Schulte Roth & Zabel

Insider Trading Developments

Summer 2014

The U.S. Securities and Exchange Commission and Department of Justice are continuing to investigate and prosecute insider trading cases at a rate not seen in a generation or more, and even the New York State Attorney General has become involved in the area. The popular and legal press have focused attention on the prominence of some of the targets, the increasingly disparate success rates of the Manhattan U.S. Attorney's Office and the SEC, and the anticipated ruling from the U.S. Court of Appeals for the Second Circuit on the question of what must be proven regarding the knowledge of a remote tippee. But several other developments may carry greater practical significance for most hedge fund managers and other members of the financial services industry. Those developments highlight the potential for insider trading prohibitions and remedies to extend beyond where one might normally expect, which, in turn, could affect portfolio managers, investment management compliance officers and other industry personnel in ways not necessarily anticipated.

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Schulte Roth & Zabel routinely and currently represents numerous entities and individuals in matters involving insider trading allegations. The firm's attorneys author the annual *Insider Trading Law & Compliance Answer Book* (Practicing Law Institute), and its Litigation department includes nine former SEC and DOJ prosecutors.

In particular, recent insider trading-related rulings, prosecutions and regulatory initiatives have clarified that:

- Insider trading laws apply to unregistered securities and Cayman Islands companies under federal common law;
- Portfolio managers can be held responsible for allegedly illicit profits that they personally did not receive or directly cause;
- Accounts may be frozen based on mere suspicions of insider trading arising from transactions that closely preceded public announcements;
- Lawfully using one's diligence or wherewithal to obtain non-confidential information upon which to make time-sensitive trades may no longer be acceptable in some circumstances;
- Lawfully disclosed information can lead to insider trading prosecutions against the recipient if there is any room for dispute about whether the information was obtained under an agreement not to trade; and
- Trading based on nonpublic information from governmental sources is under investigators' scrutiny.

Though such developments are the focus of this newsletter, that should not be taken to suggest that the more widely discussed topics mentioned above are in any way trivial. The government's wide-ranging, aggressive and largely successful prosecutions of well-known hedge fund complexes, including Galleon Management personnel and associates, demonstrate that the government is willing and able to take on some of the most prominent and well-heeled members of the financial community, much as it did in the days of Drexel Burnham &

Recent Insider Trading Actions

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Lambert and Ivan Boesky more than 25 years ago. The SEC's spate of recent trial defeats (*see, e.g.*, *SEC v. Cuban*; *SEC v. Moshayedi*; *SEC v. Obus*; *SEC v. Schvacho*) and partial defeats (*see, e.g.*, *SEC v. Jacobs* (jury rejected Rule 10b-5 charges but found against defendants on Rule 14e-3 (tender offer fraud) charges); *SEC v. Life Partners Holdings* (jury rejected insider trading charges but found against defendants on accounting fraud charges); *SEC v. Siming Yang* (jury rejected insider trading charges but found against defendant on related front-running and Schedule 13(d) charges)) shows that one need not roll over when the SEC threatens to bring a claim. But the Southern District of New York U.S. Attorney's Office's reported 81-1 record in prosecuting insider trading cases since 2009 should prevent any illusions about a criminal defendant's odds of beating insider trading charges (Rengan Rajaratnam's recent streak-breaking victory notwithstanding). Finally, the Second Circuit's forthcoming decision on the appeal of the convictions of Todd Newman and Anthony Chiasson is expected to answer the question of whether the government must prove that a criminal tippee defendant knew the initial tipper stood to gain a benefit from disclosing the material nonpublic information on which the defendant ultimately traded. That decision could also impact the December 2013 conviction of Michael Steinberg, a former portfolio manager at SAC Capital Advisors whom the government likewise has prosecuted under the theory that it need not prove the defendant knew the insider received a personal benefit in exchange for disclosing the inside information.[1]

Court Makes Clear That Insider Trading Laws Apply to Unregistered Securities and Cayman Companies Under Federal Common Law

Earlier this year, the Second Circuit ruled that the duties that make insider trading illegal under U.S. law apply to trading in unregistered securities, including securities of companies organized in the Cayman Islands or other jurisdictions that do not expressly require disclosure of the information relevant to the alleged insider trading. The court explained that the United States' federal common law, rather than the law of the country where the securities' issuer is organized, determines whether such trading is illegal.

