fedders said he was 'surprised' by the low number of market manipulation cases initiated during fiscal 1982 . . . but Fedders predicted that the figure is likely to go up during the next fiscal year"). This proclamation was brought to its most dramatic fruition with the government's market manipulation charges against Drexel. See *SEC v. Drexel Burnham Lambert, Inc.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,999 (S.D.N.Y. Sept. 7, 1988) (civil charges); *United States v. Drexel Burnham Lambert, Inc.*, 89 Cr. 41 (S.D.N.Y. Jan. 24, 1989) (LEXIS, Genfed library, Dist file) (criminal charges).

644. Indeed, based upon the emphasis placed on market volatility in the questions posed by members of the Senate Banking Committee to Chairman Breeden during his confirmation process, it is evident that Congress will be watching closely the Commission's response in future episodes of market volatility. See *Breeden Responses*, *supra* note 26, at 10-12, 17-20, 36, 50-51, 67.

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5. *International Enforcement Activities*

The agency's commitment to cooperation with foreign regulators, and its avowed concern with the prospect of fraudulent international schemes, strongly suggests that the Commission will increase its campaign against internationally-based fraudulent schemes.

6. *Stock Loan Activities*

Chairman Breeden has already subscribed to the notion that stock-loan abuses are extremely serious and should be a high priority for the Commission during his tenure.⁶⁴⁵

7. *Thrift and Depository Institution Securities Law Violations*

Chairman Breeden's familiarity with the difficulties of the thrift industry, and the enormous range of violative conduct that is presently being pursued by federal banking and criminal authorities, made it inevitable that the SEC would pursue disclosure and trading related claims against various thrift holding companies within the SEC's jurisdiction. To that end, Breeden and Enforcement Division Director McLucas are currently establishing a new financial institution task force in the Division to focus on such matters.⁶⁴⁶

8. *Financial Accounting Cases*

The Commission's campaign against faulty application of accounting techniques⁶⁴⁷ will undoubtedly continue during the next decade. The utilization of questionable accounting principles to overstate income or understate liabilities is a subject of great concern to the agency. Particularly in light of the Commission's reluctance to establish generally accepted accounting principles,⁶⁴⁸ it is logical to assume that vigorous enforcement against faulty accounting techniques will continue.

645. See *Breeden Responses*, *supra* note 26, at 14-15.

646. See *McLucas Is Named Enforcement Director of SEC, Its Second-Most Influential Post*, *supra* note 26.

647. See *supra* notes 478-83 and accompanying text.

648. See *Breeden Responses*, *supra* note 26, at 22-23.

9. *Disclosure of Adverse Information and Adverse Trends*

The Commission has recently completed an analysis of, and issued a release reminding issuers of their obligations regarding, the disclosures provided in response to the SEC's MD&A requirements.⁶⁴⁹ In light of this heightened attention to issuers' disclosure, combined with other adverse events affecting various industries,⁶⁵⁰ the Commission can be expected to pursue instances of faulty disclosures of adverse trends and other negative information.

10. *Failure to Supervise Cases*

Throughout its history, the Commission has placed great emphasis on vicarious liability as a vehicle for maximizing its capacity to police the securities markets. The Commission has recently reaffirmed its intention to pursue such cases vigorously in the coming years, a natural outgrowth of the recent ITSFEA legislation.⁶⁵¹

Conclusion

The Commission's reputation as an effective law enforcement agency is well-established, rightfully earned, and borders on the legendary. During the past decade, the agency made enormous strides in improving the visibility, popularity, and effectiveness of its enforcement program. The ingredients for the Commission's success are many. They include an outstanding staff, an intensely dedicated and aggressive spirit, and a desire for excellence that has been maintained through nearly six decades of existence. The agency's freedom from political influence, responsiveness to new trends, and flexibility in promoting prompt and effective settlements with the

649. See *supra* notes 484-95 and accompanying text.

650. See Statement of the Commission Regarding Disclosure Obligations of Companies Affected by the Government's Defense Contract Procurement Inquiry and Related Issues, Securities Act Release No. 6791, 41 SEC Docket 720 (Aug. 1, 1988).

651. See *Breeden Responses*, *supra* note 26, at 16, 37-38. And, as noted earlier, ITSFEA puts into place onerous new supervisory obligations and increased penalties for lapses in that regard. See *supra* notes 373-75 and accompanying text.

