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Life After *Newman*: The SEC May Shift Toward Administrative Proceedings in Insider-Trading Cases

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The fallout from the Second Circuit's monumental insider-trading decision in *United States v. Newman* continues, as federal prosecutors following the Supreme Court's refusal to hear an appeal of the case dropped charges against SAC Capital's Michael Steinberg and five other individuals who had pleaded guilty in connection with the government's prosecution of Newman.[1]

The action by U.S. Attorney Preet Bharara is the latest in a series of setbacks for the government in insider-trading cases following *Newman*. There, the Second Circuit reversed two insider-trading convictions, holding that ''in order to sustain a conviction for insider trading, the Government must prove beyond a reasonable doubt that the tippee knew that an insider disclosed information *and* that he did so in exchange for a personal benefit.''[2] To prove ''personal benefit,'' the government must prove ''a meaningfully close personal relationship that generates an exchange that is objec-

[1] Patricia Hurtado, *SAC Capital's Steinberg Gets Insider Trading Charges Dropped*, Bloomberg Business, Oct. 22, 2015, available at http://www.bloomberg.com/news/articles/2015-10-22/u-s-drops-charges-against-sac-capital-s-michael-steinberg.

[2] *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014).

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tive, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.''[3]

Bharara's deputy, Joon Kim, told Bloomberg earlier this year that the government views the dismissals ''to be largely the extent of the fallout from the Newman decision based on prior insider trading cases.''[4] But a string of *Newman*-related losses in other cases suggests that the government's optimism may be misplaced. Indeed, the government has either dismissed or lost on appeal 14 of 87 convictions for insider trading obtained during a six-year crackdown on insider trading.[5] And in January, following *Newman*, a district court vacated the guilty pleas of five men accused of trading on tips related to IBM's $1.2 billion purchase of SPSS, Inc.[6] The court held that the guilty pleas were not ''sufficient in light of *Newman*'s clarification of the personal benefit and tippee knowledge requirements of tipping liability for insider trading.''[7] Even before *Newman*, the government occasionally lost insider trading cases at trial. For example, in July 2014, a jury acquitted Rajarengan (Rengan) Rajaratnam (the brother of Raj Rajaratnam), and during that same year the SEC lost eight such cases.[8]

Home-court advantage

The upshot is that the Department of Justice and the SEC probably will decline to prosecute tippees where the evidence of their knowledge of the tipper's receipt of a personal benefit is unclear. And, continuing a growing trend in recent years, the SEC may elect to bypass the federal courts altogether by bringing more insider-trading cases administratively, thereby enhancing its home-court advantage. Congress effectively encouraged the SEC to expand the use of cease-and-desist proceedings before its own ALJs by giving the agency authority to impose civil penalties in such proceedings under the Dodd-Frank Act.[9] The head of the SEC's anti-foreign-corruption unit confirmed that ''APs'' were ''the new normal,'' and that ''[j]ust like the rest of the enforcement division, we're moving towards using administrative proceedings more frequently.''[10]

The Commission flexed its administrative muscles by bringing a cease-and-desist proceeding against downstream tippee Jordan Peixoto, whom it charged with illegally shorting Herbalife Ltd. stock based on nonpublic information about an anticipated short-selling campaign against Herbalife.[11] Apparently due to concerns about the viability of its theory of liability, the SEC moved to dismiss the order instituting proceedings within days of the Second Circuit's *Newman* decision, but the decision to bring this case in an administrative forum is consistent with the SEC's expanded use of this process.

Peixoto attracted controversy because, as Judge Rakoff noted, insider trading cases ''previously had only very rarely been brought administratively[.]''[12] In a speech, the judge worried that the agency ''might well be tempted . . . to bring [insider-trading] cases as administrative enforcement actions, and thereby likely avoid the sting of well-publicized defeats.''[13] One downside of such a trend, in his view, ''would be that the law in such cases would effectively be made, not by neutral federal courts, but by S.E.C. administrative judges.''[14]

The home-court advantage, however, doesn't always translate into victory for the Commission. Just last month, Administrative Law Judge Jason S. Patil dismissed insider-trading charges against Joseph C. Reggieri, holding that the SEC failed to meet its burden under *Newman* that Reggieri's tipper received a personal benefit for the tip.[15] But this case may not be indicative of a broader trend.

A more streamlined process. But is it fair?

