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Cooperation Pays in Insider Trading Enforcement and Sentencing

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Overview

The results of insider trading enforcement and sentencing continue to follow trends of years past. Most notably, defendants who enter into cooperation agreements with the government, including the Department of Justice (DOJ) and Securities and Exchange Commission (SEC), receive the tangible benefits of little-to-no prison time and reduced fines.

Insider Trading Law

"Insider trading" is an ambiguous term that includes both legal and illegal trading by insiders. Legal "insider trading" occurs when a corporate insider buys or sells stock in his or her own company and discloses the transactions to the SEC on Forms 3, 4, and 5. Legal insider trading might also include, for example, trading on information overheard between strangers sitting on a train or on information obtained through a non-confidential business relationship.

Illegal "insider trading"—although not defined in the federal securities laws—occurs when someone buys or sells stock while knowingly in possession of material nonpublic information obtained in breach of a fiduciary duty or relationship of trust. The two primary theories of illegal insider trading are: (1) the "classical" theory, under which the antifraud provisions of the Securities Exchange Act of 1934 ("Exchange Act")— section 10(b) and Rule 10b-5—apply to prohibit corporate insiders from trading on their company's confidential information in violation of their fiduciary duties to the company and its stockholders; and (2) the "misappropriation" theory, under which trading is prohibited by persons who misappropriate confidential information from a party to whom they owe fiduciary duties, for example, the duties owned by lawyers to their clients.

Under both theories, the law imposes liability for insider trading on any person who improperly obtains material nonpublic information and trades while in possession of that information. The law also holds liable any "tippee"—someone with whom that person (the "tipper") shares the information—as long as, at least prior to 2012, the tippee also knew the information was obtained in breach of a duty.

In 2012, in *SEC v. Obus*, 693 F.3d 276 (2d Cir. 2012), the Second Circuit Court of Appeals arguably expanded tipper/tippee liability—at least in SEC civil enforcement actions—to encompass cases where neither the tipper nor the tippee has actual knowledge that the confidential information was disclosed in breach of a duty. Under Obus, a tipper's liability could flow from recklessly disregarding the nature of the confidential or nonpublic information, and a tippee's liability could arise in cases where a sophisticated investor tippee should have known that the information may have been disclosed in breach of a duty.

A district court in the Southern District of New York recently relied on Obus in United States v. Newman, et al., No. 12-CR-121 (RJS), in giving a jury instruction that did not require a finding that the defendants knew that the insider tippers received a personal gain in exchange for breaching their duties. The district court concluded that under Obus, the tipper's breach of duty and receipt of personal gain are separate elements and that the tippee only needs to know of the former. The defendants' appeal is currently under submission in the Second Circuit, and the ultimate decision will have major implications regarding what the government has to prove to establish the liability of "remote tippees."

While most insider trading cases involve the purchase or sale of equity instruments (such as common stock or call or put options) or debt instruments (such as bonds), criminal and civil sanctions can apply to insider trading in connection with any "securities." What constitutes "securities" is not always clear, especially in the context of novel financial products. The Exchange Act's antifraud provisions continue to evolve and have proven to be powerful and flexible tools to address illegal efforts to capitalize on material nonpublic information.

Insider Trading Penalties

The consequences of being found liable for criminal insider trading can be severe. Individuals convicted of criminal insider trading can face up to twenty years' imprisonment per violation, criminal forfeiture, restitution, and fines of up to $5,000,000 or twice the gain from the offense.

A parallel civil insider trading action may lead to an injunction, disgorgement of profits, and a civil penalty not to exceed the greater of $1,000,000, or three times the amount of the profit gained or the loss avoided. In addition, individuals can be barred from serving as an officer or director of a public company, acting as a securities broker or investment adviser, or in the case of licensed professionals, such as attorneys or accountants, from serving in their professional capacity before the SEC.

It is also not uncommon for individuals or companies subject to government enforcement for illegal insider trading to face private litigation, particularly where the insider trading was by corporate insiders trading in their own company's stock.

Cooperating with the Government

The DOJ and SEC profess to weigh cooperation heavily when making charging and sanctioning decisions. And courts balance a defendant's cooperation carefully when making sentencing decisions.

Timely cooperation can be difficult to provide in an insider trading investigation, as investigations frequently begin mere days (if not hours) after suspicious trading and often without potential defendants being any the wiser. Absent advance self-reporting of insider trading, timeliness thus may best be gauged from the moment of first contact by the authorities.

