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BEFORE THE UNITED STATES SENTENCING COMMISSION

PUBLIC HEARING ON PROPOSED AMENDMENTS
TO THE FEDERAL SENTENCING GUIDELINES

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Thank you for the opportunity to speak today concerning the Dodd-Frank Act and proposed amendments to certain Federal Sentencing Guidelines applicable to white collar crimes. I will limit my remarks to two subjects relevant to this panel that are likely to have the greatest impact on federal criminal cases: the punishment of insider trading, including proposed Guideline amendments in that area; and the punishment of large-size accounting and investor frauds, including potential Guideline amendments applicable to such cases.[1]

I. Insider Trading

Insider trading has sometimes been described as a "victimless crime." This statement is erroneous—as it would be for any offense involving behavior properly criminalized on the ground of serious social harm. The apt distinction is between crimes with direct, identifiable victims and those that cause more diffuse and less tangible forms of harm—in which the "victim" is society as a whole, or a large class of persons.

Insider trading, unlike many other forms of fraud, does not typically cause tangible and easily measurable harm to a direct victim. When a violator trades shares on a large, liquid market on the basis of material nonpublic information, he may avoid significant losses or realize substantial gains. But his "counterparty" in such illegal trades is largely fictional. The violator's trades, and any impact they have on price, will be quickly diffused across many investors, diluting any direct harm from the insider trading. More important, other traders have not lost, or failed to gain, relative to their

[1] Because I have no special expertise in the area of mortgage-origination fraud, I will not comment on the proposed amendments relating to mortgage fraud—except to say that it seems consistent with general principles of criminal responsibility to ascribe to a fraud offender responsibility for harm avoided only because of government intervention.

position in the absence of the offender's trading. Other investors bought or sold at a market price that, at least in theory, efficiently reflected available public information.

The inside trader had no right to trade on the basis of his nonpublic information. But it does not follow that his counterparties had a right to have the same information reflected in market price before *they* traded. Indeed, if such information *had* been reflected in price, it would have been public—negating a necessary element in the wrong of insider trading. (This explains why the edict against insider trading is often described as to "disclose or abstain.")

It therefore would be an obvious error to apply a model designed to measure the seriousness for punishment purposes of a theft by A from B—or a scheme by A to deceive B into entrusting B's assets to A—to the case of A's unlawful trades for his own portfolio in a large liquid market for securities. The inside trader's gain (or loss avoided) simply is not the harm caused by his offense.

What then is the primary justification for criminalizing insider trading, and what is the corresponding social harm? Regulators, courts, Congress (at least implicitly), and the majority of academics have long agreed that insider trading—if it is common, or even perceived to be—has the potential seriously to damage investor confidence in markets.[2] This theory cannot be proved empirically in the absence of the unlikely experiment of removing legal controls on the activity. Nonetheless, most legal regimes in nations with effective and attractive securities markets now include prohibitions on insider trading, and there is some evidence that jurisdictions with actual enforcement of such laws enjoy better functioning markets.[3]

Settled economic theory is consistent with the idea that if investors in a market were to conclude that many other traders were making decisions on the basis of information unavailable even to the most diligent common investor, a "lemons market" could result, in which investors would lose trust not only in particular counterparties but in the market's pricing mechanism as a whole. As investors fled such a market, prices

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[2] *See* United States v. O'Hagan, 521 U.S. 642, 658–59 (1997); Donald C. Langevoort, *Rereading* Cady, Roberts*: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 132 (1999); Samuel W. Buell, *What Is Securities Fraud?*, 61 DUKE L.J. 511, 561-64 (2011); Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 346 (1979).

[3] *See* Utpal Battacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75 (2002).

would fall and the cost of raising capital would rise—and rise for reasons producing no offsetting social benefit.[4] This outcome would quite obviously be bad for American financial markets.

If the justification for punishing insider trading is to maintain investor confidence that markets are relatively free of insider trading (because the law effectively deters the activity), then the *publicness*, if you will, of any insider trading case is perhaps the most important aspect of the offense. The enormously complicated subject of investor psychology is not one that a sentencing authority, or perhaps even a securities regulator, would want to attempt to master and use as the primary basis for making policy. But a few basic insights about the publicness of insider trading cases would seem to be matters of common sense.

