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Is Evidence Of Contacts Followed By Trading Sufficient To Infer And Prove Tipping In An Insider Trading Case? The "Plus Factor" Rule

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I. Introduction

Insider trading cases brought by the Securities and Exchange Commission ("SEC") or the Department of Justice ("DOJ")[1] play an important role in implementing the goals of the federal securities laws by policing the nation's capital markets.[2] Some of those cases are based on claims of "tipping." Generally, tipping occurs when a person in possession of material non-public information[3] – inside information – furnishes that information to another in breach of a fiduciary duty, to give the recipient an informational advantage and that person trades in the securities markets.[4]

In tipping cases, the government frequently does not have direct evidence that the alleged tipper communicated inside information to the alleged tippee, or that the claimed tippee received information from the tipper.[5] In such cases, the government relies on inferences drawn from other facts to establish the communication/receipt element of its claim.[6] The predicate for those inferences is frequently evidence of contacts and trades – that is, facts establishing contact or communication between the claimed tipper and tippee and the subsequent securities trades by the alleged tippee. The government's reliance on an inference drawn from contact/trade evidence to prove the key communication/receipt element of an insider trading claim raises a significant issue concerning the adequacy of that inference and, in turn, the government's proof. That question is fre-

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For additional information on SEC and DOJ securities enforcement actions *see* http://www.secactions.com.

quently resolved on a pre-verdict defense motion.[7] The resolution of such a motion can be case-determinative. If the defense wins, the case is over in the district court, and if the government prevails, the case goes to the jury for decision, providing the government with an opportunity to obtain a verdict in its favor.

An analysis of opinions in insider trading actions demonstrates that to support a government-drawn inference of illegal tipping, there must be additional evidence from which guilt can be implied or that suggests deception related to the securities transactions in question or the inquiry into those transactions. The underlying contact/trade facts from which the inference is typically drawn, standing alone, are not sufficient to support the inference. While those facts frequently appear suspicious, suspicion is speculation, not proof.[8] Frequently, the additional facts supporting the inference are evidence of false or inconsistent explanations for the transactions or efforts to conceal the transactions[9] – evidence which may constitute obstruction of justice or an agency investigation.[10] The additional evidence suggesting guilt and/or deception serves as a "plus factor" that bolsters an otherwise speculative inference so the case can go to the jury for deliberation and verdict.[11]

The sole exception to the "plus factor" rule is two cases decided by the Eleventh Circuit.[12] In those cases, the court relied solely on the contract/trade facts and the inference of tipping drawn by the government from those facts, eschewing any requirement that additional facts might be necessary to support it. Following this approach raises significant questions concerning the adequacy of proof in government insider trading actions and whether prosecution verdicts are supported by adequate evidence of wrongful conduct or are based in part on speculation. Ultimately, the rule of these decisions may undercut investor and market confidence in the ability of government enforcement actions to fulfill their statutory role as market policing mechanisms.[13]

To evaluate the "plus factor" rule, and the proof required to properly support an inference of tipping in a government insider trading case, three points should be considered. First, the application of the rule should be considered—that is, the basis for rejecting certain inferences as speculation while deeming others to be adequate proof. Second, the approach used by the Eleventh Circuit to consider government drawn inferences of tipping should be evaluated. Finally, the plus factor rule should be compared to the new Eleventh Circuit's method in light of the purpose of government enforcement actions under the federal securities laws.

II. The Rule: A Plus Factor Is Required

The difference between an inference of tipping drawn from contact/trade facts that is adequate to support a government verdict and one which is mere speculation is the presence of other evidence in the record to support it. Specifically, the difference is whether there is evidence from which guilt can be implied or otherwise suggesting deception – a plus factor. When the plus factor is present, the inference has been held sufficient. Conversely, absent a plus factor, the inference is rejected as speculation, particularly where there are uncontested innocent explanations for the transactions. For discussion purposes the cases can be considered in three groups: (1) *SEC v. Truong*,[14] in which the court entered rulings rejecting and accepting government drawn inferences of tipping, (2) cases rejecting inferences of tipping as speculative, and (3) cases finding that inferences of tipping were adequately supported.

A. *SEC v. Truong*: The Line Between Adequate and Speculative

In *Truong*, the SEC brought an insider trading case against alleged tipper Hahn, an employee of Molecular Dynamics, Inc. ("MDI"), and three claimed tippees, Hahn's brothers Hen and Hein and friend Ngyuen.[15] The complaint, focused on three groups of trades, alleged that Hahn tipped the other defendants who traded on insider information.

The first set of trades: In early March 1994, senior MDI managers were told that the company was experiencing financial difficulties.[16] Hahn was not included in the meeting where this information was shared.[17] After obtaining clearance from the company to trade in its shares,[18] Hahn sold all of his MDI stock.[19] During the same period that Hahn sold his shares, Hen, Hein and Nguyen, also sold a significant number of MDI's shares.[20] From these facts, the SEC inferred that Hahn obtained material non-public information and tipped Hen, Hein and Nguyen.

The second set of trades: At a March 22 meeting, Hahn and other managers learned about the deteriorating financial condition of the company.[21] After the meeting, Nguyen did the following: 1) on March 23, ordered a short sale of 2,300 shares; 2) on March 23, called Hahn's office for between one to sixty seconds;[22] and 3) on March 24, ordered a short sale of 2,000 shares.[23] Nguyen had not previously sold short.[24] From these facts, the SEC inferred that Hahn tipped Nguyen.

The third set of trades: Hen, Hahn's brother, sold MDI shares on March 23 and 24.[25] Unlike Nguyen's trades, there was no record of any telephone call between Hen and his brother Hahn on March 23 or 24.[26] There was, however, evidence suggesting that Hahn provided cash to Hen in connection with the transactions.[27] From these facts, the SEC inferred that Hahn tipped Hen.

The court granted summary judgment in favor of the defendants as to the first and second sets of trades, citing the SEC's complete lack of evidence to support the inferences of wrong doing.[28] As to the first set of trades, the court rejected as speculation the SEC's claim that Hahn had, through his employment, obtained inside information and communicated it to the others, finding that access alone is not proof of possession.[29] The court held:

> In short, a finding that Hahn possessed any particular document would require speculation on the part of a jury. Despite many years of investigation, including dozens of depositions, the SEC failed to garner direct or circumstantial evidence that Hahn possessed material non-public information prior to March 22, 1994. The evidence of possession is so tenuous that it would require a jury to speculate, for example, that Hahn rifled through papers hidden in senior staff members' offices or to speculate about the contents written on the white board in manufacturing.[30]

There was no evidence that Hahn made any effort to access inside information. Indeed, if access was sufficient, virtually every open cubical office arrangement like that at MDI would lend itself to an inference of possession of any information. The court's conclusion was bolstered by the fact that Hahn and Hein had an established trading history in MDI shares, thus suggesting there was nothing unusual about the transactions.[31]

The court also rejected the SEC's inference of tipping as to the second set of trades.[32] Again, the court cited the lack of evidentiary support for the government-sought inference of wrongful conduct.[33] As with the first set of trades, there was no support for the claimed inference and no evidence which might be construed as a tacit admission of guilt.[34] Although there was a record of a call from Nguyen to Hahn on March 23, the court noted that it only lasted from one to sixty seconds, there was no evidence the men actually spoke, and it came after Nguyen's MDI transactions.[35]

In contrast, the court denied the defendants' motion for summary judgment as to the third set of trades,[36] because there was additional, adequate

evidence to support the SEC's inference that Hahn tipped Hen as to the March 22-23 trades.[37] As with the trades in the first two groups, the trading pattern alone in the third group would not support the suggested inference. Other facts in the record suggested both an innocent explanation for the trades and a nefarious one. Those facts included the following:

- Hahn was precluded from trading at the time of these transactions;[38]
- Hahn transferred $120,000 to Hen at the time of the trades through a circuitous route and at a time when Hahn could not trade;[39]
- After the shares were sold, Hen used an equally circuitous route to transfer the same sum back to Hahn;[40]
- There were conflicting claims concerning these transfers, as well as an innocent explanation;[41] and
- The cost to cover the short trades approximated Hen's net worth and yearly income.[42]

Although there were no phone records showing that Hahn spoke to Hen at the time of these trades, the court had no difficulty finding that the inference of tipping was sufficient to withstand summary judgment in view of the evidence implying wrongful conduct[43] – a plus factor supporting the government drawn inference of tipping.

The rulings in *Truong* illustrate the dividing line between inferences which are adequately supported by other evidence and those which are speculative: the presence of a plus factor. When the inference is supported by additional evidence from which guilt can be implied, it was found to be adequate proof. In contrast, where there was no additional evidence from which guilt could be implied, the inference was rejected as unsupported speculation.

B. SEC Drawn Inferences Rejected as Speculation

Consistent with *Truong*, courts have rejected inferences of tipping as unsupported speculation absent other supporting facts in the record – that is, other evidence suggesting wrongful conduct or deception. Two decisions in SEC enforcement actions rejecting SEC suggested inferences reflect this point.

