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# Corporate Law

# Insider Trading and Company Counsel

## Why more attorneys are being charged and what companies should do to prevent it

**By John J. Carney and Jimmy Fokas**

It's been nearly 20 years since the names Milken and Boesky dominated the financial headlines with accounts of insider trading and a corrupt fictional character named Gordon Gekko rallied shareholders with the cry of "Greed is Good." Milken and Boesky lost millions and went to prison and even Gekko suffered a tragic downfall at the movie's end. These names became synonymous with corporate greed and their downfalls were a cautionary tale for young professionals on the evils of insider trading. Consequently, anyone who lived through those times, especially lawyers, would think that history has proved that the risks of engaging in insider trading far outweighed the rewards, but sadly insider trading again seems on the rise. Sadder still, is the fact that a significant number of the cases brought this year involve alleged misconduct by attorneys.

Insider trading liability revolves around two primary theories of liability: The Classic Theory and the Misappropriation Theory. The Classic theory involves corporate insiders who knowingly trade in company stock on the basis of material nonpublic information, as well as corporate insiders who have tipped others who traded on this information.

Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 thereunder prohibits, among other things, the use of a deceptive device in connection with the purchase or sale of a security. The corporate insider who trades based on material inside information breaches a fiduciary duty owed to the corporation and violates Section 10(b) and Rule 10b-5. A corporate insider can also be held liable for merely relaying material nonpublic information to someone outside of the company even if the insider did not make any trades. A common situation involves the insider who tips a friend who makes trades based on the information. Both the "tipper" (the insider) and the "tippee" (the friend) can be held liable. See Louis Loss & Joel Seligman, *Securities Law* § 9-b-5 (3d ed. 1999). The tipper breached a duty to the company while the tippee who traded and profited, is deemed to have stepped into the shoes of the inside tipper where the tippee knows that the insider has breached a duty. The Classic Theory also applies to those who have temporary fiduciary duties to a corporation such as lawyers, accountants and consultants. *Dirks v. SEC.*, 463 U.S. 646, 655 (1983); See also Louis Loss & Joel Seligman, *Securities Law* § 9-b-5 (3d ed. 1999).

Misappropriation theory applies to an individual who is not a corporate insider, but rather someone who owes a fiduciary duty to the source of the material nonpublic information for some other reason. The fiduciary duty is breached when the "misappropriator" trades on the basis of that information. The seminal Supreme Court case expanding insider trading liability to misappropriators was *U.S. v. O'Hagan*, 521 U.S. 642 (1997). O'Hagan, a former partner at the law firm of Dorsey & Whitney, had access to confidential information of a client's pending acquisition and traded in the shares of the acquisition target based on that information. The Supreme Court upheld his criminal conviction, stating that O'Hagan breached a fiduciary duty owed to the corporate client who had provided him with the confidential information and did so in connection with the purchase or sale of a security. Accordingly, misappropriation theory "outlaws trading on the basis of nonpublic information by a corporate 'outsider' in breach of a duty owed not to a trading party, but rather to the source of

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the information."

The SEC has a powerful civil arsenal of potential penalties it could seek against those who commit insider trading. The typical SEC remedy for violations includes a permanent injunction against future violations of the securities laws, disgorgement of profits or losses avoided from the conduct, civil penalties and in certain situations, a bar against individuals from acting as an officer or director of a public company. Specifically, Section 21A of the Exchange Act (enacted after the massive insider trading scandals of the 1980s) authorizes the SEC to seek civil penalties of up to *three times* the amount of the profits or losses avoided. Section 21(d)(2) of the Exchange Act allows a court to bar an individual from acting as an officer or director of a public company if the individual's conduct demonstrates "unfitness to serve." See e.g., *SEC v. Shashikant Shah*, Lit. Rel. No. 20034 (March 8, 2007) (officer and director bar against former vice-president who settled insider trading charges).

After the passage of Sarbanes-Oxley in 2002, the maximum term of imprisonment for an insider trading conviction doubled from 10 to 20 years, and penalties were increased from $1 million to $5 million for each offense. The DOJ can also seek restitution to recover profits or losses avoided. All of these penalties are separate from the collateral consequences that result from a felony conviction including the loss of a professional license.

The SEC and DOJ have been particularly aggressive in the past year prosecuting insider traders. A sampling of cases from the first six months of 2007 and the unique factual situations therein, provide clear notice that enforcement is on the rise and that attorneys are increasingly finding themselves on the wrong side of an enforcement action script.

In March 2007, the SEC and DOJ brought one of the largest insider trading cases since the 1980s. It involved 14 defendants, including a former executive and traders at UBS Securities LLC and a former in-house counsel at Morgan Stanley. *SEC v. Guttenberg*, Lit. Rel. No. 20022 (March 1, 2007). Collectively, the defendants are accused of reaping profits of over $15 million by receiving inside information from the executive and in-house counsel. The traders allegedly traded in advance of positive stock ratings or in advance of acquisition announcements. The UBS defendants went to elaborate lengths to avoid detection, using coded text messages sent through disposable cellular phones and secret meetings at the Oyster Bar restaurant to make payments and share profits from the illicit trading. The Morgan Stanley defendants received inside information from an attorney who worked in the Global Compliance department and had access to confidential information regarding pending acquisitions. The attorney tipped her husband, also an attorney, and a broker friend yielding them approximately $30,000 in illicit profit. Multiple defendants have pleaded guilty, including the husband and wife attorneys, who pleaded guilty to conspiracy and securities fraud.

