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News Release

THE LAW OF INSIDER TRADING -- HOW THEY GET CAUGHT

Remarks to

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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

It is a pleasure to be here to address the Piedmont Economic Club tonight. I am particularly grateful that you are located in South Carolina and not in a colder climate. As you know, this evening I am going to speak to you about the law of insider trading. It is perhaps fortuitous that I decided, some weeks ago, to speak to you on the subject of insider trading. Little did we know then, that the front page headlines would be dominated by the demise of Ivan Boesky and his 100 million dollar settlement for insider trading.

During the course of this speech, I will attempt to dispel some of the common myths arising from the rather intense coverage by the media. To begin, I will try to explain, in simple terms, what does and does not constitute insider trading. I will discuss a few notorious cases that will help illustrate the means by which individuals find themselves stepping over the threshold of permissible trading into the insider trading abyss.

In so doing, we will look at one aspect of insider trading law that I am sure is of interest to at least a few of you in the audience tonight. That is, how insider traders get caught. I will talk briefly about the opposing argument, presented by Henry Manne and others, that insider trading is economically efficient and that we should leave the insider traders to their own designs. As a follow through, we will try to imagine what the securities marketplace would look like if insider trading were perfectly legal.

Given the amount of news coverage that the SEC's insider trading program has received lately, it might surprise some of you to learn that, in fact, insider trading cases comprise only a small percentage of the Commission's overall enforcement program. During the past year, for example, only about nine percent of our cases involved insider trading. I think that it is worthwhile to keep the problem in perspective.

II. WHY THE PUBLICITY?

You may wonder if the Commission is not on a calculated rampage to crack down on Wall Street, and if insider trading activities truly represent a small percentage of the Commission's resources, then why all the publicity? The fact is that if you were to flip through

the financial papers of any random period in the Commission's past, you would find reports of numerous insider trading cases involving civil injunctions, administrative bars against the violators, and referrals for criminal sanctions. The difference is that most of you would probably not recognize their names.

Contrary to recent statements made by the media, the Commission is not changing policy or expanding the law of insider trading. We are merely conducting our jobs, as usual; however, we find that the character of the violator has undergone significant change. The profile of the individual and the record dollar figures of ill-gotten gains have changed dramatically. But, the law of insider trading remains essentially unchanged.

III. INSIDER TRADING -- WHAT IS IT?

Put simply, an insider trader is one who trades securities while in possession of material nonpublic information. Unfortunately, it is not always easy: (1) to determine who is an insider; (2) to create a litmus test for evaluating materiality; or (3) to establish whether the suspicious trades occurred while the trader did, in fact, possess material nonpublic information or whether the trader merely gambled and won.

While an insider is not always as easily defined as an officer or a director of a corporation, and in fact may extend to anyone who knowingly receives information from a corporate source, a fiduciary relationship must be established. The insider must in some way have access, either directly or indirectly, to information that was intended to be used for a corporate purpose and not for his personal benefit.

Furthermore, in determining whether the information in question is material, we generally examine whether "there is a substantial likelihood that a reasonable [investor] would consider it important" in making the investment decision. 1/

It is indeed a rare case when the SEC staff presents the Commission with direct evidence to make its case. In most instances an insider trading case is based purely on circumstantial evidence and the Commission, as well as the

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

court, will engage in a very delicate balancing test to determine in which direction the pendulum of the defendant's credibility swings.

IV. HOW INSIDER TRADERS GET CAUGHT

While it is impossible for us to measure the number or the sophistication of those illegal trades that we have not investigated, and I suspect that a number of violators do manage to escape the SEC's enforcement net, those who are caught by the Commission are likely to receive a fairly stiff sanction. At least one member of the enforcement staff is on record as having said that he would like to "create an environment where the downside is so painful, it's not worth even a million bucks to take the risk." 2/ That downside includes: (1) civil injunctions; (2) permanent bars from the brokerage industry; (3) civil penalty assessments of up to three times the profits made or the losses avoided; and (4) criminal referrals to the United States Attorney's Office where criminal prosecution and a jail sentence are now common.