1. *SEC v. Goldinger*[44]

In *SEC v. Goldinger*, the Ninth Circuit affirmed the district court's decision granting summary judgment in favor of the defendants and against

the SEC in a tipping case based on circumstantial evidence.[45] The court rejected as speculation the SEC's claim that an inference of tipping could be drawn from the fact that Goldinger, a financial advisor, had inside information about a takeover stock and spoke to Cohen and other co-workers in his office shortly before Cohen and the others purchased significant amounts of the takeover stock.[46]

As he began to prepare for a meeting with a client who held a large percentage of Thrifty Corporation ("Thrifty") stock, Goldinger asked co-worker Cohen what he knew about Thrifty.[47] Prior to his conversation with Cohen, Goldinger's client told him about a possible takeover of Thrifty so he would be prepared to discuss the point at the financial planning meeting scheduled for later that day.[48] Goldinger's question to Cohen prompted Cohen to research Thrifty.[49] During his research, Cohen discovered heavy trading in the company's shares the previous week and an article speculating that Thrifty was a takeover target.[50] Later that day, Cohen and others at the firm traded heavily in Thrifty, placing over twenty-two trades which accounted for 7% of the daily trading volume in Thrifty.[51] At one point, Cohen commented, "we owe [Goldinger] for this one."[52] After the takeover was announced, Cohen and the other trading defendants sold their shares at a substantial profit.

In affirming summary judgment for the defendants, the Ninth Circuit drew a distinction between an inference that raises the possibility of wrongful conduct and one that is sufficient proof to present to the jury:

> Although reasonable inferences must be drawn in the SEC's favor, the SEC cannot merely provide circumstantial evidence to show the *possibility* of illegal trading. The SEC's evidence and reasonable inferences from that evidence must be sufficient to allow a reasonable jury could [sic] find it met its burden of persuasion.[53]

The contact/trade facts are not sufficient support for the inference. There were no other facts in the record that implied illegal conduct by the defendants. At best, the trading and the Cohen/Goldinger contacts were suspicious. Suspicion is neither proof of tipping nor sufficient to support the inference of tipping sought by the SEC. This is particularly true where, as here, the record before the court presented an unchallenged innocent explanation for the trading of Cohen and the others in the office: the research report, prior trading volume, and the experience of the defendant financial advisors all suggested that Thrifty was a takeover target and

trading could result in large profits – an unchallenged innocent explanation.[54] Accordingly, the court rejected the SEC's claim that illegal tipping should be inferred from what the agency tried to characterize as "massive and well-timed trading in Thrifty stock and options" and "incriminating statements,"[55] finding the agency's evidence "weak and speculative."[56]

2. *SEC v. Gonzalez de Castilla*[57]

SEC v. Gonzalez de Castilla is consistent with *Goldinger*. As in *Goldinger*, the court rejected an SEC proffered inference of tipping that was supported by little more than conclusory claims that the case was a "signature crime" by an international "insider trading" ring.[58] *Gonzalez de Castilla* was based on trading in the shares of a cross-boarder takeover target by defendant Alejandro Duclaud Gonzalez De Castilla ("Duclaud"), a partner in a prominent Mexico city law firm, his wife and two of her friends, Duclaud's brother, his brother-in-law and the broker for all the defendants.[59] Collectively, the defendants purchased about 800,000 shares of the target's stock just before the public announcement which were later sold at a profit of more than $3.3 million.[60]

The SEC's case centered on two inferences. First, the SEC sought to infer that the defendants possessed material non-public information based on: (1) the trading; (2) the fact that Duclaud's law firm previously had prepared Schedule 13D filings for the eventual bidder; and (3) the fact that the law firm had at one time worked on a standstill agreement for the eventual target of the takeover.[61] Second, the agency sought to infer tipping based on the trading and contacts among the defendants.[62]

As in *Truong* and *Goldinger*, after a careful review of the evidence, the court found that the SEC's proposed inferences were not supported by the record. The undisputed facts established that Duclaud's law firm was not aware of the takeover bid until the morning the deal was publicly announced, which was after most of the trades had taken place.[63] There was no evidence that the bidder actually told the law firm of the proposed takeover at the time of the work on the Schedule 13D filings or on the standstill agreement.[64] Accordingly, the court rejected as speculation the SEC's claims that Duclaud could have learned about the deal from the earlier work by his law firm.[65]

The court also rejected the SEC's efforts to support its inference by claiming that it had proof of a plus factor. Specifically, the SEC claimed that defendants engaged in deceptive conduct because they used offshore trusts for the trades and they did not inform the Mexican tax authorities

and Duclaud's law firm about the transactions.[66] The undisputed facts, however, established the reverse, an innocent explanation: the off-shore trusts were used for legitimate tax and legal reasons; a tax opinion established that the transactions need not be reported to Mexican tax authorities; and the law firm did not have a policy requiring disclosure of the trades.[67] Also unsupported was the SEC's claim that two cash transfers to Duclaud constituted a "payoff" for the tips.[68]

In sum, *Gonzalez de Castilla*,[69] like *Truong* and *Goldinger*, stands for the proposition that SEC drawn inferences in insider trading cases must be adequately supported in view of all the evidence in the record. Where those inferences are not supported by the factual record or are contrary to undisputed innocent explanations, and there is no evidence of a plus factor, that is, facts from which guilt can be implied, the inference must be rejected as speculation.[70] Suspicious contacts and trading are not sufficient proof to permit a government enforcement case to proceed to verdict.[71]

C. SEC and DOJ Inferences Found Sufficient

Courts have repeatedly found government drawn inferences of tipping sufficient when they are adequately supported by the record – that is, when evidence establishing a plus factor is present. Three SEC enforcement cases and one criminal insider trading case brought by the Department of Justice reflect this rule.

1. *SEC v. Warde*[72]

SEC v. Warde is typical of the decisions in this group. There, the SEC claimed that Edward Downe, a director of Kidde, Inc. ("Kidde"), and his long time friend, Thomas Warde, traded on inside information about a tender offer for that company obtained by Downe as a Kidde director.[73] Both men were long time stock investors. Both denied the SEC's claims.[74] A jury found Warde liable based in part on an inference that Downe tipped him.[75]

On appeal,[76] the court reviewed the sufficiency of the evidence, including the question of whether the inference that Downe tipped Warde was adequate.[77] The record established that beginning in June 1987, Fred Sullivan, the chairman of Kidde, held a series of meetings on behalf of the company that resulted in a tender offer in early August for all of the outstanding shares of Kidde.[78] Throughout the negotiations, Sullivan kept all of the board members, including Downe, informed of the progress of the discussions.[79]

Downe began buying warrants[80] to purchase Kidde shares during the takeover discussions.[81] He continued buying warrants until just before the tender offer announcement despite the rapidly increasing price and the fact that they would expire worthless in the near future.[82] Some of the warrants were purchased with a $1 million loan Downe obtained from his wife. The purchases were made through an off shore trust held in another name.[83] Downe testified that he used the trust to try and avoid the restrictions of the short swing provisions of the federal securities laws.[84]

Between late June and the end of July, Downe and Warde either spoke on the phone or met in person several times, discussing Kidde and other possible investments.[85] Following a conversation in late June with Downe, Warde began making large purchases of Kidde warrants.[86] His subsequent purchases paralleled his conversations with Downe. Warde and Downe claimed their purchases were based on market rumors.[87]

The court found ample evidence to support the inference that Downe had tipped Warde after reviewing the record.[88] Downe's trading paralleled his contacts with Sullivan. In view of Sullivan's testimony that he kept the board informed on the progress of the transaction, the court rejected Down's claim that he did not know about the deal and traded based on market rumors. Downe thus lacked any credible explanation for his trades.[89] The court's determination was further supported by the fact that Downe's trading was inconsistent with his established trading patterns, uncharacteristically risky, and his admission that he sought to conceal his trading to evade his obligations as a corporate director under Section 16 of the Exchange Act.[90]

The court also concluded that there was sufficient evidence to support the inference that Warde had been tipped by Downe.[91] Warde had a long standing relationship with Downe. Warde's trading directly paralleled his conversations with, and the trading of, Downe whose trading the court found took place when he had insider information. Like Warde, Downe's trading was also unusually large and risky.[92] Like Warde, Downe also claimed that he traded based on market rumors – a story the court found to lack credibility.[93] And, Downe relied on the discredited testimony of Warde to support his claim that he traded on market rumors – the story the court found to be untrue.

The court's conclusion in *Warde* is clearly consistent with that of other cases requiring that the government present evidence of more than just suspicious communications or contacts and trading to support an infer-

ence of illegal tipping. As in *Truong*, the parallel trading of Warde and Downe alone would not support that inference. Warde's uncharacteristically large and risky trading coupled with a plus factor was, however, sufficient. Here, the other evidence from which guilt could be implied was not only Downe's lack of a credible explanation for his extraordinary transactions but also his reliance on the discredited tale about market rumors, and testimony from, admitted securities law violator Downe.

