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White-Collar Crime

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The Quest for Expansion of Insider Trading Liability

Liability for insider trading, regulated under the antifraud provisions of the securities laws, has expanded significantly over the past 25 years.[1] The classic insider trading theory under the statutes originally enacted by Congress prohibits corporate insiders from making trades while in possession of material, nonpublic information about their companies. Such insiders are obligated to either disclose any such information prior to trading or abstain from trading altogether.[2]

In 1983, the Supreme Court expanded the prohibition against the use of material, nonpublic information to "constructive insiders," recognizing that outside lawyers, accountants, consultants, and others could be treated as insiders.[3]

In *United States v. O'Hagan*, endorsing an expansion urged by federal prosecutors, the U.S. Supreme Court further broadened the traditional view of insider trading, holding liable those "outsiders" who "misappropriate" information in the purchase or sale of securities. In the Court's opinion, the misappropriation theory compliments the classic theory of insider trading by premising liability "on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information." Where the classic theory protects against abuse by insiders, the misappropriation theory protects against abuse by "'outsiders' to a corporation who have access to confidential material information that will affect the corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders."[4]

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The recent insider trading conviction of Joseph Nacchio, former CEO of Qwest Communications International (Qwest), currently on appeal to the U.S. Court of Appeals for the Tenth Circuit, highlights the government's most recent attempts to further expand liability for insider trading. If upheld, this conviction effectively criminalizes trading that might be linked to erroneous forward-looking corporate projections. In the case against Mr. Nacchio, the government charged that he sold stock based on inside information that financial projections made by the corporation were inaccurate and unlikely to be achieved. The defendant argued that the corporation's speculative financial forecasts are not the type of material, nonpublic information required to support insider trading liability. A similar question of how to define "materiality" in the context of an insider trading case also arose as an issue in the appeal of the conviction of former Enron CEO, Jeffrey Skilling.

Rules on Forward-Looking Projections

When the Securities Exchange Commission (SEC) sought to "encourage companies to disclose management projections," they promulgated rules to protect companies from civil liability for those forecasts. Those rules provide that forward-looking statements "shall be deemed not to be a *fraudulent statement*… unless it is shown that such statement was made or reaffirmed without a reasonable basis or was disclosed other than in good faith."[5] In other words, corporations are provided a safe harbor from securities liability for management projections that turn out to be erroneous or incorrect; these statements are not deemed "fraudulent statements" without a showing of unreasonableness or bad faith.

The policy behind these safe harbor provisions was discussed by the U.S. Court of Appeals for the Seventh Circuit in *Wielgos v. Commonwealth Edison Co.*, in which investors brought a securities fraud action against a utility company for flawed projections contained in the company's prospectus.[6] The court in *Wielgos* affirmed the district court's finding that the company's statements fell within the safe harbor provision of the SEC rules.

The court noted that prior to the enactment of the safe harbor provisions, the SEC discouraged firms from making projection statements. Realizing, however, that such predictions would be made anyway, often times by outsiders whose access to information was not as reliable as the company itself, the SEC changed its tune. The court explained the need for safe harbor protection as follows:

> Convincing the SEC of the utility of projections is one thing, and convincing enterprises that they ought to make projections is another. What's in it for them? If all estimates are made carefully and honestly, half will turn out too favorable to the firm and the other half too pessimistic. In either case the difference may disappoint investors, who can say later that they bought for too much (if the projection was too optimistic) or sold for too little (if the projection turns out to be too pessimistic).

Thus the role of a safe harbor: the firm is not liable despite error.[7]

The 'Qwest' Case

Mr. Nacchio's case raises the issue whether the safe harbor provisions, and the policies underlying their creation, have some applicability beyond traditional securities fraud cases. Mr. Nacchio was charged in the U.S. District Court of Colorado with 42 counts of insider trading related to his sale of Qwest stock in 2001. After a month-long trial, he was convicted on 19 counts for trades made in April and May of that year resulting in the sale of $52 million in stock.[8] Mr. Nacchio was sentenced to six years imprisonment, fined $19 million and ordered to forfeit the $52 million.

