amendment authority. That is, neither the amendment of the simple possession statute relating to crack nor the creation of two new obscenity offenses in our view signals a congressional intent in favor of guideline amendments of the type proposed. Obviously, however, some fairly narrow amendments would address the statutory amendments.

Crack

Since we do not believe the 1988 statutory amendments provide a policy basis for the proposed guideline modifications, we have considered whether some other policy ground exists. We have sought information from prosecutors as to whether the current crack distribution guideline sentences are too low. The response has been, however, that the guideline sentences appear appropriate at present. In the absence of a consensus among prosecutors involved in drug cases that higher guideline sentences are needed, we are not inclined to recommend a change, particularly at a time when we are seeking to ensure proper plea bargaining procedures. We recognize that the situation may change in the future, and we may perceive a need for higher guideline sentences for certain drug offenses after more experience is gained under the current guidelines.

Obscenity

The obscenity guideline revisions include several aspects which are worth retaining but others that we strongly oppose. The incorporation in the base offense level of the pecuniary gain factor is a change we favor since most obscenity distribution offenses involve distribution for pecuniary gain. We recommend that the base offense level selected by the Commission be between 12 and 14 where there is pecuniary gain and eight otherwise.

We point out, however, that we would not favor such restructuring of the guideline if pecuniary gain were incorporated in the base offense level in a way that did not provide at least a base offense level of 12. That is, the fact of pecuniary gain, without the need to show a significant dollar amount, should result in a substantial increase in the offense level over non-pecuniary gain cases because in obscenity prosecutions the government must prove the obscenity of each item of pornography at issue. It is unlikely that the charged material will ever be very high in retail value, unless in an unusual case the defendant is found to have shipped numerous copies of the same film or magazine. It should be noted that the proposed specific offense characteristic, proposed §2G3.1(b)(1), relating to pecuniary gain does not provide a floor increase as does the existing characteristic.

Our greatest problem with the proposed guideline is the deletion of the existing four-level increase for material that portrays sadomasochistic conduct or other types of violence. The proposed guideline makes no distinction between types of obscenity, such as sadomasochistic conduct or bestiality, except for the cross-reference to child pornography and the application note for pseudo-child pornography. We believe that the four-level increase for violent or sadomasochistic conduct should be retained, since violent pornography has an especially harmful effect upon society.

The deletion of the four-level increase for violent portrayals is particularly significant since the proposed aggravating factor that would take its place is nearly meaningless and will be utilized far less frequently than the violence factor. The proposed new specific offense characteristic -- increases for a pattern of distributing obscene material to minors -- comes from uncertain origins and has uncertain applications. While most states have statutes prohibiting unlawful display or distribution of pornography to minors, there is no similar federal statute. Neither is distribution to minors a factor in obscenity prosecutions which normally concern interstate distribution to undercover officers or adult bookstores. Perhaps this characteristic would apply to new section 1460 of title 18, United States Code, for selling obscene material in a PX, but this scenario would be rare. Suffice it to say, we would rather have an increase for material that portrays violence than for a "pattern of distribution to minors."

The proposed amendments also add the "pattern" characteristic to the child pornography guideline, §2G2.2. This produces the result of increasing the base level for those engaged in a pattern of distributing child pornography to children. While such a scenario could conceivably happen, in our memory, it never has.

Finally, we turn to the proposed additional cross-reference, proposed §2G3.1(c)(1), involving child pornography. We agree that this new cross-reference is appropriate to take into account that the new statute, 18 U.S.C. §1460, prohibits not only possession with intent to sell obscenity but also child pornography. While most offenses involving child pornography are normally prosecuted under the child pornography statutes, rather than 18 U.S.C. §1460, there may be some cases where section 1460 will be used. We note, however, that Application Note 2 includes "pseudo-child pornography" in this cross-reference. Since caselaw establishes that the use of adults who attempt to appear youthful contributes to the "patent offensiveness" of the material, an element of the Miller v. California obscenity test, we agree with the notion of greater punishment for pseudo-child pornography cases than for obscenity cases not making use of this charade. However, pseudo-child pornography in our view is not as serious as actual child pornography and should not subject the offender to the same punishment, as would be required by the application note in question. Instead, we believe a specific offense characteristic providing a modest increase would be more appropriate for pseudo-child pornography cases than would the cross-reference to the child pornography guideline.

I look forward to the discussion of these important issues at a future meeting.

Sincerely,

Stephen A. Saltzburg /jm

Stephen A. Saltzburg
Deputy Assistant Attorney General

Children's Legal Foundation

"protecting the innocence of children"

June 30, 1989

Honorable William W. Wilkins, Chairman
United States Sentencing Commission
1331 Pennsylvania Avenue, NW, Suite 1400
Washington, D.C. 20004

Dear Sir:

I serve as Executive Director of Children's Legal Foundation, (formerly Citizens for Decency through Law, Inc.), a national, non-profit legal organization devoted to assisting police and prosecutors to enforce constitutional laws prohibiting obscenity, child pornography and sexual exploitation. Since 1957, CLF has been involved in all aspects of the fight against pornography, but especially in providing expert legal assistance to allow communities, cities, states and the federal government to take effective action against illegal activity involving pornography.

I formerly served as Executive Director of the Attorney General's Commission on Pornography and Chief of the Criminal Section of the U.S. Attorney's Office in Louisville, Kentucky.

Children's Legal Foundation assisted Congress in drafting the federal pornography statutes affected by these guidelines. Indeed, on several occasions CLF provided expert testimony in Congress. Memoranda of law authored by CLF's legal staff were entered into the Congressional Record as bedrock support for these laws on three separate occasions. CLF has submitted amicus curiae briefs in every case before the Supreme Court involving obscenity or pornography for the last three decades. In addition, CLF currently represents a 4-year-old victim of dial-a-porn in a $10 million lawsuit against the pornographic message provider and Pacific Bell. The child was molested by a 12-year-old boy after he listened to two-and-a-half hours of explicit sex messages. CLF has hundreds of affiliated citizen organizations around the United States with thousands of members, and hundreds of thousands of contributors. These supporters were instrumental in motivating Congress to pass the above legislation.

Children's Legal Foundation, Inc. • 2845 E. Camelback Rd., Suite 740 • Phoenix, Arizona 85016 • 602 381-1322
Founded 1957

This letter is in response to your June 2, 1989 request for comment on the proposed temporary emergency amendments to the Sentencing Guidelines regarding distribution of obscene materials. I would first request that you review the April 6 letter of our General Counsel, Benjamin Bull (copy attached), which sets forth in detail our views generally on this matter.

With respect to the proposed temporary, emergency amendments, Children's Legal Foundation renews its objections to several of the guidelines:

(1) The base offense level of (6) is too low to adequately confront a billion-dollar industry controlled almost exclusively by organized crime. When Congress overwhelmingly passed this legislation, it certainly did not intend that it never be used by federal prosecutors. Yet that will undoubtedly be the effect if the penalties remain this low -- prosecutors will recognize that convictions will have little to no impact on the illegal pornography industry.

(2) We oppose any attempt to increase or decrease the penalty depending on the "retail value" of obscene materials transported or whether transported for "pecuniary gain." Obscenity is illegal because it is considered harmful to communities, and to the nation as a whole. The motivation of its purveyors should not be relevant in sentencing. The fact that organized crime controls the industry because of its profitability supports our push for harsher penalties. But we do not seek to suppress obscenity <u>only</u> because organized crime gets rich selling it. We seek to suppress obscenity because it is harmful to our nation. Harsher penalties will deter organized crime, and therefore reduce the harm to our country. But it is the harm caused by obscenity, not its mere profitability, that should be the focus of law enforcement efforts and sentencing guidelines. And the harm flowing from the proliferation of obscenity in the United States exists whether disseminated for proven "pecuniary gain" or not. There is no Congressional intent to the contrary.

Again, we would ask the Commission to reconsider its proposed guidelines in light of this legislation's overwhelming support in Congress and the nation as a whole. We should point out that the trend in recent state and federal legislation has been to <u>increase</u>, not decrease, penalties for violations of obscenity and child pornography statutes, in recognition of growing evidence of organized crime's control of the industry.

The Commission's recommendations fall far below the penalties in current law for numerous states for similar intra-state violations. Let us not make the federal law into a paper tiger, to be laughed at by the career criminals who flout it daily with impunity.

Thank you very much for your consideration.

Sincerely,

Alan E Sears

Alan E. Sears
Executive Director

AES:kb

OCCIDENTAL PETROLEUM CORPORATION
10889 WILSHIRE BOULEVARD, SUITE 1500
LOS ANGELES, CALIFORNIA 90024
•
(213) 879-1700 208-8800

June 29, 1989

Mr. Paul Martin
Director of Communications
United States Sentencing Commission
1331 Pennsylvania Avenue, NW
Suite 1400
Washington, D.C. 20004

Dear Mr. Martin:

As requested by Mr. Moore in his letter of June 9, 1989, the following are our comments on the three sets of proposals regarding organizational sanctions. These have been reviewed with Frank. B. Friedman, Vice President - Health, Environment and Safety of Occidental Petroleum Corporation and he concurs.

