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Treble Damages, Deterrence, and Their Relation to Substantive Law: Ramifications Under the Insider Trading Sanctions Act of 1984

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TREBLE DAMAGES, DETERRENCE, AND THEIR RELATION TO SUBSTANTIVE LAW: RAMIFICATIONS OF THE INSIDER TRADING SANCTIONS ACT OF 1984.

INTRODUCTION

The United States economy is founded in part on investor confidence in and public perception of the fairness and integrity of the nation's securities markets.[1] This foundation is partially being eroded by what is commonly referred to as "insider trading."[2] The need to

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1. This policy was an initial impetus when Congress enacted the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1982), to deter abusive practices and restore integrity in the national securities markets. *See* S. REP. NO. 792, 73d Cong., 2d Sess. 1, 3-5 (1934); H.R. REP. NO. 1383, 73d Cong., 2d Sess. 1, 3-5, 10-14 (1934); Note, *The Role of Treble Damages in Legislative and Judicial Attempts to Deter Insider Trading,* 41 WASH. & LEE L. REV. 1069 (1984) [hereinafter cited as Note, *The Role of Treble Damages*]; Note, *CBI Industries, Inc. v. Horton: The Seventh Circuit Lets the Insider Off,* 33 AM. U.L. REV. 247 (1983). Congress continues to advocate this policy. *See* H.R. REP. NO. 355, 98th Cong., 1st Sess. 2, 3 (1983), *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 2274 [hereinafter cited as HOUSE REPORT].

2. HOUSE REPORT, *supra* note 1, at 2, 3, 21. "Insider trading" is a term used to refer to trading in the securities markets by "insiders"—corporate executives, officers or their employees—while in possession of material information not yet disseminated to the general public. This term may also be extended to include persons such as attorneys, accountants, underwriters, and other agents who, through their positions of trust and confidence, become "temporary" insiders. *See* Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983); Langevoort, *The Insider Trading Sanctions Act of 1984 and its Effect on Existing Law,* 37 VAND. L. REV. 1273 (1984). The term "insider trading" is actually a misnomer because "insiders" may be "temporary" or "constructive" insiders, "trading" may be done by "tippees" of the insider who then trade, and the information underlying an illegal trade may not be "inside" but rather external "market" information not yet generally known, all of which reveals the difficulty in concluding that insider trading is currently well defined. *Report of the Task Force on Regulation of Insider Trading Part I: Regulation Under the Antifraud Provisions of the Securities Exchange Act of 1934,* 41 BUS. LAW. 223, 224 (1985) [hereinafter cited as *Task Force Report*].

There is evidence that the incidence of insider trading is very high and may in fact be the most common violation of the federal securities laws. *See* Dooley, *Enforcement of Insider Trading Restrictions,* 66 VA. L. REV. 1, 6-7 (1980); Note, *A Critique of the Insider Trading Sanctions Act of 1984,* 71 VA. L. REV. 455, 455 (1985).

For a brief list of the vast literature dealing with the legal problem of insider trading, see H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966); Carlton & Fischel, *The Regulation of Insider Trading,* 35 STAN. L. REV. 857 (1983); Anderson, *Fraud, Fiduciaries, and Insider Trading,* 10 HOFSTRA L. REV. 341 (1982); Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation,* 80 MICH. L. REV. 1051 (1982); Heller, *Chiarella, SEC Rule 14e-3, and Dirks: "Fairness"* regulate insider trading is an issue widely debated in economic and legal theory.[3] However, the Securities and Exchange Commission (SEC) and Congress share the view that regulation proscribing insider trading is vital to principles of fairness and equity among market participants since this information is material to the investment decision process of all investors.[4]

One of the most elusive problems in curbing insider trading abuses has been finding an effective means of deterrence. Until recently, the SEC's enforcement remedies as a deterrent to insider trading were primarily limited to criminal prosecutions[5] or civil actions seeking disgorgement of profits[6] and an injunction against future violations.[7] In addition to the SEC's enforcement powers, deterrence

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Versus Economic Theory, 37 BUS. LAW. 517 (1982); Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy* 9 J. LEGAL STUD. 801 (1980); Brudney, *Insiders, Outsiders, and Informational Advantages under the Federal Securities Law*, 93 HARV. L. REV. 322 (1979).

3. Economically, an "efficient" market is one where prices always fully reflect available information, including inside information. Note, *The Efficient Capital Market Hypotheses, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031, 1073 (1977). Insider trading leads to market efficiency because such trades move the market in the correct direction. H. MANNE, *supra* note 2. Therefore, economic considerations do not justify restrictions on insider trading. *Id. But cf.* Schotland, *Unsafe at any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425 (1967) (insider trading is inherently "unfair"); Brudney, *supra* note 2, at 345-46 (informational advantages obtained by insiders also rest on considerations of equity).

4. *See, e.g.*, Thomas, *Insider Trading Revisited: The SEC's New Initiatives*, 1982-1983 CORP. PRAC. COMM. 433, 435 (SEC's view); HOUSE REPORT, *supra* note 1, at 2, 3, 21 (Congress adopting the SEC's view).

5. 15 U.S.C. § 78ff (1982). The SEC can refer criminal prosecution to the United States Attorney General. *Id.* § 78u(d).

6. *See* HOUSE REPORT, *supra* note 1, at 7. Several courts and commentators have disagreed over the proper measure of the disgorgement remedy. *See, e.g.*, SEC v. MacDonald, 699 F.2d 47 (1st Cir. 1983); Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980); SEC v. Shapiro, 494 F.2d 1301 (2d Cir. 1974); Brunelle, *Disgorgement of Insider Trading Profits in SEC Injunctive Proceedings*, 11 SEC. REG. L.J. 371, 373 (1984); Note, *The Role of Treble Damages*, *supra* note 1, at 1072-74. One federal district court has even denied the remedy because of its inadequacy as an effective deterrent to insider trading. SEC v. Randolph, 564 F. Supp. 137, 140-41 (N.D. Cal. 1983), *rev'd*, 736 F.2d 525 (9th Cir. 1984).

7. 15 U.S.C. § 78u(d) (1982). To obtain an injunction, the SEC must present proof of a past violation and a reasonable likelihood of future violations. *See* SEC v. Commonwealth Chem. Sec., Inc., 574 F.2d 90, 100 (2d Cir. 1978); HOUSE REPORT, *supra* note 1, at 6.

There are other provisions by which the SEC can investigate and enforce the insider trading prohibitions. *See, e.g.*, 15 U.S.C. § 78o-3 (1982) (discipline broker-dealers); *Id.* § 78u(a) (investigative authority); *Id.* § 78ff (1982 & Supp. II 1984) (criminal penalties).

of insider trading by private plaintiffs has met with limited success where courts have implied a private right of action.[8] Despite efforts from the SEC and the private sector, the remedies available did not provide an effective deterrent to insider trading.[9]

In an effort to rectify the ineffectiveness of enforcement remedies available to the SEC for insider trading violations, Congress enacted the Insider Trading Sanctions Act of 1984 (ITSA).[10] Congress designed the ITSA to impose a severe monetary civil penalty as the primary means of deterring future violations of insider trading.[11] Under this legislation, the SEC has the authority to seek and the courts have the power to impose up to a maximum penalty of treble damages on insider trading violations subject to the Act.[12] Before a sanction can be imposed under the ITSA, courts must first find a violation of insider trading as defined under substantive rules independent of the ITSA,[13] such as section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 (Exchange Act).[14] Once a violation is found, courts must

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8. *See* Langevoort, *supra* note 2, at 1275-77. An implied private right of action under Rule 10b-5, 17 C.F.R. § 240.10b-5 (1985), was first recognized in Kardon v. National Gypsum Co., 73 F. Supp. 798, 800 (E.D. Pa. 1947). This remedy was finally recognized by the Supreme Court in Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971). *See also* Herman & MacLean v. Huddleston, 459 U.S. 375 (1983) (current Supreme Court recognition of this remedy).

9. *See* HOUSE REPORT, *supra* note 1, at 6-8; Langevoort, *supra* note 2, at 1275-77; Note, *supra* note 2, at 455, 462, 468-69; Note, *The Role of Treble Damages*, *supra* note 1, at 1071.

10. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (1984) (codified as amended at 15 U.S.C. §§ 78a, 78c, 78o, 78t, 78u, 78ff (Supp. II 1984)) [hereinafter cited as Exchange Act]. This provision amends The Securities Exchange Act of 1934.

11. HOUSE REPORT, *supra* note 1, at 2.

12. Exchange Act, *supra* note 10, at § 21(d)(2)(A). Whenever it appears to the SEC that a person is in violation of the insider trading proscriptions, "[T]he Commission may bring an action in a United States district court to seek, and the court shall have the jurisdiction to impose, a civil penalty to be paid by such person. . . . The amount of such penalty . . . shall not exceed three times the profit gained or loss avoided." *Id.* HOUSE REPORT, *supra* note 1, at 1.

13. *See* Exchange Act, *supra* note 10, at § 21(d)(2)(A); HOUSE REPORT, *supra* note 1, at 13-15, 31-33; *Insider Trading Sanctions and SEC Enforcement Legislation: Hearings on H.R. 559 Before the Subcommittee on Telecommunications, Consumer Protection, and Finance of the Committee on Energy and Commerce House of Representatives*, 98th Cong., 1st Sess. 49, 56 (1983) [hereinafter cited as *House Hearings*] (testimony of Hon. John S. R. Shad, Chairman, SEC and John M. Fedders, Director, Division of Enforcement, SEC).

14. Section 10(b) provides in relevant part:

> It shall be unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or

decide whether this violation triggers the "substantive" culpability requirements of the ITSA.[15] If so, courts are to then determine the measure of damages up to the treble damage maximum based on the facts and circumstances of each case.[16]

With the treble damage penalty, Congress intended the ITSA to be purely a sanction statute; it was not intended to modify in any way the preexisting body of substantive insider trading law as developed under Rule 10b-5 by court and administrative holdings.[17]

> of any facility of any national securities exchange,
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> . . . .
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> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1982).

Rule 10b-5, promulgated to allow enforcement of section 10(b), provides:

> It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
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> (a) to employ any device, scheme, or artifice to defraud,
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> (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or;
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> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1985).

There are other substantive rules which impose liability for insider trading. For example, the SEC adopted Rule 14e-3 which makes it unlawful for anyone other than the bidder in a tender offer to trade based on material nonpublic information. 17 C.F.R. § 240.14e-3 (1985). Section 16(b) of the Exchange Act also imposes liability for short-term trading profits based on inside information. 15 U.S.C. § 78p(b) (1982). *See also* H. BLOOMENTHAL, SECURITIES LAW HANDBOOK §§ 16.01-.02, 20.03-.04 (1984) (discussing the application of section 10(b), Rule 10b-5, Rule 14e-3, and section 16(b) and their relation to insider trading).

When discussing the substantive law of insider trading, for purposes of simplicity this note will hereinafter refer primarily to Rule 10b-5 since most of the substantive law regarding insider trading has developed under this rule.

15. *See infra* notes 32-111 and accompanying text.

16. Exchange Act, supra note 10, at § 21(d)(2)(A). The Act provides: "The amount of such penalty shall be determined by the court in light of the facts and circumstances, but shall not exceed three times the profit gained or loss avoided as a result of such unlawful purchase or sale. . . ." *Id.*

17. HOUSE REPORT, *supra* note 1, at 13; *House Hearings*, *supra* note 13, at 49, 56; 130 CONG. REC. H7758 (daily ed. July 25, 1984). *See* 5C A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5 § 265 (2d ed. 1985 rev.); Brodsky, *Insider Trading and the Insider Trading Sanctions Act of 1984: New Wine Into New Bottles?*, 41 WASH.

Prior to the ITSA's adoption, the issue of whether the ITSA should expressly define insider trading was widely debated, but for several reasons, inclusion of a definition of insider trading was ultimately opposed.[18] This extensive congressional consideration of prevailing insider trading law and of specific proposals for definitional change is critical. Under a cannon of statutory construction, when Congress is aware of an opportunity to change prevailing judicial construction of a prior enacted provision, for example Rule 10b-5, and has decided not to do so, this inaction constitutes an implied endorsement of the prevailing judicial construction.[19]

& LEE L. REV. 921, 922 (1984); Langevoort, *supra* note 2, at 1274; Note, *supra* note 2, at 455-56, 491, 496-97.

18. The Insider Trading Sanctions Act of 1984, introduced under House bill H.R. 559, was referred to the Committee on Energy and Commerce in the House of Representatives which issued a report to accompany H.R. 559. HOUSE REPORT, *supra* note 1. The Committee believed that any statutory definition would necessarily have to be broad enough to encompass unforseen fact patterns and would result in a definition only slightly less ambiguous than current insider trading proscriptions developed by the courts. *Id.* at 14. The Committee also feared that any definition would only serve to increase litigation and legal uncertainty. *Id.* at 13, 32-33. The inability of the drafters of the proposed American Law Institute Federal Securities Code to formulate an adequate definition of insider trading also influenced the Committee. *Id.* at 13-14. *See also* Block & Barton, *Insider Trading—The Need for Legislation,* 10 SEC. REG. L.J. 350, 370-71 (1983) (the authors give a synopsis of the ALI code provisions dealing with insider trading and damages). Concern was also expressed as to the effect any definition would have on other federal securities laws. HOUSE REPORT, *supra* note 1, at 13. *See also House Hearings, supra* note 13, at 278-83 (statement of Arnold S. Jacobs) ("Hundreds of cases clarify Rule 10b-5's insider trading prohibition. . . . Even if H.R. 559 were redrafted to include [a definition of insider trading] it is highly probable that [it] would become the definition for all purposes of the federal securities laws.").

