Testimony of

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U.S. Securities and Exchange Commission
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Chairman Specter, Ranking Member Leahy, and Members of the Committee:

Thank you for inviting me to testify today about insider trading. Our laws against insider trading play an essential role in protecting our securities markets and in promoting investor confidence in the integrity of those markets. Rigorous enforcement of our current statutory and regulatory prohibitions on insider trading is an important part of the Commission's mission. I appreciate the opportunity to explain the Commission's efforts to deal with insider trading, and to answer any questions that the Committee may have.

I am especially pleased to testify together with Associate Deputy Attorney General Ronald Tenpas of the United States Department of Justice. The Commission, as you know, is a civil enforcement agency and we use civil sanctions to address insider trading. However, insider trading may also violate federal criminal law. The respective histories of the SEC and the Department of Justice demonstrate our commitment to prosecute insider trading, civilly and criminally. Our histories also demonstrate our collective commitment to working with each other.

Over the years, investigating and prosecuting insider trading violations has remained a steady component of our enforcement mission. Since 2001, this agency has brought 300 actions against over 600 individuals and entities for insider trading violations, and frozen millions of dollars in illicit trading proceeds.[1] In the aggregate, over the same period, insider trading cases have consistently made up about 7-12% of our filed caseload.[2]

At the same time, our Enforcement program is, by necessity, dynamic--we constantly strive to respond to market, as well as legal and technological, developments. Our priorities and resource allocations must change to meet trends in the market and developing forms of fraud. Even within the relatively narrow arena of insider trading, we must shift our resources to those areas where the greatest threats lie. For example, in the mid-eighties, most of our insider trading cases arose out of the merger and acquisition boom. In the recession of the late eighties and early nineties, the Commission brought more "bad news" selling cases - insiders dumping shares before adverse corporate developments were disclosed. More recently, globalization, the technology boom, a renewal of merger activity, and our concern about insider trading by hedge funds have shifted our enforcement focus yet again.

1 A list of the insider trading cases filed by the Commission in the past five years (FY2001 through the present, as of September 22, 2006) is attached hereto as Exhibit A.

2 Each year, the Division of Enforcement brings a mix of cases in core program areas, including insider trading, as well as financial fraud, offering fraud, market manipulation and actions involving the conduct of registered investment advisers and broker-dealers. Our record shows

that - despite shifting areas of concern that demand enforcement attention from year to year - insider trading has consistently been an important part of the program. In fiscal 2006 to date, the Division has initiated 44 actions against 77 individuals or entities that primarily involve insider trading allegations. In fiscal 2005, the Division initiated 49 such actions against 93 individuals or entities. In fiscal 2004, the Division initiated 42 such actions against 95 individuals or entities. In fiscal 2003, the Division initiated 50 such actions against 104 individuals or entities. In fiscal 2002, the Division initiated 59 such actions against 144 individuals or entities. In fiscal 2001, the Division initiated 57 such actions against 115 individuals or entities.

3 SEC v. Nelson J. Obus, et al., Lit. Release No. 19667, Civ. Action No. 06-3150 (GBD) (S.D.N.Y. Apr. 25, 2006).

4 SEC v. Deephaven Capital Management, LLC and Bruce Lieberman, Lit. Release No. 19683, Civ. Action No. 01:06CV00805 (D.D.C. May 2, 2006); SEC v. Langley Partners, L.P., et al., Lit. Release No. 19607, Civ. Action No. 1:06CV00467 (JDB) (D.D.C. Mar. 14, 2006); SEC v. Hilary Shane, Lit. Release No. 19227, Civ. Action No. 05-civ-4772 (S.D.N.Y. May 18, 2005); see also SEC v. Guillaume Pollet, Lit. Release No. 19199, Civ. Action No. 05-CV-1937 (SLT/RLM) (E.D.N.Y. Apr. 21, 2005) (charging former managing director of investment bank, SG Cowen & Co., with insider trading ahead of stock offering).

5 SEC v. Sonja Anticevic, et al., Lit. Release No. 19775, Civ. Action No. 05 Civ. 6991 (KMW) (S.D.N.Y., fourth amended complaint filed July 26, 2006) ("Reebok").

6 See supra n.3.
7 Deephaven, supra n. 3; In the Matter of Bruce Lieberman, Investment Advisers Act of 1940 Release No. 2517, Admin. Proc. File No. 3-12302 (May 28, 2006) (Lieberman subsequently barred from association with any investment adviser, with a right to reapply after three years).