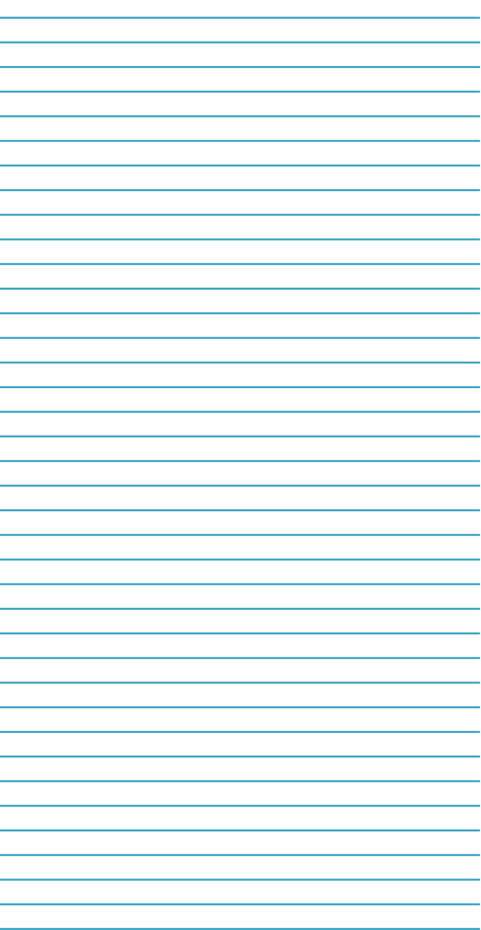
In *Steginsky v. Xcelera Inc.*, 741 F.3d 365 (2d Cir. Jan. 27, 2014), the plaintiff sold her shares in Xcelera Inc. pursuant to a tender offer made by an acquisition vehicle controlled by Xcelera's officers several years after the SEC had revoked the registration of the Cayman Islands company's securities for its failure to make its required periodic filings. No information regarding the company's financial condition was disclosed in connection with the tender offer. The plaintiff later sued the buyers for insider trading under

[1] Schulte Roth & Zabel's representations include, in some cases, matters discussed in *Insider Trading Developments* or other firm publications. The information discussed herein is limited to material contained in the public record, and nothing herein is intended to constitute an endorsement of the positions taken by any court, agency or legislator, or other public or private person or entity, or to suggest that any pleading or opinion accurately reflects the facts or the correct state of the law.

Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. The district court dismissed the complaint, ruling that the defendants had no duty to disclose any information before purchasing the plaintiff's securities because, the court said, the duty to disclose did not apply to unregistered securities and was defined by Cayman Islands law, which, the court said, imposed no such duty. The Second Circuit reversed. The court held, first, that "unregistered securities are not immune from the duty to disclose." The court then held that federal common law, rather than Cayman Islands law, determined the disclosure duty. That federal common law, the appeals court explained, requires that any insider possessing material nonpublic information must either disclose such information or abstain from trading (or recommending) the securities so long as the information remains undisclosed.

The ruling serves as an important reminder that all firms' insider trading policies should extend beyond just the paradigmatic situation involving publicly traded stocks and options, and it is especially relevant to venture capital, private equity and activist funds and managers who often have access to inside information regarding their portfolio companies by virtue of board seats, management positions or otherwise. When selling their stakes (or portions thereof) in private companies, such funds and managers must be careful to ensure that they disclose all material nonpublic information in their possession, or risk later being sued by the buyer for insider trading (though the court did not address to what extent the parties to a private transaction can contract out of (such as via "big boy" provisions) the disclosure duty imposed by federal common law). The ruling also highlights that, regardless of how permissive other countries' laws or customs may be with respect to the sharing and use of material nonpublic information, the United States' prohibitions will apply to any trading that touches this country.