The Committee concluded that since judicial decisions over the years have been sufficiently clear in developing the scope of insider trading liability, the courts are well suited to continue this task. *See* HOUSE REPORT, *supra* note 1, at 13, 27, 32. *But see Task Force Report, supra* note 2, at 224 (insider trading is currently not well defined); Freeman, *The Insider Trading Sanctions Bill—A Neglected Opportunity,* 4 PACE L. REV. 221 (1984) (calling for the broadening of the class of prohibited conduct, and the clarification of the liability of outsiders who engage in insider trading). Further, the Committee deferred to the SEC's broad rule-making authority to respond to any adverse market developments. *See* HOUSE REPORT, *supra* note 1, at 13.

There were several other issues debated during the introduction of H.R. 559 (Senate version, S.910). Issues receiving the most attention were: secondary liability, definition of profit and loss, statute of limitations, burden of proof, jury trial, and insider trading definition. For an elaboration on these issues, see generally HOUSE REPORT, *supra* note 1; *House Hearings, supra* note 13; *Insider Trading Sanctions Act of 1983; Hearings on H.R. 559 Before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs United States Senate,* 98th Cong., 2d Sess. (1984) [hereinafter cited as *Senate Hearings*].

19. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 385-86 (1983); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353, 381 (1982); Lorillard

Current judicial construction of insider trading liability under Rule 10b-5 is primarily influenced by two prominent United States Supreme Court decisions: *Chiarella v. United States*[20] and *Dirks v. SEC*.[21] In these two cases, the Supreme Court has taken a restrictive approach in interpreting the substantive provisions of Rule 10b-5.[22] If the Supreme Court and the lower courts further limit the scope of insider trading liability, the deterrent impact of the ITSA may decrease accordingly.[23] Moreover, if the scope of insider trading liability is in any way modified as a result of the ITSA, it will be contrary to legislative intent.[24] Courts may be faced with the dilemma of whether to uphold the ITSA's deterrent objective by imposing a severe treble damage penalty, or whether to avoid Draconian results—where imposition of potential penalties may be overly harsh— by restricting the scope of insider trading law.

Contrary to legislative choice, courts in other areas of the law have not been steadfast in maintaining the independence between these Draconian results and the application and interpretation of the underlying substantive law.[25] For example, the impact of overly harsh results on the underlying substantive law can be seen in section four of the Clayton Antitrust Act[26] and in the Racketeer Influenced and Corrupt Organizations Act (RICO),[27] two areas where private plaintiffs may seek a treble damage penalty.[28] However, the ITSA differs from these treble damage provisions in two respects. First, under the ITSA, only the SEC is empowered to enforce the treble damage sanction; it is not available for private plaintiffs.[29] Second, unlike the anti-

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v. Pons, 434 U.S. 575, 580-81 (1978); 2A N. SINGER, SUTHERLAND STATUTORY CONSTRUCTION § 49.09 (4th ed. 1984 rev.); Langevoort, *supra* note 2, at 1274; Note, *The Effect of Prior Judicial and Administrative Constructions on Codification of Pre-Existing Federal Statutes: The Case of the Federal Securities Code*, 15 HARV. J. ON LEGIS. 367 (1978).

20. 445 U.S. 222 (1980).

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

22. *See* Langevoort, *supra* note 2, at 1294; Note, *United States v. Newman: Misappropriation of Market Information by Outsiders*, 3 PACE L. REV. 311, 322-25 (1983); Branson, *Discourse on the Supreme Court Approach to SEC Rule 10b-5 and Insider Trading*, 30 EMORY L. REV. 263, 266-71 (1981). Also, *see infra* notes 197-207 and accompanying text.

23. *See infra* notes 129-43 and accompanying text.

24. *See supra* notes 17-19 and accompanying text.

25. *See infra* notes 114-15 & 144-58 and accompanying text.

26. 15 U.S.C. § 15 (1982).

27. 18 U.S.C. §§ 1961-1968 (1982).

28. For development of the effect of the treble damage penalty in antitrust and RICO, see *infra* notes 144-79 and accompanying text.

29. *See* Exchange Act, *supra* note 10, at § 21(d)(2)(A). Section 28(a) of the Exchange Act also provides that "no person permitted to maintain a suit for damages

trust and RICO treble damage penalty, treble damages under the ITSA is discretionary in that the penalty may be imposed up to the treble damage maximum; the maximum need not be sought in every case.[30] With these two differences, desired levels of deterrence may still be achieved while maintaining an independence between the penalty imposed and any effect it may have on the underlying substantive law.[31]

The purpose of this note is to illustrate the competing concerns between a treble damage penalty as a deterrent, and the role of substantive insider trading law, which is potentially influenced by Draconian results, yet instrumental to the deterrent objective. Divided into four parts, this note first sets forth the "substantive" provisions within the ITSA's main sections and their relation to substantive insider trading law independent of the Act. Second, this note introduces economic concepts of deterrence and the relationship of deterrence to substantive law by analyzing trends in antitrust, RICO, and federal securities law. Third, substantive law aside, the discussion analyzes the unique problems presented by treble damages as a deterrent when imposed on an entity versus an individual under the ITSA. Finally, this note recommends how the SEC and the courts should implement the ITSA to achieve its congressional objectives.

I. Substantive Law Within the Insider Trading Sanctions Act

A. *Substance versus Procedure*

Even though the ITSA was not intended to define or create a new body of substantive insider trading law, the ITSA does contain a substantive aspect. As a result of Congress' unwillingness to impose strict sanctions on every insider trading violation,[32] the ITSA contains distinct classifications of substantive insider trading liability. These classifications are derived from the specific wording of the Act and the clarifications within its legislative history.[33] The specific wor-

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under the provisions of this chapter shall recover . . . a total amount in excess of his actual damages. . . . " 15 U.S.C. § 78bb(a) (1982). Failure to amend this section under the ITSA provides further evidence that the ITSA's treble damage provision is not available for private plaintiffs. *See* Note, *supra* note 2, at 485.

30. House Report, *supra* note 1, at 8-9.

31. *See infra* notes 256-76 and accompanying text.

32. *See* House Report, *supra* note 1, at 9-11.

33. The unusual nature of the ITSA's legislative history was explained by Theodore A. Levine, a former associate director of the Enforcement Division at the

ding of the ITSA imposes substantive limitations on an underlying insider trading violation before the treble damage sanction may be applied.[34] This specific wording, in turn, expressly incorporates "clarifications" contained in the committee report accompanying the legislation.[35] The clarifications are for use as guidance in determining what limitations should exist on conduct that will be subject to the treble damage sanction under the ITSA.[36] Despite congressional recognition that the limitations and clarifications within the ITSA and its legislative history are to be given interpretive effect, there is no express recognition that these limitations and clarifications are "substantive" law.

However, there are at least two reasons why certain provisions within the ITSA can be considered substantive. First, the ITSA goes beyond a mere substantive-procedural dichotomy. Where a sanction, fixed in amount and application, is mechanically or automatically imposed upon an underlying substantive violation, the sanction is applied as a matter of pure procedure without a substantive decision.[37] Unlike a purely procedural rule, the ITSA requires that once a substantive violation under Rule 10b-5 is found, a second substantive decision must be made to determine if the violation is within the ITSA's limited scope of liability before assessing the appropriate measure of damage. Therefore, the ITSA is a hybrid or procedural-based substantive rule.[38]

Securities and Exchange Commission. *See* Levine, *Insider Trading Act Broadens Enforcement Scope*, Legal Times, Sept. 10, 1984, at 17, col. 4.

> The House version of the bill (H.R. 559) was amended by the Senate and then passed by both houses of Congress and signed by the President. In the absence of a report by the Senate Banking Committee or a House-Senate conference report, Report No. 98-355 of the House Committee on Energy and Commerce, as modified by explanations from D'Amato and Rep. John Dingell (D. Mich.) govern the interpretation of the act.

Id. (footnotes omitted). *See also* Langevoort, *supra* note 2, at 1277-78; Note, *supra* note 2, at 469-70 (elaborating on the ITSA's legislative history).

34. *See, e.g., infra* notes 42-111 and accompanying text.

35. *See* HOUSE REPORT, *supra* note 1. "[T]he clarification made to the scope of the persons liable for the penalty answers the definitional concerns of some commentators." *Id.* at 14. "The Commission does urge that the legislative history of the bill cite behavior to which the statute is not intended to apply." *Id.* at 31 n.55.

36. *See id.*

37. *See* Risinger, *"Substance" and "Procedure" Revisited with Some Afterthoughts on the Constitutional Problems of "Irrebuttable Presumptions,"* 30 UCLA L. REV. 189, 204 (1982).

38. *See id.* at 207 (distinguishing between two kinds of procedural rules and substantive rules: core substantive rules and procedurally-based substantive rules, and core procedural rules and substantively-based procedural rules).

Second, instead of imposing a pure procedural rule which would maximize accuracy, consistency, and expediency within the judicial process, Congress in effect imposed substantive limitations in order to protect values other than judicial predictability and economy.[39] For example, one of Congress' primary concerns was the need to ensure a sufficient level of culpability and deterrence through a combination of substantive limitations and discretionary levels of punishment.[40] Cognizant of this and other values and concerns, Congress incorporated substantive protections within the ITSA and chose not to mechanically impose a mandatory treble damage sanction for every insider trading violation.

The most interesting aspect of the "substantive" terms within the ITSA is the effect they may have on substantive insider trading law outside the ITSA. Many of the provisions and terms within the ITSA are derived from and even refer to other areas of insider trading law.[41] It remains to be determined whether interpretation of these terms will be instructive only in the application of the ITSA's substantive provisions, or whether the substantive provisions within the ITSA, as endorsed by Congress, will eclipse many provisions of current substantive insider trading law.

B. *The ITSA's "Substantive" Terms in Relation to Insider Trading Law*

The "substantive" clarifications and limitations within the ITSA create a defined scope of insider trading liability distinct from insider trading liability under other federal securities law provisions. The ITSA amended section 21(d)(2) of the Exchange Act and distinguishes between the liability of those persons most directly culpable under section 21(d)(2)(A) and those excluded as a result of their vicarious relationship under section 21(d)(2)(B).[42] The following is an analysis of

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39. *See id.* at 205-06. The author theorized that defining fact categories and remedy ranges reflected by congressional value judgments are characteristic of the process of substantive lawmaking. *Id.* at 208. The ITSA does contain limitations on the scope of liability, and the treble damage sanction is discretionary; therefore, the ITSA as a sanction statute includes characteristics of substantive law.

40. *See* HOUSE REPORT, *supra* note 1, at 9. *Cf.* Eichler v. Berner, ____U.S. ____, ____, 105 S. Ct. 2622, 2030 n.23 (1985) (accepting Congress' view in the ITSA that derivative liability is not as culpable as the breach of duty which gave rise to the liability in the first place).

41. *See infra* notes 42-111 and accompanying text.

42. 15 U.S.C. § 78u(d)(2) (Supp. II 1984). *See also infra* notes 42-111 and accompanying text analyzing liability and exclusions under these two sections.

Sections 21(d)(2)(A) and (B) provide in full as follows:

(2)(A) Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material nonthe interrelationship and effect these two provisions have on other insider trading law.

> public information in a transaction (i) on or through the facilities of a national securities exchange or from or through a broker or dealer, and (ii) which is not part of a public offering by an issuer of securities other than standardized options, the Commission may bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, a civil penalty to be paid by such person, or any person aiding and abetting the violation of such person. The amount of such penalty shall be determined by the court in light of the facts and circumstances, but shall not exceed three times the profit gained or loss avoided as a result of such unlawful purchase or sale, and shall be payable into the Treasury of the United States. If a person upon whom such a penalty is imposed shall fail to pay such penalty within the time prescribed in the court's order, the Commission shall refer the matter to the Attorney General who shall recover such penalty by action in the appropriate United States district court. The actions authorized by this paragraph may be brought in addition to any other actions that the Commission or the Attorney General are entitled to bring. For purposes of section 27 of this title, actions under this paragraph shall be actions to enforce a liability or a duty created by this title. The Commission, by rule or regulation, may exempt from the provisions of this paragraph any class of persons or transactions.
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> (B) No person shall be subject to a sanction under subparagraph (A) of this paragraph solely because that person aided and abetted a transaction covered by such subparagraph in a manner other than by communicating material nonpublic information. Section 20(a) of this title shall not apply to an action brought under this paragraph. No person shall be liable under this paragraph solely by reason of employing another person who is liable under this paragraph.

The ITSA also adds sections 21(d)(2)(C) and (D) to the Exchange Act, 15 U.S.C. § 78u(D)(2) (Supp. II 1984). Section 21(d)(2)(C) provides:

> For purposes of this paragraph 'profit gained' or 'loss avoided' is the difference between the purchase or sale price of the security and the value of that security as measured by the trading price of the security a reasonable period after public dissemination of the nonpublic information.

For elaboration on the ambiguities this language may create, see A. JACOBS, *supra* note 17, at 422-27; Langevoort, *supra* note 2, at 1280. Section 21(d)(2)(D) provides:

> No action may be brought under this paragraph more than five years after the date of the purchase or sale. This paragraph shall not be construed to bar or limit in any manner any action by the Commission or the Attorney General under any other provision of this title, nor shall it bar or limit in any manner any action to recover penalties, or to seek any other order regarding penalties, imposed in an action comenced within five years of such transaction.

The ITSA also amends several other provisions of the Exchange Act. Most notably, under section 32(a) the criminal fine is increased from $10,000.00 to $100,000.00. 15 U.S.C. § 78ff (1982 & Supp. II 1984). This increase was due to the fact that inflation had diminished the deterrent impact of the prior fine. HOUSE REPORT, *supra* note 1, at 8. Other enforcement related provisions that were amended include §§ 78c(a)(39), 78o(b)(4), 78o(c)(4), and 78t (1982 & Supp. II 1984).

