

Insider Trading

Hedge Funds in the Crosshairs: The Law of Insider Trading in an Active Enforcement Environment

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As the Securities Exchange Commission (the “SEC”) and federal prosecutors continue their crackdown on what they perceive to be “systemic” insider trading within the hedge fund industry,¹ now more than ever it is critical for all industry participants to be aware of the line between good research, including entirely lawful information-gathering, and impermissible insider trading. This article examines some of the commonly misunderstood areas of the law of insider trading in the context of the current, unprecedented regulatory environment. Understanding the subtleties in the statutory framework is fundamental to protecting your firm because, as we have all observed, mere allegations of insider trading can wipe out a multi-billion dollar hedge fund operation through massive investor redemptions.²

At the most fundamental level, the prohibition against insider trading bars the trading of securities on the basis of material, non-public information.³ The reach of the law, however, extends well-beyond those who actually make or even profit from tainted trades. For instance, one who shares material, non-public information (the “tipper”) with those who then trade based on that information (the “tippee”) can be liable for insider trading even where the tipper does not make any trades, earns no profits and avoids no losses.⁴ It does not matter whether the tipper trades in the security; both parties may be held liable. What’s more, it is illegal to even recommend the purchase or sale of securities on the basis of material, non-public information.⁵ Assisting someone who is engaged in any of the above-mentioned activities is likewise

prohibited.⁶ And the penalties for insider trading are very serious. In addition to required disgorgement of up to three times any profit earned (or any loss avoided) as a result of the illegal trading, the SEC can seek penalties of up to \$5 million for individuals and \$25 million for entities, prosecutors can seek up to twenty years in jail and, for investment advisers (whether or not they are registered), the SEC can obtain a lifetime bar from the industry, not to mention the significant reputational damage that comes from mere allegations of insider trading.

Although an understanding of the most basic rules relating to insider trading is of course vital to any market participant, it is particularly important for hedge fund managers and their professional staff to understand the details in this evolving area of the law and to consult regularly with experienced counsel in order to stay on the right side of the line and protect yourselves and your firm. And that is true now more than ever. Because so much of the law of insider trading depends upon the facts and circumstances of each individual case, this article is not designed to provide a comprehensive analysis of the law. Rather it is intended to give a broad overview and to answer some frequently asked questions and dispel some important misconceptions.

The Current Regulatory Environment

Both the SEC and the Department of Justice have authority to bring insider trading cases and the agencies are currently

working in concert with an unprecedented tenacity to bring new cases, especially cases involving the hedge fund community. The enhanced coordination between the agencies and their subsequent aggressive posture is hardly surprising; the recently appointed Director of the SEC's Enforcement Division, Robert Khuzami, his deputy, Lorin L. Reisner, as well as the Director of the SEC's Northeast Regional Office, George S. Canellos, are all former federal prosecutors with the United States Attorney's Office for the Southern District of New York.

Upon taking office, Mr. Khuzami announced several new initiatives, many of which indicate that the Division of Enforcement is focused on hedge funds and potential insider trading. For example, an Asset Management Unit has been established to focus exclusively on investment advisers, investment companies, hedge funds and private equity funds and the Office of Market Intelligence has been created to monitor incoming tips and complaints to the SEC. These units will be used to "ferret out" those "funds whose business model consisted of vigorous attempts to collect information from corporate insiders and to utilize that information to trade."⁷ Each of these units is headed by senior enforcement lawyers with years of SEC experience.⁸

Additionally, several procedural and structural changes designed to streamline management and internal processes at the Division of Enforcement have been implemented, including the redeployment of all branch chiefs to investigative work⁹ and the delegation of the power to issue formal orders of investigation (and the associated subpoena power) to senior officers throughout the Division, as opposed to the old protocol that required prior Commission approval.¹⁰ These efficiency-minded measures have been accompanied by the use of new and aggressive investigatory

tactics such as the utilization of "cooperating witnesses" to voluntarily record telephone and other conversations with "targets" of governmental investigations, court ordered wiretaps obtained by federal prosecutors and extensive data-mining by the SEC's Office of Market Intelligence. As a result of these changes, firms are receiving increasingly broad subpoenas that require the disclosure of wide-ranging information, such as all communications with other hedge funds and documentation of all trades over longer time periods than has been the norm in prior investigations. At the same time, the number of formal Enforcement investigations opened in 2009 more than doubled from the previous year.¹¹

