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The Inside Scoop on Insider Trading

Insider trading is often mentioned in the news, but many people want to know what "Insider Trading" exactly means, and when such conduct rises to the level of a criminal act.

In today's tumultuous economy, much focus is being placed on the perceived wrongdoings of corporate America. For this reason, insider trading is one hot area of federal litigation. The Securities and Exchange Commission (SEC) and the Department of Justice (DOJ) are willing to prosecute even if the amount of profit is relatively small[1]. The following article outlines the fundamentals of the crime of insider trading and explains the different theories used in federal court.

The Basics

To begin, it is important to note that there are legal ways to conduct insider trading. In other words, not all insider trading is a crime. Legal insider trading occurs when corporate insiders such as directors, officers, employees, and controlling shareholders trade in their company's own securities *and* report these trades to the SEC.[2]

In contrast, illegal insider trading is the purchase or sale of securities (e.g. stocks, bonds, futures, options, etc.) based on non-public material information that was received from a source that had a duty to keep the information confidential. The source may be an employee, officer, attorney, accountant, controlling shareholder, or any other corporate insider who is privy to non-public information; i.e., someone who has a fiduciary relationship with the company.

For example, a recent prominent insider trading case was the SEC investigation and subsequent DOJ prosecution of San Francisco socialite Annabel McClellan, wife to a partner at accounting firm Deloitte Touche. McClellan relayed secret information she overheard from her husband's phone conversations to her sister and brother-in-law in London, who then traded on the tips and netted approximately $3 million, half of which McClellan received. McClellan pleaded guilty to obstruction of the investigation and received an 11-month prison sentence. As part of the plea agreement, she admitted to obtaining confidential non-public information and passing the information along to her relatives.

In addition to criminal prosecution, Defendants in illegal insider trading cases may also be subject to civil lawsuits by victims of the crime and SEC enforcement action. All of these

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[1] 2 J. M. ANDROPHY, WHITE COLLAR CRIME, §12:6 (2d ed. 2010)
[2] http://www.sec.gov/answers/insider.htm

proceedings rely on the same set of statutes and regulations: the Securities and Exchange Act of 1934 §10(b)[3] [4] and the corresponding SEC Rule 10b-5[5] [6].

While neither §10(b) nor Rule 10b-5 refer directly to insider trading, they provide the broad regulatory framework that the federal government uses to prosecute insider trading cases.

Procedure[7]

Most cases begin with the SEC conducting an informal investigation into an alleged violation. If there are enough supporting facts, this informal investigation will turn into a formal investigation. The SEC may then refer the case to the DOJ. The SEC and DOJ will often cooperate in their investigations and prosecution, and the defendant may therefore find himself subject to actions brought by both bodies.

There are two primary distinctions between a criminal prosecution brought by the DOJ and civil proceedings. First, criminal proceedings call for a higher burden of proof: the jury must find that the defendant is guilty beyond a reasonable doubt, whereas in civil court the defendant's liability is found by a preponderance of the evidence.[8] Second, the DOJ must prove the defendant acted willfully in a criminal case, meaning intentionally undertaking an act that one knows to be wrongful[9], whereas the SEC or civil plaintiff would only need to prove reckless behavior.[10]

Theories of Liability

The United States Supreme Court has accepted two different theories of liability for insider trading under §10(b)/Rule 10b-5: classic insider trading and misappropriation.

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[3] 15 U.S.C. §78j(b)

[4] "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

[5] 17 C.F.R. §240.10b-5

[6] "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

[7] This section largely relies on 2 J. M. ANDROPHY, WHITE COLLAR CRIME, §12:2 (2d ed. 2010)

[8] 2 J. M. ANDROPHY, WHITE COLLAR CRIME, §12:6 (2d ed. 2010); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 355 (1943)

[9] 15 U.S.C. §78ff(a); U.S. v. O'Hagan, 521 U.S. 642, 665-66 (1997); U.S. v. Tarallo, 380 F.3d 1174, 1188 (9th Cir. 2004)

[10] Tarallo, 380 F.3d at 1189

Under the classic insider trading theory, the defendant violates Securities and Exchange Act of 1934 §10(b) and Rule 10b-5 when he or she uses material, non-public information to trade on securities of his own corporation.[11] Under this theory, corporate insiders not only include directors, officers, and controlling shareholders, but also attorneys, accountants, consultants, and others who are considered temporary fiduciaries of the corporation.[12]

Both the person who tips (tipper) and the person who receives a tip (tippee) may be guilty of insider trading. A "tipper" is one who tips material non-public information for personal benefit, which need not be monetary. A "tippee"—a person who receives the information from the tipper—may be liable if he trades on the information knowing that it was disclosed in breach of the tipper's fiduciary duty and the tipper also derived a direct or indirect personal benefit from the disclosure.[13]

One of the most notable tipper-tippee relationships is that of Galleon Group hedge fund founder Raj Rajaratnam (tippee) and former director of Proctor & Gamble and Goldman Sachs Rajat K. Gupta (tipper). Gupta provided Rajaratnam with inside information from both of his former companies, which Rajaratnam used to reap significant profits and avoid substantial losses. Gupta was arrested for insider trading-related charges in October 2011. Rajaratnam was convicted at trial and sentenced to 11 years in prison, the longest prison term ever handed down for an insider trading conviction. Although Gupta did not personally profit from any of Rajaratnam's trades, he still may be found guilty as a tipper because he stood to gain from his business relationships with Rajaratnam.[14]

Under the misappropriation theory, a defendant without a fiduciary relationship to the issuing company may still be found guilty of trading on non-public information if the information had initially been misappropriated from the company in breach of a duty of trust or confidence owed to the source of the information.[15] It's important to note that the defendant may be found guilty even if he didn't owe a duty to the issuer or its shareholders, as long as he breached a duty to the source of the information.

Penalties

If a person is found guilty of insider trading under §10(b)/Rule 10b-5 or Rule 14e-3, he or she may be fined up to $5 million, imprisoned for a maximum of 20 years, or both.[16] If the defendant is not a natural person, such as a corporation, it may be fined up to $25 million.[17]

[11] U.S. v. O'Hagan, 521 U.S. 642, 651-52 (1997)
[12] Id. at 652; see Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983)
[13] Dirks v. SEC, 463 U.S. 646 (1983); http://www.sec.gov/news/speech/speecharchive/1998/spch221.htm
[14] Nathaniel Popper and Stuart Pfiefer, *Former Goldman Sachs director Rajat Gupta*, LOS ANGELES TIMES (Oct. 27, 2011) *arrested* http://articles.latimes.com/2011/oct/27/business/la-fi-1027-gupta-charges-20111027
[15] O'Hagan, 521 U.S. at 652
[16] 15 U.S.C. §78ff(a)
[17] Id.