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Draft Outline for Workshop and Primer: "How to Investigate and Prove an Insider Trading Case"

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October 21, 1997

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Mittal Court, 'B' Wing, First Floor
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Dear Mr. Singhvi and Mr. Nabar,

Sub. : SEBI Enforcement

As requested, here is an outline for a proposed workshop and primer on "How to Investigate and Prove an Insider Trading Case", which was prepared by Mr. David Strandberg, Price Waterhouse LLP consultant. The purpose of this outline and workshop is to assist the SEBI to develop its institutional capabilities to conduct investigations of possible misconduct in the Indian markets, including insider trading.

Going forward, I expect that Price Waterhouse FIRE project consultants Mr. Cliff Kennedy and Mr. David Strandberg will further elaborate and develop this outline. I also expect that it will serve as a basis for the insider trading portion of the enforcement manual which we understand is currently under development at SEBI. I also anticipate that we will prepare and deliver similar primers and workshops on different aspects of enforcement of the securities laws over the course of this project.

As always, please let me know if there is anything else I can do. I can be reached at the FIRE project office by telephone on 496 3566 or 496 3599.

Sincerely yours,

W. Dennis Grubb

W. Dennis Grubb
Principal Consultant - Capital Markets

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Workshop Outline: How to Investigate and Prove an Insider Trading Case

I. General Principles of Enforcement and Investigations

a. Objectives

i. Protect investors to the fullest extent possible

1. The SEBI Act specifically provides that it "shall be [the] duty of the Board to protect the interests of [ ] investors in securities and to promote [the] development of, and to regulate the securities market by such measures as it thinks fit." SEBI Act Chapter IV, Section 11.(1).

ii. Promote investors' confidence in the integrity of the market
iii. Encourage broad and active participation in the market by all investors
iv. Punish wrongdoers
v. Remedy harm to investors
vi. Deter illegal conduct

1. If market participants believe that SEBI will vigorously pursue and prosecute instances of misconduct, those who may be inclined to engage in improper conduct will be less likely to do so.

b. Basic elements of an enforcement program

i. Investigate possible violations of the securities laws vigorously but fairly
ii. Recommend and institute enforcement proceedings where warranted
iii. Remedy harm to investors
iv. Punish wrongdoers and impose sanctions that correspond to the misconduct
v. Refer matters to other authorities for follow-up action as appropriate

c. Investigations are private and "non-public"

i. Preserves integrity of the investigation
ii. Protects the reputation of those market participants who may be involved before legal conclusions are reached

iii. Preserves the integrity of the evidence and ensures that documents relevant to the investigation are not improperly destroyed or hidden from investigators
iv. Ensures that securities, funds or documents are not removed beyond the jurisdiction of the regulator
v. Preserves the "element of surprise"
vi. Press inquiries

1. All press inquiries should be referred to supervisors
2. SEBI should develop a standard response to press inquiries regarding on-going investigations

II. What Is Insider Trading?[1]

a. Statutory elements

i. SEBI (Insider Trading) Regulations, 1992
ii. SEBI (Stock Brokers and Sub-Brokers) Rules, 1992
iii. Other provisions
iv. Why Investigate, or Why is Insider Trading Bad?

b. Who can be an Inside Trader?

i. Statutory definition
ii. Licensed and unlicensed individuals and entities
iii. Company officers, directors employees and other insiders
iv. Company advisers (e.g., lawyers and investment bankers), related or affiliated parties and other outsiders
v. Others (e.g., Chiarella, Carpenter)

c. Other participants: tippers, tippees, and brokers

i. Relationship to issuer
ii. Connections among themselves

d. Issuer

i. Relationship of issuer or any of its officers, directors and employees to traders, tippers, tippees and brokers

e. Price sensitive information

[1] As the applicable laws and regulations change and market practices and participants develop, this outline will need to be amended and updated.

f. Common indicia of insider trading

   i. Significant corporate events (e.g., mergers and acquisitions, earnings announcements)
   ii. Unusual price or volume activity or fluctuations which exceed historical norms or do not appear to result from normal market forces or concurrent corporate events
   iii. Unusual trading activity prior to significant corporate event such as a merger or other business combination

      1. as a matter of routine, SEBI should review all securities trades which immediately precede or surround a significant market event or corporate announcement

III. Sources of Investigations, or What Triggers an Investigation?

a. SEBI market surveillance and inspections

   i. Monitor stock exchange trading screens and reports
   ii. Inspections may reveal indications of improper activity
   iii. SEBI review of filings by issuers and other market participants

      1. Extraordinary events
      2. Dramatic shifts in financial results from one period to the next

   iv. Survey of general industry trends and developments may indicate problem areas
   v. Informal review of financial press

b. Outside sources, e.g., SROs and exchanges

   i. Develop relationships with compliance officer counterparts
   ii. Limits to SRO and stock exchange jurisdiction and authority

c. Referrals and tips

   i. Other divisions and agencies
   ii. Inquiries and complaints from public
   iii. Complaints from market professionals

      1. But may be an attempt to seek favorable treatment from SEBI
      2. May be an attempt to influence SEBI's understanding and interpretation of the facts

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3. May be an attempt to initiate SEBI investigation to weaken a rival

iv. Complaints from employees (current and former)

1. Must consider perspective and objectives of source of information

v. Complaints/tips from press
vi. Need system to track and monitor complaints and SEBI responses
vii. Must also maintain correspondence files and database

d. Referrals from regulators in other countries

i. Memorandum of Understanding between SEBI and U.S. SEC

IV. Decision to Initiate An Investigation

a. Criteria and policy considerations

i. Allocation of resources
ii. Nature of conduct
iii. Egregiousness of harm
iv. Other

b. Supervisor and management involvement and ongoing oversight

c. Procedural considerations

i. Documentation and file maintenance
ii. Development of facts
iii. Integrity of evidence
iv. Sufficient staff
v. Necessary expertise, e.g., accountant

d. Need for Coordination

i. With Other Agencies
ii. With SROs and Exchanges

V. How to Prove Insider Trading – General Principles

a. Statutory authority to conduct investigations (SEBI Act Chapter IV. Section 11.(2)

b. Develop theory of the case, that is, an explanation for what happened and why (the story)

   i. Possible motives for conduct
   ii. Benefit to trader or others (e.g., family members or business associates)
   iii. Relationship of trader to company, broker or others
   iv. Note: theory may change during investigation

c. Develop investigative plan

   i. Define scope and objectives of investigation

      1. Identify actors, scrip and time period
      2. Investigation should seek to develop facts to support each element of an alleged violation

   ii. Insider trading cases are largely based on circumstantial evidence
   iii. Confessions are rare
   iv. Identify necessary documents and witnesses

      1. Typically, SEBI should seek to gather all documentary evidence before interviewing or questioning witnesses
      2. Enables SEBI to use witnesses to explain documents to obtain a more complete explanation

   v. Timing of witnesses is important

      1. Insider/outside the issuer
      2. Top down or bottom up

   vi. Design and implement procedures to maintain confidentiality of documents and other investigative materials

d. Investigative Techniques for insider trading cases

   i. Investigations are fact-finding inquiries only
   ii. Legal conclusions are not reached during an investigation
   iii. In general, investigations seek to develop facts to answer questions: who, what, why, where, when, how, and what happened next?

      1. Must consider and be able to explain facts that do not support each element
      2. Consider opportunities for communication/exchange of price sensitive information

(a) Written chronologies of events (see below)
(b) Memberships in clubs and associations, and attendance at meetings (time, place, list of attendees and agenda)

iv. During investigations, facts are developed to furthest extent possible through:

1. Informal inquiry
2. Interviews and testimony
3. Examination of records, such as brokerage records and other documents
4. Review of trading data
5. Public and non-public sources

e. Documents are critical

i. Internal SEBI documents and information

1. Periodic and continuous reports and disclosure
2. Investment Decision Support System contains corporate data, price graphs and significant news announcements
3. Trading reports from stock exchanges
4. Price and volume history for relevant period(s) and comparison to peer-group companies in industry (may be indicia that news or announcement is price-sensitive)

ii. Trading and brokerage records

1. Required books and records. SEBI (Stock Brokers and Sub-Brokers) Rules and Regulations, 1992, Chapter IV, General Obligations and Responsibilities, 17(1)
2. Correspondence files and telephone notes
3. Customer bills, delivery slips, inward/outward record and bank slips
4. Records of accounts of family members, business associates and related or affiliated parties ("Benami" accounts)
5. Research on issuer

iii. Issuer and company documents

1. Periodic reports, offering circulars, prospectuses and other disclosure
2. Press releases and promotional materials

3. Documents related to Board of Directors and other meetings, including meeting minutes, agendas, lists of attendees
4. Notes or summaries of meetings and telephone conversations
5. Circulate list of traders within company to determine if there are any connections or relationships between traders and company insiders

iv. Stock exchange documents

1. Required reports and books and records (Securities Contracts (Regulation) Act, 1956, Section 6, subsections (2) and (4))
2. Audit trail of transactions

v. Written summaries or chronologies of events from company and advisors

1. authority of SEBI to request
2. identifies time period and key events
3. identifies key witnesses and opportunities for communication of price sensitive information
4. identifies who knew what and when
5. identifies nature of possible price sensitive information and, in the event of a corporate transaction, the certainty of terms

vi. Trader

1. Brokerage records

(a) Identifies trades, scrip, price and timing, etc.
(b) May reveal unusual patterns or activity not consistent with previous trading history

2. Telephone records

(a) May reveal opportunity for exchange of price sensitive information
(b) Comparison to timing of transactions and withdrawal of funds from bank account

3. Bank records

(a) May reveal source of funds for improper trades
(b) Unusual withdrawals, deposits or transfers

vii. Press reports

f. Witnesses

i. Inside the company
ii. Outside advisors
iii. Traders
iv. Timing issues and other considerations

g. Defenses

i. Information is not price sensitive
ii. Information was already public
iii. Trades based on other information
iv. Other

V. Decision to Initiate Proceedings or Terminate investigation

a. Criteria and policy considerations

i. Allocation of resources
ii. Impact on investors and the market
iii. Other

b. Preparation of recommendation to the Board

c. Supervisor and Management Oversight

d. Criminal and other collateral proceedings

e. Settlement

f. Publicity

i. Issue press release after public proceedings initiated
ii. Announce enforcement proceedings on SEBI website

VI. Appropriate sanctions

a. Statutory authority

b. Policy considerations

i. Seriousness of misconduct
ii. Nature of misconduct

1. Repetitive or continuous?
2. Single instance?

iii. Amount of pecuniary damage

1. Measurement

iv. Likelihood of future misconduct
v. Previous violations

VII. Some Statistics on U.S. SEC Insider Trading Investigations

a. In Fiscal Year1996, the U.S. SEC initiated 42 cases which alleged insider trading violations
b. Comparison with Enforcement cases initiated by the U.S. SEC in other program areas

VIII. Case Study

Attachments:

(I) SEC v. O'Hagan, 117 S.Ct. 2199 (1997)
(II) SEC complaint in SEC v. Power Securities Corp.
(III) Excerpts from David L. Ratner, Securities Regulation in a Nutshell, Fifth edition (1996), pp. 143-161 and 234-247
(IV) Excerpts from Stuart J. Kaswell, "An Insider's View of the Insider Trading and Securities Fraud Enforcement Act of 1988," 45 Business Lawyer 145, November 1989
(V) Excerpts from the U.S. SEC's 1996 Annual Report, pp. 17-20, 27, and Table 1

UNITED STATES, PETITIONER v. JAMES HERMAN O'HAGAN

No. 96-842

SUPREME COURT OF THE UNITED STATES

117 S. Ct. 2199; 1997 U.S. LEXIS 4033; 138 L. Ed. 2d 724;
Fed. Sec. L. Rep. (CCH) P99,482; 97 Cal. Daily Op. Service
4931; 97 Daily Journal DAR 7991; 11 Fla. Law W. Fed. S 154

April 16, 1997, Argued
June 25, 1997, Decided

NOTICE: [*1]
The LEXIS pagination of this document is subject to change pending release of the final published version.

PRIOR HISTORY: ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

DISPOSITION: <=1> 92 F.3d 612, reversed and remanded.

SYLLABUS:
After Grand Metropolitan PLC (Grand Met) retained the law firm of Dorsey & Whitney to represent it regarding a potential tender offer for the Pillsbury Company's common stock, respondent O'Hagan, a Dorsey & Whitney partner who did no work on the representation, began purchasing call options for Pillsbury stock, as well as shares of the stock. Following Dorsey & Whitney's withdrawal from the represention, Grand Met publicly announced its tender offer, the price of Pillsbury stock rose dramatically, and O'Hagan sold his call options and stock at a profit of more than $ 4.3 million. A Securities and Exchange Commission (SEC) investigation culminated in a 57-count indictment alleging, inter alia, that [*2] O'Hagan defrauded his law firm and its client, Grand Met, by misappropriating for his own trading purposes material, nonpublic information regarding the tender offer. The indictment charged O'Hagan with securities fraud in violation of @ 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, with fraudulent trading in connection with a tender offer in violation of @ 14(e) of the Exchange Act and SEC Rule 14e-3(a), and with violations of the federal mail fraud and money laundering statutes. A jury convicted O'Hagan on all counts, and he was sentenced to prison. The Eighth Circuit reversed all of the convictions, holding that @ 10(b) and Rule 10b-5 liability may not be grounded on the "misappropriation theory" of securities fraud on which the prosecution relied; that Rule 14e-3(a) exceeds the SEC's @ 14(e) rulemaking authority because the Rule contains no breach of fiduciary duty requirement; and that the mail fraud and money laundering convictions rested on violations of the securities laws, so could not stand once the securities fraud convictions were reversed.

Held:

1. A person who trades in securities for personal profit, using confidential information [*3] misappropriated in breach of a fiduciary duty to the source of the information, may be held liable for violating @ 10(b) and Rule 10b-5. Pp. 4-22.

(a) Section 10(b) proscribes (1) using any "deceptive device" (2) "in connection with the purchase or sale of any security," in contravention of SEC rules. The Commission adopted Rule 10b-5 pursuant to its @ 10(b) rulemaking authority; liability under Rule 10b-5 does not extend beyond conduct encompassed by @ 10(b)'s prohibition. See, e.g., <=2> Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214, 47 L. Ed. 2d 668, 96 S. Ct. 1375. Under the "traditional" or "classical theory" of insider trading liability, a violation of @ 10(b)

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and Rule 10b-5 occurs when a corporate insider trades in his corporation's securities on the basis of material, confidential information he has obtained by reason of his position. Such trading qualifies as a "deceptive device" because there is a relationship of trust and confidence between the corporation's shareholders and the insider that gives rise to a duty to disclose or abstain from trading. <=3> Chiarella v. United States, 445 U.S. 222, 228-229, 63 L. Ed. 2d 348, 100 S. Ct. 1108. Under the complementary "misappropriation theory" urged by the Government here, a corporate [*4] "outsider" violates @ 10(b) and Rule 10b-5 when he misappropriates confidential information for securities trading purposes, in breach of a fiduciary duty owed to the source of the information, rather than to the persons with whom he trades. Pp. 5-8.

(b) Misappropriation, as just defined, is the proper subject of a @ 10(b) charge because it meets the statutory requirement that there be "deceptive" conduct "in connection with" a securities transaction. First, misappropriators deal in deception: A fiduciary who pretends loyalty to the principal while secretly converting the principal's information for personal gain dupes or defrauds the principal. A company's confidential information qualifies as property to which the company has a right of exclusive use; the undisclosed misappropriation of such information constitutes fraud akin to embezzlement. Cf. <=4> Carpenter v. United States, 484 U.S. 19, 25-27, 98 L. Ed. 2d 275, 108 S. Ct. 316. Deception through nondisclosure is central to liability under the misappropriation theory. The theory is thus consistent with <=5> Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 473-476, 51 L. Ed. 2d 480, 97 S. Ct. 1292, a decision underscoring that @ 10(b) is not an all-purpose breach of fiduciary duty [*5] ban, but trains on conduct that is manipulative or deceptive. Conversely, full disclosure forecloses liability: Because the deception essential to the theory involves feigning fidelity to the information's source, if the fiduciary discloses to the source that he plans to trade on the information, there is no "deceptive device" and thus no @ 10(b) violation. Second, @ 10(b)'s requirement that the misappropriator's deceptive use of information be "in connection with the purchase or sale of [a] security" is satisfied by the misappropriation theory because the fiduciary's fraud is consummated, not when he obtains the confidential information, but when, without disclosure to his principal, he uses the information in purchasing or selling securities. The transaction and the breach of duty coincide, even though the person or entity defrauded is not the other party to the trade, but is, instead, the source of the nonpublic information. Because undisclosed trading on the basis of misappropriated, nonpublic information both deceives the source of the information and harms members of the investing public, the misappropriation theory is tuned to an animating purpose of the Exchange Act: to [*6] ensure honest markets, thereby promoting investor confidence. It would make scant sense to hold a lawyer-turned-trader like O'Hagan a @ 10(b) violator if he works for a law firm representing the target of a tender offer, but not if he works for a firm representing the bidder. The statute's text requires no such result. Pp. 8-15.

(c) The Eighth Circuit erred in holding that the misappropriation theory is inconsistent with @ 10(b). First, that court understood the theory to require neither misrepresentation nor nondisclosure; as this Court explains, however, deceptive nondisclosure is essential to @ 10(b) liability under the theory. Concretely, it was O'Hagan's failure to disclose his personal trading to Grand Met and Dorsey, in breach of his duty to do so, that made his conduct "deceptive" under @ 10(b). Second, the Eighth Circuit misread this Court's precedents when it ruled that, under <=6> Chiarella v. United States, 445 U.S. 222, 230, 232, 233, 63 L. Ed. 2d 348, 100 S. Ct. 1108; <=7> Dirks v. SEC, 463 U.S. 646, 655, 77 L. Ed. 2d 911, 103 S. Ct. 3255; and <=8> Central Bank of Denver, N. A. v. First Interstate Bank of Denver, N. A., 511 U.S. 164, 191, 128 L. Ed. 2d 119, 114 S. Ct. 1439, only a breach of a duty to parties to a securities transaction, or, at the most, [*7] to other market participants such as investors, is sufficient to give rise to @ 10(b) liability. <=9> Chiarella, supra, at 238, 239, 240-243, 245, expressly left open the question of the misappropriation theory's validity, and <=10> Dirks, supra, at 665, 666-667, also left room for application of the misappropriation theory in cases such as this one. Central Bank's discussion concerned only private civil litigation under @ 10(b) and Rule 10b-5, not criminal liability. Pp. 15-20.

(d) Vital to this Court's decision that criminal liability may be sustained under the misappropriation theory is the Exchange Act's requirement that the Government prove that a person "willfully" violated Rule 10b-5 in order to establish a criminal violation, and the Act's provision that a defendant may not be imprisoned

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for such a violation if he proves that he had no knowledge of the Rule. The requirement of culpable intent weakens O'Hagan's charge that the misappropriation theory is too indefinite to permit the imposition of criminal liability. See <=11> Boyce Motor Lines, Inc. v. United States, 342 U.S. 337, 342, 96 L. Ed. 367, 72 S. Ct. 329. The Eighth Circuit may address on remand O'Hagan's other challenges to his @ 10(b) [*8] and Rule 10b-5 convictions. Pp. 21-22.

2. As relevant to this case, the SEC did not exceed its rulemaking authority under @ 14(e) by adopting Rule 14e-3(a) without requiring a showing that the trading at issue entailed a breach of fiduciary duty. Section 14(e) prohibits "fraudulent . . . acts . . . in connection with any tender offer," and authorizes the SEC to "define, and prescribe means reasonably designed to prevent, such acts." Adopted under that statutory authorization, Rule 14e-3(a) forbids any person to trade on the basis of material, nonpublic information that concerns a tender offer and that the person knows or should know has been acquired from an insider of the offeror or issuer, or someone working on their behalf, unless within a reasonable time before any purchase or sale such information and its source are publicly disclosed. Rule 14e-3(a) imposes duty to disclose or abstain from trading whether or not the trader owes a fiduciary duty to respect the confidentiality of the information. In invalidating Rule 14e-3(a), the Eighth Circuit reasoned, inter alia, that @ 14(e) empowers the SEC to identify and regulate "fraudulent" acts, but not to create its own [*9] definition of "fraud"; that, under <=12> Schreiber v. Burlington Northern, Inc., 472 U.S. 1, 7-8, 86 L. Ed. 2d 1, 105 S. Ct. 2458, @ 10(b) interpretations guide construction of @ 14(e); and that, under <=13> Chiarella, supra, at 228, a failure to disclose information can be "fraudulent" for @ 10(b) purposes only when there is a duty to speak arising out of a fiduciary or similar relationship of trust and confidence. This Court need not resolve whether the SEC's @ 14(e) fraud-defining authority is broader than its like authority under @ 10(b), for Rule 14e-3(a), as applied to cases of this genre, qualifies under @ 14(e) as a "means reasonably designed to prevent" fraudulent trading on material, nonpublic information in the tender offer context. A prophylactic measure properly encompasses more than the core activity prohibited. Under @ 14(e), the SEC may prohibit acts not themselves fraudulent under the common law or @ 10(b), if the prohibition is reasonably designed to prevent acts and practices that are fraudulent. See <=14> Schreiber, supra, at 11, n.11. This Court must accord the SEC's assessment in that regard controlling weight unless it is arbitrary, capricious, or manifestly contrary to the statute. [*10] <=15> Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 844, 81 L. Ed. 2d 694, 104 S. Ct. 2778. In this case, the SEC's assessment is none of these. It is a fair assumption that trading on the basis of material, nonpublic information will often involve a breach of a duty of confidentiality to the bidder or target company or their representatives. The SEC, cognizant of proof problems that could enable sophisticated traders to escape responsibility for such trading, placed in Rule 14e-3(a) a "disclose or abstain from trading" command that does not require specific proof of a breach of fiduciary duty. Insofar as it serves to prevent the type of misappropriation charged against O'Hagan, the Rule is therefore a proper exercise of the SEC's prophylactic power under @ 14(e). This Court declines to consider in the first instance O'Hagan's alternate arguments that Rule 14e-3(a)'s prohibition of pre-offer trading conflicts with @ 14(e) and violates due process. The Eighth Circuit may address on remand any such argument that O'Hagan has preserved. Pp. 22-33.

3. This Court's rulings on the securities fraud issues require reversal of the Eighth Circuit's judgment on the mail fraud counts. [*11] O'Hagan's other arguments attacking the mail fraud convictions on alternate grounds, which have not been addressed by the Eighth Circuit, remain open for consideration on remand. Pp. 33-35.

<=16> 92 F.3d 612, reversed and remanded.

JUDGES: GINSBURG, J., delivered the opinion of the Court, in which STEVENS, O'CONNOR, KENNEDY, SOUTER, and BREYER, JJ., joined, and in Parts I, III, and IV of which SCALIA, J., joined. SCALIA, J., filed an opinion concurring in part and dissenting in part. THOMAS, J., filed an opinion concurring in the judgment in part and dissenting in part, in which REHNQUIST, C. J., joined.

OPINIONBY: GINSBURG

OPINION: JUSTICE GINSBURG delivered the opinion of the Court.

This case concerns the interpretation and enforcement of @ 10(b) and @ 14(e) of the Securities Exchange Act of 1934, and rules made by the Securities and Exchange Commission pursuant to these provisions, Rule 10b-5 and Rule 14e-3(a). Two prime questions are presented. The first relates to the misappropriation of material, nonpublic information for securities trading; the second concerns fraudulent practices in the tender offer setting. In particular, we address and resolve these issues: (1) Is a person who trades [*12] in securities for personal profit, using confidential information misappropriated in breach of a fiduciary duty to the source of the information, guilty of violating @ 10(b) and Rule 10b-5? (2) Did the Commission exceed its rulemaking authority by adopting Rule 14e-3(a), which proscribes trading on undisclosed information in the tender offer setting, even in the absence of a duty to disclose? Our answer to the first question is yes, and to the second question, viewed in the context of this case, no.

I

Respondent James Herman O'Hagan was a partner in the law firm of Dorsey & Whitney in Minneapolis, Minnesota. In July 1988, Grand Metropolitan PLC (Grand Met), a company based in London, England, retained Dorsey & Whitney as local counsel to represent Grand Met regarding a potential tender offer for the common stock of the Pillsbury Company, headquartered in Minneapolis. Both Grand Met and Dorsey & Whitney took precautions to protect the confidentiality of Grand Met's tender offer plans. O'Hagan did no work on the Grand Met representation. Dorsey & Whitney withdrew from representing Grand Met on September 9, 1988. Less than a month later, on October 4, 1988, Grand Met publicly announced [*13] its tender offer for Pillsbury stock.

On August 18, 1988, while Dorsey & Whitney was still representing Grand Met, O'Hagan began purchasing call options for Pillsbury stock. Each option gave him the right to purchase 100 shares of Pillsbury stock by a specified date in September 1988. Later in August and in September, O'Hagan made additional purchases of Pillsbury call options. By the end of September, he owned 2,500 unexpired Pillsbury options, apparently more than any other individual investor. See App. 85, 148. O'Hagan also purchased, in September 1988, some 5,000 shares of Pillsbury common stock, at a price just under $ 39 per share. When Grand Met announced its tender offer in October, the price of Pillsbury stock rose to nearly $ 60 per share. O'Hagan then sold his Pillsbury call options and common stock, making a profit of more than $ 4.3 million.

The Securities and Exchange Commission (SEC or Commission) initiated an investigation into O'Hagan's transactions, culminating in a 57-count indictment. The indictment alleged that O'Hagan defrauded his law firm and its client, Grand Met, by using for his own trading purposes material, nonpublic information regarding Grand Met's [*14] planned tender offer. Id., at 8. n1 According to the indictment, O'Hagan used the profits he gained through this trading to conceal his previous embezzlement and conversion of unrelated client trust funds. Id., at 10. n2 O'Hagan was charged with 20 counts of mail fraud, in violation of <=17> 18 U.S.C. @ 1341; 17 counts of securities fraud, in violation of @ 10(b) of the Securities Exchange Act of 1934 (Exchange Act), 48 Stat. 891, <=18> 15 U.S.C. @ 78j(b), and SEC Rule 10b-5, 17 CFR @ 240.10b-5 (1996); 17 counts of fraudulent trading in connection with a tender offer, in violation of @ 14(e) of the Exchange Act, <=19> 15 U.S.C. @ 78n(e), and SEC Rule 14e-3(a), 17 CFR @ 240.14e-3(a) (1996); and 3 counts of violating federal money laundering statutes, <=20> 18 U.S.C. @@ 1956(a)(1)(B)(i), 1957. See App. 13-24. A jury convicted O'Hagan on all 57 counts, and he was sentenced to a 1-month term of imprisonment.

------------------Footnotes------------------

n1 As evidence that O'Hagan traded on the basis of nonpublic information misappropriated from his law firm, the Government relied on a conversation between O'Hagan and the Dorsey & Whitney partner heading the firm's Grand Met representation. That conversation allegedly took place shortly before August

26, 1988. See Brief for United States 4. O'Hagan urges that the Government's evidence does not show he traded on the basis of nonpublic information. O'Hagan points to news reports on August 18 and 22, 1988, that Grand Met was interested in acquiring Pillsbury, and to an earlier, August 12, 1988, news report that Grand Met had put up its hotel chain for auction to raise funds for an acquisition. See Brief for Respondent 4 (citing App. 73-74, 78-80). O'Hagan's challenge to the sufficiency of the evidence remains open for consideration on remand. [*15]

n2 O'Hagan was convicted of theft in state court, sentenced to 30 months' imprisonment, and fined. See <=21> State v. O'Hagan, 474 N.W.2d 613, 615, 623 (Minn. App. 1991). The Supreme Court of Minnesota disbarred O'Hagan from the practice of law. See <=22> In re O'Hagan, 450 N.W.2d 571 (Minn. 1990).

-----------------End Footnotes-----------------

A divided panel of the Court of Appeals for the Eighth Circuit reversed all of O'Hagan's convictions. <=23> 92 F.3d 612 (1996). Liability under @ 10(b) and Rule 10b-5, the Eighth Circuit held, may not be grounded on the "misappropriation theory" of securities fraud on which the prosecution relied. <=24> Id., at 622. The Court of Appeals also held that Rule 14e-3(a)--which prohibits trading while in possession of material, nonpublic information relating to a tender offer--exceeds the SEC's @ 14(e) rulemaking authority because the rule contains no breach of fiduciary duty requirement. <=25> Id., at 627. The Eighth Circuit further concluded that O'Hagan's mail fraud and money laundering convictions rested on violations of the securities laws, and therefore could not stand once the securities fraud convictions [*16] were reversed. <=26> Id., at 627-628. Judge Fagg, dissenting, stated that he would recognize and enforce the misappropriation theory, and would hold that the SEC did not exceed its rulemaking authority when it adopted Rule 14e-3(a) without requiring proof of a breach of fiduciary duty. <=27> Id., at 628.

Decisions of the Courts of Appeals are in conflict on the propriety of the misappropriation theory under @ 10(b) and Rule 10b-5, see infra this page and n.3, and on the legitimacy of Rule 14e-3(a) under @ 14(e), see infra, at 25. We granted certiorari, 519 U.S. (1997), and now reverse the Eighth Circuit's judgment.

II

We address first the Court of Appeals' reversal of O'Hagan's convictions under @ 10(b) and Rule 10b-5. Following the Fourth Circuit's lead, see <=28> United States v. Bryan, 58 F.3d 933, 943-959 (1995), the Eighth Circuit rejected the misappropriation theory as a basis for @ 10(b) liability. We hold, in accord with several other Courts of Appeals, n3 that criminal liability under @ 10(b) may be predicated on the misappropriation theory. n4

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n3 See, e.g., <=29> United States v. Chestman, 947 F.2d 551, 566 (CA2 1991) (en banc), cert. denied, <=30> 503 U.S. 1004, 118 L. Ed. 2d 422, 112 S. Ct. 1759 (1992); <=31> SEC v. Cherif, 933 F.2d 403, 410 (CA7 1991), cert. denied, <=32> 502 U.S. 1071, 117 L. Ed. 2d 131, 112 S. Ct. 966 (1992); <=33> SEC v. Clark, 915 F.2d 439, 453 (CA9 1990). [*17]

n4 Twice before we have been presented with the question whether criminal liability for violation of @ 10(b) may be based on a misappropriation theory. In <=34> Chiarella v. United States, 445 U.S. 222, 235-237, 63 L. Ed. 2d 348, 100 S. Ct. 1108 (1980), the jury had received no misappropriation theory instructions, so we declined to address the question. See infra, at 17. In <=35> Carpenter v. United States, 484 U.S. 19, 24, 98 L. Ed. 2d 275, 108 S. Ct. 316 (1987), the Court divided evenly on whether, under the circumstances of that case, convictions resting on the misappropriation theory should be affirmed. See Aldave, The Misappropriation Theory: Carpenter and Its Aftermath, 49 Ohio St. L. J. 373, 375 (1988) (observing that "Carpenter was, by any reckoning, an unusual case," for the information there misappropriated belonged not to a company preparing to engage in securities transactions, e.g., a bidder in a corporate acquisition, but to the Wall Street Journal).

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A

In pertinent part, @ 10(b) of the Exchange Act provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate [*18] commerce or of the mails, or of any facility of any national securities exchange--

. . . . .

"(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 [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." <=36> 15 U.S.C. @ 78j(b).

The statute thus proscribes (1) using any deceptive device (2) in connection with the purchase or sale of securities, in contravention of rules prescribed by the Commission. The provision, as written, does not confine its coverage to deception of a purchaser or seller of securities, see <=37> United States v. Newman, 664 F.2d 12, 17 (CA2 1981); rather, the statute reaches any deceptive device used "in connection with the purchase or sale of any security."

Pursuant to its @ 10(b) rulemaking authority, the Commission has adopted Rule 10b-5, which, as relevant here, provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means [*19] or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

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

. . . . .

"(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 CFR @ 240.10b-5 (1996).

Liability under Rule 10b-5, our precedent indicates, does not extend beyond conduct encompassed by @ 10(b)'s prohibition. See <=38> Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214, 47 L. Ed. 2d 668, 96 S. Ct. 1375 (1976) (scope of Rule 10b-5 cannot exceed power Congress granted Commission under @ 10(b)); see also <=39> Central Bank of Denver, N. A. v. First Interstate Bank of Denver, N. A., 511 U.S. 164, 173, 128 L. Ed. 2d 119, 114 S. Ct. 1439 (1994) ("We have refused to allow [private] 10b-5 challenges to conduct not prohibited by the text of the statute.").

Under the "traditional" or "classical theory" of insider trading liability, @ 10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information. Trading on such information qualifies as [*20] a "deceptive device" under @ 10(b), we have affirmed, because "a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation." <=40> Chiarella v. United States, 445 U.S. 222, 228, 63 L. Ed. 2d 348, 100 S. Ct.

1108 (1980). That relationship, we recognized, "gives rise to a duty to disclose [or to abstain from trading] because of the 'necessity of preventing a corporate insider from . . . taking unfair advantage of . . . uninformed . . . stockholders.'" 41 Id., at 228-229 (citation omitted). The classical theory applies not only to officers, directors, and other permanent insiders of a corporation, but also to attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation. See =42 Dirks v. SEC, 463 U.S. 646, 655, n.14, 77 L. Ed. 2d 911, 103 S. Ct. 3255 (1983).

The "misappropriation theory" holds that a person commits fraud "in connection with" a securities transaction, and thereby violates @ 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. See Brief [*21] for United States 14. Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information. In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information.

The two theories are complementary, each addressing efforts to capitalize on nonpublic information through the purchase or sale of securities. The classical theory targets a corporate insider's breach of duty to shareholders with whom the insider transacts; the misappropriation theory outlaws trading on the basis of nonpublic information by a corporate "outsider" in breach of a duty owed not to a trading party, but to the source of the information. The misappropriation theory is thus designed to "protect the integrity of the securities markets against abuses by 'outsiders' to a corporation who have access to confidential information that will [*22] affect the corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders." Ibid.

In this case, the indictment alleged that O'Hagan, in breach of a duty of trust and confidence he owed to his law firm, Dorsey & Whitney, and to its client, Grand Met, traded on the basis of nonpublic information regarding Grand Met's planned tender offer for Pillsbury common stock. App. 16. This conduct, the Government charged, constituted a fraudulent device in connection with the purchase and sale of securities. n5

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n5 The Government could not have prosecuted O'Hagan under the classical theory, for O'Hagan was not an "insider" of Pillsbury, the corporation in whose stock he traded. Although an "outsider" with respect to Pillsbury, O'Hagan had an intimate association with, and was found to have traded on confidential information from, Dorsey & Whitney, counsel to tender offeror Grand Met. Under the misappropriation theory, O'Hagan's securities trading does not escape Exchange Act sanction, as it would under the dissent's reasoning, simply because he was associated with, and gained nonpublic information from, the bidder, rather than the target.

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[*23]

B

We agree with the Government that misappropriation, as just defined, satisfies @ 10(b)'s requirement that chargeable conduct involve a "deceptive device or contrivance" used "in connection with" the purchase or sale of securities. We observe, first, that misappropriators, as the Government describes them, deal in deception. A fiduciary who "[pretends] loyalty to the principal while secretly converting the principal's information for personal gain," Brief for United States 17, "dupes" or defrauds the principal. See Aldave, Misappropriation: A General Theory of Liability for Trading on Nonpublic Information, 13 Hofstra L. Rev. 101, 119 (1984).

We addressed fraud of the same species in <=43> Carpenter v. United States, 484 U.S. 19, 98 L. Ed. 2d 275, 108 S. Ct. 316 (1987), which involved the mail fraud statute's proscription of "any scheme or artifice to defraud," <=44> 18 U.S.C. @ 1341. Affirming convictions under that statute, we said in Carpenter that an employee's undertaking not to reveal his employer's confidential information "became a sham" when the employee provided the information to his co-conspirators in a scheme to obtain trading profits. <=45> 484 U.S. at 27. A company's confidential information, [*24] we recognized in Carpenter, qualifies as property to which the company has a right of exclusive use. <=46> Id., at 25-27. The undisclosed misappropriation of such information, in violation of a fiduciary duty, the Court said in Carpenter, constitutes fraud akin to embezzlement--"'the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another.'" <=47> Id., at 27 (quoting <=48> Grin v. Shine, 187 U.S. 181, 189, 47 L. Ed. 130, 23 S. Ct. 98 (1902)); see Aldave, 13 Hofstra L. Rev., at 119. Carpenter's discussion of the fraudulent misuse of confidential information, the Government notes, "is a particularly apt source of guidance here, because [the mail fraud statute] (like Section 10(b)) has long been held to require deception, not merely the breach of a fiduciary duty." Brief for United States 18, n.9 (citation omitted).

Deception through nondisclosure is central to the theory of liability for which the Government seeks recognition. As counsel for the Government stated in explanation of the theory at oral argument: "To satisfy the common law rule that a trustee may not use the property that [has] been entrusted [to] him, there would have to be consent. To satisfy [*25] the requirement of the Securities Act that there be no deception, there would only have to be disclosure." Tr. of Oral Arg. 12; see generally Restatement (Second) of Agency @@ 390, 395 (1958) (agent's disclosure obligation regarding use of confidential information). n6

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n6 Under the misappropriation theory urged in this case, the disclosure obligation runs to the source of the information, here, Dorsey & Whitney and Grand Met. Chief Justice Burger, dissenting in Chiarella, advanced a broader reading of @ 10(b) and Rule 10b-5; the disclosure obligation, as he envisioned it, ran to those with whom the misappropriator trades. <=49> 445 U.S. at 240 ("a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading"); see also <=50> id., at 243, n.4. The Government does not propose that we adopt a misappropriation theory of that breadth.

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The misappropriation theory advanced by the Government is consistent with <=51> Santa Fe Industries, Inc. v. Green, [*26] 430 U.S. 462, 51 L. Ed. 2d 480, 97 S. Ct. 1292 (1977), a decision underscoring that @ 10(b) is not an all-purpose breach of fiduciary duty ban; rather, it trains on conduct involving manipulation or deception. See <=52> id., at 473-476. In contrast to the Government's allegations in this case, in Santa Fe Industries, all pertinent facts were disclosed by the persons charged with violating @ 10(b) and Rule 10b-5, see <=53> id., at 474; therefore, there was no deception through nondisclosure to which liability under those provisions could attach, see <=54> id., at 476. Similarly, full disclosure forecloses liability under the misappropriation theory: Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no "deceptive device" and thus no @ 10(b) violation--although the fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty. n7

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n7 Where, however, a person trading on the basis of material, nonpublic information owes a duty of loyalty and confidentiality to two entities or persons--for example, a law firm and its client--but makes disclosure to only one, the trader may still be liable under the misappropriation theory.

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[*27]

We turn next to the @ 10(b) requirement that the misappropriator's deceptive use of information be "in connection with the purchase or sale of [a] security." This element is satisfied because the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities. The securities transaction and the breach of duty thus coincide. This is so even though the person or entity defrauded is not the other party to the trade, but is, instead, the source of the nonpublic information. See Aldave, 13 Hofstra L. Rev., at 120 ("a fraud or deceit can be practiced on one person, with resultant harm to another person or group of persons"). A misappropriator who trades on the basis of material, nonpublic information, in short, gains his advantageous market position through deception; he deceives the source of the information and simultaneously harms members of the investing public. See id., at 120-121, and n.107.

The misappropriation theory targets information of a sort that misappropriators ordinarily capitalize upon to gain no-risk profits through the purchase or [*28] sale of securities. Should a misappropriator put such information to other use, the statute's prohibition would not be implicated. The theory does not catch all conceivable forms of fraud involving confidential information; rather, it catches fraudulent means of capitalizing on such information through securities transactions.

The Government notes another limitation on the forms of fraud @ 10(b) reaches: "The misappropriation theory would not . . . apply to a case in which a person defrauded a bank into giving him a loan or embezzled cash from another, and then used the proceeds of the misdeed to purchase securities." Brief for United States 24, n.13. In such a case, the Government states, "the proceeds would have value to the malefactor apart from their use in a securities transaction, and the fraud would be complete as soon as the money was obtained." Ibid. In other words, money can buy, if not anything, then at least many things; its misappropriation may thus be viewed as sufficiently detached from a subsequent securities transaction that @ 10(b)'s "in connection with" requirement would not be met. Ibid.

The dissent's charge that the misappropriation theory is incoherent [*29] because information, like funds, can be put to multiple uses, see post, at 4-8, misses the point. The Exchange Act was enacted in part "to insure the maintenance of fair and honest markets," <=55> 15 U.S.C. @ 78b, and there is no question that fraudulent uses of confidential information fall within @ 10(b)'s prohibition if the fraud is "in connection with" a securities transaction. It is hardly remarkable that a rule suitably applied to the fraudulent uses of certain kinds of information would be stretched beyond reason were it applied to the fraudulent use of money.

