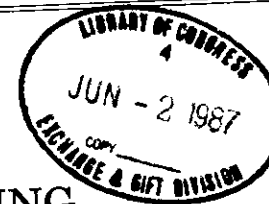


SEC AND INSIDER TRADING



HEARING
BEFORE THE
SUBCOMMITTEE ON
OVERSIGHT AND INVESTIGATIONS
OF THE
COMMITTEE ON
ENERGY AND COMMERCE
HOUSE OF REPRESENTATIVES
NINETY-NINTH CONGRESS
SECOND SESSION

DECEMBER 11, 1986

Serial No. 99-179

Printed for the use of the Committee on Energy and Commerce



U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1987

71-407

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

26. PATTY, DOUGLAS E., et al. (5 defendants) (SEC v.), Civil Action No. 86-1498 (C.D. Cal., filed Mar. 10, 1986) [Lit. Rel. No. 11022].
27. MOORE, MORGAN F. (SEC v.), Civil Action No. N-86-88-PCD (D. Conn., filed Mar. 3, 1986) [Lit. Rel. No. 11013].
28. BORER, JOHN J., JR. (SEC v.), Civil Action No. 86-1204 (C.D. Cal., filed Feb. 25, 1986) [Lit. Rel. No. 11009].
29. OFFER, CHARLES S. (SEC v.), Civil Action No. 86-0584 (D.D.C., filed Feb. 24, 1986) [Lit. Rel. No. 11008].
30. CREMONESE, JOSEPH G. (SEC v.), Civil Action No. 86-0553 (S.D.N.Y., filed Jan. 17, 1986) [Lit. Rel. No. 10984].
31. HENGEN, RONALD, et al. (5 defendants) (SEC v.), Civil Action No. 86-0306 (S.D.N.Y., filed Jan. 9, 1986) [Lit. Rel. Nos. 10981, 11113 and 11153].
32. APRAHAMIAN, RONALD V., et al. (4 defendants) (SEC v.), Civil Action No. 85-3996 (D.D.C., filed Dec. 19, 1985) [Lit. Rel. No. 10961].
33. MOOREHEAD, DWIGHT C. (SEC v.), Civil Action No. 85-2555 (D. Colo., filed Dec. 5, 1985) [Lit. Rel. No. 10948].
34. BAILEY, EMERA, et al. (7 defendants) (SEC v.), Civil Action No. 85-3145 (D.D.C., filed Oct. 2, 1985) [Lit. Rel. No. 10896].

Mr. DINGELL. The Chair recognizes first the gentleman from Oregon, Mr. Wyden.

Mr. SHAD. Mr. Chairman, may I ask—Mr. Lynch and Mr. Ketchum also have very brief opening comments.

Mr. DINGELL. Gentlemen, I apologize to each of you and to you, Mr. Shad.

Mr. Lynch or Mr. Ketchum, we will recognize you in the order of your choice.

TESTIMONY OF GARY LYNCH

Mr. LYNCH. I will go first.

I want to briefly describe the Dennis-Levine and Ivan Boesky cases, two of the most significant insider trading cases in the Commission's history.

On May 12, 1986, the Commission brought an insider trading case against Dennis Levine, an investment banker. At the time, it was the Commission's largest insider trading case. We allege that Levine made approximately \$12.6 million over a six-year period going back to 1980 by trading in the securities of at least 54 issuers while in possession of material non-public information about actual or proposed tender offers, mergers, leveraged buyouts, and other business combinations. The Commission alleged that Levine learned of these impending transactions, in many instances, through his employment as an investment banker.

On June 5, 1986, less than a month after we commenced the proceedings, Levine consented to the entry of a final judgment of permanent injunction against future violations of the Federal securities laws and agreed to disgorge \$11.6 million in illicit profits obtained as a result of his insider trading through a Bahamas bank.

Levine also agreed to the issuance of an administrative order permanently barring him from the securities industry. On the same day, Levine pleaded guilty to four felony counts: one count of securities fraud, two counts of income tax evasion, and one count of perjury, all arising from his participation in the insider trading scheme. Levine right now is currently awaiting sentencing on those charges, and is continuing to cooperate, by the way, in our continuing investigations.

