

April 16, 1987

MEMORANDUM

TO: Senate Banking Committee

FR: Steven B. Harris, Bart Naylor and
Patrick A. Mulloy

RE: Oversight Hearings on Improper Activities in the Securities
Industry

On April 22, 1987 the Committee will hold oversight hearings on improper activities in the securities industry. The witnesses will be Gary Lynch, Director of the SEC Division of Enforcement and Rudolph W. Giuliani, U.S. Attorney, Southern District of New York. The hearing will begin at 10:00 a.m. in Room SD-538 Dirksen Senate Office Building.

The purpose of this hearing is to enable the Committee to receive an update of the types of cases that the SEC and U.S. Attorney's Office have successfully brought and to get the general views of Mr. Lynch and Mr. Giuliani regarding insider trading, market manipulation, securities fraud, and other types of securities laws violations. The Committee is also interested in the views of the witnesses regarding the magnitude of the problem of illegal behavior in the securities industry and their thoughts on whether we are dealing with isolated cases or a more systemic and pervasive problem.

Mr. Giuliani said following the February arrests of Messrs. Freeman, Wigton and Tabor that the arrests were only the beginning "of a very long and substantial investigation" that includes "other institutions and people" and is not limited to insider trading.

A Chronology of the Stock Trading Scandal

May 12, 1986 SEC charges Dennis Levine of Drexel Burnham Lambert Inc., with making \$12.6 million since mid-1980 from insider trading. SEC also names as defendant Bernhard Meier, Mr. Levine's broker at Bank Leu International Ltd. in Nassau, Bahamas.

June 5, 1986 Mr. Levine pleads guilty to four felony charges and agrees to cooperate with the government in its investigation. Settling civil insider-trading charges, he agrees to pay \$11.6 million.

July 1, 1986 SEC charges Robert Wilkis and Ira Sokolow, former investment bankers at Lazard Freres & Co. and Shearson Lehman

Brothers Inc., with exchanging confidential information with Mr. Levine. They settle with SEC. Mr. Wilkis allegedly made about \$3 million from insider trading. Mr. Sokolow agreed to give up \$120,000 in profits.

July 3, 1986 David Brown, investment banker at Goldman, Sachs & Co., resigns amid SEC investigation.

July 14, 1986 Ilan Reich, takeover lawyer at Wachtell, Lipton, Rosen & Katz, resigns amid government investigation.

Sept. 4, 1986 Mr. Sokolow and Mr. Brown plead guilty to criminal charges of passing stolen information to Mr. Levine.

Oct. 3, 1986 Mr. Reich is indicted by federal grand jury in the Levine case.

Nov. 14, 1986 Ivan F. Boesky agrees to pay \$100 million penalty for trading on insider information supplied by Mr. Levine from February 1985 to February 1986; agrees to plead guilty to unspecified criminal charges.

Nov. 18-19, 1986 Drexel is identified as being under investigation for possible securities law violations in connection with the Boesky probe.

Jan. 28, 1987 Michael Davidoff, former head trader for Mr. Boesky, pleads guilty to one count of securities fraud for violating capital requirements at Mr. Boesky's firm. Mr. Davidoff, who had close contacts with many Wall Street traders, agrees to cooperate with the government.

Feb. 11-12, 1987 Three top Wall Street figures -- Robert M. Freeman, a Goldman Sachs partner; Timothy L. Tabor, a former official at Kidder, Peabody & Co. and Merrill Lynch & Co.; and Richard Wigton, a Kidder vice president -- arrested and charged with an information-swapping conspiracy that allegedly made Kidder millions of dollars in illegal profits. Mr. Freeman was also charged with trading for his own account on the information.

March 19, 1987 Boyd L. Jefferies, Jefferies Group Inc., chairman, agrees to plead guilty to two felony counts of securities law violations; he settles SEC charges that he engaged in multiple violations of securities laws as a participant in a market manipulation scheme and in a separate scheme with Boesky to "park" stock.

Types of Violations

Violations which have been the subject of recent cases involve and include the following:

Securities Fraud - Among the most important sections of the securities laws are those generalized prohibitions against "fraud or deceit" or "manipulative or deceptive devices or contrivances." Because Securities Exchange Act Section 10(b) has the broadest jurisdictional reach, it is the provision most frequently invoked, but the doctrines developed under it are also applicable to other sections.

Insider Trading - Commonly refers to the trading of securities while in the possession of material nonpublic information in violation of a duty of trust or confidence. It has been generally accepted that insider trading threatens our securities markets by decreasing the public's confidence in the fairness and integrity of the markets.

Market Manipulation - One of the most serious abuses in the securities markets on which Senate investigations focused, in the hearings which led to enactment of the 1934 Act, was the operation of "pools" which ran up the prices of securities on an exchange by series of well-timed transactions, effected solely for the purpose of "manipulating" the market price of the security, then unloaded their holdings on the public just before the price dropped. Accordingly, sections of the Securities Exchange Act prohibit a variety of manipulative activities with respect to exchange-listed securities, and Section 10(b) contains a catch-all provision permitting the SEC to prohibit by rule any "manipulative or deceptive device or contrivance" with respect to any security.

A recent market manipulation case involved an arrangement whereby a broker-dealer agreed with a certain person to effect a series of transactions in a security listed on an exchange for the sole purpose of raising or maintaining the price of that security.

Parking - Involves the creation of a false appearance of securities transactions which in fact do not involve bona-fide purchases or sales. Recently an individual admitted to buying some stock on behalf of his company from the company of an arbitrageur, on the understanding that the arbitrageur would buy it back a month later, indemnifying the individual's company for losses during that period, and paying unusually high commissions. According to the SEC, the sole purpose of this "parking" transaction was to let the arbitrageur create a false appearance of adequate net capital.

Issues

1) A number of cases that have been brought involve arbitrageurs in multi-service firms. What does this say about the Chinese Wall and the system of controls that many financial institutions

have set up to prevent confidential information about corporate clients from leaking to other departments?

2) The arrests in February of senior executives at some of the nation's most prestigious investment banks caused Business Week last month to raise the following issues and state: "The charges, if true, lend credence to the disquieting notion that there may be something inherently corrupting about the mergers-and-acquisitions game -- at least as it is currently played on the Street. The politically and legally explosive issue: How widespread is the corruption and how high does it reach?"

3) Based upon the cases brought to date what can be said about the cooperation and exchange of inside information between bankers, raiders and arbitrageurs?

4) There has been growing concern recently about collusion among some arbitrageurs, institutional investment managers, investment bankers and corporate raiders in pursuing profits from takeover-related activity. It is alleged that these groups, which control enormous pools of capital, currently have the ability to take very significant positions in the stock of publicly held companies and, through a variety of techniques, manipulate the price of that stock for enormous personal gain. To what extent is there merit to these allegations?

5) What improvements, if any, should be made by the securities industry self-regulatory organizations and by the industry itself?

6) What steps, if any, should be taken to improve surveillance?

7) What are some of the common motives of the individuals whom cases have been brought against?

8) What are the best means for deterring and detecting violations of the securities laws?