

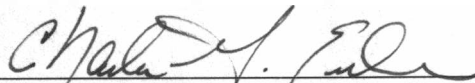
**AN INVESTIGATION OF INSIDER TRADING:
THE IMPACT OF THE MARTHA STEWART CASE**

Submitted in partial fulfillment of the requirements for graduation with honors to the Department of Accounting, Business Administration, and Economics at Carroll College, Helena, Montana.

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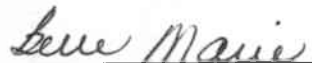
SIGNATURE PAGE

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TABLE OF CONTENTS

Acknowledgements.....	i
Foreword.....	ii
Introduction.....	1
Chapter 1.....	3
A Select History of Wall Street	
Chapter 2.....	8
Securities Act of 1933 & Securities Exchange Act of 1934	
Chapter 3.....	11
The Stock Market	
Chapter 4.....	21
Fame, Wealth, and Financial Fraud Cases	
Chapter 5.....	28
SEC Charges Martha Stewart with Insider Trading	
Chapter 6.....	39
Martha's Finances	
Chapter 7.....	42
Legal Insider Trading	
Chapter 8.....	45
The Future of Wall Street	
Conclusion.....	48
Appendix.....	50
Works Cited.....	51

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FOREWORD

Since the evolution of the New York Stock Exchange in the eighteenth century, investors have continually traded stocks in an effort to maximize their profits. Some traders have even resorted to unethical and dishonest behavior so as to minimize losses. These illegal actions were expressed in the Securities Act of 1933 and came to be enforced by the Securities and Exchange Commission. An exploration of famous financial fraud cases involving the rules set forth by the Securities Acts may reveal a twofold hidden agenda of the government. First, the government may have aimed at restoring faith and trust in businesspersons by heightening the awareness of the crimes committed. The laws passed, such as the Sarbanes-Oxley Act, are aimed at reinstating confidence in Wall Street investors after numerous financial scandals have emerged. Secondly, officials appear to lessen jail sentences and fines of the wealthy and famous, but these criminals inevitably end up being punished by the media and by financial losses resulting from the behavior of their company's stock. The examination of the Martha Stewart case shows how such an icon can be significantly chastised, even though the time spent in jail was minimal. The research suggests that highly publicized fraud cases will do little to deter others from committing the offenses, since they are often not premeditated.

INTRODUCTION

In attempting to make and save money, humans have schemed ways to “get rich quick.” Individuals have put their minds and money together in an effort to get the most out of their holdings. An example of this conglomeration was the origination of the securities business in the eighteenth century in New York City. This business later evolved into the New York Stock Exchange (“The History”).

As investors traded stocks over time, some found ways to increase profits while minimizing losses by being dishonest. “Insider trading” became known as a white-collar crime that resulted from the knowledge of confidential information that was not yet public (Ritter, Silber, & Udell 295). This crime came to be governed by the Securities Act of 1933 and enforced by the Securities Exchange Act of 1934. An investigation of the stock market with a special focus on how the highly publicized Martha Stewart case may have little to no impact on the future of Wall Street and insider trading will be the aim of this thesis. It will also be demonstrated that the Stewart debacle was a symbolic attempt of the United States government to put a hidden agenda into play.

In summary, a variety of issues must be explored to understand the dynamics involved with the Martha Stewart case. Such matters include Wall Street, the Securities and Exchange Commission, and the stock market. Next, a comparison of similar high-profile financial fraud cases will raise the issues of fame, wealth, fraud, and length of punishments. Also, an in-depth examination of the Stewart case and Martha’s personal behavior will lay the foundation of a woman who was punished not only by the court system, but by the media and much of the investing American population. Finally, a look

at future practices on Wall Street will show how Stewart's punishment may not have fit her crime.

CHAPTER 1

A SELECT HISTORY OF WALL STREET

Upon arrival in America during the seventeenth century, Dutch settlers faced obstacles that needed to be overcome in order to ensure the survival of their culture. Pirates and Indians were two of the dangers that the early Dutch encountered. To protect themselves, these pioneers decided to construct a wall between the Hudson River and the East River in New York. Little did they know that this wall would turn into the center for trade and commerce in the 21st century. Locals frequented the path that was formed along "Wall Street." Shopkeepers built their business along the street, along with the construction of a city hall and a church. New York was the national capital of the United States from 1785 to 1790. Also during this time period, Federal Hall was built on Wall Street. This location was the future inauguration site of the first President of the United States of America, George Washington, in 1789 ("The History," "George Washington").

The wealthy merchants of New York met in March of 1792 to discuss options for the regulation of the securities business. These men had been struggling to obtain the business from auctioneers, who were their competitors at this time. The result of all this hard work was the signing of the Buttonwood Agreement on May 17, 1792. The merchants named the pact in honor of their meeting place, a buttonwood tree. This treaty stipulated that the members trade securities only amongst themselves. Also, fees for trading were set and the men were under agreement not to become involved in other auctions of securities ("The History"). It was during this time frame that Spanish currency was used as a medium for trading commodities. The currency was denominated in "eights," which is how members of the exchange began quoting stock prices. This

trend continues today, as the ticker on Wall Street and other financial institutions presents current stock quotes in fractions of eighths (Holland). The accord signed by the 24 members was the birth of “what was to become the New York Stock Exchange. The Exchange would later be located at 11 Wall Street” (“The History”).

The twenty-four member New York merchant group began to realize that their stock exchange was not doing well. A major factor that led to the decline of the exchange was the plummet of revolutionary war bonds and stock that resided in the Bank of the United States. The merchants had heard about a stock exchange in Philadelphia that was founded in 1790. In 1817, the investors decided to investigate the prospering Philadelphia exchange. Upon the return of their undercover merchant and learning of the success in Philadelphia, the New York merchant group formed the New York Stock and Exchange Board on March 8, 1817, (“The History”).

Forty Wall Street was the address of the newfound exchange. A single room was the location of the exclusive organization. The stocks to be traded were read each day by Anthony Stockholm, the president of the exchange. Any person desiring a position on the exchange had to be voted in and “...a candidate could be black-balled by three negative votes” (“The History”). The membership fee was \$25 per person in 1817. By 1848, the price had hit \$400 (“The History”). On January 7, 2005, a seat on the New York Stock Exchange sold for \$1.15 million. This figure was down \$100,000 from a sale that took place in August of 2004. The highest membership fee was paid in August of 1999 at a cost of \$2.65 million (“NYSE Seat”).

Many fortunes were made on Wall Street during the 1900s. One entrepreneur in particular stunned fellow investors on Wall Street. This man’s name was J.P. Morgan.

The U.S. Steel Corporation was the result of a billion dollar merger carried out by Morgan. Morgan also helped to stabilize Wall Street during times of panic. In 1907, 800 million securities were unloaded in just a few short months, which led to runs on banks. With the encouragement of Morgan, New York bankers held off a complete financial collapse of the country. After the panic, Morgan succeeded in setting up a single banking trust in which he held the controlling interest ("The History").

By 1929, workers, shopkeepers, and high-class executives were becoming wealthy overnight by trying their luck at the stock market. "Both rich and poor put their money into stocks and bonds" ("The History"). During this time, stock prices were overvalued by as much as 400% in relation to the actual worth of the companies they represented ("The History").

Black Tuesday

On October 24, 1929, investors started to panic. Not only had the market been in a steady decline since September, but prices drastically started to fall on October 18. A record 12,894,650 shares switched hands on the New York Stock Exchange on October 24 after the increased fear had spread ("This Day"). This figure compared to the previous record number of shares traded in one day, which stood at 3,875,910 on March 12, 1928 ("The Stock Market Crash"). Some tried to buy up blocks of stock, which produced "...a moderate rally on Friday" ("This Day"). The country watched the market continue to fall on Monday the 28 and by the 29, the entire stock market crashed. The wealthiest frequenters of Wall Street lost billions of dollars in only a few hours after 16,410,030 shares were traded ("This Day"). "Black Tuesday," as it became known as, led to a long-

term economic downturn and the Great Depression. The economy did not make a turnaround until the beginning of the Second World War in 1941 (“The History”).