First, if sentences for insider trading are very light, then deterrence is less likely to be effective. By extension, and more importantly, investors observing enforcement are not likely to believe that the market is relatively free of inside traders. This would suggest the wisdom of maintaining a relationship between the size of gain to the violator and the length of sentence, so that violators and the investing public do not conclude that the potential profits from insider trading warrant risking legal penalties, including criminal punishment. It is important to appreciate that because insider trading is not like violent crime in that there is no reliable data about the frequency of violations, public perceptions about enforcement are highly important to effective deterrence.

Second, it follows that another factor, which of course is not controlled by this Commission, is at least equally important: The probability of being caught and convicted for insider trading must be high enough to persuade potential violators that the risk of criminal punishment is significant. There is an insight here, however, that *is* relevant to the Commission's work. The more that enforcement is relatively robust, the less beneficial will be extremely severe punishments for insider trading. Excessive punishment is of course to be avoided as it imposes multiple costs including: budgetary strains; unwarranted harm to offenders; and, in this context, possible loss of confidence in enforcement if the public perceives the existence of a sanctions lottery in which only a

[4] *See* STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 24 (2d ed. 2008).

few are punished in ways that appear only to express frustration at the regulatory system's inability to prevent insider trading.

Third, the investing public is likely to be sensitive to the positions occupied by insider trading violators. It stands to reason that if investors will flee a market that is permissive towards insider trading, they will flee that much more quickly a market in which insider trading is practiced by those with greatest access to the most material information, and with the highest responsibility for protection of such information. Some of this investor reaction would be rational: Inside traders with greatest access to information and with control of the largest pools of funds are likely to introduce a higher quantity and frequency of tainted trades into markets. Some of this reaction would be less rational but nonetheless worthy of the law's consideration: A market perceived as offering special returns for a privileged and closed class of investors is likely to be less attractive to the retail investor, perhaps without regard to the relative returns that market can offer.

These observations about the nature of the crime of insider trading lead to the following recommendations about § 2B1.4 of the Guidelines and the Commission's proposed amendments. It is advisable to use a base offense level that will make most cases eligible for some term of imprisonment, however long. Markets and investors should associate the crime of insider trading with a high probability of a prison sentence.[5] A base offense level of 10—higher than the current level of 8—might be desirable.

In an area such as this involving savvy and often calculating financial actors, considerations of marginal deterrence alone support the wisdom of increasing the offense level according to the amount of gain to the offender (or loss avoided). However, there is no apparent reason—except perhaps relatively weak considerations of administrative convenience—for using the same table for determining the offense level for insider trading as the Guidelines use for losses in most common property crimes. I recommend a separate dollar-amount table for § 2B1.4 that would reflect the actual distribution of gain (or loss avoided) amounts in insider trading cases prosecuted by the Department of Justice and subject to enforcement by the Securities and Exchange Commission. Such a

[5] For some information on recent trends in insider trading sentences, *see* Chad Bray & Rob Barry, *Long Jail Terms on Rise: Inside Trades Draw Lengthier Sentences, Analysis Finds*, WALL ST. J., Oct. 13, 2011; MORRISON & FOERSTER, INSIDER TRADING: ANNUAL REVIEWS (2009, 2010, 2011).

table would likely better serve aims of proportionality and marginal deterrence. Once such a distribution were established, it would then be a matter of reaching agreement on the low and high ends for insider trading sentences. My own view is that almost all cases should presumptively result in some imprisonment and that the crime of insider trading rarely if ever need be met with a sentence in excess of ten years in prison.

I agree with the Commission's inclination to enhance an insider trading offender's offense level based on his relative position in financial markets and institutions. I encourage the Commission to take a more detailed and nuanced, and perhaps a bit broader, approach than in its current proposal. I would support, for example, a position-based enhancement of two to four levels, depending on whether the defendant occupied a more senior or more junior position within the particular corporation or financial institution that was the site of the insider trading. I would not limit a position-based enhancement only to officers and directors of public companies; other important management positions, in both public and private firms, should be included. And I would support extending the position-based enhancement to include others occupying important (and sometimes fiduciary) positions in relation to financial markets, such as attorneys, auditors, regulators, and raters of credit instruments.[6]

Lastly, I am not sure I see clearly the Commission's intent in proposing a two-level enhancement for what it calls sophisticated insider trading. If the objective is to enhance penalties for cases with greater likely market impact (as factors (A) through (D) in the Application Note suggest), that could be accomplished through a new table for gain/loss avoided in insider trading cases, and through more detailed position-based enhancements. Transaction volume alone (Application Note factors (A) through (C)) does not seem particularly well correlated with culpability. I would prefer something like duration of the offense conduct (Application Note factor (D)) as a more telling means of identifying offenders whose conduct is particularly corrosive to markets.

