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PERSPECTIVES

RECENT DEVELOPMENTS IN INSIDER TRADING CASES: HAS THE PENDULUM SWUNG BACK TO THE DEFENCE?

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Recent developments in US insider trading cases have shown the limitations on prosecutions and Securities and Exchange Commission (SEC) enforcement actions, particularly those involving chains of 'tippers' and 'tippees' charged with receiving and trading on material, non-public information. This article will discuss how recent trial and appellate outcomes highlight limitations for insider trading cases and will suggest some resulting practice implications.

SEC vs. Cuban

The SEC sustained the first of these recent losses in *SEC vs. Cuban*, in which the agency had alleged

that Mark Cuban engaged in insider trading in securities of internet search firm Mamma.com, Inc. by selling his stock prior to the announcement of a private stock offering that might have diluted the value of Cuban's shares. The SEC argued that Cuban violated an agreement made during an eight-minute unrecorded call with the firm's chief executive officer (CEO) not to disclose the pending offering or to trade on it.

On 16 October 2013, after less than four hours of deliberation, a jury found Cuban not liable for insider trading, after determining that the SEC had failed to prove any of the disputed elements of its claims against him. At trial, the SEC confronted a number of challenges of proof, including the absence of any recording of the alleged conversation in which confidential information purportedly was disclosed (a conversation that Cuban testified he did not recall), the decision of the Canadian resident CEO not to testify at trial, and a former SEC official's testimony for the defence that the information Cuban received was immaterial and available to the average investor.

***SEC vs. Obus*, et al.**

In *SEC vs. Obus, et al*., the SEC alleged that defendant T. Bradley Strickland received information concerning the pending acquisition of SunSource, Inc. as a result of his position at GE Capital and that, in breach of a duty to GE, disclosed the information to his friend, defendant Peter Black of Wynnefield

Capital. The SEC further alleged that Black then disclosed the information to the general partner of Wynnefield, Nelson Obus, who traded in SunSource stock on behalf of Wynnefield.

On 30 May 2014, a federal jury in Manhattan returned a verdict in favour of all three defendants. Challenges of proof for the SEC at trial included the denials by all three defendants that a tip had occurred, the undisputed fact that Wynnefield had a long history of buying SunSource stock prior to the trade at issue, which was made in response to an unsolicited offer two weeks after purportedly receiving the tip, and a key witness' non-recollection at trial of a conversation nearly 13 years previous in which, according to the witness in a 2002 deposition, Obus told him he had been tipped.

SEC vs. Moshayedi

In one of the largest insider trading enforcement cases ever to go to trial, the SEC alleged in 2012 that sTec, Inc chairman and CEO Manouchehr Moshayedi sold 4.5 million shares of the company in a secondary offering after learning that a major customer would not renew its contract, and that he attempted to hide information related to the cancelled contract through a side deal with the customer.

On 6 June 2014, a jury in California federal court found Moshayedi not liable after less than a day of deliberations. The defendant had argued at trial that he entered into the side agreement in order to stabilise sTec's operations rather than for personal gain. The loss shows the challenges faced by the SEC even when the corporate insider is alleged to have impermissibly traded the information rather than passing it to a third party.

"With the SEC now filing more than 40 percent of its enforcement actions in the administrative forum, the SEC nearly doubled its administrative law staff last year through the hiring of at least two new judges and three law clerks."

United States vs. Newman and Chiasson

In December 2014, the US Court of Appeals for the Second Circuit overturned the insider trading convictions in *United States vs. Newman and Chiasson*, finding that the government failed to present sufficient evidence. In this landmark ruling, the court held that the government was required to prove not only that Newman and Chiasson were aware that the initial tipper disclosed the information in breach of a fiduciary duty, but that they were aware that the tipper did so in exchange for a personal benefit. The court also rejected the government's position that a mere association or friendship between a tipper and tippee is sufficient to show such benefit, holding instead that evidence suggesting a pecuniary or similarly valuable *quid pro quo* is required. The impact of *Newman* was felt immediately. On 22 January 2015, a federal district judge vacated four previously accepted guilty pleas in a separate insider trading prosecution in light of the Second Circuit's decision. Just one day later, the US Attorney filed a petition for rehearing or rehearing en banc of *Newman*. Later that month, the SEC filed a supporting amicus brief, arguing that the *Newman* decision could impede enforcement actions based on tippers' unlawful disclosure of insider information to friends. On 3 April 2015, the Second Circuit denied the petition for rehearing or rehearing en banc.

Implications

These recent high profile cases demonstrate the significant challenges of proving insider trading claims involving allegations of tipping, and could influence litigation and settlement strategy going forward.

Firstly, the government and the SEC may be more selective in the matters they choose to prosecute or bring to trial, especially those involving remote 'tippees', particularly in light of *Newman*, or where evidentiary defects or challenges are apparent. Secondly, as a corollary, defendants in appropriate insider trading cases may be more willing to take their chances at trial rather than settling.

Thirdly, as SEC staff have predicted, the agency is likely to bring more insider trading cases before its own administrative law judges, instead of in federal district court, consistent with the SEC's increasing use of that forum generally. Following the enactment of Dodd-Frank in 2010, the SEC has had the authority to obtain, through administrative proceedings, many of the same remedies as are available in district court against entities and individuals, now regardless of whether the defendants are regulated. With the SEC now filing more than 40 percent of its enforcement actions in the administrative forum, the SEC nearly doubled its administrative law staff last year through the hiring of at least two new judges and three law clerks.

This trend is notable because defending against allegations in an SEC administrative proceeding may present significant challenges. Firstly, the SEC could enjoy a home court advantage in administrative proceedings. Secondly, there are fewer due process safeguards available in administrative proceedings, which usually occur on an expedited basis, and discovery is significantly limited (for example, there is no right to take depositions). Thirdly, defendants in SEC administrative proceedings are not afforded a right to jury trial. Finally, a deferential standard of review would apply to any appeal to a federal circuit court, which may be taken only after the same five-member commission that authorised the enforcement action in the first place has reviewed the decision. A series of litigants recently challenged the constitutionality of the SEC administrative process but the outcome of those challenges remains uncertain. Because there historically have been fewer trials in the administrative courts, it is also difficult to predict if the SEC actually will be likelier to win at trial in an administrative proceeding than if it had filed a particular action in federal court.

These developments make insider trading an area to be closely monitored in 2015. CD

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