Is the DOJ and SEC War on Insider Trading Rewriting the Rules?

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TRENDS IN RECENT INSIDER TRADING CASES

By: Thomas O. Gorman[1]

I. Introduction

A. Insider trading has long been a staple of SEC Enforcement and the Department of Justice.

B. Aggressive insider trading enforcement by the DOJ and, in particular the U.S. Attorney's Office for the Southern District of New York and the SEC is raising questions about the dividing line between civil and criminal enforcement.

C. In criminal enforcement the Galleon insider trading prosecutions have made extensive use of wire taps and wired informants. These are techniques which while not unknown in insider trading cases have traditionally been used in drug and organized crime investigations and prosecutions.

D. At the same time the SEC has been very aggressive in bringing insider trading cases at times based on little more that information about trading in relation to a market event such as a merger announcement. In other instances the SEC seems to be trying to broaden the definition of insider trading.

E. An analysis of recent insider trading cases brought by the DOJ and the SEC suggests that the two agencies will at times move forward in lock step. In others however the DOJ can be expected to take the lead using its blue collar techniques while the SEC will work to expand the reach of enforcement by aggressively utilizing its traditional approach which centers on an analysis of trading and market events.

II. Blue Collar Tactics in Insider Trading Cases: DOJ, the SEC, Galleon and Expert Networks

A. ***The Galleon cases:*** In October 2009 the U.S. Attorney and the SEC filed insider trading cases centered on the owner of the multibillion dollar hedge fund managed by Galleon Management, L.P.

B. The criminal cases initially named five defendants in two cases: First *U.S. v. Rajarantnam*, Case No. 09 Mag 2306 (S.D.N.Y.) named as a defendant Raj Rajarantanam, the managing member of Galleon Management. In the second, *U.S. v. Chiesi*, Case No. 09 Mag 2307 (S.D.N.Y.), the defendants are Danielle Chiesi, an employee of new Castle Funds, LLC, Mark Kurland, a senior executive of New Castle, and Robert Moffat, senior vice president and group executive at IBM.

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1. The initial charges were based on overlapping insider trading schemes which began as early as 2006 which were claimed to have yielded $20 million in illegal trading profits.

2. The schemes involved trading in the shares of Polycom, Hilton Hotels, Google, Clearwire, Akami, Advanced Micro Devices or ADM, People Support, Intel and Sun Microsystems.

3. One scheme began in January 2006 and continued through July 2007. Here Mr. Rajarantanam is alleged to have traded on inside information about Polycom, Hilton and Google. The information came from a person identified at the time as a confidential cooperating witness who in turn obtained it from multiple sources.

4. A second scheme is alleged to have involved Messrs. Rajarantanam and Goel and took place between March 2008 and October 2008. It involved trading in the shares of Clearwire. A third, which took place from August 2008 to October 2008, involved Mr. Rajarantanam and Ms. Chiesi and trading in the shares of Akamai and AMD.

5. These cases were the largest insider trading cases based on wire taps, wired informants and taped conversations.

6. Ultimately Mr. Rajarantanam was convicted following a jury trial. He is currently awaiting sentencing. Ms. Chiesi and each of her co-defendants pleaded guilty.

C. The SEC brought a parallel case which combines the two criminal cases and adds the Galleon management company as a defendant. *SEC v. Galleon Management, L.P.*, Civil Action No. 09-CV-8811 (S.D.N.Y. Oct. 16, 2009).

D. Since the filing of the initial cases additional criminal and civil cases additional charges have been brought related to both groups of cases. The cases typically center on information regarding merger discussions or earnings releases. To date fourteen individuals have pleaded guilty in the criminal cases including all of the defendants in the *Chiesi* case. The SEC has settled with nine defendants. Generally, the Commission has settled with the criminal defendants as they have entered into guilty pleas.

E. ***The Cutillo cases:*** Shortly after the filing of the Galleon cases, charges were brought against those involved in an insider trading ring which originated at the law firm of Ropes and Gray and which overlapped with Galleon. Both criminal and civil charges were filed. *See, e.g., U.S. v. Goffer,* Case No. 9 Mg. 2438 (S.D.N.Y.); SEC *v. Cutillo,* Civil Action No. 09-09208 (S.D.N.Y. Filed July 2, 2009).

F. ***Expert network cases:*** Since the filing of these cases, the Manhattan U.S. Attorneys Office has continued to focus on insider trading. In late November

2010, an insider trading probe being conducted by that office became public when the FBI conducted simultaneous raids to execute search warrants at three firms: Level Global Investors LLP, Diamondback Capital Management LL and Loch Capital Management. Boxes of records were seized.

G. On December 16, 2010, a criminal complaint naming four defendants was unsealed as part of the expert network investigation. *U.S. v. Shimoon*, Case No. 10 Mag 2923 (S.D.N.Y. Dec. 16 2010). The defendants are Walter Shimoon, formerly a senior director of business development at Flextronics International, Inc., Mark Longoriam formerly of AMD, Manosha Karunatilaka, formerly of Taiwan Semiconductor Manufacturing Company, and James Fleishman, formerly employed at an expert networking firm Primary Global Research LLC.

1. The complaint alleges that inside information was communicate about AMD financial information and Apple sales and purchase forecasts.

2. It charges conspiracy to commit securities fraud and conspiracy to commit wire fraud.

3. It did not allege securities fraud or insider trading.

4. The complaint is based information from five cooperating witnesses and recordings of conversations

H. Subsequently insider trading charges were filed by the U.S. Attorney's Office and the SEC. *See, e.g., SEC v. Longoria,* Civil Action no. 11-CF-07530 (S.D.N.Y.)

1. The first of the expert networking cases to proceed to trial was *US. v. Jiau,* 11-cr-00161 (S.D.N.Y.). The defendant was former Primary Global Research LLC consultant Winifred Jiau. She was charged with furnishing inside information to hedge fund managers who were clients of Primary Global. Specifically, during the period 2006 to 2008 she was charged with furnishing information regarding up coming earnings releases for NVIDIA Corporation and Marvel technology Group, Ltd. Mr. Jiau was convicted following a jury trial.

2. Co-defendants Samir Barai, a portfolio manager for two different New York hedge funds, and Son Ngoc Nguyen, a former senior financial analyst for NVIDIA Corporation pleaded guilty. Mr. Barai pleaded guilty to one count of conspiracy to commit securities fraud and wire fraud, one count of securities fraud, one count of wire fraud and one count of obstruction of justice. Mr. Nguyen pleaded guilty to one count of conspiracy to commit securities fraud and wire fraud.

I. In some instances, civil and criminal insider trading charges are brought following a traditional insider trading investigation. Frequently in these cases there are repeated violations or egregious conduct.

1. *SEC v. Sebbag,* Case No. 10-cv-4242 (S.D.N.Y. Filed May 26, 2010); *U.S. v. Hoxie & Sebbag* (S.D.N.Y. Case No. 10-cv-4242 (S.D.N.Y. Filed May 26, 2010) are cases naming as defendants Bonnie Hoxie and her boyfriend Yonni Sebbag. Ms. Hoxie was an administrative assistant to a high level executive at The Walt Disney Company. The case stems from an undercover sting operation in which FBI agents posed as traders responding to a letter circulated to a number of hedge funds offering to sell inside information on an upcoming Disney earnings call. After a series of e-mails Mr. Sebbag sold the information to an undercover FBI agent. Both defendants later pleaded guilty.

2. *SEC v. Talbot* (D. Mass.); U.S. *v. Talbot*, No. 3:10-cr-30036 (D. Mass). The cases name as defendants Peter Talbot, formerly an employee of Hartford Investment Management Company and his nephew Carl Binette. Mr. Talbot is alleged to have obtained material non-public information about talks between his company and Safeo. Later Safeco was acquired by Liberty Mutual, not Hartford. Mr. Talbot is alleged to have misappropriated the information and tipped his nephew. Both men opened an account in Mr. Binette's name and traded, making a profit of $615,833. During the investigation Mr. Binette is alleged to have made false statements to the SEC.

3. *SEC v. Tajyar*; cv 09-03988 (C.D.Cal. Filed June 4, 2009), U.S. *v. Tajyar*, Case No. 2:10-cr-00310 (C.D. Cal.). Defendant Ahmad Tajyar is the owner and president of Investor Relations International. Also named as defendants are Zachary Bryant, formerly of investor relations firm Heilshorn & Associates and Omar Tajyar, Ahmad Noory and Vispi Shroff. In one conspiracy Mr. Bryant is alleged to have tipped Mr. Tajyar prior to announcements by Lippert's clients. A second involved trading on inside information about clients of Mr. Tajyar's firm.

4. *SEC v. Poteroba,* Civil Action No. 10-CF-2667 (S.D.N.Y. filed March 24, 2010); *U.S. v. Poteroba* (S.D.N.Y. Filed March 24, 2010). The criminal case names as defendants Igor Poteroba, a former Managing Director at UBS Securities and Alexei Koval. The SEC complaint also names as a defendant Alexander Vorobiev. The two cases allege that from 2005 through 2009 Mr. Poteroba tipped defendant Koval on upcoming mergers with information he learned at UBS. The criminal case is based on six illegal tips. The SEC action is based on eleven.

J. Not every criminal insider trading case involves multiple transactions however. The cases brought against a French physician involve multiple tips regarding the same event. In some instances the reaction of the traders suggests that perhaps the information was not material. At the same time the defendant was serving as an expert consultant. As noted above the USAO for New York is conducting an aggressive inquiry in this area.

1. *SEC v. Benhamou*, Civil Action No. 10-CV-8266 (S.D.N.Y. Filed Nov. 2, 20100; *U.S. v. Benhamou,* S.D.N.Y. Filed Nov. 1, 2010) are actions against French national Dr. Yves Benhamou who is a consultant to biopharmaceutical company Human Genome Sciences, Inc. and to a portfolio manager and investment advisors to a group of hedge funds that trade in healthcare related securities.

2. In November 2007 serious adverse events were reported in connection with drug trials at Human Genome. Between the time of the first report and the public announcement of that event on January 23, 2008 there were a series of meetings and discussions held to evaluate the event.

3. Dr. Benhamon is alleged to have made a series of calls to the hedge fund clients during the period in which he updated them After some calls the funds sold small amounts of Human Genome stock. In one instance they did not trade. Ultimately the funds sold their positions before the January 23 announcement, avoiding a substantial loss. Later they again established positions in the stock of the company.

4. Dr. Benhamou pleaded guilty to a four count information. He is scheduled to be sentenced on October 20, 2011. The SEC case is pending.

5. A related case is *U. S. v. Skowron,* No. 1:11-cr-00699 (S.D.N.Y.). Defendant Joseph Skowron was furnished the inside information by Dr. Benhamon. He pleaded guilty to a one count information charging conspiracy to insider trade and to obstruct justice. Sentencing is scheduled for November 18, 2011.

III. The SEC in court: Recent court rulings in insider trading cases

A. Most SEC insider trading cases settle. In the few that the Commission litigated in 2010 the rulings and verdicts obtained by the agency were mixed.

B. Rulings or verdicts favorable to the SEC.

1. *SEC v. Gowrish,* 09-5883 (N.D. Cal.) is an action against Vinayak Gowrish, a former private equity associate at TPG Capital, L.P., a hedge fund.

2. The complaint alleged that Mr. Vinayak misappropriated information from his employer about three take over transactions and tipped a friend who then tipped others.

3. Following a jury trial Mr. Vinayak was found liable.

4. The court entered a final judgment enjoining Mr. Vinayak from future violations of Exchange Act Section 10(b). The order also directed that he

pay $12,000 in disgorgement along with interest and a $100,000 civil penalty.

C. *SEC v. Teo,* 04 Civ. 1815 (D. N.J. Filed April 22, 2004) is an action in which a Newark, N.J. jury found Alfred S. Teo liable for insider trading. It also found the M.A.A.A. Trust, an entity for his children, liable for disclosure violations.

1. The Commission's complaint centers on two take-overs and disclosure violations. The first involved a tender offer for Musicland Stores Corporation. The second involved the acquisition of C-Cube Microsystems, Inc.

2. Mr. Teo was the largest shareholder in Musicland. Prior to the announcement of a tender offer by Best Buy for Musicland he learned about the proposed transaction through several confidential communications with senior management in the fall of 2000, according to the complaint.

3. Initially, the CFO and General Counsel told him that an undisclosed buyer was planning an offer. Mr. Teo later acknowledged this fact to an investment banking firm he held discussions with about conducting a leveraged buyout of the company.

4. Subsequently, the CEO of the company told him a bid by Best Buy had been delayed for a short period. The CFO later confirmed that the bid would proceed. Mr. Teo told management he supported it.

5. After learning about the tender offer, and before the announcement, Mr. Teo began buying Musicland shares. Overall he purchased 45,000 shares. He also tipped several others. Musicland announced on December 7, 2000 that it would be acquired after which the share price increased 30%. Mr. Teo sold his shares at a profit of $185,275.0. Eight others he tipped had profits of over $1.1 million, according to the complaint.

6. The MAAA trust also held a substantial number of shares of Musicland. The trust, along with Mr. Teo and another, filed a Schedule 13D which falsely disclosed their holdings. This permitted them to avoid triggering the Musicland poison pill. False reports were also filed in violation of Exchange Act Section 16(a). This stock was later sold at a profit of $22 million.

7. Teo also engaged in insider trading and illegal tipping in connection with the acquisition of C-Cube. That acquisition was announced on March 26, 2001. Mr. Teo learned about C-Cube through his board position with Cirrus Logic, Inc. At the time the company was considering acquiring C-Cube and another company. After learning this information Mr. Teo purchased 35,000 shares of C-Cube stock. He also tipped another who purchased. Following the announcement Mr. Teo sold his shares at a profit of $180,012 while his tippee had profits of $115, 155.

8. The court will determine remedies at a later date.

D. *SEC v Cuban*, 520 F. 3rd 551 (5th Cir. 2010) is an insider trading enforcement action against Mark Cuban. The SEC won a significant victor in the Fifth Circuit, obtaining a reversal of the district court's order dismissing the complaint.

1. The action centers on a 2004 PIPE offering. Mr. Cuban, who held a 6.3% stake in Mama.com learned there was to be an offering from company officials after he agreed to keep the information confidential. After a second conversation with company officials Mr. Cuban sold all of his shares prior to the public announcement of the offering. He avoided a substantial loss.

2. The district court dismissed the complaint holding that there was no breach of duty. While there was an agreement to maintain the confidentiality of the information, it did not preclude trading.

3. The Fifth Circuit reversed. The court held that all inferences must be drawn in favor of the plaintiff on a motion to dismiss. Read in this context, the complaint was sufficient.

