Testimony of

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September 26, 2006

## Insider Trading:
## Another Front in the Battle Against Corporate Fraud

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 efforts to prosecute insider trading. At the outset, let me assure you and the other members of the Committee that 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.

### The Nature of Insider Trading

The consequences of insider trading are profoundly harmful. Insider trading is a variation of corporate fraud that smacks of the secret backroom exchanges between insiders every small investor fears when he buys stock. Conceptually "insider trading" is relatively straightforward to explain, particularly when compared to other forms of corporate fraud involving complex transactions and complicated accounting schemes. By virtue of their positions within a corporation, corporate executives, managers, and employees obtain non-public "inside" information, such as information on a company's financial performance or its acquisition of another company, that will have a material effect on share prices. Similarly, persons outside the corporation, such as the corporation's clients or those, like attorneys or accountants, who provide services to the corporation, may also become aware of such non-public information. This non-public information empowers the "holder" to get a jump on the market by buying or selling stock or options in advance of the public announcement of the information. By doing so, the "insider trader" either successfully avoids investment losses or reaps unfair investment gains - while the general investing public is unable to similarly protect or enrich itself because it does not have access to the same information. The end result is that the raw material - information - on which participants in the market for the affected security base their decisions is not generally and uniformly available to all, straining the confidence of the investing public and leaving investors at the mercy of insiders with an unfair advantage.

More technically, the crime of insider trading is defined as the following: Insider trading is the willful and fraudulent buying or selling of a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, non-public information about a security. It is also unlawful to pass material non-public information to any person who may be expected to trade on the basis of that information. That practice is known as "tipping." Insider trading violations may include "tipping" information, securities trading by the person

"tipped" and securities trading by those who misappropriate such information. Most criminal insider trading cases are prosecuted as securities fraud under the Securities Exchange Act of 1934.

Criminal charges are filed alleging violations of the antifraud provisions of that Act, Title 15, United States Code , Section 78j(b), as well as Section 78ff and 17 C.F.R. § 240.10b-5. If fraud, including insider trading, is involved in a tender offer, charges may be filed under Title 15, United States Code, Section 78n(e). The punishment for willful violations of these provisions is a fine up to $5 million and imprisonment up to 20 years. Cases alleging criminal insider trading also may involve conduct in violation of the mail fraud, wire fraud, conspiracy, obstruction of justice, or perjury statutes. The current criminal statutes used to prosecute insider trading case have proven effective to address insider trading. In addition to prosecutions brought by the Department, these abuses are addressed by the Securities and Exchange Commission ("SEC") through civil actions to obtain injunctive relief, disgorgement of "ill gotten gains," assessment of stiff administrative penalties and fines and other equitable relief. In each case of established wrongdoing, a determination is made whether to pursue criminal charges, administrative remedies, civil remedies, or some combination thereof.

## The Challenges of Insider Trading Prosecutions

While the elements of criminal insider trading may be straightforward, successful investigation and prosecution of the crime presents significant challenges. For example, prosecutors charging a defendant with an insider trading violation must demonstrate that the defendant's conduct was a willful - as opposed to knowing - violation of the law, meaning that it must be proven beyond a reasonable doubt that the defendant was aware, at the time of the insider trade, that he or she was doing something in violation of the law. In addition, prosecutors must also prove that the inside information at issue in the case was both "material," meaning likely to be of interest to the reasonable investor, and "non-public," and that the defendant used the same information in making his or her trading decision. Prosecutors must also prove that the insider has a fiduciary relationship with the corporation from which the inside information comes. In cases involving corporate officers, directors or employees, this requirement is easily met, but in cases involving outsiders, and in particular those who receive tips from corporate insiders or agents, it can pose a significant burden.

Given these requirements, uncovering evidence of criminal insider trading activity requires more than just market surveillance and the discovery of spikes in trading. Anomalies such as these may be indicative of a problem, but they are simply the first step in an investigative inquiry. For example, there may be legitimate reasons for a spike in trading activity, such as expiration dates for option awards or other mechanics associated with the company's compensation program. Moreover, a spike in trading activity does not disclose to investors what information, if any, the individual involved in the trade used in making his or her trading decision, a key element in proving the crime of insider trading. Similarly, an assessment of the materiality of the inside information at issue is frequently not possible until the information itself is publicly disclosed. Only then can investigators determine if the information was something that would be of significance to a reasonable investor or if it had an impact on the company's stock price. Additionally, the identity of the traders and their "tippers" must be discovered, their possession of "insider information" must be documented, the relationship between all the subjects and targets must be understood, and the existence of any fiduciary relationships must be established. As the degrees of separation from the original source grow, proving the elements of a criminal prosecution becomes more difficult.

