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Too Big to Jail: The Lack of Suitable Culpability Elements in the Criminal Liability of Principals

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TOO BIG TO JAIL: THE LACK OF SUITABLE CULPABILITY ELEMENTS IN THE CRIMINAL LIABILITY OF PRINCIPALS

INTRODUCTION

Due to the presence of securities fraud and insider trading in the race to gain informational advantages in securities markets, how is it possible to deter these practices and prevent the rise of a lemons market?[1] If there is a public notion that there is no way to compete with these illicit schemes through legitimate information gathering, then it makes the market less attractive to the investing public.[2] In order to deter future practices of securities fraud and insider trading, United States Attorney General Eric Holder implemented a new enforcement program in 2010 called "Operation Broken Trust."[3]

Despite this gradual approach towards holding certain Wall Street malfeasants accountable, few high profile cases have been successful. For example, federal prosecutors fell short in their pursuit of Ralph R. Cioffi and Matthew Tannin, two former hedge fund managers who were allegedly responsible for Bear Sterns' 2008 collapse.[4] After this failed effort, United States law enforcement had been hesitant to indict more members of Wall Street,[5] but the public outcry since the financial crisis[6] has beckoned federal law enforcement to rise to the challenge. Federal prosecutors have made a renewed effort in response to this demand for accountability, having

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1. *See* Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 762 n.192 (2006) ("A lemons market is a market in which asymmetric information exists between sellers and buyers. Since the buyers are not fully informed as to the quality of the products, they discount the price of all products.").

2. *See* STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 24 (2d ed. 2008) (explaining how a lemons market can develop from a failure to make honest disclosures, such as in securities fraud and insider trading schemes).

3. *See* Andrew Ross Sorkin, *Pulling Back the Curtain on Fraud Inquiries*, N.Y. TIMES (Dec. 6, 2010, 8:59 PM), http://dealbook.nytimes.com/2010/12/06/pulling-back-the-curtain-on-fraud-inquiries/ (noting that Mr. Holder's new task force has brought cases against 343 criminal defendants and 189 civil defendants for fraud schemes resulting in over $8 billion in losses).

4. *See* U.S. v. Cioffi, 668 F. Supp. 2d 385 (E.D.N.Y. 2009); *see also Bear Stearns Trial: How The Scapegoats Escaped*, N.Y. TIMES (Nov. 12, 2009, 6:58 AM), http://dealbook.nytimes.com/2009/11/12/bearstearns-trial-how-the-scapegoats-escaped/.

5. *Cf. SEC Enforcement Actions: Insider Trading Cases*, SEC, http://www.sec.gov/spotlight/insidertrading/cases.shtml (last visited Sept. 28, 2013) (noting that since 2009 the number of insider trading cases the U.S. Securities & Exchange Commission (SEC) has brought has grown exponentially).

6. Neil Barofsky, a former federal prosecutor, has noted that the government should have invested in more white-collar crime investigators to aid the growing need for investigations. *See* Chris Arnold, *After Five Years, Why So Few Charges In Financial Crisis?*, NPR.ORG (July 26, 2013, 4:55 PM), http://www.npr.org/2013/07/26/205866019/fewon-wall-street-have-been-prosecuted-for-financial-crisis ("[t]he folks responsible for this incredibly painful economic damage that struck our economy have gone free.").

indicted S.A.C. Capital for insider trading and securities fraud.[7] Despite United States Attorney Preet Bharara's proclamation that he does not "think anyone is too big to indict or jail,"[8] S.A.C. Capital founder and chairman Steven A. Cohen, escaped indictment while S.A.C. Capital and several of its mid-level managers did not.[9] Cohen was not indicted along with his hedge fund despite federal prosecutor's assertions that Cohen was "the fund owner" who "encouraged" his employees to acquire insider information despite its illegality.[10]

S.A.C. Capital's federal indictment serves as a prime example of how current federal securities law is relatively powerless to hold Wall Street leaders like Cohen accountable for their misconduct in overseeing corporate malfeasance.[11] Specifically, the "knowledge" requirement of most federal securities law creates a high evidentiary burden that is oftentimes difficult to meet.[12] Moreover, this lack of a threat of criminal liability for corporate ringleaders such as Cohen reveals a more troubling absence of a deterrence mechanism that will perpetuate if the current law is not reformed.[13] For example, Cohen has not ceased his risky spending[14] in light of his hedge

7. *See generally* Sealed Indictment, United States v. S.A.C. Capital Advisors, L.P., et al., No. 13CR00541 (S.D.N.Y. July 23, 2013), 2013 WL 3829113.

8. *See* Maureen Farrell, *Wall St. Sheriff: No One Too Big to Indict*, CNN.COM (July 17, 2013, 12:40 PM), http://money.cnn.com/2013/07/17/investing/wall-street-usattorney-sac/index.html.

