

GAO

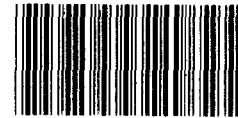
Testimony

For Release
on Delivery
Expected at
10:00 a.m. EST
Thursday
December 11, 1986

Insider Trading in the Securities Markets

Statement of
William J. Anderson, Assistant Comptroller General
General Government Programs

Before the
Subcommittee on Oversight and Investigations
Committee on Energy and Commerce
House of Representatives



131767

037572

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to participate in your hearings on insider trading. Insider trading has been viewed by the Congress as a particularly troublesome and unfair practice since the 1930's. It has been given a high priority for regulatory attention by Chairman Shad during his tenure. Recent revelations about particularly egregious insider trading abuses have heightened public awareness of and concern over this problem. Of fundamental concern is the effect of these recent revelations on the public's confidence in the fairness of the securities markets.

I would like to discuss the surveillance systems and enforcement procedures used by industry self-regulatory organizations (SROs) and the Securities and Exchange Commission (SEC) to detect, investigate, and deter insider trading. As you know, at your request, we began our work last week. We have not yet independently verified much of the information we have obtained. Therefore, the observations I will discuss today are preliminary. They are based on what we have learned over the past week or so as well as on our previous general work involving the securities markets and their regulation and oversight. We anticipate completing our efforts in three or four months. At that time we will provide you with our assessment of the SEC's and SROs' efforts to deal with the insider trading problem and, if warranted, recommendations for improvement. I will relate my observations on the SEC's and the SROs' processes to the very limited information we have gathered so far on the cases involving Mr. Ivan Boesky; however, as agreed with you, we will avoid discussing any matters that might impair current investigations of him or related individuals.

Detecting potential insider trading activity has been less troublesome on the whole than developing a link between that activity and the suspected guilty parties. Systems for detecting and analyzing suspicious trades are improving, but they do not yet provide for all the automated analyses the SEC believes are necessary to successfully identify various types of potential trading abuses. However, proving culpability remains difficult and laborious, dependent on thorough investigative work, and, in some cases, the ability to obtain testimonial evidence from someone involved in improper activity. The point is that surveillance system disclosures are not sufficient by themselves to enable the SEC and the Justice Department to prove illegal activity. They merely provide leads that may be pursued by analysis and investigation.

SCOPE OF WORK

In preparing for these hearings, we concentrated our efforts on identifying and understanding the workings of the surveillance systems and enforcement procedures used by the SEC and the New York Stock Exchange (NYSE) for detecting and investigating insider trading. We talked with SEC officials in Washington, D.C. and at SEC's New York Regional Office. We reviewed SEC exchange inspection reports and exchange responses to SEC's findings. We analyzed enforcement cases closed during FY 1985 and FY 1986 to determine the origins of insider trading investigations and the types of individuals charged in these cases. We also observed the surveillance systems in place at the NYSE and discussed these systems with NYSE officials. We attempted to identify and obtain relevant details on all SEC and NYSE investigations or inquiries relating directly or indirectly to the Boesky case. We were unable in the time available to us, to contact other SROs to discuss their handling of insider trading cases. We did not contact the Department of Justice

which at times provides leads on insider trading matters to SEC and cooperates in developing and prosecuting cases.

We relied on prior GAO reports that have dealt more generally with SEC's market oversight, enforcement, and full disclosure programs. I am appending a listing of these reports to my statement.

At this point let me turn to a discussion of the NYSE's and the SEC's detection and investigative processes for insider trading.

HOW REGULATORS TRY TO DETECT INSIDER TRADING

Though not always the case, illegal insider trading usually involves anomalous trading patterns. Someone who normally does not trade may start doing so based on insider information. Or, someone might trade an unusually large amount of shares in advance of a corporate announcement. To the extent that insider trading creates anomalies--either in volume, price movement, or historical trading patterns--they can be detected by computer surveillance systems in place at the various SROs and at the SEC itself. While these systems do not detect insider trading per se, they detect situations that could be shown through follow up analysis and investigation to have been instances of insider trading. Furthermore, these computer systems alone are not the sole means for detecting insider trading. For example, other parties such as specialists, floor governors, and even brokerage houses often bring unusual situations to the attention of self-regulatory organizations. Finally, according to the SEC, the surveillance systems have not yet been fully developed.