E. *SEC v. Suman*, Case No. 07 Civ. 6625 (S.D.N.Y. Filed July 24, 2007) is a "pillow talk" insider trading case involving a husband and wife, Shane Bashir Suman and Monie Rahman. The couple maintains separate residences. She lives in North Logan, Utah and he lives in Ontario, Canada.

1. Mr. Suman worked as an information technology specialist for MDS Sciex, a division of MDS, In. MDS announced a friendly tender offer for Molecular Devices Corporation, a NASDAQ listed company, on January 29, 2007. The announcement was followed by a 45% increase in the share price.

2. During the negotiations that lead to the transaction Mr. Suman was asked at one point about significantly increasing the capacity of the e-mail system. At another he worked for several hours on a blackberry belonging to a negotiation team member that contained information about the deal and identified the bidder. Later he was asked to retrieve a document which had the deal announcement. That night he talked with his wife for 100 minutes.

3. The morning after the phone call the couple began purchasing shares and options through the wife's E-trade Canada account. Within two days they had purchases options valued at $103,516 and 12,000 shares for $287,758.54. After the announcement the position was sold at a profit of $1,039,440. Previously the account had been used for small amounts of trading. IN a subsequent interview with the Ontario Securities Commission Mr. Suman denied having any knowledge but had deleted his computer files before producing it. In the SEC's enforcement action the couple invoked the Fifth Amendment.

4. The court granted summary judgment in favor of the SEC. First, it drew and adverse inference from the refusal to testify although the court noted this was not sufficient to justify summary judgment. Second, the court noted that the husband had access to the information. Third, the trading pattern was telling because it was unusual. The court entered an injunction and ordered the couple to pay disgorgement on a joint and several basis which it wanted distributed to the victims. To "calibrate" the penalty, the court ordered the husband to pay a $2 million civil penalty and the wife a $1 million penalty.

F. *SEC v. Dorozhko*, Civil Action No. 07 Civ. 9606 (S.D.N.Y. March 2010) is a case in which the Commission won a summary judgment motion.

1. The complaint alleged that Oleksandr Dorozhko hacked into a computer system and used the information to trade. Initially the district court dismissed the complaint, concluding that there was no deception.

2. The Second Circuit reversed and remanded the case to the district court for further consideration. The court held that since a computer "hacker" essentially deceives the computer system to gain access that this may be sufficient. The issue was left for the district court.

3. On remand the district court granted summary judgment in favor of the SEC. The motion was not opposed.

G. *SEC v. Northern*, Civil Acton No. 05-CV-10983 (D. Mass. Filed May 12, 2005) is an action against Seven Northern, a former executive at Massachusetts Financial Services. Mr. Northern is the last defendant to resolve a long running insider trading case.

1. According to the SEC Mr. Northern was provided with material non-public information from an agent who attended the Treasury Department's quarterly refunding press conference. At the October 31, 2003 conference Treasury announced that it would suspend issuance of the 30 year bond later that morning. The information was embargoed until 10:00 a.m.

2. Mr. Northern is alleged to have obtained the information from the agent who attended.

3. Mr. Northern, and two other traders at MFS to whom he gave the information, traded for three MFS funds. When the news was made public the price of the bonds soared. The three funds made profits of $3.1 million.

4. Initially, Mr. Northern was named in an SEC suit filed in the Southern District of New York along with others. Mr. Northern persuaded the Commission to dismiss that case and re-file in Boston. The others settled with the SEC and pleaded guilty to criminal charges.

5. Mr. Northern tried the case to a jury which concluded in June 2009 that he was liable. In January 2010 Mr. Northern settled, consenting to the entry of a permanent injunction prohibiting future violations of Exchange Act Section 10(b). He also agreed to pay a civil penalty of $460,000.

H. Cases in which the SEC did not prevail

1. *SEC v. Rorech*, Civil Action No. 09 iv. 4329 (S.D.N.Y.). This is the first SEC enforcement action for insider trading based on securities based swaps. Following a bench trial on the merits the court found in favor of the defendants and against the SEC.

   a. The defendants were Jon-Paul Rorech, a trader in the high yield bond sales group at Deutsche Bank, and Renato Negrin, a portfolio manager for Millennium Partners, L.P., a New York based hedge fund.

   b. The complaint claimed that Mr. Rorech misappropriated inside information and then furnished it to Mr. Negrin in two unrecorded cell phone calls on July 14 and 17 2006. The information supposedly concerned amendments to a bond offering for VNU N.V., a Dutch media holding company. As a result, the complaint alleges, Mr. Negrin bought two VNU credit default swaps on behalf of Millennium on July 17 and 18, 2008. Following a July 24, 2006 announcement that VNU's bond offering would be amended, the price of the VNU CDSs increased substantially. Millennium sold its holdings for a profit of about $1.2 million.

   c. The court rejected the defendants' claim that the case should be dismissed for lack of jurisdiction. "When Congress passed the Commodity Futures Modernization Act of 2000 it provided that Section 10(b) would prohibit fraud, manipulation and insider trading as to "securities-based swap agreement . . ." as defined in Section 206B of the Graham-Leach-Bliley Act. Under that Act a security-based swap agreement is one "in which a material term is based on the price, value or volatility of any security or any group or index of securities . . . " Here, the CDS are a swap agreement within the meaning of the Act. Since the price of those CDS is based on the spread for the VNU bonds, trading in the instruments is covered by Section 10(b) the court held.

d. The court rejected the Commission's insider trading claim, ruling that there was a failure of proof. The critical question where was if the bond offering was going to be restructured. There were widespread rumors in the market that potential purchasers wanted it restructured. The Commission argued that in fact Mr. Rorech told Mr. Negrin in an unrecorded cell phone call that it would be, thereby misappropriating material non-public information. The call, which neither remembered, was suspicious since both were talking on phones that were recorded and after hanging up spoke on their cell phones. However, the evidence demonstrated that the decision to restructure the bond offering was made after the cell phone call. In addition, Mr. Rorech had spoken with his supervisor about the bond offering before the call and told them that participants in the offering were interested in a restructuring and that he was sharing that information with others. This was typical in this market.

I. *SEC v. Obus*, Case No. 1:06-cv-3150 (S.D.N.Y.) is an insider trading case against Thomas Strickland, an employee of GE Capital Corp. along with Peter Black, an employee of Wynnefield Capital, Inc. and Nelson Obus a manager at Wynnefield. The three defendants were found not liable following a bench trial.

1. The action centered on the acquisition of SunSource by Allied Capital Corp. in 2001. According to the SEC Mr. Strickland, a member of the GE Capital team underwriting the deal, tipped his friend Peter Black who in turn passed the information on to Mr. Obus who purchased SunSource shares. He made a profit of $1.34 million on the transaction.

2. The court held that Mr. Strickland did not violate any duty and that there was no deception. No confidentiality agreement existed to suggest Mr. Strickland was a temporary insider of SunSource and GE Capital did not have any confidentiality policy that was breached. This case is on appeal before the Second Circuit Court of Appeals.

J. *SEC v. Berlacher*, Civil Action No. 07-3800 (E.D. Pa. Filed Sept. 13, 2007). This is an action against Robert Berlacher and his hedge funds alleging violations of the registration provisions and insider trading in connection with a PIPE offering.

1. The SEC claimed that over a five year period Mr. Berlacher and his funds implemented an unlawful trading scheme which yielded $1.7 million in ill-gotten gains by investing in PIPE offerings without market risk. The SEC argued that the defendants violated Securities Act Section 5 by shorting the issuer's stock after learning about the PIPE and then covering with shares from the resale registration statement. The Commission also argued that this constituted insider trading.

2. Prior to trial the court dismissed the Section 5 claim.

3. After trial the court found against the SEC on the insider trading charges. With respect to one PIPE the court held the information about it was immaterial. This was an unusual offering where the insiders were selling their shares. As to each offering the court concluded that the evidence as to the terms of the confidentiality was too vague. It was all oral. The SEC did prevail on claims that Mr. Berlacher had misrepresented the position he held in the issuer's stock in entering into the agreements.

K. Mixed results

1. *SEC v. De la Maza,* Case No. 09-21977 (S.D. Fla.) is an insider trading action against Alberto Perez and Dr. Sebastian De La Maza. Following a trial the jury returned a verdict against the SEC and in favor of Dr. Sebastian De La Maza and in favor of the SEC and against Alberto Perez.

   a. The case centered on the acquisition of Neff Corporation, an equipment rental company, by Odyssey Investment Partners, LlC, a private equity fund. The transaction was announced on April 7, 2005.

   b. In February 2005 Neff and Odyssey executed a letter of intent. Due diligence began in March 2005. When the deal was announced the share price increased 51%. According to the SEC Mr. Perez is a business associate and close friend of Neff's CEO. While working in an office at Neff's headquarters two doors from the acquisition due diligence teams, he learned about the deal according to the complaint. He subsequently purchased $282,000 of Neff stock.

   c. Dr. Sebastian De la Maza, the father-in-law of Neff's CEO, learned about the deal from his daughter who is married to the CEO according to the SEC. The Doctor denied this claim.

   d. The complaint alleged violations of Exchange Act Section 10(b). Previously another defendant, Thomas Borell had prevailed on a summary judgment motion. At that time the motion of Dr. De la Maza was denied.

IV. Aggressive insider trading enforcement.

A. The SEC has been aggressive in bringing civil insider trading cases. In some instances, the cases have been built on little more than the basic facts about a significant corporate event and trading in relation to that event. In some of these cases, the complaint is filed within days of the event, typically to freeze the transfer of the trading profits. In some instances the Commission has not been able to even identify the traders at the time the complaint has been filed.

B. **Suspicious trading cases:** The SEC has brought a series of cases based on little more than the trading. *SEC v. Garcia*, Civil Action No. 10C 5268 (N.D. Ill. Filed

Aug. 20, 2010). The Commission settled with defendant Jose Fernandez Garcia. Defendant Martin Carlo Sanchez is litigating the case.

1. The complaint alleges insider trading in advance of the announcement of the bid by Potash Corporation for BHP Billton Plc. Both men took large positions in the options market shortly prior to the deal announcement

2. Both traded through Interactive Brokers. Both profited following the deal announcement.

3. To settle Mr. Garcia consented to the entry of a permanent injunction prohibiting future violations of Exchange Act Sections 10(b) and 14(e). He also agreed to disgorge his trading profits of $576,033 and pay a civil penalty of $50,000.

C. *SEC v. Compania International Financier S.A.,* Civil Action No. 11 CV 4904 (S.D.N.Y. Filed July 15, 2011).

1. The case centers on the July 11, 2011 announcement by Lonza Group Ltd. that it planned to acquire Arch Chemicals Inc. Defendant CIF has offices in Geneva, Switzerland as do defendants Coudree Capital Gestion S.A. and Chartwell Asset Management Services. Yomi Rodrik, a Turkish national, is alleged to own and/or control CIF and Coudree. Mr. Rodrik has been "sued in the past by the SEC for trading violations."

2. All of the trading in the case involved the purchase of the common shares of Arch on July 5 and 8 through the London offices of various brokerages. In total the defendants acquired just under one million shares.

3. The complaint, which alleges violations of Exchange Act Section 10(b), states that a search of available information established that there was no news of the take-over available prior to the deal announcement. The share price of the company, however, appreciated significantly prior to the announcement of the deal. The complaint also claims that multiple accounts were used to conceal the trading.

4. The Commission obtained an order freezing the assets. The case is pending.

D. *SEC. OneleTrading & Finance Ltd.,* 10 Civ. 9159 (S.D.N.Y. Filed Dec. 8, 2010) is an insider trading case initially brought against unknown traders. The action centered on trading in advance of the December 2, 2010 announcement that PepsiCo, Inc. would acquire a 66% interest in Wimm-Bill-Dann Foods OJSC.

1. The initial complaint alleged that unknown purchasers placed orders to buy 107,500 ADRs on November 29, 2010, another 132,000 on November 30 and an additional 160,000 on December 1. Following the deal announcement the traders had profits of about $2.7 million.

2. Recently the Commission amended its complaint and named Onele as a defendant. That firm traded through an account maintained at SG Private Banking (Suisse) SA in Geneva, Switzerland and placed orders for 400,000 of the ADRs in the three day time period.

3. The company resolved the case by consenting to the entry of a permanent injunction prohibiting future violations of Exchange Act Section 10(b). The company also agreed to pay disgorgement in the amount of $2,864,638 and a civil penalty in the same amount. The sums will be paid from the assets frozen at the time the Commission filed its initial action.

E. *SEC v. One or More Unknown Purchasers of Securities of Telvent GIT S.A.,* Civil Action 11 Civ. 3794 9S.D.N.Y. Filed June 3, 2011) is an action which centers on the June 1, 2011 announcement that Schneider Electric S.A., a French company, would acquire Telvent, a company based in Madrid, Spain.

1. Between April 29, 2011 and May 27, 2011 unknown purchasers bought 1,200 Telvent call options through an account at Pershing LLC. About two thirds of the options were purchased within two trading days of the announcement, representing in one instance about 52% of the daily volume for a series.

2. Following the purchases the price of the call options increased significantly. In one instance it was up 480%. After the deal announcement the account had trading profits of about $475,000.

3. The Commission filed its action two days later, obtaining an order freezing the assets and directing the account holders to identify themselves. Expedited discovery was also ordered.

F. *SEC v. One or More Unknown Purchasers of Securities of Martek Biosciences Corporation*, Case No. 10 Civ. 9527 (S.D.N.Y. Filed Dec. 22, 2010) is a case where the SEC filed its action just days after the event in order to freeze trading profits of persons as yet to be identified.

1. On December 21, 2010 Royal DSM N.V., a Dutch company, announced it would acquire all of the outstanding shares of Maryland based Martek Biosciences Corporation at a 35% premium to market. The announcement resulted in a share price increase of 36%.

2. Between December 10, 2010 and December 15, 2010, 2,616 Martek call options were purchased through an account at UBS. Those purchases represented over 90% of the volume for those contract days.

3. Following the deal announcement the account had an unrealized profit of $1.2 million.

4. The SEC filed a complaint naming the unknown trader and alleging insider trading in violation of Exchange Act Section 10(b) two days after the announcement of the transaction. A freeze order was secured over the account. Lit. Rel. No. 21792 (Dec. 23, 2010). The complaint is based on the basic facts about the deal and the trading. The investor is not identified nor is the source of the inside information. .

