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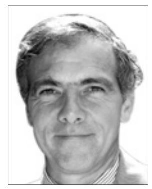
WHITE-COLLAR CRIME

Expert Analysis

The Evolving Mystery Of Illegal Insider Trading

By **Robert G. Morvillo** And **Robert J. Anello**

No statute defines illegal insider trading. Rather, the law of insider trading is the amalgamation of judicial opinions that have developed in both the civil and criminal context. Accordingly, individuals seeking to conform their conduct to the law cannot understand what is required of them by reading a statute, but instead must interpret a vast body of sometimes inconsistent case law. As recent cases demonstrate, the nature of insider trading liability is in flux, and basic questions remain unanswered.

This uncertainty exists at a time when the Securities and Exchange Commission (SEC) has placed renewed emphasis on such conduct, as evidenced by a rise in insider trading enforcement actions. Insider trading is the most frequent allegation contained in cases the SEC settles with individuals.[1] In addition, the SEC has focused heightened attention to the activities of institutional traders and hedge funds[2] and has spent significant resources investigating and bringing actions against those who trade on information in advance of mergers and acquisitions or tender offers.[3] These trends are not likely to reverse.

Basics of Liability

Typically, insider trading cases are brought under §10(b) of the Securities Exchange Act of 1934, and the rules promulgated thereunder by the SEC, which prohibit the use of "any manipulative or deceptive device" in connection with the purchase or sale of a security. Actions involving tender offers also can proceed under §17 of the Securities Act of 1933. Rule 14e-3, enacted pursuant to this provision, makes criminal "the purchase or sale of a security by one who is in possession of material information relating to [a] tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly" from an acquirer or target, regardless of whether the trader has a fiduciary duty to either party. Finally, insider trading activity now also is regulated by the Sarbanes-Oxley Act of 2002 which requires prompt reporting of insider trades[4] and prohibits trading by insiders during a pension fund blackout.[5]

In addition, §807 of Sarbanes Oxley, codified at 18 U.S.C. §1348, imposes criminal liability on anyone who knowingly executes a scheme: (1) to defraud in connection with any security or (2) to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of any security.

Section 1348 has been used by the government in at least one high-profile case to prosecute insider trading. In *United States v. Mahaffy*,[6] the defendant stockbrokers and day traders were charged with securities fraud and conspiracy to commit securities fraud in violation of §§1348 and 1349 by operating a scheme whereby the stockbrokers shared confidential information about large-volume stock orders with the day traders, giving them an inside advantage on the market. The traders accessed the information by listening to broadcasts made over the internal speaker system (or "squawk boxes") at various brokerage firms.

> Insider trading has morphed into its own area of unsettled law, leaving potential traders at a loss for what behavior is permissible.

Eastern District of New York Judge Jack B. Weinstein denied the defendants' motion to dismiss the charges brought under §1348. Noting that the statute's legislative history established that it was modeled after the mail and wire fraud statutes, the court found that a violation of §1348 required proof of three elements: (1) fraudulent intent; (2) a scheme or artifice to defraud; and (3) a nexus with a security. This formulation makes §1348 broader than §10(b) in two important ways. First, the fraud need only be "in connection" with a security rather than the "purchase or sale" of a security. In addition, the court did not require that the defendants violate a duty to be liable for a scheme to defraud under §1348, but used a more expansive notion of liability as set forth under the mail and wire fraud statutes.

Section 1348 is still a relatively new statute, and outside of the tender offer context, much of insider trading law has developed around §10(b) and its prohibition against "deceptive" conduct in association with the purchase or sale of securities. In *Chiarella v. United States*, the Supreme Court recognized the classic theory of insider trading liability where a company insider trades on non-public, material information regarding their own company. Liability in that instance is premised on the "relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation."[7]

In *United States v. O'Hagan*, the Supreme Court expanded the scope of insider trading liability to encompass the "misappropriation" theory where an outsider trades on non-public, material information in breach of a duty owed to the source of the information.[8] Under both the classic and misappropriation theories of insider trading, the "deceptive device" is the violation of the duty not to trade, owed either to the issuer of the security, the company's shareholders, or a third party. Accordingly, successful insider trading actions historically have involved a breach of duty.