Reiterating what we said in our testimony before the Commission last December, it is our feeling that while punitive penalties for past actions may be appropriate in some circumstances, prevention of future noncompliance is much more critical in the application of organizational sanctions. It must be recognized that financial penalties or financial restrictions on a corporation if possible, will be passed on to the consumer of the goods or services produced. If the penalties are truly punitive, they may result in the destruction of the company with concomitant loss of jobs. For these reasons we feel that all of the proposals place too much emphasis on financial penalties and not enough on management controls.

In addition to this general comment, the following are specific comments on sections of the three proposals:

Private Attorney Working Group

Page 3, V H 1 & 2. - The proposal properly recognizes as mitigating factors that;

> "1. the existance and effectiveness of organizational policies and practices reasonably designed to prevent violations of the type involved in the offense;
>
> 2. actual and reasonable lack of knowledge of the offense on the part of high-level management;".

Page 4, VI. - The seizure of instrumentalities needs clearer definition since, in the case of large multi facility corporations, this could be interpreted to the seizure of facilities which have been in compliance with legal requirements. Furthermore, in the case of manufacturing complexes, only a portion of the facility and its management might be involved in the cause of action.

Sentencing Commission Staff

Page 12, Par. 8 C 1.2(c) - This section on fine reduction is vague and subject to broad interpretation. We prefer the private attorney working group page 3 Par. H definition.

Page 17, Par. 8 C 2.2 Commentary & Page 17 Par. 8 C 3.1 - In the case of environmental exposures, calculation of the value of hazard or risk even though actual injury or death does not occur based on population exposed multiplied by a probability factor can only lead to inordinately large values beyond any realistic estimate of true hazard. This is based on the probability that the estimated number of injuries or fatalities will ultimately be based on some fraction of the normally occurring frequency of the illness in the general population. Experience with exposure of populations to materials released by manufacturing facilities has usually shown much lower levels of effect than theoretically estimated.

Page 31 Par. 8 D 1.3(c)(3) & U.S. Department of Justice Draft Page 21 Par. 8 F 2.2(i)(2) - The prohibition of certain types of financial transactions are not appropriate as criminal sanctions in the case of environmental or public health matters. Such sanctions will not only limit the growth of a company and possibly make it vulnerable to takeover, but may restrict its financial ability to take any needed corrective action that requires capital expenditures.

Additionally, this section is in conflict with Par. 8 D 1.3(d)(1) which says "... The organization shall not be required to...restrict, or unduly burden any lawful business operation,....unless such measure is reasonably necessary to avoid a recurrence....". Financial restrictions will not prevent environmental problems.

The Department of Justice section cited above which prohibits, without court approval, certain financial or organizational matters in essence places the company in the equivalent of bankruptcy and makes the court responsible for directing the operation of the company. This is not a workable procedure for assuring protection of the environment and public health even with expert assistance. It takes full time oversight by people intimately familiar with the operations to provide adequate control. It would be much more appropriate to require the company to institute management controls, possibly with regular reporting to the appropriate regulatory agency, as outlined in the Environmental Protection Agency Guideline for Environmental Auditing and Frank B. Friedman, Practical Guide to Environmental Management Environmental Law Institute, which was cited in my December testimony before the Commission.

This also applies to Par. 8 D 1.3(d)(1) of the Sentencing Commission Staff draft which is too vague on management control requirements.

U.S. Department of Justice Criminal Division Discussion Paper

Page 2 Item 9 - The fine range multipliers suggested are subjective. No basis is given for the modification of the values.

Page 3 Para. 3 - It should be noted that in the case of environmental and public health effects, the restitution amounts can easily, and probably will, exceed the gain from the offense. For this reason it will be punitive on the offender and should be deducted from the minimum fine.

Thank you for this opportunity to provide additional comments on the proposed organizational sanctions.

Sincerely,

Jerome Wilkenfeld

cc: Chris Stone
Frank B. Friedman

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE COMMISSIONER

April 4, 1989

The Honorable Ilene H. Nagel
U.S. Sentencing Commission
1331 Pennsylvania Avenue, N.W.
Suite 1400
Washington, D.C. 20004

Dear Commissioner Nagel:

Your letter of February 28, 1989, describing proposed revisions to the fraud and insider trading sentencing guidelines raises substantial questions that warrant careful consideration. The Commission has, on at least four occasions, alleged insider trading profits and other securities law violations of at least $5 million. These cases are, in chronological order:

SEC v. Levine, 86 Civ. 3726 (RO)(S.D.N.Y.), discussed in Lit. Rel. No. 11095 (May 12, 1986). (Levine consented to an order requiring disgorgement of $11.6 million in illegal profits.)

SEC v. Boesky, 86 Civ. 8767 (S.D.N.Y.), discussed in Lit. Rel. No. 11288 (Nov. 14, 1986). (Boesky consented to an order requiring disgorgement of $50 million in illegal profits.)

SEC v. Drexel Burnham Lambert, Inc., 88 Civ. 6209 (MP)(S.D.N.Y.), discussed in Lit. Rel. No. 11859 (Sept. 7, 1988). (Commission alleged insider trading profits in excess of $5 million. The complaint states separate causes of action against the firm and certain of its employees, including Michael Milken.)

SEC v. Wang, 88 Civ. 4461 (RO)(S.D.N.Y.), discussed in Lit. Rel. No. 11780 (June 27, 1988). (Commission's complaint alleges that Wang and Lee realized at least $19 million in insider trading profits.)

In addition, the Commission has under investigation more than one case involving insider trading in excess of $5 million. Commission regulations, however, prohibit me from discussing the particulars of these investigations.

I agree that the proposed revisions to the guidelines certainly lead to the rather curious result that there would be no marginal deterrence once a violator has engaged in $5 million of insider trading. Accordingly, assuming that violators are economically rational and well informed, they will recognize that there are economies of scale to insider trading and other forms of white collar fraud.

It is not at all clear that such an incentive structure is desirable. Larger insider trading cases tend to be correlated with the use of secret offshore bank accounts and other mechanisms designed to evade detection. The proposed incentive structure may therefore also lead to greater investment in evasion and subterfuge and make apprehension all the more difficult. Also, to the extent that the sanctions table seeks to relate marginal social harm to marginal deterrence, it is not clear that marginal social harm decreases monotonically with the magnitude of the violation, or that marginal social harm disappears once $5 million has been stolen or misallocated.

The public and Congress may also adopt a somewhat skeptical attitude toward a penalty schedule that provides a partially free ride to anyone who engages in a fraud that is large enough. The potential message of the proposed schedule is that if you are going to violate the law, do it big. Accordingly, the Sentencing Commission may wish to consider mechanisms that adjust the upper scale of the sanctions table to account for the fact that, as currently proposed, marginal deterrence disappears at a level lower than that at which violations have been found and are suspected.

Indeed, a scaling factor that adds one difference level for a loss between $2,000 and $5,000, and also adds one difference level for a loss between $2 million on $5 million seems to lose sight of the fact that, in large portions of our modern financial marketplace, it is highly unlikely that anyone would steal as little as $5,000. Accordingly, it is my impression, based on three years of personal experience in reviewing SEC enforcement proceedings, that the proposed scaling factor could be reasonably adjusted to widen the lower brackets and to increase the range over which marginal deterrence continues to exist.

The views express in this letter are my own and, as a matter of Commission policy, do not express the views of the Commission, of other Commissioners, or of Commission staff.

With best regards,

Sincerely,

Joseph A. Grundfest
Commissioner

STEER

The James A. Walsh Courthouse

Richard M. Bilby
Chief Judge
United States District Court
District of Arizona

55 E. Broadway
Tucson, Arizona
85701-1790

August 12, 1989

Honorable William W. Wilkins, Jr.,
Chairman, U. S. Sentencing Commission
1331 Pennsylvania Avenue, N.W., Suite 1400
Washington, D.C. 20004

Dear Judge Wilkins:

I am in receipt of a letter dated August 9, 1989 from Frederic Kay. This is a matter on which I have previously corresponded with you [May 16, 1989]. I cannot stress strongly enough to you the need to revisit the question of alcoholism on the reservations and the impact on the guidelines.

These are not assaults or murders involving drug transactions, but are in fact domestic and alcoholic in nature. In my almost 10 years on the bench, I have had only one case involving violence on the reservation in which both participants had not been drinking and usually, the drunker is the victim. When you consider many of these problems are exacerbated by rates of unemployment in excess of 70%, you get a better picture of the problem.

The Commission should come to Arizona, we think you would find it very illuminating.

Very truly yours,

Richard M. Bilby

Richard M. Bilby
Chief Judge

RMB/mgh

cc: Frederic Kay, FPD

Need to fix this?