5. This case recently settled after being restyled as *SEC v. Abatemarco,* Civil Action No. 10 Civ. 9527 (S.D.N.Y.). The amended complaint named Mr. Abatemarco as a defendant. He is alleged to have obtained material non-public information about the pending deal from the wife of a DSM employee working on the transaction. To resolve the action Mr. Abatemarco consented to the entry of a permanent injunction prohibiting future violations of Exchange Act Sections 10(b) and 14(e) and to the entry of an order requiring him to disgorge $1,193,594 in trading profits, pay prejudgment interest of $1,438.85 and a civil penalty of $250667.15.

G. *SEC v. One or More Unknown Purchasers of Options of InterMune, Inc*., Case No. 10-Civ. 9560 (S.D.N.Y. Filed Dec. 23, 2010) is another case where the complaint is based on little more than "suspicious" trading.

1. On December 17, 2010, the European Union's Committee for Medicinal Products for Human Use announced that a drug of InterMune, Inc., a biotechnology company based in Brisbane, California would be recommended for approval. Following the announcement, the share price for the company increased about 144%.

2. On December 7 and 8, 2010 400 call options were cleared through UBS Securities LLC. The purchases represented 100% and 57%, respectively, of the volume of transactions for the two days on which they were made.

3. On December 13, 2010 an additional 237 option contracts were cleared through Barclays Capital, New York.

4. Following the December 17th announcement the two accounts had unrealized trading profits of $912,000.

5. The SEC filed its action five days after the announcement and obtained a freeze order over the two accounts. Litigation Release No. 21794 (Dec. 23, 2010).

H. Frequently these cases involve trading from overseas. For example in *SEC v. Condroyer*, Case No. 1:09-cv-3600 (N.D. Ga. Filed Dec. 22, 2009) the action was filed against two French citizens residing in Belgium, Nicolas Condroyer and Gilles Roger.

1. The case centers on the December 21, 2009 announcement by Chattem, Inc. that it had agreed to be acquired by Sanofi-Aventis. Chattem is a

manufacturer of various health care products based in Chattanooga, Tennessee. Sanofi-Aventis is a French company based in Paris. It is one of the world's largest health care product companies. The take over price was $93.50 per share, a 32.6% premium to market.

2. On December 7 and 18, 2009 Mr. Condroyer purchased 1,970 Chattem call options for $42,000. All of the purchases were out of the money at the time. The options were bought through an account at OptionsXpress, Inc., an on-line brokerage firm based in Chicago. The account was opened on November 26, 2009.

3. On December 17, 2009 Mr. Roger purchase 940 Chattem call options for $38,000. All of the options were out of the money. The purchases were made through an account at optionsXpress, Inc. that had been opened on December 8, 2009.

4. Both defendants sold their positions the day after the announcement. Mr. Condroyer had a profit of $2.8 million. Mr. Rogers had a profit of about $1.4 million.

5. The SEC filed its complaint the day after the deal announcement and obtained a temporary freeze order over each account. The complaint does not identify the source of the inside information or even if the two defendants know each other. Indeed, the complaint makes it clear that the Commission is not sure when the deal negotiations began since it alleges on "information and belief" that they began by November 2009. No supporting facts are alleged to support the information and belief claim.

I. In a number of instances, the SEC has been able to conduct discovery, identify the traders and resolve the case. Last year the Commission successfully used this approach in *SEC v. Di Nardo*, Civil Action No. 08-cv-6609 (S.D.N.Y. Filed July 25, 2008), a case initially filed in 2006 and settled last year.

1. The complaint was initially filed as an emergency action against the unknown purchasers of DRS Technologies, Inc. and American Power Conversion Corporation options. Both companies were being acquired in October 2006 by Schneider Electric S.A.

2. In an amended complaint the SEC named Gianluca Di Nardo, an Italian citizen, and his investment vehicle Corralero Holdings as defendants. That complaint alleged that Mr. Di Nardo and his company were in possession of inside information in late September when they purchased 2,400 APCC cal options for abut $299,8000. Those options were liquidated after the deal announcement at a profit of $1.4 million. Earlier Mr. Di Nardo had purchased DRS call options while in possession of inside information according to the SEC. Those options were liquated after the deal announcement at a profit of $669,750.

3. The two defendants settled the case, consenting to the entry of permanent injunctions prohibiting future violations of Exchange Act Section 10(b). They also agreed to disgorge $2,110,000 along with prejudgment interest and to pay a civil penalty of $700,000. Litigation Release No. 21687A (Oct. 7, 2010).

J. Pushing the edge: In some cases the Commission pushes the edge of what constitutes trading on inside information.

1. In *SEC v Levinberg*, Case No. 10-CV-777 (S.D.N.Y. Filed Feb. 2, 2010) presented this question.

a. This case is based on the acquisition of Scopus Video Networks, Ltd, an Israel company with a U.S. subsidiary whose shares are traded on NASDAQ, by Harmonic, Inc. The transaction went forward under a merger agreement entered into on December 22, 2008 and announced the next day.

b. In September 2008 Scopus had approached Gilat Satellite Networks, Ltd. about being acquired. Defendant Joshua Levinberg is an Executive Vice President of Corporate Development and Business Strategy of Gilat and a resident of Israel.

c. Scopus approached Gilat in an effort to persuade them to acquire the company. As part of the inducement Scopus furnished the confidential business information. Although it was labeled proprietary and a legend stated it would not be reproduced or disclosed without permission, there was no confidentially agreement.

d. The approach was not successful. Scopus nevertheless continued to pursue a deal through December 2008.

e. Defendant purchased 102,172 shares of Scopus through a U.S. brokerage account beginning on October 31, 2008 and continuing through December 17, 2008. Gilat had an insider trading policy.

f. Following the announcement that Scopus would be acquired the share price increased by 41%. Defendant made a profit of $187,996.48.

g. The Commission filed an insider trading complaint against Mr. Levinberg. He resolved that action by consenting to the entry of a permanent injunction prohibiting future violations of antifraud provisions of the Exchange Act. He also agreed to disgorge his trading profits, pay prejudgment interest and a penalty equal to the trading profits. Lit. Rel. 21405 (Feb. 3, 2010).

2. *SEC v. Steffes*, Case No. 1:10-cv-06266 (N.D. Ill. Filed Sept. 30, 2010). This case could redraw and expand the definition of inside information.

   a. The case centers on trading by a group of family members and their friends: Rex C. Steffes, Cliff Steffes, Rex R. Steffes, Bret W. Steffes, Robert J. Steffes and W. Gary Griffiths.

   b. Defendant Gary Griffiths is married to the sister of his high school class mate and long time friend Rex C. Steffes.

   c. Rex C. Steffes has three sons who are defendants: Cliff, Bret and Rex R. His brother is defendant Robert J. Steffes.

   d. The case centers on the acquisition of Florida East Coast Railway, LLC by Fortress Investment Group LLC which was announced on May 8, 2007.

   e. On December 4, 2006 the company board engaged Morgan Stanley & Co. to sell the company through a targeted auction process. By April 13, 2007 the investment bank had obtained nine separate acquisition proposals. One was from Fortress.

   f. Defendants Gary Griffiths and Cliff Steffes were employed by the rail road. According to the complaint they obtained inside information about the deal and then tipped each of the other defendants. Each defendant is alleged to have traded. Total trading profits were about $1.6 million.

   g. According to the complaint, Gary Griffiths and Cliff Steffes had inside information based on the following:

   h. Gary Griffiths was a vice president and chief mechanical officer with an office at the headquarters in Jacksonville. He reported to the COO.

   i. Cliff Steffes was a trainman at the Bowden Rail Yard in Jacksonville. He obtained his position with the assistance of his uncle, Gary Griffiths.

   j. Gary Griffiths had inside information because:

   k. In early March the CFO asked him to prepare a comprehensive list of equipment owned by the company;

   l. He became aware that there were an unusual number of yard tours (potential bidders toured). "He believed" these were provided to investment bankers for a possible sale;

m. Employees asked him if the company was being sold and they would lose their jobs; and

n. He arranged and monitored a rail trip from the Bowden to the Hialeah Yard for Fortress executives in a special rail car reserved for visitors.

o. Cliff Steffes had inside information because:

p. There was an unusual number of yard tours involving people dressed in business attire;

q. Many employees who had not personally witnessed the tours became aware of them;

r. Shortly before the tours began a number of employees expressed concern about the company being sold and the loss of jobs; and

s. The tour for the Fortress executives toured the Bowden yard where Cliff Steffes worked.

t. Robert J. Steffes settled with the Commission, consenting to the entry of a permanent injunction prohibiting future violations of Exchange Act Section 10(b). He also agreed to pay disgorgement of $104, 981 along with prejudgment interest and a civil penalty equal to the disgorgement. Litigation Release No. 21678 (Sept. 30, 2010). The other defendants are litigating the case. *See also SEC v. Tedder*, Case No. 3:08-CV-1013 (N.D. Tex. Filed June 17, 2008) (insider trading case against two employees and their tippees; the employees observed a trading black out, an executive tour and repeated closed door meetings by the GC; an inadvertent e-mail by the CEO regarding due diligence; and rumors; all but one defendant settled who lost after a jury trial).

3. *SEC v. Ni*, Case No. CV 11 0708 (N.D. Cal. Filed Feb. 16, 2011); Lit. Rel. No. 21859 (Feb. 16, 2011). Defendant Zhenyu Ni is an IT Team Lead Manger for a public company. His sister was employed by Bare Essentials, Inc., a cosmetics company with its principal office in San Francisco, California. The sister was the Director of Tax for Bare Essentials.

a. In November 2009 the sister began work on due diligence in connection with a potential acquisition of the company by Shiseido Co., Ltd, a large Japan based cosmetics manufacturer. As part of her work she had access to the deal's data room which contained confidential information.

b. In early December Mr. Ni visited his sister at her office. During the visit she took "several phone calls" according to the complaint. During the calls his sister spoke "key words" such as "due diligence file," "potential buyer" and "merger structure." Mr. Ni realized from looking around the office and the fact that she received "numerous" phone calls that "she was very busy at work."

c. On December 10 Mr. Ni purchased 1,000 shares of Bare Essentials through his father's brokerage account. Subsequently he also made four purchases of Bare Essentials securities for his account on December 16, 22, 23 and 31. In each instance he bought 3,000 share blocks of the then NASDAQ listed securities. Mr. Ni's last purchase was on January 14, 2010 when he acquired 280 call options for his account and that of his father. The trades were made while in possession of material non-public information misappropriated from Mr. Ni's sister and in violation of his duty of confidentiality to his sister according to the SEC. The sister also had a duty of confidentiality to the company.

d. Following the close of the market on January 14 Shiseido announced a tender offer for the shares of Bare Essentials. Mr. Ni sold the securities the next day for a profit of $157,066. By the end of the day the share price had increased by 42%.

e. Mr. Ni settled the Commission's claims which were based on alleged violations of Exchange Act Sections 10(b) and 14(e). He consented to the entry of a permanent injunction prohibiting future violations of each section cited in the complaint. In addition, he agreed to pay $157,615 in disgorgement and prejudgment interest and a civil penalty in the same amount. Mr. Ni's sister was not charged.

4. *SEC v. Carroll*, Case No. 3:11-cv-00165 (W.D. Ky. Filed March 17, 2011). The complaint alleges insider trading based on the possession of material non-public information regarding the take over of Steel Technologies, Inc. by Mitsui & Co. Named as defendants are four employees of Steel Technologies, Patrick Carroll, William Carroll, David Stitt and David Calcutt. Each traded. Also named as defendants are four alleged tippees: James Carroll (son of Patrick), John Monroe (friend of Christopher Calcutt) , Stephen Somers (friend of John Monroe) and Christopher Calcutt (brother of David Calcutt). Each traded.

a. None of the employee defendants were "over the wall," that is, part of the deal team. There is no allegation that any of the employee defendants misappropriated the inside information. If they do not have inside information then clearly the tippees do not.

b. The complaint alleges two key sources. For three of the four employee defendants the source is, according to the SEC, Steel Technologies then President and COO Michael Carroll who is now the President and CEO. He is not named as a defendant. He is the brother of Patrick and Tad and uncle of James. Michael was involved in the transaction according to the complaint. Each employee defendant reported to Michael. The complaint specifically identifies him as the source for:

c. David Calcutt: After detailing earlier trades unrelated to the case where the Commission suggests he had inside information, the complaint states that "[a]s a result of one or more of his communications with Michael . . .Calcutt learned material nonpublic information . . . " about the deal;

d. Patrick Carroll: After noting that Mitsui representatives toured several company facilities including one where Patrick worked the complaint claims that "[a]s a result of those tours and one or more communications with his brother Michael . .. Patrick learned material nonpublic information . . . " about the deal; and

e. William "Tad" Carroll: After alleging that on prior occasions not related to the case Michael had given him confidential information, the complaint states that as a result of "communications with his brother Michael . . . Tad learned material nonpublic information about the forthcoming … " deal.

f. The source for David Stitt is also identified but is nameless. In this regard the complaint claims that Mr. Stitt made numerous telephone calls to and from individuals at the corporate headquarters after learning that he might have to make what was characterized as an unusual trip there on short notice. Then in the space of a few minutes he received five consecutive calls from the same number at corporate headquarters. This was also "unusual" according to the complaint. Trading commenced. There is no information about the telephone number, identification of the person to whom it belongs or the individual on the other end of the five calls.

g. The case is in litigation

5. *SEC v. Knigh*t, Civ. 2:11-cv-00973 (D. Ariz. Filed May 18, 2011) is a settled action against Mary Beth Knight, a senior vice president of Choice Hotels, and her long time friend, Rebecca Norton.

a. On June 22, 2006 Ms. Knight attended a meeting for senior executives. During the meeting earnings projections for the quarter were discussed based on materials the executives had been furnished. The projections estimated that the company would fail to meet street expectations by one cent.

b. In an earlier period the market had reacted adversely when the company did not meet street expectations.

c. Subsequently, Ms. Knight told her friend Rebecca who, between June 26 and July 7 sold 3,229 shares of Choice Hotels stock. She also sold shares short. Ms. Knight sold 12,000 shares of company stock on June 27, 2006.

d. When the earnings announcement was released the share price dropped the next day nearly 25%. As a result Ms. Norton avoided losses of $65,747 and made a profit on her short position of $7,690. Ms. Knight avoided losses of $140,400.

e. Both defendants settled, consenting to the entry of a permanent injunction prohibiting future violations of Securities Act Section 17(a) and Exchange Act Section 10(b). In addition, Ms. Knight agreed to disgorge the loss avoided of $140,400. That obligation was deemed satisfied by the fact that Ms. Knight had previously given this amount to the company. Ms. Knight also agreed to disgorge the losses avoided and profits made by her friend and pay a penalty of $185,111. Ms. Norton agreed to pay a civil penalty in an amount determined by the court.