In this environment, it is critical for those in the hedge fund industry to be aware not only of the general prohibitions against insider trading, but also those areas of the law that are less commonly understood. The following sections are designed to assist hedge fund compliance officers and in-house lawyers as well as business people to navigate these perilous regulatory waters. Of course, as this is an evolving area of the law and the SEC, federal prosecutors and other securities regulators are seeking to expand the boundaries every day, consultation with experienced securities regulatory counsel is essential.

Defining an "Insider"

It is obvious that the term "insider" encompasses officers, directors and employees of the company that issued the securities (the "Issuer"). But those people are not the only corporate "insiders" to whom the prohibition against insider trading applies. Indeed, any person (or entity) who, by reason of his or her fiduciary relationship with the Issuer, has access to material, non-public information is considered an

insider under the law.¹² That includes the Issuer's auditors, attorneys, bankers, and other advisors, who are often referred to as "temporary insiders." All "insiders" (including "temporary insiders") who are aware of material, non-public information about the Issuer have a duty to either disclose all material, non-public information to the entire marketplace or refrain from trading.¹³

What may be less obvious is that certain of the company's security holders, broker-dealers and securities analysts may become temporary insiders when they come into possession of material, non-public information as a result of a close association or relationship with the company or its insiders.¹⁴ For example, in *Ferraioli v. Cantor*, the U.S. District Court for the Southern District of New York held that a controlling stockholder was an insider and was necessarily precluded from acting on undisclosed material information.¹⁵

It is thus important to recognize that, depending on the facts and circumstances, you or your firm may become an insider, even unwillingly. At that point, a duty may arise and it may be unlawful to trade in the security at issue while in possession of material, non-public information. Furthermore, it is necessary to have an appreciation of whether an outside source of information is in fact an insider in order to avoid "tippee" liability. One must set aside the paradigm of the traditional insiders and determine how the material information was discovered. If material information is conveyed by an insider, and such information was not disclosed to the public, you may be restricted from trading in that security.

The Broad Scope of What Constitutes a "Trade in Securities"

A "trade in securities" is another phrase that has a much more expansive meaning than the general public, or even some financial industry participants, may appreciate. "Securities" is a broadly-defined term that includes virtually anything that someone might be interested in trading.¹⁶ Thus, in addition to the obvious trading of stocks and bonds, a "trade in securities" also encompasses shorting stocks, puts, calls, derivatives, and the manipulation of programmed trades.

SEC Enforcement Director Robert Khuzami has recently emphasized that the SEC will be scouring trades outside the traditional markets to detect insider trading. "The days of insider trading scrutiny being focused almost solely on the equity markets are now gone," Khuzami warned at a recent conference on hedge fund regulation in New York.¹⁷ According to Khuzami, the SEC will "roll back the curtain on those markets and look at patterns across all markets."¹⁸ In fact, the SEC brought its first insider trading case relating to credit default swaps in May, when it brought an action against a Deutsche Bank AG salesman on claims that he wrongfully conveyed information on a bond sale to a hedge-fund money manager.¹⁹ That case is currently in discovery after the defendants' motion to dismiss on the basis that the SEC had no jurisdiction over the swaps was dismissed in December 2009. The court in that case refused to dismiss the SEC's complaint and sent the case forward to the discovery phase. In doing so, the court held that it would look beyond the face of the swaps to determine whether they were securities-based swaps and therefore within the SEC's purview under Section 10(b) of the Securities Exchange Act of 1934.²⁰

It is difficult to overemphasize the breadth of what may constitute a “trade in securities”. Loan participations may even be swept under the classification depending on the facts of the case. In this context, the Supreme Court has adopted the Second Circuit’s “family resemblance” approach to determine whether a particular instrument qualifies as a security.²¹ Under this test, a note is presumed to be a security because the word “note” is included in the statutory definition of “security”, and that such a presumption may be rebutted only by showing that the note bears a strong resemblance to a judicially enumerated list of instruments which are not securities.