Nope — Rel. Conduct handles ok/JRL

February 21, 1990

MEMORANDUM:

TO: Chairman Wilkins
Commissioners
Senior Staff

FROM: Paul K. Martin PC

RE: Statute of Limitations; Guideline Sentencing Update

Two items are appended for your review: first, a thoughtful letter from Parks Small, federal defender in South Carolina, regarding the interplay of certain statutes of limitation with operation of specific guidelines sections (e.g., relevant conduct, adequacy of criminal history).

Additionally, I am circulating Volume 3, Number 1, of the Federal Judicial Center's Guideline Sentencing Update.

Attachments

OFFICE OF THE FEDERAL PUBLIC DEFENDER
DISTRICT OF SOUTH CAROLINA
1835 ASSEMBLY STREET, ROOM 146
COLUMBIA, SOUTH CAROLINA 29201

February 9, 1990

PARKS N. SMALL
FEDERAL PUBLIC DEFENDER

TELEPHONE
(803) 765-5147

Mr. Paul Martin
Public Relations Director
United States Sentencing Commission
1331 Pennsylvania Avenue, N.W.
Suite 1400
Washington, D. C. 20004

Dear Paul:

A recent case here in South Carolina has perhaps brought a question of some significance in sentencing guideline analysis that needs resolution. The problem is how to treat prior uncharged criminal conduct that is forever barred from prosecution by the Statute of Limitations.

There is a particular problem that arises when old unadjudicated conduct is similar to the offense of conviction. Old in this context is meant to be acts occurring outside the Statute of Limitations. The text of the Statutes bar indictment, trial or punishment after a stated period of time, five years under the general federal statute. The problem is whether it is allowable to place this old unadjudicated conduct in the sentencing matrix, and if allowable, where?

The threshold issue is the Statute of Limitations. A good discussion of the philosophy of these statutes is found in United States v. Lovasco, 431 U.S. 783 (1976). A plain reading of the general Statute of Limitations, 18 U.S.C. §3282, prevents punishment for offenses after five years. The second threshold issue is the Fifth Amendment and Due Process, which applies to sentencing proceedings. Townsend v. Burke, 334 U.S. 736 (1948); United States v. Tucker, 404 U.S. 443 (1971). In Tucker Due Process was invoked to prohibit the Court from enhancing punishment for a current offense based upon a prior conviction without counsel. Notably, the government's argument in Tucker had been that it mattered not whether the defendant had been convicted, but whether in fact he had engaged in criminal or antisocial conduct. However, assuming the conduct transcends these hurdles, there are arguably problems within the guideline analysis.

There are arguably two places to put the conduct under the guidelines:

1. "Same Course of Conduct", §1B1.3(a)(2). If placed under this section, the unadjudicated and prosecution-barred conduct would be made a part of the relevant conduct for the offense of conviction and could cause offense level enhancement because of specific offender characteristics associated therewith, i.e., amounts, etc. However, to place the conduct in this category requires "same course of conduct" to be interpreted only as the same type of conduct as opposed to a continuous uninterrupted course of conduct. The guidelines do not seem to address which is intended. There is, however, in the Train the Trainer Manual a reference to Rule 8(a), Federal Rules of Criminal Procedure for direction.

2. Treat the unadjudicated criminal conduct under criminal history in §4A1.3 as grounds for an upward departure based on inadequate criminal history.

There are anomalies to each of these treatments. When treated as relevant conduct, the ultimate offense level of the chapter five matrix is effected rather than the criminal history category. The prior unadjudicated conduct has an ultimate potential of more harm by inflating the guideline range by using it to boost the offense level of the matrix rather than criminal history. That duplicity in treatment of unadjudicated criminal conduct alone promotes disparity in the guideline sentence. The same analysis does not hold true if the unadjudicated criminal conduct is not similar. Then it does not threaten relevant conduct enhancement, it would be used in criminal history only. The conduct may be just as serious but because it is not the same course of conduct, the guidelines would treat it less seriously because it would only be considered in criminal history.

The result of the duplicitous use of the conduct can be further confusing if the guideline policy of §4A1.2, Instructions for Computing Criminal History, is considered. Application note 6, Invalid Convictions, says guidelines will not consider invalid convictions, i.e. convictions without counsel, United States v. Tucker, 404 U.S. 443 (1971), except they may be considered pursuant to §4A1.3, if it is reliable evidence of past criminal activity. It would certainly appear that Statute of Limitations barred, unadjudicated, and thus without counsel, criminal activity would be in the same category; that is, it would not be used anywhere other than in §4A1.3.

It is humbly suggested that the better policy to minimize the use of unadjudicated, time-barred conduct is to limit its use to §4A1.3 analysis. This would also conform with the overall Sentencing Guideline Policy. The Commission's philosophy has been an "empirical" approach to resolve its practical problem of relevant distinctions. The Commission has recognized the wisdom of looking to those distinctions that judges and legislators have made over the course of time that have been found important over a period of time from either a moral or crime control perspective. Not the least of these rules are the Statute of Limitations. The Commission, for the purpose of uniformity, could easily direct a policy statement in the area previously discussed. A statement placing time-barred unadjudicated criminal activity to the departure area of Criminal History would resolve this dilemma. Such conduct does not deserve a place of primacy in the sentencing process because of Due Process and statutory policy of long standing.

If I may be of further assistance in this matter, please do not hesitate to call.

Very truly yours,

Parks N. Small

Parks N. Small
Federal Public Defender

PNS:lam

UNIVERSITY OF CALIFORNIA
HASTINGS COLLEGE OF THE LAW

WILLIAM K.S. WANG
Professor of Law

March 15, 1989

The Honorable William W. Wilkins, Jr.
Chair,
The United States Sentencing Commission
1331 Pennsylvania Ave., N.W., Suite 1400
Washington, D.C. 20004

Dear Commissioner Wilkins:

I understand that the Commission has invited public comment on the fraud guidelines.

Although I have no remarks on the level of the guidelines, I do wish to address the issue whether stock market insider trading is a victimless crime, as some commentators have suggested.

Each stock market insider trade has specific victims. The outstanding number of shares of a company generally remains constant between the insider trade and public dissemination of the information on which the insider acted. With an insider purchase of an existing issue of securities, the insider has more of that issue at dissemination; someone else must have less. That someone is worse off because of the insider trade. With an insider sale of an existing issue of securities, the insider has less of that issue at dissemination; someone else must have more. That someone is worse off because of the insider trade. In a 1981 law review article, I called this phenomenon "the law of conservation of securities" and labelled those harmed by it "trade victims." Enclosed is an excerpt from that article, Trading on Material Nonpublic Information on Impersonal Stock Markets: Who Is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?, 54 S. Cal. L. Rev. 1217, 1234-40 (1981).

Those who trade on insider information clearly benefit financially. To assume that such a benefit has no corresponding cost is contrary to common sense. To paraphrase Milton Friedman, there is no such thing as a free insider trade.

Respectfully,

William Wang

200 McALLISTER STREET • SAN FRANCISCO, CALIFORNIA 94102-4978 • (415) 565-4666

TRADING ON MATERIAL NONPUBLIC INFORMATION ON IMPERSONAL STOCK MARKETS: WHO IS HARMED, AND WHO CAN SUE WHOM UNDER SEC RULE 10b-5?

William K.S. Wang*

TABLE OF CONTENTS

* Professor, Hastings College of the Law. B.A. 1967, Amherst College. J.D. 1971, Yale Law School. Member, California Bar. This Article was written primarily while the author was a professor of law at the University of San Diego.

Roger Blanc, Esq., and Professors Joseph Bishop, Louis Loss, Grant Morris, Mike Navin, and David Ratner made helpful comments on portions of the drafts of this Article. The author is especially grateful to Professor Homer Kripke for thoroughly reviewing the manuscript and suggesting numerous improvements, and to Professor Lawrence Alexander for acting as a sounding board throughout the writing of this Article. Valuable research assistance was provided by Gerald Sims, Edwin F. McPherson, and Cheryl Peterson.

better off.[62] Members of the same type class, however, are unsympathetic figures. Along with the inside trader, they are either buying into a windfall gain or selling into a windfall avoidance of loss. On the other hand, members of the opposite type class are selling into a fortuitous avoidance of gain or buying into a fortuitous loss. The price change induced by the inside trade decreases the extent of these various undeserved fortuities. Arguably, this is beneficial.[63]

C. Harm to Specific Individuals Caused by the Nondisclosure

1. *Moral or Legal Causation*

A stock market inside trader fails to disclose the nonpublic information to both the party in privity and the world. As noted in Part III(B) above, the typical inside trade harms neither the party in privity nor the overwhelming majority of investors. Normally, the inside trader is a total stranger to the party in privity and other investors. If the inside trader were to disclose to a stranger who would be unharmed by the trade, the inside trader would be acting like a Good Samaritan.[64] If the inside trader had disclosed to the party in privity, the latter would have traded at a different price or not at all. Had the inside trader decided to be a quasi-Samaritan and disseminated the secret information to the investing public, the universe would have been dramatically different. In the case of favorable information, the price would have been higher. Sellers would have benefited, and buyers would have been harmed. Many individuals would have abstained from selling once they knew the good news. With adverse news, the price would have dropped. Buyers would have been better off, and sellers would have been harmed. Many investors would have abstained from buying once they knew the bad news.

