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News Release

INSIDER TRADING -- THE MARKET'S ALBATROSS

Remarks to

Center for the Study of Banking
and Financial Markets

University of Washington
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Charles C. Cox
Commissioner
Securities and Exchange Commission
Washington, D. C. 20549

The views expressed herein are those of Commissioner Cox and do not necessarily represent those of the Commission, other Commissioners or the staff.

I. INTRODUCTION

Good morning. It is a pleasure to be back in Seattle again. I have been asked to talk to you today on a topic that has received a great deal of attention over the past year -- that of insider trading. The organized trading scheme with Ivan Boesky as the central figure has now expanded to include high officials at two major securities houses. The almost theatrical arrest last week of Robert Freeman of Goldman Sachs and Richard Wigton of Kidder Peabody, both of whom were taken from their executive offices by Federal Marshals, was understandably met by the industry with great shock. In an attempt to keep my remarks brief and to cover only those aspects of the law of insider trading that you are most interested in, my discussion will focus on certain areas suggested by Mr. Hess. Specifically, I will address the following issues: (1) what <u>is</u> insider trading; (2) the SEC's allocation of resources for insider trading; (3) how is insider trading detected; (4) how pervasive is insider trading; and (5) how is insider trading prosecuted.

II. WHAT IS INSIDER TRADING?

While there is no statutory definition of insider trading, the case law draws clear parameters on who can be charged with a Section 10b-5 violation -- the antifraud provision of the Securities Exchange Act of 1934. Briefly, an inside trader is one who trades securities while in possession of material non-public information.

Although an insider for 10b-5 purposes may extend beyond the typical officer or director of a corporation, to one who knowingly receives information from a corporate source, the Commission looks to the existence of a fiduciary relationship or some other duty of trust.

A "temporary insider," for example, who may have been hired to provide specific expert advisory services, probably owes a fiduciary duty to the corporation and is expected to use any material non-public information for its intended corporate purpose -- not for his own pecuniary or reputational benefit.

It is important to understand that all non-public information is not "material" for 10b-5 purposes simply because it was obtained from a corporate source. Rather, the Commission and the courts will evaluate the specific non-public information to determine whether "there is a substantial likelihood that a reasonable [investor] would consider it important" in making a particular investment decision. 1/

To illustrate, let me use an example that you are all familiar with -- Ivan F. Boesky. Ivan Boesky, the arbitrageur who has become a near household name, received material non-public information from New York investment banker, Dennis B. Levine. Dennis Levine, as part of what we now know to be an organized trading scheme, received his information from a number of individuals. Individuals implicated thus far include: Robert M. Wilkis, an investment banker at Lazard Freres & Co.; Ira B. Sokolow, an investment banker at Lehman Brothers Kuhn Loeb Incorporated, later Shearson/Lehman American Express; David Brown, investment broker at Goldman Sachs; Ilan Reich, a takeover lawyer at Wachtell, Lipton, Rosen & Katz; Michael Davidoff, formerly the head trader for Boesky and, most recently, Robert M. Freeman, a partner at Goldman Sachs; Timothy L. Tabor, a former official at Kidder Peabody and Merrill Lynch; Richard Wigton, a Vice President at Kidder Peabody and Martin A. Siegel, an investment banker at Kidder.

The non-public information, which the average investor would certainly consider to be important and is thereby material, concerned, among other things, a possible merger of Nabisco Brands Inc. and R.J. Reynolds, a possible tender offer for Houston Natural Gas Corp. by InterNorth Inc., and a possible recapitalization of FMC Corporation.

In most insider trading cases, the Commission must rely solely on circumstantial evidence to prove its case. Here, however, the Commission had direct evidence establishing the fact that Boesky and Levine entered into an arrangement whereby Boesky agreed to pay Levine five percent of any profits received, provided Boesky based his investment decision on the material non-public information he obtained from Levine. If, on the other hand, Boesky merely continued to hold or increased his holdings in a security, after having received information from Levine, Boesky would pay him one percent.

