

New York Law Journal

SECURITIES LITIGATION & REGULATION

Monday, July 7, 2008

ALM

When Is Insider Trading Subject To Criminal Prosecution?

'Pillow talk' and other 'bad stories' are often the deciding factor.

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IN RECENT YEARS, criminal prosecutions for unlawful insider trading have increased. Both the legal and financial press have closely tracked this increase, routinely providing front-page coverage detailing the nefarious schemes of alleged insider-trading defendants. These reports also detail the risk of criminal prosecution faced by virtually anyone who trades in violation of the federal securities laws. These stories and cases, however, often fail to address the factors that determine whether a particular scheme will be prosecuted criminally as well as civilly.

Until relatively recently, enforcement of insider trading was the exclusive domain of the Securities and Exchange Commission (SEC) except in the most extreme cases. Although the securities laws also provide the Department of Justice (DOJ) with criminal enforcement authority for unlawful insider trading, up until recently, the

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DOJ exercised this jurisdiction sparingly. When it did so, the prosecutions were typically of high-profile defendants such as Ivan Boesky and Michael Milken in the late 1980s.

In recent years, however, prosecutions of criminal insider trading defendants have run the gamut from low-level employees with four-figure illicit gains to corporate CEOs engaged in multi-million-dollar schemes.¹ Simultaneously, other alleged insider traders have faced only civil enforcement actions by the SEC, despite earning far greater illicit profits than many of those subjected to criminal charges.

Because both civil and criminal-insider-trading cases rely on the same regulatory framework, one cannot merely look to the statutes to explain these seemingly inconsistent results. Instead, the common element that appears to run through these criminal prosecutions is the "bad story"/negative facts that suggest a high level of culpability and/or an elevated need for deterrence. This attribute, more than any other, appears to



tip the balance from a solely civil enforcement action by the SEC to a parallel criminal prosecution involving the DOJ. As a practical matter, this specter of criminal prosecution requires attorneys and compliance officers who practice in this area to treat every insider-trading case as a potential criminal matter from inception and to tailor their defense strategy accordingly.

The Law of Insider Trading

Both the SEC's and DOJ's primary weapon against insider trading is the same: §10(b) of the

Securities and Exchange Act of 1934 (“§10(b)”) and Rule 10b-5 promulgated thereunder.² Under these provisions, insider trading takes place when someone trades a security on the basis of material, nonpublic information, with scienter, in violation of a duty. The two most common theories of insider trading are: (1) classic insider trading by corporate employees, officers, and directors; and (2) insider trading by non-issuer defendants under the misappropriation theory.

Under the classic theory of insider trading, the government must prove that: (1) a corporate insider obtained material nonpublic information due to his or her position in the company; and (2) the insider, or his tippee, traded in the corporation’s securities based upon that information.³ Under the misappropriation theory, the trader must have: (1) obtained information that was material and nonpublic; (2) used this information to trade securities; and (3) violated a duty owed to the source of the information by trading on it.⁴

The basic elements of proof for insider trading are the same for civil and criminal enforcement actions. Criminal enforcement differs from civil only in the areas of intent and burden of proof.⁵ To impose criminal sanctions, the government must prove that the defendant “willfully” performed each element of the offense, whereas civil liability may attach if the defendant acted “recklessly.”⁶ Insider trading can be a difficult crime to prove because the evidence tends to be largely circumstantial, which may partially help explain the historical trend toward civil enforcement by the SEC.⁷

The ‘Bad Story’

Given the virtually identical statutory framework, what determines if a case is pursued solely through civil enforcement or through criminal prosecution as well? Quite often the determination comes down to the defendant’s “story”—the facts and circumstances surrounding the alleged unlawful trading. The more egregious the story—the more aggravating facts associated with the alleged conduct—the greater the possibility of criminal charges.

Such aggravating factors may include: (1) the number of alleged conspirators involved in the scheme; (2) the scope of the violation; (3) the amount of profits; (4) the strength of proof (e.g., incriminating e-mails); and, (5) the perceived deterrent value of criminal prosecution (e.g., does the case involve a securities-industry profession-

al). This last factor, perceived deterrent effect, may help explain why cases that have particularly exotic or salacious facts or involve well-known Wall Street banks appear most likely to draw the attention of criminal prosecutors.

