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INSIDER TRADING

Crossing Our Borders: Insider Trading, A Global Perspective

BY HOWARD R. ELISOFON

The Securities and Exchange Commission ("SEC") is suing foreign citizens in the United States for insider trading even though they have no contact with this country other than their investments, which in many cases are handled through local branches of U.S. financial institutions or, in some instances, foreign banks.

And while the fact that foreign citizens are being sued in the United States for the mere purchase of securities of U.S.-based companies is troubling, even more problematic is the fact the remedy the SEC has sought in many recent civil lawsuits is drastic: temporarily freezing foreign citizens' bank or brokerage accounts. The effect is real: hundreds of thousands or even millions of foreign dollars of alleged foreign insider traders are being frozen by U.S. courts.

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This article discusses the evolution of U.S. courts' interpretation and enforcement of insider trading laws, the application of these laws to foreign citizens investing in U.S.-based companies on U.S. exchanges, and some traditional defenses used in insider trading cases.

A Quick Primer on Insider Trading. To this day, insider trading has never been defined by any statute or regulation in the United States. The effect: no clear, bright-line test has been articulated by any governmental body. Instead, it has been and continues to be the role of the U.S. courts to articulate what acts constitute insider trading.

The first landmark case on insider trading was *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961). In *Cady, Roberts & Co.*, the Commission held that trading in the open market on material, nonpublic information is a "deceptive device," violating Section 10(b) of the Securities and Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, which are anti-fraud provisions of the Act. The SEC also established the rule now commonly known as the "disclose or abstain rule," whereby an insider must disclose all material nonpublic information known before trading, or abstain from trading entirely.

The Second Circuit upheld and expanded this rule to include corporate insiders in *Securities and Exchange Commission v. Texas Gulf Sulphur*, 401 F.2d 822 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). In this case, the court ruled that a corporate insider who possesses material nonpublic information must either dis-

close the information before trading or abstain from trading until the information is disclosed.

In 1981, courts created the ''misappropriation theory'' to expand the scope of insider trading to include professionals such as lawyers, consultants and even investment bankers who legitimately receive confidential information from a corporation within the course and scope of providing services to the corporation. The main distinction between these professionals and the individuals formerly charged with insider trading is that these professionals owe no fiduciary duty to the issuer but are nonetheless liable for trading the securities of the issuer while in possession of information. The misappropriation theory focuses upon whether ''the insider breached a fiduciary duty to any lawful possessor of material non-public information.'' *Securities and Exchange Commission v. Cherif*, 933 F.2d 403, 409 (7th Cir. 1991). *See also Securities and Exchange Commission v. Svoboda*, 409 F. Supp. 2d 331, 341 (S.D.N.Y. 2006) (holding that a credit policy officer breached his fiduciary duties to his employer bank and its clients ''by passing along confidential information. . . for trading purposes and by personally trading on such information despite his knowledge that doing so violated NationBank's insider trading policies, including a duty to keep all inside information confidential and to use such information only for the business purpose it was communicated.'') (internal citations omitted).

Insider trading was also expanded to include ''tippee'' liability meaning persons who were tipped by a fiduciary and traded on inside information provided by that fiduciary. *See*, *e.g.*, *Securities and Exchange Commission v. Svoboda*, 409 F. Supp.2d 331 (S.D.N.Y. 2006) (holding tippee, accountant, liable for trading on inside information obtained from friend who was a credit policy officer of bank). However, simply being a ''tippee'' is not always enough to find someone liable for insider trading. For example, in *United States v. Chestman*, the Government charged the stockbroker of Keith Loeb, who is married to a Waldbaum, with securities fraud, fraudulent trading and other related offenses. 947 F.2d 551 (2d Cir. 1991). A few days prior to the sale of Waldbaum, Keith Loeb's wife told him about the sale. *Id.* at 555. Keith Loeb telephoned his broker about the potential sale and that morning the stockbroker executed several purchases of Waldbaum stock. *Id.* The court held that Keith Loeb's status as the husband of a Waldbaum ''could not itself establish fiduciary status'' and thus he did not owe his wife or the Waldbaum family ''a fiduciary duty or its functional equivalent.'' *Id.* at 571. Thus, Keith Loeb did not defraud the Waldbaum family by disclosing the news of the tender offer to his stock broker and the stockbroker could not be derivatively liable as Keith Loeb's tippee. *Id.*

