Cleveland State Law Review

Volume 61 | Issue 1 Article 7

2013

The Blindsided Insider: Insider Trading Liability for Supervising a Rogue Trader

Adam Felsenthal

Recommended Citation

Adam Felsenthal, *The Blindsided Insider: Insider Trading Liability for Supervising a Rogue Trader* , 61 Clev. St. L. Rev. 167 (2013)
available at https://engagedscholarship.csuohio.edu/clevstlrev/vol61/iss1/7

THE BLINDSIDED INSIDER: INSIDER TRADING LIABILITY FOR SUPERVISING A ROGUE TRADER

ADAM FELSENTHAL[*]

ABSTRACT

In the past few years, federal prosecutors and the Securities and Exchange Commission (SEC) have engaged in the widest-ranging and most successful probe of insider trading ever, focusing in particular on investment professionals. However, the government has failed to charge anyone on the basis of supervisory liability, essentially an accusation of failing to notice and stop illicit trading done under one's supervision. This Article discusses all of the potential ways in which prosecutors could bring such a charge, ranging from SEC administrative liability to civil and criminal charges. Through the lens of a theoretical situation in which an "innocent bystander" manager has failed to stop a "rogue trader" from trading on the basis of material non-public information, it proposes answers for some of the unanswered questions in this area of the law, and assesses the practical potential for the government bringing any of the above charges against such a manager.

[*] J.D., New York University School of Law, 2010; B.S. Yeshiva University, 2004. The opinions expressed herein are solely those of the author.

INTRODUCTION

One of the greatest nightmares of any investment professional is of being accused of insider trading. Recently, this has become closer to reality. The Department of Justice, the Federal Bureau of Investigation (FBI), and the Securities and Exchange Commission (SEC) (collectively, the "government") have been engaged in a broad investigation of insider trading over the past few years. Insider trading involves the trading of a public company's stock on the basis of material non-public information. Public corporations must disclose material information to all investors or potential investors at the same time. This five-year investigation, dubbed "Perfect Hedge," is primarily run by prosecutors in the U.S. Attorney's office in the Southern District of New York, the FBI's New York office, and the Securities and Exchange Commission.

One theory of liability that has not yet been utilized in the insider trading probe is "control person" liability or liability arising from a manager's supervision of an employee or firm that has violated the securities laws, even if the manager him or herself has not committed a crime. However, the government has indicated that it will step up this area of enforcement. Merri Jo Gillette, Director of the Chicago Regional Office of the Securities and Exchange Commission, recently stated that the SEC "is now bringing more secondary liability cases."[1] This Article analyzes the

[1] Noam Noked, *An "Entrepreneurial" and Restructured SEC Pledges Proactive Enforcement*, HARV. L. SCH. FORUM ON CORPORATE GOVERNANCE & FIN. REGULATION, http://blogs.law.harvard.edu/corpgov/2012/04/05/an-entrepreneurial-and-restructured-sec-pledges-proactive-enforcement/ (last visited Jan. 26, 2013).

potential civil and criminal "control person" or supervisory liability of a manager arising from violations of the securities laws committed by his or her subordinate employees. In particular, this Article focuses on a theoretical situation. In this situation, a "rogue trader" has knowingly traded on the basis of material non-public information. The trader's "innocent bystander" manager has had contact with the trader but is unaware of the trader's illicit activities. The Article primarily focuses on the prevailing law in the Second Circuit, in addition to SEC administrative law.[2] It begins by discussing briefly two global issues, applicable to any assertion of control person liability, regarding the definition of a "control person" and the power of such a person to delegate responsibility. Then, the potential claims are discussed. Although control person charges arising out of insider trading are extremely rare, this Article discusses the potential bases for liability of SEC civil liability under section 20(a) and 21A (the Insider Trading and Securities Fraud Enforcement Act) of the Exchange Act, sections 203 and 204A of the Investment Advisers Act, primary insider trading liability under (1) the "conscious avoidance," doctrine, (2) as an aider and abettor, or (3) under common law respondeat superior principles, and finally potential control-person related criminal liability.

This Article concludes that the threat of traditional control person liability under 21A (the most likely claim) or other bases for liability will depend on how much the manager participated in the fraud or have access to sufficient red flags to alert him or her to any potential wrongdoing on the part of the rogue trader, and on the compliance systems in place to protect against such wrongdoing. The SEC would have a better case for administrative liability as there is a lower bar for the level of misconduct required on the part of the control person, but such a case could not be brought in federal court and in any case would turn on the level of the compliance program of the firm in question. In addition, such a manager faces little threat from primary liability as the respective bars for a mental state (under the "conscious avoidance" doctrine) or required action on the part of the control person (under aiding and abetting liability) are too high to warrant concern. Finally, federal prosecutors would have essentially no basis for criminal liability against the manager.

ANALYSIS

I. GLOBAL ISSUES IN CONTROL PERSON LIABILITY

A. Definition of "Control Person"

To assert control person liability against a manager, prosecutors would first have to allege that the manager "controlled" the firm and/or an individual at the firm who violated the securities laws. In sum, it appears fairly clear that most manager would

[2] Many hedge funds are located in the District of Connecticut or the Southern District of New York. In addition, essentially all of the most prominent insider trading charges against hedge funds have been brought in the Southern District of New York. As a result, this Article assumes that any claims/charges would be brought in the Second Circuit. However, it should be noted that a provision in "Dodd-Frank" grants the SEC power to serve subpoenas anywhere in the U.S. for claims brought under several statutes including the Exchange Act. Pub. L. No. 111-203, § 929E (2010). One source has suggested that this provision may encourage the SEC to file suits in circuits with friendlier pleading standards, provided that it can show proper venue. *See* Zachary S. Brez, R. Daniel O'Connor & Joseph G. Cleeman, *Control Person Liability*, 5 BLOOMBERG L. REPS. 17 (2011).

be considered a control person, due to the broad nature of the tests used by both the regulatory guidance and relevant case law.

1. Statutory Definition and Regulatory Guidance

A control person for purposes of the securities laws statutorily includes: "Every person who, directly or indirectly, controls any person liable."[3] Because the statute itself does not define what it means to "control any person," the SEC provided clarification in Rule 405: "control means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."[4] While there is no formal definition of control beyond the above, the definition provided in the Uniform Application for Broker-Dealer Registration with the SEC may shed some light on "control":

> The power, directly or indirectly, to direct the management or policies of a company, whether through ownership of securities, by contract, or otherwise. Any person that:
>
> (i) is a director, general partner or officer exercising executive responsibility (or having similar status or functions);
> (ii) directly or indirectly has the right to vote 25% or more of a class of a voting security or has the power to sell or direct the sale of 25% or more of a class of voting securities; or
> (iii) (iii) in the case of a partnership, has the right to receive upon dissolution, or has contributed, 25% or more of the capital, is presumed to control that company.[5]

However, this latter definition is binding only for the purpose of Form BD.

2. Case Law

Some courts cite directly to the SEC guidance when determining who is a controlling person. "Most, however, find alternative reasoning in their determination of control and ignore the SEC's definition altogether."[6] In the Second Circuit, a plaintiff must plead facts which "support a reasonable inference that [defendants] had the potential power to influence and direct [] activities."[7] This is a broad test; as explained by one court, "'Control' for purposes of control person liability . . .

---

[3] 15 U.S.C.A. § 78t(a) (West 2012).

[4] 17 C.F.R. 230.405(f) (2012).

[5] Sec. & Exch. Comm'n, Uniform Application for Broker-Dealer Registration (Form BD), *available at http*://www.sec.gov/about/forms/formbd.pdf (last accessed Mar. 20, 2013).

[6] Laura Greco, *The Buck Stops Where?: Defining Controlling Person Liability*, 73 S. CAL. L. REV. 169, 173 (1999). While most of the cases discussed below are in the specific context of an alleged violation of section 20(a) of the Exchange Act, the various avenues for liability as a control person all use this body of law as a model for defining a control person.

[7] Sloane Overseas Fund Ltd. v. Sapiens Int'l Corp., 941 F. Supp. 1369, 1378 (S.D.N.Y. 1996); Food & Allied Serv. Trades Dep't, AFL-CIO v. Millfeld Trading Co., 841 F. Supp. 1386, 1392 (S.D.N.Y. 1994).

requires only some indirect means of discipline or influence short of actual direction."[8] As a result, generally control will be imputed if de facto day-to-day control can be demonstrated regardless of the formal title. In this regard, courts in the Second Circuit have held people with a wide variety of positions and circumstances liable as control persons of an organizational defendant, including inside or outside directors;[9] persons with a substantial equity interest;[10] persons with a right to appoint directors;[11] persons with preemptive rights over a firm and an ability to control public communication;[12] makers or signers of required SEC statements;[13] executive officers[14]; persons with a family relationship to a controlling persons;[15] persons with the ability to approve statements or SEC filings;[16] and persons who directed corporation with regards to specific primary violations at issue, despite not being a director or senior executive.[17]

One specific issue for many firms which include an array of interconnected legal entities is whether a manager would be considered a control person of any of the affiliated entities. While there are not that many decisions specifically within the Second Circuit on this issue, generally courts simply consider whether the person had in fact meaningful control over the other entities, regardless of technical structuring. For example, the following principles apply:

---

8 *In re* Bausch & Lomb, Inc. Sec. Litig., 941 F. Supp. 1352, 1368 (W.D.N.Y. 1996).