2. *SEC v. Sargent*[94]

The First Circuit used the same approach to reverse a directed verdict entered in favor of the defendants in *SEC v. Sargent*. In that insider trading case, a key issue was the sufficiency of an inference that material non-public information had in fact been communicated to those who traded. In *Sargent*, the SEC claimed that Dennis Shepard, who learned of a possible takeover of Purolator Products Co. ("Purolator") from his business associate, tipped Michael Sargent, his friend and dentist, who in turn tipped his friend, Robert Scharn.[95] After Sargent spoke with Shepard, he rapidly acquired a very substantial position in Purolator through two brokerage accounts.[96] The purchases were made against the advice of his regular broker to whom he lied about the reason for his interest in the company.[97] Sargent paid for the trades, in part, using margin, a bank loan, and by liquidating another stock position which was converted to options. He had never taken out a bank loan to pay for a stock purchase.[98]

Scharn's trading pattern was similar to that of Sargent.[99] Like Sargent, this was Scharn's largest stock purchase of the year.[100] Both men sold their positions at a substantial profit after the announcement of the merger.[101] Sargent and Scharn denied any illegal tip.[102] Although Sargent offered a plausible explanation for his trading, he and Scharn admitted lying to SEC investigators about the reasons for their stock transactions by initially claiming that their purchases were based on information from a conversation overheard in a bar.[103] Both men were indicted and convicted for making false statements to a federal official in violation of Title 18 U.S.C.A. § 1001.[104]

On appeal, the SEC argued that the inference of illegal tipping drawn from the contact and trade evidence was sufficient in view of the totality of the evidence, part of which involved deceptive conduct by the defendants.[105] The circuit court agreed, holding:

> Here, the Commission presented evidence that the first business day following his dinner with Shepard, Sargent contacted his broker before the market opened and stated that he had heard something over the weekend about Purolator. A few hours later, Sargent bought Purolator even after receiving a negative recommendation from his broker. When asked by his broker how he had heard about Purolator, Sargent was evasive, and there was some evidence that even at that early stage, he was telling the "two guys in a bar" lie. Over the next three weeks, Sargent purchased 20,400 shares, his largest investment ever in a single stock. He even took out a $50,000 bank loan to finance the purchase.[106]

The lies told by Sargent to his broker, and later by both men to the SEC about the reason for their respective stock purchases – a plus factor – coupled with the other evidence demonstrating the uncharacteristic nature of the transactions, adequately supported an inference of illegal tipping.[107]

3. *SEC v. Euro Security Fund*[108]

In *SEC v. Euro Security Fund*, the court concluded that inferences of possession of material nonpublic information and tipping were sufficient to withstand a defense motion for summary judgment. A review of the record demonstrated that those inferences were supported by evidence from which guilt can be implied – a plus factor.

In *Euro Security Fund*, the SEC brought an insider trading case against Giovanni Piacitelli, a Swiss based broker and others.[109] The SEC claimed that Piacitelli and his client, Euro Security Fund ("Euro") purchased shares of Elsag Bailey Process Automation, N.V. ("Elsag") in advance of public disclosures about the company based on inside information.[110] The first trades were placed by Piacitelli for his client Euro's account shortly before Elsag's parent announced it planned to sell its stake in the company.[111] The second group of trades were placed by Piacitelli for Euro's account, his personal account, and those of friends shortly before the merger announcement.[112] The final trades were placed just after the announcement of a merger.[113]

Citing *Truong,* Piacitelli denied any tipping and argued that the inferences relied on by the SEC were mere speculation. The court rejected Piacitelli's argument, finding, "[h]ere, however, and unlike in *Truong*, the SEC has offered evidence of evasiveness and inconsistent statements on

Piacitelli's part that support an inference of guilty knowledge ..."[114] The evidence demonstrated that:

- Piacitelli had handwritten notes indicating the name of Elsag's corporate parent along with the name and phone number of a board member;[115]
- The board of Elsag's corporate parent was briefed regularly on the status of the proposed sale of Elsag;[116]
- Piacitelli refused to produce phone records and later destroyed them;[117]
- Piacitelli was evasive when questions about his connection to a man related to Elsag's parent;[118] and
- Piacitelli violated firm policy by placing his personal trades through a brokerage account he maintained at another firm which had not been disclosed to his firm.[119]

The inference of guilty knowledge drawn from these facts, coupled with access to material nonpublic information and the suspicious trading pattern, was more than sufficient to permit the case to proceed to trial.

4. *United States. v. Larrabee*[120]

The same approach was used in *United States v. Larrabee* to affirm a criminal conviction for insider trading based, in part, on an inference of illegal tipping. Larrabee was privy to confidential information concerning a pending bank merger through his position as a director of financial services for a large law firm.[121] The day before the public announcement of the bank merger, and after accessing a computer used by a firm partner working on the merger, Larrabee telephoned D'Angelo, a broker to whom he directed most of the law firm's securities business and with whom he also had a close personal relationship.[122] Immediately after the phone call, D'Angelo placed an order to purchase shares in the target bank through his trading assistant who also ordered shares for her personal account.[123] D'Angelo's order was about twice the size of his typical trade.[124] Later that day D'Angelo called the trader and stayed on the line until the purchase was completed – an action his assistant characterized as "unusual."[125] After the merger was announced, D'Angelo sold the stock at a substantial profit.[126]

Subsequently, the brokerage and law firms conducted inquiries into the trading.[127] Larrabee and D'Angelo denied any improper conduct.[128] During

his interview, Larrabee characterized his relationship with D'Angelo as primarily professional and failed to mention its personal side including the fact that his family had received substantial gifts from D'Angelo.[129] Failing to disclose the personal side of the relationship violated firm policy.[130] Larrabee also misrepresented the frequency of his contacts with D'Angelo, claiming that he had not talked to D'Angelo for several days.[131] In fact, Larrabee had spoken with D'Angelo the morning of the interview.[132]

Echoing *Truong*, the court noted that trading and "access to the information is not enough."[133] There were, however, six key evidentiary points to support the two inferences the government sought to draw:

> We examine myriad factors, including (1) access to information; (2) relationship between the tipper and the tippee; (3) timing of contact between the tipper and the tippee; (4) timing of the trades; (5) pattern of the trades; and (6) attempts to conceal either the trades or the relationship between the tipper and the tippee.[134]

The court went on to carefully evaluate each point, concluding that the evidence supported an inference of tipping.[135]

The *Larrabee* court's finding of adequacy based, in part, on evidence from which guilt can be implied, is consistent with the determinations in *Euro Security Fund*, *Sargent*, *Warde*, *Gonzalez de Castillo*, *Goldinger* and *Truong*. Collectively these cases stand for the proposition that a government drawn inference of tipping drawn from contact/trade facts must be evaluated carefully in view of all the evidence in the record to determine if it is adequate proof. Where there is evidence of a "plus factor,"[136] that is, additional facts from which guilt may be implied, and uncontested innocent explanations for the transaction are not present, the inferences is adequate proof.[137]

III. The Eleventh Circuit Exception

In two SEC enforcement actions, the Eleventh Circuit ignored the approach used by other courts for evaluating inferences of tipping in insider trading cases.[138] In *Adler* and *Ginsburg*, the court only looked at the selected contact/trade facts from which the inference had been drawn. The court did not examine or consider other facts in the record. The court left it to the jury to review the other evidence in the record despite the absence of a plus factor and even when there were innocent explanations for the transactions. This approach has the potential to create the situation

Truong, *Goldinger,* and other courts which have considered this issue sought to avoid: creating the opportunity for juries to speculate and base a verdict on nothing more than suspicious circumstances.

A. *SEC v Adler:*[139] *No Analysis*

In *SEC v. Adler*, the Eleventh Circuit created its approach for evaluating inferences of tipping. There, the court reversed a district court ruling directing a verdict in favor of the defendants after a jury verdict for the government.[140] The district court concluded that the evidence did not support the SEC drawn inference of tipping. On appeal the court focused on the question of whether there was sufficient evidence to support inferences that Comptronix Corporation ("Comptronix") board member Richard Adler: 1) tipped two long time business associates, Harvey Pegram and Domer Ishler; or 2) if Adler only tipped either Pegram or Ishler, but not both, that either Pegram tipped Ishler or Ishler tipped Pegram after one of them had been tipped by Adler; and 3) if Pegram then tipped one of his other business associates, Philip Choy.[141] The court found the inferences adequate despite the lack of a plus factor and the presence of unchallenged innocent explanations for the transactions.

The facts demonstrate that Adler learned at a November 15 telephonic Comptronix board meeting about a possible financial fraud which could have a material impact on the company's financial statements.[142] During the pertinent time period, Adler had two conversations with Ishler with whom he spoke periodically about business.[143] The first occurred during the November 15 Comptronix board meeting.[144] While the meeting was in progress, Ishler telephoned.[145] Adler put the board call on hold and briefly told Ishler he could not talk.[146] Ishler did not trade after the call.[147]

Ishler spoke to Adler for a second time on November 23, although he tried repeatedly and without success to contact Adler after their November 16 conversation.[148] At the time of the second conversation, Adler again was participating in a board meeting.[149] Again, Adler placed the board meeting call on hold and briefly told Ishler he would have to get back to him.[150] Ishler also spoke with Pegram, a former Comptronix comptroller, on November 23.[151]

On November 24, Ishler purchased 300 put options in Comptronix stock.[152] Ishler's broker, however, testified that before the purchase he and his client discussed the transaction as well as others.[153] The broker also stated that his client had a history of trading in "highly speculative,

high risk, leverage type stocks in industries similar to Comptronix."[154] Later, Ishler sold the options at a profit of $368,000.[155]

On November 16, the day after the telephonic Comptronix board meeting, Adler also had two conversations with Pegram, with whom he spoke periodically about business.[156] The first call lasted 72 seconds while the second lasted 114 seconds.[157] Following his first call with Adler, Pegram spoke with his wife who later the same day placed a limit order to sell 50,000 shares of Comptronix.[158] Between the date of that sale and November 24, Pegram and his wife sold an additional 100,000 shares of Comptronix.[159] The sales permitted the Pegrams to avoid losses of about $2.3 million.[160] Prior to his call on November 16 with Adler, Pegram and his wife had planned to sell 150,000 of their 400,000 shares of Comptronix.[161] The court characterized the evidence of the Pegram's pre-existing plan as "strong."[162]