8 Langley Partners, supra n. 3

9 Obus, supra n. 2.

10 SEC v. Michael K.C. Tom, et al., Lit. Release No. 19404, Civ. Action No. 05-CV-11966-NMG (D.Mass. Sept. 29, 2005). On June 8, three defendants who traded settled for fraud injunctions, disgorgement and civil money penalties. Defendant Michael Tom agreed to be barred from association with any investment adviser in March 2006, In the Matter of Michael K.C. Tom, Investment Advisers Act of 1940 Release No. 2494, Admin. Proc. File No. 3-12233 (Mar. 8, 2006).

11 SEC v. A. B. Watley Group, Inc., et al., Lit. Release No. 19335, Civ. Action No. CV-06-1274 (ILG) (E.D.N.Y. Mar. 21, 2006).

12 SEC v. John J. Amore, et al., Lit. Release No. 19335, Civ. Action No. CV-053885 (Glasser) (E.D.N.Y. Aug. 15, 2005).

13 In the Matter of Morgan Stanley & Co., Inc. and Morgan Stanley DW Inc., Securities

Exchange Act of 1934 Release No. 54047, Admin. Proc. File No. 3-12342 (June 27, 2006).

14 See, e.g, In The Matter of Van D. Greenfield and Blue River Capital LLC, Securities Exchange Act of 1934 Release No. 52744, Admin Proc. File No. 3-12098 (Nov. 7, 2005) (Blue River violated rules requiring policies governing handling of non-public information when it received such information about companies on whose bankruptcy and bondholder's committees Blue River principal Greenfield sat); In re Goldman, Sachs & Co., Securities Exchange Act of 1934 Release No. 48436, Admin. Proc. File No. 3-11240 (Sept. 4, 2003) (Goldman, Sachs failed to have policies and procedures in place to prevent improper handling of embargoed information regarding Treasury Department's decision to abolish 30-year bond); In re Gintel Asset Management, Inc., et al., Investment Advisers Act of 1940 Release No. 2079, Admin. Proc. File No. 3-10930 (Nov. 8, 2002) (firm violated provisions of the Investment Advisers Act of 1940 by failing to have policies in effect to prevent adviser from buying shares for client accounts before it releases favorable information regarding issuer); In re DePrince, Race & Zollo, Inc., et al., Investment Advisers Act Release No. 2035, Admin. Proc.File No. 3-10798(June 12, 2002) (firm violated Advisers Act by failing to have procedures addressing possible conflicts of interest arising from transactions in stock of issuer on whose board firm principal sat); In re Guy P. Wyser-Pratte et al., Securities Exchange Act of 1934 Release No. 44283, Admin. Proc. File No. 3-10479 (May 9, 2001) (firm violated Advisers Act and Exchange Act policy requirements by failing to have in place policies to prevent misuse of inside information gleaned by firm principal in course of advancing shareholder proposals); In re Gabelli & Co., Inc. and Gamco Investors, Inc., Securities Exchange Act of 1934 Release No. 35057, Admin. Proc. File No. 3-8564 (Dec. 8, 1994) (broker-dealer and affiliated adviser violate Exchange Act and Advisers Act by failing to implement policies to prevent misuse of nonpublic information despite role of firms' principal as CEO of issuer whose securities firms'accounts could have traded).

15 See United States Securities and Exchange Commission, Final Report to the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Energy and Commerce Regarding the Market Oversight and Surveillance System at 2-3, 14-15 (Jan. 15, 1985).

16 SEC v. Alexander J. Yaroshinsky, Lit. Release No. 19625, Civ. Action No. 06CV2401 (S.D.N.Y. Mar. 28, 2006).

17 See SEC v. William A. Day, Lit. Release No. 19553, Civ. Action No. 06-CV-10202-RWZ (D.Mass. Feb. 2, 2006) (coded message board posting alluding to nonpublic information); SEC v. John Freeman, et al., Lit. Release No. 16469, Civ. Action No. 00 Civ. 1963 (VM) (S.D.N.Y. Mar. 14, 2000) (nonpublic information on 16 transactions passed through internet chat rooms).

18 This list includes cases that we have classified as insider trading cases, although they may involve multiple allegations. This list does not include additional cases that may involve insider trading allegations, but that we have determined are more appropriately given another primary classification (for example, Broker-Dealer).
19 FY 2006 information is not finalized and is subject to change.