The SEC has sought to justify its shift toward administrative actions by citing supposed advantages in ''efficiency'' compared with federal trials. Administrative

[3] *Id.* at 452.

[4] Hurtado, *supra* note 1.

[5] *Id.*

[6] *United States v. Conradt*, No. 12 Cr. 887(ALC), 2015 BL 34404, at *1 (S.D.N.Y. Jan. 22, 2015); *see also* Erik Larson, *IBM Insider-Trading Charges to Be Dropped Against Five Men*, Bloomberg Business, Jan. 29, 2015, *available at* http://www.bloomberg.com/news/articles/2015-01-29/ibm-insider-traders-to-have-charges-against-them-dropped. The defendants had settled the SEC's parallel civil cases against them. After their guilty pleas in the criminal case were vacated, they moved to vacate their settlement agreements and consent judgments in the civil case under Federal Rules of Civil Procedure 60(b)(5) and (6). Judge Rakoff denied their motions, holding that ''*Newman* could not, and did not, overrule any binding precedent, nor were the arguments it accepted in any material way novel.'' *SEC v. Conradt*, 309 F.R.D. 186, 188 (S.D.N.Y. July 23, 2015). ''Even if (contrary to the Court's view), *Newman* could be read to materially change the law, relief under 60(b) is not intended to allow one side of a settlement agreement to obtain the benefits of finality while placing the other side at risk that future judicial decisions will deprive them of the benefit of their bargain. When it comes to civil settlements, a deal is a deal, absent far more compelling circumstances than are here presented.'' *Id.* (citation omitted). Judge Rakoff has been skeptical of insider-trading defendants' efforts to leverage *Newman*. *See, e.g.*, *United States v. Whitman*, —- F. Supp. 3d —-, 2015 BL 235778, at *1 (S.D.N.Y. July 22, 2015)(''Whitman now moves pursuant to 22 U.S.C. § 2255 to vacate his conviction and sentence, joining the ranks of defendants who seek to find belated advantage in an overbroad reading of the Second Circuit's recent decision in [*Newman*].'').

[7] *Conradt*, 2015 BL 34404, at *1.

[8] See *SEC v. Obus*, 693 F.3d 276 (2d Cir. 2012); Final Judgment, *SEC v. Moshayedi*, No. 8:12-CV-01179-JVS-ANX (C.D. Cal. June 11, 2014), ECF No. 473; *SEC v. Schvacho*, 991 F. Supp. 2d 1284 (N.D. Ga. 2014); *SEC v. Yang*, 999 F. Supp. 2d 1007 (N.D. Ill. 2013); *SEC v. Steffes*, 805 F. Supp. 2d 601 (N.D. Ill. 2011); *SEC v. Wyly*, 950 F. Supp. 2d 547 (S.D.N.Y. 2013); *SEC v. Bauer*, 723 F.3d 758 (7th Cir. 2013); and *SEC v. Arrowood*, No. 1:12-CV-82-RWS, 2013 BL 216543 (N.D. Ga. Aug. 7, 2013).

[9] Wall Street Reform and Consumer Protection (Dodd-Frank) Act § 929P, 15 U.S.C. § 77h-1(g) (2010).

[10] Jed S. Rakoff, Judge, U.S. District Court for the Southern District of New York, Keynote Address at the PLI Securities Regulation Institute (Nov. 5, 2014)(''Rakoff Speech'')(citing 2013 comments by Andrew Ceresney, Director of the SEC's Division of Enforcement)(citing 2013 comments by Kara Brockmeyer).

[11] *In re Peixoto*, File No. 3-16184 (Sept. 30, 2014).

[12] Rakoff Speech, *supra* note 10.

[13] *Id.*

[14] *Id.*

[15] *In the Matter of Gregory T. Bolan, Jr., and Joseph C. Ruggieri*, Exchange Act Release No. 877, 2015 WL 5316569, at *49 (Sept. 14, 2015).