Court Holds That Individuals Can Be Required to Disgorge Insider Trading Profits of Hedge Funds They Managed



In *SEC v. Contorinis*, 743 F.3d 296 (2d Cir. Feb. 18, 2014), a divided Second Circuit panel held that a hedge fund manager could be held liable for disgorgement of the illicit profits earned by the fund for which he placed illegal insider trades even if the manager did not make any trades for his own account or otherwise directly profit from the trading. (The manager in the case did receive $427,875 of linked compensation from the trades, which he previously had been ordered to forfeit as part of his criminal conviction and was not a subject of the appeal.) The court further held that the manager could be ordered to pay prejudgment interest on the disgorgement amount even though he did not actually have use of the ill-gotten gains during the prejudgment period (or any period).

The manager, Joseph Contorinis, was found to have used inside information he learned from an employee of an investment bank regarding a pending merger to place trades on behalf of a hedge fund for which Contorinis was a co-manager. The fund realized profits of $7,304,738 as a result of the trades. He was ultimately convicted of insider trading and sentenced to six years in prison, and the SEC then obtained a civil judgment against him as well. Though the Second Circuit had earlier ruled that his criminal sentence could not require him to *forfeit* the amount of the hedge fund's profit, this past February the court held that Contorinis could be ordered to pay

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disgorgement of that amount in the SEC's civil case. The majority reasoned that because prior cases had established that a tipper could be ordered to disgorge insider trading profits earned by a tippee, the same should be true for a defendant who, instead of passing the inside information on to a third-party tippee, places the trade directly in the third party's (e.g., the hedge fund's) account.

The case demonstrates that the government can hold portfolio managers liable for millions of dollars of insider trading profits that the portfolio managers never received personally. The result is similar to last year's ruling by a unanimous panel of the Third Circuit, which held that, when determining a convicted insider trading tipper's sentencing range under the U.S. Sentencing Guidelines, courts are to consider the combined illicit gains of all the traders to whom the defendant provided material nonpublic information. *U.S. v. Kluger*, 722 F.3d 549 (3d Cir. July 9, 2013).

SEC Increasingly Seeks to Freeze Accounts Suspected of Holding Insider Trading Proceeds

Information regarding trading patterns gleaned through automated reviews of trading data has led to an increasing tendency of the SEC essentially to "shoot first and ask questions later" by seeking and obtaining court-ordered asset freezes of accounts — wherever located — of individuals and entities believed to have engaged in insider trading. For example, during the past two years, the SEC has sought and obtained court orders freezing:

- A multi-million-dollar Swiss-based trading account of a Brazilian national the day after the public announcement of a proposed acquisition of H.J. Heinz Company, based on the fact that call options had been purchased in the account the day before the announcement (*SEC v. Certain Unknown Traders in the Securities of H.J. Heinz Co.*, No. 13-cv-1080 (S.D.N.Y.));
- $38 million worth of Hong Kong and Singapore-based trading accounts of a Hong Kong company and initially unknown persons and entities less than four days after the public announcement of a proposed acquisition of Nexen Inc., based in part on the fact that Nexen shares had been purchased in the accounts during the week before the announcement (*SEC v. Well Advantage Ltd.*, No. 12-cv-05786 (S.D.N.Y.)); and
- A $6-million U.S.-based trading account of a Thai national less than a week after the public announcement of a proposed acquisition of Smithfield Foods, based largely on the fact that Smithfield stock, options and futures had been purchased in the account during the week before the announcement (*SEC v. Badin Rungruangnavarat*, Case No. 13-cv-04172 (E.D. Ill.)).

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In each of those cases, the SEC has gone on to obtain multi-million-dollar consent judgments for disgorgement and civil penalties against the accountholders (who could not access the assets in their accounts while the cases remained pending). Further, insofar as those cases all involve foreign accounts and/or traders, they demonstrate that the SEC is taking a broad view of its jurisdictional reach (in addition to an aggressive view of its right to provisional remedies).