If the Commission's intent with proposed § 2B1.4(b)(2) is instead to enhance penalties for offenders who take steps to make their conduct more difficult to detect and prosecute (as Application Note factors (E) and (F) suggest), that concern would seem to

[6] I agree that, with such an enhancement, there should be language in § 2B1.4 that prevents double counting under Guidelines § 3B1.3 (Abuse of Position of Trust).

be covered by the Guidelines' general obstruction of justice provisions, as well as by the original decision to adopt a separate guideline for insider trading cases on the basis that they involve a "sophisticated" form of fraud. If the Commission concludes otherwise, I would suggest a more straightforward and explicit enhancement in § 2B1.4 for unusual efforts to thwart detection of insider trading. But first I would want some evidence from the enforcement agencies that this kind of behavior is a particular obstacle in the policing of insider trading as opposed to other forms of financial crime.

II. Major Accounting and Investor Frauds

Both potential and actual Guidelines sentences in large-size federal criminal fraud cases have grown enormously in the last three decades. I need not repeat here the story in which a justified concern with avoiding weakness and inconsistency in white collar sentences led, in part, to the enactment of the Sentencing Reform Act itself; and then to increases in the severity of fraud Guidelines in the early 2000s; and then to further increases in severity in the wake of the Sarbanes-Oxley Act; and then to renewed concern about deterrence of fraud as expressed in the Dodd-Frank Act provisions that are before the Commission today.[7] Even before *Booker*, and increasingly in its wake, federal trial judges have expressed frustration with the sometimes embarrassingly draconian results that seem to be dictated by the Guidelines in cases of large frauds involving publicly traded investment products.[8] I and others in the academy and among the bar have written about the potential loss of proportionality in a system—such as the one currently set forth in § 2B1.1 of the Guidelines—that would dictate a life sentence without parole for a public company officer who presided over fraudulent accounting practices that resulted in (or even contributed to) a sharp drop in the company's market capitalization.[9]

Good intentions, perhaps too often emphasized, have produced an inexorably inflationary process in Guidelines amendments (including so called factor creep) that has

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[7] *See* Gabrielle S. Friedman, Kan M. Nawaday & Daniel M. Gitner, *Challenging the Guidelines' Loss Table*, 20 FED. SENT'G REP. 174 (2008); Frank O. Bowman, III, Pour encourager les autres? *The Curious History and Distressing Implications of the Criminal Provisions of the Sarbanes-Oxley Act and the Sentencing Guidelines Amendments that Followed*, 1 OHIO ST. J. CRIM. L. 373 (2004); Daniel Richman, *Federal White Collar Sentencing in the United States—A Work in Progress* 10 (Feb. 3, 2012), *available at* http://ssrn.com/abstract=1999102.

[8] *See, e.g.*, United States v. Parris, 573 F. Supp. 2d 744 (E.D.N.Y. 2008); United States v. Adelson, 441 F. Supp. 2d 506 (S.D.N.Y. 2006); United States v. Ovid, 2010 WL 3940724 (E.D.N.Y. Oct. 1, 2010).

[9] *See* Samuel W. Buell, *Reforming Punishment of Financial Reporting Fraud*, 28 CARDOZO L. REV. 1611 (2006).

grown to undermine the important values of equity and proportionality that justify the very existence of sentencing guidelines.[10] The answer to this problem is *not* to rely on individual judges to keep using their *Booker* discretion—as some have been, in part due to the absence of good alternatives—to apply big discounts to Guidelines sentences in some large fraud cases (but not others).[11]

Three problems are primarily involved in the question of how to sentence the offender who is an officer of a public company that plummets in value in part due to revelation of fraud—or the violator who manages a large pool of investment assets that dramatically evaporates because of fraud in the soliciting and/or handling of funds. First, what role should loss or gain play in the calculation of punishment? Second, how should loss or gain be measured in the calculation of punishment? And third, what considerations involving the offender's position and means of committing the offense should also be relevant to calculating punishment, and how should one weigh those considerations along with measurements of loss or gain?

Referring the Commission to prior work in which I have addressed these questions in some depth,[12] I will limit my remarks here to those matters most amenable to remedy under the existing Guidelines and most relevant to the Commission's current proposals and requests for comment.