Insider trading has remained an enforcement priority. As I mentioned a moment ago, the Commission has charged over 600 hundred insiders and tippees in recent years. Our investigative staff has pursued individuals who engage in insider trading in our markets all across the globe--from a corporate lawyer's office in New York City to a small town in Eastern Europe. By seeking immediate emergency relief, our staff has frozen and preserved millions of dollars in insider trading proceeds, often within only days of the illegal trading that created them.

We have had some remarkable successes. A few months ago, we brought an action against three hedge funds and two individuals for allegedly trading ahead of a merger announcement.3 Over the past 18 months, we brought insider trading charges against another three hedge funds and three hedge fund managers for trading ahead of the public announcement of dozens of stock offerings by public companies.4 And over the past year, we have charged a total of 17 defendants in the Reebok case--who we allege participated in an international insider trading ring that netted at least $6.8 million in illicit gains by, among other things, stealing information from Merrill Lynch, BusinessWeek and a sitting New Jersey grand jury.5

Perhaps more than any other recent insider trading case we've filed, the Reebok case demonstrates the ingenuity and perseverance of our staff, and the lengths to which we will go in tracing a fraud. In Reebok, the Commission alleges that two individuals--one current and one former employee of Goldman, Sachs--engaged in a complex and wide-ranging scheme in which they illegally obtained inside information from the various sources I mentioned a moment ago (among others), and then forwarded the tips to multiple co-conspirators who traded on them throughout the United States and Europe.

We first focused on the Reebok trading in August 2005, when a retired Croatian seamstress made a series of sophisticated options trades that essentially amounted to a bet that the stock of Reebok International, Ltd. would rise quickly. In fact, just a day after her last trade, Reebok announced it had agreed to be acquired by Adidas-Salomon, AG, netting the seamstress a profit of over $2 million. Because of this extraordinary and fortuitous profit by an apparently inexperienced options trader, we filed an emergency action freezing the securities account in which these trades were made. Our New York office continued to investigate the matter, leading to additional actions alleging that the seamstress was in fact trading on instructions from her nephew, former Goldman, Sachs broker David Pajcin, and that Pajcin's co-principal in the scheme was Goldman, Sachs research analyst Eugene Plotkin.

Based on information discovered to date, the Commission's complaint charges Plotkin and Pajcin with orchestrating a scheme that involved a large group of unlikely co-conspirators who either illegally tipped inside information to others, or traded on the tips, and then shared in the trading profits. Chief among them was a mergers and acquisitions analyst at Merrill Lynch, who is alleged to have provided nonpublic information regarding pending corporate transactions. Two other individuals allegedly obtained jobs at a Wisconsin printing plant in order to steal information on Business Week articles before the magazine was circulated. Pajcin and Plotkin also allegedly obtained information from a letter carrier who was sitting on a federal grand jury in New Jersey regarding the grand jury's probe of a public company. Finally, to capitalize on the stolen information, Pajcin and Plotkin allegedly tipped a broad network of cooperating traders throughout the United States and Europe--including Pajcin's aunt, the retired Croatian seamstress, and a friend employed as an exotic dancer in New York. To date, the staff has charged 17 individuals in the scheme, which ultimately involved insider trading in the securities of not only Reebok, but a total of 26 different issuers. The staff's investigation--here and abroad--

is continuing.
As I said before, even within a discussion of unlawful insider trading - a very specific type of violation - there are important areas of concentration we can consider. One such area involves insider trading by hedge funds--an area of significant concern to the Commission, the Enforcement Division, and I know, to this Committee. In fiscal year 2006 to date, the Commission has brought 44 insider trading cases. Of these, five involved hedge funds or their advisers.
The Commission has brought at least three cases in the past two years involving insider trading by hedge funds and their managers in advance of PIPEs offerings.6 "PIPE" is an acronym for "private investment in public equities," a form of stock offering often used by distressed companies to raise capital when they are unable to obtain financing by other means. Hedge funds frequently invest in such offerings, but typically agree not to trade the stock before the PIPE offering is publicly announced. In the most recent of the PIPEs cases, the Commission charged that hedge fund adviser Deephaven Capital Management, LLC, a registered investment adviser, violated its agreements not to trade by selling stock short before PIPEs offerings were announced, and then covering with shares obtained in the offerings. In all, the Commission charged Deephaven and its former portfolio manager with insider trading prior to the public announcement of no fewer than 19 PIPEs offerings. In settling the case, the Commission obtained permanent anti-fraud injunctions and a total of $5.8 million in disgorgement, penalties, and interest from the adviser and portfolio manager, as well as an industry bar against the portfolio manager.7 In a similar case, Langley Partners, three hedge funds and their portfolio manager paid nearly $16 million to settle an action involving insider trading in advance of the public announcement of 7 PIPE transactions.8

