



Financial Fraud Law Report

AN A.S. PRATT & SONS PUBLICATION

JULY/AUGUST 2013

HEADNOTE: THE SEC'S DECISION TO LIFT THE ADVERTISING BAN ON PRIVATE INVESTMENTS

Steven A. Meyerowitz

PERSPECTIVES ON THE SEC'S DECISION TO LIFT THE ADVERTISING BAN ON PRIVATE INVESTMENTS

H. David Kotz

AUDITORS AT THE GATE: RESTORING THE REPUTATIONAL CAPITAL OF THE PROFESSION – PART I

Richard H. Kravitz

RECENT FEDERAL COURT DECISIONS REVITALIZE THE GOVERNMENT'S CIVIL ENFORCEMENT POWER UNDER FIRREA

Marvin G. Pickholz and Mary C. Pennisi

FIRST HALF 2013 INSIDER TRADING REVIEW

Michael Rosensaft

FIVE CYBERSECURITY MISTAKES COMPANIES MAKE THAT COULD RESULT IN THEIR PROSECUTION

Michelle A. Reed and Elizabeth D. Scott

TAMING THE "WILD WEST": REGULATORS TAKE AIM AT UNREGULATED VIRTUAL CURRENCIES

Marcus Asner, Andrew Joseph Shipe, and Alexandra L. Mitter

SEC TAKES AIM AT FUND DIRECTORS OVER VALUATION PROCESS: A LOOK AT *IN RE J. KENNETH ALDERMAN ET AL.*

Rose F. DiMartino, Margery K. Neale, and Maria R. Gattuso

NO LONGER THE SLEEPING DOG, THE FCPA IS AWAKE AND READY TO BITE: ANALYSIS OF THE INCREASED FCPA ENFORCEMENTS, THE IMPLICATIONS, AND RECOMMENDATIONS FOR REFORM

Rouzhna Nayeri

EDITOR-IN-CHIEF

Steven A. Meyerowitz

President, Meyerowitz Communications Inc.

BOARD OF EDITORS

Frank W. Abagnale

Author, Lecturer, and Consultant
Abagnale and Associates

William J. Kelleher III

Corporate Counsel
People's United Bank

Sareena Malik Sawhney

Director
Marks Paneth & Shron LLP

Stephen L. Ascher

Partner
Jenner & Block LLP

James M. Keneally

Partner
Kelley Drye & Warren LLP

Mara V.J. Senn

Partner
Arnold & Porter LLP

Thomas C. Bogle

Partner
Dechert LLP

H. David Kotz

Director
Berkeley Research Group, LLC

John R. Snyder

Partner
Bingham McCutchen LLP

David J. Cook

Partner
Cook Collection Attorneys

Richard H. Kravitz

Founding Director
Center for Socially
Responsible Accounting

Jennifer Taylor

Partner
McDermott Will & Emery LLP

David A. Elliott

Partner
Burr & Forman LLP

Frank C. Razzano

Partner
Pepper Hamilton LLP

Bruce E. Yannett

Partner
Debevoise & Plimpton LLP

The FINANCIAL FRAUD LAW REPORT is published 10 times per year by Matthew Bender & Company, Inc. Copyright 2013 Reed Elsevier Properties SA., used under license by Matthew Bender & Company, Inc. All rights reserved. No part of this journal may be reproduced in any form — by microfilm, xerography, or otherwise — or incorporated into any information retrieval system without the written permission of the copyright owner. For permission to photocopy or use material electronically from the *Financial Fraud Law Report*, please access www.copyright.com or contact the Copyright Clearance Center, Inc. (CCC), 222 Rosewood Drive, Danvers, MA 01923, 978-750-8400. CCC is a not-for-profit organization that provides licenses and registration for a variety of users. For subscription information and customer service, call 1-800-572-2797. Direct any editorial inquires and send any material for publication to Steven A. Meyerowitz, Editor-in-Chief, Meyerowitz Communications Inc., PO Box 7080, Miller Place, NY 11764, smeyerow@optonline.net, 631.331.3908 (phone) / 631.331.3664 (fax). Material for publication is welcomed — articles, decisions, or other items of interest. This publication is designed to be accurate and authoritative, but neither the publisher nor the authors are rendering legal, accounting, or other professional services in this publication. If legal or other expert advice is desired, retain the services of an appropriate professional. The articles and columns reflect only the present considerations and views of the authors and do not necessarily reflect those of the firms or organizations with which they are affiliated, any of the former or present clients of the authors or their firms or organizations, or the editors or publisher.