1. Section 21(d)(2)(A)

According to the first part of section 21(d)(2)(A), "[w]henever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder. . . the Commission may bring an action in a United States district court" seeking the civil penalty.[43] First, this vests the SEC with the sole authority to bring an action seeking treble damages under the ITSA against a "person" who "violates" an insider trading proscription.[44] Interpretation of the term "person" may be derived from section 3(a)(9) of the Exchange Act's broad definition which includes "a natural person, company, government, or political subdivision, agency, or instrumentality of a government."[45] Since Congress rejected the suggestion that the word "violated" be modified by the word "willfully,"[46] the penalty may be invoked where a person has violated insider trading law under the usual scienter standard.[47] The violation must be of "any provision of this title or the rules or regulations thereunder"[48] which refers to insider trading provisions under the Exchange Act.[49]

For purposes of the ITSA, a violation of an insider trading provision must occur when "purchasing or selling a security while in possession of material nonpublic information."[50] The terms "purchasing," "selling," and "security" are not specially defined by the Act and should be construed according to similar terms under Rule 10b-5.[51] However, purchasing or selling "while in possession of" within section 2(d)(2)(A) is specifically distinguishable from trading "on the basis

43. Exchange Act, *supra* note 10, at § 21(d)(2)(A).

44. *See id. See also* A. JACOBS, *supra* note 17, at 409 (a private party has no standing to invoke the penalty for the government); *supra* note 29 and accompanying text (the ITSA's treble damage provision is not available under a private right of action).

45. 15 U.S.C. § 78(c)(a)(9) (1982). *See* A. JACOBS, *supra* note 17, at 409.

46. *See House Hearings*, *supra* note 13, at 196-203 (statement of Arnold S. Jacobs, Acting Chairman, Association of the Bar of the City of New York, introducing a letter from the New York Bar's Committee on Securities Regulation to Senator Alphonse D'Amato and Congressman Timothy E. Wirth (February 14, 1983)); A. JACOBS, *supra* note 17, at 409.

47. A. JACOBS, *supra* note 17, at 409. The "scienter" standard under Rule 10b-5 is defined as an intent to deceive, manipulate, or defraud. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

48. Exchange Act, *supra* note 10, at § 21(d)(2)(A).

49. A. JACOBS, *supra* note 17, at 410. *See also* Langevoort, *supra* note 2, at 1279 n.28 (noting that § 15(c) under the Exchange Act prohibiting certain broker-dealer fraud could be covered as well).

50. Exchange Act, *supra* note 10, at § 21(d)(2)(A).

51. A. JACOBS, *supra* note 17, at 410. For an elaboration on the derivation of the definition of a "security" as interpreted by the courts, see 5 A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5 § 38.03 (2d ed. 1985 rev.).

of" inside information, which implies an underlying motivational requirement.[52] At least for purposes of the ITSA's application, the mere possession of inside information when trading is controlling.[53] Also, "material nonpublic information" is another phrase derived from general insider trading law which is usually used when referring to inside information useful to the decision-making process of investors.[54]

The type of transaction encompassed in the terms above is limited in that the transaction must be one "(i) on or through the facilities of a national securities exchange or from or through a broker or dealer, and (ii) which is not part of a public offering by an issuer of securities other than standardized options."[55] Under the first limitation, insider trading in an over-the-counter security (unless through a broker-dealer) or a direct trade between a buyer and seller would be exempt.[56] Therefore, liability under Rule 10b-5 prohibiting insider trading through the mails or interstate commerce[57] is broader than the ITSA's more limited requirement that the transaction occur on an exchange or from or through a broker or dealer before the civil penalty can be imposed.[58] The second limitation exempts a public offering in which the issuer is selling securities.[59] But, even in this case,

52. Trading "on the basis of" inside information raises the question whether liability exists only when possession of the information itself was the reason for trading or whether an insider could claim as a defense that he would have traded anyway, with or without the information. Langevoort, *supra* note 2, at 1289-90; Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CALIF. L. REV. 1, 43-44 (1982).

This distinction was presented in hearings before the House, *House Hearings*, *supra* note 13, at 48-49, but the Act's language does not require trading to be "on the basis of" inside information. Exchange Act, *supra* note 10, at § 21(d)(2)(A). *See* A. JACOBS, *supra* note 17, at 410-11.

53. The language of the ITSA and its legislative history imply a legislative design to make mere possession controlling. Langevoort, *supra* note 2, at 1290. *But see* Brodsky, *supra* note 17, at 939 (the "while in possession of" language may change the causation standard, requiring the SEC to prove the trading was motivated by the inside information).

However, this "mere possession" test has been criticized in that if improperly interpreted, such test may be used in reviving the parity of information theory rejected by the Supreme Court, bringing in other securities statutes under the ITSA contrary to Congress' intent, undermining the Chinese Wall protection under the Act, chilling beneficial market activities, and changing the common-law definition of insider trading. Note, *supra* note 2, at 493-97.

54. A. JACOBS, *supra* note 17, at 412-13. *See also* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (defining "materiality").

55. Exchange Act, *supra* note 10, at § 21(d)(2)(A).

56. A. JACOBS, *supra* note 17, at 411-13.

57. 17 C.F.R. § 240.10b-5 (1985). *See supra* note 14.

58. A. JACOBS, *supra* note 17, at 413.

59. *See id.*

where standardized options[60] are offered, the transaction is still subject to the civil penalty.[61] The inference to be drawn from these two limitations is that the ITSA's deterrent objective is tailored toward protecting the integrity of more impersonal markets.[62]

Section 21(d)(2)(A) continues by providing that "the Commission may bring an action in the United States district court to seek, and the court shall have the jurisdiction to impose, a civil penalty."[63] This provision should enhance the effectiveness of the SEC's settlement procedures since it allows a court to impose a penalty when a defendant consents without first finding a violation of insider trading law.[64] Otherwise, absent a defendant's consent or settlement agreement, a court must find the prerequisite violation of an insider trading provision under the Exchange Act before application of the ITSA's provisions can be considered.[65]

Under the ITSA, a "person, or any person aiding and abetting the violation of such person" shall be subject to the civil penalty.[66] This language essentially encompasses two classifications of substantive liability which are subject to the ITSA's civil penalty. First, the ITSA's treble damage sanction applies where violations are found to be "direct."[67] Under the ITSA, persons (or persons on behalf of an entity) in a position to direct a transaction and receive the benefits from the trade shall be classified as "direct violators."[68] The usual insider trading case involves an individual insider who, by trading on inside information for his personal account, becomes a direct violator.[69] However, under the ITSA, direct violators may also include

60. An option, the right to buy or sell at a certain price, can come in many forms, but those which are regularly traded on a national securities exchange are "standardized options." For an analysis of the various terms and forms associated with options, see 5 A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5 § 38.03[p] (2d ed. 1985 rev.).

61. A. JACOBS, *supra* note 17, at 414.

62. Langevoort, *supra* note 2, at 1279; Note, *supra* note 2, at 478-79.

63. Exchange Act, *supra* note 10, at § 21(d)(2)(A).

64. *See* A. JACOBS, *supra* note 17, at 414. *E.g.*, SEC v. Gaffney, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,002 (S.D.N.Y. April 18, 1985) (without admitting or denying allegations in the complaint, the defendants consented to an injunction, equitable relief, and civil penalties under the ITSA).

65. *See* A. JACOBS, *supra* note 17, at 414.

66. Exchange Act, *supra* note 10, at § 21(d)(2)(A).

67. *See* HOUSE REPORT, *supra* note 1, at 10-11.

68. *Id.* at 10.

69. A typical example of a primary or direct violation of insider trading is where an individual is an insider—an officer, director, or employee of an issuer—and breaches a fiduciary duty by trading on material nonpublic information. *Cf.* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976

employers, control persons, or a corporate entity when they direct and receive the benefits from the trade while in possession of material nonpublic information.[70] Individuals or entities classified as direct violators are primarily liable under the ITSA and subject to its treble damage sanction and other traditional SEC enforcement remedies.[71]

The second category satisfying the substantive requirements of the ITSA includes "tippers"—those who unlawfully tip inside information to others who actually trade.[72] "Tippee" liability was given little consideration in the ITSA's legislative history, but a tippee may be liable under Rule 10b-5 if he "misappropriate[s] or illegally obtain[s]

(1969) (not only are directors or management officers of a corporation "insiders" but anyone in possession of material inside information is an "insider" and must either disclose it to the investing public or abstain from trading or recommending the securities concerned while such inside information remains undisclosed).

70. HOUSE REPORT, *supra* note 1, at 10-11. The Committee, in clarifying entity liability, stated the following:

> [W]hen a corporate entity itself is in reality the trader, it would not escape liability under the bill. Thus, if the board of directors of a corporation, while having material nonpublic information, directed an employee to trade for the corporation's account, the corporation itself would be liable for the penalty. In that situation, the corporation would not be an aider or abettor, but would, in fact, be a direct violator who traded on the inside information.

Id. The report also hypothesizes a scenario where senior management of a multi-service brokerage firm trades for the firm account based on inside information from its investment banking department. *Id.* at 11. In such a situation, the firm would be liable for the treble damage sanction as a direct violator. *Id.* The firm, in essence, directed the transaction and received the benefit from the trade. In comparison, where only an advisor, while in possession of material nonpublic information, directs trades on behalf of an investment company, the advisor would be a direct violator and not the investment company shareholders. *Id.*

The committee report further limits treble damage liability in a multi-service brokerage firm where one employee possesses nonpublic information but another employee, not knowing of the information, trades for the firm's account. *Id.* Under this "Chinese wall" approach, the firm would not be liable for trades effected on one side of the wall, notwithstanding the possession of inside information by firm employees on the other side. *Id.* at 11, 28 n.52.

These provisions must further be reconciled with Exchange Act Release No. 19244, FED. SEC. L. REP. (CCH) ¶ 83,276, at 85,477 (Nov. 17, 1982) which adopts Rule 10b-18 providing a safe harbor from liability for manipulation under Sections 9(a)(2) and 10(b) of the Exchange Act and Rule 10b-5 thereunder in connection with purchases by a user and certain related persons of the issuer's common stock. However, this safe harbor under Rule 10b-18 "confers no immunity from possible Rule 10b-5 liability where the issuer engages in repurchases while in possession of favorable, material non-public information concerning its securities." *Id.* at 85,478 n.5.

71. HOUSE REPORT, *supra* note 1, at 9-11.

72. *Id.* at 9.

the information."[73] Under the specific "aiding and abetting" language of the Act,[74] those who unlawfully tip information leading to a purchase or sale would be subject to the treble damage sanction.[75] Tippers aid and abet a transaction when a tippee trades on the tipped inside information.[76] The penalty is imposed on those tippers as aiders and abettors even though they themselves do not in fact trade.[77] As a substantive classification, tipper misconduct is also considered just as culpable as other direct violations subject to the Act since without their inside tip, tippee trading on inside information would not occur.[78] The effect of this aiding and abetting language is an express Congressional endorsement of this type of liability which has yet to be endorsed by the Supreme Court.[79] This Congressional endorsement—that judicial application of aiding and abetting liability will help achieve the remedial purposes of securities laws[80]—implies this language may be applicable to other areas of securities laws.[81]

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73. Eichler v. Berner, ____ U.S. ____, ____, 105 S. Ct. 2622, 2630 n.22 (1985); Dirks v. SEC, 463 U.S. 646, 665 (1983); HOUSE REPORT, *supra* note 1, at 14-15.

74. Exchange Act, *supra* note 10, at § 21(d)(2)(A). Before aiding and abetting liability under section 21(d)(2)(A) of the Exchange Act can be imposed, it should be reconciled with the aiding and abetting exclusions under section 21(d)(2)(B). *See infra* notes 97-101 and accompanying text.

75. *See* HOUSE REPORT, supra note 1, at 28. The Committee report also gives an example of aiding and abetting liability. Broker-dealers and their registered representatives who only execute trades for customers who are trading unlawfully are not subject to the ITSA. *See id.* at 10. However, where a registered representative or broker received inside information, then tipped a customer who traded, he would be directly liable for the treble damage sanction (and other available remedies) as an aider and abettor. *Id.* at 9.

76. *Id.* at 28.

77. *Id.* at 9.

78. *Id. See* Eichler v. Berner, ____ U.S. ____, ____, 105 S. Ct. 2622, 2630 n.23 (1985).

79. HOUSE REPORT, *supra* note 1, at 10: "The Committee endorses the judicial application of the concept of aiding and abetting liability to achieve the remedial purposes of the securities laws." citing at n.17: SEC v. Coven, 581 F.2d 1020, 1028 (2d Cir. 1978), *cert. denied,* 440 U.S. 950 (1979); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir.), *cert. denied,* 439 U.S. 1039 (1978). *See* Brodsky, *supra* note 17, at 939-40. *See also* Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934,* 69 CAL. L. REV. 80, 87 (1981) (noting that the Supreme Court has never faced whether section 10(b) and Rule 10b-5 would support theories of secondary liability).

80. HOUSE REPORT, *supra* note 1, at 10.

81. *See* A. JACOBS, supra note 17, at 414-15; Langevoort, *supra* note 2, at 1286. The concept of aiding and abetting liability under the ITSA and Rule 10b-5 are very similar. *See also* 5 A. JACOBS, LITIGATION & PRACTICE UNDER RULE 10b-5 § 40.02 (2d ed. 1985 rev.) (discussing aiding and abetting liability and its relation to Rule 10b-5). *But see* Fischel, *supra* note 78, at 97-98 (arguing that since Congress made special provision for secondary liability in other securities statutes but not in section 10(b), a statutory construction rationale often invoked by the Supreme Court, to impose second-

When the direct liability rises to the level of the ITSA's substantive requirements in order to invoke the penalty provision, "[t]he amount of such penalty shall be determined by the court in light of the facts and circumstances, but shall not exceed three times the profit gained or loss avoided as a result of such unlawful purchases or sale. . . ."[82] Very few guidelines were provided in the Act's legislative history as to what facts and circumstances may be considered,[83] and no provision is provided within the Act itself for clarification. However, to guide courts in this determination, factors considered in other SEC enforcement actions,[84] the other remedies to which a defendant may be subject,[85] and the level of culpability[86] may provide a general framework. Other factors may include the defendant's financial resources and level of sophistication.[87] Calculation of the "profit gained or loss avoided" is measured under section 21(d)(2)(C).[88]

As to who is subject to the penalty calculation, some dispute may exist as to whether the treble damage penalty is the maximum to be imposed on a single transaction even though involving multiple offenders or whether each offender is separately subject to the treble damage penalty.[89] A literal construction of the language implies

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ary liability under section 10(b) would disrupt the legislative scheme). If secondary liability, e.g. aiding and abetting, was not a viable theory under section 10(b) prior to the ITSA, congressional recognition of this form of liability under the ITSA may be an instance where it will impact substantive law outside the Act, i.e. section 10(b).

