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WHITE-COLLAR CRIME

Expert Analysis

Revisiting Criminal Insider Trading Liability

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The insider trading trial and conviction of Raj Rajaratnam, founder of the Galleon Group hedge funds, in the Southern District of New York, has continued to spark debate on issues ranging from the government's aggressive use of blue-collar investigative tools in white-collar cases[1] to the breadth of federal insider trading law. In affirming Rajaratnam's conviction, the U.S. Court of Appeals for the Second Circuit relied on circuit precedent, originally articulated in *United States v. Teicher*,[2] broadly interpreting insider criminal trading liability to include instances where a defendant has knowledge of insider information without evidence that he relied on the information in making a trade.

Rajaratnam, who currently is serving a sentence of 132 months imprisonment, is seeking review of the Second Circuit's unique position on this issue by the U.S. Supreme Court. The application for certiorari coincides with the Second Circuit's reconsideration of another significant insider trading issue, characterized by the Second Circuit as an open question, in the appeal of *United States v. Newman*[3]—whether a remote tippee in possession of inside information can be criminally liable if he does not know that the information was misappropriated.[4] During oral argument, the Second Circuit panel expressed skepticism at the government's prosecution of such defendants.[5]

This article focuses on the first question raised in Rajaratnam's certiorari petition, whether in an insider trading case the government must prove that the inside information at issue was a substantial factor in the defendant's trading activities. The court's resolution of the issue is particularly significant as the Second Circuit, home to the financial center of the world, is alone among the federal circuit courts in upholding the validity of insider trading convictions without proof that the defendant used inside information to make a trade.

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The Law of Insider Trading

Illegal insider trading is not defined by statute, but by an amalgamation of judicial opinions.[6] Under Section 10(b) of the Securities Exchange Act of 1934 and the rules promulgated thereunder, the use of "any manipulative or deceptive device" in connection with the purchase or sale of a security is prohibited. In the context of insider trading, an individual is said to violate these provisions by trading securities while in possession of material nonpublic information. The question raised in *Rajaratnam* is whether a defendant's mere possession of inside information when he trades is sufficient or whether, to be criminally responsible, he must actually "use" the inside information in making the trade.

The Second Circuit first touched upon this question in *Teicher* in 1993.[7] In that case, the district court had instructed the jury that "the government need not prove that the defendants purchased or sold securities because of the material nonpublic information that they knowingly possessed. It is sufficient if the government proves that the defendants purchased or sold securities while knowingly in possession of the material nonpublic information."

In dicta, the Second Circuit suggested that the "knowing possession" standard was sufficient to sustain an insider trading conviction. First, the court opined that the requirement in Section 10(b) that a deceptive practice be conducted "in connection with the purchase or sale of a security" should be construed flexibly to include practices which merely "touch" the sale of a security. The court also found that the "knowing possession" standard comported with the maxim that one in possession of such information was obligated to either "disclose or abstain" with regard to trading and had the attribute of simplicity.[8]

The Second Circuit expressly adopted the position asserted in *Teicher* in 2008 in *United States v. Royer*.[9] The court was persuaded that the "knowing possession" standard was correct by the Securities and Exchange Commission's 2000 promulgation of Rule 10b5-1 to define "when a purchase or sale constitutes trading 'on the basis' of material nonpublic information in insider trading cases."[10] The rule provides that a transaction is made "on the basis" of inside information "if the person making the purchase or sale was aware of the material nonpublic information" when the person made the transaction.

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Rule 10b5-1 goes on to recognize that a person cannot be held liable for trading on the basis of inside information if he had entered into a contract to make a trade, instructed another to make the trade, or adopted a written plan for trading securities before he became in possession of the inside information.[11] Commentators have referred to Rule 10b5-1 as "schizophrenic" because it "pushes aside the need to find deception under the awareness approach while adopting affirmative defenses that underscore the importance of making actual use of material nonpublic information when committing the offense."[12] Although Section 10(b) and Rule 10b-5 specifically target fraudulent behavior, Rule 10b5-1 broadens the traditional notion of insider

trading by reaching conduct undertaken with an "awareness" of material nonpublic information without proof of deceptive intent.

