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Insider Trading: Making Punishment Fit the Crime

Under the federal Sentencing Guidelines, an insider trading defendant's sentence is primarily calculated based on the "gain resulting from the offense."

But exactly when does the offense of insider trading begin and end for sentencing purposes?

In October, the U.S. Court of Appeals for the Eighth Circuit sitting en banc held that the proper measure of gain should be the total dollar value obtained by the defendant on all transactions involving the securities in question. In so ruling, the Eighth Circuit split with at least one other circuit, which had held that the proper measure should be limited to those gains that occurred before the market finished reacting to the information misused by the defendant.

The Eighth Circuit's methodology, part of the current trend of stiff sentences in securities cases, could lead to widely disparate punishments for similarly situated defendants whose conduct is essentially identical. Such disparities contravene the intent of the guidelines, which were supposed to promote uniformity in sentencing, particularly for white-collar offenders.

When confronted with this issue in the future, courts should decline to adopt the Eighth Circuit's approach.

The *Mooney* Case

Michael Alan Mooney was the vice president of underwriting for United Healthcare Corp., a large health care management service company. In the spring of 1995, United entered into negotiations with MetraHealth, another health insurance company, regarding a possible acquisition by United. Mr. Mooney attended a series of due diligence meetings at which he had access to Metra's confidential financial information. Shortly after the meetings, Mr.

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Mooney sold a substantial number of shares of United stock, which he had recently purchased through an employee stock option plan, and then promptly used the proceeds to purchase $258,283 worth of call options in United stock. These options gave him the right to purchase

> *The Eighth Circuit said the measure of gain should be the total obtained on the securities transactions. [But] this could mean disparate punishments for essentially identical acts.*

40,000 shares of United stock at $35 a share in the upcoming months of September, December, and January.

On June 21, 1995, shortly after Mr. Mooney had purchased the call options, a *New York Times* article reported that United was in advanced negotiations with Metra. On June 26, 1995, United publicly announced an agreement to acquire Metra. In July and October, Mr. Mooney sold his call options, generating a total return of $532,482.

Mr. Mooney was subsequently convicted by a jury on securities fraud, mail fraud, and money-laundering charges in connection with his participation in a scheme to defraud United and its shareholders through his sale of United stock and his purchase of call options while in possession of material nonpublic information.

In calculating Mr. Mooney's sentence, the district court turned to the United States Sentencing Guidelines (USSG) §2B1.4, which provides offense level enhancements for the "gain resulting from the offense." The commentary to §2B1.4 states that "[b]ecause the victims and their losses are difficult if not impossible to identify, the gain, i.e., the total increase in value realized through trading in securities by the defendant…is employed instead of the victims' losses." Applying that commentary, the district court calculated the gain from the offense to be $274,199, representing the total amount realized from Mr. Mooney's sale of the United call options ($532,482) minus the amount he used to purchase the options ($258,283). The court then sentenced Mr. Mooney to 42 months in prison, roughly the middle of the applicable guidelines range.

On appeal, Mr. Mooney argued that gain should not be determined from the proceeds he ultimately received on the sale of the options, principally relying on the reasoning in *SEC v. MacDonald,* 699 F2d 47 (1st Cir. 1983), a civil insider trading case.

In *MacDonald,* a corporate officer purchased company shares while in possession of nonpublic information. The question before the U.S. Court of Appeals for the First Circuit was whether the defendant should be required to disgorge the entire profits from the sale of those securities or only the "amount representing the increased value of the shares at a reasonable time after the public dissemination of the information." *MacDonald* held that defrauded sellers could recover only the amount they lost before they reasonably could have obtained access to the material nonpublic information at issue.

MacDonald also provided a formula for lower courts to make this calculation. Specifically, the court stated that "in determining what was a reasonable time after the inside information had been generally disseminated, the court should consider the volume and price at which [the] shares were traded following the disclosure, insofar as they suggested the date by which the news had been fully digested and acted upon by investors."

Using this "market absorption approach," Mr. Mooney argued that the gain from his offense should be calculated solely using the increase in

market value of the call options in the period before Mr. Mooney's inside information became public until it was later absorbed by the market. Mr. Mooney contended that the market would have absorbed the news of the acquisition by June 28, two days after the announcement of the merger, when the call options were valued at $308,750. According to Mr. Mooney, any gain from his purchase of the call options after this date would be based purely on fluctuations in the market that could not be attributed to his misuse of inside information. Under Mr. Mooney's proposed formula, his gain would be $50,467, resulting in a sentencing range of 24-30 months.

In *United States v. Mooney,* 425 F3d 1093 (8th Cir. 2005), the Eighth Circuit, sitting en banc, rejected his argument. Adhering to the language of the commentary to USSG §2B1.4, the court noted that "[t]he guideline employs the concept of gain resulting from the offense as an alternative measure of loss because of the difficulty of ascertaining the victims and their losses for such offenses." The court declined to incorporate *MacDonald's* "imprecise" civil standard into the interpretation of a criminal sentencing guideline, arguing that the civil recovery theory was remedial in nature, in contrast to the goal of criminal punishment. The court further held that Mr. Mooney's use of June 28 as the date he claimed the market would have absorbed the inside information was problematic given that information about Metra, a privately held company, was not publicly available, raising the issue of "how quickly the stock market could learn and absorb material information about the value of United's acquisition." By contrast, the court found, "[t]he use of actual sales to calculate gain provides a clear and coherent bright-line rule, eliminating the need for extensive factfinding to try to determine when the market has absorbed nonpublic information." Accordingly, the Eighth Circuit affirmed the district court's decision that "gain" was the total profit actually derived from the defendant's securities transactions.