The dissent does catch the Government in overstatement. Observing that money can be used for all manner of purposes and purchases, the Government urges that confidential information of the kind at issue derives its value only from its utility in securities trading. See Brief for United States 10, 21; post, at 4-6 (several times emphasizing the word "only"). Substitute "ordinarily" for "only," and the Government is on the mark. n8

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n8 The dissent's evident struggle to invent other uses to which O'Hagan plausibly might have put the nonpublic information, see post, at 7, is telling. It is imaginative to suggest that a trade journal would have paid O'Hagan dollars in the millions to publish his information. See Tr. of Oral Arg. 36-37. Counsel for O'Hagan hypothesized, as a nontrading use, that O'Hagan could have "misappropriated this information of [his] law firm and its client, delivered it to [Pillsbury], and suggested that [Pillsbury] in the future . . .

might find it very desirable to use [O'Hagan] for legal work." Id., at 37. But Pillsbury might well have had large doubts about engaging for its legal work a lawyer who so stunningly displayed his readiness to betray a client's confidence. Nor is the Commission's theory "incoherent" or "inconsistent," post, at 1, 14, for failing to inhibit use of confidential information for "personal amusement . . . in a fantasy stock trading game," post, at 7.

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Our recognition that the Government's "only" is an overstatement has provoked the dissent to cry "new theory." See post, at 9-11. But the very case on which the dissent relies, <=56> Motor Vehicle Mfrs. Assn. of United States, Inc. v. State Farm Mut. Automobile Ins. Co., 463 U.S. 29, 77 L. Ed. 2d 443, 103 S. Ct. 2856 (1983), shows the extremity of that charge. In State Farm, we reviewed an agency's rescission of a rule under the same "arbitrary and capricious" standard by which the promulgation of a rule under the relevant statute was to be judged, see <=57> id., at 41-42; in our decision concluding that the agency had not adequately explained its regulatory action, see <=58> id., at 57, we cautioned that a "reviewing court should not attempt itself to make up for such deficiencies," <=59> id., at 43. Here, by contrast, Rule 10b-5's promulgation has not been challenged; we consider only the Government's charge that O'Hagan's alleged fraudulent conduct falls within the prohibitions of the rule and @ 10(b). In this context, we acknowledge simply that, in defending the Government's interpretation of the rule and statute in this Court, the Government's lawyers have pressed a solid point too far, something lawyers, [*31] occasionally even judges, are wont to do.

The misappropriation theory comports with @ 10(b)'s language, which requires deception "in connection with the purchase or sale of any security," not deception of an identifiable purchaser or seller. The theory is also well-tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence. See 45 Fed. Reg. 60412 (1980) (trading on misappropriated information "undermines the integrity of, and investor confidence in, the securities markets"). Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law. An investor's informational disadvantage vis-a-vis a misappropriator with material, nonpublic information stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill. See Brudney, Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws, 93 Harv. L. Rev. 322, 356 (1979) ("If the market is thought to be systematically populated with . . . transactors [trading [*32] on the basis of misappropriated information] some investors will refrain from dealing altogether, and others will incur costs to avoid dealing with such transactors or corruptly to overcome their unerodable informational advantages."); Aldave, 13 Hofstra L. Rev., at 122-123.

In sum, considering the inhibiting impact on market participation of trading on misappropriated information, and the congressional purposes underlying @ 10(b), it makes scant sense to hold a lawyer like O'Hagan a @ 10(b) violator if he works for a law firm representing the target of a tender offer, but not if he works for a law firm representing the bidder. The text of the statute requires no such result. n9 The misappropriation at issue here was properly made the subject of a @ 10(b) charge because it meets the statutory requirement that there be "deceptive" conduct "in connection with" securities transactions.

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n9 As noted earlier, however, see supra, at 9-10, the textual requirement of deception precludes @ 10(b) liability when a person trading on the basis of nonpublic information has disclosed his trading plans to, or obtained authorization from, the principal--even though such conduct may affect the securities markets in the same manner as the conduct reached by the misappropriation theory. Contrary to the dissent's suggestion, see post, at 11-13, the fact that @ 10(b) is only a partial antidote to the problems it was designed to alleviate does not call into question its prohibition of conduct that falls within its textual proscription. Moreover, once a disloyal agent discloses his imminent breach of duty, his principal may seek appropriate equitable relief under state law. Furthermore, in the context of a tender offer, the principal who authorizes an agent's trading on confidential information may, in the Commission's view, incur liability for an Exchange Act violation under Rule 14e-3(a).

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C

The Court of Appeals rejected the misappropriation theory primarily on two grounds. First, as the Eighth Circuit comprehended the theory, it requires neither misrepresentation nor nondisclosure. See <=62> 92 F.3d at 618. As we just explained, however, see supra, at 8-10, deceptive nondisclosure is essential to the @ 10(b) liability at issue. Concretely, in this case, "it [was O'Hagan's] failure to disclose his personal trading to Grand Met and Dorsey, in breach of his duty to do so, that made his conduct 'deceptive' within the meaning of [@]10(b)." Reply Brief 7.

Second and "more obvious," the Court of Appeals said, the misappropriation theory is not moored to @ 10(b)'s requirement that "the fraud be 'in connection with the purchase or sale of any security.'" See <=63> 92 F.3d at 618 (quoting <=64> 15 U.S.C. @ 78j(b)). According to the Eighth Circuit, three of our decisions reveal that @ 10(b) liability cannot be predicated on a duty owed to the source of nonpublic information: <=65> Chiarella v. United States, 445 U.S. 222, 63 L. Ed. 2d 348, 100 S. Ct. 1108 (1980); <=66> Dirks v. SEC, 463 U.S. 646, 77 L. Ed. 2d 911, 103 S. Ct. 3255 (1983); and <=67> Central Bank of Denver, N. A. v. First Interstate Bank of Denver, N. A., 511 U.S. 164, 128 L. Ed. 2d 119, 114 S. Ct. 1439 [*34] (1994). "Only a breach of a duty to parties to the securities transaction," the Court of Appeals concluded, "or, at the most, to other market participants such as investors, will be sufficient to give rise to @ 10(b) liability." <=68> 92 F.3d at 618. We read the statute and our precedent differently, and note again that @ 10(b) refers to "the purchase or sale of any security," not to identifiable purchasers or sellers of securities.

Chiarella involved securities trades by a printer employed at a shop that printed documents announcing corporate takeover bids. See <=69> 445 U.S. at 224. Deducing the names of target companies from documents he handled, the printer bought shares of the targets before takeover bids were announced, expecting (correctly) that the share prices would rise upon announcement. In these transactions, the printer did not disclose to the sellers of the securities (the target companies' shareholders) the nonpublic information on which he traded. See ibid. For that trading, the printer was convicted of violating @ 10(b) and Rule 10b-5. We reversed the Court of Appeals judgment that had affirmed the conviction. See <=70> id., at 225.

The jury in Chiarella had [*35] been instructed that it could convict the defendant if he willfully failed to inform sellers of target company securities that he knew of a takeover bid that would increase the value of their shares. See <=71> id., at 226. Emphasizing that the printer had no agency or other fiduciary relationship with the sellers, we held that liability could not be imposed on so broad a theory. See <=72> id., at 235. There is under @ 10(b), we explained, no "general duty between all participants in market transactions to forgo actions based on material, nonpublic information." <=73> Id., at 233. Under established doctrine, we said, a duty to disclose or abstain from trading "arises from a specific relationship between two parties." Ibid.

The Court did not hold in Chiarella that the only relationship prompting liability for trading on undisclosed information is the relationship between a corporation's insiders and shareholders. That is evident from our response to the Government's argument before this Court that the printer's misappropriation of information from his employer for purposes of securities trading--in violation of a duty of confidentiality owed to the acquiring companies--constituted [*36] fraud in connection with the purchase or sale of a security, and thereby satisfied the terms of @ 10(b). <=74> Id., at 235-236. The Court declined to reach that potential basis for the printer's liability, because the theory had not been submitted to the jury. See <=75> id., at 236-237. But four Justices found merit in it. See <=76> id., at 239 (Brennan, J., concurring in judgment); <=77> id., at 240-243 (Burger, C. J., dissenting); <=78> id., at 245 (Blackmun, J., joined by Marshall, J., dissenting). And a fifth Justice stated that the Court "wisely left the resolution of this issue for another day." <=79> Id., at 238 (STEVENS, J., concurring).

Chiarella thus expressly left open the misappropriation theory before us today. Certain statements in Chiarella, however, led the Eighth Circuit in the instant case to conclude that @ 10(b) liability hinges exclusively on a breach of duty owed to a purchaser or seller of securities. See <=80> 92 F.3d at 618. The Court said in Chiarella that @ 10(b) liability "is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction," <=81> 445 U.S. at 230 (emphasis added), and observed that the [*37] printshop employee defendant in that case "was not a person in whom the sellers had placed their trust and confidence," see <=82> id., at 232. These statements rejected the notion that @ 10(b) stretches so far as to impose "a general duty between all participants in market transactions to forgo actions based on material, nonpublic information," <=83> id., at 233, and we confine them to that context. The statements highlighted by the Eighth Circuit, in short, appear in an opinion carefully leaving for future resolution the validity of the misappropriation theory, and therefore cannot be read to foreclose that theory.

Dirks, too, left room for application of the misappropriation theory in cases like the one we confront. n10 Dirks involved an investment analyst who had received information from a former insider of a corporation with which the analyst had no connection. See <=84> 463 U.S. at 648-649. The information indicated that the corporation had engaged in a massive fraud. The analyst investigated the fraud, obtaining corroborating information from employees of the corporation. During his investigation, the analyst discussed his findings with clients and investors, some of whom [*38] sold their holdings in the company the analyst suspected of gross wrongdoing. See <=85> id., at 649.

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n10 The Eighth Circuit's conclusion to the contrary was based in large part on Dirks's reiteration of the Chiarella language quoted and discussed above. See <=86> 92 F.3d 612, 618-619 (1996).

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The SEC censured the analyst for, inter alia, aiding and abetting @ 10(b) and Rule 10b-5 violations by clients and investors who sold their holdings based on the nonpublic information the analyst passed on. See <=87> id., at 650-652. In the SEC's view, the analyst, as a "tippee" of corporation insiders, had a duty under @ 10(b) and Rule 10b-5 to refrain from communicating the nonpublic information to persons likely to trade on the basis of it. See <=88> id., at 651, 655-656. This Court found no such obligation, see <=89> id., at 665-667, and repeated the key point made in Chiarella: There is no "'general duty between all participants in market transactions to forgo actions based on material, nonpublic information.'" [*39] <=90> Id., at 655 (quoting <=91> Chiarella, 445 U.S. at 233); see Aldave, 13 Hofstra L. Rev., at 122 (misappropriation theory bars only "trading on the basis of information that the wrongdoer converted to his own use in violation of some fiduciary, contractual, or similar obligation to the owner or rightful possessor of the information").

No showing had been made in Dirks that the "tippers" had violated any duty by disclosing to the analyst nonpublic information about their former employer. The insiders had acted not for personal profit, but to expose a massive fraud within the corporation. See <=92> Dirks, 463 U.S. at 666-667. Absent any violation by the tippers, there could be no derivative liability for the tippee. See <=93> id., at 667. Most important for purposes of the instant case, the Court observed in Dirks: "There was no expectation by [the analyst's] sources that he would keep their information in confidence. Nor did [the analyst] misappropriate or illegally obtain the information . . . ." <=94> Id., at 665. Dirks thus presents no suggestion that a person who gains nonpublic information through misappropriation in breach of a fiduciary duty escapes @ 10(b) liability [*40] when, without alerting the source, he trades on the information.

Last of the three cases the Eighth Circuit regarded as warranting disapproval of the misappropriation theory, Central Bank held that "a private plaintiff may not maintain an aiding and abetting suit under @ 10(b)." <=95> 511 U.S. at 191. We immediately cautioned in Central Bank that secondary actors in the securities markets may sometimes be chargeable under the securities Acts: "Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming . . . the requirements for primary liability under Rule 10b-5 are met." Ibid. (emphasis added). The Eighth Circuit isolated the statement just quoted and drew from it the conclusion that @ 10(b) covers only deceptive statements or omissions on which purchasers and sellers, and perhaps other market participants, rely. See <=96> 92 F.3d at 619. It is evident from the question presented in Central Bank, however, that this Court, in the quoted passage, sought only to clarify that secondary [*41] actors, although not subject to aiding and abetting liability, remain subject to primary liability under @ 10(b) and Rule 10b-5 for certain conduct.

Furthermore, Central Bank's discussion concerned only private civil litigation under @ 10(b) and Rule 10b-5, not criminal liability. Central Bank's reference to purchasers or sellers of securities must be read in light of a longstanding limitation on private @ 10(b) suits. In <=97> Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 44 L. Ed. 2d 539, 95 S. Ct. 1917 (1975), we held that only actual purchasers or sellers of securities may maintain a private civil action under @ 10(b) and Rule 10b-5. We so confined the @ 10(b) private right of action because of "policy considerations." <=98> Id., at 737. In particular, Blue Chip Stamps recognized the abuse potential and proof problems inherent in suits by investors who neither bought nor sold, but asserted they would have traded absent fraudulent conduct by others. See <=99> id., at 739-747; see also <=100> Holmes v. Securities Investor Protection Corporation, 503 U.S. 258, 285, 117 L. Ed. 2d 532, 112 S. Ct. 1311 (1992) (O'CONNOR, J., concurring in part and concurring in judgment); <=101> id., at 289-290 (SCALIA, J., concurring in judgment). [*42] Criminal prosecutions do not present the dangers the Court addressed in Blue Chip Stamps, so that decision is "inapplicable" to indictments for violations of @ 10(b) and Rule 10b-5. <=102> United States v. Naftalin, 441 U.S. 768, 774, n.6, 60 L. Ed. 2d 624, 99 S. Ct. 2077 (1979); see also <=103> Holmes, 503 U.S. at 281 (O'CONNOR, J., concurring in part and concurring in judgment) ("The purchaser/seller standing requirement for private civil actions under @ 10(b) and Rule 10b-5 is of no import in criminal prosecutions for willful violations of those provisions.").

In sum, the misappropriation theory, as we have examined and explained it in this opinion, is both consistent with the statute and with our precedent. n11 Vital to our decision that criminal liability may be sustained under the misappropriation theory, we emphasize, are two sturdy safeguards Congress has provided regarding scienter. To establish a criminal violation of Rule 10b-5, the Government must prove that a person "willfully" violated the provision. See <=104> 15 U.S.C. @ 78ff(a). n12 Furthermore, a defendant may not be imprisoned for violating Rule 10b-5 if he proves that he had no knowledge of the rule. See ibid. n13 O'Hagan's charge that [*43] the misappropriation theory is too indefinite to permit the imposition of criminal liability, see Brief for Respondent 30-33, thus fails not only because the theory is limited to those who breach a recognized duty. In addition, the statute's "requirement of the presence of culpable intent as a necessary element of the offense does much to destroy any force in the argument that application of the [statute]" in circumstances such as O'Hagan's is unjust. <=105> Boyce Motor Lines, Inc. v. United States, 342 U.S. 337, 342, 96 L. Ed. 367, 72 S. Ct. 329 (1952).

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n11 The United States additionally argues that Congress confirmed the validity of the misappropriation theory in the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), @ 2(1), 102 Stat. 4677, note following <=106> 15 U.S.C. @ 78u-1. See Brief for United States 32-35. ITSFEA declares that "the rules and regulations of the Securities and Exchange Commission under the Securities Exchange Act of 1934 . . . governing trading while in possession of material, nonpublic information are, as required by such Act, necessary and appropriate in the public interest and for the protection of investors." Note following <=107> 15 U.S.C. @ 78u-1. ITSFEA also includes a new @ 20A(a) of the Exchange Act expressly providing a private cause of action against persons who violate the Exchange Act "by purchasing or selling a security while in possession of material, nonpublic information"; such an action may be brought by "any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased . . . or sold . . . securities of the same class." <=108> 15 U.S.C. @ 78t-1(a). Because we uphold the misappropriation theory on the basis of @ 10(b) itself, we do not address ITSFEA's significance for cases of this genre. [*44]

n12 In relevant part, @ 32 of the Exchange Act, as set forth in <=109> 15 U.S.C. @ 78ff(a), provides:

"Any person who willfully violates any provision of this chapter . . . or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this chapter . . . shall upon conviction be fined not more than $ 1,000,000, or imprisoned not more than 10 years, or both . . .; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation."

n13 The statute provides no such defense to imposition of monetary fines. See ibid.

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The Eighth Circuit erred in holding that the misappropriation theory is inconsistent with @ 10(b). The Court of Appeals may address on remand O'Hagan's other challenges to his convictions under @ 10(b) and Rule 10b-5.

III

We consider next the ground on which the Court of Appeals reversed O'Hagan's convictions for fraudulent trading in connection with a tender offer, in violation of @ 14(e) of the [*45] Exchange Act and SEC Rule 14e-3(a). A sole question is before us as to these convictions: Did the Commission, as the Court of Appeals held, exceed its rulemaking authority under @ 14(e) when it adopted Rule 14e-3(a) without requiring a showing that the trading at issue entailed a breach of fiduciary duty? We hold that the Commission, in this regard and to the extent relevant to this case, did not exceed its authority.

The governing statutory provision, @ 14(e) of the Exchange Act, reads in relevant part:

"It shall be unlawful for any person . . . to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer . . . . The [SEC] shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative." <=110> 15 U.S.C. @ 78n(e).

Section 14(e)'s first sentence prohibits fraudulent acts in connection with a tender offer. This self-operating proscription was one of several provisions added to the Exchange Act in 1968 by the Williams Act, 82 Stat. 454. The section's second sentence delegates definitional and prophylactic [*46] rulemaking authority to the Commission. Congress added this rulemaking delegation to @ 14(e) in 1970 amendments to the Williams Act. See @ 5, 84 Stat. 1497.

Through @ 14(e) and other provisions on disclosure in the Williams Act, n14 Congress sought to ensure that shareholders "confronted by a cash tender offer for their stock [would] not be required to respond without adequate information." <=111> Rondeau v. Mosinee Paper Corp., 422 U.S. 49, 58, 45 L. Ed. 2d 12, 95 S. Ct. 2069 (1975); see <=112> Lewis v. McGraw, 619 F.2d 192, 195 (CA2 1980) (per curiam) ("very purpose" of Williams Act was "informed decisionmaking by shareholders"). As we recognized in <=113> Schreiber v. Burlington Northern, Inc., 472 U.S. 1, 86 L. Ed. 2d 1, 105 S. Ct. 2458 (1985), Congress designed the Williams Act to make "disclosure, rather than court-imposed principles of 'fairness' or 'artificiality,' . . . the preferred method of market regulation." <=114> Id., at 9, n.8. Section 14(e), we explained, "supplements the more precise disclosure provisions found elsewhere in the Williams Act, while requiring disclosure more explicitly addressed to the tender offer context than that required by @ 10(b)." <=115> Id., at 10-11.

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n14 In addition to @ 14(e), the Williams Act and the 1970 amendments added to the Exchange Act the following provisions concerning disclosure: @ 13(d), <=116> 15 U.S.C. @ 78m(d) (disclosure requirements for persons acquiring more than five percent of certain classes of securities); @ 13(e), <=117> 15 U.S.C. @ 78m(e) (authorizing Commission to adopt disclosure requirements for certain repurchases of securities by issuer); @ 14(d), <=118> 15 U.S.C. @ 78n(d) (disclosure requirements when tender offer results in offeror owning more than five percent of a class of securities); @ 14(f), <=119> 15 U.S.C. @ 78n(f) (disclosure requirements when tender offer results in new corporate directors constituting a majority).

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Relying on @ 14(e)'s rulemaking authorization, the Commission, in 1980, promulgated Rule 14e-3(a). That measure provides:

"(a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the 'offering person'), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the [Exchange] Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:

"(1) The offering person,

"(2) The issuer of the securities sought or to be sought by such tender offer, or

"(3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source [*48] are publicly disclosed by press release or otherwise." 17 CFR @ 240.14e-3(a) (1996).

As characterized by the Commission, Rule 14e-3(a) is a "disclose or abstain from trading" requirement. 45 Fed. Reg. 60410 (1980). n15 The Second Circuit concisely described the rule's thrust:

"One violates Rule 14e-3(a) if he trades on the basis of material nonpublic information concerning a pending tender offer that he knows or has reason to know has been acquired 'directly or indirectly' from an insider of the offeror or issuer, or someone working on their behalf. Rule 14e-3(a) is a disclosure provision. It creates a duty in those traders who fall within its ambit to abstain or disclose, without regard to whether the trader owes a pre-existing fiduciary duty to respect the confidentiality of the information." [*49] <=121> United States v. Chestman, 947 F.2d 551, 557 (1991) (en banc) (emphasis added), cert. denied, <=122> 503 U.S. 1004, 118 L. Ed. 2d 422, 112 S. Ct. 1759 (1992).

See also <=123> SEC v. Maio, 51 F.3d 623, 635 (CA7 1995) ("Rule 14e-3 creates a duty to disclose material non-public information, or abstain from trading in stocks implicated by an impending tender offer, regardless of whether such information was obtained through a breach of fiduciary duty.") (emphasis added); <=124> SEC v. Peters, 978 F.2d 1162, 1165 (CA10 1992) (as written, Rule 14e-3(a) has no fiduciary duty requirement).

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n15 The rule thus adopts for the tender offer context a requirement resembling the one Chief Justice Burger would have adopted in Chiarella for misappropriators under @ 10(b). See supra, at 10, n.6.

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-In the Eighth Circuit's view, because Rule 14e-3(a) applies whether or not the trading in question breaches a fiduciary duty, the regulation exceeds the SEC's @ 14(e) rulemaking authority. See <=125> 92 F.3d at 624, 627. Contra, <=126> Maio, 51 F.3d at 634-635 (CA7); <=127> Peters, 978 F.2d at 1165-1167 (CA10); <=128> Chestman, 947 F.2d at 556-563 (CA2) (all holding Rule 14e-3(a) a proper exercise of SEC's statutory authority). In support of its holding, the Eighth Circuit relied on the text of @ 14(e) and our decisions in Schreiber and <=129> Chiarella. See 92 F.3d at 624-627.

The Eighth Circuit homed in on the essence of [*50] @ 14(e)'s rulemaking authorization: "The statute empowers the SEC to 'define' and 'prescribe means reasonably designed to prevent' 'acts and practices' which are 'fraudulent.'" <=130> Id., at 624. All that means, the Eighth Circuit found plain, is that the SEC may "identify and regulate," in the tender offer context, "acts and practices" the law already defines as "fraudulent"; but, the Eighth Circuit maintained, the SEC may not "create its own definition of fraud." Ibid. (internal quotation marks omitted).

This Court, the Eighth Circuit pointed out, held in Schreiber that the word "manipulative" in the @ 14(e) phrase "fraudulent, deceptive, or manipulative acts or practices" means just what the word means in @ 10(b): Absent misrepresentation or nondisclosure, an act cannot be indicted as manipulative. See <=131> 92 F.3d at 625 (citing <=132> Schreiber, 472 U.S. at 7-8, and n.6). Section 10(b) interpretations guide construction of @ 14(e), the Eighth Circuit added, see <=133> 92 F.3d at 625, citing this Court's acknowledgment in Schreiber that @ 14(e)'s "'broad antifraud prohibition' . . . [is] modeled on the antifraud provisions of @ 10(b) . . . and Rule 10b-5," <=134> 472 U.S. at 10 [*51] (citation omitted); see <=135> id., at 10-11, n.10.

For the meaning of "fraudulent" under @ 10(b), the Eighth Circuit looked to <=136> Chiarella. See 92 F.3d at 625. In that case, the Eighth Circuit recounted, this Court held that a failure to disclose information could be "fraudulent" under @ 10(b) only when there was a duty to speak arising out of "'a fiduciary or other similar relationship of trust and confidence.'" <=137> Chiarella, 445 U.S. at 228 (quoting Restatement (Second) of Torts @ 551(2)(a) (1976)). Just as @ 10(b) demands a showing of a breach of fiduciary duty, so such a breach is necessary to make out a @ 14(e) violation, the Eighth Circuit concluded.

As to the Commission's @ 14(e) authority to "prescribe means reasonably designed to prevent" fraudulent acts, the Eighth Circuit stated: "Properly read, this provision means simply that the SEC has broad regulatory powers in the field of tender offers, but the statutory terms have a fixed meaning which the SEC cannot alter by way of an administrative rule." <=138> 92 F.3d at 627.

The United States urges that the Eighth Circuit's reading of @ 14(e) misapprehends both the Commission's authority to define fraudulent [*52] acts and the Commission's power to prevent them. "The 'defining' power," the United States submits, "would be a virtual nullity were the SEC not permitted to go beyond common law fraud (which is separately prohibited in the first [self-operative] sentence of Section 14(e))." Brief for United States 11; see id., at 37. In maintaining that the Commission's power to define fraudulent acts under @ 14(e) is broader than its rulemaking power under @ 10(b), the United States questions the Court of Appeals' reading of Schreiber. See id., at 38-40. Parenthetically, the United States notes that the word before the Schreiber Court was "manipulative"; unlike "fraudulent," the United States observes, "'manipulative' . . . is 'virtually a term of art when used in connection with the securities markets.'" Id., at 38, n.20 (quoting <=139> Schreiber, 472 U.S. at 6). Most tellingly, the United States submits, Schreiber involved acts alleged to violate the self-operative provision in @ 14(e)'s first sentence, a sentence containing language similar to @ 10(b). But @ 14(e)'s second sentence, containing the rulemaking authorization, the United States points out, does not [*53] track @ 10(b), which simply authorizes the SEC to proscribe "manipulative or deceptive devices or contrivances." Brief for United States 38. Instead, @ 14(e)'s rulemaking prescription tracks @ 15(c)(2)(D) of the Exchange Act, <=140> 15 U.S.C. @ 78o(c)(2)(D), which concerns the conduct of broker-dealers in over-the-counter markets. See Brief for United States 38-39. Since 1938, see 52 Stat. 1075, @ 15(c)(2) has given the Commission authority to "define, and prescribe means reasonably designed to prevent, such [broker-dealer] acts and practices as are fraudulent, deceptive, or manipulative." <=141> 15 U.S.C. @ 78o(c)(2)(D). When Congress added this same rulemaking language to @ 14(e) in 1970, the Government states, the Commission had already used its @ 15(c)(2) authority to reach beyond common law fraud. See Brief for United States 39, n.22. n16

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n16 The Government draws our attention to the following measures: 17 CFR @ 240.15c2-1 (1970) (prohibiting a broker-dealer's hypothecation of a customer's securities if hypothecated securities would be commingled with the securities of another customer, absent written consent); @ 240.15c2-3 (1970) (prohibiting transactions by broker-dealers in unvalidated German securities); @ 240.15c2-4 (1970) (prohibiting broker-dealers from accepting any part of the sale price of a security being distributed unless the money received is promptly transmitted to the persons entitled to it); @ 240.15c2-5 (1970) (requiring broker-dealers to provide written disclosure of credit terms and commissions in connection with securities sales in which broker-dealers extend credit, or participate in arranging for loans, to the purchasers). See Brief for United States 39, n.22.

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We need not resolve in this case whether the Commission's authority under @ 14(e) to "define . . . such acts and practices as are fraudulent" is broader than the Commission's fraud-defining authority under @ 10(b), for we agree with the United States that Rule 14e-3(a), as applied to cases of this genre, qualifies under @ 14(e) as a "means reasonably designed to prevent" fraudulent trading on material, nonpublic information in the tender offer context. n17 A prophylactic measure, because its mission is to prevent, typically encompasses more than the core activity prohibited. As we noted in Schreiber, @ 14(e)'s rulemaking authorization gives the Commission "latitude," even in the context of a term of art like "manipulative," "to regulate nondeceptive activities as a 'reasonably designed' means of preventing manipulative acts, without suggesting any change in the meaning of the term 'manipulative' itself." <=142> 472 U.S. at 11, n.11. We hold, accordingly, that under @ 14(e), the Commission may prohibit acts, not themselves fraudulent under the common law or @ 10(b), if the prohibition is "reasonably designed to prevent . . . acts and practices [that] are fraudulent." <=143> 15 U. [*55] S. C. @ 78n(e). n18

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n17 We leave for another day, when the issue requires decision, the legitimacy of Rule 14e-3(a) as applied to "warehousing," which the Government describes as "the practice by which bidders leak advance information of a tender offer to allies and encourage them to purchase the target company's stock before the bid is announced." Reply Brief 17. As we observed in Chiarella, one of the Commission's purposes in proposing Rule 14e-3(a) was "to bar warehousing under its authority to regulate tender offers." <=144> 445 U.S. at 234. The Government acknowledges that trading authorized by a principal breaches no fiduciary duty. See Reply Brief 17. The instant case, however, does not involve trading authorized by a principal; therefore, we need not here decide whether the Commission's proscription of warehousing falls within its @ 14(e) authority to define or prevent fraud.

n18 The Commission's power under @ 10(b) is more limited. See supra, at 6 (Rule 10b-5 may proscribe only conduct that @ 10(b) prohibits).

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Because Congress has authorized the Commission, in @ 14(e), to prescribe legislative rules, we owe the Commission's judgment "more than mere deference or weight." =145 Batterton v. Francis, 432 U.S. 416, 424-426, 53 L. Ed. 2d 448, 97 S. Ct. 2399 (1977). Therefore, in determining whether Rule 14e-3(a)'s "disclose or abstain from trading" requirement is reasonably designed to prevent fraudulent acts, we must accord the Commission's assessment "controlling weight unless [it is] arbitrary, capricious, or manifestly contrary to the statute." <=146> Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 844, 81 L. Ed. 2d 694, 104 S. Ct. 2778 (1984). In this case, we conclude, the Commission's assessment is none of these. n19

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n19 The dissent urges that the Commission must be precise about the authority it is exercising--that it must say whether it is acting to "define" or to "prevent" fraud--and that in this instance it has purported only to define, not to prevent. See post, at 18-19. The dissent sees this precision in Rule 14e-3(a)'s words: "it shall constitute a fraudulent . . . act . . . within the meaning of section 14(e) . . . ." We do not find the Commission's rule vulnerable for failure to recite as a regulatory preamble: We hereby exercise our authority to "define, and prescribe means reasonably designed to prevent, . . . [fraudulent] acts." Sensibly read, the rule is an exercise of the Commission's full authority. Logically and practically, such a rule may be conceived and defended, alternatively, as definitional or preventive.

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In adopting the "disclose or abstain" rule, the SEC explained:

"The Commission has previously expressed and continues to have serious concerns about trading by persons in possession of material, nonpublic information relating to a tender offer. This practice results in unfair disparities in market information and market disruption. Security holders who purchase from or sell to such persons are effectively denied the benefits of disclosure and the substantive protections of the Williams Act. If furnished with the information, these security holders would be able to make an informed investment decision, which could involve deferring the purchase or sale of the securities until the material information had been disseminated or until the tender offer has been commenced or terminated." 45 Fed. Reg. 60412 (1980) (footnotes omitted).

The Commission thus justified Rule 14e-3(a) as a means necessary and proper to assure the efficacy of Williams Act protections.

The United States emphasizes that Rule 14e-3(a) reaches trading in which "a breach of duty is likely but difficult to prove." Reply Brief 16. "Particularly in the context of a tender offer," as the Tenth Circuit recognized, "there [*58] is a fairly wide circle of people with confidential information." <=148> Peters, 978 F.2d at 1167, notably, the attorneys, investment bankers, and accountants involved in structuring the transaction. The availability of that information may lead to abuse, for "even a hint of an upcoming tender offer may send the price of the target company's stock soaring." <=149> SEC v. Materia, 745 F.2d 197, 199 (CA2 1984). Individuals entrusted with nonpublic information, particularly if they have no long-term loyalty to the issuer, may find the temptation to trade on that information hard to resist in view of "the very large short-term profits potentially available [to them]." <=150> Peters, 978 F.2d at 1167.

"It may be possible to prove circumstantially that a person [traded on the basis of material, nonpublic information], but almost impossible to prove that the trader obtained such information in breach of a fiduciary duty owed either by the trader or by the ultimate insider source of the information." Ibid. The example of a "tippee" who trades on information received from an insider illustrates the problem. Under Rule 10b-5, "a tippee assumes a fiduciary duty to the shareholders of [*59] a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach." <=151> Dirks, 463 U.S. at 660. To show that a tippee who traded on nonpublic information about a tender offer had breached a fiduciary duty would require proof not only that the insider source breached a fiduciary duty, but that the tippee knew or should have known of that breach. "Yet, in most cases, the only parties to the [information transfer] will be the insider and the alleged tippee." <=152> Peters, 978 F.2d at 1167. n20

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n20 The dissent opines that there is no reason to anticipate difficulties in proving breach of duty in "misappropriation" cases. "Once the source of the [purloined] information has been identified," the dissent asserts, "it should be a simple task to obtain proof of any breach of duty." Post, at 20. To test that assertion, assume a misappropriating partner at Dorsey & Whitney told his daughter or son and a wealthy friend that a tender for Pillsbury was in the offing, and each tippee promptly purchased Pillsbury stock, the child borrowing the purchase price from the wealthy friend. The dissent's confidence, post, at 20, n.12, that "there is no reason to suspect that the tipper would gratuitously protect the tippee," seems misplaced.

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In sum, it is a fair assumption that trading on the basis of material, nonpublic information will often involve a breach of a duty of confidentiality to the bidder or target company or their representatives. The SEC, cognizant of the proof problem that could enable sophisticated traders to escape responsibility, placed in Rule 14e-3(a) a "disclose or abstain from trading" command that does not require specific proof of a breach of fiduciary duty. That prescription, we are satisfied, applied to this case, is a "means reasonably designed to prevent" fraudulent trading on material, nonpublic information in the tender offer context. See <=153> Chestman, 947 F.2d at 560 ("While dispensing with the subtle problems of proof associated with demonstrating fiduciary breach in the problematic area of tender offer insider trading, [Rule 14e-3(a)] retains a close nexus between the prohibited conduct and the statutory aims."); accord, <=154> Maio, 51 F.3d at 635, and n.14; <=155> Peters, 978 F.2d at 1167. n21 Therefore, insofar as it serves to prevent the type of misappropriation charged against O'Hagan, Rule 14e-3(a) is a proper exercise of the Commission's prophylactic power under @ 14(e). n22 [*61]

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n21 The dissent insists that even if the misappropriation of information from the bidder about a tender offer is fraud, the Commission has not explained why such fraud is "in connection with" a tender offer. Post, at 19. What else, one can only wonder, might such fraud be "in connection with"?

n22 Repeating the argument it made concerning the misappropriation theory, see supra, at 21, n.11, the United States urges that Congress confirmed Rule 14e-3(a)'s validity in ITSFEA. <=156> 15 U.S.C. @ 78u-1. See Brief for United States 44-45. We uphold Rule 14e-3(a) on the basis of @ 14(e) itself and need not address ITSFEA's relevance to this case.

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As an alternate ground for affirming the Eighth Circuit's judgment, O'Hagan urges that Rule 14e-3(a) is invalid because it prohibits trading in advance of a tender offer--when "a substantial step . . . to commence" such an offer has been taken--while @ 14(e) prohibits fraudulent acts "in connection with any tender offer." See Brief for Respondent 41-42. O'Hagan [*62] further contends that, by covering pre-offer conduct, Rule 14e-3(a) "fails to comport with due process on two levels": The rule does not "give fair notice as to when, in advance of a tender offer, a violation of @ 14(e) occurs," id., at 42; and it "disposes of any scienter requirement," id., at 43. The Court of Appeals did not address these arguments, and O'Hagan did not raise the due process points in his briefs before that court. We decline to consider these contentions in the first instance. n23 The Court of Appeals may address on remand any arguments O'Hagan has preserved.

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n23 As to O'Hagan's scienter argument, we reiterate that <=157> 15 U.S.C. @ 78ff(a) requires the Government to prove "willfull violation" of the securities laws, and that lack of knowledge of the relevant rule is an affirmative defense to a sentence of imprisonment. See supra, at 21-22.

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IV

Based on its dispositions of the securities fraud convictions, the Court of Appeals also reversed O'Hagan's convictions, under <=158> 18 U.S.C. [*63] @ 1341, for mail fraud. See <=159> 92 F.3d at 627-628. Reversal of the securities convictions, the Court of Appeals recognized, "did not as a matter of law require that the mail fraud convictions likewise be reversed." <=160> Id., at 627 (citing <=161> Carpenter, 484 U.S. at 24, in which this Court unanimously affirmed mail and wire fraud convictions based on the same conduct that evenly divided the Court on the defendants' securities fraud convictions). But in this case, the Court of Appeals said, the indictment was so structured that the mail fraud charges could not be disassociated from the securities fraud charges, and absent any securities fraud, "there was no fraud upon which to base the mail fraud charges." <=162> 92 F.3d at 627-628. n24

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n24 The Court of Appeals reversed respondent's money laundering convictions on similar reasoning. See <=163> 92 F.3d at 628. Because the United States did not seek review of that ruling, we leave undisturbed that portion of the Court of Appeals' judgment.

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The United States urges that the [*64] Court of Appeals' position is irreconcilable with Carpenter: Just as in Carpenter, so here, the "mail fraud charges are independent of [the] securities fraud charges, even [though] both rest on the same set of facts." Brief for United States 46-47. We need not linger over this matter, for our rulings on the securities fraud issues require that we reverse the Court of Appeals judgment on the mail fraud counts as well. n25

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n25 The dissent finds O'Hagan's convictions on the mail fraud counts, but not on the securities fraud counts, sustainable. Post, at 23-24. Under the dissent's view, securities traders like O'Hagan would escape SEC civil actions and federal prosecutions under legislation targeting securities fraud, only to be caught for their trading activities in the broad mail fraud net. If misappropriation theory cases could proceed only under the federal mail and wire fraud statutes, practical consequences for individual defendants might not be large, see Aldave, 49 Ohio St. L. J., at 381, and n.60; however, "proportionally more persons accused of insider trading [might] be pursued by a U.S. Attorney, and proportionally fewer by the SEC." id., at 382. Our decision, of course, does not rest on such enforcement policy considerations.

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[*65]

O'Hagan, we note, attacked the mail fraud convictions in the Court of Appeals on alternate grounds; his other arguments, not yet addressed by the Eighth Circuit, remain open for consideration on remand.

* * *

The judgment of the Court of Appeals for the Eighth Circuit is reversed, and the case is remanded for further proceedings consistent with this opinion.

It is so ordered.

CONCURBY: SCALIA (In Part); THOMAS (In Part)

DISSENTBY: SCALIA (In Part); THOMAS (In Part)

DISSENT: JUSTICE SCALIA, concurring in part and dissenting in part.

I join Parts I, III, and IV of the Court's opinion. I do not agree, however, with Part II of the Court's opinion, containing its analysis of respondent's convictions under @ 10(b) and Rule 10b-5.

I do not entirely agree with JUSTICE THOMAS'S analysis of those convictions either, principally because it seems to me irrelevant whether the Government's theory of why respondent's acts were covered is "coherent and consistent," post, at 13. It is true that with respect to matters over which an agency has been accorded adjudicative authority or policymaking discretion, the agency's action must be supported by the reasons that the agency sets forth, <=164> SEC v. [*66] Chenery Corp., 318 U.S. 80, 94, 87 L. Ed. 626, 63 S. Ct. 454 (1943); see also <=165> SEC v. Chenery Corp., 332 U.S. 194, 196, 91 L. Ed. 1995, 67 S. Ct. 1575 (1947), but I do not think an agency's unadorned application of the law need be, at least where (as here) no Chevron deference is being given to the agency's interpretation. In point of fact, respondent's actions either violated @ 10(b) and Rule 10b-5, or they did not--regardless of the reasons the Government gave. And it is for us to decide.

While the Court's explanation of the scope of @ 10(b) and Rule 10b-5 would be entirely reasonable in some other context, it does not seem to accord with the principle of lenity we apply to criminal statutes (which cannot be mitigated here by the Rule, which is no less ambiguous than the statute). See <=166> Reno v. Koray, 515 U.S. 50, 64-65, 132 L. Ed. 2d 46, 115 S. Ct. 2021 (1995) (explaining circumstances in which rule of lenity applies); <=167> United States v. Bass, 404 U.S. 336, 347-348, 30 L. Ed. 2d 488, 92 S. Ct. 515 (1971) (discussing policies underlying rule of lenity). In light of that principle, it seems to me that the unelaborated statutory language: "to use or employ in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance," @ 10(b), [*67] must be construed to require the manipulation or deception of a party to a securities transaction.