Several recent decisions and prosecutions question whether the "deceptive device" element of a securities fraud claim requires the breach of some duty by the trader in insider trading cases, and if it does, the nature of that duty. These cases reveal a continued uncertainty about the scope of insider trading and serve as a reminder that "insider trading" is, in fact, just one variation of broad securities fraud prohibited by §10(b). Thus, traders and their counsel cannot find comfort in relying on traditional notions of what constitutes illegal "insider trading."

Fraudulent Conduct Element

The Second Circuit's 2009 decision in *SEC v. Dorozhko*[9] held that a breach of duty, fiduciary or otherwise, is not required to prove insider trading. The decision significantly expands the type of activity that may constitute insider trading beyond the two historically recognized theories. Specifically, the court held that where an affirmative misrepresentation (as opposed to mere silence) is made in connection with the purchase or sale of a security, that misrepresentation can serve as the deceptive device sufficient to constitute securities fraud.

Oleksandr Dorozhko was alleged to have hacked into a secure server of Thompson Financial Services Inc. and to have gained access to an unreleased earnings report from which he gleaned material, nonpublic information about a public company. Mr. Dorozhko traded on the basis of this information. Although the SEC received a temporary restraining order freezing the proceeds of the transactions, after a preliminary injunction hearing, Southern District Court Judge Naomi R. Buchwald denied the SEC's application to further enjoin the proceeds, finding, in an exhaustive and well-reasoned opinion, that the SEC had failed to demonstrate a likelihood of success on the merits. Judge Buchwald concluded that computer hacking, although potentially a breach of other federal and state criminal statutes, did not constitute a violation of §10(b) without an accompanying breach of a fiduciary duty.[10]

The Second Circuit disagreed, finding that the long line of insider trading cases requiring a breach of fiduciary duty involved omission or silence by the defendant rather than an affirmative misrepresentation. The court distinguished Dorozhko's case, stating that "misrepresentations are fraudulent, but…silence is fraudulent only if there is a duty to disclose."[11]

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Accordingly, the case was remanded to the district court for a determination of whether the hacking involved fraudulent misrepresentations that were deceptive "within the ordinary meaning of Section 10(b)." On remand, the district court granted the SEC's unopposed motion for summary judgment.

Although violation of a fiduciary duty not to use information is a deceptive device under §10(b), *Dorozhko* held that it is not the exclusive device. This notion of looking at the deception entwined with the securities transaction to evaluate the transgression also has arisen in the context of sentencing in insider trading cases.[12] In those cases, the courts have looked to the "use of a manipulative or deceptive contrivance in connection with the purchase," rather than the purchase or sale itself, in calculating the gain to be attributed to the defendant at sentencing.[13]

The calculation of the defendant's gain was an issue in *United States v. Nacchio*.[14] The U.S. Court of Appeals for the Tenth Circuit was called upon to review the sentence of Joseph Nacchio, the former CEO of Qwest Communications, who was convicted of insider trading based on his personal sale of Qwest stock. The circuit court noted that with respect to insider trading, the offense "is not the purchase of the stock itself, but the use of a manipulative or deceptive contrivance in connection with the purchase itself." Thus, "gain resulting from the offense" is not gain resulting from the purchase of stock, but gain resulting from the deception employed in the stock transaction.

In Nacchio's case, the Tenth Circuit concluded that Mr. Nacchio's deception did not render Qwest's stock worthless and noted that Mr. Nacchio should not be sentenced based on gain attributable to legitimate price appreciation and the underlying value of Qwest's shares. The court suggested instead that employing the disgorgement analysis typically used by the SEC in civil cases—"generally the difference between the value of the shares when the insider sold them while in possession of material, non-public information, and their market's value 'a reasonable time after public dissemination of the inside information'"[15]—properly would focus the court on the gain directly attributable to a defendant's deception or fraud.