Insider trading cases are rarely proved with a "smoking gun." These cases almost universally turn on circumstantial evidence and insider traders frequently proffer a number of alternative explanations for their conduct. Furthermore, while it may be easier to tie the trading activity of known corporate executives to insider trading in their companies, the cases we have investigated and prosecuted demonstrate that insider trading can also be conducted by individuals with no readily apparent tie to the affected company or security - an outside accountant or an employee of a printing plant just as easily can be the recipient of "inside information" or can disclose inside information.

Our investigations must be conducted in a thorough and methodical manner to insure the evidence presented at trial is sufficient to prove beyond a reasonable doubt that the crime has been committed by the defendant. The prosecutive decision whether to file criminal charges is made by the United States Attorney or by Department prosecutors, based on an assessment of the evidence, the factual background of the particular case, and the applicable statutory provisions. These cases are difficult and risky, and the investigations are often protracted and complex.

How Are Insider Trading Cases Investigated?

Investigating and prosecuting insider trading is a collaborative effort. A majority of our insider trading cases emerge from our government enforcement partners or self-regulatory bodies, such as the SEC, the Commodity Futures Trading Commission ("CFTC"), the National Association of Securities Dealers ("NASD"), or the New York Stock Exchange ("NYSE"). In a typical case, the SEC begins an inquiry or formal investigation into activity that may indicate the presence of illegal insider trading. This investigation may be generated by suspicious securities trading activity immediately before announcement of a significant corporate event, which is detected by the SEC, CFTC, NASD or the NYSE. Such entities have sophisticated computer programs designed to track and match unusual trading patterns with merger announcements and have specialized expertise in detecting these anomalies.

But that is only the beginning of the process. After detecting an unusual pattern of trading activity, the SEC then may contact the United States Attorney's Office in its region, the Department of Justice, the Federal Bureau of Investigation ("FBI") or other law enforcement agencies, to inform these agencies of the results of its preliminary inquiry. The law enforcement agencies typically will then request access to the SEC investigative materials. Should the preliminary inquiry indicate there may have been trading by insiders, the FBI, or another law enforcement agency, will often initiate a criminal investigation, in coordination with a United States Attorney's Office, while remaining in contact with the SEC, which will continue with its own investigation.

The prosecutors and the SEC maintain parallel and independent investigations, with the SEC pursuing its statutory responsibilities by ascertaining whether there has been a violation of the federal securities laws that warrants civil or administrative action to stop the illegal insider trading through injunctive or other relief, while the Department of Justice conducts its own criminal investigation. In this respect, I note that the Department respectfully disagrees with a recent district court decision in the District of Oregon, United States v. Stringer, in which the district court found that the criminal prosecutors were effectively using SEC attorneys as their agents to investigate the criminal case. That case is on appeal. The Department does not use the SEC to investigate its criminal cases. Rather, it properly coordinates with that agency to obtain documents and testimony properly obtained in the civil case for use in its criminal investigation. This coordination, which Congress has long authorized and encouraged, prevents a needless duplication of effort by the company under investigation and preserves scarce government

resources. The Department and the SEC make completely independent charging decisions based on very different standards of proof and enforcement priorities.

## The Department's Successful Track Record

Despite the significant hurdles to the successful criminal prosecution of insider trading cases, the Department has been very successful in prosecuting those who seek to exploit their access to information at the expense of the market. Our cases 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. While these cases are significant and troubling in their own right, perhaps the most egregious category of insider trading defendants consists of those who work in the financial services industry, including employees of law, banking, brokerage and printing firms who were given access to inside information to provide services to the corporation whose securities they traded and who - particularly in the case of brokers - sacrificed their duties to their clients to enrich themselves.