9 Salit v. Stanley Works, 802 F. Supp. 728 (D. Conn. 1992) (reasoning that directors are found necessarily to have some indirect means of influence over their corporation and its management, and that the conclusion is inescapable that persons acting as directors are in control of the corporation); *In re* Philip Servs. Corp. Sec. Litig., 383 F. Supp. 2d 463 (S.D.N.Y. 2004) (the court found the directors liable in part because they signed a registration statement for the securities at issue).

10 Ind. Energy Holdings PLC Sec. Litig., 154 F. Supp. 2d 741 (S.D.N.Y. 2001) (stating that defendants had "substantial equity" in corporation and had signed registration statements in question); *In re* Health Mgmt., Inc. Sec. Litig., 970 F. Supp. 192 (E.D.N.Y. 1997) (finding control liability even against wife of founder and holder of 11.4% equity interest; wife was also a director).

11 Griffin v. PaineWebber, Inc., No. 99 Civ. 2292(VM), 2001 WL 740764 (S.D.N.Y. June 29, 2001).

12 *Id.*

13 *E.g.*, Robbins v. Moore Med. Corp., 788 F. Supp. 179 (S.D.N.Y. 1992).

14 Neubauer v. Eva-Health USA, Inc., 158 F.R.D. 281 (S.D.N.Y. 1994) (finding control liability not only against husband who was Chairman, CEO, and Founder, but even against wife who was merely Corporate Secretary).

15 *In re* MTC Elec. Techs. S'holders Litig., 898 F. Supp. 974 (E.D.N.Y. 1995) (involving director of marketing who was also son and nephew of two most powerful corporate officers); *In re Health Mgmt.*, 970 F. Supp. 192; *Neubauer*, 158 F.R.D. 281.

16 Food & Allied Serv. Trades Dept., AFL-CIO v. Millfeld Trading Co., 841 F. Supp. 1386 (S.D.N.Y. 1994).

17 *In re* Adler, Coleman Clearing Corp., 469 F. Supp. 2d 112 (S.D.N.Y. 2007).

- An officer of one of several related companies with integrated operations can be considered a control person over all of the companies.[18]
- An officer of a parent can be considered a control person over a subsidiary.[19]
- An officer of a subsidiary can be considered a control person over a parent when allegations involved misconduct relating to the sub.[20] However, the sub's officer is not considered a control person over the parent generally.[21]
- Directors of a corporation can be considered control persons of partnerships that were major shareholders of the corporation.[22]

3. Insider Trading Context

Although charges against individuals for controlling persons liability in conjunction with insider trading are extremely rare, the available case law indicates that the definition used in this context similarly places greater emphasis on whether a person had de facto control than a particular title. In the case of *SEC v. Haddad*, for example, the SEC alleged that someone was a control person of an employee of a securities firm, even though he was not in any way "formally associated" with the firm, because he "shared control over [the firm's] personnel and operations with his brother Jeffrey Brooks" who was the President and CEO of the firm.[23]

In sum, it appears fairly clear that anyone with de facto control over a firm's affairs is considered a control person over that firm.

B. Delegation

Another global issue is whether a manager could avoid all control person-based liability if he or she is not directly responsible for supervising the trading of subordinates, through designating sub-managers between him or her and the trader in question. In general, control person-related liabilities are "not limited to hands-on managers; they also apply to top executives."[24] However, although delegation does

[18] Poptech, L.P. v. Stewardship Credit Arbitrage Fund, LLC, 792 F. Supp. 2d 328 (D. Conn. 2011) (officer had served as chief credit officer, managing director, and later president of one of three related corporations, that the three corporations were operated as one entity, that officer exercised a degree of control over the content of information that investors were getting from at least one of the corporations).

[19] Wells v. Monarch Capital Corp., No. 91-10575-MA, 1991 WL 354938 (D. Mass. Aug. 23, 1991) (noting the officer's control over the subsidiary's financial statements).

[20] *In re* Reliance Sec. Litig., 91 F. Supp. 2d 706 (D. Del. 2000).

[21] Copland v. Grumet, 88 F. Supp. 2d 326 (D.N.J. 1999); *In re* Cooper Sec. Litig., 691 F. Supp. 2d 1105 (C.D. Cal. 2010).

[22] *In re* SmarTalk Teleservices, Inc. Sec. Litig., 124 F. Supp. 2d 527 (S.D. Ohio 2000).

[23] Sec. & Exch. Comm'n v. Haddad, S.E.C. Release No. 13473, 1992 WL 383778, at *5 (Dec. 17, 1992).

[24] THOMAS L. HAZEN & JERRY W. MARKHAM, 23A BROKER-DEALER OPERATIONS UNDER SECURITIES AND COMMODITIES LAW § 11:4 (2010); *see also In re* David D. Grayson, Exchange Act Release No. 34-33298, 1993 WL 518406 (Dec. 8, 1993) (noting that the SEC has

not provide an automatic shield from liability, the case law indicates that delegation can provide a basis for a defense that the top manager did not know or have reason to believe that the delegated-to party was not properly supervising the employee. In one case, the court rejected a defense that the ultimate supervisor properly delegated responsibility regarding a manager's trading.[25] The court reasoned that the control person "knew or should have known" that the lower supervisors "were not adequately carrying out those supervisory responsibilities" because he knew that they did not perform particular reviews of the trader's positions, and that in any case much of the trader's volume was unauthorized without any controls for the middle managers to be able to monitor it.[26] On the other hand, the court accepted the interlocking compliance system set up by the defendant in *Piper*, which provided for checks and balances and each piece of which had precise responsibilities, as a satisfactory use of the power to delegate.[27] The law thus indicates that deciding whether a manager properly delegated will depend on the robustness of the compliance department of the firm in question and the strength of the monitoring of that department on the firm's traders.

II. SECTION 20(A) OF THE EXCHANGE ACT

A. Statutory Background

Section 20(a) of the Exchange Act states that:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable . . . unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.[28]

This statute renders a person who controls others jointly and severally liable for violations of any provision of the Exchange Act,[29] subject to a good faith defense.

---

repeatedly emphasized that supervisory responsibilities are imposed on even the most senior members of management of a broker-dealer).

[25] *In re* First Capital Strategists, Investment Advisors Act Release No. IA-1648, 1997 WL 458704, at *7 (Aug. 13, 1997).

[26] *Id.*

[27] *In re* Piper Capital Mgmt. Inc., S.E.C. Release No. 175, 2000 WL 1759455, at *60 (Nov. 30, 2000).

[28] 15 U.S.C.A. § 78t(a) (West 2012).

[29] *See* Lewis D. Lowenfels & Alan R. Bromberg, *Controlling Person Liability Under Section 20(a) of the Securities Exchange Act and Section 15 of the Securities Act*, 53 BUS. LAW. 1, 4-5 (Nov. 1997) ("[S]ection 20(a) imposes secondary liability for primary violations of section 10(b) and Rule 10b-5, the sweeping antifraud provisions of the 1934 Act. . . . In addition, persons can be held vicariously liable under section 20(a) for primary violations of any other provision of the 1934 Act or rule promulgated thereunder . . . .").

This statute has been described as "remedial" in character, and is therefore to be construed broadly.[30]

A provision of "Dodd-Frank" explicitly provided standing to the SEC to assert 20(a) claims, due to a split in the circuits whether it had such standing.[31] However, under the Insider Trading and Securities Fraud Enforcement Act (ITSFEA) of 1988, discussed in Part III, *infra*, the SEC cannot assert section 20(a) to seek civil money penalties.[32] Although the SEC could seek an injunction under section 20(a),[33] some sources claim that the ITSFEA has effectively replaced 20(a) as an enforcement proceeding for insider trading supervisory liability.[34] Supporting this view, the SEC has not brought any insider trading prosecutions under 20(a) since ITSFEA. Despite the lack of practical likelihood that the SEC would assert a violation of 20(a) arising out of insider trading, this Article discusses the requirements of that provision due to the influence that its well-developed case law has had on other bases for control person liability, as discussed below.

B. Requirement of "Culpable Participation"

In the Second Circuit as well as several other judicial circuits, in addition to showing that a primary violation occurred and that the defendant "controlled" the primary violator, the prosecution must show that the defendant was, in some meaningful sense, a culpable participant in the controlled person's fraud."[35] Courts in the Second Circuit, particularly those in the Southern District of New York, have expressed three views on whether this requirement, which has no basis in the statutory text, imposes a special requirement for pleading and/or proof of the charge. Some courts have held that it requires plaintiffs to plead and prove "culpable participation" by the defendant.[36] These courts themselves diverge on whether a

---

[30] *See* H.R. REP. NO. 73-1383, pt. II, at 7 (1934).

[31] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929P(c), 124 Stat. 1376, 1864 (2010).

[32] 15 U.S.C.A. § 78u-1(b)(2) (West 2012) ("No person shall be subject to a penalty under subsection (a) of this section solely by reason of employing another person who is subject to a penalty under such subsection, unless such employing person is liable as a controlling person under paragraph (1) of this subsection. Section 78t(a) of this title shall not apply to actions under subsection (a) of this section.").

[33] 15 U.S.C.A. § 78u(d)(1) (West 2012).

[34] *Compare* THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 12.24[6] (2013) ("Although the controlling person liability provision of section 20(a) applies to private actions for improper trading on non-public information, it does not apply under SEC enforcement provisions dealing with insider trading."), *with* Harold K. Gordon & Tracy V. Schaffer, *Recent SEC Actions Show Employer Liability for Insider Trading*, CORP. COUNSEL (July 30, 2007), http://www.law.com/jsp/cc/PubArticleFriendlyCC.jsp?id=900005487324 (listing section 20(a) as one of the SEC's enforcement options for control person liability for insider trading).