Some causes of the stock market crash of 1929 were evident even before this disaster occurred. There had been a period of large speculation that reached a peak in August of 1929. The economy was weakening due to decreased production and increased unemployment rates (“This Day”). Many investors were “buying on margin,” which meant they only had to put up ten percent of the price of the security while borrowing the remainder from a broker or dealer. This practice was monitored under “Regulation T” (Holland). Other contributors to Black Tuesday included “...low wages, the proliferation of debt, a weak agricultural [sector], and an excess of large bank loans that could not be liquidated” (“This Day”).

Subsequent to the crash of 1929, the stock market was at the trough of the economic cycle. Since stock prices were so low, they “had nowhere to go but up” (“This Day”). There was some recovery of stock prices in the weeks following October 29, but prices dropped overall as the United States slipped into the Great Depression. Compared to their value in the summer of 1929, stocks in 1932 were worth only 20 percent of this figure (“This Day”).

In retrospect, the warning signs of an economic disaster were pinpointed by some of Wall Street’s experts. However, citizens were too engulfed in the booming period of the twenties to take notice of the financial crisis that was looming. A bull market was in full swing and Americans were busy making money (Savill). As stated by R. Richard Savill, “When the bulls are stampeding, it raises a cloud of dust that makes it hard to see danger. This boom of the 20’s is almost as famous as the bust” (par. 4).

Black Monday

Wall Street enthusiasts were devastated when the market crashed for a second time within a century. On October 19, 1987, "Black Monday," the Dow Jones dropped 508 points (Holland). This was "the largest one-day loss in the stock market's history" ("The History"). Many traders attributed this crash to computer systems becoming overloaded, which led to prices dropping sharply and investors accumulating large losses on their portfolios ("The History").

CHAPTER 2

SECURITIES ACT OF 1933 & SECURITIES EXCHANGE ACT OF 1934

Prior to “the Great Crash of 1929, there was little support for federal regulation of the securities market” (“The Investor’s Advocate,” par. 9). Many investors were amused with the idea that they could become rich quickly. During this time, stock traders did not fathom the dangers that were inherent in the market. “During the 1920s, approximately 20 million large and small shareholders took advantage of post-war prosperity and set out to make their fortunes in the stock market” (“The Investor’s Advocate,” par. 10).

Americans experienced the crumbling of the market in 1929 and entered the worst depression in history:

By 1933, nearly half of America’s banks had failed, and unemployment was approaching 15 million people, or 30 percent of the workforce. It would take World War II, and the massive level of armaments production taken on by the United States, to finally bring the country out of the Depression after a decade of suffering. (“This Day”)

After the crash, President Franklin D. Roosevelt (FDR) and Congress decided that some regulations needed to be implemented to safeguard the economy of the United States. The Depression that followed was characterized by low investor confidence in the market. To instill the faith in securities traders that existed before the crash of the market, Congress searched for solutions that would restore American assurance (“The Investor’s Advocate,” par. 12).

The first policy enacted was the Securities Act of 1933. This piece of legislation is commonly called the “truth in securities” law. The act’s purpose was twofold. The

first standard would “require that investors receive financial and other significant information concerning securities being offered for public sale...” (“The Laws,” par.1). Next, it would “prohibit deceit, misrepresentations, and other fraud in the sale of securities (“The Laws,” par. 1). The registration statement for securities that was mandated by the Securities Act of 1933 was the first step in the initial public offering process (“The Laws,” par. 2). The essentials of the registration form included:

- a description of the company’s properties and business
- a description of the security to be offered for sale
- information about the management of the company
- financial statements certified by independent accountants

(“The Laws,” par. 3)

One year after the Securities Act was created, it was determined that a governing body was crucial to the implementation of its provisions. To solve this issue, the Securities Exchange Act of 1934 was passed and “Congress created the Securities and Exchange Commission” (“The Laws,” par. 7). “The primary mission of the U.S. Securities and Exchange Commission (SEC) is to protect investors and maintain the integrity of the securities markets” (“The Investor’s Advocate,” par. 1). The Securities and Exchange Commission was given “broad authority over all aspects of the securities industry. This [included] the power to register, regulate, and oversee brokerage firms, transfer agents, and clearing agencies as well as the nation’s securities self regulatory organizations [SROs]” (“The Laws,” par. 7).

The SEC is composed of five commissioners, who are appointed by the President of the United States. “Their terms last five years and are staggered so that one

commissioner's term ends on June 5 of each year. To ensure that the commission remains non-partisan, no more than three commissioners may belong to the same political party" ("The Investor's Advocate," par. 16).

The headquarters of this oversight agency are located in Washington, D.C. This regulatory body has four divisions and eighteen offices. In addition, there are eleven regional and district offices of the SEC. All of the positions filled by the SEC amount to 3,100 total employees ("The Investor's Advocate," par. 15).

CHAPTER 3

THE STOCK MARKET

To better understand the workings of the stock market and the fraudulent behaviors that can surface from trading securities, it is imperative to explore the basic terms and concepts that are used on Wall Street.

A stock represents ownership or equity in a company. Corporations issue stock as a means of raising capital or financing the operations of their businesses. The benefit shareholders receive comes in the form of dividend income. There are two main variations of stock. Preferred stock allows stockholders a fixed dividend and features a seniority status over common stockholders. Certain shares of preferred stock may also have a convertible characteristic, which allows the holder to convert their preferred stock into common stock at a predetermined price. A residual or variable dividend payment is what the common shareholder is entitled to, which is a positive feature if the particular company is doing well (Ritter, Silber, & Udell 37).

Initial Public Offering

In order for a stock to be traded publicly in the secondary market, it must be offered initially in the primary market. This market exists solely for the purpose of original stock distribution (Ritter, Silber, & Udell 141). Other than in the case of an exemption, Section 5 of the Securities Act of 1933 forbids the offer or sale of securities to the public without abiding by measures set forth by the Securities and Exchange Commission. Corporations wanting to obtain financing through the means of a stock sale must register with the SEC (Palmer & Dodge, par. 2).

Filing a registration statement with the SEC is only the first step in the lengthy process of having an initial public offering or "IPO" (Palmer & Dodge, par. 3). This document includes a prospectus, which serves two purposes. The first is intended "...to present investment in the company as an exciting opportunity" (Palmer & Dodge, par. 40). The prospectus also acts as "...a disclosure document [,] which must make complete and accurate disclosure of all material information about the company and the offering to protect the company from claims by investors" (Palmer & Dodge, par. 41). To aid in the process of organizing the necessary documents for the offering and to assist with the initial sale of the stock, a company that desires to "go public" typically hires an investment bank. This institution serves as an underwriter of the security (Palmer & Dodge, par. 3). An underwriting syndicate may then be formed to spread the financial risk that is present before the underwriting agreement is signed. The syndicate can be composed of a number of different underwriters from various investment banks (Palmer & Dodge, par. 13). The underwriter(s) then agree to purchase the shares being offered with the intention of selling them to the public (Palmer & Dodge, par. 3).

Once the registration statement has been filed, then "...underwriters may make oral offers" (Palmer & Dodge, par. 48). These offers are made possible "through the use of the preliminary prospectus, which is often referred to as a 'red herring,' because it contains on its cover a legend printed in red stating that offers to buy may not be accepted nor sales made prior to the effectiveness of the registration statement" (Palmer & Dodge, par. 48). Subsequent to the announcement of the offering, the underwriters may go on a "road show" in which investment in the company is promoted in key cities (Palmer & Dodge, par. 50).

After the registration statement is approved by the SEC, then the corporation that is going public must, "...register its shares under the Securities and Exchange Act of 1934, as amended (the '1934 Act'), which regulates the resale of securities and imposes reporting requirements on the issuer, its directors, officers and controlling stockholders" (Palmer & Dodge, par. 4). Finally, the new shares may be traded in the secondary market the next morning (Palmer & Dodge, par. 59).

The secondary market is the arena commonly referred to as the "stock market" (Ritter, Silber, & Udell 141). The New York Stock Exchange (NYSE) paints a picture of chaotic hand signaling, paper throwing, bell ringing, and computer screen flashing of numerous numbers. This is the location that is most visible to the public (Holland). Another reason why the NYSE is highly noticeable to consumers is because, "shares of the largest and best-known corporations are traded there" (Ritter, Silber, & Udell 141). There are approximately 2,800 corporations whose shares are traded on the floor of the NYSE each day. The person responsible for each location of traded stock or post is deemed the specialist. He or she sees that the various securities are traded in an orderly fashion (Ritter, Silber, & Udell 141). Another secondary market for securities trading is the American Stock Exchange (AMEX) ("The Laws," par. 7). The AMEX prides itself in being "a pioneer in market innovation for more than a century and remains committed to developing successful new investment products and innovative services for companies and investors" ("About Amex").

