Insider Trading: Ambiguous Statute as Warning

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Introduction

In the last eighteen months, 47 people have been charged with insider trading; 35 of those defendants have either pled guilty or been convicted. None have been acquitted after trial. Raj Rajaratnam’s and Zvi Goffer’s convictions are examples of the most recent and high-profile. It is widely believed that the U.S. Attorney’s Office in the Southern District of New York is planning to return a number of other indictments against outside consultants and others in an inquiry into an expert networking firm. How has such an impressive record of convictions and pleas been built without a single acquittal?

The answer is twofold. First, the insider trading laws are among the most amorphous and vague in the entire criminal code. Most people, including jurors, believe insider trading means buying or selling a security based on information that is not publically available. It does not. Rather, the definition of insider trading is complex. Indeed, it took almost a generation and a half of legal scholarship to determine its elements. Juries simply do not understand insider trading, and often succumb to the argument that if a defendant traded on information not available to others—and made a lot of money—he is guilty.

Second, one essential key to an acquittal in an insider trading case is an explanation of why the defendant traded. The defendant must take the witness stand and testify how he arrived at the decision to trade the stock in question at that precise moment. In insider trading cases, it is impossible to raise a reasonable doubt without the defendant’s testimony of innocent conduct; unlike other white-collar crime cases in which the defense may rest on the government’s inability to prove its case. In an insider trading case, the government will be able to prove that the defendant knew an insider, who had material non-public information, and was in contact with that insider shortly before executing a trade. If the defendant does not take the stand and explain his conduct, the inference that he traded on insider information will be overwhelming. Yet, most defendants will have unwittingly disabled themselves at the very outset of the investigation from taking the witness stand at the trial.

Section 10(b) – A Vague and Ambiguous Law

In 1934, when Congress passed Section 10(b) of the Securities Exchange Act (Exchange Act)—the so-called "securities fraud" provision—it was the accepted wisdom on Wall Street that the only way to make money in the markets was to trade on insider information. There was not a single individual who believed that Section 10(b), which outlaws "deception" in connection with the purchase or sale of a security, covered insider trading. In fact, the Exchange Act specifically covered insider trading in another section—Section 16(b)—which provides that profits by an insider witness stand and testify how he arrived at the decision to trade the stock in question at that precise moment. In insider trading cases, it is impossible to raise a reasonable doubt without the defendant’s testimony of innocent conduct; unlike other white-collar crime cases in which the defense may rest on the government’s inability to prove its case. In an insider trading case, the government will be able to prove that the defendant knew an insider, who had material non-public information, and was in contact with that insider shortly before executing a trade. If the defendant does not take the stand and explain his conduct, the inference that he traded on insider information will be overwhelming. Yet, most defendants will have unwittingly disabled themselves at the very outset of the investigation from taking the witness stand at the trial.

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from the purchase and sale of securities within six months must be disgorged.

*Developing a Definition*

It was not until almost thirty years later, in *Cady, Roberts and Co.*,¹ that the Securities and Exchange Commission (SEC) suggested that a corporate insider violates Section 10(b) of the Exchange Act—the securities fraud provision—when trading in the shares of his own company, unless he first disclosed all material inside information that he knew. Following the SEC’s lead, the Second Circuit several years later in *SEC v. Texas Gulf Sulphur*² held that anyone who possesses information, even if he was not an insider within the meaning of the Exchange Act, must either disclose that information to the investing public, or be precluded from trading or recommending the stock while the information remained undisclosed. In other words, there must be equality of information in the marketplace among all traders, and those who trade on material non-public information not available to all commit securities fraud in violation of Section 10(b).

The U.S. Court of Appeals for the Second Circuit’s definition was simple and easy to apply, and, even to this day, is what most people believe constitutes insider trading. In fact, this simplistic definition survived for only twelve years. In *Chiarella v. United States*,³ the U.S. Supreme Court rejected the concept of equality of information in the marketplace, and developed what has become known as the classical theory of insider trading. Under the classical theory, the relationship between a corporate insider and a shareholder of that corporation gives rise to an obligation on the part of the insider either to disclose or refrain from trading. If the trader is neither an insider, nor a fiduciary, there is no obligation to disclose material non-public information. In *Chiarella*, the jury, in accordance with *Texas Gulf Sulphur*, had been instructed that the defendant owed a duty to everyone when he used material information. Thus, in view of the Court’s redefinition of insider trading, *Chiarella*’s conviction was reversed.

In *Chiarella*, the Supreme Court essentially held that equality of information in the marketplace is not a hallmark of our capitalist system. It also is not fraudulent to trade on information others do not possess, unless you obtain the information in breach of a duty owed to the corporation in whose stock you are trading. A mere possession of inside information creates no duty in and of itself.

