

Insider Trading: New Developments and How to Deal with Them

By John H. Sturc and Adam Chen



John H. Sturc is a partner in the Washington, DC office of Gibson, Dunn & Crutcher LLP. He is Co-Chair of the firm's Securities Enforcement Practice Group. He joined the firm's Washington, D.C. office in 1990, where he focuses on securities and financial institutions enforcement matters, securities law, internal investigations, and criminal and civil litigation.



Zern-shun Adam Chen is an associate in the New York office of Gibson, Dunn & Crutcher. He is a member of the firm's Litigation Practice.

Insider trading remains a high priority in enforcement of the federal securities laws. Recently, the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ) have stepped up their investigative efforts. In 2009, the SEC brought 37 insider trading actions; this number increased to 53 cases in 2010.¹ The DOJ has similarly brought numerous criminal prosecutions on insider trading schemes, including bringing a case, and receiving guilty verdicts against, Raj Rajaratnam, the founder of the hedge fund Galleon Management.

Due to the increased focus on insider trading in the SEC's and DOJ's investigative efforts, financial service firms and other companies should re-evaluate their compliance programs for preventing insider trading activity. Companies can be liable for insider trading by employees for the account of the firm and, in limited circumstances, as a "controlling person" of one who engages in insider trading.² In addition, insider trading can disrupt the market for a company's stock and interrupt prospective transactions, and government investigations are costly and distracting.

This article discusses current trends in insider trading investigations, including recent changes to the DOJ's and SEC's enforcement focus and methods used in investigating insider trading. It also discusses several ways a firm can change its policies and practices to better assure that its directors, officers and employees avoid possible liability for insider trading.

Current Trends in Insider Trading

The accelerated activity by the SEC and the DOJ is the result of a perception that certain market participants have engaged in abuse, but the law of insider trading has not changed in the past few years: almost all insider trading cases under the securities laws are still based on either the "classical theory" of insider trading, where a person purchases or sells securities, with *scienter* (guilty knowledge), while in possession of material, nonpublic information in breach of a duty arising out of a fiduciary relationship to the issuer of the security—or the "misappropriation theory"—where a person violates securities

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laws when he misappropriates and trades on the basis of confidential information in a breach of a duty of trust or confidence owed to *the source of the information*.³ Instead, the principal changes have been the increased intensity of effort and the use of investigative techniques molded in other areas of criminal practice. Additionally, while there continue to be major cases involving insider trading by corporate insiders, the SEC and DOJ have also increased their attention on hedge funds, expert networks and “access persons” and extended insider trading cases to non-traditional securities and trading techniques.

Changes in Enforcement Focus

Hedge Funds

From June 2009 to November 2010, 49 hedge-fund managers and employees have been charged in connection with insider trading. Of those, 46 have either pled guilty or been found guilty after trial. The most significant hedge fund case has been the criminal trial of Raj Rajaratnam and the parallel SEC civil trial, *SEC v. Galleon Management*.⁴ Raj Rajaratnam, the founder and head of Galleon Management, a hedge fund that managed \$3.7 billion in assets at the time of Rajaratnam’s arrest, was charged by federal prosecutors with securities fraud and conspiracy.⁵ The SEC also brought insider trading charges in the parallel civil case. In a new development, the federal prosecutor’s case relied, in large part, on extensive wiretaps of Rajaratnam’s conversations.⁶ On May 11, 2011, Rajaratnam was convicted of all 14 counts of securities fraud and conspiracy brought by federal prosecutors.⁷

The government has also been successful in cases against other Galleon-related defendants. For example, Zvi Goffer, a former employee of Galleon, was found guilty of insider trading through acquiring tips from attorneys at corporate law firms.⁸ Emanuel Goffer, Zvi Goffer’s brother, and Michael Kimelman were also found guilty of conspiracy and securities fraud,⁹ while the attorney who acted as the broker between the attorney-tipper and the traders pled guilty to insider trading and received a three-year prison sentence.¹⁰ Arthur Cutillo, an attorney, was charged with providing the inside information to Zvi Goffer.