[35] ATSI Commc'ns, Inc. v. Shaar Fund, Ltd., 493 F.3d 87, 108 (2d Cir. 2007); *see also* Sec. & Exch. Comm'n v. First Jersey Sec., Inc., 101 F.3d 1450, 1472 (2d Cir. 1996); Boguslavsky v. Kaplan, 159 F.3d 715, 720 (2d Cir. 1998).

[36] *E.g.*, *In re* Deutsche Telekom AG Sec. Litig., No. 00 CIV 9475 SHS, 2002 WL 244597, at *7-8 (S.D.N.Y. Feb. 20, 2002); Rich v. Maidstone Fin., Inc., No. 98 CIV. 2569(DAB), 2001

plaintiff must satisfy the heightened pleading requirements of Rule 9(b) for fraud-related claims,[37] or the even-higher requirement of the Private Securities Litigation Reform Act (PSLRA).[38] Others have stated that it is merely an element that must be proven but does not impose a heightened pleading requirement as well.[39] Finally, the "oft-stated view" of one Southern District judge (Judge Kaplan) is that plaintiffs need not plead or prove culpable participation, claiming in this regard that this "element" is essentially non-binding dicta.[40]

Relatedly, courts in the Second Circuit dispute what state of mind plaintiffs must demonstrate to succeed in demonstrating "culpable participation," variously holding respectively that the plaintiff must prove (1) negligence,[41] (2) "conscious misbehavior as a culpable participant in the fraud,"[42] (3) that the controlling person "knew or should have known that the primary violator . . . was engaging in fraudulent conduct,"[43] or (4) "either conscious misbehavior or recklessness."[44]

Finally, several courts have previously held that, in order to avoid liability under section 20(a), a broker-dealer, and perhaps theoretically an investment adviser as well, has an higher affirmative duty to ensure that its employees comply with

---

WL 286757, at *11 (S.D.N.Y. Mar. 23, 2001); Mishkin v. Ageloff, No. 97 Civ. 2690 LAP, 1998 WL 651065, at *24 (S.D.N.Y. Sept. 23, 1998).

[37] *See* Wallace v. Buttar, 239 F. Supp. 2d 388, 395-97 (S.D.N.Y. 2003), *rev'd and remanded on other grounds*, 378 F.3d 182 (2d Cir. 2004); *Maidstone*, 2001 WL 286757, at *8-10; *In re* Sotheby's Holdings, Inc., No. 00 Civ. 1041(DLC), 2000 WL 1234601, at *8 (S.D.N.Y. Aug. 31, 2000).

[38] *In re* CINAR Corp. Sec. Litig., 186 F. Supp. 2d 279, 310 (E.D.N.Y. 2002); *In re Deutsche Telekom,*, 2002 WL 244597, at *7; *Mishkin*, 1998 WL 651065, at *23-25.

[39] *E.g.*, *In re* Initial Pub. Offering Sec. Litig., 241 F. Supp. 2d 281, 392-97 (S.D.N.Y. 2003); Sedona Corp. v. Ladenburg Thalmann & Co., No. 03Civ.3120(LTS)(THK), 2005 WL 1902780, at *16 (S.D.N.Y. Aug. 9, 2005).

[40] *See In re* Parmalat Sec. Litig., 474 F. Supp. 2d 547, 554 (S.D.N.Y. 2007); *In re* Parmalat Sec. Litig., 375 F. Supp. 2d 278, 307-10 (S.D.N.Y. 2005).

[41] *In re Initial Pub. Offering*, 241 F. Supp. 2d at 396.

[42] *Mishkin*, 1998 WL 651065, at *25.

[43] *In re Deutsche Telekom*, 2002 WL 244597, at *9; Cromer Fin., Ltd. v. Berger, 137 F. Supp. 2d 452, 484 (S.D.N.Y. 2001); Dietrich v. Bauer, 126 F. Supp. 2d 759, 765-66 (S.D.N.Y. 2001).

[44] Steed Fin. LDC v. Nomura Sec. Int'l, Inc., No. 00 CIV. 8058(NRB), 2001 WL 1111508, at *10 (S.D.N.Y. Sept. 20, 2001); *see also In re* Bristol Myers Squibb Co. Sec. Litig., 586 F. Supp. 2d 148, 172 (S.D.N.Y. 2008) ("The culpable participation requirement can be satisfied by a showing of recklessness, for example, where there has been an extreme departure from the standards of ordinary care, or when defendants are aware of facts or have access to information contradicting their public statements."); Wallace v. Buttar, 239 F. Supp. 2d 388, 397 (S.D.N.Y. 2003), *rev'd and remanded on other grounds*, 378 F.3d 182 (2d Cir. 2004) ("Thus, the level of mental culpability required . . . is intention or recklessness, the control person must have participated . . . with knowledge that the securities laws were being violated, or with reckless indifference as to whether a violation occurred.").

applicable securities regulations.[45] However, courts have not cited this rule recently; one court has explained that, after the Second Circuit clarified that culpable participation is an element of the cause of action, and good faith is a defense, this broker-specific rule was also implicitly rejected.[46]

C. Case Law Analysis/Factual Basis for Liability

Most allegations of 20(a) control person liability, especially in the Second Circuit, arise in the securities class action context, in which courts rarely reach final judgment or even summary judgment. However, there are several cases that have clarified what type of factual basis is needed for liability, although any individual decision may depend on which standard for "culpable participation" the specific court has accepted. On one hand, courts appear to demand a showing of involvement in the specific transactions at issue. For example, in one relatively recent case, a Southern District court vacated an arbitration panel's decision to impose control person liability and found that its decision "manifestly disregarded the facts and the law."[47] The court reasoned that "no evidence was adduced that the Petitioners were involved in the allegedly unsuitable and unauthorized transactions in the [Plaintiffs'] accounts, or in the misrepresentations and fraud of [the primary violator]."[48] The court, applying a standard for culpable participation based on conscious or reckless behavior, noted that the plaintiffs had no contact with the defendants themselves save for a sole handshake, and indeed the plaintiffs could not recall any contact nor had heard the names of the defendants prior to initiating the arbitration. Finally, the court noted that "general deficiencies" in control are irrelevant in this inquiry, reasoning that the culpable participation requirement requires facts "with regard to the specific trades and representations at issue."[49]

On the other hand, the involvement required of the alleged control person involvement can be extremely high-level, and possibly even purely financial in terms of receiving profits or providing financial backing. For example, in one case, the court denied the motion for summary judgment of a defendant sole shareholder of a securities broker.[50] The court, appearing to apply a "willful blindness" standard for culpable participation, rejected the defendant's claim that he was a passive investor who was not involved in the day-to-day management of the firm and therefore could not be liable as a controlling person, noting that the firm bore his name, that he met with the executive in charge of managing the firm, that he received profits, as well as contested testimony that the defendant was in fact a director of the firm.[51] The court also reasoned that "there is no real dispute that [Defendant] not only failed to take steps to prevent the primary violation but actually provided the financial means by

[45] *See* Marbury Mgmt., Inc. v. Kohn, 629 F.2d 705, 716 (2d Cir. 1980); Metzner v. D.H. Blair & Co., 689 F. Supp. 262, 266 (S.D.N.Y. 1988); Ruiz v. Charles Schwab & Co., 736 F. Supp. 461, 464 (S.D.N.Y. 1990).

[46] *See Dietrich,* 126 F. Supp. 2d at 767-68.

[47] *Wallace*, 239 F. Supp. 2d at 395-397.

[48] *Id.* at 396-96.

[49] *Id.*

[50] *See id.*

[51] *Dietrich*, 126 F. Supp. 2d at 766.

which the fraud was accomplished, and therefore rejected summary judgment even though "the evidence is circumstantial, and in some ways rather thin."[52] In addition, some courts have cited the receipt of financial benefits as a factor in finding that a defendant has violated this element, although no court appears to have relied on this factor exclusively.[53]

D. Good Faith Defense

Section 20(a) also provides a defense to liability if a defendant can meet the burden of demonstrating that he or she "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."[54] In the Second Circuit, the defendant bears the burden of demonstrating good faith.[55] Courts have explained that, to satisfy this burden, the defendant must show that he or she "exercised due care in his supervision of the violator's activities in that he maintained and enforced a reasonable and proper system of supervision and internal controls."[56]

Courts reject a good faith defense when it is shown that the controlling party has ignored several "red flags" and/or has multiple holes in its compliance programs for which the control person was ultimately at least partially responsible. For example, in *SEC v. First Jersey Securities, Inc.,* the Second Circuit affirmed a decision that a broker-dealer had failed to demonstrate good faith in defending against claims that it provided excessive mark-ups for securities the market for which it controlled.[57] The firm argued that "the markups . . . were established by the Firm's trading department," and the compliance department reviewed the trades by looking at the published listings of interdealer quotes, but the court noted that the defendant's witness acknowledged the defendant's procedures "did not require" a different markup for securities for which the Firm did not control the market.[58] Defendant's argument that compliance personnel searched for improprieties was rejected because "[compliance officer] conceded that he did not look at all sales and that he determined the Firm's acquisition cost for a security by looking only at transactions

---

[52] *Id.*

[53] *In re* Blech Sec. Litig., No. 94 Civ. 7696 RWS, 2002 WL 31356498, at *21 (S.D.N.Y. Oct. 17 2002) ("[A] controlling person's receipt of financial benefits can demonstrate culpable participation."); *In re* Oxford Health Plans, Inc., 187 F.R.D. 133, 143 (S.D.N.Y. 1999) (noting that in addition to other factors indicating participation by defendants, "[p]laintiffs allege sufficiently that these defendants had the power to control the activities which comprise the underlying violation and that they participated in the fraud at least by reaping the benefits of insider trading").