*Tipper/Tippee*

Three years later, in *Dirks v. SEC*,⁴ the Supreme Court determined that when a tippee receives material non-public information from an insider, the tippee also has a duty to disclose because the tippee’s duty of disclosure derives from that of the insider. In other words, the tippee assumes the insider’s duty, not because the information has been made available to him, but because it has been made available to him improperly by the tipper, with knowledge by the tippee that the tipper passed along the information in breach of his or her fiduciary duty. Whether the disclosure is improper and in breach of fiduciary duty is determined by analyzing the purpose for the disclosure. If the purpose is a personal benefit to the tipper, that constitutes a breach of fiduciary duty, of which the tippee should have been aware.

*Open Questions*

It took a full 22 years to arrive at a basic framework for what constitutes insider trading, starting from the first inkling mentioned in *Cady, Roberts*, that insider trading might violate Section 10(b), and culminating with *Dirks*. But, the saga was not yet done. All the Supreme Court had done in the first 22 years is craft the classical theory of insider trading, in which an insider, in breach of a fiduciary duty owed to his corporation, trades in a stock or tips another who trades. This left open the question of whether an individual, who did not derive the non-public information from the corporation whose stock in which he traded, could be held liable for insider trading under Section 10(b).
In *United States v. Newman*, the Second Circuit sought to fill this void by adopting the so-called misappropriation theory, which was first suggested by Justice Berger in his dissent in *Chiarella*. Under that theory, whenever someone misappropriates information in breach of fiduciary duty, and trades upon that information, the defendant has engaged in actionable fraud in connection with the purchase or sale of a security in violation of Section 10(b). In other words, the duty breached need not be owed to the corporation whose stock is traded as is required under the classical theory. Any breach of duty will suffice. But this so-called misappropriation theory was not free from doubt. It was unclear, even as defendants were prosecuted under that theory, whether the Supreme Court would accept it. In *Carpenter v. United States*, the Supreme Court divided 4-4 when faced with this issue. As a consequence, the lower court judgment was affirmed – but without any precedential value.

**O'Hagan**

It would take the Supreme Court another ten years to return to the issue of the validity of the misappropriation theory in *United States v. O'Hagan*. There, the Supreme Court held that criminal liability under Section 10(b) of the Exchange Act could be predicated on the misappropriation theory, i.e., the theory of securities fraud upon which it had evenly divided ten years before. Thus, it took 36 years for the Supreme Court to work out what the parameters of insider trading were. Clearly, given such a track record, determining what constitutes insider trading is not a clear-cut or simple task.

**Isn't Insider Trading Theft?**

Although in their press releases announcing insider trading indictments and convictions, prosecutors often tout the fact that insider trading is nothing more than simple theft, one need only look to the history of insider trading to know the truth. The 36-year history of repeated attempts by the Supreme Court to define insider trading puts the lie to such simplistic comments.

While it is true that human beings, either by religion or reason, know that certain practices, such as theft, are intrinsically evil and must be avoided, neither religion nor reason tells us that insider trading is an intrinsic evil. Moses, after all, did not come down from Mount Sinai with an eleventh commandment saying, “Thou shalt not insider trade.” Nor does reason teach us that trading upon inside information is an intrinsic evil. Indeed, the Supreme Court recognized in *Dirks* that inequality of information in the marketplace is a natural by-product of our economic system. Moreover, whole industries such as equity research thrive on the non-controversial notion that increased information about a company leads to sounder investment choices.

**Due Process Concerns**

The hallmark of any democratic system of justice is due process, which requires clear and definite laws that tell us when we are within the bounds of the law, and when we are not. As Thomas More states in *A Man for All Seasons*, "the law must be like a road, with clearly defined edges, so that one can know when he is on or off the road." The law of insider trading is not such a law.

How can we expect the average citizen to determine when he is or is not trading illegally on inside information, when it took the Supreme Court 36 years to work out the definition of insider trading? How, for example, was Martha Stewart or Mark Cuban supposed to make that determination in the blink of an eye, when nine justices of the Supreme Court needed to ponder it for decades?

**Are Insider Trading Cases Difficult To Prove?**

While nearly every press release and news story that has appeared in the past eighteen months repeats the mantra that insider trading cases are difficult to prove, just the opposite is true. Insider
trading cases are exceedingly easy to prove. This is what makes the fact that insider trading is such a vague and amorphous crime all the more troubling in a free democratic society.

