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When Insider Trading is Not Insider Trading & Updates to the Federal Sentencing Guidelines

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Insider Trading

- "Classical" Theory:
  - A corporate insider (such as an officer or director) violates Section 10(b) and Rule 10b-5 by trading in the corporation's securities on the basis of material, nonpublic information about the corporation
  - There is a special relationship of trust and confidence between the shareholders of the corporation and those insiders who have obtained information by reason of their position within that corporation.
- "Misappropriation" Theory:
  - Expands scope of insider trading liability to certain other "outsiders" who do not have any fiduciary or other relationship to a corporation or its shareholders
  - Liability may attach where an "outsider" possesses material non-public information about a corporation and another person uses that information to trade in breach of a duty owed to the owner.
  - Such conduct violates Section 10(b) because the misappropriator engages in deception by pretending loyalty to the principal while secretly converting the principal's information for personal gain
- Not explicitly prohibited by a federal statute

Insider Trading: Tippee Liability

- Tippee Liability
  - Tippee: outsider who trades on the material nonpublic information received from tipper
  - Tipper: company insider or misappropriator who breaches fiduciary duty in sharing the information
- Derivative Liability: Tippee liability is based on a breach of duty by *someone else:* the "tipper," or source, of the inside information.
  - Tippee does not have independent duty

Insider Trading: Tippee Liability

- *Dirks v. SEC*, 436 U.S. 646 (1983)
  - Addressed the liability of a tippee analyst who received material nonpublic information about possible fraud at a company from one of the company's former officers; the analyst relayed that information to some of his clients who in turn sold their shares
  - Supreme Court dismissed the SEC's case against the tippee analyst for aiding and abetting securities fraud
  - General principle:
    - An insider breaches his fiduciary duty in violation of the federal securities laws when "the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach."
    - A tippee's duty to refrain from trading on inside information is derived from the insider's duty and the tippee is liable "only when the insider has breached his fiduciary duty to the shareholders by disclosing information to the tippee and the tippee knows or should know that there has been a breach."

Insider Trading

- Top Enforcement Priority
- From the SEC's Website:
  - "Insider trading continues to be a high priority area for the SEC's enforcement program. In recent years, the SEC has filed insider trading cases against hundreds of entities and individuals, including financial professionals, hedge fund managers, corporate insiders, attorneys, and other whose illegal tipping or trading has undermined the level playing field that is fundamental to the integrity and fair functioning of the capital markets."
- Examples of insider trading cases that have been brought by the SEC are cases against:
  - Corporate officers, directors, and employees who traded the corporation's securities after learning of significant, confidential corporate developments;
  - Friends, business associates, family members, and other "tippees" of such officers, directors, and employees, who traded the securities after receiving such information;
  - Employees of law, banking, brokerage and printing firms who were given such information to provide services to the corporation whose securities they traded; and
  - Government employees who learned of such information because of their employment by the government.