JUSTICE THOMAS, with whom THE CHIEF JUSTICE joins, concurring in the judgment in part and dissenting in part.

Today the majority upholds respondent's convictions for violating @ 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder, based upon the Securities and Exchange Commission's "misappropriation theory." Central to the majority's holding is the need to interpret @ 10(b)'s requirement that a deceptive device be "used or employed, in connection with the purchase or sale of any security." <=168> 15 U.S.C. @ 78j(b). Because the Commission's misappropriation theory fails to provide a coherent and consistent interpretation of this essential requirement for liability under @ 10(b), I dissent.

The majority also sustains respondent's convictions under @ 14(e) of the Securities Exchange Act, and Rule 14e-3(a) promulgated thereunder, regardless of whether respondent violated a fiduciary duty to anybody. I dissent too from that holding because, while @ 14(e) does allow regulations prohibiting nonfraudulent acts as a prophylactic against certain fraudulent acts, [*68] neither the majority nor the Commission identifies any relevant underlying fraud against which Rule 14e-3(a) reasonably provides prophylaxis. With regard to the respondent's mail fraud convictions, however, I concur in the judgment of the Court.

I

I do not take issue with the majority's determination that the undisclosed misappropriation of confidential information by a fiduciary can constitute a "deceptive device" within the meaning of @ 10(b). Nondisclosure where there is a pre-existing duty to disclose satisfies our definitions of fraud and deceit for purposes of the securities laws. See <=169> Chiarella v. United States, 445 U.S. 222, 230, 63 L. Ed. 2d 348, 100 S. Ct. 1108 (1980).

Unlike the majority, however, I cannot accept the Commission's interpretation of when a deceptive device is "used . . . in connection with" a securities transaction. Although the Commission and the majority at points seem to suggest that any relation to a securities transaction satisfies the "in connection with" requirement of @ 10(b), both ultimately reject such an overly expansive construction and require a more integral connection between the fraud and the securities transaction. The majority states, for example, that the [*69] misappropriation theory applies to undisclosed misappropriation of confidential information "for securities trading purposes," ante, at 7, thus seeming to require a particular intent by the misappropriator in order to satisfy the "in connection with" language. See also ante, at 11 (the "misappropriation theory targets information of a sort that misappropriators ordinarily capitalize upon to gain no-risk profits through the purchase or sale of securities") (emphasis added); ante, at 11-12 (distinguishing embezzlement of money used to buy securities as lacking the requisite connection). The Commission goes further, and argues that the misappropriation theory satisfies the "in connection with" requirement because it "depends on an inherent connection between the deceptive conduct and the purchase or sale of a security." Brief for United States 21 (emphasis added); see also ibid. (the "misappropriated information had personal value to respondent only because of its utility in securities trading") (emphasis added).

The Commission's construction of the relevant language in @ 10(b), and the incoherence of that construction, become evident as the majority attempts [*70] to describe why the fraudulent theft of information falls under the Commission's misappropriation theory, but the fraudulent theft of money does not. The majority correctly notes that confidential information "qualifies as property to which the company has a right of exclusive use." Ante, at 9. It then observes that the "undisclosed misappropriation of such information, in violation of a fiduciary duty, . . . constitutes fraud akin to embezzlement--the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another." Ibid. (citations and internal quotation marks omitted). n1 So far the majority's analogy to embezzlement is well taken, and adequately demonstrates that undisclosed misappropriation can be a fraud on the source of the information.

-----------------Footnotes-----------------

n1 Of course, the "use" to which one puts misappropriated property need not be one designed to bring profit to the misappropriator: Any "fraudulent appropriation to one's own use" constitutes embezzlement, regardless of what the embezzler chooses to do with the money. See, e.g., <=170> Logan v. State, 493 P.2d 842, 846 (Okla. Crim. App. 1972) ("Any diversion of funds held in trust constitutes embezzlement whether there is direct personal benefit or not as long as the owner is deprived of his money").

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[*71]

What the embezzlement analogy does not do, however, is explain how the relevant fraud is "used or employd, in connection with" a securities transaction. And when the majority seeks to distinguish the embezzlement of funds from the embezzlement of information, it becomes clear that neither the Commission nor the majority has a coherent theory regarding @ 10(b)'s "in connection with" requirement.

Turning first to why embezzlement of information supposedly meets the "in connection with" requirement, the majority asserts that the requirement "is satisfied because the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities. The securities transaction and the breach of duty thus coincide." Ante, at 11.

The majority later notes, with apparent approval, the Government's contention that the embezzlement of funds used to purchase securities would not fall within the misappropriation theory. Ante, at 11-12 (citing Brief for United States 24, n.13). The misappropriation of funds used for a securities transaction is not covered by its [*72] theory, the Government explains, because "the proceeds would have value to the malefactor apart from their use in a securities transaction, and the fraud would be complete as soon as the money was obtained." Brief for United States 24, n.13; see ante, at 12 (quoting Government's explanation).

Accepting the Government's description of the scope of its own theory, it becomes plain that the majority's explanation of how the misappropriation theory supposedly satisfies the "in connection with requirement is incomplete. The touchstone required for an embezzlement to be "used or employed, in connection with" a securities transaction is not merely that it "coincide" with, or be consummated by, the transaction, but that it is necessarily and only consummated by the transaction. Where the property being embezzled has value "apart from [its] use in a securities transaction"--even though it is in fact being used in a securities transaction--the Government contends that there is no violation under the misappropriation theory.

My understanding of the Government's proffered theory of liability, and its construction of the "in connection with" requirement, is confirmed by the Government's [*73] explanation during oral argument: "[Court]: What if I appropriate some of my client's money in order to buy stock?

. . . . .

"[Court]: Have I violated the securities laws?

"[Counsel]: I do not think that you have.

"[Court]: Why not? Isn't that in connection with the purchase of securities just as much as this one is

"[Counsel]: It's not just as much as this one is, because in this case it is the use of the information that enables the profits, pure and simple. There would be no opportunity to engage in profit-

"[Court]: Same here. I didn't have the money. The only way I could buy this stock was to get the money.

. . . . .

"[Counsel]: The difference . . . is that once you have the money you can do anything you want with it. In a sense, the fraud is complete at that point, and then you go on and you can use the money to finance a number of other activities, but the connection is far less close than in this case, where the only value of this information for personal profit for respondent was to take it and profit in the securities markets by trading on it.

. . . . .

"[Court]: So what you're saying is, is in this case the misappropriation can only be [*74] of relevance, or is of substantial relevance, is with reference to the purchase of securities.

"[Counsel]: Exactly.

"[Court]: When you take money out of the accounts you can go to the racetrack, or whatever.

"[Counsel]: That's exactly right, and because of that difference, [there] can be no doubt that this kind of misappropriation of property is in connection with the purchase or sale of securities.

"Other kinds of misappropriation of property may or may not, but this is a unique form of fraud, unique to the securities markets, in fact, because the only way in which respondent could have profited through this information is by either trading on it or by tipping somebody else to enable their trades." Tr. of Oral Arg. 16-19 (emphases added).

As the above exchange demonstrates, the relevant distinction is not that the misappropriated information was used for a securities transaction (the money example met that test), but rather that it could only be used for such a transaction. See also, Tr. of Oral Arg. 6-7 (Government contention that the misappropriation theory satisfies "the requisite connection between the fraud and the securities trading, because it is [*75] only in the trading that the fraud is consummated") (emphasis added); id., at 8 (same).

The Government's construction of the "in connection with" requirement--and its claim that such requirement precludes coverage of financial embezzlement--also demonstrates how the majority's described distinction of financial embezzlement is incomplete. Although the majority claims that the fraud in a financial embezzlement case is complete as soon as the money is obtained, and before the securities transaction is consummated, that is not uniformly true, and thus cannot be the Government's basis for claiming that such embezzlement does not violate the securities laws. It is not difficult to imagine an embezzlement of money that takes place via the mechanism of a securities transaction--for example where a broker is directed to purchase stock for a client and instead purchases such stock--using client funds--for his own account. The unauthorized (and presumably undisclosed) transaction is the very act that constitutes the embezzlement and the "securities transaction and the breach of duty thus coincide." What presumably distinguishes monetary embezzlement for the Government is thus that it [*76] is not necessarily coincident with a securities transaction, not that it never lacks such a "connection."

Once the Government's construction of the misappropriation theory is accurately described and accepted--along with its implied construction of @ 10(b)'s "in connection with" language--that theory should no longer cover cases, such as this one, involving fraud on the source of information where the source has no connection with the other participant in a securities transaction. It seems obvious that the undisclosed misappropriation of confidential information is not necessarily consummated by a securities transaction. In this case, for example, upon learning of Grand Met's confidential takeover plans, O'Hagan could have done any number of things with the information: He could have sold it to a newspaper for publication, see Tr. of Oral Arg. 36; he could have given or sold the information to Pillsbury itself, see id., at 37; or he could even have kept the information and used it solely for his personal amusement, perhaps in a fantasy stock trading game.

Any of these activities would have deprived Grand Met of its right to "exclusive use," ante, at 9, of the information [*77] and, if undisclosed, would constitute "embezzlement" of Grand Met's informational property. Under any theory of liability, however, these activities would not violate @ 10(b) and, according to the Commission's monetary embezzlement analogy, these possibilities are sufficient to preclude a violation under the misappropriation theory even where the informational property was used for securities trading. That O'Hagan actually did use the information to purchase securities is thus no more significant here than it is in the case of embezzling money used to purchase securities. In both cases the embezzler could have done something else with the property, and hence the Commission's necessary "connection" under the securities laws would not be met. n2 If the relevant test under the "in connection with" language is whether the fraudulent act is necessarily tied to a securities transaction, then the misappropriation of confidential information used to trade no more violates @ 10(b) than does the misappropriation of funds used to trade. As the Commission concedes that the latter is not covered under its theory, I am at a loss to see how the same theory can coherently be applied [*78] to the former. n3

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n2 Indeed, even if O'Hagan or someone else thereafter used the information to trade, the misappropriation would have been complete before the trade and there should be no @ 10(b) liability. The most obvious real-world example of this scenario would be if O'Hagan had simply tipped someone else to the information. The mere act of passing the information along would have violated O'Hagan's fiduciary duty and, if undisclosed, would be an "embezzlement" of the confidential information, regardless of whether the tippee later traded on the information.

n3 The majority is apparently unimpressed by the example of a misappropriator using embezzled information for personal amusement in a fantasy stock trading game, finding no need for the Commission to "inhibit" such recreational uses. Ante, at 12-13, n.8. This argument, of course, misses the point of the example. It is not that such a use does or should violate the securities laws yet is not covered by the Commission's theory; rather, the example shows that the misappropriation of information is not "only" or "inherently" tied to securities trading, and hence the misappropriation of information, whatever its ultimate use, fails the Commission's own test under the "in connection with" requirement of @ 10(b) and Rule 10b-5.

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[*79]

The majority makes no attempt to defend the misappropriation theory as set forth by the Commission. Indeed, the majority implicitly concedes the indefensibility of the Commission's theory by acknowledging that alternative uses of misappropriated information exist that do not violate the securities laws and then dismissing the Government's repeated explanations of its misappropriation theory as mere "overstatement." Ante, at 12. Having rejected the Government's description of its theory, the majority then engages in the "imaginative" exercise of constructing its own misappropriation theory from whole cloth. Thus, we are told, if we merely "substitute 'ordinarily' for 'only'" when describing the degree of connectedness between a misappropriation and a securities transaction, the Government would have a winner. Ibid. Presumably, the majority would similarly edit the Government's brief to this Court to argue for only an "ordinary," rather than an "inherent connection between the deceptive conduct and the purchase or sale of a security." Brief for United States 21 (emphasis added).

I need not address the coherence, or lack thereof, of the majority's new theory, for it suffers [*80] from a far greater, and dispositive, flaw: It is not the theory offered by the Commission. Indeed, as far as we know from the majority's opinion, this new theory has never been proposed by the Commission, much less adopted by rule or otherwise. It is a fundamental proposition of law that this Court "may not supply a reasoned basis for the agency's action that the agency itself has not given." <=171> Motor Vehicle Mfrs. Assn. of United States, Inc. v. State Farm Mut. Automobile Ins. Co., 463 U.S. 29, 43, 77 L. Ed. 2d 443, 103 S. Ct. 2856 (1983). We do not even credit a "post hoc rationalization" of counsel for the agency, <=172> id., at 50, so one is left to wonder how we could possibly rely on a post hoc rationalization invented by this Court and never even presented by the Commission for our consideration.

Whether the majority's new theory has merit, we cannot possibly tell on the record before us. There are no findings regarding the "ordinary" use of misappropriated information, much less regarding the "ordinary" use of other forms of embezzled property. The Commission has not opined on the scope of the new requirement that property must "ordinarily" be used for securities trading in order for its misappropriation [*81] to be "in connection with" a securities transaction. We simply do not know what would or would not be covered by such a requirement, and hence cannot evaluate whether the requirement embodies a consistent and coherent interpretation of the statute. n4 Moreover, persons subject to this new theory, such as respondent here, surely could not and cannot regulate their behavior to comply with the new theory because, until today, the theory has never existed. In short, the majority's new theory is simply not presented by this case, and cannot form the basis for upholding respondent's convictions.

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n4 Similarly, the majority's assertion that the alternative uses of misappropriated information are not as profitable as use in securities trading, ante, at 12, n.8, is speculative at best. We have no idea what is the best or most profitable use of misappropriated information, either in this case or generally. We likewise have no idea what is the best use of other forms of misappropriated property, and it is at least conceivable that the best use of embezzled money, or securities themselves, is for securities trading. If the use of embezzled money to purchase securities is "sufficiently detached," ante, at 12, from a securities transaction, then I see no reason why the non-"inherent" use of information for securities trading is not also "sufficiently detached" under the Government's theory. In any event, I am at a loss to find in the statutory language any hint of a "best-use" requirement for setting the requisite connection between deception and the purchase or sale of securities.

The majority's further claim that it is unremarkable that "a rule suitably applied to the fraudulent uses of certain kinds of information would be stretched beyond reason were it applied to the fraudulent use of money," ante, at 12, is itself remarkable given that the only existing "rule" is Rule 10b-5, which nowhere confines itself to information and, indeed, does not even contain the word. And given that the only "reason" offered by the Government in support of its misappropriation theory applies (or fails to apply) equally to money or to information, the application of the Government's theory in this case is no less "beyond reason" that it would be as applied to financial embezzlement.

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[*82]

In upholding respondent's convictions under the new and improved misappropriation theory, the majority also points to various policy considerations underlying the securities laws, such as maintaining fair and honest markets, promoting investor confidence, and protecting the integrity of the securities markets. Ante, at 12, 14. But the repeated reliance on such broad-sweeping legislative purposes reaches too far and is misleading in the context of the misappropriation theory. It reaches too far in that, regardless of the overarching purpose of the securities laws, it is not illegal to run afoul of the "purpose" of a statute, only its letter. The majority's approach is misleading in this case because it glosses over the fact that the supposed threat to fair and honest markets, investor confidence, and market integrity comes not from the supposed fraud in this case, but from the mere fact that the information used by O'Hagan was nonpublic.

As the majority concedes, because "the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, [*83] there is no 'deceptive device' and thus no @ 10(b) violation." Ante, at 10 (emphasis added). Indeed, were the source expressly to authorize its agents to trade on the confidential information--as a perk or bonus, perhaps--there would likewise be no @ 10(b) violation. n5 Yet in either case--disclosed misuse or authorized use--the hypothesized "inhibiting impact on market participation," ante, at 14, would be identical to that from behavior violating the misappropriation theory: "Outsiders" would still be trading based on nonpublic information that the average investor has no hope of obtaining through his own diligence. n6

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n5 See Tr. of Oral Arg. 9 (Government conceding that, "just as in [=173 Carpenter v. United States, 484 U.S. 19, 98 L. Ed. 2d 275, 108 S. Ct. 316 (1987)], if [the defendant] had gone to the Wall Street Journal and said, look, you know, you're not paying me very much. I'd like to make a little bit more money by buying stock, the stocks that are going to appear in my Heard on the Street column, and the Wall Street Journal said, that's fine, there would have been no deception of the Wall Street Journal"). [*84]

n6 That the dishonesty aspect of misappropriation might be eliminated via disclosure or authorization is wholly besides the point. The dishonesty in misappropriation is in the relationship between the fiduciary and the principal, not in any relationship between the misappropriator and the market. No market transaction is made more or less honest by disclosure to a third-party principal, rather than to the market as a whole. As far as the market is concerned, a trade based on confidential information is no more "honest" because some third party may know of it so long as those on the other side of the trade remain in the dark.

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The majority's statement that a "misappropriator who trades on the basis of material, nonpublic information, in short, gains his advantageous market position through deception; he deceives the source of the information and simultaneously harms members of the investing public," ante, at 11 (emphasis added), thus focuses on the wrong point. Even if it is true that trading on nonpublic information hurts the public, it is true whether or not there is any deception of [*85] the source of the information. n7 Moreover, as we have repeatedly held, use of nonpublic information to trade is not itself a violation of @ 10(b). E.g., <=174> Chiarella, 445 U.S. at 232-233. Rather, it is the use of fraud "in connection with" a securities transaction that is forbidden. Where the relevant element of fraud has no impact on the integrity of the subsequent transactions as distinct from the nonfraudulent element of using nonpublic information, one can reasonably question whether the fraud was used in connection with a securities transaction. And one can likewise question whether removing that aspect of fraud. though perhaps laudable, has anything to do with the confidence or integrity of the market.

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n7 The majority's statement, by arguing that market advantage is gained "through" deception, unfortunately seems to embrace an error in logic: Conflating causation and correlation. That the misappropriator may both deceive the source and "simultaneously" hurt the public no more shows a causal "connection" between the two than the fact that the sun both gives some people a tan and "simultaneously" nourishes plants demonstrates that melanin production in humans causes plants to grow. In this case, the only element common to the deception and the harm is that both are the result of the same antecedent cause--namely, using non-public information. But such use, even for securities trading, is not illegal, and the consequential deception of the source follows an entirely divergent branch of causation than does the harm to the public. The trader thus "gains his advantageous market position through" the use of nonpublic information, whether or not deception is involved; the deception has no effect on the existence or extent of his advantage.

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[*86]

The absence of a coherent and consistent misappropriation theory and, by necessary implication, a coherent and consistent application of the statutory "use or employ, in connection with" language, is particularly problematic in the context of this case. The Government claims a remarkable breadth to the delegation of authority in @ 10(b), arguing that "the very aim of this section was to pick up unforeseen, cunning, deceptive devices that people might cleverly use in the securities markets." Tr. of Oral Arg. 7. As the Court aptly queried, "that's rather unusual, for a criminal statute to be that open-ended, isn't it?" Ibid. Unusual indeed. Putting aside the dubious validity of an open-ended delegation to an independent agency to go forth and create regulations criminalizing "fraud," in this case we do not even have a formal regulation embodying the agency's misappropriation theory. Certainly Rule 10b-5 cannot be said to embody the theory--although it deviates from the statutory language by the addition of the words "any person," it merely repeats, unchanged, @ 10(b)'s "in connection with" language. Given that the validity of the misappropriation theory turns on the construction [*87] of that language in @ 10(b), the regulatory language is singularly uninformative. n8

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n8 That the Commission may purport to be interpreting its own rule, rather than the statute, cannot provide it any greater leeway where the Rule merely repeats verbatim the statutory language on which the entire question hinges. Furthermore, as even the majority recognizes, Rule 10b-5 may not reach beyond the scope of @ 10(b), ante, at 6, and thus the Commission is obligated to explain how its theory fits within its interpretation of @ 10(b) even if it purports to be interpreting its own derivative rule.

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Because we have no regulation squarely setting forth some version of the misappropriation theory as the Commission's interpretation of the statutory language, we are left with little more than the Commission's litigating position or the majority's completely novel theory that is not even acknowledged, much less adopted, by the Commission. As we have noted before, such positions are not entitled to deference and, at most, [*88] get such weight as their persuasiveness warrants. Metropolitan Stevedore Co. v. Rambo, 521 U.S. , , , n.10 (1997) (slip op., at 17, 19, n.10). Yet I find wholly unpersuasive a litigating position by the Commission that, at best, embodies an inconsistent and incoherent interpretation of the relevant statutory language and that does not provide any predictable guidance as to what behavior contravenes the statute. That position is no better than an ad hoc interpretation of statutory language and in my view can provide no basis for liability.

II

I am also of the view that O'Hagan's conviction for violating Rule 14e-3(a) cannot stand. Section 14(e) of the Exchange Act provides, in relevant part: "It shall be unlawful for any person . . . to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer . . . . The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative." <=175> 15 U.S.C. @ 78n(e).

Pursuant to the rulemaking authority conferred by this section, the [*89] Commission has promulgated Rule 14e-3(a), which provides, in relevant part: "(a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive, or manipulative act or practice within the meaning of @ 14(e) of the [Securities Exchange] Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:

"(1) The offering person,

"(2) The issuer of the securities sought or to be sought by such tender offer, or

"(3) [Any person acting on behalf of the offering person or such issuer], to purchase or sell [any such securities or various instruments related to such securities], unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise." 17 CFR @ 240.14e-3(a) (1996).

As the majority acknowledges, Rule 14e-3(a) prohibits a broad range of behavior regardless of whether such behavior is fraudulent under [*90] our precedents. See ante, at 25 (rule applies "'without regard to whether the trader owes a pre-existing fiduciary duty to respect the confidentiality of the information'") (quoting <=176> United States v. Chestman, 947 F.2d 551, 557 (CA2 1991) (en banc), cert. denied, <=177> 503 U.S. 1004, 118 L. Ed. 2d 422, 112 S. Ct. 1759 (1992)) (emphasis omitted).

The Commission offers two grounds in defense of Rule 14e-3(a). First, it argues that @ 14(e) delegates to the Commission the authority to "define" fraud differently than that concept has been defined by this Court, and that Rule 14e-3(a) is a valid exercise of that "defining" power. Second, it argues that @ 14(e) authorizes the Commission to "prescribe means reasonably designed to prevent" fraudulent acts, and that Rule 14e-3(a) is a prophylactic rule that may prohibit nonfraudulent acts as a means of preventing fraudulent acts that are difficult to detect or prove.

The majority declines to reach the Commission's first justification, instead sustaining Rule 14e-3(a) on the ground that under @ 14(e), the Commission may prohibit acts, not themselves fraudulent under the common law or @ 10(b), if the prohibition is 'reasonably designed to prevent . . . acts and [*91] practices [that] are fraudulent.'" Ante, at 29 (quoting <=178> 15 U.S.C. @ 78n(e)).

According to the majority, prohibiting trading on nonpublic information is necessary to prevent such supposedly hard-to-prove fraudulent acts and practices as trading on information obtained from the buyer in breach of a fiduciary duty, ante, at 31-32, and possibly "warehousing," whereby the buyer tips allies prior to announcing the tender offer and encourages them to purchase the target company's stock, ante, at 28-29, n.17. n9

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n9 Although the majority leaves open the possibility that Rule 14e-3(a) may be justified as a means of preventing "warehousing," it does not rely on that justification to support its conclusion in this case. Suffice it to say that the Commission itself concedes that warehousing does not involve fraud as defined by our cases, see Reply Brief for United States 17, and thus preventing warehousing cannot serve to justify Rule 14e-3(a).

-----------------End Footnotes----------------

I find neither of the Commission's justifications for [*92] Rule 14e-3(a) acceptable in misappropriation cases. With regard to the Commission's claim of authority to redefine the concept of fraud, I agree with the Eighth Circuit that the Commission misreads the relevant provision of @ 14(e).

"Simply put, the enabling provision of @ 14(e) permits the SEC to identify and regulate those 'acts and practices' which fall within the @ 14(e) legal definition of 'fraudulent,' but it does not grant the SEC a license to redefine the term." <=179> 92 F.3d at 624.

This conclusion follows easily from our similar statement in <=180> Schreiber v. Burlington Northern, Inc., 472 U.S. 1, 11, n.11, 86 L. Ed. 2d 1, 105 S. Ct. 2458 (1985), that @ 14(e) gives the "Commission latitude to regulate nondeceptive activities as a 'reasonably designed' means of preventing manipulative acts, without suggesting any change in the meaning of the term 'manipulative' itself."

Insofar as the Rule 14e-3(a) purports to "define" acts and practices that "are fraudulent," it must be measured against our precedents interpreting the scope of fraud. The majority concedes, however, that Rule 14e-3(a) does not prohibit merely trading in connection with fraudulent nondisclosure, but rather it prohibits trading [*93] in connection with any nondisclosure, regardless of the presence of a pre-existing duty to disclose. Ante, at 25. The Rule thus exceeds the scope of the Commission's authority to define such acts and practices as "are fraudulent." n10

------------------Footnotes------------------

n10 Even were @ 14(e)'s defining authority subject to the construction given it by the Commission, there are strong constitutional reasons for not so construing it. A law that simply stated "it shall be unlawful to do 'X', however 'X' shall be defined by an independent agency," would seem to offer no "intelligible principle" to guide the agency's discretion and would thus raise very serious delegation concerns, even under our current jurisprudence, <=181> J. W. Hampton, Jr., & Co. v. United States, 276 U.S. 394, 409, 72 L. Ed. 624, 48 S. Ct. 348 (1928). See also <=182> Field v. Clark, 143 U.S. 649, 693-694, 36 L. Ed. 294, 12 S. Ct. 495 (1892) (distinguishing between making the law by determining what it shall be, and executing the law by determining facts on which the law's operation depends). The Commission's interpretation of @ 14(e) would convert it into precisely the type of law just described. Thus, even if that were a plausible interpretation, our usual practice is to avoid unnecessary interpretations of statutory language that call the constitutionality of the statute into further serious doubt.

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[*94]

Turning to the Commission's second justification for Rule 14e-3(a), although I can agree with the majority that @ 14(e) authorizes the Commission to prohibit non-fraudulent acts as a means reasonably designed to prevent fraudulent ones, I cannot agree that Rule 14e-3(a) satisfies this standard. As an initial matter, the Rule, on its face, does not purport to be an exercise of the Commission's prophylactic power, but rather a redefinition of what "constitutes a fraudulent, deceptive, or manipulative act or practice within the meaning of @ 14(e)." That Rule 14e-3(a) could have been "conceived and defended, alternatively, as definitional or preventive," ante, at 30, n.19, misses the point. We evaluate regulations not based on the myriad of explanations that could have been given by the relevant agency, but on those explanations and justifications that were, in fact, given. See <=183> State Farm, 463 U.S. at 43, 50. Rule 14e-3(a) may not be "sensibly read" as an exercise of "preventive" authority, ante, at 30, n.19; it can only be differently so read, contrary to its own terms.

Having already concluded that the Commission lacks the power to redefine fraud, the regulation [*95] cannot be sustained on its own reasoning. This would seem a complete answer to whether the Rule is valid because, while we might give deference to the Commission's regulatory constructions of @ 14(e), the reasoning used by the regulation itself is in this instance contrary to law and we need give no deference to the Commission's post hoc litigating justifications not reflected in the regulation.

Even on its own merits, the Commission's prophylactic justification fails. In order to be a valid prophylactic regulation, Rule 14e-3(a) must be reasonably designed not merely to prevent any fraud, but to prevent persons from engaging in "fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer." <=184> 15 U.S.C. @ 78n(e) (emphasis added). Insofar as Rule 14e-3(a) is designed to prevent the type of misappropriation at issue in this case, such acts are not legitimate objects of prevention because the Commission's misappropriation theory does not represent a coherent interpretation of the statutory "in connection with" requirement, as explained in Part I, supra. Even assuming that a person misappropriating information from the bidder commits [*96] fraud on the bidder, the Commission has provided no coherent or consistent explanation as to why such fraud is "in connection with" a tender offer, and thus the Commission may not seek to prevent indirectly conduct which it could not, under its current theory, prohibit directly. n11

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n11 I note that Rule 14e-3(a) also applies to persons trading upon information obtained from an insider of the target company. Insofar as the Rule seeks to prevent behavior that would be fraudulent under the "classical theory" of insider trading, this aspect of my analysis would not apply. As the majority notes, however, the Government "could not have prosecuted O'Hagan under the classical theory," ante, at 8, n.5, hence this proviso has no application to the present case.

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Finally, even further assuming that the Commission's misappropriation theory is a valid basis for direct liability, I fail to see how Rule 14e-3(a)'s elimination of the requirement of a breach of fiduciary duty is "reasonably designed" to prevent the underlying [*97] "fraudulent" acts. The majority's primary argument on this score is that in many cases "'a breach of duty is likely but difficult to prove.'" Ante, at 31 (quoting Reply Brief for United States 16). Although the majority's hypothetical difficulties involved in a tipper-tippee situation might have some merit in the context of "classical" insider trading, there is no reason to suspect similar difficulties in "misappropriation" cases. In such cases, Rule 14e-3(a) requires the Commission to prove that the defendant "knows or has reason to know" that the nonpublic information upon which trading occurred came from the bidder or an agent of the bidder. Once the source of the information has been identified, it should be a simple task to obtain proof of any breach of duty. After all, it is the bidder itself that was defrauded in misappropriation cases, and there is no reason to suspect that the victim of the fraud would be reluctant to provide evidence against the perpetrator of the fraud. n12 There being no particular difficulties in proving a breach of duty in such circumstances, a rule removing the requirement of such a breach cannot be said to be "reasonably designed" to prevent underlying [*98] violations of the misappropriation theory.

-----------------Footnotes-----------------

n12 Even where the information is obtained from an agent of the bidder, and the tippee claims not to have known that the tipper violated a duty, there is still no justification for Rule 14e-3(a). First, in such circumstances the tipper himself would have violated his fiduciary duty and would be liable under the misappropriation theory, assuming that theory were valid. Facing such liability, there is no reason to suspect that the tipper would gratuitously protect the tippee. And if the tipper accurately testifies that the tippee was (falsely) told that the information was passed on without violating the tipper's own duties, one can question whether the tippee has in fact done anything illegal, even under the Commission's misappropriation theory. Given that the fraudulent breach of fiduciary duty would have been complete at the moment of the tip, the subsequent trading on that information by the tippee might well fail even the Commission's own construction of the "in connection with" requirement. See supra, at 5-8. Thus, even if the tipper might, in some circumstances, be inclined to protect the tippee, see ante, at 32, n.20, it is doubtful that the tippee would have violated the misappropriation theory in any event, and thus preventing such nonviolations cannot justify Rule 14e-3(a). Second, even were this scenario a legitimate concern, it would at most justify eliminating the requirement that the tippee "know" about the breach of duty. It would not explain Rule 14e-3(a)'s elimination of the requirement that there be such a breach.

----------------End Footnotes----------------

[*99]

What Rule 14e-3(a) was in fact "designed" to do can be seen from the remainder of the majority's discussion of the Rule. Quoting at length from the Commission's explanation of the Rule in the Federal Register, the majority notes the Commission's concern with "'unfair disparities in market information and market disruption.'" Ante, at 30 (quoting 45 Fed. Reg. 60412 (1980)). In the Commission's further explanation of Rule 14e-3(a)'s purpose--continuing the paragraph partially quoted by the majority--an example of the problem to be addressed is the so-called "stampede effect" based on leaks and rumors that may result from trading on material, nonpublic information. 45 Fed. Reg. 60413. The majority also notes (but does not rely on) the Government's contention that it would not be able to prohibit the supposedly problematic practice of "warehousing"--a bidder intentionally tipping allies to buy stock in advance of a bid announcement--if a breach of fiduciary duty were required. Ante, at 28-29, n.17 (citing Reply Brief for United States 17). Given these policy concerns, the majority notes with seeming approval the Commission's justification of Rule 14e-3(a) "as a means necessary [*100] and proper to assure the efficacy of Williams Act protections." Ante, at 30.

Although this reasoning no doubt accurately reflects the Commission's purposes in adopting Rule 14e-3(a), it does little to support the validity of that Rule as a means designed to prevent such behavior: None of the above-described acts involve breaches of fiduciary duties, hence a Rule designed to prevent them does not satisfy @ 14(e)'s requirement that the Commission's Rules promulgated under that section be "reasonably designed to prevent" acts and practices that "are fraudulent, deceptive, or manipulative." As the majority itself recognizes, there is no "'general duty between all participants in market transactions to forgo actions based on material, nonpublic information,'" and such duty only "'arises from a specific relationship between two parties.'"

Ante, at 16 (quoting <=187> Chiarella, 445 U.S. at 233). Unfair disparities in market information, and the potential "stampede effect" of leaks, do not necessarily involve a breach of any duty to anyone, and thus are not proper objects for regulation in the name of "fraud" under @ 14(e). Likewise (as the Government concedes, Reply Brief for United [*101] States 17), "warehousing" is not fraudulent given that the tippees are using the information with the express knowledge and approval of the source of the information. There simply would be no deception in violation of a duty to disclose under such circumstances. Cf. ante, at 9-10 (noting Government's concession that use of bidder's information with bidder's knowledge is not fraudulent under misappropriation theory).

While enhancing the overall efficacy of the Williams Act may be a reasonable goal, it is not one that may be pursued through @ 14(e), which limits its grant of rulemaking authority to the prevention of fraud, deceit, and manipulation. As we have held in the context of @ 10(b), "not every instance of financial unfairness constitutes fraudulent activity." <=188> Chiarella, 445 U.S. at 232. Because, in the context of misappropriation cases, Rule 14e-3(a) is not a means "reasonably designed" to prevent persons from engaging in fraud "in connection with" a tender offer, it exceeds the Commission's authority under @ 14(e), and respondent's conviction for violation of that Rule cannot be sustained.

III

With regard to respondent's convictions on the mail-fraud counts, [*102] my view is that it may be sustained regardless of whether respondent may be convicted of the securities fraud counts. Although the issue is highly fact-bound, and not independently worthy of plenary consideration by this Court, we have nonetheless accepted the issue for review and therefore I will endeavor to resolve it.

As I read the indictment, it does not materially differ from the indictment in <=189> Carpenter v. United States, 484 U.S. 19, 98 L. Ed. 2d 275, 108 S. Ct. 316 (1987). There, the Court was unanimous in upholding the mail-fraud conviction, <=190> id., at 28, despite being evenly divided on the securities fraud counts, <=191> id., at 24. I do not think the wording of the indictment in the current case requires a finding of securities fraud in order to find mail fraud. Certainly the jury instructions do not make the mail-fraud count dependent on the securities fraud counts. Rather, the counts were simply predicated on the same factual basis, and just because those facts are legally insufficient to constitute securities fraud does not make them legally insufficient to constitute mail fraud. n13 I therefore concur in the judgment of the Court as it relates to respondent's mail-fraud convictions.

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n13 While the majority may find it strange that the "mail fraud net" is broader reaching than the securities fraud net, ante, at 34, n.25, any such supposed strangeness--and the resulting allocation of prosecutorial responsibility between the Commission and the various United States Attorneys--is no business of this Court, and can be adequately addressed by Congress if it too perceives a problem regarding jurisdictional boundaries among the Nation's prosecutors. That the majority believes that, upon shifting from securities fraud to mail fraud prosecutions, the "practical consequences for individual defendants might not be large," ibid., both undermines the supposed policy justifications for today's decision and makes more baffling the majority's willingness to go to such great lengths to save the Commission from itself.

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IN THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF COLORADO

CIVIL ACTION NO.______________

SECURITIES AND EXCHANGE COMMISSION
450 Fifth Street, N.W.
Washington, D.C. 20549

Plaintiff,

v.

POWER SECURITIES CORPORATION,
RICHARD T. MARCHESE,
ERIC G. MONCHECOURT,
ORVILLE L. SANDBERG,
MARK D. BEHRINGER,
REX A. JOHNSON,
DAVID F. NOBLE,
RONALD G. BAJOREK,
ALLIED CAPITAL GROUP, INC.,
BARRY H. FREEDMAN,
PETER MERCALDI,
ANITA M. POSEY,
WILLIAM F. MASUCCI,
MARTI R. BAREN,
RAYMOND G. KLINGENBERG,
JOSEPH V. PIGNATIELLO,
HENRY FONG,

Defendants,

and

CONSTANCE C. PIGNATIELLO,
DONALD REDFERN,
JOVIJUCO INVESTMENTS, INC.,
CAROLINE FONG,
EQUITEX, INC.,

Nominal Defendants.

COMPLAINT FOR PERMANENT INJUNCTION AND OTHER RELIEF

Plaintiff Securities And Exchange Commission ("Commission") alleges for its Complaint the following:

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1. Defendants, personally or through direction of their agents, have engaged in acts, transactions, practices and courses of business which constitute violations of the securities laws and regulations of the United States, as described more fully below.

JURISDICTION AND VENUE

2. The Commission brings this action pursuant to Section 22(a) of the Securities Act of 1933 ("Securities Act") [15 U.S.C. §77v(a)], Sections 21 and 27 of the Securities Exchange Act of 1934 ("Exchange Act") [15 U.S.C. §§78v and 78aa], and Section 44 of the Investment Company Act of 1940 (the "Investment Company Act") [15 U.S.C. §80a-44].

3. Each of the defendants has made use of the means and instrumentalities of interstate commerce and of the mails in connection with the acts, practices, and courses of business alleged herein, certain of which have occurred within the District of Colorado.

4. Venue lies in this Court pursuant to Section 22(a) of the Securities Act [15 U.S.C. §77v(a)], Section 27 of the Exchange Act [15 U.S.C. §78aa] and Section 44 of the Investment Company Act.

5. Each defendant, unless permanently restrained and enjoined by this Court, will continue to engage in the acts, transactions, practices and courses of business alleged herein, and in acts, transactions, practices and courses of business of similar purport and object.

THE DEFENDANTS

6. Defendant Power Securities Corporation ("Power") is registered as a broker-dealer with the Commission pursuant to Section 15 of the Exchange Act [15 U.S.C. §78o]. Power's headquarters were in Las Vegas, Nevada and the firm operated approximately 15 branch offices in Colorado, Georgia, California, Illinois, New York and Florida with over 1,000 salespeople. On February 13, 1989, Power voluntarily terminated its operations.

7. Defendant Richard T. Marchese ("Marchese"), age 30, a resident of Las Vegas, Nevada, was chairman of the Board, a director and chief executive officer of Power. Marchese had overall responsibility for the management of the firm and, among other things, was in charge of customer sales and trading activities.

8. Defendant Eric G. Monchecourt ("Monchecourt"), age 29, a resident of Las Vegas, Nevada, was executive vice-president and a

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director of Power. Monchecourt was responsible for supervision of sales activities and branch office operations.

9. Defendant Orville L. Sandberg ("Sandberg"), age 64, a resident of Aurora, Colorado, was president, a director and the head trader of Power. Sandberg supervised Power's trading department and with Marchese directed trading activity.

10. Defendant Mark D. Behringer ("Behringer"), age 34, a resident of Las Vegas, Nevada, was manager of Power's Las Vegas, Nevada branch office from November, 1987, through February, 1989. During the summer of 1988 Behringer was promoted to western regional vice president. Behringer engaged in customer sales and trained and supervised brokers in the Las Vegas office.

11. Defendant Rex A. Johnson ("Johnson"), age 33, a resident of Fort Collins, Colorado, was manager of Power's Fort Collins, Colorado branch office from February, 1988, through February, 1989. Johnson engaged in customer sales and trained and supervised brokers in the Fort Collins office.

12. Defendant David F. Noble ("Noble"), age 41, a resident of Windsor, Colorado, was assistant manager of Power's Fort Collins, Colorado branch office from August, 1988, through February, 1989. Noble engaged in customer sales and trained and supervised brokers in the Fort Collins office.

13. Defendant Ronald G. Bajorek ("Bajorek"), age 27, a resident of San Jose, California, was manager of Power's Santa Barbara, California branch office from November, 1987, through February, 1989. Bajorek engaged in customer sales and trained and supervised brokers in the Santa Barbara office.

14. Defendant Allied Capital Group, Inc. ("Allied") is registered as a broker-dealer with the Commission pursuant to Section 15 of the Exchange Act. Allied's headquarters are in Englewood, Colorado. Allied contracted with certain defendants and other persons to own and operate Allied branch offices in Pompano Beach, Fort Lauderdale, Wellington and Tampa, Florida. At its peak, Allied had a sales force of over 100 salespeople. On or about November 17, 1989, Allied ceased operations and terminated virtually all of its employees.

15. Defendant Barry H. Freedman ("Freedman"), age 38, a resident of Parker, Colorado, acquired a one-half interest in Allied in late 1984 and became the sole owner of the firm in late 1985. Freedman was Allied's owner and President until May 1988 and was responsible for the overall management of Allied.