The mantra that insider trading cases are difficult to prove mistakenly originates from the fact that they are largely circumstantial. But very often, circumstantial evidence can be just as compelling, if not more so, than direct evidence. If you have evidence that a tipper possessed material non-public information, was in contact with a tippee, and that tippee shortly thereafter traded in the stock, most individuals applying common sense logic will conclude that the tipper passed the information on to the tippee. Few if any jurors will focus on the issues of duty, breach of duty, and improper purpose when analyzing facts. It is the rare insider trading case where a jury will not return to the court after several hours of deliberation, and ask "Your Honor, you mentioned breach of fiduciary duty. What is that?" The judge will then tell them in ponderous tones that a fiduciary duty is the highest duty one can owe to another. It is a relationship of trust characterized by dominance of one party over another and reliance by one party on another. The jurors will then retire, and when seated in the jury room ask "What the heck did he just say?" They may even try again to get an answer from the judge. When they fail, they will return to the jury room and ask themselves, "Now what?" Then someone will say, "You know, the judge said we can apply our common sense." They then will unanimously decide, based on their common sense and without reference to legal principles, that the defendant is guilty since he had information others did not.

It appears that something very much like this occurred in the Rajaratnam trial. It is reported that when the jurors in that case retired to their deliberations, they were just as confused about when insider trading constitutes securities fraud as the Supreme Court was for decades, so they consulted reference materials that offered explanations. We can only hope that those reference materials, whatever they were, accurately summarized the holdings of the Supreme Court’s 36-year journey attempting to define this crime. I will leave it to Rajaratnam’s trial team to determine whether, assuming this in fact occurred, it permits inquiry into the validity of the verdict under Federal Rule of Evidence 606(b).

How can a defendant overcome a jury’s preference for common sense, over the substantive and, as argued herein, confusing elements of the violation? In order to secure an acquittal, the defendant must take the witness stand to testify, and the jury must credit his testimony.

Blue-Collar Tactics

However, most defendants will never have the opportunity to testify in their own defense because the government’s use of blue-collar investigative tactics will cut off this avenue off well before trial. I refer not to relatively sophisticated blue-collar tactics, such as the use of wire taps or search warrants, which are discussed later. Instead, I refer to the use of a relatively simple blue-collar technique, the ambush interview, which might severely impede a putative defendant’s ability to obtain an acquittal.

Hypothetical

Assume your neighbor is an executive in the finance department of a major corporation. You observe that she is burning the midnight oil, neglecting her obligations to her family and community due to her job. You also learn from her husband that she is visiting, on a regular basis, a city where her employer’s major competitor is located. You put two and two together, and conclude that it is likely that her company is about to acquire the competitor, and decide to buy the stock. When a merger is announced, you sell the stock and make a tidy profit. This is known as leakage. Professor Gregg Jarrell, who testified in the Rajaratnam case, has long written and lectured on this perfectly common, normal and legal phenomenon.
Some months or perhaps years after the trade, on a lovely summer afternoon, you drive up to your house and park in the driveway. As your wife and children come to greet you, two men in ill-fitting dark suits approach you and flash badges announcing in voices loud enough for all the neighbors to hear that they are FBI agents. They ask if they can come into your home and suggest that your wife and children repair to the recreation room, because they have a few questions to ask you.

And then it comes. The agents ask you why you decided to buy stock in your neighbor’s employer. Your life now hangs in the balance. The immediate thought that will go through your mind is, my God, I must have traded on insider information. Why? Because the average person does not know what the elements of inside information are.

In the scenario I have posited, there was no trading on inside information. You merely observed your neighbor’s public habits and drew a conclusion. There is nothing unlawful about this. Your neighbor breached no fiduciary duty to anyone, nor did you.

However, as you sit there with the FBI agents, you will not know this. The natural tendency of all human beings when they are confronted by government authorities, who are implying that they may have done something wrong, is to justify their conduct. Instead of saying that you observed your neighbor’s behavior and motions and put two and two together, you are more likely to say: "I read a story about it." Being less than candid and forthright with a government official is a violation of 18 U.S.C. § 1001 and obstruction of justice, as Martha Stewart learned. Few people will have the presence of mind to say "I want to talk to a lawyer."

Even if our putative defendant is completely candid, after several months or years have passed, his recollection of the events leading up to the trade may fade. Even if he tells the FBI agents what he now honestly believes to be the absolute truth, he will now be stuck with that story forever, unable to supplement or modify it when his recollection is refreshed with documents without being accused of lying.

Alternative Hypothetical

In an alternate scenario, it may not be the FBI who comes to your home. It may be a surprise call at the office from the SEC. Indeed, the casualness of a telephone call from the SEC is more likely to induce you to talk to them. But once you have opened your mouth and spoken to the SEC, you will never again be able to change your story. Indeed, if you do change your story, the government will argue that you have made two inconsistent statements, which in and of itself is evidence of guilt.

