Chapter 8

Market Fraud and Its Victims

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Market Fraud and Its Victims

Fraud in securities markets and fraud in futures markets stem from greed and corruption and, in some cases, naivete' on the part of the victims. They are similar in that detection and enforcement can be difficult. They differ in the details of the abusive practices. There is little consensus on whether the losses to public customers are greater in securities or futures markets, and there are no widely accepted figures for the magnitude of the losses in either market.[1]

Public attention has recently been drawn to a variety of abuses in financial markets, including insider trading, sales abuses and penny stock scams in securities markets, and fraud in futures trading pits. As a result, legal authorities and resources for enforcement are being bolstered. Coordination among regulators and law enforcement authorities is improving. International cooperation is also beginning to broaden.

There will always be opportunities for fraudulent or abusive behavior, but domestic actions in recent years by Congress, the Securities and Exchange Commission (SEC) and Commodities Futures Trading Commission (CFTC), self-regulatory organizations (SROs), and States show promise of reducing some types of abuses and, in some cases, have raised the penalties for convictions. Related actions concerning international fraud, including those involving foreign countries, should also narrow the scope of familiar opportunities for low-risk fraud and abuse. However, many of these actions are relatively new and still evolving, so it is too early to judge their long-term effectiveness.

Fraud and abuse are certain to continue in one form or another and increasingly will become international. Legislators in the world's major trading markets will have to judge where to target their limited resources. Recent domestic efforts to institutionalize the coordination of Federal, State, and SRO actions to deter abuse will have to become more coordinated internationally in order to be effective. Undoubtedly, there will be a need for continuing congressional attention as new opportunities emerge for fraudulent behavior in both domestic and international trading.

The further adoption of modern electronic systems both for floor and off-exchange trading can reduce opportunities for fraud in both securities and futures markets. Modern systems can eliminate many, although not all, kinds of abuses. Some types of abusive activities, both in securities and futures markets, will remain difficult to detect and prosecute.

ABUSES IN U.S. SECURITIES MARKETS

SEC Authorities

The SEC, which has primary responsibility for detection and deterrence of fraud in the securities markets, has responded to the increases in fraud not only with targeted enforcement initiatives (e.g., against penny stock fraud), but also by seeking and applying tougher enforcement remedies (e.g., civil penalties for insider traders). The SEC also works closely with SROs, other Federal agencies, and State and foreign authorities to coordinate investigations and share information for enforcement purposes.

The SEC has broad authority to enforce the Federal securities laws through the filing of civil actions in the Federal courts and through administrative proceedings. These enforcement actions are generally preceded by an investigation (or an inspection of regulated entities). The Federal securities laws authorize the SEC to initiate formal investigations, in order to issue subpoenas to compel testimony and the production of books and records.

In the Federal courts, the principal remedy available to the SEC is a civil injunction, which prohibits future violations of the securities laws. Noncompliance with an injunction is punishable as civil or criminal contempt, and may result in fines or imprisonment. In addition, the SEC often seeks other equitable relief such as forfeiture of ill-gotten gains or rescission. In SEC actions for insider

[1] The North American Securities Administrators Association estimates that fraud in penny stock securities alone, discussed later, amounted to about $2 billion in 1987 and 1988. *Survey of Penny Stock Fraud and Abuse,* a report by NASAA for the House of Representatives, Subcommittee *on* Telecommunications and Finance, submitted September 1989.

trading violations, civil penalties can be imposed of up to three times the profit gained or loss avoided as a result of such violations.

The SEC may institute several types of administrative proceedings. Most such proceedings are brought against regulated entities (e.g., brokers, dealers, investment companies, and others).[2] Sanctions that may be imposed upon regulated entities range from censure to a revocation of registration, while sanctions for "associated persons" range from censure to being barred from association with regulated entities. Administrative proceedings may also be instituted against persons who appear or practice before the SEC, such as attorneys and accountants. The SEC may suspend or bar them from appearance or practice before the agency.[3]

The SEC also is authorized to refer matters to the U.S. Attorney General for possible criminal action, and it exchanges information and assists in investigations into possible criminal violations of the securities laws.[4]

Recently, several bills have been introduced to further strengthen the SEC's enforcement capacity. The Securities Law Enforcement Remedies Act (Remedies Act), introduced as H.R. 975 and S.647, would strengthen Federal courts' and the SEC's authorities to levy penalties on violators of securities laws, require disgorgement, and issue cease-and-desist orders.[5] The Remedies Act also would amend the Federal Criminal Code to make it easier for Federal courts to issue orders permitting disclosure of grand jury information to the SEC for use in matters within the agency's jurisdiction. The International Securities Enforcement Cooperation Act, introduced as H.R. 1396 and S.646, would, among other things, permit the SEC and the SROs to deny registration to persons who have been sanctioned by foreign regulators, and would exempt confidential documents received from foreign authorities from disclosure under the Freedom of Information Act, thereby removing an impediment to the development of information from, and negotiation of memoranda of understanding with, foreign authorities.[6]

The SROs also play an active part in the detection and deterrence of unlawful conduct, under the oversight of the SEC. They monitor trade and transaction data to detect suspicious trading patterns, and may initiate their own investigations and disciplinary actions against their member firms and persons associated with the fins. The SROs are authorized to apply penalties that include frees, suspensions, and revocations of stock assignments to specialists. The SROs may refer certain matters to the SEC for possible enforcement action.[7]

The SROs formed the Intermarket Surveillance Group (ISG) in 1981 to facilitate the sharing of information and the coordination of inter-market surveillance activities. The ISG provides access by the SROs to a computerized database containing audit trail and clearing information on all transactions in each market in which a security or derivative contract is traded. When an SRO begins an inter-market trading investigation, the information is readily available from the ISG database.

Insider Trading

Insider trading refers to "the purchase or sale of securities in breach of a fiduciary duty or other

[2] See, e.g., sec. 15(b)(4) and (6) of the Securities Exchange Act.

[3] 17 CFR *201.2,* Rule *2(e)* of the SEC'S Rules of Practice. Other administrative proceedings may be instituted to suspend the effectiveness of an issuer's registration statement containing false or misleading statements, or to order compliance with reporting, beneficial ownership, proxy, and tender offer provisions of the Exchange Act.

[4] Although criminal proceedings generally involve only the most egregious fraudulent conduct, criminal penalties are available for any willful violations of the federal securities laws. (See, e.g., sec. 32 of the Securities Exchange Act.) U.S. Attorneys may exercise prosecutorial discretion to charge violations of various provisions of the Federal Criminal Code (typically relying upon the mail and wire fraud statutes) in cases involving conduct that would constitute securities law violations. In addition, the Racketeer Influenced and Corrupt Organization Act (RICO) has been used, on occasion, in connection with indictments for securities law violations. Because RICO permits pre-trial seizure of assets as well as the imposition of treble damages after conviction, its use in white-collar crime contexts has been the subject of criticism.

[5] The Act would: 1) authorize the Federal courts to order the payment of civil money penalties fOr violations Of the Securities laws; 2) authorize the SEC to order disgorgement and impose civil penalties in certain administrative proceedings; 3) authorize the SEC to issue cease-and-desist orders; and 4) expressly affirm the authority of the Federal courts to issue orders that prohibit individuals who have committed egregious violations of the general antifraud provisions from serving as officers or directors of any reporting company.

[6] Other bills recently introduced include the Penny Stock Reform Act of 1990, H.R. 4497; the Corporate Integrity and Full Disclosure Act, S.1886; and the Investor Equality Act of 1989, S.1658.