Factors the courts consider include: (i) the motivations that would prompt a reasonable buyer to enter into the transaction; (ii) the plan of distribution of the instrument; (iii) the reasonable expectations of the investing public; and (iv) whether some other factor, such as the existence of another regulatory scheme, significantly reduces the risk of the instrument.²² And while many industry participants remain of the view that loan participations are unlikely to be swept within the ambit of “security” – the SEC has yet to bring an insider trading case involving the trading of bank debt – the issue is not free from doubt in every case.

Because the SEC has clearly announced its intention to pay closer attention to non-equity markets in its campaign against insider trading, hedge funds should expect the rules to be applied to an ever expanding swath of financial products.

The Meaning of a Trade Which Is “On the Basis of” Material, Non-Public Information

Consider the following scenario: your fund has spent countless hours researching and analyzing Company X

through publicly available information as well as other work that you have done on the company (but which does not include obtaining any material, non-public information). On Friday, your analyst finishes developing an investment thesis and a model in which he believes that Company X is undervalued by the market and its stock price is likely to rise as the market realizes Company X’s true potential. As the firm’s portfolio manager, you consider the analyst’s view over the weekend and decide to build a sizeable position in Company X’s shares starting the following Monday. Unbeknownst to you, over the weekend – after you have made your decision to buy Company X’s stock on the basis of your analyst’s thoughtful and painstaking analysis but before your firm has purchased those shares – one of your firm’s other professionals talks with a senior executive at Company X, who tells her that the company is in the final stages of negotiating a merger with its largest competitor. On Monday you would still like to build the same position in Company X’s stock as you did over the weekend and it is still based upon your analyst’s work prior to learning this obviously material, non-public information about the company’s merger plans. Can you do so? The answer is NO! Why? Because even though the information about the Company’s merger plans is not the reason for your desire to buy Company X’s stock, your firm is now “aware” of material, non-public information about Company X and the SEC takes the view that any trade made while “aware” of material, non-public information is a trade made “on the basis of” that information (even if the information did not really motivate your firm to trade).

As you can see from this hypothetical, what it means for a trade to be “on the basis of” material, non-public information is not intuitive and represents an area of the

law filled with misconceptions. Simply put, you don't have to actually use the information you receive in trading for a trade to be "on the basis of" that information. Indeed, the SEC adopted a rule dealing directly with this point. Under SEC Rule 10b5-1, a trade is "on the basis of" material, non-public information if anyone in your organization is "aware" of the information at the time of the trade (unless a safe harbor applies).²³ Importantly, the time for measuring "awareness" is "when the person made the purchase or sale" not when the person decided to make the purchase or sale.²⁴ It is also significant to note that awareness of material, non-public information by any one individual within your firm is imputed to everyone at your firm (again, subject to the safe harbors discussed below).²⁵ As a result, looking back to the hypothetical fund's desired purchase of Company X's shares, the desired trade would likely violate the insider trading laws, even though the material, non-public information was obtained by a different person than either the analyst (who came up with the investment recommendation) or the portfolio manager (who made the decision to trade) and even though the information was obtained only after the decision to trade had been made. This is because the firm became aware of the material, non-public information before the trade was made.

As noted above, there are several safe harbors to the rule that awareness of information equates to a subsequent trade being "on the basis of" that information. First, an individual or entity may adopt a "10b5-1 Trading Plan," which must (i) specify the "amount" of securities to be purchased or sold, and the "price" and "date" of the purchase or sale; (ii) include a written formula for determining the amount; or (iii) forbid the individual or entity to exercise any subsequent influence over how, when, and whether to conduct the purchases or

sales, and delegate those decisions to a person who did not possess material, non-public information. Also, the purchase or sale at issue must be "pursuant to the contract, instruction, or plan," meaning that the individual or entity that entered into the contract did not alter or deviate from it, or engage in a corresponding or hedging transaction with respect to the securities.²⁶