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proceedings *are* more efficient to the extent that they ''involve much more limited discovery than federal actions, with no provision whatsoever for either depositions or interrogatories. Similarly, at the hearing itself, the Federal Rules of Evidence do not apply and the SEC is free to introduce hearsay'' and other forms of evidence allowable under the Commission's more relaxed Rules of Practice.[16] Even the SEC's own General Counsel acknowledged that it was fair for attorneys to question whether the SEC's rules for administrative proceedings were still appropriate, with the rules last revised ''quite some time ago.''[17] ''Further still, there is no jury, and the matter is decided by an administrative law judge appointed and paid by the S.E.C. It is hardly surprising in these circumstances that the S.E.C. won 100% of its internal administrative hearings in the fiscal year ending September 30, 2014, whereas it won only 61% of its trials in federal court during the same period.''[18]

The defense bar, perhaps predictably, has complained about this trend, arguing that defendants are far less likely to receive a fair trial on the SEC's home turf.[19] Statistical analysis shows that they may have a point.[20] And Lillian McEwan, a former ALJ, seemed to confirm these fears, speaking publicly of an environment in which ''the burden was on the people who were accused to show that they didn't do what the agency said they did.''[21]

Increasingly, parties are challenging the legality of administrative proceedings under the SEC's framework. One Georgia district court even took the unusual step of enjoining an SEC proceeding based on the defendant's Appointments Clause challenge to appearing before an ALJ.[22] Dallas Mavericks owner Mark Cuban, who in 2013 famously defeated insider-trading charges before a federal jury in Texas, has taken up the banner, filing a friend-of-the-court brief in an appeal of the Georgia case.[23] Cuban wrote that the SEC's procedures ''are woefully inadequate in complex securities fraud cases, such as insider trading cases[.]''[24]

In response to such criticisms, the SEC recently proposed changes to its Rules of Practice that, among other things, would allow defendants limited depositions (three for solo defendants; five for cases with multiple defendants).[25] Some say that these changes, while welcome, don't go nearly far enough, and in certain ways provide ''goodies'' for the benefit of the SEC's Division of Enforcement that, in the words of one critic, ''achieve no meaningful goal other than to make it easier for the Division . . . to win.'' One such ''goody,'' for example, is the proposed requirement that respondents plead not only affirmative defenses (as required by the Federal Rules of Civil Procedure) but also theories for ''avoidance of liability or remedies.'' Unlike under the Federal Rules, this rule would effectively require respondents to identify instances in which they plan to introduce evidence counteracting elements on which the SEC has the burden of proof.[26] In light of this and other concerns, it is doubtful the proposed rule changes will be sufficient to satisfy concerns about the expanded use of insider trading cases brought as administrative proceedings.

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[16] Rakoff Speech, *supra* note 10.

[17] Daniel Wilson, *SEC Administrative Case Rules Likely Out Of Date, GC Says,* Law 360, June 17, 2014, *available at* http://www.law360.com/banking/articles/548907.

[18] Rakoff Speech, *supra* note 10.

[19] *See, e.g.*, Gretchen Morgenson, *At the S.E.C., a Question of Home-Court Edge*, New York Times, Oct. 6, 2013, at BU1, *available at* http://www.nytimes.com/2013/10/06/business/at-the-sec-a-question-of-home-court-edge.html. *See also*, *Gupta v. SEC*, 796 F. Supp. 2d 503, 503 (S.D.N.Y. 2011)(The SEC, ''having previously filed all of its Galleon-related insider trading actions in this federal district[,] decided it preferred its home turf.'').

[20] *See* Jean Eaglesham, *SEC Wins With In-House Judges*, Wall Street Journal, May 6, 2015, *available at* http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803 (reporting that from October 2010 through March 2015, the SEC ''won against 90% of defendants before its own judges in contested cases,'' versus a 69% success rate in federal courts over the same period).

[21] *Id.*

[22] *Hill v. SEC*, —- F.3d —-, 2015 BL 182985, at *19 (N.D. Ga. June 8, 2015).

[23] Brief of Mark Cuban as Amicus Curiae Supporting Plaintiff-Appellee, 11th Cir. (No.15-12831).

[24] *Id.*

[25] Amendments to the Commission's Rules of Practice, Release No. 34-75976, File No. S7-18-15 (to be codified at 17 C.F.R. pt. 201), *available at* http://www.sec.gov/rules/proposed/2015/34-75976.pdf.

[26] *Why the SEC's Proposed Changes to Its Rules of Practice Are Woefully Inadequate – Part I,* Securities Daily, Oct. 8, 2015, *available at* http://securitiesdiary.com/2015/10/08/why-the-secs-proposed-changes-to-its-rules-of-practice-are-woefully-inadequate-part-i/.