CUBICASSET MANAGEMENT, LLC

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"Never forget that everything Hitler did in Germany was legal."
- Martin Luther King, Jr.

Barry Switzer is well-known to every football fan. After a variety of assistant coaching positions he became the head coach of the University of Oklahoma following the 1972 season, where his teams went undefeated the next two years, winning consecutive national championships. He won a third in 1985, on his way to compiling one of the greatest coaching records in history, 100-11-1. He went on to coach the Dallas Cowboys from 1994 to 1997, winning the Super Bowl in 1996, making him one of only two men to ever coach championship teams at both the collegiate and pro level.

Less well-known is that Switzer was charged by the Securities & Exchange Commission with insider trading in 1981. At that time, in addition to being head coach at Oklahoma, Switzer was the host of a television show sponsored by energy company Phoenix Resources. The CEO of Phoenix was George Platt, a vocal booster of Oklahoma football and long-time season ticket holder. Platt and Switzer both attended a track meet at the University and chatted for a while, after which Switzer laid down on a row of bleachers behind Platt to sunbathe. While lying there he overheard Platt talking to his wife about the fact that Phoenix had just retained Morgan Stanley to advise on the sale of a subsidiary that was also publicly traded. Switzer called his broker and some friends and bought shares in the subsidiary, which resulted in a hefty profit when the sale was announced. The SEC brought Switzer to trial in 1984. But the judge found that Platt's conversation was not conducted with an "improper purpose", because he had a confidential relationship with his wife. Since Platt was not guilty of anything and insider trading is a derivative crime, Switzer was acquitted. Interestingly, if Platt had had the same conversation with a friend, rather than his wife, both Platt and Switzer would have been guilty. It is certainly odd that Switzer's actions, which would be identical no matter to whom Platt was speaking, would be criminal in one case but not in the other.

Barry Switzer is only one of a long list of high-profile individuals to run afoul of insider trading laws. Martha Stewart served five months in prison for lying to investigators after she was accused of trading on inside information in ImClone stock. It is worth noting, though, that her conviction was for lying about a crime (insider trading), for which she was never convicted, or even charged. George Soros paid a $2 million fine after being found guilty of insider trading in 2002. The owner of the Dallas mavericks basketball team, Mark Cuban, has been embroiled in a seven year battle over his sale of stock in Mama.com.

Insider trading has been very much in the news lately. In April the government completed the largest hedge fund insider trading case in history, against Raj Rajaratnam, former head of Galleon Group. Rajaratnam was estimated by Forbes Magazine to be one of the 250 richest men in America and the richest Sri Lankan in the world, with a net worth estimated to be $1.8 billion. Buttressed by literally thousands of tape recordings obtained using wire taps, Rajaratnam and various associates were accused and subsequently convicted of using illegally obtained information to reap $21 million in trading profits, a surprisingly small amount in light of his enormous wealth. The alleged tipsters included Rajiv Goel, an Intel Capital executive, Robert Moffat, an IBM executive, and Anil Kumar, an executive with McKinsey & Company. Thus far, twenty six individuals have plead guilty to insider trading. The insider trading scheme was brought to the Securities & Exchange Commission by Roomy Khan, a former Galleon employee who was trying to use knowledge of the conspiracy to bargain for a lighter sentence in a previous insider trading conviction.

As a side note, Rajaratnam, Goel and Kumar were all members of the Class of 1983 from the Wharton Business School. Based on their previous business successes and subsequent fall from grace, the trio likely never took an ethics course. According to recent research (A. Hussey, "The Effect of Ethics on Labor Market Success: Evidence from MBAs", Journal of Economic Behavior & Organization, forthcoming) men who received ethical training in business school earned less than their peers. Who says crime doesn't pay?