Additionally, the U.S. Sentencing Commission recently put out for public comment preliminary guidelines for sanctioning criminal wrongdoing by corporations. The proposed guidelines would increase substantially the potential fines, probationary terms, and other applicable sanctions. See *Commission Would Up Punishment*, NAT'L L.J., Nov. 20, 1989, at 3, col. 1. Thus, if heightened SEC enforcement activities continue to generate resulting criminal prosecutions, the stakes in certain supervision cases will increase dramatically.

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targets of its enforcement attentions have produced an efficient and successful enforcement program.

And yet, part of the process by which this enforcement program continues to grow has been an effort—both within and without the agency—to build greater rigidity into the agency's past practices. This is evidenced by, among other things, the effort of the media and Congress to assume an unduly critical stance towards the agency's enforcement judgments, often taking the agency to task for settling too cheaply or too quickly.⁶⁵² The SEC is sensitive to such criticism, and seeks to deflect it as best it can. Recognizing the greater visibility of its enforcement program, one can expect the agency to impose upon its Enforcement Division the responsibility for producing harsher and more publicly-acceptable settlements. This process is comparable to the internal process by which members of the Commission, commencing in the early 1980s, questioned the judgments of the Enforcement Division Staff in settling cases too "cheaply" or prematurely. Again, the response has been to increase the price of settlements the SEC's staff is even willing to present to the Commission.

Similarly, the SEC has succeeded in increasing the level of penalties it can seek in connection with various illegal activities. This effort, accomplished through the efforts of Congress, has produced a greater risk for certain types of activities. There is no way to measure whether the increase in sanctions has had a proportionally increased deterrent effect, since one can never measure the violations of law that are contemplated but do not take place. But the bidding for increased sanctions continues, with proposals pending in Congress as of this writing, authored by the SEC, that, if adopted, would give the Commission inappropriate powers to determine who may, and who may not, serve as a corporate officer and director, despite (or even in the face of) conflicting judgments made by corporate shareholders. As with the review of settlements, the increase in SEC powers produces a concomitant scrutiny to ascertain whether, and how well, the Commission is making use of its new powers.

All of these efforts have the effect of making it more difficult for the SEC to pursue violators on the assumption that a large percentage of its cases will be settled. To the extent that the stakes have risen, the SEC may find itself confronted with the need to engage in more litigation. While a certain amount of litigation is

652. See *supra* notes 440-43.

healthy for the agency, and for the system, the greater the SEC's litigation burdens, the less will be its ability to undertake additional investigations of other activities. The agency will find itself devoting its resources to litigation rather than to investigation and consensual resolutions.

In sum, about the only threat to the Commission's continued success is its past success. Those who seek to make a good program perfect may be casting the seeds of a weakening of the agency's future effectiveness. In particular, efforts to saddle the agency with authority it does not need, or at least does not want,⁶⁵³ and procedures that may encumber its ability to move rapidly, should be rethought. Stagnation of enforcement initiatives is not in the public interest; saddling an effective agency with more administrative burdens than it reasonably should be expected to handle is similarly not within the public interest.

The future for the SEC's enforcement program is bright, particularly if the agency and those who support it do not succumb to the temptation to overload the agency with responsibilities that will erode its principal strengths—efficiency and flexibility.

653. The phenomenon of empowering the Commission with authority (and the concomitant responsibility) it neither needs nor desires was recently played out in the Congressional debate over whether to vest in the SEC Chairman the power to halt trading in the securities markets during periods of extreme volatility. Chairman Breeden resisted such authority, which is presently vested in the President. See *Brady Wants SEC to Be Able to Close Markets During an Emergency*, L.A. Times, Oct. 27, 1989, at D3, col. 4, in which it was reported that:

Treasury Secretary Nicholas F. Brady, taking issue with newly installed Securities and Exchange Commission Chairman Richard C. Breeden, endorsed a proposal Thursday that would give the SEC the right to shut down the stock market in an emergency.

Breeden told lawmakers Wednesday that he did not want the authority to close securities markets, arguing that uncertainty over whether the SEC might halt trading could worsen market volatility.

See also *Panel Votes to Give SEC Powers Over Programs; House Bill Would Ban 'Abusive' Practices*, Wash. Post, Nov. 15, 1989, at F3, col. 1; *Heat Is on Again for Programme Traders*, Fin. Times (U.K.), Nov. 2, 1989, at 24, col. 1.