First, the use in cases involving publicly traded securities of a loss table primarily designed for forms of theft and basic fraud makes little sense. The typical offender in a large accounting or investor fraud case bears a more attenuated relationship to the loss that follows from his conduct than does the garden-variety thief or scam artist. Usually the loss does not flow to the offender as gain. Sometimes there is no gain at all, or at least no measurable direct gain. And usually market losses relating to fraud are entangled with market losses stemming from other causes. The result of failing to account for these realities is a loss table that ranges from only $0 to $1 million in its lower half but from $1 million to over $400 million in its upper half. Even still, the rapidly growing size,

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[10] *See* Frank O. Bowman, *Sentencing High-Loss Corporate Insider Frauds after* Booker, 20 FED. SENT. RPT. 167 (2008); David Debold & Matthew Benjamin, *"Losing Ground"—In Search of a Remedy for the Overemphasis on Loss and Other Culpability Factors in the Sentencing Guidelines for Fraud and Theft,* 160 U. PA. L. REV. PENNUMBRA 141 (2011).
[11] For a lengthy list of examples of disparity just in accounting fraud cases circa 2006, see Buell, *supra* note 9, at 1626-27.
[12] *See id.* at 1628-42.

complexity, and interdependency of financial market events have sometimes made $400 million look like a small number.

The Commission is well motivated in its consideration of whether offense levels should be capped or constrained in some fashion for offenders who gain only small amounts in otherwise high loss cases. Such a cap plainly would be preferable to allowing an alternative measure of gain to supplant entirely reliance on loss, since the presence or absence of gain is as often a matter of fortuity as of offender culpability. But I would be concerned about both overinclusion and underinclusion if the Commission were, as suggested, simply to pick a gain number below and above which an offender would be either eligible or ineligible for any form of cap. And it is not clear why a gain amounting to one percent or less of the loss should, as the Commission's request for comment suggests, typically qualify a case as one of substantially lesser culpability. A further complication is that gain in public company fraud cases often takes less quantifiable forms, such as promotion, retention of position, increase in the offender's value in the talent market, or prestige in general. It is my perception that the growing concerns about outsized offense levels in some public securities fraud cases has had as much to do with reduced offender role in the offense, or in the relevant company or institution, as it has had to do with lack of large profit to the offender.

It would seem to me more to the point to create a new, separate loss table for large accounting and investor fraud cases. The Commission might, in the process, eliminate the additional table involving numbers of victims by making the new loss table applicable, for example, to cases of fraud involving publicly traded securities in which the fraud causes loss, or serious risk of loss, to 50 or more victims. As with insider trading, I would urge the Commission to base such a table on the distribution of losses in known large fraud cases reflected in data collected by the DOJ, the SEC, and the courts. I might also favor a position-based reduction within § 2B1.1 that would perhaps mirror the current enhancement for public company officer or director status. As with the insider trading Guideline, I believe the Commission could do more to take into account the particularities of an offender's position within the financial markets and the various institutions that constitute those markets—a matter of high relevance to how investors and the general public perceive the seriousness of cases involving public market fraud.

Second, I agree with the Commission that methodology for loss calculation in large publicly traded securities cases is an important problem on which guidance is needed, regardless of how the applicable loss table is scaled from bottom to top. This problem has been prominent in all forms of securities litigation and the Commission is wise, in its request for comments, to draw from the experience of those cases in considering potential methodologies.

However, we should bear in mind that, in determining sentences of imprisonment, we are not calculating damages or fines. The principal function of sentencing guidelines is to situate cases relative to each other, in the service of proportionality and equity. Somewhat rough and ready methods for calculating loss are acceptable as long as they are applied with reasonable consistency. Loss is only one factor of many appropriately weighed in a judge's exercise of sentencing discretion. Federal sentencing hearings in securities-related cases should not be diverted into wasteful—and often inconclusive—battles of experts offering complex economic models.

I recommend that the Commission provide a method for calculating loss in publicly traded securities cases that is both simple and tied to objective market data. Courts might use something like the following approach: Calculate the average share price during the period from the commencement of the fraud until the last day before the first public revelation of any aspect of the fraud (the average fraud price); calculate the average share price during the 90 days following the first date of public revelation of any aspect of the fraud (the average post-fraud price);[13] estimate as accurately as possible the total number of shares that were purchased between the commencement of the fraud and the first date of public revelation of any aspect of the fraud *and* that were held at least until the first date following first public revelation of the fraud (the affected shares); finally, subtract the average post-fraud price from the average fraud price and multiply by the number of affected shares to derive an initial loss figure.