Insider trading has since become criminalized, creating two potential avenues of liability—civil, with possible monetary penalties; and criminal, potentially resulting in incarceration. For example, in *United States v. Victor Teicher & Co.*, defendants charged with conspiring to violate the federal securities laws and other offenses based on defendants' purchase and sale of securities while in possession of misappropriated, material, non-public information. Defendants' sources of information were law firm associates and investment bankers. The jury convicted the defendants on all counts and the two individual defendants were sentenced to eighteen months in prison. The Defendants appealed from their convictions, but the Supreme Court denied certiorari. 114 S.Ct. 467 (1993). Defendants then applied for a reduction in their sentences, which the court also denied. No. 88 CR 796, 1994 WL 141979, at *2 (S.D.N.Y. Apr. 20, 1994).

In another recent example, in *Securities and Exchange Commission v. One or More Unknown Purchasers of Call Options For the Common Stock of TXU Corp., et al.*, a former Credit Suisse investment banker, Hafiz Muhammad Zubair Naseem, was arrested and charged criminally for insider trading. This case is currently pending on the criminal docket in the Southern District of New York. *United States of Am. v. Naseem, et al.*, 1:07-cr-00610-RMB-1. *See_alsoUnited States v. Tom*, 504 F.3d 89, 97 (1st Cir. 2007) (sentencing defendant to imprisonment for insider trading); *United States v. Bhagat*, 436 F.3d 1140, 1148 (9th Cir. 2006) (upholding conviction for insider trading and remanding for sentencing).

The Long Arm of U.S. Law. Traditionally, insider trading laws have been enforced to prevent U.S. citizens from trading in U.S. markets while in possession of material, nonpublic inside information. Courts have later expanded these laws to allowing for the prosecution of professionals such as lawyers and investment bankers, who have traded on non-public information with which they were entrusted while rendering services to a corporation. Today, courts are reaching around the globe to enforce these laws both civilly and criminally against any individual who trades on inside information in U.S. markets, in U.S.-based companies, regardless of whether he or she has any other minimum contacts with the United States.

Normally, U.S. courts can hear cases only where the parties have certain minimum contacts with the jurisdiction where they are being sued. But recently courts have allowed the SEC to sue foreign citizens whose only contact with the United States was the purchase of stock of U.S.-based companies.

In May 2007 alone, the SEC filed two lawsuits alleging insider trading by foreign nationals through local offices of U.S. broker-dealers using U.S. exchanges.[1] In these two cases, the courts noted that to assert jurisdiction over a foreign individual, the SEC was required to demonstrate nothing more than that the foreign citizen invested monies in U.S. companies' stocks, in U.S. markets, which allegedly adversely affected U.S. citizens.

How can U.S. authorities reach you and your money abroad? Though anti-insider trading laws vary widely from country to country[2] in terms of when such laws were enacted and how they are applied, there is coop-

[1] *Securities and Exchange Commission v. Wong*, Civil Action No. 07 cv 3628, and *Securities and Exchange Commission v. One or More Unknown Purchasers of Call Options For the Common Stock of TXU Corp., et al.*, Civil Action No. 1:07 cv 1208. In these two cases (both of which were filed in May, 2007), the SEC alleged that the defendants purchased stock in U.S. based companies using foreign brokerage firms which have offices in the United States. The defendants in the *Wong* case settled with the SEC in February of 2008.