82. Exchange Act, *supra* note 10, at § 21(d)(2)(A).

83. The committee report only indicates the level of a defendant's awareness and the amount of proof demonstrated by the SEC as factors. HOUSE REPORT, *supra* note 1, at 9.

84. For example, in considering whether to impose an injunction on an SEC enforcement action, courts have considered the past conduct of the defendant, the nature of the violation, whether or not and under what circumstances the defendant ceases his insider trading, whether the defendant disclaimed an intent to violate the insider trading provisions in the future, the defendant's opportunity to commit future breaches, whether the defendant admitted guilt, whether the defendant reimbursed the victims, and equitable and policy considerations. A. JACOBS, *supra* note 17, at 415. *See also* A. JACOBS, *supra* note 17, at § 261.02.

85. Other liability remedies may include: recovery in a private right of action under the federal securities law, common law, state blue sky laws; civil or criminal RICO; disgorgement of profits in an SEC enforcement action; recovery by or on behalf of the issuer under Section 16(b) of the Exchange Act if the offending purchase and sale by an insider can be matched against another sale or purchase within a six-month period; administrative sanctions imposed by the SEC; and any jail sentence or fine meted out as a criminal penalty. A. JACOBS, *supra* note 17, at 415-16.

86. HOUSE REPORT, *supra* note 1, at 9; Langevoort, *supra* note 2, at 1278. Other circumstances may include whether the defendant consented to the civil penalty, and if he did, to what amount did he and the SEC agree as to the size of the penalty. Regarding aiders and abettors, consideration may be given as to whether or not they received any benefit from the insider trading and how close they were to the heart of the violation. A. JACOBS, *supra* note 17, at 416.

one penalty: "*a* civil penalty to be paid by such person or any person aiding and abetting the violation" and "*the* amount of such penalty . . . . shall not exceed three times the profit gained or loss avoided . . . . "[90] However, the legislative history and the underlying deterrent objective suggest each violator in an insider trading transaction should be subject to treble damages.[91]

The rest of this section does not contain any controversial or ambiguous wording. The penalty "shall be payable into the Treasury of the United States," and if it is not paid within the time provided by the court, the SEC "shall refer the matter to the Attorney General who shall recover such penalty in the appropriate United States district court."[92] The SEC or the Attorney General is not preempted from bringing any other action or actions by reason of this Act.[93] An action under this section is independent from any other remedy, and it may be either the sole remedy or enforced cumulatively.[94] Section 27 of the Exchange Act pertaining to jurisdiction and service also controls under this portion of the Act.[95] Finally, if the SEC so desires, it may "by rule or regulation . . . . exempt from the provisions of this [particular section] any class of persons or transactions."[96]

2. Section 21(d)(2)(B)

This section is another limitation within the ITSA which exempts three classes of potential defendants from liability under the Act. First, "[n]o person shall be subject to a sanction under [section 21(d)(2)(A)] solely because that person aided and abetted a transaction covered by such subparagraph in a manner other than by communicating

87. Langevoort, *supra* note 2, at 1278.

88. Exchange Act, *supra* note 10, at § 21(d)(2)(C). *See supra* note 42.

89. *See* A. JACOBS, *supra* note 17, at 416-17.

90. Exchange Act, *supra* note 10, at § 21(d)(2)(A).

91. "[P]ayment of a civil penalty by any person does not extinguish the liability of any other person .... The Commission may, in its discretion, seek a penalty from any or all persons covered by this provision." 130 CONG. REC. H7758 (daily ed. July 25, 1984) (statement by Rep. Dingell), *cited in* Langevoort, *supra* note 2, at 1278. *See also* A. JACOBS, *supra* note 17, at n.53 & text (noting ambiguity between the Act's language and other parts of the legislative history).

92. Exchange Act, *supra* note 10, at § 21(d)(2)(A).

93. The Act provides: "The actions authorized by this paragraph may be brought in addition to any other actions that the Commission or the Attorney General are entitled to bring." *Id.*

94. HOUSE REPORT, *supra* note 1, at 20-21. *See* A. JACOBS, *supra* note 17, at 418.

95. 15 U.S.C. § 78aa (1982); 15 U.S.C. § 78u (Supp. II 1984); A. JACOBS, *supra* note 17, at 418.

96. Exchange Act, *supra* note 10, at § 21(d)(2)(A).

material nonpublic information."[97] In contrast to the aiding and abetting liability under section 21(d)(2)(A), as long as a person does not communicate material nonpublic information, that person cannot be subject to the civil penalty solely as an aider and abettor.[98] For example, "tippers" could violate the Act under section 21(d)(2)(A) by aiding and abetting when a tippee trades, but the broker who only executes the trade and does not "tip" the information may be exempt under section 21(d)(2)(B) even though he knowingly aided and abetted the transaction.[99] This section does not necessarily insulate a line or succession of intermediate tippers who aid and abet the transaction when they communicate material nonpublic information and others trade on that information.[100] However, it may still be unclear the extent to which an aider and abettor may exempt himself or even his firm from liability based upon further use of the information gained through executing a transaction, and the level of knowledge as to its inside character.[101]

Second, section 20(a) of the Exchange Act dealing with control persons does not apply to an action brought under the ITSA.[102] In other words, when someone is liable and subject to the civil penalty, the control person responsible for the actions of the violator is not liable under the Act merely because of his control person status.[103] However, as this provision envisions the interrelationships between a firm and its employees, it brings into question whether senior management may incur liability for the inadequate supervision of its employees.[104]

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97. *Id.* at § 21(d)(2)(B).

98. A. JACOBS, *supra* note 17, at 418-19.

99. *See* Brodsky, *supra* note 17, at 939-40. *But cf.* HOUSE REPORT, *supra* note 1, at 28. An example in the Committee report implies an exception to the general rule that the ITSA only applies to those who trade or tip others who trade. Where a registered representative knew or should have known that a customer was trading on inside information, he may be liable as an aider and abettor for up to three times the customer's profits regardless of whether he tipped or traded. *Id.*

100. *See* A. JACOBS, *supra* note 17, at 419.

101. *See* Brodsky, *supra* note 17, at 940.

102. The Act provides: "Section 20(a) of this title shall not apply to an action brought under this paragraph." Exchange Act, *supra* note 10, at § 21(d)(2)(B). *See* HOUSE REPORT, *supra* note 1, at 9-10.

103. A. JACOBS, *supra* note 17, at 419.

104. *See* Brodsky, *supra* note 17, at 940. The committee report notes that "[a] broker-dealer or person associated with a broker-dealer who fails reasonably to supervise another person committing a violation may also be subject to the broad range of Commission administrative remedies." HOUSE REPORT, *supra* note 1, at 10. *But cf.* Langevoort, *supra* note 2, at 1282 n.44 (the ITSA exempts controlling persons whose only role in the impropriety was a failure to supervise).

Third, no person shall be liable for the civil penalty "solely by reason of employing another person who is liable under this paragraph."[105] This provision is primarily concerned with exempting an employer-entity from respondeat superior liability if its employee or agent violates the law.[106] However, the ITSA does not specifically address the extent to which the knowledge of an employee or agent is imputed to the entity which may, in turn, subject the entity to direct liability.[107] The legislative history expresses an intent to except from liability the situation in a multi-service brokerage firm where one employee may possess material nonpublic information but another employee, not knowing of the information, trades for the firm's account.[108] Under this "Chinese Wall" approach, the firm would not be liable for trades effected on one side of the wall, notwithstanding the possession of inside information by firm employees on the other side.[109]

The significant effect of the provisions within section 21(d)(2)(B) is express congressional recognition that aiding and abetting, control person, and respondeat superior liability have applicability in federal securities law.[110] Indeed, while each provision under section 21(d)(2)(B) is an exemption from the ITSA's civil penalty, Congress intended that the aiding and abetting, control person, and respondeat superior theories of liability continue to be subject to other SEC enforcement actions.[111]

With the distinct culpability requirements, limitations, and exemptions of the ITSA, the ultimate scope of liability subject to the

105. Exchange Act, *supra* note 10, at § 21(d)(2)(B).

106. *See* HOUSE REPORT, supra note 1, at 9-10. *See also* Langevoort, *supra* note 2, at 1282-83 (provision designed to assure that the SEC does not use common law doctrine of respondeat superior to circumvent exemption under section 20(a) of Exchange Act).

107. *See* A. JACOBS, *supra* note 17, at 419-22.

108. HOUSE REPORT, *supra* note 1, at 11. *But see* Brodsky, *supra* note 17, at 940 (concern that the Act does not go far enough to exempt all section 20(a) and respondeat superior liability especially based on inadequate supervision).

109. HOUSE REPORT, *supra* note 1, at 11, 28 n.52.

110. *See* A. JACOBS, *supra* note 17, at 421-22. Langevoort, *supra* note 2, at 1283; Note, *supra* note 2, at 492-93.

111. HOUSE REPORT, *supra* note 1, at 10, 17, 27. *But cf.* Fischel, *supra* note 79, at 82 (concluding that the theory of secondary liability, unless expressly prohibited by statute, is no longer viable in light of recent Supreme Court decisions strictly interpreting the federal securities laws). The explicit statutory recognition of the respondeat superior theory of secondary liability, in addition to section 20(a) of the Exchange Act, should resolve any doubts as to the viability of the common-law doctrine, but may raise new questions as to other employment related or other common-law derivative liability. Langevoort, *supra* note 2, at 1283.

Act's treble damage provision is left to the interpretive discretion of the courts. This discretion is dependent upon both the legislative intent underlying the ITSA and current trends in judicial interpretation of inside trading liability under Rule 10b-5. In addition, courts must now combine these factors and implement a sanction, up to a discretionary treble damage amount, to effectively deter insider trading.

II. DETERRENCE, TREBLE DAMAGES, AND THEIR RELATION TO SUBSTANTIVE LAW

As the foregoing sections indicate, there is a dual objective implicit within the ITSA. First, the primary objective of the ITSA's treble damage penalty is to deter insider trading. Deterrence is not only a function of the severity of the sanction,[112] it may also be a function of the substantive law itself.[113] Second, the ITSA is not intended in any way to change the substantive law of insider trading. However, as the preceding analysis indicates, many of the "substantive" provisions within the ITSA itself may effect interpretation of other securities laws independent of the ITSA. Furthermore, while contrary to legislative intent, courts in other areas of the law have restricted the scope of liability to avoid Draconian results when faced with imposing a severe sanction.[114] This conflict is particularly evident in the

112. *See infra* notes 118-25, 235-36 & 250-51 and accompanying text.

113. *See infra* notes 129-43 and accompanying text.

114. *See, e.g.*, Lennon v. Immigration and Naturalization Serv., 527 F.2d 187, 193 (2d Cir. 1975) (deportation is not a penal sanction "[b]ut in severity it surpasses all but the most Draconian criminal penalties . . . [and] harsh sanctions should not be imposed where moral culpability is lacking"); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 242 (2d Cir. 1974) (expressly noting the concern for possible Draconian liability, the court suggested that the trial court might find that the nature of the violations "may require limiting the extent of liability."); Coffee, *Corporate Crime and Punishment: A Non-Chicago View of the Economics of Criminal Sanctions*, 17 AM. CRIM. L. REV. 419, 422 (1980) (discussing an economic theory of criminal sanctions, the author notes the relationship between "traditional elements of economic analysis (such as uncertainty) and non-economic factors that are deeply embedded in the structure of our criminal justice system (such as the tendency toward nullification of extreme penalties)."); Lamber, *Private Causes of Action Under Federal Agency Nondiscrimination Statutes*, 10 CONN. L. REV. 859, 888 n.150 (1978) (noting that because of the "extreme and harsh" nature of a fund cut-off sanction, HEW had terminated funding for only three educational institutions in 14 years).

As a general rule, even when remedies explicitly created by Congress may lead to unusually harsh results, the judiciary is not at liberty to modify the remedies. *See, e.g.*, Touche Ross & Co. v. Redington, 442 U.S. 560, 578 (1979) ("The ultimate question is one of congressional intent, not one of whether this Court thinks that it can improve upon the statutory scheme that Congress enacted into law."). *But cf.* Guardians Ass'n v. Civil Serv. Com'n of N.Y., 463 U.S. 582, 626-27 (1983) (Marshall, J., dissenting) effect a mandatory treble damage sanction has had on the underlying law in the area of antitrust.[115] While RICO suffers from a similar effect, court adherence to legislative intent indicating broad application of RICO's flexible provisions has reinforced viability of express private treble damage recovery for federal securities law violations, including insider trading.[116] Now, with the enactment of the ITSA's treble damage sanction at a time when the Supreme Court is already restricting the scope of insider trading liability under Rule 10b-5,[117] the threat is real that courts may be tempted to further restrict liability to avoid harsh results at the expense of added deterrence, which is contrary to legislative objectives.