The SEC's willingness and ability to seek and obtain preliminary asset freezes extends even to cases where the ultimate outcome on the merits is far from certain. In one case, in fact, a court ruled (four months after the asset freeze involving what the SEC alleged were Canary Islands and Lebanon traders or accounts was put in place) that the SEC's complaint failed to satisfy basic pleading standards. Specifically, in *SEC v. One or More Unknown Traders in the Securities of Onyx Pharmaceuticals, Inc.*, No. 13 Civ. 4645 (S.D.N.Y. Nov. 21, 2013), the court dismissed the SEC's complaint, reasoning that trading history alone was insufficient to support an insider trading claim in the absence of evidence of a breach of fiduciary duty, tipping of material nonpublic information, a tipper or a tippee. Even that court, however, maintained the asset freeze it had earlier imposed (albeit in a more limited form) while the SEC considered whether to amend the complaint, and while the parties litigated the defendants' motion to dismiss that amended complaint. (A ruling on that motion is pending.)

Meanwhile, another court granted summary judgment to several defendants a year and a half after having frozen their assets in response to a request the SEC had made less than a month after the public announcement of a merger involving a Chinese company whose stock the defendants (all of whom were Chinese persons or entities) had purchased in U.S. accounts just days before the announcement. *SEC v. All Know Holdings Ltd.*, No. 11-cv-08605 (N.D. Ill. June 11, 2013). The court found that the SEC could not sustain its allegations in the absence of evidence of any tipper. (The SEC reached settlements with three other defendants.) Similarly, in another case (which involved trading in the stock of a Chinese company by Chinese nationals and a BVI entity in U.S. accounts), the SEC obtained an asset freeze in April 2012, but stipulated in August 2012 to the dismissal with prejudice of three defendants and suffered an adverse verdict in January 2014 on insider trading charges against two other defendants (though it did secure a favorable verdict on front-running and reporting charges against one of those defendants). *SEC v. Siming Yang*, No. 12-cv-02473 (N.D. Ill.). (The SEC reached a December 2013 settlement with another defendant.)

It remains to be seen whether the *Onyx*, *All Know Holdings*, and/or *Yang* results will stem the SEC's burgeoning tactic in this area (either by causing the SEC to use it more judiciously or by causing courts to view it more skeptically), or whether the SEC (and the courts) will instead view occasional setbacks as a small price to pay for the benefits of securing potential illicit profits before they are dissipated and of creating greater economic pressure for holders of frozen accounts to consent to judgments. In any case, the SEC's practice of seeking asset freezes serves as a caution flag for the consequences that can potentially (and immediately) flow from trading in advance of merger announcements, whether or not such trading was well-informed or merely coincidental, and regardless of the locales in which the trading proceeds are held and the traders and issuers are located.

The New York State Attorney General's 'Insider Trading 2.0' Initiative Looks to Expand the Universe of Prohibited Information and Trading

Perhaps the most interesting set of insider trading-related developments in the past year or so do not actually involve insider trading, as defined by federal law, at all. Largely in response to a push by the New York State Attorney General dubbed "Insider Trading 2.0," financial media organizations and others who often have information or opinions capable of swaying securities prices have been agreeing to cease providing selective or staggered disclosure of such information and views. Last July, Thomson Reuters agreed to stop selling to priority subscribers early access to the University of Michigan's consumer confidence survey. On February 25 of this year, the Attorney General announced that he had reached agreements under which 18 of the country's largest broker-dealers promised to no longer respond to certain surveys from buy-side firms seeking analyst sentiment. And on April 29 of this year, PR Newswire followed the earlier leads of Business Wire and Marketwired by agreeing with the Attorney General to require its subscribers to certify that they would not engage in high-frequency trading with information they receive via that outlet's direct data feed. Meanwhile, the Attorney General has said he is also investigating the traders who obtain and use such selective or early information.

None of the information that is the subject of those agreements, or any trading based on it, would appear to have been covered by existing federal insider trading law, as the disclosure of the information did not breach any duties to securities issuers, or anyone else, and neither the disclosure nor the use of the information was prohibited by the original (or intermediate) sources of the information. To the contrary, everyone understood that one of the main purposes of the information was to inform trading decisions. By proceeding under authority conferred by New York's Martin Act, however, the Attorney General appears to be seeking to push the law toward eliminating trading based on unequal access to information rather than just trading on information disclosed in breach of a fiduciary or contractual duty. Thus, based on the new policies, anyone obtaining and trading on selective, early or, potentially, otherwise unequal information going forward would run the risk of an insider trading prosecution, both because of the New York prosecutor's expanded view of the law and because any disclosure (or early disclosure) or use of information subject to one of the agreements with the Attorney General would now potentially constitute misappropriation of the information. Put another way, violating an agreement with, say, PR Newswire to not engage in high-frequency trading with information from its data feed would not necessarily be just a breach of contract; it could potentially be a crime.