If the inside trader does not engage in any quasi-Samaritan disclosure, the question is whether he has morally or legally harmed all those who would have been better off had he disclosed. This is the issue of

62. *See* Manne, *In Defense of Insider Trading*, 44 Harv. Bus. Rev. 113 (1966), *reprinted in* R. Posner & A. Scott, Economics of Corporation Law and Securities Regulation 130, 132 (1980). *Cf.* Stromfeld v. Great Atl. & Pac. Tea Co., 484 F. Supp. 1264, 1270, 496 F. Supp. 1084, 1086 (S.D.N.Y. 1980) (amended complaint) (If the price of A & P common stock was artificially depressed by defendants' section 10(b) and 13(d) violations, plaintiff buyers actually benefited by paying less for the stock than it was actually worth.).

63. *See* text accompanying notes 28-31 *supra*. *But see* note 32 and accompanying text *supra* (suggesting that inside trading would not have a significant effect on stock prices).

64. Henceforth, such an obligation to disclose will be referred to as a "quasi-Samaritan" duty.

U.S. Department of Justice

United States Attorney

Southern District of Texas

3300 Federal Building and U.S. Courthouse
515 Rusk Avenue
Houston, Texas 77002

Post Office Box 61129
Houston, Texas 77208

April 12, 1989

The Honorable William Wilkins
United States Sentencing Commission
Suite 1400
1331 Pennsylvania Avenue, N.W.
Washington, DC 20004

Re: Proposed Amended Sentencing Guidelines for Title 8, United States Code, Section 1326

Dear Judge Wilkins:

As you are aware, Section 7345 of the Omnibus Anti-Drug Abuse Act of 1988 amended 8 U.S.C. § 1326 and set up a three-part sentencing structure. For an alien who re-enters after a prior deportation and does not have any prior convictions, the maximum penalty remains two years; for a defendant who was deported after a conviction of a felony and returned to the United States, the maximum penalty is five years imprisonment; and for a person who was convicted of an aggravated felony (which includes any drug trafficking crime), the maximum penalty is fifteen years imprisonment. The Sentencing Commission has proposed amendments to the current guidelines to accommodate these new statutory changes.

The proposed amendments which relate to those aliens who return and have no prior convictions or have a plain felony conviction seem appropriate. The suggested "specific offense characteristics" would raise the offense level another four levels which would reflect the seriousness of the offense. The proposed enhancement for those defendants convicted of an "aggravated felony" does not seem to be adequate however. The proposed guidelines suggest that in the case of an illegally re-entering defendant previously convicted of an aggravated felony "an upward departure <u>should</u> be considered." We are concerned that the proposal does not provide adequate deterrence to re-entering aliens, especially for those defendants who have been convicted of prior drug offenses because the enhancement does not set a definite, stern term of imprisonment that an alien <u>knows</u> will be imposed if he returns illegally.

The proposal to have the court "consider" an upward departure in the case of these aggravated felons we believe would not provide sufficient deterrence. It would lead to highly variable sentences from district to district and in many cases it might lead to a sentence that is not lengthy enough to be deemed a deterrent to other returning drug dealers. It should be noted that the returning aliens often are part of an organization that has members both in the United States and in other countries. News between members of the organization people does travel. If we intend to provide both specific and general deterrence to those who are considering re-entry after deportation, a special offense characteristic level which would raise the offense level to 24 would provide such a deterrent. The time of incarceration then would range between five and twelve years. This would provide the kind of deterrence that we believe would be effective and commensurate with the seriousness of the offense.

In sum, we hope the Commission will raise the offense level so that returning drug dealers will realize that their actions will result in long-term incarceration, rather than a brief stop on their way back to dealing drugs in the United States.

Thank you for your cooperation.

Very truly yours,

Stephen S. Morris

for Henry K. Oncken
United States Attorney

U.S. Department of Justice
United States Parole Commission

Office of the Chairman

5550 Friendship Blvd.
Chevy Chase, Maryland 20815

April 11, 1989

Honorable William W. Wilkins, Jr., Chairman
United States Sentencing Commission
1331 Pennsylvania Avenue, Northwest, Suite 1400
Washington, D.C. 20004

Re: Proposed rule Changes:
Use of home detention and cost
of incarceration.

Dear Chairman Wilkins:

I would like to take this opportunity to comment on two proposals recently published in the Federal Register.

First, I would like to comment on the use of home detention as an alternative to imprisonment (Section 5F5.2). The current Sentencing Commission policy should be changed to allow home detention as a substitute for imprisonment under intermittent confinement or community confinement. Experience of the U.S. Parole Commission with home detention, combined with electronic monitoring, has shown that home detention is not only cost effective but it results in greater offender accountability than typically occurs when an offender is placed in a halfway house. Our experience has shown that it is easier to monitor the whereabouts of an offender in home detention than is often the case in a halfway house.

Further, home detention should be substituted on an exact day for day ratio since it is comparable in punishment, if not more so. Based on our findings in this area, home detention under the restrictions of a strict curfew, is viewed as punishment by offenders. It is seen by the offender as at least on the same level of punishment as halfway house placement.

I do not recommend that the tool of electronic monitoring be an absolute requirement for home detention. While the use of electronic monitors to enforce a curfew should be the rule rather than the exception, there may be unusual circumstances where the use of electronic monitors is unnecessary, impractical, or prohibitively expensive.

In my opinion home detention provides a more positive environment than will be experienced in a halfway house; at a much lower cost; and protection to the public will be enhanced.

Second, I would like to comment on the feasibility of requiring offenders to pay for the cost of incarceration. I believe prisoners should pay for the costs of their confinement. As outlined in Section 7301 of the Omnibus Anti-drug Abuse Act of 1988, the Sentencing Commission should study the feasibility of allowing prisoners unable to pay fines the opportunity to work at paid employment to reimburse the government for the cost of incarceration. In addition, emphasis should be placed on allowing prisoners to work in the community during confinement to pay these costs. A number of states are experimenting with innovative approaches to community corrections. The Sentencing Commission should be a leader in this regard. It is possible to design community corrections programs that are nearly self-sufficient, which maintain accountability without endangering the public, and are viewed as punishment by the offender and the general public. The burden on the taxpayer for maintaining and expanding the Federal Prison System threatens to be overwhelming. A means of reducing this burden should be explored wherever feasible.

I look forward to the discussion of these issues at the Commission meeting in April.

Sincerely,

Ben Baer

Benjamin F. Baer
Chairman

CC: ALL COMMISSIONERS

U.S. Department of Justice
United States Parole Commission

Office of the Chairman

5550 Friendship Blvd.
Chevy Chase, Maryland 20815

April 11, 1989

Honorable William W. Wilkins, Jr., Chairman
United States Sentencing Commission
1331 Pennsylvania Avenue, Northwest, Suite 1400
Washington, D.C. 20004

Re: Proposed rule Changes:
Use of home detention and cost of incarceration.

Dear Chairman Wilkins:

I would like to take this opportunity to comment on two proposals recently published in the Federal Register.

First, I would like to comment on the use of home detention as an alternative to imprisonment (Section 5F5.2). The current Sentencing Commission policy should be changed to allow home detention as a substitute for imprisonment under intermittent confinement or community confinement. Experience of the U.S. Parole Commission with home detention, combined with electronic monitoring, has shown that home detention is not only cost effective but it results in greater offender accountability than typically occurs when an offender is placed in a halfway house. Our experience has shown that it is easier to monitor the whereabouts of an offender in home detention than is often the case in a halfway house.

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CC: ALL COMMISSIONERS

whether an inside trade has helped or harmed a specialist/market-maker. Suppose that the inside trader bought 100 shares from a specialist, thereby reducing the latter's inventory from 1100 shares to 1000, and that the specialist kept his prices absolutely stable. Purchases and sales cancel each other, so that at the time of disclosure of the good news the specialist's inventory was 1000 shares.

The following are two scenarios that might have happened *absent* the inside trade. Because the specialist wanted to decrease his inventory to 1000 and because there was no inside trade resulting in that reduction, the specialist lowered his prices. His inventory could have been 800 at the time of disclosure of the good news. Alternatively, after the specialist lowered his prices, his inventory could have initially decreased to 800; but before disclosure he could have compensated for the excess decrease by raising his prices, and his inventory could have unexpectedly risen to 1300 by the time of disclosure.

In the first case, the inside trade has made the specialist considerably worse off. Indeed, the harm to the specialist exceeds the gain to the inside trader. In the second case, the inside trade has made the specialist better off. This hypothetical situation is quite simple; in reality the specialist will have altered his prices many times between the time of the inside trade and the time of the public disclosure.