[7] Because the SROs may exercise authority only over their members and persons associated with their members, cases requiring wider inquiry are generally referred to the SEC. As a practical matter, for example all insider trading cases are referred to the SEC.

relationship of trust or confidence, while in possession of material nonpublic information about an issuer or the trading market for an issuer's securities.' In other words, someone uses privileged information not available to the public to make, or to assist others to make, profitable trades. Federal securities laws prohibit such trading not only by corporate officers and directors and other persons having a relationship of trust and confidence with the issuer or its shareholders, but also by persons who misappropriate material nonpublic information from sources other than the issuer. "Tippees" of such persons may also be subject to the prohibition. Insider trading in the context of tender offers is specifically prohibited.[8]

Enforcement actions against insider trading are brought by the SEC under the general antifraud provisions of the securities laws.[9] The Insider Trading Sanctions Act of 1984 (ITSA) authorized the imposition of civil penalties in insider trading cases of up to three times the profit gained or the loss avoided by insider trading. The Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA) further amended the Federal securities laws.[10] ITSA and ITSFEA also contain provisions that increase the criminal penalties for violations of securities laws, including insider trading violations.[11]

Market vulnerability to insider trading increased in recent years because of the increased numbers of mergers and acquisitions.[12] Increases in stock prices just before the announcement of major corporate announcements may be an indicator of insider trading. The General Accounting Office (GAO) reported that for a 2-year period (1986-87), the records of the major exchanges showed 83,000 "business events or anomalous trading that warranted analysis. ' '[13] Of these, 468 were investigated and referred to the SEC, which then investigated 203, or 43 percent.[14]

Trades by insiders must be reported to the SEC, which publishes a record of these transactions in its *Official Summary of Security Transactions and Holdings.* A number of studies using such data have shown that, generally, stocks in which there has been heavy insider buying provide returns that are significantly above average,[15] thus rewarding the early inside trader.

The detection of insider trading on the regional exchanges is more difficult because data on transactions is collected and sorted by a manual process, rather than by automated systems. On all exchanges, much of the evidence on insider trading comes from cooperative witnesses. As much as one-third of such trading may be conducted through foreign bank

[8]The Federal securities laws do not contain a definition of insider trading, and the scope of the violation has therefore been a matter Of judicial determination. Congress has on occasion considered the possibility of adopting a definition, most recently in connection with S.1380, the Insider Trading Proscriptions Act of 1987, introduced on June 17, 1987.

The U.S. Court of Appeals for the Second Circuit in 1990 reversed the criminal conviction of Robert Chestman in a case involving the liability of a "remote tippee," i.e., one who does not have a fiduciary or other relationship of trust or confidence, but acts on insider information. One of the three opinions in the case suggested that the SEC's Rule 14e-3 is overly broad.

[9]Primarily Section 10(b) of the Exchange Act and Rule 10b-5.

[10]It: 1) expanded the scope of civil penalties to "controlling perSons" who fail to take appropriate measures to prevent insider trading by their employees; 2) gave the SEC the authority to award payments to persons who provide information regarding insider trading violations; 3) requires brokers, dealers and investment advisers to establish, maintain and enforce written policies designed to prevent misuse of material, nonpublic information; 4) increases the maximum jail term and fine for those convicted of criminal securities law violations; 5) codifies a private right of action for persons who trade at the same time as, and on the opposite side of the market from, insider traders; 6) enhances the SEC's authority to assist foreign governmental authorities in the investigation of international securities laws violations; and 7) authorized a study of the adequacy of present securities laws.

[11]With the ITSA and ITSFEA amendments, the Exchange Act now provides that individuals convicted of securities violations may be sentenced to a maximum term of 10 years imprisonment and freed up to $1 million. Securities firms, corporate issuers, and other defendants may be freed a maximum of $2.5 million. These penalties in criminal actions may be obtained in addition to remedial relief obtained in actions by the SEC.

[12]Recent studies indicate that insider trading has continued and possibly increased, despite regulatory responses to such conduct, with large profits to its practitioners. See Nasser Arshadi and Thomas H. Eyssell (University of Missouri, St. Louis), "The Law and Finance of Corporate Insider Trading: The Effects of Regulation on the Volume and Incidence of Insider Trading Prior to Tender Offers," a paper presented at the European Conference on Financial Integration, June 28-30, 1989, University of Paris, Dauphine, France.

[13]U.S. General Accounting Office, *Securities Regulation: Efforts to Detect, Investigate, and Deter Insider Trading*, GAO/GGD-88-1 16, August 1988. The analysis covered the NYSE, AMEX, NASD and CBOE, together having 90 percent of trade volume.

[14]Instances of suspected insider trading are usually referred to the SEC which may invoke its subpoena power to compel production Of documents and testimony.

[15]Norman G. Fosback, *Stock Market Logic: A Sophisticated Approach to Profits on Wall Street, May 1987,* pp. 235-239. The author is editor of 'The Insiders," an investment advisory service providing coverage of insider trading activities.

accounts, and many countries have legal barriers to providing evidence in such cases.

The investigation of insider trading cases is often more complex than other types of investigations, because the SEC must usually rely upon proof by circumstantial evidence or on informers. In addition, trading by or through foreign banks or brokers may make it more difficult to identify the persons who engage in insider trading.

During the 1980s, the SEC clearly seemed to change course by bolstering its enforcement actions against insider trading. The number of insider trading actions brought by the SEC has increased dramatically. From 1934 to 1979, there were only 53 such actions. From 1980 through 1983 there were 10 actions, and from 1984 through 1987, the SEC brought 61 cases, an average of 15 per year, with 21 cases filed in 1987 alone. In 1988 there were 27 cases, and in 1989 there were 42.

In spite of these prosecutions, however, insider trading still flourishes. A recent study indicated that, in the year from May 1986 (when inside traders Dennis Levine and Ivan Bees@ were arrested) to April 1987, while "inside-insider" trading sharply decreased, "outside-insider" trading did not.[16] The study suggested that this may be because court decisions have narrowed the coverage of inside trading laws to those having fiduciary duties to the firm issuing the stock or to others having related responsibilities (i.e., brokers) .17

Frontrunning

Frontrunnin g is the purchase or sale of securities by a person who possesses "material nonpublic information' regarding an imminent block transaction. The typical case involves a broker who trades in advance of a large order placed by one of its customers. The broker can profit by such trades if the block order is large enough to affect the price of the security in which the broker is trading.[18] Frontrunning can also occur in inter-market trading.[19]

Frontrunning is primarily regulated by the SROs. While none of the SROs has a specific rule in this area, their rules of just and equitable principles of trading have been uniformly interpreted as prohibiting frontrunning and written statements to this effect have been issued to the members of the self-regulatory organizations.[20]

''Self-frontrunning' involves the purchase of futures or options by a broker in advance of a large trade for its own account in the equities market. While such transactions are not prohibited by existing rules, some critics maintain that they may account for ''extraordinary volatility "[21] that others have more generally blamed on stock-index arbitrage, and argue that this intra- or inter-market frontrunning is ''increasingly manipulative and detrimental."[22] In late 1989, the New York Stock Exchange (NYSE) and two futures exchanges began a study of manipulative program trading that was suspected to have caused unusual price differences between stock-index futures and underlying stock.

Other Violations

While insider trading and penny stock fraud have dominated the headlines in recent years, other forms of fraud by broker-dealers also continue to cause losses to investors.

16Arshadi and Eyssell, op. cit., footnote 9. "Outside-insiders" are, for example, a fro's lawyers.

17In May 1990, a New York Circuit Court of Appeals panel further reduced the SEC's ability to prosecute insider trading cases. The Court adopted a narrow interpretation of the conditions under which those who receive inside information, i.e., "remote tippees, " can be held liable under the SEC's Rule 10135. This decisions expected to make SEC prosecutions of remote tippees more difficult. The same Court's decision also narrowed the conditions under which the SEC may prosecute insider trading cases using Rule 14e-3. This rule prohibits anyone from knowingly trading on inside information in takeover situations.