Investors who are interested in a potential stock will want to know the price of a share. After their purchase, they can calculate an estimate of the future price of that stock. The constant-growth model, commonly referred to as the Gordon model,

“assumes that dividends will grow at a constant rate, but at a rate that is less than the required return” (Gitman 281). In the following equation, P_0 is the value of the stock, D_t is the “per-share dividend expected at the end of year t,” k_s is the required return on the stock, and g is the constant rate of growth:

$$P_0 = \frac{D_t}{k_s - g}$$

(Gitman 282)

This rate will be similar to the risk-free rate of return on a 90-day Treasury bill. Economic factors can easily influence the price of a stock. A positive outlook for a company may increase the price since its future dividend payments are likely to increase. However, bad news, such as an anticipated poor performance in the future, could have the effect of driving down the stock price (Ritter, Silber, & Udell 593).

The denominator must be taken into consideration when studying the movements of stock prices. An increased interest rate in the lower portion of the price formula equates to a lower stock price. Therefore, “Higher government bond rates will increase the denominator of our formula and reduce stock prices while lower government bond rates will decrease the denominator and raise stock prices” (Ritter, Silber, & Udell 145).

Another economic factor that influences the price of stocks is the supply of money. A “loose” or expansionary monetary policy will leave the public with extra funds, “finding itself with more cash than it needs for current transactions” (Ritter, Silber, & Udell 145). Due to the increased number of investors and the law of supply and demand, stock prices will inevitably increase. On the other hand, a tight monetary policy will decrease the money supply, resulting in less cash for investors, which will lead to lower stock prices (Ritter, Silber, & Udell 145).

The case may arise in which a company pays no dividends on its stock. In this situation, a ratio such as the market price to sales ratio can be applied. The closer the ratio or percentage is to one, then the closer the market price is to being 100 percent of the company's sales:

$$\frac{\text{Market price per share}}{\text{Sales per share}}$$

(Harrington 48)

Those interested in purchasing stock may track an index that measures the "trends in overall common stock prices" (Ritter, Silber, & Udell 37). One gauge is called the Standard & Poor's 500 Stock Index, commonly referred to as the S&P 500. The S&P 500 is a broad representation, since it contains the prices of 500 stocks (Ritter, Silber, & Udell 144).

An even wider range of stocks is portrayed by the National Association of Securities Dealers Automated Quotation System (NASDAQ). This over-the-counter (OTC) market "is a linkage of many dealers and brokers who communicate with each other via telephone and computer terminals" (Ritter, Silber, & Udell 141). There is no physical location for trading securities on the NASDAQ. Rather, "bid and asked prices for thousands of OTC-traded securities on video screens hooked up to a central computer system" is the mechanism for trading equities of companies listed on the NASDAQ (Ritter, Silber, & Udell 141). Not only is the NASDAQ an OTC market, but also an index of common stocks. There are more than 4,000 stocks listed on this system, which allows the index to be extensive (Ritter, Silber, & Udell 38).

Ironically, "the most popular and widely followed measure of all, even though it is the least representative, is the Dow Jones Industrial Average, which is based on the

prices of only 30 stocks” (Ritter, Silber, & Udell 38). However, the Dow Jones Industrial Average (DJIA) is a depiction of 30 high-quality stocks that are deemed blue chip (Ritter, Silber, & Udell 144).

White-Collar Crime

The stock market is a great mechanism for gaining a return on investments. Many investors follow the rules set forth by the SEC in the act of 1934. However, some feel the need to bend certain SEC regulations. One such fracture is generalized as a “white-collar crime” (“White-Collar,” par. 1). The phrase “white-collar” was coined only five years after the enactment of the 1934 SEC law. In 1939, Edwin Sutherland told “the American Sociological Society” that the term was a “crime committed by a person of respectability and high social status in the course of his occupation” (“White-Collar,” par. 1). The term remains ambiguous today, but “generally encompasses a variety of nonviolent crimes usually committed in commercial situations for financial gain” (“White-Collar,” par. 1).

Often, white-collar criminals are tough to punish because they are usually highly intellectual individuals. A majority of the actions committed involve complicated accounting procedures and transactions, which makes it easier for the criminal to conceal the offense (“White-Collar,” par. 1). White-collar crimes may be committed by senior executive officials of corporations who may feel pressure to do well because their compensation packages are normally tied to the level of performance in a fiscal year.

Insider Trading

One variation of white-collar crime that has become highly publicized recently is called insider trading:

According to the SEC, insider trading is trading that takes place when those privileged with confidential information about important events use the special advantage of that knowledge to reap profits or avoid losses on the stock market, to the detriment of the source of the information and to the typical investors who buy or sell their stock without the advantage of 'inside' information. ("White-Collar," par. 17)

The idea of "insider trading" is also surrounded with ambiguity. It is forbidden to trade on the basis of "confidential information," which can be confusing. However, "it clearly includes information received by officers, directors, lawyers, and investment advisers working directly or indirectly for a company that might affect the price of the company's stock" (Ritter, Silber, & Udell 295).

According to Ritter, Silber, & Udell, "It is clear, however, that certain parties are unambiguously considered insiders—for example, officers, directors, and major stockholders—and they are prohibited from trading on private information that has not yet been released to the public" (294). The SEC foresaw the potential for insider trading of corporate officials. The regulatory body did take some precautions to lessen the occurrence of this crime by requiring "all officers, directors, and major stockholders" to disclose their individual trading records of all company stock held (Ritter, Silber, & Udell 294).

Insider trading was recognized in the Securities Exchange Act of 1934. The idea of insider trading is more clearly communicated in Section 10(b) set forth by the SEC:

Section 10(b) of the Securities and Exchange Act of 1934 makes it unlawful for any person 'to use or employ, in connection with the

purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe.' To implement Section 10(b), the SEC adopted Rule 10b-5. (Newkirk, part III.)

Under 10-b5, the SEC required that:

It shall be unlawful for any person, directly or indirectly...,

(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of a security. (Newkirk, part III.)

The theory behind insider trading laws is to provide all investors, regardless of knowledge or status, with a fair opportunity to earn a return on the securities in which they invest. The insider trading restrictions were not implemented to provide efficient stock prices. For any price to be efficient, it must "fully reflect all available information" (Ritter, Silber, & Udell 295). Ironically, many analysts argue that trading on the basis of information that was previously nonpublic could lead to more efficient stock prices. Confidential information is frequently valuable to potential investors and if it were released to the public, then the prices of a particular security would immediately change (Ritter, Silber, & Udell 295).

Penalties for Insider Trading

Under Section 21A of the Securities Exchange Act of 1934, civil penalties may be imposed on the person who was engaged in insider trading and any other persons who helped with the security transaction (“Section 21A”). The judicial branch maintains the authority to enforce civil penalties:

Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder by purchasing or selling a security or security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) while in possession of material, nonpublic information in, or has violated any such provision by communicating such information in connection with, a transaction on or through the facilities of a national securities exchange or from or through a broker or dealer, and which is not part of a public offering by an issuer of securities other than standardized options or security futures products... (“Section 21A”)

The extent of the civil penalties enforced against any person committing or aiding an inside trade varies according to the circumstances of the particular situation. The investor who committed the crime may be subject to the following penalty:

The amount of the penalty which may be imposed on the person who committed such violation shall be determined by the court in light of the facts and circumstances, but shall not exceed three times the profit gained or loss avoided as a result of such unlawful purchase, sale, or communication. (“Section 21A”)

The “amount of penalty for [the] controlling person” is as proceeds:

The amount of the penalty which may be imposed on any person who, at the time of the violation, directly or indirectly controlled the person who committed such violation, shall be determined by the court in light of the facts and circumstances, but shall not exceed the great of \$1,000,000, or three times the amount of the profit gained or loss avoided as a result of such controlled person’s violation. (“Section 21A”)

If the accused is found guilty of insider trading, then that individual may not only be fined, but “banned from sitting on the executive or board of directors of a public company and even jailed” (Rasmussen).

