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A Look at the Past, Present, and Expected Future of Insider Trading
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As news of the insider trading probe into Phil Mickelson and Carl Icahn gains steam, insider trading is on the mind of (most) people. On its website, the Securities and Exchange Commission ("SEC") notes that "insider trading continues to be a high priority area for the SEC's enforcement program" and "in recent years, the SEC has filed insider trading cases against hundreds of entities and individuals."[i] As media is flooded with insider trading updates, a look at the past, present, and expected future of insider trading charges is warranted.

Insider Trading Overview

"Insider trading" is a term most commonly used to refer to illegal trading conduct. However, as the SEC describes, although insider trading is often illegal, it can also be legal if proper procedures are followed (i.e, when corporate officers trade in their own securities and file a report of their trades with the SEC). Illegal insider trading specifically refers to "buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security."[ii] Once material information has been made public, at which time the assumption is that insiders do not have a direct advantage over other investors in the market, insider trading is legal so long as insiders report all transactions to the SEC.

Available Punishment for Illegal Insider Trading

The power to punish illegal insider trading derives from Sections 10(b) and 14(e) of the Securities and Exchange Act of 1934, which gives the SEC the authority to seek a court order to require violators to return any profits gained from an illegal trade. Furthermore, the SEC also has the authority ask the court to impose a penalty of up to three times the profit violators realized from their insider trading.

In addition to civil, financial penalties, illegal insider trading can also carry criminal penalties. While civil actions are monitors by the SEC, criminal probes are carried out by the Department of Justice ("DOJ"). Recently, prison terms for insider trading convictions have been on the rise. According to the *Wall Street Journal*, from 2009 to 2011 the median jail sentence for an insider trading conviction was 30 months, an increased from the median term of 18 months during the 2000s. The rationale for increasing punishment is simple: courts and regulators are trying to make sure that potential punishment will outweigh any gain a defendant might realize from an illegal trade, thus inducing insider to refrain from illegal trades.

Why Punish Insider Trading?

Although it appears that the trend has been to enforce stiffer punishments for insider trading, there has been some debate over whether insider trading should even be a punishable criminal offense.[iii] On one side of the debate, some argue that insider trading is helpful to markets and

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investors. Furthermore, proponents of the practice argue that it is so hard to police that any attempt at enforcement would be wasteful. The argument here is that when insiders buy and sell stocks based on their knowledge of a public company, they "play a critical role in keeping asset prices honest—in keeping prices from lying to the public about corporate realities."[iv] For example, according to Doug Bandow, a senior fellow at the Cato Institute, punishing insider trading simply means that "we make more bad decisions, and markets take longer to adjust." In essence, as explained by Bandow, those on this side of the debate find it foolish that "we are supposed to make today's trades based on yesterday's information." On the other side of the debate, opponents of insider trading argue that the practice keeps the wealth among insiders at the top, negatively affects economic growth and increases the price of a security. Some argue against insider trading on purely ethical grounds following the well-known argument: "It's just not right." These arguments mirror the SEC's official statement regarding the rationale of punishing insider trading, which provides: "Because insider trading undermines investor confidence in the fairness and integrity of the securities markets, the SEC has treated the detection and prosecution of insider trading violations as one of its enforcement priorities."

Some may—rightfully—wonder if undermining investor confidence in the securities markets is a fair basis for criminal punishment. However, whatever the arguments may be advanced for or against the practice of insider trading, two things appear to be clear, at least for the near future: the debate over punishing insider trading is not going away, but neither is the punishment for the activity.