18Frontrunning is not limited to transactions in the same security as the block order, and may involve, for example, transactions in options on those securities.

19A report of the NYSE's blue-ribbon panel included among its conclusions concern about the existence of widespread inter-market trading abuses involving the stock, options, and futures markets, and suggested that inter-market regulation and surveillance systems need to be improved "to prevent undetected wrongdoing in today's complex marketplace.' NYSE, *Market Volatility and Investor Confidence,* June 7, 1990.

20The written statements regarding frontrunning were amended in 1987 by the SROs to clarify that trading in index options by persons possessing material, nonpublic information concerning imminent transactions in the component stocks of an index may also constitute frontrunning in violation of the rules of just and equitable trading.

21Gerald Beirne, in a letter dated Dec. 6, 1988, to the SEC Secretary re SEC file SR-NYSE-88-34, which proposed a rule change re frontrunning.

22Testimony by John J. Morton in Hearings on the Stock Market Reform Act of 1989, before the Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, House of Representatives, July 27, 1989.

A survey conducted by the North American Securities Administrators Association (NASAA) following the 1987 crash noted that investors in options were the most likely to complain of abusive broker sales practices that preceded the crash.[23] Many investors who suffered major losses were not suitable candidates for placement in options markets by stockbrokers. For example, unsuitable investment strategies executed by brokers accounted for 40 percent of all options-related complaints, though only 9 percent of common stock-related complaints. Investors also overwhelmingly expressed a lack of understanding of margin agreements, mutual fund fees and procedures, and the existence of mandatory arbitration clauses in the written customer agreements filed with their brokers. NASAA concluded that half of the problems complained of by investors might have been prevented if brokers had observed proper sales practice rules, and suggested that much of the financial loss suffered by individual investors was unnecessary and avoidable.

These cases often involve stockbrokers who put their clients into unsuitable investments, such as "naked' call options (where the customer does not own the underlying securities, putting him at risk of unlimited obligations), churn customers' accounts to raise commissions,[24] and coax customers into signing agreements which give the stockbroker discretionary authority to make investment decisions without prior approval by the customer.

Those who were subject to abuse often were small investors who did not understand the risks incurred, because of relative lack of experience and training in financial markets, as indicated by income and education levels.

Stock market abuses tend to have colorful names. A few other commonly recognized ones include:

- *Parking-One* attempting a takeover gets others to buy stock with the commitment to sell it back to him later, allowing the takeover specialist to circumvent the requirement that anyone who owns 5 percent of a company's stock report this to the SEC.
- Soft *dollar abuses—'* Soft dollars" are rebates on broker commissions made to large institutional customers in the form of free research, computer services, or other trading-related services. Soft dollar arrangements are not per se illegal, but are subject to abuses such as offering investment managers research results- or even free vacations and expensive gifts—that do not benefit the customers who pay for them. Such practices raise concerns about conflicts of interest and the manager's fulfillment of fiduciary obligations to customers.
- *Wash sales-securities* transactions involving no real change of ownership, for example, a sale to one's spouse or simultaneous sale from one account and purchase to another account of the same person. Such transactions have been used as part of stock manipulations schemes, to create the appearance of active trading in a security.

Penny Stock Fraud

"Penny stocks" is a term used to refer to low-priced securities traded in the over-the-counter market. While the majority of these securities are quoted in the "Pink Sheets" published by the National Quotation Bureau, Inc., many are quoted through the National Association of Securities Dealers Automated Quotation (NASDAQ) system. Many penny stocks represent legitimate investment opportunities. However, many other penny stocks are used in fraudulent schemes. They usually involve "shell" companies with no operating history, few employees, few assets, no legitimate prospects for business success, and markets that are manipulated to the benefit of the promoters of the companies or the market professionals involved.

Penny stock scams generally involve high--pressure sales operations from "boiler rooms" where unsolicited, or cold, telephone calls are made to prospective clients whose names are obtained from telephone books or other readily available lists. Prospective clients, often unsophisticated in such investments, are promised large, rapid, and often "guaranteed' returns on their investments. Many of them end up with little to show for their investments and no way to recover their losses.

[23]NASAA conducted a telephone hot-line survey for about a year which received thousands of complaints from investors concerning abusive practices by brokerage fins. About half of the complaints reflected inadequacies in investor protection measures, or poor supervision of stockbrokers, e.g., unsuitability of investment, unauthorized trading, and false and misleading investments. The *NASAA Hot Line 1988 Survey,* October 1988.

[24]Churning involves excessive trading by a broker in a customer's account over which the broker exercises discretionary authority.

There is also a ''wholesale" side in which a network of traders in different firms might control trading among themselves ("boxing" the stock), perhaps including sales to the public, to manipulate the price of a stock. This type of operation typically involves thinly traded stock and may include buying and holding a large block of stock off the market (i.e., "parking" it, making manipulation easier). Customers are sold stock from inventory after its price rises significantly.[25] Customers who decide to sell may find that their holdings are illiquid and therefore either worthless or can only be sold at a significant loss.

There is no solid data on the number of investors in the United States who are bilked of their investments by penny stock operators, but they probably number at least in the tens of thousands each year. Heightened enforcement efforts by the SEC, NASD, and State agencies manage to uncover many such operations, but the same violators often quickly reappear in new scam operations, or as consultants in other operations, and can move rapidly from one State to another, or to off-shore locations. State regulators observe that gathering evidence on penny stock scams often requires inside informers or wiretaps, and that efforts to prosecute are often frustrated. These frustrations sometimes lead to criticisms of the SEC, whether justified or not. (See box 8-A.)

SEC officials note that their empirical data indicates that beginning in 1988 the increase in the number of SEC 'cause examinations' '[26] was largely attributable to penny stock fraud, but by mid-1990 there was a substantial decline in the number of penny stock broker-dealers. Yet, some experts in State enforcement functions are skeptical that these scams will ever be eradicated because they are lucrative for operators, and difficult to detect and prosecute, and the operators often don't get prosecuted.[27]

Although penny stock fraud remains a major problem, Federal and State enforcement agencies are continuing their efforts to stem abuses. For example, in October 1988, the SEC established the Penny Stock Task Force. The Task Force has focused on: 1) increased coordination and information sharing with other Federal, State and local regulators and prosecutors; 2) stepped-up enforcement activities; 3) targeted regulatory solutions to the problem of penny stock fraud; and 4) increased investor education. The SEC brought 68 enforcement actions during 1989, compared to 43 actions in 1988.

The SEC's new "cold call" rule[28] is designed to address the problem of high-pressure telephone solicitations by penny stock boiler room operators. It requires brokers and dealers to approve new customers' accounts for transactions in penny stocks by making and providing to the customer, before his frost purchase, a written determination that penny stocks are suitable for the customer. In addition, the broker or dealer must obtain the customer's written agreement to initiate penny stock purchases.[29]

In the last 3 years, the NASD brought some 250 enforcement cases of its own in the penny stock area, and now makes many surprise audits. The NASD now operates an investor information system to disclose brokers' disciplinary histories and has recently introduced an electronic bulletin board that captures and displays on a real-time basis, during market hours, firm and non-firm quotations, or unpriced indications of interest in eligible over-the-counter (OTC) securities. The bulletin board provides the frost computerized listings of penny stocks.

The Justice Department has brought numerous indictments involving activities by penny stock fins, including Blinder, Robinson & Co., F.D.

[25] In a recent court case involving a group involved with a now bankrupt fraudulent penny stock operation based in Florida, the manipulated prices of three stocks increased between 400 and 1,100 percent in a few weeks. Press release: "Two Principals of Florida-Based Penny Stock Securities Brokerage Plead Guilty Today in Connection With the Price Manipulation of Three Stocks," U.S. Attorney, District of New Jersey, May 24, 1990.