POSTMASTER: Send address changes to the *Financial Fraud Law Report*, LexisNexis Matthew Bender, 121 Channon Road, North Building, New Providence, NJ 07974. ISBN: 978-0-76987-816-4

First Half 2013 Insider Trading Review

MICHAEL ROSENSAFT

The new insider trading cases in 2013 reflect some bold prosecutions that further stretch the bounds of the misappropriation theory and demonstrate heavy reliance on circumstantial evidence.

Insider trading continues to be a major focus of regulators and prosecutors. During the first half of 2013, approximately thirty new insider trading complaints and indictments were filed by the SEC and the Department of Justice (including parallel proceedings). This number obviously does not represent the number of new investigations by either entity that did not result in a complaint or indictment being filed. Nevertheless, looking at these cases illustrates both how prosecutors and regulators are detecting insider trading and what they see as the legal constraints of those charges. The new insider trading cases in 2013 reflect some bold prosecutions that stretch further the bounds of the misappropriation theory and demonstrate heavy reliance on circumstantial evidence.

CASE CHARACTERISTICS

Unsurprisingly, the great majority of insider trading cases continue to be filed in the Southern District of New York with approximately 50 percent of the new insider trading complaints and indictments in 2013 filed in that district.¹ Although Judge Rakoff was most often in the news for his insider trading rulings, Judge Baer actually received more than a third of

Michael M. Rosensaft, a former federal prosecutor in the Southern District of New York, is a partner at Katten Muchin Rosenman LLP in the firm's White Collar Defense Group. He can be reached at michael.rosensaft@kattenlaw.com.

these new cases. The SEC brought parallel civil actions every time a criminal indictment was brought except in one case, demonstrating the incredibly close working relationship between the SEC and DOJ. Expectedly, following what Senior Associate Director Sanjay Wadhwa has dubbed the SEC New York Regional Office's "aggressive pursuit of hedge fund insider trading,"² the majority of these new cases target hedgefunds. On the criminal side, again unsurprisingly, the U.S. Attorney's Office for the Southern District of New York accounted for 50 percent of all new federal insider trading prosecutions in 2013.³ Other federal criminal cases were filed in the Central and Northern Districts of California,⁴ the District of New Jersey,⁵ and the Eastern District of New York.⁶

The information that was allegedly tipped in these new investigations is overwhelming information about mergers and acquisitions, with approximately 63 percent of the new insider trading complaints and indictments involving such information. This is not surprising since a proposed merger or acquisition is almost certainly non-public, material information. That said, this concentration in mergers and acquisition most likely also reflects a prosecutorial bias towards these insider information cases, given the way the SEC, in particular, identifies insider trading cases by focusing on key company events that greatly affect stock prices. Certainly there is other valuable inside information about a company, such as earnings releases, investor information, or new developments that can also greatly affect a company's stock price; but trades based on insider information about mergers and acquisition tend to be both easier to identify and easier to prove.

To prove insider trading, the insider information must be material — that is, information that would have been "viewed by the reasonable investor as having significantly altered the total mix of available information."⁷ The SEC has in fact been burned multiple times when courts have deemed insider information immaterial — especially when rumors of the insider information already existed in the public domain.⁸ Thus, with dozens of analyst reports being issued daily about earnings and performance, it is not surprising that the SEC and federal prosecutors tend to concentrate their prosecutions around mergers and acquisitions, which are much cleaner events to recognize as material and thus less prone to a materiality attack.

The industries involved in the tipped information varied wildly in the

new 2013 cases, although there were concentrations in technology companies and healthcare/pharmaceutical companies. This is not surprising in the tech sector, given the relatively higher volatility of tech stocks and abundance of mergers.

The person doing the tipping was, in approximately two-thirds of cases, a real insider: an officer, board member, or employee of the company at issue. In the other third of the 2013 cases, the tipster was an attorney or a third party such as an auditor, investment banker, or a contractor involved in investor relations.⁹ Although it is difficult to track insider versus outsider tipsters across the years, it seems that there is an increased focus by prosecutors and regulators on “outsiders,” reflecting the ever-growing reach of the misappropriation theory. As investigative techniques become more aggressive and the misappropriation theory widens, more third parties are liable to be caught in insider trading nets in the latter half of 2013.