Courts' Power in the Insider Trading Game and the Reign of the Second Circuit

Recent court decisions have signaled a shift toward more in depth investigations and harsher penalties for insider trading. In February 2014, Mathew Martoma became the 79th person to be convicted as part of a sweeping "Wall Street" insider trading crackdown. Martoma is the former SAC Capital ("SAC") portfolio manager. He was charged with trading illegal on inside information obtained from doctors that were involved in a 2008 pharmaceutical trial for an Alzheimer drug. The trades made SAC $276 million.[v] The Martoma trial followed a decade of federal investigation into SAC. Prior to this, former Goldman Sachs Director, Rajat Gupta was found guilty on charges of insider trading and conspiracy and sentenced to two years in prison, while former Galleon Group founder, Raj Rajaratnam is currently serving an 11 year prison sentence on insider trading charges. The insider trading crack down on Wall Street is spear headed by Preet Bharara, the U.S. Attorney for the Southern District of New York. The recent prosecutions have earned Bharara the title of "Enforcer of Wall Street" or the "New Sheriff of Wall Street."

For example, in a recent decision in *Steginsky v. Xcelera Inc.*, the Second Circuit upheld insider trading claims under Sections 10(b) and 20(a) of the Securities Exchange Act arising from an investor's sale of company stock in a tender offer by a shell company allegedly controlled by corporate insiders. The court held that Section 10(b) applies to both registered and unregistered securities, thus the securities were governed by federal securities even though they were deregistered. Furthermore, although the company and insiders had no affirmative duty to

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disclose information about the company once its shares were deregistered, the duty to refrain from trading on material nonpublic information continues to apply.[vi]

Last month Michael Steinberg, an ex-trader at SAC fund was sentenced for three and a half years in prison for his insider trading conviction. Despite 68 letters from friends and family attesting to Steinberg's good character, the Court found that the prison sentence and the $2 million fine was "necessary to send a message to others on Wall Street that insider trading is not a trivial crime."

Although courts and enforcement agencies like the SEC appear to be much tougher on those suspected of insider trading, there is some hope—though slight—for those fighting insider trading charges. For example, after an investigation and subsequent litigation, Nelson Obus was cleared by a jury of his insider trading charges. The win did not come easy however; Obus spent $9 million dollars and 10 years fighting the charges. This was the second loss the SEC experienced in an insider trading case in the past year. Similarly, a jury also previously acquitted Mark Cuban, the owner of the Dallas Mavericks of his insider trading charges. These small victories against insider trading charges, however, get lost amidst the many more convictions.

The Effect on Law Firms

A (perhaps) startling reality is that many insider trading tips come from within law firms. Clients often rely on firms to protect their secrets, ranging from intellectual property to news of an upcoming merger. Recently, news broke of an insider trading scheme arising out of the New York office of Simpson Thatcher & Bartlett LLP, where a managing clerk leaked confidential information on a number of transactions, which was accessed on the firm's computer system. This highlights the main risk factor that law firms are currently facing in the insider trading arena: material, non-public information is only a click away for most law firm employees. Years ago, sensitive information was only available to those who—quite literally—possessed a key to be able to access it. Today, most of the work being done is electronic. According to Eric Friedberg, an executive at Stroz Friedberg, a computer forensics and investigations firm that has consulted with multiple firms on these security threats, "some firms are very sophisticated and have considered the insider threat and have dealt with access control accordingly." Some, however, have not. While most large law firms have systems and procedures in place to guard confidential documents, most would likely benefit from revisiting such procedures in today's age of insider trading convictions.

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[i] For a list of some of the most notorious insider trading cases in history, click here and here.

[ii] For the SEC's overview of insider trading, click here. "Insider Trading – A U.S. Perspective," which is a speech by SEC staff providing an overview of the SEC's approach to insider trading is also available here.

[iii] For a utilitarian perspective of insider trading, click here.

[iv] For an examination of the effect of federal sentencing guidelines on insider trading convictions, click here.

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[v] For an interesting account of the trial, including federal prosecutors' failed attempts to introduce evidence of Martoma fainting when arrested by the FBI and unsealing records related to Martoma's expulsion from Harvard Law School for fabricating his transcript, click here.

[vi] The case is Steginsky v. Xcelera Inc., 741 F.3d 365 (2d Cir. 2014). Click here to view the opinion.