Again, unlike most discovered violators, Boesky consented to charges that he at all times knew that the information was confidential and that it was obtained through misappropriation or a breach of a fiduciary duty. If he had made the trades based on his market experience, on a good guess, or on a tip that, while it may have

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1/ See generally, TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1979).

fortuitously turned out to be correct, was not an inside tip based on material non-public information, Boesky would not have violated the law.

Actions by the Commission have proven that no one, whether he is a well known arbitrageur such as Ivan Boesky or the former Deputy Secretary of the United States Department of Defense, Paul Thayer, is immune from civil or criminal sanctions. While it is true that we have noticed a different, perhaps a more sophisticated high profile type of violator, and while the dollar amounts continue to break all time records, we have broken no new ground in the law of insider trading.

Based on this organized trading scheme Boesky agreed to pay the equivalent of $100 million in cash and assets; $50 million of which represents disgorgement of his illegal profits and $50 million of which represents a civil penalty. Dennis Levine has disgorged $12.6 million of ill-gotten gains. Both are out of the securities business for life and face criminal charges.

III. THE SEC'S ALLOCATION OF RESOURCES FOR INSIDER TRADING

Whenever I have an opportunity to speak about the Commission's insider trading program, I try to put the Commission's emphasis on insider trading in its proper perspective. To read the newspapers or view the nightly news broadcasts, one might imagine that the Commission's Division of Enforcement handles little else beyond insider trading cases. In truth, however, the insider trading program consumes a rather small percentage of the Commission's overall enforcement resources.

In 1986, for example, approximately ten percent of the enforcement cases initiated by the Commission involved insider trading. Over the past four years, Enforcement's allocation of resources devoted to the insider trading program averaged close to seven percent. While we are likely to see an increase that could reach as high as fifteen percent in the coming year, the figures are far from staggering.

By comparison, the Division of Enforcement, in its nationwide enforcement program, allocated approximately 28% of its resources to securities offering cases involving both regulated and non-regulated entities and approximately 20% to broker-dealer cases during the same period. Broker-dealer cases, among other things, would include numerous forms of back-office violations, fraud against customers and stock loan cases.

IV. HOW IS INSIDER TRADING DETECTED?

Recent technological advances in market surveillance contribute to a much more efficient and accurate monitoring system with which to identify insider trading activities. The market is routinely monitored though the use of sophisticated electronic systems capable of gathering and analyzing data involving unusual trading activity. The SEC, the various stock exchanges and the National Association of Securities Dealers, the self-regulatory organization that oversees the over-the-counter market, have at their disposal automatic systems that search for such anomalies as unusual trading volume in a given stock or for inexplicable price run-ups.

Electronic surveillance at the New York Stock Exchange, for example, includes a computer system entitled "Stock Watch." Stock Watch is a program that continuously monitors trading on the NYSE's trading floor. Stock prices that exceed certain parameters will trigger an alert and market trading analysts will begin to investigate the trade. The analyst may call the company to inquire as to any pending announcements or may search for links between the identified trader and the corporation in whose stock he has traded.

One tool for the market trading analyst is a newly developed system known as ASAM -- the Automated Search and Match. ASAM is capable of electronically cross checking customer information against the public information on approximately 75 thousand companies and nearly 500 thousand business executives. With the use of ASAM, analysts are able to search for possible connections suggesting insider trading activity. When appropriate, such as in instances where a wider jurisdictional basis is necessary, the NYSE will refer the names of potential violators to the Commission for further investigation.

Although the Commission does not proceed formally against every referral from a self-regulatory organization, it will make further inquiries to determine whether formal proceedings are warranted. Certainly, uncharacteristic trades are not always indicative of illegal insider trading activities.

An uncharacteristic trade for a first time investor, if it is viewed in conjunction with other suspicious events, such as a telephone call from the CEO of the corporation minutes before the investor placed the order with his broker, may combine to create sufficient circumstantial evidence to support a formal order of investigation. I would emphasize, however, that a mere suspicion, in and of itself, is generally not enough for the Commission to authorize a formal action.

Finally, in addition to the various surveillance techniques, the staff may learn of an alleged violator through a tip from an informant. The Commission receives such tips from a myriad of sources including: disgruntled employees, former partners, attorneys, and, in at least one instance, a scorned lover. Whether the tip is received from a known or anonymous informant, the staff will engage in a series of preliminary inquiries before proceeding with the force of a subpoena.