The SEC as well as the various stock exchanges are diligently at work to improve the technology of its market surveillance. Audit trails routinely monitor the market and search for unusual trading volume in specific stocks and for inexplicable price run-ups where there has not been a favorable public announcement to correspond to the run-up.

The Enforcement Division of the SEC is increasing its efforts to identify insider trading even where there is no obvious run-up in the stock. Trades that are uncharacteristic for the individual, such as a first time trader who purchases deep out of the money options, are inherently suspicious. A mere suspicion, however, is usually not enough for the Commission to authorize formal action. In the example I just cited, a formal complaint for injunctive relief might follow where the first time trader has a long standing personal relationship with the director of the company in whose stock he has traded and where the telephone records show that the director, for example, called the friend immediately following a significant board meeting.

2/ Dannen, "The SEC's Insider Trading Quandary," Institutional Investor, Oct. 1986, at 14.

By far the most common way in which an insider is caught is through a tip to the staff from an informant. Even where the informant chooses to remain anonymous, the staff will engage in some preliminary investigation to test its validity. Lawyers and other market professionals who witness some irregularities in the way the business is being handled or who otherwise are faced with blatant violative conduct will frequently contact the Commission for fear that they may in some way be implicated if they do not come forward with the information.

V. SPECIFIC EXAMPLES OF INSIDERS WHO GOT CAUGHT

Ivan F. Boesky

Last Friday the Commission announced what is already a landmark case in the history of insider trading -- SEC v. Ivan F. Boesky. 3/ The complaint alleges that Ivan Boesky caused securities to be purchased for certain affiliated entities while in possession of material nonpublic information that was provided to him by Dennis B. Levine, as part of an organized trading scheme. Levine received his information from Robert M. Wilkis, an investment banker at Lazard Freres & Co. and from Ira B. Sokolow, an investment banker at Lehman Brothers Kuhn Loeb Incorporated, later Shearson/Lehman American Express, and others.

The nonpublic information concerned tender offers, mergers or other business combinations. Boesky at all times knew that such information was confidential and had been obtained through misappropriation or a breach of a fiduciary duty. The nonpublic information included 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 contemplated recapitalization of FMC Corporation.

The complaint further states that Boesky agreed to pay Levine five percent of his profits that accrued to certain of the entities under his control where Boesky based his decision to purchase the securities on the nonpublic information provided by Levine. A lesser amount, of one percent, was agreed upon if Boesky merely continued to hold or increased his holdings in the security based on such information.

3/ See Litigation Release No. 11288, Nov. 14, 1986.

Boesky has agreed to pay the equivalent of $100 million in cash and assets. Of that amount, $50 million represents disgorgement of his ill-gotten gains and will be placed in escrow for the benefit of investor claims and the remaining $50 million represents a civil penalty that, pursuant to the Insider Trading Sanctions Act of 1984, 4/ will be paid to the Treasury of the United States. The $100 million amount is the highest figure ever to be obtained as part of a resolution involving any violation of the federal securities laws. In addition to the disgorgement and civil penalty, Boesky has consented to the entry of a final judgment of permanent injunction restraining and enjoining him from future violations of Sections 10(b) and 14(e) of the Securities Exchange Act of 1934.

Furthermore, in a related public administrative proceeding, Boesky submitted an offer of settlement that the Commission has accepted. Subject to a limited stay, the settlement provides that Boesky consents to an administrative order barring him from association with any broker, dealer, investment adviser, investment company or municipal securities dealer. It is clear that with the exception of making his own personal trades through a commissioned broker/dealer, Boesky is out of the U. S. securities business for life.

While the Commission is only authorized to impose civil sanctions on its defendants, it often refers cases to the Justice Department or the United States Attorney's Office for criminal proceedings. In this instance, Boesky has reached a plea agreement with the U.S. Attorney's Office for the Southern District of New York. Obvious ramifications include the possibility of imprisonment for the conduct that gave rise to the Commission's charges. Boesky is cooperating with the Commission and it is not yet determined how many other insider traders will surface in this trading ring that began with the once prominent New York investment banker, Dennis B. Levine.