The problem is that the inside trade changes the specialist/market-maker's inventory. This change in inventory may create a pattern of price quotations different from the one that would have existed absent the trade. Such an altered pattern will create different reactions by the public and by competing specialists and market-makers. To determine the effect of this new price pattern on the intermediary in privity with an inside trader, it is necessary to recreate the pattern that would have prevailed absent the inside trade and to ascertain the consequence of that pattern on the intermediary's inventory. Unfortunately, this is impossible. Therefore, a specialist/market-maker cannot demonstrate harm from an inside trade.

4. *The Law of Conservation of Securities*

Despite the suggestions of some commentators that market participants are generally not harmed by inside trading,[56] each act of inside trading

56. Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 315 F. Supp. 42, 44 (1970); *rev'd on other grounds*, 474 F.2d 514 (1973), *cert. denied*, 414 U.S. 874 (1973); 3 A. BROMBERG & L. LOWENFELS, *supra* note 2, § 8.7(2), at 217 & nn.75-76 ("[Inside] trading causes no damage", Bromberg makes almost the opposite statement later on the same page, however: "Except for

does in fact harm other individuals.[57] With a purchase of an existing issue of securities, someone has less of that issue; with a sale of an existing issue, someone ultimately acquires more of that issue. This phenomenon is labeled "The Law of Conservation of Securities." This law has three corollaries:

1. When someone trades on nonpublic information, the group of all other investors suffers a net loss. (Some members of this group gain, others lose; but the losses will exceed gains.)

2. The group's net loss is equivalent to the inside trader's gain.

3. To the extent that some outside investors gain from an inside trade, those harmed by the trade will lose more than the inside trader's gain.

5. *Who Bears the Net Loss Caused by an Inside Trade*

The Law of Conservation of Securities could work in one or both of two ways. The inside trade could induce opposite trade transactions that otherwise would not have occurred, or preempt trades of the same type that otherwise would have occurred. Thus, there are at least two categories of people harmed by an inside trade: those who would not have made bad purchases or sales but for the inside trade; and those who would have made good purchases or sales but for the inside trade.[58]

a. *Induced adverse trades*: An inside purchase could be a but for cause of many different transactions. Sellers in these induced transac-

what insiders as a group take out, the net effect on the market . . . is zero."); Dooley, *supra* note 39, at 33, 36, 55, 68; Note, *Damages to Uninformed Traders for Insider Trading on Impersonal Exchanges*, 74 COLUM. L. REV. 299, 310, 316, 317 (1974) [hereinafter cited as *Damages to Uninformed Traders*]; Note, *Civil Liability Under Section 10b and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658, 675-76, 679 (1965). *Cf.* H. MANNE, *supra* note 20, at 93-104 (outsiders as a group do not necessarily suffer a net loss as a result of insider trading); Ratner, *Federal and State Roles in the Regulation of Insider Trading*, 31 BUS. LAW. 947, 966-67 (1976) (Mundheim discussion following article) (market participants generally not harmed); W. PAINTER, *supra* note 2, § 5.10, at 249 ("[I]n a perfectly functioning econometric model, investors . . . might realize that insider trading does not really "hurt" them directly . . .), 195 ("open market investors are not even hypothetically harmed by insider trading in a monetary sense, assuming of course that the insider trading does not somehow induce public trading by its effect on the market price . . . .").

57. Comment, *Insider Trading Without Disclosure—Theory of Liability*, 28 OHIO ST. L.J. 472, 477 (1967); Note, *Insider's Liability Under Rule 10b-5 for the Illegal Purchase of Actively Traded Securities*, 78 YALE L.J. 864, 872 (1969). *See* Scott, *supra* note 39, at 807, 809.

58. *See* H. MANNE, *supra* note 20, at 103; Whitney, *Section 10b-5: From Cady, Roberts to Texas Gulf: Matters of Disclosure*, 21 BUS. LAW. 193, 201 (1965); Note, *supra* note 57, at 872 n.45.

tions are adversely affected because they miss the increase in value after the public announcement of good news. Similarly, an inside sale could be a but for cause of transactions in which buyers suffer a windfall loss when the bad news is announced.

There are many ways by which an inside trade could directly or indirectly induce transactions that otherwise would not have occurred. If the party in privity had a limit order, there is a remote possibility that the order would not have been executed but for the inside trade. The most common way by which an inside trade induces transactions, however, is by altering the behavior of a specialist or market-maker. Whether or not the party in privity is a specialist/market-maker, the inside trade probably affects an intermediary's inventory. If the inside trader is in privity with the specialist/market-maker, the intermediary's inventory is directly affected. Even if the inside trader deals with a public investor, a trade has probably been diverted from a specialist or market-maker. This direct or indirect change in the intermediary's inventory may precipitate a different pattern of price quotations and transactions by him. In transactions that otherwise would not have occurred, either the buyer or seller is harmed—depending upon whether the nonpublic information is good or bad.

Although it is unlikely, the additional volume or price movement caused by a large inside trade conceivably might attract trend-riding speculators and create an avalanche effect that would harm all those who sold into good news or bought into bad news.

b. *Preempted traders*: Instead of inducing opposite trade transactions, an inside trade may preempt trades of the same type.[59] When an inside trade directly or indirectly changes a specialist/market-maker's inventory, the new pattern of quotations may either induce new transactions or deter ones that would otherwise have occurred. For example, if an inside trade increases a market-maker's inventory, he may lower his price quotations to encourage purchases from him and deter sales to him. If an inside trade decreases the market-maker's inventory, he may increase his prices to encourage sales to him and deter purchases from him.

c. *The practical difficulty of identifying those harmed by an inside trade*: The foregoing analysis demonstrates that after an inside trade,

59. H. MANNE, *supra* note 20, at 103; Whitney, *supra* note 58, at 201; Note, *supra* note 57, at 872 n.45.

the universe is different than it would have been in the absence of the trade. In practice, however, it is virtually impossible to recreate the universe that would have existed had there been no inside trade.

If the party in privity, *P*, is a specialist/market-maker, *S/M*, his inventory is directly affected by the trade. If *P* is a member of the public, a *S/M*'s inventory is indirectly affected by the trade for one of the following reasons: (1) *P* would otherwise have traded with a *S/M*; (2) *P* would have traded with *X*, who instead traded with a *S/M*; (3) *P* would have traded with *X*, who instead traded with *Y*, who would have traded with a *S/M*, and so on.

It is impossible to determine how the inside trade's direct or indirect effect on an intermediary's inventory altered the intermediary's price quotations, and how these in turn affected the behavior of public investors. The following diagram illustrates the problem (the arrows indicate the direction of the stock transfers):

1. *T* (an inside trader) $\xleftrightarrow{\text{trades with}}$ *P*
   (directly or indirectly affecting the inventory of *S/M*)

2. *S/M* alters his price quotations and either:

   a. *S/M* (sells) $\longrightarrow$ $B_1, B_2 \ldots$ (who otherwise would not have bought)
      (preempting $X_1, X_2 \ldots$ who otherwise would have sold)

   OR

   b. *S/M* (buys) $\longleftarrow$ $S_1, S_2 \ldots$ (who otherwise would not have sold)
      (preempting $Y_1, Y_2 \ldots$ who otherwise would have bought)

It is therefore extremely difficult to allocate an inside trade's harm between intermediaries, outside marginal buyers or sellers, and outside marginal nonbuyers and nonsellers.

Such difficulty is not confined to securities markets. Suppose *A* owns a small car rental agency and secretly learns that a certain make of car has a serious defect. *A* owns five cars of this make and sells all of them to a large used car dealer, who still owns these cars at the time the defect is made public and prices drop. It is possible that in both the universe in which *A* sold the five cars and the one in which he did not, the dealer would have the same inventory at the time of the public announcement of the defect. In the first universe, prior to the announcement, the dealer may have lowered his prices or raised them less than he otherwise would have. These lower prices may have attracted purchasers or deterred sellers or both. Thus, in the first universe, some members of the public may find themselves owning defective cars who would not have owned them in the second universe.

Recreating the hypothetical second universe, however, is almost impossible. Both the used car dealer and his purchasers will give self-serving testimony. Regardless how low the level of his inventory was at the time of the announcement, the dealer will claim that his inventory would have been even lower had *A* not sold him the five cars. Regardless how high the prices actually charged by the dealer were during the period between *A*'s sale and the public announcement, outside buyers will claim that *A*'s sale caused the dealer to charge lower prices than otherwise, and that but for these lower prices, the outsiders would not have bought. Outside nonsellers will claim that *A*'s sale caused the dealer to charge lower prices than otherwise, and that but for these lower prices, the nonsellers would have sold. In summary, the Law of Conservation of Securities indicates that although an inside trade does harm specific individuals, identifying them is almost impossible.[60]

60. In unusual situations, it may be possible to identify the probable victims of an inside transaction in a publicly traded stock. When the stock is very thinly traded, transactions may be so isolated that a plaintiff could argue persuasively that, but for defendant's trade, plaintiff would have had a smaller (or larger) holding of the stock. In addition, institutions and block-trading firms dealing in large amounts of shares occasionally may operate in what is in effect a separate market with isolated transactions. In this block-trading market, a plaintiff might be able to demonstrate that but for the defendant's trade the plaintiff would have had a smaller (or larger) holding of stock. *Cf.* ALI CODE, *supra* note 2, § 1702(b), Comment (4) (observing that many institutional trades are negotiated "offboard" and "crossed" on the floor, and that such trades would fall within the Federal Securities Code provision covering nonfortuitous transactions not effected in a stock market).

