

Criminal Prosecutorial Discretion in Insider Trading Cases: Let's Look at the Numbers

Prepared by the Securities Subcommittee of the White Collar Criminal Litigation Committee

Introduction

The Securities and Exchange Commission ("SEC"), a civil agency, has statutory authority to bring suit against inside traders (tippers and tippees) in federal district court to obtain injunctive relief, disgorgement of profits gained or losses avoided plus interest, civil penalties of up to three times the amount of profits gained or losses avoided, and individual bars from acting as officers or directors of public companies. The SEC may also bring administrative proceedings to secure individual bars from association with entities regulated by the SEC.

But the trials of the inside trader do not always end with the SEC. The SEC can and often does advise the Department of Justice ("DOJ") of its insider trading investigations, and the SEC and DOJ may conduct parallel investigations.¹ It is not unusual for the SEC to file suit against an inside trader in federal district court on the same day the DOJ announces that it has obtained an indictment against that inside trader. The criminal penalties for insider trading may be severe depending on the circumstances of the case, including fines of up to \$5,000,000 and prison sentences of up to 20 years.

Robert Khuzami, the SEC's Director of Enforcement, at the recent joint DOJ/SEC press conference announcing the filing of parallel civil and criminal insider trading actions related to the Galleon hedge fund, stated: "Our law enforcement agencies are together much more than the sum of our parts. That is why coordination, of which today's actions are a prime example, is critically important to the goal of rooting out fraud and misconduct in our markets."²

In determining whether to bring parallel criminal actions to SEC civil insider trading actions, Assistant United States Attorneys ("AUSAs") are guided by the prosecution principles outlined in the DOJ's United States Attorneys' Manual ("Manual"). In short, it is the responsibility of the DOJ prosecutor to make "certain that the general purposes of the criminal law...are adequately [met.]"³ Under the Manual, even though a AUSA may believe that a person's conduct constitutes a Federal offense, and the admissible evidence will probably be sufficient to obtain and sustain a conviction, the AUSA should decline prosecution of such person if: (1) "no substantial Federal interest would be served by prosecution"⁴; (2) "the person is subject to effective prosecution in another jurisdiction;" or (3) "there exists an adequate non-criminal alternative to prosecution."⁵

In light of these considerations, AUSAs routinely exercise their discretion to decline criminal prosecution of inside traders sued by the SEC. In fact, as more fully described below, the DOJ pursued criminal cases with respect to only 65 of the 159 individuals sued by the SEC in the New York federal courts over a recent six year period.⁶ This statistic raises the question, why? Why does the DOJ bring criminal insider trading charges against certain individuals sued by the SEC, but not others? What factors determine which civil investigations become criminal ones?

To answer this question, we analyzed the DOJ's prosecution or non-prosecution of defendants named in SEC insider trading complaints filed in the New York federal district courts during SEC fiscal years 2004 to 2009.⁷ The analysis revealed the following, which should be of interest to lawyers practicing in this area: licensed professionals (e.g., investment bankers, brokers, traders, investment advisers, attorneys, and accountants) face a very high likelihood of prosecution by the DOJ. During the relevant time period, the SEC brought insider-trading cases against 69 licensed professionals, and the DOJ pursued criminal charges against 42, or sixty-one percent of these SEC defendants. The analysis also suggests that licensed professionals are substantially more likely to face criminal prosecution than officers and directors of public companies who conduct insider trading in the stocks of their companies. Our analysis showed that the DOJ brought criminal insider trading charges against only one out of every three officers or directors of public companies sued by the SEC.

The analysis also suggests that tippers face a far higher risk of criminal prosecution than do tippees or sole actors. Fifty-eight percent of the SEC defendants selected by the DOJ for prosecution tipped inside information to others, whereas thirty-six percent of defendants were mere tippees, and six percent of defendants were sole actors who did not tip anyone.