9. *See* Patricia Hurtado, et al., *SAC Capital Indicted For Unprecedent Insider Trading Scam*, BLOOMBERG.COM (July 25, 2013, 5:53 PM), http://www.bloomberg.com/news/2013-07-25/sac-capital-indicted-in-six-year-u-s-insider-probe.html.

10. *Id.*

11. Bharara has noted the dangers of financial entities with large amounts of capital and a small moral compass. *See* Jeff Cox, *No One is Too Big to Jail, Wall Street Cop Says*, CNBC.COM (July 17, 2013, 10:33 AM), http://www.cnbc.com/id/100892955 ("If you give people a blank check and tell them they have a get-out-of-jail-free card because of their size . . . that's a very dangerous thing.").

12. *See generally* Samuel W. Buell, *What Is Securities Fraud?*, 61 DUKE L.J. 511 (2011).

13. *See* Andrew Ross Sorkin, *Pulling Back the Curtain on Fraud Inquiries*, N.Y. TIMES (Dec. 6, 2010, 8:59 PM), http://dealbook.nytimes.com/2010/12/06/pulling-back-the-curtain-on-fraud-inquiries/ (noting that in light of Operation Broken Trust, federal prosecutors have not brought criminal charges against any corporate official, instead prosecuting small-time targets).

14. Not only did Cohen purchase a $155 million Picasso painting shortly after S.A.C. Capital's civil settlement, he also threw an extravagant party in the Hamptons days after S.A.C. Capital was indicted. *See* Richard Vines & Katya Kazakina, *Cohen Buys Picasso's 'Le Reve' From Wynn for $155 Million*, BLOOMBERG.COM (Mar. 26, 2013, 2:12 PM), http://www.bloomberg.com/news/2013-03-26/cohen-buys-picasso-from-wynn-for-155-million-post-says.html; *see also* Matthew Goldstein, *Steven Cohen Throws Party Despite His Fund's Indictment*, REUTERS.COM (July 28, 2013, 3:58 PM), http://www.reuters.com/article/2013/07/28/us-sac-fund-party-idUSBRE96R0BQ20130728.

fund shedding assets[15] and despite settling a civil suit for a large sum of money.[16]

This Note applies several alternative criminal doctrines and codes to illustrate how federal securities law can be reformed to invoke a greater threat of criminal liability to principals of companies that engage in securities fraud and insider trading. These proposed alterations include changing the statutory language of 78ff(a) and 78j of the Securities Exchange Act of 1934 (the "Exchange Act") to impose liability when a principal, "willfully and knowingly *or by deliberate avoidance* makes, or causes to be made," any fraudulent securities exchanges. An exception would be provided for principals who have no responsibility and authority to prevent a violation of its agents and employees. This synthesis of the responsible corporate officer doctrine and the willful blindness doctrine lowers the current *mens rea* requirement and motivates principals to adhere to federal guidelines.

Part I of this Note will first discuss the U.S. Attorneys Office's development of its prosecution against S.A.C. Capital. Part II will analyze the jurisprudence of federal securities law, with specific attention to the statutory and deterrence limitations of current federal securities law to explain the difficulty of indicting Cohen. Part III will analyze Cohen's conduct if he were subject to the responsible corporate officer doctrine, including the potential benefits and criticisms if it were incorporated into federal law. Part IV will investigate whether the willful blindness doctrine offers a more practical solution to principal criminal liability, addressing both its proponents and detractors. Part V will conclude that an adoption of an industry specific securities law involving a synthesis of the responsible corporate officer doctrine and the statutory language of the willful blindness doctrine will serve as an effective deterrent, imposing a larger threat of criminal liability on principals and attenuating the zeitgeist for accountability on Wall Street.

I. BACKGROUND OF STEVEN COHEN AND S.A.C. CAPITAL'S INDICTMENT

The hedge fund, formerly known as S.A.C. Capital,[17] is a group of fund management companies[18] that are owned by Cohen. Cohen has a net worth

15. *See* Saijel Kishan, *SAC Shrinks U.S. Stock Holdings by $2 Billion Amid Probe*, BLOOMBERG.COM (Aug. 15, 2013, 12:00 AM), http://www.bloomberg.com/news/2013-08-15/sac-shrinks-u-s-stock-holdings-by-2-billion-amid-probe.html.

16. S.A.C. Capital recently settled with the SEC for $616 million. *See* Peter Lattman, *SAC Capital to Pay $616 Million in Insider Trading Cases*, N.Y. TIMES (Mar. 15, 2013, 1:58 PM), http://dealbook.nytimes.com/2013/03/15/sac-settles-insider-trading-cases-for-616-million/.