In a non-Galleon hedge-fund case, the SEC charged Dr. Joseph Skowron, a former portfolio

manager for six health care related hedge funds, with insider trading in health care related stocks after receiving tips from a medical researcher overseeing a drug trial that the results would be unsuccessful.¹¹ Skowron and the affiliated hedge funds agreed to settle with the SEC by paying back \$33 million in disgorgement and interest. Skowron pled guilty to criminal insider trading charges in August 2011.¹²

The federal government has not won all of its cases against hedge fund personnel. In September 2010, a hedge fund manager and his co-defendants won summary judgment against the SEC’s allegations of insider trading.¹³ The SEC alleged that defendant Brad Strickland, an employee of a lender, tipped his friend, defendant Peter Black, about an acquisition of SunSource, Inc., a potential borrower of from the lender. Black then informed his superior, Nelson Obus, who, in turn, purchased SunSource stock. The court rejected the SEC’s allegations. The court noted that financial institutions typically owe no fiduciary duties to borrowers and found that no such duty arose in this case. Similarly, a district court dismissed insider trading charges in *SEC v. Berlacher*.¹⁴ There, the hedge fund manager emerged victorious because the SEC failed to prove that the alleged nonpublic information was material.

Expert Networks

Several of the hedge fund cases arise from the activity of employees of or consultants for expert network firms, firms that attempt to connect investment professionals with subject matter experts for consultation on investments in companies related to the experts’ fields. The SEC and DOJ have alleged that personnel at some firms provided information that is not merely difficult to obtain, but unlawfully disclosed nonpublic information, and the consultant-expert was hired by clients with the expectation of providing this unlawful information.

The DOJ’s and SEC’s focus on expert networks began in November 2010, when they announced criminal and civil insider trading charges against French doctor Yves Benhamou.¹⁵ Benhamou served on the steering committee that oversaw clinical trials of a new hepatitis drug being developed by a pharmaceutical company. During this time, Benhamou had a consulting relationship with hedge funds that invested in health care related securities, including with Dr. Joseph Skowron, discussed above. The DOJ and SEC alleged that Benhamou

tipped Skowron of adverse test results from clinical trials, which allowed the hedge fund to avoid losses of \$30 million.

After the initiation of the Benhamou case, the DOJ and SEC filed multiple criminal and civil charges against consultants and employees of the expert network firm Primary Global Research and their hedge fund clients. The DOJ and SEC alleged that James Fleischman, an employee at Primary Global, arranged for consultants to work with Primary Global's hedge fund clients with the expectation that the consultants would provide inside information.¹⁶ Some of those charged, including Walter Shimoon and *Dung Ching Trang Chu*, have pled guilty.¹⁷ Others, such as Winifred Jiau, a Primary Global consultant, have been found guilty for passing insider information to clients.¹⁸

“Access Persons”

The SEC and DOJ have begun several actions against “access persons,” employees of service firms such as accounting firms and law firms, who obtain material nonpublic information about issuer clients, for insider trading. These actions include the action against Arthur Cutillo, an attorney, who was found guilty of providing information on upcoming transactions by firm clients to professional traders. Matthew Kluger, a corporate attorney, and Garrett Bauer, a self-employed trader, were also charged by the SEC in April 2011 with insider trading in advance of at least 11 merger and acquisition announcements involving clients of Kluger's law firm.¹⁹ Parallel criminal charges were also brought against Kluger and Bauer. The SEC charges that Kluger accessed his law firm employer's internal document management system to find nonpublic material information concerning the mergers and acquisitions of the law firm's clients. Bauer then placed trades on the confidential information for himself and Kluger. The SEC alleges that Kluger and Bauer illegally profited by at least \$500,000 and \$32 million, respectively.²⁰

In March 2011, the SEC also charged Todd Treadway, a corporate attorney, with insider trading.²¹ The SEC alleges that Treadway used information he obtained while advising clients on the employee benefit and executive compensation consequences of mergers and acquisitions to purchase stock in two separate companies before their announcement of the acquisitions.

In a case involving an accounting firm, the SEC settled insider trading charges against former “Big 4” accounting firm partner Thomas Flanagan and his son Patrick Flanagan for trading in the securities of several of the accounting firm's clients.²² According to the SEC complaint, Thomas Flanagan illegally traded nine times between 2005 and 2008,

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each time based on nonpublic information obtained from clients. He also relayed the information to his son. The Flanagans agreed to pay approximately \$1.1 million to settle the charges.