EVIDENCE AND THEORIES

Despite the increased use of wiretaps in insider trading cases, only eight percent of the new complaints and indictments specifically mentioned any recorded calls. That said, the courts have continued to affirm prosecutors’ use of wiretaps without much ado, even where the wiretap was aggressive. As one example, in a surprisingly quiet summary order, in January 2013, the Second Circuit upheld the judgment of conviction of James Fleishman, who was convicted for conspiracy to commit securities fraud and wire fraud based in part on a “trunk line” wiretap.¹⁰ The wiretap order was not of Fleishman’s phone, but of a third party: a 1-800 number conference line that Fleishman and others were alleged to have used to facilitate their criminal activities. Fleishman had his own PIN number, but the wiretap was not restricted to Fleishman’s PIN, or even to the alleged co-conspirators’ PINs, but the order allowed the government to listen to 104 different PIN numbers, the majority for which there was no probable cause in the application that those particular PIN numbers were being used to facilitate criminal activity. The district court and Second Circuit both quickly affirmed this wiretap under the theory that it was the 1-800 number as a whole that was the “communications facility” and the PIN numbers were basically irrel-

evant. Although the government is always required to minimize its wiretapping, once there was probable cause to believe any one person used that 1-800 conference line in furtherance of criminal activity, every single PIN number of that conference line could be intercepted. Despite this being really an unprecedented, aggressive use of wiretaps, the Second Circuit gave it no more than a summary order, signaling its increasingly expansive support of the use of wiretaps.

While the type of wiretaps courts are upholding may be expanding, insider trades are still overwhelmingly identified in the way they have been for years: first through scrutinizing the trading history surrounding significant company announcements, and then pairing findings with phone records that show contact between the traders and the insiders. This accounted for the evidence against the insider traders in 30 percent of new cases. Other law enforcement techniques referenced in the new complaints, but to a lesser degree, included: obtaining text messages, gathering emails, and, in one instance, involved an undercover FBI agent purchasing insider draft earnings reports from an individual at an investor relations firm.¹¹ That said, according to the complaints, the majority of the investigations started with the SEC or DOJ prosecutor simply scrutinizing who made money in trading surrounding key company announcements.

The aggressiveness of prosecutors and regulators in combating insider trading is apparent in the batch of new insider trading cases. First, in *SEC v. Moore*,¹² the SEC may be further pushing the boundaries of what is material, non-public information. In that case, the SEC has alleged that Moore was an investment banker and learned through his business relationships that a former and potential future client was working on a large acquisition and was traveling to London frequently. Although that information in and of itself was not enough to inform Moore's trades, according to the complaint, Moore paired that information together with his seeing the client at a charity event with the CEO of a United Kingdom engineering firm, where Moore allegedly ascertained that that UK firm must be the target of the acquisition. According to the SEC, Moore violated a fiduciary duty to his own employer by using the information he learned from a former client and coupling that with the public information he observed at the charity event.¹³ This complaint seems to invite a mosaic theory defense — that

even if the information gleaned through Moore's employer were insider information, it was only pairing it with the public information at the charity event that made it material. However, the SEC seems unconcerned.

In addition, prosecutors and regulators are further expanding the misappropriation theory to satisfy § 10(b)'s requirement that there be a "deceptive device or contrivance."¹⁴ As noted in *SEC v. Dorozhko*,¹⁵ the Supreme Court, in a series of cases that began with *United States v. Chiarella*¹⁶ and continued with *United States v. O'Hagan*,¹⁷ has held that where the insider trading allegations turn on the defendant's nondisclosure of insider information (as opposed to affirmative misrepresentations), the government need prove that the trader violated some fiduciary duty to the source of that information.¹⁸ In classical insider trading contexts, the company insider violates a duty to the shareholders by trading on the inside information without disclosing it to them. Under the misappropriation theory, the SEC and Department of Justice have successfully cited almost any breach of privacy or a fiduciary agreement as a basis to bring insider trading charges against third parties.¹⁹

The SEC has stretched further to find the limits of the misappropriation theory in the first half of 2013 with *SEC v. Begelman*.²⁰ In that case, Mark Begelman is alleged to have gone to a corporate retreat as a member of the World Presidents' Organization ("WPO").²¹ According to the longstanding policy of the WPO, its members are mandated to "operate in an atmosphere of absolute confidentiality." During that retreat, however, it is alleged that Begelman learned of an upcoming merger from another member of the WPO and traded on that information "[i]n breach of the duty of trust and confidence he owed to the [WPO member]."²² In short, Begelman was accused of violating the confidentiality rules governing the World Presidents' Organization during their Florida Keys retreat. It is clear that the SEC is willing to aggressively latch onto any confidentiality or privacy violation to fulfill the Supreme Court's mandates in *O'Hagan*. It remains to be seen whether courts will place any limits on that reach or if anyone further presses that point.