6. *SEC v. Doyle,* Civil Action No. 11-cv-4964 (S.D.N.Y. July 20, 1011) centers on the acquisition of Brink's Home Security by Tyco International, Inc. on January 18, 2010.

a. Prior to the announcement defendant Robert Doyle obtained inside information about the transaction from a person identified as one of Tyco's investment bankers, according to the SEC.

b. Specifically, the SEC alleged that Mr. Doyle obtained inside information as a result of:

(i) A reference by the Banker that he was traveling on Tyco's plane to Boca Raton and the fact that Mr. Doyle knew he often worked on mergers;

(ii) A document the banker inadvertently left at his home which identified Tyco as the "Acquirer" and Brink's as "Target;" and

(iii) Changes in the Banker's travel plans gleaned from a phone conversation which suggested to Mr. Doyle that the transaction was imminent.

c. After obtaining this information Mr. Doyle, on January 14 and 15, 2010, purchased call options and 250 Brink's shares in breach of his duty to the Banker.

d. Following the deal announcement the share price for Brink's stock increased over 30%. Mr. Doyle sold the options and exchanged his shares under the terms of the deal. Overall Mr. Doyle had profits of $88,555.

e. Mr. Doyle settled with the SEC by consenting to the entry of a permanent injunction prohibiting future violations of Exchange Act Section 10(b). He also agreed to disgorge his trading profits and pay a civil penalty of $44,277.50.

V. Market professionals

A. Insider trading cases involving market professionals frequently center on insider trading rings in which a securities professional with access to inside information such as merger negotiations repeatedly tip others. These cases tend to involve civil and criminal prosecutions.

1. *SEC v. Hollander*, Civil Action No. 11-CV-2885 (S.D.N.Y. Filed April 28, 2011) is a settled insider trading action against Jonathan Hollander, a former hedge fund professional.

a. The case centers on the acquisition of Albertsons, LLC by a group of buyers announced on January 23, 2006. Prior to the announcement Mr. Hollander learned about the deal from a friend employed by Albertsons financial advisor. Subsequently, Mr. Hollander told a family member and a friend. Each traded in the securities of Albertsons. Mr. Hollander purchased shares of stock while the family member and friend each acquired options.

b. After the deal announcement each trader sold yielding profits for Mr. Hollander of $17,742, for the family member of $72,815 and the of friend, $5,250.

c. Mr. Hollander settled the case, consenting to the entry of a permanent injunction prohibiting future violations of Exchange Act Sections 10(b). He also agreed to pay $95,807 in disgorgement plus prejudgment interest and a civil penalty equal to the amount of the disgorgement.

2. *U.S. v. Baue*r, Mag. No. 11-3536 (D. N.J. Filed April 6, 2011); *SEC v. Kluge*r, Case No. 11-cv-1936 (D. N.J. Filed April 6, 2011). These cases name as defendants Matthew Kluger, an attorney who worked at three prominent law firms, and Garrett Bauer, a professional stock trader.

   a. At the center of the case is a person identified as CC-1, a friend of each defendant. According to the criminal complaint, the insider trading scheme began in 1994 and continued until 1999 when it stopped for a period. During this time Mr. Kluger generally furnished inside information from merger deals he worked on to CC-1 who in turn passed to Mr. Bauer who traded.

   b. The scheme halted because of concerns about being apprehended. In the initial period of the scheme the men traded in five take over stocks. Mr. Kluger left the law firm where he was employed in 2001.

   c. The second phase of the scheme began in May 2006 shortly after Mr. Kluger took a position with another firm. It continued through February 2011. During this period, the group invested over $109 million in eleven take-over stocks, reaping $32,365,000 in trading profits.

   d. The scheme unraveled in March 2011 when the IRS and FBI executed a search warrant at the residence of CC-1. Subsequently, CC-1 taped conversations separately with Mr. Kluger and Mr. Bauer. On the tapes, portions of which are quoted in the criminal complaint, the two defendants discuss the insider trading and the destruction of evidence.

   e. The criminal complaint charges the two men with one count of conspiracy to commit securities fraud, eleven counts of securities fraud and one count of conspiracy to commit money laundering. In addition, each defendant has been charged with two counts of obstruction. It also seeks the forfeiture of eight bank or securities accounts and a sum of money equal to $685,000.

   f. The SEC's complaint alleges violations of Exchange Act Sections 10(b) and 14(e). Both cases are pending.

3. *U.S. v. Johnson* (E.D. Va. May 25, 2011) is an action in which Donald Johnson pleaded guilty to one count of securities fraud.

   a. Mr. Johnson is a former managing director on NASDAQ's market intelligence desk in New York. During the time period of this case he was a member of NASDAQ's Corporate Client Group.

b. On eight different occasions he traded on inside information entrusted to him by various companies as a result of his position, according to the court papers. The trades, placed between 2006 and 2009, yielded about $640,000 in profits. Mr. Johnson typically placed small trades that he thought would escape notice through his wife's account.

c. He was sentenced to 42 months in prison.

4. *SEC v. Liang*, Case 8:11-cv-00819 (D. Md. Filed March 29, 2011) and *U.S. v. Liang* (D. Md. Filed March 29, 2011) are actions against FDA chemist Cheng Yi Liang.

a. The criminal case also names his son as a defendant. Mr. Lang is alleged to have used confidential information from the FDA to trade in the stock of pharmaceutical companies. Overall he made profits of $3.6 million from trades placed through several accounts he controlled.

b. The criminal complaint charges the father and son with conspiracy to commit securities and wire fraud, securities fraud and wire fraud relating to their trading in the securities of five companies.

c. The SEC complaint against the father alleges violations of Securities Act Section 17(a) and Exchange Act Section 10(b). It is based on trading in advance of 27 announcements involving 19 stocks. A civil forfeiture action was also filed. All three cases are pending.

5. *SEC v. Poteroba* (S.D.N.Y. Filed March 24, 2010) and the parallel criminal case, *U.S. v. Poteroba* (S.D.N.Y. Filed March 24, 2010) are actions involving market professionals alleged to have repeatedly traded on misappropriated inside information.

a. The defendants are Igor Poteroba, a managing director at UBS Securities in their Healthcare Group; Alexei Koval, previously employed at Citigroup Asset Management; and Alexander Vorobiev. All three defendants are Russian nationals.

b. Mr. Poteroba is alleged to have provided inside information to Mr. Koval beginning in 2005 and continuing through February 2009.

c. According to the papers in the criminal case the inside information concerned pending mergers involving six companies: Guiford Pharmaceuticals, Inc., Molecular Devices Corporation, PharmaNet Pharmaceuticals, Inc., and Indevus Pharmaceuticals, Inc.

d. The criminal information contains one count of conspiracy and three counts of securities fraud.

e. Overall the trading is alleged to have generated about $870,000 in illegal profits.

f. The SEC complaint is based on the same scheme but adds tips on five additional deals. Those concern ID Biomedical Corporation, ViaCell, Inc., Radiation Therapy Services, Inc., Datascope Corp. and Sciele Pharma, Inc. This version of the scheme is alleged to have generated over $1 million in illegal trading profits. The Commission's complaint alleges violations of Exchange Act Sections 10(b) and 14(e). Both cases are in litigation.

B. In some instances market professionals are alleged to have used their position as insiders to trade.

1. *SEC v. Garcia*, Civil Action No. 10C 5268 (N.D. Ill. Filed Aug. 20, 2010) is an action against defendants Juan Jose Fernandez Garcia the Head of European Equity Derivatives at Banco Santander, S.A. and Luis Martin Caro Sanchez. Both defendants reside in Madrid, Spain.

a. The action centers on the unsolicited bid for Potash Corporation of Saskatchewan by BHP Billiton Plc announced on August 17, 2010. BHP offered a 16% premium to market which caused the share price to rise by 27%. Potash was advised by Banco Santander.

b. Before the bid Mr. Garcia purchased 282 Potash call options for $13,669. After the announcement they were sold at a profit of $576,033. Mr. Sanchez purchased 331 call options in Potash in mid-"August at a cost of $47499. Both purchases were through Interactive Brokers. Mr. Sanchez sold his position after the announcement for $496,953.33. The complaint alleges violations of Exchange Act Sections 10(b) and 14(e).

2. *In the Matter of David W Baldt*, Adm. Proc. File No. 3-13887 (Filed May 11, 2010). Mr. Baldt was a portfolio manager for two municipal bond funds sponsored by Schroder Investment Management, North America. Several members of his family held positions in the funds.

a. As the market deteriorated in mid-September 2008 one family ember called for advice. Mr. Baldt noted that if her concerns were preventing her from sleeping she should sell her position and buy Treasury Bills. He also noted that a second family member should do the same.

b. As market conditions continued to decline Schroder learned of a potential $12 million redemption which was about 8% of the total assets of one fund. Management directed Mr. Baldt and his team to liquidate the securities – a directive he disputed.

c. In October when the family member called again for advice he told her to consider selling her position and emphasized that she should "go the full route." He also told her to share the advice with another family member.

d. The Order alleges violations of Securities Act Section 17(a), Exchange Act Section 10(b) and Advisers Act Section 206. The case is in litigation.

3. *SEC v. Marquardt*, Civil Action No. 10-10073 (D Mass. Jan. 20, 2010) is a settled action against Charles Marquardt, the former Senior Vice President and Chief Administrative Officer for operations of Boston-based Evergreen Investment Management Co., LLC.

a. In June 2008 Mr. Marquardt learned the Ultra Fund may soon reduce the value assigned to several of its mortgage backed securities holdings. That action would reduce NAV.

b. The next day Mr. Marquardt and a family member redeemed all of their Ultra Fund Shares.

c. Later the same month Evergreen announced that Ultra fund would be liquidated. As a result of the trades defendant and his family members avoided losses of, respectively, $4,803 and $14,304.

d. Mr. Marquardt resolves the case by consenting to the entry of a permanent injunction prohibiting future violations of the antifraud provisions. He also agreed to pay disgorgement of $19,107 with includes the avoided losses for his account and the family member along with prejudgment interest. He also agreed to pay a civil penalty equal to the total amount of the disgorgement.

e. In a related administrative proceeding he consented to being barred from association with any broker, dealer, or investment adviser with the right to reapply after two years. *See also* Litg. Rel. 21383 (Jan. 20, 2010).

C. Other professionals such as accountants and attorneys frequently have access to inside information.

1. *SEC v. Flanagan*, Civil Action No. 10-CV-4885 (N.D. Ill. Filed Aug. 4, 2010) is an action against a father and son. The father is Thomas P. Flanagan, CPA and former Vice Chairman of Deloitte, resident in the firm's Chicago office. His son is Patrick, the COO of a private company in the health care business. The case follows a private damage action filed by the accounting firm against Mr. Flanagan.

a. Between 2005 and 2009 Mr. Flanagan is alleged to have traded on inside information nine times. In each instance the information was obtained through his position at Deloitte. It concerned Bet Buy Co., Motorola, Inc., Walgreens Company, Option Care, Inc., and Sears Holding Corporation. In each instance it was "market moving" information.

b. Mr. Flanagan used several different accounts to make 71 purchases. To conceal his scheme he failed to report the trades as required, lied to the firm about his compliance with its independence policies and gave false information to its personal income tax preparers about the identity of the companies whose securities he traded. He had trading profit of about $430,000.

c. Mr. Flanagan also tipped his son on occasion. He traded and made profits of about $57,000.

d. The action was resolved with each defendant consenting to the entry of a permanent injunction prohibiting future violations of Exchange Act Sections 10(b) and 14(e). Thomas Flanagan agreed to pay disgorgement and prejudgment interest of 4557,158 and a penalty of $493,884. His son agreed to pay disgorgement and prejudgment interest of $65,614 and a penalty of $57,656.

e. In a separate administrative proceeding Mr. Flanagan consented to the entry of an order denying him the right to appear and practice before the Commission as an accountant. Lit. Rel. 21612 (Aug. 4, 2010).

2. *SEC v. Gansman*, Civil Action No. 08-CV-4918 (S.D.N.Y. Filed May 18, 2008) is an insider trading case against James Gansman and Donna Murdoch. Mr. Gansman was an attorney at the Transaction Advisory Services group of Ernst & Young. Ms. Murdoch is his former stock broker and close friend.

a. Mr. Gansman is alleged to have tipped Ms. Murdoch concerning at least seven different acquisition targets of E&Y clients.

b. Ms. Murdoch traded on each tip and also tipped her father. In addition she recommended trading in two stocks to others who traded.

c. To settle, each defendant consented to the entry of a permanent injunction prohibiting future violations of Exchange Act Sections 10(b) and 14(e). Mr. Gansman also agreed to pay disgorgement of

$233,385 along with prejudgment interest. Ms. Murcoch agreed to pay disgorgement of $339,110 along with prejudgment interest. Mr. Gansman also agreed to the entry of an order barring him form appearing or practicing before the Commission as an attorney. Ms. Murdoch agreed to the entry of an order barring her from associating with any broker or dealer.

d. Mr. Gansman previously was convicted on parallel criminal charges and sentenced to serve a year and a day in prison. Ms. Murdoch pleaded guilty to a seventeen count superseding information in December 2008. check sentencing.

e. *See also SEC v. Hansen*, Civil Action No. 10-CV-5050 (E.D. Pa. Filed Sept. 27, 2010) which is an insider trading action against Richard Hansen, a registered representative and former chairman of a regional investment bank. Also named as a defendant was his long time friend Stuart Kobrovsky. Mr. Hansen was alleged to have been tipped by Donna Murdoch, a business associate regarding several pending business deals. As a result the two men had trading profits of about $215,000. Mr. Kobrovsky settled with the SEC consenting to the entry of a permanent injunction prohibiting future violations of Exchange Act Section 10(b) and agreeing to disgorge trading profits of $160,000 along with prejudgment interest. The case against Mr. Hansen, along with parallel criminal charges, is pending. *U.S. v. Hansen*, 10 Crim 875 (S.D.N.Y.).