Especially large trading gains or losses avoided by the defendant do not result in criminal prosecution as frequently as one might expect. The DOJ prosecuted only slightly more than half of the defendants accused by the SEC of earning profits or avoiding losses of more than \$100,000. On the other hand, defendants accused of pocketing smaller gains or avoiding smaller losses (between \$25,000 and \$100,000) appear statistically less likely to be prosecuted.

On the other hand, the analysis suggests that certain aggravating factors have an impact on the DOJ's exercise of discretion, such as the defendant's criminal misconduct during the investigation (*e.g.*, obstructing justice and making false statements to the SEC), and the defendant's commission of substantive crimes in addition to insider trading (*e.g.*, falsifying books and records, bribery and violating grand jury secrecy laws). The analysis also suggests that certain mitigating factors, such as the defendants' age and marital relationship to other defendants or relevant parties had an impact on the DOJ's charging decisions. And the analysis shows that individuals who consent to settlements with the SEC prior to the filing of the SEC's complaints are, on a statistical basis, rarely the subjects of a parallel criminal prosecution.

While the empirical analysis does not (and likely cannot) account for the array of factors that influence the DOJ to prosecute or not prosecute any particular defendant, the findings set forth in this article should be useful to practitioners representing clients in insider trading investigations, particularly in the current environment of increased coordination between the SEC and federal prosecutors.

A. The Methodology

1. Which Cases, Which Defendants

We reviewed the complaints filed by the SEC in the United States District Courts for the Southern District of New York ("SDNY") and Eastern District of New York ("EDNY")⁸ for all cases characterized by the SEC in its annual reports for fiscal years 2004-2009 as "insider trading" cases (excluding administrative proceedings instituted as a follow-up to injunctive relief or criminal conviction) (these cases are referred to herein as the "relevant case set"), and checked to see if the DOJ in any district also brought criminal charges against the defendants named in those complaints. Usually it is the Offices of the United States Attorney for the SDNY and for the EDNY which bring proceedings parallel to SEC insider trading cases filed in SDNY or EDNY, but this is not always the case. To the extent the SEC filed separate complaints arising from the same insider trading scheme, we looked at the totality of the complaints filed arising from the scheme to determine whether the DOJ prosecuted none or some of the defendants.

We excluded from the analysis defendants who were "unknown purchasers" sued by the SEC; corporate entities or partnerships (which, for the most part, simply were trading vehicles for the individual inside traders); and individuals specifically named as relief defendants only. During the relevant period there were three "unknown purchasers" complaints filed by the SEC in the SDNY. In two cases, the SEC never identified the purchasers and terminated the actions. In the other case, the SEC later amended the complaint to name two entities and an individual, then without explanation subsequently

agreed to a dismissal of the action against all defendants without prejudice.

If a tippee or tipper was mentioned, but not named, in a complaint in the relevant case set, but was named in an action that fell outside the relevant time period (2004-2009) or was not commenced in a district court in New York, we did not analyze the profile of that defendant.

Using this methodology, we found and reviewed sixty-two insider-trading cases against 159 defendants filed by the SEC in the SDNY and EDNY during fiscal years 2004-2009 (during that period the SEC filed a total of 220 insider trading complaints throughout the country, 103 of which named multiple defendants). Of those sixty-two SEC cases filed in the SDNY and EDNY, we found forty complaints, naming sixty-seven total defendants, where the DOJ prosecuted none of the defendants named in the SEC's Complaint. As such, the forty SEC cases filed in the SDNY and EDNY where the DOJ took no action against any of the defendants (plus the three "unknown purchaser" cases filed by the SEC in the SDNY where the DOJ also took no criminal action) represent sixty-nine percent of all SEC insider trading complaints filed in the New York federal courts during the relevant period. In other words, the DOJ declined to bring any parallel criminal proceedings in over two-thirds of all SEC insider trading cases filed in the SDNY and EDNY for SEC fiscal years 2004 through 2009.