Dennis B. Levine

As you may recall, on May 12, of this year, Dennis Levine was sued by the Commission and arrested pursuant to a warrant obtained by the United States Attorney's Office for the Southern District of New York. Until that time he was, by all reports, a well respected New York investment

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4/ See 15 U.S.C. §78u(d)(2)(a).

banker. Dennis Levine, at the age of 34 became a near household name when he was caught with 12.6 million dollars of ill-gotten gains. Before Ivan Boesky was implicated in the case, Dennis Levine and his accomplices represented by far the largest, and one of the most theatrical, insider trading cases in history.

I must admit, that at times reading through the myriad of memoranda captioned Dennis Levine, et al, was not unlike turning another chapter in an Agatha Christie mystery novel "Fraud on the Wall Street Express." Chapter 1 -- May 1986, the staff finally discovers the identity of the person whose tracks they had been following for months. Chapter 2 -- all of the bank employees cover for Levine and attempt to conceal his identity when the staff uncovers the key to the safe at Bank Leu International, Ltd. in the Bahamas. Chapter 3 -- will we manage to seize the $95,000 Ferrari automobile as one of the assets to be liquidated in satisfaction of claims arising out of his illegal trading activities? The final chapter, or so the staff thought, when enforcement hit the jackpot and identified a number of prominent Wall Street accomplices and unmasked Levine's reputed ring.

Many at the Commission believed that the story had ended when the Commission filed charges against Ira B. Sokolow, Robert Wilkis, Ilan K. Reich (the attorney from Wachtell, Lipton, Rosen & Katz) and David S. Brown of Goldman, Sachs & Company. As we now know, that was only the tip of the iceberg. With Levine's continued cooperation and now the cooperation of Ivan Boesky, we have reason to believe that we can expect a sequel -- "Fraud on the Wall Street Express Part II."

Oddly enough, when the case first broke, earlier this year, the staff was approached by a television producer who proposed the concept of a weekly television series glamorizing the SEC's so called crack down on securities fraud. The proposed television show, that is affectionately referred to by the staff as "Wall Street Blues" would depict the SEC's enforcement/investigative team in a Hill Street Blues type action format.

Naturally the staff got carried away with the prospect of stardom. Before we knew it, the self-delegated staff member in charge of casting circulated a list of potential actors and actresses to play the various roles. Who should play me? One list suggested Jack Nicholson, another suggested Bob Newhart.

Seriously though, the case that unveiled the insider trading activities of Dennis Levine, and his many

accomplices began with a lucky tip to the enforcement staff. Whether it comes to the staff via a disgruntled informer or market surveillance is beside the point. The effect of such widely publicized cases as the Levine case and the so-called "yuppie five" case which involved two securities analysts, two arbitrageurs and one lawyer, is to send a clear message that insider trading will not be tolerated -- not by the government and not by professionals on the street. The very real threat of criminal sanctions for insider trading is perhaps the best deterrent we have.

W. Paul Thayer

On January 5, 1984, the Commission filed a complaint seeking an injunction against another notable party -- the Former Deputy Secretary of the United States Department of Defense -- Paul Thayer. The SEC and the Justice Department, in separate investigations, found that Thayer had disclosed inside information to his friends while he served as chief executive officer of LTV Corporation. In total, the group netted $1.9 million from illegal tips concerning certain corporate developments of LTV and other corporations that it received from Thayer. While Thayer did not actually receive any financial gain from the trading, he did receive a benefit to his reputation when he communicated the information to his friends.

The Paul Thayer story is especially scandalous in that he tipped his inside information to a circle of eight friends on the fast track. Much to the surprise of Thayer's wife, the circle included Thayer's young mistress, as well as the flamboyant Dallas stockbroker Billy Bob Harris.

Before the dust settled there were reports of wild parties, fast airplanes and fast bikes, vacations in the Rockies with the mistress riding on the back of Thayer's motorcycle and more.

On January 12, 1984 Paul Thayer resigned from his post at the Department of Defense. In March of 1985, both Thayer and Billy Bob Harris pleaded guilty to an obstruction of justice charge that they had lied during the Commission's investigation. On May 8, 1985, Thayer was sentenced to serve four years for his obstruction of justice. In addition, he was personally ordered to disgorge $555,000 for his insider trading activities. Having served approximately one third of the sentence behind bars, he is presently spending nights at a halfway house in Dallas where he will remain until December of this year.