A. *The Economics of Deterrence*

Modern economic theory has postulated how optimal levels of deterrence can be achieved through various forms and severity of punishment. Deterrence is a function of the expected punishment, which is a product of both the perceived probability and severity of punishment.[118] By increasing one factor, for example the severity of punishment, the overall level of deterrence should increase.[119] This increase in deterrence is not without limit. When the severity of punishment is increased to an extreme level, only marginal or diminishing levels of deterrence will result.[120] An increase in the severity of punishment combined with an increase in the perceived probability of punishment would yield higher levels of deterrence.[121]

Not only is deterrence limited by its optimal levels, it is also limited by the level of risk an insider is willing to assume.[122] The general theory is that the rational insider is normally a "risk averter" and will therefore be deterred by the threat of severe punishment

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(arguing that the statutory sanction of a fund cut-off is "too Draconian to be widely used.").

115. *See infra* notes 144-58 and accompanying text.

116. *See infra* notes 158-79 and accompanying text.

117. *See infra* notes 180-207 and accompanying text.

118. R. POSNER, ECONOMIC ANALYSIS OF LAW 463 (2d ed. 1977); Stigler, *The Optimum Enforcement of Laws,* in ESSAYS IN THE ECONOMICS OF CRIME AND PUNISHMENT 55-57 (1974); Dooley, *supra* note 2, at 25-26.

119. *See* Stigler, *supra* note 118, at 55-57; Dooley, *supra* note 2, at 25-26.

120. *See* R. POSNER, *supra* note 118, at 463; Stigler, *supra* note 118, at 55-57; Dooley, *supra* note 2, at 25-26. *Cf.* K. ELZINGA & W. BREIT, THE ANTITRUST PENALTIES: A STUDY IN LAW AND ECONOMICS 131 (1976) (objections to a fine oriented system only indicate that there is some ceiling above which fines should not go).

121. *See* R. POSNER, *supra* note 118, at 463; Stigler, *supra* note 118, at 55-57; Dooley, *supra* note 2, at 25-26.

122. *See* Coffee, *supra* note 114, at 428-33.

alone.[123] On the other hand, if the individual is a "risk taker" and thus more prone to take risks because of collusion within a group,[124] deterrence could better be achieved by increasing the probability of punishment.[125]

The perceived probability of punishment is a function of the resources devoted to detection and apprehension of those who violate the law.[126] However, the ITSA's treble damage sanction represents a compromise reached by Congress to increase deterrence at minimum government cost. Budgetary constraints have caused the SEC's enforcement resources to decline over the years.[127] Therefore, the most cost efficient way to achieve the greatest level of deterrence is to enact a severe penalty instead of more rigorous law enforcement.[128] Even though less cost efficient, the ITSA could yield higher levels of deterrence with an increase in resources devoted to enforcement.

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123. *See id.* at 433.

124. This phenomenon is commonly referred to as "risky shift." Coffee, *"No Soul to Damn: No Body to Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386, 390 (1981); Coffee, *supra* note 114, at 433.

125. K. ELZINGA & W. BREIT, *supra* note 120, at 118; Note, *supra* note 2, at 490-91.

126. *See* K. ELZINGA & W. BREIT, *supra* note 120, at 118; Ehrlich & Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257, 275-77 (1974); Note, *supra* note 2, at 490-91.

127. Even though the SEC has given priority to prosecuting insider trading, *see* Thomas, *supra* note 4, at 435; Note, *supra* note 2, at 466-67, it has done so with a concurrent decrease in the amount of resources allocated to enforcement. *See* HOUSE REPORT, *supra* note 1, at 6. "In recent years, the securities markets have grown dramatically in size and complexity, while the Commission enforcement resources have declined. The level of Commission resources allocated to enforcement has dropped 11% from 1979 levels." *Id.*

128. Coffee, *supra* note 114, at 421; Posner, *Optimal Sentences for White-Collar Criminals*, 17 AM. CRIM. L. REV. 409 (1980).

Even though the ITSA's treble damage award is not available for private plaintiffs, private enforcement can add deterrence without any additional cost to the government. *See, e.g.*, Landes & Posner, *The Private Enforcement of Law*, 4 J. LEGAL STUD. 1, 30-44 (1975) (economic analysis of the benefits derived from the division of responsibilities between public and private enforcers); Note, *The Role of Treble Damages*, *supra* note 1, at 1086 (noting the SEC's position that private enforcement adds supplemental deterrence to insider trading). *But cf.* 2 P. AREEDA & D. TURNER, ANTITRUST LAW § 331(b) (1978) (government enforcement is preferable to private enforcement because of "unfairness" to defendants, and discretionary trebling is proposed to remedy unfairness); Sullivan, *Breaking Up the Treble Play: Attacks on the Private Treble Damage Antitrust Action*, 14 SETON HALL L. REV. 17, 25-52 (1983) (public and private antitrust enforcement may be less "efficient" than a fine system enforced only by government); Breit & Elzinga, *Antitrust Enforcement and Economic Efficiency: The Uneasy Case for Treble Damages*, 17 J. LAW & ECON. 329, 347 (1974) (private enforcement spawns nuisance suits and in terrorem suits).

The perceived probability of punishment and the level of deterrence are also increased when a prohibition is made more specific.[129] Within the probability and severity deterrence formula, the probability of punishment is determined by the level of resources devoted to apprehension and conviction, and the burden of proof required to convict.[130] By specifying the prohibited conduct more exactly, a statute lightens the prosecutor's burden of proof and makes conviction easier.[131] Easing the ability to convict or punish raises the perceived probability of punishment and overall level of deterrence.[132]

Further deterrence can be achieved indirectly through other changes in the substantive law. Increasing the number of plaintiffs who may sue, for example, by loosening standing requirements or class action certification, may increase detection and possible punishment of those who violate the law.[133] While this may be applicable under the express private right of action to sue for treble damages under antitrust law[134] or RICO,[135] the ITSA vests only the SEC with standing to enforce the Act's trebling provision.[136]

Another way substantive change can add to deterrence is by broadening the scope of liability under a particular substantive provision, thereby increasing the number of defendants who may be sued.[137] For example, relaxing a knowledge requirement or extending a duty subjects more acts to liability and increases the perceived probability of being punished. While various forms of expanding the plaintiff class or the defendant class may often overlap, the effect is that substantive change can increase or decrease deterrence.

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129. *See* R. POSNER, *supra* note 118, at 424-25; Ehrilch & Posner, *supra* note 126, at 275.

130. *See* R. POSNER, *supra* note 118, at 424-25; Ehrilch & Posner, *supra* note 126, at 275-77.

131. *See* R. POSNER, *supra* note 118, at 424-25; Ehrilch & Posner, *supra* note 126, at 276.

132. *See* R. POSNER, *supra* note 118, at 424-25; Ehrilch & Posner, *supra* note 126, at 275-77.

133. *See generally,* K. ELIZINGA & W. BREIT, *supra* note 120, at 65 (noting several ways to indirectly increase antitrust damages: "easing the burden of proof of damages, enlarging the class of potential plaintiffs, lengthening the statute of limitations on such suits, facilitating the assembling of potential plaintiffs, and permitting consent decrees and pleas of *nolo contendere* to serve as prima facie evidence of guilt in private damage suits."); Breit & Elzinga, *supra* note 128, at 346 (same).

134. 15 U.S.C. § 15 (1982).

135. 18 U.S.C. § 1964(c) (1982).

136. *See supra* notes 29 & 44 and accompanying text.

137. *Cf.* Note, *The Role of Treble Damages*, *supra* note 1, at 1086 (noting the Supreme Court's trend in restricting fiduciary duties among defendants frustrates private enforcement and its deterrent potential).

The uncertainty and changes in the substantive law may, however, also chill legitimate investments, adversely effecting the efficiency of the national securities markets.[138] Some legitimate investment may be deterred to the extent investors are unsure of the scope of acceptable conduct, especially in light of the threat of a severe sanction.[139] Because the ITSA lacks a definition of insider trading, some concern was expressed in the House hearings that a case-by-case approach would be unsuitable for such a drastic penalty.[140] However, Congress expressed an intent that courts should avoid using the ITSA to inhibit valid research efforts necessary to market efficiency.[141] Consistency in interpreting insider trading prohibitions in order to maintain a status quo common law definition would add certainty to the perceived probability of punishment and overall level of deterrence while decreasing the chilling effects on legitimate investment and market efficiency.

Since Congress chose not to specifically define insider trading, but instead endorsed an amalgamation of court decisions,[142] the breadth of liability deterred by the ITSA will depend in part on current trends in judicial interpretation of insider trading under Rule 10b-5. As an analogy, judicial trends in the areas of antitrust law and RICO reveal the effect a mandatory treble damage sanction under private enforcement can have on the underlying substantive law.[143] These provisions differ from the ITSA which has a discretionary treble damage sanction available only under public enforcement of the SEC; nevertheless, these judicial trends are instructive.

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138. *See* Note, *supra* note 2, at 490 n.278.

139. *See id.*

140. *See, e.g., House Hearings, supra* note 13, at 106-07, 122-23, 149-51.

141. In clarifying Senate amendments to the ITSA the following explanation was given of the Senate's consideration of an insider trading definition:

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

130 CONG. REC. H7758 (daily ed. July 25, 1984) (statement of Rep. Dingell).

However, this langauge was criticized as tempting courts to create a safe harbor for financial or securities analysts in cases where protection should not be given. Langevoort, *supra* note 2, at 1293-94.

142. *See* HOUSE REPORT, *supra* note 1, at 13-15.

143. Analogy to antitrust law has been used to interpret the RICO treble damage clause. *See* Harper v. New Japan Sec. Int'l, Inc., 545 F. Supp. 1002, 1007 (C.D. Cal. 1982). *See infra* notes 144-79 and accompanying text.

B. *Treble Damages Under Antitrust and RICO*

Section 4 of the Clayton Act provides a mandatory treble damage award to private plaintiffs who are injured in their business or property by reason of an antitrust violation.[144] Conceived as a primary means of ensuring antitrust compliance, private enforcement initially was relatively inactive due mainly to widespread judicial hostility toward the remedy.[145] This inactivity shifted under the Warren Court, which broadened many of the substantive provisions,[146] ultimately leading to a sharp increase in private antitrust litigation.[147] However, concerned that the treble damage remedy will inflict unintended harms on defendants and society as a whole, current judicial interpretation of the antitrust provisions under the Burger Court has been more restrictive.[148]

Three major cases under the Burger Court have had substantial impact on restricting the availability of the treble damage award. First, the availability of large consumer class actions for alleging an antitrust violation was severely restricted in *Eisen v. Carlisle & Jacquelin*,[149] when the Court held federal rule 23 required individual notice be sent

144. 15 U.S.C. § 15 (1982). Section 4 of the Clayton Act provides that "[a]ny person who shall be injured in his business or property by reason of anything forbidden in the antitrust laws may sue . . . and shall recover threefold the damages by him sustained, and the cost of suit, including a reasonable attorney's fee." *Id.*

145. Sullivan, *supra* note 128, at 18-19. The judicial climate manifested itself by creating the in pari delicto defense, requiring a "public injury" as a part of a plaintiff's cause of action, and requiring a clear showing in proving the amount of damages. *Id.* at 19-20.

146. *Id.* at 20-21. The Warren Court also curtailed such prior doctrines as the in pari delicto defense and the "public injury" requirement. Sullivan, *supra* note 128, at 21. Further, the Warren Court rejected the pass-on defense which would have permitted a defendant to avoid liability on the theory that the plaintiff passed-on any harm to purchasers in the form of increased costs. *Id.* at 20, 21 n.21 (citing Hanover Shoe, Inc. v. United Shoe Mach. Corp., [392] U.S. 481 (1968)). However, the Burger Court denied the right of these "indirect purchasers" to bring a damage suit. Sullivan, *supra* note 128, at 21 n.21 (citing Illinois Brick Co. v. Illinois, 431 U.S. 720 (1977)).

147. Sullivan, *supra* note 128, at 20, 21. *See also* Posner, *A Statistical Study of Antitrust Enforcement*, 13 J.L. & ECON. 365, 371 (1970) (providing empirical data on the number of private antitrust cases over the years).

148. Sullivan, *supra* note 128, at 22-23. *See* Note, *A Farewell to Arms: The Implementation of a Policy-Based Standing Analysis in Antitrust Treble Damage Actions*, 72 CAL. L. REV. 437 (1984). *See also* L. SULLIVAN, HANDBOOK OF THE LAW OF ANTITRUST § 247, at 770-71 (1977) (judiciary has not been generous in construing section 4 of the Clayton Act and has developed devices to limit availability of the treble damage remedy and other equitable relief).

149. 417 U.S. 156 (1974).

to all class members who may be ascertained through reasonable effort, and that plaintiffs must bear the cost of sending this notice.[150] Second, in *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*,[151] the Court held that for plaintiffs to recover treble damages for an antitrust violation the injury complained of must be more than just "casually linked to an illegal presence in the market;" plaintiffs must prove "antitrust injury."[152] This antitrust injury test—an "injury of the type the antitrust laws were intended to prevent and that flows from that which makes defendant's acts unlawful"[153]—has been interpreted as a sort of standing doctrine imposing a broad limitation on the kinds of injury for which plaintiffs may recover treble damages under antitrust law.[154] Third, in *Illinois Brick Co. v. Illinois*,[155] the Court held that indirect purchasers could not recover treble damages on the theory that overcharges paid by a direct purchaser to an alleged antitrust violator were passed on to the indirect purchaser.[156] The underlying threat of this theory was the potential for "double liability trebled."[157] If only offensive use of the "pass on" theory were available, defendants would be at risk to multiple liability.[158]

While the treble damage provisions under antitrust law are in many ways similar to treble damages under RICO,[159] courts have not only refused to draw parallels between the substantive provisions for the two Acts,[160] but judicial treatment of the RICO provisions have

150. *Id. See* Sullivan, *supra* note 128, at 22.

151. 429 U.S. 477 (1977).

152. *Id.* at 489.

153. *Id.*

154. Sullivan, *supra* note 128, at 22 n.30; *See also* Note, *supra* note 148, at 468 (noting that the antitrust injury rule and the standing requirements allow judges to inject their own views on the substantive antitrust law and the class of person subject to the treble damage remedy).