[26] Cause exruminations are initiated when there is an indication of wrongdoing serious enough to warrant further SEC inquiry.

[27] OTA interview with Richard Barry, New Jersey Bureau of Securities, July 11, 1990

[28] Rule 15c2-6, 17 C.F.R. 244).15 c2-6.

[29] The SEC has also proposed amendments to Rule 15c2-11 under the Exchange Act, which would increase the responsibilities of broker-dealers who make markets in penny stocks. Rule 15c2-11 governs the submission and publication of quotations by broker-dealers for certain over-the-counter securities that are not traded on the NASDAQ system. In general, the rule requires broker-dealers to obtain specified financial and other information about an issuer before initiating quotations. The proposed amendments would revise the rule by requiring a broker-dealer to review the information about the security specified in the rule and to have a reasonable basis to believe that the information is true and accurate and obtained from reliable sources. The proposal would also require a broker-dealer to have in its records a copy of any trading suspension order, or SEC release announcing a trading Suspension with respect to the issuer's securities during the preceding year.

Box 8-A-Continued Need for Coordination of Federal, SRO, and State Actions

OTA's exploration of penny stock fraud, including discussions with State securities regulators, revealed widely held misconceptions. One is that the Federal budget cuts during the early 1980s led to a blossoming of penny stock fraud because of a reduction in the SEC's screening of initial public offerings (IPOs) and other filings. However, during the 1980s, the SEC was not subjected to budget cuts and, in fact, continued to evaluate all securities IPOs and other sensitive applications. It established more cost-efficient methods of operating its screening process, but there was no reduction in the level of applications screened. Thus, the growth of penny stock seam operations probably sterns from other causes.

A second misconception concerns the basis for the criteria used by the SEC in screening IPOs, secondary public stock offerings, and proxy statements. The SEC is required by the Securities Exchange Act of 1933 to use "full disclosure" as its central criteria for deciding whether to register equity offerings. For decades, about 10 States relied on SEC registrations of initial and secondary public stock offerings to automatically grant State registration.[1] The growth of penny stock scams in Utah, Colorado,[2] and Florida, however, is evidence that SEC registration criteria alone will not protect investors against false statements by issuers. It is not clear that any criteria can provide such protection. However, a number of these States have now passed legislation requiring State evaluation of IPOs and secondary equity issues. The evaluation criteria in some States is based on merit (i.e., whether the offering is fair, just, and equitable to investors). In some States, the offering price must have some reasonable relationship to actual, or reasonable expectations of, earnings. Some States have a prohibition against 'cheap stock'—where shares of stock are given at no cost. Other States may disallow the sale of any issues if they appear deceptive or especially prone to fraud.

Some State regulators argue that SEC evaluations would serve the public better if they, too, were based on merit criteria in addition to the full disclosure criteria. Others argue that a well-informed public and State regulators are better able to decide which entrepreneurial ventures are worthy.[3] Others advocate the establishment of a national register listing brokers and agents who have been barred from securities practice or have been convicted of securities violations.

In spite of intensified enforcement efforts, rule making, legislation, and increased coordination among the SEC, U.S. Justice Department, the NASD, State regulators, and SROs, a goal of sharply reducing the currently significant presence of scams may require a greater commitment of resources at the Federal and State levels for educating the public, identifying abusers, and enforcement. The recent establishment within the SEC of a Penny Stock Task Force and an office of International Affairs, and the annual SEC-State relators' coordination meetings, are important steps in the right direction. In addition, the Penny Stock Reform Act of 1990 will strengthen the SEC's enforcement authorities.

Many State regulators are complimentary about the SEC's and NASD's recent efforts to fight penny stock scams. Yet some say that the SEC could be more effective if it devoted more of its resources to protecting small investors. Perceptions among some critics are that, compared to many States' actions, there are relatively few SEC enforcement actions against broker-dealers and their associated persons who directly abuse small investors. (SEC officials dispute this.) Critics argue that the SEC's major insider trading cases involving hundreds of millions of dollars (e.g., Michael Milken, Ivan Boesky, and Dennis Levine), have no apparent direct impact on the abuses suffered by many thousands of ordinary citizens who are often totally dependent on their savings, and who don't know where to turn for assistance.[4]

State regulators may never have sufficient resources to satisfactorily control the level of penny stock scam operations. A more specific plan of attack, jointly developed by the SEC, U.S. Justice Department, the NASD, and State regulators, may become even more important if scam operations continue to migrate to off-shore havens, and if, as some fear,[5] the current international efforts to harmonize investor protections among European countries[6] results in lowering U.S. standards of investor protection. OTA project staff, however, found little reason to expect a lowering of investor protections in the United States.

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[1]Other States have used their own evaluation processes, some of which are based on legislation dating from the turn of the century.

[2]Colorado, in the early 1980s, had no significant registration or enforcement authorities, which is seen as having opened the door to an influx of penny stock scam operators.

[3]The debate about the appropriate Federal role dates from before the creation of the SEC. The SEC has no legislated authority to use a merit criteria.

[4]These views were expressed most clearly by John Perkins, Missouri Securities Commissioner, and Richard Barry, New Jersey Bureau of Securities, in telephone interviews with OTA project staff, July 1990.

[5]Various speakers at the NASAA Conference on 'Global Markets: A World of Risk for Small Investors, " Washington, DC, April 1990.

[6]See OTA Background Paper *Trading Around the Clock:* Securities *Markets and Information Technology,* OTA-BP-CIT (Washington, *DC:* U.S. Government Printing Office, July 1990).

Roberts Securities, and Monarch Funding Corp. The prosecution in the latter case is seeking $20 million in forfeitures pursuant to the Racketeer Influenced and Corrupt Organization Act (RICO).

State regulators believe that 70 percent of all penny stock issues are "blank check offerings."[30] So far, some 36 States have passed or are considering regulations that ban such offerings, and Federal legislation has been proposed that would impose certain restrictions on registration statements filed by any issuer in connection with blank check offerings.[31] New Jersey, Florida, and Colorado are among the States that have been heavily hit by such scam operations, and each has taken law enforcement actions to reduce these abuses. New Jersey, for example has increased its investigators from 2 in 1986 to 20 in 1989. New Jersey obtained 30 penny stock convictions in 1989 and about 70 others during 1986-89. The Florida Penny Stock Task Force created a law enforcement group in 1988 that eliminated 30 scam brokers during 1988 and 1989 which collectively employed a sales force of 3,700.[32] Utah prosecutors obtained 17 indictments and convictions in 1989 as a result of sting operations.

Arbitration

Many cases of clients claiming to have been victimized are settled by arbitration. There are ten arbitration forums. Two of them, the NYSE and the NASD, handle 92 percent of all arbitration cases. Three-member panels sanctioned by stock exchanges usually conduct the arbitration. Arbitration panels typically include a securities executive and sometimes a second panelist with ties to Wall Street. They are therefore perceived as stacked against the small investor, although this is denied by the securities industry. Investors win about 60 percent of the cases brought before the independent American Arbitration Association and about 50 percent of the cases brought before the nine arbitration forums supported by the securities industry. Even when the customer wins the case, he often doesn't recover the full amount of the injury. Until recently, arbitrated cases were usually decided within 2 days. Some are settled by agreement, between the customer and broker firm, without formal arbitration procedures.