3. *SEC v. Foley*, Civil Action No. 1:00-cv-00300 (D.D.C. Filed Feb. 25, 2010) is an insider trading action against John Foley, Aaron Graian, Timothy Vernier and Bradley Hale. Mr. Foley was an employee benefits specialist at Deloitte.

a. According to the complaint Mr. Foley obtained inside information regarding three Deloitte clients which was passed to Messrs Grassian and Verner. Each traded and made a profit.

b. Mr. Grassian later provided Mr. Foley with information about a take-over. He learned the information from Mr. Hale who was employed at one of the companies. Mr. Hale did not trade.

c. The case was settled with each defendant consenting to the entry of a permanent injunction prohibiting future violations of the antifraud provisions. Each trading defendant also agreed to disgorge their profits which collectively exceeded $210,000 along with prejudgment interest. Mr. Foley was not assessed a penalty based on his financial condition while Mr. Vernier paid a reduced penalty for the same reason. Mr. Grassian agreed to pay a penalty equal to his trading profits. Lit. Rel. No. 21425 (Feb. 25, 2010).

d. In a related administrative proceeding Tara Eisler, who permitted Mr. Foley to repeatedly use her brokerage account to trade, consented to the entry of a cease and desist order that she not engage in future violations of Exchange Act Section 10(b). *In the Matter of Tara L. Eisler*, Adm Proc. File No. 3-13792 (Filed Feb. 25, 2010).

VI. Corporate Executives

A. A number of SEC insider trading cases involve corporate executives. In some instances the executive is alleged to have traded for his or her account. In others the executive furnished the information to a friend.

B. Examples of cases in which the executive traded for his or her personal account include:

1. *SEC v. Powell,* Case No 6:11-cr-161 (W.D. Tex. Filed June 10, 2011) is an action against Phillip E. Powell, former chairman of the board of first Cash Financial Services, Inc.

a. In November 2007 the company announced a share repurchase program for up to 1 million shares. The announcement did not indicate when the program would begin.

b. Later Mr. Powell learned when the program would start. The day before it commenced he purchased 100,000 shares of the company.

c. The complaint claims the company overpaid for repurchases by $36,000 because of Mr. Powell's purchase. He also made profits from the purchase of $124,000. Mr. Powell also refused to file a Form 4 when told by his broker. The complaint alleges violations of Exchange Act Sections 10(b) and 16(a). The case is pending.

2. *SEC v. Wyly*, Case No. 10 CV 5760 (S.D.N.Y. Filed July 29, 2010) is a case against two prominent corporate directors and their attorney and broker are alleged to have maintained an elaborate web of off-shore trusts to insider trade.

a. The defendants in this action are Sam Wyly, his brother Charles Wyly, their attorney Michael French and their broker Louis Schaufele. The Wyly brothers have held various board and officer positions with Michaels, Sterling Software and Scottish Re.

b. The complaint details an elaborate scheme which the Commission claims was used to insider trade in the shares of companies in which one or both of the brothers held board or officer positions. Specifically, the complaint claims that the Wyly defendants maintained an elaborate web of off-shore trust which they used to hold significant blocks of stock in the companies with which they were affiliated. The trusts were used to insider trade in those shares.

c. Messrs. French and Schaufele are alleged to have facilitated this scheme which traded over $750 million of stock in the four companies.

d. The complaint charges all four defendants with violations of Exchange Act Section 10(b). It also alleges that the two Wyly defendants and Mr. French violated Exchange Act Sections 13(d), 14(a) and 16(a). The two Wyly defendants are also charged with violations of Securities Act Section 5 and aiding and abetting violations of Exchange Act Sections 13(a) and 14(a). Mr. French is also charged with aiding and abetting violations of Exchange Act.

3. *SEC v. Wildstein,* Civil Action No 11-01297 (D.D.C. Filed July 19, 2011) is an action alleging violations of Exchange Act Sections 10(b) and 14(e) against Howard Wildstein, a former Pitney Bowes, Inc. executive. Mr. Wildstein, according to the complaint, learned that his employer was considering the acquisition of MapInfo Corporation prior to the public announcement of the deal on March 15, 2007. Specifically, Mr. Wildstein is alleged to have learned that MapInfo was a potential acquisition target and that the mergers and acquisition people from the company had recently visited the company. Based on this information he purchased 8,000 shares of MapInfo. After the announcement of the deal he realized profits of $51,177. To settle the case Mr. Wildstein consented to the entry of a permanent injunction prohibiting future violations of the sections cited in the complaint. He also agreed to pay $114,848 in disgorgement, prejudgment interest and civil penalties.

4. *SEC v. Leyva*, Civil Action No. 09 CV 1565 (S.D. Cal.) is an action against the former Director of Strategic Marketing Analysis for Qualcomm Incorporated, Andres Leyva. When Nokia surprised Qualcomm with a substantial offer to settle a critical litigation on the eve of trial, the lead company negotiator phoned Mr. Leyva and reviewed the terms. Two hours later Mr. Leyva purchased 80 Qualcomm call options at $0.39 each with a strike price of $50. After the market closed the settlement was announced. The next day the share price increased 17% to $52.43. Mr. Leyva sold his options for a profit of $34,739.98. To settle the case Mr. Leyva consented to the entry of a permanent injunction prohibiting future violations of Exchange Act Section 10(b). He also agreed to disgorge his trading profits and to pay prejudgment interest and a civil penalty equal to the amount of the disgorgement and prejudgment interest. Litg. Rel. No. 21559 (June 17, 2010).

5. *SEC v. Navarro*, Civil Action No. 4:10-CV-189 (N.D.Okla. Filed March 31, 2010) is a settled insider trading case against Gary Navarro. In July 2008 Mr. Navarro was the crude oil purchasing manger of SemCrude. He learned that the parent company, SemGroup Energy Partners LP and its largest customer were having significant cash flow difficulties. Subsequently he liquidated his holdings in the parent company. Three days later the company announced its cash flow difficulties. The next day the share price dropped 65% lower than the average sale price Mr. Navarro obtained. Accordingly, he avoided a loss of $83,602. Mr. Navarro resolved the case by consenting to the entry of a permanent injunction prohibiting future violations of Exchange Act Section 10(b). He also agreed to pay disgorgement in an amount equal to the loss he avoided along with prejudgment interest and a civil penalty in the same amount. Lit. Rel. No. 21469 (March 31, 2010).

6. *SEC v. Duffell*, Civil Action No. CV-11-1404 (N.D. Cal. March 24, 2011) is an action against Mark Duffell, a consultant for private investment firm Accel-KKR.

a. According to the complaint, Mr. Duffell, on behalf of AKKR, approached SumTotal Systems about a take over. Two days later, while in possession of confidential information about that proposed transaction, he began purchasing shares of SumTotal.

b. The deal was publically announced on March 2, 2009. Mr. Duffell made a profit of $162, 500.

c. To resolve the case Mr. Duffell consented to the entry of a permanent injunction prohibiting future violations of Exchange Act Section 10(b). In addition, he agreed to pay disgorgement of $162,500, prejudgment interest and a penalty equal to the amount of his trading profits.

d. *SEC v. Wiener*, Action No. 1:11cv292 (E.D. Va. March 23, 2011) is an action alleging violations of Exchange Act Section 10(b) by Daniel Wiener.

(i) The defendant was employed at BAE Systems, Inc On December 21, 2007 an announcement was made that BAE would acquire MTC Technologies, Inc. Although Mr. Wiener was not a member of the deal team he had regular contact with employees involved in the acquisition.

(ii) Prior to the public announcement he participated in a staff meeting in which the transaction was discussed using code names. During that meeting Mr. Wiener discussed the products of the target in a manner which demonstrated that he knew the identity of the company. Thirty minutes after the meeting ended he purchased a block of MTC stock in his personal brokerage account. Subsequently, he purchased additional shares in his wife's account. Following the public announcement of the deal he liquidated his holdings, realizing a profit of $67,686.99. The case is in litigation.

7. *SEC v. Deskovick*, Civ. 11-1522 (D.N.J. Filed March 17, 2011) is an action alleging violations of Exchange Act Section 10(b) by Kim Ann Deskovick and Brian S. Haig.

a. The case centers on the acquisition of First Morris Bank and Trust by Provident Financial Services, Inc. which was announced on October 16, 2006. Defendant Deskovick was a director of the bank prior to the take over.

b. Prior to the transaction announcement the bank made efforts to be acquired. As those efforts moved forward Ms. Deskovick was updated. Those updates continued through the merger negotiations. During that time period Ms. Deskovick tipped her friend and kept her updated. Her friend in turn tipped Brian Haig, telling him the source of the information. Mr. Haig also tipped a friend. Following the deal announcement Mr. Haig and his friend had profits from the 14% share price increase of 68,277.

c. The action was settled with each defendant consenting to the entry of a permanent injunction prohibiting future violations of Exchange Act Section 10(b). Mr. Haig was also ordered to disgorge the total trading profits of he and his friend made along with prejudgment interest. Ms. Deskovick was ordered to pay a penalty of $64,277 and is barred from serving as an officer or director for five years. Mr. Haig was ordered to pay a penalty of $34,138.

8. *SEC v. Horn*, Civil Action No. 1:10-CV-00955 (N.D. Ill. Feb. 16, 2010) is an action against Gerald Horn, a medical director for one of the facilities of LCA Visions, Inc. According to the complaint, from December 2005 through August 2006, the defendant made six separate trades while in possession of inside information. The information came from reviewing internal reports about the number of eye surgeries done which permitted him to estimate revenue. By trading in LCA options the defendant is alleged to have obtained profits of $869,629. This case is in litigation. Lit. Rel. No. 2114 (Feb. 16, 2010).

9. *SEC v. Wagner*, Case No. 1:10-cv-10031 (D. Mass. Filed Jan. 11, 2010) is a settled insider trading case against Brooke D. Wagner, former VP of Corporate Communications of Indevus Pharmaceuticals, Inc. According to the complaint Mr. Wagner learned that the FDA had expressed concerns about the side effects of a drug for which the company was seeking approval. Prior to the public announcement about the FDA in June 2008, the defendant sold his shares in the company and later sold additional shares short. The share price fell about 69% following the announcement. To settle the case, Mr. Wagner consented to the entry of a permanent injunction prohibiting future violations of the antifraud provisions of the federal securities laws and agreed to pay disgorgement of about $64,000 along with prejudgment interest and a civil penalty equal to the amount of the disgorgement. Lit. Rel. No. 21370 (Jan. 11, 2010).

10. *SEC v. Fogel*, Case No. 1:10-CV-10097 (D. Mass. Jan 22, 2010) is a settled insider trading case against Avi Fogel, the former Vice President of strategic initiatives at EMC Corporation. The case centers on the acquisition of Document Sciences Corporation or DOCX by EMC which was announced on December 27, 2007. Mr. Fogel lead a team which eventually recommended the acquisition of DOCX. As the company pursued the deal Mr. Fogel was on occasion consulted about the pricing of a possible transaction. While the price was being negotiated he purchased 20,000 shares of DOCX stock. Two days before the announcement he purchased an additional 10,000 shares. Following the deal announcement the share price increased by about 76%. Mr. Fogel settled the case by consenting to the entry of a permanent injunction prohibiting future violations of the antifraud provisions. He also agreed to disgorge $1919,393, pay prejudgment interest and a penalty equal to the trading profits. Lit. Rel. No. 21392 (Jan. 22, 2010).

C. In some instances the cases focus on corporate insiders tipping others.

1. *SEC v. Self*, Civil Action No. 10-cv-430 (E.D. Pa. Filed Sept. 1, 2010) is an action against James Self, Jr., the executive director at Merck & Co. and Stephen Goldfield, an unemployed former hedge fund manager. Messrs. Self and Goldfield were long time friends. Prior to the acquisition in April 2007 of AstraZeneca by Medimmune, Inc., Mr. Self and others were solicited by investment bankers representing Medimmune about a possible acquisition. Mr. Self was on the team which reviewed material non-public information about the deal. By March 2007 Mr. Self furnished his friend with information on this subject. Mr. Goldfield purchased Medimmune options and, following a deal announcement, made profits of $13.9 million. The case settled with each defendant consenting to the entry of a permanent injunction prohibiting future violations of Exchange Act Section 10(b). Mr. Self also agreed to pay a civil penalty of $50,000 based on his financial condition. Mr. Goldfield agreed to disgorge the trading profits along with prejudgment interest. All but $600,000 of that

amount was waived based on his financial condition. Lit. Rel. No. 21638 (Sept. 1, 2010).

2. *SEC v. Berrettini*, Civil Action No. 10-CV-01614 (N.D. Ill. Mar. 31, 2010) is an insider trading action against Ralph Pirtle, former Director of Real Estate for Philips Electronics North America, a subsidiary of Royal Philips, N.M. and his friend Morando Berrettini. According to the complaint Mr. Pirtle illegally tipped his friend about the interest of Phillips in acquiring Lifeline Systems, Inc., Invacare Inc and Intermagnetics Corporation. In each instance Mr. Berrettini traded, making a total profit of over $240,000. In a series of side deals, Mr. Berrettini used cashiers' checks totaling $226,000 to purchase goods and services for Mr. Pirtle. The complaint alleges violations of the Exchange Act antifraud provisions. The case is in litigation. Lit. Rel. No. 21472 (Apr. 1, 2010)

VII. Family and Friends

A. A number of insider trading cases involve family members. In some instances the family members are working together. In others one family member misappropriates the information from another.

B. In recent months the SEC filed several cases where family members and/or friends joined forces to insider trade.

1. *SEC v. Clay Capital Management, LLC,* Civil Action No. 2:11-cv-05020 (D. N.J. Filed Aug. 31, 2011) is an action against James Turner and his fund, Clay Capital Management, LLC, along with Scott Vollmar, Mr. Turner's brother-in-law, Scott Robarge, his friend, and Mark Durbin, and a neighbor of Mr. Vollmar.

   a. The trading involved the shares of Moldflow Corporation, Autodesk, Inc. and Salesforce.com, Inc.

   b. The first scheme centered on the tender offer by Autodesk for Moldflow, announced on May 1, 2008. Prior to the deal announcement Mr. Vollmar, illegally tipped James Turner and Mark Durbin about the deal. At the time Mr. Vollmar was the director of business development for Autodesk and had been heavily involved in the acquisition discussions. Each traded. Mr. Turner also tipped his brother-in-law, Scott Robarge who in turn recommended the stock to others. Collectively the traders netted $2.3 million in illicit trading profits according to the complaint.

   c. The second scheme centered on trading prior to the fourth quarter 2008 earnings announcement for Autodesk on February 26, 2008 Mr. Vollmar again tipped Messrs. Turner and Robarge. Each traded. Mr. Robarge also recommended the shares to others.