CHAPTER 4

FAME, WEALTH, AND FINANCIAL FRAUD CASES

An exploration of other financial fraud cases will help to compare the sentences received by the famous and wealthy criminals who committed them. This will lead to a discussion of the future of business practices in corporations and on Wall Street.

Michael Milken

“A financial genius who fell victim to envy and became the scapegoat for economic disasters caused by the government” is how author Daniel Fischel describes Michael Milken, the 1980s junk-bond king. Milken will long be known as the financial executive who “transformed corporate takeovers” and financed them “by the use of high-yield junk bonds” (“The Columbia Encyclopedia”). Fischel blatantly opposes the sentence received by Milken, which included “years of government persecution, fines of over \$1 billion, two years imprisonment, and lifetime ban from the securities industry” (Fischel).

Fischel argues that the “economic shifts of the early 80s combined with deregulation and relaxed antitrust enforcement” created ‘new entrepreneurial opportunities’ for taking over badly-managed corporations, reorganizing them, and redirecting or selling resources for more productive use.” This argument was the basic premise on which Milken did business during his 18-year career with Drexel. Milken dramatically expanded “the market for high-yield bonds” (Fischel). The junk-bond king also improved corporate efficiency in America by carrying out a “restructuring revolution. The Dow Jones Industrial Average tripled during the 1980s after remaining flat throughout the 70s” (Fischel).

In his novel, *Payback: The Conspiracy to Destroy Michael Milken and His Financial Revolution*, Fischel contends that Milken was persecuted by the government through “vague laws designed to prevent takeovers.” These laws “led to vaguer laws criminalizing ‘insider trading,’ ‘stock parking,’ [and] ‘manipulation’” (Fischel). He also states “legitimate and beneficial business activities became purposely undefined crimes to give government ‘maximum power and discretion to prosecute whomever they choose for essentially whatever reasons they might choose’” (Fischel). After Milken was indicted on 98 charges, he pled guilty to six of the “more serious” charges. Research conducted by Fischel argues that the six felonies consisted of “mere bookkeeping infractions which violated no legitimate rights and harmed nobody.”

On the other hand, James Stewart, a Pulitzer Prize-winning journalist for the Wall Street Journal, documents “A damningly detailed rundown on the predatory conspirators whose willful violations of securities law and ethical standards gave Wall Street a deservedly bad name during the takeover frenzy of the 1980’s” in his work, *Den of Thieves*. Stewart contends that Milken “convinced many savings institutions and insurance companies to buy these [junk] bonds in large quantities” and “may have indirectly contributed not only to the bailout of various thrifts but also to the insolvency of some insurance companies.”

After receiving his MBA from the Wharton School at the University of Pennsylvania, Milken researched a market that he felt lacked representation—high-yield debt. By dedicating 15 hours of his day to work, he became known as a controversial figure in the financial world. Milken favored the use of junk bonds “in corporate finance and acquisitions, which fueled the 1980s leveraged buyout boom” (“Michael Milken”).

His work led to the increased profitability of his company, Drexel. Milken was said to have “moved from \$1.2 million in fees to over \$4 billion in 1986” (“Michael Milken”). Drexel became “the most profitable firm on Wall Street,” while Milken’s “\$550 million salary, and bonus” of the late 1980s “still stands in the Guinness Book of World Records” (“Michael Milken”).

Milken was charged with “98 counts of racketeering and fraud” in 1989 and later indicted by a federal grand jury (“Michael Milken”). His original sentence carried ten years in prison and scores of fines. An initial fine of \$200 million was paid, along with “another \$400-800 million in settlements relating primarily to civil lawsuits” (“Michael Milken”). In 1990, “the government dropped the more serious charges of insider trading and racketeering” (“The Columbia Encyclopedia”). By 1991, his sentence had been reduced to only two years in prison and three years probation upon release. After working as a “strategic business consultant” Milken was charged with multiple violations of his probation (“The Columbia Encyclopedia”). He paid \$47 million to settle with the SEC in 1998 for allegedly overstepping his ban from the securities industry. This fine stemmed from his advising of the MCI/News Corporation in 1995 and Revlon/New World Communications in 1996 (“Michael Milken”).

Milken’s “original ten-year sentence was reduced in 1992, because he cooperated, although only in a small way, with the government investigation” (Alcaly). It is interesting that such a wealthy and prominent business figure in corporate America was able to get eight years shaved off of his original sentence. Like Martha Stewart, who faced up to 20 years in prison, but had to only serve five months in a minimum-security facility, Milken only received a so-called “slap on the wrist” for his corporate crimes

(Steinhaus). The fines paid by Milken were minimal in relation to the enormous profits he generated over a lifetime. With minimal punishments such as these, what is to deter the average businessperson from committing fraudulent crimes such as their infamous and wealthy predecessors have done? The reasoning behind the convictions of prominent business entrepreneurs may be to serve as a precedent for others to recognize, but in the end a significant smudge is put on the reputations of corporate gurus through the punishment of public humiliation. The same pattern of reduced fines, punishments, and damaged reputations permeate throughout the case of another infamous financial criminal—Leona Helmsley.

Leona Helmsley

When New York's "King of real estate" Harry Helmsley passed away in 1997, he left his widow their estate, valued at \$1.7 billion, making her "one of the wealthiest people in the United States" ("The United States"). Helmsley's death came after a decade of court proceedings involving his wife, Leona Helmsley ("The United States").

Dubbed "the Queen of Mean," Leona Helmsley was a recognized figure throughout the 1980s. Leona and Harry were involved in the real estate business for many years. They started with a "conversion of apartment buildings to condominiums, greatly to the consternation of some of the tenants" ("Leona Helmsley"). After this venture, the Helmsleys began to "concentrate on the hotel industry, building the Helmsley Palace on Madison Avenue near Saint Patrick's Cathedral" ("Leona Helmsley"). Leona was known "primarily for two things—as a tyrannical 'boss from hell' whose petulance seemed ill-suited to the 'hospitality' industry, and for being

prosecuted for, and eventually convicted and sentenced to prison for, income tax evasion” (“Leona Helmsley”).

On June 26, 1989, Leona’s trial got under way. The prosecution alleged that “the Helmsleys accumulated approximately \$4 million dollars of personal expenses, which they illegally deducted as business expenses in order to avoid paying more than \$1 million in taxes to the government” (“The United States”). During the trial, “It appeared that the Helmsleys, Leona in particular, had indeed gone to extreme lengths to hide their extra expenditures accumulated from work done at their estate” (“The United States”). By combining invoices, falsifying them, and creating phony ones, Leona managed to “cover up the work from the estate” (“The United States”). These invoices were then “sent to Helmsley subsidiaries to be figured in with the companies’ business expenses” (“The United States”).

When the verdict was read on August 30, 1989, Leona was “convicted of 33 felony counts of trying to defraud the government and IRS, including mail fraud, tax evasion and filing false tax returns” (“The United States”). However, Leona was lucky since she “managed to escape being convicted for extortion, which carried an enormous prison sentence” (“The United States”).

Similar to Michael Milken, Leona’s initial sentence of sixteen years of concurrent prison service was reduced significantly. Upon appeal to the New York Supreme Court, Leona “ended up serving approximately eighteen months in a federal penitentiary” (“The United States”).

Minimal Punishment

After looking at the cases of Martha Stewart, Michael Milken, and Leona Helmsley, it is clear that many high profile cases carry hefty sentences initially, but are later dropped as a result of cooperative behavior and/or an appeal to a higher court. Not only was it evident to the public that Stewart faced minimal charges, but the queen of homemaking even publicly stated that her offense was not a big issue. Stewart said "she regretted that this 'small personal matter' had been blown out of proportion. She clearly tried to convey the message that she was prosecuted for a crime because she was a celebrity" (Kiernan). In fact, Stewart's "small personal matter" became a felony on her newfound criminal record. "The impression left by Stewart is that little crimes, if you are famous, really shouldn't count or, in other words, what she did was okay because, after all, everybody cheats" (Kiernan). The research suggests that there may be a correlation between wealth, fame, and the likelihood of criminal sentences being reduced. A reason for minimal prison terms and fines given to these high profile cases may be that the government has a hidden agenda: condemning financial fraud cases by tarnishing the reputation of well recognized names.

The SEC and the United States Government try to set a precedent for future business practices in corporations and on Wall Street by merely slapping successful business people "on the wrist" after breaking securities laws. However, this practice ends up hurting celebrities a great deal in the end since their affairs are widely broadcasted and documented by the media. Their hard work and efforts contributed to the business world and economy may be looked down upon and the stock of their companies may drop as a result of the government's motives.