Brokerage firms have favored the arbitration process in the past, and many typically required all but their larger customers to sign an agreement to submit disputes to arbitration for settlement (i.e., to forego seeking relief through court settlement). However, new SEC rules allow pretrial conferences and discovery, and hearings now take 5 days or more. Most importantly, arbitration panels have begun to levy large punitive damage awards (in addition to compensatory, or actual, damage awards) under the RICO statute or the Federal Arbitration Act, which can be as much as triple damage.[33]

The caseload of arbitration has grown from under 1,000 in 1980 to over 6,000 in 1988, 65 percent of which were filed with the NASD and 27 percent of which were filed with the NYSE. SEC rules issued in 1989 have opened the arbitration process to public view, putting pressure on brokerage firms to avoid negative publicity, in addition to their continuing need to reduce costs. Securities firms settled 37 percent more customer disputes at the NASD since the new SEC rule took effect.

International Securities Fraud

Increasing internationalization of the securities markets will provide access to new sources of capital for U.S. corporations, Table 8-1 shows the rapid growth of foreign transactions in U.S. corporate stock. U.S. securities regulators are not as well equipped to tackle fraud from off-shore sources. The

[30]Blank check offerings are those in which stock issuers either disclose no specific business planer purpose, or state that the business plan is to merge with an unidenti.tied entity or to acquire unidentified assets, without identifying the business sought to be acquired or the managers responsible for operating the company after the merger. See *Investor Alert! How to Protect Your Money From Schemes, Scams, and Frauds, The Council* of Better Business Bureaus and the North American Securities Administrators Association, February 1988. There are also "blind pool" offerings, Blind pool offerings are those in which the business plan of the issuer is to seek mergers or acquisitions in an identified business line, but the specific organization or assets sought to be acquired are not identified.

[31]The Penny Stock Reform Act of 1990, H.R. 4497. For purposes of this legislation, this means any developmental-stage company that is issuing a penny stock (as defined by the bill), that has no specific business plan or purpose, or has indicated that its business plan is to merge with an unidentified company or companies.

[32]The Florida Penny Stock Task Force grew out of a meeting sponsored by the SEC's Miami BranchOffice, and includes the State of Florida, the NASD, U.S. Attorneys' Offices, the FBI, the IRS, and other Federal law enforcement authorities. The Florida Task Force serves as a model for ongoing State and Federal cooperation.

[33]Beginning in 1989, data on arbitration awards were made part of the public record. Since then, arbitration panels granted 21 punitive damage awards totaling $4.5 million to investors. During the prior year, 9 punitive damage awards were made, totaling $1.7 million.

Table 8-I—Foreign Activity in U.S. Corporate Stock[a]

	Purchases	Sales
1977	14,154	11,479
1983	69,770	64,360
1987	249,122	232,849
1989	213,778[b]	203,386[b]

[a]AmountS are in millionsofu.s. dollars.
[b]prefimina~ctatafromthe *TreasuryBulletin* March 1990.
SOURCE: U.S.Treasury Department.

total amount of fraud perpetrated from off-shore is -unknown, but is believed to be significant[34] and the fastest growing form of securities fraud.

Transactions in foreign stocks by U.S. investors grew from $15 billion to $220billion between 1982 and 1989, according to the Treasury Department.

Internationalization magnifies the need for international cooperation among securities regulators. International pressure for increased participation in, and easy access to, U.S. markets, will result in increased enforcement responsibilities.

In 1988, a House Subcommittee report questioned the ability of the SEC to police international securities fraud. This report, based on congressional hearings and a study of SEC records of investigations of suspicious trades originating from or through foreign countries,[35] focused on: 1) the extent to which possible violations of U.S. securities laws, such as insider trading and market manipulation, involve transactions that originate from foreign countries where SEC identification of traders can be difficult, if not impossible; 2) the process the SEC uses to pursue those foreign-originated trades where violations are suspected; and 3) the problems the SEC has encountered in investigating such suspicious trades.

One witness at the hearing noted that:

> . . . the globalization of the securities markets . . . have introduced greater rewards at. . . less risk for those who seek to take advantage and . . . conceal their wrongdoing behind the mantle of foreign nondisclosure laws. I believe that. . . insider trading has been on the rise over the last two decades, with a significant amount of wrongful trading effected from abroad. These foreign cases challenge the [SEC'S] staff far more than even domestic investigations do.[36]

Other witnesses testified that some U.S. and foreign investors avoid SEC scrutiny of their transactions in U.S. markets by executing their transactions through financial institutions in foreign countries that have bank secrecy and blocking statutes.[37] Former SEC Chairman David Ruder testified that:

> . . . [i]t is relatively easy for individuals and entities to open accounts with foreign banks or brokerages, which can then place trades on U.S. markets without revealing the identities of their clients [incorporated, for example, in Panama, Liechtenstein, Monaco, or Costa Rica] that issue bearer shares, making it more difficult to identify the beneficial owner. Accounts may be opened in fictitious names, or established as nominee accounts.

The Subcommittee also received testimony that identifying suspicious foreign traders who use off-shore accounts was becoming more difficult as schemes to hide a trader's identity increase in sophistication. Some investors open accounts in foreign banks and use shell corporations located in other countries to place trades though the banks .38 Such activity may involve two or more layers between the person who places the trade in the United States and the actual beneficial owner directing the trade. Detecting the identity of the investor becomes much more complicated if layers of nominees and agents, such as shell corporations,

[34]NASAA concludes, based on 87 major enforcement actions by 40 States during 1988 and 1989, that small investors lost an estimated $1.1 billion from international investment fraud of various types. These include both off-shore *investment scams* and those that falsely claim to operate from overseas. *NASAA 1990 Study of International Investment Fraud and Abuse,* NASAA, July 1990.

[35]"Problems With the SEC's Enforcement of U.S. Securities Laws in Cases Involving Suspicious Trades Originating From Abroad," Subcommittee on Commerce, Consumer, and Monetary Affairs of the House Committee on Government OperationH.R. Rep. No. 1065,100th Cong., 2d sess. (1988).

[36]Testimony of Harvey Pitt.

[37]Bank secrecy laws typically prohibit banks in the host countries from disclosing such information as the identities of customers and records of their transactions. These laws protect private, rather than public, interestsand, thus, generally maybe waived provided that information concerning third parties is not disclosed. Blocking laws generally prohibit the disclosure, copying, inspection or removal of financial documents located in the host country andoftenprovide criminal penalties forviolations. Blocking laws are intended to protect the country's national interest and, thus, are not waivable by private parties.

[38]Dennis Levine used the relatively simple approach of trading from a number of accounts in a Bahamian bank. Nevertheless, he was able to make illegal trades in over 50 securities from 1980 to 1985 without being identified by name. His conviction resulted from an anonymous informant.

dummy organizations, foreign banks, and multiple accounts are used in a series of jurisdictions having secrecy or blocking laws.

Many off-shore havens with strong secrecy or blocking statutes means that enforcement actions against suspicious trading from these countries may be nonexistent, lax, or uncoordinated. In Costa Rica, the Bahamas, Panama, parts of Europe, Liberia, and South Africa, some violations maybe detected only at considerable expense and with some luck, but many will not be detected. Some of these foreign havens have no extradition agreements with the United States.

At a conference in April 1990, State experts in securities predicted that a major issue for the 1990s will be international securities fraud, much of it from off-shore havens.[39] SEC efforts to police the internationalized U.S. markets, and to overcome difficulties of the sort identified by the Subcommittee, have required the development of ways to obtain information from abroad.[40] For example, the SEC often finds it necessary to obtain evidence relating to foreign trading (insider trading and market manipulation cases) and accounting records of foreign subsidiaries of U.S. publicly held corporations.

The SEC's primary approach to curb foreign-initiated trading violations is via Memoranda of Understanding (MOUs) with foreign countries for obtaining cooperation in international enforcement matters and for all contacts with foreign securities agencies. In December 1989, the SEC created a new Office of International Affairs, reporting directly to the SEC's Chairman, that has primary responsibility for negotiating Memoranda of Understanding (MOU) between the SEC and foreign securities regulators and for coordinating related enforcement programs. The Office will have perhaps eight professional staff members in FY 1991, up from two in FY 1989.