At trial, the government alleged that Mr. Nacchio traded Qwest stock on the basis of inside knowledge that the company's year-end 2001 financial projections were risky, aggressive and inaccurate. On appeal the defense characterized the prosecution as "unprecedented," asserting that the government was "dressing up a misleading statements case as an insider-trading case."[9] According to the defense, this posture allowed the government to avoid the well-settled legal rules limiting liability for erroneous financial projections.

The forward projections at issue were set by Qwest in fall 2000. The revenue, earnings and growth targets set at the time were significantly higher than the prior year. Mr. Nacchio and Qwest employees knew that to successfully reach the higher targets, Qwest would have to shift its business model from "one-time" transactions to recurring transactions earned monthly from regular subscribers. The government argued that a number of Qwest executives told Mr. Nacchio that the projected numbers were unrealistic.[10] In his brief on appeal Mr. Nacchio acknowledged that "Qwest employees expressed doubt about whether Qwest could achieve its internal revenue targets for year-end 2001."[11]

'Something Big' Was Needed

According to the government, the evidence presented at trial demonstrated that in order successfully to meet the growth targets, the company substantially and immediately would have to increase its recurring revenue stream. Mr. Nacchio's understanding of this concept was evidenced by comments he made to sales staff that "'something big' had to happen 'by April'" and that the "first half of 2001 would be 'absolutely critical.'" A failure to quickly grow, or "ramp up," the number of regular subscribers would impact the company's ability to meet targets for the third and fourth quarter.[12]

Qwest's success in implementing this plan was differently characterized by Mr. Nacchio and the government. The defense asserted that "Qwest's revenues met public expectations in the first and second quarters, and nearly equaled the internal targets." Despite this fact, the defense acknowledged continued concern inside Qwest that the company would be unable to meet its year-end financial projections.[13] The government stated that this concern was legitimate because Qwest's revenue numbers from the first and second quarter were not the result of increased subscription sales, but relied heavily on the company's sale of indefeasible rights of use (IRUs) which were property rights in Qwest's network. Furthermore, the company could not continue to rely on its ability to sell IRUs, because Qwest employees had indicated to Nacchio that the IRU market was "drying up."[14] Despite this information, Qwest's year-end projections were not altered, a decision the government asserted was made entirely by Mr. Nacchio.[15]

Starting in January 2001, Mr. Nacchio began to sell Qwest stock, in accordance with a plan he had announced to the public in October 2000. In possession of more than 7.4 million stock options due to expire in June 2003, Mr. Nacchio asked the board to extend the term of the options, but was told that the board was prevented from doing so for accounting reasons. According to the defense, Mr. Nacchio then decided to exercise and sell one million options per quarter in an effort to "protect Qwest by spreading the sales over time."[16] He argued that the fact that he publicly announced his intention to sell the stock more than six months before they were made is proof that he did not trade because of "inside information." Rather, he traded consistent with his stated intentions, selling stock during specified "trading windows" as long as the price of the stock was "reasonable."[17]

The government rejected Mr. Nacchio's assertion, arguing that "inside information" regarding Qwest's "dire" circumstances and inability to meet the year-end target numbers played a "significant factor" in his decision to sell the stock. The government observed that Mr. Nacchio could have exercised his options without selling and that his decision to sell the stock was inconsistent with his "bullish" position on the value of Qwest stock.[18]

Perhaps the most significant issue raised on appeal, however, is whether the alleged "inside information" related to Qwest's year-end 2001 financial projections was material, as required in an insider trading case, and how the jury should have been instructed to decide the issue of materiality. Mr. Nacchio argued that any information he had regarding Qwest's ability to meet predictions regarding the company's year-end performance numbers could not be deemed material, noting that the Supreme Court had held that the "materiality of information about contingent future events 'depend[s] at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.'"[19] Moreover, Mr. Nacchio noted that the SEC rules provide that "projections of future performance" were actionable under 10b-5 only if they "are supported by specific statements of fact or are worded as guarantees."[20] Mr. Nacchio argued that the district court should have instructed the jury regarding these legal principles to assist them in determining whether the information was material.

