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Trading in Deal Stocks Triggers Look at Banks

Study Shows Pattern Of Buying by Advisers; 'Benign or Nefarious'?

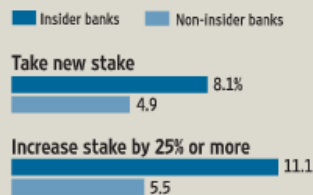
By **MARK MAREMONT** and **SUSANNE CRAIG**
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In the spring of last year, two investment arms of **J.P. Morgan Chase & Co.** began accumulating shares in Rural Cellular Corp., a small Minnesota provider of mobile-phone service. The bank units, which hadn't previously owned any shares, reported a combined 2.4% stake at the end of June.

The timing turned out to be fortunate for J.P. Morgan. On July 30, Rural Cellular's stock jumped 34% after the company announced it was being acquired by **Verizon Wireless**. The two sides had been negotiating since at least early May. The investment bank that advised Verizon Wireless in the deal: J.P. Morgan.

A Matter of Timing

Prior to deals, banks advising acquirers buy stock in target firms more often than 'non-insider' banks do, according to a study. Activity during the quarter prior to an announcement:



Note: Based on common stock ownership as reported in 13F filings, for the top 25 investment banks
 Sources: Andriy Bodnaruk, Massimo Massa, Andrei Simonov

Investment banks aren't allowed to trade on their inside information about potential mergers. But sometimes by chance, one arm of a bank will buy a stock without knowing that another arm is advising on a deal. That's what J.P. Morgan says happened with Rural Cellular. "These purchases were made on behalf of our clients and were totally appropriate," says a spokesman.

Regulators are now conducting a broad review of pre-deal trades by investment banks to determine if they were coincidences, or something else. It isn't clear what deals they're looking at.

Their interest was sparked by a new academic study that finds such trading happens much more often than would be expected by chance. The study, which examines statistical patterns, concludes that some banks likely are trading on their inside information about deals.

The Wall Street Journal, by reviewing stock-ownership and deal records, identified dozens of instances in which investment banks appeared to be buying shares in target companies around the same time their bankers were advising the acquirers. The transactions involved most of the major investment banks, including **Citigroup Inc.**, **Credit Suisse Group**, **Goldman Sachs Group Inc.**, **Merrill Lynch & Co.** and **Morgan Stanley**. The firms either declined to comment or said they found no problems with the trading.

The issue is "definitely on our radar screen," says Stephen Luparello, a top official at the Financial Industry Regulatory Authority, or Finra, formed last year when the National Association of Securities Dealers and the enforcement unit of the New York Stock Exchange merged. After Finra's in-house economics staff alerted top brass about the academic research last month, officials decided to ask investment banks about trading before certain mergers, and the rigor of internal procedures to prevent the spread of inside information.

Mr. Luparello adds that the inquiry may not find any problems. The facts in the study "can have benign or nefarious explanations," he says.

Statistical Pattern


The statistical pattern could be no more than a series of coincidences, reflecting unconnected events in disparate parts of giant investment banks. But if banks really are using inside information to profit on the run-up in stocks of companies that are taken over, that would be both illegal and unfair to other investors.



• Read "The Dark Role of Investment

Banks in the Market for Corporate Control," three European finance professors examined more than 1,600 U.S.

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Banks in the Market for Corporate Control.¹

merger deals between 1984 and 2003, along with quarterly 13F filings of institutional stock ownership. They found that during the last quarter before a merger announcement, large investment banks serving as lead advisers to acquirers accumulated shares in target companies just over 19% of the time -- either by taking new stakes or significantly increasing existing stakes. That's nearly double the 10.5% rate of investment banks not serving in that role.

Andrei Simonov, one of the co-authors, says that the data don't prove wrongdoing. Nevertheless, he says, the pattern is so strong that "the most probable explanation is that banks are trading on inside information."

Critics say the research is flawed. One issue is that quarterly filings provide an incomplete and sometimes outdated picture of a bank's true holdings. Not included, for example, are certain types of options. Behind the scenes, an investment bank holding stock simultaneously could be using options to hedge its position or to bet that the stock will decline.

