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Will Rakoff Opinion Impact Decision On Steven Cohen?

Law360, New York (December 05, 2012, 12:02 PM ET) -- Recently, U.S. District Judge Jed Rakoff threw the government's war on hedge fund insider trading a curveball when he issued an opinion addressing the law of remote tippee liability in the Southern District of New York. The opinion memorialized the court's earlier formulation of jury instructions in the Douglas Whitman insider trading criminal prosecution. It specifically addressed what prosecutors need to show in terms of (1) a remote tippee's understanding of the source and circumstances surrounding the initial transmission of material nonpublic information from a corporate insider to an intermediate tippee, and (2) the nature of the remote tippee's intent to commit fraud.

Today, after the filing of the highest dollar figure insider trading case in history — against a portfolio manager of an SAC Capital-affiliated fund, but not against SAC's owner, Steven Cohen — the opinion might already be influencing certain government charging decisions.

At issue is language in a Nov. 14 opinion, which if followed by other judges in the Southern District, would add to the government's evidentiary obligations in remote tippee insider trading prosecutions. Judge Rakoff said his purpose was to clarify an unsettled area of law affecting situations in which hedge fund principals — such as Whitman, Raj Rajaratnam and potentially Steven Cohen — make trading decisions based on material non-public information received indirectly from sources within publicly traded companies.

The Whitman opinion holds that in these types of scenarios, for a remote tippee to be found criminally culpable of insider trading, the government must prove the traditional elements of the offense plus three things.

First, the remote tippee must generally know that a fiduciary duty was breached as part of the initial communication from the insider to the intermediate tippee — a point of law consistent with current Southern District and appellate court holdings. Second, the remote tippee must generally know the insider received an associated benefit in exchange for the tip. Courts have previously required this second element to establish liability for direct tippees, but have not precisely stretched it to fact patterns in which the trader was exclusively a remote tippee (likely the Cohen scenario). Finally, in using the information to trade, the remote tippee must have the specific intent to defraud the company to which the confidential information related — another requirement not precisely articulated as a prerequisite for remote tippee liability.

As to the knowledge of the benefit issue, the court noted that "[t]he Government argued that it needed only to show that the defendant knew (or recklessly disregarded) that the information he was obtaining was an unauthorized disclosure by some inside tipper, but not that he also knew of any benefit provided to the tipper." Disagreeing, the court countered that a "tippee must have knowledge that ... self-dealing [in the form of a personal benefit] occurred. ... Without such a knowledge requirement, the tippee does not know if there has been an 'improper' disclosure of inside information."

The government protested that, "such a standard would create loopholes for tippees to insulate themselves from liability." Unsympathetic, the court recognized the apparent ease with which the government effectively collected and presented direct evidence of Mr. Whitman's understanding of the quid pro quo between the insider and the intermediate tippee, stating that "Mr. Whitman's own words, in recorded conversations, indicated that he not only was well aware of the benefit requirement, but also was confident that the tippers here were receiving actual or anticipated benefits."

Judge Rakoff offered some consolation to the government by acknowledging an entitlement to a "willful blindness" or "conscious avoidance" instruction to the jury. But he then concluded, "One can imagine cases where a remote tippee's knowledge that the tipper was receiving some sort of benefit might be difficult to prove. If, however, this is an unfortunate 'loophole,' it is a product of the topsy-turvy like way the law of insider trading has developed in the courts and cannot be cured short of legislation."

The final question decided by the court was whether criminal insider trading required "specific intent," and, if so, in what sense. The government initially objected to the court's charging the jury on specific intent, but withdrew its objection when the court engaged on the issue. Because the government initially objected and filed a brief on the subject, the court deemed it appropriate to address the issue.

Finding no binding precedent at the district court or appellate levels, the court declared itself free to consider the issue de novo. The court then pronounced that in insider trading cases "the heart of the fraud is the breach of the duty of confidentiality owed to both the company and its shareholders, and accordingly the specific intent to defraud must mean, in this context, an intent to deprive the company and its shareholders of the confidentiality of its material nonpublic information."

Comparing this aspect of the Whitman opinion to the Second Circuit's recent construal of intent in the remote tippee case of hedge fund principal Nelson Obus, one might conclude that prosecutors would be better off if district courts followed Obus rather than Whitman. In Obus, the Second Circuit noted that the intent required in these types of scenarios is an intent to use the tip to trade directly or further disseminate it to others while having "reason to know that confidential information was initially obtained and transmitted improperly." Though technically distinguishable because Obus was sued civilly by the SEC and the case was charged as a misappropriation-based breach, the facts are similar.

As the government continues to wage its war on hedge fund insider trading, it does so carrying the heavy burden of being the caretaker of an unblemished record of more than 60 convictions arising out of its much-publicized Operation Perfect Hedge. In the Whitman case and other headline-grabbing prosecutions, the government has had the luxury of using cooperating co-conspirators and audio recordings to establish the requisite knowledge and state of mind for liability. However, given the heightened awareness of the surreptitious tactics used by the government to develop this type of evidence, it is unlikely that prosecutors will have a comparable evidentiary record in future cases.

The recent criminal insider trading action filed against SAC Capital-affiliated portfolio manager Mathew Martoma, and the companion SEC case filed against Martoma and the corporate insider alleged to have tipped him, suggest that another precedent-setting remote tippee case may be in the offing. The government appears to have phone logs, trading records and contemporaneous emails reflecting timely trades by Cohen after communicating by email and phone with Martoma.

If the government can flip Martoma and through his testimony establish that Cohen possessed knowledge of the circumstances surrounding the initial tip of inside information between the source and Martoma, the government might be able to establish that Cohen had sufficient knowledge of the tipper's benefit and breach to satisfy this aspect of the Whitman opinion. Perhaps more challenging might be the government's task of presenting evidence showing that Cohen used the information with the specific intent to deprive the underlying companies of the confidentiality of their information.

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