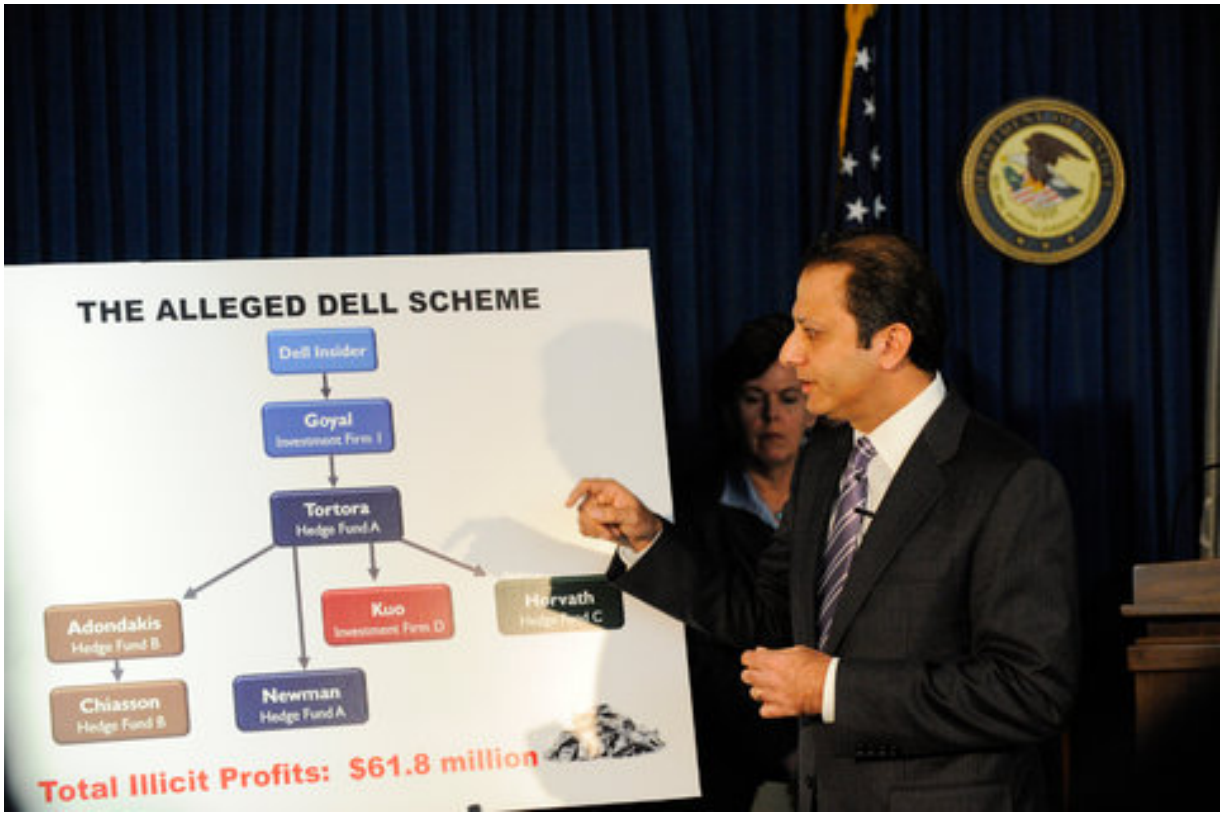
Insider Trading

- Recent Second Circuit Decision shaking everything up!
  - "The New Definition of Insider Trading" on Washington Post Moneybeat blog on December 10, 2014:
    - "An appeals court has drawn brighter lines around what constitutes insider trading. The new, more narrow definition of insider trading was a win for two portfolio managers Todd Newman and Anthony Chiasson, who saw 2012 insider trading convictions and prison sentences of several years overturned by they Second U.S. Circuit Court of Appeals Wednesday. The decision delivered a big blow to the Justice Department's fight against insider trading."
  - "Appeals Court Deals Setback to Crackdown on Insider Trading" on New York Times DealBook blog on December 10, 2014:
    - "The convictions had racked up in recent years, 85 people all told, as Manhattan prosecutors swept through Wall Street with what they described as clear-cut evidence of insider trading. But on Wednesday, a federal appeals court upended the government's campaign. And in the process, the court rewrote the insider trading playbook, imposing the greatest limits on prosecutors in a generation."

United States v. Newman et al.

- Defendants:
  - Todd Newman, portfolio manager at Diamondback Capital Management
  - Anthony Chiasson, portfolio manager at Level Global Investors
- Government's Case:
  - Low level analysts of investment firms, who had pleaded guilty and cooperated, testified that they were working with corporate insiders to gain information for their respective traders (Newman and Chiasson)
  - This group of analysts had formed what they referred to as a "Fight Club," vowing secrecy and sharing of confidential information that each had obtained.
  - Newman and Chiasson used the material, nonpublic information to make profitable trades for their respective hedge funds
  - Newman and Chiasson maintained that they were unaware that the information was "inside information" and that they had no knowledge of any benefit or payment made in exchange for the inside information
    - Newman and Chiasson were at the end of a four- or five-person chain of information that started with insiders at Dell and Nvidia, and wound its way through a network of traders before reaching Newman and Chiasson
    - Prosecutors never changed the sources at Dell and Nvidia

United States v. Newman et al.



United States v. Newman et al.

- Convicted & Sentenced by the District Court
  - Found guilty on charges of securities fraud in violation of sections 10(b) and 32 of the Securities Exchange Act of 1934 (the "1934 Act"), 48 Stat. 891, 904 (codified as amended at 15 U.S.C. §§ 78j(b), 78ff), Securities and Exchange Commission (SEC) Rules 10b–5 and 10b5–2 (codified at 17 C.F.R. §§ 240.10b–5, 240.10b5–2), and 18 U.S.C. § 2, and conspiracy to commit securities fraud in violation of 18 U.S.C. § 371.
  - U.S. District Judge Richard Sullivan sentenced Newman to 54 months in prison and Chiasson to 78 months in prison.
- Appealed the decision to the Second Circuit

United States v. Newman et al.: 2d Circuit

- Key Rulings:
  - "Because the government failed to present sufficient evidence that the defendants willfully engaged in substantive insider trading or a conspiracy to commit insider trading in violation of the federal securities law, we reverse Newman and Chiasson's convictions and remand with instructions to dismiss the indictment as it pertains to them with prejudice."
  - "We hold that the evidence was insufficient to sustain a guilty verdict against Newman and Chiasson for two reasons: First, the Government's evidence of any personal benefit received by the alleged insiders was insufficient to establish the tipper liability from which defendants' purported tippee liability would derive. Second, even assuming that the scant evidence offered on the issue of personal benefit was sufficient, which we conclude it was not, the Government presented no evidence that Newman and Chiasson knew that they were trading on information obtained from insiders in violation of those insiders' fiduciary duties."