16. Defendant Peter Mercaldi ("Mercaldi"), age 41, a resident of Aurora, Colorado, was Allied's operations manager beginning in December, 1984. He acquired 250 shares of Allied

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stock in January, 1988, and became Allied's sole shareholder and president in May 1988. From March, 1988 to May, 1988, Mercaldi was involved in managing the day-to-day activities of Allied. From May 1988 to the present, Mercaldi has been responsible for the day-to-day operations of the firm.

17. Defendant Anita M. Posey ("Posey"), age 29, a resident of Denver, Colorado, was Allied's assistant trader from May, 1986 through April, 1988 and thereafter was the firm's head trader.

18. Defendant William F. Masucci ("Masucci"), age 29, a resident of Boca Raton, Florida, owned a one-half interest in and was co-manager of the Allied branch offices which operated in Pompano, Florida from March, 1988 to January, 1989 and in Fort Lauderdale, Florida, from July, 1988 to January, 1989.

19. Defendant Marti R. Baren ("Baren"), age 38, a resident of Boca Raton, Florida, owned a one-half interest in and was co-manager together with defendant Masucci of the Allied branch offices which operated in Pompano, Florida from March, 1988 to January 1989 and in Fort Lauderdale, Florida, from July, 1988 to January, 1989.

20. Defendant Raymond G. Klingenberg ("Klingenberg"), age 47, a resident of Palm Beach, Florida, owned and was co-manager of the Allied branch office which operated in Wellington, Florida from March, 1988 to early 1989 and was a part owner of the Allied branch office which operated in Tampa, Florida from July, 1988 to early 1989.

21. Defendant Henry Fong ("Fong"), age 54, a resident of Denver, Colorado, controls nominal defendant Equitex, Inc. ("Equitex") and is its president and chairman of the board.

22. Defendant Joseph V. Pignatiello ("Pignatiello"), age 43, a resident of Englewood, Colorado, is the president of nominal defendant Jovijuco Investments, Inc. ("Jovijuco"). Pignatiello was convicted in 1986 of conspiracy to commit securities and tax fraud. He was sentenced to two years in prison and fined $25,000 by the United States District Court for the District of Colorado. In February, 1987, the United States District Court for the District of Colorado permanently enjoined Pignatiello from various activities unlawful under the federal securities laws. The injunction was entered at the request of the Commission upon consent of the defendant, who neither admitted nor denied the allegations of the Complaint. In May, 1987, the Commission permanently barred Pignatiello from association in any capacity with any broker, dealer, investment company, investment advisor or municipal securities dealer.

23. Nominal defendant Jovijuco, a Colorado company, was founded in May, 1987. Jovijuco purports to provide financial and

business consulting services to start-up companies and invests in penny stocks in the over the counter market. Nominal defendant Constance Pignatiello and her three minor children are the holders of all the outstanding stock of Jovijuco. Jovijuco is in possession of certain funds, all or portions of which are attributable to illegal stock trading by defendant Pignatiello.

24. Nominal defendant Constance C. Pignatiello (a/k/a Connie Wilson), age 33, a resident of Englewood, Colorado, is Pignatiello's wife. She is in possession of certain funds, all or portions of which are attributable to illegal stock trading by defendant Pignatiello.

25. Nominal defendant Donald Redfern ("Redfern"), a resident of Colorado, is a retired dentist and private investor. Redfern is Pignatiello's father-in-law. Redfern is in possession of certain funds, all or portions of which are attributable to illegal stock trading by defendant Pignatiello.

26. Nominal defendant Equitex, a Denver, Colorado based Delaware corporation, is controlled by Fong and is engaged primarily in the business of investing in and providing managerial assistance to developing companies. Its common stock is registered with the Commission under Section 12(g) of the Exchange Act [15 U.S.C. § 781(g)] and is quoted for trading on the National Association of Securities Dealers' Automated Quotation System ("NASDAQ"). Equitex is a business development company for the purposes of the Investment Company Act and accordingly is not registered with the Commission pursuant to the Investment Company Act, although it is subject to certain requirements of that Act. Equitex is in possession of certain funds, all or portions of which are attributable to illegal stock trading by defendant Fong.

27. Nominal defendant Carolyn Fong (a/k/a Carolyn Keller), a resident of Denver, Colorado, is Fong's wife. She is in possession of certain funds, all or portions of which are attributable to illegal stock trading by defendant Fong.

OTHER INDIVIDUALS AND ENTITIES

28. Toni S. Allen ("Allen"), age 39, a resident of Las Vegas, Nevada, was a registered representative in Power's Las Vegas office from February 1988 through February 1989.

29. Art Cards, Inc. ("Art Cards"), a Denver-based Colorado corporation, is primarily engaged in manufacturing and marketing greeting cards. Art Cards common stock is listed in the "pink sheets," which are publicly distributed listings of low priced securities and the prices, if any, at which broker-dealers offer to deal in such securities. Art Cards common stock is registered

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with the Commission pursuant to Section 12(g) of the Exchange Act.

30. OTC America, Inc. ("OTC America") is a Colorado corporation headquartered in Denver organized for the purported purpose of providing management and business consulting services and bridge or interim financing to startup companies. OTC America's common stock and A and B warrants are listed in the pink sheets and are registered with the Commission pursuant to Section 12(g) of the Exchange Act.

31. Inner Vision, Inc. ("Inner Vision"), a privately held Delaware corporation, was organized in late 1987 to develop, design, manufacture and market disposable razors.

32. Star Publications, Inc. ("Star"), a Colorado corporation with headquarters in New York, was organized for the purpose of publishing football annuals and athletic event programs. Star subsequently merged with Inner Vision, purportedly to acquire the rights held by Inner Vision to a compact, disposable folding razor called "Matchbox" and a multi-blade semi-disposable cartridge razor called "Voyager". Star's common stock and warrants are listed in the pink sheets and registered with the Commission pursuant to Section 12(g) of the Exchange Act.

33. Jamie A. Darder ("Darder"), age 45, a resident of New York, New York, is the majority shareholder and president of Star Publications. Darder was the sole shareholder of Inner Vision prior to its merger with Star.

34. Genexus International, Inc. ("Genexus"), a Utah corporation headquartered in Salt Lake City, provides consulting services and support for the formation, funding and operation of "Innovation Centers." Innovation Centers purportedly help to develop new business entities, most of them involved in high-technology and bio-technology research and development. Genexus's common stock is listed in the pink sheets and is registered with the Commission pursuant to Section 12(g) of the Exchange Act.

35. AST Group, Inc. ("AST") (formerly Zodiac Resources, Inc.), is a Delaware corporation based in El Cajon, California. It was promoted as a "blind pool" securities issue but in June 1988 it acquired all of the issued and outstanding stock of AST Vending Services, Inc. Since the acquisition, AST has been engaged in the business of owning, leasing and operating a network of snack, food and beverage vending machines. AST's common stock and warrants are listed in the pink sheets.

36. The Westwind Group, Inc. ("Westwind"), a Delaware corporation based in Los Angeles, California, is primarily engaged in the business of producing and licensing low budget

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motion pictures. Westwind's common stock and warrants to purchase common stock are listed in the pink sheets. Westwind has filed reports with the Commission pursuant to Section 15(d) of the Exchange Act [15 U.S.C. § 78o(d)].

THE OVERALL SCHEME TO DEFRAUD

37. Beginning in late 1987 or early 1988 and continuing at least until the fall of 1988, defendants Power, Marchese, Monchecourt, Sandberg, Behringer, Johnson, Noble, Bajorek, Allied, Posey, Mercaldi, Masucci, Baren, Klingenberg and others engaged in an unlawful scheme to mislead and defraud the investing public (the "overall fraudulent scheme"). The scheme included, among other things, knowingly or recklessly inducing customers to invest in selected low-priced securities, commonly referred to as "penny stocks", through the use of materially false or misleading statements or omissions, the making of investment recommendations without a reasonable basis in fact, and high pressured, coercive sales practices. These defendants also defrauded investors by secretly coordinating the activities of Power and Allied so that they dominated and controlled the markets for certain securities sold to customers and could unlawfully profit from undisclosed excessive markups charged by Power and Allied to their customers. The defendants also defrauded customers by making it difficult for them to liquidate their investments and withdraw cash from their accounts. In this way, capital would continue to be held within Power and Allied to perpetuate the unlawful scheme. As alleged below, numerous violations of the federal securities law arose from the overall fraudulent scheme.

FIRST CAUSE OF ACTION: FRAUDULENT MISREPRESENTATIONS AND OMISSIONS

Defendants Power, Allied, Marchese, Monchecourt, Sandberg, Behringer, Johnson, Noble, Bajorek, Mercaldi, Masucci, Baren and Klingenberg Employed Fraudulent Devices, Material Misrepresentations and Omissions in the Sale of Securities in Violation of Section 17(a) of the Securities Act [15 U.S.C. §77 q(a)], Sections 10(b) and 15(c) of the Securities Exchange Act [15 U.S.C. §78j(b) and §78o(c)] and Rules 10b-5 and 15c1-2 [17 C.F.R. §§240.10b-5 and 240.15c1-2] Thereunder

38. Paragraphs 1 through 37 are realleged and incorporated herein by reference.

39. The principal business of Power and Allied was dealing in selected penny stocks, and acting in a principal capacity as a

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market maker in selling those securities to customers. Power, Allied and other defendants employed various fraudulent sales practices in order to sell or assist others in the sale of certain of those securities. These practices included fraudulent misrepresentations of material facts and omissions of material facts in presentations to customers concerning the investment merit of those securities and reasons for doing business with Power and Allied. Certain of these practices also constituted a manipulative, deceptive or other fraudulent device or contrivance.

40. A significant part of the business of Power and Allied was generated by telephone calls made by brokers to prospects who had no previous dealings with Power, Allied or the calling broker. Such telephone calls were referred to as "cold calls." Brokers used instructions and scripts furnished by the managements of Power and Allied to induce prospects to invest in penny stocks which Power and Allied were selling.

A. Fraudulent Misrepresentations and Omissions In Cold Calling at Power

[Power, Marchese, Monchecourt, Behringer, Johnson, Noble, Bajorek]

41. As part of Power's cold call system, brokers were directed to make materially false and misleading statements to prospective customers or to omit material information in connection with the purchase or sale of securities. Among these statements and omissions were:

a. telling prospective customers that Power was a "full service" firm specializing in the over-the-counter market and that it recently had been rated the number one underwriter nationwide of low-priced securities. In fact, Power was not a "full service" firm, Power discouraged brokers from handling any kind of transaction other than solicited trades in Power-recommended penny stocks in which it was a market maker, and Power lacked any reasonable basis in fact for claiming it was rated the number one underwriter of low-priced securities;

b. telling prospective customers that Power's "research department" was reviewing several securities and would be recommending one in the near future or that the broker himself was following a "special situation" which he might soon recommend if he thought it was a suitable investment. In fact, Power had no research department, the securities which Power offered for sale were chosen by Marchese and management discouraged brokers from researching the stocks being recommended to their clients. The brokers' references to "special situations" were part of a misleading scripted sales technique, repeated as part of each new cold-calling campaign;

c. omitting to give customers material negative factual information (e.g., financial information regarding the issuer) concerning the security's investment merit;

d. telling prospective customers that the recommended security would return a specified profit (typically a 20-40 percent profit) within a specified period of time (typically a 60-90 day holding period);

e. omitting to state to prospects that Power, either alone or in concert with Allied, dominated and controlled the markets for a number of securities offered for sale, (including those of Art Cards, OTC America, Star, Genexus, AST and Westwind);

f. omitting to state to prospects that Power had a practice of making it difficult for customers to liquidate their holdings to cash.

42. The cold calling system described above was instituted by Marchese and Monchecourt and implemented at Power's Las Vegas office by Behringer, at Power's Fort Collins, Colorado office by, among others, Johnson and Noble, and at Power's Santa Barbara, California office by Bajorek. These defendants knew, or were reckless in not knowing, that Power had no research department, that brokers did little or no research of the "special situations" touted in the cold call scripts, that the brokers were trained to sell securities by omitting to disclose to customers material facts, that specific profit predictions were being made, that Power, either alone or in concert with Allied, controlled and dominated the market for certain securities it sold, and that Power's practice was to make it difficult for customers to liquidate their holdings.

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B. Fraudulent Misrepresentations and Omissions In Cold Calling At Allied

[Allied, Mercaldi, Masucci, Baren, Klingenberg, Marchese, Power]

43. As part of Allied's cold call system, brokers were directed to make materially false and misleading statements to prospective customers or to omit material information in connection with the purchase or sale of securities. Among these statements and omissions were:

a. stating that the broker was following a "special situation" which he might soon recommend. In fact, many of the securities sold by Allied were chosen by Marchese and the brokers did not research those securities when recommending them to their clients;

b. omitting to give customers material negative factual information (e.g., financial information regarding the issuer) concerning the security's investment merit;

c. stating that the recommended security would return a specified profit (typically a 20-25 percent profit) within a specified period of time (typically a 60-90 day holding period);

d. omitting to state that Allied, either alone or in concert with Power, dominated and controlled the markets for a number of the securities which it offered for sale, including those of Art Cards, OTC America, Star, and Genexus;

e. omitting to state to prospects that Allied had a practice of making it difficult for customers to liquidate their holdings to cash.

44. On or about July, 1988, Marchese directed an assistant manager of Power's Fort Collins, Colorado branch office, to go to Florida to teach Power's cold calling practices to the Allied brokers who worked for Baren and Masucci. While in Florida, the assistant manager instructed Allied's brokers to sell securities: (i) by touting a minimal number of selectively positive selling points management provided regarding the security while omitting to provide material financial and other factual information concerning the security's investment merit; (ii) by falsely claiming to personally be following a "special situation", and (iii) by telling prospective customers that the recommended security would return a specified profit within a specified period of time.

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45. The cold calling system described above was instituted by Masucci, Baren, Klingenberg and others, under Marchese's and Mercaldi's supervision and control. These defendants knew, or were reckless in not knowing, that Allied brokers were not following "special situations," did not research stocks they recommended to customers and that Marchese selected the stocks to be recommended, that brokers were trained to sell securities by omitting to disclose to customers material facts, that specific profit predictions were being made and that Allied, either alone or in concert with Power, dominated and controlled the market for certain securities it offered for sale.

46. While subject to Mercaldi's supervision and control, Masucci, Baren, Klingenberg and others implemented and directed a cold call system in which Allied's brokers used a technique known in the penny stock industry as an "assumed close." The "assumed close" required the broker to call a prospective customer and immediately begin soliciting the necessary information to open an account. The broker would then conclude the call by "assuming" that the prospect had purchased a specified number of shares of the recommended security without ever asking the customer whether he or she wished to make the recommended purchase. The "assumed close" operated as a fraud or deceit upon customers who did not agree to purchase the securities which were offered and defendants Mercaldi, Masucci, Baren and Klingenberg knew, or were reckless in not knowing, that the practice was fraudulent.

47. While subject to Mercaldi's supervision and control, Masucci, Baren, Klingenberg and others implemented and directed a cold call system in which Allied's brokers used a technique known in the penny stock industry as a "take away" close. The "take away" close required the broker to excite a prospective customer about a security and then falsely to tell the customer that he could purchase only a limited number of the security when, in fact, there was no limit on the amount of the security the broker had available for sale. The technique operated as a fraud or deceit by causing the customer to make a hasty and uninformed decision in the false belief the security was in heavy demand and, therefore, had to be purchased immediately because of supposedly limited availability. Mercaldi, Masucci, Baren and Klingenberg knew, or were reckless in not knowing, that the "take away" close was fraudulent.

C. Lack of Basis for Recommendations by Power and Allied

[Power, Allied, Marchese, Monchecourt, Behringer, Johnson, Noble, Bajorek, Mercaldi, Masucci, Baren, Klingenberg]

48. Power's management typically provided brokers with little or no relevant financial information and with sales scripts containing selectively positive selling points, including

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statements which were materially false and misleading, while not including material negative information. More detailed materials either were not obtained by Power or were not made available to brokers for study.

49. Allied's and Power's management typically provided Allied's brokers with lists containing a few selectively positive selling points and little or no relevant financial information regarding the issuer, while not including negative information. More detailed materials either were not obtained by Power and Allied or were not made available to Allied's brokers for study.

50. Power and Allied management did not provide their brokers with an adequate or reasonable basis in fact for their recommendations of securities and discouraged brokers from doing any independent analysis of the recommended securities.

51. Defendants Power, Allied, Marchese, Monchecourt, Behringer, Johnson, Noble, Bajorek, Mercaldi, Masucci, Baren, Klingenberg and others directed brokers to recommend securities when they knew, or were reckless in not knowing, that the brokers had no reasonable basis in fact for the recommendation.

D. __Fraudulent Flips__

[Power, Allied, Marchese, Monchecourt, Behringer, Johnson, Noble, Bajorek, Mercaldi, Masucci, Baren, Klingenberg]

52. The term "flips" refers to situations in which brokers recommend to customers the sale of one security and the purchase of another for the purpose of increasing commissions. Flipping occurred when Power or Allied offered to buy a customer's security at a premium price higher than the bid price for the purpose of inducing the customer to sell and to purchase new securities. Power and Allied would not quote the premium price or execute a sale at the premium price if a customer wished only to sell his securities for cash without purchasing another security from Power or Allied. Power and Allied failed to disclose the practice of offering to purchase a security at different prices to obtain flips at the time they initially solicited customers to invest in securities they recommended. This constituted an omission of material information in connection with the offer or sale of a security and accordingly was fraudulent.

53. Marchese and Monchecourt developed and implemented the fraudulent flipping practices. Marchese, Monchecourt, Behringer, Johnson, Noble, Bajorek and others directed Power's brokers and Marchese, Mercaldi, Masucci, Baren, Klingenberg and others directed Allied's brokers to flip customers in the manner described herein. Marchese and Mercaldi specified those

securities customers should be pressed to sell and buy and the prices at which the securities were to be bought and sold in fraudulent flips. Marchese, Monchecourt, Behringer, Johnson, Noble, Bajorek, Mercaldi, Masucci, Baren and Klingenberg knew, or were reckless in not knowing, that this practice was not disclosed to customers at the time they were initially solicited to invest in securities recommended by Power and Allied and that this omission was fraudulent.

E. Power and Allied Discouraged or Prevented Customers from Liquidating Their Portfolios

[Power, Allied, Marchese, Monchecourt, Sandberg, Behringer, Johnson, Noble, Bajorek, Mercaldi, Masucci, Baren, Klingenberg]

54. Except when attempting to flip customers as described above, Power and Allied typically kept their bid price for securities in which they made a market below the customer's cost of acquiring a security in order to discourage the customer from liquidating his portfolio and requiring Power or Allied to send cash to the customer.

55. Marchese, assisted by Monchecourt, Sandberg, Behringer, Johnson, Noble and Bajorek at Power, discouraged or refused to execute "net sell orders" in which a customer's sell order was for a greater dollar amount than his buy order, and "naked sell orders" in which a customer sold without buying other securities. The effect of a net sell or naked sell order, if executed, was to create a cash balance in the customer's account which the customer might attempt to withdraw. Net sells and naked sells were discouraged in order to make it difficult for customers to withdraw cash from their accounts.

56. Marchese, assisted by Monchecourt, Sandberg, Behringer, Johnson, Noble, Bajorek and others at Power, and Marchese and Mercaldi, assisted by Masucci, Baren, Klingenberg and others at Allied, enforced practices discouraging or preventing customer liquidation of accounts by requiring brokers to replace any customer cash withdrawals from Power or Allied with new investments by other customers in equal or greater amounts. In general, brokers were expected to replace any cash withdrawals plus 10 to 20 percent in additional cash.

57. The practices discouraging or preventing liquidation of customer accounts were not disclosed to customers when they purchased securities from Power or Allied. Failure to disclose these practices was an omission of material facts in connection with the purchase or sale of securities. Marchese, Monchecourt, Sandberg, Behringer, Johnson, Noble, Bajorek, Mercaldi, Masucci, Baren and Klingenberg knew, or were reckless in not knowing, that the omission to disclose these practices was fraudulent.

F. Recommending, Purchasing and Selling the Same Security at Different Prices

[Power, Allied, Marchese, Monchecourt, Masucci, Mercaldi]

58. Power on at least two occasions in 1988, one of which involved the securities of Westwind and one of which involved the securities of Star, caused brokers at one or more of its branch offices to recommend to customers the sale of a security at one price while brokers at a different office or offices were at substantially the same time recommending to customers the purchase of the same security at a higher price. Failure to disclose to sellers and purchasers that Power was recommending sale of the security to some customers while recommending its purchase to others at a higher price was a material omission and constituted a device, scheme or artifice to defraud.

59. In or about May, 1988, during which time Power had direct or indirect control over Allied, or Power and Allied were under the direct or indirect common control of Marchese, Marchese directed brokers at one or more of Power's branch offices to solicit customers to sell OTC America stock at $.20 per share and purchase Art Cards stock at $.34 per share, while at substantially the same time he directed Allied to solicit customers to sell Art Cards stock at $1.70 per unit ($.17 per share) and purchase OTC America stock at $.25 per share.

60. Since Power and Allied were under common control, the failure to disclose to sellers and purchasers that Power and Allied, as affiliated entities, were recommending the sale of OTC America and Art Cards stock to some customers while recommending the purchase of these securities to others at a higher price was a material omission and constituted a device, scheme or artifice to defraud.

61. Marchese, Monchecourt, Allied, Mercaldi and Masucci knew, or were reckless in not knowing, that Power was engaged in the substantially simultaneous solicitation of the purchase and sale of the same security at different prices at different Power branch offices, or between Power and Allied offices, that this information was material and was not disclosed to customers and that the practice constituted a device, scheme or artifice to defraud.

G. False and Misleading Statements in Connection With the Offer or Sale of Star Securities

[Power, Marchese, Monchecourt]

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62. Power caused its brokers to use scripts that made materially false and misleading statements and omitted to state material facts to prospective customers in connection with the sale of Star securities. The scripts, among other things:

(i). falsely stated that Star's razor product was "biodegradable" when in fact the razor was made out of plastic which would not decompose and was not biodegradable;

(ii). falsely stated that Star was negotiating the sale of razor products with the U.S. military, airlines and with the manufacturer of L'eggs pantyhose when in fact Star was never involved in negotiations with the U.S. military, airlines or the manufacturer of L'eggs pantyhose;

(iii). falsely stated that Star had zero liabilities when in fact Star had significant liabilities, including major outstanding obligations to the purported licensor of its primary product;

(iv). falsely stated that Star had $225,000 in cash when in fact the company did not have $225,000 in cash much of the time Power was selling Star securities to its customers;

(v). falsely stated that Star had "55 million shares total outstanding -- 20 million trading" when in fact Star had 170 million to 500 million shares outstanding at the time the false statements were made, and;

(vi). failed to disclose a legal challenge to Star's right to market its principal product, the Matchbox razor, which challenge was known to Power by at least April 1988, and even earlier to Star's controlling shareholder, Fong, and which resulted in an arbitrator's decision which effectively invalidated Star's right to market the Matchbox razor.

63. Marchese and Monchecourt directed and controlled brokers who employed the Star scripts containing the false and misleading statements of material fact and omissions of material fact and knew, or were reckless in not knowing, that the statements were materially false and misleading and that the omissions were material.

H. False and Misleading Statements in Connection <u>With the Offer or Sale of Art Cards Securities</u>

[Power, Marchese, Monchecourt]

64. Power caused its brokers to use scripts that made materially false and misleading statements to prospective customers in connection with the offer or sale of Art Cards securities. The scripts, among other things:

a. falsely stated that the management of Art Cards had been involved in two other greeting card companies, one of which was acquired by Hallmark Cards, Inc. and the other of which was bought by American Greetings Corporation, when in fact the founder of Art Cards and its only manager, Richard Miller, had never worked for another greeting cards company, had not dealt with American Greetings and had only brief contact with Hallmark about the possibility of licensing it to distribute a line of Art Card's products, which did not result in any licenses;

b. falsely stated that two well known figures in entertainment and the arts, Yoko Ono and Peter Max, had agreed to become spokespersons for Art Cards and that they had been on network and cable television (including FNN, MTV and the Larry King "Live" show on CNN) to promote Art Cards, when in fact neither Yoko Ono nor Peter Max agreed to become spokespersons or did any promotional work for Art Cards, and;

c. falsely stated that Peter Max was a licensor of Art Cards when in fact Peter Max was not a licensor of Art Cards.

65. Marchese and Monchecourt directed and controlled Power brokers who employed the Art Cards scripts containing the false and misleading statements of material fact, and knew, or were reckless in not knowing, that the statements were materially false and misleading.

I. False and Misleading Statements in Connection <u>With the Offer or Sale of Genexus Securities</u>

[Power, Marchese, Monchecourt]

66. Power caused its brokers to use scripts that made materially false and misleading statements to prospective customers in connection with the offer or sale of Genexus securities. The scripts, among other things:

a. falsely presented Genexus as a large, global leader in its field when in fact it was a startup company;

b. falsely stated that Genexus had its first pilot program at Oak Ridge, Tennessee purchased by Martin-Marietta Corporation, when in fact Genexus was a consultant to Martin Marietta Corporation;

c. falsely stated that Genexus was so successful that the U.S. Commerce Department and the National Science Foundation referred all business incubator inquiries to Genexus, when in fact neither of these organizations referred all business incubator inquiries to Genexus, and;

d. falsely stated that inquiries from persons seeking support from Genexus for new technologies were so numerous that Genexus established a non-profit organization to handle them, when in fact Genexus was able to handle the number of inquiries it received and had not established any non-profit organization to handle inquiries.

67. Marchese and Monchecourt directed and controlled Power brokers who employed the Genexus scripts containing the false and misleading statements of material fact and knew, or were reckless in not knowing, that the statements were materially false and misleading.

J. False and Misleading Statements in Connection With the Offer or Sale of Westwind Securities

[Power, Marchese, Monchecourt]

68. Power caused its brokers to use scripts that made materially false and misleading statements to prospective customers in connection with the offer or sale of Westwind securities. The scripts, among other things:

a. falsely stated that through preselling its films Westwind "know[s] what kind of profits they'll have before the films are made," when in fact Westwind was not certain of its profits through preselling;

b. falsely stated that "[h]orror films are big sellers worldwide and Westwind Productions puts a heavy emphasis on this", when in fact Westwind did not make horror films.

69. Marchese and Monchecourt directed and controlled Power brokers who employed the Westwind scripts containing the false and misleading statements of material fact and knew, or were reckless in not knowing, that the statements were materially false and misleading.

70. By reason of the acts and practices alleged herein in the First Cause of Action, from on or about November, 1987, through at least August, 1988, as part of the overall fraudulent scheme, Power, Allied, Marchese, Monchecourt, Sandberg, Behringer, Johnson, Noble, Bajorek, Mercaldi, Masucci, Baren and Klingenberg singly and in concert, in the offer or sale of securities, by the use of means or instruments of transportation or communication in interstate commerce, means or instrumentalities of interstate commerce, or by the use of the mails, directly or indirectly: (a) employed devices, schemes, or artifices to defraud; (b) obtained money or property by means of untrue statements of material facts or omissions to state material facts necessary in order to make statements made, in the light of the circumstances under which they were made, not misleading; (c) made untrue statements of material fact or omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or (d) engaged in transactions, practices, or courses of business which operated or would operate as a fraud or deceit upon purchasers of securities.

71. By reason of the acts or practices alleged herein in the First Cause of Action, from on or about November, 1987, through at least August, 1988, as part of the overall fraudulent scheme, Power and Allied, aided and abetted by Marchese, Monchecourt, Sandberg, Behringer, Johnson, Noble, Bajorek, Mercaldi, Masucci, Baren and Klingenberg, directly or indirectly, made use of the mails or means or instrumentalities of interstate commerce to effect transactions in, or induce or attempt to induce the purchase or sale of securities by means of manipulative, deceptive, or other fraudulent devices or contrivances.

72. By reason of the foregoing acts, practices, and courses of business, Power, Allied, Marchese, Monchecourt, Sandberg, Behringer, Johnson, Noble, Bajorek, Mercaldi, Masucci, Baren and Klingenberg violated Section 17(a) of the Securities Act [15 U.S.C. §77q(a)] and Section 10(b) of the Exchange Act [15 U.S.C. §78j(b)] and Rule 10b-5 [17 C.F.R. §240.10b-5] thereunder.

73. By reason of the foregoing acts, practices and courses of business, Power and Allied violated Section 15(c) of the Exchange Act [15 U.S.C. §78o(c)] and Rule 15c1-2 thereunder [17 C.F.R. §240.15c1-2].

74. By reason of the foregoing acts, practices, and courses of business, Marchese, Monchecourt, Sandberg, Behringer, Johnson, Noble, Bajorek, Mercaldi, Masucci, Baren and Klingenberg aided and abetted Power's and Allied's violations of Section 15(c) of the Exchange Act.

SECOND CAUSE OF ACTION:
SECRET CONTROL OF ALLIED BY POWER AND MARCHESE

Power and Marchese Failed to Disclose a Secret Relationship With Allied in Violation of Section 15(b) of the Exchange Act [15 U.S.C. §78o(b)], Rule 15b3-1(b)[17 C.F.R. §240.15b3-1(b)] and Form BD [17 C.F.R. §249.501]

75. Paragraphs 1 through 74 are realleged and incorporated herein by reference.

76. From on or about March, 1988 through at least August, 1988, as part of the overall fraudulent scheme, Power and Allied maintained a secret working relationship which Power and Marchese, aided and abetted by Toni Allen, failed to disclose in amendments to Items 8 and 9 of Power's Form BD [17 C.F.R. §249.501] as required by Section 15(b) of the Exchange Act [17 C.F.R. §78o(b)] and Rule 15b3-1(b) [17 C.F.R. §240.15b3-1(b)] thereunder.

77. In or about late 1987 or early 1988, Power acquired direct or indirect control over Allied, or Allied and Power came under the direct or indirect common control of Marchese (hereinafter called the "control relationship"). Power and Marchese were required to disclose such control under Item 9 of Form BD.

78. In or about December, 1987, Marchese and Freedman, then Allied's owner, agreed that Marchese would, directly or indirectly, purchase Allied for $680,000. A purchase agreement was entered into between Freedman and Allen on or about February 25, 1988 (the "Allied Purchase Agreement"), under which Allen agreed to purchase Freedman's shares of Allied, which were then over 96 percent of the outstanding shares, for $680,000. Allen acted as the undisclosed nominee of Marchese to aid and abet Marchese's failure to disclose his common control of Power and Allied.

79. At Marchese's request, Allen gave Freedman a check for $10,000 from a partnership in which she and Marchese were the only partners as a down payment for the purchase of Allied. The purchase agreement provided, among other things, that an escrow would be funded with the remaining $670,000 of the purchase price. The escrow never was funded. Instead, in May 1988,

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pursuant to an agreement between Mercaldi and Freedman, Allied redeemed Freedman's shares of Allied stock for $670,000 paid from Allied's capital account. The amount paid Freedman equalled the amount due Freedman under the purchase agreement between Freedman and Allen. Allied obtained all or most of the funds to purchase Freedman's stock in the company through a series of securities sales to Power in April and early May 1988. On at least one occasion, Power paid Allied approximately 20 percent more for a security than Power was charging its customers for the same security.

80. Mercaldi was the only shareholder of Allied other than Freedman in May 1988. The effect of the redemption was to make Mercaldi the sole shareholder of Allied.

81. Subsequent to May 1988, Marchese stated that he had "made" Allied, that he was its "controlling person", and that he was the one that had "pumped" the money into Allied and provided Allied with its profits and net capital. Subsequent to May 1988, Mercaldi stated that he owed Marchese between $600,000 and $800,000, or approximately the amount needed by Allied to redeem Freedman's stock for $670,000.

82. Power and Marchese exercised actual control and direction over Allied. Marchese directly or indirectly provided financing to defendant Masucci to enable Masucci and his partner, defendant Baren, to open an Allied franchised branch office. Marchese caused Power to provide Allied customer lists and leads obtained from Power advertising campaigns. Marchese met with and informed prospective Allied franchisees early in 1988 that Allied and Power would be coordinating the marketing of the same securities. Marchese also instructed Allied's Florida managers as to the securities they should sell, the prices they should charge and when and under what terms the securities would be repurchased from Allied's customers. Marchese also implemented at Allied some or all of the high pressure, fraudulent sales practices employed at Power, such as flips and requiring brokers to replace 120 percent of all cash liquidations by their customers.

83. By reason of the foregoing acts, practices, and courses of business, Power and Marchese violated Section 15(b) of the Exchange Act, Rule 15b3-1(b) thereunder, and Form BD.

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THIRD CAUSE OF ACTION: ALLIED FAILURE TO DISCLOSE CONTROL BY POWER AND MARCHESE

Allied, Freedman and Mercaldi's Failure to Disclose a Secret Relationship in Violation of Section 15(b) of the Exchange Act, Rule 15b3-1(b) Thereunder and Form BD

84. Paragraphs 1 through 83 are realleged and incorporated herein by reference.

85. From on or about March 1988 through at least May 1988, Allied and Freedman, and from on or about May 1988 through at least December 1988, Allied and Mercaldi, failed promptly to disclose the control over Allied exercised by Power and Marchese, the financing provided to Allied by Power through purchases of securities at above-market prices and leads provided to Allied by Power in amendments to Items 6A, 6B and 9 of Allied's Form BD application as required by Section 15(b) of the Exchange Act and Rule 15b3-1(b).

86. By reason of the foregoing acts, practices, and courses of business, Allied, Freedman and Mercaldi violated Section 15(b) of the Exchange Act, Rule 15b3-1(b) thereunder and Form BD.

FOURTH CAUSE OF ACTION: MANIPULATION OF THE MARKET FOR STAR SECURITIES

Power, Allied, Marchese, Freedman, Fong and Pignatiello Manipulated the Market for Star Publications Securities in Violation of Section 17(a) of the Securities Act, Section 10(b) and 15(c) of the Securities Exchange Act and Rules 10b-5 and 15c1-2 Thereunder

87. Paragraphs 1 through 86 are realleged and incorporated herein by reference.

A. Origins of the Star Scheme

88. From on or about November 1987 through at least August 1988, defendants Power, Allied, Marchese, Freedman, Pignatiello and Fong engaged in a scheme ("the Star scheme") to manipulate the market for Star securities by, among other things, secretly limiting the freely tradeable supply of Star securities, secretly agreeing to supply Power with Star securities to sell, securing domination and control over the market for Star securities in order to artificially control supply, demand and the prices of Star securities, disseminating false information to prospective investors and by failing to disclose material nonpublic negative information concerning Star's principal products.

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89. Star was incorporated in 1985 with startup assistance provided by Fong. Star issued 116.5 million shares of unregistered stock (the "Rule 144" shares) to a group of approximately 30 investors during the period November, 1985 through September, 1986. Pursuant to Securities Act Rule 144 [17 C.F.R. §230.144], the Rule 144 stock was subject to certain restrictions, including a prohibition on public sale for at least two years.

90. The 116.5 million Rule 144 shares included 54.5 million shares issued to Star's management in exchange for services; 20.33 million shares issued to Fong and affiliated entities; and 41.17 million shares issued to approximately 30 other investors, most of whom were recruited as purchasers by Fong.

91. Fong assisted Star in raising capital through an initial public offering in April, 1987. Each of 53.42 million units sold to the public for $.01 consisted of one share of common stock and one warrant to purchase a share of common stock at $0.02.

92. From May through October of 1987, Fong and persons or entities under his control purchased sufficient Star securities such that, combined with the Star securities he or entities under his control previously purchased, Fong controlled a majority of the voting securities of Star.

93. Fong caused Equitex to purchase 40.5 million shares of Rule 144 stock from Star's management on or about September 29, 1987. This purchase reimposed the restrictions of Rule 144, effectively keeping the 40.5 million shares out of the public stock markets until September 1989 at the earliest. The remaining 14 million shares held by Star's management were placed in a trust account as part of a settlement of litigation between Star's president and Fong, under conditions that prevented them from being sold until at least late summer 1988. Accordingly, Fong's actions in September, 1987 ensured that 54.5 million of the 116.5 million shares of Star Rule 144 stock would not be traded for one year or more.

94. In early November 1987, Fong, Freedman, who was president of Allied, and Pignatiello, who was retained as a consultant by Inner Vision, met to discuss a possible merger of Inner Vision with Star. Fong sought assurances that Allied would make a market in Star securities after the merger. Freedman was willing to have Allied be a market maker in Star securities, but was concerned that Rule 144 stock which Fong did not own or control was about to become freely tradeable. Freedman was afraid that this would cause the market price for Star securities to decline and make it difficult to obtain exercise of the warrants. Freedman made it clear to Fong that Allied would not make a market in Star securities unless Fong obtained commitments from the holders of the Rule 144 stock not to sell their stock

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even after the two year holding period expired. Such commitments are sometimes called lockups. Fong agreed to obtain lockups.

95. Fong succeeded in locking up a majority of the restricted shares. The lockups were never disclosed to Allied's or Power's customers, or to the public.

96. During the first week of November 1987, at the same time Freedman and Pignatiello were negotiating the Star/Inner Vision merger with Fong, Freedman contacted Marchese at Power to solicit Power's participation as a market maker in Star. Freedman wanted Power's sales force to help sell Star securities. Freedman and Pignatiello met with Marchese and Monchecourt prior to November 6, 1987. Freedman told Marchese that he was in the process of negotiating a letter of intent for a Star/Inner Vision merger. Marchese agreed that if a letter of intent was signed Power would become a market maker in Star securities.

97. Marchese also agreed to purchase, at Allied's cost, half of any Star securities acquired by Allied, so that Power would have an inventory of Star securities for sale. Marchese wanted to buy through Allied to avoid alerting the market to Power's interest in Star, which might drive up the price of the securities before Power could acquire the desired inventory.

98. On or about Friday, November 6, 1987, Power and Allied began acquiring Star securities to be retailed in connection with the Star Scheme. In the week of November 9, 1987, Allied began selling Star securities to customers pursuant to the fraudulent Star scheme. In the week of November 16, 1987, Power began selling Star securities to customers pursuant to the fraudulent Star scheme.

99. By the end of November, 1987, Power and Allied jointly controlled over 60 percent of the freely tradeable Star stock through their inventory and in customer accounts. From December, 1987 through August, 1988, Power and Allied jointly dominated and controlled the market for Star common stock, holding between 70 percent and 80 percent of the freely tradeable stock in their inventory and customer accounts. During the period March, 1988 through August, 1988, Power and Allied jointly dominated and controlled between 70 percent and 90 percent of the freely tradeable Star warrants in their inventory and customer accounts. This domination and control, and the fact that it enabled Power and Allied to charge excessive markups, was not disclosed to Power's or Allied's customers, an omission that was material.

B. False Statements in the Business Plan
[Pignatiello]

100. In or about October, 1987, Pignatiello materially altered a written business plan prepared by Darder and disclosed to Pignatiello in confidence. Pignatiello created a document he titled Innervision Inc., Condensed Business and Marketing Plan ("the condensed plan"). In preparing the condensed plan, Pignatiello knowingly or recklessly added untrue statements of material fact, or altered information provided by Darder such that it contained untrue statements of material fact, including the following:

(i) The condensed plan claimed that "Matchbox will be launched by January, 1988." In fact, by November 1987, Inner Vision projected product introduction in December 1988, assuming the merger with Star was completed by December 1987 and the warrants were exercised within 60-90 days thereafter;

(ii) The condensed plan stated that Inner Vision "has identified the Italian manufacturing [sic] to be the most cost effective, since that company is owned by the inventor." In fact, no manufacturer for U.S. distribution of the Matchbox razor had been identified;

(iii) The condensed plan stated that "the inventor [of the razors] will become a shareholder of the company" and that the inventor "is a shareholder in the Company." In fact, Darder was not the inventor and at all times relevant hereto was the sole shareholder of Inner Vision, and Pignatiello had no reasonable basis in fact for believing that the inventor of the razors would become a shareholder of Star; and

(iv) The condensed plan described Inner Vision as a "wholly owned subsidiary of Star Publications, Inc." when the companies only had signed a letter of intent to merge. Inner Vision did not become a wholly-owned subsidiary of Star until May, 1988, by which time Inner Vision's license to distribute the razors was under legal challenge.

101. Pignatiello provided copies of the condensed plan to various securities brokers, including brokers at Power and Allied, for the purpose of selling Star securities.

102. Pignatiello knew, or was reckless in not knowing, that the business plan distributed to Power and Allied brokers contained false and misleading statements of material fact.