I do not mean to ascribe any nefarious intent to the FBI or SEC by employing these tactics. They are, of course, legitimate. My only point is that if a putative target tells one story at the initial interview due to failure of recollection, or a simple desire to cut the interview short, she may well be stuck with that story forever.

The only way to avoid the dilemma that you now face is to do what is almost unnatural for the average layman, and that is slam the door on the FBI agents — and hang up the phone on the SEC. But, normal people simply will not do this. Believing that they can talk their way out of their problems, they will engage in an extended conversation with either the FBI or the SEC, trying to justify the legitimacy of the trade. Yet, as the discussion proceeds the hole will be dug more deeply.

On these assumed facts, it would be almost impossible to secure an acquittal. Anyone ensnared in an insider trading investigation must keep his or her options open. I say this not because a lawyer will help the client craft a false story to sell to the jury. Rather, it is essential when faced with the overarching might and power of the United States government to seek legal advice to determine whether or not a law has been violated, and to help reconstruct the facts, the memory of which likely
have dimmed with the passage of time. An attorney may be able to pinpoint facts that may show that the elements that would make the accusation an offense were simply not present.

**Rational and Coherent Explanation**

As I noted above, in any insider trading case, it is essential that the defendant testify and be able to explain to the jury in a rational and coherent manner, why it is that he or she became interested in this stock and why he or she traded at that exact moment. Sometimes admitting that the interest in the stock came from the insider is the best approach, albeit a counter-intuitive one.

In the scenario above, interest in the stock was initiated by the insider, but that does not mean that the subsequent trade was based on insider information. Insider trading has a precise definition built up over the course of 36 years. It is not, as the United States government once advocated, merely trading while in possession of material non-public information. But the only way that an individual who has not studied the 36-year history of insider trading can ever hope to escape is by seeking the advice of a lawyer and analyzing his own particular facts against the legal standard.

**Tape Recordings**

Many reading this article to this point may think, "All of this is all well and good, but that wouldn't have helped Rajaratnam, because he was caught on tape." Tape recordings are just another blue-collar tactic, like the ambush interview. An individual who makes his or her living in the securities industry and who does not want to become a defendant in an insider trading case, must do two things to deal with such aggressive tactics.

First, he or she must have a good grasp of the law, and should never act in any marginal situation without documented legal advice. Second, and more importantly, securities professionals must learn discipline when speaking to even their most trusted friend about anything that can be misinterpreted and misconstrued by government agents listening to telephone conversations. Remember they are listening to put you in jail, and will give your words no leeway as just "joking around."

After nearly 40 years defending securities professionals, the one thing I have learned is that professionals, including (and some would say, particularly) lawyers, enjoy boasting to each other. It bolsters their egos and makes themselves seem more important and more influential than they really are. At times, these professionals will say the silliest and stupidest things on a telephone. I am sure that many of you reading this article may have said at one time or another, even if it wasn’t true, to someone on a telephone, "I know somebody on the board." That simple, innocuous boast, even if untrue, will never be viewed by your friendly FBI agent or SEC staff member as a boast, but as conclusive evidence of insider trading.

It has been reported that some of the people caught on tape speaking to Rajaratnam did just that – boasted about their contacts. When such boasting occurs, a listener must terminate the call, or admonish the speaker. Otherwise, the government will point to the call as evidence of evil intent.

**Conclusion**

So what is a person to do? First, if approached by the FBI or the SEC, seek legal advice; do not under any circumstances talk to the agents. And, remember, the fact that the FBI or SEC does not read you Miranda rights doesn’t mean that they have not targeted you for prosecution. It only means you have not yet been placed under arrest, since only people who are not free to go are entitled to Miranda warnings. Second, engage in e-mail and telephone discipline. Assume that every single e-mail is being read and every single telephone conversation is being listened to. Do not put foolish comments into e-mails or make foolish
statements on telephone conversations. Your life may depend upon it!

Mr. Razzano is a partner in Pepper Hamilton LLP’s Washington, D.C. office, and focuses his practice on all areas of civil, commercial and criminal litigation, with an emphasis on U.S. Securities and Exchange Commission enforcement. He secured an acquittal in a criminal insider trading case for a tippee, despite the fact that the tipper was convicted. He is also an Adjunct Professor at the University of Maryland Law School, where he has taught courses on White Collar Crime, International Criminal Law, Securities Litigation, Broker-Dealer Regulation and Evidence.

1 40 SEC 907 (1961).
2 401 F.2d 833 (2nd Cir. 1968).