The Commission could provide that a court should reduce the resulting offense level by, for example, two to four levels if the court finds that factors not related to the fraud affecting the firm, the firm's industry, or the market as a whole substantially

[13] The 90-day period is taken from the damages rule in 15 U.S.C. § 78u-4(e)(1), a provision of the Private Securities Litigation Reform Act.

contributed to the loss figure—while directing that a court determine such facts from basic sources of information such as market indices and press reports rather than from complex event studies. (To name just one simple measure, publicly traded stocks have a readily accessible "beta" value, representing the stock's return rate over time relative to the market's rate of return over the same period.)

There are of course other methods the Commission could adopt for calculating loss. Again, in the context of guidelines for criminal sentences, it is less important that the Commission adopt an economist's optimal means of loss measurement than that it guide courts towards the use of a simple, consistent, and reasonably realistic methodology. I might add that the use of especially complex methodologies for calculating loss in securities cases is likely to exacerbate disparity in sentences, if only because some defendants will be able to afford to employ the best economists to testify at sentencing hearings, while others will not have such wherewithal.

Last, and certainly not least, there is the matter of the interaction in large fraud cases between the loss table and the many offense level enhancements that have been added to § 2B1.1. Here is where one finds the dynamic that has produced potential sentences of life imprisonment in contemporary cases of white collar crime. The problem is two-fold: the loss table can start a case involving a large volume of securities at a very high offense level; and then the multiple enhancements for other offense characteristics can cause forms of double-counting.

Consider what happens to the case of an officer of a large public company with shares that substantially decline in value upon revelation of accounting fraud in some part of the company's finances and in which the officer is culpable. The loss table is likely to yield an offense level in the mid 30s; the victim table is likely to increase that sentence to the low 40s; and enhancements for endangering a public company and having public company officer status (not to mention a potential general enhancement for role in the offense) are likely to move the offense level quickly past the maximum of 43 on the Sentencing Table. Such a crime is, to be sure, arguably as serious as a white collar offense can be—save perhaps an investment fraud case of large scale such as several recent high-profile Ponzi schemes. But these Guidelines calculations have not begun to account for factors that might mitigate a particular defendant's culpability relative to the culpability of another defendant, even in a major accounting fraud case.

More to the point, does anyone seriously think that we can or should be imposing sentences of life without parole in federal prison for accounting fraud if we are committed to proportionate distribution of punishments for the myriad of crimes, violent and other, committed across the United States? It should not surprise the Commission that few such sentences have actually been imposed, despite the near decade during which the fraud Guidelines have provided for such sentences. It is apparent that a growing number of federal judges—and even many federal prosecutors—believe such sentences would be unjust. Of course, it is also a legal reality that *Gall* and related decisions likely permit a judge to impose a sentence below the Guidelines range in such a case on just that ground. The legitimacy of the Guidelines is likely to weaken as the gap between their letter and their application becomes more obvious as more of these large cases reach sentencing.

This leads me to conclude by underlining a previous point. The Commission would be well advised to stop the inflationary and somewhat jury rigged process by which § 2B1.1 has been repeatedly tweaked to accommodate the large, high profile cases of securities fraud that have unfortunately arrived in the system in increasing numbers in the last decade or so. A simpler and more restrained approach would be to adopt a separate loss table for such cases, based on information about the actual size and distribution of investor losses in such cases. Such an approach should include a threshold determination for application of the separate table that is based on the nature of the case. And it perhaps should include a two- or four-level enhancement or reduction based on factors relating to the defendant's position in the financial markets or the relevant corporation or institution (which could substitute for the less tailored Chapter Three, Part B adjustments in the Guidelines, in part to avoid double counting). At the least, the Commission should not exacerbate the problem by adding another enhancement to § 2B1.1, such as for "significant disruption of a financial market," that would produce only further double counting.

Similar to the view I expressed about insider trading, I believe *both* that all serious market frauds should be associated with significant terms of imprisonment *and* that even the most severe cases of such fraud need not be punished in excess of a dozen years or so of real time, absent grievous circumstances.

White collar sentencing is tougher, and more predictably tough, than it was before the Sentencing Reform Act. But there is increasing evidence of large gyrations in federal white collar sentences that, given the lengthy terms of imprisonment at stake, are perhaps more costly than the variations that gave rise to federal sentencing reform in the first instance. These developments are troubling and require remedy. Thank you again for the opportunity to address the Commission today on these important matters affecting the sentencing of white collar offenders.