Collectively, the trading in Autodesk shares yielded about $1.1 million in illicit trading profits.

d. Finally, Mr. Robarge, a recruiting technology manager for Salesforce, is alleged to have tipped Mr. Turner about the pending earnings announcement for his company. Mr. Turner traded and told Mr. Vollmer who also purchase shares and options in Salesforce. Mr. Robarge also traded on the information prior to the announcement and recommended the stock to other friends. Collectively, the trading in the shares of Salesforce yielded about $500,000 in illicit trading profits according to the complaint. The Commission's complaint alleges violations of Securities Act section 17(a) and Exchange Act Sections 10(b) and 14(e).

e. Messrs. Robarge and Durbin settled with the SEC. Each consented to the entry of a permanent injunction prohibiting future violations of Exchange Act Sections 10(b) and 14(e). In addition, Mr. Robarge agreed to pay disgorgement of $232,591 along with prejudgment interest and a penalty equal to the amount of the disgorgement. Mr. Durbin also agreed to pay disgorgement in the amount of $8,391.26 along with prejudgment interest and a penalty equal to the amount of the disgorgement. The other defendants did not settled with the SEC.

2. *SEC v. Peterson,* Civil Action No. 11-CV-5448 (S.D.N.Y. Filed Aug. 5, 2011); *U.S. v. Peterson* (S.D.N.Y. Filed Aug. 5, 2011) are cases involving a father and son.

a. Clayton Peterson, a member of the board of directors and chairman of the audit committee of Mariner Energy, Inc., and his son Drew Peterson, who worked as an investment adviser in Denver, Colorado, pleaded guilty to criminal insider trading charges and were named as defendants in an SEC suit.

b. Clayton Peterson learned at board meetings that his firm would be acquired by Apache Corporation in a deal that was announced on April 15, 2010. After first learning about the deal he repeatedly tipped his son, instructing him to trade through an account belonging to his sister.

c. The son traded and tipped a hedge fund manager who also traded. Following the announcement of the deal the share price of Marine Energy rose about 42%. The hedge fund manager liquidated his positions, yielding a profit of $5 million. Within days Drew Peterson, and the various accounts for which he traded, liquidated their positions yielding a profit of $150,000.

d. Clayton Peterson and his son Drew each pleaded guilty to one count of conspiracy to commit securities fraud and one count of securities fraud. Sentencing is scheduled for January 12, 2012.

e. The SEC brought a civil injunctive action against Clayton Peterson and his son. The complaint alleges violations of Exchange Act Section 10(b). The action is pending.

3. *SEC v. Decinces*, SACU 11-1168 (C.D.Cal. Aug 4, 2011), is an action against Douglas Decinces, a former major league baseball player, his physical therapist Joseph Donahoe, and two of his friends, Roger Wittenbach and Fred Jackson each of whom was named as a defendant.

a. The action centers on the tender offer for Advanced Medical Optics Inc. by Abbott Laboratories Inc. which was announced on January 12, 2009.

b. Prior to that date Mr. Decinces learned from an employee at Advanced Medical about the pending transaction. Subsequently, he made several purchases of stock, eventually building his portfolio to 83,700 shares. During this period, and prior to the public announcement, he tipped Messrs. Donahoe, Jackson and Wittenbach who also traded. Mr. Wittenbach in turn tipped his sister.

c. Each defendant settled, consenting to the entry of permanent injunctions prohibiting future violations of Exchange Act Sections 10(b) and 14(e). In addition, Mr. Decinces agreed to pay disgorgement of $1,282,691 along with prejudgment interest and a penalty of $1,197,998. Mr. Donahue agreed to pay disgorgement of $75,570 and a penalty of $37,785. Mr. Jackson agreed to pay disgorgement of $140,259 along with prejudgment interest and a penalty of $140,259. Mr. Wittenbach agreed to pay disgorgement of $201,692 along with prejudgment interest and a penalty of $214,906.

4. *SEC v. Goetz,* Case No. 11 CV 1220 (S.D. Cal. June 3, 2011) is an insider trading case against Dean Goetz, an attorney who practices in Solana Beach, California, who is alleged to have obtained inside information from his daughter.

a. His practice focuses on personal injury litigation. His daughter is a corporate associate in the Los Angeles office of an international law firm.

b. The case centers on the acquisition of Advanced Medical Optics, Inc. by Abbott Laboratories. The deal was announced on January 12, 2009. From mid-December 2008 through the end of the year the daughter stayed at her parent's home. During that time she could not participate in the family holiday activities because of her work on the deal for firm client, Advanced Medical. She cut her visit short, telling her parents that she thought the deal she was working on would close soon.

c. On January 8, 2009 Mr. Goetz purchased 500 shares of Advanced Medical through his on-line brokerage account while in possession of inside information he misappropriated from his daughter, according to the complaint.

d. Following the deal announcement the share price increased about 143%. He liquidated his account on February 19, 2009 at a profit of $11, 418.

e. Mr. Goetz settled the action, consenting to the entry of a permanent injunction prohibiting violations of Exchange Act Sections 10(b) and 14(e). He also agreed to disgorge his trading profits along with prejudgment interest and pay a penalty equal to the trading profits.

5. *SEC v. Haim,* Civil Action No. 11-cv-295 (D.N.Y. Filed May 24, 2011) is an action against Abraham Haim. Between April 2006 and March 2007 his relative, and banker, worked on five corporate take-over deals.

a. Prior to each deal announcement Mr. Haim, who had a close relation with the relative, misappropriated inside information about the pending transaction that he obtained by secretly listening in on the banker's confidential telephone conversations or reading non-public business documents on visits to the banker's home.

b. In each instance he traded in advance of the public announcement of the transaction. As a result he had trading profits of $30,126.00.

c. To settle the case Mr. Haim consented to the entry of a permanent injunction prohibiting future violations of Exchange Act Section 10(b). In addition, he agreed to disgorge his trading profits along with prejudgment interest and to pay a civil penalty equal to the amount of the trading profits.

6. *SEC v. Cohen*, Case No. 10 CV 2514L (S.D. Cal. Filed Dec. 8, 2010) is an insider trading case involving two brothers, a fraternity brother and an uncle. The two brothers were not identified. The fraternity brother and uncle have been named as defendants in the SEC case. The defendants are Brett Cohen, a consultant residing in Baltimore and the fraternity brother of Tipper B. The other defendant is David Myers, a resident of Cleveland. He is the Uncle of Mr. Cohen. Tipper A is a patent agent for Sequenom, Inc., a San Diego based company which does diagnostic testing and genetics analysis. Tipper B is his brother who resides in Maryland.

a. Tipper A dealt with Tipper B who in turn communicated with defendant Cohen who contacted his uncle, defendant Myers.

b. The first key event is a transaction by Sequenom to acquire Exact Sciences in 2008. Tipper A participated in the due diligence. There was a series of phone calls on October 22 and 23 involving Tippers A and B and the two defendants. There were also "coded" e-mails, interpreted to refer to the deal.

c. On October 27 Mr. Myers made his first ever purchase of EXAS securities. It was his first securities transaction since 2007. He then made additional purchases.

d. Following the deal announcement on January 9, 2009 the share price rose 50%. EXAS rejected the offer. Mr. Myers sold his holdings between January 13 and February 13. There were more phone calls during this period. Mr. Myers made profits of $34,102.99.

e. The second event involved the April 29, 2009 announcement that previously disclosed test data for a Sequenom product could not be relied on. Tipper A was the patent agent working on this product. After a series of phone calls and coded e-mails between the brothers, Mr. Cohen began purchasing Sequenom put options just before the close of the market on April 29, 2009. The next morning the stock dropped 76% on the announcement about the test data. Mr. Myers sold the options for a profit of $572,540. He later paid Tipper B $10,000 in cash. The SEC complaint alleges violations of Exchange Act Section 10(b). Lit. Rel. 21767 (Dec. 8, 2010). A parallel criminal case has been filed. U.S. v. Myers, Case No. 10 CR 4832 (S.D. Cal. Filed Dec. 8, 2010).

7. *SEC v. Temple*, Case No. 10-cv-1058 (D. Del. Filed Dec. 7, 2010) is an action against two-brothers-in-law. The defendants are Jeffery Temple and his brother-in-law Benedict Pastro. From August 12, 2002 through October 11, 2010, Mr. Temple was employed at a Wilmington, Delaware law firm. He was terminated because of this case.

a. Mr. Temple held the position of Information Systems manager. This gave him access to electronic and other files containing material non-public information.

b. From June 2009 through October 2010 Mr. Temple traded in advance of 22 prospective mergers and/or acquisition related announcements involving 20 firm clients. In 12 instances he tipped his brother-in-law.

c. Over the period Mr. Temple made relatively modest trades. Overall he made profits of $88,300. Mr. Pastro made $94,000 in trading profits. The complaint alleges violations of Exchange Act Sections 10(b) and 14(e). The case is in litigation. Litg. Rel. No. 21765 (Dec. 7, 2010).

8. *SEC v. McClellan*, Case No. CV 10 5412 (N.D. Cal. Filed Nov. 30, 2010) involved two families and an international insider trading ring. The defendants are two couples, one residing in San Francisco and one in London. Arnold McCellan and his wife Annabel reside in San Francisco. Mr. McCellan was a mergers and acquisitions tax partner at Deloitte Tax LLP in the San Francisco office. Mrs. McCellan was previously employed at Deloitte in London and san Jose. Miranda Sanders, the sister of Mrs. McCellan, and her husband James, reside in London where he is a director, shareholder and co-founder of Blue Index limited. Mrs. Sanders works part time at Blue Index.

a. Over a two year period beginning in 2006 Arnold McClellan disclosed confidential information on seven deals he was working on to his wife. She in turned passed that information on to her sister and brother-in-law.

b. Mr. Sanders traded, purchasing a kind of derivative known as a spread contract. The two families split trading profits of over $3 million.

c. The complaint also details three instances in which the families traded but did not make a profit.

d. In some instances Mr. Sanders passed the information on to his firm which touted it to customers.

e. The SEC complaint alleges violations of Exchange Act Section 10(b). It is in litigation. Lit. Rel. No. 21578 (Nov. 30, 2010).

f. The FSA in London has filed criminal charges against James and Miranda Sanders and their colleagues who are alleged to have made about $20 million.

g. U.S. authorities have not filed criminal charges based on the insider trading. Mrs. McClellan however has been indicted on obstruction of justice charges arising out of the SEC investigation. Get cite.

9. *SEC v. Jantzen*, Case No. 1:10-cv-00740 (W.D. Te. Oct. 5, 2010) is an insider trading action against former Dell employee Marteen Jantzen and her husband John, a broker.

   a. The case centers on the tender offer by Dell for Perot Systems in September 2009. Mrs. Jantzen learned abut the deal during the course of her employment. She executed an agreement not to trade.

   b. The day before the announcement of the deal, Mrs. Jantzen transferred funds to her brokerage account. Almost immediately her husband purchased 500 shares and 24 options in Perot. The position was sold immediately after the announcement at a profit of over $25,813.58.

   c. The complaint alleges violations of Exchange Act Sections 10(b) and 14(e). The case is in litigation. Lit. Rel. No. 21685 (Oct. 6, 2010). This is the second case brought by the relating to this ?? transaction. *See also SEC v. Salen*, Case No. 3:09-cv-01778 (N.D. Tex. Filed Sept. 23, 2009). That case settled.

C. In some instances family members misappropriate inside information for their own use as in *SEC v. Macdonald*, Case No. 3:10cv151 (D. Conn. Filed Feb. 2, 2010). Here, defendant Bruce Macdonald is alleged to have misappropriated inside information.

1. Mr. Macdonald's wife is a corporate secretary and vice president of human resources of Mamry Corporation which had put itself up for sale. Throughout the sale process she was involved at each key step.

2. Mrs. Macdonald informed her husband about the transaction. Periodically she furnished him with updates.

3. The complaint states that based on the marital relation, Mrs. Macdonald expected that her husband would keep the information confidential. It does not specify that she in fact directed him to maintain the confidentiality of the information.

4. Mr. Macdonald purchased shares of the company in his business account and that of a long-time friend for whom he regularly traded, Bruce Bohlander (a relief defendant). He also tipped three friends who traded. Robert Maresca, one of his friends, purchased 9,000 shares.

5. Overall, Mr. Macdonald had ill-gotten gains of $890 in his account and $25,509 in the other account that he traded. His three friends had profits of almost $20,000.

6. To resolve the case, Messrs. Macdonald and Maresca consented to the entry of permanent injunctions prohibiting future violations of the antifraud provisions of the Exchange Act. Each man also agreed to the entry of an order requiring him to disgorge the trading profits along with prejudgment interest and to pay a penalty equal to the trading profits. Mr. Bohlander consented to the entry of a final judgment requiring him to disgorge the trading profits and pay prejudgment interest. Lit. Rel. No. 21404 (Feb. 2, 2010).

7. *SEC v. Scammell,* 2:11-cv-06597(C.D. CA. Filed Aug. 11, 2011) is an action in which the defendant is alleged to have obtained the inside information from his girlfriend. It names as a defendant Toby Scammell and centers on the acquisition of Marvel Entertainment, Inc. by the Walt Disney Company, was announced on August 31, 2009.

- **a.** Prior to the acquisition, Mr. Scammell lived with his girlfriend in Los Angeles. During that period she was an extern at Disney assigned to work on the Marvel acquisition. She worked long hours during the summer of 2009 and periodically discussed the project in general terms with Mr. Scammell but did not reveal the name of the company. Frequently she worked from home where there were papers about the deal. She was aware of the announcement date for the deal and the $50 price. Mr. Scammell had access to her papers and blackberry. During one conversation she suggested that the project would be done shortly after labor day.

- **b.** Mr. Scammell, who had never before traded options, began making large and unusual purchase of Marvel options in mid – August with an expiration date in September. The strike price was in the range of $45 to $50. Since he did not have the money to pay for all of the options he used funds in his brother's account without permission.

- **c.** When the deal was announced Mr. Scammell liquidated his holdings, making a profit of $192,497 or over 3000% of his investment. He did not tell his girlfriend or brother. The Commission's complaint alleges violations of Exchange Act Section 10(b). The case is in litigation.

8. *SEC v. Marovitz,* 1:11-cv-05259 (N.D. Ill. Aug. 3, 2011) is an action against attorney William Morovitz, the former husband of then Playboy CEO Christie Hefner. According to the complaint, Mr. Morovitz traded on inside information he misappropriated from his wife in three instances.

a. In 2009 he bought shares of Playboy before a takeover announcement and sold most of the shares just before the deal collapsed, thus avoiding a loss.

b. In 2008 he sold shares of the company just before a poor earnings announcement, avoiding another loss.

c. In 2004 he purchased shares of the company shortly before the announcement of a new offering of another class of securities resulting in an unrealized profit.

d. In 1998 Ms. Hefner had cautioned her husband that all information he learned from her was confidential. She also had the general counsel of the company reiterate that directive to her husband.

e. Mr. Marovitz settled with the SEC, consenting to the entry of a permanent injunction prohibiting future violations of Securities Act Section 17(a) and Exchange Act Section 10(b). He also agreed to pay $168,352 in disgorgement, prejudgment interest and civil penalties. The case originated from an inspection of a broker dealer.