Enforcement of Requirements that Broker/Dealers and Investment Advisers Have and Maintain Insider Trading Policies and Procedures

Brokerage firms and investment advisers are required by Section 15(f) of the Exchange Act and Section 204A of the Investment Advisers Act to establish, maintain and enforce written policies to prevent the misuse of material nonpublic information by the firm or its associated persons. In the past year, the SEC has brought enforcement actions against firms that fail to establish or maintain such policies and procedures even without any allegation of an underlying violation. In July 2011, the SEC filed an administrative action against Janney Montgomery Scott LLC, a brokerage firm, for failing to maintain and enforce such policies.²³ The SEC's allegations focused on monitoring trading of securities on the firm's “watch list,” enforcement of restrictions on contacts between research staff and investment bankers and enforcement of policies on pre-clearance of personal trades, annual questionnaires and reviews of accounts of associated persons. The SEC imposed an \$850,000 fine and Janney has agreed to hire an independent compliance consultant to assist the firm in undertaking remedial measures. Similarly, in November 2010,

the SEC settled an administrative action against Buckingham Research Group, a broker dealer, its investment adviser subsidiary, and the director of compliance for failing to create certain required policies and procedures and for failing to enforce others that had been created.²⁴

5. *Beyond Equity Securities*

The SEC has brought cases alleging improper trading in securities other than equities and listed options, such as credit default swaps (CDSs), exchange-traded funds (ETFs) and mutual funds and through the use of new trading vehicles such as Rule 10b5-1 plans.

In 2010, the SEC alleged insider trading in credit default swaps by a bond salesman and a hedge fund manager.²⁵ The SEC alleged that the bond salesman learned of a CDS before it was announced to the public from bankers at his firm who were working on the deal and tipped off the hedge fund manager prior to the public announcement of the swap, who subsequently bought the swaps. During trial, defendants argued that the CDS at issue were outside the SEC's jurisdiction because they were not tied to a specific securities issue and were priced based on a variety of factors including the strength of the overall economy and the market's assessment of the referenced company's credit risk. Following trial, the Southern District of New York court concluded that the insider trading charges were unfounded because there had been no dissemination of material non-public information. In a victory for the SEC, however, the court held that the swaps were sufficiently securities-based to be within the SEC's jurisdiction. The court reasoned that price terms of the CDSs were fundamentally (though not expressly) based on the price, yield, and value of the company's bonds and, as such, were securities-based swaps.

With respect to mutual fund shares, the SEC has also brought an action against a mutual fund portfolio manager who allegedly encouraged his daughter to redeem fund shares when he knew the fund was experiencing material distress.²⁶ The SEC brought an administrative proceeding against the manager, and the administrative law judge subsequently imposed sanctions and a fine against the manager.

The SEC has also brought an action against a former employee of a major investment bank for trading securities ETFs based on material, nonpublic information in an administrative proceeding.²⁷ In September 2011, the SEC alleged

that the employee obtained information on the investment bank's nonpublic plans to purchase large amounts of securities underlying an ETF and passed that information on to his father. The two then allegedly used that information to make profitable trades. The proceeding is ongoing.

CFTC "Insider Trading" Authority

The Commodities Futures Trading Commission ("CFTC") is also poised to become more involved in insider trading actions. Under the Dodd-Frank Act, a new Section 6(c)(1) has been added to the Commodities Exchange Act prohibiting any deceptive device or contrivance in connection with a swap, future or cash contract in contravention of CFTC rules. Under this new law, the CFTC has promulgated Rule 180.1(a)(1)-(3), which is expressly patterned on SEC Rule 10b-5. Unlike securities markets, futures markets do not have corporate issuers. Thus, the new rule prohibits trading on the basis of material nonpublic information obtained through fraud or deceit *or in breach of a pre-existing duty*; the rule does not create a new duty to disclose. Under the new Rule 180.1, trading on one's own, material nonpublic information is permitted. However, trading on information that was inappropriately obtained or used in breach of a duty created by the circumstances under which it was obtained, is not.