### IMCLONE

Several of the cases we have prosecuted illustrate the wide range of insider trading activity. For example, Samuel Waksal was the former Chief Executive Officer of ImClone Systems, a medical research company which developed Erbitux, a well publicized cancer drug. In December 2001, Waksal learned the Food and Drug Administration (FDA) would not approve the license to distribute Erbitux. Before this information became public, Waksal contacted his stockbroker, Peter Bacanovic, and liquidated $10 million of family holdings in ImClone. After the FDA's decision was released, ImClone's stock price dropped significantly. Following his indictment, Waksal pleaded guilty to two counts of securities fraud for the insider trading scheme as well as charges of conspiracy, bank fraud, obstruction of justice and perjury. He was sentenced to seven years and three months and fined $3 million on June 10, 2003.

Bacanovic also was the stockbroker for Martha Stewart. In an interview with the FBI, Stewart lied about her sale of ImClone by claiming that she had a preexisting agreement with Bacanovic to sell the stock when it dropped below a specific price. Bacanovic provided a similar false explanation in an interview with investigators from the SEC. Stewart was convicted on four counts of obstructing justice for lying about her sale of ImClone stock. Bacanovic was convicted on four counts of conspiracy and false statements. Each received a sentence of five months in custody and five months home detention.

### PAJCIN/PLOTKIN

A case prosecuted recently in the Southern District of New York involved both insider trading associated with merger and acquisition activity and persons employed in the financial services industry. Earlier this year, Eugene Plotkin, an associate at Goldman Sachs, and Stanislav Shpigelman, an investment banking analyst at Merrill Lynch, were charged with participating in a $6.7 million insider trading scheme by obtaining confidential information relating to numerous pending mergers and acquisitions handled by Merrill Lynch. The confidential information was used by the defendants and others to purchase securities based on knowledge of the deals prior to the public announcement of the transactions and then sell the securities immediately after the public announcements. On July 14, 2006, Shpigelman pleaded guilty to the insider trading scheme and he is awaiting sentencing. Jason Smith, a grand juror on a federal grand jury in New Jersey who provided information to the group about the grand jury's investigation of accounting fraud at Bristol-Myers, also pleaded guilty to securities fraud, conspiracy and contempt on August 10, 2006, and he is awaiting sentencing.

In addition, according to the charges, Daniel Pajcin and Plotkin were at the center of schemes to trade on inside information not only from Shpigelman, but from pre-publication issues of Business Week. Pajcin allegedly directed defendant Renteria to get a job at the Business Week printing plant and Renteria then began giving Pajcin information about stocks from upcoming issues of Business Week prior to publication and dissemination to the public. Pajcin conducted stock trades on that information before the issues were distributed. Between May and August 2005, Pajcin directed trades from his aunt's account in Croatia, making millions in profit. Plotkin, along with Juan Renteria and another employee of the printing plant, Nickolaus Shuster, were also charged in a separate scheme to gain advance information of favorable reviews of numerous stocks in the "Inside Wall Street" column of Business Week by bribing employees of that magazine and then trading in approximately 20 stocks one day before those stocks were reviewed in the magazine. Plotkin, Renteria and Shuster are scheduled to proceed to trial in April 2007.[1] Pajcin pleaded guilty and is cooperating.

MIN T. MA

Insider trading activity connected with mergers and acquisitions has not been limited solely to corporate insiders and financial analysts. For example, in the Northern District of California, an individual, Min T. Ma, was prosecuted for using his position as an employee of a company providing desktop publishing services to Merrill Lynch to profit illegally from insider trading. The case began when the FBI's San Francisco Division received a referral from the SEC and the NASD about suspicious purchases of a company's stock prior to the public announcement that the company had agreed to a merger. During the investigation, law enforcement officers learned that Ma had obtained material, non-public information related to potential mergers as a result of his position as an employee of a company that provided desktop publishing services to the Palo Alto and Menlo Park offices of Merrill Lynch. Ma used that material non-public information to buy stock in two companies. Following the public announcement of mergers involving these companies, Ma sold the stock for net profit of $197,258.62. In 2005, Ma pleaded guilty in the Northern District of California to two counts of insider trading. The district court sentenced Ma to 18 months' imprisonment and ordered him to pay restitution in the full amount of his improper gain.

1 The defendants are presumed innocent of these allegations, unless and until proven guilty in a court of law.

2 These statistics are provided in the aggregate. The Department recognizes that the 1996-2000 data reflects a five year period, while the 2001-2006 reflects a six year period. However, five year statistics were not available at the time of this submission.