Calls are options to buy stock; puts are options to sell. Both types of options are issued or written by private individuals who obligate themselves to buy or sell at a certain price. An option trade based on nonpublic information also harms specific individuals. If a person buys a call based on inside information, the purchase either preempts another purchase or elicits the writing of a new call by someone (not necessarily the party in privity) who would not have done so otherwise.

In the first case, the person whose purchase is preempted is harmed. In the second case, the person who writes the additional call is worse off unless he purchases additional shares to "cover" the call. If the writer's call is "covered," the option buyer (on inside information) in effect has bought shares with the option writer acting as intermediary. The option writer is not harmed, but the inside trader's de facto purchase is subject to the Law of Conservation of Securities. Either the stock purchase preempts another buyer or it attracts a seller of the stock.

The analysis of puts is similar. When a person buys a put based on inside information, the

6. *Price Change Effects on Those Trading About the Same Time as the Inside Trade*

If a substantial purchase or sale based on nonpublic information causes the specialist or market-maker to change his price quotations, those engaging in the same type of transaction at approximately the same time as the inside trade (the "same type" class) will either pay more or receive less than they otherwise would. For example, after selling to an inside trader, a specialist or market-maker might increase price quotations; after buying from an inside trader, a specialist or market-maker might decrease his prices. On organized stock exchanges, changes in specialist price quotations would affect the prices of brokers "trading in the crowd" around the specialist's booth. In short, if an inside purchase increases the market price, those purchasing at about the same time will pay more. If an inside sale decreases the market price, those selling at about the same time will receive less.[61]

Although the members of the same type class are unquestionably worse off, those with whom they transact (the "opposite type" class) are

purchase either preempts another option purchase or causes a new put to be written by someone. The writer of the new put may or may not cover himself by short selling the stock.

When a person trades in puts or calls based on nonpublic information, the harm is especially difficult to trace. It may fall on: (1) a person who has been induced to write an option, (2) a preempted would-be option purchaser, (3) someone who would not have traded the stock but for a stock trade by the option writer, or (4) someone who would have traded the stock but for a stock trade by the option writer. For a simpler discussion of insider purchases of calls omitting the "crowding out" complication, see H. MANNE, *supra* note 20, at 90-91.

For a general discussion of option trading, see SEC, *Report of the Special Study of the Options Market* (Committee Print for the use of the House Committee on Interstate and Foreign Commerce, 1979), Securities Exchange Act Release No. 15569, ch. II (Feb. 15, 1979); G. GASTINEAU, THE STOCK OPTIONS MANUAL (2d ed. 1979); OPTION TRADING (L. Merrifield, chairman, 1974) (PLI Course Handbook No. 146); Johnson, *Is It Better To Go Naked in the Street? A Primer on the Options Market*, 55 NOTRE DAME LAW 7 (1979); Lipton, *The Special Study of the Options Markets: Its Findings and Recommendations*, 7 SEC. REG. L.J. 299, 305-07 (1980).

61. This phenomenon is sometimes called loss causation, as distinguished from transaction causation. *Cf.* Falls v. Fickling, 621 F.2d 1362 (5th Cir. 1980) (Public announcement of material information prior to sheriff's sale would have brought substantially higher bids than those actually received absent the disclosure; therefore, nondisclosure by bidders in actual sheriff's sale harmed plaintiff.). *See also* Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981) (en banc) (bond purchaser has cause of action if he can prove that he reasonably relied on integrity of market to protect him from bonds not entitled to be marketed); Blackie v. Barrack, 524 F.2d 891, 906-08 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380-81 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975); 3A H. BLOOMETHAL, *supra* note 2, § 9.21[5][b]; 3 A. BROMBERG & L. LOWENFELS, *supra* note 2, § 8.7(1), at 216; 5 A. JACOBS, *supra* note 2, § 64.03, at 3-226 to -227; R. JENNINGS & H. MARSH, *supra* note 51, at 1066; W. PAINTER, *supra* note 2, at 187, 206-07; Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584, 592-96 (1975).

FRAUD / INSIDER TRADING

UNITED STATES SENTENCING COMMISSION
1331 PENNSYLVANIA AVENUE, NW
SUITE 1400
WASHINGTON, D.C. 20004
(202) 662-8800

March 31, 1989

MEMORANDUM:

TO: Commissioners
Staff Director
Legal, Research, Drafting & Hotline Staffs

FROM: Paul K. Martin PS

SUBJECT: Written Statements & Public Comment

Appended for your review is comment from Professor Larry E. Ribstein of the George Mason University School of Law and Catherine England of the Cato Institute. Professor Ribstein and Dr. England are scheduled to appear at the Commission's April 7th public hearing.

Also, please note public comment form Edward J. Kane, professor of banking and economics at Ohio State University. Additional testimony and public comment will be distributed immediately upon receipt.

Attachments

STATEMENT OF

PROFESSOR LARRY E.RIBSTEIN
GEORGE MASON UNIVERSITY
SCHOOL OF LAW

ON CRIMINAL PENALTIES FOR INSIDER TRADING

BEFORE THE

U.S. SENTENCING COMMISSION
APRIL 7, 1989

I oppose Amendment 116 to the extent that it would increase penalties for insider trading under Guidelines Section 2f1.2 and, in response to the issues raised in Amendment 119, oppose higher offense levels for insider trading than for other frauds. These changes would exacerbate two fundamental problems with the current guidelines: (1) The punishment is unrelated to defendant's conduct; and (2) the punishment will deter legitimate activity.

THE PUNISHMENT IS UNRELATED TO THE WRONGFUL CONDUCT

Section 2f1.2 mistakenly bundles insider trading with conventional criminal fraud. Whatever insider trading is, it is <u>not</u> fraud in the sense of deception. The insider trader on an anonymous exchange misleads no one by simply placing a buy or sell order with a broker. The insider's breach of duty is <u>trading</u>, <u>not</u> misrepresenting or failing to disclose facts. Thus, an insider who refrains from trading is not liable for failing to disclose. Even academics who generally support insider trading liability recognize this difference between insider trading and deception.[1]

Since it begins from the wrong premise -- that insider trading is like conventional fraud -- Section 2f1.2 not surprisingly reaches the wrong conclusion. By incorporating

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1. See Langvoort, Setting the Agenda for Legislative Reform: Some Fallacies, Anomalies, and Other Curiosities in the Prevailing Law of Insider Trading, 39 Ala. 399, 402-03 (1988).

the penalties under Section 2f1.1, Section 2f1.2 wrongly ties the penalty for insider trading to the market loss caused by the insider's nondisclosure. Even if the criminal penalty for insider trading should be measured by market loss (which is not at all clear), the losses should be connected with the defendant's trading.[2] This connection normally will be difficult, if not impossible, to make. Securities prices are not moved by volume of trades alone, but rather by information communicated by these trades.[3] Investors usually ignore insider transactions. When investors know insiders are trading they will tend to jump in on the same side and so will gain from the insiders' trading. Specialists may be injured because they are required by exchange rules to execute insider trades, but they pass their costs on -- ultimately to the issuers themselves as a cost of floating securities.[4]

Connecting the penalty for insider trading with the market reaction to the nondisclosed information therefore does not appropriately "reflect the seriousness of the offense" (18 U.S.C. Section 3553(a)(2)(A), incorporated in 28 U.S.C. Section 991(b)(1)) or the "nature and degree of

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2. See Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), cert. denied 429 U.S. 1053 (1977). But see Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974).

3. See Scholes, The Market for Securities: Substitution Versus Price Pressure and the Effects of Information on Share Prices, 45 J.Bus. 179 (1972).

4. See Carney, Signalling and Causation in Insider Trading, 36 Cath. U.L.Rev. 863 (1987).

the harm caused by the offense" (28 U.S.C. Section 994(c)(3)). Indeed, the current penalty schedule for insider trading is inconsistent even with the Commission's own Note 11 to Section 2f1.1, which provides that the penalty should be adjusted where, among other things, the value of securities declined for reasons unrelated to the defendant's misrepresentation. It follows that applying even greater market-loss-related penalties to insider trading would increase these problems.