The second safe harbor involves the implementation of effective policies and procedures designed to prevent individuals who make investment decisions from acquiring material, non-public information from other parts of the firm. Such policies and procedures are often referred to as "information barriers," an "ethics wall," or a "Chinese Wall". In order for an entity to rely on the "information barrier" safe harbor in Rule 10b5-1, the entity must show that: (i) the individual who made the investment decision on behalf of the entity was not aware of the material, non-public information; and (ii) the entity had implemented reasonable policies and procedures, in light of the nature of the entity's business, to ensure that those making investment decisions on its behalf would not violate the insider trading laws.²⁷ In addition, those policies and procedures must be in place before anyone in your firm becomes "aware" of material, non-public information, meaning that you cannot wall someone off from the rest of the firm after she becomes aware of material, non-public information (only before she becomes aware of that information). It is important to note that the SEC contemplates fairly draconian separation between "public teams" and "private teams" for information barriers to be deemed effective and this can often be difficult (but certainly not impossible) to implement in practice in a hedge fund environment.

Determining Whether Information is “Material”

A significant number of insider trading cases turn on the issue of whether the non-public information received is actually “material.” It is therefore vital to understand how the courts have interpreted this element. Information is “material” if there is a “substantial likelihood that the disclosure of [that information] would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”²⁸ Another formulation frequently used is that information is material if a reasonable investor would consider it important in making an investment decision.²⁹ Materiality “does not require proof of substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his [position]. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder.”³⁰

Whether information is material often depends on the facts and circumstances of each particular case. Examples of information that is often viewed as material include: restatement of financials,³¹ earnings information,³² mergers and acquisitions³³ and impending bankruptcy filings.³⁴ Significantly, the determination of whether a piece of information is indeed material typically requires a collaborative effort between the business people who best understand the Issuer and the market for its securities and their lawyers.

The question of materiality is similarly central to Regulation FD, another rule promulgated by the SEC pursuant to the Securities Exchange Act of 1934 relating to how publicly traded companies can dispense market information.

Regulation FD prohibits Issuers from selectively disclosing material, non-public information to securities professionals (or anyone else) without making simultaneous public disclosure of the same information. In essence, Regulation FD is the flip side of insider trading: Regulation FD precludes Issuers from selectively disclosing material, non-public information while the laws against insider trading preclude the recipient of such information (as well as the corporate insider) from trading in securities while aware of that information. Because insider trading and Regulation FD are so closely related, Reg FD cases can offer guidance on insider trading law and vice versa, particularly for firms struggling with the process of determining whether information is material.

An early Regulation FD investigation emphasizes the importance of knowledgeable business people in making materiality determinations and not just leaving it to the lawyers. In 2002, the SEC released its Report of Investigation in the Matter of Motorola, regarding its investigation into whether Motorola Inc. (“Motorola”) violated Regulation FD when one of its senior officials selectively disclosed information about the company’s quarterly sales and orders during private telephone conversations with selected sell-side analysts.³⁵ Before the conversations occurred, the senior Motorola officials sought legal advice from in-house counsel, who approved the selective disclosures on the basis that the information in question was not materially different from information the company had already made public. According to counsel, the original public disclosure that Motorola’s sales and orders were experiencing “significant weakness” was not materially different from the private disclosure of what officials understood the term “significant” to mean: a change of 25 percent or more.

Although the SEC acknowledged that the Motorola officials acted in good faith, the Commission concluded that counsel's determination was erroneous. What is more, according to the SEC, the senior officials should have known that the information was material notwithstanding counsel's legal advice to the contrary. Ultimately, the SEC decided not to bring an enforcement action, but strongly cautioned the business people involved.

Matter of Motorola teaches that business people can neither remove themselves from the decision of what is deemed material nor protect themselves by simply relying on the advice of counsel, at least in the Regulation FD context.³⁶ Because materiality is based upon what a "reasonable investor" would consider important when making an investment decision, the SEC emphasized in Motorola the important role of business people in making this determination.

Some of the factors that are relevant to determining if information is material include: the probability that the event will occur; the potential impact on the market if the event does occur; the credibility of the source of the information; and the likely market reaction. But it is also always important to consider how the SEC will view the information with the benefit of hindsight.