The Commission's continuing investigation subsequently led to a series of cases against four individuals who participated with Levine in his insider trading scheme. These individuals worked at other investment banking firms and a law firm and allegedly participated in the scheme by misappropriating information from their firms and passing that information to Levine.

One of these individuals, a gentleman by the name of Robert Wilkis, who is also an investment banker, also allegedly purchased securities on material non-public information provided to him by Levine.

Each of the four individuals consented to a permanent injunction against future violations of the securities laws, and the three individuals associated with investment banking firms also agreed to be permanently barred from the securities industry.

They also agreed to pay a total of \$3.7 million in disgorgement and \$875,000 in civil penalties. Three of them have also pleaded guilty to criminal charges arising from the insider trading scheme.

On November 14, 1986, our investigation coming out of Levine resulted in the institution of the largest insider trading case in the Commission's history against Ivan F. Boesky, an arbitrageur.

The Commission alleged that Boesky caused certain affiliated entities to trade in securities while in possession of material non-public information provided to him by Levine.

As part of the settlement of that action, Boesky consented to the entry of a permanent injunction and agreed to pay out of his own individual funds the equivalent of \$100,000,000 in cash and assets.

\$50,000,000 of that amount represents disgorgement of profits obtained by the entities affiliated with Boesky as a result of the illegal insider trading, and \$50,000,000 represents a civil penalty paid by Boesky to the U.S. Treasury under the Insider Trading Sanctions Act.

In our complaint against Boesky, we specifically allege that from February 1985 to February 1986, Levine provided Boesky with information concerning a number of tender offers, mergers or other business combinations or extraordinary corporate transactions.

Levine, as I said earlier, allegedly obtained the information by virtue of his employment as an investment banker and from some of the other people that I just mentioned.

The Commission also alleged that Boesky agreed to pay Levine five percent of the profits received in those instances where the inside information provided by Levine was the initial basis for Boesky's purchase of the securities, and a lesser percentage of the profits where the information provided by Levine was material to Boesky's decision to hold or increase his holdings of a specific security.

Boesky agreed to pay Levine approximately \$2.4 million pursuant to this arrangement, but Levine was sued and arrested on May 12, 1986, in connection with our insider trading case and the U.S. Attorney's investigation before he was paid any money by Boesky.

As part of the settlement of the matter, Boesky also consented to the entry of an administrative order barring him from association with any broker or dealer.

The order entered by the Commission provides that the bar will be stayed until April 1, 1988, or such earlier time as the Commission determines, to permit an orderly transfer of control of Boesky's present businesses.

A special compliance agent is monitoring Boesky's compliance with the Federal securities laws during the stay and will report to the Commission's staff. The staff of the New York Stock Exchange, at the request of the Commission, is also monitoring Boesky's trading.

An important element of the Boesky settlement agreement is Boesky's agreement to cooperate with the Commission and to truthfully disclose all information pertaining to his activities and the activities of others about which the Commission might inquire.

TESTIMONY OF RICHARD KETCHUM

Mr. KETCHUM. Mr. Chairman, members of the subcommittee, my division, the Division of Market Regulation at the SEC, monitors the regulation of the securities markets, primarily by overseeing the regulatory programs of the exchanges of the NASD who refer self-regulatory investigations, or SRO's.

As part of this oversight function, the division staff inspects the operations of the SRO's automated market surveillance and audit trail systems. These systems allow the SRO's to redirect their surveillance staffs from routine, time-consuming, manual reviews of volume news trading records to better focus investigations, suspicious trading activities identified by automated surveillance procedures.

The division's inspections have confirmed that the SRO's have made substantial progress in developing audit trails in the surveillance systems they make possible.

All major equities and options markets now have audit trail systems in place and are concentrating on improving the accuracy of the data produced to facilitate its incorporation into new or enhanced automated surveillance systems to detect a wide range of trading violations including insider trading.

In addition, the SRO's have joined together to form the inner-market surveillance group which facilitates the fast and efficient sharing of surveillance information among stock and options exchanges.

While the Commission has noticed substantial progress in all these areas, we are continuing to work with the SRO's in improving the performance of their surveillance and investigatory programs.

Continued improvements in these SRO programs are necessary to keep pace with changing market conditions.

Over the last few years, rising trading volume reflecting increased activities of institutional investors, trading related to stock index options and futures, and the increased internationalization of the world securities markets has made automated market surveillance a necessity.