For most defendants, therefore, cooperation is most significantly gauged by the value and comprehensiveness of the assistance that they provide.

Cooperating with the Department of Justice

The DOJ considers a criminal defendant's willingness to provide timely and useful cooperation when making charging recommendations and in deciding whether to move for a downward departure at sentencing. Likewise, the Federal Sentencing Guidelines focus on the timeliness and comprehensiveness of a criminal defendant's assistance.

A review of insider trading sentences handed down over the past four years reveals that defendants who pleaded guilty and cooperated routinely received no prison time and fared better than defendants who entered guilty pleas without cooperating, even when the cooperators' recommended sentencing guidelines range was higher. Specifically, cooperators received an average sentence equal to 10 percent of the low end of the recommended guidelines range. In contrast, non-cooperating defendants who plea-bargained received sentences equal to 70 percent of the low end of the guidelines range. And defendants who went to trial received average sentences equal to 64 percent of the low end of the guidelines range.

This trend was nearly the rule in 2013. Of the fifteen cooperators sentenced last year, eleven received no prison time, and the longest prison sentences were for one year on pleas by defendants with minimum sentencing guideline recommendations of nearly six years, and over eight years, respectively. In contrast, twelve sentences were handed down to non-cooperators in insider trading cases in 2013. The prison sentences for these defendants averaged slightly over three years.

A review of insider trading sentences also suggests a relationship between a defendant's role—that is, whether he or she is a tipper, a tippee, or both—and the length of the defendant's sentence. In general, tippers and defendants who both tipped and traded fared better than defendants who just traded as tippees. This holds true for both cooperators and non-cooperators alike. All cooperators, however, received substantially less prison time than non-cooperating defendants regardless, of role.

In 2013, the relationship between a defendant's role and his or her sentence was stark, with non-cooperating tippers receiving average sentences of less than fifteen months, while tippees received over forty months on average.

Prosecutors in the Southern District of New York continue to secure the longest prison sentences for insider trading. Over the past four years, that district has also continued to reward cooperation most handsomely as well, with cooperators routinely receiving supervised release and averaging less than two months of prison time. Non-cooperators, on the other hand, average over thirty months of prison time.

Cooperating with the Securities and Exchange Commission

The SEC similarly engages in a multi-part analysis to assess a defendant's cooperation in an enforcement action. Specifically, the SEC will weigh the value and the nature of the cooperation, considering factors like the timeliness and voluntariness of the cooperation and the benefits the cooperation provided.

Companies may cooperate, as well. In assessing a company's cooperation, the SEC will determine whether the company practiced sufficient self-policing, self-reported fully and accurately to the authorities, took appropriate remedial action, and assisted the government on an ongoing basis during the investigation.

Although civil penalties up to three times the amount of the profit gained or the loss avoided may be imposed in civil actions, this result is rare, particularly for cooperators, who are much more likely than non-cooperators to receive no penalty at all.

Conclusion

While cooperators generally receive leniency, their violations are not entirely forgiven, and cooperation is not all upside. Prosecution, a civil injunction, disgorgement of any illegal profits, professional bars, and reputational harm are all near certainties. Indeed, under the SEC's new approach to settlements, defendants, and perhaps even cooperating defendants, could be forced to admit wrongdoing when settling charges. Cooperators also face substantial demands on their time due to multiple meetings with prosecutors and SEC enforcement lawyers, testifying (and enduring often grueling cross-examination) at trials, depositions, and hearings, and potentially having to record conversations with erstwhile friends and colleagues. Even cooperating entities may suffer debilitating reputational and business harms from insider trading cases involving their employees.

Whether to cooperate always depends on the specific facts of any case. Recent trends in enforcement and sentencing suggest that for defendants with a low likelihood of success at trial, cooperating with a DOJ investigation makes good sense. Cooperating with the SEC may yield a financial benefit for defendants, albeit perhaps not as significant as compared to the benefits received in sentencing.

Nevertheless, insider trading cases are often about more than just numbers. They are human stories filled with personal risks, emotions, and often complicated relationships and dynamics. These subjective factors may drive the decision to cooperate as much as any statistical trend.

Additional Resources

Haims, Joel, et al., Second Circuit Maintains Expansive View of Civil Liability for Insider Trading
Morrison & Foerster, 2013 Insider Trading Annual Review
Newkirk, Thomas C., Speech by SEC Staff: Insider Trading – A U.S. Perspective
Securities and Exchange Commission, Insider Trading
Securities and Exchange Commission, The Laws That Govern the Securities Industry

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