[2] Many countries did not enact laws making insider trading illegal until the 1980s. In the U.K., for example, insider trading did not become illegal until 1986, with the enactment of the Financial Services Act. Today, insider trading in the U.K. is regulated by the Financial Services and Markets Act of 2000. Japan did not enact its first law against insider trading until 1988.

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eration among international enforcement authorities. As insider trading often crosses borders, this teamwork is essential. To foster international prosecution of insider trading, the SEC has entered into 32 arrangements (including Memoranda of Understanding (''MOU'')) with their counterparts abroad[3] which provide for information sharing and cooperation in investigating and prosecuting securities laws violations. Indeed, in 2004 the SEC made 380 requests to foreign governments for enforcement assistance and responded to 372 requests from foreign regulators. Enforcement authorities have another tool in the Hague Convention, which prescribes procedures by which a judicial authority in one contracting state can request evidence located in another contracting state for civil cases.[4]

What if the SEC has one of these arrangements with the government of your home country? The SEC may be able to attach your assets in the U.S. and abroad, and even question witnesses in your home country. In one example, the SEC filed an emergency action in New York against two Singapore residents, alleging that the defendants purchased call options through an account at the Singapore local branch office of a U.S. brokerage firm prior to the public announcement that the issuer would be acquired. The court granted the SEC's request for an order temporarily freezing the assets in the defendants' accounts which were attributed to the trading of the call options.[5] The SEC also brought their fight to the defendants' doorstep, using the Hague Convention to ask the High Court of the Republic of Singapore to appoint an examiner to take evidence from witnesses in Singapore to be used in the lawsuit pending in New York. The Singapore court held in favor of the SEC, ''finding that an action for an injunction under Section 10(b) and Rule 10b-5 is a civil proceeding according to the law of the United States and the law of Singapore.''[6]

You can't hide, either. U.S. courts are allowing the SEC to serve a complaint on foreign citizens by means of overnight mail for residents of countries bound by the Hague Convention, and even by serving a defendant's bank or brokerage firm where an account was maintained because they are an ''agent'' of a defendant. In one of the cases filed in May 2007, the court allowed service of process on the two Hong Kong defendants by ''facsimile, hand delivery, overnight courier, mail, electronic mail, or any alternative permitted by Rule 4 of the Federal Rules of Civil Procedure, including letters rogatory, or as this Court may direct by further order.''[7] The court went on to order that ''service of all pleadings, process, and papers in this litigation, including the summons, complaint, and this Order'' may be served on the defendants' broker, as their agents.

The implication is simple: if you use, for example, a U.S.-based brokerage firm that has a branch in Singapore, the SEC can serve that brokerage firm's New York office and the court will consider you served.

Put Your Money in the Mattress. Foreign citizens are afforded many of the same rights as U.S. citizens under the U.S. Constitution. In fact, a foreign citizen is protected by the privilege against self-incrimination guaranteed by the Fifth Amendment when he or she is the subject of a criminal proceeding in the United States. *United States v. Bin Laden*, 132 F. Supp.2d 168 (S.D.N.Y. 2001).

In spite of this, U.S. courts are practically reaching into foreign citizens' pockets to freeze their assets for allegedly engaging in insider trading even in the absence of physically entering into the United States to engage in such activities.[8] For example, in *Securities and Exchange Commission v. Wong*, 07 Civ. 3628 (S.D.N.Y.), the court allowed the SEC to freeze assets representing profits from an alleged act of insider trading, *without requiring the SEC to show risk of irreparable injury*. The court reasoned that, unlike a preliminary injunction, an asset freeze requires the SEC to demonstrate only that it is likely to succeed on the merits or that ''there is a basis to infer that the appellants traded on inside information.'' It's a low standard for such a drastic remedy, and courts have taken the remedy even further: courts have allowed the SEC to freeze assets in the amount of three times the profit, reasoning that because of statutory authority to seek treble damages, it should be permissible for them to freeze sufficient collateral to cover both profits and treble damages.[9] While an opponent may argue that these are drastic tactics that have a chilling effect on foreign investors, proponents contend that without them, such illegal acts will continue to occur in U.S. markets.

