Katten

Katten Muchin Rosenman LLP

A Look Back at Insider Trading in 2013

This article appeared in Law360 on January 13, 2014.

The year 2013 would have been a significant year for insider trading prosecutions even if it did not culminate in the conviction of SAC Capital Advisors LP's Michael Steinberg and the guilty plea of SAC Capital. Summoning Gordon Gekko in announcing the plea, Preet Bharara, the United States attorney for the Southern District in New York, announced "Greed, sometimes, is not good."

Countering the victories in the Southern District of New York, however, the end of 2013 saw the US Securities and Exchange Commission lose its high-profile insider trading trial this year against Mark Cuban. Cuban demonstrated possibly that greed can be good by successfully convincing a jury that although he traded on insider information and avoided a loss, he simply never agreed to keep the information confidential.

Insider trading prosecutions continue to increase, regulators and federal prosecutors have taken aggressive positions as to what constitutes insider trading, and judges have taken harsher stances in doling out sentences. That said, 2013 also hinted that some of those aggressive positions may be having a backlash in the courts and with juries.

Circumstantial Evidence

In 2013, the SEC relied heavily on circumstantial trading analysis in their insider trading complaints, which resulted in unparalleled freezing of assets. This kind of evidence begins many of the SEC investigations, although increasingly it is the end of investigations as well with the SEC willing to file complaints (or at least asset freezes) based on the trading analysis alone. Two cases in 2013 illustrate this best: *SEC v. Certain Unknown Traders in the Securities of H.J. Heinz Company*, which became *SEC v. Terpins*, 13 Civ. 1080 (Oct. 10, 2013); and *SEC v. One of More Unknown Traders in the Securities of Onyx Pharmaceuticals, Inc*., 13 Civ. 4645 (2013).

Both cases entailed asset freezes with the SEC not knowing who placed what they deemed highly suspicious trades; but the two cases had dramatically different results. In *SEC v. Terpins*, the SEC sought and obtained an asset freeze based on suspicious trading in call option contracts of H.J. Heinz Company the day prior to an acquisition announcement. According to the *Terpins* complaint, the traders purchased $90,000 worth of calls, which became valued at over $1.8 million after the announcements.

The SEC noted that in addition to the trades being suspiciously timed, the traders had not previously purchased these securities and the trades represented a drastic increase in calls of the stock. Despite what seemed like paltry evidence, after freezing the funds two previously unidentified brothers and a Cayman-islands based entity agreed to disgorge the $1.8 million and pay another $3 million in penalties, although neither admitting nor denying the conduct. It was a big win by the SEC based almost solely on their circumstantial trading analysis.

On the other hand, the SEC was sharply rebuked in relying on the same type of circumstantial trading analysis to freeze funds in *SEC v. One of More Unknown Traders in the Securities of Onyx Pharmaceuticals, Inc*., 13 Civ. 4645 (2013). In that case, the SEC complaint alleged that the traders had generated profits of over $4.8 million by purchasing calls of Onyx Pharmaceuticals while in possession of material, nonpublic information. Just as in *Terpins*, the SEC cited "highly suspicious" trading that deviated from the historic trading for Onyx calls. In both cases, the SEC merely alleged that "on information and belief" the traders had insider information.

Unlike the success of the *Terpins* case, Judge Oetken in the Southern District of New York ruled in the *Onyx* case that the SEC allegations were “all belief and no information” and there was absolutely no evidence that there was any violation of a fiduciary duty: “there is no indication that the SEC knows whether material nonpublic information was tipped, who did the tipping, or who received the tip.”

Although rebuffed in the second case and obviously invigorated by the first, the cases are very similar. The juxtaposition of the two cases make a few matters clear. First, it goes without being said that the SEC is aggressively freezing accounts based predominantly on trading history. If a trader makes money on trades prior to a significant company announcement, they will be scrutinized and if there is no similar trading history in the company, the SEC may deem that fact alone enough to bring litigation. Asset freezes seem to be granted freely based on circumstantial evidence, and yet in *Onyx* the case was dismissed on the same set of facts that led to the freeze.

Prosecutions Based on Direct Evidence

Of course, circumstantial trading evidence is usually just the start of an insider trading case, but it is not always the end. The increasing use of wiretaps in insider trading cases has been a rampant subject of discussion. The Rajaratnam wiretaps, for example, have been the nail in the coffin of dozens of defendants. While the conversation about wiretaps may overstate their true significance (recorded calls were only mentioned in approximately 10 percent of the 2013 insider trading cases), when they are mentioned, they typically lead to a quick admission of guilt.

More importantly, judges, who may be used to routinely upholding wiretaps overwhelmingly in drug cases, have overwhelmingly approved of wiretaps in securities cases, sometimes to alarming degrees.

In a surprisingly quiet summary order, the Second Circuit in 2013 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. *United States v. Fleishman*, Summary Order, No. 12-94-cr (2d Cir. Jan. 8, 2013). 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. The government didn’t just tap Fleishman’s PIN, but 104 different PIN numbers, for the majority of 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 irrelevant. Thus, as long as there is probable cause to believe that one person is using his or her PIN number on the conference line in furtherance of a criminal act, anyone using that conference line can be recorded. It obviously should make anyone pause before using a conference service if this remains good law. Despite this really being really an unprecedented, aggressive use of wiretaps, the Second Circuit gave it no more than a quiet, summary order.