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C. False Statements In A Magazine

[Pignatiello, Allied, Freedman, Power, Marchese]

103. Speculator Magazine ("Speculator") is a publication for brokers and investors containing articles and advertisements promoting low-priced and penny stocks. In December, 1987, the publisher of Speculator met with Pignatiello and Freedman to discuss Star securities. Freedman and Pignatiello wanted to promote Star's securities through the press.

104. In January 1988, Pignatiello substantially caused Speculator to publish an article about Star containing false and misleading statements of material fact provided by Pignatiello. These statements included:

(i). that "[t]he company expects to introduce its Matchbox razors in the United States in March [1988]" when there was no basis for such a claim;

(ii) that Inner Vision "has contracted" with a major distributor when there was no such contract;

(iii) that the distributor Inner Vision had supposedly contracted with would make "the product available to approximately 30,000 ... stores in New York State" when there was no proposal to make the product available to 30,000 stores in New York State; and

(iv) that Matchbox has been shown to the military "which is considering issuing camouflaged versions of Matchbox razors to GIs" when the product had not been shown to the military and the military had expressed no interest in it.

105. On or about March 18, 1988, Pignatiello sent Marchese multiple copies of the Speculator article. Marchese distributed copies of the article to Power's brokers who used it as a source of information for the purpose of selling Star's securities to customers. Marchese knew, or was reckless in not knowing, that the article contained false or misleading statements of material fact concerning Star.

106. Allied used the Speculator article as a source of information to be provided to customers to induce them to invest in Star's securities. Allied brokers were provided with copies of the article and instructed to send copies to customers who appeared interested in Star securities.

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107. Pignatiello, Allied, Freedman, Power and Marchese knew, or were reckless in not knowing, that the Speculator article contained false and misleading statements of material fact.

D. Manipulative Star Trading
[Power, Allied, Freedman, Fong and Pignatiello]

108. During the period November, 1987 through August, 1988, Power and Allied sold millions of shares of Star common stock to customers at escalating prices. During the period March, 1988 through August, 1988, Power and Allied sold millions of Star warrants at escalating prices.

109. On or about December 17, 1987, Power sold 2 million shares of Star common stock to customers at a price of 20 cents, per share and ended the day on December 17, 1987 with its inventory account having a short position of over 7 million shares. On or about December 18, 1987, Power solicited 3.5 million shares of Star common stock at 11-12 cents per share from its customers to fill the buy orders solicited the previous day. Power did not disclose to customers that it was substantially simultaneously soliciting both purchases and sales of Star common stock at substantially different prices. Such information was material.

110. On or about June 13, 1988, Allied through solicited transactions repurchased a large quantity of Star common stock from customers in various offices other than its Wellington, Florida office, acquiring approximately 3.7 million shares at 13¢ per share in a single day. This repurchase coincided with a sales campaign by Allied's Wellington office which, on or about June 15, 1988, sold over 6.7 million shares of Star to customers at 14.5¢ per share. These purchase orders were filled through Allied's transfer of a 7.2 million share block from its inventory to its Wellington office on June 16, 1988. Allied did not disclose to customers that it was substantially simultaneously soliciting both purchases and sales of the same stock at substantially different prices. Such information was material.

111. From on or about November 1987 through at least August 1988, defendant Fong, as part of the Star scheme, caused millions of Star securities to be sold for his own account and on behalf of nominal defendants Equitex and Carolyn Fong. These sales resulted in illegal profits in excess of $400,000.

112. Equitex and Carolyn Fong hold all or portions of the funds realized from defendant Fong's above described sales of Star securities as constructive trustees.

113. Equitex and Carolyn Fong obtained and have an interest in all or portions of the funds described in paragraph 111 above under circumstances in which it is not just, equitable or

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conscionable for them to retain the funds. Equitex and Carolyn Fong obtained the funds at the expense of defrauded investors in Star. As a result, Equitex and Carolyn Fong have been unjustly enriched in an amount to be determined at trial.

114. From on or about January 1988 through at least September 1988, defendant Pignatiello, as part of the Star scheme, caused millions of Star securities to be sold on behalf of nominal defendants Constance Pignatiello, Jovijuco and Redfern. These sales resulted in illegal profits in excess of $200,000.

115. Constance Pignatiello, Jovijuco and Donald Redfern hold all or portions of the funds realized from defendant Pignatiello's above described sales of Star securities as constructive trustees.

116. Constance Pignatiello, Jovijuco and Redfern obtained and have an interest in all or portions of the funds described in paragraph 114 above under circumstances in which it is not just, equitable or conscionable for them to retain the funds. Constance Pignatiello, Jovijuco and Redern obtained the funds at the expense of defrauded investors in Star. As a result, Constance Pignatiello, Jovijuco and Redfern have been unjustly enriched in an amount to be determined at trial.

117. By virtue of the Star Scheme, Power realized at least approximately $5,181,233 in unlawful profits.

118. By virtue of the Star scheme, Allied realized at least approximately $2,957,164 in unlawful profits.

119. By virtue of their participation in the Star scheme, defendants Power, Allied, Marchese, Freedman, Fong and Pignatiello, singly and in concert, knowingly or recklessly, in the offer or sale of securities, by the use of means of transportation or communication in interstate commerce, by the use of means or instrumentalities of interstate commerce or by the use of the mails, (a) employed devices, schemes, or artifices to defraud; (b) obtained money or property by means of untrue statements of material fact or omissions to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, (c) made untrue statements of material fact or omitted to state material facts necessary in order to make the statements made, in the light of the circumstances under which thery were made, not misleading; and (d) engaged in transactions, practices or courses of business which operated or would operate as a fraud or deceit upon purchasers of Star securities.

120. By virtue of their participation in the Star scheme, defendants Power and Allied, aided and abetted by Marchese,

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Freedman, Fong and Pignatiello, made use of the mails, or means or instrumentalities of interstate commerce to effect transactions in, or attempt to induce the purchase or sale of Star securities by means of manipulative, deceptive or other fraudulent devices or contrivances.

121. By reason of the foregoing acts, practices, and courses of business, Power, Allied, Marchese, Freedman, Fong and Pignatiello directly and indirectly violated Section 17(a) of the Securities Act.

122. By reason of the foregoing acts, practices, and courses of business, Power, Allied, Marchese, Freedman, Fong and Pignatiello directly and indirectly violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

123. By reason of the foregoing acts, practices and courses of business, Power and Allied, directly and indirectly, violated Section 15(c) of the Exchange Act and Rule 15c1-2 thereunder.

124. By reason of the foregoing acts, practices and courses of business, Marchese, Freedman, Fong and Pignatiello, directly and indirectly, aided and abetted Power and Allied's violations of Section 15(c) of the Exchange Act and Rule 15c1-2 thereunder.

FIFTH CAUSE OF ACTION:
INSIDER TRADING IN STAR SECURITIES

Power, Allied, Marchese, Freedman and Pignatiello Engaged in Insider Trading in Star Securities in Violation of Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 Thereunder

125. Paragraphs 1 through 124 are realleged and incorporated herein by reference.

126. During the week of November 2, 1987, a series of meetings was held between Fong, Freedman and Pignatiello concerning plans for the proposed Star-Inner Vision merger. Freedman attended these meetings in his capacity as a financial adviser to Star and because he was responsible for arranging for the exercise of the Star warrants necessary to fund Inner Vision's business plan. Pignatiello attended the meeting in his capacity as Darder's and Inner Vision's business adviser. Marchese was informed of the status of negotiations and plans for a merger by Freedman.

127. Fong, Freedman and Pignatiello knew, or were reckless in not knowing, that the consultations, deliberations and negotiations concerning the possible merger of Star and Inner Vision were confidential, and that the relationships of Freedman

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to Star and of Pignatiello to Inner Vision were fiduciary or other relationships of trust and confidence.

128. On the morning of November 6, 1987, at approximately 9:00 a.m., a meeting was held in Fong's office at Equitex with Darder, his counsel, Pignatiello, Freedman, Fong and Fong's aide. A letter of intent to merge Star and Inner-Vision was signed in the mid-to-late afternoon. The letter of intent provided that the Star-Inner Vision merger was to occur within 60 days. Public announcement of the Star-Inner Vision letter of intent was made on Monday, November 9, 1987, at approximately 12:01 p.m. Eastern Standard Time.

129. Early in November 1987, Fong informed Freedman that Dunhill Securities might have a large supply of Star securities in inventory or in customer accounts. Freedman contacted Dunhill during the week prior to November 6, 1987 and told Dunhill that Allied expected to purchase approximately 20 million units of Star in the very near future. Freedman offered a price of $0.012 per unit, to which Dunhill agreed. Freedman did not disclose to Dunhill that Star was in merger negotiations with Inner Vision and Dunhill had no knowledge of such negotiations.

130. On November 6, 1987 at approximately 9:19 a.m., Dunhill received an order from Allied to purchase 18 million Star units at $0.012 per unit. Dunhill already had contacted its customers and determined their interest in selling their Star units to Dunhill for $0.011 per unit. None of these customers was informed that Star and Inner Vision were engaged in merger negotiations. Within two hours, Dunhill had purchased 18 million Star units from its customers, which were sold to Allied for $0.012 per unit. This sale occurred at approximately 11:17 a.m. on November 6, 1987.

131. The Allied order to purchase 18 million Star units from Dunhill on November 6, 1987, was placed pursuant to Freedman's instruction while Freedman was in possession of material, nonpublic information that Star was negotiating a letter of intent to merge with Inner Vision.

132. On November 6, 1987, Allied purchased 4.85 million Star units from a group of six of its customers at prices ranging from $0.010 to $0.011 per unit. These trades were solicited by Allied's brokers at Freedman's direction while Freedman was in possession of material, nonpublic information that Star was negotiating a letter of intent to merge with Inner Vision. The selling customers were not informed of the merger negotiations.

133. Consistent with his prior agreement with Marchese and in furtherance of the Star scheme, Freedman caused Allied to sell half of the block purchased from Dunhill, or 9 million shares, to Power at $0.012 per share, the price paid by Allied. The sale to

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Power occurred on November 6, 1987 at approximately 12:35 p.m., prior to the public announcement of the letter of intent for Star to merge with Inner Vision.

134. Pignatiello caused certain of his affiliates to purchase Star securities on November 6, 1987 while he was in possession of material nonpublic information concerning the intention to merge Star and Inner Vision. Pignatiello purchased 1 million Star units for his father-in-law, Donald Redfern, and 185,000 Star units for his wife, of which 125,000 units were bought in an account in the name of Constance Pignatiello and 60,000 units were bought in an account in her prior married name, Constance Wilson. All of these purchases were at $0.0135 per unit and all of the purchases preceded the public announcement of Star's intention to merge with Inner Vision. As discussed in ¶¶ 114-116, these securities were sold at Pignatiello's direction in 1988 and such sales resulted in unlawful profits in excess of $200,000.

135. Allied began selling Star securities to customers on November 9, 1987, the day the letter of intent to merge was announced. Allied sold 1.05 million Star units to customers on that day at prices ranging from $0.015 to $0.03 per unit. It split up the remaining units, placing the warrants in an inventory account and selling 11.515 million shares of common stock at prices ranging from $0.02 to $0.05 per share. Allied realized approximately $238,397.50 in unlawful profits from these sales.

136. Power split up the 9 million Star units it purchased from Allied on November 6, 1987, placing the warrants in an inventory account and selling the common stock. Power sold 9 million shares of Star common stock on November 18, 1987 for $0.09 per share. Power realized approximately $702,000 in unlawful profits from these sales.

137. Prior to the public announcement by Star and Inner Vision at approximately noon on November 9, 1987 that the companies had executed a letter of intent to merge, all information received by Freedman, Marchese and Pignatiello concerning the merger negotiations and letter of intent to merge was confidential. This confidential information was material and was disclosed to Freedman and Pignatiello solely for their use on behalf of Star and Inner Vision in the course of an ongoing fiduciary or other relationship of trust and confidence with Star and Inner Vision, and was not for use in trading stock for the benefit of Freedman, Allied, Power or Pignatiello.

138. Pignatiello, for his direct or indirect benefit and through misappropriation or breach of a fiduciary duty or other relationship of trust and confidence or other wrongful acts, directed trading in Star securities while in possession of

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material, nonpublic information relating to the proposed Star-Inner Vision merger that he obtained in his capacity as business adviser to Inner Vision.

139. Freedman, for his or Allied's direct or indirect benefit and through misappropriation or breach of a fiduciary duty or other relationship of trust and confidence or other wrongful acts, directed trading in Star securities while in possession of material, nonpublic information relating to the proposed Star-Inner Vision merger that he obtained in his capacity as a financial adviser to Star.

140. Freedman, for his or Allied's direct or indirect benefit and through misappropriation or a breach of fiduciary duty or other relationship of trust and confidence or other wrongful acts, knowingly disclosed to Marchese material nonpublic information relating to the proposed Star-Inner Vision merger which he obtained in his capacity as a financial adviser to Star, under circumstances in which Freedman knew or was reckless in not knowing that Marchese or Power was likely to effect transactions in Star securities.

141. Marchese directed trading in Star securities while in possession of material, nonpublic information relating to the proposed Star-Inner Vision merger, under circumstances in which he knew or was reckless in not knowing that such information was confidential and had been disclosed to him by Freedman through misappropriation or breach of fiduciary duty or other relationship of trust and confidence or other wrongful acts.

142. By purchasing Star securities while in possession of material, nonpublic information, Power, Allied, Freedman, Pignatiello and Marchese knowingly or recklessly employed a device, scheme or artifice to defraud, made untrue statements of material fact or omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or engaged in acts, practices or course of business which operated as a fraud in connection with purchase or sale of securities.

143. By reason of the foregoing, Power, Allied, Freedman, Pignatiello and Marchese violated Section 10(b) of the Exchange Act, Rule 10b-5 thereunder and Section 17(a)(1) of the Securities Act.

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SIXTH CAUSE OF ACTION:
MANIPULATION OF THE MARKET FOR ART CARDS

Power, Allied, Marchese, Sandberg, Mercaldi and Masucci Manipulated the Market for Art Cards Securities in Violation of Section 17(a) of the Securities Act, Sections 10(b) and 15(c) of the Securities Exchange Act and Rules 10b-5 and 15c1-2 Thereunder

144. Paragraphs 1 through 143 are realleged and incorporated herein by reference.

145. From on or about March 1988 through at least August 1988, defendants Power and Marchese, aided and abetted by defendants Allied, Sandberg, Mercaldi and Masucci, engaged in a scheme (the "Art Cards Scheme") to manipulate the market for the securities of Art Cards by, among other things, secretly arranging to obtain domination and control over the market for the securities of Art Cards, disseminating false and misleading material information to prospective investors and omitting to give prospective investors material information.

146. In 1987, Art Cards undertook to find an underwriter for an initial public offering of its securities. By October 1987, Allied had agreed to be Art Cards' lead underwriter. After Allied failed to organize a syndicate of underwriters, Allied chose to place the Art Cards offering with its own customers.

147. As a condition to underwriting the offering, Allied required Art Cards to obtain lockup agreements from the holders of at least 95 percent of restricted stock which had previously been issued. Such lockups would extend the resale restrictions on the stock for an additional two years. Art Cards secured such lockups from the holders of more than 95 percent of the previously issued restricted stock. Allied's condition that the lockup agreements be acquired was disclosed in the prospectus prepared in connection with the Art Cards public offering.

148. Allied sold Art Cards' initial public offering on April 27, 1988. The offering was for 2 million units at a price of $0.50 per unit. Each unit consisted of 10 shares of common stock and 10 warrants exercisable at a price of $0.75 for a share of common stock. Approximately 95 percent of the offering was placed in Allied customer accounts.

149. The float in Art Cards securities immediately after the initial public offering consisted of the 2 million public offering units (including 20 million shares of common stock and 20 million warrants) and approximately 533,420 shares of previously issued restricted common stock whose owners refused to enter into lockup agreements.

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150. From April 27, 1988 through May 27, 1988, Allied's market making activities constituted almost the entire market for Art Cards units. Allied's transactions with its customers constituted approximately 95 percent of the trading activity of all broker-dealers in the units. The price rose from $0.50 per unit in the public offering to $0.95 per unit on May 19, 1988.

151. On May 20, 1988, at Marchese's direction and as part of the Art Cards Scheme, Power commenced soliciting its customers to purchase Art Cards common stock at $0.34 per share. Because the units consisted of 10 shares of common stock and 10 warrants, Power's price of $0.34 per share for the common stock implied a price of at least $3.40 per unit (assuming the warrants are valued at $0.00, as Power did on its books). Although Power did not have any Art Cards securities in its inventory, it sold approximately 5.1 million shares on May 20, 1988. On May 23 and 24, 1988, Power sold 600,000 more shares without having any Art Cards securities in its inventory. Accordingly, it was short approximately 5.7 million shares on May 24, 1988, equivalent to over 25 percent of the freely tradable shares.

152. Prior to commencing its solicitation of customers to purchase Art Cards common stock on May 20, 1988, Power and Marchese arranged with Allied, Mercaldi and Masucci for Allied to supply Marchese with substantially all of the 1.9 million Art Cards units held in Allied's inventory and in customer accounts. The Art Card units held at Allied, either as inventory or in customer accounts, were equivalent to over 90 percent of the freely tradeable securities of Art Cards. Thus, through a secret, undisclosed agreement, Marchese and Power had effectively acquired domination and control over the market for Art Cards securities. Power's domination and control and the fact that it allowed Power to charge excessive markups on Art Cards securities, were not disclosed to its customers when they were being solicited to purchase Art Cards securities.

153. On May 23, 1988, as part of the Art Cards Scheme, Marchese directed Allied to begin soliciting customers to sell their Art Cards units back to Allied at $1.70 per unit (or $0.17 per share, assuming that the warrants are valued at $0.00). Marchese's directions were implemented by Allied's management, including Mercaldi and Masucci, among others. By May 24, 1988, approximately 1.9 million units had been sold to Allied by its customers, all at $1.70 per unit.

154. Pursuant to Marchese's directions, Masucci orchestrated the solicitation of repurchases of Art Cards units in the Pompano and Fort Lauderdale, Florida offices of Allied. Thereafter, Masucci caused the Pompano office of Allied to purchase all of the Art Cards units held by the Wellington office of Allied for $1.75 per unit, thereby consolidating into the Pompano office's

inventory 1.9 million units, or over 90 percent of the freely tradeable Art Cards units. On May 24, 1988, pursuant to Marchese's direction, Masucci caused the Pompano office of Allied to sell its 1.9 million units of Art Cards to Power for $1.85 per unit. At this time, Masucci knew or was reckless in not knowing that Marchese and Power were engaged in unlawful activities in connection with the purchase and sale of Art Cards securities and that by following Marchese's directions, Masucci was rendering substantial assistance to these unlawful activities.

155. Power's May 24, 1988 purchase of 1.9 million units of Art Cards, which included 19 million shares of common stock and 19 million warrants, enabled it to cover its 5.7 million share short position in Art Cards common stock and realize a profit of $0.155 per share.

156. In a prearranged transaction which was part of the Art Cards Scheme and which gave Power domination and control, Power sold a control block of the common stock of OTC America, Inc. to Allied at substantially the same time as Allied sold the control block of Art Cards units to Power. Allied bought 19,284,415 shares of OTC America common stock (over 80 percent of the outstanding shares) from Power. Allied solicited customers to purchase OTC America stock before it had any such stock in its inventory, and covered its short position with the block purchases from Power. Defendant Sandberg executed these transactions on behalf of Power and knew, or was reckless in not knowing, that the block of Art Cards stock purchased by Power from Allied gave Power domination and control over the market for Art Cards securities and the consequent ability to charge excessive markups thereon. The amounts owed by each firm to the other as a result of the Art Cards and OTC America transactions were nearly offsetting: $3,636,883 Allied owed Power for OTC America and $3,515,000 Power owed Allied for Art Cards.

157. Mercaldi knew, or was reckless in not knowing, of the Art Cards Scheme, knew or was reckless in not knowing that it involved illegal activity, and provided substantial assistance to the manipulative scheme through the facilities of Allied.

158. Sandberg rendered substantial assistance to the Art Card's scheme by executing or supervising the execution of Power's Art Cards trades. Sandberg knew, or was reckless in not knowing, that Power dominated and controlled the market for Art Cards, and knew of the disparity between Power's cost and the prices it was charging customers. Sandberg knew, or was reckless in not knowing, that Power was engaged in illegal activity by manipulating the market for Art Cards stock, and that the stock's price was artificially inflated.

159. By virtue of the Art Cards Scheme, Power realized at least approximately $2,361,865.64 in unlawful profits.

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160. By virtue of their participation in the Art Cards scheme, Power and Marchese, aided and abetted by defendants Sandberg, Allied, Mercaldi and Masucci, singly and in concert, knowingly or recklessly, in the offer or sale of securities, by the use of means or instrumentalities of interstate commerce, by the use of means or instruments of interstate commerce or by the use of the mails, (a) employed devices, schemes, or artifices to defraud; (b) obtained money or property by means of untrue statements of material fact or omissions to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; (c) made untrue statements of material fact or omitted to state material facts necessary to make the statements made, in the light of the circumstances under which they were made, not misleading; and (d) engaged in transactions, practices or courses of business which operated or would operate as a fraud or deceit upon purchasers of Star securities.

161. By virtue of their participation in the Art Cards scheme, defendants Power and Marchese, aided and abetted by defendants Sandberg, Allied, Mercaldi and Masucci, made use of the mails, or means or instrumentalities of interstate commerce to effect transactions in, or attempt to induce the purchase or sale of Star securities by means of manipulative, deceptive or other fraudulent devices or contrivances.

162. By reason of the foregoing acts, practices, and courses of business, Power and Marchese violated Section 17(a) of the Securities Act.

163. By reason of the foregoing acts, practices, and courses of business, Allied, Sandberg, Mercaldi and Masucci aided and abetted Power's and Marchese's violations of Section 17(a) of the Securities Act.

164. By reason of the foregoing acts, practices, and courses of business, Power and Marchese violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

165. By reason of the foregoing acts, practices and courses of business, Allied, Sandberg, Mercaldi and Masucci aided and abetted Power's and Marchese's violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

166. By reason of the foregoing acts, practices and courses of business, Power violated Section 15(c) of the Exchange Act and Rule 15c1-2 thereunder.

167. By reason of the foregoing acts, practices, and courses of business, Marchese, Allied, Sandberg, Mercaldi and Masucci

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aided and abetted Power's violations of Section 15(c) of the Exchange Act and Rule 15c1-2 thereunder.

SEVENTH CAUSE OF ACTION: UNDISCLOSED EXCESSIVE MARKUPS

Power and Allied Imposed Undisclosed Excessive Mark-ups in Violation of Section 17(a) of the Securities Act, Section 10(b) and 15(c) of the Securities Exchange Act and Rules 10b-5 and 15c1-2 Thereunder

[Power, Allied, Marchese, Sandberg, Mercaldi, Posey]

168. Paragraphs 1 through 167 are realleged and incorporated herein by reference.

169. Sandberg, Power's head trader, directed activities in the trading room, including the execution of interdealer and customer trades and the monitoring of trading activity for excessive markups. Sandberg kept Marchese informed of market conditions in securities Power was selling to customers, and was under Marchese's control and supervision. Marchese and Sandberg determined the prices to be charged Power's customers for securities.

170. Posey, Allied's head trader, was responsible for the execution of customer trades, was engaged in certain interdealer trades and was responsible for monitoring trading activity to detect excessive markups. Posey kept Mercaldi informed of market conditions in securities Allied was selling to customers, and was generally under Mercaldi's control and supervision. Marchese, Mercaldi and Posey determined the prices to be charged for Allied's sales of securities.

171. During the period June 28 through August 31, 1988, when Power dominated and controlled the market for AST Group securities, Power charged its customers undisclosed, excessive markups of over 10 percent on approximately 3,935 transactions in AST Group securities, realizing at least $6,168,096 in unlawful profits.

172. During the periods March 14 through April 30, 1988 and June 6 through June 24, 1988, when Power together with Allied dominated and controlled the market for Star Publications warrants, Power charged its customers undisclosed, excessive markups of over 10 percent on approximately 1,193 transactions in Star warrants, realizing at least $1,232,959 in unlawful profits.

173. During the periods March 14 through April 30, 1988 and June 6 through June 24, 1988, when Power together with Allied dominated and controlled the market for Star Publications common

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stock, Power charged its customers undisclosed, excessive markups of over 10 percent on approximately 339 transactions in Star common stock, realizing at least $166,627 in unlawful profits.

174. During the period March 7 through March 31, 1988, when Power dominated and controlled the market for Westwind Group securities, Power charged its customers undisclosed, excessive markups of over 10 percent on approximately 1,370 transactions in Westwind securities, realizing at least $750,043 in unlawful profits.

175. During the period May 23 through July 8, 1988, when Power together with Allied dominated and controlled the market for Genexus International securities, Power charged its customers undisclosed, excessive markups of over 10 percent on approximately 964 transactions in Genexus securities, realizing at least $393,870 in unlawful profits.

176. During the period May 12 through June 10, 1988, when Power together with Allied dominated and controlled the market for OTC America securities, Allied charged its customers undisclosed, excessive markups of over 10 percent on approximately 654 transactions in OTC America securities, realizing at least $399,738 in unlawful profits.

177. During the period March 14 through April 30, 1988 and June 6 through June 24, 1988, when Power together with Allied dominated and controlled the market for Star Publications warrants, Allied charged its customers undisclosed, excessive markups of over 10 percent on approximately 520 transactions in Star warrants, realizing at least $209,986 in unlawful profits.

178. During the period March 14 through April 30, 1988 and June 6 through June 24, 1988, when Power together with Allied dominated and controlled the market for Star Publications common stock, Allied charged its customers undisclosed, excessive markups of over 10 percent on approximately 27 transactions in Star common stock, realizing at least $16,736 in unlawful profits.

179. During the period June 15 through July 8, 1988, when Power together with Allied dominated and controlled the market for Genexus International securities, Allied charged its customers undisclosed, excessive markups of over 10 percent on approximately 319 transactions in Genexus securities, realizing at least $140,360 in unlawful profits.

180. By reason of the foregoing acts, practices and courses of business, Power, Marchese, Sandberg, Allied, Mercaldi and Posey violated Section 17(a) of the Securities Act.

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181. By reason of the foregoing acts, practices and courses of business, Power, Marchese, Sandberg, Allied, Mercaldi and Posey violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

182. By reason of the foregoing acts, practices and courses of business, Power and Allied violated Section 15(c)(1) of the Exchange Act and Rule 15c1-2 thereunder.

183. By reason of the foregoing acts, practices and courses of business, Marchese, Sandberg, Mercaldi and Posey aided and abetted Power's and Allied's violations of Section 15(c)(1) and Rule 15c1-2 thereunder.

EIGHTH CAUSE OF ACTION:
FONG'S VIOLATIONS OF THE INVESTMENT COMPANY ACT

Fong Violated Sections 57(a)(1) and 57(a)(4) of the Investment Company Act [15 U.S.C. §§ 80a-57(a)(1) and 80a-57(a)(4)] and Rule 17d-1 Thereunder [17 C.F.R. §270.17d-1]

184. Paragraphs 1 through 183 are realleged and incorporated herein by reference.

185. Sections 57(a)(1) and 57(a)(4) of the Investment Company Act [15 U.S.C. §§80a-57(a)(1) and 80a-57(a)(4)] and Rule 17d-1 promulgated under the Investment Company Act [17 C.F.R. § 270.17d-1] include certain provisions intended to protect investors in the securities of business development companies ("BDCs") such as Equitex from potential conflicts of interest by prohibiting certain transactions of principals with or involving BDCs. Transactions otherwise prohibited by these provisions are permissible if the Commission issues an exemption order or otherwise approves the activity as provided by statute.

186. In 1986 and 1987, Fong and an affiliate under his control engaged in certain transactions with or involving Equitex in violation of Sections 57(a)(1) and 57(a)(4) of the Investment Company Act and Rule 17d-1 thereunder.

187. On or about January, 1986, Fong purchased 8 million shares of Star Rule 144 stock for .0005¢ per share. On or about October, 1986, Fong sold to Equitex the 8 million shares of Star Rule 144 stock. At the time of these transactions, Equitex was a business development company for purposes of the Investment Company Act and Fong was a director and the president of Equitex.

188. These transactions were subject to the proscriptions of Section 57(a)(4) of the Investment Company Act and neither Fong nor Equitex filed an application for or received a Commission

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order exempting the sale of Star Rule 144 stock to Equitex from those proscriptions.

189. Fong, during the period May, 1987 through October, 1987, directed the purchase of over 50 million Star securities through his personal brokerage accounts, accounts maintained in his wife's name and in Equitex's accounts. Although these transactions were subject to the proscriptions of Rule 17d-1 of the Investment Company Act, Fong did not apply for or receive approval from the Commission pursuant to Rule 17d-1 with respect to any of these transactions. These purchases resulted in Fong and Equitex gaining control of Star and enabled Fong to direct Star's affairs.

190. Fong, as the president and a director of Equitex, is an affiliated person of Equitex under Section 2(a)(3)(D) of the Investment Company Act [15 U.S.C. §80a-2(a)(3)(D)]. Fong's wife, whose brokerage accounts Fong controlled, is an affiliated person of Fong under the same provision.

191. The series of purchases of Star securities directed by Fong was a "joint enterprise or other joint arrangement" under Rule 17d-1, since Equitex and two affiliated persons participated in the arrangement under Fong's control for their joint and several benefit and profit.

192. Fong and his wife held equity interests in Star and benefitted when Fong was able to use Equitex to acquire control of Star, and thereafter involve Equitex in a scheme to manipulate the market for Star securities by which Fong benefitted directly and indirectly. The scheme, and in particular the lockups of the restricted stock held by Star's former management, would have been more difficult to achieve if Fong had not used Equitex to purchase most of the shares held by the former management.

193. By reason of the foregoing acts, practices and courses of business, Fong violated Sections 57(a)(1) and 57(a)(4) of the Investment Company Act and Rule 17d-1 thereunder.

RELIEF REQUESTED

WHEREFORE, Plaintiff respectfully requests that this Court:

I.

Grant permanent injunctions restraining and enjoining defendants Power, Allied, Marchese, Monchecourt, Sandberg, Behringer, Johnson, Noble, Bajorek, Freedman, Mercaldi, Posey, Masucci, Baren, Klingenberg, Pignatiello and Fong, and their officers, agents, servants, employees, attorneys, and those persons in active concert or participation with them from violating, directly or indirectly, Section 17(a) of the

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Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

II.

Grant permanent injunctions restraining and enjoining defendants Power, Allied, Marchese, Monchecourt, Sandberg, Behringer, Johnson, Noble, Bajorek, Freedman, Mercaldi, Posey, Baren, Masucci, Klingenberg and Pignatiello, and their officers, agents, servants, employees, attorneys, and those persons in active concert or participation with them from violating, directly or indirectly, Section 15(c)(1) of the Exchange Act and Rule 15c1-2 thereunder.

III.

Grant permanent injunctions restraining and enjoining defendants Power, Allied, Marchese, Freedman and Mercaldi, and their officers, agents, servants, employees, attorneys, and those persons in active concert or participation with them from violating, directly or indirectly, Section 15(b)(2) of the Exchange Act and Rule 15b3-1 and Form BD thereunder.

IV.

Grant a permanent injunction restraining and enjoining defendant Fong, his officers, agents, servants, employees, attorneys, and those persons in active concert or participation with him from violating, directly or indirectly, Sections 57(a)(1) and 57(a)(4) of the Investment Company Act and Rule 17d-1 thereunder.

V.

Enter an order requiring the defendants, and each of them, to account for and disgorge all profits and monies received and losses avoided as a result of their illegal conduct as alleged by the Commission herein, together with interest thereon as provided by law.

VI.

Enter an order requiring defendants Power, Allied, Freedman, Marchese and Pignatiello, and each of them, to pay civil penalties under the Insider Trading Sanctions Act of 1984 [15 U.S.C. §u(d)(2)(a)], in the amount of three times the illegal trading profits gained or loss avoided, as described herein.

VII.

Impose a constructive trust on the portions of the funds being held by Carolyn Fong and Equitex that are attributable to illegal stock trading by Fong; enter judgment that Carolyn Fong and Equitex have been unjustly enriched in an amount to be determined at trial; and enter an order requiring Carolyn Fong and Equitex to account for and disgorge all profits and monies received as a result of the illegal conduct of Fong in connection with the sale of Star securities on their behalf, together with interest thereon as provided by law.

VIII.

Impose a constructive trust on the portions of the funds being held by Constance Pignatiello, Jovijuco and Redfern that are attributable to illegal stock trading by Pignatiello; enter judgment that Constance Pignatiello, Jovijuco and Redfern have been unjustly enriched in an amount to be determined at trial; and enter an order requiring Constance Pignatiello, Jovijuco and Redfern to account for and disgorge all profits and monies received as a result of the illegal conduct by Pignatiello in connection with the sale of Star securities on their behalf, together with interest thereon as provided by law.

IX.

Retain jurisdiction of this action in order to implement and carry out the terms of any orders or judgments which may be entered.

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X.

Grant such other and further relief as the Court may deem just and equitable.

Respectfully submitted,

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SECURITIES REGULATION
IN A NUTSHELL

Fifth Edition

By

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§ 19. Insider Trading

One of the most important applications of Rule 10b–5 is its use as a sanction against "insider trading"—purchases or sales by persons who have access to information which is not available to those with whom they deal or to traders generally.

Early applications of the rule focused on the situation with which it was specifically designed to deal—purchases in direct transactions by the corporation or its officers without disclosure of material favorable information about the company's affairs. Ward La France, 13 S.E.C. 373 (1943); Speed v. Transamerica, 99 F.Supp. 808 (D.Del.1951). In this context, it was available to supplement state common law, which in most states did not afford a remedy to the aggrieved seller in this situation in the absence of affirmative misstatements or "special circumstances."

In a series of administrative decisions and injunctive proceedings, commencing in 1961, the SEC greatly broadened the applicability of Rule 10b–5 as a general prohibition against any trading on "inside information" in anonymous stock exchange transactions as well as in face-to-face dealings. The three most significant decisions were Cady Roberts, 40 S.E.C. 907 (1961), SEC v. Texas Gulf Sulphur, 401

F.2d 833 (2d Cir.1968), and Investors Management, 44 S.E.C. 633 (1971). However, the subsequent decisions of the Supreme Court in Chiarella v. United States, 445 U.S. 222 (1980), and Dirks v. SEC, 463 U.S. 646 (1983), have cast doubt on some of the doctrines developed in those decisions.

(a) Elements of the Violation

In *Cady Roberts,* a partner in a brokerage firm received a message from a director of Curtiss–Wright that the board of directors had just voted to cut the dividend. He immediately placed orders to sell Curtiss-Wright stock for some of his customers, and the sales were made before the news of the dividend cut was generally disseminated. In *Texas Gulf Sulphur,* officers and employees of the company made substantial purchases of the company's stock after learning that exploratory drilling on one of the company's properties showed promise of an extraordinary ore discovery (although the drilling had not gone far enough to establish whether there was a commercially mineable body of ore). In *Investors Management,* an aircraft manufacturer disclosed to a broker-dealer, which was acting as principal underwriter for a proposed debenture issue, that its earnings for the current year would be substantially less than it had previously forecast publicly. The broker-dealer's underwriting department passed the information to members of its sales department, who in turn passed it to representatives of major institutional clients. The institutions

sold large amounts of stock before the revised earnings estimate became public.

In all three cases, the persons who effected the transactions (or who passed information to those persons) were held to have violated Rule 10b–5.

In *Chiarella,* an employee of a financial printing firm, who was working on documents relating to contemplated tender offers, ascertained the identities of the companies which were the targets of those offers, purchased stock in those companies, and sold the stock at a profit after the tender offers were announced. The Supreme Court reversed his conviction of a criminal violation of Rule 10b–5.

In *Dirks,* a security analyst received confidential information from a former employee of Equity Funding Corporation (EFC) to the effect that a large percentage of EFC's policies were fake. The employee's motivation in giving Dirks the information was to obtain his aid in exposing the fraud. While attempting to ascertain the truth of these allegations, Dirks passed along the information to a number of his institutional clients, who sold large amounts of EFC stock. Subsequently, the allegations were confirmed and EFC went into bankruptcy. The SEC brought a disciplinary proceeding against Dirks, alleging that he had violated Rule 10b–5 by giving the information to his clients. The Supreme Court held that Dirks had not acted illegally, since (a) he owed no duty to purchasers of EFC stock, and (b) he could not be found to have aided and abetted a violation by the insider from whom he obtained the information, since the insider had not acted from an improper motive in giving the information to him.

The scope of the prohibition, as it emerges from these decisions, seems roughly as follows:

Which Clause Is Violated? The opinions have not been terribly clear as to which clause of the rule prohibits insider trading. Since all of the cases involved total nondisclosure, they presumably did not violate clause (2), which requires some "statement." In *Cady Roberts,* the Commission said that the broker's conduct "at least violated clause (3) as a practice which operated as a fraud or deceit upon the purchasers" and that there was therefore no need to decide the scope of clauses (1) and (2). Subsequent decisions have not significantly clarified this question.

To Whom Is the Duty Owed? If clause (3) is violated, is it because of a "fraud or deceit" on the company or on persons on the other side of the market? In *Cady Roberts,* the Commission indicated that there were elements of both: "'The obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing."

In *Chiarella,* the Supreme Court sharply limited the second element, holding that "when an allegation of fraud is based on nondisclosure, there can be no fraud absent a duty to speak * * * arising from a relationship of trust and confidence between parties to a transaction" and that the lower courts had "failed to identify a relationship between [Chiarella] and the sellers that could give rise to a duty." Stating that "not every instance of financial unfairness constitutes fraudulent activity under § 10(b)," the Court stated flatly that "a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information." With respect to the first element, the Court declined to pass on the question whether Chiarella's breach of duty to his employer and to the corporations making the tender offers would support a conviction under Rule 10b-5, since this "misappropriation" theory had not been properly submitted to the jury. Subsequent criminal convictions of stockbrokers, lawyers, printers and others have been upheld by the Second Circuit on the basis that they violated Rule 10b–5 by trading on confidential information which they "misappropriated" from their employers. United States v. Newman, 664 F.2d 12 (2d Cir.1981); SEC v. Materia, 745 F.2d 197 (2d Cir.1984). In 1987, the validity of the "misappropriation" theory reached the Supreme Court in a case involving a Wall Street Journal writer who traded on advance knowledge of what stocks he was going to recommend in his column. The Second Circuit had upheld his conviction on the basis that he had "misappropriated" property belonging to the Journal, i.e., the advance knowledge of its recommendations. United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986). This decision was affirmed by the Supreme Court, but by an equally-divided court, without opinion. At the same time, the Supreme Court unanimously upheld the defendants' convictions for the same actions under the mail and wire fraud statutes, 18 U.S.C. §§ 1341, 1343, on the ground that they had engaged in a scheme to deprive the Journal of its property by means of fraud. Carpenter v. United States, 484 U.S. 19 (1987).

What is "Material" Information? There was no question that the dividend cut, in *Cady Roberts*, the reduced earnings, in *Investors Management*, and the proposed tender offers, in *Chiarella*, were "material" in the sense that they would affect the willingness of an investor to buy or sell the stock at the current price. In *Texas Gulf Sulphur*, however, the defendants argued that the information about the ore discovery did not become "material" until further drilling established the existence of a commercially mineable ore body. They pointed to the SEC's own rules under Regulation A, prohibiting a company from making any statement about the existence of an ore body unless it was sufficiently tested to be properly classified as "proven" or "probable". The court held, however, that the test of "materiality" for Rule 10b–5 purposes was not whether the company would be permitted to disclose the information if it were selling securities, but whether it was the kind of information that

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might affect the judgment of reasonable investors, including "speculative" as well as "conservative" investors. On this question, the court found that the size and timing of the purchases, by the defendants, some of whom had never owned TGS stock, were "highly pertinent evidence and the only truly objective evidence of the materiality of the discovery."

When Is Information "Non-Public"? Under *Texas Gulf Sulphur*, an insider may not act at the moment the company makes a public announcement of the information, but must wait "until the news could reasonably have been expected to appear over the media of widest circulation." In *Investors Management*, defendants argued that the information about the company's reduced earnings was already "public" because it was the subject of rumors circulating in the financial community. The Commission held, however, that the information they received was different from the information previously circulating, since it was (a) more specific and (b) more trustworthy, having come from a firm known to be acting as underwriter for the company.

