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Insider Trading Developments — Summer 2012

Posted by Noam Noked, co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Monday October 8, 2012

Editor's Note: The following post comes to us from Paul N. Roth, founding partner and chair of the Investment Management Group at Schulte Roth & Zabel LLP. This post is based on a Schulte Roth & Zabel newsletter by Eric A. Bensky, Harry S. Davis, Howard Schiffman and Katherine Earnest; the full publication, including a detailed chart of DOJ/SEC insider trading actions, is available here.

While the insider trading conviction of Rajat Gupta and SEC settlement with Hall of Fame baseball player Eddie Murray attracted headlines — and the 12-year prison sentence imposed earlier this summer on former corporate attorney Matthew Kluger set a new standard for criminal insider trading penalties — there have been several other legislative, regulatory and judicial developments in recent months relating to insider trading that are of equal or greater significance. All reflect an increased focus on preventing and prosecuting the trading of securities and commodities based on material nonpublic information.

Congress has passed legislation expressly prohibiting its members and other government officials from trading on nonpublic information they learn from their official positions, even as a prominent Congressman was investigated regarding (though ultimately not charged with) such alleged trading. Meanwhile, the Department of Justice and the SEC have continued their active pursuit of those they believe supplied and traded on inside information obtained and disseminated via "expert network" investment research firms. Finally, courts and prosecutors have demonstrated an inclination to find at least the possibility of illegal insider trading even when the information came from an indirect source or via seemingly benign means.

These recent developments all suggest that, in the current environment, investors and investment advisers should be particularly vigilant in ensuring that they and their employees do not acquire and trade on nonpublic information obtained directly or indirectly from an individual or entity who was not authorized to disclose it, or that otherwise is not in the public domain.

Congress Expressly Prohibits Insider Trading by Its Members, Staffers and Other Federal Employees

On April 4, 2012, President Obama signed the Stop Trading on Congressional Knowledge ("STOCK") Act into law. The law specifies that lawmakers and federal employees have "a duty arising from a relationship of trust and confidence" to Congress, the federal government and U.S. citizens, and expressly prohibits congressional members, staffers and other federal employees from using nonpublic information gained from their positions for personal benefit. As a result, persons who are not government employees can be held liable as tippees if they trade on information that they learn from government employees — be they in the legislative, executive, or judicial branch — in breach of those employees' duties.

Meanwhile, even as the STOCK Act was being debated and passed, the House member who presided over a congressional hearing on the STOCK Act was investigated by the House's Office of Congressional Ethics ("OCE") for possible insider trading. The independent investigative agency reportedly investigated suspicious trades by House Financial Services Committee Chairman Spencer Bachus (R-AL), and investigators reportedly initially informed him that there was evidence that insider trading violations had been committed. The investigation appeared to focus, in part, on several short options that Rep. Bachus traded in September 2008 after participating in a closed-door briefing with Treasury Secretary Henry Paulson and Federal Reserve Chairman Benjamin Bernanke in which the participants discussed the nation's impending economic decline. The investigation also appeared to involve other trades that coincided with major policy announcements concerning industries under the oversight of House committees on which he sits. Rep. Bachus denied any wrongdoing and, in April, the OCE board recommended that the House Ethics Committee not bring a case against him.

Regulators Aggressively Prosecute Expert Network Cases

Since late 2010, the DOJ and the SEC have been bringing insider trading charges against the employees and clients of investment research firms that provide "market intelligence" through "expert networks" that allegedly engaged in illegal tipping of information obtained from public company insiders.

One such firm is Primary Global Research LLC ("PGR"), which marketed itself as an "independent investment research firm that provides institutional money managers and analysts with market intelligence" through a "global advisory team of experts." Winifred Jiau, a consultant with PGR, allegedly formed friendships with technology company insiders, who provided her with quarterly revenues, gross margins and earnings per share for specific quarters for multiple publicly traded companies. Jiau then communicated such nonpublic information to investment adviser clients, who paid PGR, which in turn paid Jiau up to $10,000 per month. Jiau was convicted of insider trading and sentenced to four years in prison in September 2011. James Fleishman, the vice president of sales for PGR, was sentenced to two-and-a-half years in prison in December 2011 for forwarding emails containing nonpublic information obtained by other PGR consultants to investment advisers, who then executed trades through PGR's affiliated broker-dealer (PGR Securities).

