

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 involving hedge funds. 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 am especially pleased to testify together with Associate Deputy Attorney General Ronald Tenpas of the United States Department of Justice, and Richard Blumenthal, Attorney General of the State of Connecticut. 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, as well as state securities regulations and other state laws. The respective histories of the SEC and the Department of Justice, as well as those of state attorneys general and securities regulators, demonstrate our collective commitment to prosecuting insider trading, civilly and criminally, under federal and state law. Our respective histories also demonstrate our collective commitment to working with each other.

Proving An Insider Trading Case

When I last appeared before this Committee a few months ago, I noted that insider trading by hedge funds was an area of significant concern to the Commission, the Enforcement Division, and this Committee. Insider trading by hedge funds remains a substantial concern to the Division, and represents a significant focus of our current enforcement efforts. As suggested by your staff, I will discuss the process we follow in bringing insider trading cases in general, and also speak to cases involving insider trading by hedge funds.

Over the years, investigating and prosecuting insider trading violations has remained a central and important element of our enforcement mission. The Division pursues these cases day in and day out, and has developed unparalleled expertise in this area. Basically, the staff must prove that a trade was made on the basis of material, non-public information, with the requisite intent to violate the law, and that the information was used or obtained in violation of a duty to the source of the information. That's quite a mouthful, even for a lawyer, so it may be helpful if I describe in more detail, the three key legal requirements that must be met for the SEC to bring a civil insider trading case, which are:

- 1) access to material, non-public information;
- 2) scienter (or culpable intent); and
- 3) breach of a duty to the source of the information.

Before I detail these legal requirements, however, let me step back and discuss some background regarding our insider trading investigations. Insider trading leads come from a host of sources, not only market surveillance but also the 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. While the SEC's Enforcement Division has brought hundreds of successful insider trading cases, there are also many investigations that are opened and later closed without enforcement action. We may open an investigation based on suspicious trading and all of the circumstances may look troubling, but after a thorough look, we may discover no evidence of insider trading or not enough evidence to prove there has been a violation of law. Because an investigation may not lead to an enforcement action, we are always mindful that public disclosure of the mere fact of an SEC investigation may unfairly impugn the reputations of the entities and individuals whose conduct may be exonerated. For this reason, as a matter of long-standing Commission policy, our investigations are conducted on a confidential basis and, as a general matter, we do not confirm or deny the existence of any ongoing investigations.

One of the challenges in successfully prosecuting insider trading is that so much of the relevant activity-trading-is legitimate and must be protected. Trading based on one's own research and financial acumen or strategies is not only legitimate but encouraged. The problem arises only when trades become unlawful because they are based on material non-public information obtained through a breach of duty to the source of the information.

As the law of insider trading has developed over time, it has come to impose legal requirements intended to distinguish legitimate conduct from illegitimate conduct. As I mentioned a moment ago, the law requires that the information be confidential and non-public. If so many people already know the information that it crosses the tipping point where it can be deemed public-based on prior media reports, for instance-there is no violation. The staff must also show scienter-a culpable state of mind or intent to violate the law. In other words, the tipping or trading must be undertaken with culpable intent to commit a violation, and not as the result of an inadvertent slip or innocent mistake. Finally, the staff must also show a violation of duty to the source of the information. The duty to the source may be easy to prove against a tipper who passes on information in breach of a confidentiality agreement. But if information is passed along a chain of tippees, it may become harder to prove that a trader who obtained the information third- or fourth-hand had any duty to the source, or knowledge of the original tipper's duty to the source. Though each of these legal requirements must be established in every insider trading case, they are important because they help to distinguish unlawful trading from the much larger universe of lawful trading.

Insider trading can be, and usually is, accomplished within a very small group or even by a single individual. The communications that result in insider trading do not necessarily generate much of a paper trail. The executive working on due diligence for a confidential deal may meet his brother-in-law in a public park on his lunch hour and pass along a tip. Because there are so

few people involved, there may not be witnesses or bystanders who will come forward and report the tipping.