On June 13, the SEC brought and settled securities fraud charges against David Schwinger, the former managing partner of law firm Katten Muchin's Washington, D.C., office. *SEC v. David A. Schwinger*, Lit. Rel. No. 20152 (June 13, 2007). Schwinger allegedly misappropriated confidential information learned while interviewing the former Chief Counsel of Vastera Inc. for a position at his law firm. Schwinger was accused of trading in advance of an acquisition announcement of Vastera generating approximately $13,000 in profits. In a settlement with the SEC, Schwinger consented to a permanent injunction, disgorgement and a civil penalty twice the amount of the profit. While unstated by the SEC, it is likely that the civil penalty was twice the amount because Schwinger was a legal professional and was held to a higher standard.

In April, the SEC and DOJ brought securities fraud charges against Kevin J. Heron, the former general counsel and the chief insider trading compliance officer of Amkor Technology, Inc. *SEC v. Kevin J. Heron*, Lit. Rel. No. 20079 (April 18, 2007). As the officer responsible for the company's insider trading policies, Heron was responsible for instituting black-out periods preventing company officers and directors from trading in company stock as well as approving their trades. Heron allegedly used his position to trade in advance of company earnings and business transaction announcements. According to the SEC's complaint, Heron reaped profits and avoided losses of approximately $290,000. The DOJ charged Heron with four counts of securities fraud which could lead to imprisonment of up to 20 years on each count and millions of dollars in fines. The civil and criminal cases are pending.

In February, the SEC and DOJ brought actions against the Rosenthal family and a sophisticated insider trading network they were alleged to have been operating. *SEC v. Aragon Capital Management LLC et al.* Lit. Rel. No. 19995A (February 13, 2007). Zvi Rosenthal, a former vice president of Taro Pharmaceuticals Industries Ltd., provided confidential information concerning upcoming earnings and FDA approvals to various family members and friends. The tippees included a son, Amir Rosenthal, who was an attorney, and two certified public accountants. Because of the large profits they were generating from the illegal trading, the Rosenthal family members formed a hedge fund, Aragon Partners, apparently for the purpose of pooling together money from the family anonymously and continue insider trading in Taro stock. The defendants' scheme netted them more than $3.7 million in profits and losses avoided. Several of the Rosenthal family members have pleaded guilty to securities fraud charges and are awaiting sentencing. Amir Rosenthal, the attorney, pleaded guilty to conspiracy and faces five years of imprisonment and fines of up to $250,000. In addition, the SEC permanently barred Amir from association with any investment adviser.

The increase in number of high-profile insider trading cases involving attorneys and senior corporate executives who should have known better,

underscore the need for companies to strengthen and modernize their compliance programs to avoid the negative publicity, reputational harm and significant costs of an insider trading scandal.

For years, companies have relied upon written policies warning their officers and employees of the serious consequences of trading on material nonpublic information or the dissemination of such information to others who trade. Companies have instituted "black-out" periods, which prohibit officers, directors and others from buying or selling company stock during periods when they might be in possession of material nonpublic information. These situations may include periods prior to the release of quarterly earnings or the release of significant business news likely to move the market. Many companies have also developed so-called 10b5-1 plans pursuant to SEC Rule 10b5-1 of the Exchange Act. These plans allow corporate insiders to sell company stock pursuant to prearranged plans which are not generally subject to the black-out periods. Companies have also supplemented their insider trading policies by requiring the preapproval of employee stock transactions and have implemented software designed to monitor employee securities trading.

Although it is often said that compliance and ethics policies are only as effective as the individuals that are responsible for implementing and following them, there are steps companies can take to increase their effectiveness.

A primary method for preventing the dissemination of confidential information within an entity is to limit its dissemination to those individuals who have a "need to know." Technology can be used to limit an employee's access to electronic information that is of a sensitive nature. Simple solutions such as controlling the dissemination and destruction of draft documents as they are created and discarded can help prevent inadvertent disclosure. Entities that often find themselves in possession of material nonpublic information concerning other companies should take additional steps to ensure that employees do not misuse that information.

Companies should also consider a thorough review and update of their code of conduct as well as other more specific policies concerning personal securities trading by employees. Corporations should continue to require the preclearance of trades by employees.

Reliance should not only be placed on written policies or a code of conduct, instead corporations should employ interactive programs. The training should incorporate "real life" examples so employees can be sensitized to the fact that there is no acceptable amount of insider trading, and that improper use of information regarding other corporations is subject to prosecution. In addition to civil and criminal penalties, training should highlight the significant reputation and professional consequences of engaging in such conduct.

Registered entities such as broker-dealers and investment advisers are required by statute and regulation, to maintain adequate policies and procedures to prevent the misuse of material nonpublic information by employees and others associated with their businesses. Broker-dealers and investment advisers would be wise to review their policies and procedures as regulators continue to focus their energy on this area.

In 2006, the SEC brought a settled administrative proceeding against Morgan Stanley for its failure to maintain and enforce written policies and procedures designed to prevent the misuse of confidential information and to adequately monitor employee trading. *In the Matter of Morgan Stanley Co. Inc. and Morgan Stanley DW, Inc.*, Exchange Act Rel. No. 54057 (June 27, 2006). Morgan Stanley agreed to a $10 million fine and hired an independent consultant to recommend improvements to its policies and procedures. The SEC brought this action even though there was no evidence that Morgan Stanley employees engaged in insider trading.

As the SEC and the DOJ both continue to make insider trading an enforcement priority, companies must reassess their policies, procedures and training and make appropriate changes to prevent the misuse of material nonpublic information. The costs of not taking proactive steps to strengthen procedures and training before a problem arises include the significant costs of the investigation, potential regulatory and criminal sanctions to key employees and the incalculable cost of reputational harm to both the employee and the company. ■