In an even more extreme example, in *Securities and Exchange Commission v. Wang*, the SEC convinced a court to freeze a Hong Kong resident's assets and deposit monies into the Court's registry from his Hong Kong bank account for alleged insider trading in the United States. 699 F. Supp. 44 (S.D.N.Y. 1988). The defendant had $12.5 million in a bank account with Standard and Charter Bank, which had branch offices in New York and Hong Kong. The defendant, believing that a New York court lacked jurisdiction over him as he is a Hong Kong resident, sued in Hong Kong in an attempt to unfreeze his assets. Surprisingly, his at-

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[3] For example, the U.S. has entered into MOUs with Germany, Portugal, India, Japan and Jersey in the past seven years. Michael D. Mann & William P. Barry, *Developments in the Internationalization of Securities Enforcement*, 1428 PLI/CORP 355, 378 (2004).

[4] Rule 4(f) of the Federal Rules of Civil Procedure provides that service upon individuals in a foreign country may be effected ''by any internationally agreed means reasonably calculated to give notice, such as those means authorized by the Hague Convention on the Service Abroad of Judicial and Extrajudicial Documents. . . .'' The United States, the United Kingdom and Hong Kong are all signatories to the Hague Convention and thus service of process on a defendant residing in any of these countries is governed by the convention. *See Burda Media, Inc. v. Viertel*, 417 F.3d 292, 299-300 (2d Cir. 2005).

[5] Securities and Exchange Commission, Litigation Release No. 15334, April 15, 1997, http://www. sec.gov.

[6] Thomas C. Newkirk, Associate Director, Securities and Exchange Commission, Insider Trading — A U.S. Perspective (Sept. 19, 1998).

[7] *Securities and Exchange Commission v. Wong*, Order dated May 8, 2007.

[8] For example, in *Securities and Exchange Commission v. Grand Logistic, S.A.*, Civ. Action No. 06-cv-15274, the SEC obtained an asset freeze to prevent an Estonia-based ''account intrusion'' scheme which targeted U.S. online brokerage accounts in an effort to manipulate the markets. The court also issued a temporary restraining order which, among other things, froze the defendants' assets and ordered the repatriation of monies which were taken out of the United States.

[9] *Securities and Exchange Commission v. Unifund Sal*, 910 F.2d 1028 (2d Cir. 1990).

tempts were futile—the SEC got the Southern District of New York court to order the bank to deposit the money into the court's registry in New York despite the fact that he did not do any banking nor maintain any accounts in New York. After the bank complied with the order, the Hong Kong court denied the defendant's suit. Stunned, the defendant sought to set aside the default judgment in the U.S., arguing for the first time that the alleged inside information he used was public. But the court disagreed and ordered disgorgement of the defendant's profits.[10]

Foreign investors often have a mistaken belief that U.S. courts cannot have jurisdiction over them and hence decline to even appear or respond to a complaint. As evidenced in *Wang*, however, courts in the United States can and will attach a foreign citizens' assets where United States' citizens interests are effected. Moreover, many countries now have extradition treaties with the U.S., making it possible for foreign citizens to be extradited in either direction for committing insider trading even while living abroad and never being a U.S. citizen. However, the United States has a ''dual criminality'' requirement for extradition — meaning that an individual may be extradited ''only if the alleged criminal conduct is considered criminal[11] under the laws of both the surrendering and requesting nations.'' *Murphy v. United States*, 199 F.3d 599, 602 (2d Cir. 1999) (internal citations omitted); *see generallySecurities and Exchange Commission v. Sekhri*, No. 98 Civ. 2320, 2002 U.S. Dist. LEXIS 13289 at *26 (S.D.N.Y. July 22, 2002) (stating that Sekhri was extradited from Australia to the United States for violations of the U.S. securities laws).