Changing Methods in Enforcing Insider Trading Laws

With the SEC's and DOJ's increased attention on insider trading and hedge funds, the government has methods and approaches to finding and bringing actions against violators. The SEC has created two specialized units within its Enforcement Division to focus on insider trading and certain financial institutions: the Market Abuse Unit and Asset Management Unit. The Market Abuse Unit is tasked to investigate insider trading, market manipulation, front-running, collusive trading and abusive short selling. The Asset Management Unit will focus on investment advisers, hedge funds, private equity funds and mutual funds. Recent developments have also seen an increase in cooperation and coordination between the SEC and DOJ.

The SEC and DOJ are also making greater use of investigative techniques drawn from criminal procedure. These methods include the use of

wiretaps, search warrants, increased leniency to cooperators and administrative proceedings.

Wiretaps

Much of the federal government's success against insider trading in the Galleon cases has been the result of evidence gleaned from court-ordered wiretaps. The Rajaratnam case was the first insider trading to rely extensively on wiretaps by federal prosecutors. Prosecutors used over 90 hours of telephone conversations to build its case.²⁸ The DOJ has started using wiretaps to build other insider trading cases. In *United States v. Goffer*, prosecutors used wiretaps to gather evidence against several individuals who gained inside information from an associate at a law firm on upcoming deals involving the firm's clients.²⁹

Wiretap evidence presents complex issues in parallel criminal and civil investigations, specifically in whether the SEC can gain access to the use of such wiretaps for a civil proceeding through a defendant's acquisition of those wiretaps from a criminal proceeding. Because of the extensive statutory protections over electronic interception, the SEC is not entitled to obtain wiretap evidence from the Department of Justice. But it may obtain the evidence through civil discovery. This issue arose in the Galleon cases as the defendants obtained wiretap evidence from prosecutors in their discovery in the criminal case. The SEC, in its civil action, then sought discovery of that evidence from defendants, not the DOJ.³⁰ In initially hearing the issue, the district court ordered the production of the wiretaps from the defendant. Upon appeal to the Second Circuit, the circuit court held that a district court may order production of the wiretap evidence from defendants but that production is not universally permitted. In deciding whether production is appropriate, a district court must balance the SEC's interest in obtaining discovery against the defendants' privacy interest.

Search Warrants

Search warrants differ from the traditionally used SEC or grand jury subpoena in that to obtain the warrant, the government must provide evidence showing probable cause that a crime has been committed and that evidence will be found in the location to be searched. Since search warrants will publicize the government's investigation, prosecutors will use search warrants when they are ready to publicize the investigation or if the "cat is out of the bag," such as

when the head of a technology research firm sent an e-mail to his clients' hedge funds about being visited by FBI agents whom he said wanted him to record conversations with his clients to gather information about insider trading.³¹ In 2010, the government used search warrants on three hedge fund offices to gather evidence for its insider trading cases.³² Here too, the SEC's ability to use search warrant evidence is limited because the evidence is obtained by authority that is only given to prosecutors in criminal cases.

Leniency to Cooperators

The DOJ and SEC are using promises of leniency in their criminal and civil actions to encourage defendants' cooperation. For example, in the Rajaratnam case federal prosecutors entered into plea agreements with several key witnesses for their testimony against other defendants. Similarly, in *United States v. Murdoch* and *United States v. Gansman*, the cooperating defendant received six months of home detention for testifying against the co-defendant even though the cooperating defendant's profits were for more than \$390,000. In contrast, the co-defendant who went to trial made no profits, but was sentenced to one year in prison.

Historically, the SEC had not extended offers of leniency to encourage witnesses to cooperate in its investigations. To encourage tips and cooperation, the SEC announced a new cooperation initiative in 2010.³³ Under this initiative, the SEC would treat cooperators more favorably when imposing penalties or bringing enforcement actions. This initiative calls for the SEC to use more deferred-prosecution and non-prosecution agreements, cooperation agreements and increased use of proffer agreements. In December 2010, the SEC entered into the first non-prosecution agreement under the initiative.³⁴ The non-prosecution agreement (NPA) was entered into with Carter's, Inc., a children's clothing company, and related to alleged wrongdoing by a former executive vice president of the company alleged to have engaged in financial fraud by making material misstatements in Carter's publicly reported financial statements. Under the NPA, the SEC agreed not to bring any enforcement action or proceeding against Carter's in connection with its investigation of this issue, in exchange for Carter's "full, truthful and continuing cooperation" in the investigation and any related enforcement litigation or proceeding for an indefinite period of time. The NPA reserves to the SEC the right to bring an enforcement action based

on the underlying conduct if Carter's violates the NPA regardless of whether the claim is barred by any statute of limitations.

