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BNA Insights
Insider Trading

A Look Inside an Insider Trading Trial

BY TERENCE J. LYNAM

Insider trading has received a great deal of press coverage recently, based on some high-profile prosecutions of Wall Street executives. However, the press coverage rarely provides much insight into how these cases are actually proven at trial.

As a legal matter, what must be proven is well-settled: In order to convict, the government must prove beyond a reasonable doubt that the defendant *traded securities on the basis of material non-public information that was disclosed by someone in breach of a duty* or conspired with someone to do so. But what do these terms mean and how are they proven at trial?

While the court will provide a legal definition of these terms to the jury, the prosecution does not want the jury to fixate on them. The prosecutor's job is to simplify things and convince the jury to accept that simplified view. Indeed, some insider trading cases are simple and fairly easy to prove. For example, cases involving defendants who do not usually trade stocks, but who suddenly trade a large dollar volume just before a market-moving company announcement present easy pickings for the government.

But cases against professional money managers, who daily trade stocks in large volumes, are more challenging to prove.

This article discusses methods and arguments that prosecutors might employ in these more complicated cases, drawing, in part, from the recent insider trading trial of *United States v. Rajaratnam*.[1]

1. Equate Confidential Information With Material Non-Public Information. What exactly is ''material non-public information''? Recent history would suggest that it is whatever the government says it is, as long as a witness will testify that the information is confidential. The legal definition is more exacting: Information is ''material'' if it would be significant to a reasonable investor in deciding whether to buy or sell a security, i.e., it must be viewed by a reasonable investor as significantly altering the ''total mix'' of information that is then available. ''Non-public'' means that the information is not available to the public through sources such as press releases, SEC filings, analyst reports, newspapers, or even word of mouth.

But in an insider trading trial, the government does not observe these legal niceties. Instead, it will equate ''confidential information'' with material non-public information and argue that if the defendant receives confidential information from an insider, then that establishes the receipt of material non-public information.

The government relies on the fact that, in today's corporate environment, companies' policies place a wide range of information under the ''confidential'' umbrella, including personal employee information; customer lists; a draft agenda for a board meeting; preliminary profit and loss numbers; a decision to seek proposals from investment banks about a potential transaction; internal M&A discussions; and actual financial results. Not all of these items would be ''material'' under the legal definition noted above. A reasonable investor might not care, for example, about preliminary discussions inside a company because these might not amount to anything; or preliminary profit and loss numbers, which are subject to change; or agenda topics for a directors' meeting that do not reveal any board decisions.

Nevertheless, in an insider trading trial, the government will build its case on the disclosure of *any* type of confidential information.

[1] The author represented Mr. Rajaratnam at this trial.

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The government can easily get a corporate representative to testify that the information at issue is confidential and that dissemination outside the company is contrary to corporate policy. Indeed, some corporate policies state that virtually anything that has not been publicly disseminated by the company is confidential.

Presenting such evidence about confidentiality goes a long way towards proving the prosecutor's theory of insider trading because juries will have a difficult time differentiating between what the company says is confidential and what the prosecutor claims is ''material and non-public'' for insider trading purposes, even when the latter term is defined in the jury instructions. By showing that the information falls under the broad category of being company ''confidential information,'' the prosecutor's burden of proving the very essence of the violation (i.e, that *material non-public information* was conveyed) is considerably lessened.

2. Treat Public Information as Irrelevant. Professional stock traders have a wealth of public information to utilize when making investment decisions. Public companies are followed by stock analysts who publish their analyses of a company's expected financial results, of its possible strategic acquisitions, and of industry trends that might affect its market share, as well as other information that ''a reasonable investor might consider significant in deciding whether to buy or sell the securities'' (in other words, ''material'' information).

The number of analysts reporting on public companies is enormous—indeed, for large companies such as Intel, 40–50 analysts may publish publicly available monthly or quarterly reports about the company. Analysts have a wealth of legal, legitimate sources for this information, including the companies themselves, which hold analyst days and make informational presentations. Company officials, while mindful of Securities and Exchange Commission ''fair disclosure'' regulations, also meet with analysts to answer questions.

In addition, companies often have investor relations personnel to answer analysts' questions. Good analysts also perform plain old hard work, such as ''channel checks'' with suppliers to check parts shipments, or comparisons with other companies in the same sector (i.e., if AMD, Intel's sole PC chip competitor, is having a bad quarter, does that mean Intel is taking away market share and having a good one?). The role of stock analysts to ''ferret out and analyze information'' is well-recognized.[2]

Professional stock traders learn to read analysts' reports and evaluate which are insightful and useful and which are not. These reports are one part of the ''mosaic'' of information that informs trading decisions.[3] Traders also consider macroeconomic events, such as the unemployment rate or a new world terrorism threat, as these can overtake the stock market, causing prices to fall even when a company has an exceptional quarter.