In addition to the PIPEs cases, the Commission has brought two cases against hedge funds involving insider trading ahead of mergers and acquisitions. In a settled insider trading action against a hedge fund I mentioned earlier today, the fund manager allegedly directed the purchase of shares in a merger target after receiving a tip from an insider through an intermediary, realizing illegal profits of over $1.3 million.9 In yet another case brought within the past year, a Massachusetts-based hedge fund manager and his fund were charged with trading on material nonpublic information regarding Citizens Bank's planned takeover of Charter One Financial, making nearly three-quarters of a million dollars in illegal profits.10 The latter case also illustrates the importance of criminal sanctions, as the fund manager recently pled guilty to five counts of criminal securities fraud.

The Commission has always viewed as particularly troubling malfeasance by the brokers, investment advisers and other professionals registered with us. Earlier this year, the Commission filed a civil injunctive action against a former Merrill Lynch broker and ten former A.B. Watley day traders and their managers for participating in a scheme that involved allegedly trading ahead of large institutional orders broadcast over Merrill's in-house "squawk boxes."11 The Commission alleged that the Merrill broker arranged to provide the A.B. Watley day traders with an open phone line to the Merrill trading floor throughout the workday, so they could hear the squawk box announcements of major orders and trade ahead of them. The Commission also sued A. B. Watley Group, A.B. Watley's publicly-traded holding company, in connection with this conduct. Earlier, in August 2005, the Commission charged five other individuals as part of this alleged scheme.12

Our concern extends beyond individual violations; indeed, it extends to the entities that shoulder the primary responsibility for supervising the professionals who work for them. A few months ago, we instituted a settled administrative proceeding against Morgan Stanley for its failure to maintain and enforce adequate written policies and procedures to prevent the misuse of material nonpublic information by the firm or persons associated with it.13 There was no evidence that material nonpublic information was misused as a result of that failure. Morgan Stanley agreed to pay a $10 million civil penalty, as well as to engage an independent consultant to conduct a review of its policies, practices and procedures, and to recommend changes to those policies to prevent the future abuse of such nonpublic information. Morgan Stanley is the most recent in a line of cases in which the Commission has consistently made clear that broker-dealers and investment advisers are responsible for designing and enforcing policies to prevent the misuse of insider information.14

Let me step back and make some general observations about our insider trading program, in light of recent questions that have been raised in the press about its efficacy.

We have a lot of ground to cover. Our Enforcement Division's Office of Market Surveillance (OMS) is in daily contact with its counterparts in the various self-regulatory organizations, or SROs. After substantial study in the mid-1980s under the oversight of two Congressional Committees, an intermarket surveillance system was developed under which the SROs perform primary surveillance, as they are the entities closest to the market action.15 The SROs monitor the markets for unusual peaks and valleys in trading, sudden changes in a security's price, or other unusual market activity. OMS maintains an open line of communication with the SROs, through which they continually pass on to us information concerning market events.

The surveillance departments at the SROs, such as the National Association of Securities Dealers (NASD), the New York Stock Exchange (NYSE), and the Options Regulatory Surveillance Authority, use cutting-edge software programs to isolate unusual trading activity that may indicate insider trading. These surveillance programs employ complex algorithms that alert analysts to anomalous trading activity. The SROs can rapidly identify the executing broker-dealer and the account for which a particular transaction was performed and investigate the basis for the trading. These programs are constantly being re-evaluated and updated as new trading mechanisms and strategies are introduced in the markets.