In a handful of recent cases, prosecutors have indicted participants in far-flung insider-trading schemes involving multiple firms and trades, even though the central defendants garnered only modest profits. For example, Randi and Christopher Collotta were prosecuted despite garnering only \$9,000 from a larger insider trading conspiracy.⁸ The government alleged that Ms. Collotta, a former Morgan Stanley attorney, utilized her position to gain nonpublic information that she passed to her husband.⁹

The couple tipped a broker who traded on the information and tipped others.¹⁰ Although the broker paid the Collottas only \$9,000 from his profits, the larger conspiracy netted illicit profits of \$8 million and included 13 co-conspirators.¹¹ The Collottas each pleaded guilty to one count

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of conspiracy and one count of securities fraud.¹² The Collottas were sentenced to serve six months home confinement followed by probation, and agreed to forfeit the \$9,000.¹³

Like the Collottas, another husband and wife team was also recently prosecuted for insider trading. Jennifer Wang, a former Morgan Stanley vice president, and her husband, Ruben Chen, were criminally charged with making illegal profits based upon tips given from Ms. Wang to Mr. Chen regarding imminent corporate acquisitions. Mr. Chen subsequently traded on the information in accounts created in the name of Ms. Wang’s mother, who lives in Beijing, China.¹⁴ The defendants profited from these trades in the amount of \$600,000.¹⁵

Ms. Wang and Mr. Chen each pleaded guilty to one count of conspiracy and three counts of insider trading.¹⁶ Both husband and wife were sentenced

to 18 months in prison.¹⁷ The prosecution of Ms. Wang and Mr. Chen and the Collottas illustrate a subgenre of insider trading cases commonly referred to as “pillow-talk” cases, in which prosecutors and regulators have pursued husbands and wives, boyfriends and girlfriends, and others involved in intimate relationships.¹⁸ Indeed, in 2007, the SEC commenced at least seven different cases involving married couples, and a number of others involving unmarried couples in intimate relationships.

The insider trading conspiracy perpetrated by David Pacjin, Eugene Plotkin, and a host of others provides another, somewhat more exotic, chapter in the pillow-talk cases. Mr. Plotkin and Mr. Pacjin, two former Goldman Sachs traders, received tips on impending mergers from Stanislav Shpigelman, an analyst at Merrill Lynch whom the two had recruited to assist them.¹⁹ Msrs. Plotkin and Pacjin also planted two employees inside one of the printing plants used by Business Week in order to obtain advance copies of its “Inside Wall Street” column.²⁰

Using the information gleaned from Mr. Shpigelman and their Business Week sources, Msrs. Pacjin and Plotkin executed their trades using accounts in the names of various individuals, including Mr. Pacjin’s exotic-dancer girlfriend and his Croatian-seamstress aunt.²¹ In all, more than 15 individuals were involved in the scheme, which yielded over \$6.7 million in illicit trading profits. The case led to guilty pleas from six people, including Mr. Plotkin, who was sentenced to more than 4½ years in prison, Mr. Shpigelman, who was sentenced to three years, and Mr. Pacjin, who cooperated with the government and served nearly two years.

Like Ms. Wang, Mr. Plotkin, Mr. Pacjin, and others, the defendant in *United States v. Naseem* worked at a well-known investment bank and apparently believed, incorrectly, that using tippers located abroad would somehow prevent enforcement officials from uncovering the scheme. Hafiz Naseem, a banker in Credit Suisse’s Energy Group, passed confidential, material nonpublic information regarding possible transactions involving nine publicly traded companies to Ajaz Rahim, the former head of investment banking at Faysal Bank in Karachi, Pakistan.²² Mr. Rahim then traded on the tips in an overseas account in Bahrain.²³

Through this scheme, Mr. Naseem and Mr. Rahim netted approximately \$7.8 million in illicit gains, including over \$5 million from trading related to the private equity buyout of TXU, a Texas energy company.²⁴ Prosecutors charged Mr.