As of July 1990, the SEC had MOUs with three Canadian provinces, the United Kingdom, Brazil, the Netherlands, and France, and treaties with Switzerland and other countries. It has ongoing negotiations with Mexico, Israel, W. Germany, Australia, and certain Nordic countries. These MOU arrangements represent a major improvement in bilateral cooperation among nations. Nevertheless, the development of MOUs is cumbersome, necessitated by disparate laws and regulations of different countries. Over time, these agreements are expected to become more uniform. Efforts by the SEC and other countries' regulators are needed to accelerate the harmonization process and facilitate law enforcement worldwide. Such a goal would be a worthy challenge for, e.g., the International Organization of Securities Commissioners (IOSCO).[41]

In 1989, the SEC received 150 requests for information sharing from foreign governments, and made 100 requests (up from about 60 in 1988) to foreign governments.[42] An increasing number of nations are more inclined toward bilateral and multinational cooperation as international linkages increase and abuses in all markets become increasingly similar. The SEC and the CFTC both participate in international forums that address multilateral issues, such as disclosure requirements for securities offerings and multilateral recognition of broker-dealer registration.[43]

Some key questions are: 1) whether efforts by U.S. and foreign regulators will adequately safeguard the public against violators, 2) what the costs

[39] Mark Maddox, Commissioner, Indiana Securities Division, and others at a panel on 'International Enforcement: Con Artists Cash In on the Rush to Global Investing," NASAA Conference on Global Markets: A World of Risk for Small Investors, Washington DC, Apr. 26, 1990.

[40] The SEC, as does the CFTC, requires SROS to enter into appropriate agreements regarding information sharing and surveillance before the SEC approves a trade link with a foreign exchange. Such agreements exist, for example, between the AMEX and the European options exchanges, and the CME and the Tokyo Stock Exchange.

[41] IOSCO is scheduled to issue a report in September 1990 on the elements of negotiating MOUs.

[42] Many of the requests to and from the SEC involved penny stock fraud.

[43] The SEC has considered certain other approaches to international enforcement problems. For example, the Subcommittee recommended that the SEC adopt a regulation modeled on the CFTC's Rule 21.03, which requires foreign brokers and traders, among others, to provide to the CFTC, upon a' 'special call, ' certain market information. This information concerns their options and futures trading, including trader identification. The CFTC may prohibit the foreign broker or trader from further trading on U.S. futures exchanges and with Futures Commission Merchants upon refusal to provide such information. The SEC found, however, that this would not capture all foreign trading activity, and that both U.S. and foreign commentors believed that the requirement would have a chilling effect on foreign investment in U.S. markets and drive legitimate business off-shore. Another concept was published by the SEC in 1984, referred to as "waiver by conduct." This concept would have established as a matter of law that persons who trade in U.S. markets from abroad waived all rights to which they may have been entitled under foreign law. The concept met with overwhelming criticism and was abandoned. Another approach, also rejected, would have required foreign banks that use omnibus accounts (one large account under the bank's name) in placing trades with U.S. brokers to identify the beneficial owners if suspicious trades ar identified.

will be, and 3) how international enforcement and mutual assistance practices can be expeditiously harmonized. The collective efforts of regulators will likely reduce the level of violations from some foreign countries, but U.S. investors and markets may continue to suffer losses from fraudulent conduct by persons who trade through foreign accounts, particularly in countries that do not have agreements with the U.S. for information sharing, surveillance, or extradition, or that have poor investigative and enforcement capabilities. Continued attention by Congress will be needed to assure that U.S. investors are adequately protected against both yesterday's types of fraud and abuse and those that will develop in global markets.

FRAUD IN FUTURES TRADING

The CFTC addresses fraud and abuse through direct surveillance of futures markets and market participants, oversight of futures trading SROs (including the exchanges and the National Futures Association), and referrals to the exchanges for investigative and disciplinary action. They also include enforcement actions brought before the CFTC's administrative judges and the Federal courts, and authority to conduct civil investigations and to impose administrative fines of up to $100,000 for rule violations.

As a result of recent Department of Justice investigations,[44] subpoenas were issued to dozens of brokers and traders at the Chicago Mercantile Exchange (CME) and Chicago Board of Trade (CBOT) during the first months of 1989. In August 1989, a Federal grand jury indicted 46 commodity traders, brokers, and a clerk on charges including cheating or defrauding customers, evading taxes, mail and wire fraud, and noncompetitive *execution* of customers' orders in hundreds of trades; two additional traders were indicted in November 1989.[45] Some of those indicted were charged with violating the RICO statute, among other charges. This was the fist attempt by the government to use this statute against commodities traders for allegedly engaging in efforts to defraud investors.[46] Sixteen of those indicted had pleaded guilty as of June 1990.

The alleged illegal activities centered on the U.S. T-bond and soybean pits at the CBOT and the Japanese yen and Swiss franc currency pits at the CME. The magnitude of the alleged fraudulent activities raises suspicion that the abusive practices were widespread.[47] Yet, one of the FBI agents involved in the undercover operation was reported to have spent about 6 months in the CME's Standard& Poor (S&P) stock-index futures pits without having detected illegal trading practices.

The U.S. Attorney General's office has announced that the investigation is continuing. The frost of two scheduled trials was completed in July 1990 and a second and third trial are scheduled to begin in September 1990. Two of the accused were found guilty of some non-RICO charges and a third acquitted during their trial in June and July 1990. In July, the CFTC charged four New York Mercantile Exchange (NYME) traders with fraud in handling customer orders, including noncompetitive buy and sell transactions on crude oil futures trades for customers on the NYME floor and making fictitious trades. The case will be heard by CFTC administrative law judges.[48]

Illegal trading activity prohibited in futures markets includes:

[44] CFTC staff prefer to describe this as the "joint investigation of the CFTC, FBI, and U.S. Attorney's office."

[45] The brokers allegedly directed accommodating locals t. accept losses that resulted from the brokers' errors, or outtrades, with the understanding that the locals would be repaid later through the manipulation of customer orders. Brokers are personally liable for their trading mistakes, therefore these repayment arrangements were used as a means to avoid paying their clearing firm or customers from their own funds. "Have Futures of Traders Hit the Pits?" *The National Law Journal,* June 11, 1990, p. 8. Also see: "Traders Are Indicted for Running the Fits By Their Own Rules," *The Wall Street Journal,* Aug. 3, 1989, p. A 1. "Jury Indicts 46 in Futures Probe," *The Washington Post,* Aug. 3, 1989, p. A-1.

[46] *United States* v. *Martin J. Dempsey et al., Government's Santiago* Proffer, U.S. District Court, Jan. 5, 1990. The undercover FBI agent and cooperating defendants noted, and testified later during the first jury trial in June 1990, that they "routinely engaged in illegal prearranged trades with the defendants. Most of these illegal trades were designed to: 1) pay them back for assuming the loss from brokers' trading errors or outtrades; 2) build up a bank of money that could later be kicked back to the brokers' personal trading accounts; 3) disguise prearranged trading between other traders. . or, 4) permit the broker to take the other side of customer orders filling them himself rather than through another trade," p. 15.

See also, *United States v. Robert D. Mosky* et al., Government's Santiago Proffer, U.S. District Court, Mar. 13, 1990. "The essence of the charged conspiracy and fraud scheme is that brokers regularly solicited. . local traders. . . to absorb losses caused by order-filling errors or outtrades and repaid such locals through the illegal manipulation of other customer orders. . .," p. 11.