THE PUNISHMENT DETERS LEGITIMATE CONDUCT

By tying insider trading penalties to the market loss caused by the insider's nondisclosure, Section 2f1.2 potentially imposes long prison sentences disproportionate to any gains reaped by the insider. While this undoubtedly improves enforcement of insider trading laws, it also imposes substantial costs. In determining whether to trade, traders balance potential gains against potential penalties discounted by the risk that their conduct will be characterized as unlawful. Even if most traders who are actually prosecuted under the insider trading laws are aware of the illegality of their conduct, severe penalties will deter at least some <u>legitimate</u> trading.

The uncertain scope of insider trading liability increases this deterrence of legitimate conduct. For example, under Dirks v. SEC,[5] a tippee of inside information is liable if his tipper gained a vaguely defined "personal benefit" from tipping. As the Court acknowledged in Dirks, it "will not always be easy for courts" to determine whether such benefit exists. A personal desire to expose fraud did not count in Dirks, but the Court indicated that a "gift" of information would have. Moreover, the tippee may or may not have the requisite level of knowledge of the tipper's motivation to satisfy the general scienter requirement. And even if defendant knows the tip was improper, he may not know whether it was "material." Congress' refusal to define insider trading perpetuates these problems.

Many valuable activities may be deterred because they lie in the vague border area. For example, securities analysts play an important role in ensuring market efficiency. Analysts are not merely passive conduits of information, but also evaluate, monitor the accuracy of, and lend credibility to corporate information. Because analysts learn many essential facts in non-public conversations with corporate executives, stiff mandatory prison terms for ill-defined conduct related to those conversations may impede analysts' activities. Broad liability for insider trading may even reduce the general liquidity of the stock market by inhibiting ordinary traders who cannot be absolutely sure that their brokers' recommendations were not illegal tips.

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5. 463 U.S. 646 (1983).

The Supreme Court in Dirks explicitly responded to considerations like these by limiting insider trading liability so as not to interfere with analysts' activities.

The combined effects of an uncertain standard of conduct and a penalty that is unrelated to the seriousness of the conduct are illustrated by SEC v. Switzer.[6] Barry Switzer, the Oklahoma football coach, while sunbathing at a track meet, overheard a corporate executive friend of his discussing with the friend's wife an impending business trip to arrange the sale of a company. Switzer and a number of tippees and remote tippees profited from purchases and sales of the company's stock based on the nonpublic information. The court denied relief because the executive did not breach a duty by revealing the information for gain and, in all events, the traders did not have the requisite level of knowledge of any breach of duty.

What if Switzer had had reason to know that the executive knew he was there -- for example, because the executive glanced quickly at him? Should Switzer conclude that the executive had intended to reap a personal benefit by making a gift of the information? The court found that the executive did not know Switzer was there, needed to talk to his wife about child care arrangements, and was not very "impressed" by Switzer. How would Switzer know these facts? Yet on such facts hinge mandatory criminal sentences for Switzer and all of his friends and friends' friends who

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6. 590 F.Supp. 756 (W.D.Okla.1984).

traded on the information,[7] measured under Section 2f1.2 by the difference between the sale prices of outsiders trading during the relevant period and the post-disclosure price -- perhaps millions of dollars.

All of these problems might be worth the considerable cost of stiff criminal penalties for insider trading if there were a clear national consensus about the evils of insider trading. The "community view of the gravity of the offense" and "the public concern generated by the offense" are relevant to drafting the guidelines under 28 U.S.C. Section 994(c)(4)-(5). But the public's view of insider trading is, at best, ambiguous. Huge insider trading scandals are a small minority of insider trading prosecutions.[8] The stock market itself, which perhaps best indicates society's attitude to insider trading, barely reacted even to the Boesky scandal.[9]

CONCLUSION

Insider trading sentences under the current guidelines are unjust. Increasing them -- particularly through adjustment of market-loss levels -- will make a bad

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7. See SEC v. Musella, 678 F. Supp. 1060 (S.D.N.Y. 1988).

8. See Pulver, Insider Trading Unmasked: An Empirical Study (1988).

9. This was the judgment of SEC Chairman John Shad testifying before a House committee. "SEC Permitted Boesky Actions to Cut Partnership's Liabilities $1.32 Billion," Wall St.J., Dec. 12, 1986, at 3, col. 1.

situation even worse. Instead, the Commission should consider adopting completely new criteria for insider trading sentences, such as the amount of gain realized by defendant or the loss actually caused to the owner of the information.

Testimony by
Catherine England, Ph.D.
Director of Regulatory Studies,
Cato Institute
before the
U.S. Sentencing Commission
April 7, 1989

I'd like to thank the Commission for the opportunity to comment on proposed amendments to the U.S. anti-fraud laws. In particular, I am concerned with questions about how the law should be applied to owners and managers of federally insured savings and loans and other depository institutions.

I am not a lawyer, and I have no in-depth knowledge of how the proposed changes will affect the legal sanctions applied economics, and I have spent considerable time studying how the legal and regulatory environment affect the decisions of economic actors--in this case, owners and managers of insolvent savings and loans.

My understanding is that the legal definition of fraud is not always clear cut--particularly in cases where managerial investment decisions promised large returns and then did not come to fruition. I would argue that it is especially important in the case of depository institutions and in light of the current savings and loan industry fiasco to distinguish between "fraud" in a legal sense and bad judgment or mismanagement. In addition, it is useful to consider the constraints under which savings and loan managers labored as they struggled to protect the interests of stockholders or owner/depositors.

The enormous losses the thrift industry has suffered during the past decade are now being publicly recognized, and elected government officials have promised to address the problem. The unprecedented infusion of taxpayer funds that will be required to protect depositors in hundreds of insolvent S&Ls, and the size of the proposed bailout, has caused widespread concern and indignation. The natural tendency in a situation like this one is to attempt to identify those who are culpable, to search for villains to shoulder the clean-up costs. In making this effort, many politicians, journalists, and taxpayers have directed their attention to the part played by savings and loan owners and managers who, after all, made the investment decisions that generated these substantial losses.

There is no doubt that fraudulent and speculative owners and mangers were attracted to the savings and loan industry during the part decade by low capital requirements, a loose supervisory environment, and federal deposit insurance. During the 1980s, neither regulatory authorities nor federally insured depositors monitored very effectively the investment decisions of individuals operating thrifts. S&L managers were able to raise large sums of federally insured money and then pursue a wide range of investments, some of them embodying substantial risk. Because public supervision was ineffective, and private supervision from federally insured depositors was almost totally lacking, individuals with a speculative or fraudulent bent found the savings and loan industry a more than normally inviting environment. But the greatest portion of the $100 billion in losses suffered by the thrift industry can be attributed to unlucky and incompetent managers who, with the very best of intentions, found themselves attempting a task at which they could not possibly succeed.

To understand how hundreds of thrift managers, and with them the nation's taxpayers, were placed in a no-win situation, we need to review recent history. In the late 1970s and early 1980s, adverse interest rate and general economic conditions left hundreds of savings and loans insolvent. Rather than providing the funds and the manpower to close these institutions quickly, however, Congress and the Administration chose to follow a policy of "forbearance." That is, they redefined the way capital was measured, they lowered capital standards, and when all else failed, federal authorities simply ignored the continued operations of institutions that had no capital.

Now consider the well-intentioned manager at one of these insolvent savings and loans. Under normal circumstances, the value of a financial institution's assets, on which income is earned, exceeds the value of its liabilities (deposits) for the bank or S&L to prove profitable, but the larger size of the asset base works in favor of managers attempting to cover operating costs in addition to interest expenses and earn a reasonable profit.

For the manager of an insolvent institution, however, this situation is reversed. The value of his liabilities, on which he pays interest, exceeds the value of the assets on which he earns income. To make a profit, therefore, the spread earned by an insolvent institution, the difference between the average interest earned on assets and the average interest paid on deposits, must be much larger than the spread for a healthy organization. But earning a larger than normal "spread" is all but impossible in a competitive environment.

We can get some idea of how difficult the task presented to depository managers was by reviewing the performance of those savings and loans placed in the FSLIC's management consignment program. In the management consignment program, the FSLIC took over the thrifts losing the most money and placed them under the management of hand-picked teams, hoping to at least slow their losses if not return these institutions to profitability and health. The management consignment program was begun in 1985, and in September 1987, the General Accounting Office reported on the condition of the 45 institutions in the program as of the end of 1986. As a group, the institutions in the program reported $2 billion in losses between the end of the quarter during which they entered the program and year-end 1986. Furthermore, their aggregate GAAP (generally accepted accounting procedure) net worth declined from -$0.8 billion to -$3.49 billion over the same period. If the best hand-picked FSLIC management teams encountered such difficulties, what can we expect from less skilled managers left to attempt to deal with losses at their institutions?

