REMARKS OF
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BEFORE THE
II INTERNATIONAL MEETING ON THE PREVENTION OF CREDIT FRAUD

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The views expressed herein are those of Commissioner Schapiro and do not necessarily represent those of the Commission, other Commissioners or the staff.

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I. Introduction

Good morning. Usually when I have the privilege of speaking in Latin America, it provides an opportunity to discuss innovations in cross-border trading or important breakthroughs for developing markets. Unfortunately, however, not all innovators are committed to new products, new markets, or improved technology. Some of the more creative minds in the U.S securities markets, as well as some of the less creative, dedicate their time and energy to the planning and execution of fraudulent schemes.

The U.S. market, with its depth and breadth of issuers and investors, offers those with less than pure motives ample opportunity to trade on insider information, to issue false and misleading corporate information, or to manipulate the market for smaller, less liquid companies. Confronted with these realities, the Securities and Exchange Commission, with the assistance of the self-regulatory organizations, regulated entities, and to a lesser extent, state regulators, must expend a significant portion of its time and resources in the prevention, detection, and prosecution of securities

fraud. To fail to do so would result in a crippling loss of investor confidence in the fairness and quality of the markets, so we must remain ever vigilant, despite the knowledge that we can never completely eradicate securities fraud.

II. The Commission's Enforcement Effort

The SEC's commitment to enforcement is obvious. Last year we brought approximately 400 cases in which hundreds of millions of dollars in disgorgement and fines, as well as other ancillary relief, was obtained. At any given time, over 1000 matters are under investigation by the SEC staff. Of the 2700 SEC staff, approximately 800 work directly on enforcement matters. Underlying these statistics is the conviction that the SEC is ready, willing, and able to police its securities markets, and the deterrent value of that commitment should not be underestimated.

Cases have come to the attention of the Commission in more ways than I can remember, and if I took the time to discuss them all there would be no time remaining for any of today's other speakers.

Therefore, for the sake of brevity, I will discuss three of the more common ways investigations are commenced and pursued at the Commission: (1) detection of improper trading by an exchange or the NASD (the over-the-counter market); (2) observation of irregularities by the SEC staff in periodic financial statements or regulated entity books and records; and (3) investigations that involve or incorporate foreign trading or the movement of funds to other countries.

Commission investigations also commonly are triggered by broker-dealer or investment adviser inspections; complaints from members of the public, including issuers and their current or former employees, or anonymous sources; referrals from other government agencies; and reports in the news media. All these sources of information about possible illegal conduct are extremely important for the Commission. For example, problems in the operation of a mutual fund might not be detected by shareholders or the news media, but can be readily apparent to SEC inspectors who periodically visit the fund and review its books and records.

An investigation is preliminary to, not a substitute for, a prosecution. Because an investigation only indicates Commission interest in a company or an event, and does not necessarily mean

that there were violations of the securities laws, the Commission and staff must keep even the existence of an investigation confidential. To fail to do so could result in significant harm, both professional and reputational, to the person, corporation, broker-dealer or investment adviser being investigated before we are sure that violations of the law have occurred.

As a preface to a discussion about insider trading investigations, it would be useful to outline the U.S. self-regulatory scheme, and the cooperative roles of the Commission and the exchanges within that structure. At the Commission, we cannot and should not be responsible for the primary monitoring of day-to-day trading activity. Because of their proximity to the market and its participants, the exchanges are able to do a more efficient job of market surveillance.

The heightened efficiency of SRO monitoring is the result of a number of factors. First, they are already in the business of market data gathering, doing the necessary work of assembling trade information for the purpose of transaction reporting (transparency) and the clearance and settlement of trades on their markets. Those facilities coincide with, and are sometimes identical to, those needed

for market surveillance. As both trading and back office systems are developed to improve the quality of our markets, those innovations are quite often directly transferrable to improved market surveillance.