Focus on Breach of Duty

Despite decades of case law analyzing the misappropriation theory of insider trading, uncertainty still exists about when a breach of duty may constitute a "deceptive device" under §10(b). In *SEC v. Cuban*,[16] the District Court for the Northern District of Texas found that liability under the misappropriation theory need not depend on the existence of a pre-existing fiduciary or fiduciary-like relationship, but also may arise in the context of a duty created by agreement.

Where the duty arises by agreement, however, the district court—rejecting an SEC interpretation embodied in its Rule 15b5-2(b)—held that the agreement must be more than a mere promise not to disclose. Instead, the court held it "must also impose on the party who receives the information the legal duty to refrain from trading on or otherwise using the information for personal gain." Thus, according to the district court in *Cuban*, the duty by agreement has two facets: non-disclosure and non-use. Further, the duty not to trade is not unilateral—arising merely based on the source's belief that the recipient won't trade—but must be specifically understood by the recipient.[17]

The defendant, Mark Cuban, entered into an oral confidentiality agreement with a company of which he was the primary shareholder regarding the company's planned private investment in a public equity (PIPE) offering, but subsequently sold his shares in the company before public announcement of the offering, avoiding losses in excess of $750,000. The court held Mr. Cuban could not be liable for insider trading because he did not specifically promise to refrain from using the information to trade.

Accordingly, the court dismissed the SEC's complaint as insufficient to plead a misappropriation case.[18] The district court's opinion has been appealed by the SEC, and oral argument is scheduled to be heard by the Fifth Circuit this month. The Supreme Court previously has found that a confidentiality agreement suffices for liability under §10(b) in *Carpenter v. United States*, a case in which a reporter and a news clerk for The Wall Street Journal were convicted for misappropriating information from the newspaper.

In those cases, unlike *Cuban*, the Supreme Court appeared to merge the non-disclosure and non-use requirements. In its decision affirming the conviction, the Supreme Court stated that the district court found the employee had undertaken "not to reveal prepublication information…a promise that became a sham when in violation of his duty he passed along to his co-conspirators confidential information belonging to the Journal, pursuant to an ongoing scheme to share profits from trading in anticipation of the [] column's impact on the stock market." The Court also referred to the general proposition that a person who acquires special knowledge by virtue of a confidential or fiduciary relationship is "not free to exploit" that information for his own benefit. The exploitation would appear to include not only the disclosure, but the use of the information by which profits were derived.[19]

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Amici briefs filed in the Fifth Circuit appeal in *Cuban*, distinguishes *Carpenter*, noting that the duty to maintain confidentiality in *Carpenter* arose in the context of the fiduciary duty an employee has to his employer. Mr. Cuban had no affiliation with the company other than as a shareholder, and had no fiduciary relationship with the company. Further, amici argue that Mr. Cuban did not undertake a duty not to use the information provided to him. "To allow such a promise, without more, to trigger Section 10(b)'s 'extraordinary' duty of nonuse, would signal a radical break from the Supreme Court's jurisprudence in this area…."[20] This argument seems to overlook statements made by Mr. Cuban essentially acknowledging that he was prohibited from trading once he was in possession of the confidential information.[21]

Is Statute Too Broad?

A broader question that arises after *Cuban* and *Dorozhko* is whether defendants adequately have been put on notice of exactly what constitutes an insider trading violation of §10(b). In his book titled "Three Felonies a Day," Harvey Silverglate suggests that "federal prosecutors are abusing their power by using the criminal law to prosecute law-abiding citizens whose conduct is arguably covered by extremely vague criminal statutes that are capable of reaching acts which are believed to be lawful by those who commit them."[22] Perhaps, §10(b) is one such law.