ROGER D. BLACKWELL

The Department has also prosecuted cases involving corporate directors, the individuals who participate in a company's most significant and sensitive decisions. One of these cases involved Roger D. Blackwell, a member of the Board of Directors for Worthington Foods. Blackwell provided a tip to friends and associates about the Kellogg Company's pending purchase of Worthington. The subjects traded a total of 81,074 shares of Worthington stock and realized net profits of $882,065. The FBI's Cincinnati Division and its Columbus Resident Agency opened this investigation based on a criminal referral from the SEC. The investigation determined that Blackwell, while a member of Worthington's Board of Directors, obtained material, non-public information regarding Kellogg's intentions to purchase Worthington. After the acquisition

became public knowledge, Worthington's share price rose 61% in value. Blackwell used this information to tip friends and associates so they could purchase Worthington stock prior to its increase in value. In addition to his position on Worthington's Board of Directors, Blackwell is a well known Marketing Professor at Ohio State University.

In the ensuing prosecution, a jury in the Southern District of Ohio convicted Blackwell and two other executives of conspiracy to commit securities fraud, false statements, and obstruction regarding their involvement in an insider trading case. Blackwell was sentenced to 72 months' imprisonment and fined one million dollars.

SCHOFIELD

On June 7, 2006, Brady M. Schofield, the owner and president of several companies in the food distribution business, pleaded guilty in the Southern District of New York to signing false audit confirmation letters and insider trading. The insider trading arose when an employee at U.S. Foodservice, Inc., a company that Schofield was doing business with, told Schofield that Royal Ahold, a Dutch food conglomerate, intended to acquire the company. Knowing this, Schofield purchased U.S. Foodservice stock and sold it after the merger announcement, making $287,288.00 in illegal profits. This insider trading prosecution was also brought in conjunction with an accounting fraud to falsify earnings.

Insider Trading Statistics

The Department of Justice has maintained a consistent focus on insider trading criminal cases in partnership with the SEC, NASD, the FBI and the United States Postal Inspection Service. Statistics for the past six years available from the FBI illustrate this commitment. In FY01, the FBI statistics report 53 pending cases, 16 indictments and 14 convictions. In FY06 there were 56 pending cases, 24 indictments and 15 convictions. During this six year period, the number of pending cases, indictments, and convictions has remained relatively constant.

Table 1: FBI Insider Trading Statistics: FY01 through FY06 (to date)

| | Pending Cases | Indictments | Convictions |
|---|---|---|---|
| FY01 | 53 | 16 | 14 |
| FY02 | 52 | 16 | 12 |
| FY03 | 51 | 14 | 15 |
| FY04 | 53 | 21 | 13 |
| FY05 | 67 | 19 | 19 |
| FY06 | 56 | 24 | 15 |

The case load of the Postal Inspection Service similarly demonstrates law enforcement's commitment to combating insider trading activity. For the period from 2001-2006, the Postal Inspection Service reports that the number of its cases nearly tripled, the number of indictments doubled, and total restitution soared from $25,000 to $70,402,388 in comparison to the previous five years. As stated, many of these cases were jointly investigated with the FBI.

Table 2: USPIS I Insider Trading Statistics (Comparing 1996-2000 with 2001-2006)

| | 1996 - 2000 | 2001 - 2006[2] |
|---|---|---|
| Cases | 9 | 24 (9 joint with FBI) |
| Arrests | 15 | 26 (18 joint with FBI) |

Indictments 12 23 (18 joint with FBI)
Convictions 14 8 (4 joint with FBI)
Declinations 1 2 (2 joint with FBI)
Restitution $25,000 $70,402,388 ($1,110,877 joint with FBI)

But these statistics tell only part of the story. Many of the most sophisticated corporate and securities frauds, involving elaborate misrepresentations or accounting schemes, also involve insider trading activity. Defendants such as corporate officers or directors engage in such elaborate schemes with the aim of not only improving the appearance of the corporation to their outside investors - and thereby artificially enhancing the stock price - but also enriching themselves at investors' expense by selling shares at these inflated prices.