The day after his two conversations with Adler, Pegram had one of his periodic calls with business associate Philip Choy.[163] Choy sold 5,000 Comptronix shares after his phone call with Pegram, thus avoiding a loss of $75,000.[164] There was evidence that Choy had previously planned to sell his Comptronix shares which the court characterized as "weak."[165]

In reversing the district court ruling in favor of defendants, the Eleventh Circuit first drew a distinction between the possession of inside information and its use.[166] The court held that possession of inside information creates a rebuttable presumption that the information was in fact used to make the trades – a distinction the SEC disputed.[167] Using the same approach, the court then concluded that facts establishing a contact between an insider, such as Adler, and a trader, such as Pegram, followed by stock trades, creates a rebuttable inference of tipping and insider trading,[168] holding: "based on this suspicious sequence of events [telephone call and trade], an inference arises that Pegram received material nonpublic information from Adler. However, the inference can be rebutted."[169] The brief time period of the call did not trouble the court because "[a]though the telephone call with Pegram [and Adler] lasted only 72 seconds, a jury could find that sufficient time existed for Adler to convey material nonpublic information to Pegram."[170] This inference was bolstered, according to the court, by the evidence of other calls with Adler by defendants and their subsequent trading.[171]

The same approach was used to conclude that inferences of tipping as to Choy and Ishler were adequately supported by the evidence. In each instance, the court limited its consideration to the facts relating to the contacts involving Adler, Choy and Ishler and the trades.[172] Other evidence was not considered. In each instance, the court concluded that the case must go to deliberation and verdict.[173] In reaching its conclusion, the court ignored undisputed evidence establishing that:

- There were innocent explanations for the transactions, including the fact that Mr. and Mrs. Pegram had a pre-existing business plan to sell the shares they sold;[174]
- The three men spoke periodically for valid business reasons;[175]
- Ishler spoke to Adler during the November 15 board meeting where the fraud was discussed and did not trade following the call;[176]
- Mrs. Pegram's first sale was a limit order;[177]
- The Pegrams did not sell most of their Comptronix holdings;[178]
- Adler failed to return Ishler's phone calls for days;[179] and
- There was no evidence from which guilt could be implied such as deception, wrongful conduct or inconsistent explanations.

Similarly, the court did not comment on the fact that its rulings as to Choy and Ishler were based on multiple inferences, depending on how the facts are viewed.[180] The multiplicity of inferences, like virtually everything else,[181] was left for the jury to sort out.[182]

B. *Following Adler: SEC v. Ginsburg*[183]

SEC v. Ginsburg followed and applied the holding of *Adler*. In *Ginsburg*, the SEC brought an insider trading case against Scott Ginsburg, who ran the family radio company, Evergreen Media Corporation ("Evergreen"), his brother Mark, and father Jordan, based on claims that Scott tipped: 1) Mark and Jordan as to a possible acquisition (which ultimately failed) by Evergreen of radio company EZ Communications, Inc. ("EZ"); and 2) Mark as to a possible acquisition by Evergreen of radio company Katz Media Group ("Katz").[184]

As to EZ, the bid by Evergreen began on July 12, when Scott Ginsburg met with EZ to discuss the matter, and concluded on August 5 when an-

other company was named the successful bidder.[185] There were contacts between Scott and Mark on several occasions during this period, including July 14, July 18, and July 28.[186] There were also contacts between Scott and Jordan on July 16 and 17.[187] Mark and Jordan purchased shares of EZ prior to the public announcement.[188] In total, Mark purchased 48,000 and Jordan purchased 25,000 shares of EZ. Those EZ shares were sold by Mark and Jordan for a profit of, respectively, $664,000 and $412,000 after the announcement that EZ would be acquired.[189]

As to Katz, Scott, on behalf of Evergreen, was in discussions with that company between March 20 and July 14.[190] On June 16, Scott met with a Katz official who encouraged him to talk to the chairman of Katz about a possible deal and urged him to move quickly because Katz was in discussions with others.[191] Telephone records reflect a call from Scott's cell phone to Mark on the evening of June 16.[192] This was one of a number of calls among family members during the period.[193] On June 17, Mark purchased 150,000 shares of Katz that he sold after an announcement on July 14 that an Evergreen subsidiary would acquire Katz.[194] Mark made a profit of $729,000 on the transaction.[195]

As in *Adler*, the circuit court limited its review of the SEC drawn inferences of tipping to the facts from which it was drawn.[196] As in *Adler*, the Court did not consider evidence regarding contacts, other than those used as a predicate for drawing the inference, or facts concerning innocent explanations for the contacts and trades based on the theory that:

> The fact-finder in an insider trading case need only infer the most likely source of that belief. The temporal proximity of a phone conversation between the trader and one with insider knowledge provides a reasonable basis for inferring that the basis of the trader's belief was the inside information. The larger and more profitable the trades, and the closer in time the trader's exposure to the insider, the stronger the inference that the trader was acting on the basis of inside information. The magnitude of the incentive to trade on insider information is illustrated by the trades that were made in this case.[197]

The court however did not analyze or even discuss temporal proximity in its opinion.

Although the court determined that the trading pattern in *Ginsburg* was not as strong as the one in *Adler*, it was not troubled by this conclusion:

> In *Adler* the calls/trades pattern repeated twice on one day and once again the next week. In this case there is evidence of one clear call/trade pattern concerning EZ stock (the July 14 call from Ginsburg to Mark followed the next day by his purchase of 3,800 shares), and one concerning Katz stock (the June 16 call from Ginsburg to Mark followed the next day by his purchase of 150,000 shares). The other EZ calls match less well with trades. The July 25 call to Jordan was followed by a purchase by Mark, and the July 28 call to Mark followed with a purchase by Jordan. But because Mark and Jordan admitted discussing EZ throughout that period, the mismatch of calls and trades is not a big problem. The multiple occurrences of the pattern in this case are similar enough to those in *Adler*.[198]

The court's reliance on selected facts makes its analysis and conclusions questionable at best. Citing evidence that Mark and Jordan discussed EZ to bolster the "pattern" of contacts and trades is of little value unless the related facts are considered. Those facts demonstrate that the family was in the radio business and thus family members could be expected to discuss competitors such as EZ, that EZ was one of a number of competitors, that EZ was up for auction and that Ginsberg family members had previously traded EZ shares. The court's acceptance of the inference as to the Katz transaction is even more disconcerting. As to that transaction, there was no trading pattern because only one trade was placed.

Finally, as in *Adler*, the *Ginsburg* court was not troubled by the fact that all the evidence in the record was of lawful transactions and innocent explanations and that the only suggestion of deception or illegal conduct was an SEC drawn inference of tipping. As in *Adler*, the *Ginsburg* court did not consider the undisputed innocent explanations for the trading. Indeed, the court relegated to a footnote the fact that there were numerous other calls among the family members.[199] Likewise, the court failed to mention the fact that there was no evidence in the record from which guilt could be implied. As in *Adler*, the *Ginsburg* court left it for the jury to sort out questions such as whether the SEC's inference amounted to more than simple suspicion.[200] Indeed, under *Adler* and *Ginsburg*, the Circuit defers the question of whether there is any evidence in the record other than the contact/trade facts from which it was drawn to support a government drawn inference of illegal tipping to the jury. In contrast, courts outside the Eleventh Circuit carefully evaluate the evidence supporting the inference to avoid giving the jury the opportunity to base its

verdict on an inference not properly supported by the evidence – that is, render a verdict based on suspicion and speculation.

IV. The Plus Factor Rule And The Eleventh Circuit Compared

The analytical approach used by courts to determine the adequacy of an inference of tipping, reflected in cases such as *Truong*, *Gonzales de Castilla*, *Goldinger*, *Larrabee* and others, contrasts sharply with the one used in *Adler* and *Ginsburg*. The review for adequacy undertaken by the courts outside the Eleventh Circuit is designed to ensure that inferences and, ultimately, verdicts are properly supported by the evidence. When the review by the court is made on a pre-verdict motion, it is designed to preclude a case from going to verdict when a key element of the claim is based on speculation or suspicion.[201] When the review is made on appeal, it acts as a check to make sure that verdict of the jury is supported by the evidence, not merely supposition.[202] In each instance, review by the court acts as a check to help ensure proper verdicts. Stated differently, the review helps ensure that the government only prevails and that, in turn, a defendant only suffers the consequences of an adverse verdict, when there is evidence that establishes wrongful conduct in violation of the federal securities laws.