"Given that it is impossible to draw any meaningful conclusions about trading activity from 13F filings, it is inconceivable that anyone with knowledge of the subject would take the work seriously," says Alan M. Cohen, global head of compliance at Goldman Sachs.

Henry Hu, a corporate and securities-law professor at the University of Texas at Austin, says the study's data "do not necessarily prove anything sinister is going on."

The researchers acknowledge the limitations of the data. But they say it isn't likely that including the nonreported holdings would erase the statistical disparity between banks that served as advisers and banks that didn't.



Andrei Simonov

The paper -- by Mr. Simonov, Massimo Massa of French business school Insead, and Andriy Bodnaruk of Maastricht University in the Netherlands -- was presented earlier this month at an American Finance Association conference, but hasn't yet been published. Its underlying implication is that suspect trading could be occurring in the early stages of deal talks, long before it is likely to raise red flags.

"If you're taking a position three days before a deal, you are subject to investigation," says Mr. Simonov, an associate professor of finance at Stockholm School of Economics. "But if it's three months before, you're much less likely to be on the radar screen."

The paper points out "potentially serious problems," says David Yermack, a New York University finance professor. "People doing these mergers hire the banks to be their best agent. But from the data, it seems that the banks are doing what's best for themselves, rather than the clients."

The study is part of a new wave of investigative financial research in which academics spend months poring over gigabytes of data in search of unusual statistical patterns. Academic studies played a major role in uncovering the recent stock-option backdating scandal.

Diversified investment banks, by their very nature, are awash with potential conflicts of interest and opportunities to profit from nonpublic information. One arm of a bank could be lending money to a distressed company, while another is trading in that company's debt. Analysts issue market-moving research reports on the same stocks owned by the firm's trading desk.

Investment banks try to manage these conflicts with information barriers, sometimes called Chinese walls. Banks have strict policies against employees discussing nonpublic information with other departments, and often reinforce barriers by physically separating units on different floors or buildings. All trading, including in employees' personal accounts, is supposed to be monitored by internal "compliance" departments that are the first line of defense against any leak.

'Watch Lists'

Few types of information are more sensitive than secret merger talks. Buyout offers nearly always carry a premium over market share prices, so people who know about deals early can make windfall profits. Banks are supposed to keep a closely guarded "watch list" or "gray list" of potential deals on which they're advising, and to monitor trading in the affected securities.

Securities and Exchange Commission officials say they are concerned that banks' compliance departments are stretched thin, even as top executives are under pressure to create synergies between myriad business units. In such an environment, they say, there's a growing risk that nonpublic information could leak or be misused. The SEC says it has stepped up its inspections of compliance departments to see if proper procedures are being followed.

"Given the potential for abuse, and indeed, the instances of insider trading we've seen recently, this is an area of significant priority for SEC examiners," says Lori Richards, the Director of the SEC's Office of Compliance Inspections and Examinations.

Last May, Barclays Bank PLC and a top distressed-debt executive paid a total of \$11.7 million to settle SEC charges that the firm illegally traded on the basis of confidential information that the executive received from serving on the creditors' committees at six bankrupt companies. They neither admitted nor denied the allegations.

In 2006, Morgan Stanley paid \$10 million to settle allegations of a breakdown in its monitoring of information barriers. Among other things, the SEC said the bank over a four-year period failed to monitor daily trading in more than 3,000 securities on its watch list. "As a result of these systemic failures," the SEC charged, "Morgan Stanley may have failed to detect illegal insider trading by the firm, its employees, or people related to its employees." The firm neither admitted nor denied the allegations.

Walter Ricciardi, deputy director of the SEC's enforcement division, says the potential that banks could be trading ahead of their own merger deals "is definitely an area of interest," but he won't comment on specifics. In most cases of insider trading involving banks, he says, employees are illegally trading for their own gain, not for the benefit of their employers.

One potential weakness in bank monitoring procedures involves the construction of watch lists. Typically, bankers are supposed to notify their compliance departments when merger talks become "material." But that's a judgment call. For some bankers, this moment occurs when they receive a formal engagement letter from a client. For others, it's when the banker has a gut feeling the deal is going to go through. In either case, that could be long after initial discussions begin, leaving a window of opportunity for news of the talks to leak without much scrutiny.