Finally, traders must consider what the consensus view of ''the Street'' is. If Wall Street already believes that a company is going to have a good quarter and earn 10 cents more per share than last quarter, then that expectation is likely already built into the share price. The announcement of this expected news is not likely to move the share price. However, if a money manager believes that a company will announce better results than the Street's consensus, then there might be a buying opportunity.

In short, a professional money manager must apply his or her own knowledge and experience, utilizing the wealth of available public information, in deciding whether to buy or sell a particular stock. No one piece of information is dispositive. Even if an insider arguably disclosed ''material non-public information,'' unless it would change the market's expectation of the stock, it may be irrelevant to the buy/sell decision. No one piece of information, even if from an insider, can be considered in a vacuum.

In an insider trading trial, however, the government will try to minimize the importance of all the public information that a money manager must consider and argue that it is irrelevant or, at best, guesswork and that the only information that matters is whatever the insider says. This view is often not the real world that a money manager lives in—evaluating the Street's expectations are a critical part of the trading decision. However, when coupled with the fact that, as noted above, the government will attempt to equate merely ''confidential'' information with ''material non-public'' information, treating anything the insider discloses as improper, the public information will be marginalized at trial, even though it may have been more important and determinative than the so-called inside information.

3. No Need to Show that the Trade Was Based on Material Non-Public Information. By its very name, ''insider trading'' means trading based on inside information. Both Congress and the Supreme Court have affirmed this. The securities fraud statute that Congress enacted proscribes the ''use'' or ''employ[ment]'' of a ''manipulative or deceptive device'' ''in connection with the purchase or sale'' of a security.[4] That ''use'' and ''in connection with'' requirement has been interpreted by the Supreme Court as requiring the government to prove that the defendant traded ''*on the basis of* material, non-public information.''[5] Indeed, it would seem axiomatic that because the essence of the crime of insider trading is the *trading* of a security, then to constitute an offense, the trade must be based on material non-public information. If the trade occurs for some other reason, then the statutory requirement of the ''use'' of a manipulative or deceptive device is not satisfied.

Nevertheless, some courts have held that the government need *not* prove that the trade was based on material non-public information to satisfy the ''use'' element of the statute. Rather, these courts have adopted a ''knowing possession'' standard whereby it is sufficient if the government proves the defendant possessed the inside information at the time of the trade.[6] One court instructed the jury that it could find the ''use'' element satisfied ''if the material non-public information provided

[2] *See* Dirks v. SEC, 463 U.S. 646, 658 (1983).

[3] *See* Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 165 (2d Cir. 1980) (''A skilled analyst with knowledge of the company and the industry may piece seemingly inconsequential data together with public information into a mosaic which reveals material non-public information.'').

[4] 15 U.S.C. § 78j(b).

[5] United States v. O'Hagan, 521 U.S. 642, 651–52 (1997).

[6] *See* United States v. Teicher, 987 F.2d 112, 119–21 (2d Cir. 1993) (suggesting, in dicta, that it would approve a ''knowing possession'' standard); United States v. Royer, 549 F.3d 886, 899 (2d Cir. 2008) (adopting the ''knowing possession'' standard that was ''arguably dictum'' in *Teicher*).

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to the defendant was a *factor, however small,* in the defendant's decision to purchase or sell the stock.''[7] Instructions like these dilute the ''use'' element so much as to be almost meaningless.

The watering down of the ''use'' element has a history rooted in civil insider trading cases. The SEC was unhappy with a requirement that it prove actual use of the material non-public information, claiming that proof of possession of the information, followed by a trade, should be sufficient to establish liability. It eventually enacted Rule 10b5-1, which simply defined trading ''on the basis of'' material non-public information to include trades made when the trader ''was aware of'' such information. This ''awareness'' standard has now extended to criminal insider trading cases, with instructions such as ''factor, however small'' not meaningfully distinguishable from simple awareness or possession.

This ''awareness and possession'' standard benefits the government when prosecuting a professional money manager for insider trading. As noted, that money manager will have access to a great deal of information from analysts reporting all sorts of legitimately obtained information about the company.

While the government will attempt to treat such information as irrelevant, in the real world, where trading decisions are not made in a vacuum, a professional money manager must study what the Street is saying. Even if the money manager receives information that is arguably ''material non-public,'' it must be analyzed to determine whether it really is material. That is, would a reasonable investor consider it important in deciding whether to buy or sell and does it alter the total mix of information then available?

A well-informed money manager may have been planning to buy or sell that stock anyway, based on a wealth of legitimate research and information, and may not consider the new information to be material because it does not influence his trading strategy. But when the government does not have to prove that the inside information was the basis for the trade, it has an enormous advantage. The mere fact that the manager possesses the information could give rise to liability.

[7] This instruction was given in *United States v. Rajaratnam*.