The Galleon Group case is only one in a very long list of intensive crackdowns on insider trading in corporate America and Wall Street. In April, Kenneth T. Robinson plead guilty to securities fraud and conspiracy in a scheme that netted a whopping $37 million over 15 years. Mr. Robinson served as the middleman between Matthew Kluger, an attorney, and Garrett Bauer, a trader. The conspiracy began in 1994 when Kruger interned at the well-know law firm of Cravath, Swain & Moore, LLP, and became privy to details of an upcoming takeover transaction. He called his friend Robinson, with whom he had worked previously at a real estate firm, who passed the information along to Bauer. Over the next decade and a half, Kluger worked at a series of high-powered law firms, where he learned of Oracle's plan to acquire Sun Microsystems, among many others. The men would meet in Atlantic City to divvy up the spoils from their trading, and might have remained undetected except for two errors. First, Bauer began buying fancy homes and cars and paying in cash, attracting unwarranted attention. But then even after his arrest served notice that their scheme was unraveling, Robinson received word that Hewlett-Packard was about to acquire 3Com and Intel intended to acquire software security firm McAfee. Both deals were advised by the same law firm, Wilson, Sonsini, Goodrich & Rosati PC, where Matt Kluger worked. The temptation for one last score was too great, and he bought shares in the target under his own name, rather than using a proxy. The game was up.

The SEC has also charged six corporate employees, moonlighting as expert network consultants, with insider trading for tipping hedge fund managers to developments at technology companies Advanced Micro Devices, Dell, Flextronics and Marvell. Ironically, the now suspect expert network industry arose in the aftermath of the stock market collapse post the dot-com bubble, as an attempt to reform financial markets following a slew of corporate and accounting scandals.

Even that paragon of virtue, Warren Buffett, has become involved in a case which may involve misappropriation of corporate information by an insider. This case involves David Sokol, who was formerly chairman of two Berkshire Hathaway units (Mid-American Energy and NetJets), and who was frequently touted as a potential successor to Buffett himself. In late 2010, investment bankers from Citigroup approached Sokol with a "pitch book" about specialty chemicals producer Lubrizol, which seemed to exhibit the financial characteristics that Buffett seeks when looking for acquisitions. Sokol purchased $10 million worth of the stock for his personal account and then suggested to Buffett a month

later that Berkshire should consider acquiring Lubrizol. Sokol mentioned that he owned the stock, although he did not indicate the size of his position, nor how he had come to own it. When the deal was announced in March, Lubrizol stock soared 30% in a single day, reaping a windfall for Sokol. In his initial statement about the controversy on March 20, Buffett minimized the significance of Sokol's actions, and said he didn't regard the trades as "in any way unlawful." Coincidentally, within a few days Sokol announced his resignation, but added that his decision to leave the company was unrelated to his purchase of the shares and that he believes he did nothing wrong. Sure.

The interesting thing is that while Sokol violated Berkshire's insider trading policies and code of ethics, he may not have broken any laws, even though every non-lawyer would agree that what he did was wrong. Lawyers, though, seem to view the world differently. Stephan Bainbridge, a law professor at UCLA and member of the Bar association's Committee on Corporate Laws, thinks Sokol's actions were legal. William Wang, author of *Insider Trading*, a law professor at UC Hastings and member of the National Adjudicatory Council for FINRA (who regulates U.S. securities firms), believes Sokol broke the law.

Similarly, if a burglar had broken into Warren Buffett's house in Omaha and stolen papers analyzing the proposed takeover of Lubrizol, it would have been perfectly legal for him to trade on that news in advance of Berkshire Hathaway's takeover announcement, because under securities law the burglar does not have a fiduciary relationship with his victims.

After the Rajaratnam conviction, a well known securities attorney was quoted as saying that the lesson to be learned was to be more circumspect when talking on the telephone. That seems an odd takeaway. This is like advising someone contemplating murder to be careful about leaving DNA evidence.

Undoubtedly, insider trading is rampant. Academic studies of trading in the stocks of acquired companies show strong outperformance in the thirty days prior to the announcement of the merger. Somebody is obviously acting on information that the majority is not privy to. But is there actually more insider trading now than there was twenty or thirty years ago, or is it just that more people are getting caught? Certainly law enforcement officials have better tools at their disposal, such as wiretaps, e-mail trails and the ability to use computer algorithms to detect suspicious trading patterns. And the fact that ten years have passed since September 11, 2001 has allowed resources that were previously devoted to detecting terrorism to be re-allocated to white collar crime. But regulators face a conundrum. If they pursue a large number of cases, the deterrent effect will be strong, but the public may come to lose faith in the capital markets. If they pursue too few cases, transgressors may calculate that the rewards of illegal activity outweigh the risks.