VIII. Reg FD

A. Reg FD generally prevents issuers and others from selectively disclosing material non-public information. In this regard, it complements the insider trading rules.

B. Last year the SEC brought two Reg FD cases suggesting that perhaps this may again become more of an enforcement priority than in prior years.

1. *SEC v. Office Depot, Inc*., Civil Action No. 9:10-cv-81239 (S.D. Fla. Filed Oct. 21, 2010) is an enforcement action against the company based on Reg FD and other filing violations. Two related administrative proceedings were also filed. One is against the CEO and chairman of the board of the company, Stephen Odland. The other names as a respondent the former CFO of the company Patricia McKay. *In the Matter of Stephen Odland*, Adm. Proc. File No. 3-14095 (Filed Oct. 21, 2010); *In the Matter of Patricia McKay,* Adm. Proc. File No. 3-14096 (Filed Oct. 21, 2010).

a. The claims center on a series of talking points used by the director of investor relations in comments to analysts. At the time the internal company estimates conclude that it would not make guidance.

b. The CEO and CFO worked out a series of talking points for the IR director to deliver. Those talking points did not reference material non-public information. Rather, they focused on publicly-available information regarding the difficulty of making guidance.

c. Following the talk, a number of analysts lowered guidance. The company settled the Reg FD charge as part of an overall global settlement of other filing violations. The two individuals also settled. Each consented to the entry of a cease and desist order based on Exchange Act Section 13(a) and Reg FD. Each also undertook to pay a civil penalty of $50,000.

2. *SEC v. Presstek, Inc.*, Civil Action No. 10-1058 (E.D.N.Y. Filed March 9, 2010) is an action against the company, a Connecticut based manufacturer, and the former chairman of its audit committee, Edward Marino.

a. The SEC alleged that Mr. Marino received an e-mail from the company controller on September 10, 2006. It stated that performance in both North America and Europe for August was weak and had a negative impact on margin and operating income relative to plan. No announcement was planned before early October.

b. On September 28, 2006 Mr. Marino received a telephone cal from Michael Barone, a managing partner of Sidus, a registered investment adviser. The funds managed by the adviser owned almost half a million shares of the company. During the conversation, Mr. Marino told the adviser that the summer had not been as vibrant as expected in North America and Europe. This is reflected in notes of the conversation prepared by Mr. Barone and quoted in the complaint. The notes also stated that Mr. Marino, in substance, said that "overall a mixed picture" emerged from the company for the quarter.

c. Mr. Barone began selling company shares almost immediately. He sent an e-mail during the call to begin. By the end of the day, most of his position had been liquidated.

d. The next day the company issued a preliminary announcement that the quarterly financial performance was below prior estimates.

e. The company settled, consenting to the entry of a permanent injunction prohibiting future violations of Exchange Act Section 13(a) and Reg FD. The company also agreed to pay a $400,000 civil penalty. The SEC acknowledged the cooperation of the company and its remedial efforts. Check – did the share price go down pre or post announcement

f. Mr. Marino is litigating the case. Lit. Rel. No. 21443 (Mar. 9, 2010).

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THE ABA CRIMINAL JUSTICE SECTION PRESENTS:

IS THE DOJ AND SEC WAR ON INSIDER TRADING REWRITING THE RULES?

CO-CHAIRS:

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September 23, 2011
Dorsey & Whitney LLP
New York City

INTRODUCTION

- **Insider trading is a key priority of the DOJ and the SEC**
- **In recent years the U.S. Attorney's Office in Manhattan has led the charge on the criminal side, bringing a series of high profile cases which many thought would redefine insider trading**
  - **In the last eighteen months about 50 indictments have been returned**
  - **Each case that has gone to trial ended with a conviction**
- **The SEC has participated in those cases**
- **The SEC has also staked out its own position which may in fact be more aggressive than that of the DOJ**

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INVESTIGATIONS

- The tactics
  - Many have decried the use of “blue collar” tactics in recent cases
    - Wiretaps
    - Wired informants
    - Cooperating witness
    - FBI raids
  - The SEC continues to use its traditional approach but has added
    - Co-operation agreements
    - Whistleblower rules offering the potential for large payments but which do not require reporting first to the company

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INVESTIGAIONS

- Tactics (cont)
  - How does the impact of the tactics on a business or individual affect their choice?
  - Some criminal cases focus on expert networking organizations.
    - How do they guard against being swept up in an investigation?
    - Will the new rules in Mass. protect these entities?
- The financial fraud task force
  - This requires sharing information which could alter investigative tactics
  - Is the task force resulting in more parallel proceedings and changing the tactics?

CRIMINAL OR CIVIL?

- The securities laws require that the additional element of "willfulness" be established to prove a criminal violation
- Recent court decisions defining that term as well as scienter, reckless disregard and consciousness avoidance have blurred the line
- What is the dividing line or is there one?
- Is Exchange Act Section 10b to vague? Consider *U.S. v. Gansman*

WHAT IS INSIDER TRADING?

- Trading: is trading sufficient to prove insider trading?
  - FINRA refers "suspicious" trading for investigation
    - Is this enough?
    - Is a "plus factor" required?
  - Consider cases such as *SEC v. Troung* and *SEC v. Goldinger*
  - What else is required?
    - No rational basis for the trade
    - Cover–up
    - Other actions showing "guilty knowledge"

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WHAT IS INSIDER TRADING?

- Breach of fiduciary duty: Is it required after *SEC v. Dorozhko*?
  - Previously many courts thought a breach of duty was required, e.g. *Chiarella, Dirks & O'Hagan*
  - Is deception now enough?
  - Is this consistent with *O'Hagan* and *Zanford?*

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WHAT IS INSIDER TRADING?

- Breach of fiduciary duty and deception after *SEC v. Dorozhko* (cont)
  - If so, how is "deception" defined– is fraud or theft enough?
    - *Santa Fe* requires but does not define the concept
  - What is deception?
  - Any kind of theft?
  - Consider the government's brief in *O'Hagan* arguing that embezzlement is sufficient and Chief Justice Burger, dissenting, in *Chiarella* positing that theft is sufficient
  - Can scheme liability suffice – consider *SEC v. Diafotes*

WHAT IS INSIDER TRADING?

- The mosaic theory
  - Under this theory putting together bits and pieces of non-material information to reach a conclusion is not inside information
  - Is the SEC rewriting these rules in recent employee cases such as *SEC v. Stefes* and others?
  - Is this consistent with the cautionary note in the recent case of *U.S. v. Gansman?*

WHAT IS INSIDER TRADING?

- Traditionally, insider trading is based on an abuse of position by someone entrusted with inside information
- Can the company authorize insider trading?
  - Consider *SEC v. Knight*
- Can a company create an insider trading violation as a result of its compliance procedures?
  - Consider *SEC v. Cuban*

WHAT IS INSIDER TRADING?

- Dodd-Frank now permits the SEC to obtain a financial penalty against any person in an administrative proceeding
- Will the Commission now bring insider trading cases in that forum?

COMPLIANCE

- What are the key elements of a compliance program?
- How do expert networking organizations protect their business or is it possible?
  - Primary Global had an insider trading policy but one of its officers was convicted and another pleaded guilty
- Professional traders
- Corporations – what do they black out after *Steffes* and *Knight?*

CONCLUSIONS

- Insider trading is a key enforcement priority
- The landscape of parallel proceedings has changed
- Expect aggressive criminal enforcement in areas traditionally defined as "insider trading" such as M&A information and earnings releases
- The SEC will continue with its current trends

CONCLUSIONS

For additional information please see

www.secactions.com

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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

By Thomas O. Gorman[*]

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 inference 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 another 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 traditional 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*, *Goldinger*, 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.").

4

Building an Effective Information Barrier Policy – What Every Compliance Officer Should Know

Tammy Eisenberg
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Key Elements of a Successful Policy

- Tone at the Top
- Clearly Defined Policy and Procedures
- Monitoring
- Training
- Certifications

Tone at the Top

- **Why?**
  - Emphasizes importance of policy
  - Consequences for violation of policy

Clearly Defined Policy and Procedures

- **Who is covered**
- **What kind of information is covered**
- **Whether and how information can be shared**
- **What information needs to be disclosed to Compliance and how often**

Information Flow

- **Identify sources and flow of information in your business**
  - Client Confidential Information
  - Proprietary Firm Information
  - Material Nonpublic Information
- **Determine who receives it and how it is shared**
  - Frequently/ordinary course of business
  - Sometimes
  - Never
- **Determine who is responsible for controlling/monitoring flow**
  - Procedures

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Client Confidential Information

- **Information about clients**
  - Identity
  - Tax ID
  - Account holdings
  - Transactions in trading accounts
  - Investment Objectives
  - Gains/losses

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Proprietary Firm Information

- Trading strategies
- Projections
- Models
- Internal research
- Internal reports (financial, exceptions, etc.)
- Minutes of meetings
- Internal memos
- Policies and procedures

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Examples of Material NonPublic Information

- Tender offers, merger or acquisition plans
- Earnings or earnings estimates
- Dividends and dividend changes
- Stock splits
- Public offerings, private offerings, cancellations of offerings, changes in timing or terms
- Calls, redemptions or issuer repurchases
- Changes in key personnel and other management developments
- Events requiring SEC filings, other regulatory filings
- Significant write-downs of assets or additions to reserves for bad debts/contingent liabilities
- Proposed expansions/curtailments of operations
- Actual/threatened litigation or government investigations, other enforcement actions
- Debt rating changes
- Significant increases/decreases in orders
- Divestitures or leveraged buy-outs
- Recapitalization or restructuring
- Liquidity problems
- Significant financing transactions
- New products, inventions or discoveries
- Acquisition/loss of major contract
- Impending block trades, ownership positions in securities
- Unpublished sell-side research reports

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Receiving/Sharing Information

- **The Jargon**
  - Information Barriers
    - Also called Chinese Walls, Ethical Walls, etc.
  - Above the Wall
  - Over the Wall
  - Public Shop
  - Private Shop
  - Wall Crossing

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Information Barriers

Wall is between:

- Those who receive sensitive information frequently/ordinary course of business
- Those who sometimes receive sensitive information
- Those who never receive sensitive information

- **Procedure**
  - Document
    - Details of information
    - Who has access/need to know (wall-crossing)
  - Update frequently
  - Monitor

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Wall Crossing

- **Standard = Need to Know**
- **Need must be legitimate**
  - Need to know vs. Want to Know
- **Documentation**
  - Pre-approval
  - Who
  - What
  - When
- **Procedures**
  - Chaperoning
  - Restrictions
  - Monitoring

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Monitoring – Types of Lists

- **Conflicts List**
  - List of companies which have not yet shared MNPI
  - Company has not yet engaged you
  - Employees may trade in these companies unless they are part of the deal team or other potential insider
- **Watch List**
  - List of companies that have shared MNPI or about which you possess MNPI
  - Engagement letter or other contract in place with confidentiality clause
  - Employees may trade in these companies unless they are over the wall
  - Research reports generally permitted
- **Restricted List**
  - MNPI is now public; trading is restricted to avoid:
    - Appearance of impropriety
    - Trading on information possessed by you that may not be public
    - Types of restrictions:
      - No solicited trades
      - No personal trades
      - No research reports unless permitted by SEC rules

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Monitoring – What to review

- **Personal trading**
  - Disclosure of accounts (personal, immediate family)
- **Proprietary trading**
- **Solicited trading/managed accounts**
- **Research reports**
- **Other communications**
  - E-mail
  - Bloomberg/Bloomberg IM

Some Dos and Don'ts

Do

- **Use password protection and encryption**
- **Exercise discretion**
- **Lock files**
- **Use code words and project names**

Don't

- **Discuss confidential information in public places**
- **Leave confidential information in plain sight on your desk**
- **Share confidential information without consulting compliance**

Training & Certifications

- Orientation
- Annually
- As-needed

Questions?

5

Insider Trading: Ambiguous Statute as Warning

Frank C. Razzano, Pepper Hamilton LLP

Introduction

In the last eighteen months, 47 people have been charged with insider trading; 35 of those defendants have either pled guilty or been convicted. None have been acquitted after trial. Raj Rajaratnam's and Zvi Goffer's convictions are examples of the most recent and high-profile. It is widely believed that the U.S. Attorney's Office in the Southern District of New York is planning to return a number of other indictments against outside consultants and others in an inquiry into an expert networking firm. How has such an impressive record of convictions and pleas been built without a single acquittal?

The answer is twofold. First, the insider trading laws are among the most amorphous and vague in the entire criminal code. Most people, including jurors, believe insider trading means buying or selling a security based on information that is not publically available. It does not. Rather, the definition of insider trading is complex. Indeed, it took almost a generation and a half of legal scholarship to determine its elements. Juries simply do not understand insider trading, and often succumb to the argument that if a defendant traded on information not available to others—and made a lot of money—he is guilty.

Second, one essential key to an acquittal in an insider trading case is an explanation of why the defendant traded. The defendant must take the witness stand and testify how he arrived at the decision to trade the stock in question at that precise moment. In insider trading cases, it is impossible to raise a reasonable doubt without the defendant's testimony of innocent conduct; unlike other white-collar crime cases in which the defense may rest on the government's inability to prove its case. In an insider trading case, the government will be able to prove that the defendant knew an insider, who had material non-public information, and was in contact with that insider shortly before executing a trade. If the defendant does not take the stand and explain his conduct, the inference that he traded on insider information will be overwhelming. Yet, most defendants will have unwittingly disabled themselves at the very outset of the investigation from taking the witness stand at the trial.

Section 10(b) – A Vague and Ambiguous Law

In 1934, when Congress passed Section 10(b) of the Securities Exchange Act (Exchange Act)—the so-called "securities fraud" provision—it was the accepted wisdom on Wall Street that the only way to make money in the markets was to trade on insider information. There was not a single individual who believed that Section 10(b), which outlaws "deception" in connection with the purchase or sale of a security, covered insider trading. In fact, the Exchange Act specifically covered insider trading in another section—Section 16(b)—which provides that profits by an insider

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from the purchase and sale of securities within six months must be disgorged.

Developing a Definition

It was not until almost thirty years later, in *Cady, Roberts and Co.*,[1] that the Securities and Exchange Commission (SEC) suggested that a corporate insider violates Section 10(b) of the Exchange Act—the securities fraud provision—when trading in the shares of his own company, unless he first disclosed all material inside information that he knew. Following the SEC's lead, the Second Circuit several years later in *SEC v. Texas Gulf Sulphur*[2] held that anyone who possesses information, even if he was not an insider within the meaning of the Exchange Act, must either disclose that information to the investing public, or be precluded from trading or recommending the stock while the information remained undisclosed. In other words, there must be equality of information in the marketplace among all traders, and those who trade on material non-public information not available to all commit securities fraud in violation of Section 10(b).