The government countered that the safe harbor provisions relied on by Mr. Nacchio protect only certain forward-looking statements filed with the SEC. Moreover, the government noted that Mr. Nacchio was charged with trading on inside information, not the making of misstatements. "[I]nsider trading is not premised on statements; it involves trading in violation of an insider's duty to shareholders. Extending these provisions to protect trading on undisclosed information would ignore their text and undermine their purpose of 'promot[ing] greater accessibility to...information for all investors.'"[21]

Hard Facts About Quality

Specifically, the government asserted that the evidence supported the conclusion made by the jury that in selling his Qwest stock, Mr. Nacchio relied on insider information that included "hard facts about the present quality and sustainability of Qwest's revenues—facts that Nacchio and his executives agreed would, if disclosed, surprise investors and cause Qwest's stock price to plummet." The then-existing information, as opposed to vague forecasts, included that: i) Qwest had met public projections only by selling IRUs, the market for which was drying up; ii) Qwest had failed to successfully ramp up its recurring revenue stream; and iii) other Qwest executives and employees repeatedly had expressed their belief that the year-end projections were unattainable.[22]

The Washington Legal Foundation (WLF), a national, nonprofit public interest law and policy center based in Washington, D.C., wrote a brief of amicus curiae in support of Mr. Nacchio's appeal. The organization argued that the district court's instructions as to materiality failed to provide the jury with adequate instruction as to how to draw the line between material and immaterial information. WLF noted that juries in civil securities fraud cases frequently are provided with more information regarding materiality than the jury was in this case where Mr. Nacchio's liberty was at stake. More detailed instructions are "necessary to mitigate the risk that juries will wrongly impose liability on the basis of hindsight."[23]

Detailing the legislative history and case law "highlight[ing] the importance that both Congress and the courts give to ensuring that the securities laws do not inhibit a corporation's public dissemination of soft information as long as the disclosure is made in good faith and with a reasonable basis," the WLF said that the district court, indeed, any court hearing a criminal prosecution, was obliged to extend such protection to Mr. Nacchio.[24] The district court's instructions constituted reversible error, according to the WLF.

> Allowing the materiality of such soft information to be determined by a jury without a framework obligating it to determine materiality with regard to the specific content of the prior statement wrongfully deprives the jury of context and guidance. Moreover, it allows the jury to determine materiality based on an open-ended construction that erroneously pays no heed to the acknowledged public policy behind the numerous protections that have developed over the past three decades to protect and encourage the dissemination of forward-looking information.[25]

Oral argument in the Nacchio case currently is scheduled for early December.

Materiality in Enron Case

The proper materiality instruction also is an issue in Jeffrey Skilling's appeal of his conviction for conspiracy, securities fraud, false statements to auditors, and insider trading, currently pending before the U.S. Court of Appeals for the Fifth Circuit. Mr. Skilling, the former CEO of Enron, is alleged to have committed insider trading when he sold 500,000 shares of Enron stock with the knowledge of the company's "dire financial state" and that it was set to "implode in a wave of accounting scandals."[26]

With respect to the insider trading charge against Mr. Skilling, the district court broadly instructed the jury that a statement is material so long as a reasonable shareholder would consider it "important" in making an investment decision. Mr. Skilling argued that this instruction was insufficient because "[a] lay juror who has never invested in stock in his or her life, or who has only limited experience doing so, may have a very hard time deciding what is an 'important' fact without concrete examples with which to compare it. And on the theory that the more information the better, a juror might easily conclude that a reasonable investor would want to know as much as possible about a company.... But of course this is quite wrong as a matter of law: investors are only entitled to certain information about a company, i.e., that which is *legally material*."[27] The defense asserted that the court's instruction erroneously allowed the jury to find liability based on forward-looking statements in contravention of the safe harbor provisions set forth in securities regulations.