Compliance officials say that bankers sometimes wait too long before notifying them of a potential transaction. Some bankers say there is incentive to delay: Putting a deal on the watch list too early increases the likelihood that news will seep out, possibly inviting a rival bid.

The Wall Street Journal asked several major investment banks about a number of deals in which they appeared to be accumulating shares in target companies and also advising the acquirers. In some cases, the banks were among the largest accumulators of a target company's stock in the quarter prior to the deal's announcement. It is impossible to determine if the banks ultimately profited on their investments, because the quarterly disclosures don't indicate precisely when they bought and sold, and at what price.

Not long after it went public, **United Parcel Service Inc.** was scouting for an acquisition to help the parcel-delivery company expand into bigger-ticket freight shipping. It approached San Francisco-based Fritz Cos. in November 2000, regulatory filings show. Although UPS executives did the bulk of the negotiating, Citigroup investment bankers also advised the big Atlanta shipper. The takeover was announced Jan. 10, 2001, offering Fritz shareholders \$431 million, or \$11.70 a share. Fritz shares soared 62% on the news.

Citigroup's reported holdings of Fritz surged nearly ninefold in the fourth quarter of 2000. As of Dec. 31, 2000, 10 days before the deal was announced, Citigroup reported owning 1,009,913 shares of Fritz. The buying made Citigroup the second-largest acquirer of the stock in the fourth quarter, out of 70 institutional owners, according to FactSet Research Systems Inc., which tracks institutional ownership of stocks. Jan H. Raymond, Fritz's former general counsel, says executives weren't aware at the time of Citigroup's big new stake, adding, "I wouldn't believe it's a coincidence."

Citigroup says the stock purchases took place in the firm's mutual funds, not for its own account. A spokesman says that Citigroup "maintained appropriate information barriers" between its asset-management and investment-banking divisions. "We have no reason to believe any breach occurred."

It's unusual for an investment bank to advise both sides in a deal. But that's what Credit Suisse did in a 2001 merger, while also appearing to accumulate stock in the target company.

The transaction involved a takeover by **Royal Bank of Canada** of Centura Banks Inc., a regional bank in North Carolina. Credit Suisse was a longtime adviser to Royal Bank of Canada, and according to regulatory filings, played a key role in helping identify Centura as the target.

Preliminary discussions between the parties began in September 2000, and by that Oct. 13, Centura also had hired Credit Suisse to advise it. A final agreement was announced in late January 2001, with Royal Bank offering more than a 20% premium.

As of Sept. 30, 2000, just as talks were getting under way, Credit Suisse did not own a single share of Centura common stock, and had not reported any substantial holdings for at least six quarters prior to that, according to FactSet. By the end of the next quarter, Credit Suisse's asset-management arm reported ownership of 250,649 shares. A portion of the share increase may have been the result of Credit Suisse's purchase during that quarter of an asset manager that, according to FactSet, previously reported owning about 38,000 Centura shares.

A Credit Suisse spokesman declined to comment about the trading.

Vital Information

Public filings rarely indicate when someone at an investment bank first learned of an impending deal, and don't show the exact date the bank bought stock in the target company. But that information is vital in assessing whether the bank was in possession of nonpublic information at the time of its stock purchases. If it wasn't, its trading cannot be faulted.

Take the September 2006 transaction in which **Motorola Inc.** acquired Symbol Technologies Inc., a maker of bar-code readers and other devices. The protracted talks began more than a year earlier, in August 2005. Goldman Sachs counseled the

big cellular-phone company on the \$3.9 billion deal, filings indicate.

Goldman also was a big accumulator of Symbol's stock in the final quarter before the transaction's announcement. The buying brought its reported holdings to 1,169,200 shares at the end of June 2006.

Did Goldman, a longtime adviser to Motorola, know about the talks when it bought the stock? The firm says not. It bought the bulk of the stock for its own account in late April 2006, according to a person close to Goldman. Motorola didn't hire Goldman to advise on the deal until more than a month later, on June 1, says firm spokesman Lucas van Praag, adding that Goldman put the deal on its watch list on that date. "To the best of my knowledge, Goldman did not know about the negotiations before it was retained," he says. Motorola confirms that it signed an engagement letter with Goldman on June 1.

