Compliance Clinic

Insider Trading Sentences Get Extra Bite

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In response to a Dodd-Frank Act directive, the **U.S. Sentencing Commission** has promulgated amendments increasing the recommended sentences for defendants convicted of federal insider trading crimes. Under the proposed new regime, making "considered" or "calculated" efforts to trade on inside information—as distinguished from "opportunistic" instances of insider trading—will trigger higher sentencing guidelines offense levels and, likely, longer prison terms.

Additionally, defendants who have abused a position of "special" trust in committing the offense, or have used a position as a specially skilled employee to facilitate the crime (a group that expressly includes hedge fund professionals and any other worker who regularly participates in "creating, issuing, buying, selling, or trading securities or commodities"), will also face extended possible prison terms.

Unless Congress overrules the amendments, which is unlikely, the changes take effect Nov. 1, 2012.

The amended guidelines, which directly expand recommended sentences for hedge fund employees and investment managers, respond to prosecutors' heightened interest in these professions. The best way for these firms to avoid the embarrassment and reputational damage of an investigation into insider trading is to make sure, through a strong compliance program, that their employees do not engage in prohibited activities.

In practice, the sentencing guidelines promulgated by the Sentencing Commission and approved by Congress supply a formula that is meant to standardize sentencing for federal judges across the country. The guidelines take into account both the severity of the crime (the "offense level") and the criminal history of the convicted defendant. The guidelines are advisory, not mandatory, though judges must use them as a starting point in imposing any criminal sentence.

By drastically increasing offense levels—and, indirectly, the sentencing range—the insider trading amendments stand to add substantial prison time to those convicted of insider trading offenses. In particular, the offense level will be significantly higher for insider trading involving "an organized scheme." The Commission defines such schemes as "considered, calculated, systematic or repeated efforts to obtain and trade on inside information, as distinguished from fortuitous or opportunistic instances of insider trading." As an illustrative example, this new enhancement for a first-time offender will result in a baseline sentencing range of 15-21 months, up from 0-6 months.

Since the Commission already prescribes an offense level increase for defendants who abuse a position of special trust, the recent amendments will extend this to cover defendants with "special" professional skills who use their "employment in a position that involved regular participation or professional assistance in creating, issuing, buying, selling or trading securities or commodities… to facilitate significantly the commission or concealment of the offense." The Commission has expressly included hedge fund professionals and lawyers in this group, assuming the defendant's employment in that position was used to facilitate the crime. These additional offense level points can correspond to a recommended six months to more than two years of extended prison time, even for an offender with a previously clean record. Taken together, the pair of insider trading sentencing amendments indicates that a financial professional accused of anything but opportunistic insider trading will face several additional years in a federal penitentiary.

> **INSIDER TRADING SENTENCES:**
> **Key Points**
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> - Increase in recommended prison time for using an "organized scheme" to engage in insider trading, defined as "considered, calculated, systematic, or repeated efforts to obtain and trade on inside information"
> - Enhanced prison terms for financial professionals, lawyers and other skilled employees who use their employment to facilitate insider trading crimes

The Commission has also passed a third amendment that stands to impact sentences for insider trading. In all financial fraud cases, the sentencing guidelines provide for enhancements based on the amount of loss involved in the offenses. The current guidelines calculate the loss as the greater of "actual" or "intended" loss—a number that can be significant in any insider trading case that is predicated on a widely-traded security. In response to criticisms of this provision, the amendment proposes a modified calculation: The difference between the average price of the security during the period that the fraud occurred and the average price of the security during the 90-day period after the market learned of the fraud, multiplied by the number of shares outstanding. However, the amendment specifically articulates that judges should be cognizant that even this calculation may overstate the seriousness

of the offense, particularly in instances when external market forces caused changes in stock value.

A More Aggressive Approach

Overall, the amendments stand to bring about a major change in approach to insider trading penalties; a change prompted by both Congress and the **U.S. Department of Justice**. The political branches have, in short, made plain that public faith in financial markets is of paramount importance, and that there is a need for increased emphasis on enforcement in this area. Indeed, in advocating for amendments to the guidelines, prosecutors have said that higher sentences are key to ensuring "consistently tough and fair outcomes."

But judges have not demonstrated that they find the extant insider trading penalties inadequate. The Commission's own statistics for its fiscal year 2011 (ending Sept. 30) show that of the 27 defendants sentenced under the insider trading guidelines during that period, 21 received a below-guidelines sentence—and none received a sentence above the guidelines range.

So while past practice suggests that judges have not found the existing insider trading guidelines insufficient, the proposed amendments will necessarily have a substantial impact in the field. First, although strict adherence to the sentencing guidelines is not mandatory, federal district judges are required to at least calculate and consider the guidelines sentencing range before imposing a sentence. Judges have to explain the reasonableness of any downward departure, and the further below the guidelines range, the better the explanation must be to survive appeal. As the ranges go up, it stands to reason that so too will the minimum below-guidelines sentence a judge would be willing to render.

Second, regardless of culpability, a financial professional accused of insider trading will face increased exposure, ratcheting up the government's leverage and possibly altering the plea calculus. And, of course, the background to these amendments is Congress and the DoJ, which have given notice that they do not view insider trading as a victimless crime.

To be sure, the sentencing amendments do not expand criminal liability for insider trading: To secure a conviction, the government must still prove beyond a reasonable doubt that the defendant willfully misappropriated confidential, material and nonpublic information for securities trading purposes, in breach of a trust or confidence. But the amendments, which signal an ever-expanding political crackdown on insider trading, do give cause for companies to review with employees which particular behaviors are prohibited. Companies should also emphasize with skilled workers that they could stand to face increased punishment for insider trading crimes. Hedge funds and investment management firms—upon which the amendments shine a spotlight—must be particularly diligent to avoid a costly government investigation and any resulting damage to reputation.

COMPLIANCE CHECKLIST:

- ▲ Revamp compliance programs in light of more aggressive enforcement efforts and stiffer penalties that are aimed particularly at hedge funds and investment management firms
- ▲ Review with all employees behavior that is prohibited by federal insider trading laws
- ▲ Emphasize to skilled staff their increased potential exposure to incarceration

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