Briefs Before the Court

The validity of a standard that requires no causal connection between the inside information and the trade is hotly debated in briefs submitted by Rajaratnam and the government to the Supreme Court. Rajaratnam urges the Supreme Court to grant certiorari because the Second Circuit's position that trading while in "knowing possession" of inside information contradicts the text of Section 10(b) and is contrary to decisions from other circuits. Arguing that the Second Circuit has "criminalized trading-in-possession without regard to fraudulent intent or whether the information was used in the trading decision," Rajaratnam insists the Teicher and Royer decisions "tilt[] the legal playing field in securities fraud prosecutions—most of which are likely to proceed within the Second Circuit—decidedly in the government's favor."[13]

Rajaratnam points to the plain language of Section 10(b), which makes it illegal "to use or employ" any "manipulative or deceptive device" in connection with a securities transaction, arguing that the point of rules preventing insider trading is to "eliminate 'use of inside information for personal advantage.' When someone merely possesses inside information, but does not actually use it to make trading decisions, there is no fraud for Section 10(b) to prevent."[14]

Rajaratnam also observes that the Eighth, Ninth and Eleventh Circuit Courts of Appeal and commentators repeatedly have rejected a "possession" standard like that articulated in *Teicher*. In *United States v. Smith*,[15] the Ninth Circuit found *Teicher* to be inconsistent with the text of the statute and statements made by the Supreme Court in its seminal insider trading cases, *O'Hagan*, *Dirks*, and *Chiarella*,[16] that insider trading requires the actual use of insider information. In analyzing insider trading law, a Georgetown University law professor wrote, "[T]he reason insider trading is prohibited is to protect against unfairness. Insider trading is only unfair when it is abusive, and only abusive when the information is actually used."[17]

Further, the Ninth Circuit found the knowing possession standard had the improper effect of creating strict criminal liability for trading while in possession of inside information even if the information played no role in the defendant's trading decision.[18] As articulated by Rajaratnam, the Second Circuit's "knowing possession" standard "reads both causation and scienter out of the statute."

For its part, the government rejects Rajaratnam's assertion that a disagreement exists among the federal circuit courts, noting that the Eighth, Ninth and Eleventh Circuit decisions all preceded the SEC's promulgation of Rule 10b5-1 in 2000, which requires only that the individual be "aware" of the material nonpublic information to be held liable for making a trade "on the basis of" inside information as required by the statute. Further, the government urges the court to deny certiorari in the Rajaratnam case specifically because the jury found overwhelming evidence that Rajaratnam's trades were the direct and immediate result of his receipt of inside information, making it a poor test case even if a disagreement among the circuits existed.[19]

Rajaratnam, however, insists that even the SEC's own rule recognizes that a "trading-in-possession" standard is too low, pointing to the affirmative defenses set forth in subsection (c) of Rule 10b5-1. In those scenarios, the mere fact that a person trades while in knowing possession of inside information is not enough to render the transaction illegal because the trading had nothing to do with the possession of inside information.

> The government rebuts Rajaratnam's claim that the standard creates a 'strict liability' offense, noting that prosecutors are still obligated to prove the defendant acted with fraudulent intent.

Rajaratnam further argues that if the "knowing possession" standard is allowed to stand, Section 10(b) provides insufficient guidance on what constitutes criminal liability. "Surely if such a [strict liability] crime does exist, Congress must be the one to say so—especially given the serious prison sentences and massive financial penalties at stake."[20] Rajaratnam asserts that the "knowing possession" standard puts the livelihood of professional traders at risk, arguing that the character of their job "makes it virtually impossible to wholly avoid coming into contact with information that arguably originated from an inside source." For this reason, he opines that the inside information must at least play a "substantial factor" in the decision to trade in order to mitigate the "otherwise constant threat of criminal liability."