Second, the exchanges enjoy proximity to the market players. That closeness allows the surveillance staffs of an exchange often to perform quick, routine examinations of apparently suspicious trading, often to find that there are legitimate explanations. By its very nature as a governmental agency with certain police powers, the ability of the Commission to distinguish real from apparent fraud on a speedy, informal basis is necessarily limited. We cannot match the ability of an exchange floor official or compliance officer to appear on the trading floor within minutes, and, without causing a disruption, to make an assessment of whether the unusual movement in a stock on that day was the result of legitimate or illegal market forces at work. In summary, exchange officials are "on the spot" with the necessary tools to be immediately alerted to potential problems.

With that as background, let me run through an example of how the cooperative efforts of the Commission and the exchanges can come together to detect and prosecute securities fraud. Through years of experience and trial and error, the exchanges have

developed sophisticated computer programs that monitor trading on the exchange floor, or in the case of the NASD, through the over-the-counter market. These programs monitor the market for each individual security, searching for price movements or volume surges that exceed pre-determined, mathematically calculated norms.

When a parameter is exceeded, an alert is signalled to the exchange compliance staff. For example, if a stock that normally trades several thousand shares a day suddenly has volume in the tens of thousands, or a stock that trades in a range of $15-$20 begins to trade at $30, something unusual may be happening that requires an investigation. An investigation commences, at first to determine whether the seemingly unusual market activity is readily explainable. To take an extreme example, on the day of the market break in October 1987, nearly all New York Stock Exchange stocks exceeded their volume parameters, yet obviously not all were the result of improper activity. A more routine scenario is when a sudden spike or drop in a stock's price can be readily explained by the prior announcement of a tender offer or a decline in corporate earnings.

But let's take the tender offer scenario one step further. Assume that on Monday and Tuesday the price of a certain issuer

increases significantly, in excess of its pre-determined parameters. An investigation is opened by the exchange staff, and there is at first no easy explanation for the unusual activity. On Thursday, however, the issuer announces that it has received a tender offer from a third party. Suddenly, the unusual activity of earlier in the week looks even more suspicious. Perhaps there was trading on insider information about the coming tender offer. Through the use of available clearing data, the exchange staff can identify the member firm broker-dealers that did the largest amount of trading in the issue prior to the announcement. Using a jurisdictional reach that extends only to the broker-dealer and its associated persons, the staff will then send a request for information about the trading executed through the broker-dealer on the days in question.

Time is of the essence during the preliminary stages of these investigations. The exchange staff and later the Commission staff attempt to prosecute illegal trading on a timely basis, in hopes of identifying wrongdoers before illegal profits are dissipated or moved offshore. Appreciating the time sensitivity, the exchanges and the Commission have exerted pressure on broker-dealers to respond quickly to these preliminary data requests, and have even begun to

fine or otherwise discipline broker-dealers that fail to comply with reasonable deadlines.

After receiving complete information from broker-dealers and getting a snapshot of trading during the period in question, the role of the exchange investigators begins to draw to a close. Jurisdictional reach begins to limit the effectiveness of exchange investigators, who have no ability to compel non-registered individuals or institutions to discuss their trading strategy, nor do they have the ability to discipline non-members for illegal trading.

However limited, the role of the exchange investigator at this point is not unimportant. Although it is not usually the case, if suspicious trading has been done through firm, as opposed to customer, accounts, the exchange can fully pursue that case, either on its own or on a parallel track with a Commission investigation. It can review customer trading, hopefully detecting suspicious concentrations, patterns, or name connections to insiders. However, at some point in this process, hopefully within three or four months from the original suspicious trading, the exchange will complete its preliminary investigation and refer the case to the Commission.

Commission investigations tend to follow one general pattern, although obviously, the facts will make each investigation different. Generally, the staff obtains and reviews the relevant documents. In our example, that would include the trading data and account information compiled by the exchange, as well as filings made with the Commission, newspaper articles and other public documents.