Who Is an "Insider"? *Cady Roberts* held that Rule 10b–5, unlike SEA § 16(b), extends beyond officers, directors, and major stockholders to anyone who receives information from a corporate source. *Texas Gulf Sulphur* established that a person who passes on inside information to another person who effects a transaction is as culpable as a person who utilizes it for his own account, and *Investors Management* established the liability of the indirect "tippee", no matter how many links there are in the chain of information.

In *Chiarella*, the Supreme Court implicitly recognized "a relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation" and a resulting "duty to disclose because of the necessity of preventing a corporate insider from taking advantage of the uninformed minority stockholders." The Court also indicated that the liability of a "tippee" could be "viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty." The decision in *Dirks* and subsequent lower court cases limit tippee liability further by holding that the tippee can be held liable only if the information was passed to the tippee for the personal benefit of the tipper, and if the tippee knew or had reason to know that the tipper had satisfied all the elements of tipper liability.

Chiarella also raises the question whether there can be any liability under Rule 10b–5 for trading on the basis of non-public "market information," such as a prospective tender offer, where the source of the information has no connection with the company whose shares are being traded. With respect to tender offers, the SEC adopted Rule 14e–3, which makes it illegal for any person to purchase or sell a security while in possession of material non-public information about a prospective tender offer if he knows or has reason to know that such information

emanates from either the offering person or the issuer or persons acting on their behalf. In United States v. Chestman, 947 F.2d 551 (2d Cir.1991), the defendant challenged the validity of Rule 14e–3 on the ground that SEA § 14(e) prohibits only "fraudulent, deceptive or manipulative" acts and that Rule 14e–3 reaches uses of non-public information that could not be deemed "fraudulent" under the Supreme Court decision in *Chiarella*. The Second Circuit, however, in a 10–1 *en banc* decision, upheld the validity of the rule, on the ground that the delegation of authority to the SEC in § 14(e) to enact rules "reasonably designed to prevent fraud * * * necessarily encompasses the power to proscribe conduct outside the purview of fraud, be it common law or SEC–defined fraud."

Scienter. In *Investors Management*, the Commission rejected the contention that, in order to violate Rule 10b–5, a tippee must have "actual knowledge that the information was disclosed in a breach of fiduciary duty," and held that it was sufficient that the tippee "know or have reason to know that it was non-public and had been obtained improperly by selective revelation or otherwise." The Commission indicated that liability would also attach where the tippee "knew or had reason to know that the information was obtained by industrial espionage, commercial bribery or the like." As far as the "tipper" is concerned, "one who deliberately tips information which he knows to be material and non-public to an outsider who may reasonably be expected to use it to his advantage has the requisite scienter." Elkind v. Liggett & Myers, 635 F.2d 156, 167 (2d Cir.1980).

Causation. In *Investors Management,* the Commission held that where various factors might have affected a tippee's decision to buy or sell, it is only necessary to show that the inside information was "*a* factor" in the decision, and that "where a transaction of the kind indicated by the information is effected by the recipient prior to its public dissemination, an inference arises that the information was such a factor."

Countervailing Fiduciary Obligations. In *Texas Gulf Sulphur,* defendants argued that they could not disclose the information about the ore discovery because the corporation was engaged in acquiring options to purchase the land surrounding the exploration site. The court, while considering this a "legitimate corporate objective" (itself an interesting commentary on the differing standards in land transactions and securities transactions) held that it was "no justification" for trading; if the insiders could not disclose, they "should have kept out of the market until disclosure was accomplished."

In *Cady Roberts,* defendant argued that he had a fiduciary obligation to his customers to sell for their account when he came into possession of adverse information. The Commission rejected this defense: "clients may not expect of a broker the benefits of his inside information at the expense of the public generally." This may create a dilemma for brokers. In Slade v. Shearson, CCH ¶ 94,329

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(S.D.N.Y.1974), plaintiff alleged that Shearson had solicited customer purchases of Tidal Marine stock at a time when it was in possession of material non-public adverse information which it had received from Tidal Marine in its capacity as an investment banker for that company. Shearson moved for summary judgment, arguing that under the SEC's interpretations of Rule 10b–5, "even if Shearson's corporate finance department had known this non-public information, it was precluded from using it to prevent the solicitation of purchases by its retail sales force until the information was made public." The court denied the motion, holding that prior decisions under Rule 10b–5 held only that inside information could not be disclosed to favored customers, and that its fiduciary obligations to its customers required it to refrain from making affirmative recommendations under the circumstances.

To deal with this problem, many commercial banks and broker-dealers have established "firewalls" barring communication between their commercial banking or underwriting departments, on the one side, and their investment advisory or sales departments, on the other, to prevent the transmission of "inside" information and the liabilities that may result from its use or non-use.

(b) Civil Liability

As noted above, a violation of Rule 10b–5 has been held to give rise to a private right of action by a person who can show that the violator invaded an interest of his which the rule was designed to protect. As applied to insider trading, this doctrine has raised difficult questions. The nature of the questions differs depending on (a) whether the transaction involves direct dealings or is effected through the impersonal facilities of an exchange, and (b) whether the right is being asserted by the person on the other side of the transaction or by or on behalf of the corporation.

Claims by the Seller (Purchaser). The operative provisions of Rule 10b-5 are worded in terms of "fraud or deceit". A common law action for deceit requires a showing of (a) false representation of fact, (b) knowledge by D that it is false (scienter), (c) intention to induce P to act, (d) justifiable reliance by P, and (e) damage to P. See W. Prosser & W. Keeton, Torts 728 (5th ed. 1984). The decisions involving civil liabilities for violation of Rule 10b–5 have evidenced a progressive dilution of these requirements.

Direct Dealings. In List v. Fashion Park, 340 F.2d 457 (2d Cir.1965), plaintiff authorized his broker to sell shares at not less than $18 a share. Defendant, acting through his own broker, purchased the shares at $18.50 and plaintiff subsequently sued him, alleging that defendant had failed to disclose (a) that he was a director of the company and (b) that negotiations were pending that eventually resulted in a merger of the company that caused the stock to be worth $50 a share. The court held, first, that, in order to recover, plaintiff was not required to show an affirmative misrepresentation; non-disclosure of a material fact was

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sufficient under clause (3) of Rule 10b-5. Second, to show reliance, plaintiff need only show that the undisclosed facts would have affected his judgment (i.e., the "materiality" test, with plaintiff substituted for the "reasonable investor"). However, the court found that the facts as known to the defendant at the time of the transaction would not have affected the plaintiff's judgment, and denied him recovery. (The court was obviously impressed by the fact that the defendant had resold most of the shares at a profit of only $1 a share.)

In Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972), the Supreme Court collapsed the requirements still further. Defendants had purchased shares of the Ute Development Corporation from members of the tribe without telling them that the shares were then trading at higher prices in another market. The Court held that defendants had no right to remain silent:

"Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact."

Stock Exchange Transactions. When an "insider" buys or sells on a stock exchange without disclosing material facts, there is an additional problem. Not only will there be nobody on the other side of the market who can show "reliance" in the traditional sense; there will normally be nobody who is able to trace the shares he had sold or bought to the defendant.

In 1952, the Second Circuit affirmed a decision that plaintiffs who purchased shares on an exchange in November and December could not recover damages from insiders who had sold on the exchange between March and October and had failed to disclose material adverse information. The court said that a "semblance of privity" between the seller and the buyer was required. Joseph v. Farnsworth, 99 F.Supp. 701 (S.D.N.Y.1951), aff'd, 198 F.2d 883 (2d Cir.1952).

In 1974, the Second Circuit reversed this position and held that privity was not required in an insider trading case under Rule 10b 5. It held that a class action could be brought on behalf of all persons who purchased stock of a company on an exchange during the period that defendants were selling that stock on the basis of inside information. Shapiro v. Merrill Lynch, 495 F.2d 228 (2d Cir.1974). With respect to defendant's argument that their sales could not be said to have "caused" plaintiffs' losses, the court simply cited *Affiliated Ute* for the proposition that the nondisclosure of material information established the requisite element of causation in fact.

The *Shapiro* decision of course raises a difficult question of damages. The court recognized that if

damages were measured by the "losses" suffered by all members of the class, the liability would be "Draconian", and left to the district court "the fashioning of appropriate relief, including the proper measure of damages."

This problem of "Draconian liability" led the Sixth Circuit to reject the idea of any civil liability in this situation. In Fridrich v. Bradford, 542 F.2d 307 (6th Cir.1976), the court held that insiders who bought in the open market on the basis of nonpublic information were not liable to persons selling in the open market during the same period on the ground that "defendants' act of trading with third persons was not causally connected with any claimed loss by plaintiffs who traded on the impersonal market and who were otherwise unaffected by the wrongful acts of the insider." *Affiliated Ute* was distinguished on the basis of the face-to-face dealings and the pre-existing relationship between the parties.

The Second Circuit, however, dealt with the damage question in a different way. In Elkind v. Liggett & Myers, 635 F.2d 156, 172 (2d Cir.1980), the court adopted a "disgorgement" approach. Under that approach, any uninformed investor may sue for the difference between what he paid (or received) for his stock and the market value that it reached a reasonable time after public disclosure of the inside information, but the total recovery by all such persons is limited to "the amount gained by the [insider] as a result of his selling [or purchasing] at the earlier date rather than delaying his sale [or purchase] until the parties could trade on an equal informational basis." This approach, adapted from the proposed Federal Securities Code, seems to be the most reasonable compromise between imposing "Draconian" liability or no liability at all.

Recovery by the Company. One element of the obligation under Rule 10b–5 to refrain from trading on inside information is "the existence of a relationship giving access to information intended to be available only for a corporate purpose and not for the personal benefit of anyone." Cady Roberts, *supra.* It would therefore seem that the company (or a shareholder suing derivatively on its behalf) should have a right of action under Rule 10b–5 to recover the insider's trading profits, at least where the information he used was intended solely for corporate purposes. However, one significant court-imposed limitation on private rights of action under Rule 10b–5, see § 18(b) *supra*, is that the person bringing the action must be a "purchaser" or "seller" of securities in the transaction in question. The courts have accordingly held that the issuer may not sue to recover an insider's trading profits under Rule 10b–5. See e.g., Davidge v. White, 377 F.Supp. 1084 (S.D.N.Y.1974).

There are, however, three alternative ways in which the insider's profits may be recovered by the corporation. First, they may be recoverable under SEA § 16(b). However, this will only apply if the insider is an officer, director or 10% shareholder, and if there was a matching purchase and sale within a six-month period.

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Second, where the SEC brings an injunctive action against an insider for trading in violation of Rule 10b–5, it may request, and the court may grant, as "ancillary relief", a decree ordering the defendant to turn over her profits to the company, "subject to disposition in such manner as the court may direct." See SEC v. Texas Gulf Sulphur, 312 F.Supp. 77 (S.D.N.Y.1970), aff'd, 446 F.2d 1301 (2d Cir.1971); SEC v. Golconda, 327 F.Supp. 257 (S.D.N.Y.1971).

Third, in certain states, a corporation may be able to recover insider trading profits of its officers or directors under common law agency principles of fiduciary duty. See Diamond v. Oreamuno, 24 N.Y.2d 494, 301 N.Y.S.2d 78, 248 N.E.2d 910 (1969); Brophy v. Cities Service, 31 Del.Ch. 241, 70 A.2d 5 (1949); Rest.2d, Agency § 388, Comment c. However, other courts have rejected the approach taken in these cases, holding that the corporation has no right to recover unless it suffered actual damage. Freeman v. Decio, 584 F.2d 186 (7th Cir.1978); Schein v. Chasen, 313 So.2d 739 (Fla. 1975).

In view of the prevailing uncertainty as to the availability of a private damage remedy for insider trading and as to the adequacy of existing penalties in deterring insider trading, the SEC urged Congress to enact stiffer sanctions. Congress responded with two pieces of legislation, the Insider Trading Sanctions Act of 1984 (ITSA) and the Insider Trading and Securities Fraud Enforcement Act of

1988 (ITSFEA), adding new §§ 20A and 21A to the 1934 Act.

Under § 21A, if any person violates the 1934 Act or any rule thereunder by trading while in possession of material nonpublic information, or by communicating such information in connection with a securities transaction, the SEC can go to court to seek a civil penalty equal to three times the amount of the profit gained or the loss avoided by the illegal transaction. "Profit" or "loss" is defined as the difference between the purchase or sale price and the value of the security a reasonable period after public dissemination of the nonpublic information. The SEC may seek such a penalty both against the person who committed the violation and on any person who "controlled" the violator (which, in most cases will mean the firm with which the violator is associated). The penalty imposed on the "controlling person" cannot exceed $1 million and can only be imposed if the SEC establishes that such person knowingly or recklessly failed to take appropriate steps or establish adequate procedures to prevent such violations. The amount of the penalty is reduced by any amount the defendant is required to disgorge in an injunction action brought by the Commission under § 21(d).

To provide an incentive for people to "blow the whistle" on insider trading, § 21A(e) provides that up to 10% of any civil penalty recovered by the SEC may, in the SEC's discretion, be paid as a bounty to any person or persons who provide information leading to the imposition of the penalty.

Under § 20A, any person who violates the 1934 Act or any rule thereunder by trading while in possession of material nonpublic information is liable to any person who was "contemporaneously" trading the same security on the other side of the market. Liability under this Section also extends to any person who communicates material nonpublic information and to any person who "controls" the violator, and is similarly reduced by the amount of any disgorgement in an injunction action brought by the SEC.

An action under either § 20A or § 21A may be brought up to five years after the last violation, a considerably longer statute of limitations than is found in other specific civil liability provisions of the federal securities laws (see § 37(b) *infra*).

During the hearings on the 1984 Act, Congress was urged to define more precisely the kind of insider trading that would give rise to liability. However, faced with irreconcilable differences between the SEC and industry views, Congress finally opted to define the offense simply by reference to existing law.

The 1988 amendment also modified SEA § 32 to increase the maximum criminal penalty for violation of the Act from $100,000 to $1 million, in the case of individuals, and from $500,000 to $2.5 million, in the case of other entities.

§ 20. Corporate Misstatements

The specific disclosure requirements of SEA §§ 13 and 14 apply only to reports, proxy state-

VII. SANCTIONS FOR VIOLATIONS

The federal securities laws provide for several different types of official sanctions against persons who violate the law, and specify the procedures to be followed in utilizing them.

§ 31. SEC Investigations

The SEC has statutory authority to conduct investigations to determine whether there has been a violation of federal securities law. This authority includes power to subpoena witnesses, administer oaths, and compel the production of books and records anywhere in the United States. SEA § 21; SA §§ 19(b), 20(a). In areas of doubtful jurisdiction, this authority empowers the SEC to conduct an initial inquiry to determine whether the subject of the inquiry is in fact subject to the securities laws. SEC v. Wall St. Transcript, 422 F.2d 1371 (2d Cir.1970); SEC v. Brigadoon, 480 F.2d 1047 (2d Cir.1973). However, where it is alleged that an SEC investigation was commenced because of political pressures, a court may deny enforcement of an SEC subpoena on grounds of abuse of process. SEC v. Wheeling-Pittsburgh, 648 F.2d 118 (3d Cir.1981).

In general, when information comes to the attention of the Commission indicating that a violation

may have occurred, the Commission first conducts an informal inquiry, interviewing witnesses but not serving any compulsory process or taking any sworn statements. If this initial inquiry indicates the existence of a violation, the staff will ask the Commission for a formal order of investigation, which delineates the scope of the investigation and designates the staff members entitled to administer oaths and compel the production of witnesses and records.

The procedures to be followed in "formal investigative proceedings" are set forth in the Commission's Rules Relating to Investigations (RRI), 17 C.F.R. Pt. 203. Under these rules, a witness compelled to testify or produce evidence is entitled to see a copy of the formal order of investigation, RRI 7(a), and to be accompanied, represented and advised by counsel, RRI 7(b), (c). To prevent collusion among witnesses, no witness or her counsel may be present at the examination of any other witness, RRI 7(b); however, the SEC may not bar a witness from being represented by her regular counsel, even though that counsel has also represented other witnesses, unless it can establish that the dual representation will "impede its investigation," SEC v. Csapo, 533 F.2d 7 (D.C.Cir.1976). The Commission may for good cause deny a witness the right to obtain a copy of the transcript of her own testimony (although she has an absolute right to inspect the transcript), RRI 6. See Commercial Capital v. SEC, 360 F.2d 856 (7th Cir.1966).

The conduct of an SEC investigation is subject to the same testimonial and related privileges as a judicial proceeding, McMann v. SEC, 87 F.2d 377 (2d Cir.1937), including the attorney-client privilege, the Fourth Amendment prohibition against unreasonable searches and seizures, and the Fifth Amendment privilege against self-incrimination. However, since the securities business is "affected with a public interest" and the securities laws require the maintenance of certain books and records, production of records related to the business may be compelled in spite of Fifth Amendment claims. Shapiro v. United States, 335 U.S. 1 (1948); SEC v. Olsen, 354 F.2d 166 (2d Cir.1965).

The Commission is exempt from the Right to Financial Privacy Act of 1978 where it can show good reason to obtain financial records of a customer from a financial institution. SEA § 21(h). The Commission need not notify the customer of its investigation for up to ninety days.

The SEC's formal investigative proceedings are normally conducted privately, RRI 5, to avoid unwarranted injury to the reputations of the persons being investigated. SEA § 21(a) authorizes the Commission to publish information concerning any violations which it uncovers in the course of its investigations. In some cases, the Commission has allowed persons who are under investigation to submit written statements describing their actions and promising to behave better in the future, which the Commission then makes public under § 21(a), "as part of the process of resolving their involvement in the investigation." One member of the Commission strongly criticized this procedure, arguing that the publicity constitutes the imposition of a sanction, and that it "is wrong for a government prosecutor to impose sanctions based on factual admissions, as contrasted to violations of law." SEA Rels. 15664, 15665, 15667 (1979).

If the Commission determines to conduct a public investigation in a particular situation, and the record contains implications of wrongdoing by any person, that person must be afforded a reasonable opportunity for cross-examination and for production of rebuttal testimony or documentary evidence. RRI 7(d). However, in a private investigation, a person who knows herself to be a target of the investigation has no right to appear before the staff or the Commission to rebut charges that may have been made against her. See SEC v. National Student Marketing, 538 F.2d 404 (D.C.Cir.1976).

An SEC investigation may serve as the prelude to several different types of governmental proceedings.

§ 32. SEC Administrative Proceedings

If an SEC investigation uncovers evidence of a violation of the securities laws, the Commission may order an administrative hearing to determine responsibility for the violation and to impose sanctions. An administrative proceeding can only be brought against a person or firm registered with the Commission (such as a broker-dealer, investment adviser, investment company or other regulated entity), or with respect to a security registered with the Commission. Sanctions available in an administrative proceeding include censure, limitations on the registrant's activities, or revocation of registration.

Prior to 1964, the Commission had no direct means of disciplining an employee of a broker-dealer firm who had participated in the firm's illegal activities. The 1964 Securities Acts Amendments gave the Commission direct power to suspend or bar from association with any broker-dealer any person who the Commission finds has violated one or more specified provisions of the 1934 Act.

In 1990, Congress significantly expanded the SEC's powers by giving it authority (a) to impose civil penalties of up to $500,000 and/or order disgorgement of profits in administrative proceedings, and (b) to issue cease and desist orders against persons found to be violating or about to violate the securities laws, whether or not such persons are registered with the SEC. See SEA §§ 21B, 21C.

(a) Conduct of Hearings

An administrative hearing is commenced by serving a copy of the Commission's order for the hearing on all named respondents. The hearing is held before an independent Commission employee known as an "administrative law judge" and is generally conducted in the same manner as a non-jury trial, with the Commission staff and the respondents each having the right to present evidence and testimony and to cross-examine witnesses. The hearing may be either public or private in the

Commission's discretion (proceedings under the 1933 Act must be public), with respondents often favoring private proceedings to minimize the adverse publicity.

At the conclusion of the hearing, the administrative law judge must file an "initial decision" containing her findings of fact and conclusions of law. This decision may be reviewed by the Commission itself either on petition of one of the parties or on the Commission's own initiative. The Commission is not required to grant a petition for review, but its Rules of Practice provide that it will do so where suspension, denial or revocation of registration is involved. The Commission decides the matter on the basis of briefs and (if requested) oral argument, and may modify the initial decision in any way, including an increase in the sanctions imposed. See Hanly v. SEC, 415 F.2d 589 (2d Cir.1969).

It is quite common for respondents to make offers of settlement, consenting to lesser sanctions and SEC publication of its findings of violations in exchange for saving the expense and prolonged adverse publicity of a protracted proceeding. The Commission normally insists, as a condition of settlement, that the respondent agree that the Commission may publish its finding as to respondent's violations. Critics of the SEC have charged that the Commission uses its power to force settlements as a means of making and announcing new "law" in essentially non-adversary proceedings.

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Under Rule 102(e) of its Rules of Practice, the SEC has asserted its authority to "deny * * * the privilege of appearing or practicing before it to any person who is found by the Commission after notice of and opportunity for hearing," (a) not to possess the requisite qualifications, (b) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct, or (c) to have willfully violated federal securities laws. Under this Rule, the Commission has disqualified a number of lawyers and accountants from practice before it, despite objections that any person authorized by state law to practice his profession is entitled to appear before the SEC. While the courts may overturn an SEC disqualification which is not supported by substantial evidence or is procedurally improper, Kivitz v. SEC, 475 F.2d 956 (D.C.Cir.1973), Rule 2(e) itself has been upheld as a valid exercise of the Commission's power to protect the integrity of its own processes. Touche Ross v. SEC, 609 F.2d 570 (2d Cir.1979).

(b) Judicial Review of SEC Actions

Any party aggrieved by a final order entered in an SEC administrative proceeding may obtain review of the order in the United States Court of Appeals for the District of Columbia or in the circuit in which the party resides or has its principal place of business. SA § 9; SEA § 25; ICA § 43. The courts have on occasion been critical of the SEC for its failure to enunciate clearly the legal rules or facts on which it was basing its decisions. See, e.g.,

Berko v. SEC, 297 F.2d 116 (2d Cir.1961), 316 F.2d 137 (2d Cir.1963). Despite claims that the imposition of severe sanctions, based on allegedly fraudulent conduct, should be made only on the basis of "clear and convincing evidence," the Supreme Court has upheld the power of the Commission, under § 7 of the Administrative Procedure Act, to find a violation on the basis of "a preponderance of the evidence." Steadman v. SEC, 450 U.S. 91 (1981).

The Commission has taken the position that certain of its actions are not "orders" subject to judicial review. These include (a) a decision not to order a company to include a shareholder proposal in its proxy statement, see Medical Committee v. SEC, 432 F.2d 659 (D.C.Cir.1970), vacated as moot, 404 U.S. 403 (1972), (b) a decision not to object to the action of a stock exchange increasing the minimum commission rates to be charged by its members, see Independent Investor Protective League v. SEC, CCH ¶ 93,270 (2d Cir.1971)(summary of SEC brief), and (c) the adoption of a rule disqualifying certain types of entities from membership on a stock exchange, see PBW Stock Exchange v. SEC, 485 F.2d 718 (3d Cir.1973).

With respect to Commission "no-action" positions, the courts have taken the position that if the action involves a routine matter which the Commission properly delegated to its staff and declined to re-examine, there is no "order" subject to judicial review. Kixmiller v. SEC, 492 F.2d 641 (D.C.Cir. 1974); see Koss v. SEC, 364 F.Supp. 1321 (S.D.N.Y.

1973). With respect to SEC rule-making proceedings, the 1975 Securities Acts Amendments reversed the holding in the *PBW Stock Exchange* case, *supra*, and authorized persons "adversely affected" by the adoption of an SEC rule to obtain review in a court of appeals. SEA § 25(b). In addition, courts have held that an SEC rule adoption, while not an "order", is "agency action" subject to judicial review under § 10 of the Administrative Procedure Act. Independent Broker–Dealer Trade Assn. v. SEC, 442 F.2d 132 (D.C.Cir.1971); Natural Resources Defense Council v. SEC, 389 F.Supp. 689 (D.D.C.1974).

§ 33. SEC Injunction Actions

In addition to its power to bring administrative proceedings against persons and firms registered with it, and to issue cease and desist orders, the Commission has specific statutory authority to bring an action in a federal district court to enjoin violations of the securities laws by any person. See, e.g., SEA § 21(d).

Standards for Granting. In determining whether the SEC has made a "proper showing" for the issuance of an injunction, a court does not apply the "irreparable injury" test applicable to injunction actions by private parties. However, an SEC injunction action is generally commenced some time after the allegedly illegal acts have taken place, and "the current judicial attitude toward the issuance of injunctions on the basis of past violations at the SEC's request has become more circumspect than

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in earlier days." SEC v. Commonwealth, 574 F.2d 90 (2d Cir.1978). An injunction will be granted only where "there is a reasonable likelihood of further violation in the future," id., or where the defendant poses a "continuing menace" to the public. SEC v. Caterinicchia, 613 F.2d 102 (5th Cir. 1980).

Scope of Injunction. In appropriate cases, the injunction may prohibit specified kinds of illegal conduct with respect to any securities, not merely those involved in the past violation, but it may not be so broad as to turn any violation of law into a contempt of court, SEC v. Savoy, 665 F.2d 1310 (D.C.Cir.1981).

Consequences. In addition to giving rise to a possible contempt citation if the defendant commits another violation of the securities laws, the issuance of an injunction has certain direct consequences. A person who has been enjoined from future violations is disqualified from utilizing the exemption from 1933 Act registration provided by Regulation A or by Rule 505, or from being associated with a registered investment company, see ICA § 9(a)(2). More significantly, the Supreme Court has held that a defendant who is found to have violated the law in an SEC injunction action is barred by the doctrine of collateral estoppel from relitigating that issue in a subsequent private damage action based on the same course of conduct. The Court rejected arguments that this holding violated the defendant's constitutional right to a jury trial in the damage action. Parklane v. Shore, 439 U.S. 322 (1979).

Ancillary Relief. In addition to an injunction against further violations, the SEC will often ask the court for ancillary relief appropriate to the type of violation committed. For example, where the defendant has profited from "insider trading" or manipulative activities, the court may require him to make a rescission offer, see SEC v. Bangor Punta, 331 F.Supp. 1154 (S.D.N.Y.1971), aff'd with modifications, 480 F.2d 341, 390–91 (2d Cir.1973), or to turn over his profits to the issuer or to a court-appointed trustee for distribution to persons entitled to them. See SEC v. Texas Gulf Sulphur, 446 F.2d 1301 (2d Cir.1971); SEC v. Golconda, 327 F.Supp. 257 (S.D.N.Y.1971). Where the offense involves pervasive corporate mismanagement, the SEC may obtain appointment of a receiver, SEC v. Fifth Avenue Coach Lines, 289 F.Supp. 3 (S.D.N.Y. 1968), or of independent directors and special counsel to pursue claims on behalf of the corporation, SEC v. Mattel, Lit.Rels. 6531, 6532 (D.D.C.1974), or of a "special agent" to supervise defendant's compliance with the law, SEC v. Beisinger, 552 F.2d 15 (1st Cir.1977).

In 1990, Congress expanded the power of the courts in actions brought by the SEC by authorizing them (a) to prohibit any person who is found to have violated SEA § 10(b) from serving as a director or officer of a company registered under the 1934 Act, and (b) to impose civil penalties of up to $500,000 on securities law violators. SEA §§ 21(d)(2), (3).

§ 34. Criminal Prosecutions

Willful violations of the securities laws or the rules promulgated under them are punishable by fine and imprisonment. See, e.g., SA § 24; SEA § 32. The Commission does not prosecute criminal cases itself, but transmits the evidence to the Justice Department, which decides whether to prosecute and handles the prosecution. See SEA § 21(e).

As in criminal prosecutions generally, the "willfulness" requirement means only that the defendant must have intended the act which he did, and does not require a showing that he knew he was violating the securities laws. United States v. Schwartz, CCH ¶ 93,023 (E.D.N.Y.1971).

The courts have consistently rejected arguments by defendants that various provisions of the securities laws are unconstitutionally vague when made the basis for criminal prosecutions. See United States v. Wolfson, 405 F.2d 779 (2d Cir.1968).

Conviction of a violation of the securities laws carries with it automatic disqualification from certain benefits or positions, such as the use of the Regulation A exemption, SA Rule 252(c)(3), (d)(1), or association with a registered investment company, ICA § 9(a)(1).

§ 35. SRO Disciplinary Proceedings

In an SEC administrative proceeding against a broker-dealer, one of the sanctions available to the Commission is the suspension or revocation of the respondent's membership in a self-regulatory organization (SRO), such as a national securities exchange or national securities association. In addition, the SROs themselves are specifically authorized, and indeed required, to impose sanctions on their members for violations of the securities laws or the SROs' own rules. SEA §§ 6(b)(6), 15A(b)(7), 19(g)(1).

Originally, SRO disciplinary proceedings were rather informal, with respondents being accorded few of the protective features associated with governmental sanctions. It has been held, however, that SROs are sufficiently involved with the SEC to bring their disciplinary actions "within the purview of Fifth Amendment controls over governmental due process." Intercontinental Industries v. American Stock Exchange, 452 F.2d 935 (5th Cir.1971). On the other hand, SROs have been held not to be subject to the procedural requirements of the Administrative Procedure Act, Shultz v. SEC, 614 F.2d 561 (7th Cir.1980), and a claim that an SRO is "structurally biased" because its disciplinary decisions are made by members of the industry who have a pecuniary interest in putting the respondent out of business has also been rejected. First Jersey v. Bergen, 605 F.2d 690 (3d Cir.1979). Under the 1975 amendments to the Exchange Act, SROs must notify members of the specific charges against them, give them an opportunity to defend themselves, and support any sanctions with a statement setting forth the specific acts in which the member was found to have engaged, the specific rules which

he was found to have violated, and the reasons for the sanction imposed. SEA §§ 6(d)(1), 15A(h)(2).

Prior to 1975, disciplinary actions by the NASD were subject to SEC review, but disciplinary actions by stock exchanges were not. Under the 1975 amendments, reports of all SRO disciplinary actions must be filed with the SEC, and such actions are subject to review by the SEC, either on its own motion or on application of any aggrieved person. If the SEC finds that the respondent engaged in the acts charged, that such acts violated the specified provisions, and that such provisions were applied in a manner consistent with the purposes of the Exchange Act, it is to affirm the sanction; if not, it is to set aside the sanction and, if appropriate, remand the matter to the SRO for further proceedings. The SEC must also set aside the sanction if it is excessive or oppressive or if it imposes any burden on competition not necessary in furtherance of the purposes of the Exchange Act. SEA § 19(e). An SEC order affirming an SRO sanction is subject to court review in the same manner as an SEC sanction imposed in one of its own administrative proceedings.

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n36. In an editorial entitled "The 2 A.M. Wall Street Raid," the Wall Street Journal stated that "[n]ot even the insiders know how many Senators were actually there early Saturday morning to give voice approval to the inside-trading bill. In the dark of night, someone decided to wrap a neat

gift for American lawyers and British stockbrokers." The editorial went on to criticize the bill for what it does and does not do. Wall St. J., Oct. 25, 1988, at A26, col. 1. While one may not approve of late night sessions of Congress or may oppose the provisions of the bill, the author disagrees with the suggestion that this bill snuck through Congress without the benefit of any public comment. As noted throughout this article, the bill was subjected to substantial public discussion and intense private debate and scrutiny, even though there was only one public hearing on the bill.

[redacted] ITSFEA

PRIOR LAW

Insider Trading Prohibitions

The securities laws clearly prohibit individuals and firms from engaging in insider trading and contain powerful disincentives against such behavior. It is well known that the basic prohibitions against insider trading arise from judicial interpretations of the general anti-fraud provisions of section 10(b) of the Exchange Act and rule 10b-5. n37 The Exchange Act and the rules thereunder also create incentives for broker-dealers to maintain appropriate safeguards against insider trading. [redacted](4)(E) of the Exchange Act

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provides that the SEC may censure, limit the activities of, suspend for up to one year, or revoke the registration of a broker-dealer that has willfully aided, abetted, counseled, commanded, induced, or procured the violation of the federal securities laws and the rules thereunder, or rules of the Municipal Securities Rulemaking Board, or has failed reasonably to supervise and prevent other persons from violating these provisions. n38 Section 15(b)(4)(E) of the Exchange Act provides, however, that a firm will not be deemed to have failed reasonably to supervise another person if: (i) it has established procedures and systems designed to prevent and detect violations; and (ii) the firm has "reasonably discharged the duties and obligations incumbent upon [it] by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with."

n37. 15 U.S.C.A. @ 78j(b) (West 1981) and 17 C.F.R. @ 240.10b-5 (1988), respectively. See, e.g., SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

n38. 15 U.S.C.A. @ 78o(b)(4)(E) (West Supp. 1989).

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The mergers and acquisitions department of a broker-dealer can be a valuable source of inside information, if it has confidential information on upcoming tender offers. To prevent improper trading on this information, the SEC has

adopted **rule 14e-3, which, in effect, requires firms to establish internal "Chinese Walls" to contain inside information**. n39 Paragraph (a) of the rule makes it illegal for a person to trade while in possession of inside information regarding a tender offer under specified circumstances. Paragraph (b) of the rule provides that a person other than a natural person will not violate paragraph (a), if (1) the firm's trading department does not learn of the inside information, and (2) the firm has **policies and procedures reasonable under** the **circumstances that either ensure that the firm's traders do not trade** the **relevant security, or that prevent the traders from knowing the inside information**.

n39. 17 C.F.R. @ 240.14e-3(a), (b) (1988). Chinese Walls are a broker-dealer's set of rules and procedures designed to prevent material, non-public information, usually about an upcoming merger, acquisition, or other major corporate event, from leaking to other departments of the firm. For example, a broker-dealer would want to prevent its merger and acquisition department from revealing information regarding its client's impending tender offer to the firm's arbitrage department. Although such information would be extremely valuable, the arbitrage department's trades would be made while in possession of illegal, insider information. In addition, any such trading would be a violation of the broker-dealer's fiduciary duty to its client. See also **rule 14e-3(d) which prohibits the tipping of inside information concerning**

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tender offers. Id. @ 240.14e-3(d)

ITSA

At the urging of the SEC, Congress passed the Insider Trading Sanctions Act of **1984 ("ITSA")** n40 to bolster the SEC's enforcement efforts. ITSA addressed the criticism that, when the SEC caught an inside trader, it often was impractical to impose a greater sanction than forcing the violator to give back his ill-gotten gains and to promise never to do it again. ITSA added section **21**(d)(2)(A) of the Exchange Act, which provides that whenever a person has illegally purchased or sold a security while in possession of material nonpublic information, the SEC may seek, and a U.S. District Court may impose, a civil penalty against that person, or a person aiding and abetting such a violation. n41 The amount of the penalty is determined by the court in light of the facts and circumstances, but may not exceed **three times the profit gained or loss avoided as a result of the unlawful purchase or sale.**

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n40. P.L. No. 98-376, 98 Stat. 1264 (1984).

n41. 15 U.S.C. @ 78u(d)(2)(A) (Supp. II 1984), repealed by ITSFEA, supra note 1, @ 3 and replaced by new @ 21A, 15 U.S.C.A. @ 78u-1 (West Supp. 1989). Section 3(a)(9) of the Exchange Act defines a person to be a "natural person,

company, government, or political subdivision, agency, or instrumentality of a government." 15 U.S.C.A. @ 78c(a)(9) (West 1981). Accordingly, a broker-dealer would fall within the definition of a person.

Under ITSA, the SEC successfully could seek a civil penalty against a broker-dealer, if the firm itself traded on inside information. As noted in the ITSA Report, "if senior management of a multiservice brokerage firm had received inside information from the investment banking department and directed the trading desk to trade for the firm's account, the firm would be liable as a [redacted]r." n42

n42. H.R. Rep. No. 355, 98th Cong., 1st Sess. 11 (1983).

However, ITSA did not impose liability based on a derivative theory n43 and, in fact, contained limitations to prevent the possibility of imposing treble damages liability on firms simply for employing an inside trader. Section 21(d)(2)(B) of the Exchange Act, as amended by ITSA, provided that "no person shall be subject to the [civil penalty for insider trading] solely because that person aided and abetted [an inside trader] in a manner other than by communicating material nonpublic information." In other words, a broker-dealer could not be subject to an ITSA civil penalty for the insider trading of its employee unless the broker-dealer's actions included "tipping" inside

information to others. It provided that section 20 of the Exchange Act shall not apply to actions involving ITSA penalties. [redacted] In addition, section 21(d)(2)(B) provided that "[no] person shall be liable under this paragraph solely by reason of employing another person who is liable under this paragraph."

n43. In one sense, ITSA did impose derivative liability on corporations. In the example of the corporate broker-dealer that transmits information from the investment banking department to the trading department, the broker-dealer as a legal entity would be liable for a civil penalty as a result of the illegal activities of its employees. See infra notes 45-46 and accompanying text. Nevertheless, it probably is simpler to think of the broker-dealer itself committing the illegal action, even if a corporate broker-dealer must act through its employees.

n44. Section 20(a) of the Exchange Act provides that a controlling person

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(i.e., a person who directly or indirectly controls another person) shall be jointly and severally liable with, and to the same extent as, a controlled person when that controlled person is liable for violations of the Exchange Act, or its rules. 15 U.S.C.A. @ 78t(a) (West 1981). However, the controlling person is not liable for the controlled person's violation if the controlling person can prove that he acted in good faith and did not directly or

indirectly induce the act constituting the violation or cause of action.

The SEC has obtained ITSA penalties in cases settled with two broker-dealers. In Securities and Exchange Commission v. First Boston Corporation, n45 First Boston disgorged profits of $ 132,138 and paid an ITSA penalty of twice that amount to the U.S. Treasury. First Boston was a financial adviser to CIGNA Corporation and, on two occasions, CIGNA told First Boston's employees that CIGNA would announce a large additional loss reserve. When this information became public, it caused CIGNA's stock price to fall. Since First Boston placed CIGNA stock on its restricted list, it could not trade CIGNA stock for its own account. Nonetheless, First Boston's trading department sold CIGNA stock short and bought put options on the basis of this information, without checking the restricted list. First Boston's own internal system detected the improper trading, as did the New York Stock Exchange's ("NYSE") surveillance system, and both reported the trades to the SEC. As part of a settlement with the SEC, First Boston agreed to review and revise its restricted list and its Chinese Wall procedures.

n45. SEC v. First Boston Corp., SEC Litigation Release No. 11,092, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P92,712 at 93,465 (May 5, 1986). See also Bus. Wk., May 19, 1986, at 125.

In Securities and Exchange Commission v. Kidder Peabody & Co., Inc., n46 Kidder paid $ 25.3 million in a settlement, including $ 11.3 million which was designated as a civil penalty under ITSA. In Kidder, an arbitrageur employed by another investment bank provided inside information to Martin Siegel, n47 a senior investment banker at Kidder. Siegel advised Kidder's risk arbitrage department of the information, and the firm earned profits and avoided losses by trading these securities on the basis of that information. To reciprocate for this information, Siegel told the outside arbitrageur of impending mergers, acquisitions, and other transactions being undertaken by Kidder's investment banking department. n48

n46. SEC v. Kidder Peabody & Co., SEC Litigation Release No. 11,452, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P93,271 (June 4, 1987).

n47. See also SEC v. Siegel, SEC Litigation Release No. 11,354, [1987

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Transfer Binder] Fed. Sec. L. Rep. (CCH) P93,123 (Feb. 13, 1987).

n48. The SEC charged Kidder with a number of additional securities law violations, including parking stock for Ivan Boesky. SEC v. Kidder Peabody & Co., supra note 46, at P96,350.

The SEC obtained ITSA penalties from First Boston and Kidder only because they traded for their own accounts. The ITSA penalty, however, was not designed specifically to force broker-dealers into policing the activities of their employees. On the other hand, the new legislation is intended to expand the liability of controlling persons for controlled persons' insider trading.

Additional Factors

Several of the [redacted] new rules requiring [redacted] improve their supervisory systems. n49 These rules require firms to prevent violations well beyond insider trading. For example, [redacted] surveillance, requirement provides that the system must be reasonably designed to achieve compliance with applicable securities laws and regulations, and with the rules of the NASD -- not just insider trading laws. The [redacted] other things, require firms to designate certain offices of supervisory jurisdiction, identify qualified employees to supervise all registered representatives, and maintain written supervisory procedures.

n49. NASD Rules of Fair Practice, Art. III, Sec. 27, NASD Manual (CCH) P2177; American Stock Exchange Rules 320, 922, 2 Am. Stock Ex. Guide (CCH) PP9374, 9722; Chicago Board Options Exchange Rules 4.2, 9.8, Chi. Bd. Options Ex. Const. & Rules (CCH) PP2082, 2308. See also New York Stock Exchange

("NYSE") rules, infra note 54.