The application of New York's securities fraud statute, set forth in the Martin Act, raises similar issues. The New York Attorney General argues that the misdemeanor portion of the statute provides for strict liability, allowing for criminal misdemeanor liability for any fraud, deception, concealment or false representation with respect to stocks, bonds and other securities without proof of criminal intent.[23] Few reported decisions exist on the misdemeanor portion of the Martin Act, however, and the very essence of using "fraud, deception, concealment or false representation" seemingly would require some sort of scienter.

Conclusion

Insider trading is a catchphrase used to describe a particular type of securities fraud—that which involves trading on material information that is unavailable to the marketplace. It has morphed, however, into its own area of unsettled law, leaving potential traders at a loss for what behavior is permissible. The Second Circuit's decision in *Dorozhko* seemingly suggests a renewed focus in insider trading cases on the fraud, rather than the duty violated. The Fifth Circuit's opinion in *Cuban* will tell whether this is a trend or whether litigants and their lawyers will continue to confront issues regarding the existence and nature of duties owed by traders in possession of nonpublic information.

1. Marcia Coyle, "Report Anticipates Increase in SEC Enforcement Actions," The National Law Journal (Nov. 20, 2008).
2. SEC Commissioner Elisse B. Walter, Testimony Concerning Securities Law Enforcement in the Current Financial Crisis (March 20, 2009).
3. Randall J. Fons, Brian Neil Hoffman, and Kady Dodds, "SEC Enforcement Trends in Insider Trading," ABA Securities Litigation Journal (Spring 2008).
4. Sarbanes Oxley Act of 2002 §403.
5. Sarbanes Oxley Act §306(a).
6. *United States v. Mahaffy*, 2006 WL 2224518 (EDNY Aug. 2, 2006).
7. 445 U.S. 222, 228 (1980).
8. 521 U.S. 642, 652 (1997). A thorough presentation of the elements of an insider trading misappropriation case is contained in the opinion issued by Southern District of New York Judge John G. Koeltl in *SEC v. Rorech*. The court found that the SEC had failed to prove any of these elements by a preponderance of the evidence in its insider trading case brought against a Deutsche Bank employee and a hedge fund portfolio manager for activity related to credit derivatives. __F. Supp.2d__, 2010 WL 2595111 (SDNY June 25, 2010). The authors' firm represented an individual in that action.
9. 574 F.3d 42 (2d Cir. 2009).
10. Id. at 45.
11. Id. at 50 (internal citation omitted).
12. The notion that the focus should be on the deceptive conduct, rather than the duty owed is supported by SEC Rule 14e-3 which criminalizes insider trading in connection with a tender offer regardless of whether the trader has a fiduciary duty to either the acquirer or target of the transaction.
13. Because of the near impossibility of identifying the victims and their losses in insider trading cases, courts have looked to the defendant's gain—the total increase in value realized through the deceptive trading—for sentencing purposes. U.S.S.G. §2B1.4 cmt. background. See Elkan Abramowitz and Barry A. Bohrer, "Loss Calculation in Sentencing for Securities Fraud Cases," New York Law Journal (Sept. 1, 2009).
14. 573 F.3d 1062 (10th Cir. 2009).
15. *SEC v. Happ*, 392 F.3d 12, 31 (1st Cir. 2004) (internal citation omitted).
16. 634 F.Supp.2d 713 (N.D.Tex. 2009).
17. Id. at 725.
18. Id. at 731. The court also rejected the SEC's reliance on Rule 10b5-2(b)(1), whereby a person agrees to maintain information in confidence, to impose the required duty. The court held that the SEC improperly sought to base misappropriation liability on an agreement lacking in an obligation not to trade or otherwise use confidential information, exceeding its §10(b) authority.
19. 484 U.S. 19, 27-28 (1987) (citations omitted).
20. Brief of Amici Curiae Law Professors in Support of Defendant-Appellee, *SEC v. Cuban*, 09-10996 (5th Cir) at pp. 23- 25.
21. 634 F.Supp.2d at 717.
22. Harvey A. Silverglate, "Three Felonies a Day," Encounter Books (2009), Foreword by Alan M. Dershowitz.
23. N.Y. Gen. Bus. Law §352-c(1)-(4).