PROFITS AND PENALTIES

The amount of profits these defendants made from their trades was surprisingly low in some circumstances. In *Begelman*, for instance, the de-

fendant, an executive in his own right, made a little less than \$15,000 with his alleged insider information.²³ The average amount of profits alleged in all new insider trading cases in 2013 was a bit higher at a little under \$1.5 million, with the largest amount being \$6,900,000.²⁴ The total amount of alleged illegal profits in new insider trading cases was a little over \$32 million.

The penalties for cases that were settled, at least from the SEC, were very predictable. In 75 percent of 2013 cases, the SEC settled the case for an amount equal to twice the profit gained from the illegal trade plus interest. In two cases, the SEC settled the case by just requiring disgorgement of the illegal profit with no additional penalty, and in one case they imposed a penalty of two times profit. Presumably because the parties agreed to settle these cases, the SEC did not seek the maximum penalty of three times profits in any of the 2013 matters.²⁵ In one of the two cases where the SEC did not impose a penalty, the defendant was already subject to criminal penalties, which most likely led to their decision.²⁶ It is unclear what led to the reduced penalties in the second case,²⁷ or why the SEC imposed additional penalties in *SEC v. Bertini*,²⁸ although that is the only 2013 settlement filed in the Northern District of California, and it may simply reflect a regional difference.

LOOKING AHEAD

Between the continuing remnants of the Galleon prosecutions, the SAC Capital investigation, and the seemingly never-ending stream of additional investigations, it is clear that insider trading cases will continue to abound in the latter half of 2013. The SEC notes on its webpage that “insider trading continues to be a high priority area for the SEC’s enforcement program,” which will no doubt continue at the helm of Chairman and former U.S. Attorney Mary Jo White. U.S. Attorney for the Southern District of New York Preet Bharara is similarly focused, as demonstrated through comments of the recent insider trading sentencing of Anthony Chiasson:

With his sentence today, Anthony Chiasson chose to be part of a corrupt circle of friends that cheated the market to gain an unfair trading

advantage, and for that, he lost his career, his reputation and now he has lost his liberty. Such catastrophic losses should deter those who would be tempted to break the law....

He then ominously added: “but for those who are undeterred, we are not going away.”²⁹

NOTES

¹ *SEC v. Rogers*, 13 Civ. 374 (S.D.N.Y.); *SEC v. Certain Unknown Traders in the Securities of H.J. Heinz Company*, 13 Civ. 1080 (S.D.N.Y.); *SEC v. Sigma Capital Mgmt.*, 13 Civ. 1740 (S.D.N.Y.); *SEC v. Rajarengam Rajaratnam*, 13 Civ. 1894 (S.D.N.Y.); *United States v. Rajarengam Rajaratnam*, 13 Cr. 211 (S.D.N.Y.); *SEC v. Teeple*, 13 Civ. 2010 (S.D.N.Y.); *United States v. Riley*, 13 Mag. 806 (S.D.N.Y.); *United States v. Johnson*, 13 Cr. 190 (S.D.N.Y.); 13 Cr. 190 (S.D.N.Y.); *SEC v. Steinberg*, 13 Civ. 2082 (S.D.N.Y.); *United States v. Steinberg*, 12 Cr. 121 (S.D.N.Y.); *SEC v. Nguyen*, 12 Civ. 5009 (S.D.N.Y.); *SEC v. Moore*, 13 Civ. 2514 (S.D.N.Y.); *SEC v. Mancuso*, 13 Civ. 2555 (S.D.N.Y.); *SEC v. Stilwell*, 13 Civ. 3437 (S.D.N.Y.); *SEC v. Dosti*, 13 Civ. 3897 (S.D.N.Y.); *SEC v. Bartoszek*, 13 Civ. 3837 (S.D.N.Y.).