In addition to the specific legal prohibitions outlined above, firms associated with any insider trading have suffered embarrassment and may suffer loss of business. For example, the SEC alleged that Stephen Sui-Kuan Wang, a junior analyst at Morgan Stanley & Co., and Fred C. Lee engaged in an illegal insider trading scheme by which Wang provided material nonpublic information to Lee, who directed the purchase and sale of securities through various accounts. n50 As of this writing, there is no evidence that Morgan Stanley had any culpability in the case, and indeed all accounts indicate that Morgan Stanley worked closely with federal authorities to prosecute Wang. Nonetheless, the incident embarrassed Morgan Stanley and harmed, at least temporarily, its good reputation. Insider trading cases occurring at retail firms might have an especially deleterious effect on business, even if the broker-dealer was not culpable.

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n50 SEC v. Wang, Jr., SEC Litigation Release No. 11,780 [1987-88 Transfer Binder] Fed. Sec. L. Rep. (CCH) P93,802, and SEC v. Wang, Jr., 699 F. Supp. 44 (S.D.N.Y. 1988). Wang also pled guilty to charges of mail, wire, and securities fraud, and was sentenced to three years in prison. See also Wall St. J., Oct. 27, 1988, at A5, col. 1. The Commission obtained an injunction against Wang prohibiting future violations of the antifraud and tender offer provisions of

the Exchange Act. Wang disgorged approximately $ 125,000, or virtually all of his assets. SEC v. Wang, Jr., SEC Litigation Release No. 11,982, 1989 SEC LEXIS 210 (Feb. 1, 1989) (LEXIS, Fedsec library, Secrel file). Wang also settled administrative proceedings with the SEC and without admitting or denying the findings, consented to an order barring him from association with any broker-dealer, municipal securities dealer, investment company, or investment adviser. In re Wang, Jr., Securities Exchange Act Release No. 26511, 1989 LEXIS 175 (Feb. 2, 1989) (LEXIS, Fedsec library, Secrel file).

Yet, the existing law did not impose civil penalty liability on controlling persons for the insider trading of controlled persons. Moreover, there was no direct requirement in the federal securities laws for broker-dealers and investment advisers to have surveillance systems to deter and detect insider trading. The SEC could not have sanctioned a broker-dealer or investment adviser for failure to have such a system in the absence of any specific wrongdoing. The Committee decided to address these and other issues in legislation.

NEW LEGISLATION

Need for Additional Broker-Dealer Supervision and Liability

The Committee's effort to draft new insider trading legislation began with the unstated premise that broker-dealers in particular, and others in general, were not doing enough to detect and deter insider trading. The securities industry n51 argued that the existing laws and rules provided adequate prohibitions and deterrents against insider trading. The industry believed that additional penalties would be either redundant with existing sanctions or disproportionately large. SEC Chairman David Ruder endorsed a series of SEC initiatives "to promote the clarity and enforcement of the insider trading proscriptions." n52 But he expressed concern about whether imposing additional civil penalties would be the most effective means of deterring insider trading. In testimony before the Subcommittee on Telecommunications and Finance, Chairman Ruder stated that:

n51. The securities industry is not a monolith and did not act as such during these negotiations. While it is convenient to describe the "industry" view of legislation, such a description is an oversimplification. The

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securities industry as a whole was represented by counsel for the Securities Industry Association. In addition, many other firms, including retail wire houses and institutional firms, through in-house counsel or outside attorneys, were involved in the discussion of the bill. Although these attorneys tried to
work together, they did not always view each issue in lock-step and firms differed on various issues.

n52. Additional Methods to Deter and Prosecute Insider Trading: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce, 100th Cong., 2d Sess. 7 (testimony of David S. Ruder) [hereinafter Ruder testimony].

It has not been the Commission's experience that existing mechanisms for preventing individual insider trading violations by employees have presented unique supervisory problems. Existing incentives in this area are already substantial. Nevertheless, it is necessary to assure that reasonable policies and procedures continue to be implemented to prevent and detect employee violations. While the imposition of civil penalties on firms in the event of employee insider trading violations would undoubtedly increase incentives to compliance . . . it may be more desirable to address any perceived inadequacy in
broker-dealer supervisory processes on a more comprehensive basis. n53

n53. Id. at 14-15. Chairman Ruder subsequently endorsed ITSFEA. In a briefing before the Subcommittee on Telecommunications and Finance regarding the
SEC's civil action against Drexel Burnham Lambert, and others, Chairman Ruder stated in response to Chairman Markey's question:

First of all, I must say that I speak here personally and not to give the Commission's view, not because I believe the Commission would have a different

view, but because we have not had occasion as a Commission to present testimony
on the exact bill which is now being considered.

There is, and are substantial weapons available to us in the securities law enforcement area. But I personally support the bill that you have brought before Congress. I think that increases in sanctions in the insider trading area will be helpful and effective in detering that kind of conduct.

There are, as always, minor language problems that we think could be handled
in a slightly better way, but as you know, our staffs are communicating with your staff to try to work those things out.

Hearings on H.R. 4945 Before the Subcommittee on Telecommunications and Finance of the House Comm. on Energy and Commerce, 100th Cong. 2d. Sess. 264 (1987).

In this regard, Chairman Ruder then outlined certain new rules of the NYSE

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that codify and make explicit certain broadly defined [redacted]
compliance
obligations of NYSE member firms. n54

n54. Ruder testimony, supra note 52, at 16, (citing NYSE Rule 342.21 approved in Securities Exchange Act Rel. No. 25,763, May 27, 1988, 53 Fed.
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Reg. 20,925). NYSE Rule 342.21(a) requires NYSE firms to review trading for their own accounts and the accounts of associated and allied members, employees, and their families. NYSE Rule 342.21(b) requires firms to conduct investigations into trades that may violate the Exchange Act, SEC rules, or NYSE rules. In that release, the SEC also approved other changes to NYSE rules, including NYSE Rule 342.30, which requires every member firm to prepare a report on supervising and compliance efforts that it has undertaken during the year and submit it to the firm's chief executive officer. The release also approved NYSE Rule 351(e), which requires each firm's senior officer to certify on a quarterly basis that the firm had adequate review procedures for proprietary trading and certain employee trading. The officer must certify that there is no basis to assume that any such trade is illegal, or that the firm is investigating the suspicious trade. See also supra note 49 and accompanying text and NYSE Rule 354, as approved in Securities Exchange Act Release No. 26,605, 1989 SEC LEXIS 455 (Mar. 7, 1989).

Despite the existence of these substantial requirements and powerful enforcement tools, the Committee determined that additional requirements and penalties were needed to ensure that managements of broker-dealers were policing their employees adequately. Moreover, the political environment in a presidential election year strongly favored new legislation to address the public's concern about insider trading on Wall Street.
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Findings

The Committee wanted to draft legislation that would assist the SEC in its efforts to bring insider trading cases; at the same time, the Committee decided that it did not wish to create a definition of that offense or alter the substantive law of insider trading. The Committee sought to accomplish these objectives by endorsing explicitly the Commission's rules and enforcement efforts. This was done in the final legislation by specifically finding that:

(1) [T]he rules and regulations of the Securities and Exchange Commission under the Securities Exchange Act of 1934 governing trading while in possession of material, non-public information are, as required by such Act, necessary

and
appropriate in the public interest and for the protection of investors; [and]

(2) [T]he Commission has, within the limits of accepted administrative and judicial construction of such rules and regulations, enforced such rules and regulations vigorously, effectively, and fairly. n55

n55. ITSFEA, supra note 1, @ 2.

Consistent with these findings, portions of the Committee Report ("Report") attempt to lend substantial support to the "misappropriation" theory of

insider trading. The Report noted that the United States Supreme Court failed to address the validity of this theory under rule 10b-5 in the R. Foster Winans case and stated that "in the view of the Committee . . . this type of security fraud [i.e., the misappropriation theory] should be encompassed within Section 10(b) [of the Exchange Act] and Rule 10b-5." n56

n56. Insider Trading and Securities Fraud Enforcement Act of 1988, H. R. Rep. No. 910, 100th Cong., 2d Sess. 10 (1988) (reprinted in 1988 U.S. Code Cong. & Admin. News 6043, 6046). See also [redacted], 791 F.2d 1024 (2d Cir. 1986), aff'd on securities law counts by an equally divided court, 484 U.S. 19 (1987).

The Report also noted that the Committee declined to recommend to the House legislation that included a definition of insider trading. The Committee noted that (i) case law has made the law of insider trading clear in most cases, ~~and (ii) an~~ inartfully drafted insider trading definition could i[redacted] narrow the scope of the prohibitions and f~~acilitate evasion~~ of the law, and determined that the lack of consensus on a definition of insider trading should not prevent Congress from enacting other remedies. The Report concluded that "accordingly, the Committee does not intend to alter the substantive law with respect to insider trading with this legislation." n57

n57. Report, supra note 56, at 11. For example, ITSFEA's use of the words "purchasing or selling a security while in possession of material, non-public information" did not mean that the Committee endorsed a "possession" standard of proof for insider trading cases. See, e.g., @ 3(a) of ITSFEA. This language had appeared in ITSA and the Committee simply replicated existing language. See, e.g. @ 21(d)(2)(A) of the Exchange Act prior to the enactment of ITSFEA. (15 U.S.C. @ 78u(d)(2)(A) (Supp. II 1984). It was the author's understanding that this legislation was entirely neutral with respect to the debate over the possession standard. If the SEC can prove insider trading on the basis of possession, it should not be because, or in spite, of ITSFEA.

Civil Penalties for Controlling [redacted]

ITSFEA imposes substantial new responsibilities and liabilities on firms and others for insider trading. It deletes section 21(d)(2) of the Exchange Act and adds a new section 21A. n58 The civil penalty provision in section 21A(a)(1)(A) remains essentially the same as old section 21(d)(2) for persons who themselves violate the law by trading while in possession of inside information. The amount of the penalty in section 21A(a)(2) basically is unchanged from old section 21(d)(2)(A) and shall be determined by the court in light of the facts and circumstances, but shall not exceed three times the profit gained or the loss avoided as a result of the insider trading.

However, Congress did add the words "communicating" as one of the additional bases for measuring the penalty, for reasons discussed below.

n58. See supra note 41.

The most significant change in this portion of the law is that Congress added a new provision in section 21A(a)(1)(B) permitting the SEC to bring an action to impose a civil penalty against certain persons who [redacted] who traded on insider information in violation of the law. n59 The law provides that the court shall determine the amount of the penalty in light of the facts and circumstances, but the penalty shall not exceed the greater of $ 1 million or three times the profit gained or the loss avoided as a result of the insider trading. The new penalty provision theoretically would permit a court to assess a firm for a penalty of $ 1 million even when, for example, the employee only pays $ 3000 in penalties for $ 1000 in profits from the insider trading.

n59. 15 U.S.C.A. @ 78u-1(a)(1)(B) (West Supp. 1989).

When the Committee began circulating initial drafts of the legislation for comment, the securities industry objected strenuously to subjecting firms to a treble damages civil penalty for employee wrongdoing. In response to those drafts, some industry lawyers suggested that, instead of a new civil penalty,

the Exchange Act should require broker-dealers to have a new requirement of creating and maintaining a surveillance system against insider trading These industry attorneys argued that, since the Committee's objective was to prevent and deter insider trading, a surveillance system more directly achieved that goal than would a civil penalty. n60

n60. It is interesting that counsel for some broker-dealers suggested a surveillance system as an alternative to the civil penalty. As noted, when the

Lent-Rinaldo bill was introduced, it included a requirement for a surveillance system, coupled with the threat of treble damages penalties. At that time, the securities industry objected strenuously to this portion of the bill. See 133 Cong. Reg. 2342 (daily ed. June 11, 1987) (Summary of bill). Because the Committee adopted the industry's suggestion of a surveillance system but did not delete the controlling person civil penalty provision, in some respects the final bill bore an interesting similarity to the earlier Republican bill

The Committee did refine the controlling person liability section and accepted the idea of the surveillance system but was not willing to eliminate the treble damages penalty. Once it was clear that Congress intended firms to have some vicarious liability, the industry lawyers argued that it was unreasonable to hold firms responsible for employees' conduct on either a strict liability basis or based on a negligence standard. The industry argued that a

firm should be liable only if the SEC could prove that there was scienter with respect to the firm's failure to prevent the insider trading. The Committee agreed with the assertion that the SEC should have the burden of proof for when a court should impose the penalty. n61 The issue then became what would be the standard for imposing firm liability.

n61. The SEC already had the burden of proof where it sought a civil penalty under ITSA. In 1983, the Committee rejected the suggestion that the SEC's burden of proof should be higher than the traditional "preponderance of the evidence" test. ITSA Report, supra note 42, at 15.

Counsel for some securities firms argued that a firm should be liable as a controlling person only if it aided and abetted an employee's wrongdoing. It is well established in the case law that, to hold a defendant liable as an aider and abettor, a plaintiff must prove three elements: (i) a primary violation, (ii) knowledge or awareness by the aider and abettor, and (iii) substantial assistance to the primary violator. n62 The industry attorneys acknowledged that there was disagreement among courts as to whether a broker-dealer's inaction or failure to deter and detect insider trading would constitute substantial assistance to the primary violator if the controlling person had no duty to supervise. n63 But these industry lawyers argued that the new requirement of a surveillance system would make clear that broker-dealers had such a duty. As

part of the SEC staff's technical advice, the staff identified other objections to the aiding and abetting standard. Aiding and abetting in this context might be interpreted as involving a higher level of firm participation, including knowledge and awareness of the insider trading activity, than the Committee intended. n64 Adding a new civil penalty with an aiding and abetting test might not have added appreciably to the SEC's enforcement arsenal. Consequently, the SEC staff observed that the aiding and abetting standard might not achieve the Committee's goal of substantially increasing controlling person liability. While the Committee could have sought to impose controlling person liability based on an aiding and abetting standard as construed in certain cases referenced in the Committee Report accompanying the bill, this idea was rejected. Even if the Committee Report provided that the words aiding and abetting as used in this legislation should have the construction accorded to them in a certain series of cases, there was no certainty that a court would consider itself bound by the accompanying Report, especially if there were additional legislative history with a different view. In short, the term aiding and abetting meant too many things to too many people to satisfy the Committee members on both sides of the aisle. Accordingly, the staffs began searching for another standard.

n62. See, e.g., Armstrong v. McAlpin, 699 F.2d 79, 91 (2d Cir. 1983); Cleary v. Perfectune, 700 F.2d 774, 777 (1st Cir. 1983); IIT, An Int'l Inv. Trust v.

Cornfeld, 619 F.2d 909 (2d. Cir. 1979).

n63. Some courts have suggested that, absent an independent duty to act, inaction may not constitute the assistance necessary to impose liability as an aider and abettor. Cornfeld, 619 F.2d at 927; Cleary, 700 F.2d at 778. Other courts have held that in the absence of an independent duty to act, mere inaction constitutes substantial assistance only where there is a conscious intention to further the principal violations. Woodward v. Metro Bank of Dallas, 522 F.2d 84 (5th Cir. 1975).

n64. It is ironic that counsel for the securities industry argued that aiding and abetting was easy to prove, while the SEC staff pointed out the difficulties of proving an aiding and abetting case against a broker-dealer. Presumably, this situation was the reverse of a traditional litigation setting.

The search for the new standard resulted in an alternative test in section 21A(b)(1)(A) and (B) of the Exchange Act; a controlling person can be liable under either subsection. Although these are alternative tests, they are intended to impose liability for failures to meet essentially similar standards of conduct. The first test in subparagraph (A) applies to any controlling person, regardless of the nature of its business, and provides that a controlling person may not be held liable for the controlled person's activity

unless the SEC established that the controlling person knew or recklessly disregarded the fact that such controlled person was likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent such act or acts before they occurred.

The second test in section 21A(b)(1)(B) of the Exchange Act can impose liability only on broker-dealers and investment advisers. It provides that the controlling person is subject to a penalty if the SEC establishes that the controlling person knowingly or recklessly failed to establish, maintain, or enforce the surveillance system required under new section 15(f) of the Exchange Act or new section 204A of the Investment Advisers Act of 1940 ("Advisers Act") n65 and "such failure substantially contributed to or permitted the occurrence of the act or acts constituting the violation." n66

n65. 15 U.S.C.A. @ 78o(f) (West Supp. 1989) and 15 U.S.C.A. @ 80b-4a (West Supp. 1989).

n66. It was the author's understanding at the time the statute was drafted that, as a matter of statutory construction, the word "substantially" modifies both "contributed to" and "permitted." See 134 Cong. Rec. H7468 (daily ed. Sept. 13, 1988) (floor statement of the Honorable Matthew J. Rinaldo: "that failure substantially contributed to, or substantially permitted the insider trading

. . . .") (emphasis added). See also 134 Cong. Rec. H7470 (daily ed. Sept. 13, 1988) (floor statement of the Honorable Norman F. Lent).

Since the Committee was determined to link civil penalty liability for broker-dealers and investment advisers with the operation of the surveillance system, it was necessary to add the first prong of the test for controlling persons that are not broker-dealers or investment advisers. Otherwise, Congress would have had to limit the definition of controlling persons to broker-dealers or investment advisers; however, Congress intended no change whatsoever to the definition of controlling person. Alternatively, Congress might have given the SEC the authority to establish rules for preventing insider trading with respect to all controlling entities -- from law firms to widget manufacturers. Such a result is not desirable.

New section 21A(b)(1) provides that, in order to hold the controlling person liable, there must be a nexus between the supervisory failure and the insider trading. For example, it would not be reasonable to hold a broker-dealer liable under section 21A(b)(1)(B) of the Exchange Act for insider trading that occurred in its New York office solely because it had an unrelated failure in its supervisory system in Chicago. By the same token, the liability test is not quite as rigorous as a "but for" test, that is, "but for" the surveillance system failure, the insider trading would not have occurred. The SEC is not

obliged to prove that a narrowly identified surveillance system failure caused or allowed insider trading to occur. A firm could be liable for insider trading if it had a poor or non-existent surveillance system or if the firm fostered an environment in which insider trading was tolerated. Under such circumstances, the SEC must prove that the general supervisory environment was so lax as to allow the insider trading to occur. As Congressman Lent noted on the House floor, "the bill requires a [redacted] between the failure of the controlling person's surveillance system and the controlled person's violation." n67

n67. Lent, supra note 66, at H7470.

The legislation also addresses several questions regarding the liability of tippers. First, ITSFEA deletes certain references to aiders and abettors in old [redacted] of the Exchange Act to conform the language to the underlying law as it had evolved and to [redacted] a [redacted] all [redacted]8 However, these deletions were not intended to reduce the liability of wrongdoers for aiding and abetting violations.

n68. Report, supra note 56, at 19. At the time ITSA was enacted, it was debatable as to whether tippers directly violated the anti-fraud provisions of the securities laws, or if they were aiders and abettors. For example, in the ITSA Report, the Committee noted that the new civil penalty "would also be imposed upon persons who aid and abet violations by communicating ('tipping') material nonpublic information, even if they do not trade." ITSA Report, supra note 42, at 9. Similarly, at the time the Energy and Commerce Committee was considering ITSA, SEC Chairman Shad wrote that "the Commission recommends amending the [ITSA] bill to limit the imposition of the new penalty to those who actually trade while in possession of material nonpublic information or who tip such information to others who trade. Employers, control persons, and aiders and abettors (other than tippers) of those who violate would not be subject to the new penalty . . ." Letter from John Shad, Chairman, SEC, to Timothy E. Wirth, Chairman, Subcommittee on Telecommunications, Consumer Protection, and Finance (June 29, 1983) (reproduced in ITSA Report, supra note 42, at 27) (emphasis added).

Second, the legislation limits the amount of the civil penalty that courts may impose on controlling persons in cases involving "remote tippees." When illegal tipping occurs, t[redacted] tipper is jointly and severely liable for the profits obtained or losses avoided by the tippee, n69 and the SEC would be able to seek disgorgement of those profits from the tipper and the tippee. n70 ITSA

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permits courts to impose a civil penalty on a tipper and a tippee, in an amount up to three times the profit gained or loss avoided. If a tippee himself illegally tipped another tippee (a "remote tippee"), a court could impose a civil penalty on the tipper measured by the profits of the direct tippee and the remote tippee. If there were subsequent generations of illegal tips, presumably courts would need to apply a test of "reasonable foreseeability" with respect to the subsequent generations of tippees to avoid imposing disproportionate civil penalties on the tipper. n71

n69. SEC v. Tome, 638 F. Supp. 596, 617 (S.D.N.Y. 1986) (citing Bateman Eichler, Hill Richards, v. Berner, 472 U.S. 299, 312-13 (1985); SEC v. Tome, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P92,877 (S.D.N.Y. July 22. 1986) (pre-judgment interest), aff'd. 833 F.2d 1086 (2d Cir. 1987), cert. denied, 108 S. Ct. 1751 (1988).

n70. Tome, 638 F. Supp. at 609.

n71. Moreover, courts are able to adjust the amount of the penalty based on the facts and circumstances of each case. Memorandum of the SEC in Support of the Insider Trading Sanctions Act of 1982 as reproduced in ITSA Report, supra note 42, at 26. See also Id. at 11-12 (discussion of the time period during which profits or losses are calculated for purposes of disgorgement).

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Because ITSFEA imposes civil penalty liability on controlling persons, the Committee attempted to place clearer limits on the civil penalty that a court can impose on a controlling person when a controlled person tips. Section 21A(a)(3) provides that, if the controlled person's violation was a violation by communication, the profit gained or the loss avoided, for purposes of the controlling person's civil penalty liability only, is limited to the profit gained or the loss avoided by the person or persons to whom the controlled person directed the communication. Assume, for example, that Mr. X, who was an employee of Broker-Dealer, Inc., learned of insider information and illegally tipped Mr. A, who, in turn tipped Mr. B. The liability of Broker-Dealer for the controlling person penalty would be limited to the profits gained or losses avoided by Mr. A. By comparison, Mr. X could be subject to an ITSA civil penalty for the profits or avoided losses of both Messrs. A and B, if their trading was reasonably foreseeable. There is one additional qualification to Broker-Dealers' liability: if Mr. X intended that Mr. A serve as a conduit for the insider information to Mr. B, and only Mr. B traded, then a court could profits obtained or losses avoided by the tippee. n69 and the SEC would be able to seek disgorgement of those profits from the tipper and the tippee. n70 ITSA

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It is important to emphasize that the legislation did not alter the underlying standards for tipper and tippee liability. The Committee did not wish to discourage corporations from providing information to securities analysts under appropriate circumstances. The Committee specifically embraced

current law to minimize this risk. n72

n72. Report, supra note 56, at 19, citing Dirks v. SEC, 463 U.S. 646 (1983).

However, some will argue that, by imposing substantial new penalties on controlling persons, the effect of the legislation will be to discourage corporations from providing information to securities analysts.

The new legislation also grants slightly more flexibility to the SEC in granting exemptions from the civil penalty provisions. In section 21(d)(2)(A) of the old law, the SEC "by rule or regulation" could exempt from the provisions of that paragraph any class of persons or transactions. Under section 21A(c) of the new law:

The Commission by such rules, regulations, and orders as it considers necessary or appropriate in the public interest or for the protection of investors, may exempt, in whole or in part, either unconditionally or upon specific terms and conditions, any person or transaction or class of persons or transaction from this section. n73

n73. 15 U.S.C.A. @ 78u-1(c) (West Supp. 1989) (emphasis added).

The Commission never used its previous exemptive authority, and there is no reason to believe it will use this new, broader authority.

Surveillance System Requirement

ITSFEA includes provisions designed to prevent insider trading before it occurs by creating surveillance mechanisms intended to detect and deter insider trading. For the first time, section 15(f) of the Exchange Act directly requires broker-dealers to have a surveillance system reasonably designed to prevent insider trading. ITSFEA adds a new section 204A to the Investment Advisers Act to impose a similar statutory obligation on investment advisers. The existence of a surveillance system is no longer merely a defense to a violation under sections 15(b)(4)(E) of the Exchange Act n74 or rule 14e-3. n75 n74. 15 U.S.C.A. @ 78o(b)(4)(E) (West Supp. 1989).

n75. 17 C.F.R. @ 240.14e-3 (1988).

Congress recognized that firms have different types of businesses with different types of risks. For example, a small discount broker-dealer would not need nearly as extensive a surveillance system as a major firm with divisions

engaged in retail brokerage, investment banking, investment advisory services, arbitrage, and specialist operations. Accordingly, firms must tailor their surveillance systems to address their specific needs.

There was some dispute about whether the SEC should be required to adopt rules specifying the details of a surveillance system. On the one hand, had Congress directed the SEC to adopt specific rules, the broker-dealers and investment advisers would have an easier task developing surveillance systems that meet the requirements. On the other hand, such a requirement could minimize firms' responsibilities for developing appropriate procedures for policing their own activities. Moreover, a positive requirement could force inappropriate and ineffective uniformity on broker-dealers and investment advisers for their surveillance systems. Accordingly, ITSFEA grants the SEC the discretion to adopt rules, but does not make adoption of such rules mandatory.

[redacted]

Another important provision in the legislation is that the SEC now has the authority to award bounties. The awarding of bounties has been used in other law enforcement contexts, most notably in the Internal Revenue Code. n76 There had been general discussion for several years within the securities law community of whether the Congress should grant the SEC the authority to award

bounties in insider trading cases. On May 21, 1987, Congressman Rick Boucher (D. Va.) introduced a bill to grant the SEC the authority to award bounties. n77 The Boucher bill would have allowed the Commission to pay bounties for violation of the Exchange Act or its rules by trading on inside information or for violations of section 9 of the Exchange Act. n78 The bounties would have been payable out of appropriated funds. ITSFEA also employs bounties to ferret out insider trading but takes a different approach than the Boucher legislation.

n76. 26 U.S.C.A. @ 7623 (West 1989). This section provides that "the Secretary . . . is authorized to pay such sums, not exceeding in the aggregate the sum appropriate therefor, as he may deem necessary for detecting and bringing to trial and punishment persons guilty of violating the internal revenue laws . . . ." This section has its origins in a law passed on March 2, 1867, ch. 169, @ 7, 14 Stat. 473.

n77. H.R. 2494, 100th Cong., 1st Sess. (1987).

n78. 15 U.S.C.A. @ 78i (West 1981). Section 9 of the Exchange Act prohibits market manipulation of securities prices on stock exchanges.

Section 21A(e) of the Exchange Act now grants to the Commission the sole discretion to pay bounties to persons who provide information to the SEC or

the Attorney General regarding insider trading that leads to the imposition of a penalty under section 21A of the Exchange Act. n79 The bounty may not exceed ten percent of the civil penalty recovered. ITSFEA grants very broad discretion to the SEC in deciding whether to pay a bounty to an informant.

n79. 15 U.S.C.A. @ 78u-1(e) (West Supp. 1989). The Commission has adopted rules governing the payment of bounties to informants in insider trading cases. Applications for Bounty Awards on Civil Penalties Imposed in Insider Trading Litigation, Exchange Act Release No. 26,994, [Current Binder] Fed. Sec. L. Rep. (CCH) P84,123 (June 30, 1989) (to be codified at 17 C.F.R. @@ 201.61-68).

Unlike the Boucher bill, ITSFEA bounties would be payable only with respect to insider trading cases and would not be available for market manipulation or other section 9 violations of the Exchange Act which did not involve insider trading. Another distinction is that, under ITSFEA, the bounties would not be paid out of appropriated funds, but would be paid out of the civil penalties collected from a violator.

Under ITSFEA, the SEC could pay a bounty to one person for civil penalties imposed upon a primary violator and a controlling person. Assume for example, Mr. Observer told the SEC that Mr. Registered Representative illegally traded

on insider information, earned $ 1,000 in illegal profits, and that Broker-Dealer had recklessly failed to install an adequate surveillance system.
If the SEC were to successfully sue the individual and the firm and to extract civil penalties of $ 3,000 from both, or $ 6,000 total, the SEC could pay Mr. Observer up to $ 600 as a bounty.

The securities industry raised some initial objections to the bounty provision, claiming that it had "Orwellian" overtones, and was unseemly. Members rejected these objections since the Internal Revenue Service has had the authority to pay bounties to tax informants for years without any apparent ill effects on civil liberties in the United States.

The securities industry raised a more serious objection that the bounty system would create economic incentives that would undermine firms' surveillance efforts. For example, if Employee A of Broker-Dealer, Inc. learned that Employee B was trading on insider information, he might wait for the inside trader to accrue large profits and then tell the SEC. Broker-Dealer might be subject to a large civil penalty for its failure to maintain its surveillance system. The securities industry feared that firms would be subject to large civil penalties out of which supervisory employees could collect large bounties.

In addition, all agreed that it would have been inappropriate for exchange and NASD surveillance officials, or members, officers, or employees of any

appropriate regulatory authority n80 or the Department of Justice, to collect bounties because their official duties include securities law enforcement. n81

n80. Section 3(a)(34) of the Exchange Act defines appropriate regulatory agency. 15 U.S.C.A. @ 78c(a)(34) (West 1981 & Supp. 1989).

n81. Apparently, state law enforcement officials theoretically are eligible to receive bounties. It would be difficult to imagine circumstances under which such payments would be appropriate if a state employee learned of the insider trading scheme within the scope of his employment. Such persons should be no more entitled to a bounty than an SEC staff member.

Section 21A(e) of the Exchange Act expressly excludes specified government officials and SRO personnel from receiving bounties. But the legislation does not exclude employees of broker-dealers or investment advisers because of concerns about "whistle blowers." In the Committee's view, the SEC generally should not pay bounties to employees of broker-dealers and investment advisers, particularly when the person who learns of the insider trading has compliance and supervisory responsibilities. n82 However, there may be circumstances in which it would be appropriate for the SEC to award a bounty to an employee of a broker-dealer. For example, a bounty might be appropriate if a supervisory employee of a firm learned of insider trading and told the firm's senior

management of the problem, but management took no action within a reasonable period of time. It might also be appropriate if an employee learned of insider trading at a firm, but was afraid to inform management because of a well-grounded fear of retribution. Under these or other relatively rare circumstances, the SEC might pay the employee a bounty for advising it of the insider trading. Unfortunately, it is difficult to write a workable "whistle blower" exception into the statute. Presumably, the SEC will use good judgment in determining to reward employees of broker-dealers and investment advisers with bounties so as not to undermine their employers' surveillance efforts.

n82. Report, supra note 56, at 23.

Expanded Private Rights of Action

Contemporaneous Traders

ITSFEA expands the rights of private parties to sue insider traders for damages. However, the legislation is designed to place careful limits on this expansion and the Committee rejected a major increase in such remedies.

The Federal securities laws include many express and implied rights of action
and also specify circumstances in which controlling persons may be liable. n83

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The Committee agreed with Chairman Ruder's assessment that "private rights of action have traditionally served as an important supplement to Commission action." n84

n83. Section 12 of the Securities Act of 1933, 15 U.S.C. @ 771 (1982), [hereinafter Securities Act] is a typical example of an explicit private right of action in the federal securities laws. In general, that section provides that the purchaser of a security may sue a person who offers or sells the security without complying with the registration provisions of @ 5 of the Securities Act, or by means of a prospectus or oral communication which includes
an untrue statement of material fact or omits to state a material fact. The purchaser may sue for rescission or damages, if he no longer owns the security.
The implied right of private parties to sue for violations of rule 10b-5 also is
well established. See, e.g., Herman & MacLean v. Huddleston, 459 U.S. 375 (1983). Controlling person liability is found in @ 15 of the Securities Act, 15
U.S.C.A. @ 77o (West 1981), and @ 20 of the Exchange Act, 15 U.S.C.A. @ 78t (West 1981 & Supp. 1989).

n84. Ruder testimony, supra note 52, at 3.

The Committee added a new section 20A to the Exchange Act, which creates new
private rights of action in favor of contemporaneous traders against insider

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traders. n85 This provision would allow any person who was a contemporaneous trader, as defined by the courts, to sue the insider trader for damages. The provision specifically overturns the holding in Moss v. Morgan Stanley, which held that contemporaneous market traders have no private right of action under the misappropriation theory against individuals who misappropriate and trade on
inside information. n86

n85. 15 U.S.C.A. @ 78t-1 (West Supp. 1989).

n86. 719 F.2d 5 (id Cir. 1983). In Moss, Warner-Lambert Co. retained

Morgan
Stanley as its investment adviser to assist it with a tender offer for Deseret Pharmaceutical Co. Cortois, an employee of Morgan Stanley, told Antonin of the impending tender offer and he, in turn, tipped Newman. On November 30, 1976, Newman bought Deseret stock at $ 28 per share on behalf of himself, Cortois and
Antonin. On the same day, Moss sold 5,000 shares of Deseret at $ 28. On December 1, 1976, the NYSE halted trading in Deseret, and subsequently Warner made an offer for Deseret stock at $ 38 per share. Moss brought a class action
suit on behalf of all persons who sold stock prior to the announcement. The court rejected Moss's claim, stating that Cortois and Newman had no duty of trust to Moss, and they had no duty to disclose the information to them before trading. Id. at 15. In addition, the court rejected arguments that the defendants owed a general duty to all participants in the market and found

that the misappropriation theory did not protect them. Id. at 16.

There are several important limitations on this new private right. First, the insider trader may be liable for an amount not exceeding the profit gained or loss avoided. n87 Absent such a limitation, the insider trader who earned $ 1000 in illegal profits could be liable for millions of dollars in losses claimed by contemporaneous traders. Second, the amount of the damages will be reduced by any court ordered disgorgement of profits that the SEC obtains under
section 21(d) of the Exchange Act. n88 The Committee included this offset provision since disgorged profits, under certain circumstances, may be paid to harmed investors to compensate them for their losses. Third, in cases involving
tipping, the legislation limits the liability to the person to whom the communication was directed. n89 This limitation is identical to the limitation in section 21A(a)(3) of the Exchange Act, which limits the amount of the civil penalty that may be imposed on controlling persons for tipping violations by their controlled persons. Finally, section 20A(b)(3) of the Exchange Act makes
explicit that controlling persons are subject to liability under this section as
provided for under existing section 20(a) of the Exchange Act. n90 There is no additional or heightened liability for controlling persons under the new private
right and the Committee rejected a respondeat superior standard of liability. n91

n87. Section 20A(b)(1) of the Exchange Act, 15 U.S.C.A. @ 78t-1(b)(1) (West
Supp. 1989).

n88. Section 20A(b)(2) of the Exchange Act, 15 U.S.C.A. @ 78t-1(b)(2) (West
Supp. 1989).

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n89. Section 20A(c) of the Exchange Act, 15 U.S.C.A. @ 78t-1(c) (West Supp. 1989).

n90. 15 U.S.C.A. @ 78t-1(b)(3) (West Supp. 1989).

n91. Report, supra note 56, at 27.

Deletion of Additional Private Rights of Action

When the Full Energy and Commerce Committee marked up ITSFEA, Chairman Dingell offered, and Congressman Rinaldo urged approval of, an amendment that would delete another private right of action that the Telecommunications and finance Subcommittee had incorporated. In its consideration of the bill, the Committee had been concerned about the effects of insider trading on bidders in tender offers. Assume, for example, that Bidder Co. planned to make a hostile tender offer for Target Co. at $ 50 per share. Mr. Greed, an employee

of Bidder's investment bank, learned of the impending offer, bought 1000 shares of Target Co. for his own account at the current price of $ 35 per share, and tipped other buyers. Soon the price of Target Co. shares was bid up, forcing Bidder to raise the price of its tender offer to $ 60 per share. n92 Members of the Committee were sympathetic to the idea that Mr. Greed should be liable to Bidder for the additional price Bidder paid for Target's stock. Conceivably, Mr. Greed could be held liable for any increase in price paid for all shares purchased in the tender offer -- a crippling amount of civil liability. Nonetheless, in an effort to address this problem, the draft of ITSFEA, as marked up by the Telecommunications and Finance Subcommittee, included proposed section 20A(a)(2) of the Exchange Act, which would have provided that:

n92. Compare this hypothetical case with Anheuser-Busch Corporation v. Thayer, CA3-85-0794-R (N.D. Texas 1986). See also Busch Comments on Pleas in Campbell Taggart Probe, PR Newswire (Mar. 4, 1985) (NEXIS, Nexis library, PR News file).

Any person (other than a person entitled to recovery solely under paragraph (1) of this subsection) [i.e., recovery against contemporaneous traders] injured by a violation described in such paragraphs in connection with such person's purchase or sale of securities may bring an action in any court of competent jurisdiction to seek recovery of any damages caused by such violation, or for

appropriate equitable relief, or both.

Some argued that this provision merely granted standing to potential plaintiffs who would then be forced to plead and prove their damages. But others argued that this provision created far-reaching civil liability. The views with respect to the meaning of this provision were so divisive that this disagreement threatened to splinter support for the bill in the waning hours before Full Committee mark-up. At the urging of Congressman Rinaldo and other Republicans, Chairman Dingell offered a block of amendments that included deletion of this provision in the Full Committee mark-up.

There were a number of sound reasons for deleting this new cause of action. First, the provision could have created havoc when there were multiple bidders for a target company. To whom would the insider trader be liable: the first bidder or subsequent bidders? How much of a rise in the target company's stock would be deemed caused by the illegal insider trading, and how much caused by legitimate market activities? In addition, which types of insider trading would be considered a proximate cause of the damages? To whom would duties be owed and under what circumstances? n93 Was it appropriate for the securities laws to compensate bidders with monetary penalties? Traditionally the securities laws have compensated investors, not bidders, and the amount of any judgment could come at the expense of investor recoveries. Moreover, the Committee did

not want otherwise to hamper the development of the case law on private rights of action against insider traders. This provision may have had unintended consequences on that body of law.

n93. The issue of delineating the types of insider trading that would be subject to civil liability was particularly vexing. Efforts to specify which types of illegal activity should trigger liability inevitably bordered on crafting a definition of insider trading. Chairman Dingell opposed any such definition. See supra note 28 and accompanying text. On the other hand, Republican members opposed the creation of any new civil liability that was not circumscribed narrowly. Id.

The Committee members and their staffs worked hard to resolve these issues, but finally agreed that a solution could not be drafted in time to proceed with the mark-up. There were only a few days remaining in the session for Full Committee mark-up and the House Democratic leadership had announced a target adjournment of early October. n94 If the Committee delayed mark-up on the bill, it might have jeopardized enactment of the bill during the 100th Congress. Accordingly, the Committee members agreed to delete this provision, rather than to delay mark-up or to proceed with a flawed bill. The Committee agreed to rely on new section 20A(d) of the Exchange Act and let the case law continue to develop. In addition, in lieu of this private right, the Committee included

in the Report accompanying the bill language supporting the plaintiff's assertion in Anheuser-Busch that it has standing to sue the defendant. n95

n94. As noted supra note 36, Congress did not adjourn sine die until October

22, 1989. However, the Committee had to operate on the assumption that Congress would meet its target adjournment date of early October and complete its work in time for the full House and Senate to act.

n95. Report, supra note 56, at 26-28. Courts may give varying amounts of deference to the language in the Committee's Report endorsing Anheuser-Busch.

([redacted] Penalties

ITSFEA amended section 32(a) of the Exchange Act t[redacted] that Act. n96 This increase was the latest in a series of amendments raising the criminal penalties in the hope of deterring subsequent violations. It remains to be seen whether the latest increase will have any greater deterrent effect.

n96. 15 U.S.C.A. @ 78ff(a) (West Supp. 1989).

When Congress passed ITSA in 1984, it increased criminal fines for all persons other than exchanges from $ 10,000 to $ 100,000. n97 Prior to the enactment of ITSA, exchanges had been subject to criminal fines of up to $ 500,000 and ITSA did not alter that ceiling. n98 The Criminal Fine Improvements Act of 1987 superseded ITSA by permitting courts to impose for a felony conviction a maximum fine of $ 250,000 for individuals and $ 500,000 for organizations. n99 In his testimony before the Subcommittee on Telecommunications and Finance, Chairman Ruder noted that the current maximum fines available under existing law did not appear to be inadequate. Ruder believed that the five-year prison term, which had not been increased since 1934, was the most important sanction. n100 But after Ivan Boesky and Dennis Levine pled guilty to amassing millions of dollars in illegal profits, fines of $ 100,000 or $ 250,000 seemed puny. Accordingly, the Committee was determined to raise the criminal fine ceilings.

n97. ITSA Report, supra note 42, at 12.

n98. Id. at 20, 34, and 38.

n99. 18 U.S.C.A. @@ 3571(b), (c); see also 18 U.S.C. @ 3571(d) and Ruder testimony, supra note 52, at 23.

n100. Ruder testimony, supra note 52, at 23.