The Dissent

In a colorful dissenting opinion joined by two other judges, Judge Myron Bright argued that the majority's interpretation of §2B1.4 "envisions that the punishment depends on the gyrations of the stock market," which in turn would result in "unequal sentences for equal crimes."

First, the dissent took issue with the majority's reading of §2B1.4. While the majority focused on the term "gain" in interpreting the commentary, the dissent pointed out that the guideline commentary had ignored the phrase "resulting from the offense" which followed the term "gain." The offense, the dissent compellingly argued, was not the purchase of stock itself, but rather the use of a manipulative or deceptive contrivance in connection with the purchase. Thus the "gain resulting from the offense" is not the gain resulting from the purchase but rather, "the gain resulting from the deception."

The dissent cited the example of three hypothetical insiders (Larry, Moe, and Curly) who each separately, with the same insider's knowledge, buy 1,000 shares of stock at a price of five dollars per share. Larry sells his shares on the day on which the insider information is made public, yielding a gain of $10,000. Moe and Curly hang onto their shares. Three months later the stock price has soared to $50 per share. Moe sells, pocketing gains of $45,000. Curly does not sell for a substantial period of time. Six months later the market crashes, the stock price plummets, and Curly sells out at two dollars per share.

Under this scenario, Larry, Curly, and Moe committed the same crime, with the same effect on the market. But using the majority's methodology, Larry would receive a two-level enhancement for a $10,000 gain, Moe a six-level enhancement for a $45,000 gain, and Curly no increase at all because he actually lost money. If these increases were applied to the base offense level, they would translate into additional prison time of six months for Larry, 22 months for Moe, and no additional time for Curly. The dissent concluded that it was simply unreasonable to apply the guidelines in a way that would lead to such disparate sentences for similarly situated defendants whose actual conduct was identical.

Just weeks after the *Mooney* decision, the U.S. Court of Appeals for the Fifth Circuit issued an opinion in a securities fraud case, albeit not an insider trading case, in which it found abundant reason for using civil liability theory to interpret and apply a criminal sentencing guideline.

In *United States v. Olis,* 04-20322 (5th Cir., Oct. 31, 2005), the defendant, a senior executive at Dynegy Corp. was convicted of mail, wire, and securities fraud charges in connection with his role in Project Alpha, a scheme to borrow $300 million and make it appear to the outside world as if the money had been generated by Dynegy's business operations. When the scheme was exposed, and Dynegy was forced to restate its cash flows, the stock price was adversely affected.

At sentencing, the district court, applying the fraud guideline, USSG §2B1.1, had to determine the "actual loss," which is defined in the guidelines as "the reasonably foreseeable pecuniary harm that resulted from the offense." The district court found that Mr. Olis should be held responsible for the entire $105 million stock market decline suffered by a single large shareholder, the University of California Retirement System (UCRS), based on an oversimplified analysis of the stock price at the time of purchase and sale by UCRS. Consequently the court enhanced the defendant's offense level by 26 levels, and sentenced him to 292 months in prison.

The Fifth Circuit vacated the sentence, noting that the district court had failed to consider, much less quantify, other significant extrinsic causes of the UCRS loss, such as the fact that UCRS had purchased most of its Dynegy holdings at the top of the market, or the fact that much of the drop in price occurred either before Project Alpha was revealed, or long after the restatement was announced.

In contrast to the Eighth Circuit, the Fifth Circuit specifically approved of the methodology used in calculating damages in a civil securities fraud case as an appropriate measure in a criminal case "both because it furnishes the standard of compensable injury for securities fraud victims and because it is attuned to stock market complexities." The Fifth Circuit observed that "there is no loss attributable to a misrepresentation unless and until the truth is subsequently revealed and the price of the stock accordingly declines. Where the value of a security declines for other reasons, however, such decline, or component of the decline, is not a loss attributable to the misrepresentation."[1]

Conclusion

Ultimately, *Mooney* simply fails to consider the compelling need, particularly after the Supreme Court's decision in *U.S. v. Booker* striking down the mandatory guidelines regime, to avoid unwarranted sentence disparities among similarly situated defendants. The Second Circuit has yet to squarely address the issue of calculating gain under §2B1.4.[2] In this era of ever-increasing penalties for white-collar crimes it may be tempting for courts to take the easy way out and follow the Eighth Circuit. But while the Eighth Circuit's bright-line rule is certainly easier to apply, ease is a poor justification for countenancing inequitable results. A criminal defendant's punishment should be based on the seriousness of his or her conduct, not on the vagaries of the market.

1. The recent decision in *Dura Pharmaceuticals Inc. v. Broudo,* 125 SCt 1627, (2005) offers additional insight into the use of the civil market absorption theory. In *Dura Pharmaceuticals,* the Supreme Court held that when a stock goes down after an earlier misrepresentation, "that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions or other events, which taken separately or together account for some or all of that lower price." Id. at 1632. The Court added that "[o]ther things being equal, the longer time between purchase and sale, the more likely this is so." Id.

2. In *United States v. Cusimano,* 123 F3d 83 (2d Cir. 1997), the defendant challenged his insider trading conviction on the grounds that there was insufficient evidence that the information he possessed about a proposed acquisition was non-public. The defendant claimed the information at issue was essentially public because it was already fully "impounded" in the price of the stock. The Second Circuit rejected that argument. In addition, the court held that the profits made by other tippees in an insider trading scheme were properly attributable to a defendant in calculating "trading gains" for sentencing purposes under USSG §2F1.1, a precursor to §2B4.1. While the defendant on appeal challenged the district court's aggregation of his gains with those of the tippees, the defendant did not raise, and the court did not confront, the issue of how "trading gains" should be calculated in the first place.

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