The "Mosaic Theory" and its Relationship to "Materiality"

The "mosaic theory" involves putting together lots of disparate pieces of information with your own analysis into an investment thesis which then motivates you to trade a security.³⁷ It is a little bit like putting together a jigsaw puzzle. The pieces of information that you include in your

"mosaic" can include any public information about the issuer whose securities that you seek to trade as well as immaterial information that may not be public. The idea is that you are piecing together an investment thesis from information that is either public or is not material and it is the totality of that information – and not any one piece of information in isolation – which motivates you to trade. Thus, even if the last piece of a puzzle is non-public information, so long as that piece of information – by itself – is not material, there is no insider trading violation if you trade based upon the whole picture that you have created.³⁸ The mosaic theory is grounded in the notion that each piece of information that you obtain must be analyzed in isolation to determine if it constitutes material, non-public information. If it is, then you may not trade without running the risk of violating the prohibition against insider trading. If each piece of information is either immaterial or public, then you are free to trade in the issuer's securities even though it is the accumulation of all those disparate pieces of information together with your own analysis which is material to your decision to invest in the company.³⁹

Putting together a mosaic is good research, not insider trading. It is what good analysts do, both on the sell side (resulting in research reports and investment recommendations) and on the buy side (resulting in trading decisions). Care must be taken, however, to ensure that each piece of the "mosaic" is either public or immaterial and that it is the broader picture – and not one piece of information in isolation – which motivates you to trade the issuer's securities.

Does the "mosaic theory" allow a firm to trade based on analysis that incorporates both material, non-public

information and public or non-material information? Absolutely NOT! Indeed, this is one of the most common misconceptions of insider trading law. A mosaic may include: (1) public information; (2) non-public information which is not material; and (3) your own analysis and evaluation BUT it may NOT include any material, non-public information.⁴⁰

Thus, analysts may gather disparate pieces of nonmaterial information or material, but public, information from a variety of sources and create a “mosaic” from which material, non-public information may be deduced. Decisions whether or not to trade based on this resulting “mosaic” may likely be outside the reach of insider trading liability. Nevertheless, it is important to consult counsel in order to keep your firm on the correct side of the line which separates good research from insider trading.

Conclusion

Securities regulators as well as criminal prosecutors have made clear that bringing cases to stop insider trading within the hedge fund industry is a top priority and that they believe this is a significant problem meriting their attention. As such, it is imperative that the hedge fund industry clearly understand the “do’s and don’ts” and gain a fulsome understanding of the law in this evolving area. Comprehensive and properly tailored policies and procedures, trade testing, strong compliance, a serious tone at the top and proper training are critical to protecting your firm in this environment. And because so much of the law of insider trading turns on the facts and circumstances of each situation, consulting regularly with experienced counsel is essential too.

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¹ Robert Khuzami, Director, Division of Enforcement, SEC, *Address at the Bloomberg Washington Summit* (November 12, 2009).

² See Susan Pulliam and Gregory Zuckerman, *Galleon Clients Abandon Ship*, *The Wall Street Journal*, October 21, 2009 (explaining that The Galleon Group would begin to wind down its hedge funds in wake of around \$1.3 billion in redemption requests); Andrew Ross Sorkin, ed. *Galleon to Begin Winding Down Funds*, *DealBook*, N.Y. Times, October 21, 2009 (same).

³ 15 U.S.C. § 78j(b). Civil insider trading enforcement cases are brought by the SEC pursuant to Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder; the United States Attorneys’ Offices bring criminal insider trading cases pursuant to the same statute. The most critical difference between a civil insider trading case and one which merits criminal

prosecution is the degree of misconduct involved (which can be very subjective) and the burden of proof (criminal cases require proof beyond a reasonable doubt whereas civil cases require a mere preponderance of the evidence).

⁴ 15 U.S.C. § 78j(b); 15 U.S.C. § 78t(b).

⁵ 15 U.S.C. § 78j(b); 15 U.S.C. § 78t(a).

⁶ 15 U.S.C. § 78j(b); 15 U.S.C. § 78t(b).

⁷ See note 1, *supra*.