² *SEC Charges Sigma Capital Portfolio Manager With Insider Trading*, SEC News Digest, Issue 2013-60 (Mar. 29, 2013).

³ *See fn 1.*

⁴ *United States v. London*, 13 Cr. 379 (C.D. Cal.); *United States v. Lee*, 13 Cr. 180 (N.D. Cal.).

⁵ *United States v. Dowd*, 13 Mag. 6515 (D.N.J.).

⁶ *United States v. Perna*, 13 Cr. 103 (E.D.N.Y.).

⁷ *Basic v. Levinson*, 485 U.S. 224, 231-32 (1988).

⁸ *See, e.g., SEC v. Monarch Fund*, 608 F.2d 938, 942 (2d Cir. 1979) (general tips regarding impending securities offering not material as rumors already existed); *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8 (2d Cir. 1977) (tip regarding company increasing loss reserves immaterial due in part to market speculation); *SEC v. Rorech*, 720 F. Supp. 2d 367 (S.D.N.Y. 2010) (information regarding potential restructuring of a company and investor interest too ambiguous to be material).

⁹ *See, e.g., SEC v. Balchan*, 13 Civ. 2555 (S.D.N.Y.) (lawyer’s husband allegedly traded on insider information of a firm’s client); *United States v. London*, 13 Cr. 379 (auditor allegedly provided insider information about clients to a friend);

United States v. Perna, 13 Cr. 103 (E.D.N.Y.) (trader obtained draft earnings reports of assorted companies from an investor relations firm).

¹⁰ *United States v. Fleishman*, Summary Order, No. 12-94-cr (2d Cir. Jan. 8, 2013).

¹¹ *Perna*, 13 Cr. 103.

¹² 13 Civ. 2514 (S.D.N.Y.).

¹³ *Id.* at 8.

¹⁴ 15 U.S.C. § 78j(b).

¹⁵ 574 F.3d 42 (2d Cir. 2009).

¹⁶ 445 U.S. 222 (1980).

¹⁷ 621 U.S. 642 (1997).

¹⁸ *But see Dorozhko*, 574 F.3d 42 (2d Cir. 2009) (breaking into computer and stealing information falls under the category of insider trading because there is a deception in the act of hacking); *SEC v. Zandford*, 535 U.S. 819, 819 (2002) (noting that Section 10(b) “should be construed not technically and restrictively, but flexibly to effectuate its remedial purpose”).

¹⁹ *See, e.g., O’Hagan*, 621 U.S. 642 (attorney working on tender offer breached fiduciary duty to client); *United States v. Willis*, 778 F. Supp. 205 (S.D.N.Y. 1991) (psychiatrist breached fiduciary duty to patient); *United States v. Carpenter*, 484 U.S. 19 (1987) (Wall Street columnist breached duty of confidentiality to newspaper about his own column, although Supreme Court ultimately was divided over whether that constituted securities fraud or just wire and mail fraud); *United States v. Reed*, 601 F. Supp. 685 (S.D.N.Y. 1985) (confidential relationship between father and son sufficient for breach of fiduciary duty); but see *United States v. Kim*, 184 F. Supp. 2d 1006 (N.D. Cal. 2002) (“In the opinion of this Court, *Reed* conflates ‘confidential’ relationships with those that share the essential characteristics of a fiduciary relationship.”); *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (husband wife relationship not sufficient for breach of fiduciary duty).

²⁰ 13 Civ. 80396 (S.D. Fla.).

²¹ *Id.* at 1.

²² *Id.* at 5.

²³ *Begelman*, 13 Civ. 80396.

²⁴ *Teeple*, 13 Civ. 2010.

²⁵ *See* 15 U.S.C. § 78u-1(a)(2).

²⁶ *Nguyen*, 12 Civ. 5009.

²⁷ *Rogers*, 13 Civ. 374.

²⁸ 13 Civ. 1292 (N.D. Cal.).

²⁹ *Former Hedgefund Co-Founder, Anthony Chiasson, Sentenced In Manhattan Federal Court to 78 Months in Prison for Insider Trading*, May 13, 2013, U.S. Attorney's Office, Southern District of New York, *available at* <http://www.justice.gov/usao/nys/pressreleases/May13/ChiassonAnthonySentencingPR.php>.