Testimony of

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STATEMENT

OF

RONALD J. TENPAS
ASSOCIATE DEPUTY ATTORNEY GENERAL
DEPARTMENT OF JUSTICE

BEFORE THE

COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

CONCERNING

"EXAMINING ENFORCEMENT OF CRIMINAL INSIDER TRADING AND HEDGE FUND ACTIVITY"

PRESENTED ON

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"Examining Enforcement of Criminal Insider Trading and Hedge Fund Activity"

Good morning Chairman Specter, Ranking Member Leahy, and members of the Committee. Thank you for inviting the Department of Justice to testify today concerning its views on the draft bill you have shared with us, entitled the "Criminal Misuse of Material Nonpublic Information and Investor Protection Act of 2006."

As I noted in my testimony before this Committee in September, the Department and the Corporate Fraud Task Force are committed to maintaining fairness and integrity in the marketplace by ensuring that individual investors are able to invest their hard-earned dollars without fear of being taken advantage of by those - whether they be corporate officers, members of the financial services industry or others - who improperly use inside information to enrich themselves at the expense of others. I know that I speak for the Task Force membership in extending our appreciation to this Committee for its thoughtful examination of the issues presented by insider trading and the parallel proceedings that are often used to investigate such conduct.

As discussed at your last hearing, while the Department of Justice and the SEC frequently investigate the same misconduct, the remedies which each of our agencies bring to bear vary, with the SEC pursuing civil remedies and the Department of Justice responsible for criminal prosecutions. Thus, I will focus my remarks on the bill's criminal provisions and the effect those provisions would have on our criminal enforcement tools. More particularly, I would like to present our preliminary thoughts on some of the overarching problems the bill seeks to address, while also discussing examples of specific concerns we have identified that we think warrant additional attention. In general, we welcome the overall thrust of several of the criminal provisions, although we have a number of specific concerns about language in the bill and whether that language will effectively accomplish its apparent purposes. I want today to give you some illustrative examples of these concerns in the hope that we can work with you in a more detailed fashion moving forward so that any legislation achieves our shared goals of clarifying the legal responsibilities of insiders and supporting our corporate fraud enforcement efforts.

I would like to start my discussion with Section 4 of the bill. This section would amend Title 18, Section 1348 by adding a new subsection (b) that expressly prohibits insider trading. When I testified in September, I noted challenges we face in prosecuting insider trading but explained that despite various hurdles, the Department has enjoyed consistent success in prosecuting those who seek to exploit their access to information at the expense of the market. I described examples of our cases, which involve all types of defendants, from corporate officers, directors and employees who traded the company's securities after learning of significant confidential corporate developments, to friends, family members, and other "tippees" who traded the securities after receiving inside information.

Nevertheless, we believe it could be helpful to put "inside trading offenses" on a firmer statutory footing than they now stand, which is as a judicially-recognized species of Title 15 offenses that

prohibit schemes to deceive associated with the offering and sale of securities. The fact that the detailed elaboration of the elements of this offense have emerged largely through judicial decision-making has produced some degree of uncertainty for our prosecutors and for others for whom clarity in this area is important.

Yet, while we agree with the underlying premise of this section, we have a number of concerns about the specifics reflected in the bill. For example, this section is entitled "Willful misuse of material nonpublic information." As you know, in the criminal law, "willful" has a very particular meaning and imposes the highest burden on prosecutors with respect to the "state of mind," or "scienter," we must establish for a criminal defendant. Yet, despite the section's title, the various subsections of the bill contain a variety of other "scienter" standards - the new paragraph (b)(2)(1)(A) incorporates a "knowingly" standard, while paragraph (b)(2)(1)(B) provides no explicit scienter requirement, not even "knowingly." We would like an opportunity to work with you on developing a consistent approach that fairly penalizes wrongdoing but which does not unfairly ensnare the innocent actor.

I also observe that new subsection (b) as currently worded introduces at least two substantial changes from current law. First, it eliminates the element that the person who is charged with insider trading be shown to have a "duty" with respect to that information. We are concerned that eliminating this requirement potentially subjects to criminal sanctions those who innocently come by valuable information and trade on it. Thus, it may extend criminal liability more broadly than is warranted. Conversely, the draft bill essentially adds an affirmative defense that trading on inside information is acceptable if that information was "gained by. . . research and skill." We are concerned that, while this may not be the intent, such a formulation will make it more difficult to prove insider trading than is the case under current law. In addition, we are concerned that the phrases "research and skill," "of a specific nature" and "significant factor" may impose burdens we do not currently face, or may be insufficiently precise to provide the notice function normally required of a criminal statute and thus will present real difficulties of proof at trial and in formulating jury instructions. Thus, we think it might be helpful for the Committee, as a better model, to look to the definition of insider trading that the SEC has already promulgated through its regulatory process and to build from that if any adjustments are necessary. We would be happy to work with the Committee in any such effort.