The government counters that the "knowing possession" standard is in fact consistent with two other maxims of insider trading law—first, that the holder of material nonpublic information must either "disclose or abstain" with regard to trading and second, "that a trader who is aware of inside information when making a trading decision inevitably makes use of the information."[21]

Further, the government rebuts Rajaratnam's claim that the standard creates a "strict liability" offense, noting that prosecutors are still obligated to prove the defendant acted with fraudulent intent. According to the government, while the "knowing possession" standard establishes that an insider trading violation may occur when a person trades while in possession of material nonpublic information, no violation occurs unless the defendant: 1) knew that the information was material and nonpublic and 2) acts with intent to defraud by failing to disclose the information that he knows he has a duty to disclose. Finally, the government rejects Rajaratnam's claim that the "knowing possession" standard will wreak havoc on the trading industry, noting that market analysts have continued to do their job despite the promulgation of the "awareness" standard in Rule 10b5-1 in 2000.

Conclusion

The outcome of Rajaratnam's petition is difficult to predict, especially in light of the fact that the Supreme Court twice before has declined to review the Second Circuit's "knowing possession" standard.[22] In addition, Rajaratnam's petition includes a crucial second question regarding the scope of federal wiretap law, which is the subject of three amici curiae briefs filed with the court and has drawn more mainstream attention. The significance of the first question should not be lost, however, and well merits the court's full attention.

1. See Robert J. Anello, "Rajaratnam Appeal: Is Snowden Right that Big Brother is Listening?" The Insider Blog, Forbes.com (June 27, 2013); Robert J. Anello and Richard F. Albert, "Rajaratnam, 'Necessity' and the Path for Future Wiretaps," NYLJ (Dec. 4, 2012).
2. 987 F.2d 112 (2d Cir. 1993).
3. 13-1837(L), 13-1917(CON) (2d Cir.)
4. See Robert J. Anello and Richard F. Albert, "Second Circuit to Resolve Split on Insider Trading," NYLJ (Dec. 3, 2013).
5. Ben Protess and Matthew Goldstein, "Appeal Judges Hint at Doubts in Insider Case," The New York Times (April 22, 2014).
6. Robert G. Morvillo and Robert J. Anello, "The Evolving Mystery of Illegal Insider Trading," NYLJ (Aug. 3, 2010).
7. Co-author Robert Anello represented the defendant at trial.
8. 987 F.2d at 120-21.
9. 549 F.3d 886 (2d Cir. 2008).
10. 17 C.F.R. 240.10b5-1.
11. 17 C.F.R. 240.10b5-1(c).
12. Carol B. Swanson, "Insider Trading Madness: Rule 10b5-1 and the Death of Scienter," 52 U. Kan. L. Rev. 147, 151 (2003).
13. Petition for a Writ of Certiorari, *Rajaratnam v. United States*, No. 13-1001 at p. 12-13 (Feb. 18, 2014).
14. Id. at 17 (citing *Dirks v. SEC*, 463 U.S. 646, 662 (1983)).
15. 155 F.3d 1051 (9th Cir. 1998).
16. *United States v. O'Hagan*, 521 U.S. 642 (1997); *Dirks v. SEC*, 463 U.S. 646, 662 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980).
17. Donald C. Langevoort, "Rereading Cady, Roberts: The Ideology and Practice of Insider Trading," 99 Colum. L. Rev. 1319, 1334 (1999).
18. 155 F.3d at 1069.
19. Brief for the United States in Opposition, *Rajaratnam v. United States*, No. 13-1001 at p. 12 (May 9, 2014).
20. Rajaratnam's Brief at p. 24.
21. Government's Brief at p. 14.
22. *Royer v. United States*, 558 U.S. 935 (2009); *Teicher v. United States*, 510 U.S. 976 (1993).

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