In fact, the chances of success for well-intentioned managers of any single insolvent institutions were undermined by the hundreds of other troubled thrifts with which they had to compete. Just to meet cash flow requirements, these insolvent S&Ls had to continue attracting new funds. To compete effectively for new deposits, insolvent thrifts bid up the interest rates paid by all banks and S&Ls, regardless of their financial condition. To cover the rising costs of attracting new accounts and holding onto exiting customers, all depository managers sought to increase expected income on their loan and investment portfolios. Generating higher expected returns was particularly important for managers of S&Ls whose liabilities exceeded their assets. The catch is that assets promising a higher return also generally embody greater risk. So what began as an interest rate problem in the late 1970s became an asset quality problem in the mid-1980s.

My point is reviewing the downward spiral of the bottom third of the thrift industry is this: The largest portion of the current problem did not grow out of an malicious intent on the part of thrift industry managers. The substantial losses incurred by the industry arose out of an impossible situation created by a misguided federal policy of forbearance. Managers are charged first with attempting to protect the interests of the owners of the companies they oversee. In the case of insolvent thrifts, affected managers also were instructed by government regulators to outgrow the problems created by the adverse economic conditions of a decade ago. Unfortunately, the steps that seemed necessary to regain profitability and recoup losses for owners, the efforts to outgrown past problems, represented gambles that for most insolvent thrifts did not pay off, and losses mounted.

Because of these considerations, I would urge you to go slow in answering the question you posed: "Should there be a higher offense level for fraud involving a federally chartered or insured financial institution?" Certainly, fraud should be punished. Strong anti-fraud laws are necessary for the efficient operation of a market economy. But before punishment can be meted out to managers of federally insured depository institutions, especially in the current crisis situation, "fraud" in managing a depository institution needs to be carefully defined. Careful deliberation is especially important now as political actors attempt to avoid blame themselves by levelling vaguely worded charges of fraud at thrift managers throughout the country.

Federally insured depository institutions are different from other corporations. The existence of federal deposit guarantees means that less competent managers will not be eliminated by the operations of the market as they are in other industries. With extensive federal deposit insurance in place, decapitalized banks and S&Ls can continue to operate indefinitely because they can continue to attract funds from federally insured depositors. For the most part, the government has replaced the market, not only in overseeing the decisions of depository managers but also in deciding when an institution will be closed. We face a $100 billion problem, not because of any inherent market failure among savings and loan mangers generally, but because the government failed to do the job it has assumed from the private sector.

It is certainly not my intent to serve as an apologist for the savings and loan industry. Indeed, I would argue that it is a mistake to subsidize an industry devoted to housing finance. Mortgages would continue to be readily available without a thrift industry as such. But it is not even clear what "mismanagement" should mean in the context of the hundreds of weak and insolvent thrifts that were allowed to continue to operating during the past decade, kept alive by the life support system of federal deposit insurance. THat makes it especially important to carefully communicate to regulatory authorities and judges throughout the country what "fraud" should mean in this context.

In the widespread search for villains in the savings and loan industry fiasco, many are pointing a finger at the managers of these institutions. There is public indignation and outrage at the presumed profits made by fraudulent managers, and many frustrated taxpayers feel there ought to be a way to make those directly responsible pay a more sizable portion of the clean-up costs, or at least make them pay. But the Bush Administration's proposal for additional Justice Department funding to address fraud among depository institutions, and congressional pressure to bring these individuals to trial are distractions, meant to direct public attention away from the real causes of the problem. At the root of the $100 billion mess is a federal policy of capital forbearance coupled with extensive federal deposit guarantees. Had sanctions been in place 10 years ago that imposed penalties two or three or ten times the current levels for "fraud" in managing depository institutions, the last decade in the savings and loan industry would have played out much the same. The managers who were not removed from insolvent thrifts in 1981 and 1982 have been as victimized by the government's mistakes just as we taxpayers have been.

Statement of
Derek J. Vander Schaaf
Deputy Inspector General,
Department of Defense
April 7, 1989

I am pleased to appear before you today to discuss the proposed amendments recently published by the United States Sentencing Commission. Let me briefly describe briefly the role of the Inspector General of the Department of Defense in criminal investigations of procurement fraud.

In 1982, Congress established the Office of the Inspector General for the Department of Defense under the authority granted by the Inspector General Act. In so doing, Congress vested the IG with overall responsibility for creating and implementing policy guidance, and conducting oversight over all matters of fraud, waste, and abuse within the DoD. That includes oversight responsibility for the three military investigative organizations, the Criminal Investigation Command (CIDC), the Naval Investigative Service (NIS), and the Air Force Office of Special Investigations (AFOSI). In addition, the Office of the Inspector General has its own criminal investigators, the Defense Criminal Investigative Service, also known as the DCIS.

In matters involving Defense procurement fraud, the IG gives top priority to the investigation of cost mischarging (charging labor or materials to the wrong contracts); defective pricing (providing the DoD fraudulent cost and pricing data prior to contract award); criminal acts which undermine the integrity of the procurement process (such as bribery, kickbacks and antitrust matters); and, most importantly, those cases we refer to as product substitution. Product substitution is a broad category of fraud involving false testing, failure to test, defective products, and the substitution of products.

False testing is the falsification of tests results in order to meet the contract specifications. Failure to test involves a contractors failure to conduct a test required under the contract. Defective products are products that do not meet the standard required by the contract such as parachute cords made of inferior nylon which causes the parachute to fail. The substitution of products in general includes the tender by the contractor of a product other than the one identified in the contract such as a specific request for original equipment manufacturer replacement part, but receiving a counterfeit foreign made replacement part.

Product substitution categories often interrelate. Even though no apparent harm seems to exist, there may be substantial harm. For example, the Government may have requested an original equipment replacement fuel pump because it had previously tested the fuel pump, whereas the foreign counterfeit may never have been tested and may be inferior, resulting in a problem during a critical operation.

In 1988, the efforts of the four Defense criminal investigative organizations (CIDC, NIS, OSI, and the DCIS) assisted the Department of Justice in obtaining 679 convictions and monetary recoveries (including fines, restitution, forfeitures, penalties and civil recoveries through settlements) in the amount of $445.3 million. That includes the convictions of both large and small contractors, as well as individuals. Since December 1983, DoD criminal investigative efforts have resulted in 21 convictions involving Top 100 Defense contractors.

The IG has a significant interest in proposed amendment 119 which relates to the Major Fraud Act of 1988. The amendment is directed at product substitution. The proposed legislation provides for an additional two years incarceration for matters covered by the Major Fraud Act "where conscious or reckless risk of serious personal injury results from the fraud."

The applicability, however, is limited to contracts over $1 million. The IG strongly believes, based on our experience in investigating those matters, that the applicability of the enhanced incarceration should not be limited to the amount of the contract.

The DoD procurement system to a large extent depends on the honesty and self certification of the contractor to assure that the required tests have been properly conducted, the product meets the specifications, and the product is the same as contracted for. Numerous instances have been documented in which the DoD has been provided with nonconforming and faulty products. Occasionally the defects are readily observable by Government inspectors or the end users of the products. Unfortunately, the substituted product usually contains a latent defect that is not readily identifiable because the product is a component of a larger system. For example, an inferior metal may be installed in springs used in an aircrafts hydraulic landing gear or flaps. If the springs fail under stress, the landing gear or flaps may malfunction with potential life threatening circumstances. Such defects in critical parts in weapon systems may cause malfunctions and failures in operation, thereby jeopardizing DoD personnel and missions.

We believe it is imperative in all sentencing in product substitution cases where a risk of serious injury was created, that the Sentencing Guidelines should provide for significant incarceration even if monetary loss to the Government has not been proven. It is generally difficult in product substitution cases to quantify the actual loss to the Government since losses are determined differently depending on the facts of the case. For example, in some instances the replacement value of the individual part may be the measure of the loss, while in others it may be the the larger component made ineffective by the defective part.

Only successful prosecution, coupled with meaningful sentencing, will deter individuals from committing that type of fraud and send a clear message to those who contemplate similar activity that the Government will not countenance such a lack of business integrity.

In September 1987, the OIG conducted a review of selected significant product substitution cases involving the DoD that resulted in convictions and sentences between 1985 and early 1987. The review encompassed cases with either a high dollar loss or where the product substitution had a serious impact on readiness or mission requirements of the DoD. We concluded that few of the sampled cases involved sentences of significant deterrent value. We further concluded that monetary penalties were also generally not significant.

The 15 cases reviewed revealed the following sentencing patterns:

Minimum 18 months incarceration	3
12-18 months incarceration	4

6-12 months incarceration	1
1 day to 6 months incarceration	6
no incarceration	9

Relatively lenient sentences may have been attributed to several factors. For example, defendants successfully argued their prior unblemished record. Courts were routinely presented with the picture of a defendant who was otherwise the pillar of the community. Courts were frequently told that the contractor found it necessary to commit the improper conduct to stay solvent which, in turn, represented jobs for the community, or was needed by the military for the security of the Nation. In other instances, the court was told that the product substitution was of no great consequence to the Department of Defense, in other words, no harm, no foul. In nearly all instances, the contractor denied any knowledge that individual lives,