As demonstrated by cases like Reebok, we can and will move swiftly and decisively when conditions warrant. One of the principal tools we employ to prevent wrongdoers from benefiting from insider trading is the asset freeze. In Reebok, over $6 million in allegedly illicit trading proceeds have been frozen. Other recent cases have also used this remedy effectively. In recent action against drug company executive Alexander Yaroshinsky, alleging insider trading before the announcement of negative FDA findings on an experimental drug, the Commission took quick action ensure that Yaroshinky's assets were frozen before they could be dissipated.16

Insider trading leads come from a host of sources, not only market surveillance but also the news media, public tips, and information developed in our own inspections and investigations. Identifying suspicious trading is an essential starting point, but it is only the first step in

compiling a viable case.
It is important to understand how difficult it is to build an insider trading case. They are unquestionably among the most difficult cases we are called upon to prove, and despite careful and time-consuming investigations, we may not be able to establish all of the facts necessary to support an insider trading charge. The challenge is not to establish facts that show suspicious trading--the surveillance records alone are often sufficient to establish that much. The real challenge is to establish that a particular individual was in possession of material non-public information and in fact traded on it in breach of a duty, and to establish those facts based on admissible evidence that can withstand challenge at trial.
Piecing together an insider trading case can be a complex and painstaking process. It is rare to find a "smoking gun;" virtually all insider trading cases hinge on circumstantial evidence. It is quite common for insider traders to come up with alternative rationales for their trading--rationales that the staff must refute with inferences drawn from the timing of trades, the movement of funds and other facts and circumstances. And because many insider trading cases involve secret communications between two people - the tipper and his tippee - assembling compelling circumstantial evidence is often difficult. In some cases, such as when a corporate insider trades on company information or when an outsider steals nonpublic information, there are no communications at all to use as evidence at trial, but only the facts of the wrongdoer's access and trading. Building an insider trading case based on circumstantial evidence can be frustrating, risky and time-consuming. Because of these challenges, we also have to accept that a number of the insider trading investigations we open may not result in a filed enforcement action--not for any lack of diligence on the part of the staff, but for lack of evidence.
Despite these challenges, our staff has become particularly adept at sifting through all available forms of evidence, including phone records, emails, instant messages, and the electronic footprints of internet protocol data.17 Our staff culls through trading records, interviews and takes the testimony of witnesses, and reviews bank and brokerage statements. With these tools and resources, our staff has built solid, credible enforcement actions against hundreds of wrongdoers.
The Commission employs a broad range of remedies to address insider trading: injunctive relief, disgorgement of ill-gotten gains, penalties, industry bars and officer and director bars. And the Department of Justice, through its criminal prosecutions, can send insider traders to prison.
In the Commission's civil cases, the Commission generally seeks injunctive relief, disgorgement and civil financial penalties. Since 1984, the Commission has been authorized by statute to seek penalties in insider trading cases. Under the Insider Trading Sanctions Act of 1984 (ITSA) - and later expanded in the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA) - Congress gave the Commission authority to bring civil actions in federal court seeking money penalties from insider traders of up to three times the illegal profits they made or losses they avoided.

In settling cases, we have typically sought and obtained a "one-time" penalty, or in other words, a penalty that is equal to the amount of illegal profits realized or losses avoided. This approach is particularly common when the Commission settles matters before proceeding to litigation. In some cases, where the conduct is particularly egregious, we have sought more than a one-time penalty. Among other circumstances, we believe additional penalties may be appropriate where the defendant lies to investigators, jeopardizing the integrity of our investigative process; where the defendant has taken extraordinary measures to conceal or disguise the trading activities; or where the defendant is a recidivist with a history of securities or other frauds. In other cases, where the equities dictated, we have agreed to less than a one-time penalty. In each of these instances, we made a determination that the penalty accurately reflected the seriousness of the wrongdoing, served as just punishment for the defendant's actions, and provided significant deterrent value.

We have also sought and obtained non-monetary sanctions. When appropriate, we have barred or suspended brokers, investment advisers and other professionals who have engaged in insider trading from their respective industries. Similarly, we have barred officers or directors who have insider traded from serving in that capacity for a limited time, or sometimes permanently.

We believe these remedies, along with the threat of incarceration by criminal authorities for large-scale or repeat offenders, those who go to great lengths to conceal their illicit activities, or those who lie or otherwise obstruct our investigations, give us an effective arsenal for enforcement and deterrence.

Insider trading undermines the integrity and credibility of our markets. We appreciate the fact that the market is dynamic. We understand the power of technology and we have and will use it to our advantage. We will continue to work hard to protect the world's finest and fairest markets.

I would be glad to answer any questions you might have.