Naseem with 29 counts of insider trading, and he was ultimately found guilty on all of them.²⁵ In February 2008, Mr. Naseem was sentenced to 10 years in prison and ordered to forfeit \$7.5 million in illicit gains.²⁶

Last, *United States v. Guttenberg* involved a conspiracy that included 13 people, including employees of Bank of America, Morgan Stanley, and Bear Stearns. Mitchel Guttenberg was a member of UBS's Investment Review Committee which reviewed securities upgrades or downgrades prior to their release.²⁷ He sold material nonpublic information pertaining to upcoming upgrades and downgrades to David Tavdy, a trader at Assent LLC, and others.²⁸

In exchange for this information, Mr. Guttenberg received hundreds of thousands of dollars.²⁹ Mr. Tavdy and the other individuals used the information to make hundreds of trades, purportedly yielding illicit gains in excess of \$17.5 million.³⁰ Mr. Guttenberg pleaded guilty to two counts of conspiracy to commit securities fraud and four counts of securities fraud.³¹ Mr. Tavdy pleaded guilty to one count of conspiracy to commit securities fraud and two counts of securities fraud.³² Mr. Guttenberg has not yet been sentenced. Ultimately, 12 of the 13 Guttenberg defendants pleaded guilty.³³ Authorities called this conspiracy one of the most pervasive insider-trading schemes since the 1980s.³⁴

Lessons for Practitioners

These examples make clear that in today's enforcement environment, virtually every civil insider-trading investigation carries with it the risk of a criminal investigation and prosecution. Defendants have challenged parallel civil and criminal investigations on the ground that they force potential defendants to make the Hobson's Choice between asserting their Fifth Amendment rights to protect themselves in the criminal case or waiving their rights in order to bolster their position in the civil case. These challenges, however, have rarely been successful.³⁵ Absent egregious misconduct by the relevant government agencies, courts see little constitutional impropriety in this approach.³⁶

The possibility of "parallel proceedings" should inform counsel's approach to insider trading cases from the moment of retention. When deciding how to defend the case, counsel must consider the prospect of potential criminal prosecution when making threshold decisions such as whether a client should testify before the SEC or invoke his

Fifth Amendment right against self-incrimination. The attorney should also consider the shadow cast by the "bad story" in developing his client's defense and presenting his case to enforcement personnel and investigators. Calling attention to sympathetic facts and presenting a persuasive narrative can make the difference between civil enforcement proceedings and the threat of prison time and other severe criminal sanctions. These considerations will become even more important as prosecutors and courts become even more aggressive in their pursuit and punishment of insider trading.



1. See, e.g., Jenny Anderson & Michael J. de la Merced, "13 Are Accused of Trading as Insiders," N.Y. TIMES, March 2, 2007, at C1.

2. 15 USC §78j(b); 17 CFR §240.10b-5.

3. *United States v. O'Hagan*, 521 U.S. 642, 651-52 (1997).

4. See *id.*, at 652.

5. *United States v. Chiarella*, 588 F.2d 1358, 1369 n.16 (2d Cir. 1978) ("It is well established that, except for issues of intent and burden of proof, criminal and civil liability under the securities laws are co-extensive."), *rev'd* on other grounds, 445 U.S. 222 (1980).

6. 15 USC §78ff(a); See *United States v. Cassese*, 428 F.3d 92, 98 (2d Cir. 2005), Richard H. Walker and David M. Levine, "'You've Got Jail': Current Trends in Civil and Criminal Enforcement of Internet Securities Fraud," 38 AM. CRIM. L. REV. 405, 416 (2001).

7. Thomas C. Newkirk, Associate Director, Division of Enforcement, Securities and Exchange Commission and Melissa A. Robertson, Senior Counsel, Division of Enforcement, Securities and Exchange Commission, Trading—A U.S. Perspective, (Sept. 19, 1998).

8. Michael J. de la Merced, "Guilty Pleas and Charges Filed in 2 Couples' Insider Cases," N.Y. TIMES, May 11, 2007 available at <http://www.nytimes.com/2007/05/11/business/11insider.html>.

9. *Id.*

10. *Id.*

11. *Id.*; Robert E. Kessler, "Inside a Trading Scandal," NEWSDAY, March 14, 2007, at A35.