United States v. Newman et al.: 2d Circuit

- Key Rulings:
  - Of Dirks: "*Dirks* clearly defines a breach of a fiduciary duty as a breach of the duty of confidentiality in exchange for a personal benefit" and "[a]ccordingly we conclude that a tippee's knowledge of the insider's breach necessarily requires knowledge that the insider disclosed confidential information in exchange for a personal benefit." (emphasis added)
  - Heightened standard for "personal benefit":
    - While a "personal benefit" is broadly defined and may include a reputational benefit or the benefit one would receive for making a gift of confidential information to a friend, it is not limitless and requires more than "the mere fact of friendship."
    - Rather, a personal benefit "requires evidence of 'a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the [latter]. . . . [if] the Government was allowed to meet its burden by proving that two individuals were alumni of the same school or attended the same church, the personal benefit requirement [from Dirks] would be a nullity."

United States v. Newman et al.: 2d Circuit

- Key Rulings:
  - "The Government's overreliance on our prior dicta merely highlights the doctrinal novelty of its recent insider trading prosecutions, which are increasingly targeted at remote tippees many levels removed from corporate insiders. By contrast, our prior cases generally involved tippees who directly participated in the tipper's breach (and therefore had knowledge of the tipper's disclosure for personal benefit) or tippees who were explicitly apprised of the tipper's gain by an intermediary tippee … We note that the Government has not cited, nor have we found, a single case in which tippees as remote as Newman and Chiasson have been held criminally liable for insider trading."
  - Five-part test for tippee liability:
    - "In sum, we hold that to sustain an insider trading conviction against a tippee, the government must prove each of the following elements beyond a reasonable doubt: that (1) the corporate insider was entrusted with a fiduciary duty; (2) the corporate insider breached his fiduciary duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit; (3) the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit; and (4) the tippee still used that information to trade in a security or tip another individual for personal benefit."

United States v. Newman et al.: 2d Circuit

- Of the decision: Mr. Bharara said "today's decision by the Court of Appeals interprets the securities law in a way that will limit the ability to prosecute people who trade on leaked inside information."
- Government has requested en banc review on January 23, 2015
  - Request rarely granted
  - Criteria: whether there is a disputed legal issue that can form the basis of a Circuit conflict, or whether there is a fact-specific sufficiency determination an issue of exceptional importance
- Opposition to review: request for reconsideration akin to "a petulant rooster whose dominion has been disturbed."

United States v. Newman et al.: Impact on Other Cases

- Most of the S.D.N.Y's 85 convictions for insider trading will stand despite the decision
  - Michael Kimelman
    - Kimelman, of Incremental Capital LLC, argued in 2011 that prosecutors failed to present any evidence that he was aware of a tip from an insider when he purchased shares of 3Com Corp. Kimelman was sentenced by Judge Sullivan to 30 months in prison. He's now on Supervised Release. In a recent ruling, Judge Sullivan denied a motion by Kimelman to have his Supervised Release terminated early.
  - But Michael Steinberg
    - Steinberg, formerly of SAC Capital, was also convicted of receiving similar information in a separate trial and sentenced to 42 months in prison by Judge Sullivan
    - Currently out on bail pending the outcome of his appeal; conviction likely to be overturned as well
  - Could also lead to dismissal of the cooperating witnesses who pleaded guilty to trading on the same threat of information about Dell and Nvidia
  - U.S. District Judge Carter, Jr. vacated the guilty pleas of four individuals who had been charged with insider trading on information related to IBM's acquisition of SPSS, Inc. (*U.S. v. Conradt*)
- Andrew Ceresney: Ruling shouldn't be a problem

Federal Sentencing Guidelines: Proposed Amendments to Section 2B1.1

- Changes to the loss table for inflation
- Revision to the number-of-victims enhancement
- Clarification of “intended loss” definition
- Revision to “fraud on the market” loss calculations for securities fraud

Federal Sentencing Guidelines: Proposed Amendments to Section 2B1.1

- Addresses offenses involving the fraudulent inflation or deflation in the value of a publicly traded security or commodity
- Removal of any loss calculation in securities fraud cases in favor of gain
- Current rule: Modified Rescissory Method (MRM)
  - "there shall be a rebuttable presumption that the actual loss attributable to the change in value of the security or commodity is the amount determined by— (I) calculating the difference between the average price of the security or commodity during the period that the fraud occurred and the average price of the security or commodity during the 90-day period after the fraud was disclosed to the market, and (II) multiplying the difference in average price by the number of shares outstanding.
- The Commission is proposing a wholesale deletion of MRM or any other measure of loss and using "gain"
  - "based on the gain that resulted from the offense rather than the loss"
  - In no event, would the enhancement be less than a specified number of Guideline levels (14- 22 levels)