Primary responsibility for daily market surveillance rests with the SROs. The SEC's surveillance system is used to help it oversee and inspect SRO systems and to make special studies of particular situations or develop new surveillance methods.

In general, surveillance systems are used in two ways. In the first instance, trades are tracked as they are made and compared with preprogrammed parameters that represent acceptable variances from averages of price performance or historical trading patterns and share activity. The systems now in place vary in analytical sophistication. Tracking is designed to detect not just insider trading but also market manipulation and other forms of unacceptable trading activity. If a particular trading situation is flagged because its characteristics fall outside the bounds of certain parameters, it is brought to the attention of the SRO's analysts. In the second instance, SRO analysts may start with a news event--such as an announcement of a takeover--and then ascertain through the systems if any unusual trading activity had occurred prior to the event.

Quite often a flag may be explained fairly readily by matching a particular news announcement or even a brokerage firm's recommendations to the trading in question. Depending on the explanations the analysts find, they may open a wider inquiry into a particular trading situation if they become suspicious. If insider trading is suspected, the analysts try to find a link between individuals involved in the trading activity and the company whose shares are being traded.

The NYSE's Market Surveillance Services Division operates its real-time surveillance system, called Stock Watch. When the system flags anomalies, the three staff members in the Stock Watch Section may consider it an "alert" situation that should be brought to the attention of the NYSE's analysts via a Stock

Watch On-Line Alert Report. For the first 11 months of this year, the NYSE reported that over 9,000 alerts occurred.

The analysts, a group of 17 individuals in the Market Surveillance Services Division's Market Trading Analysis Department, use a variety of methods to study a particular alert situation. A series of automated reports from the NYSE trading data systems can be reviewed to ascertain which firms were trading in the stocks in question. Analysts also use a system that provides information on trades at NYSE and other securities markets called ISIS (Intermarket Surveillance Information System). Furthermore, analysts use a system called ASAM (Automated Search and Match) as part of the attempt to match individuals who might have shared inside information. The analysts also contact the trading firms to find out who their customers were for a trade in question, or talk to specialists, or contact the companies that issued the securities in question. Further contacts may be made with the Intermarket Surveillance Group (ISG) which reviews trading in securities in multiple markets. On the basis of the alert reviews, the analysts will, with supervisory approval, either close the review or open an investigation. We were told it is not unusual for over 125 alert reviews to be conducted in a single month.

Naturally, the more sophisticated a system is, the better chance it has to uncover potential improper trading. Although we have not yet evaluated the SRO systems, the SEC has. SEC inspection reports on SRO surveillance systems indicate that they have been steadily improving but are not yet totally satisfactory. The NYSE's Stock Watch system, recently criticized by the SEC for certain deficiencies related to the parameters tracked and other items, will be replaced within a year or so with a more sophisticated one, called Parameter

Analysis and Variance Alert system (PAVA). The SEC believes that PAVA should solve many of the problems that exist with the current system.

While I am using the NYSE system as an example here, I pointed out earlier that the SEC has also noted deficiencies in other SRO systems. What we have concluded in a past report, though, is that all these systems have been evolving over just the past few years, and even the SEC believes the SROs have made much progress. We have observed that the SROs are spending a considerable amount of time and money to develop and improve the systems, and in the next year or so many of these improvements should be fully implemented.

INVESTIGATING POTENTIAL
INSIDER TRADING AND DEVELOPING
VIABLE CASES

The NYSE and the SEC conduct many different types of investigations. The NYSE typically is involved in investigations of market manipulation, insider trading, and other market-related matters, as well as broker/dealer violations of securities laws and regulations. The SEC investigates many of the same types of violations and others related to disclosure and accounting problems.