The Commission has statutory powers that enable it to fully investigate illegal trading. No power is more important to the Commission than its subpoena authority. Returning to our hypothetical, let's assume that the among the list of traders active during the week of the tender offer announcement were two individuals: a lawyer for a prominent mergers and acquisitions firm; and a person who has the same last name as a member of the board of directors of the target company.

The exchange staff, if vigilant, would have been able to conclude that the trading by these two individuals was suspicious, but would lack the ability to prove it. The Commission, on the other hand, is not similarly disabled. Staff from our Division of Enforcement can, pursuant to subpoena, take the testimony of the two customers, subpoena their bank records and telephone records,

and begin to piece together information. They can take the testimony of insiders to the negotiations, and attempt to establish circumstantial links between insiders and the traders. For example, testimony by a corporate officer can establish that the lawyer who traded prior to the announcement had been retained by the company to advise it during negotiations, and that the lawyer knew concrete details of the deal the weekend before the announcement. Evidence can be obtained that shows that the trader sharing the last name of the director is in fact a relative, and subpoenaed telephone records can establish that the two spoke on numerous occasions in the days prior to the announcement.

For all the traditional ways we detect and prosecute securities fraud, one of the most important will always be the lack of honor among thieves. Many of our cases have been the result of good investigative skills developing one case, which then leads to our defendant, in an attempt to curry favor, giving us information about another fraud, which leads to a third case.

Clearly, the most notable example of this theory was the major insider trading scandals of the late 1980s. The Commission had investigated Ivan Boesky and Michael Milken for years, but had been unable to build a clear case. In 1985, a separate investigation

involving suspicious trading in the Bahamian branch of a Swiss bank led the Commission to a Drexel trader named Dennis Levine. Commission staff were very successful at proving an elaborate insider trading ring involving Mr. Levine, but were as surprised as anyone when he volunteered the information that he had been swapping inside information with Ivan Boesky for two years. After his arrest, Mr. Boesky then took a page from Mr. Levine, providing voluminous information about Michael Milken in return for a shorter prison sentence.

There is no doubt how important a strong program to detect and prosecute insider trading is to the maintenance of market fairness and integrity. However, the fairness and openness of the markets are equally dependent on the accuracy and reliability of the information on which people make their investment choices. Because of this emphasis on full disclosure of material information, the Commission maintains an active program to detect, investigate and pursue cases involving false and misleading financial disclosure and the issuance of false financial statements by public corporations.

The Commission's Division of Corporation Finance routinely reviews and comments upon issuer filings. When the Division detects

potential problems, it may refer the matter to the Division of Enforcement for investigation. Cases in this area often are very complex, requiring detailed investigation and analysis by attorneys and accountants. Often it is necessary to understand not only the nature of the issuer's business, but of specific projects as well, to be able to determine whether the company has provided full and timely disclosure. Issues in this context have included the timing and propriety of the recognition of revenues and expenses, valuation of inventories, assets and loan portfolios, compensation of officers and directors, and the basic ability of an issuer to meet its financial obligations.

Although it is not always the case, false financial information often is part of a larger scheme to either conceal or further a fraud. Unscrupulous corporate officials will create false earnings and income figures when they fear what dissemination of the real figures will do the price of the stock or their ability to sell a further distribution of their securities.

When taken to these extremes, issuers can get very creative in their attempts to maintain an appearance of profitability and prosperity when the reality is anything but. One case that we filed

involved a scheme to inflate net earnings by allegedly creating fictitious inventory by packing bricks into inventory cases and shipping them to distributors, thereby concealing from auditors an inventory shortfall. The participants developed the scheme to a point where a computer program was designed to generate the false inventory information necessary to perpetuate the scheme. The participants in the fraud, it was later discovered, referred to the computer program as the "cookbook," perhaps a reference to our colloquialism for financial fraud, namely "cooking the books."