Insider Trading Rates

The SEC website claims that “there are almost 500 civil enforcement actions each year against individuals and companies that break securities laws. Insider trading is one of the most common laws broken” (Rasmussen). The trend of white-collar crime has permeated throughout corporate America over the past decade. The number of insider trading cases brought forth by the SEC has increased dramatically. In 1993, the enforcement agency filed only 31 cases, versus the 59 it brought forth in 2002. The 2002 figure represents 10 percent of all SEC cases (Pender). The following chart depicts the surge of securities violations from 1993 to 2002:

Fiscal Year	Insider Trading Cases	All Cases	% of Insider Trading Cases
1993	31	417	7%
1995	35	486	7
1997	48	489	10
1999	57	525	11
2001	57	485	12
2002	59	598	10

Adapted from Kathleen Pender
Source: Securities and Exchange Commission

CHAPTER 5

SEC CHARGES MARTHA STEWART WITH INSIDER TRADING

On June 4, 2003, Martha Stewart and her former stockbroker Peter Bacanovic were indicted on nine criminal charges that centered on securities fraud (“Martha Stewart”). The SEC believed that Stewart engaged in illegal insider trading practices when she sold her ImClone Systems, Inc. (ImClone) stock on December 27, 2001 (“SEC Charges Martha”). That same day, Stewart “resigned as CEO and chairman of Martha Stewart Living Omnimedia” (“Martha Stewart”). The charges brought by the SEC against Stewart led the domestic diva from a vast empire of perfection in homemaking to a minimum-security prison camp in Alderson, West Virginia (“Martha Stewart”).

Background of Martha Stewart

Stewart was born as Martha Helen Kostyra in Jersey City, New Jersey in 1941. While growing up in New Jersey with her four brothers and sisters, Stewart received a scholarship to Barnard College in New York City. While majoring in art, European history, and architectural history, Stewart worked as a part-time model to cover her college expenses. The birth of her daughter Alexis put an end to her modeling career in 1965. At this point, Stewart began a new life as a stockbroker, which continued through 1973 (“Martha Stewart”).

After moving to Westport, Connecticut and remodeling an 1805 farmhouse with her husband Andrew Stewart, Martha started a catering business. She then “began writing columns and articles on topics such as cooking, gardening, and home furnishing” (“Martha Stewart”). Her passion for homemaking led to the position of contributing editor for *Family Circle* magazine during the 1980s. It was during this time that Stewart

became a spokesperson for Kmart. In 1990, she had crafted her own magazine entitled *Martha Stewart Living*. “That same year her husband filed for divorce on the same day that her book on weddings came out” (“Martha Stewart”).

By 1993, *Martha Stewart Living* had become an half-hour television show. “The Martha Stewart Everyday Collection” was the home products line introduced by Stewart shortly after her show aired. “Stewart rose to national prominence with regular appearances on NBC’s *The Today Show*” (“Martha Stewart”). Stewart’s first exclusive product line premiered in 1997. This introduction eventually led to eight more exclusive lines. Stewart was becoming a familiar face on television since she hosted two new shows in the late 1990’s. *From Martha’s Kitchen* and *From Martha’s Garden* were Stewart’s broadcasts. During these shows, she displayed a “persona of perfection,” which led to Stewart “[becoming] an easy target for mockery and parody on late-night talk shows and *Saturday Night Live*” (“Martha Stewart”).

In an effort to unite her various enterprises, Stewart founded Martha Stewart Living Omnimedia in 1999. This company is traded on the NYSE under the symbol MSO. Stewart was chief executive officer (CEO) and chairperson of the board until she stepped down in 2003. Her 94% voting power and 61% ownership of the company’s equity gave Stewart immense control of the homemaking-based empire (“Martha Stewart”).

Stewart was nominated “to serve on the board of directors of the NYSE” on March 22, 2002. She proved to be a popular icon for this position and was elected to the board on June 6, 2002. However, she ended up resigning on October 3, 2002 (“Find

Law” 2). Stewart’s resignation of CEO and chairperson at her company came on the same day she and her broker were indicted, which was June 4, 2003 (“Martha Stewart”).

Insider Trading Scandal

On December 27, 2001, Martha Stewart made a stock trade that changed her life forever. A complaint filed by the SEC on June 4, 2003 accused Stewart of illegally trading 3,928 shares of ImClone stock in late December of 2001. Stewart’s broker was Peter Bacanovic, who held a Master’s of Business Administration degree from New York University. Merrill Lynch, Pierce, Fenner & Smith Incorporated employed Bacanovic at the time of Stewart’s stock sale. Previous to his work at Merrill Lynch in 1993, Bacanovic was involved in marketing for ImClone (“Peter Bacanovic”).

Stewart received an illegal tip from Bacanovic via another one of his clients, ImClone CEO Samuel Waksal. According to Waksal, his biopharmaceutical company was awaiting a ruling on a submitted application to the Food and Drug Administration (FDA) on a cancer treatment drug called Erbitux that ImClone was hoping to market (“SEC Charges Martha”). The product would have likely increased sales and the price of ImClone shares.

On the morning of December 27, 2001, “Bacanovic instructed his assistant, Douglas Faneuil, to tell Stewart that Waksal and his daughter were selling all the ImClone Stock they held in their Merrill Lynch accounts” (“SEC Charges Martha”). Upon receiving this knowledge, Stewart asked Faneuil to sell all of her ImClone stock. Waksal’s fear of the FDA rejecting ImClone’s application for the Erbitux drug came true on December 28, 2001 (“SEC Charges Martha”). “By the close of the next trading day, Monday, [December] 31, 2001, the price of ImClone stock dropped 16% to \$46 per

share. By selling when she did, Stewart avoided losses of \$45,673” (“SEC Charges Martha”). “That kind of profit motive [was], or course, minimal for Stewart, who in 2000 and 2001 was named on *Forbes* magazine’s list of the 400 wealthiest Americans” (Ulick).

Waksal was convicted and received a hefty sentence in June of 2004 for his role in the scandal involving the insider trading of ImClone stock. He “was sentenced to 87 months in prison and fined \$3 million” (“On Trial”).

Charges

The civil suit filed against Stewart and her broker Bacanovic involved a variety of charges. Both Stewart and Bacanovic were charged with one count of conspiracy. Under Title 18, Chapter 19, Section 371 of the United States Code, this was the “Conspiracy to commit offense of to defraud the United States” (“The Law”). Next, Stewart was charged with two counts of false statements and Bacanovic was charged with one. Her broker was also charged with one count of false documents. These “statements or entries generally” fall under Title 18, Chapter 47, Section 1001 of the U.S. Code (“The Law”). Perjury was the fourth charge that Bacanovic received, which falls under Title 18, Chapter 79, Section 1621 and refers to “perjury generally” (“The Law”). Stewart and Bacanovic were each charged with a count of “obstruction of proceedings before departments, agencies, and committees.” This was found under Title 18, Chapter 73, Section 1505 of the U.S. law (“The Law”). Each of these charges carried a penalty of up to five years in prison.

The last charge that Stewart initially received was securities fraud. Under Title 15, Chapter 2B, Section 78j of the U.S. Code, Stewart was accused of using

“manipulative and deceptive devices” (“The Law”). However, Judge Cederbaum threw out the securities fraud charge on February 27, 2004. If convicted, this charge carried a maximum penalty of 10 years imprisonment and a possible one million dollar fine. “The judge called the charge ‘unfounded’ and said that ‘no jury could feasibly find it to be accurate’” (“Martha Stewart”).

In essence, Stewart was initially indicted on four U.S. laws. However, the fourth charge of securities fraud of the U.S. Code fell under the branch of the SEC. Since the charge was thrown out by Judge Cederbaum, Stewart escaped a possible penalty of up to ten years in prison. Had the securities fraud not been thrown out, then Stewart would have faced repercussions of the SEC (“The Law”).

The Trial

Stewart’s trial began on January 27, 2004 with a review of “Merrill Lynch’s Policies on Safeguarding Client Information and Insider Trading,” so as to show the boundaries that her broker, Bacanovic, crossed (“Stewart Convicted;” “Find Law” 3). Not only were the policies of “Confidentiality of Client Information” and “Client Information Privacy Policy” to be followed by all investment advisors at Merrill Lynch, but the concept of “piggybacking” was forbidden. This was “the buying or selling a security after a client bought or sold the same security in order to take advantage of that client’s perceived knowledge or expertise” (“Find Law” 3-4).