[54] 15 U.S.C.A. § 78t(a) (West 2012).

[55] Marbury Mgmt., Inc. v. Kohn, 629 F.2d 705, 716 (2d Cir. 1980), *cert. denied*, 449 U.S. 1011 (1980); Sec. & Exch. Comm'n v. First Jersey Sec., Inc., 101 F.3d 1450, 1473 (2d Cir. 1996); *see also In re Blech*, 2002 WL 31356498, at *22 (rejecting the argument that the Second Circuit subsequently overruled *Marbury*).

[56] *First Jersey*, 101 F.3d at 1473 (citations and internal quotation marks omitted).

[57] *Id.*

[58] *Id.* at 1473.

that occurred on the very day the Firm sold the security."[59] Finally, the court noted that "the record showed that the Firm gave its sales representatives little information about proper procedures or about the securities they were hawking," citing such deficiencies as a lack of information on risks inherent in the securities, a failure to distribute information manuals, a policy that forbade sales representatives from contacting the research department without permission from the branch manager, and a lack of training on customer suitability concerns.[60]

On the other hand, the court in another SEC case found for defendant Lehman Brothers where a fairly robust training program was in place.[61] In the case, a salesperson traded on the basis of material non-public information, and the firm was aware that he had frequent contact with management of a particular company even though the broker's customers held large quantities of the company's stock. Lehman at the time had a compliance department, staffed by "several competent and experienced attorneys," which provided training on compliance issues relating to the securities laws, and published memoranda on new issues in addition to a procedural manual. Counterweighing this was the fact that the firm only instituted a seemingly necessary rule prohibiting contact with management of companies whose stock is owned by its clients after the incident in question.[62] The court, although admitting that "the issue is close," found for Lehman on the basis of the good faith defense.[63] The court reasoned that the firm had no actual or constructive notice that the employee would pass along the information, had no reason to distrust the salesperson's judgment, and in addition did not book the trade in question.[64] The court refused to make the broker liable solely because it failed to institute the rule mentioned above, reasoning that the firm had a justifiable "lack of focus" on this area especially since this "was the first situation that [the control person] had known about where such a relationship was maintained."[65]

As the cases above indicate, good faith is a fact-intensive inquiry, but a defendant can successfully apply the defense if he or she can show robust compliance programs and a lack of tolerance for deviation. As explained by one recent source regarding precautions to take to avoid liability, this defense demands

> sufficient precautions to prevent securities violations before they happen…training, supervision, and guidance appropriate to the nature of the business . . . the proper "tone from the top" at all times. Controlled persons must understand that misconduct will not be tolerated . . . update policies and procedures . . . establish a monitoring/internal audit program designed to access the strength and success of the compliance programs.[66]

---

[59] *Id.*

[60] *Id.* at 1473-74.

[61] *See* Sec. & Exch. Comm'n v. Lum's, Inc., 365 F. Supp. 1046 (S.D.N.Y. 1973).

[62] *Id.* at 1064-65.

[63] *Id.*

[64] *Id.* at 1065.

[65] *Id.* at 1065.

[66] Zachary S. Brez et al., *Control Person Liability,* 5 BLOOMBERG L. REPS. 17 (2011).

E. Application to "Innocent Bystander" Managers

As discussed above, a major determinate of any liability under section 20(a) is the standard that the court adopts for assessing "culpable participation." Assuming, as appears to be the general trend in the Second Circuit, that some finding of recklessness is required, a "bystander" a government action would have trouble implicating a manager who was not subjectively aware of the illicit nature of a rogue trader's actions. Whileone point that may support liability on this prong is that some of the trades in question will likely have taken place in official firm accounts and the firm will have both provided financial backing and received financial benefits from these trades, as no case has substantially relied on this ground, it is unlikely that prosecutors would attempt to assert liability on it exclusively.

In any case, "bystander" managers would likely have a strong good faith defense. As the cases above indicate, good faith is a fact-intensive inquiry, but a defendant can successfully apply the defense if he or she can show robust compliance programs and a lack of tolerance for deviation.[67] A manager could point to a lack of "red flags" in the trader's history, as well as a strong compliance program generally.

III. THE INSIDER TRADING AND SECURITIES FRAUD ENFORCEMENT ACT (ITSFEA) OF 1988

A. Statutory Background

In 1988, Congress passed the Insider Trading and Securities Fraud Enforcement Act (ITSFEA), which added section 21A to the Exchange Act and thereby amended the Insider Trading Sanctions Act of 1984. The ITSFEA authorizes the SEC to seek treble damages from employers or supervisors who failed to prevent insider trading by individuals whom they "directly or indirectly controlled."[68] In order to succeed on a claim for control person liability under the ITSFEA, the SEC must show that the control person either:

> (A) knew or recklessly disregarded the fact that such controlled person was likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent such acts or acts before they occurred, or
> (B) knowingly or recklessly failed to establish, maintain, or enforce any policy or procedure required under 78o(f) of this title or section 80b-4a of this title and such failure substantially contributed to or permitted the occurrence of the act or acts constituting the violation.[69]

The statute is modeled on the standard for controlling persons liability created by the Exchange Act[70] with some differences. The first prong is essentially derivative liability, tempered by a recklessness requirement similar to that used by several

---

[67] *Id.* (specifying precautions to take to avoid liability).

[68] 15 U.S.C.A. § 78u-1(a)(1)(B) (West 2012).

[69] 15 U.S.C.A. § 78u-1(b)(1)(A)-(B) (West 2012).

[70] H.R. REP. NO. 100-910, at 17 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6054 (describing legislative history of ITSFEA, explaining that "[t]he expansion of the scope of civil penalties relies on the concept of "controlling person" currently contained in Section 20(a) of the Exchange Act").

courts inside the Second Circuit to measure the "culpable participation" requirement under section 20(a) of the Exchange Act.[71] Supporting this interpretation, the House Report indicates that the statute mandates "an objective standard of supervision" which requires proof of "a gross deviation from the standard of care that a responsible person would exercise in such a situation" and "encompasses a heedless indifference as to whether circumstances suggesting employee violations actually exist."[72] This prong also tempers the standard of liability with a proviso that that liability does not attach if a control person took "appropriate steps" to prevent the violation, which appears substantively similar to the "good faith" defense under section 20(a).[73]

However, there are three major differences between ITSFEA and 20(a). First, as opposed to 20(a), where the burden is on the defendant to demonstrate good faith, under ITSFEA, the SEC bears the burden of proving the lack of a good faith attempt "to take appropriate steps to prevent such acts"[74] or provide an adequate compliance program. In addition, the second prong incentivizes affirmative steps to create and follow proper procedures by shielding supervisors instituting such procedures from control person liability.[75] Finally, as discussed above the SEC can pursue a civil money penalty under ITSFEA but not 20(a).[76]

B. Case Law

The SEC has infrequently attempted to impose liability on controlling persons under ITSFEA.[77] To date it has only brought three unlitigated settlements.[78] One

[71] *See supra* notes 40-43 and accompanying text.

[72] H.R. REP. NO. 100-910, at 18 (1988) (internal citation omitted).

[73] *See id.* at 17 (noting that the concept of "controlling person" in section 21A is based on section 20(a)); *see also* 134 CONG. REC. E3,079 (daily ed. Sept. 23, 1988) (Statement of Rep. Markey) (stating that principal legislative sponsor explaining that the standard of recklessness in ITSFEA falls "well below the standard of 'actual knowledge' of circumstances suggesting violation by the control person").

[74] 15 U.S.C.A. § 78u-1(b)(1)(A) (West 2012).

[75] Richard M. Phillips, *ITSFEA & Controlling Person Liability for Insider Trading Violations*, AM. LAW INST. at *222-23 (May 3, 1990) (citing a senior official at the SEC as publicly explaining that "the existence of effective procedures would weaken the Commission's ability to show reckless conduct" but noting that "the absence of procedures would not result in the converse presumption"); 134 CONG. REC. S17,218 (daily ed. Oct. 21, 1988) (Statement of Sen. Proxmire) (suggesting that failure to take appropriate preventative action while possessing knowledge that a controlled person had committed a violation in the past could constitute a basis for liability).

[76] *See supra* note 31 and accompanying text.

[77] Donald C. Langevoort, 18 INSIDER TRADING REGULATION, ENFORCEMENT & PREVENTION § 8:5 (2011).