We found ten complaints filed by the SEC in the SDNY and EDNY during the same time period where the DOJ prosecuted some (a total of twenty-five) but not all of the defendants, and ten SEC complaints where all of the defendants (a total of eleven) were charged by the DOJ. We also found two additional SEC complaints, involving six additional defendants who were sued for insider trading violations, but those cases were not classified by the SEC in its Annual Reports as insider trading cases. Each of the defendants, however, were described as tippers in other SEC complaints in the relevant case set, and each of these defendants were prosecuted by the DOJ.

2. Categorizing the Defendants

Based on information contained in the SEC Complaints and Releases, we placed each of the SEC insider trading defendants into one or more applicable categories that, based on our experience, we believe would be relevant to a non-prosecution analysis. Those categories are: (1) tippers (including tippees who subsequently tipped); (2) mere tippees (tippees who did not tip); (3) "downstream" tippees (second-generation or later tippees); (4) sole actors (defendants who were not improperly tipped/did not tip); (5) size of profits generated/losses avoided; (6) licensed professionals (*e.g.*, investment bankers, brokers, traders, attorneys and accountants); (7) officers or directors of public companies; (8) overseas defendants; (9) defendants who negotiated settlements with the SEC prior to the filing of the SEC complaints; and (10) per-

sonal considerations (age, and marital relationship with tipper/tippee).

With respect to the size of profits generated/losses avoided category, we assigned the defendants to one of three classes: negligible profits/losses avoided (less than \$25,000); moderate profits/losses avoided (\$25,000 to \$99,999); and substantial profits/losses avoided (\$100,000 and above). Where a tipper did not trade, we grouped the tipper with the tippee for purposes of the profits/losses avoided categorization. Also, to the extent the SEC did not provide a breakdown of profits/losses avoided by defendant, but provided a gross profit/losses avoided for all defendants, we applied that gross profit/losses avoided number for all defendants.

We initially sought to test the relevance of another factor, the defendants' cooperation or self-reporting to the SEC. Out of the ninety-four individual defendants we isolated those who were sued by the SEC but not prosecuted by the DOJ, the SEC's public releases referenced the defendant's cooperation with respect to only two defendants. Because the SEC does not always reference a defendant's cooperation in its public releases, and a defendant's cooperation with the DOJ is virtually never mentioned in the releases, and because, from our experience as practitioners, we believe more than two of the ninety-four defendants likely cooperated with the SEC, we determined that there was not enough information available to include this as a separate category.

Finally, with respect to the defendants prosecuted by the DOJ, we sought to review the criminal record (if any) of each to determine whether these defendants (1) engaged in any aggravating criminal conduct during the SEC investigation (*i.e.*, false statements to government officials, perjury, obstruction of justice); and (2) whether these defendants were charged with any other substantive crimes in addition to insider trading.

3. Considerations Not Subject to Empirical Analysis

The methodology suffers from some shortcomings. With respect to cases where the DOJ prosecuted none of the defendants, it is possible that the SEC did not refer the matter to the DOJ, the DOJ otherwise never learned of the matter, the DOJ was too busy with other mandates at the time of the referral to focus on a particular case, the DOJ initiated an investigation that subsequently fell through the cracks, or the case suffered from evidentiary or legal theory problems. Further, with respect to cases where the DOJ prosecuted some but not all of the defendants, it is possible that non-prosecution decisions were based on cooperation of certain defendants, or other factors such as those described above that are not apparent from the public record. Although the DOJ is required to keep records detailing the reasons for non-prosecution in a given case,⁹ these records are not public.

B. The Results

1. Factors Increasing the Likelihood of Criminal Prosecution by the DOJ

The analysis suggests that the DOJ holds licensed professionals to a higher standard than other individuals engaged in insider trading schemes. The DOJ prosecuted sixty-one percent of the defendants who were licensed securities professionals, and sixty percent of the defendants who were other types of licensed professionals (attorneys, CPAs and actuaries). By contrast, the DOJ prosecuted only thirty-three percent of the defendants in the relevant case set who were officers or directors of a public company who traded their company's stock on inside information.