[47] Those indicted represent about 20 percent of the yen pit trader population and 10 percent of the soybean trader population. "Traders Are Indicted For Running the Pits By Their Own Rules,' *The Wall Street Journal,* Aug. 3, 1989, p. 1.

[48] "Charges Are Filed Against 4 Traders at New York Merc," *The Wall Street Journal,* July 25, 1990, p. C 1.

- *Noncompetitive execution of trades: Two brokers* may agree to fill a customer's order at a prearranged price-a higher than market price for a purchase, and lower for a sale-and divide the extra profit among themselves.
- *"Wash" trades: These give the* appearance of trading, but do not result in a change in market position.
- *Bucket trading:* A broker may take the opposite side of a customer's order directly, or through a "bagman,' outside of the competitive auction process.
- *Order crossing:* Brokers may cross, or match, customers' orders directly, without involvement in the open outcry market.
- *Cheating or defrauding customers:* This includes "tick shaving, " where customers are cheated of small amounts, perhaps $25 on a million dollar face value order, on many transactions. Customers probably will not notice the small amounts, but these can result in significant illegal gain to locals over the long term.
- *Fraudulent withholding of customers' orders:* Floor brokers may delay filling a customer's order, if it will affect the market price, in order to benefit another exchange member or market professional.

Since the FBI investigations, futures exchanges in Chicago and New York and the CFTC have undertaken special reviews and have proposed substantial changes in trading practices, rule enforcement, and market procedures.[49] The CME proposals advanced by a Special Committee were deemed particularly impressive, and in slightly altered form are being adopted by the Exchange and submitted to the CFTC for approval. In contrast with the CME's proposed limitations on dual trading, the CBOT internal investigation committee recommended that dual trading be continued in the interest of liquidity.[50] Both exchanges are improving trade monitoring systems and increasing penalties for trading abuses.[51]

The CFTC proposed, in August 1989, a number of regulatory enhancements. These include final CFTC rules which require more frequent collection of trading cards and stricter controls on the manner of their preparation (e.g., sequential numbering, prohibitions on the skipping of lines); a pilot program for increased on-floor surveillance, including inspection of trading cards and order tickets; and final CFTC rules establishing stricter criteria for exchange members to serve on governing boards and specific committees.[52] To improve their automated trade reconstruction, the CME and CBOT both now require a 15-minute, instead of a 30-minute, time bracket for traders and brokers to record the time of each trade. (See ch. 4.)

Inter-market frontrunning is a potential abuse involving both futures and securities markets, but the extent of the problem is unknown.[53] A brokerage firm that is about to buy or sell a large block or basket of stock for itself or for a customer, may first take a position in stock-index futures, hoping to profit if the stock transaction moves the price. This inter-market activity is a practice recognized as abusive for a decade.

One issue that surfaced during the 1989 CFTC Reauthorization hearings was whether futures exchanges have been lax in disciplining members, as has been charged by Thomas F. Eagleton, former U.S. Senator and former public member of the Board

[49] *Reportof th, Chicago Mercantile Exchange Special Committee. .* ., Apr. 19,1989. The report contains two categories of recommendations: trading practices and rule enforcement reforms, including a partial ban on dual trading, and trade surveillance improvements. Other recommendations emphasized sterner disciplinary actions and more severe penalties. For a fuller description see testimony of Leo Melamed Chairman n of the Executive Committee, Chicago Mercantile Exchange, before the Committee on Agriculture, Nutrition and Forestry, U.S. Senate, May 17, 1989.

[50] CBOT OKs Dual Trade Practice, Reportedly at Customers' Urging, "*Investors Daily, Feb. 9, 1989,* P. 3.

[51] Ibid.

[52] "CFTC Moves to Tighten Trading Rules, " *The Washington Post,* Aug. 30, 1989, p. Cl.

[53] According to the SEC,". . .we are not able to determine the extent to which such trading (frontrunning) occurs yet remains undetected (by the SROs) nor the impact on the markets or firm profitability. Based on the known instances of frontrunning which the SROS have uncovered and prosecuted, however, we do not believe that these practices are widespread nor their impact on markets and firm profitability significant." Memorandum from Richard G. Ketchum, Director, Division of Market Regulation, to SEC Chairma n Ruder, June 30, 1989, p. 15. But the press continues to report that the problem is grow@ see "Is Program Trading the Target of a Witch-Hunt?" *Business Week, Nov. 13, 1989,* p. 122.

of Governors of the CME.[54] A recent GAO review said that GAO was ''unable to reach conclusions about the adequacy or effectiveness of exchange disciplinary action programs primarily because the universe of abuses is unknown. "[55] However, GAO noted that the number and severity of penalties has increased since the investigations became public, which "appears to indicate an increased commitment by the exchanges. . . . The GAO report strongly recommended that the CFTC require the exchanges to develop and use means for 'independent, precise, and complete timing of trades' because presently there *is* limited ability to detect rule violations.

One organizational arrangement that may be conducive to trading abuses involves broker associations.[56] This involves organizations of brokers and traders who fill orders from the public, pooling their collective revenues and expenses. This arrangement is legal, can improve customer service, and, by reducing the traders' risk, makes possible reduced trading costs to customers. But it also may facilitate opportunities for unethical behavior within broker associations, such as concentration of trades within the group in order to maximize commission revenues; rewarding members of the group with favorable trades; and influencing the behavior of low-paid trainees to participate in questionable trading behavior.

Broker associations, the CFTC believes, may facilitate certain trading abuses, such as prearranged or noncompetitive trading with the aid of other association members.[57] As a result, the CFTC proposed rules to provide a common definition of broker associations and to require exchanges to register such associations in order to particularize and heighten review of their trading activity .58

Approaches To Reducing Fraud in Futures Markets

Trade practice abuses should be detected either through an SRO'S *internal sources,* such as audit trails and observations of trading, or through *external sources,* which include complaints from exchange members or customers. Detecting some types of trading abuses in the open outcry system are difficult, and may be impossible without undercover surveillance, because there may be several hundred active traders shouting and gesticulating. Exchanges are required to have audit trails. Efforts have been made to improve automated methods for surveillance, but the present systems still have serious shortcomings recognized by both the CFTC and the exchanges. For example, while the CFTC requires trade-reconstruction[59] times for the purpose of audit trails to be precise to the nearest minute, a single minute of active trading may include hundreds of trades, several of which could be made by a single floor participant at different prices.[60] Furthermore, these are imputed, not actually recorded times; reconstructed using trading cards that now are collected every 30 minutes, order ticket timestamps, and other data.[61] There are open questions about the effectiveness of any of these systems to deter certain types of abusive trading practices, especially given opportunities for collusion among floor brokers and

54. , ."When it comes to a choice between protecting an insider and preserving the integrity of the futures markets, there is no question where the exchange stands"

Eagleton also concluded that:

. . .As long as the existing system of ''open outcry,'' which consists of shouts, gestures, winks andotherphysical signals, remains there will be substantial cheating at the futures exchanges. They have to be brought into the 21st century with an electronic trading system that leaves verifiable audit trail. Thomas F. Eagleton, "Chicago's Markets: Corrupt to the Core," New *York Times, Nov 19, 1989,* p. *27.*

55U.S. General Accounting Office, *Futures Markets: Strengthening Trade Practice Oversight, GAO/GDD-89-120,* September 1989, PP. 2-3.

56Currently, four exchanges (Chicago Mercantile Exchange, New York Mercantile Exchange, Commodities Exchange, and the New York Futures Exchange) have rules explicitly clef@ associated or affiliated brokers. These include among affiliations: 1) employer and employee (employees of the same employer), and 2) partners. Various exchanges include some others, such as corporations and relationships among two or more brokers sharing brokerage expenses, e.g., a clerk's salary,officers, directors, and 10 percent shareholders of a member, and brokers who share a deck of orders. Most exchanges' rules do not include adefinition of broker associations and some do not require them to register as associations with the exchangeCFTC, Division of Trading and Markets, Memorandum toCommissioners, Broker Association Study, Jan. 4, 1990, p. 2.

