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Company Focus

Pre-merger trading on P&G, Gillette raises flags

Options trading on both companies spiked before the deal was announced, resulting in huge profits. Some observers expect the SEC to investigate.

By Michael Brush

Well before the investing public learned of the $57 billion takeover of Gillette by Procter & Gamble, traders apparently got wind of the deal: Options-trading volume in both companies spiked more than fourfold on Jan. 27, before news of the marriage was announced.

The action, which led to one-day profits of more than 500% on some of those trades, has raised more than a few eyebrows on Wall Street.

"It looks very suspicious to me. It warrants an investigation by the authorities," says Phil Erlanger, a former technical analyst with Fidelity Investments who now heads Phil Erlanger Research. "Somebody knew something."

Both **Procter & Gamble** (PG, news, msgs) and **Gillette** (G, news, msgs) declined comment on the unusual trading.

Heavy volume, fat profits

At issue is trading in "put" and "call" options on Jan. 27. After the market close that day, news organizations started reporting that Procter & Gamble was going to buy Gillette. Put options give you the right to sell a stock at a pre-established price. Traders buy these if they think a stock is going to go down. Call options give you the right to buy a stock at a pre-set price. Traders pile into these when they think a stock is going to spike up. For technical reasons, options set to expire in the coming three months give traders the best leverage.

On Jan. 27, trading in Procter & Gamble's soon-to-expire options spiked to 8,172 contracts, or more than five times that month's average daily volume, says Christopher Johnson, director of quantitative analysis at Schaeffer's Investment Research, an options firm based in Cincinnati. Trading in Gillette calls spiked to 4,788 contracts, nearly five times the average daily volume of about 1,000 contracts. A contract is equivalent to 100 shares.

On Jan. 28, the day after the merger news hit the wires, prices on the Gillette call options jumped 510% to 620%, rewarding buyers with phenomenal one-day gains, says Johnson. Traders who bought the Procter & Gamble puts didn't do as well, but those puts still doubled in value in the two trading days after the deal was announced.

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Was it insider trading?

Did these lucky traders really have insider information? "It certainly is suspicious," says David Marder, a former Securities and Exchange Commission investigator and attorney who now works at the law firm Robins, Kaplan, Miller & Ciresi in Boston, defending people accused of violating securities laws.

But Marder points out that it would be a mistake to jump to conclusions. "It is possible that a large investor had a reason to trade that is not related to the merger. It doesn't sound likely, but it is possible." If there was illegal inside information circulating, it doesn't necessarly implicate Procter & Gamble or Gillette. Inside information can leak from many places, including law firms consulting on the deal or the offices of investment bankers involved.

The SEC declined comment on the unusual trading, as did the Chicago Board Options Exchange. But Marder says the SEC may be well into an investigation of the options trading by now. "When I was at the SEC, the first thing we looked at after a merger was whether there was any unusual stock trading or option trading right before the news."

An investigation would play out slowly

If there was, he says, the next step would be to get the trading records and see whether a handful of individuals or one person was behind the trades. "If those people have a relationship with the companies, the SEC is going to be very interested in this."

If the market watchdog is investigating, it could be more than a year before we learn anything. Typically, the SEC won't tip its hand before filing a lawsuit, a process that takes months to play out.

At least there's some good news from the merger front. Johnson, at Schaeffer's Investment Research, says there was absolutely no suspicious trading ahead of news of two other big recent mergers -- the proposed purchase of **AT&T** (T, news, msgs) by **SBC Communications** (SBC, news, msgs), and an announced buyout of **Circuit City Stores** (CC, news, msgs).

At the time of publication, Michael Brush did not own or control shares in any of the companies listed in this column.

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