Further on in Section 4, paragraph (c) contains a variety of provisions. Again, we find much to applaud in terms of the general thrust, but are concerned with various specifics. In general, we welcome the effort to make clear the Department's authority to investigate insider trading offenses and to do so in a manner that involves express coordination with our partners at the SEC. As you are aware, recent court decisions have, unfortunately, created potential barriers to the conduct of parallel investigations by the Department and the SEC, which are so important to the efficient, targeted and expedited resolution of these complex cases. And one of those decisions, United States v. Stringer, the United States has appealed to the Court of Appeals for the Ninth Circuit. It is unclear to us to what degree the lower court's decision in Stringer, which rested at least in part on constitutional grounds, is likely to be embraced, rejected or expanded by the Court of Appeals. Thus, we would urge that any final decisions on how to respond should be made only after that Court has issued its opinion, so that we may carefully assess the degree to which legislation can respond to the appellate court's rationale and insure that any legislation

provides as comprehensive a fix as possible.

In addition, even as currently drafted, there are several aspects of the bill we would like to work with you further on. For example, the language of subsection (c) may result in some unintended consequences because paragraph (1)(A) of subsection (c) restates plenary authority to investigate, an authority we believe falls to the Attorney General generally as to all federal criminal violations. We are always cautious when we see language restating authority we believe already exists. Such language may be cited as evidence that the authority did not exist prior to this revision, or that a prior authority has been altered because the language of the revision does not identically track the pre-existing language found elsewhere. Thus, it may simply be best to remove this language, although again, this is something we would like to discuss more fully.

Similarly, proposed paragraph (c)(2) of revised section 1348 would provide that neither the Attorney General nor any other Federal agency would have a duty to disclose any investigation or to disclose any contacts made with a companion agency to "request or receive evidence," except pursuant to a court order issued on good cause shown that the sole basis for a civil investigation is to assist in a criminal investigation. We appreciate the intent of this provision to clarify an area of the law which has been made more murky by recent court decisions such as Stringer. We are concerned, however, that this revision may be too narrow. For example, we have traditionally coordinated our efforts with the SEC through steps more than just "requesting or receiving evidence." Thus, this language might be argued to cut-back on, rather than confirm, the propriety of our traditional coordination efforts with the SEC. Similarly, the language in (c)(2) applies only to investigations of violations of "this section", i.e. Section 1348 of Title 18. Yet, we continue to have parallel proceedings involving the SEC that involve other criminal provisions of Title 18 and Title 15, which could equally be frustrated by these court decisions. Thus, (c)(2)'s limitation in coverage to Section 1348 might be read as an intention to disallow consultation in such other matters.

Let me turn now to Section 5, a section to create incentives for private citizens to report and assist in the investigation of insider trading. We always welcome the assistance of private citizens and whistleblowers who report criminal acts or other violations of laws. These reports often reveal wrongdoing which would have otherwise gone undetected. One example of this with which the Committee is familiar is the civil False Claims Act, which provides for monetary awards to successful plaintiffs who initiate a civil qui tam proceeding on behalf of the United States.

We are concerned, however, about replicating such a reward statute with respect to criminal proceedings. Giving such substantial financial incentives to individuals to make criminal allegations would be a fairly dramatic departure from past practice in the criminal arena. Thus, we would like the opportunity to think further about whether such a step would on balance be a net positive or negative for our enforcement efforts. Such incentives may produce not only meritorious allegations that are helpful to the government but also false allegations that could result in individuals being falsely accused. In addition, such incentives could be expected to become important grist for impeachment of a key government witness in a criminal trial, perhaps hurting our efforts to prosecute matters successfully. Also, it is unclear to us whether the factors that the statute indicates should be considered in fashioning a reward amount are meant to be

exhaustive or only illustrative. One factor that is missing, but which strikes us as potentially quite important, is whether the person providing the information was himself complicit in the crime. Finally, we are reviewing whether the reward scheme conflicts with the Justice for All Act and would impinge on our associated efforts to insure that victims are made whole through restitution, as well as detract from our traditional use of criminal fines to support the crime victim's fund.

Finally, a short comment regarding Section 6, which would create new regulatory requirements for hedge funds, including civil penalties, and which the SEC and the Department would have joint enforcement authority over. As I noted at the outset, the Department and the SEC have well-established roles with regard to our securities markets. The SEC has, over the years, developed considerable expertise in promulgating detailed regulatory requirements and enforcing such regulations through civil enforcement action. Thus, we believe it would be a mistake at this stage to tamper with that scheme, and to extend such enforcement duties to the SEC and Department of Justice jointly. We believe it best if the Department "sticks to its knitting" and continues to focus on criminal enforcement, with the SEC having sole authority in the civil arena.

Conclusion

In closing, let me again thank the Committee for its continuing interest in our corporate fraud enforcement efforts, and its interest in insuring that we have the tools necessary to perform effectively. We remain committed to combating all threats to the integrity of our capital markets and to the welfare of the investing public, as we know you do. Thus, we look forward to working with you to address some of the matters of concern that I have raised, both today in this hearing and beyond. Thank you.