The SEC has also adopted a new whistleblower program, which rewards whistleblowers who provide high-quality tips that lead to successful enforcement actions. Implemented under the new Dodd-Frank Act, the program rewards whistleblowers who voluntarily provide the SEC with original information that leads to a successful enforcement action in which sanctions of more than \$1 million are imposed. The program augments a pre-existing bounty provision for insider trading which the SEC used to pay \$1 million to a whistleblower in *SEC v. Samberg & Pequot Capital*.³⁵ (Prior to *Samberg*, only five people had received whistleblower payments; the biggest payment was \$55,220.) The SEC has created a new whistleblower page on its website and has made clear its intention to use the program vigorously.

Administrative Proceedings

The Dodd-Frank Act grants the SEC authority to impose monetary penalties beyond SEC-registered entities and associated persons to any person or entity in administrative cease-and-desist proceedings.³⁶ An administrative proceeding is sometimes viewed as a more favorable venue for the Enforcement Division because it affords the respondent no discovery, other than access to the staff's investigative file, and ensures a bench trial before the SEC's administrative law judges and an appeal to the Commission rather than a jury trial in an Article III court.

As noted earlier, the SEC has previously used administrative proceedings for insider trading cases concerning associated persons of broker/dealers and investment advisers. In March 2011, the SEC brought an administrative action against Rajat Gupta, formerly a director of Goldman Sachs and Proctor & Gamble, alleging that he disclosed material nonpublic information to Raj Rajaratnam regarding Berkshire Hathaway's impending \$5 billion investment in Goldman Sachs and other nonpublic financial results of Goldman Sachs and Proctor & Gamble. In response, Gupta denied the charges and filed a complaint in federal court against the SEC. Gupta challenged the legality of the administrative proceedings filed against him, including the retroactive application of the Dodd-Frank Act—the alleged insider trading occurred 1½ years before enactment of the Dodd-Frank Act. Gupta has also challenged

the due process constitutionality of the administrative proceeding, alleging that the proceeding's more lenient procedures, more lenient evidentiary standards and the deference afforded to any award from any appellate review would deprive Gupta of his constitutional rights. On July 11, the court presiding over Gupta's suit ruled that he could proceed with his equal protection claim against the Commission based on the apparent discrepancy between the Commission's decision to seek relief in federal civil actions as to all other defendants in the Galleon related cases.³⁷ As a result, the SEC has dismissed the administrative proceeding against Gupta.³⁸

The SEC has also brought an administrative proceeding and secured a judgment against a portfolio manager of municipal bond funds for engaging in insider trading by tipping family members to redeem shares in funds he managed.³⁹ Another administrative proceeding was also recently filed against a Goldman Sachs employee for trading on ETF securities based on information the employee gained from Goldman.⁴⁰ The SEC alleges that the employee then passed the information on to his father and the two then illegally bought and sold shares of the securities.

What Companies Should Consider Now: Preventing and Detecting Insider Trading

Public companies, broker-dealers and investment advisers alike have to take note of how they can prevent insider trading committed by their directors, officers or employees so that they can avoid the adverse consequences of insider trading and government investigations. Moreover, as the *Janney* and *Buckingham* cases highlight, establishing comprehensive and enforceable policies and procedures is itself a requirement of the securities laws for broker dealers and investment advisers.