The Committee believed that individuals should be subject to criminal fines of up to $ 1 million. In addition, the Committee wanted to raise the second fine ceiling, which applied only to exchanges, to retain the principle that organizations should be subject to higher fines than individuals. As noted,

the
Criminal Fine Improvements Act permits higher criminal fines for all organizations, not just exchanges. However, it was troubling that the provision in the Exchange Act itself permitted higher criminal fines to be levied only on exchanges. The Committee saw little purpose in raising a fine ceiling for exchanges, which had not been participants in any insider trading schemes. n101 The Committee could have expanded this category to include securities associations such as the NASD or other SROs but there was absolutely no evidence to suggest that any SROs were involved in any wrongdoing. Such an amendment would have conveyed that inaccurate impression. Instead, the legislation allows courts to levy higher penalties on all non-natural persons, including broker-dealers and investment advisers. The legislation increased the ceiling from $ 500,000 to $ 2.5 million.

n101. There has been remarkably little illegal activity involving exchanges and their officials. Perhaps the best known case occurred in 1938 and involved a former NYSE president. Richard Whitney was president of the NYSE firm of

Whitney and Company and had been a vigorous opponent of President Franklin Roosevelt's efforts to regulate securities exchanges. Whitney had served as president of the NYSE until 1935, before the Exchange reformed its organizational structure and hired a full-time paid president. In 1938, Whitney pled guilty to grand larceny and misappropriating $ 105,000 in securities from a trust fund and the theft of $ 100,000 of securities from the New York City Yacht Club. Later that year, the SEC demonstrated that Whitney had borrowed over $ 6 million dollars from other exchange firms and was unable to repay it and had embezzled hundreds of thousands of dollars from the NYSE Gratuity Fund. Seligman, The Transformation of Wall Street, A History of the Securities and Exchange Commission and Modern Corporate Finance 120, 168-171 (1982).

In addition to increasing the criminal fine ceilings, the legislation also increased maximum jail terms for securities law violators from five to ten years. The Energy and Commerce Committee probably lacked jurisdiction to increase jail sentences; the Committee on the Judiciary, chaired by Peter W. Rodino, Jr. (D.N.J.), had jurisdiction over legislation concerning jail sentences. n102 In an exchange of letters between Chairmen Dingell, Markey, and Rodino, the Judiciary Committee agreed to waive its right to a referral of the bill on increasing jail sentences, and permitted the Energy and Commerce Committee to make the change. The Committee opined that "courts should impose jail terms for . . . these crimes" and that it "expects that raising the

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ceiling will increase the certainty of substantial prison sentences." n103

n102. Rule X, Clause 1(M), Rules of the U.S. House of Representatives.

n103. See Report, supra note 56, at 23. The securities industry raised no opposition to the increase in criminal penalties.

[redacted]

Section 3(c) of ITSFEA directs the SEC to transmit any recommendations it deems appropriate to the House and Senate regarding additional civil penalties or administrative fines. Previously, the SEC had instructed its staff to develop legislative recommendations based on the conclusions of the Treadway Commission. n104 These recommendations would give the SEC greater flexibility to impose a range of penalties on broker-dealers that had acted improperly. For example, Commissioner Cox has suggested that the SEC should have new authority to impose a fine on a firm, in addition to the existing authority to bar the firm from participating in the securities industry. n105 The Committee initially anticipated that the SEC would complete its work on these legislative recommendations in time for the Committee to consider including them in ITSFEA.
To demonstrate the members' interest in these issues, the Committee included a provision in the early drafts of ITSFEA directing the SEC to submit its

recommendations.

n104. Report of the National Commission on Fraudulent Financial Reporting (1987) (chaired by former SEC Commissioner James C. Treadway, Jr.).

n105. Barron's, May 23, 1988 at 17.

The SEC did not submit its Treadway Committee recommendations until September 28, 1988, two weeks after the House approved the legislation. By that time and with the press of other business, the Committee was unable to consider the SEC's recommendations. The requirement for the SEC to submit recommendations remained in ITSFEA and was enacted into law.

In satisfaction of that statutory directive, the SEC submitted to the Congress a revised set of recommendations on January 18, 1989. Chairman Dingell introduced this legislation on February 9, 1989. n106 It is expected that the SEC's recommendations will be considered carefully during the 101st Congress.

n106. H.R. 975, 101st Cong., 1st Sess., 135 Cong. Rec. H272 (1989).

Assistance to Foreign Securities Authorities

ITSFEA includes a provision that will allow the SEC to assist foreign securities authorities with their investigations. This provision is intended to
encourage foreign governments to cooperate with the SEC in pursuing its investigations.

Insider traders have been able to hide their illegal activities by trading through foreign bank accounts. Banks in countries renowned for their bank secrecy laws simply would refuse to disclose to SEC investigators the names of the beneficial owners of the accounts. For example, assume the NYSE surveillance system detected unusual buying in a stock a few days before another
company announced a takeover bid. The NYSE's investigation revealed that the U.S. broker executing the trade had received the purchase orders from a foreign
bank. It the NYSE turned the matter over to the SEC, the SEC would have no authority to subpoena the bank's records and the bank often would refuse SEC requests to reveal its customer's name. The SEC would have hit an insurmountable road block and would have been compelled to abandon its case. n107

n107. Former SEC Enforcement Division Director John Fedders suggested that all persons trading in the U.S. securities markets should be deemed to have waived their rights of secrecy afforded by foreign laws. N.Y. Times, June 1, 1984, at D11. The "waiver by conduct" theory was highly controversial and

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might not have addressed the problem of foreign blocking statutes under which only foreign governments, and not individuals, can waive their secrecy rights. Moreover, the concept may have raised questions about the U.S. attempting to apply its law extraterritorially. After Fedders left the SEC staff, neither the
SEC nor Congress pursued this interesting theory.

However, in recent years, this trend began to change. Foreign governments, often concerned about fraud in their own markets, have begun cooperating with SEC on specific investigations. n108 With respect to the Dennis Levine case, Gary Lynch, Director of the SEC Enforcement Division, testified that piercing the secrecy of the Bahamian bank account was critical to proving its case against Levine. n109 The SEC also has concluded Memoranda of Understanding with
its counterpart agencies in Switzerland, Canada, the United Kingdom, Japan, and
Brazil to provide reciprocal assistance in investigating a variety of suspected
illegal activities, including insider trading. The U.S. also is a party to mutual assistance treaties with Switzerland, the Netherlands, Turkey, and Italy.
n110

n108. In a hearing on June 18, 1986, Congressman Rinaldo, SEC Enforcement Director Gary Lynch, and SEC Chairman John Shad discussed the problem of

foreign
bank secrecy:

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Mr. Rinaldo. So in effect, what you are saying is that sometimes, in some cases, foreign banks are actually a hindrance in the uncovering and prosecution of insider trading cases?

Mr. Lynch. I am saying that. There is no question that if trading emanates out of a country where there are secrecy laws, it is more difficult for us to find out who is responsible for the trading than if it occurred through the New York office of a major broker-dealer.

But I have to add quickly, after saying that, we have made incredible inroads into solving the foreign secrecy problem, as we see it, in the past several years.

Mr. Rinaldo. Are foreign governments cooperating in assisting you in your efforts to detect insider trading cases?

Mr. Shad. They are increasingly cooperative. We have a 1982 accord with Switzerland that provides the mechanism . . . .

One of the important things, I think, they have done is gently give notice to their clients throughout the world, that if they do not consent to being identified, they will not execute transactions for those clients in U.S.
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markets.

It is interesting to note that Chairman Shad did not believe Congress needed to take additional steps to assist the Commission's efforts to detect international insider trading. The hearing continued with the following exchange:

Mr. Rinaldo. Is there anything Congress could or should do to increase your capability to go after activities in foreign countries?

Mr. Shad. I do not think so, at this time.

Hearings on H.R. 168 Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce, 99th Cong., 2d Sess. 41-42 (1986).

n109. In testimony before the Subcommittee on Oversight and

Investigations,
Mr. Lynch responded to a question by Chairman Dingell that the SEC had identified Bank Leu's suspicious trading prior to tender offers. Mr. Lynch stated that "the major achievement that we had in the Dennis Levine case was having enough instances [of suspicious trading] that we were in a position that
we could penetrate Bahamian secrecy, that we were in a position to force the

bank, Bank Leu, to tell us the names [sic] Dennis Levine." Hearing on H R. 179 Before the Subcomm. on Oversight and Investigations of the House Comm. on Energy
and Commerce, 99th Cong., 2d Sess. 104 (1986).

n110. Report, supra note 56, at 29. See also Report of the Senate Committee
on Banking, Housing, and Urban Affairs, International Securities Enforcement Cooperation Act of 1988, S. Rep. No. 461, 100th Cong., 2d Sess. 5-6 (1988) [hereinafter Senate Report].

The members were impressed with the SEC's substantial efforts to track down international insider traders and wanted to provide the SEC with additional enforcement tools to further that effort. In particular, the Republicans had wanted to encourage other countries to cooperate with SEC investigations by offering the possibility of the SEC assisting their investigations. However, existing law placed limitations on the SEC's ability to issue subpoenas to assist foreign authorities. Prior to ITSFEA, section 21(a) of the Exchange Act
provided that the Commission may make such investigations as it deems necessary
to uncover violations of the Exchange Act, SEC rules, or SRO rules. n111 Section
21(b) of the Exchange Act permitted the Commission to issue subpoenas for the purposes of such investigations or for any other proceeding under the title. n112 But the Exchange Act made no provision for the SEC to conduct investigations and issue subpoenas where violations of only foreign laws may

have occurred. n113 For example, assume that Mr. Fraud was a resident of Country
X and a director of a company incorporated in that country. The shares of the company were traded only in Country X. Mr. Fraud learned that the company is about to announce unexpectedly low earnings and sold all his shares of the company's stock, violating Country X's insider trading laws. Mr. Fraud now resides in the United States, although he has substantial property in Country X.
Although Country X's laws were violated, there was no violation of the U.S. securities laws. As a result, under the prior law, the SEC would not have been
able to subpoena Mr. Fraud's records in the United States to assist Country X's
authorities.

n111. 15 U.S.C.A. @ 78u(a) (West 1981).

n112. 15 U.S.C.A. @ 78u(b) (West 1981).

n113. See also @ 19(b) of the Securities Act of 1933, -15 U.S.C.A. @ 77s(b) (West 1981); @ 42 of the Investment Company Act of 1940, 15 U.S.C.A. @ 80a-41 (West 1981) [hereinafter the 1940 Act]; and @ 209 of the Investment Advisers Act of 1940, 15 U.S.C.A. @ 80b-9 (West 1981).

To remedy this problem, the Lent-Rinaldo bill would have amended the Securities Act, Exchange Act, 1940 Act, and Advisers Act to broaden the SEC's

investigatory authority. The amendments gave the SEC the discretion to assist foreign securities authorities in investigating violations of foreign laws, even if there were no violations of U.S. law. The provision did not impose any requirement that foreign governments agree in advance to offer reciprocal assistance to the SEC. n114

n114. Lent-Rinaldo bill, supra note 16, @ 202. That bill amended each of the statutes referenced to include the following:

For purposes of this subsection, an investigation undertaken at the request of a law enforcement authority of a foreign government to assist it in the enforcement of the securities laws or regulations of that country may, in the discretion of the Commission and to the extent the Commission believes it will improve cooperation in the enforcement of United States securities laws and regulations, be considered a proceeding under this title.

This provision attracted some favorable international attention. In a private meeting on January 14, 1988, representatives of the British Department of Trade and Industry indicated to a group of Subcommittee and Minority staffers, including the author, that the Department favored enactment of this provision.

This provision from the Lent-Rinaldo bill was included in the initial drafts of ITSFEA. However, on June 3, 1988, the SEC submitted to Congress its "first comprehensive legislative effort to deal with the internationalization of the securities markets" -- the International Securities Enforcement Cooperation Act of 1988 ("International Act"). n115 This bill contained a provision similar to the Lent-Rinaldo bill that would have allowed the SEC to assist foreign securities authorities by conducting investigations on their behalf. n116

n115. Letter from David S. Ruder, Chairman, SEC, to James C. Wright, Speaker of the House (June 3, 1988) [hereinafter Wright letter].

n116. Id. The bill also included provisions: (i) assuring confidential treatment for records produced under reciprocal arrangements with foreign

securities authorities and provided for exemptions to the Freedom of Information
Act (hereinafter the FOIA); (ii) clarifying the Commission's authority to grant
access to its records to foreign and domestic officials; and (iii) authorizing the Commission to institute administrative proceedings against securities professionals when a foreign authority has determined that such person engaged in illegal or improper conduct.

In the Senate, Messrs. Riegle, Proxmire, Garn, and Dodd introduced the bill on June 20, 1988 n117 with one basic change from the SEC version. The Senate

version allowed the SEC to conduct investigations on behalf of foreign securities authorities only if that authority agreed to provide similar assistance to the Commission in securities matters. The SEC had drafted its proposal to give itself greater discretion as to whether it wanted to assist foreign securities authorities. The Senate Committee on Banking, Housing, and Urban Affairs passed the bill on July 27, 1988. n118

n117. S. 2544, 100th Cong., 2d Sess. (1988), 134 Cong. Rec. S8316 (1988). See also Senate Report, supra note 110.

n118. On August 8, 1988, the Senate Committee on Banking, Housing, and Urban
Affairs reported the bill to the Senate with one amendment. 134 Cong. Rec. S11102 (1988). The amendment made comprehensive stylistic changes to the bill and directed the Commission to report to Congress on "the effectiveness of memoranda of understanding as a means of improving enforcement of United States
securities laws." See also Senate Report, supra note 110.

On the House side, Messrs. Dingell, Markey, Lent, and Rinaldo introduced the
International Act by request of the SEC and without any changes from the SEC's draft. n119 The Subcommittee on Telecommunications and Finance held a hearing on
the bill on August 3, 1988. n120

n119. H.R. 4945, 100th Cong., 2d Sess. (1988), 134 Cong. Rec. H4937 (1988) (introduced June 29, 1988).

n120. SEC Chairman Ruder was the sole witness and the hearing lasted only forty minutes. During the hearing Mr. Rinaldo noted that the Senate Committee on Banking, Housing, and Urban Affairs had passed a slightly different version of the International Act and asked him to describe the difference for the record:

Mr. Ruder. The only significant change between the bill before us today and
the Senate bill, has to do with the so-called reciprocity provision. In the draft of the bill before us today, the reciprocity provision is merely one of

the factors that must be taken into account by the Commission, whereas in the Senate bill, the inclusion of reciprocity is a requirement.

Mr. Rinaldo then asked whether Mr. Ruder preferred the Senate version. Mr. Ruder replied that he preferred the House version for the following reasons:

Reciprocity is, of course, something that we think is important and the main purpose of our legislation is to encourage other countries to give us subpoena power, compulsory enforcement power in our investigative work overseas. We believe, however, that there may be two occasions in which we may want to

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grant a foreign country access to our records when they do not grant it to us

The first would be a situation in which we felt that U.S. interests were somehow involved in the activity overseas and that it would be beneficial to U.S. interests to use our powers to allow the overseas officials to conduct our investigation. The second situation might be one in which a country was somewhat recalcitrant in providing reciprocal authority to us and we might use a one-time grant of our subpoena power as an effort to induce them to enter into an agreement with us.

Hearings on H.R. 225 Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce, 100th Cong., 2d. Sess. 238-39 (1988).

The Committee agreed to amend ITSFEA and replace the investigatory assistance language taken from section 202 of the Lent-Rinaldo bill, with section 101 of the SEC's bill. The Committee made its change for two reasons. First, the SEC's version was simpler and required amending only the Exchange Act, not four securities titles. Second, the SEC's version had that agency's "imprimatur" and the Committee believed that the language drafted by the SEC had been very carefully scrutinized and would garner broader support.

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The Committee also made a tactical decision not to include in ITSFEA the other provisions of the International Act. There was some concern that other provisions of this bill, particularly the exemptions to the Freedom of Information Act, would complicate the bill, trigger referrals to other Committees, or otherwise slow the progress of ITSFEA in a short legislative year. The Committee retained some hope that, if the House passed ITSFEA and the Senate passed the International Act, the two houses would hold a conference on both bills, and enact the complete package. For a variety of reasons, the full Senate did not pass the International Act and this scenario never came to pass.

However, the remaining portions of the International Act have a good chance of being considered during the 101st Congress. n121

n121. On March 1, 1989, the SEC resubmitted the remaining portion of the International Act to Congress for consideration. The proposal includes two new provisions that would: (i) expand the definition of statutory disqualification under @ 3(a)(39)(F) of the Exchange Act to add the words "or any other felony"; and (ii) amend @ 4 of the Exchange Act to allow the SEC to accept reimbursement from foreign securities authorities for expenses incurred in connection with providing assistance to those foreign authorities. On March 14, 1989, by the request of the SEC, Chairman Markey introduced the bill. H.R. 1396, 101st Cong., 1st Sess. (1989). The original co-sponsors included: Congressmen Dingell, Rinaldo, Lent, Eckart, Slattery, Boucher, Cooper, Wyden, Manton,

Ritter, Madigan, Whittaker, Barton, Bliley, Bilirakis, and McMillan.

Special Study

As noted earlier, Congressman Rinaldo believed that Congress should direct the SEC to make a new special study of the securities markets. n122 Congressman Rinaldo believed that the plethora of insider trading and other securities fraud cases, as well as the wealth of innovations in, and greater complexity of, the securities and financial markets demanded a new and comprehensive study. Congressman Rinaldo garnered support for the new special study and, with certain modifications, it is included in the legislation. n123

n122. See supra notes 22-23 and accompanying text.

n123. ITSFEA, supra note 2, at @ 7.

Background

In 1961, Congress enacted legislation directing the SEC to make a study and investigation of the rules of national securities exchanges and national securities associations and their disciplinary authority over member firms to determine whether those rules adequately protected investors. n124 To ensure

that the SEC did not need to divert resources from other activities to complete the study, Congress authorized a separate appropriation for the task.

n124. Securities Exchanges-Study, Pub. L. No. 87-196, 75 Stat. 465. That legislation provided that "[t]he Commission is authorized and directed to make a study and investigation of the adequacy, for the protection of investors, of the rules of national securities exchanges and national securities associations, including rules for the expulsion, suspension, or disciplining of a member for conduct inconsistent with just and equitable principles of trade." Id.

The SEC created a Special Study task force headed by Milton Cohen which produced a massive and comprehensive study of the securities markets. n125 It served as the basis for the 1964 amendments to the securities laws. It also became the textbook on U.S. securities regulation for generations of investment bankers, securities lawyers, academics, legislators, regulators, and the general public.

n125. Report of the Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963).

While the Special Study was, and some of it remains, an extremely useful document, much of it has become obsolete. Since the early 1960s, the

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securities markets have undergone major changes, such as the development of NASDAQ, the growth of standardized options, unfixing of commission rates, immobilization of securities certificates, and the development of index options, financial futures, and index arbitrage. In addition, in recent years, the vigorous law enforcement efforts of the SEC and the Department of Justice have revealed troubling insider trading and other securities frauds.

Accordingly, Congressman Rinaldo believed that the congress should direct the SEC to undertake a new study of the securities markets. While the Congress and its Committees have directed the SEC to study certain topics in the intervening years, n126 the SEC has not conducted a comprehensive examination of the securities markets in twenty-five years.

n126. See, e.g., Report of the Special Study of the Options Markets, 96th Cong., 1st Sess., (Committee Print 1978).

[redacted]

Congressman Rinaldo contemplated a study that would have had several differences from the 1963 study. First, the scope of the study was intended to be much broader. The SEC had read its 1961 congressional mandate quite broadly and had produced a study that addressed topics including broker-dealer

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regulation, activities of investment advisers, and obligations of reporting companies. n127 Nonetheless, the language of the 1961 statute was fairly narrowly drawn and the Commission could have produced a very limited study confined to a few areas of broker-dealer regulation. Congressman Rinaldo did not want to leave open such a possibility and specified that the study should address a wide range of topics. n128

n127 The 1963 Special Study included the following thirteen chapters: I. Introduction; II. Qualifications of Persons in the Securities Industry: III Broker-Dealers, Investment Advisers, and their Customers -- Activities and Responsibilities; IV. Primary and Secondary Distributions to the Public; V. Trading Markets -- Introduction; VI. Exchange Markets; VII. Over-the-Counter Markets; VIII. Trading Markets -- Interrelationships; IX. Obligations of Issues of Publicly Held Securities; X. Security Credit; XI. Open-end Investment Companies (Mutual Funds); XII. The Regulatory Pattern; XIII. The Market Break of May 1962. [Special Services] Fed. Sec. L. Rep. (CCH) P74,002 (1972).

n128. Section 302(b) of the Lent-Rinaldo bill, supra note 16, directed the Commission to study and analyze the matters listed below (deletions made in ITSFEA are enclosed in brackets; additions are italicized):

(1) the extent of improper trading [on the basis] while in possession of insider information, such as trading [on the basis of] with advance knowledge of tender offers or forthcoming announcements of material financial information; (2) the adequacy of the surveillance methods and technologies of brokers, dealers, and self-regulatory organizations; (3) the adequacy of cooperation between [extent to which the securities industry and] Federal, [and] State, and foreign enforcement authorities concerning securities laws enforcement and [regulators operate a coordinated and comprehensive system for policing the securities markets, and the obstacles to more effective coordination, such as impediments to information sharing, the separation of civil and criminal enforcement, and the use of extra-territorial trading facilities;] (4) impediments to the fairness and orderliness of the securities markets and to improvements in the breadth and depth of the capital available to the securities markets and additional methods to promote those objectives [the need for additional resources or civil or criminal remedies, or both, to combat fraud and improve enforcement, including an analysis of whether existing trading restrictions applicable to corporate management should be extended to other persons; (5) the practices in which unregulated affiliates of brokers and dealers are engaged, such as interest rate swaps, foreign currency arbitrage, and any other activities; and (6) the nature and use of all sources of financing for both hostile and friendly takeovers].

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Second, unlike the 1963 Study, Congressman Rinaldo intended that a panel of five securities experts appointed by the SEC oversee the new study. The panel was intended to ensure that a wide range of views was considered in the study. n129 n129. The SEC has itself employed similar techniques with its "roundtable" discussions of major issues. E.g., SEC, SEC Roundtable on Major Issues (Sept 5 and 11, 1985) (discussions of tender offers, one-share/one-vote, government securities markets, securities immobilization, and other issues).

Although the Committee agreed to include the study provision in ITSFEA, the Committee made several changes to the study's provisions. First, the members drafted the language of the study slightly more narrowly so that the study would be focused primarily on insider trading, even if it addressed other issues. The Committee deleted subjects such as the separation of civil and criminal enforcement of the securities laws and the practices of unregulated affiliates of broker-dealers. n130 The reason for this change was that some members feared that, if the study contained a laundry list of subjects for study, it would attract floor amendments to the securities laws on a variety of topics such as tender offers or program trading. Such amendments would not have been subject to careful scrutiny and could have jeopardized support for the bill. Those amendments might have been germane under the rules of the House, and these

members of the Committee did not wish to accentuate the breadth of the study. n131 Accordingly, section 7(b)(2)(A)-(C) of ITSFEA provides that the study shall include an analysis of a range of topics related to insider trading, market surveillance, and federal and state law enforcement efforts. However, section 7(b)(2)(D) of ITSFEA directs the Commission to analyze the "impediments to the fairness and orderliness of the securities markets and to improvements in the breadth and depth of the capital available to the securities markets, and additional methods to promote those objectives." This provision was intended to give the SEC the discretion to look at virtually any securities-related topic that it deemed appropriate. The Report accompanying the bill clarifies the Committee's intention that the study should be comprehensive. n132

n130. See supra note 128 for the differences between the Special Study provisions in the Lent-Rinaldo bill, supra note 16, and ITSFEA.

n131. The House considered the bill under suspension of the House rules, and no amendments were permitted. Nonetheless, while drafting the bill, the members could not have been certain that the bill would not have been considered on the floor subject to an open rule.

n132. Report, supra note 56, at 32 provides that:

The Committee intends that this study go well beyond an examination of the problems of securities fraud . . . . The Committee intends that the Commission shall use its discretion to examine a broad range of topics from legal, economic, or public policy perspectives. For example, the Commission could decide to examine the effects of mergers and acquisitions on the economy and the efficacy of federal and state laws regulating [mergers and acqusitions]. The Commission also could study investment activities, whether or not they are regulated currently by federal and state law. The Committee intends that the SEC include in its study the issue of the role of institutional fund managers and their impact on the market, given the increasing trend of institutional holdings in the market and the growing power of fund managers in determining the outcome of proxy contests. The study is intended to be broad in scope and in method of analysis, commensurate with the amount of the appropriation and the extensive expertise of the SEC's attorneys, accountants, economists, and other professional staff.

Second, the Committee believed that the legislation should provide that the study would be conducted by the SEC itself, and not under the auspices of a five member panel of experts. Some members opposed the panel for fear that private attorneys appointed to the panel would use the study to further their own views or the views of their clients. Others viewed the panel structure as a means to ensure a diversity of views. Nonetheless, the members agreed to delete the

panel provision and have the study conducted by the SEC. n133

n133. ITSFEA, supra note 1, does provide the SEC with broad authority to hire a range of people to work on the Study. Section 7(b)(3) of ITSFEA provides that the SEC "may appoint, without regard to the civil service laws, rules, and regulations, such personnel as the Commission deems advisable to carry out such study and investigation and to fix their respective rates of compensation without regard to such laws, rules, and regulations . . . ."

Third, the study is contingent on Congress's appropriating $ 5 million for the project. Some members feared that, unless additional funds were appropriated for the study, the SEC would be forced to reduce other discretionary expenditures. For example, the Committee did not want the SEC to bring fewer enforcement cases, in order to have sufficient resources to complete the congressionally mandated study. While this provision does protect the SEC's other programs -- a laudable objective -- it does make funding the study a formidable objective. Although the SEC generates fees well in excess of its appropriation, n134 it may be extremely difficult for Congress to fund an additional $ 5 million for the study in an era of federal deficit reduction. It remains to be seen whether Congress will appropriate the funding for this long-term reassessment of the nation's securities laws and markets.

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n134. For example, in fiscal year 1988, the SEC earned $ 248.9 million in fee revenue, or 184% of its appropriation. SEC Budget Estimate Fiscal 1990, at IX-1.

Assistance to International Securities Organizations

Section 8 of the bill amended the SEC's authorization to allow it to fund activities of the International Organization of Securities Commissions ("IOSCO"). The SEC indicated that it had been working with IOSCO to further international cooperation on enforcement activities and other securities regulation issues. The SEC wanted to be able to pay its share of expenses for IOSCO and had adequate funds to do so out of its existing appropriation. However, the Committee on Appropriations had been reluctant to appropriate funds without a specific authorization. Section 8 of ITSFEA eliminated this obstacle.

[redacted]

ITSFEA constitutes a rational congressional response to a significant number of insider trading cases. The Majority and Minority members of the Committee worked together to craft a consensus bill that attempts to be balanced and to impose controlling person liability under reasonable circumstances. The drafters' extensive consultations with the SEC and its staff, and with

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industry lawyers markedly improved the legislation. During the drafting process, the Committee considered and either accepted or rejected a wide variety of remedies designed to address insider trading. The drafters made substantial efforts to set a standard for controlling person liability that is neither a hair trigger of firm liability, nor an insurmountable standard that, from a practical standpoint, is unavailable to the SEC. The bill also preserves existing substantive law with respect to permitting the legitimate flow of information from issuers to investment analysts. Courts will need to interpret and apply the newly invented standards included in the legislation and will have the difficult task of striking the balance that the Committee contemplated in specific circumstances. In addition, the legislation provides the SEC with important supplemental authority to adopt prophylactic rules designed to prevent insider trading.

ITSFEA is a compromise in the truest sense among all interested parties. Democratic and Republican members of the Committee had concluded that Congress

should enact stringent, but reasonable, new proscriptions against insider trading. The Committee was able to bring together various diverse views and forge a consensus bill. It is significant that most of ITSFEA did not originate
with the SEC. By comparison, ITSA was developed by, and enacted at the urging of, the SEC. Nonetheless, Chairman Ruder endorsed the final bill with only minor reservations. The securities industry initially opposed the legislation

but, because of improvements to the bill, most securities firms ceased their opposition.

Within the Committee, Democrats tried to be accommodating to a range of views
and were responsive to suggestions for refinements. Despite their minority status, Republican members of the Committee had significant input into the bill
and had a major role in shaping the final product. Republicans made a number of
substantive contributions adopted from the Lent-Rinaldo bill that were included
in ITSFEA. Of particular note is the SEC's expanded authority to assist foreign
securities authorities with investigations.

For all of these reasons, in the author's judgment, the members of the Committee have reason to be proud of the legislation. Congress can never be sure how well legislation will function once it becomes law. Only time will tell whether ITSFEA will have the desired effects of deterring fraud and improving international securities surveillance, without harming the efficiency
of the financial markets. But the Committee members and their staffs tried diligently to assure that ITSFEA would achieve these goals.

If ITSFEA fails to deter insider trading, it is hard to imagine that Congress could increase the penalties and disincentives against insider trading to even higher levels, without seriously jeopardizing the efficiency

of our securities markets. In these circumstances, Congress would need to explore other means of attacking the insider trading problem, such as enacting
a definition of insider trading to fill any gaps in the law, or further expanding enforcement and regulatory efforts.

LANGUAGE: ENGLISH

Table 1
ENFORCEMENT CASES INITIATED BY THE COMMISSION
DURING FISCAL YEAR 1996 IN VARIOUS PROGRAM AREAS

(Each case initiated has been included in only one category listed below, even though many cases involve multiple allegations and may fall under more than one category. The number of defendants and respondents is noted parenthetically.)

Program Area in Which a Civil Action or Administrative Proceeding Was Initiated	Civil Actions 1/	Administrative Proceedings	Total	% of Total Cases
Securities Offering Cases				
(a) Non-regulated Entity	51 (201)	17 (26)	68 (227)	
(b) Regulated Entity	25 (87)	34 (55)	59 (142)	
Total Securities Offering Cases	76 (288)	51 (81)	127 (369)	28%
Broker-dealer Cases				
(a) Fraud Against Customer	18 (60)	43 (60)	61 (120)	
(b) Failure to Supervise	0 (0)	17 (22)	17 (22)	
(c) Government Securities	2 (2)	3 (4)	5 (6)	
(d) Books & Records	2 (2)	8 (11)	10 (13)	
(e) Other	0 (0)	7 (8)	7 (8)	
Total Broker-dealer Cases	22 (64)	78 (105)	100 (169)	22%
Issuer Financial Statement and Reporting Cases				
(a) Issuer Financial Disclosure	23 (76)	49 (71)	72 (147)	
(b) Issuer Reporting Other	3 (4)	1 (1)	4 (5)	
Total Issuer Financial Statement and Reporting Cases	26 (80)	50 (72)	76 (152)	17%
Other Regulated Entity Cases				
(a) Investment Advisers	8 (21)	34 (47)	42 (68)	
(b) Investment Companies	2 (4)	4 (5)	6 (9)	
(c) Transfer Agent	0 (0)	1 (1)	1 (1)	
(d) SROs	0 (0)	2 (2)	2 (2)	
Total Other Regulated Entity Cases	10 (25)	41 (55)	51 (80)	11%
Contempt Proceedings	32 (47)	0 (0)	32 (47)	7%
Insider Trading Cases	29 (92)	0 (0)	29 (92)	6%
Delinquent Filings				
(a) Issuer Reporting	5 (4)	1 (1)	6 (5)	
(b) Forms 3/4/5	2 (5)	7 (11)	9 (16)	
Total Delinquent Filings Cases	7 (9)	8 (12)	15 (21)	3%
Market Manipulation Cases	4 (13)	7 (15)	11 (28)	2%
Fraud Against Regulated Entities	3 (10)	1 (1)	4 (11)	1%
Corporate Control Cases	0 (0)	3 (3)	3 (3)	1%
Miscellaneous Disclosure/Reporting	3 (7)	2 (2)	5 (9)	1%
GRAND TOTAL	212 (635)	241 (346)	453 (981)	100%

1/ This category includes injunctive actions and civil and criminal contempt proceedings.

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$31,672.75 representing his losses avoided from sales of Kendall stock, plus prejudgment interest (*In the Matter of Thomas J. MacCormack*[33]).

The Commission alleged that Akhilesh Chandoke, the former president, chief executive officer, and director of Automated Telephone Management Systems, Inc. (ATM); Frank Mzyk, ATM's former controller and principal accounting officer; and David Jacobs, its former secretary and vice president of sales, engaged in a fraudulent scheme to inflate the company's revenue for the fiscal year ended September 30, 1993 (*SEC v. Automated Telephone Management Systems, Inc.*[34]). ATM allegedly recognized $1.3 million in revenue from a fictitious sales contract that represented 25 percent of the company's revenue for 1993. The defendants concealed inventory, created fictitious invoices, and backdated internal documents to conceal the fraud from auditors. Chandoke and Mzyk consented to the entry of injunctions and orders barring them from acting as officers or directors of public companies. Default injunctions were entered against ATM and Jacobs, who also was barred from serving as an officer or director of a public company. In a related action, Earl V. Young, a former ATM director, consented to the entry of an injunction and an order requiring him to pay a civil penalty of $15,000 (*SEC v. Earl V. Young*[35]).

Insider Trading

Insider trading occurs when a person in possession of material non-public information engages in securities transactions or communicates such information to others who trade. The Commission often seeks ancillary relief, including disgorgement of any profits gained or losses avoided, in addition to permanent injunctions. The ITSA penalty provisions authorize the Commission to seek a civil penalty, payable to the United States Treasury, of up to three times the profit gained or loss avoided against persons who unlawfully trade in securities while in possession of material non-public information or who unlawfully communicate material non-public information to others who trade. Civil penalties also can be imposed upon persons who control insider traders. During 1996, the Commission brought 42 cases alleging insider trading violations.

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In emergency situations, the Commission will take action to protect the markets when the identity of potential violators has been concealed or is otherwise unknown. In *SEC v. Certain Purchasers of the Common Stock of CBI Industries, Inc.*,[36] the Commission filed a complaint alleging that unknown persons, acting through the offices of foreign financial institutions (three Swiss and one German), made highly profitable purchases of common stock issued by CBI Industries just days before the public announcement of a proposed takeover of CBI by Praxair, Inc. Because the price of CBI stock rose by over 50 percent following the public announcement, the defendants stood to realize substantial profits. The court entered a temporary restraining order that froze the shares of stock in the accounts at issue, along with any proceeds from sales of such stock. Subsequently, the court entered an injunction by default against the two individuals and seven companies that had been identified as responsible for the trading. The order requires total disgorgement of $1.4 million, plus $1.2 million in ITSA penalties from seven of the defendants.

The Commission also filed an action, *SEC v. Certain Purchasers of Call Options of Duracell International, Inc.*,[37] alleging that unknown persons purchased call options prior to the public announcement of a merger agreement between Duracell International and The Gillette Company The defendants' purchases resulted in profits of approximately $950,000. The Commission obtained a preliminary injunction and an asset freeze in this case, which was pending at the end of the year.

The Commission filed an action against six individuals, alleging that they engaged in insider trading in the securities of Intuit, Inc., or tipped to others who traded, prior to the announcement of a proposed merger between Microsoft Corporation and Intuit on October 13, 1994 (*SEC v. Kathleen Lane*[38]). Kathleen Lane learned of the proposed merger from her spouse, Intuit's chief financial officer, and tipped her son and daughter who in turn tipped the three other defendants. Seven months later, Lane learned that the merger plans were to be abandoned and communicated this information to her son and one of his tippees. The defendants consented to the entry of

injunctions and orders requiring the payment of a total of $472,342 in disgorgement and penalties.

The Commission charged a psychiatrist with insider trading in the securities of Lockheed Corporation (*SEC v. Mervyn Cooper*[39]). In 1994, Mervyn Cooper provided marriage counseling to a Lockheed executive who was involved in the due diligence process related to a planned merger between Lockheed and Martin Marietta Corporation. The executive confided confidential information concerning a major transaction involving Lockheed, which Cooper tipped to Kenneth E. Rottenberg, who opened a brokerage account in which he and Cooper jointly purchased call option contracts for Lockheed stock. They also purchased shares of Lockheed stock. As a result of their illegal trading, the defendants had combined profits of $177,235.60. The defendants consented to the entry of injunctions and orders requiring Cooper to disgorge profits of $53,458.02 plus prejudgment interest and to pay a civil penalty of $53,458.02, and requiring Rottenberg to disgorge $53,909.85.

A complaint filed by the Commission charged Donald Tyson and Frederick Cameron with insider trading in 1992 in the common stock of Arctic Alaska Fisheries Corporation (*SEC v. Donald John Tyson*[40]). Tyson, who was then the chairman of the board of directors of Tyson Foods, Inc. and a majority shareholder of the company, communicated material non-public information to Cameron, a friend, concerning Tyson Foods' proposed acquisition of Arctic Alaska. While in possession of that information, Cameron purchased 9,000 shares of Arctic Alaska stock for $59,625; following the public announcement of the proposed acquisition, he realized a profit of $46,125 on the sale of the stock. The defendants consented to the entry of an injunction and orders by which Cameron was required to disgorge $46,125, plus prejudgment interest of $18,153.43, and by which Cameron and Tyson each were required to pay civil penalties of $46,125.

Three individuals were charged with insider trading in the common stock of Skybox International, Inc. (*SEC v. Hugo Aldo Sallustro*[41]). Sallustro, the managing director of Panini S.r.L., a European subsidiary of Marvel Entertainment Group Inc., misappropriated information concerning a possible acquisition of Skybox, and purchased Skybox stock while in possession of this information; he also tipped Anna Baroni and Ferrucio Camponovo, who both traded Skybox stock. Following the public announcement of Marvel's tender offer for Skybox, the defendants realized total profits of $152,718. The defendants consented to the entry of injunctions and orders requiring total payments of $165.980 representing disgorgement plus prejudgment interest and $102,608 in civil penalties.

Regulated Entities

The NASD Proceedings

Under the Exchange Act, the Commission exercises oversight of SROs in the securities business. Administrative proceedings were instituted during the year against the NASD to address its alleged failure to comply with certain of its own rules and its failure to enforce compliance by market makers on the Nasdaq system with NASD rules and the federal securities laws (*In the Matter of National Association of Securities Dealers, Inc.*[42]). In settling the proceedings, the NASD agreed to provide for more diversity on its Board of Governors and certain policy making committees, improve the process by which it disciplines member firms and admits new members, and strengthen its enforcement efforts and enhance its surveillance regarding market making activities. The NASD also represented that $25 million had been authorized to enhance its market surveillance systems and that an additional $75 million would be committed for this purpose over the next five years. The Commission released a report of investigation regarding the NASD and the Nasdaq market[43] detailing a number of problem areas including the anticompetitive pricing convention used by market makers, by which most stocks were quoted only in even eighths (*i.e.*, $.25, $.50, $.75), so that spreads were never less that $.25. The report also discussed regulatory deficiencies at the NASD.

approved by Seaboard's vice president of compliance. This matter was pending at the end of the year.

Michael C. Robertson, the former investment adviser to the Employees' Retirement Fund for Fort Worth, Texas and the investment adviser to the Oklahoma Police Pension Retirement System, and his advisory firm, M.C. Robertson & Associates, Inc., were charged in administrative proceedings with making materially false and misleading statements regarding the receipt of compensation from broker-dealers and mutual funds in connection with their advisory business (*In the Matter of Michael C. Robertson*[61]). Robertson and his firm received approximately $721,461 in undisclosed service fees paid by three mutual funds in the Fort Worth fund's portfolio and undisclosed commission payments totaling $13,863.72 in a commission recapture program. The respondents also received undisclosed commission payments totaling $48,205.12 in connection with the Oklahoma Police Pension fund commission recapture program. This matter was pending at the end of the year.

Sources for Further Inquiry

The agency publishes the SEC Docket, which includes announcements regarding enforcement actions. SEC litigation releases describe civil injunctive actions and report certain criminal proceedings involving securities-related violations. These releases typically report the identity of the defendants, the nature of the alleged violative conduct, and the disposition or status of the case. The SEC Docket also contains Commission orders instituting administrative proceedings, making findings, and imposing sanctions in those proceedings, and initial decisions and significant procedural rulings issued by Administrative Law Judges. In addition, recent litigation releases, orders in administrative proceedings, and other information of interest to investors are posted on the internet at the SEC's World Wide Web site (http://www.sec.gov). The Commission's Enforcement Complaint Center may be reached through the Enforcement Division page of the website and e-mail messages may be sent directly to the division at enforcement@sec.gov.