Moreover, those who know about the tip may become participants in a scheme because the potential (though illegal) rewards are enormous.

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. 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.

Proving Insider Trading In the Context of Hedge Funds

Investigating potential insider trading by hedge funds presents additional challenges because of their high volume trading and proprietary trading strategies. Because they often have substantial assets under management, hedge funds may place extremely large trades in many different securities on a daily basis. The huge volume of trading by hedge funds across a broad range of securities may generate any number of transactions that appear to be unusual or suspicious, but for some hedge funds these trades may be typical. When the SEC approaches a hedge fund with evidence of a large and suspicious trade in advance of a public announcement by a company, the hedge fund often replies that it placed trades of the same magnitude in the same security on many different occasions- and the trading records generally support that claim.

Tracking a hedge fund's trading in a specific security may also be challenging. It is not uncommon for hedge funds to use the services of multiple prime brokers-registered broker-dealers that facilitate trades and other transactions on behalf of hedge funds. A hedge fund may break up a single large trade into many smaller trades to be facilitated through a number of prime brokers over time because, for example, the hedge fund may want to make its trading less obvious in the market, often to protect its proprietary trading strategy. Thus, to develop an accurate composite view of a hedge fund's trading in a particular security, it may be necessary to review records from all of its prime brokers.

The prime brokers provide the SEC with a window into the trading activities of the hedge funds they serve, but it is admittedly a limited window. While a prime broker has information about the transactions it performs for a hedge fund, it generally has little information about activities the hedge fund may be conducting through other prime brokers. Nonetheless, the Enforcement Division remains optimistic about prime brokers as a source of leads regarding unlawful insider trading.

While the SEC has access to the trading records of prime brokers and receives referrals from the SROs regarding suspicious trading executed through their markets, the available documents are generally organized according to the security involved in the suspicious transactions (e.g., XYZ Company), not the identity of the trader. Similarly, the SROs' surveillance systems are set up to trigger alerts based on aggregate trading parameters regarding a particular security, and not based on the identity of the trader. A referral from an exchange usually identifies the issuer of the security involved (which might have announced a merger or other major transaction) and a list of identified traders, which may include one or more hedge funds or accounts trading on behalf of

hedge funds. As a result, referrals about suspicious trading by a particular hedge fund appear like random puzzle pieces, but whether the pieces are part of a larger pattern is far from obvious. One SRO may report suspicious trading in a security by a specific hedge fund, among other traders, on one day, while another SRO may report suspicious trading in a different security by the same hedge fund, again among other traders, on a different day. The SEC presently does not have an electronic system to aggregate referrals based on the identities of the specific traders involved, but we anticipate implementing a new case tracking system by mid-2007 that will enable us to compile all referrals from different exchanges and different time periods by trader.

The identification of suspicious trading and resulting referrals are only the start of the necessary detective work by the SROs and the SEC. The SEC and the SROs gather and analyze the trading records and survey employees of the issuer about any relationship or association they may have with a list of known traders. The objective is to eliminate traders who did not have access to inside information, and more importantly, to establish links between known traders and potential sources of inside information. In the course of an enforcement investigation, the staffs search for access to inside information is meticulous, time-consuming, and sometimes proves to be inconclusive, but all potential leads are carefully considered and examined.

The SEC's Investigation of Potential Insider Trading by Pequot

I know our investigation of potential insider trading by a well-known hedge fund, Pequot Capital Management, has piqued the Committee's interest. A former SEC attorney has alleged that the investigation was impeded and the attorney was terminated because he sought to take testimony from a prominent individual. Speaking for the Division of Enforcement, I want you to know that these allegations are simply not true.