The Enron investigation provided an example of such activity. Enron CEO Jeffrey Skilling was convicted not only of misrepresentations involving the company's performance, but also of profiting from those misrepresentations by selling some of his Enron stock when the price was artificially high - based in no small measure on the lies he and his co-defendant Kenneth Lay told over and over during their stewardship of the company. Similarly, defendants Paula Rieker, an officer in Enron's investor relations unit, and David Delainey, CEO of Enron's retail energy division, pleaded guilty to insider trading charges for their part in the same effort to falsely portray Enron as a thriving business. Other executives, such as Ken Rice, CEO of Enron's Broadband Services division, pleaded guilty to securities fraud charges rather than insider trading yet admitted that their lies and misrepresentations were aimed at unjustly enriching themselves at investors' expense, the hallmark of insider trading, and agreed to disgorge the windfall profits they reaped from the sale of their own Enron stock and options while the company's securities traded at artificially high prices. This is an example of how statistics focused on insider trading alone risk underreporting the extent of the Department's efforts to address this crime.

Corporate Fraud Task Force

No matter what form corporate fraud takes, the American investing public demands that it be eradicated. Our efforts against insider trading do not stand alone, but are an integral component of our overall corporate fraud initiative. Our experience has been that insider trading is not conducted in a vacuum, but often in concert with other manifestations of fraud. Whether the fraud involves insider trading, backdating of stock options, concealment of corporate losses through false financial reports, or the deliberate manipulation of fictitious business transactions, these abuses tilt the fair and even investment playing field in favor of those perpetrating the fraud, potentially placing the financial well-being of the investing public in serious jeopardy. These fraudulent activities are often conducted in concert as part of an overall scheme to pillage the corporate entity. Repeated reports of multiple incarnations of fraud by corporate directors, managers and other insiders erode investor confidence and undermine the foundations of our capital markets. We are mindful that investors have suffered catastrophic losses as a consequence of successful schemes, whether hatched in a corporate boardroom or executed by a rogue executive trading on inside information.

You all are aware that a hallmark of the Department's commitment to prosecuting corporate and white collar crime is the President's Corporate Fraud Task Force, established just over four years ago. The Task Force's mandate is to clean up corruption in the boardroom; restore investor confidence in the fair operation of our markets; and send a strong message that corporate wrongdoing will not be tolerated. Since its formation, the Department has worked hard, together with its partners, to move aggressively against corporate fraud and other related white collar criminal activity. That partnership is expansive. The Task Force, chaired by the Deputy Attorney

General, includes members from the United States Attorney community, the heads of the Department's Criminal and Tax Divisions, and a broad range of law enforcement and regulatory agencies, including the FBI, the Postal Inspection Service, the SEC, the CFTC, and the Internal Revenue Service. The Task Force meets periodically in Washington, D.C., to map out strategy and identify best practices. At the working level, the agencies interact daily on individual matters. The Task Force has been a resounding success and remains an essential part of the Department's priority in fulfilling its ongoing mission. The Task Force's record is impressive. From its inception in 2002 through this past December, the Task Force has obtained over 1,000 corporate fraud convictions, and has convicted 92 corporate presidents, 82 Chief Executive Officers, 40 Chief Financial Officers, 14 Chief Operating Officers, 98 Vice Presidents, and 17 corporate counsel or attorneys. The Enron Task Force alone has charged 34 individuals and obtained 25 convictions to date, which include the convictions of former Enron CEO Jeffrey K. Skilling and former Enron Chairman and CEO Kenneth L. Lay. During roughly the same period, FBI records show that more than 74 defendants were convicted of insider trading-related charges, including Enron's Jeff Skilling, Paula Rieker, and David Delaney.

Our successes are directly attributable to effective interagency coordination, which ensures focus and maximizes the combined efforts of the Department and other key law enforcement agencies. We all rely on these same techniques, resources and coordination in the fight against insider trading.

Conclusion

In closing, let me again thank the Committee for its continuing interest in our corporate fraud enforcement efforts, and its specific interest today in prosecuting insider trading. The story of the Department of Justice's efforts to prosecute corporate corruption has been one of success - our cases have been significant and we are committed to building on the advances we have made in developing more effective techniques to investigate and prosecute complex white collar fraud cases. We continue to leverage the impact of our resources by working closely with our law enforcement and regulatory partners. We also strive to maximize the effectiveness of these available resources by ensuring that our casework is accomplished in keeping with the real-time enforcement mandate of the Corporate Fraud Task Force. We remain committed to combating all threats to the integrity of our capital markets and to the welfare of the investing public. I look forward to your questions.