[78] Sec. & Exch. Comm'n v. Haddad, S.E.C. Release No. 13473, 1992 WL 383778 (Dec. 17, 1992); Sec. & Exch. Comm'n v. Adelt, S.E.C. Release No. 18442, 2003 WL 22492696 (Nov. 3, 2003); Sec. & Exch. Comm'n v. Barclays Bank PLC, S.E.C. Release No. 20132, 2007 WL 1559227 (May 30, 2007); *see also* The Ret. Sys. of Ala., Exchange Act Release No. 57446, 2008 WL 762991 (Mar. 6, 2008) (investigating into possible insider trading at pension fund, noting potential controlling persons liability and that the suspect trading in question

settlement suggests that the SEC expects supervisors to make inquiries based on red flags emerging from the trades themselves, such as a pattern of initiating profitable trading shortly before announcements.[79] In *SEC v. Haddad*, the SEC alleged that a financial representative at a broker-dealer made several highly successful trades on the basis of MNPI that he obtained from an investment banker regarding upcoming takeovers. The complaint asserted controlling persons liability on the basis that the broker-dealer and the representative's managers "learned of" the five highly successful trades "at or about the time that such trading activity occurred" which was, as mentioned above, "just prior to the announcements that those companies were the subject of takeover attempts."[80] Nevertheless, the supervisors "failed to make any serious inquiry" of the representative's reason for making the transaction.[81]

The other two cases allege fairly obvious violations. In one, the controlling bank failed to "wall off" a proprietary trader from entering trades based on information he received from serving on creditors committees on behalf of the bank.[82] In the other, an employee traded the company's stock as part of the company's own stock option program during a period when he was in possession of MNPI, which was a regular occurrence as part of his duties; the SEC claimed that, despite this violation, the company failed to take steps to prevent the employee from further trading in the stock during periods when he was in possession of MNPI.[83]

C. Application to "Innocent Bystander" Managers

If the SEC pursues a charge under ITSFEA, it would likely proceed on the basis of the same evidence as discussed above in Part II.E. However, managers would have a better chance of dismissing such charges than a charge under 20(a), because the SEC bears the initial burden of demonstrating lack of good faith under the first prong, and a defendant would be able to point to its robust compliance systems to parry any attempt under the second prong of the statute.

IV. SEC ADMINISTRATIVE LIABILITY

A. Section 203(e) and (i) of the Investment Advisers Act

Bystander managers may also face control person liability under section 203 of the Investment Advisers Act (IAA), which provides the SEC with authorization to censure, place limitations on the activities of, or suspend/revoke the registration of an entire investment advisory firm[84] or an individual advisor,[85] as well as seek civil

"could have been prevented if RSA had adequate policies and procedures to assure compliance with the federal securities laws").

[79] *See generally Haddad,* 1992 WL 383778.

[80] *Id.* at *11.

[81] *Id.* at *11-12.

[82] *See generally Barclays Bank,* 2007 WL 1559227.

[83] *Adelt*, 2003 WL 22492696, at *2.

[84] 15 U.S.C.A, § 80b-3(e)(6) (West 2012).

[85] 15 U.S.C.A. § 80b-3(f) (West 2012).

money penalties,[86] for failing to supervise personnel who violate the Exchange Act or other securities laws. Liability can be imposed even when the underlying violator was a rogue employee who conspired to break the law.[87]

Generally, the standards imposed by the IAA are "comparable to those in the Securities Exchange Act."[88] The IAA defines a liable party in general terms as one who "has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision."[89] It also provides for a defense that

> no person shall be deemed to have failed reasonably to supervise any person if there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and systems were not being compiled with.[90]

This provision is different from both 20(a) and the ITSFEA. On one hand, it is similar to 20(a) in that the defendant has the burden of proving an affirmative defense of good faith.[91] However, it is more similar to ITSFEA than 20(a) in specifying the creation of robust compliance systems to detect wrongdoing as a prerequisite to asserting the defense,[92] and in the potential for a monetary penalty. Finally, the language that the control person is "without reasonable cause to believe" that violations have occurred may indicate a somewhat lower bar for recklessness than that of 20(a) or the ITSFEA, a conclusion that would accord with the administrative nature of this charge.

Several cases have imposed liability on investment advisory firms as well as senior personnel of such firms for failing to supervise portfolio managers based on section 203, but no cases specifically concern insider trading.[93] The decisions

---

[86] 15 U.S.C.A. § 80b-3(i)(1)(A)(iv) (West 2012).

[87] *In re* William V. Giordano, Exchange Act Release No. 36742, 1996 WL 21031, at *4 (Jan. 19, 1996) (liability imposed for failure to supervise rogue "direct access" trader who conspired with his wife to charge excessive mark-ups).

[88] HAZEN & MARKHAM, *supra* note 24, at 11:6.

[89] 15 U.S.C.A. § 80b-3(e)(6) (West 2012).

[90] 15 U.S.C.A. § 80b-3(e)(6)(A)-(B) (West 2012).

[91] *See In re* Scudder Kemper Inv., Inc., Investment Advisor Act Release No. 1848, 1999 WL 1240645, at *4 (Dec. 22, 1999).

[92] *See* HAZEN & MARKHAM, *supra* note. 24, at 11:10 ("Unlike supervision, these concepts [including section 20(a)] do not impose operational requirements on the broker-dealer.").

[93] *See In re* CS First Boston Inv. Mgmt. Corp., Investment Advisor Act Release No. 7583, 1998 WL 652134 (Sept. 23, 1998); *In re* Rhumbline Adv., Investment Advisor Act Release No. 1765, 1998 WL 667626 (Sept. 29, 1998); *In re* Dawson-Samberg Capital Mgmt., Inc., Investment Advisor Act Release No. 1889, 2000 WL 1062685 (Aug. 3, 2000); *In re* Vanderbilt Capital Adv. LLC, Investment Advisor Act Release No. 2053, 2002 WL 2005452

primarily discuss two sources of liability. First, they frequently cite a supervisor's failure to follow up, or a delay in doing so, after becoming aware of "red flags" indicating possible fraud;[94] as stated in one case: "Supervisors must respond vigorously to indications of possible wrongdoing . . . Red flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review. When indications of impropriety reach the attention of those in authority, they must act decisively to detect and prevent violations."[95]

Second, several of these cases turn on the strength or lack thereof of the compliance programs for which the control person is ultimately responsible. The SEC has also instituted proceedings against advisers for failing to engage in independent reviews of portfolio manager transactions in order to catch violations.[96] The SEC has specifically frowned upon relying on personnel to self-report their activities and relying on their trustworthiness.[97] In addition, the Commission looks to whether the firm instituted formal compliance procedures, preferably in writing.[98] Finally, the Commission has noted that advisers "must also provide effective staffing, sufficient resources, and a system of follow-up" in order ensure that the firm is able to enforce their procedures.[99] The SEC has repeatedly ruled that

(Sept. 3, 2002); *In re Scudder Kemper*, 1999 WL 1240645*; In re* First Capital Strategists, Investment Advisor Act Release No. 1648, 1997 WL 458704 (Aug. 13, 1997).

[94] *See In re CS First Boston*, 1998 WL 652134, at *4 (involving supervisor that failed to investigate further for over a month after noticing red flag); *In re Rhumbline*, 1998 WL 667626, at *3 (involving supervisors that failed to follow up on discrepancies in option spreads and positions in excess of amount permitted by guidelines); *In re First Capital*, 1997 WL 458704, at *7 (involving supervisors that ignored excessive trading and other discrepancies).

[95] *In re Rhumbline*, 1998 WL 667626, at *4.

[96] *See In re Scudder Kemper*, 1999 WL 1240645, at *5 (imposing liability for failing to review order tickets and reports and reconcile the tickets with reports in order to catch trading in excess of authorized amount); *In re First Capital*, 1997 WL 458704, at *7 (involving firm that failed to independently run mark-to-market analysis or review to ensure trader's positions were properly hedged); *In re Vanderbilt Capital*, 2002 WL 2005452, at *3 (providing no procedures for review of transaction prices, traders have "unsupervised control"); *In re Dawson-Samberg*, 2000 WL 1062685, at *7 (involving firm that failed to require a "designated compliance individual to conduct a periodic review" of "soft-dollar" vendors).

[97] *In re Dawson-Samberg*, 2000 WL 1062685, at *7.

[98] *See id.* at *6 (involving firm that failed to establish a "clear procedure" for complying with soft-dollar credit rules, did not provide "clear or sufficiently detailed instructions," and noting that "written procedures also would have clarified" the duties of personnel); *In re Rhumbline*, 1998 WL 667626, at *4 (stating that firm "had no policies or procedures designed to detect or prevent unauthorized trading," nor any "system for risk management or for monitoring the CIO's trading"); *In re First Boston*, 1998 WL 652134, at *4 (stating that firm "lacked adequate procedures to ensure that marketing materials . . . did not mislead . . . . [and] also lacked adequate procedures to ensure that the Portfolio Manager complied with the Firm's investment policies").

[99] *In re Dawson-Samberg*, 2000 WL 1062685, at *6 (stating that firm "devoted inadequate resources to soft dollar compliance and control mechanisms . . . . The Registrant relied on Mack's on-the-job training . . . without substantive review or follow-up . . . the lack of formal training and guidelines became a problem. . . .").

improper procedures are enough to impose supervisory liability even if there was a total absence of red flags.[100]

On the other hand, a particular strong compliance program can be a way to avoid liability under the IAA.[101] For example, in *Piper Capital Management*, in addition to numerous primary charges, the SEC looked to impose liability under section 203 for failing to supervise portfolio managers who violated a fund's disclosed investment guidelines and objectives.[102] The judge rejected this claim, noting that the defendant "established a multi-layered and integrated internal supervisory system," including an Operations Department (which "was tasked with ensuring compliance between portfolio holdings and prospectus investment restrictions and was provided with written guidelines"), a Risk and Control Committee (which was created to monitor risk, volatility and adherence to objectives, and which included representatives from management and peer portfolio managers), an Audit Committee, and the Board of Directors. The judge found that the supervisor established a system that "reasonably could have been expected to prevent and detect securities laws violations."[103]

In responding to any control person charges under section 203 of the IAA, firms and managers will need to defend against the lack of follow-up on any suspicions that a rogue trader may have been relying on illicit information. In addition, the compliance systems and procedures at a firm will be scrutinized by the SEC, in particular any policies and procedures relating to the illegal conduct in question. In any case, as mentioned above there is no precedent for using this provision in the context of insider trading, or in federal court. Even though there does not appear to be any formal bar for doing so, the SEC may decide to not assert it for this reason.

