The Insider Trading Sanctions Act of 1984

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SEC COMMENTARY

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The Insider Trading Sanctions Act of 1984

In 1984, Congress enacted a potent new statutory weapon for use in the fight against those who use unpublished "inside" market information to obtain an unfair advantage in the purchase or sale of securities. The Insider Trading Sanctions Act (ITSA), signed into law by President Reagan on August 10, 1984, supplements and amends the remedies available against those who violate the substantive provisions of the federal securities laws.[1]

Prior to 1984, the Securities and Exchange Commission was empowered to sue to enjoin future inside trading violations, and to require "disgorgement" by a violator of any profits realized by the wrongdoing. Further, the courts had recognized the rights of private plaintiffs to sue to recover damages under the securities laws. Before ITSA, the enforcement emphasis in insider trading cases was primarily upon returning defendants to the "status quo" existing prior to their misconduct and compensating victims of that misconduct.

ITSA, however, alters significantly the enforcement emphasis in the direction of punishing defendants. The means adopted to accomplish this punitive goal is the Act's treble damages sanction. Under the statute, the SEC may seek a civil remedy of up to three times the amount of profit gained by a defendant as a result of the defendant's misconduct. The Act also increases from $10,000 to $100,000 the maximum criminal fine for all violations of the Securities Exchange Act.

Thus ITSA may be correctly viewed as a policy statement by Congress that it intends to get "tough" with those who trade using inside information.[2] There are important reasons for Congress to be concerned about insider trading. Insider trading undermines the confidence of investors in the securities market, confidence upon which effective capital formation and economic growth depend. Further, insider trading injures specific people, who suffer direct, often substantial economic harm as a result of the misconduct of those who use non-public information to unfair advantage.

It was to remedy these ills that Congress passed ITSA in 1984 as an amendment to the securities laws. In doing so, Congress sought to augment the "risk-reward" equation by making the penalties for insider trading more commensurate with the magnitude of the temptation for profit, reasoning that potential violators would be restrained by the threat of substantial pecuniary penalties.

ITSA as a Civil Sanction: General Considerations

ITSA creates a civil penalty for violation of the substantive insider trading provisions of the securities laws. The penalty is available only in those circumstances where there exists a fiduciary duty on the part of the defendant either to disclose his/her inside "tip" or abstain from trading. This breach of fiduciary duty must be coupled with fraudulent conduct by the defendant.

The first requirement for liability—the existence of a fiduciary duty—means simply that the defendant must in fact be an *insider*. As the United States Supreme Court made clear in *Chiarella v. United States*,[3] the fiduciary duty is owed by officers, directors, broker dealers, etc., but did not extend to persons outside of the trading framework, e.g., an employee of a printer engaged in printing and processing merger documents. Subsequent to *Chiarella*, the SEC adopted Rule 14e-3 which made it illegal for any person to purchase or sell a security while in possession of material nonpublic information about a prospective tender offer, if he/she knows or has reason to know that such information emanates from either the offering person or the issuer or person acting on their behalf.[4]

As to the second prerequisite to liability—fraud on the defendant's part—the Supreme Court has held that the term "fraud" in the securities laws requires proof of deception. Thus it is clear that there may be cases in which a defendant may owe a fiduciary duty but will not be liable under ITSA. For example, liability would not lie where there exists no causal connection between defendant's activity and a decision by the "victim" either to sell or not to sell, or affecting some other related aspect of investment activity.

The heart of ITSA is its delineation

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[1] Pub. L. No. 98-376, 98 Stat. 1264 (1984), 15 U.S.C. §78(u)(d) (Supp. II 1984).

[2] Fox, *Insider Liability After the Insider Trading Sanctions Act of 1984*, 18 Bus. L. Rev. 13, 14 (1985).

[3] 445 U.S. 222 (1980).