The judicial check on government enforcement actions reflected in the decisions of courts outside the Eleventh Circuit also helps make sure that those cases fulfill their statutory role as market policing mechanism for the securities markets.[203] A verdict or settlement in favor of the government serves notice to the markets and investors that the integrity of the nation's capital markets is being maintained and that improper practices will not be tolerated.[204] The careful review process courts use to evaluate inferences in insider trading cases helps bolster investor confidence and market integrity by assuring investors and the markets that government enforcement actions are fulfilling their statutory purpose of eliminating prohibited practices from the securities markets.[205] Rigorous scrutiny of the government's evidence by the courts also encourages prosecutors to marshal their evidence carefully during investigations and to only initiate cases when there is adequate evidence of wrongful conduct – a result that again helps to ensure that those actions fulfill their intended purpose.[206]

In contrast, *Adler* and *Ginsburg* reject the approach of other courts in favor of a methodology that creates the opportunity for verdicts based on speculation and which may lead to incorrect results all of which can undermine the market policing function of those actions. *Adler-Ginsburg* represents a lack of analysis by the court and an abdication of the tradi-

tional judicial role. In one sense the Eleventh Circuit approach defers all analysis to the jury since examining only selected contact/trade facts is not a meaningful analysis – virtually any set of selected contact/trade facts will support some inference of tipping. In another sense, it effectively delegates the pre-verdict decision regarding adequacy to the proponent of the inference, the government.

At the same time, the Eleventh Circuit's approach virtually guarantees that any government enforcement action based on an inference of tipping will go to the jury. That prospect creates the opportunity for verdicts based on speculation rather than adequate evidence. Verdicts based on speculation can lead to incorrect judgments and the imposition of severe sanctions despite a failure by the government to properly prove a violation of law.[207] That result can undermine confidence in government enforcement actions as effective market policing mechanisms with a resulting loss of investor confidence in the integrity of the markets.

The reason the Eleventh Circuit chose to disregard the approach used by other courts is not explained clearly in either *Adler* or *Ginsburg*. The concluding paragraph of *Ginsburg*, however, does hint at a possible rationale for the approach. There, the court states that if evidence of contacts between a person with inside information and one who subsequently trades is insufficient to establish liability for insider trading "family members who regularly traded in a particular stock or type of stock could trade based on inside-information with impunity."[208] Although *Adler* does not contain a similar passage, the same concern applies because the case involved a group of close friends and business associates who frequently spoke on the phone and traded securities.

While the court's fear that insider trading may go undetected is understandable, it is not a valid rationale for its approach to insider trading cases or the abduction of the court's traditional role. There can be no doubt that insider trading is difficult to detect and prosecute. That difficulty may be compounded where family members or close friends or business associates frequently contact each other in person or on the phone – particularly if those persons regularly trade stock. That fact, however, does not suggest that courts should abdicate their obligation to evaluate the reasonableness of inferences on which key elements of proof are based on refusal to act as a safeguard against incorrect results. Likewise, the difficulty of detection does not suggest that that courts should dilute evidentiary standards to ensure that government enforcement actions proceed to verdict. Sending cases to the jury for deliberation that should otherwise

be terminated on defense motions only invites arbitrary results in enforcement actions and incorrect verdicts.[209]

To ensure that government enforcement actions serve their proper purpose and aid the efficiency of the capital markets, before an SEC or DOJ action for insider trading based on inferences of illegal tipping is permitted to go to verdict, it is imperative that the court carefully examine all the evidence and require something more than a suspicious trading pattern, the possibility of wrongful conduct or a fear of not detecting illegal conduct. Before such a case proceeds to verdict the court should be obligated to at least review the evidence in the record and determine whether the inference of illegal tipping is supported by something more than guesses or supposition. That "something more" is well illustrated by the rulings in *Truong*. There the court used evidence of deception as a "plus factor" to differentiate inferences which are speculation from those which are properly supported. This same approach is reflected in cases such as *Sargent* and *Larrabee* and others but is conspicuously absent in *Adler* and *Ginsburg*. It is precisely this type of evidence – a plus factor – which should be present before a circumstantial case based on inferences of tipping is permitted to proceed to verdict.

V. Conclusion

Under the federal securities laws government enforcement actions play an important role in policing the U.S. capital markets, deterring insider trading and thus aiding the overall efficiency and integrity of the markets. Those cases only foster the goals of the statutes, however, when they are based on evidence establishing wrongful conduct. In contrast, basing government enforcement actions on speculation can only serve to undermine their market policing function and ultimately the integrity of the markets.

The federal courts traditionally have been instrumental in ensuring that government insider trading enforcement actions serve their intended market policing and investor confidence bolstering role while safeguarding persons against unsupported verdicts. When courts take affirmative steps to make sure that inferences offered as proof of illegal tipping are supported by more than suspicious contact/trade facts and that there is a plus factor or evidence which at least implies guilt, they act not only to help ensure a proper verdict and preclude inappropriate results but also in furtherance of the goals of the federal securities laws. Thus, when courts adhere to the method for evaluating government drawn inferences of tipping used outside the Eleventh Circuit, by carefully examining all the evidence in the record and only permit the case to go forward when there is

evidence of a plus factor – facts implying guilt – they help ensure that government enforcement actions fulfill their intended purpose while protecting against unsupported verdicts. Decisions such as *Truong*, *Goldinger*, *Gonzalez de Castilla*, *Larrabee*, and *Euro Security* thus aid the investor confidence and market integrity goals of the statutes while safeguarding persons from findings of liability based on speculation rather than evidence of wrongdoing.

In contrast, the approach of the Eleventh Circuit in *Adler* threatens to undermine the market policing goals government enforcement acts are intended to fulfill while creating the prospect for incorrect verdicts. Abandoning any analysis of adequacy and leaving the question of sufficiency to the jury opens the door to verdicts based on supposition and speculation. Such a process also increases the chances of settlements based on a fear of litigation rather than the merits of the case. Indeed, such a prospect raises the specter of improperly initiated government enforcement actions, all of which undermines the intended purpose of government enforcement actions. Accordingly, it is imperative that the plus factor rule arising from cases such as *Truong*, *Goldinge*r, and others be followed rather than decisions such as *Adler*.

NOTES

[1.] The SEC has authority to institute civil enforcement actions. 15 U.S.C.A. § 78u-1(a). While the SEC cannot bring a criminal action, it can refer the case to the Department of Justice. 15 U.S.C.A. § 78u-(h)(9)(a); *see also SEC v. Dresser Indus., Inc.*, 628 F.2d 1368 (D.C. Cir. 1980). The Department of Justice can bring criminal insider trading actions. 15 U.S.C.A. § 77x; 15 U.S.C.A. § 78ff.

[2.] Government securities enforcement actions are intended to police the markets. 15 U.S.C.A. § 78k-1; *see also Chemical Bank v. Arthur Anderson & Co.*, 726 F.2d 930, 943 (2d Cir. 1984) ("The purpose of [Section] 10(b) and Rule 10b-5 is to protect persons who are deceived in securities transactions—to make sure that buyers of securities get what they think they are getting...."); Arthur Levitt, *A Question of Investor Integrity: Promoting Investor Confidence by Fighting Insider Trading*, Address Before the "SEC Speaks" Conference, (Feb. 27, 1998); Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 409 (1990). To ensure the integrity of the markets, the SEC has been vested with extensive investigative powers, as well as the authority to bring enforcement actions.

[3.] Generally, material information is defined as information that would be important to a reasonable investor in the total mix of information considered in making an investment decision. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (stating that "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available"); *Basic, Inc. v. Levinson*, 485 U.S. 224, 232 (1988) (defining materiality in the context of merger negotiations using a sliding scale).

[4.] See *infra* note 6; *see, e.g., Dirks v. SEC*, 463 U.S. 646 (1983) (discussing tipping); *United States v. O'Hagan*, 521 U.S. 642, 117 (1997) (discussing the misappropriation theory).

[5] *See e.g., SEC v. Singer*, 786 F. Supp. 1158, 1164 (S.D.N.Y. 1992) (citing Black's Law Dictionary (6th ed. 1990) to define circumstantial evidence as "indirect evidence, '[t]estimony not based on actual personal knowledge or observation of the facts in controversy, but on other facts from which deductions are drawn, showing indirectly the facts sought to be proved.'"); *see also* 1 A K. O'Malley, J. Grenig, & W. Lee, Federal Jury Practice and Instructions, Criminal §12.04 (5th ed. 2000); 4 L. Sand, J. Siffert, W. Loughlin, S. Reiss, & N. Batterman, Modern Federal Jury Instructions ¶ 74.01 (model instruction 74-2) (2002).

[6] The elements of tipper/tippee liability are: (1) the tipper acted willfully and with a mental state known as "scienter;" (2) the tipper communicated material nonpublic information to the alleged tippee with the intent of giving the outsider an informational advantage in trading in shares of the company; (3) the tippee traded in securities while in possession of the nonpublic information provided by the tipper; (4) the tippee knew or should have known that the tipper violated a relationship of trust by relaying the information; and (5) the tipper benefited by the disclosure to the tippee. 15 U.S.C.A. § 78J(b) and 17 C.F.R. § 240.10b-5; *United States v. O'Hagan*, 521 U.S. 642 (1997); *Dirks v. SEC*, 463 U.S. 646 (1983).

[7] For example, a defendant in an SEC enforcement action may file a motion for summary judgment prior to trial or make a motion for a directed verdict during or after trial. *See* Fed. R. Civ. P. 41 and 56; *see infra* note 66. Federal Criminal Rules 12 and 29 permit a criminal defendant to file a motion to dismiss and a motion for judgment of acquittal, respectively. *See* Fed. Crim. P. 12 and 29. While each of these motions differ, each generally permits the moving party to challenge the sufficiency of the evidence and requires the court to determine whether any inferences are reasonable and sufficient to permit the case to proceed to the jury for consideration. *See* Fed. Crim. P. 12 and 29.