B. Cease and Desist Enforcement

Another option for supervisory liability for insider trading is for the SEC to simply sanction a firm through ordering it to cease and desist from failing to establish and follow proper policies and procedures and requiring it to institute such procedures in the future. Such charges have a long history of precedent with regards to insider trading specifically, as well as a lack of a recklessness requirement, although it will not have the opportunity to either assert a civil action in federal court (as would be possible with a 20(a) or 21A charge) or collect civil money penalties (as would be possible under section 203(e) and (i) of the IAA).

---

[100] *See In re* Gary W. Chambers, Exchange Act Release No. 27963, 1990 WL 311728 (Apr. 30, 1990); *In re* Blinder, Robinson & Co., Exchange Act Release No. 19057, 1982 WL 33,469 (Sept. 17, 1982); *see also In re* William V. Giordano, Exchange Act Release No. 36742, 1996 WL 21031, at n.4 (Jan. 19, 1996) ("While the presence of 'red flags' warning of possible irregularities may often be an aggravating factor, the absence of such warning signs is not a defense where the gravamen of the supervisory deficiency is a failure to have reasonable procedures.").

[101] *See In re* Piper Capital Mgmt. Inc., S.E.C. Release No. 175, 2000 WL 1759455, at *59-60 (Nov. 30, 2000).

[102] *Id.*

[103] *Id.* at *60.

1. Section 203(k) of the Investment Advisers Act

First, under section 203(k) of the Investment Advisers Act, if the SEC determines that any person or firm "is violating, has violated, or is about to violate" any provision of the Investment Advisers Act, it may enter an order requiring the person or firm to cease and desist from committing such a violation.[104] More applicable to a hedge fund, the SEC can apply the same order to anyone who "would be a cause" of such a violation, in effect creating control person liability.[105] In addition, the order can require the primary violator or the supervisor to take steps to ensure compliance in the future, either on a permanent or temporary basis,[106] and order disgorgement, although not monetary penalties.[107] The statute broadly permits a finding of a "cause" based on any "act or omission the person knew or should have known would contribute to such violation."[108]

As a primary violation, the SEC can point to section 204A of the Advisers Act, which affirmatively requires registered investment advisers to "establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such investment adviser's business, to prevent the misuse . . . of material, nonpublic information by such investment adviser or any person associated with such investment adviser."[109] As many hedge funds are now required to register with the SEC, this provision may apply to them. The legislative history has provided clues as to what type of policies and procedures would be adequate under section 204A. First, the procedures must be in written form, and disseminated widely within the firm.[110] Second, the legislative history demands a proactive approach by supervisors both with respect to ensuring that the policies are followed by personnel and updating the necessary controls when called for.[111] The House Report also specifies that firms should educate their personnel regarding firm policies and the federal securities laws generally.[112]

2. Exchange Act

A parallel provision in the Exchange Act authorizes the SEC to institute a cease-and-desist order to protect against a violation of any provision of the Exchange Act.[113] An employer's failure to develop or implement proper policies and procedures to prevent insider trading could be sufficient to "cause" a violation and permit a cease-and-desist order, as the statute broadly permits a finding of a "cause" based on any "act or omission the person knew or should have known would

---

[104] 15 U.S.C.A. § 80b-3(k)(1) (West 2012).

[105] *Id.*

[106] *Id.*

[107] 15 U.S.C.A. § 80b-3(k)(5) (West 2012).

[108] 15 U.S.C.A. § 80b-3(k)(1) (West 2012).

[109] 15 U.S.C.A. § 80b-4a (West 2012).

[110] *See* H.R. REP. NO. 100-910, at 21 (1988).

[111] *Id.*

[112] *Id.* at 22.

[113] 15 U.S.C.A. § 78u-3(a) (West 2012).

contribute to such violation."[114] In such a situation, the Commission would be able to point to a primary violation, or potential violation, of section 10(b) or 21A; indeed, theoretically they could also claim that a firm's lack of proper procedures may "cause" supervisors to be liable as controlling persons.[115] The SEC might consider using this provision instead of asserting traditional controlling persons liability under section 20(a) or 21A in a situation where the requirements of recklessness under those provisions is not met.

3. Case Law

As opposed to the fairly rare enforcement of controlling persons liability for insider trading under section 20(a) or 21A, the SEC has instituted numerous administrative cease-and-desist orders against financial institutions for failing to enact proper policies and procedures to protect against insider trading by personnel.[116] At least seven proceedings relied in part on the Investment Advisers Act provision requiring policies and procedures.[117] In addition, the SEC, for apparently the first time, recently asserted a claim under section 204A of the Advisers Act in federal court, obtaining a default judgment against an investment adviser based in part on its failure to follow proper policies and procedures.[118] However, the SEC has yet to enter a cease-and-desist order alone under the Exchange Act for causing or potentially causing a violation of 10(b) or 21A.

The case most concerning to an "innocent bystander" manager would appear to be *In re Massachusetts Financial Services Company*.[119] There, the SEC instituted cease-and-desist proceedings against an investment adviser under section 204A. The firm allegedly "paid several outside consultants to gather information . . . from various sources . . . concerning the financial markets, as well as political, budgetary and regulatory developments in Washington."[120] The SEC alleged that one such consultant disclosed an upcoming Treasury Department announcement concerning a

---

[114] *Id.*

[115] The Exchange Act also contains an affirmative provision to establish, maintain and enforce written policies and procedures reasonably designed to prevent insider trading by employees, but that provision only applies to broker-dealers. *See* 15 U.S.C.A. § 78o-1 (West 2012).

[116] *See In re* Merrill Lynch, Inc., Exchange Act Release No. 2851, 2009 WL 613541 (Mar. 11, 2009); *In re* Guy P. Wyser-Pratte, Exchange Act Release No. 1934, 2001 WL 487946 (May 9, 2001); *In re* Morgan Stanley & Co. Inc., Exchange Act Release No. 2526, 2006 WL 1749842 (June 27, 2006); *In re* Banc of Am. Sec. LLC, Exchange Act Release No. 55466, 2007 WL 763699 (Mar. 14, 2007); *In re* Mass. Fin. Servs. Co., Investment Advisors Act Release No. 2165, 2003 WL 22056989 (Sept. 4, 2003); *In re* Gintel Asset Mgmt., Inc., Exchange Act Release No. 2079, 2002 WL 31499839 (Nov. 8, 2002); *In re* Money Growth Inst., Inc., Investment Advisors Act Release No. 1506, 1995 WL 442094 (July 14, 1995); *In re* Belsen Getty, LLC, Investment Advisors Act Release No. 3212, 2011 WL 2139876 (May 31, 2011).

[117] *See* releases cited *supra* note 116.

[118] *See* Sec. & Exch. Comm'n v. Locke Capital Mgmt., 726 F. Supp. 2d 105, 106 (D.R.I. 2010).

[119] *In re Mass. Fin. Servs. Co.*, 2003 WL 22056989.

[120] *Id.* at *1-2.

particular type of bond to a firm employee, who subsequently traded that bond; the announcement resulted in the bond experiencing its largest one-day price change in more than ten years. While the firm did have a written policy regarding MNPI, it did not specify the potential for receiving MNPI from outside consultants, only noting company insiders and advisers such as attorneys. The SEC argued that the firm's procedures "did not describe the potential that consultants . . . could obtain and provide" MNPI to the firm, nor were there any written guidelines discussing the use of such consultants.[121] The SEC ordered the firm to cease-and-desist under 204A, and in addition censured the firm and required it to pay a civil money penalty under 203(e), discussed in Part IV.[122] While obviously application of this decision to a bystander manager would require additional development regarding a firm's policies relating to illicit conduct by the rogue trader, this decision is notable for the detail it demanded of the defendant firm's policies.

V. PRIMARY LIABILITY

A. Conscious Avoidance

Perhaps the greatest concern for any manager is being directly liable for insider trading due to the activities of a rogue trader. The "conscious avoidance" doctrine would make such a nightmare possible. However, the doctrine only applies when the evidence shows that the defendant subjectively must have realized that the information was in all likelihood illicit, and not just some type of recklessness or negligence commonly asserted for control person liability, as discussed above. As a result, there is little chance of it being applied to "innocent bystander" managers.

As defined by the Supreme Court, this doctrine can result in a defendant being considered as aware of a fact without knowing it as such, if (1) the defendant subjectively believe[s] that there is a high probability that a fact exists and (2) the defendant take[s] deliberate actions to avoid learning of that fact."[123] Case law has used the "conscious avoidance" doctrine, in both the criminal and civil context, as one avenue to prove the scienter element of a 10b5 insider trading charge. The defendant's conscious avoidance creates liability under the "misappropriation theory," which "requires that the defendant subjectively believe that the information received was obtained in breach of a fiduciary duty" by providing the "circumstantial evidence" sufficient to indicate such belief.[124] As this is just evidence supporting the claim that the defendant had such a belief, if the defendant indeed had a subjective belief that the information was not illegally obtained, despite the high probability otherwise, that removes the conscious avoidance issue.[125] As applied, this doctrine would impute to a fund manager the knowledge that the rogue trader had received information in breach of a duty of trust or loyalty, and subsequently passed that information to the fund manager, despite the fact that the trader had never told the manager that his activities were illegal.