The surge in market activity has coincided with the recent increase in large-scale corporate mergers acquisitions which has provided expanded opportunities for insider trading violations.

Therefore, the Commission also has been working with the SRO's in improving their detection and investigation of possible insider trading.

Because insider trading investigations often involve parties outside the jurisdiction of the SRO's, timely referrals to the Commission's enforcement staff are essential for successful prosecution of violations.

Therefore, the Commission has closely monitored the Commission's developments of programs to expedite this investigation referral process.

For example, the New York Stock Exchange has implemented and is expanding its automated search and match system which consists of a computer data base identifying a wide range of corporate insiders including officers, directors, investment bankers, at-

torneys and accountants for comparison with accounts appearing in—trading records during suspicious periods.

Another ongoing project to expedite investigations at the SROs is the joint effort of the SEC, New York Stock Exchange, American Stock Exchange, NASD and Securities Industries Association to establish a comprehensive automated system for the dissemination and analysis of individuals firms' records of the trading activities of their and their customers' accounts, information currently compiled by too many consumers manually responding to questionnaires, so-called blue sheets.

Once implemented with at least the major retail broker dealers, this electronic blue sheet project promises to accelerate the process of identifying accounts for further investigations.

In our discussion of insider trading, however, we must keep in mind that improvements in the SROs automatic surveillance and investigatory programs only provide the raw information on trading activities which warrant further investigation by enforcement staff.

The mere identification of large purchases before a news announcement, for example, is not sufficient in and of itself to prove that this trading occurred while in possession of material non-public information for which the person had a duty to disclose or abstain from trading.

Surveillance systems are only tools, albeit useful and essential tools to assist in our policing of the Nation's securities markets. Thank you.

Mr. SHAD. Mr. Chairman, to put in perspective some of our discussions this morning here, it all brings to mind the comments of a friend of mine who used to be the Special Agent in charge of the New York office of the FBI years ago.

He told me that the FBI has the largest and most highly trained and skillful staff of investigators and the best crime detection laboratories in the world, but when it comes to solving a crime, there is no substitute for an informant who can tell you who did it, and where he is, and so that is part of what you have been hearing today.

We have, I think, in the securities area, the best surveillance and detection techniques known to the world today, but sure, a lead such as we obtained through Merrill Lynch's offices, as to Mr. Levine, was fundamental. It was from an informant.

It was anonymously, but it gave us the facts that then permitted the Commission to expose and prosecute Mr. Levine and get him to be a cooperating witness to identify others, Mr. Boesky and others.

Mr. DINGELL. Mr. Shad, the Chair wants to agree with you, and in all sincerity the Chair must say truthfully on these two matters, you and the Commission have done a superb job. Your staff and the staffs of Mr. Lynch and Mr. Ketchum have done a superb job, and you deserve the commendations of the committee today.

Our concern today is less that you are doing a good job than it is that we are concerned that you have the resources, and that your tools are the most current available to you.

For example, we would ask you to tell us, a, what your enforcement budget is, and b, what will be the level of enforcement that you will need to properly deal with not only the insider trading

questions, but the other related questions of takeovers and mergers, and questions that are associated therewith, because it appears very much to the Chair that these are related matters and may perhaps be simply different portions of the same apple.

Mr. SHAD. I would be pleased to provide you supplementally with the hard facts, but let me just characterize it. Over a third of the SEC's resources are devoted to enforcement, and in a sense, all of our resources are devoted to enforcement, because what we are doing is insisting on full disclosure and reviewing all these filings, and we will be able to do it better with automated systems that we are proposing to you as well later this year, or early next year, and we are requesting a substantial increase.

We are presently in the process of defining those parameters for budgetary purposes.

Mr. DINGELL. The Chair will request that you submit to us both the response to the question of the Chair in an appropriate fashion, and I want to know not only about your professional employees in your several offices, but also your support people and your paralegals.

I am informed that you have a number of very fine hunt-and-peck typists among your professionals who lack adequate numbers of support people, and that seems to me to be a rather bad application of your resources in having skilled security analysts and attorneys engaging in pecking out documents in response to their duties at your office.

I also would like to have you submit to us your request for budget in your several departments and so forth for next year, without having cleared that with the Office of Management and Budget. We find that when we get stuff from OMB, it tends to be somewhat strained, and at least modestly distorted.