Subsequent to the review of Merrill Lynch’s Policies, the court walked through the day of December 27, 2001. The request of the Waksal family to unload their ImClone shares was marked ‘URGENT – IMMEDIATE ACTION REQUIRED’ (“Find Law” 6). After Stewart had received word from Faneuil regarding the sale of the Waksal

shares, the price of the ImClone stock stood at \$61.53 per share. The information given to Stewart was considered “misappropriated and stolen from Merrill Lynch and its clients” (“Find Law” 7).

The closing price of ImClone stock on December 28, 2001 was \$55.25 per share. After the FDA decision on ImClone’s cancer drug was publicly announced, its stock opened at \$45.39 on December 31, 2001, which was the next trading day (“Find Law” 8).

After Stewart learned that she would be under investigation for insider trading, she and Bacanovic:

...entered into an unlawful conspiracy to obstruct the investigations; to make false statements and provide false and misleading information regarding Stewart’s sale of ImClone stock; and to commit perjury, all to conceal and cover up that Bacanovic had breached his duties of trust and confidence to Merrill Lynch and its clients and caused Stewart to be provided information regarding the sale and attempted sales of the Waksal shares, and that Stewart had sold her ImClone stock while in possession of that information. (“Find Law” 9-10)

Stewart and her broker decided to fabricate a story in order to explain the sale of her ImClone stock. They told authorities that they “had a pre-existing agreement to sell the stock if and when the price dropped to \$60 per share” (“The Law” 10). Bacanovic and Stewart went to great lengths to ensure the validity of their story about selling the ImClone shares. Around January 28, 2002, the SEC requested documents “relating to brokerage accounts maintained by Martha Stewart” (“Find Law” 15). Bacanovic altered a worksheet “in order to fabricate evidence that would purportedly corroborate

Bacanovic's and Martha Stewart's claims that Stewart had decided to sell her ImClone stock if the market price fell to \$60 per share" ("Find Law" 15). Stewart's broker used a blue ballpoint ink pen to include '@ 60' next to the transactions made with Stewart's ImClone stock ("Find Law" 16-17). All of these actions amounted to "The Scheme to Obstruct Justice" ("Find Law" 9). Also, the alibi created by Stewart and Bacanovic led to Stewart's first charge of false statements ("Find Law" 13).

The dispute involving the notation made on Bacanovic's worksheet resulted in national ink expert Larry F. Stewart being called to the witness stand. Mr. Stewart testified that the "@ 60" had "been made in a different ink than other marks on the sheet" ("Feds Announce"). After his testimony, the scientist was accused of lying on the stand, but "the false testimony did not make [Stewart's] conviction invalid" ("Feds Announce"). Martha Stewart requested twice for a new trial due to the perjury of the expert, but "U.S. District Judge Miriam Goldman Cedarbaum said there was 'no reasonable likelihood that this perjury could have affected the jury's verdict.' The judge added that 'overwhelming independent evidence' supports the guilty verdict" ("Judge Denies").

Stewart's other charge of false statements resulted from a phone message she altered that contained information from Bacanovic about ImClone stock going down ("Find Law" 12). The queen of homemaking knew that the message was "recorded in the phone message log maintained by her assistant" ("Find Law" 13). Stewart "well knew but concealed and covered up the message" that "was recorded in the phone message log, the substance of which - - 'Peter Bacanovic thinks ImClone is going to start trading downward'" ("Find Law" 13). The truth was that Stewart had tampered with the

message because she knew investigators were coming to question her just days later (“Find Law” 13).

The Conspiracy developed by Stewart and Bacanovic is as follows:

From in or about January 2002 until in or about April 2002, in the Southern District of New York and elsewhere, Peter Bacanovic and Martha Stewart, and others known and unknown, unlawfully, willfully, and knowingly did combine, conspire, confederate and agree together and with each other to commit offenses against the United States, to wit: to obstruct justice, in violation of Section 1505 of Title 18, United States Code; to make false statements, in violation of Section 1001 of Title 18, United States Code; and to commit perjury, in violation of Section 1621 of Title 18, United States Code. (“Find Law” 20-21)

Bacanovic’s alteration of the worksheet by making the notation of “@ 60” landed him a false document conviction. Also, when subpoenaed by the SEC in February of 2002, Bacanovic lied under oath in order to conceal the conspiracy devised by him and Stewart (“Find Law” 17).

When the five-week long trial ended on March 5, 2004, neither Stewart nor Bacanovic had testified on the witness stand (“Stewart Convicted”). However, Stewart was convicted on the remaining charges that stood. Conspiracy, two counts of false statements, and obstruction were the convictions made by the jury. In addition to the convictions received by Stewart, Bacanovic added perjury and false documents to the list (“Find Law” 17). Some time after the trial, Bacanovic’s assistant, Faneuil, was barred “from association with a broker, dealer, or investment adviser” (“SEC Charges Martha”).

Sentencing

Approximately four months after the highly publicized insider trading trial ended, the woman who was known for her perfection saw that her flawless reputation would be blemished by five months of prison time. On July 16, 2004, Stewart learned that in addition to serving five months of jail time, she would also “spend five months confined to her home and fined \$30,000” (McClam). Just before the sentence was given, she “rose from her seat and, her voice breaking almost to the point of sobs, told the judge she feared her life would be ‘completely destroyed’” (McClam). Bacanovic was given the same sentence for prison and home confinement, but he only had to pay a \$4,000 fine (“Martha Stewart”).

After the trial was over, Stewart made some public comments that were rather surprising. When speaking of the entire ordeal she had gone through, she stated “What was a small personal matter became over the last two and a half years an almost fatal circus event of unprecedented proportions spreading like oil over a vast landscape, even around the world” (McClam). Stewart declared that the scandal was “full of ‘such venom and such gore—I mean it’s just terrible’” as she marched down the courthouse steps (McClam). To cap her infamous trial, she vowed ‘I’ll be back. I will be back. Whatever I have to do in the next few months, I hope the months go by quickly. I’m used to all kinds of hard work, as you know, and I’m not afraid’ (McClam).

In mid-September of 2004, Stewart decided to “trade her freedom for the good of her company” (Sellers). In order to ‘plant the new spring garden’ Stewart decided to begin serving her five-month jail sentence. The reason was that “She wanted ‘closure,’ ‘finality’ and to ‘put this nightmare behind me’” (Gasparino). Stewart was also

concerned about shooting her television show “in time for the fall 2005 season” (Sellers). However, Stewart must find a new distributor for her program since Viacom dropped it from its affiliates such as CBS and UPN on March 8, 2004 (Sellers; “Martha Stewart”). After the trial began, the show was moved “from prime daytime timeslots into less desirable early-morning slots” (“Martha Stewart”).

Despite her request to report to federal prison camp in Danbury, Connecticut, Stewart ended up serving her time in a minimum-security facility in Alderson, West Virginia (Vitello). The federal prison camp is “the nation’s oldest prison for women” (Vitello). Stewart described the camp ‘like an old-fashioned college campus – without the freedom, of course’ (Vitello). After spending some time in the prison, Stewart reported that ‘everyone is nice – both the officials and my fellow inmates’ (Vitello).

The Alderson Federal Prison Camp “covers 105 acres of rolling countryside along the Greenbrier River, about 115 miles from the state’s capital, Charleston” (Vitello). The camp opened in 1927 and has seen many famous criminals, such as Billie Holiday. Inmates are required to wear “prison-issued khaki trousers and green shirts” (Vitello). Stewart is sure to keep busy, as campers rise at 5 a.m. and work on an assignment from 8 a.m. to 5 p.m. (Vitello). The prison has no fences and “inmates are generally free to walk around the compound unescorted (“Martha Stewart”).

When Stewart finished serving her prison sentence, she went back to her Bedford, Connecticut estate and would be confined there for five more months (Drury). This may seem like a relief, but Stewart’s 153 acre home is so large that she may not be able to enjoy the entire estate. Stewart will have to stay within the confines set by authorities so that she does not wander out of monitoring range. “Multiple monitoring units might be

needed just to cover the expense of her living quarters” (“Stewart’s Home”). She will wear a bracelet that helps to monitor her location. Stewart “will be able to leave for up to 48 hours a week to shop, work, attend religious service and visit doctors” (Drury).