[121] *Id.* at *2.

[122] *Id.* at *3-4.

[123] Global-Tech Appliances, Inc. v. SEB S.A., 131 S. Ct. 2060, 2070 (2011).

[124] United States v. Mylett, 97 F.3d 663, 668 (2d Cir. 1996).

[125] *See* United States v. Kaiser, 609 F.3d 556, 566 (2d Cir. 2010) (stating that the instruction failing to include this point was clear error).

However, this doctrine probably does not fit the circumstances of a "rogue trader" situation. A charge based on "conscious avoidance" is only appropriate when the defendant displayed a very high level of recklessness and "deliberately avoided learning the truth," not when the evidence only tended to show that "the defendant had not tried hard enough to learn the truth" or that "there was only equivocal evidence that the defendant had actual knowledge."[126] The facts underlying decisions that apply the "conscious avoidance" doctrine solidify the conclusion that it is only applicable where the defendant was either certain or should have been certain that the information was illicit. For example, in one case, despite the length of a chain of tippers and tippees of information ultimately emanating from an employee at Sullivan & Cromwell, the evidence showed that the "sophisticated investor" defendants were "quite certain" that the information they received was from confidential sources.[127] In two others, the defendant received information directly from bank employees and communicated with the tippers shortly before several major corporate announcements,[128] circumstances which one of the decisions classified as "overwhelmingly suspicious."[129] In another, the tipper was an investment banker and the doctrine precluded the claim that he did not know that the client documents he provided to the tippee, a very close friend, were material.[130]

B. Civil Aiding and Abetting Liability

Another potential source for primary liability is aiding and abetting liability. Although plaintiffs in private securities litigation are precluded under the Supreme Court's decision in *Central Bank* from bringing aiding and abetting claims for securities fraud violations, the SEC has authority under section 20(e) of the Exchange Act, passed into law by Congress shortly after that decision, to bring claims for aiding and abetting any violation of the Exchange Act.[131] One source has suggested that "if the SEC deemed an employer's conduct in relation to an employee's insider trading to be sufficiently active and egregious, it could name the employer as an aider and abettor of the employee's illegal trading in a federal court injunctive action."[132] Indeed, the SEC recently brought an aiding and abetting action in the insider trading context specifically.[133]

[126] United States v. Ferrarini, 219 F.3d 145, 154 (2d Cir. 2000).

[127] Sec. & Exch. Comm'n v. Musella, 678 F. Supp. 1060, 1063 (S.D.N.Y. 1988).

[128] Sec. & Exch. Comm'n v. Sekhri, No. 98 Civ. 2320(RPP), 2002 WL 31100823, at *13 (S.D.N.Y. July 22, 2002); United States v. Svoboda, 347 F.3d 471, 477-78 (2d Cir. 2003).

[129] *Svoboda*, 347 F.3d at 480.

[130] United States v. Rahim, 339 F. App'x. 19, 25 (2d Cir. 2009).

[131] 15 U.S.C.A. § 78t(e) (West 2012).

[132] Gordon & Schaffer, *supra* note 32; *see also* Jennifer Banzaca, 4(38) HEDGE FUND L. REP. (Oct. 27, 2011) (quoting a former senior SEC enforcement attorney that "the SEC can sue a hedge fund manager for aiding and abetting insider trading").

[133] Sec. & Exch. Comm'n v. Aragon Capital Advisors LLC, No. 07-cv-919, 2011 WL 3278907, at *17-18 (S.D.N.Y. July 26, 2011) (denying motion to dismiss aiding and abetting claim).

Aiding and abetting is just one of the many potential charges for secondary actors, but it is a particularly serious one due to the potential for defendants to receive the same punishment as those directly responsible for the insider trading. Section 20(e) provides that "any person that knowingly provides substantial assistance to another person" towards any violation of the Exchange Act is liable for that violation "to the same extent as the person to whom such assistance is provided." [134] Lesser forms of secondary liability for managers and other financial professionals include failing to supervise traders and act on "red flags,"[135] as well as failing to maintain proper control policies and procedures.[136] In addition, an entity can be found liable for the civil and criminal violations of its employees.[137]

Unsurprisingly, however, an aider and abettor must have violated stricter requirements than which exists under many other secondary claims. Courts have broken down this language into several distinct requirements. As explained by a recent Southern District decision, a 20(e) claim "must allege (1) a primary violation of the Exchange Act, (2) . . . knowledge of the violation by the aider and abettor, and (3) that the aider and abettor substantially assisted the primary violation."[138] The first requirement would include insider trading or one of the Exchange Act's other provisions. In terms of the second "knowledge" requirement, Congress specified in the "Dodd-Frank" legislation passed in 2010 that recklessness in addition to actual knowledge would be sufficient to plead an aiding and abetting charge.[139]

C. Prior Law on "Substantial Assistance" Requirement

The third requirement that the defendant provided "substantial assistance" to the primary violator is the one where the law has only recently changed. Previously, many lower courts in the Second Circuit have delimitated a strict standard to meeting this hurdle, the same as that used by courts deciding aiding and abetting claims in private litigation before the Supreme Court precluded private claims.[140] Under this standard, courts have provided that in enforcement actions the complaint must allege that the aider and abettor's conduct was a "substantial causal factor" in the perpetuation of the underlying violation,[141] and that the acts of the aider and abettor "proximately caused" the primary violation.[142] As the courts explained, this meant

---

[134] *Id.*

[135] *See, e.g.*, 15 U.S.C.A. § 78u-1(b)(1)(A) (West 2012); 15 U.S.C.A. § 80b-3(f) (West 2012); 15 U.S.C.A. § 80b-3(i)(1)(A)(iv) (West 2012).

[136] *See, e.g.*, 15 U.S.C.A. § 78u-1(b)(1)(B) (West 2012); 15 U.S.C.A. § 80b-4a (West 2010); 15 U.S.C.A. § 78o(f) (West 2010).

[137] *See generally In re* Raymond James Fin. Servs., Inc., S.E.C. Release No. 296, 2005 WL 2237628 (Sept. 15, 2005).

[138] Sec. & Exch. Comm'n v. Dibella, 587 F.3d 553 (2d Cir. 2009).

[139] Pub. L. No. 111–203, 124 Stat. 1376 (2010) (imposing liability on "any person that knowingly or recklessly provides substantial assistance to another person in violation of [the securities laws]").

[140] Bloor v. Carro, Spanbock, Londin, Rodman & Fass, 754 F.2d 57 (2d Cir. 1985).

[141] *See* Sec. & Exch. Comm'n v. Zwick, No. 03 Civ. 2742(JGK), 2007 WL 831812, at *16 (S.D.N.Y. Mar. 16, 2007).

[142] *See* Sec. & Exch. Comm'n v. Treadway, 430 F. Supp. 2d 293, 339 (S.D.N.Y. 2006).

that a "defendant provides substantial assistance only if [[s]he] affirmatively assists, helps conceal, or by virtue of failing to act when required to do so enables the fraud to proceed."[143] Conversely, a defendant's inaction was sufficient only if the defendant's inaction was "designed intentionally" to aid the primary fraud or it was in conscious or reckless violation of a duty to act."[144] Thus, "[a]wareness and approval, standing alone, do not constitute substantial assistance."[145] On the other hand, a very strong showing of "scienter" or intent can counteract a relatively weak showing of substantial assistance to permit a case to go forward.[146]

One recent decision illustrated how to apply these doctrines to the insider trading context. In *SEC v. Aragon Capital Advisors, LLC*,[147] the court denied the motions to dismiss the SEC's aiding and abetting charges against two of the individual defendants. The SEC claimed that these two individuals aided and abetted because their brokerage accounts were used for the trading involved. The court, in refusing to dismiss these charges, noted that the charges involved "more than mere awareness" because the allegations also stated that the secondary defendants would receive the profits from the trades in these accounts, and because the sheer length of the scheme "supported the inference that their inaction was intentional."[148] The court also reasoned than the high level of scienter shown on the defendants' part also militated in favor of allowing the charges to go forward.[149]

D. New Standard of Second Circuit

However, the Second Circuit recently relaxed the standards for pleading "substantial assistance." In the case before the court, the defendant negotiated the details of the transaction at issue, signed agreements designed to hide a company's risks, and approved or had knowledge of fraudulent invoices issued by the company for whom he worked, even though others were responsible for bringing about the fraudulent sale-leaseback transaction at issue and the defendant never authorized them to do so. In an opinion written by District Court Judge Jed Rakoff, sitting by designation on the circuit panel, the court rejected the strict standard above as applicable only to private litigation, which seek monetary damages as compensation

143 JP Morgan Chase Bank v. Winnick, 406 F. Supp. 2d 247, 256 (S.D.N.Y. 2005) (internal quotation marks omitted).

144 *Treadway*, 430 F. Supp. 2d at 339 (quoting Armstrong v. McAlpin, 699 F.2d 79, 91 (2d Cir.1983)).

145 *Armstrong*, 699 F.2d at 92 (2d Cir.1983).

146 ITT v. Cornfeld, 619 F.2d 909, 922 (2d Cir.1980) ("there may be a nexus between the degree of scienter and the requirement that the alleged aider and abettor render 'substantial assistance'"), *abrogated on other grounds by* Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869 (2010); ABF Capital Mgmt. v. Askin Capital Mgmt., L.P., 957 F. Supp. 1308, 1328 (S.D.N.Y. 1997) ("where there are particularly strong allegations of motivation and scienter, the allegations of substantial assistance need not be as directly tied to the [primary fraud violation]").