–By Michael M. Rosensaft, Katten Muchin Rosenman LLP

Theories of Insider Trading

The death knell's sound on the mosaic defense — that traders make decisions based on dozens or hundreds of different sources of information — was confirmed by the Second Circuit when it upheld the conviction of Raj Rajaratnam in 2013, upholding the jury instructions given at trial under which the jury only need find that the "material non-public information given to the defendant was a factor, however small, in the defendant's decision to purchase or sell the stock." Rajaratnam's alleged tipster, Rajat Gupta, thus took another tack in his defense.

The government did not have the abundance of wiretaps as they had with Rajaratnam, but were able to juxtapose calls by Rajaratnam with phone records and the timing of board meetings to argue that Gupta was supplying the insider information. The defense was basically a "it wasn't me" defense, as they argued that another board member was supplying the information and Gupta had nothing to gain in the endeavor. As noted by commentators, the jury might have bought the defense for one suspiciously timed call, but given the amount of suspiciously timed calls, the jury convicted after two days (although it was a difficult deliberation for the jury as some jury members were visibly crying as they announced the verdict).

While 2013 saw many defense theories rejected, prosecution theories have been expanded. In 2013, the SEC stretched further to find the limits of the misappropriation theory with *SEC v. Begelman*, 13 Civ. 80396 (S.D. Fla.). In that case, Mark Begelman was alleged to have gone to a corporate retreat as a member of the World Presidents' Organization. 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]."

The SEC thus wasn't relying on an employment agreement, confidentiality agreement covering new pharmaceutical research, or a lawyer or accountant learning confidential information about a company they are working on, but Begelman was accused of violating vague confidentiality rules published by the World Presidents' Organization for time he spent during their Florida Keys retreat. Begelman neither admitted nor denied the conduct, but agreed to a five-year officer ban and penalties. It is clear that the SEC is willing to aggressively latch onto any confidentiality or privacy violation.

Pleas and Penalties

Begelman was able to neither admit nor deny his allegations, but the possibility of such a resolution seems to be disappearing. 2013 saw the entrance of Mary Jo White as chairwoman of the SEC. As one of many changes, she stated in a September 2013 speech that she has reexamined the SEC's policies, and that "shaped by the time [she] spent in the criminal arena," the SEC will require more companies and individuals to admit their wrongdoing where there was a significant harm, where the conduct posed a significant risk, where admissions would aid investors, or where an admission would "send an important message" to the market. Remarks made the Council of Institutional Investors (Sept. 26, 2013). The SEC's new policy may, though, cause Judge Jed S. Rakoff less grief.

No look at 2013 would be complete without mentioning the prosecution of SAC Capital, but even the company itself can't plead guilty without heavy judicial scrutiny. In November, SAC Capital pled guilty to securities and wire fraud before Judge Laura Taylor Swain in the Southern District of New York. However, Judge Swain did not accept the plea immediately and stated she wanted to first read the pre-sentence report. It can't be said this is necessarily an abnormal procedure, but what happens with that plea and other pending cases of individuals at SAC Capital will have to wait until 2014.

Similarly deferred prosecution agreements, which had always been marginally overseen by the courts, but really were up to the prosecutors to monitor, now face increased judicial scrutiny. In 2013, United States District Judge John Gleeson, in *United States v. HSBC Bank USA, N.A. and HSBC Holdings PLC*, 12 Cr. 763 (E.D.N.Y.), was asked to exclude time under the Speedy Trial Act to allow the United States and HSBC to enter into a deferred prosecution agreement, at the end of which the case would be dismissed under the terms of the agreement if all the terms were complied with.

Deferred prosecution agreements are commonplace, especially with lower-level financial crimes and with defendants without prior criminal history. Judges traditionally make sure that the defendant understands the agreement and then excludes time under the Speedy Trial Act so the government can monitor compliance. However, Judge Gleeson, obviously wanting a heightened role in the process, held that under the Speedy Trial Act he needed to approve the agreement and had the power to monitor it as closely as he wanted to, which he intends to do.

Mark Cuban

How can an insider trading review of 2013 end without talking about the insider trading trial of Mark Cuban. In *SEC v. Cuban*, 08 Civ. 2050 (N.D. Tex.), Cuban sold his entire stake in a company right before they announced that they were raising capital through a Private Investment in Public Equity offering. According to the complaint, Cuban had been told about the impending PIPE by the company's CEO. When the PIPE was announced to the public, the shares dropped, and Cuban avoided a large loss.

Cuban stayed away from mosaic explanations, and had a very simple defense: Yes, the CEO told him about the PIPE; yes, that was insider information; yes, Cuban traded on it; but Cuban simply didn't agree to keep it confidential. The jury didn't have to consider complex trading analysis or wrestle with the bounds of the misappropriation theory — all they had to do is to gauge Cuban's word against the CEO as to one conversation on one day. It turned out to be a simple decision for the jury, which left an emboldened Cuban who had select words for the SEC and stated that he was glad he could stand up to them.

And perhaps that is the lesson coming out of 2013 for the white collar litigator facing an insider trading case. Just as with politics, complications tend to favor the incumbent. With the government's increasing power in insider trading cases, new investigative tools at its disposal, and cooperators signing up at the door, if you do challenge the evidence, the simpler defense you can present — the easier you can make it for the jury — the better.

Of course, you don't always have that luxury.

Michael M. Rosensaft, a former federal prosecutor in the Southern District of New York, is a partner at Katten Muchin Rosenman LLP in their White Collar Defense Group.