The U.S. Court of Appeals for the Second Circuit's definition was simple and easy to apply, and, even to this day, is what most people believe constitutes insider trading. In fact, this simplistic definition survived for only twelve years. In *Chiarella v. United States*,[3] the U.S. Supreme Court rejected the concept of equality of information in the marketplace, and developed what has become known as the classical theory of insider trading. Under the classical theory, the relationship between a corporate insider and a shareholder of that corporation gives rise to an obligation on the part of the insider either to disclose or refrain from trading. If the trader is neither an insider, nor a fiduciary, there is no obligation to disclose material non-public information. In *Chiarella*, the jury, in accordance with *Texas Gulf Sulphur*, had been instructed that the defendant owed a duty to everyone when he used material information. Thus, in view of the Court's redefinition of insider trading, *Chiarella's* conviction was reversed.

In *Chiarella*, the Supreme Court essentially held that equality of information in the marketplace is not a hallmark of our capitalist system. It also is not fraudulent to trade on information others do not possess, unless you obtain the information in breach of a duty owed to the corporation in whose stock you are trading. A mere possession of inside information creates no duty in and of itself.

Tipper/Tippee

Three years later, in *Dirks v. SEC*,[4] the Supreme Court determined that when a tippee receives material non-public information from an insider, the tippee also has a duty to disclose because the tippee's duty of disclosure derives from that of the insider. In other words, the tippee assumes the insider's duty, not because the information has been made available to him, but because it has been made available to him improperly by the tipper, with knowledge by the tippee that the tipper passed along the information in breach of his or her fiduciary duty. Whether the disclosure is improper and in breach of fiduciary duty is determined by analyzing the purpose for the disclosure. If the purpose is a personal benefit to the tipper, that constitutes a breach of fiduciary duty, of which the tippee should have been aware.

Open Questions

It took a full 22 years to arrive at a basic framework for what constitutes insider trading, starting from the first inkling mentioned in *Cady, Roberts*, that insider trading might violate Section 10(b), and culminating with *Dirks*. But, the saga was not yet done. All the Supreme Court had done in the first 22 years is craft the classical theory of insider trading, in which an insider, in breach of a fiduciary duty owed to his corporation, trades in a stock or tips another who trades. This left open the question of whether an individual, who did not derive the non-public information from the corporation whose stock in which he traded, could be held liable for insider trading under Section 10(b).

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In *United States v. Newman*,[5] the Second Circuit sought to fill this void by adopting the so-called misappropriation theory, which was first suggested by Justice Berger in his dissent in *Chiarella*. Under that theory, whenever someone misappropriates information in breach of fiduciary duty, and trades upon that information, the defendant has engaged in actionable fraud in connection with the purchase or sale of a security in violation of Section 10(b). In other words, the duty breached need not be owed to the corporation whose stock is traded as is required under the classical theory. Any breach of duty will suffice. But this so-called misappropriation theory was not free from doubt. It was unclear, even as defendants were prosecuted under that theory, whether the Supreme Court would accept it. In *Carpenter v. United States*,[6] the Supreme Court divided 4-4 when faced with this issue. As a consequence, the lower court judgment was affirmed – but without any precedential value.

O'Hagan

It would take the Supreme Court another ten years to return to the issue of the validity of the misappropriation theory in *United States v. O'Hagan*.[7] There, the Supreme Court held that criminal liability under Section 10(b) of the Exchange Act could be predicated on the misappropriation theory, *i.e.*, the theory of securities fraud upon which it had evenly divided ten years before. Thus, it took 36 years for the Supreme Court to work out what the parameters of insider trading were. Clearly, given such a track record, determining what constitutes insider trading is not a clear-cut or simple task.

Isn't Insider Trading Theft?

Although in their press releases announcing insider trading indictments and convictions, prosecutors often tout the fact that insider trading is nothing more than simple theft, one need only look to the history of insider trading to know the truth. The 36-year history of repeated attempts by the Supreme Court to define insider trading puts the lie to such simplistic comments.

While it is true that human beings, either by religion or reason, know that certain practices, such as theft, are intrinsically evil and must be avoided, neither religion nor reason tells us that insider trading is an intrinsic evil. Moses, after all, did not come down from Mount Sinai with an eleventh commandment saying, "Thou shalt not insider trade." Nor does reason teach us that trading upon inside information is an intrinsic evil. Indeed, the Supreme Court recognized in *Dirks* that inequality of information in the marketplace is a natural by-product of our economic system. Moreover, whole industries such as equity research thrive on the non-controversial notion that increased information about a company leads to sounder investment choices.

Due Process Concerns

The hallmark of any democratic system of justice is due process, which requires clear and definite laws that tell us when we are within the bounds of the law, and when we are not. As Thomas More states in *A Man for All Seasons*, "the law must be like a road, with clearly defined edges, so that one can know when he is on or off the road." The law of insider trading is not such a law.

How can we expect the average citizen to determine when he is or is not trading illegally on inside information, when it took the Supreme Court 36 years to work out the definition of insider trading? How, for example, was Martha Stewart or Mark Cuban supposed to make that determination in the blink of an eye, when nine justices of the Supreme Court needed to ponder it for decades?

Are Insider Trading Cases Difficult To Prove?

While nearly every press release and news story that has appeared in the past eighteen months repeats the mantra that insider trading cases are difficult to prove, just the opposite is true. Insider

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trading cases are exceedingly easy to prove. This is what makes the fact that insider trading is such a vague and amorphous crime all the more troubling in a free democratic society.

The mantra that insider trading cases are difficult to prove mistakenly originates from the fact that they are largely circumstantial. But very often, circumstantial evidence can be just as compelling, if not more so, than direct evidence. If you have evidence that a tipper possessed material non-public information, was in contact with a tippee, and that tippee shortly thereafter traded in the stock, most individuals applying common sense logic will conclude that the tipper passed the information on to the tippee. Few if any jurors will focus on the issues of duty, breach of duty, and improper purpose when analyzing facts. It is the rare insider trading case where a jury will not return to the court after several hours of deliberation, and ask "Your Honor, you mentioned breach of fiduciary duty. What is that?" The judge will then tell them in ponderous tones that a fiduciary duty is the highest duty one can owe to another. It is a relationship of trust characterized by dominance of one party over another and reliance by one party on another.

The jurors will then retire, and when seated in the jury room ask "What the heck did he just say?" They may even try again to get an answer from the judge. When they fail, they will return to the jury room and ask themselves, "Now what?" Then someone will say, "You know, the judge said we can apply our common sense." They then will unanimously decide, based on their common sense and without reference to legal principles, that the defendant is guilty since he had information others did not.

It appears that something very much like this occurred in the Rajaratnam trial. It is reported that when the jurors in that case retired to their deliberations, they were just as confused about when insider trading constitutes securities fraud as the Supreme Court was for decades, so they consulted reference materials that offered explanations. We can only hope that those reference materials, whatever they were, accurately summarized the holdings of the Supreme Court's 36-year journey attempting to define this crime. I will leave it to Rajaratnam's trial team to determine whether, assuming this in fact occurred, it permits inquiry into the validity of the verdict under Federal Rule of Evidence 606(b).

How can a defendant overcome a jury's preference for common sense, over the substantive and, as argued herein, confusing elements of the violation? In order to secure an acquittal, the defendant must take the witness stand to testify, and the jury must credit his testimony.

Blue-Collar Tactics

However, most defendants will never have the opportunity to testify in their own defense because the government's use of blue-collar investigative tactics will cut off this avenue off well before trial. I refer not to relatively sophisticated blue-collar tactics, such as the use of wire taps or search warrants, which are discussed later. Instead, I refer to the use of a relatively simple blue-collar technique, the ambush interview, which might severly impede a putative defendant's ability to obtain an acquittal.

Hypothetical

Assume your neighbor is an executive in the finance department of a major corporation. You observe that she is burning the midnight oil, neglecting her obligations to her family and community due to her job. You also learn from her husband that she is visiting, on a regular basis, a city where her employer's major competitor is located. You put two and two together, and conclude that it is likely that her company is about to acquire the competitor, and decide to buy the stock. When a merger is announced, you sell the stock and make a tidy profit. This is known as leakage. Professor Gregg Jarrell, who testified in the Rajaratnam case, has long written and lectured on this perfectly common, normal and legal phenomenon.

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Some months or perhaps years after the trade, on a lovely summer afternoon, you drive up to your house and park in the driveway. As your wife and children come to greet you, two men in ill-fitting dark suits approach you and flash badges announcing in voices loud enough for all the neighbors to hear that they are FBI agents. They ask if they can come into your home and suggest that your wife and children repair to the recreation room, because they have a few questions to ask you.

And then it comes. The agents ask you why you decided to buy stock in your neighbor's employer. Your life now hangs in the balance. The immediate thought that will go through your mind is, my God, I must have traded on insider information. Why? Because the average person does not know what the elements of inside information are.

In the scenario I have posited, there was no trading on inside information. You merely observed your neighbor's public habits and drew a conclusion. There is nothing unlawful about this. Your neighbor breached no fiduciary duty to anyone, nor did you.

However, as you sit there with the FBI agents, you will not know this. The natural tendency of all human beings when they are confronted by government authorities, who are implying that they may have done something wrong, is to justify their conduct. Instead of saying that you observed your neighbor's behavior and motions and put two and two together, you are more likely to say: "I read a story about it." Being less than candid and forthright with a government official is a violation of 18 U.S.C. § 1001 and obstruction of justice, as Martha Stewart learned. Few people will have the presence of mind to say "I want to talk to a lawyer."

Even if our putative defendant is completely candid, after several months or years have passed, his recollection of the events leading up to the trade may fade. Even if he tells the FBI agents what he now honestly believes to be the absolute truth, he will now be stuck with that story forever, unable to supplement or modify it when his recollection is refreshed with documents without being accused of lying.

Alternative Hypothetical

In an alternate scenario, it may not be the FBI who comes to your home. It may be a surprise call at the office from the SEC. Indeed, the casualness of a telephone call from the SEC is more likely to induce you to talk to them. But once you have opened your mouth and spoken to the SEC, you will never again be able to change your story. Indeed, if you do change your story, the government will argue that you have made two inconsistent statements, which in and of itself is evidence of guilt.

I do not mean to ascribe any nefarious intent to the FBI or SEC by employing these tactics. They are, of course, legitimate. My only point is that if a putative target tells one story at the initial interview due to failure of recollection, or a simple desire to cut the interview short, she may well be stuck with that story forever.

The only way to avoid the dilemma that you now face is to do what is almost unnatural for the average layman, and that is slam the door on the FBI agents – and hang up the phone on the SEC. But, normal people simply will not do this. Believing that they can talk their way out of their problems, they will engage in an extended conversation with either the FBI or the SEC, trying to justify the legitimacy of the trade. Yet, as the discussion proceeds the hole will be dug more deeply.

On these assumed facts, it would be almost impossible to secure an acquittal. Anyone ensnared in an insider trading investigation must keep his or her options open. I say this not because a lawyer will help the client craft a false story to sell to the jury. Rather, it is essential when faced with the overarching might and power of the United States government to seek legal advice to determine whether or not a law has been violated, and to help reconstruct the facts, the memory of which likely

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have dimmed with the passage of time. An attorney may be able to pinpoint facts that may show that the elements that would make the accusation an offense were simply not present.

Rational and Coherent Explanation

As I noted above, in any insider trading case, it is essential that the defendant testify and be able to explain to the jury in a rational and coherent manner, why it is that he or she became interested in this stock and why he or she traded at that exact moment. Sometimes admitting that the interest in the stock came from the insider is the best approach, albeit a counter-intuitive one.

In the scenario above, interest in the stock was initiated by the insider, but that does not mean that the subsequent trade was based on insider information. Insider trading has a precise definition built up over the course of 36 years. It is not, as the United States government once advocated, merely trading while in possession of material non-public information. But the only way that an individual who has not studied the 36-year history of insider trading can ever hope to escape is by seeking the advice of a lawyer and analyzing his own particular facts against the legal standard.

Tape Recordings

Many reading this article to this point may think, "All of this is all well and good, but that wouldn't have helped Rajaratnam, because he was caught on tape." Tape recordings are just another blue-collar tactic, like the ambush interview. An individual who makes his or her living in the securities industry and who does not want to become a defendant in an insider trading case, must do two things to deal with such aggressive tactics.

First, he or she must have a good grasp of the law, and should never act in any marginal situation without documented legal advice. Second, and more importantly, securities professionals must learn discipline when speaking to even their most trusted friend about anything that can be misinterpreted and misconstrued by government agents listening to telephone conversations. Remember they are listening to put you in jail, and will give your words no leeway as just "joking around."

After nearly 40 years defending securities professionals, the one thing I have learned is that professionals, including (and some would say, particularly) lawyers, enjoy boasting to each other. It bolsters their egos and makes themselves seem more important and more influential than they really are. At times, these professionals will say the silliest and stupidest things on a telephone. I am sure that many of you reading this article may have said at one time or another, even if it wasn't true, to someone on a telephone, "I know somebody on the board." That simple, innocuous boast, even if untrue, will never be viewed by your friendly FBI agent or SEC staff member as a boast, but as conclusive evidence of insider trading.

It has been reported that some of the people caught on tape speaking to Rajaratnam did just that – boasted about their contacts. When such boasting occurs, a listener must terminate the call, or admonish the speaker. Otherwise, the government will point to the call as evidence of evil intent.

Conclusion

So what is a person to do? First, if approached by the FBI or the SEC, seek legal advice; do not under any circumstances talk to the agents. And, remember, the fact that the FBI or SEC does not read you *Miranda* rights doesn't mean that they have not targeted you for prosecution. It only means you have not yet been placed under arrest, since only people who are not free to go are entitled to *Miranda* warnings. Second, engage in e-mail and telephone discipline. Assume that every single e-mail is being read and every single telephone conversation is being listened to. Do not put foolish comments into e-mails or make foolish

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statements on telephone conversations. Your life may depend upon it!

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[1] 40 SEC 907 (1961).
[2] 401 F.2d 833 (2nd Cir. 1968).
[3] 445 U.S. 222 (1980).
[4] 463 U.S. 646 (1983).
[5] 664 F.2d 12 (2d. Cir. 1981).
[6] 484 U.S. 19 (1987).
[7] 117 S. Ct. 2199 (1997).

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