As with other aspects of the law of insider trading, the law on this point is not exactly clear. Notwithstanding the Second Circuit's view, other circuits have interpreted the ''use'' element more consistently with the *O'Hagan*, holding that the trading must be ''on the basis of'' the material non-public information.[8]

The Supreme Court may one day decide this issue and clarify its intent in *O'Hagan* regarding the requirement of proof of trading ''on the basis of material, non-public information.'' Until then, the prosecutor's burden in insider trading cases will continue to be lightened by not having to prove this ''use'' element.

4. Minimize the Personal Benefit to the Tipper. From the earliest days of insider trading law, the purpose of the law was viewed as the elimination of the ''use of inside information for personal benefit.''[9] To that end, in determining if an insider breached a fiduciary duty, the Supreme Court held that ''the test is whether the insider personally will benefit, directly or indirectly, from his disclosure.''[10] This makes sense because proof of a personal benefit, e.g., a payment by the tippee to the tipper, is probative of whether the tipper acted for his own benefit and, thus, failed to honor the duty imposed on him regarding the information. It is this payment, particularly when in the form of money, that often gives an insider trading case the appearance of corruption.

However, this requirement has also been diluted. Payment of tangible things of value is not required. Courts have instructed juries that this benefit can be satisfied simply by ''the satisfaction that comes with making a gift to a friend or relative.''[11] In other words, the benefit need not flow *from* the tippee *to* the tipper as compensation for the inside information. The benefit can be entirely generated by the tipper simply by feeling satisfied at sharing the information with a friend or relative. In this situation, the tipper becomes the provider of his own benefit.

[8] *See* SEC v. Lipson, 278 F.3d 656,660 (7th Cir. 2002) (information actually ''influenced'' trade); SEC v. Adler, 137 F.3d 1325, 1327 (11th Cir. 1998) (rejecting the ''knowing possession'' standard in *Teicher*); United States v. Smith, 155 F.3d 1051, 1066 (9th Cir. 1998) (rejecting *Teicher* standard in favor of ''significant factor'' test); United States v. Anderson, 533 F.3d 623, 630 (8th Cir. 2008) (proof is required that ''the defendant did not just possess the information but actually used the information'').

[9] *In re* Cady, Roberts & Co., 40 S.E.C. 907 at 912 n.15 (S.E.C. 1961), *quoted in* Dirks v. SEC, 463 U.S. 646, 662 (1983).

[10] *Dirks*, 463 U.S. at 662.

[11] This instruction was given in *United States v. Rajaratnam*. The government argued that it was supported by *Dirks*.

This is one of the more unusual developments in the evolution of the law of insider trading: The ''manipulative or deceptive device'' prohibited by statute has evolved to include a personal benefit—the satisfaction of providing information—that the tipper provides *to himself*. Because such satisfaction can be said to exist every time someone tells another something about a public company that is arguably ''confidential,'' the personal benefit element has been watered down to where it is not an additional meaningful requirement at all.

What this means at trial is that if a friend discloses to a money manager something that is arguably ''confidential,'' the government will not only equate it with material non-public information, but will also argue that the satisfaction that the friend received by providing the information is sufficient to establish the necessary benefit. In these circumstances, the *Dirks* test of a personal benefit flowing to the insider as evidence of the insider's breach of a fiduciary duty is all but eliminated.

5. Turn Routine Trading Practices to Your Advantage. Professional money managers often build a position in a stock leading into a quarterly earnings announcement, meaning that if they believe that the quarterly results will be favorable, they will begin to buy shares in the week or two before the earnings announcement. During this period, they might buy more shares when the price dips, or, conversely, if the price spikes unexpectedly, sell or ''trim'' their position and take some profit. As the announcement of quarterly earnings gets closer, the trader may develop different views on the stock and trim even more. Building and trimming a position in a stock during the period shortly before an earnings announcement is quite common and entirely consistent with money managers' fiduciary duties to act in their clients' best interests.

However, such routine trading practices are a concern to prosecutors attempting to prove that insider trading occurred, because sales of stock while supposedly in possession of favorable inside information run

counter to the notion that the trader holding this information is waiting to ''cash in'' when the share price jumps after the public announcement.

One way the government deals with such a trading pattern is to try to turn that practice to its advantage by arguing that it is designed to hide actual insider trading. That is, the government will argue that stock sales *prior to* an expected favorable earnings announcement are actually part of a cover-up and are designed to create the illusion that no insider trading occurred because selling is inconsistent with the inside information allegedly conveyed to the trader.

Conclusion

The law of insider trading has evolved into an elaborate checklist of requirements that must be satisfied for such trading to constitute a form of fraud ''in connection with the purchase or sale of securities.'' An insider trading trial against a professional money manager presents unique challenges for both the prosecution and the defense.

Through reinterpretation, expansive definition, dilution, misdirection, and other strategies, prosecutors have, in many cases, satisfied these complex requirements and overcome many defenses that can be raised in such a trial. Anticipating these stratagems and responding to them are critical to the defense of an insider trading trial.

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