155. 431 U.S. 720 (1977).

156. *Id.* at 736.

157. L. SULLIVAN, *supra* note 148, § 252, at 790.

158. 431 U.S. at 730.

159. *See* Long, *Treble Damages for Violations of the Federal Securities Laws: A Suggested Analysis and Application of the RICO Civil Cause of Action*, 85 DICK. L. REV. 201, 208-09 (1981); Note, *A Day of Reckoning is Near: RICO, Treble Damages and Securities Fraud*, 41 WASH. & LEE L. REV. 1089, 1109-12 (1984) [hereinafter cited as Note, *A Day of Reckoning is Near]*; Note, *Civil RICO: The Temptation and Impropriety of Judicial Restriction*, 95 HARV. L. REV. 1101, 1109-14 (1982) [hereinafter cited as Note, *Civil RICO*].

160. *E.g.*, Schacht v. Brown, 711 F.2d 1343, 1356-58 (7th Cir. 1983) (Congress enacted RICO to attack organized crime, not restrain competition), *cert. denied*, 464 U.S. 1002 (1983); Bennett v. Berg, 685 F.2d 1053, 1058-59 (8th Cir. 1982) (rejecting application of antitrust's restrictive standing, and noting Congress did not intend to limit RICO to the antitrust goal of preventing interference with free trade).

generally been less restrictive.[161] Defendants have continually attempted to limit recovery by alleging several defenses,[162] most notably a causation-standing requirement similar to one under antitrust law,[163] but most have failed under the courts' liberal construction of the RICO provisions which are based on a legislative history indicating broad and flexible application.[164] Even with the concern that certain construction may create "a runaway treble damage bonanza for the already excessively litigious,"[165] courts have generally deferred to congressional intent and construed the provisions broadly.

The RICO provisions create an express private right of action whereby a plaintiff injured in his business or property by a RICO violation may recover treble damages and attorneys' fees.[166] In general, a plaintiff must demonstrate that a person has invested in, controlled, or conducted an enterprise through a pattern of racketeering activity.[167] The statutory definition of a pattern of racketeering activity under RICO consists of at least two violations of enumerated federal or state crimes occurring within a ten-year period.[168] One of the crimes

161. *See* Note, *A Day of Reckoning Is Near*, *supra* note 159, at 1092; Note, *Civil RICO*, *supra* note 159, at 1102-03.

162. Courts have rejected such arguments by defendants that there be an affiliation with organized crime, Moss v. Morgan Stanley, Inc., 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984); Mauriber v. Shearson/American Express, 567 F. Supp. 1231 (S.D.N.Y. 1983); that ordinary securities fraud violations should not apply under RICO because adequate remedies exist under federal securities laws, Schacht v. Brown, 711 F.2d 1343 (7th Cir. 1983), *cert. denied*, 464 U.S. 1002 (1983); *but see* Noland v. Gurley, 566 F. Supp. 210 (D. Colo. 1983) (accepting the argument); that RICO is only applicable when it infiltrates legitimate but not illegitimate enterprises, United States v. Turkette, 452 U.S. 576 (1981); that proof of an enterprise must be distinct from a pattern of racketeering, *Moss*, 719 F.2d at 21-22; *but see* Bennett v. Berg, 685 F.2d 1053 (8th Cir. 1982) (requiring distinct, independent proof of each element); and that a private action can proceed only against a defendant who has already been convicted of a predicate act on RICO violations, Sedima, S.P.R.L. v. Imrex Co., ___ U.S. ___, 105 S. Ct. 3275 (1985).

163. *See supra* notes 151-54 and accompanying text; Note, *A Day of Reckoning Is Near*, *supra* note 159, at 1109-12; Note, *Civil RICO*, *supra* note 159, at 1109-14.

164. *See* Note, *A Day of Reckoning Is Near*, *supra* note 159, at 1092; Note, *Civil RICO*, *supra* note 159, at 1102-03. This liberal construction is not so surprising since Congress included an express "liberal construction clause" which provides: "The provisions of this title shall be liberally construed to effectuate its remedial purposes." Organized Crime Control Act of 1970, Pub. L. No. 91-452, § 904(a), 84 Stat. 947. *See* Bridges, *Private RICO Litigation Based Upon "Fraud in the Sale of Securities,"* 18 GA. L. REV. 43, 46 (1983), reprinted in 1984-1985 CORP. PRAC. COMM. 503; Note, *RICO and the Liberal Construction Clause*, 66 CORNELL L. REV. 167 (1980).

165. Schacht v. Brown, 711 F.2d 1343, 1361 (7th Cir.), *cert. denied*, 464 U.S. 1002 (1983).

166. 18 U.S.C. §§ 1961-1968 (1982).

167. 18 U.S.C. §§ 1961, 1962 (1982).

168. *Id.*

included within this definition of racketeering activity is fraud in the sale of securities.[169] A "person" subject to liability for securities fraud is defined to include not only an individual or informal group of individuals, but also a legal entity,[170] such as an investment firm or corporate defendant, even though such "person" has no apparent connection with organized crime.[171] With the liberal construction of RICO by the courts, the express private right of action allowing treble damages and attorneys' fees may potentially have far-reaching effects on individual or entity liability under the federal securities laws.

While no plaintiff has yet recovered treble damages for insider trading under RICO, three recent cases indicate that securities fraud actions are likely to continue under RICO. In *Moss v. Morgan Stanley, Inc.*,[172] the Second Circuit considered whether RICO is applicable to ordinary securities fraud under section 10(b) of the Exchange Act.[173] While the Second Circuit affirmed the dismissal of the RICO claim for failure to show the predicate violation of section 10(b), the court disagreed with the district court which ruled that RICO does not encompass private actions for violations of securities statutes by ordinary businesses.[174] Similarly, in *Schacht v. Brown*,[175] the Seventh Circuit rejected the argument that a broad reading of securities fraud under RICO would eclipse federal securities laws.[176] The court, in deferring to legislative intent, held that civil RICO is applicable in ordinary business fraud cases.[177] Most recently, the Supreme Court in *Sedima, S.P.R.L. v. Imrex Co., Inc.*[178] continued to construe the RICO provisions broadly, recognizing that the current statutory scheme permits recovery for the predicate offense of securities fraud.[179] These decisions imply that upon a proper showing of the necessary predicate securities law violation, courts will impose treble damages under RICO against an individual or entity defendant for trading on inside information. The important parallel to be drawn between RICO and the

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169. 18 U.S.C. § 1961(1)(D) (1982).

170. 18 U.S.C. § 1961(3) (1982).

171. Note, *A Day of Reckoning Is Near*, *supra* note 159, at 1092.

172. 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984).

173. *Id.* at 20-21.

174. *Id.* at 12, 20-21. *See* Moss v. Morgan Stanley, Inc., 553 F. Supp. 1347 (S.D. N.Y. 1983).

175. 711 F.2d 1343 (7th Cir.), *cert. denied*, 464 U.S. 1002 (1983).

176. *Id.* at 1353.

177. *Id.* at 1353-56.

178. ___ U.S. ___, 105 S. Ct. 3275 (1985).

179. *Id.* at ___, 105 S. Ct. at 3287. *See also Task Force Report*, *supra* note 2, at 224, 247 (recognizing the effect of this case for recovery of treble damages under RICO).

ITSA is that both treble damage provisions are dependent upon judicial interpretation of the securities fraud provisions.

C. *The Supreme Court's Restrictive Approach to Federal Securities Law Violations*

Recent Supreme Court decisions have conservatively interpreted the broad anti-fraud provisions of Rule 10b-5, thereby limiting the substantive scope of liability.[180] The Court has used substantive requirements of standing,[181] intent,[182] and fiduciary relationship[183] as means to narrowly construe Rule 10b-5 liability. The policy reasons for strict construction emphasized by the Court include limiting the growth of private actions,[184] preventing vexatious litigation,[185] and maintaining principles of federalism.[186]

The Supreme Court's conservative approach to Rule 10b-5 is exemplified by three cases in which the Court imposed substantive restrictions for practical policy reasons. In *Blue Chip Stamps v. Manor Drug Stores*,[187] the Supreme Court imposed a "purchaser-seller" standing requirement for private damage suits brought under Rule 10b-5.[188] Concerned that vexatious litigation might result from allowing implied private causes of action, the Court limited the scope of liability by restricting potential plaintiffs to "those who have at least dealt in the security."[189] In another action for civil damages, the Supreme Court in *Ernst & Ernst v. Hochfelder*[190] held that conduct cannot amount to fraud under Rule 10b-5 without "scienter."[191] The effect of this decision precludes liability in private actions which are based on claims of mere negligence.[192] In a third example, the Supreme Court in *Santa*

180. *See* Note, *United States v. Newman: Misappropriation of Market Information by Outsiders*, 3 PACE L. REV. 311, 322-25 (1983); Branson, *Discourse on the Supreme Court Approach to SEC Rule 10b-5 and Insider Trading*, 30 EMORY L. REV. 263, 266-71 (1981).

181. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

182. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

183. *See* Dirks v. SEC, 463 U.S. 646 (1983); Chiarella v. United States, 445 U.S. 222 (1980); Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977).

184. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

185. *Id.* at 740; Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 478-79 (1977).

186. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479 (1977) (citing Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971)).

187. 421 U.S. 723 (1975).

188. *Id.* at 736-37.

189. *Id.* at 747.

190. 425 U.S. 185 (1976).

191. *Id.* at 193. "Scienter" was defined as "a mental state embracing intent to deceive, manipulate or defraud." *Id.* at 193-94 n.12.

192. The question still remains as to whether civil liability can be based on reckless behavior. *See* Branson, *supra* note 180, at 268.

Fe Industries, Inc. v. Green[193] held that the mere breach of fiduciary duty does not necessarily amount to a violation of Rule 10b-5.[194] The Court in *Santa Fe* also relied on federalism principles to support its ruling.[195] As a result, the Court deferred the substantive decision to the state courts by stating that the existence of a state law remedy "while not dispositive" should be considered by lower courts before entertaining a Rule 10b-5 cause of action.[196] These cases illustrate how the Supreme Court, by imposing substantive restrictions on plaintiffs, has limited the scope of potential liability under Rule 10b-5.

This restrictive trend by the Supreme Court is also evident in the substantive law of insider trading as developed in two prominent cases interpreting Rule 10b-5. In *Chiarella v. United States*,[197] the defendant, an employee of a financial printer, traded on undisclosed information of a prospective takeover bid that he deduced from publication information received by his employer.[198] The Supreme Court reversed his conviction for willfully violating section 10(b) and Rule 10b-5.[199] Relying on notions of common law fiduciary principles, the Court held that Rule 10b-5 does not create a duty to disclose information prior to trading without some pre-existing fiduciary duty or other relationship of trust or confidence between a specific purchaser and seller of the securities.[200] Since the defendant in *Chiarella* did not have a fiduciary duty to the plaintiff seller of securities, he had no duty to disclose prior to trading on the inside information.[201] The mere possession of undisclosed material information was not in itself a violation of Rule 10b-5.[202]

The Supreme Court again limited the extent of fiduciary obligations under Rule 10b-5 in *Dirks v. Securities and Exchange Commis-*

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193. 430 U.S. 462 (1977).

194. *Id.* at 473-74.

195. *Id.* at 478. For an analysis of the federalism issue as it relates to securities law, see Anderson, *The Meaning of Federalism: Interpreting The Securities Exchange Act of 1934*, 70 VA. L. REV. 813 (1984); Kitch, *A Federal Vision of the Securities Law*, 70 VA. L. REV. 857 (1984); Gorman, *At the Intersection of Supreme Avenue and Circuit Street: The Focus of Section 10(b) and Santa Fe's Footnote Fourteen*, 7 J. CORP. L. 199 (1982).

196. 430 U.S. at 478.

197. 445 U.S. 222 (1980).

198. *Id.* at 224.

199. *Id.* at 225.

200. *Id.* at 227-28.

201. *Id.* at 235.

202. *Id.* *Compare supra* notes 52-53 and accompanying text regarding the effect the "mere possession" language within the ITSA.

sion.[203] In *Dirks*, the defendant was disclosing information in an attempt to get the SEC and the *Wall Street Journal* to investigate what he believed to be a fraud.[204] Dirks received this material nonpublic information from insiders, and disclosed the information to investors who traded in the shares of the expanding corporation.[205] The Court in *Dirks* held that a tippee of inside information acquires no fiduciary duty to a corporation's shareholders to abstain from trading, absent a breach of fiduciary obligation by the insider who tipped the information to him.[206] The Court found that the tippers received no monetary or personal benefit in revealing the information and therefore did not breach any duty to the shareholders of their corporation.[207] Requiring a derivative breach by the tipper-insider before imposing liability on the tippee, the Supreme Court placed a further substantive limitation on Rule 10b-5 liability.

This substantive limitation in *Dirks* was characterized by Justice Blackmun in his dissent as engrafting a subjective limitation on the scope of an insider's duty to shareholders because, as the majority held, an insider is not guilty of breaching his duty if he does not have the improper purpose of personal gain when relaying inside information.[208] Justice Blackmun found this improper purpose requirement unacceptable as resting implicitly on considerations of economic policy.[209] According to Justice Blackmun, the majority justified their decision because the general benefit derived from the violation of the insider's duty to his shareholders outweighed the harm caused to those shareholders.[210] The import of this economic analysis is that the benefit conferred on society may be paid for by the losses caused to the trading shareholders; in other words, the end justifies the means.[211] This analysis suggests the Court may accede the merits of economic theory as it applies to substantive insider trading law.

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203. 463 U.S. 646 (1983).

204. *Id.* at 648-52.

205. *Id.*

206. *Id.* at 661-64.

207. *Id.* at 665-67.

208. *Id.* at 668 (Blackmun, J., dissenting) (Justices Brennan and Marshall joined in the dissent).