The government's prosecution of insider trading charges involving expert networks has continued this year. On April 6, 2012, the U.S. District Court for the Southern District of New York entered a consent judgment ordering Diamondback Capital Management LLC ("Diamondback") to pay more than $9 million to settle insider trading charges brought by the SEC and the U.S. Attorney's Office involving former Diamondback employees Todd Newman (a portfolio manager) and Jesse Tortora (an analyst). Newman and Tortora were accused of illegally trading Dell and Nvidia Corp. stock based on material, non-public information learned through outside consultants and expert network firms. Newman pled not guilty on February 14, 2012. Tortora pled guilty on January 18, 2012 and is cooperating with the government.

Meanwhile, on June 26, 2012, Tai Nguyen, the president and sole employee of California expert networking firm Insight Research LLC, pled guilty to conveying insider information to two hedge fund managers who were clients of his firm. The managers (Samir Barai and Noah Freeman) had themselves pled guilty to insider trading charges last year. Nguyen admitted to providing them with confidential earnings information regarding biotechnology company Abaxis Inc. that he had received from his brother, who worked in the company's finance department.

Finally, on July 25, 2012, John Kinnucan, the founder of Broadband Research LLC, pled guilty to conspiracy and securities fraud charges in connection with receiving nonpublic information regarding quarterly revenue and anticipated legal disputes from employees of publicly traded companies, such as F5 Networks Inc., SanDisk, Apple and Flextronics International Ltd. Kinnucan paid his sources with money, stock tips, expensive meals and, in one case, by investing $25,000 in the source's business venture. Kinnucan then passed the information on to his clients, including a former portfolio manager of Dallas-based hedge fund Carlson Capital LP.

Congress has taken notice of expert networks and similar market intelligence firms that focus on political developments. The STOCK Act orders a report from the Comptroller General on the role of "political intelligence firms" that operate as information gatherers for hedge funds and private investors.

In short, even using information obtained from ostensibly legitimate research firms does not inoculate investors and managers against potential insider trading investigations or charges. Rather, the government's inquiries into and prosecutions of such firms and their clients demonstrate that one must consider the ultimate source of the information upon which one trades, regardless of how far down the chain the investor or manager may be, or how innocent the immediate source may appear.

Prosecutors and Courts Are Taking a Broad View of Insider Trading

Certain recent cases demonstrate what appears to be an inclination of prosecutors and courts to find at least the possibility of illegal insider trading even where the information in question came from an indirect source or via seemingly benign means.

For example, in SEC v. Kueng, No. 09-8763 (KBF) (S.D.N.Y. Dec. 8, 2011), the defendant, a sell side coverage employee at J.P. Morgan Chase, allegedly learned rumors of Electronic Arts' ("EA") planned acquisition of Jamdat Mobile Inc. ("Jamdat") from a professional and personal acquaintance (William Dailey) with whom she was drinking at a bar. Daily had learned the information while sitting with the defendant at the bar via a cell phone conversation that Dailey had with William Jones, III, who, in turn, had learned it from his brother (Benjamin Jones), who was a senior vice president of North American sales at one of the companies. Although Kueng made no trades in either company's securities, she passed along information about the impending merger to several of her clients, who traded. The SEC brought an enforcement action against Kueng, alleging that she either knew or should have known that the information about the merger had to have come from a corporate insider, charging her as a "tipper" and seeking disgorgement from her of the profits earned by her clients who had traded based on the information she had passed along. The U.S. District Court for the Southern District of New York denied the defendant's summary judgment motion on the ground that there were triable issues of fact as to whether the employee breached any fiduciary duty in disclosing the information to his brother (who did not trade on the information but who previously had traded on other non-public information received from his brother) and whether the defendant acted with culpable intent when later conveying the information to several colleagues and clients who then profitably traded on it. (The SEC and Kueng thereafter reached a settlement in which Kueng agreed to pay a fine and disgorgement.)

In the case In re Washington Mutual, Inc., No. 08-12229 (MFW) (Bankr. D. Del. Sept. 13, 2011), the United States Bankruptcy Court for the District of Delaware issued a decision finding that the Committee of Equity Security Holders (the "Equity Committee") stated a colorable claim sufficient to grant the Equity Committee standing to pursue equitable disallowance of claims held by certain hedge fund creditors (the “Funds”) based on allegations that they traded on inside information that they learned during bankruptcy settlement negotiations. However, as described below, the court subsequently vacated the portions of its decision dealing with this issue.