Goldman says it reviewed the trading at the time and found nothing improper.

In addition to disclosing stock holdings, quarterly institutional-ownership filings also report on certain types of options -- financial instruments that allow the holder to bet on the direction in a designated stock.

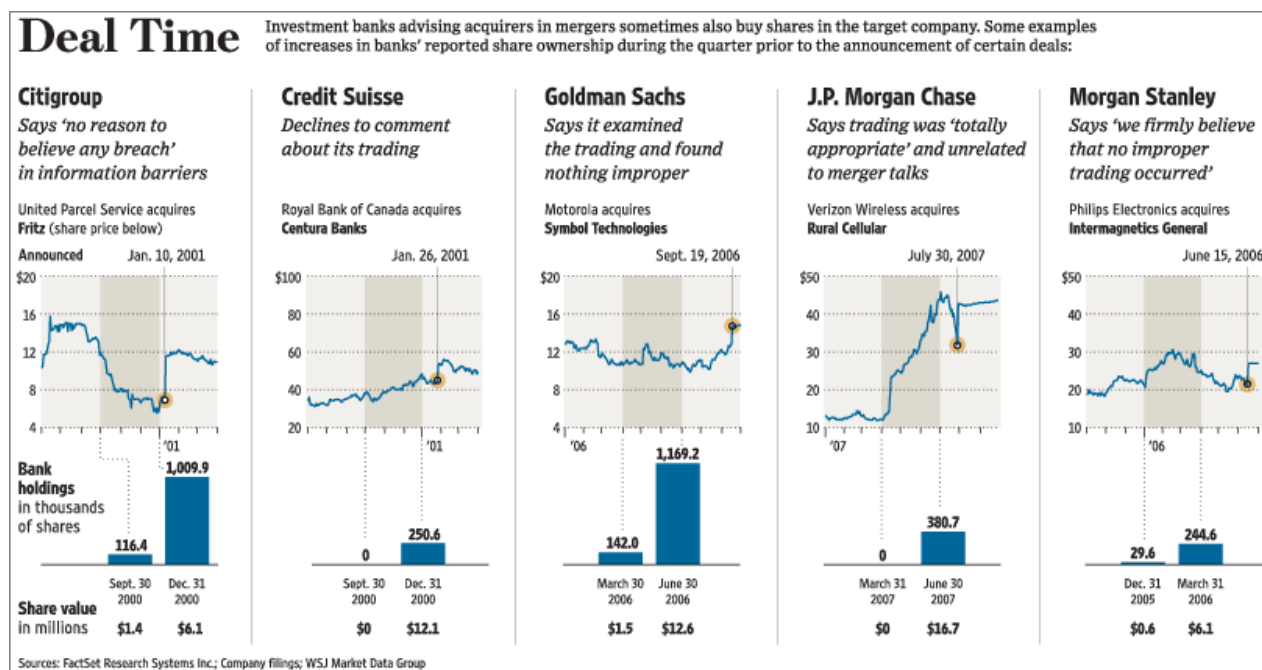
In the fall of 2005, **Philips Electronics NV** of the Netherlands began talks to acquire Intermagnetics General Corp., a small Latham, N.Y., maker of magnets for medical-imaging machines, filings show. Morgan Stanley advised Philips. According to one person with knowledge of the situation, Morgan Stanley was involved early on in the discussions.

During the first quarter of 2006, Morgan Stanley's reported holdings of call options in Intermagnetics rose from zero to 21,000. The options essentially were bets that Intermagnetics stock would rise above a certain threshold. In addition, Morgan Stanley's common-stock holdings in Intermagnetics increased eightfold during that quarter, to 244,571 shares. The options and most of the stock were held in the name of Morgan Stanley & Co., suggesting it was the bank's own capital at risk.

On June 15, 2006, Philips announced a deal to buy Intermagnetics for \$1.3 billion. Intermagnetics' shares rose 26%, or \$5.60, on the news.

In a statement, a Morgan Stanley spokeswoman said the bank has "strict policies" to prevent the spread of nonpublic information, and doesn't believe they were violated in this case. "We firmly believe that no improper trading occurred."

Write to Mark Maremont at mark.maremont@wsj.com² and Susanne Craig at susanne.craig@wsj.com³



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