Defendants who tip others are more likely to be criminally prosecuted than those who are tippees only or sole actors. Fifty-eight percent of the defendants who were prosecuted by the DOJ were tippers (including direct tippees or remote tippees who thereafter tipped the information to others). Thirty-six percent of the defendants in the relevant case set who were prosecuted by the DOJ were mere tippees (tippees who did not tip anyone else). These findings are unsurprising. We would expect the DOJ to take a greater interest in those who pass material non-public information to others who then trade than in those who trade without doing so.

Defendants who engage in aggravating criminal conduct in the course of investigations, such as making false statements to government officials, perjury, and obstruction of justice are also more likely to be criminally prosecuted. The likelihood of prosecution also increases where the defendant engages in substantive criminal misconduct in addition to the insider trading, such as falsifying books and records, bribery, and violating grand jury secrecy laws. Of the 64 SEC defendants prosecuted by the DOJ, thirteen percent were also criminally charged with aggravating conduct, and twenty-three percent were charged with additional substantive crimes.

2. Factors Reducing the Likelihood of Criminal Prosecution by the DOJ

With respect to avoiding criminal prosecution for insider trading, the analysis suggests it is better, as a defendant, to have acted alone. In forty-eight percent of the forty SEC insider trading cases filed in the SDNY and EDNY where the DOJ brought no criminal action, the case involved a sole actor—typically an individual who was granted access to material nonpublic information in the course of his employment, but who could not resist the temptation to make a quick profit by trading on such information. Of the sixty-seven individual defendants not prosecuted by the DOJ in those cases, a total of twenty-one, or thirty-one percent of the defendants, were sole actors. Overall, only sixteen percent of the sole actors

named in SEC complaints were criminally prosecuted by the DOJ.

The argument in favor of non-prosecution of sole actors would appear self-evident. Their misconduct generally is limited in scope and time, and may have been attributable to a momentary lapse of judgment facilitated by the ease of placing securities trades through online accounts. Where there is no evidence of conspiratorial conduct or coordinated wrongdoing, the equities weigh heavily in favor of letting the SEC enforcement process handle the matter.

Forty-one of the 159 total defendants in our study (one-quarter of all defendants) settled with the SEC simultaneous with the filing of the SEC's complaint (*i.e.*, the settlements had been reached well in advance of the filing of the complaints), and consented to the imposition of some form of remedial and/or punitive relief, including injunctions, disgorgement payments, civil penalty payments, bars from serving as officers or directors of public companies, or bars from association with securities investment firms. The raw numbers show that the DOJ did not criminally prosecute approximately ninety-five percent (39 out of 41) of these individuals.

It is impossible to know whether in these cases the DOJ declined to prosecute because it believed the SEC settlements constituted an adequate, non-criminal alternative to prosecution.¹⁰ It may be that these non-prosecutions predominantly are the conveyance of two unrelated considerations. First, the SEC may never have referred the matter to the DOJ, because it believed such a referral was unwarranted.¹¹ Second, the SEC may have referred the matter to the DOJ, but the DOJ determined there was insufficient evidence to support a criminal prosecution against, or the expenditure of DOJ resources on, some or all of the individuals who settled civil charges with the SEC. But from a purely statistical standpoint, individuals who agreed up-front to settle SEC insider trading cases enjoyed the lowest criminal prosecution rates of all categories of defendants in our analysis.

During the relevant period, the DOJ criminally prosecuted only thirty-two percent of the downstream tippers named in SEC complaints. Not surprisingly, the factor that weighs in favor of non-prosecution of downstream tippers generally is their lesser degree of culpability in insider trading schemes.¹² Downstream tippers are neither the original tipper who breached the fiduciary, nor any other duty to the source of the information to maintain the confidentiality of the material nonpublic information, or the original tippee with the relationship with the tipper who was in the best position to know that the tipper breached a particular duty of confidentiality. As the information is tipped down the line, knowledge and proximity to the source of the breach, and resultant derivative legal assumption of duty to maintain confidentiality, is diluted.