The government responded that the district court essentially captured the essence of Mr. Skilling's proposed instructions by separately instructing the jury that "'a statement predicting future events concerning Enron or its stock' could be considered untrue only if the government proved that Skilling did not believe the statement and lacked a reasonable basis for the statement when he made it." Moreover, the government asserted that any error was harmless.[28] Although only a brief point in a voluminous appellate brief, the issue raised by the defense in *Skilling* strikes a similar chord as that raised in the *Nacchio* case.

Conclusion

In considering whether forward-looking statements can be deemed "material" for purposes of insider trading cases, courts and prosecutors should exercise restraint, resisting the further expansion of insider trading liability. The job of many corporate employees, including executives, is to speak positively about their corporate principal. Imposing criminal liability for transactions made when such predictions of success fail improperly gives the government the benefit of 20-20 hindsight. Moreover, the characterization of these erroneous forward-looking statements as "material" contradicts the policies underlying the safe harbor provisions contained in the securities regulations.

1. See, Richard W. Painter, Kimberly D. Krawiec, and Cynthia A. Williams, "Don't Ask, Just Tell: Insider Trading After 'United States v. O'Hagan,'" Virginia Law Review (March 1998); Saikrishna Prakash, "Our Dysfunctional Insider Trading Regime," Columbia Law Review (October 1999).
2. *Ciarella v. United States*, 445 U.S. 222 (1980).
3. *Dirks v. SEC*, 463 U.S. 646 (1983).
4. 521 U.S. 642, 652-53 (1997).
5. See 17 C.F.R. §240.3b-6(a); 17 C.F.R. §230.175(a) (emphasis added).
6. 892 F.2d 509 (7th Cir. 1989).
7. Id. at 514; see also *United States v. Nacchio*, No. 07-1311, Brief of Amicus Curiae of the Washington Legal Foundation in Support of Defendant-Appellant Seeking Reversal at pp. 9-12 (detailing public policy and legislative history reasons for SEC safe harbor provisions).
8. Mr. Nacchio was acquitted of all charges related to the sale of stock before those dates. Sandy Shore, "Ex-Qwest CEO Files Appeal," Associated Press (Oct. 10, 2007).
9. *United States v. Nacchio*, No. 07-1311, Appellant's Opening Brief at p. 2.
10. *United States v. Nacchio*, No. 07-1311, Brief for the United States at pp. 4-5.
11. Appellant's Opening Brief at p. 4.
12. Brief for the United States at pp. 7-8 (citing trial testimony).
13. Appellant's Opening Brief at p. 4.
14. Brief for the United States at pp. 8-9.
15. Id. at p. 10.
16. Appellant's Opening Brief at p. 11.
17. Id. at pp. 11-12.
18. Id. at p. 23.
19. Id. at p. 15 (citing *Basic Inc. v. Levinson*, 485 U.S. 224, 238 (1988) (internal citations omitted)).
20. Id. at p. 16 (citing *Malone v. Microdyne Corp.*, 26 F.3d 471, 479 (4th Cir. 1994)).
21. Brief for the United States at pp. 39-41 (citing 44 Fed. Reg. 38810, 38813 (July 2, 1979); cf. 69 Fed. Reg. 67392, 67402 (Nov. 17, 2004)).
22. Id. at pp. 17, 27-28.
23. *United States v. Nacchio*, No. 07-1311, Brief of Amicus Curiae of the Washington Legal Foundation in Support of Defendant-Appellant Seeking Reversal at pp. 6-7.
24. Id. at pp. 14-15.
25. Id. at pp. 15-16. The National Association of Criminal Defense Lawyers also submitted a brief of amicus curiae in support of Mr. Nacchio's appeal. That brief did not focus on the issue of whether the jury was improperly instructed regarding materiality.
26. *United States v. Skilling*, 06-20885, Brief for the United States as Appellee at p. 101.
27. *United States v. Skilling*, 06-20885, Brief of Defendant-Appellant Jeffrey K. Skilling at pp. 101-102.
28. *Skilling*, Brief for the United States as Appellee at pp. 119-120.