Another financial fraud case involved an individual that was the founder and CEO of a chain of electronics stores in New York. Being from that area, I had his local television commercials permanently burned into my memory, a frenetic man named Crazy Eddie screaming into the camera about the prices of goods being too low to be believed. Unfortunately, that lack of credibility extended to his financial statements. For years, he perpetrated a scheme of false financial statements, false inventories, and destroyed records, and during that time, sold stock to the public at artificially high prices based on the fraudulent information. We finally detected the fraud, in part with the help of an informant, when the numbers became too large to conceal.

As I think you understand, insider trading and other securities fraud investigations sometimes follow neat, predictable patterns, but more often unexpected developments occur. One such obstacle that the Commission has faced with increased regularity is illegal or suspicious trading done in foreign accounts and related attempts to move illegal profits out of the country and out of the jurisdiction of the SEC.

During the early stages of an investigation, the presence of foreign market participants often complicates trade data gathering. In many cases, foreign laws relating to bank secrecy or the existence of blocking statutes can impede the collection of trading or other information abroad. On occasion, the problems are mitigated when the target is partially within the reach of orders of the U.S. courts. We have had success requiring U.S. broker-dealers to produce some trading records, even when the firm took the order through an overseas branch. We also have had modest success obtaining the records of foreign subsidiaries of U.S. publicly held corporations, when we are able to demonstrate to a court that those records are subject to the possession, custody, and control of the U.S. issuer.

Our experience in these areas has demonstrated that even when foreign entities have some connection to the U.S., our information gathering abilities can be compromised. That situation gets significantly more difficult when the witness or target has no connection to the U.S. regulatory scheme other than the illegal activity that took place here. These shortcomings have highlighted the need to develop new avenues and methods for obtaining trading data and other information, and for ensuring access to illicit profits held outside our country.

The most common new method has been the development of memoranda of understanding. These bilateral mutual assistance agreements are attempts to codify or memorialize the state of international cooperation between the SEC and foreign authorities. MOUs create a framework for mutual assistance by establishing, among other things, the scope of the matters for which assistance may be provided, the uses of information obtained, and provisions relating to the confidentiality of information.

Although insider trading may be the most highly visible of international securities law violations, as regulators we also need assistance in investigating other, less high-profile violations.

Therefore, it is important for regulators to have the authority to provide mutual assistance to each other covering the full range of matters covered by either authority's domestic securities laws. Because the securities laws of different countries may vary, it is important for an MOU to provide assistance without regard to commonality of violations.

Complications to our international enforcement efforts aren't limited to investigatory difficulties. Over the last few years, the Commission has attempted to use the U.S. courts to prevent assets from leaving the country, even prior to conclusive evidence that the assets are the result to securities fraud or who even is the ultimate owner of the funds. We have been successful on some occasions convincing a court that an asset freeze was appropriate, realizing that if the assets are moved out of the jurisdiction it could render the rest of the investigation moot.

Sometimes the asset freezes come too late, or the money leaves the country anyway. In the financial fraud case I spoke of a few moments ago, the defendant was able to ship tens of millions of dollars off-shore before our investigation was completed, and then followed the money himself to avoid criminal prosecution. For the

better part of three years, Commission staff, in conjunction with the criminal authorities, continued to look for the defendant. Having found him, we are again going through the process of identifying and attempting to freeze foreign accounts. But, without a doubt, we were lucky to find him, and even luckier to find the money, and this case reinforces the importance locking up the money before it has an opportunity to leave the country.

III. Conclusion

Without question, the responsibility for policing a market with the breadth and scope of the U.S. securities market is a daunting one. The task is made more difficult by the knowledge that all our efforts will never completely eliminate fraud and unfair dealing from our markets. This fact, however, also must serve as a motivation, to compel us to make the commission of fraud as difficult as possible and the punishment as painful as possible, because if we fail to so, it will surely result in the destruction of the integrity, and ultimately the viability of the market.