209. *Id.* at 676 (Blackmun, J., dissenting).

210. *Id.* at 676-77 (Blackmun J., dissenting) (citing Heller, *Chiarella, SEC Rule 14e-3, and Dirks: "Fairness" Versus Economic Theory*, 37 BUS. LAW 517, 550 (1982); Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 338).

211. *Dirks*, 463 U.S. at 676-77 (Blackmun, J., dissenting). Justice Blackmun notes the majority also seems persuaded by the theory that insider trading brings relevant information to the market (citing H. MANNE, INSIDER TRADING AND THE STOCK MARKET

These economic considerations are important because they will ultimately determine the role of the ITSA in the area of insider trading law and deterrence theory. Under Justice Blackmun's characterization, the majority limited the substantive scope of 10b-5 liability not on account of any threat of a treble damage sanction, but on mere notions of social benefit outweighing private harm. Now, with the ITSA and recent developments under RICO, the threat of Draconian liability is a reality because a "person" could theoretically pay sevenfold his gain for trading on inside information—mandatory treble damages based on an express private right of action under RICO, disgorgement of profits, and a maximum penalty imposed under the ITSA's discretionary trebling.[212] In order to avoid the potential of a grossly disproportionate penalty, similar to the result in the area of antitrust law, the Court could, for example, further limit the reach of fiduciary obligation under Rule 10b-5 in the wake of *Chiarella* and *Dirks*, or narrowly construe the ITSA to prevent "direct" liability under its "substantive" provisions. As an alternative, and without altering the underlying substantive law, harsh results may be alleviated by imposing far less than the treble damage maximum. However, courts must be aware that under both alternatives, Congressional objectives of increasing deterrence under the ITSA without affecting the substantive law of insider trading may be undermined.

III. DISCRETIONARY TREBLING AND ITS RAMIFICATIONS

Justice Blackmun's characterization of the majority's approach in *Dirks* also gains importance under the ITSA because similar economic policy justifications can be used to achieve optimal levels of deterrence when imposing up to a treble damage amount based on the facts and circumstances of each case. Indeed, deterrence theory within an economic framework was even presented in the ITSA's House hearings.[213] As noted above, deterrence is not only a function of the perceived probability of punishment, it is also a function of the severity of the sanction.[214] Through the ITSA, Congress armed

59-76, 111-146 (1966); Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 565-76 (1970), and a variant of this theory which postulates that insider trading causes no harm at all to those who purchase from the insider). *Dirks*, 463 U.S. at 677 n.14.

212. *See, e.g.*, Langevoort, *supra* note 2, at 1281 (with disgorgement of profits and treble profits as a penalty under the ITSA, RICO amounts to a "quadruple profits sanction"); Note, *supra* note 2, at 471 (disgorgement and treble damages imposes civil liability up to four times the profit gained).

213. *House Hearings*, supra note 13, at 236, 268-77 (statement of Ted J. Fiflis, Professor of Law, University of Colorado Law School).

214. *See supra* notes 118-21 and accompanying text.

the SEC with a treble damage penalty, rather than an increased enforcement budget, as the primary means to deter insider trading.

A. *Economic Considerations*

If the ITSA's treble damage penalty is to prove effective, the purpose or purposes of the penalty must first be identified before an appropriate penalty amount can be determined and imposed.[215] A treble damage penalty normally provides two functions: a compensation function to victims or society and a deterrence function against violators of the law.[216] However, the ITSA contains no direct compensation function to victims or society,[217] since the treble damage penalty is sought by the SEC as public enforcer, and any penalty imposed under the Act is paid to the United States Treasury. While this form of payment may provide indirect compensation to the government for funding the SEC,[218] there is no indication of an express, or direct compensation function such as a provision that the penalty imposed shall go to a special fund or even SEC enforcement.[219] On the other hand, the ITSA's legislative history is replete with evidence indicating a deterrent purpose.[220] Further, frequent reference to consideration of "culpability" within the legislative history[221] connotes a deterrent objective.[222] Therefore, the ITSA's treble damage provision envisions one primary or overriding purpose—deterrence.

From the viewpoint of economic theory, deterrence is often measured in terms of cost, and is used to minimize the costs to society

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215. *See* Diver, *The Assessment and Mitigation of Civil Money Penalties by Federal Administrative Agencies*, 79 COLUM. L. REV. 1435, 1455, 1461 (1979).

216. R. POSNER, ANTITRUST LAW, AN ECONOMIC PERSPECTIVE 221 (1976); Diver, *supra* note 215, at 1455-56; Note, *The Role of Treble Damages*, *supra* note 1, at 1082.

217. *See* Note, *The Role of Treble Damages*, *supra* note 1, at 1082-83.

218. *See, e.g.*, Helvering v. Mitchell, 303 U.S. 391, 401 (1938) (compensation to the government for its enforcement expenses is a legitimate objective of money penalties); Diver, *supra* note 215, at 1456 (money penalties serve a "general" compensatory function by compensating "society" at large for a harm incurred from a violation or alternatively the penalties compensate the government for the enforcement costs incurred).

219. *Cf.* Diver, *supra* note 215, at 1462 ("[A] provision that sums collected will go into a special fund to be 'applied toward reimbursement of the costs of determining the violations and assessing and collecting such penalties,' may imply a compensatory purpose.").

220. *See* HOUSE REPORT, *supra* note 1; *House Hearings*, *supra* note 13; *Senate Hearings*, *supra* note 18.

221. *See supra* note 40 and accompanying text.

222. Diver, *supra* note 215, at 1462.

as a result of aberrant behavior.[223] When a person violates the law, he imposes costs on society equal to the loss created by the activity itself, the cost of enforcing the prohibition, and the cost of imposing and collecting the sanction including external costs.[224] Economic theory has postulated that a fine multiplier which sanctions the violator with a cost equal to the cost that his violation created for society would yield an optimal balance.[225] These theories have as a basis, without accounting for risk preference, an assumption that a potential violator will calculate the costs and benefits of an activity, and if the costs exceed the benefits, he will not violate the law.[226] If a sanction is set too low, the potential violator may not be deterred—he will not be motivated to minimize social harm—or society may be undercompensated for the harm that does occur.[227] If a sanction is set too high, the cost of imposing and collecting the penalty and related external costs will increase—increasing net social loss[228]—or behavior, illegal or not, that produces a net social benefit may be discouraged.[229]

It must be kept in mind that while these theories seek to balance the relative costs to achieve an optimal and efficient level of deterrence, implicit within the deterrent calculus is a compensation function which provides restitution for societal losses incurred.[230] Additionally, this optimal level of deterrence is measured purely from an economic efficiency viewpoint without consideration of whether there is an express legislative purpose that a particular sanction should be imposed in such a manner. Nevertheless, as the deterrent and compensatory functions necessarily overlap to a certain degree,[231] an effective deterrent scheme with indirect compensation elements as a by-product is desirable because it will help reduce the cost associated

223. *See id.* at 1463-64; Note, *supra* note 2, at 486-89. *See generally* Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

224. Note, *supra* note 2, at 486-87. For consideration of external costs, see *infra* notes 238-44 and accompanying text.

225. R. POSNER, *supra* note 216, at 221-27. *See* Note, *The Role of Treble Damages*, *supra* note 1, at 1082.

226. R. POSNER, *supra* note 118, at 164-65; R. POSNER, *supra* note 216, at 221-24; Note, *supra* note 2, at 486.

227. R. POSNER, *supra* note 216, at 221-22; Diver, *supra* note 215, at 1458.

228. Note, *supra* note 2, at 487. *See* Diver, *supra* note 215, at 1474.

229. R. POSNER, *supra* note 216, at 221-22; Diver, *supra* note 215, at 1458.

Indeed, had the ITSA been in effect at the time the defendant in Dirks v. SEC, 463 U.S. 646 (1983), decided to expose the fraud, he may have been deterred from doing so, and society would have continued to absorb the fraud.

230. *Cf.* R. POSNER, *supra* note 216, at 221 (compensatory function is subsidiary since a well-designed system of deterrence would assure adequate compensation as a by-product).

231. *See* Diver, *supra* note 215, at 1461.

with enforcement and collection of the penalty. While the ITSA's primary purpose is deterrence, the discretionary elements within the Act's treble damage sanction may necessarily entail a balancing of factors, including the relative costs and benefits to society, victims, and violators.

When faced with the decision to impose the ITSA's treble damage sanction, courts will encounter different costs and consequences depending upon whether a corporate entity or an individual is deemed a direct violator of the ITSA's substantive requirements. The consequences of corporate entity liability are especially important not only because of possible negative effects external to the corporation,[232] but also because of uncertainty as to the extent of corporate and corporate management liability.[233]

B. *Entity Liability*

At the corporate entity level, the imposition of a severe penalty on a corporation may result in several undesirable or unfair consequences. First, where the expected gain exceeds the certainty and costs of apprehension and conviction, the illegal act may not be deterred.[234] When a severe money penalty is the chief enforcement tool designed to counteract this expected gain, the full amount of deterrence is limited by the corporation's wealth or "ability to pay."[235] Any penalty imposed above this threshold level of corporate resources fails to add any further deterrent or punitive effect.[236] In addition, the stigma or social opprobrium of an individual criminal conviction cannot raise this threshold level of deterrence since the corporation as a entity cannot, as yet, be convicted.[237] To the extent that other enforcement remedies are imposed with disgorged profits set aside for

232. *See infra* notes 238-48 and accompanying text.

233. *See supra* notes 43-111 and accompanying text.

234. *See* R. POSNER, *supra* note 118, at 165-67; Stigler, *supra* note 118, at 55-57; Dooley, *supra* note 2, at 25-26.

235. Coffee, *supra* note 124, at 390. *See* Black & Lind, *Crime and Punishment Reconsidered*, 4 J. LEGAL STUD. 241, 242-43 (1975).

The term "ability to pay" can have at least three distinct meanings: 1) the subjective pain a sanction inflicts on the wrongdoer, 2) the practical ability of the government to collect the debt, and 3) the hardship imposed on the wrongdoer or, secondarily, on others as to warrant a sanctions reduction. Diver, *supra* note 215, at 1469-70. *See also* Goldschmidt, *An Evaluation of the Present and Potential Use of Civil Money Penalties as a Sanction by Federal Administrative Agencies*, in 2 RECOMMENDATIONS AND REPORTS OF THE ADMINISTRATIVE CONFERENCE OF THE UNITED STATES 896, 946 (1972).

236. *See* Coffee, *supra* note 124, at 390. Professor Coffee labels this situation a "deterrence trap." *Id.*

237. *Id.* at 389.

private plaintiffs, or to the extent treble damages are imposed under a successful RICO suit, the corporation's ability to pay and the ultimate threshold level of deterrence is further limited. Therefore, where a corporation is liable as a direct violator under the ITSA, the upper penalty limit a corporation can absorb and still feel the deterrent impact may in many cases be substantially less than the full treble damage amount.

The imposition of treble damages under the ITSA on a corporation will result in both internal and external costs. When severe corporate penalties are imposed to punish a corporation, the penalty cost incurred by the corporation may be internalized and become a cost of production.[238] However, severe corporate penalties also spill over and impose costs external to the corporation on parties less culpable in the corporation's underlying offense.[239]

Professor Coffee cites four areas where severe corporate penalties are borne externally.[240] First, stockholders bear the reduced value in their securities which reflect the penalty incurred by the corporation.[241] Second, bondholders and other creditors also bear the corporate penalties since their interests are ultimately associated with a riskier corporation.[242] Third, employees and the general public suffer when penalties reduce corporate expansion or solvency, thereby decreasing the level of full employment and minority recruitment.[243] Fourth, the internal costs borne by the corporation may be externalized to the consumer in the form of higher prices,[244] at least up to the extent the market will bear. Where a corporation's wealth is limited or even diminishing and the external costs are high in proportion to the internal costs of the penalty, any corporate liability may result in negative consequences for many less culpable or innocent parties. Due to the threat of Draconian liability in such a situa-

238. *See, e.g.*, R. POSNER, *supra* note 118, at 139 (noting that strict liability may compel a firm to internalize all of its accident costs but leads to inefficient solutions in conflicting resource use problems); Diver, *supra* note 215, at 1464 ("penalty for violating a regulation serves as surrogate 'cost' of production—a way to internalize otherwise external costs").

239. *See* Coffee, *supra* note 124, at 401.

240. *Id.*

241. *Id. See also* MODEL PENAL CODE § 2.07, Comment (Tent. Draft No. 4, 1955). Kadish, *Some Observations on the Use of Criminal Sanctions in Enforcing Economic Regulations*, 30 U. CHI. L. REV. 423, 433 (1963).

242. Coffee, *supra* note 124, at 401. *See also* MODEL PENAL CODE § 2.07, Comment (Tent. Draft No. 4, 1955); Kadish, *supra* note 241, at 433.

243. Coffee, *supra* note 124, at 401.

244. *Id.*

tion,[245] courts may narrowly construe the underlying substantive law or impose a penalty so low that it jeopardizes potential deterrence, both contrary to congressional objectives.

The externality problem, the uncertainty of the law, and the threat of potential treble damages may also extort a settlement from an otherwise innocent corporation. Economically, a corporation faced with a lawsuit may determine that the benefits of a reduced settlement cost outweigh the costs associated with an expensive and prolonged lawsuit to establish its innocence.[246] This problem may be less severe where the SEC acts as public enforcer.[247] However, the corporation is still faced with the additional civil penalties that private plaintiffs may recover in the event liability is found. While the use of settlements may not affect the underlying substantive law of insider trading, the uncertainty in the underlying substantive law as well as uncertainty in the penalty amount may affect the decision of whether to litigate or settle.[248]

C. *Individual Liability*

When imposing the ITSA's penalty to deter or motivate future behavior, the economic considerations noted above suggest that severity of punishment is important in deterring prohibited conduct by both corporate entities and individuals.[249] Like a corporation, an individual is also limited by his wealth or ability to pay in the event of civil penalty.[250] Any penalty imposed above this threshold level will not add any further deterrent or punitive effect.[251] A person's ability to

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245. *See, e.g.*, Diver, *supra* note 215, at 1470 (not only is secondary unemployment as economic dislocation undesirable, where a penalty creates an "inability to pay," then "its very Draconian character suggests that 'ability to pay' may—or should—also include consideration of the welfare of the violator, either for his own sake or for the sake of those dependent on him.").