My personal suspicion, though, is that there is actually more insider trading now. I recall once reading a murder mystery in which the detective ferreted out the killer when no one else could find him. When asked how he had decided who the culprit was among the many suspects, he replied that the perpetrator was a man of extraordinary ambition, but ordinary talent, and therefore had to cheat to win. He simply could not succeed on merit alone. At the start of this millennium there were fewer than 3,000 hedge funds. There are more than 10,000 now. There are simply not enough extraordinary talents to produce exceptional results in a group that large. Because the rewards are so out-sized, many hedge fund managers find themselves dancing along the thin gray line that separates financial research and financial crime. Many, unfortunately, will step across the line, especially since its edges are fuzzy.

This lack of clarity is a huge problem for market participants, who cannot always determine in advance which activities are legal and which illegal. According to Thomas Lee Hazen, who holds the Cary C. Boshamer Distinguished Professor of Law chair at the University of North Carolina, "there is no legal definition of insider trading or the limits on trading with material, non-public information." In fact, there is no definition of what is "material" or who is an "insider". There is no single civil or criminal statute which even uses the phrase "insider trading".

As another example of the lack of clarity, despite fifty years of cases, it has never been decided whether the legal test for insider trading is trading "based on" material non-public information or trading "while knowingly in possession" of such information. Imagine a money manager who researches a company only to conclude that there is an equal chance that the stock will rise or fall over the next few months. While undecided about whether or not to buy the stock, he receives a tip from a source within the company who has only occasionally been correct that the company is about to receive a takeover offer. This new information tips his decision, and he buys the stock. The decision was made while in possession of insider information but, because he was previously contemplating the purchase anyway, it was not based upon it. Was a crime committed?

Consider a pharmaceutical company analyst who is puzzled when one of the smaller companies that he follows cancels a long-scheduled presentation at an investor conference. In an attempt to figure out whether this presages good or bad news, the analyst decides to fly to company headquarters. On the plane, he observes several Goldman Sachs investment bankers going to the same city reviewing pitch books. Guessing that these data points suggest a possible takeover, he buys the stock. Taken individually, neither fact is material. Taken together, though, this scenario may constitute an instance of insider trading. Congress and the SEC have had numerous opportunities to codify insider trading laws, but have consistently deferred dealing with the matter. Professor Jonathan Macey of Yale Law School was quoted in the Wall Street Journal on this issue. "For decades the SEC has kept insider trading rules vague and undefined. This ambiguity increases the SEC's power and allows government lawyers to pick and choose among prosecution targets." This strategy seems to be modeled after the practices of the tyrannical Roman Emperor Caligula, who would post his edicts in tiny print upon signs posted so high that they were far beyond the range of anyone to be able to read them. Thus, the average Roman would always have to wonder if he were breaking the law; today, it is Wall Street traders who must wonder if they are being targeted.

Maddeningly, insider trading is legal for members of Congress. Congress has consistently refused to create insider trading laws for government workers. If a U.S. Senator who sits on the Armed Services Committee learns that the military is about to award a big contract to Lockheed Martin, he is allowed to buy shares in advance of any announcement. Congress has no fiduciary duty to the voters.

A case can be made that insider trading should not be illegal for anyone, not simply members of Congress, as is the case in many other countries. After all, one of the goals guiding the regulation of financial markets is to make them efficient, in the sense that stock prices should reflect all information about a company's prospects. If informed investors were permitted to trade based upon information not widely held, this would have the effect of moving asset prices closer to their correct level.

Our own view is similar to that espoused by Yales' Professor Macey. "Some, but by no means all, trading on the basis of informational advantage is and should be illegal. But the government should be compelled to provide clear guidance as to what constitutes legitimate, albeit aggressive, research." Every driver knows when he/she has been speeding. The speed limits are posted. In the same way, traders should know, without having to be subjected to a jury trial, whether a given trade is legal or illegal. In 2002 Congress passed Sarbanes-Oxley financial reforms under a Republican majority. In 2010 Dodd-Frank rewrote the rules of financial regulation, this time under a Democratic majority. In both cases they kicked the can of insider trading standards down the road. Perhaps they could skip the vote to declare January National Oatmeal Month to devote some time to clarifying vague, poorly defined concepts which only serve to invite overreaching by regulators, create a sense that the laws are arbitrarily enforced and place market participants in legally ambiguous situations on which even legal scholars cannot agree.