[4] 17 C.F.R. §240. 14e-3 (1985).

of the activity that gives rise to liability for treble damages. Section 2 prohibits "purchasing or selling a security while in possession of material nonpublic information."[5] Since the term "possession" is not defined in the Act, it will no doubt be judicially construed with reference to common law agency principles. Thus an institution (principal) would be held to "possess" whatever its employees (agents) possess. Since the potential for such vicarious liability could become far-reaching, portending treble damages in cases where *any* employee of the firm traded on the basis of material inside information, the Act in a sense mandated a future SEC rule which would contain the spectre of vicarious liability by allowing a defendant institution to rebut the presumption of liability resulting from possession. Under the rule contemplated by Congress, liability would not exist where the defendant institution could prove the existence of a "Chinese Wall"—a communication bar enacted by the firm that ensures that material non-public information in the hands of, e.g., lower level research employees, will not reach employees who trade on behalf of the firm.[6] The legislative history of the Act makes plain that Congress intended this type of device to insulate institutions from otherwise boundless vicarious liability,[7] and the SEC enacted Rule 14e-3(b) to accomplish this purpose.[8]

One difficulty with ITSA as a civil sanction is that it fails to define adequately the conduct that it purports to prohibit. For while the Act incorporates the substantive law of the securities acts, specifically Rules 10b-5 and 14e-3[9] for a definition of insider trading, this law is far from crystal clear. The fact that ITSA ignores the confusion apparent in the insider trading case law may prove troublesome in the future. While Congress did consider numerous definitional proposals, they were rejected in the fear that any definition would introduce new language, and thus new ambiguities and unanswered questions. In Congress' view, the potential for injecting new uncertainty outweighed the merits of any of the proposed definitions.[10] We are thus left with a statute that does not specifically define the scope of the conduct that it purports to prohibit. The consequent uncertainty may mean that a defendant can incur liability without fair prior notice of the illegality of his conduct. In such a case, if a reasonable person in the defendant's position would not have been aware that his conduct violated the ACT, the imposition of the treble damages penalty might be construed as a violation of due process.

"Aiding and Abetting" under ITSA

ITSA provides for the liability of "secondary parties;" parties who assist in the violation of the securities laws, with certain express limitations. The Act explicitly states that anyone aiding or abetting trading based on inside information will be liable under ITSA and the securities laws,[11] but adds two important qualifications to the imposition of such liability.

Firstly, §2-B provides that no person shall be liable solely because he/she aided and abetted a prohibited transaction in a manner other than by communicating non-public information. In this provision, it was Congress' intent to exclude from the Act's coverage such parties as broker-dealers and their registered representatives who are trading illegally. However, a registered representative *could* be liable as an aider and abettor if he/she learned the information from one customer and then tipped off other customers who traded.

Secondly, §2-B provides that no person should be liable solely by employing another person who is liable under ITSA. The purpose of this provision is to set limits on the liability of a large multistate firm, where one employee may possess information but another employee who trades for the firm, who does not possess the information, trades for the firm before the information is made public. Thus, absent negligence or other fault on the part of the employer, the Act's aider and abettor provisions do not encompass an employer merely because an employee possessed nonpublic information.

Miscellaneous Procedural Considerations

Since ITSA is a civil statute that does not purport to create criminal liability, mere civil enforcement procedures are required. Thus, in an ITSA case, the defendant is entitled only to the ordinary procedural protection of a civil lawsuit. This poses certain concerns for potential ITSA defendants.

The designation of an ITSA case as a *civil*, as opposed to a criminal, proceeding, means that a relatively low standard of proof will be applied. In an ITSA proceeding, the SEC need not prove liability "beyond a reasonable doubt." Rather, the Commission need only prove that a defendant is liable by a "preponderance of the evidence," which means that the Commission must persuade the trier of fact that liability exists "more probably than not." This standard of proof reflects society's minimal concern regarding the outcome of civil suits, where penalties often involve the mere exchange of money damages

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[5] 15 U.S.C. §78(u)(d)(2)(A) (1984).

[6] Silver, *Penalizing Insider Trading: A Critical Assessment of the Insider Trading Sanctions Act of 1984*, 1985 Duke, L.J. 960, 978 (1985).

[7] H.R. Rep. 355, 98th Cong. 2d Sess. II (1983).

[8] 17 C.F.R. §240.14e-3(b) (1985).

[9] 17 C.F.R. §240.10b-5, 14e-3 (1985).

[10] *See Hearings on H.R. 599 Before the Subcomm. on Securities of the Senate Committee on Banking, Housing, and Urban Affairs*, 98th Congr. 2d Sess. 36 (1984).