If an NYSE analyst believes an anomalous situation should be investigated beyond the alert report review stage mentioned above, an investigation may be opened with the approval of a director of one of the sections of the Market Trading Analysis Department. At the NYSE, 167 investigations were opened by that Department in 1985. Of these, 118 were insider trading investigations. In the first 11 months of 1986 NYSE opened 154 investigations of which 100 were related to insider trading

activity. The NYSE notifies the SEC and the ISG and keeps them informed of its investigations through memoranda and telephone contacts.

The exchange may, during its investigation, contact brokers, specialists, and issuing company officials. The exchange can pursue disciplinary action against those associated with member firms who fail to cooperate. If the exchange has jurisdiction in the matter, it may also be referred to its Enforcement and Regulatory Standards Division. Finally, if the exchange and/or the SEC believe that it is more appropriate for SEC to pursue the matter, it is referred to SEC's Enforcement Division.

When an investigation is closed, another memorandum is prepared and sent to the SEC, containing conclusions and, if appropriate, recommendations for further action. In 1985, the NYSE forwarded 65 matters to SEC, 43 of which involved suspicions of illegal insider trading. In the first 11 months of 1986, NYSE forwarded 37 matters, 28 of which involved suspicions of insider trading.

When the SEC receives intelligence information such as a referral from an SRO, it first decides whether to pursue the matter. If it decides to go ahead it will open either an investigation or a Matter Under Inquiry (MUI). MUIs are opened when more information is needed to decide whether the matter merits a full investigation. Eighty staff hours is the limit SEC has imposed upon itself for MUI activity. If, at the end of that time, it is decided that the case should be pursued, an investigation is opened.

Investigations can be conducted under formal orders from the Commissioners when the issuance of subpoenas is required, or without formal orders if witnesses are willing to cooperate.

During the course of an investigation, SEC may trace suspects' funds through financial accounts at brokerage firms or banks, send questionnaires to parties involved, take depositions, subpoena records or individuals, and gather any other factual information deemed necessary.

Depending on the results of the investigation, the SEC staff will recommend to the Commissioners whether sanctions should be sought against persons or companies. The Commissioners then decide whether to issue the charges, amend the charges or reject the staff's recommendation based on their assessment of the evidence. The SEC may seek administrative or civil sanctions, or both, against investigative targets. But if the SEC decides that criminal sanctions are in order, then the matter must be referred to the Department of Justice. If Justice decides to pursue the matter, then the SEC may assist the U.S. Attorney with the investigation.

In fiscal year 1985, SEC brought 269 enforcement actions of all types. Of that total, 20 were administrative or civil proceedings involving insider trading. Those 20 proceedings stemmed from 15 case investigations. From the documentation reviewed for these investigations, we found SROs given as a source of investigations 8 times; market surveillance by either SEC or an SRO noted 5 times; complaints or informant tips noted 3 times; and a news media report, a securities industry contact, or another SEC division given as a source once each. Some of these cases stemmed from multiple sources.

In fiscal year 1986, SEC brought 313 enforcement actions. Of that total 34 were administrative or civil proceedings involving insider trading. Those 34 proceedings stemmed from 24 case investigations. From the case documentation reviewed, we found complaints and informant tips given as a source of

investigations 10 times; SROs noted 9 times; market surveillance efforts by SEC or SROs noted 3 times; and other sources were given 11 times. Once again, some of the investigations emanated from more than one source.

INFORMATION ON THE
IVAN BOESKY MATTER

Let me turn now to the Ivan Boesky matter. We agreed to try to provide you with information on how the systems and processes I have described above worked in this situation. Although time constraints and sensitivities regarding still ongoing investigations have prevented us from conducting a complete analysis of the Boesky matter, we have gathered certain statistics which we believe may be of interest to this Subcommittee.

NYSE market surveillance staff indicated that there were 47 investigations of anomalous trading during 1983-1986 which identified entities which the NYSE staff believed might have been associated with Ivan Boesky. It is important to note that these instances do not necessarily mean that Mr. Boesky or his affiliates were, according to the NYSE, suspected of illegal activity. It simply means that Mr. Boesky or his affiliates were, according to the NYSE, identified along with a number of other parties in an unusual trading situation. Of the 47 investigations, 23 had been closed by NYSE and the remaining 24 were still open at the time of our work last week. The NYSE recommended that SEC consider further review on 10 of the 23 cases closed at NYSE. NYSE sent closing reports to SEC for all 23 cases.