12. De la Merced, *supra* note 8.

13. *Id.*; Kati Cornell, "Ex-Morgan Insiders Get Home Time," N.Y. POST, Oct. 5, 2007.

14. See "'Chinese Defense' Unravels, Jennifer Wang and Ruben Chen Sentenced for Insider Trading," New York Magazine, Dec. 5, 2007, available at http://nymag.com/daily/intel/2007/12/were_jennifer_wang_and_ruopian.html.

15. *Id.*

16. Elaine Chow, "Morgan Stanley VP Pleads Guilty to Insider Trading," SECURITIES LAW 360, Sept. 6, 2007.

17. "'Chinese Defense' Unravels, Jennifer Wang and Ruben Chen Sentenced for Insider Trading," *supra* note 14.

18. Ellen Rosen, "Rise in Insider-Trading Cases Shows the Perils of Pillow Talk," N.Y. TIMES, Aug. 24, 2007 available at <http://www.nytimes.com/2007/08/24/business/24trading.html>.

19. Larry Neumeister, "Ex-Goldman Sachs Analyst Gets 5 Years for Insider Trading Case," THE ASSO-

CIATED PRESS, Jan. 4, 2008.

20. Chris Blackhurst, "America Can't Be Only Place With Bent Bankers," THE EVENING STANDARD (London), Jan. 7, 2008.

21. *Id.*

22. "Former Credit Suisse Investment Banker Convicted on 29 Counts in Insider Trading Case," U.S. FED NEWS, (Feb. 4, 2008).

23. *Id.*

24. *Id.*; David Weidner, "Is Naseem the Last of the Insider Traders?" MARKETWATCH, June 3, 2008.

25. "10-Year Term for Former Pakistani Banker in US," BUSINESS RECORDER, June 1, 2008.

26. "10 Years for Ex-Banker Convicted of Insider Trading," N.Y. TIMES, May 31, 2008, at C2.

27. Press Release, U.S. Attorney's Office (SDNY), "Securities Trader and Former UBS Executive Pleads Guilty to Charges in Massive Insider Trading Schemes" (Feb. 27, 2008).

28. *Id.*

29. "2 Plead Guilty to Insider Trading," L.A. TIMES, Feb. 28, 2008, at 4.

30. "Two More Enter Guilty Pleas in a Big Insider Trading Case," N.Y. TIMES, Feb. 28, 2008, at C 10.

31. *Id.*

32. *Id.*

33. *Id.*

34. De la Merced, *supra* note 8.

35. See, e.g., *United States v. Luce*, No. 05 CR 340, 2006 U.S. Dist. LEXIS 76052, at *16 (N.D. Ill. Sept. 29, 2006) (finding no violation of Fifth Amendment because defendant was provided with sufficient notice that criminal prosecution may occur); *SEC v. Sandifur*, No. C05-1631C, 2006 U.S. Dist. LEXIS 40716, at *7 (W.D. Wash. June 19, 2006) (holding that interaction between SEC and DOJ violates due process if SEC virtually becomes a tool of DOJ).

36. See, e.g., *United States v. Scrusby*, 366 F.Supp.2d 1134, 1140 (N.D. Ala. 2005) (finding that "the government manipulated the simultaneous investigations for its own purposes"); *United States v. Stringer*, 408 F.Supp.2d 1083, 1089 (D. Or. 2006) (dismissing indictment because the Department of Justice spent years "hiding behind the civil investigation to obtain evidence, avoid criminal discovery rules, and avoid constitutional protections."), *rev'd* 521 F.3d 1189 (9th Cir. 2008); see also Eli Ewing, Comment, "Too Close for Comfort: *United States v. Stringer* and *United States v. Scrusby* Impose a Stricter Standard on SEC/DOJ Parallel Proceedings," 25 YALE & POLY REV. 217 (2006). *United States v. Mahaffy*, 446 F.Supp.2d 115, 126 (E.D.N.Y. 2006) (limiting the holdings of *Stringer* and *Scrusby* to when the government engages in such "egregious conduct as to constitute a violation of the universal sense of justice").