Compliance Measures for Public Companies

Insider trading typically affects public companies when a director, officer or employee or persons to whom they disclose the information buy or sell shares of the company (or another company with which it does business) based on material nonpublic information they obtained because of their work for the company. Below are a few ways companies can deter this from happening and promote compliance with securities laws:

- *Education and training.* Directors, officers and employees need to understand their responsibilities and obligations in order to avoid violating securities laws. An effective, ongoing, education and training program is central to this goal.
- *Keep sensitive information on a need-to-know basis.* Certain corporation actions or transactions, such as mergers and acquisitions or the release of quarterly earnings, carry a greater risk of insider trading on this information. Keeping information on a need-to-know basis minimizes the risk of misuse of the information and limits possible suspects if misappropriation does occur. For instance, confining the information of a company's forthcoming earnings to a core team minimizes the risk that someone from the company will trade on that information.
- *Secure sensitive information.* We live in an era of information portability and flexibility at work. Several recent insider trading cases arise out of situations in which information on personal computers left off site has been accessed and used to trade.
- *Establish and maintain "quiet periods" and pre-clearance processes.* Insider trading investigations typically begin with broad sweeps of trading activity in advance of disclosures of material events. Many companies therefore have "quiet" periods between, for example, the close of an accounting period and an earnings release during which transactions are not permitted in order to avoid even the appearance of insider trading. Many companies supplement that policy by requiring pre-clearance of transactions by senior personnel so as to better assure compliance outside of quiet periods.
- *Encourage officers and directors to consider Rule 10b5-1 plans.* SEC Rule 10b5-1 provides an affirmative defense to an insider trading charge if the trade was made pursuant to a contract or a written plan that "[does] not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales"⁴¹ These plans can allow officers and directors to buy or sell their company's shares without fear of potential insider trading violations.
- *Monitor company share repurchase programs to assure compliance.* Like individuals, corporations which repurchase their own equity securities can be subject to 10b-5 liability if they are in possession of material nonpublic information at

the time of the repurchase program. Thus, such programs should be monitored and pre-cleared.

Compliance Measures for Brokerage Firms and Investment Advisers

Insider trading prevention and detection compliance measures must meet several sets of rules. Rules 204A-1 and 17j-1 promulgated under the Investment Advisers Act of 1940 requires firms to establish a Code of Ethics and outline parameters on employee personal trading and reporting. NASD Rule 3010 requires that member firms establish and maintain compliance policies and procedures. NASD Rule 3050 and NYSE Rule 407 require the disclosure of outside accounts. NASD Rule 3060 establishes rules regarding gifts and entertainment. And NASD Rule 3030 requires the disclosure of all outside business activities. In the "front lines" of securities trading, broker-dealers and investment advisers face unique challenges in ensuring compliance with securities laws. While educating employees on what constitutes a securities law violation is certainly imperative, other compliance measures should be considered. Here are several areas that merit renewed attention in today's enforcement environment:

- *Be mindful of broker-dealer obligations under Exchange Act § 15(g) and investment adviser obligations under IA Act § 204A.*
- *Establish, maintain and enforce written policies and procedures.* As seen in the *Janney and Buckingham* actions, ineffective or unenforced policies and procedures can be sanctioned.
- *Identify sources of possible material, nonpublic information, develop watch/restricted lists, information barriers and other measures.* Outside directorships, investment banking, and possibly other activities of a multiservice firm create potential conflicts and sources of material nonpublic information that should be identified and monitored.
- *Require disclosure of employee trading and accounts and analyze them for potential issues.* Use pre-clearance and holding periods when warranted.
- *Establish trading surveillance inside and outside the firm.*
- *Conduct regular employee training and obtain certifications of compliance.*
- *Investigate and resolve instances of potentially suspicious activity.*

Conclusion

Insider trading will likely remain an important area for the government in 2012 and beyond. Understanding issues of concern to the SEC and

DOJ can help companies and their personnel comply with the law. While no system is foolproof, insider trading policies and procedures will help a firm prevent violations, protect its franchise, and assist its personnel.

ENDNOTES

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- ³⁹ *In the Matter of David W. Baldt*, Admin. Proc. File No. 3-13887, Initial Decision Release No. 418 (SEC May 20, 2011), available at www.sec.gov/litigation/aljdec/2011/id418rgm.pdf; see also <http://www.sec.gov/litigation/aljdec/2011/33-9210.pdf>.
- ⁴⁰ SEC Press Release No. 2011-188 (Sept. 21, 2011), available at <http://www.sec.gov/news/press/2011/2011-188.htm>.
- ⁴¹ 17 C.F.R. § 240.10b5-1(c)(1)(i)(B)(3).

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