At our request, the SEC enforcement staff provided us with the status of all 23 of the above cases this week. SEC took no further action on 8 of the 23 matters. Eleven of the matters are currently under investigation, and the remaining 4 matters were closed after an investigation. In those 4 closed cases the SEC determined that there was no involvement by Mr. Boesky.

We also requested SEC to identify all inquiries and investigations it had initiated where Ivan Boesky or possible related entities were identified in some way. SEC identified 7 investigations, initiated as early as 1980, in which Mr. Boesky was stated to be involved in some manner. Of these 7, 3 are currently open investigations, and we did not obtain any further information on them. The other 4 involved taking testimony from Mr. Boesky as part of SEC's investigation of other parties; Mr. Boesky's conduct was not a focus of these 4 investigations.

CONCLUSIONS

As you can see, we have only begun our evaluation of systems for detecting insider trading and how suspected cases are investigated. While we, of course, cannot yet reach any final conclusions, we offer the following observations:

--On average, more than 75,000 trades involving 150 million shares of stock are made daily at the New York Stock Exchange alone. Thousands of trades occur in the other markets as well. Effectively monitoring these trades is an enormous task. SEC's challenge and that of the exchanges is to ferret out the questionable trades and develop further evidence pointing to possible violations of the securities laws. Toward that end, SEC and the exchanges have invested millions of dollars to develop and upgrade the capabilities of computer systems to monitor and analyze trading. And, further improvements are needed.

--Insider trading and similar violations such as market manipulation pose unusual difficulties in terms of developing the evidence necessary for an enforcement action. Even the most sophisticated computer surveillance systems will not produce the evidence necessary to link questionable trades with one or more individuals using inside information. These systems can provide an important and necessary part of the story. They can provide the initial leads indicating suspicious trading and produce a lot of circumstantial evidence. They can show, after the fact, who traded what stock, at what prices and when. But they do not produce irrefutable evidence showing who passed inside information to whom. Nor is it conceivable that, no matter how well designed, they could ever accomplish that task.

As requested earlier by this Subcommittee, we are currently reviewing the SEC Enforcement Division's procedures for investigating all kinds of cases. Moreover, we intend to continue our evaluation of surveillance systems now in place and under development at the various SROs, building on the SEC's own inspections. Also, we intend to look at SEC's own systems. Furthermore, one idea that we would like to explore in the future is the possibility of developing new approaches to dealing with the problem of market trading abuses. We have noted in the past that law enforcement agencies have tried to design novel approaches to attacking specific types of crimes, such as white collar crime and taxpayer compliance. While implementing better surveillance systems is a necessary part of an overall approach, perhaps we can involve a variety of disciplines in industry, government and academia to conceive new ways to attack insider trading problems. It is at least an issue we would like to pursue with the SEC and the industry.

We will, of course, keep this Subcommittee fully informed of our progress and issue final reports later. We wish to acknowledge the excellent cooperation we have received so far from the SROs and the SEC.

This concludes my statement, Mr. Chairman; we will be happy to respond to any questions from the Subcommittee.

GAO REPORTS PERTAINING TO THE SEC

Securities Regulation: SEC
Oversight of Self-Regulation
GAO/GGD 86-83, September 30, 1986

SEC Enforcement Program:
Information on Productivity
Statements and Cases Closed
Without Action
GAO/GGD 86-106BR, August 26, 1986

Securities Regulation: SEC Enforcement
Efforts in 1978 and 1985
GAO/GGD 86-97FS, July 16, 1986

Securities Regulation: Background and
Selected Statistics on SEC's Full
Disclosure Program
GAO/GGD 86-87FS, July 10, 1986

Securities and Futures: How the Markets
Developed and How They Are Regulated
GAO/GGD-86-26, May 15, 1986

Functional Regulation: An Analysis
of Pooled Investment Funds
GAO/GGD-86-63, May 12, 1986

Statistics on SEC's Enforcement Program
GAO/GGD-85-28, March 25, 1985