[11] Pub. L. No. 98-376 §2 (1984).

between the private litigants.[12] It has been argued, however, that given the private interest at stake in an ITSA case (the issuance of a substantial financial penalty coupled with damage to reputation) and the risk of error inherent in the "preponderance" standard, that a higher standard of proof should be applied in ITSA cases.[13]

Another burden flowing to defendants from the "civil" designation of the ITSA treble damages sanction is the inapplicability of the constitutional protections afforded by the Fifth Amendment's prohibition against double jeopardy. Since the ITSA treble damages penalty is not exclusive, the Commission could seek an injunction, disgorgement, *and* the ITSA damages penalty in addition to criminal prosecution. The ITSA defendant could be jeopardized more than once for the same offense in separate suits because the double jeopardy clause applies only to criminal or quasi-criminal statutes.

[12] Silver, *supra* note 6 at 1002.
[13] *Id.* at 1002-07.

Courts will ignore the labelling of a statute as civil for purposes of double jeopardy analysis only when sanctions under the statute involve imprisonment or some other substantial loss of liberty. Courts have not held that mere monetary loss, even where accompanied by injury to reputation, is sufficiently serious to construe such sanctions as criminal notwithstanding the designation supplied by the enacting legislature. It has been argued that in view of the punitive nature of the ITSA treble damages sanction, the statute is quasi-criminal, and that the double jeopardy clause is therefore applicable.[14] Since the statute provides for multiple penalties in addition to sanctions imposed concurrently under other law, ITSA could prove vulnerable to a double jeopardy attack, if a threshold determination is made that the fundamental nature of the Act is punitive.

The potential for multiple payments under ITSA also poses other problems. Extensive liability imposed against ITSA defendants may violate fundamental principles of fairness to the extent that such liability is too severe in relation to the activity to which it applies. Assessment of multiple damages in unreasonable amounts may have the undesirable effect of discouraging legitimate trading conduct of a creative or novel nature.

Problems of unfairness involving ITSA damages may be substantially vitiated by the fact that the Act leaves the district court ample discretion on the damages issue. In a typical proceeding, the SEC will propose the amount of damages (usually the maximum) and the judge determines whether that sum is appropriate. In doing so, the judge considers various factors, including the defendant's culpability and the effect of the defendant's conduct on the trading public.

A final procedural issue is whether defendants being prosecuted under ITSA have a right to a jury trial. Since the statute is silent on the question, the issue is a constitutional one involving the Seventh Amendment, which provides that "[i]n suits at common law, where the value in controversy shall exceed 20 dollars, the right of trial by jury shall be preserved."[15] The "suit at common law" language of the Seventh Amendment means that the constitutional right to a jury trial does *not* exist in cases where the relief sought is of a kind traditionally administered by *equity* courts; i.e., injunctive relief. While it is true that an action under ITSA may include a prayer for injunctive relief or disgorgement, the treble damages action that lies at the heart of the statute is clearly *legal*, not equitable, in nature, and thus within the purview of the Seventh Amendment.

[14] *See* Note, *Implications of the 1984 Inside Trading Sanctions Act: Collateral Estoppel and Double Jeopardy*, 64 N.C. L. Rev. 117, 146-49 (1985).
[15] U.S. CONST. amend. VII.

While the SEC argued against jury trials under ITSA at the congressional hearings on the ground that juries would unduly lengthen and complicate proceedings, such reasoning is no justification for denying jury trials to ITSA defendants, and has never been endorsed by a court of law.[16] Further, jury trials under ITSA impose no greater burden on the SEC than they do under other statutory schemes involving other enforcement agencies.

Conclusion

The Insider Trading Sanctions Act of 1984 significantly increases the potential liability of those who violate the substantive provisions of the federal insider trading laws. In shifting the emphasis from compensation of victims to punishment of the offenders, however, the Act raises problems that will require appropriate judicial attention in the future. The most important issues to be dealt with include the scope of liability under the Act, and the availability of certain procedural safeguards and protections necessary to preserve fundamental fairness and justice. Once these questions are properly resolved by the courts, ITSA will no doubt prove to be a more valuable weapon in the war against those who abuse their fiduciary duties by utilizing unpublished market information for their own pecuniary gain. Ω

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[16] Silver, *supra* note 6 at 1008.