[8] *See, e.g., SEC v. Goldinger*, No. 95-56092,1997 WL 21221 (9th Cir. Jan. 14, 1997) (not for publication) (rejecting an inference drawn from contact/trade evidence where there was an uncontested innocent explanation for the transactions as speculative). *Goldinger* is discussed *infra* beginning at note 45.

[9] Cases in which the courts held the inference to be speculative are discussed *infra* beginning at note 72. Cases in which the courts found the inference adequate are discussed *infra* beginning at note 15.

[10] See e.g., 18 U.S.C.A. § 1505 (obstruction of pending proceeding); 18 U.S.C.A. § 1510 (obstruction of a criminal investigation); 18 U.S.C.A. § 1001 (making false statements).

[11] Frequently, in cases where the inference was rejected, there were uncontested innocent explanations for the transactions in question. *See, e.g., SEC v. Troung*, 98 F. Supp. 2d 1086 (N.D. Cal. 2000) discussed infra beginning at note 15. Conversely, in cases where the inference was deemed sufficient frequently there was no credible explanation for the transactions. *See, e.g., SEC v. Warde*, 151 F.3d 42, 46 (2d Cir. 1998) discussed infra beginning at note 73.

[12] These cases are discussed infra beginning at notes 139 and 183.

[13] *See supra* note 2.

[14] 98 F. Supp. 2d 1086 (N.D. Cal. 2000).

[15] Id. at 1088.

[16] Id. at 1090-91.

[17] Id.

[18] Id. at 1089-90.

[19] Id. at 1090. On March 18, his sale of 19,500 shares constituted 29.6 percent of the daily MDI share volume. Id. Although it is unclear from the opinion, it appears MDI had an insider trading policy which required pre-clearance of trades in company stock by the general counsel.

Apparently, compliance with that policy by Hahn was not considered significant by the SEC. *See also infra* note 181.

[20.] Id. at 1092-94.

[21.] Id. at 1091.

[22.] Id. at 1094.

[23.] Id.

[24.] "Short selling is a device whereby the speculator sells stock which he does not own, anticipating that the price will decline and that he will thereby be enabled to 'cover,' or make delivery of the stock sold, by purchasing it at the lesser price. If the decline materializes, the short seller realizes as a profit the differential between the sales price and the lower purchase or covering price." Louis Loss & Joel Seligman, Fundamentals of Securities Regulation 699 (3d ed. 1988) (quoting Stock Exchange Practices, Report of Comm. on Banking & Currency, S. Rep. No. 1455, at 50-51 (1934)) (internal quotation marks omitted).

[25.] Id. at 1094, 1100.

[26.] Id. at 1101.

[27.] Id. at 1094, 1100.

[28.] Id. at 1102.

[29.] Id. at 1098-99.

[30.] Id. at 1099.

[31.] Id.

[32.] Id at 1098-1100.

[33.] Id at 1099.

[34.] Id at 1098-99.

[35.] Id. at 1102; Nguyen did not have a history of trading in MDI shares.

[36.] Id. at 1102-03.

[37.] Id. at 1101-02.

[38.] Id at 1089-90.

[39.] Id. at 1100-01.

[40.] Id. at 1101.

[41.] Id.

[42.] Id. at 1094.

[43.] Id.

[44.] *SEC v. Goldinger*, No. 95-56092, 1997 WL 21221 (9th Cir. Jan. 14, 1997) (not for publication). *Cf.* Fed. R. App. P. 32.1 (On April 12, 2006, the U.S. Supreme Court approved new Appellate Rule 32.1, permitting citation to opinions issued not for publication on or after January 1, 2007.)

[45.] Goldinger, 1997 WL 21221, at *3.

[46.] Id.

[47.] Id. at *1.

[48.] Id.

[49.] Id.

[50] Id. Others in the office also overheard Goldinger comment to Cohen that Thrifty's put options were over priced. Id. at *2.

[51] Id.

[52] Id. The SEC based its complaint on the misappropriation theory. Under that theory "a person commits fraud 'in connection with' a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information." *United States v. O'Hagan*, 521 U.S. 642, 652 (1997).

[53] *Goldinger*, 1997 WL 21221, at *3 (emphasis in original).

[54] The facts demonstrate that Cohen and the others in the office knew that: (1) Goldinger had a client who was a large shareholder in Thrifty; (2) Goldinger had a client meeting scheduled for later that day at which Thrifty would be discussed; (3) research indicated recent heavy trading in Thrifty; (4) a market report speculated that the company was a takeover target; and (5) Thrifty's stock was undervalued. For professional advisors such as Cohen and the others, these facts provided more than an adequate basis for concluding that Thrifty was, in fact, a takeover target as the market report suggested. *Cf. SEC v. Materia*, 745 F.2d 197, 199 (2d Cir. 1984) (noting that any information about a possible takeover target can send the target company's share price soaring).

[55] The SEC did not offer sufficient evidence to support its characterizations. *Goldinger*, 1997 WL 21221, at *2.

[56] Id.

[57] *SEC v. Gonzalez de Castilla*, 184 F. Supp. 2d 365 (S.D.N.Y. 2002).

[58] Id. at 379.

[59] Id. at 367-68.

[60] Id. at 371-72.

[61] Id. at 377-80.

[62] Id. at 368.

[63] Id. at 377.

[64] Id. at 369-70. A Schedule 13D must be filed under Section 13(d) of the Exchange Act when a person acquires 5% of an issuer's outstanding securities. *See* 17 C.F.R. § 240.13d-1(a). The filing of a Schedule 13D does not necessarily mean that the purchaser intends to acquire the company whose shares were purchased. In part, the form requires the filer to disclose his or her intentions. 17 C.F.R. § 240.13d-1(b). Here, there is no indication that the filer stated it intended to acquire the company in the forms filed. Similarly, negotiating a stand still agreement, does not necessarily mean that a merger is planned. To the contrary, companies frequently negotiate such an agreement when a person has been acquiring an issuer's securities and the company is seeking an assurance that further purchases will not be made. *See generally*, Nicole E. Clark, Doing Deals 2006: Understanding the Nuts & Bolts of Transactional Practice Various Preliminary Agreements, PRACTISING LAW INSTITUTE PLI Order No. 8440, (Mar. 22, 2006); Guhan Subramanian Essay, Bargaining In The Shadow Of Takeover Defenses, YALE L. J., (Dec., 2003). Since neither of these points support its argument, the SEC's citation to these pieces of evidence as supporting facts only serves to underscore the speculative nature of the agency's proof.

[65] Id. at 380. The SEC's complaint in this case was written using broad conclusions, generally alleging that Duclaud had communicated material nonpublic information to the other defendants. Although the defendants challenged the sufficiency of the complaint under Federal Civil Rules 9(b) and 12(b)(6), the court permitted the case to proceed. *SEC v. Gonzalez de Castilla*, No. 99 Civ. 3999 (RWS), 2001 WL 940560 (S.D.N.Y. Aug. 20, 2001). If the SEC were required to state with specificity the facts on which its conclusions of illegal conduct are based, perhaps the courts

and defendants would be spared the burden and cost of extended discovery when, as here, it was clearly not merited based on the evidence the SEC developed during its pre-complaint investigation. *See generally SEC v. Pimco Advisors Fund Management LLC*, 341 F. Supp. 2d 454 (S.D. N.Y. 2004) (holding the SEC's complaint met the heightened pleading standard of Rule 9(b)); *SEC v. Lambert*, 38 F. Supp. 2d 1348 (S.D.Fla. 1999) (holding that, although the SEC failed to identify the alleged tipper, the SEC's complaint stated a claim for insider trading); *SEC v. Feminella*, 947 F. Supp. 722 (S.D.N.Y. 1996) (denying defendant's motion to dismiss because complaint gave defendant "fair notice" of the SEC's claims). *Cf. SEC v. Jerry T. O'Brien, Inc.*, 467 U.S. 735, 751 (1984) (noting importance that investigations into violations of federal securities laws be conducted in an expeditious manner).

[66] *Gonzalez de Castilla*, 184 F. Supp. 2d at 380.

[67] Id. at 367, 379-80.

[68] Id. at 368.

[69] Although the court granted summary judgment in favor of all defendants, it permitted the SEC to amend the complaint to add another insider trading claim. Id. at 380-81.

[70] The SEC seems to have implicitly recognized the fact that evidence implying guilt is necessary to support an inference of tipping. In both *Goldinger* and *Gonzalez de Castilla*, the SEC sought to support inferences of tipping with conclusory allegations suggesting wrongful conduct. In both cases, however, the SEC failed to offer facts to support its conclusions. *Goldinger*, 1997 WL 21221, at *2; *Gonzalez de Castilla*, 184 F. Supp. 2d at 380.