Although it is uncomfortable to discuss an individual's job performance in detail in a public setting, the former SEC employee's false allegations against the Enforcement Division have made the facts surrounding his termination a public issue. Therefore, I feel compelled to share with you the Enforcement Division's perspective on his performance problems and his resulting termination. After an unhappy probationary period of employment, the former SEC employee was terminated on September 1, 2005 because of "his inability to work effectively with other staff and his unwillingness to operate within the Securities and Exchange Commission (SEC) process." The SEC's termination letter is attached hereto. When the staff attorney was hired, he was required to serve a one-year probationary or trial period during which his employment could be terminated for any reason or no reason, but there were indeed many reasons in this particular case. He had continued personality conflicts with other staff attorneys, resisted standard supervision, and ignored the SEC's chain of command. Despite these problems, the SEC attempted to accommodate him and to ameliorate the problems he caused in his work groups. During his brief tenure, he was, at his request, transferred from his original supervisor to a supervisor he requested, about whom he now bitterly complains. He also requested, and received, official time to pursue an unsuccessful age discrimination claim against the SEC for failing to hire him on 22 prior applications. The EEOC's opinion denying those claims is attached; the former employee is appealing the decision.

During his tenure, the former employee demonstrated his own dissatisfaction with his employment by twice leaving the office abruptly during the workday after disagreeing with other

attorneys, and on a third occasion, by actually tendering his written resignation, only to rescind it some time later. After assuming primary responsibility for the Pequot investigation for several months in 2005, the former employee announced he would not draft the customary memorandum summarizing the investigation he now so publicly discusses. With respect to the substance of his work, he issued -without his supervisors' review or approval -subpoenas that violated federal privacy law, which were withdrawn as soon as his supervisors learned of them. But for the corrective actions of his SEC supervisors, the staff attorney's work product could have been extremely damaging to the SEC, and his continued resistance to supervision created a substantial risk of future error. After the SEC expended considerable efforts in attempts to make the employment relationship work, we decided not to extend his employment beyond the one-year probationary period.

As to the potential insider trading matters at issue in the Pequot case, they were thoroughly investigated. The investigation was ultimately conducted in large part by staff other than the one former attorney who is now heard to complain and was continued long after he left the agency. Between February 2002 and April 2005, the Enforcement Division received a total of 15 SRO referrals regarding various transactions in which Pequot, among others, was identified as a trader. After preliminary screening by two senior supervisors, 13 of these transactions were forwarded on to enforcement staff for further review and consideration, including 10 that were forwarded to staff working on the Pequot investigation. The GEIHeller transaction investigated by the former employee was not the subject of an SRO referral, and our closing of the matter was consistent with the NYSE's original decision to close the matter in 2002. After reviewing the suspicious trading at issue, the NYSE decided not to refer the matter to the SEC for further investigation, but instead sent the Commission a closing memorandum dated January 30, 2002, for informational purposes only, noting that "the deal was expected and the size did not appear out of character." Although the SEC's Pequot investigation reviewed that transaction and many others, we did not find sufficient evidence to support an enforcement action. As a result, the investigation was closed by the Enforcement Division due to lack of evidence, and thus we will not be asking the Commission to take any further action. Because of the public attention this case has received, the Commission has authorized the Division to make its closing memorandum available to the public, and it is attached to my testimony. I think you will find it a useful summary of the many hours of hard work that went into this investigation.

Finally, Mr. Chairman, the three supervisors working on the Pequot investigation, who collectively have decades of experience and who have been involved in some of our toughest cases, were not influenced by who any of the particular people involved in the investigation were, but rather by the facts and the evidence. This is consistent with the finest traditions of this agency. We follow the facts, and if those facts take us to John or Jane Doe or some more famous John or Jane, so be it. We have gathered evidence from and about, and in some instances we have sued, captains of industry, Presidential cabinet members, Members of Congress, and celebrities, as well as thousands of other far less well known people. Indeed, a long list of prominent and not so prominent individuals would undoubtedly testify that the Enforcement Division does not pull its punches. I want to assure the Committee that we are passionate about our work and will pursue it with vigor, skill and fairness.

That concludes my testimony. I would be glad to answer any questions you may have.