The debtors filed for Chapter 11 bankruptcy in September 2008. In March 2009, the debtors, the Funds, and other parties began discussions concerning a global settlement agreement regarding claims to the debtors’ assets. As a condition to their participation in the discussions, the Funds at various times entered into confidentiality agreements in which the Funds were required either to restrict trading in the debtors’ securities or to establish an ethical wall between those who made trading decisions and those engaged in settlement negotiations. The confidentiality agreements contained an express termination date and also required that at the end of the confidentiality period, the debtors publicly disclose any material nonpublic information that may have been communicated. It was undisputed that the Funds abided by the confidentiality agreements and that the debtors represented at the end of the respective confidentiality periods that any material nonpublic information provided during those periods had been disclosed. After the expiration of the confidentiality periods, the Funds traded in the securities of the debtors.

Thereafter, the debtors and other parties to the global settlement negotiations announced that they had reached a settlement. In addition to opposing the settlement plan, the Equity Committee sought to disallow the Funds’ claims to the bankruptcy estate’s assets on the ground that the Funds violated insider trading laws by trading while knowing the state of the settlement negotiations. In concluding that the Equity Committee had stated a “colorable” claim for equitable disallowance, the court said that settlement negotiations may have been sufficiently advanced to qualify as “material” by the time of the trades, and that the debtor’s view of what was material nonpublic information was not dispositive. The court noted, however, that the colorability standard is low, and the opinion did not constitute a finding that the Funds engaged in insider trading. The court also recognized that the equitable disallowance claim could be vigorously litigated, and did not permit the Equity Committee to proceed with it until the parties engaged in court-ordered mediation. The mediation resulted in a global resolution of numerous claims, including the claims against the hedge fund creditors that would have been pursued by the Equity Committee, and a plan was approved permitting the debtors’ emergence from bankruptcy. In connection therewith, the Court vacated the portions of its September 13, 2011 decision dealing with the insider trading issue.

In late July, the SEC filed a civil complaint alleging Ladislav “Larry” Schvacho traded on material non-public information he gleaned about the impending acquisition of an employment services company whose CEO was a close friend who discussed the deal in his presence in the belief that the defendant would not disclose or misuse the information. The July 24, 2012 Northern District of

Georgia complaint alleges the two friends shared confidential information with one another with the expectation it would be maintained in confidence, but that, after overhearing the CEO having telephone conversations regarding the potential acquisition of the company (Comsys IT Partners Inc.) by another staffing company, Schvacho purchased Comsys stock and made profits of more than half a million dollars after the acquisition was announced. The case is potentially significant in that the SEC does not allege the insider breached any fiduciary duty or that the defendant had any contractual or professional obligation to keep the information he learned confidential. Instead, the complaint alleges the defendant had a duty of trust and confidence to the CEO by virtue of their "close and long-standing business and personal relationship and their history, pattern and practice of sharing confidences," and that the defendant breached that duty and illegally misappropriated the information by trading on it while knowing the CEO reasonably expected the defendant to maintain it as confidential and not trade on or otherwise misuse it.

Finally, on September 6, 2012, the U.S. Court of Appeals for the Second Circuit reversed a summary judgment ruling against the SEC in a case where the alleged tipper is charged with having misappropriated from his employer confidential information about a company that did not appear on his employer's restricted list at the time. In SEC v. Obus, the SEC alleged that defendant Thomas Bradley Strickland, an assistant vice president and underwriter at General Electric Capital Corporation ("GE Capital"), performed due diligence on SunSource Inc. in connection with Allied Capital Corporation's request that GE Capital provide financing for it to acquire SunSource. The SEC alleges Strickland told his friend, defendant Peter F. Black, about the potential acquisition during the course of a conversation in which Strickland claims that, as part of his due diligence, he asked Black questions about SunSource's management, with whom Black was familiar by virtue of the fact that his employer, hedge fund manager Wynnefield Capital Inc., held an existing position in SunSource. Black then reported the conversation to his boss, defendant Nelson Obus, who caused Wynnefield Capital to increase its position in SunSource following a solicitation from one of Wynnefield's brokerage firms. Though Strickland, Black and Obus all deny that Strickland told Black about the impending acquisition, the court of appeals held that a jury would need to decide that question. The court also explained that, though SunSource was not on GE Capital's transaction restricted list at the time of the conversation, that fact was "not determinative to the court's analysis" of whether Strickland knew he was obligated to keep information regarding the potential acquisition confidential. In addition, the court ruled that a conclusion by GE Capital following its own internal investigation that Strickland did not breach any duty to it did not prevent the SEC from potentially proving the opposite because the internal investigation was not "indisputably reliable," and because other evidence that the investigators did not possess contradicted its conclusions.

Further information about DOJ/SEC insider trading actions is available here.