[71] The decision in *SEC v. Switzer*, 590 F. Supp 756 (W.D. Okla. 1984), is consistent with *Goldinger*, *Truong* and *Gonzalez de Castilla*. The decision, however, was rendered after a bench trial when the court could consider the credibility of the witnesses, a factor which could not be utilized in making the decisions in the cases discussed in the text. In *Switzer*, the SEC brought an insider trading action against then Oklahoma football coach Barry Switzer and two groups with whom he traded. Id. at 757. The weekend before the trades were placed, Switzer overheard George Platt, chairman of TIC which owned a controlling interest in publicly traded Phoenix, talking with his wife about the possible liquidation of Phoenix. Id. at 762. Based on this information, and just prior to the public announcement that Phoenix may be liquidated, Switzer, through two groups, purchased shares in Phoenix. Id. at 763. One group was a partnership through which Switzer usually traded. Id. The second was a group of friends who financed Switzer's interest in the purchases. Id. All the shares were sold at a substantial profit after the announcement. Id. at 759. The court rejected the SEC's efforts to infer illegal tipping from the evidence of trading and contact among the defendants. The court found for the defendants, holding that Platt did not breach his duty to the company because he did not intend to communicate the information to Switzer. Id. at 766. The court also concluded that Switzer did not know that the facts he heard were material nonpublic information, although he knew Platt was chairman of the parent company of Phoenix. Id. There was no evidence of deceptive conduct by the defendants.

[72] 151 F.3d 42 (2d Cir. 1998).

[73] Id. at 47.

[74] Id. at 45.

[75] Id. at 45-46.

[76] The standard used to make that determination is similar to the test employed by the district courts in ruling on a motion for a direct verdict. *See SEC v. Warde*, 151 F.3d 42, 46 (2d Cir. 1998) ("We will overturn a jury's verdict in favor of a plaintiff if the evidence supporting the verdict, viewed in the light most favorable to the plaintiff, is insufficient to support a reasonable finding in plaintiff's favor. The test is the same as it would be if the question were whether the case should have been permitted to go to the jury.")

[77] *Warde*, 151 F.3d 42 (2d Cir. 1998).

[78] Id. at 45.

[79] Id.

[80] Id. at 45-46. A "stock warrant" is a security instrument "granting the holder a long-term option to buy shares at a fixed price" and is "commonly attached to preferred stocks or bonds." Black's Law Dictionary (8th ed. 2004) ("warrant"). Typically a warrant can be purchased for a fraction of the per-share cost. Additionally, because a warrant is only good for a specific period of time it is a more risky investment than purchasing the underlying shares. *Warde*, 151 F.3d 46 n.1.

[81] Id. at 45-46.

[82] Id.

[83] Id. at 46.

[84] Id. at 49. Under Section 16(a) of the Exchange Act, a corporation's officers, directors, and any beneficial owners of more than 10% of a class of the company's securities must file a statement of ownership regarding those securities with the SEC. 15 U.S.C.A. § 78p(a). The initial filing is on Form 3. 17 C.F.R. § 240.16a-3. Any changes in ownership are reported on Form 4. Id. Section 16(b) of the 1934 Act also precludes an officer, director, or beneficial owner of 10% of the company's stock from the "purchase and sale" or the "sale and purchase" of the issuer's stock securities within a six month period. 15 U.S.C.A. § 78p(b). Any covered person who profits from such a trade can be held liable in an action by the company for the profits. Id. Section 16(b) is the only express "insider trading" section in the Exchange Act as originally enacted in 1934. The anti-fraud provisions of the Act and the resulting case law have shaped current insider trading law. Since the Act's enactment, Congress has enacted legislation permitting increased penalties and fines for insider trading. 15 U.S.C.A. § 78u-1.

[85] Id. at 47-48.

[86] Id. at 46, 48.

[87] Id. at 46.

[88] Id. at 47.

[89] Id.

[90] Id. at 47-48.

[91] Id.

[92] Id. at 48.

[93] Id. at 49.

[94] 229 F. 3d 68 (1st Cir. 2000).

[95] Id. at 71-72.

[96] Id. at 72-73.

[97] Id. at 72, 75.

[98] Id. at 73.

[99] Id.

[100] Id.

[101] Id.

[102] Id. at 73.

[103] Id.

[104] Id. Sargent was also indicted for insider trading. Id. At the conclusion of the evidence the district court granted a defense motion for acquittal. Id. The SEC enforcement action heard by the

circuit court was based primarily on the evidence from the criminal case because the district court refused in the civil enforcement action to permit any discovery in view of the prior proceedings. Id. at 80.

[105] Id. at 75.

[106] Id. at 75.

[107] Id. at 79-80. Subsequently, the First Circuit decided *SEC v. Happ*, 392 F. 3d 12 (1st Cir. 2004), which upheld a jury verdict finding the defendant liable for inside trading. Although the ultimate issue in Happ focused on whether the defendant traded on inside information, the key question was whether the information obtained from insiders was, in fact, material. *But see, U.S. v. Cassese*, 428 F.3d 92 (2d Cir. 2005) (affirming the district court's decision granting defendant's post trial motion for acquittal where the circumstantial evidence was insufficient to establish willfulness in a criminal inside trading case).

[108] 2000 WL 1376246 (S.D.N.Y. Sep 25, 2000) (NO. 98 CIV., 7347 (DLC)).

[109] Id. at *1.

[110] Id.

[111] Id.

[112] Id.

[113] Id.

[114] Id. at *3.

[115] Id. at *2.

[116] Id.

[117] Id. at *1.

[118] Id.

[119] Id.

[120] 240 F.3d. 18 (1st Cir. 2001).

[121] Id. at 19.

[122] Id. at 20.

[123] Id.

[124] Id.

[125] Id. at 23.

[126] Id. at 20, 23.

[127] Id. at 20.

[128] Id.

[129] Id.

[130] Id. at 22. Recently, a corporate employee was indicted for violating 18 U.S.C.A. § 1001 (making false statements to a federal official) for making misleading statements to investigators from a private law firm conducting an internal corporate investigation where the witness knew the statements would be given to government investigators. The witness later pled guilty. *See* Jim Walden & Allen Burton, "Lawyers Beware," Business Crimes May 2005; Carrie Johnson, "Lawyers In the Limelight; SEC Helps Police Their Misconduct," The Washington Post Nov. 20, 2004. *See also* the Second Superseding Indictment in *United States v. Singleton*, Crim. No. H-04-514-55 (S.D. Tex. Mar. 2006) (Count X contains an allegation of obstruction of justice in violation of 18 U.S. 6.5(5)(23)(c)(2) based on statements made to lawyers conducting an internal investigation where it was clear that the material could go to the government.).

[131] *Larrabee*, 240 F.3d. at 24.

[132] Id.

[133] Id. at 22.

[134] Id. at 21-22.

[135] Id. at 24-25.

[136] The decision in *SEC v. Pardue*, 2005 WL 736884 (E.D.Pa., April 01, 2005), is consistent with the rule. While the court's decision was made after a bench trial and, thus, was not rendered in the same procedural posture as the cases in the text, the presence of "plus factor" evidence supported a verdict for the SEC in a circumstantial insider trading case. Id. at *16-18. In Pardue, the SEC brought an enforcement action alleging that the defendant traded based on inside information concerning an impending acquisition of a company founded by his wife's family and at which he previously worked. In finding for the SEC, the court noted the suspicious timing of the defendant's trades, that he liquidated other holdings at a loss to purchase the shares, and that "none of Pardue's alternative explanations supported his conduct. Many of the events upon which he relied occurred before his decision to sell. The rest have been dismissed." Id. at *16; *see also supra* note 71. Clearly, the defendant's lack of candor was a plus factor.

[137] Even when the contact/trade facts presents a very strong pattern, courts have looked to "plus factor" evidence to support an inference of tipping. In *SEC v. Musella*, 578 F. Supp. 425 (S.D.N.Y. 1984) ("Musella I"), the SEC presented evidence demonstrating that defendants, who had never before traded equity stock, repeatedly took high risk positions in stocks and that one defendant had access to insider information on each stock through his law firm employment. Nevertheless, before concluding that the SEC had presented a prima facie case on its motion for a preliminary injunction, the court looked to, and relied on, the fact that the defendants were unable to present any credible explanation for their trades and on an adverse inference drawn from the defendants' invocation of the Fifth Amendment to rule in favor of the government. Similarly, when the case finally proceeded to trial against the sole remaining defendant, the court did not base its decision solely on the contacts and repeated trading in shares of companies who were clients of the law firm where the one defendant had been employed. Rather, the court keyed its findings for the SEC to the lack of any credible explanation for the trades and evidence it concluded reflected a consciousness of guilt – a "plus factor." *SEC v. Musella*, 748 F. Supp. 1028 (S.D.N.Y. 1989) ("Musella II"); *see also*, *SEC v. Singer*, 786 F. Supp. 1158, 1165 (S.D.N.Y. 1992) (noting that "arguably" there may be enough similarity between the evidence here and in Musella I and Musella II to permit the case to proceed to trial, but basing the decision to go forward on direct evidence of tipping.). *Cf. Deutsche Bank Securities, Inc. v. Montana Board of Investments*, No. 5185, 5185A 21 A.D.3d 90, 97, (slip op), (N.Y. App. Div. June 14, 2005) (citing Truong, the court refused to permit discovery in a class action alleging insider trading, where plaintiff argued the contact/trade information inferred insider trading); *Froid v. Berner*, 649 F. Supp. 1418 (D.N.J. 1986) (granting summary judgment in securities class action in favor of defendants where court refused to imply insider trading from contact/trade evidence in view of innocent explanations for transactions).

[138] *SEC v. Adler*, 137 F.3d 1325 (11th Cir. 1998); *SEC v. Ginsburg*, 362 F.3d 1292 (11th Cir. 2004).

[139] 137 F.3d 1325 (11th Cir. 1998).

[140] Id. at 1344.

[141] Id at 1340.