CHAPTER 6

MARTHA'S FINANCES

Stewart's Portfolio

A look at Stewart's stock portfolio may help gain insight to her financial motives. It may also provide clarity as to why a former stockbroker would engage in such an activity. Like most investors, Stewart held both winning and losing stock. However, "Stewart also violated the cardinal rule of investing: diversify, diversify, diversify" (Farrell). The portfolio owned by Stewart weighed heavily in the stock of high-tech companies. In addition, she funneled a majority of her wealth to the performance of her company, Martha Stewart Omnimedia. Much of her empire's money was lost when its stock price dropped upon the development of Stewart's problems with the law (Farrell).

As of December 20, 2001, she had 35 stocks "valued at more than \$2.3 million" (Farrell). Since Stewart was one of Merrill Lynch's highly valued clients, she often received "highly desirable allotments in hot initial public offerings" (Farrell). By the end of December 2001, the domestic diva's portfolio had lost 47.35% of its June 2000 value, which was worth \$4.5 million. This fact poses some peculiarities since the S&P 500 had a decline of only 21.26% over the same time period (Farrell).

Another interesting aspect is that of Stewart's investment behavior. Bacanovic, her former broker, reported that Stewart was often reluctant "to cash in short-term gains" and also "held on to shares she had bought of various IPOs, watching her instant paper gains eventually turn into losses" (Farrell). Stewart was known to ignore the advice of her broker when advised to sell a particular stock in order to turn a profit. During his testimony, Bacanovic stated "she's very loath to sell stock, ever, and has often watched

good gains evaporate” (Farrell). The behavior of Stewart was strange, since she was a former broker and had a vast background in the field. Also, it makes no sense to pay for a high priced broker and ignore his investment advice (Farrell).

Martha Stewart Living Omnimedia

A look at the stock of Martha Stewart Living Omnimedia will show the indirect punishment Stewart received as a result of being indicted on charges relating to her inside trading scheme. Due to the high publicity of the ordeal, the stock in Stewart’s company suffered blows and displayed abnormal behavior as compared to its previous stability. This is just an example of how a reputation tarnished by an inflated scandal by the media can lead to consequences outside of the courtroom.

The month before Stewart was charged, her company’s stock price climbed from \$8 to just over \$12 per share. When Stewart and Bacanovic were indicted on June 4, 2003 in relation to the insider trading scandal, Martha Stewart Living Omnimedia (MSO) stock dropped from \$11.40 to \$9.52 per share. Throughout the trial, MSO’s stock climbed steadily. Many investors were convinced that Stewart “would be found innocent” (“Martha Stewart Living”). The stock drastically increased from \$13 to \$17 a share only 30 minutes before the guilty verdict was announced on March 5, 2004. MSO’s equity then hit \$10.86 immediately following the decision of the jury (“Martha Stewart Living”).

The sentencing of Stewart revealed more erratic stock behavior. One half-hour before she was sentenced, her company’s stock was trading between \$9.35 and \$9.45 per share. It ended up much higher, trading at \$11.81 per share on the NYSE that day. Also,

the volume of shares traded was heavy with about 17.1 million shares switching the hands of investors (“Martha Stewart Living”).

When Stewart decided to “put her ‘nightmare’ behind her” and begin serving her prison sentence as soon as she could, MSO shares increased by more than 30% (Learmonth). However, the increasing stock price on that September 2004 day would not be representative of its behavior throughout the duration of her prison term. Only five days after announcing her desire to fulfill her prison sentence, her company’s shares plummeted 10.4%. On September 27, 2004, the realization was made by investors “that to get back to where it once was, the company [needed] more than big-name consultants and a stint in jail for its former CEO” (Brady).

As Stewart’s prison time neared its end, her company’s stock price continued to climb. On the day she was released from prison her stock started to soar downward. It was clear that her crimes were not only punished by a prison sentence, but by the trading public as well. Figure 1 of the appendix depicts the behavior of Martha Stewart Living Omnimedia stock throughout Stewart’s insider trading scandal.

CHAPTER 7

LEGAL INSIDER TRADING

There have been various arguments for repealing insider trading laws. Allowing insider trading “will simply lead to information being spread faster and more efficiently throughout Wall Street” (Moore). Also, some insider trading already “takes place legally every day, when corporate insiders - officers, directors or employees – buy or sell stock in their own companies within the confines of company policy and the regulations governing this trading” (Newkirk).

One opposition to the prohibition of insider trading argues that the practice “is a legitimate form of compensation for corporate employees, permitting lower salaries that, in turn, benefits shareholders” (Newkirk). For instance, the development of a new product or service may be an incentive to employees since the company’s stock will increase accordingly.

However, this particular argument:

fails to address the real and significant hazard of creating an incentive for corporate insider to enter into risky or ill-advised ventures for short term personal gain, as well as to put off the public release of important corporate information so that they can capture the economic fruits at the expense of shareholders. (Newkirk)

Next, “Others have argued that American reliance on several antifraud provisions, and the absence of a statutory definition of insider trading, may lead to unfairly penalizing traders whose conduct comes close to the line” (Newkirk). There are two underlying reasons for this belief. “First, *scienter*, a fraudulent intent, is an element that

must be proven” (Newkirk). Also, the difficulty of “investigating and proving insider trading cases” leads to illegal activity “that goes undetected or unpunished” due to the ambiguous definition of insider trading (Newkirk).

A third position advances the idea “that strict insider trading regulation may have a chilling effect on the work of securities analysts, prohibiting ‘sensible dialogue’ between company officials and analysts” (Newkirk). The fear is that financial analysts will not be able to make accurate projections about the behavior of a company’s stock because they lack all information available.

Another argument stems from the previous position. There is an “important role that analysts play in our markets and [we] seek to encourage legitimate research” (Newkirk). The SEC “is concerned about selective corporate disclosure of material information to favored analysts prior to public disclosure and the resulting threat to market fairness when the favored few get to trade prior to public disclosure” (Newkirk). If insider trading were deemed legal, then the SEC, corporations, and shareholders would not have to worry about information falling into certain hands while bypassing others.

“Finally, there are those who argue that insider trading is a victimless offense and that enforcing insider trading prohibitions is simply not cost effective” (Newkirk). Those who support this view believe that “the amount of money recovered does not justify the money and human capital spent on investigating and prosecuting insider traders” (Newkirk). When looking at a cost-benefit analysis of enforcing the laws of insider trading, it is believed by some that the costs significantly outweigh the benefits.

The arguments for allowing insider trading are interesting. However, the underlying idea behind the laws prohibiting this practice is to create a level playing field

for all investors involved. It is not likely that Wall Street will want to create an advantage for some through inside information while penalizing other stockholders that are not privileged with such information.

CHAPTER 8

THE FUTURE OF WALL STREET

Some believe that the enforcement of maximum sentences “won’t eliminate future insider-trading violations, any more than capital punishment clearly deters murder” (Pender). This is due to the fact that “illegal insider trading, like murder, is often unpremeditated” (Pender). The author goes on to state, “When people stumble onto market-moving information, they often have little time to act on it. Pumped with adrenaline and dreaming of riches (or avoiding losses), they might not think through the consequences of trading on non-public information” (Pender).

The improvement of surveillance technology leads to the increased conviction rate of those who trade on inside information. Investigators can now “subpoena bank records [and] telephone records.” Also, “most conversations are taped by brokerage firms” (Pender). Even after considering the consequences that may be suffered due to insider trading, “some people trade on inside information anyway. Like criminals everywhere, they gamble on not getting caught” (Pender). Some investors convince “themselves it’s not illegal or harmful to anyone” (Pender). Martha Stewart may have fallen into this pattern of rationalization.

Sarbanes-Oxley Act of 2002

New legislation will also help to deter the white-collar crime of insider trading. On July 30, 2002, the Sarbanes-Oxley Act was signed into law by President George W. Bush. “The Act mandated a number of reforms to enhance corporate responsibility, enhance financial disclosures and combat corporate and accounting fraud” (“The Laws,” par. 20). Title VIII: Corporate and Criminal Fraud Accountability of the Sarbanes-Oxley

Act would have applied to the Martha Stewart case, had it been enacted earlier. It states that "It is a felony to 'knowingly' destroy or create documents to 'impede, obstruct or influence' any existing or contemplated federal investigation" ("Summary"). Stewart's alteration of the phone message left by Bacanovic and his subsequent changes made to a worksheet may have been punishable under this act.