V. HOW PERVASIVE IS INSIDER TRADING?

Although the Commission, with the help of the self-regulatory agencies, is far more capable of detecting insider trading violations today than at any time in its history, it is impossible to know, with any degree of certainty, how much insider trading is really taking place.

During fiscal year 1986, the Commission initiated a total of 54 civil actions and six administrative proceedings against defendants and respondents, respectively, for insider trading violations. During that same period, the dollar amount for disgorgement in those cases reached just under $30 million. An additional $3.7 million was received in penalties pursuant to the Insider Trading Sanctions Act of 1984 ("ITSA"). 2/

It is important to distinguish disgorgement from civil penalties in that the disgorgement, which represents the amount of ill-gotten gains or loses avoided, is generally placed in escrow for the benefit of investor claims while the civil ITSA penalty is paid to the Treasury of the United States.

As you may recall, the case against Ivan Boesky was not filed until November of 1986 and would therefore not be included in the above-mentioned figures. In that case alone, Boesky agreed to pay the equivalent of $100 million in cash and assets. Of that figure $50 million represented

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2/ See 15 U.S.C. §78u(d)(2)(a).

disgorgement of his ill-gotten gains and $50 million represented a civil ITSA penalty.

VI. HOW IS INSIDER TRADING PROSECUTED?

The Commission is making criminal referrals to the Justice Department and to the United States Attorney's Offices with greater frequency than ever before. Earlier I referred to the recent arrests of top figures in connection with the insider trading scandal that began with Dennis Levine and Ivan Boesky. Following the arrests of Robert Freeman, a partner at Goldman Sachs, Timothy L. Tabor, a former official at Kidder Peabody and Merrill Lynch and Robert Wigton, a Vice President at Kidder Peabody, the Commission filed a complaint for injunctive and other relief against Martin A. Siegel. Siegel was employed as an investment banker at Kidder Peabody and was formerly the co-head of the mergers and acquisitions department at Drexel Burnham.

The complaint alleges that Siegel provided Boesky with material non-public information and that Siegel received substantial secret payments from Boesky as compensation for the non-public information. The complaint further alleges that an individual or individuals acting as agent(s) for Boesky met Siegel in a prearranged conspicuous public place, identified him or themselves by use of a password and delivered a briefcase containing a cash payment. Payments received in this manner amounted to approximately $700,000. Siegel, Boesky and others, continue to cooperate with the SEC and the U.S. Attorney's Office in this matter.

While a criminal referral, if it results in a criminal prosecution, often results in a jail sentence, it is important to recognize that the Commission itself does not have the authority to prosecute anyone. Rather it is authorized to impose only civil penalties on its defendants. Such sanctions include the imposition of civil injunctions, permanent bars from the securities industry and, pursuant to the Insider Trading Sanctions Act, civil penalties of up to three times the profits gained or the losses avoided.

The current trend, suggesting a marked increase in criminal referrals and resulting criminal prosecutions, is an important weapon in the Commission's arsenal. In fact, criminal prosecution may be the only effective means of dealing with some chronic violators. The possibility of a jail sentence threatens even those recidivists for whom the civil injunction carries about as much weight as a fine issued to a street vendor. It is unfortunate that for some chronic violators, civil injunctions seem to come with the territory. Criminal prosecutions, by contrast, carry with them serious long-term effects and, we believe, have a proven deterrent effect in the securities community.

VII. CONCLUSION

In closing, I would like to emphasize that with the benefit of sophisticated monitoring systems and the threat of an ITSA penalty, the Commission's job has been made somewhat easier. If there was ever a time when engaging in insider trading was known to carry too great a personal risk, the time is now. If, despite the odds, one chooses to play the game and loses, he can expect to receive a stiff civil sanction and possibly criminal sanctions as well.

The SEC, often in partnership with the U.S. Attorney's Office, is a government watchdog agency now known to have a bite. Together we hope to renew public faith and confidence in the fairness of the markets. As so artfully stated by essayist H. L. Mencken, what, after all, is the conscience but "the small inner voice that tells us someone is watching."

Thank you.