57Ibid., p. 6.

58Ibid.

59Trade data are reconstructed on the CME, CBOT, and the Coffee, Sugar, and Cocoa Exchange.

60The CME, CBOT, and Coffee, Sugar, and Cocoa Exchange reconstruct trades to the nearest 10 seconds.

61U.S. General Accounting Office, Chicago *Futures* Market: *Initial Observations* on *Trading* Practice *Abuses,* GAO/GGD-89-58, March 1989, pp. 13-17. This GAO report studied the ''level, or intensity, ofCFTC [and the CME and CBOT] exchange efforts to detect and penalize trading abuses" between 1984 and early 1989, and made "no recommendations."

traders-which are very difficult to detect, requiring abusive trading patterns to be identified. Undercover investigations greatly improve efforts to identify these activities.[62] And, as CFTC Chairman Gramm noted in a comprehensive review of the CFTC's and the SROs' compliance efforts, "computer-assisted (surveillance) programs generally are less effective in detecting abuses which are susceptible to being effected through alteration of documents, and fictitious trade submissions. . . prearranged trading or trading ahead of customer orders. ' '[63]

The exchanges have announced a determined effort to overcome these concerns and to make obsolete the present system of scribbling transactions on slips of paper which are passed by hand to clerks for computer entry. The CME and CBOT are committed to jointly developing abetter technological approach to establish precise and verifiable audit trails from the beginning-i.e., at the time of the transaction and not by reconstruction afterward. This system, called AUDIT (Automated Data Input Terminal), will use an electronic hand-held computer to record each transaction on the exchanges' floors at the time it is made and to transfer trade data to exchanges' computers. The system will support exchange operations, and surveillance and compliance monitoring. Prototype equipment are scheduled for testing in late 1990.[64] Research and experiments are also being conducted, or planned, on hand-held devices by the CBOE and COMEX.[65]

It is not clear yet whether the prototypes will be immediately accepted by floor traders and whether the new equipment will suit the specific needs of traders (ergonomically and fictionally, such as speed of trades). Their success may depend, in part, on whether traders find the devices beneficial, non-threatening to their unique skills and experience, and whether the devices impair liquidity.

The legislation which initiated public regulation of futures trading half a century ago said that regulation was necessary because "the transactions and prices of commodities are susceptible to speculation, manipulation, and control. . . ."[66] The recent revelations of abuses came not from the Exchanges, which as SROs have primary responsibility for market discipline, nor from the CFTC which oversees the SROs, but from the FBI with the cooperation of the CFTC.[67]

Questions have been raised about the determination of governors of futures exchanges to enforce fair trading practices, although recent actions suggest that substantial improvements are underway. Congress can therefore ask whether present supervisory and disciplinary procedures are adequate, or whether government must take a more active role in market discipline, and if so, what agency should exercise that responsibility. (See ch. 9.)

There is a view that because futures markets are used primarily by large, sophisticated institutions, abuses could easily be detected by the victims themselves and corrected by free market forces. The current large-scale indictments, admissions of guilt, and plea bargaining provide evidence to the contrary. Institutional investors in futures markets represent millions of Americans through pension, life insurance, and mutual funds; the ultimate victims in futures market fraud are these people. Moreover, trading abuses can create price distor-

[62] According to former U.S. Attorney Anton Valukas, who headed the Justice Department probe into trading abuses in the Chicago exchanges, ". . . .experience suggests that some of the things we found could only have been discovered by having people actually in the pits. " And, "The whole aspect of how audits are conducted and what type of audit trails are kept is something that should be reviewed. " As quoted in "Paladin in the Pits, " Barron's, Aug. 21, 1989, p. 6.

[63] Wendy L. Gramm, Chairman, CFTC, in attachment to letter to Sen. Patrick Leahy, Mar. 7,1989, p. 4. See also, Statement of Dr. Wendy Lee Gramm before the Senate Committee on Agriculture, Nutrition and Forestry, Mar. 9, 1989.

An alleged example of such practices was reported in the *Wall Street Journal* of Oct. 24, 1989, p. C1; an international money manager has sued a major securities firm on the grounds that the firm colluded with pit traders to hold back the international fund's large sell order until the market price plunged, then bought up the contracts, pushing the price up rapidly (one trader is alleged to have made $900,000 in 90 seconds). "Soros Is Accusing Shearson of Fraud After 1987 Crash. "

[64] "CME, CBOT Select Vendors for Next Phase of AUDIT Selection Process," Joint CME-CBOT press release, Mar. 7, 1990. Units developed by NYNEX, as one example, were being tested in early 1990 by traders at the Commodity Exchange (COMEX) in New York.

[65] IBM study, of Clearing and Settlement for the U.S. Congress-OTA, Aug. 1, 1989, p. 74. Roger Rutz, Bored of Trade Clearing Corp. (BOTCC), is cited as observing tbat "so far the acceptance of on-line trade data input devices is high, but finding a good working device has been largely unsuccessful. " Officials at other exchanges, e.g., CBOE, made similar comments to OTA staff.

[66] 7 U.S.C. 5; CCH Rep. No. 1031, p. 1558.

[67] The FBI, but not the CFTC, has authority t. conduct undercover surveillance investigations. The illegal activities in the futures pits, including collusion, were not readily detectable through the routine surveillance of the SROs and the CFTC.

tions that affect prices in other markets. Thus, it is important that these markets be free of fraud.

Genuine fairness may be achievable in large-scale markets only with trading procedures that place great reliance on automated systems and ever-diminishing reliance on the trader. The trends already underway toward computerized trading have been given further stimulus by the investigations by the FBI, the CFTC, and SROs. If, indeed, the only certain way to reduce adequately some forms of abuse in the current trading environment requires oppressive costs, then computer-based systems may receive added impetus as a means of achieving fairness and efficient allocation of scarce resources. Such changes should recognize that adequate resources for regulators will also be required to police the exchanges. The level of fraud identified in futures markets suggests that the CFTC's current resources are less than adequate. The need for policing abuses in these markets won't disappear, but their form will change.

The Intermarket Surveillance Group, noted earlier, has as one of its major purposes to provide a check against intermarket frontrunning. The CME and the NYSE developed new circulars aimed at preventing inter-market frontrunning, which were approved by the CFTC in 1988 and the SEC in 1989. The CFTC has followed through on plans for a number of market reforms, including the placing of more staff monitors on the floor of the exchanges and the drafting of new rules on market procedures related to areas in which abuses have been cited by the FBI investigation. In July 1989 a bill was introduced in the House which would strengthen the CFTC's authority to prevent trading abuses and other objectives.[68] The Senate introduced its own bill in November 1989.[69]

[68] H.R. 2869, Commodity Futures Improvement Act of 1989. The bill would do this by: placing restrictions on dual trading in heavily traded contracts and on trading among members of brokers' groups; requiring improved and verifiable audit trail da@ strengthening the SRO disciplinary structure and increasing the penalties for certain rule violations; setting standards for participation on SRO governing boards; and making the wrongful use or disclosure of inside information by certain officials a felony offense. CFTC authority to assist foreign futures authorities in investigations would be expanded also.

6%.1729, Futures Trading Practices Act of 1989. This bill would: expand the CFTC's staff and legal powers; require exchanges to use tamper-proof, computerized audit trails and curb dual trading; increase penalties against abusive trading practices and permit victimized customers to sue for punitive civil damages; and tighten rules against exchange conflicts of interest.