Title IX of the new law is described as "White Collar Crime Penalty Enhancements" ("Summary"). This part of the act "Creates a crime for tampering with a record or otherwise impeding any official proceeding" ("Summary"). Similar to Title VIII of the Sarbanes-Oxley act is Section 1102, which falls under Title IX. The section is labeled as "Tampering With a Record or Otherwise Impeding an Official Proceeding" and:

Makes it a crime for any person to corruptly alter, destroy, mutilate, or conceal any document with the intent to impair the object's integrity or availability for use in an official proceeding or to otherwise obstruct, influence or impede any official proceeding is liable for up to 20 years in prison and a fine. ("Summary")

Another effort to set the tone at the top was laid out in the Sarbanes-Oxley Act. The clause will help individuals such as Sam Waksal to be fair in business and accounting practices. To ensure honesty within a corporation, the Sarbanes-Oxley Act created Section 302 called "Corporate Responsibility For Financial Reports" ("Summary"). It prescribes the CEO and CFO of every corporation to "prepare a statement to accompany the audit report to certify the 'appropriateness of the financial statements and disclosures contained in the periodic report, and that those financial

statements and disclosures fairly present, in all material respects, the operations and financial condition of the issuer” (“Summary”). Mandating that the head of every company sign off on the audit helps to hold the individuals in charge responsible for any financial fraud that may present itself. This action permeates a powerful message throughout the corporation and that is “the surest way to ensure faith in business is to resurrect the old-fashioned notion that honesty and responsibility come from the top. Chief executives should not only be held accountable, but hold themselves accountable—to shareholders, to the standards of integrity and to the law” (Chidley).

CONCLUSION

From the first days of trading on Wall Street to the regulation set up by the SEC in 1933 and 1934, the stock market has evolved into a vast marketplace where numerous transactions take place each day. The increase in white-collar crime and insider trading on Wall Street has led to continued regulation imposed by new legislation. The fame and wealth that accompany some financial fraud cases are a reflection of the loopholes of trading that have yet to be ruled by any authoritative body. When looking at the cases of Stewart, Milken, and Helmsley, it is evident that they did not deter investors from committing financial fraud. The chart adapted from Kathleen Pender shows that insider trading cases and the overall number of securities violations have been on the rise since the early 1990s. Such cases have been brought about not only to serve justice to their respective criminals, but to deter other financial gurus from committing crimes like insider trading.

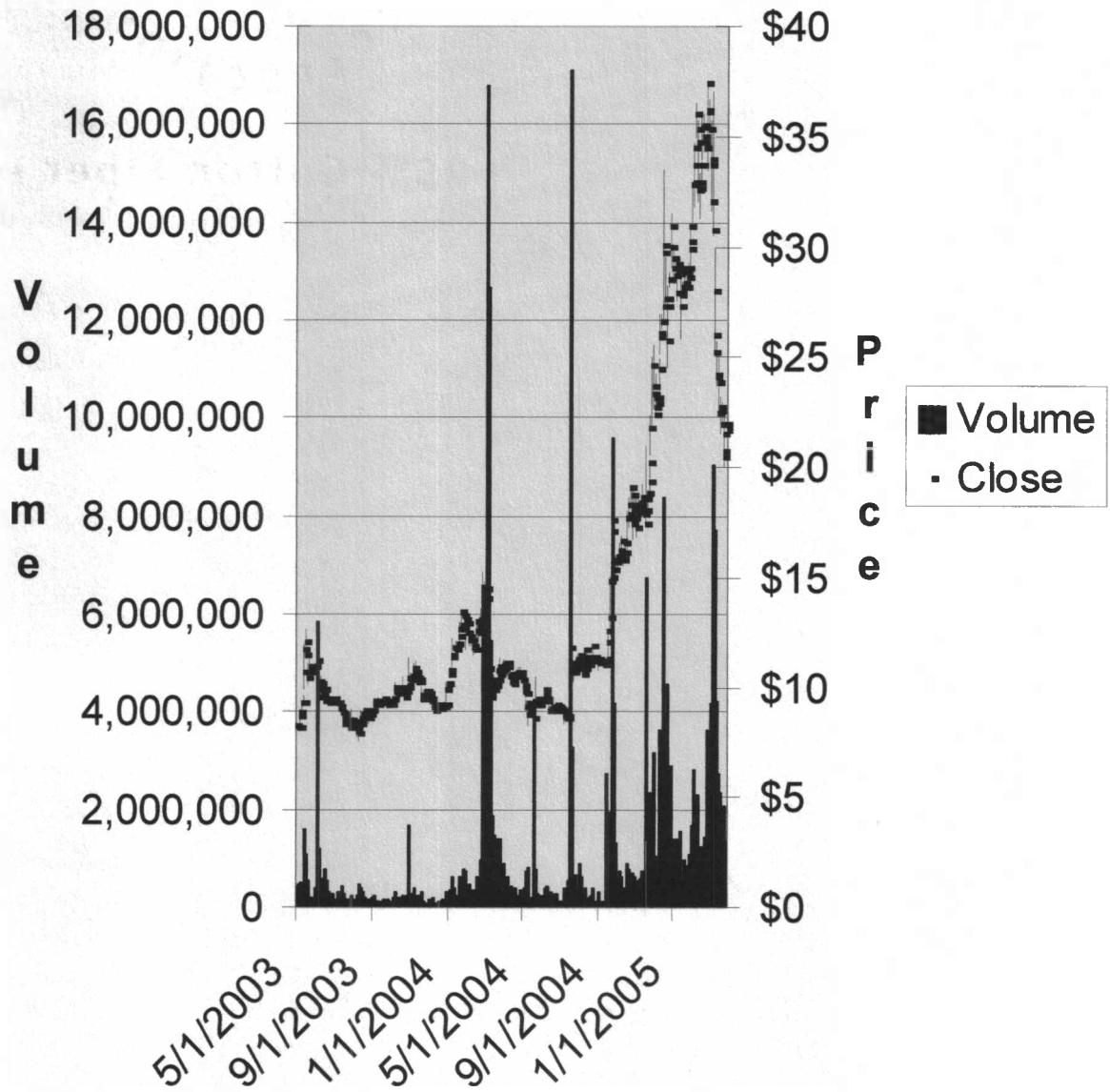
It is possible that the Stewart case was highly publicized by the media so as to illustrate a hidden agenda of the government: the significance that should accompany conspiracy, false statements, obstruction, and her initial charge of securities fraud. Next, officials may simply give famous icons minimal sentences and reduced fines because the punishment by the media and stock traders of their respective companies ends up being severe and, in addition, damages their reputations. Also, the government may have aimed at restoring faith and trust in businesspersons and Wall Street traders who deal with companies such as Imclone, and other firms that have been tied to corporate fraud, such as Enron, World Com and Tyco. Various newspapers, television shows, and on-line journals made clear what can happen to individuals who appear as flawless. Prior to her

convictions, America's "Ms. Perfect" was portrayed as the homemaking queen who did no wrong.

The charges related to insider trading that were brought forth by the United States against Stewart may have been an attempt to heighten the awareness and seriousness of the crime. This conclusion is drawn on the fact that Stewart only traded a few shares that December day and merely saved what would be classified as "pocket change" to this multi-millionaire. Of the millions of shares traded on Wall Street each day, Stewart disposed of 3,928 shares and saved a meager \$45,673. In essence, the United States judicial system tried to use the Stewart case to steer potential inside traders away from the crime. In the end, Stewart received minimal punishment from the court system and hefty consequences from the public due to the vast amount of attention drawn by her case. However, since trading on the basis of inside information is often unpremeditated, Stewart's case will likely have little to no impact on Wall Street and/or insider trading.

The financial fraud cases presented in this thesis will eventually lead to more stringent directives issued by the SEC and Congress. Such mandates may have the effect of restoring confidence in investors who wish to engage in the trading of securities in the stock market. Over time, laws may have the effect of covering a majority of the crimes committed on Wall Street, but the institution may never be completely free of securities fraud.

Martha Stewart Living Omnimedia, Inc.



APPENDIX
Figure 1

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