VI. VIEWS ON INSIDER TRADING

Opponents of insider trading maintain that insider trading serves to destroy investor confidence in the stock market; particularly that of small investors. This, it is argued, causes investors to move away from securities and ultimately decreases market liquidity.

Proponents of insider trading, such as Henry G. Manne, Dean of the George Mason University Law School, on the other hand, espouse the view that insider trading should be allowed because it is socially beneficial. In particular, Manne contends that insider trading improves market efficiency by moving stock prices in the proper direction sooner than it would otherwise have occurred. Furthermore, Manne argues that insider trading is an efficient way to compensate innovative entrepreneurs. To use Dean Manne's language, he believes that "insider trading is the best, if not the only, method of adequately compensating corporate innovators." 5/

Regardless of the position you take, no hard evidence exists to support either theory. In order to make a proper analysis, questions such as the following must be answered: Would the stock market be more efficient if insider trading were legal? If so, by how much? Does insider trading prevail over other methods of entrepreneurial compensation in countries where it is legal? Can empirical evidence be produced to suggest that investor confidence and/or market liquidity is inversely related to insider trading?

The Office of the Chief Economist at the SEC has not, as yet, produced studies to answer these questions. They are, however, examining some aspects of the insider trading question. Presently, the Chief Economist is conducting a study involving price run-ups that occur just prior to the announcement of a tender offer to determine how much of the run-up can be attributed to factors other than insider trading. The study uses 172 run-ups that took place on the New York and the American Stock Exchanges between 1981 and 1985.

The fact that the price of a takeover target's stock rises just prior to an announcement of a tender offer is a well documented empirical fact. The price run-up on average amounts to approximately fifty percent of the

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5/ Manne, "In Defense of Insider Trading," 44 Harv. Bus. Rev. 113, at 114 (1966).

premium offered by the bidding company. Preliminary results from the Chief Economist's study suggest that over half of the price run-ups are attributable to public news in the form of a speculative newspaper or magazine article or a significant filing with the Commission prior to the formal announcement of a tender offer.

Specifically, the filing of a 13D with the Commission, which requires purchasers of five percent or more of a corporation's common stock to disclose their intent -- that is whether they intend to take control of the corporation or have purchased the stock merely for passive investment purposes -- are likely to cause a price run-up on the stock. When a Form 13D is filed by a well known corporate raider such as a T. Boone Pickens or a Carl Icahn, the market reacts.

In such instances the information upon which investors trade is certainly material, but it is typically not nonpublic nor is it obtained either by a traditional insider, a temporary insider or one who otherwise owes a fiduciary duty to a corporation and later breaches that duty by misappropriating the information for his own personal use. 6/ I believe it is important to realize that while Ivan Boesky was provided with material nonpublic information by Dennis Levine, had he conducted the same arbitrage activities by relying on probability and market insight instead of an illegal tip, he would have been acting completely within the boundaries of the law. I emphasize this point because I do not want to walk away leaving you with the impression that every investment banker or arbitrageur on Wall Street is playing with a marked deck. That would be far from the truth. In fact, a surge in volume or a price run-up is very often a market reaction to the dissemination of perfectly legitimate market information.

The fact that a handful of Wall Street investment bankers, arbitrageurs and even a prominent takeover attorney were caught with their hands in the till does not imply that everyone in the business is corrupt. It does exemplify that as watchdogs of Wall Street the Commission is doing its job and that insider traders will be sought after vigorously and either enjoined or, where appropriate,

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6/ A traditional insider is an officer or a director of a corporation. A temporary insider, put simply, is one who typically learns of the material inside information while offering expert corporate advice on a project.

referred to the Justice Department for criminal prosecution.

Those who subscribe to the Henry Manne school of insider trading would argue that the price run-up is merely further evidence of how wide spread insider trading is and that the SEC is simply without the resources to combat insider trading.