Would you do that for us, please?

Mr. SHAD. I don't know if there is any legal constraints on what we can do.

Mr. DINGELL. Mr. Shad, there are no legal constraints on your providing this to the committee.

Mr. SHAD. I defer to counsel.

Mr. DINGELL. I assure you we have gone many rounds with the OMB on this, and they always lose.

Mr. SHAD. I may do that with a perfect sense of comfort and ease.

Mr. DINGELL. Without objection, the record will remain open for these matters.

[Testimony resumes on p. 103.]

[The following information was received:]

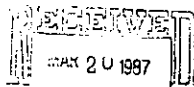


UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

March 20, 1987

Hand delivered

The Honorable John D. Dingell
Chairman
Subcommittee on Oversight and Investigations
Committee on Energy and Commerce
R-331 Rayburn House Office Building
Washington, D.C. 20515



Dear Chairman Dingell:

Enclosed for your information are two charts compiled by the Commission's staff which indicate staff years to be devoted to various program areas within the Commission during the 1986 to 1988 fiscal years which you requested at the Subcommittee's hearing of December 11, 1986. The charts also include, as you requested, the staff years for each program contained in our original request to OMB for fiscal year 1988.

Also, enclosed are a letter dated today to Congressman Luken and an accompanying staff memorandum of March 17, 1987. That memorandum responds to a request made by Mr. Luken during the December 11 hearing for information as to actions taken by the Commission with respect to surveillance reports relating to trading in securities that the Commission ultimately alleged were the subject of insider trading by Dennis Levine and others. Mr. Luken had also made a request for the same information at a June 18, 1986 hearing of the Subcommittee on Telecommunications, Consumer Protection and Finance.

Sincerely yours,

John Shad
John Shad

Enclosures

SECURITIES AND EXCHANGE COMMISSION
PROGRAM STAFFING FY-1986 THRU FY-1988
(IN STAFF YEARS)

PROGRAM	FY-1986 ACTUAL	FY-1987 ESTIMATE	FY- 1988	
			REQUESTED OF OMB	REQUEST TO CONGRESS
FULL DISCLOSURE	432	452	524	495
(Edgar - non-add)	(24)	(31)	(61)	(38)
PREVENTION AND SUPPRESSION OF FRAUD	594	629	749	684
REGULATION AND SUPERVISION OF SECURITIES MARKETS	239	242	258	252
INVESTMENT MANAGEMENT REGULATION	206	208	231	221
LEGAL SERVICES	113	113	132	116
ECONOMIC AND STATISTICAL RESEARCH	41	40	45	41
PROGRAM DIRECTION	246	246	271	257
TOTAL PERMANENT POSITION STAFFING	1,871	1,930	2,210	2,066
TEMPORARY POSITION STAFFING	27	20	20	20
TOTAL AGENCY STAFFING	1,898	1,950	2,230	2,086
PERMANENT POSITION EQUIVALENT	2,086	2,086	2,460	2,267
FUNDING	\$106,323	\$114,500 *	\$154,681	\$145,036

* Includes a proposed supplemental of \$4,000,000 for the January, 1987 pay increase and the new Federal Employees' Retirement System (FERS).

SECURITIES AND EXCHANGE COMMISSION
 PREVENTION AND SUPPRESSION OF FRAUD
 RESOURCES FY-1986 THRU FY-1988
 (PERMANENT POSITION STAFF YEARS)

ORGANIZATION	FY- 1988			
	FY-1986 ACTUAL	FY-1987 ESTIMATE	REQUESTED OF OMB	REQUEST TO CONGRESS
Division of Enforcement	184	213	254	230
Office of Applications and Reports Services	10	10	12	11
Office of Consumer Affairs and Information Services	11	11	15	13
Regional Offices	389	395	468	430
TOTAL	594	629	749	684

MEMORANDUM OF THE
 CONCERNING
 AND MARKET

In connection with the
 market surveillance, the
 Investigations of the
 requested information
 to the Commission by
 the National Association
 Specifically, the
 the Commission took
 to trading in securities
 were the subject of
 in SEC v. Dennis
 1986). We agreed
 that it would not

Background

The Commission
 million between
 at least 50
 information
 leveraged
 effected