246. Coffee, *supra* note 124, at 402. *See also* Note, *Contribution and Antitrust Policy*, 78 MICH. L. REV. 890, 906 (1980) ("A Company faced with this massive liability may have little choice but to settle and to surrender its opportunity to go to trial on the merits of its case."); R. POSNER, *supra* note 118, at 434, 477 (discussing several scenarios in the decision of whether to settle or go to trial).

For consideration of recent activity regarding the SEC's settlement process, *see generally* Block & Barton, *Contribution and Indemnification Under the Federal Securities Laws*, 11 SEC. REG. L.J. 351 (1984); Kronstein, *SEC Settlements—Is There a Need for a Judicial Rubber Stamp?* 11 SEC. REG. L.J. 284 (1983).

247. *See* Coffee, *supra* note 124, at 403.

248. *See* Diver, *supra* note 215, at 1471-73. *See generally* D'Amato, *Legal Uncertainty*, 71 CAL. L. REV. 1 (1983).

249. *See supra* notes 215-31 and accompanying text.

250. *See supra* note 235 and accompanying text.

251. *See supra* note 236 and accompanying text.

pay is further threatened when profits are disgorged and he is faced with potential liability under a RICO treble damage suit. Therefore, an individual found liable under the ITSA may also be deterred by a monetary penalty substantially less than the full treble damage amount.

Nevertheless, severe punishment directed to deter individual behavior is not fraught with all the problems associated with penalties imposed on a corporation. Unlike a corporate entity, an individual can be fined and imprisoned.[252] As a corollary, severe monetary penalties coupled with the stigma of a criminal conviction can raise the individual's perceived cost of punishment to exceed the expected gain.[253] The spill-over problems associated with external costs are not present with individual defendants; however, since insider trading is not clearly defined, and uncertainty exists as to the penalty amount, some individuals may also feel similar settlement pressures.[254] To the extent that the law and penalty are uncertain, an individual may be deterred from engaging in questionable conduct, depending on his degree of risk aversion.[255]

IV. Recommended Approach and its Effect on Entity and Individual Liability Under the ITSA

A. *A General Rule*

Through the ITSA, the SEC and the courts have the ability to achieve the dual congressional objectives of maximizing deterrence without modifying underlying substantive insider trading law. Because the ITSA's legislative history suggests an overriding deterrent purpose, achievement of the ITSA's full deterrent potential mandates that, as a general rule, the SEC seek the full treble damage maximum in most cases.[256] This would ensure that the ITSA's treble damage sanc-

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252. Criminal prosecutions can be pursued under section 32 of the Securities Exchange Act of 1934, 15 U.S.C. § 78ff (1982), and under the Insider Trading Sanctions Act of 1984 where the fine assessed against criminals was increased from $10,000 to $100,000. Exchange Act, *supra* note 10, at § 32(a), 15 U.S.C. § 78ff (Supp. II 1984).

253. *See* Coffee, *supra* note 124, at 389, 409. However, since the treble damage sanction, coupled with other remedies is so severe, it may be unlikely that the SEC would seek both civil and criminal remedies. *See House Hearings*, *supra* note 13, at 70-71 (testimony of John M. Fedders, Director, Division of Enforcement, SEC).

254. *See supra* notes 246-48 and accompanying text.

255. *See supra* notes 122-25 & 138-41 and accompanying text.

256. Langevoort, *supra* note 2, at 1278-79; Block & Barton, *Insider Trading The Need for Legislation*, 10 SEC. REG. L.J. 350, 372 (1983).

tion is perceived as a severe deterrent threat.[257] Courts should only allow mitigating circumstances to reduce this amount when necessary to alleviate harsh results.[258] When mitigating circumstances exist, courts should incorporate the economic considerations discussed above before reducing the penalty. Moreover, since the SEC in the past has not always assessed the maximum available penalty in its settlement process,[259] this process should be monitored to ensure that a sufficient level of deterrence is maintained and that penalties assessed are consistent among similar types of violations.[260] If most cases are settled well below a defendant's threshold level of deterrence, the perceived deterrent potential of the Act will be thwarted.

There are several ways the SEC and courts can maintain the ITSA's objective of achieving deterrence without modification of substantive insider trader law. The primary method would be for the courts to consciously avoid taking into account the severity of the ITSA's sanction or its substantive elements when determining whether a 10b-5 violation exists. If a court finds that equity favors less than treble damages, courts should not narrow the scope of liability under Rule 10b-5; but rather, should resort to mitigating circumstances to limit the amount of damages. The discretion given to courts in imposing up to the treble maximum should be viewed as the sole means of achieving equitable and economically efficient results in individual cases. Another method by which the SEC can maintain the current scope of insider trading law is through its rule-making authority.[261]

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257. *Cf.* Diver, *supra* note 215, at 1483 (invoking the highest potential monetary liability maximizes the likelihood that response to an assessment will be taken seriously and expeditiously and may also strengthen the agency's bargaining position).

258. Block & Barton, *supra* note 256, at 372. Since the ITSA is a "variable-penalty" statute, a decision-maker is empowered and implicitly directed to consider mitigating factors when assessing the penalty, Diver, *supra* note 215, at 1444, and it may even confer a broad range of discretion to settle cases. *See id.* However, "[m]itigation is an act of mercy, exceptional and dispensational: allowing the agency to grant 'anticipatory' mitigation permits the exception to swallow the rule." *Id.* at 1481. Premature mitigation may result in excessive leniency due to initial lack of reliable evidence of mitigating circumstances. *Id.*

259. *See* Dooley, *supra* note 2, at 12-13; Thomforde, *Patterns of Disparity in SEC Administrative Sanctioning Practice*, 42 TENN. L. REV. 465, 486 (1975); Note, *supra* note 2, at 468-69. *Cf.* Coffee, *supra* note 124, at 406 (Justice Department recommended the maximum fine in less than a third of the cases where it obtained convictions); Goldschmidt, *supra* note 235, at 919 (as of 1972, federal agencies settled 90% of the cases by means of compromise, remission or mitigation devices).

260. *See generally* Diver, *supra* note 215 (recommending a monitoring process by federal agencies to develop penalty standards).

261. For example, Rule 14e-3 was promulgated by the SEC in response to the Supreme Court's decision rendered against it in Chiarella v. United States, 445 U.S.

Since the Supreme Court has narrowed insider trading liability mainly by restricting the extent of fiduciary obligation, the SEC could promulgate rules clarifying the reach of fiduciary obligations, and make those rules commensurate with the "direct" liability definition of the ITSA's "substantive" provisions.

The SEC can also achieve optimal levels of deterrence by its choice of what type of insider trading violations to prosecute. A temptation may exist to concentrate on prosecuting only those cases which could meet the ITSA's substantive requirements in an effort to actively deter insider trading.[262] The SEC should be cognizant of this temptation and not allow the ITSA to overshadow its other beneficial enforcement remedies. Investigating cases involving secondary liability through injunctions and disgorgement remedies will provide private plaintiff recovery while maintaining a viable source of insider trading law independent of the ITSA. Indeed, recovery under theories of secondary liability should be pursued in light of recent congressional endorsement of this type of recovery. If all insider trading cases are brought under the more limited scope of the ITSA, court interpretation and application of the ITSA's substantive elements may become the norm as an insider trading definition, thereby supplanting insider trading as defined by prior court interpretations of Rule 10b-5. In addition, the use of criminal sanctions as an added deterrent should be pursued as often as possible. This is especially important with respect to individuals who, because of their wealth and reputation, stand to lose more from a criminal conviction than from a severe monetary penalty.

Finally, as analyzed above, deterrence may be increased by increasing the perceived probability of punishment.[263] Aside from internal efficiency and priorities within the SEC, the most direct way to increase the threat of punishment would be to earmark the fines collected under the ITSA for SEC enforcement of insider trading.[264] However, while this may inject a direct form of compensation, the

222 (1980). *See* Heller, *supra* note 2, at 541 & n.58; Block and Barton, *supra* note 256, at 365. The ITSA expressly defers to the SEC's rulemaking authority, permitting the SEC to set the parameters of the Act's application. Exchange Act, *supra* note 10, at § 21(d)(2)(A).

262. *Cf.* Note, *supra* note 2, at 467 (noting that faced with limited enforcement resources, the SEC's "big bang" approach in prosecuting highly visible cases to maximize publicity and resulting deterrence).

263. *See supra* notes 118, 121, 126-28 and accompanying text.

264. *See* Note, *supra* note 2, at 491; Note, *The Role of Treble Damages*, *supra* note 1, at 1083.

overriding deterrent purpose of the ITSA should not be altered under this proposal.

B. *Difference in Application between Corporations and Individuals*

Even with the above recommendations as general guidelines, it must be remembered that their application to corporations and individuals is not the same. As previously noted, corporate punishment, unlike individual punishment, may result in undesirable or unfair consequences.[265] The decision to impose the treble damage sanction on the corporation creates problems for the SEC and the courts due to an inherent paradox. On the one hand, a severe penalty is the most effective and cost efficient way to counter the disadvantage of the SEC's limited resources and deter misbehavior.[266] On the other hand, when corporations are involved, a rule imposing the maximum penalty in every case may lead to undesirable or unfair results for several reasons. First, since a corporation will only be deterred up to its ability to pay, the threat of the treble damage maximum may have no effect.[267] Second, the ultimate effect of the penalty may be felt by those less culpable, or even worse, innocent investors because of a corporation's ability to externalize these costs.[268] Such a result would be contrary to the Act's goal of protecting innocent investors. Third, the threat of a severe sanction may result in the unfairness of an extorted settlement.[269] These few examples illustrate some of the negative consequences of corporate punishment.

In contrast, punishment of individuals, while sharing some of the same problems as corporate punishment, is more effective in directly deterring those responsible for the violation. When punishing individuals, the treble damage penalty may not deter beyond an individual's ability to pay, but the threat of losing one's economic base is a severe deterrent in itself. Even though a corporate penalty suffers from the same limitations, individuals are not able to externalize their cost. In addition, the perceived threat of a criminal prosecution can raise the level of deterrence for an individual.[270]

In view of the benefits of individual punishment over corporate punishment, courts and the SEC could attempt to equalize these differences by punishing the individuals responsible for the corporate

265. *See supra* notes 234-55 and accompanying text.
266. *See supra* notes 126-37 and accompanying text.
267. *See supra* notes 235-36 and accompanying text.
268. *See supra* notes 238-44 and accompanying text.
269. *See supra* notes 246-48 and accompanying text.
270. *See supra* notes 252-53 and accompanying text.

wrongdoing, rather than punishing the corporate entity itself. Punishing the individuals responsible for the corporate liability is consistent with the ITSA's concept of direct liability. In theory, by punishing the corporation, with the threat of a corporate fine sufficient to deter, the corporation will institute internal controls on its management and employees to prevent their misconduct for which the corporation is legally responsible.[271] But, if liability is placed on those responsible for the misconduct, the incarceration deterrent is retained and the externality problem is prevented.[272] This approach may also quell some of the fears that the ITSA does not go far enough in defining the breadth of the term "person" or protecting forms of secondary liability.[273] Where a board of directors directs an employee to trade for the firm's benefit using inside information, the entity is liable for a direct violation under the ITSA.[274] However, the Act also deems those who are in a position to direct a transaction and receive the benefits of the trade to be direct violators.[275] Because it is actually the board members themselves who direct the trade, and they are in a position, at least indirectly, to receive the benefits of the trade, they should be held individually liable as direct violators.[276]

Despite the fact that the level of deterrence achieved through the severe sanctions authorized by the ITSA is more problematic with regard to a corporate entity than an individual, congressional objectives can still be upheld in punishing a corporation, albeit to a limited extent. Even though the rationale behind direct liability would support punishing corporate actors trading for the firm's account, the legislative history suggests congressional intent to impose punishment on the corporation itself. In light of this congressional choice, the SEC and the courts should continue to strive for the maximum possible deterrent by proceeding against corporations as well as individuals.

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271. *See* R. POSNER, *supra* note 118, at 236; Langevoort, *supra* note 2, at 1285. *See also* Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051 (1982).

272. *See* Coffee, *supra* note 124, at 408.

273. *See* Brodsky, *supra* note 17, at 940.

274. *See supra* note 70 and accompanying text.

275. *Id.*

276. *Cf.* Dirks v. SEC, 463 U.S. 646 (1983) (whether an insider breaches a duty "requires courts to focus on objective criteria, i.e., whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings"). Board members essentially tip information to the corporation and execute trades for it, and when a corporation trades on nonpublic material information which goes undetected and improves its financial position, board members reap, at least indirectly, part of the increased future earnings and reputation.

CONCLUSION

In response to the need for an enforcement remedy sufficient to deter insider trading, Congress incorporated a severe treble damage sanction into the ITSA. The congressional choice to enact a sanction statute imposing a severe deterrent was not in any way intended to affect judicial interpretation of the underlying substantive law. As a result of the severity of the treble damage sanction and the current trend of Supreme Court decisions narrowing the scope of liability under Rule 10b-5, the congressional objectives to deter without modifying substantive law may be jeopardized by courts trying to alleviate Draconian results. In spite of the differences the ITSA's treble damage sanction creates when applied to corporations and individuals as direct violators, the SEC and the courts can still uphold the congressional objectives of the Act without compromising the underlying substantive law by consistently injecting the threat of a severe sanction.

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