Personally, I disagree with such pessimism. While we can not yet claim to have stopped insider trading altogether, it is clear that we have made a significant dent in deterring insider trading activities wherever it is found. I await the presentation of further evidence that factors other than insider trading are present to explain price run-ups that occur before the announcement of a tender offer or another significant corporate event.

VII. IF INSIDER TRADING WERE LEGAL

Let us imagine for a moment that insider trading was not a violation of either the federal or state securities laws. I imagine that the ability to trade on material nonpublic information was available for corporations to use as a means of compensating managers and directors.

As I mentioned earlier, commentators, such as Henry Manne, oppose the prohibitions on insider trading. Manne suggests that the decision to allow or prohibit insider trading should be left to the individual corporation. Suppose that we were to accept Manne's argument and allow corporations to decide for themselves whether to permit insiders to trade on nonpublic information. It seems to me that if insider trading were legalized, we would probably end up about where we are at present. The corporate entity itself would desire to ensure its own good reputation. I think that most corporations would adopt a charter and bylaw provision prohibiting insider trading.

Certainly trades made by its employees based on corporate inside information would present a conflict of interest between the corporation's stockholders and the employees own self interest. If the corporation allowed its employees to profit from their special knowledge while at the same time allowing shareholders to continue trading, the shareholders would be at a very definite disadvantage. The question remains -- would this be an effective deterrent?

Without regulatory laws do you suppose the securities industry would enforce or monitor insider trading activities? Would companies that prohibit insider trading exercise aggressive monitoring to prevent it? I think not! Corporations simply do not have the available access to market surveillance that the government and the exchanges maintain. They would be unable to determine, with any degree of certainty, when one of their employees traded on inside information. You simply cannot rely on an employee's sense of honesty to come forward and admit that he has violated company policy.

Moreover, corporations that find employees who have violated company policy have a tendency to fire the violator without suing him. I am reminded of a story that I read in the Wall Street Journal about two months ago. The story concerned a man who had held accounting jobs at numerous companies and embezzled funds from all of them. When the embezzlement was discovered, each company fired the violator. None sued him, but some gave him good recommendations for a job at another company. This was the least costly way of dealing with the problem for each individual company, but not the least costly solution for the business community as a whole.

My point is that corporations faced with the difficult problem of monitoring and enforcing insider trading prohibitions would soon ask for help through the police power of government to enforce their rules. This is why I think that an SEC with rules against insider trading would eventually evolve and we would have about the same regulatory system that we have today.

A recent Wall Street Journal editorial tells the story of a Mr. Geoffrey Collier, a 35 year-old "hot-shot" merchant banker from Morgan Grenfell in London. Insider trading laws have only recently taken form in London and it should be noted that they played no part in this scenario. Morgan Grenfell maintained its own internal rule that required its employees to trade only through its own brokerage departments. In complete disregard of the company rule Mr. Collier allegedly bought shares of a target company, known to him through his affiliation with Morgan Grenfell, and purchased the shares through another brokerage house. When discovered, Mr. Collier resigned. The Wall Street Journal concludes that "federal securities laws aren't needed to discipline thieves of merger information." Here is a situation with the strongest of incentives for the company -- an investment bank -- to police its employees' use of material information. Yet what was the solution? The employee resigned. I will bet that Morgan Grenfell does not sue Mr. Collier for damages.

I would like to end with a quote from the American Bar Association's Report of the Task Force on the Regulation of Insider Trading. The report states:

> In our society, we traditionally abhor those who refuse to play by the rules, that is, the cheaters and the sneaks. The spitball pitcher or card shark with an ace up his sleeve, may win the game but not our respect. And if we know such a person is in the game, chances are we won't play. 7/

Until we are convinced that a better system of deterrence for the abuses of trust to individual clients and to the shareholders of corporations exists, the Commission will maintain a strong presence to police the securities markets and to carry out its mandate to protect investors and to maintain the fairness and integrity of the securities markets.

Thank you.

7/ American Bar Association, Report of the Task Force on the Regulation of Insider Trading, Committee on Federal Regulation of Securities, reprinted in 41 Bus. Law. 223, at 227 (1985).