The DOJ's principles of non-prosecution do not delve deeply into the defendant's personal characteristics extrinsic to the crime, such as age, health, family responsibilities, *etc.* Our analysis showed that certain personal characteristics—age and marital relationship with another defendant—appear to be significant.

In cases where the DOJ criminally charged none of the SEC defendants, fifteen percent of defendants were over sixty years old. Overall, the DOJ prosecuted only twenty-three percent of the defendants in the relevant case set who were over sixty years of age. The DOJ's exercise of discretion with respect to more elderly persons may be based on the Manual's proscription that prosecutors should consider the "probable sentence or other consequences if the person is convicted."¹³

In SEC insider trading cases where the DOJ did not prosecute any of the defendants, twenty-two percent of those defendants either were married to another defendant, to the source of the leaked information, or to the tippee. Overall, the DOJ prosecuted twenty-nine percent of the defendants in the relevant case set who were married to another defendant, to the source of the leaked information, or to a tippee. These results tend to show that the DOJ may be sensitive to the potential legal and other complications that may arise from prosecuting husband and wife, or to the probable and unfortunate consequences that may arise where one or both parents of younger children could be sent to prison if convicted.

Prior to fiscal year 2009, none of the seventeen overseas defendants in the relevant case set were prosecuted by the DOJ, even though in many of these cases the DOJ criminally prosecuted some of their co-defendants. During fiscal year 2009, four out of the six total overseas defendants charged by the SEC in the relevant case set were also charged criminally. However, because all four defendants who were criminally charged were part of the same insider trading case, it is not clear whether future overseas defendants would be more or less likely to be charged criminally post-2009.

3. Impact of Size of Defendants' Profits Gained/Losses Avoided on the Likelihood of Prosecution by the DOJ

The DOJ prosecuted only five of the twenty-seven defendants (nineteen percent) who reaped profits or avoided trading losses of less than \$25,000. Although one would expect the prosecution rate to consistently increase as dollar amounts increased, the analysis showed that only one of the 17 defendants (six percent) who earned profits or avoided losses of between \$25,000 and \$99,000 was criminally prosecuted. This strikes us as anomalous and not easily accounted for. There is a substantial increase in prosecution rates where the dollar amounts gained or losses avoided exceeds six figures. Fifty-nine of the 115 defendants (fifty-one percent) who earned profits

or avoided losses of more than \$100,000 found themselves named as defendants in a parallel criminal case.

Conclusion

In New York, licensed professionals stand a greater chance of being prosecuted than others (including officers of public companies); tippers tend to be treated more harshly than tippees; sole actors may be treated more leniently than those who advance a fraudulent scheme by tipping others; clients who made or stood to make less money, or avoid smaller losses, on their unlawful trading may be viewed more favorably than those who enjoy greater gains; those who consent up-front to settlements with the SEC do not tend to be prosecuted by the criminal authorities; and those who commit aggravating or additional stand-alone crimes are more likely to find themselves defendants in parallel criminal cases.

Whether advising a client concerning his or her settlement (or guilty plea) options or advocating to the DOJ why a particular case—based on the Department’s historical handling of such cases—should not be treated criminally, these findings should be of value to New York lawyers representing clients in insider trading cases. This is particularly true given the stated aim of the SEC’s Enforcement Division to coordinate closely with federal prosecutors in such cases.