Even Lawfully Disclosed Information Can Lead to Insider Trading Prosecutions

"The SEC is making clear that it does not view insider trading as limited to situations involving surreptitious tips from rogue employees or agents."

The SEC is making clear that it does not view insider trading as limited to situations involving surreptitious tips from rogue employees or agents. To the contrary, it has brought a number of cases under a misappropriation theory against persons who were openly and properly given material nonpublic information by fully authorized personnel who were soliciting investments from the recipients, but under agreements — or alleged agreements — to keep the information confidential and not to trade on it. For example, in *SEC v. Massoud*, No. 13-cv-01691 (D. Conn.), the SEC charged the managing member of an investment group with insider trading based on information the investment group allegedly learned

under a confidentiality agreement that it had entered into upon joining the bidding process for the issuer. He settled the charges by paying nearly $1.5 million in disgorgement and penalties. Likewise, in *SEC v. Langston*, No. 13-cv-24360 (S.D. Fla.), the SEC charged an investor with insider trading ahead of the public announcement of a secondary offering based on information he learned from a placement agent for the offering after allegedly agreeing to keep the information confidential and not trade on it. He agreed to pay nearly $400,000 to resolve the charges (which alleged that he had made just under $200,000 on the trading).

Of course, the most prominent insider trading case involving undisputedly lawfully disclosed information was the SEC's recent prosecution of Dallas Mavericks owner Mark Cuban. He sold shares he held in Mamma.com after having been told by its CEO that it would be making a PIPE offering. The CEO and SEC claimed that Cuban had agreed to keep the information confidential and not trade on it, but Cuban denied having so agreed. Though last fall's well-publicized jury verdict in Cuban's favor exonerated him with respect to that dispute, the case is nevertheless a cautionary tale of the dangers of trading even on lawfully disclosed material nonpublic information: Cuban spent five years and millions of dollars litigating with the SEC over a trade on which he allegedly avoided losses of just $750,000. Thus, the case is a reminder that the SEC is not shy about pursuing non-classic insider trading cases under a misappropriation theory, or about doing so even where the evidence of any confidentiality agreement or agreement not to trade is disputed.

The Government Is Investigating the Disclosure and Use of Political Intelligence

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Although no charges have been brought yet under the Stop Trading on Congressional Knowledge (STOCK) Act during the two-plus years since it became law, both the SEC and the DOJ are actively pursuing at least one investigation into potential violations of its provisions, which specify that lawmakers and other federal employees have "a duty arising from a relationship of trust and confidence" to Congress, the federal government, and U.S. citizens, and expressly prohibit congressional members, staffers and other federal employees from using information gained from their positions for personal benefit. That investigation stems from an incident in April 2013 in which the staff director of the House Ways and Means Committee's Subcommittee on Health reportedly informed a lobbyist of a change in Medicare reimbursement rates before the official announcement of the change. The lobbyist then reportedly emailed the information to a brokerage firm, which then issued an alert to clients, and the share prices of insurance companies that were positively affected by the change promptly rose. By early May of this year, the staff director and the committee itself had each received SEC subpoenas regarding the matter, and the staff director had also received a grand jury subpoena. The committee and staff director objected to the SEC subpoenas, and in June the SEC sued to compel responses. Regardless of how that particular dispute turns out, it is clear that the government is monitoring trading in advance of not only corporate announcements but also government announcements, and that portfolio managers and traders need to be mindful of whether information relevant to their trading decisions may have been provided, directly or indirectly, in breach of a government employee's duty to the government or its citizens.

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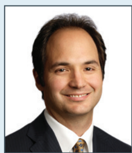

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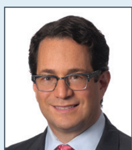

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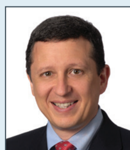

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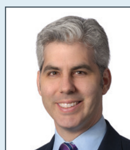

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