Valid Defenses. The SEC hasn't always succeeded in exercising jurisdiction over, or freezing the assets of, non-U.S. citizens with very tenuous connections to the U.S. But the decisions seem to be based on the individual facts of each case, so your best bet is to learn what constitutes insider trading under U.S. law and avoid it. Ignorance of the law is not an excuse.[12] Here are some examples of U.S. courts rebuffing the SEC:

■ *The information is public_(i.e. the word was out).* Information is nonpublic ''if it has neither achieve[d] a broad dissemination to the investing public generally and without favoring any special person or group nor been traded on by a few persons with knowledge, causing the information to be fully impounded into the price of the particular stock.'' *SEC v. Svoboda*, 409 F. Supp. 2d 331, 340 (S.D.N.Y. 2006) (internal quotation omitted). In one example, the court vitiated a temporary freeze order against defendants who purchased stock the day before a merger was announced. In this case, the media was actively engaging in takeover speculation at the time, and the trading volume of the stock had doubled on the day before the defendant's trade, and doubled again on the day he traded. The court reasoned that the trading volume, combined with the media coverage, reflected that the 'word was out' to the investing public.[13]

■ *Sufficient investment interest independent of inside information.* In one case, a court held that mere knowing possession or proof that an insider traded while in possession of material nonpublic information is not per se a violation of the insider trading laws. However, when an insider trades while in possession of material nonpublic information, a strong inference arises that such information was used by the insider in trading. The insider can attempt to rebut the inference by showing that the information was not used, such as, for instance, by showing that he had a pre-existing investment plan.

■ *No evidence implicating the tipper.* According to some courts, you cannot be guilty of insider trading if there is no proof that an insider leaked information to you, or that you received information that was leaked.[14]

■ *It was just a rumor.* If there were substantial rumors in the marketplace regarding the information such as, for example, that a company was going to be taken over or merged, a possible argument could be constructed that the securities were purchased based upon rumors in the public domain rather than from an unproven tip. SEC v. Gonzalez de Castilla, 145 F. Supp.2d 402, 412 (S.D.N.Y. 2001).

■ *The information wasn't material.* The information is considered material where there is a substantial likelihood that a reasonable investor would consider it important when deciding how to invest. *SeeBasic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988).

Conclusion. Courts are looking beyond the U.S. borders and are enforcing U.S. insider trading laws against foreign citizens who invested in U.S. companies' stocks, in U.S. markets even if they never entered the United States nor did any business in the United States. The result of such extraterritorial actions is astounding: more and more foreign citizens are being prosecuted both civilly and criminally for insider trading. Even more alarming is the fact that the SEC has and continues to seek to freeze assets of foreign citizens who allegedly committed insider trading inside U.S. borders.

It is clear that foreign citizens may no longer hide within their own borders to avoid prosecution from U.S. authorities.

[10] *Securities and Exchange Commission v. Wang*, 699 F. Supp. 44 (S.D.N.Y. 1988).

[11] Insider trading is considered an extraditable defense if it is a crime under the laws of both the surrendering and requesting nations. For example, in 2001, a federal judge in Massachusetts ordered a former chief executive to be extradited to Belgium to face charges of insider trading, stock-market manipulation and violation of bookkeeping laws. *In re Lernout & Hauspie Sec. Litig.*, 208 F. Supp. 2d 74 (D. Mass. 2002).

[12] *United States v. Paracha*, No. 03 Cr. 1197, 2006 WL 12768, at *30 (S.D.N.Y. Jan. 3, 2006).

[13] *Securities and Exchange Commission v. Gonzalez De Castilla*, 145 F. Supp. 2d 402 (S.D.N.Y. 2001).

[14] *SEC v. Gonzalez De Castilla*, 145 F. Supp. 2d 402 (S.D.N.Y. 2001).

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