Endnotes

1. For a discussion of the considerations and processes for referral of SEC matters to the DOJ, see SEC Division of Enforcement Manual, Section 5.2.1 at 108-111, and Section 5.6.1 at 115-118 (Jan. 13, 2010).
2. Remarks by Robert Khuzami at SEC v. Galleon Management, LP Press Conference (Oct. 16, 2009), available at <http://www.sec.gov/news/speech/2009/spch101609rk.htm>.
3. Manual at 9-27.110.
4. Manual at 9-27.230.
5. Manual at 9-27.110.
6. Analysis reflects prosecutions by the DOJ as of April 13, 2010 against insider trading defendants who were charged by the SEC during fiscal years 2004-2009.
7. The SEC’s fiscal year begins on October 1st of the previous calendar year. For example, fiscal year 2009 began on October 1, 2008 and ended on September 30, 2009. The SEC’s annual report for fiscal year 2008 noted that fiscal year 2008 saw the highest number of insider trading cases brought by the SEC in the agency’s history. See SEC 2008 Performance and Accountability Report (Nov. 14, 2008), available at <http://www.sec.gov/about/secpar/secpar2008.pdf>.
8. During the relevant time period, the SEC filed no insider trading complaints in the Western or Northern Districts of New York.
9. The Manual, at 9-27.270, states:
 - A. Whenever the attorney for the government declines to commence or recommend Federal prosecution, he/she should ensure that his/her decision and the reasons therefore are communicated to the investigating agency involved and to any other interested agency, and are reflected in the office files.

B. Comment. USAM 9-27.270 is intended primarily to ensure an adequate record of disposition of matters that are brought to the attention of the government attorney for possible criminal prosecution, but that do not result in Federal prosecution. When prosecution is declined in serious cases on the understanding that action will be taken by other authorities, appropriate steps should be taken to ensure that the matter receives their attention and to ensure coordination or follow-up.

10. One of the DOJ’s principles of federal prosecution is that prosecution may be declined where “there exists an adequate, non-criminal alternative to prosecution.” The Manual notes that “resort to the criminal process is not necessarily the only appropriate response to serious forms of antisocial activity,” particularly where “Congress and state legislatures have provided civil and administrative remedies for many types of conduct that may also be subject to criminal sanction. Examples of such non-criminal approaches include...civil actions under the securities... laws.” Manual at 9-27.250. In determining whether these civil remedies provide an effective substitute for criminal prosecution, the attorneys should consider the “sanctions available under the alternative means of disposition” and “the nature and severity of the sanctions.” *Id.*
11. As discussed above, with regard to two out of every three insider trading complaints filed by the SEC in New York during the analysis period, the DOJ took no parallel criminal action against any of the named defendants.
12. The Manual provides: “Although the prosecutor has sufficient evidence of guilt, it is nevertheless appropriate for him/her to give consideration to the degree of the person’s culpability in connection with the offenses, both in the abstract and in comparison with any others involved in the offense. If for example, the person was a relatively minor participant in a criminal enterprise conducted by others, the prosecutor might reasonably conclude that some course other than prosecution would be appropriate.” Manual at 9-27.230 B.4.
13. Manual at 9-27.230.

This report was prepared in May 2010 by the Securities Subcommittee of the White Collar Criminal Litigation Committee of the Commercial and Federal Litigation Section of the New York State Bar Association. Jeffrey Plotkin and Barry Rashkover are co-chairs of the Subcommittee. From 1986-1991, Mr. Plotkin worked in the Enforcement Division of the SEC where, among other positions, he served as Assistant Regional Administrator of the SEC’s Northeast Regional Office. From 1995-2004, Mr. Rashkover worked in the Enforcement Division of the SEC where, among other positions, he served as Associate Regional Director and Co-Head of Enforcement for the SEC’s Northeast Regional Office. Evan Barr and Joanna C. Hendon are co-chairs of the Committee. Ms. Hendon and Mr. Barr served as Assistant United States Attorneys in the Criminal Division of the U.S. Attorney’s Office for the Southern District of New York, from 1995-2001 and from 1995-2004, respectively.

Mr. Plotkin was the principal author of this report and was assisted by committee members Lorraine Bel-lard and Kerry Land. On May 12, 2010, this report was unanimously approved by the Executive Committee of the Commercial and Federal Litigation Section.