147 Sec. & Exch. Comm'n v. Aragon Capital Advisors, LLC, No. 07-cv-919, 2011 WL 3278907 (S.D.N.Y. July 26, 2011).

148 *Id.* at *18.

149 *Id.* at n.17.

for damages incurred by particular plaintiff.[150] In contrast, the court argued, a looser standard must be provided to enforcement actions such as those brought by the SEC towards the goal of deterring wrongdoing. As the court explained, "[m]any if not most aiders and abettors would escape all liability if such a proximate cause requirement were imposed since, almost by definition, the activities of an aider and abettor are rarely the direct cause of the injury brought about by the fraud."[151] As a result, the court applied a standard used in criminal cases that defined an aider and abettor as anyone who made some purposeful contribution to a fraud's success, even if the participation was not a cause in the literal sense.[152] In the court's words, quoting from a 1938 decision, the aider and abettor must "in some sort associate[] himself with the venture . . . participate[] in it as in something that he wishe[s] to bring about" and "[seek] by his action to make it succeed."[153]

As applied to an "innocent bystander" manager, regardless of whether his or her mental state met the recklessness required under 20(e), the involvement with a rogue trader would likely not satisfy the substantial assistance requirement. The three most likely points of support for the idea that the manager "assisted" the rogue trader are that the firm provided financial backing and compensation to the trader. However, these points do not appear to support a finding of "substantial assistance." First, with regards to the capital, this would not be unique to the illegal investment at issue. In addition, as one decision indicates, merely providing the account in which the trading takes place is at best considered inaction;[154] indeed, in that decision, the defendants suspiciously provided their own personal account to the trader, apparently in an attempt to avoid connection between the trading and a person with access to confidential information. Finally, compensation appears to be a non-starter as such compensation again is not unique to the trader at issue and in any case post-hoc compensation cannot show that the manager "proximately caused" the fraud itself.

VI. CRIMINAL LIABILITY

This Part proceeds by discussing the requirement for any criminal liability for securities fraud and then discusses any requirements unique to specific charges. Generally, the strict mental state that the Exchange Act requires for criminal liability makes any criminal prosecution based on control person liability unlikely for an "innocent bystander" manager. Generally, it is true that "Congress may constitutionally impose criminal liability upon a business entity for acts or omissions of its agents within the scope of their employment."[155] However, the Exchange Act only provides for criminal liability against someone who violates its provisions

[150] Sec. & Exch. Comm'n v. Apuzzo, 689 F.3d 204 (2d Cir. 2012).

[151] *Id.* at 213.

[152] *Id.*

[153] *Id.* at 212.

[154] *See Aragon*, 2011 WL 3278907, at *17-18 (ruling that person who knew of illegal activity but did not prevent trader from using his account was considered inaction).

[155] United States v. Hilton Hotels Corp., 467 F.2d 1000 (9th Cir. 1972) (citing United States v. A & P Trucking Co., 358 U.S. 121, 125-26 (1958)).

"willfully."[156] The Second Circuit defines that term as "a realization on the defendant's part that he was doing a wrongful act" [under the Exchange Act] in a situation where "the knowingly wrongful act involved a significant risk of effecting the violation that has occurred."[157] This definition includes two particular parts of note. First, the defendant must realize that he or she is doing something wrong; in the words of the case that set the Second Circuit's standard in this regard, the statute must be violated "intentionally and deliberately" and not as the result of an "innocent mistake, negligence, or inadvertence."[158] Second, while specific intent is not required, the act must involve a "significant risk" of violating the law.

A. Conspiracy

While theoretically, the U.S. Attorney's Office (USAO) could also assert liability against a manager as a co-conspirator with traders who committed insider trading, such a charge against an "innocent bystander" manager would appear to be baseless. To prove a conspiracy to commit an "offense against the United States" such as securities fraud, "the government must prove: (i) an agreement between the defendant and others as to the object of the conspiracy; (ii) specific intent to achieve the objective of the conspiracy; and (iii) an overt act in furtherance of the conspiracy by the defendant or one of his co-conspirators."[159] Even disregarding that the mental state of a bystander manager would not match that required for a criminal charge, such a manager certainly would not have made an "agreement" with a rogue trader to commit insider trading. As a result, such a charge would have no basis.

B. Criminal Aiding and Abetting Liability

In addition to the primary violator, anyone who "aids, abets, counsels, commands, induces or procures the commission of an offense against the United States is punishable as a principal for the underlying offense."[160] However, a defendant is only liable for aiding and abetting if he or she knew about the violation and provided "substantial assistance" to the primary violator.[161] In all likelihood the USAO would not be able to bring such a charge against a bystander manager, both, as discussed above, due to the likely lack of "substantial assistance" provided by the manager to the rogue trader, and also due to the manager's lack of actual knowledge of any potential fraud on the part of the rogue trader.

---

[156] 15 U.S.C.A. § 78ff(a) (West 2012).

[157] United States v. Cassese, 428 F.3d 92, 98 (2d Cir. 2005).

[158] United States v. Peltz, 433 F.2d 48, 55 (2d Cir. 1970).

[159] United States v. Montour, 944 F.2d 1019, 1024 (2d Cir. 1991); *see also* United States v. Sprecher, 783 F. Supp. 133, 156-60 (S.D.N.Y. 1992), *aff'd*, 988 F.2d 318 (2d Cir. 1993) (citing *Montour*, 944 F.2d at 1024 in case partially based on conspiracy to commit securities fraud).

[160] *Sprecher*, 783 F. Supp. at 157 (S.D.N.Y. 1992) (citing 18 U.S.C. § 2) (internal quotation marks omitted).

[161] *See generally* Graham v. Sec. & Exch. Comm'n, 222 F.3d 994, 1000 (D.C. Cir. 2000) (reviewing the elements of aiding and abetting liability); *In re* Michael T. Sullivan, Investment Advisors Act Release No. 1849, 1999 WL 1240647, at *3 (Dec. 22, 1999) (reviewing elements of charge in context of assertion of aiding and abetting liability against investment adviser).

C. Criminal Violation of Section 20(a)

A criminal charge under section 20(a), while a theoretical possibility, is extremely unlikely and has not been previously brought. As an initial matter, section 20(a) is a strict liability-like statute that simply requires control and a primary violation, and mentions no specific mental state or even any specific act. Seemingly this would be at odds with the black-letter principle in criminal law that there is no criminal liability for strict liability offenses. While, as discussed *infra* in Part II.A.2., the courts have added a requirement of "culpable participation" to section 20(a) claims, a requirement to which virtually all courts in the Second Circuit subscribe, the courts describe this element as requiring recklessness or "willful blindness"— concepts that imply something distinct from actual knowledge of committing a violation.

Second, the government's standing to enforce 20(a) is uncertain. The statute previously extended standing for this cause of action "to any person to whom such controlled person is liable."[162] As the Exchange Act includes government agencies in the definition of "person,"[163] the Second Circuit has held that the SEC has standing to enforce this section.[164] However, because some courts have rejected the SEC's standing,[165] the SEC historically brought relatively few actions under this provision. Recently, a provision of the Dodd-Frank Act amended 20(a) to explicitly provide standing to the SEC as well.[166] However, this provision only singled out the SEC and did not generally grant standing to the United States. No secondary sources discuss the possibility of a criminal charge for violations of 20(a). In sum, there is likely no criminal liability for a violation of section 20(a).

CONCLUSION

Obviously every case will depend on the specific facts present. However, generally it appears unlikely that the government would be able to sustain any primary liability, either through aiding and abetting or the conscious avoidance doctrine, or any criminal liability against an "innocent bystander" manager due to the activities of a rogue trader. On the other hand, sustaining a traditional charge of control person liability, based on such sources as section 20(a) or 21A of the

---

[162] 15 U.S.C.A. § 78t(a) (West 2012).

[163] *See* 15 U.S.C.A. § 78c(a)(9) (West 2012). This provision also includes the "government" itself in the definition, so seemingly the Second Circuit's reasoning would provide the United States with standing as well.

[164] Sec. & Exch. Comm'n v. First Jersey Sec., Inc., 101 F.3d 1450, 1472 (2d Cir. 1996); *see also* Sec. & Exch. Comm'n v. Mgmt. Dynamics, Inc., 515 F.2d 801, 812 (2d Cir. 1975); *accord* Sec. & Exch. Comm'n v. J.W. Barclay & Co., Inc., 442 F.3d 834 (3d Cir. 2006); Sec. & Exch. Comm'n v. Scrushy, No. CV-03-J-615S, 2005 WL 3279894 (N.D. Ala. Nov. 29, 2005); Sec. & Exch. Comm'n v. Buntrock, No. 02 C 2180, 2004 U.S. Dist. LEXIS 9495, at *27-28 (N.D. Ill. 2004); Sec. & Exch. Comm'n v. Fitzgerald, 135 F. Supp. 2d 992 (N.D. Cal. 2001).

[165] *E.g.*, Sec. & Exch. Comm'n v. Coffey, 493 F.2d 1304, 1318 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975); Sec. & Exch. Comm'n v. Stringer, No. Civ. 02-1341-ST, 2003 WL 23538011 (D. Or. Sept. 3, 2003).

[166] The Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, § 929P(c) (2010).

Exchange Act or section 203 of the Investment Advisers Act, will depend on whether the facts provide an indication of reckless conduct, and the legal bar for the government would be lowered if they work through an administrative procedure alleging a lack of proper policies and procedures regarding insider trading, based on the SEC's cease-and-desist power.