[142] Id. at 1329.

[143] Id. at 1331.

[144] Id.

[145] Id.

[146] Id.

[147] Id.

[148] Id. at 1331.

[149] Id.

[150] Id.

[151] Id. The court's opinion does not indicate the sequence of these telephone calls.

[152] Id.

[153] Id.

[154] Id.

[155] Id.

[156] Id. at 1329-30.

[157] Id.

[158] Id. at 1330. A limit order is a directive to either purchase or sell stock, contingent on price. Black's Law Dictionary (8th ed. 2004) ("order"). In contrast, a market order directs the broker to executed the transaction at the then available market price. Id. Since, execution of a limit order is contingent on price, there is no assurance the transaction will be consummated, in contrast to a market order.

[159] *Adler*, 137 F.3d at 1330.

[160] Id.

[161] Id.

[162] Id. at 1342.

[163] Id. at 1330-31.

[164] Id.

[165] Id. at 1342.

[166] Id. at 1343.

[167] This conclusion was based on the language of Exchange Act §10b and Rule 10b-5, both of which use the phrase "on the basis of material non-public information...." The language can be interpreted to require a causal link between possession of the information and the trades. *See, e.g.*, *United States v. Smith*, 155 F.3d, 1051, 1068 (9th Cir. 1998); Allan Horwich, Possession Versus Use: Is There a Causation Element in the Prohibition on Insider Trading?, 52 Bus. Law. 1235, 1268-69 (1997). The SEC put an end to the "use" vs. "possession" issue by enacting Rule 10b-5(1). Exchange Act Release No. 33-7881 (Aug. 15, 2000). The approach the court adopted to the question of "use" is consistent with its approach to evaluating factual inferences of tipping – both involved the evaluation of rebuttable inferences by the jury. *See also*, *United States v. Causey*, Crim. No. H-04-025-55, 2005 WL 3560632 (S.D.Tex., Dec. 29, 2005) (discussing the issue of "use vs. possession").

[168] *Adler*, 137 F.3d at 1343.

[169] Id. at 1342.

[170] Id. at 1341.

[171] Id. at 1342.

[172] Id. at 1340-43.

[173] Id. at 1343.

[174] Id. at 1330. *See, e.g.*, Rule 10(b)5-1(c), 17 C.F.R. § 240.10b5-1(c), enacted after Adler that makes qualifying prior trading arrangements an affirmation defense to trading "on the basis of" insider information.

[175] Id. at 1330-31.

[176] Id. at 1331.

[177] Id. at 1330.

[178] Id.

[179] Id. at 1331.

[180] For example, as to Choy, if he was tipped by Pegram, then the first inference is that Pegram was tipped and the second is that Pegram tipped Choy, something which could not happen if the first inference was incorrect. As to Ishler, if he was tipped by Pegram – the SEC could not decide if it was Pegram or Adler – then the first inference is that Adler tipped Pegram and second inference is that Pegram passed on the illegal tip to Ishler. *See also infra* note 182.

[181] The SEC's complaint also claimed that three years prior to the transactions discussed above, Pegram had traded on inside information he obtained in a company board meeting, although at the time the general counsel of the company cleared Pegram to trade. The district court granted summary judgment on that claim prior to trial finding that the information Pegram learned at the board meeting was not material. The Court reversed, concluding that there was a material dispute of fact regarding the materiality of the information Pegram learned at the meeting, precluding summary judgment. *Adler*, 137 F.3d at 1339.

[182] In conspiracy cases, however, courts are mindful of the morass created by inferences upon inferences. *See generally Direct Sales Co. v. United States*, 319 U.S. 703, 711 (1943) ("[c]harges of conspiracy are not to be made out by piling inference upon inference"); *United States v. Sturman*, 951 F.2d 1466, 1475 (6th Cir. 1991) (quoting Direct Sales); *United States v. Cardenas Alvarado*, 806 F.2d 566, 569 (5th Cir. 1986).

[183] *SEC v. Ginsburg*, 362 F.3d 1292 (11th Cir. 2004).

[184] Id. at 1295.

[185] Id. at 1296.

[186] Id.

[187] Id.

[188] Id.

[189] Id. at 1297.

[190] Id.

[191] Id.

[192] Id.

[193] Id.

[194] Id.

[195] Id.

[196] Id. at 1299. Ginsburg was tried to a jury which found in favor of the SEC and against all defendants. In granting defendants' post trial motions requesting that the verdict be set aside and that judgment be entered in their favor as a matter of law, the district court concluded that the Eleventh Circuit's rulings concerning drawing inferences from circumstantial evidence utilized different standards. *SEC v. Ginsburg*, 242 F. Supp. 2d 1310, 1315-16 (S.D. Fla. 2002). Specifically, the district court found that the standard for considering permissible inferences used in Adler differed materially from that used by the circuit court in a line of employment

cases. Id. at 1318-19. Relying on the standard used in the employment cases, rather than that used by Adler, the court concluded that the contacts between Scott and the other family members and the trading were insufficient to support a jury verdict based in part on an inference of tipping. Id. at 1319. The circuit court rejected this analysis, distinguishing its employment cases. *Ginsburg*, 362 F.3d at 1298-99.

[197.] Id. at 1299.

[198.] Id. at 1300.

[199.] Id. at 1301, note 2.

[200.] Id.

[201.] In ruling on a pre-verdict motion such as a motion for summary judgment, courts must find sufficient evidence to support the non-moving party's position. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 252 (1986) (holding that the "mere existence of a scintilla of evidence in support of the plaintiff's position will be insufficient; there must be evidence on which the jury could reasonably find for the plaintiff."); *see also*, *Morse v. Lower Merion Sch. Dist.*, 132 F.3d 902, 906 (3d Cir. 1997) (stating that in deciding a motion to dismiss the court need not credit a complaint's "bald assertions.").

[202.] *See supra* note 76.

[203.] *See supra* note 2.

[204.] The SEC as a matter of policy issues press releases covering all of its enforcement actions. *See e.g.*, http://www.sec.gov/news/press.shtml.

[205.] *See supra* note 2.

[206.] In criminal cases contact/trade facts unsupported by a plus factor may be offered by the government as evidence of a criminal conspiracy. Thus, in *United States v. Gutierrez*, the court denied a defense motion in limine which sought to exclude contact/trade evidence relating to other family members of the defendant in a conspiracy to commit securities fraud case. 181 F. Supp. 2d 350, 356 (S.D.N.Y. 2002). The court held that the question of whether the trading by other family members was relevant and admissible was "not a particularly difficult question in this case." Id. at 353.

[207.] In civil cases the remedies and sanctions imposed may include a statutory injunction, disgorgement, pre-judgment interest, fines and, where appropriate, an officer/director bar. 15 U.S.C.A. § 78u. In criminal cases the penalties can include a term of imprisonment and fines. 15 U.S.C.A. § 78ff.

[208.] *SEC v. Ginsburg*, 362 F.3d 1301 (11th Cir. 2004); *see e.g.*, *In Re WorldCom, Inc. Securities Litigation*, No. 03-9350 Brief of the Securities and Exchange Commission, Amicus Curiae (2d Cir. Apr. 16, 2004), available at http://www.sec.gov/litigation/briefs/wchevesi_amicus.htm.

[209.] For example, under the Adler-Ginsburg approach, virtually any officer or director involved in a merger could potentially face insider trading charges that would have to go to verdict to be resolved. Prior to the announcement of a merger, trading typically increases significantly in the shares of the company being acquired based on what economists called "leakage." That leakage, in part, results from trading by persons who have pieced together various bits of immaterial information from events such as the increased activity that typically swirls around entities involved in merger discussions. Gregg A. Jarrell & Annette B. Poulsen, Stock Trading before the Announcement of Tender Offers: Insider Trading or Market Anticipation?, Journal of Law, Economics and Organization, vol. 5(2), at 225-48 (1989); Sara Fisher Ellison & Wallace P. Mullin, Gradual Incorporation of Information into Stock Prices: Empirical Strategies, NBER Working Papers 6218, (1997) National Bureau of Economic Research, Inc.; Arthur J. Keown & John M. Pinkerton, Merger Announcements and Insider Trading Activity: An Empirical Investigation, JOURNAL OF FINANCE, American Finance Assoc., vol. 36(4), at 855-69 (1981). This type of analysis and trad-

ing is beneficial to the markets because it aids efficiency. *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 165 (2d Cir. 1980) (permitting "[a] skilled analyst with knowledge of [a] company and the industry [to] piece seemingly inconsequential data together with public information into a mosaic which reveals material non-public information."). Yet, under the approach adopted by the Eleventh Circuit, any corporate officer or director involved in a merger could potentially be named as a defendant in an insider trading prosecution if he or she encountered a person who analyzed bits of immaterial information as the merger discussions continued and then traded. This prospect can only serve to discourage proper analysis and trading which is beneficial to the markets and chill the ability of companies to recruit qualified officers and directors who may fear inappropriate prosecutions and liability. *Cf. SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 9 (2d Cir. 1977) (describing the relationship between a corporate spokesperson and an analyst as analogous to a "fencing match conducted on a tightrope."). *See generally*, Frank C. Razzano, "Insider Trading… or Not?" Business Law Today, 34, 4 (May/June 2006) (stating that "ambiguous circumstances and trading may often be transformed by the prosecution into circumstantial evidence of insider trading.").