⁸ The Asset Management Unit is led by Bruce Karpati and Robert Kaplan. Mr. Karpati was the head of the SEC's Hedge Fund Working Group, and is an Assistant Regional Director and former Branch Chief at the SEC. Mr. Kaplan is an Assistant Director of the SEC's Division of Enforcement and formerly served as Assistant Chief Litigation Counsel and Senior Counsel in the Enforcement Division. The Office of Market Intelligence will be led by Thomas Sporkin. Mr. Sporkin was a former Deputy Chief in the Office of Internet Enforcement at the SEC. Press Release, SEC, *SEC Names New Specialized Unit Chiefs and Head of New Office of Market Intelligence*, January 13, 2010, available at <http://www.sec.gov/news/press/2010/2010-5.htm>.

⁹ Robert Khuzami, Director, Division of Enforcement, SEC, *Speech by SEC Staff: My First 100 Days as Director of Enforcement* (Aug. 5, 2009).

¹⁰ Stephen Taub, "George Canellos Talks Tough/The Message is Going Out," *Absolute Return* (Oct. 2009).

¹¹ Jason S. Flemmons, Associate Chief Accountant, Division of Enforcement, SEC, *Speech by SEC Staff: Remarks Before the 2009 AICPA National Conference on Current SEC and PCAOB Developments*, December 8, 2009.

¹² *S.E.C. v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (1968).

¹³ *Id.*

¹⁴ See e.g., *In re Cady, Roberts & Co.*, 40 SEC 907 (1961).

¹⁵ 281 F. Supp. 354, 356 (S.D.N.Y. 1967).

¹⁶ See 15 U.S.C. § 77b(a)(1).

¹⁷ David Scheer and Joshua Gallu, "SEC to Focus on Derivatives as Insider Probes Expand," *Bloomberg News*, Nov. 23, 2009, available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=avw9gnboEVfc&pos=3>.

¹⁸ *Id.*

¹⁹ *SEC v. Rorech*, No. 09 CV 4329 (S.D.N.Y. filed May 5, 2009).

²⁰ *Securities and Exchange Commission v. Rorech*, 09 Civ. 4329, *New York Law Journal*, December 11, 2009.

²¹ *Reves v. Ernst & Young*, 494 U.S. 56, 65 (1990).

²² *Id.* at 66.

²³ 17 C.F.R. § 240.10b5-1; see also *United States v. Royer*, 549 F.3d 886, 889 (2d Cir. 2008) (holding that a person need not "use" information to meet the "on the basis of" requirement).

²⁴ See note 20, *supra*.

²⁵ See Donald C. Langevort, 18 *Insider Trading Regulation, Enforcement, and Prevention* § 3:15 (2006).

²⁶ 17 C.F.R. § 240.10b5-1(c).

²⁷ *Id.*

²⁸ *TSC Industries v. Northway*, 426 U.S. 438 (1976).

²⁹ *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

³⁰ *Id.*

³¹ *In re Atlas Worldwide Holdings, Inc. Securities Litigation*, 324 F. Supp. 2d 474, 487 (S.D.N.Y. 2004).

³² *Elkind v. Liggett & Meyers, Inc.*, 635 F.2d 156 (2d Cir. 1980).

³³ *United States v. O'Hagan*, 521 U.S. 642 (1997).

³⁴ *S.E.C. v. Luldiner*, SEC Lit. Release No. 13,638 (C.D. Cal. May 18, 1983).

³⁵ *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Motorola Inc.*, Release No.

34-46898 (November 25, 2002), at Section III.

³⁶ Relying on advice of counsel in an insider trading investigation or enforcement action may still help persuade the trier of fact that the defendant did not have scienter (an intent to deceive), which is required to bring an insider trading case. Alternatively, it might be helpful in persuading the government to pursue the case civilly but not criminally.

³⁷ See *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 165 (2d Cir. 1980).

³⁸ See Selective Disclosure and Insider Trading, Securities Act Release No. 33-7881, Exchange Act Release No. 34-43154 (August 15, 2000), at Section II.B.3.

³⁹ See *id.*

⁴⁰ *Id.*