17. The moniker S.A.C. Capital represents the collective affiliated hedge funds operated by Cohen. Sealed Indictment, *supra* note 7, para. 2. The hedge fund operated as a pool of numerous individual portfolios respectively handled by a portfolio manager responsible for the profit or loss of their portfolio. *Id.* para. 8. After settling his hedge fund's criminal charges, Cohen renamed the

of $10.3 billion,[19] is currently number 121 on the Forbes' 400 Richest People in America,[20] and is the fifth richest American hedge fund manager.[21] Aside from being the owner, Cohen founded S.A.C. Capital in 1992.[22] Cohen serves the company as the CEO and Managing Director, whose offices are based in New York, New York and Stamford, Connecticut.[23] Through these entities, Cohen has produced a very successful operation using a "mosaic theory of investing,[24] earning him as much as $585 million in 2011.[25] While many critics have questioned whether this trading strategy constitutes insider trading,[26] the practice is considered by others as "perfectly legitimate and it is encouraged."[27]

S.A.C. Capital's success has not come without certain consequences. In April 2013, S.A.C. Capital settled a $602 million insider trading scheme with the U.S. Securities and Exchange Commission (SEC).[28] The SEC's

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entities Point 72 Asset Management. *See* Saijel Kishan & Kelly Bit, *Cohen Changes SAC Name to Point72 in Family Office Shift*, BLOOMBERG.COM (Mar. 11, 2014, 2:40 PM), http://www.bloomberg.com/news/2014-03-11/sac-capital-to-rename-as-point72-asset-management-memo-says.html.

18. The fund management companies served as investment advisors to S.A.C. Capital. The companies, referred to by Bharara as the "SAC Entity Defendants", include: CR Intrinsic Investors, LLC (CR Intrinsic), Sigma Capital Management, LLC (Sigma Capital), S.A.C. Capital Advisors, LLC, (S.A.C. Capital LLC), S.A.C. Capital Advisors, L.P. (S.A.C. Capital LP). *Id.* para. 3.

19. *See Steve Cohen*, FORBES.COM, http://www.forbes.com/profile/steve-cohen/ (last visited Sept. 30, 2014).

20. *Id.*

21. *See 2013 400 Richest Americans—Hedge Fund Managers*, FORBES.COM, http://www.forbes.com/pictures/eilm45fijj/5-steve-cohen/ (last visited Sept. 28, 2013).

22. *See Company Overview of S.A.C. Capital Management, LLC*, BUSINESSWEEK.COM (Sept. 29, 2013, 4:42 PM), http://investing.businessweek.com/research/stocks/private/people.asp?privcapId=1527066.

23. *Id.*

24. Mosaic theory is "the analysis of public and nonmaterial nonpublic information as the basis for investment recommendations and decisions even if those conclusions would have been material inside information had they been communicated directly to the analyst by a company." INTEGRITY RESEARCH ASSOCS., STANDARDS OF PRACTICE HANDBOOK 51 (10th ed. 2010), *available at* http://www.cfainstitute.org/learning/products/publications/ccb/Pages/ccb.v2010.n2.1.aspx.

25. Cohen keeps fifty percent of the profit his hedge fund earns. *See* Julie Creswell & Azam Ahmed, *Large Hedge Funds Fared Well in 2011*, N.Y. TIMES (Mar. 29, 2012, 11:00 PM), http://dealbook.nytimes.com/2012/03/29/large-hedge-funds-fared-well-in-2011/.

26. Many critics question the "materiality" of the nonpublic information that "mosaic theory" traders acquire. *See* Andrew Ross Sorkin, *Just Tidbits, or Material Facts for Insider Trading?*, N.Y. TIMES (Nov. 29, 2010, 8:56 PM), http://dealbook.nytimes.com/2010/11/29/just-tidbits-or-material-facts-for-insider-trading/? r=0.

27. It is argued that "each individual piece of information is nonmaterial by itself . . . [t]aken together, however, the bits of information can form a meaningful mosaic." *See* INTEGRITY RESEARCH ASSOCS., CFA LEVEL I ETHICS AND STANDARDS, *available at* http://www.investopedia.com/exam-guide/cfa-level-1/ethics-standards/standard-nonpublic-information.asp.

28. *See* Bob Van Voris, *SAC's Record $602 Million SEC Settlement Approved*, BLOOMBERG.COM (Apr. 16, 2013, 1:28 PM), http://www.bloomberg.com/news/2013-04-16/sac-s-record-602-million-sec-settlement-approved.html.

claim asserted that former S.A.C. Capital portfolio manager Mathew Martoma provided illegal tips about Alzheimer's medication to both CR Intrinsic and S.A.C. Capital, resulting in $276 million of illegal profit and the avoidance of losses on shares with Elan Corporation, plc and the former pharmaceutical company, Wyeth.[29] Although the allegation claims that Martoma shared this information with Cohen,[30] he was not charged or sued by the SEC.[31] While Cohen and his hedge fund appeared to have escaped the SEC's civil claim with a small fee, criminal charges and public notoriety were on the horizon.

On July 23, 2013, United States Attorney Preet Bharara indicted S.A.C. Capital, its entities, and seven former SAC employees on one count of wire fraud[32] and four counts of securities fraud.[33] The indictment charged S.A.C. Capital and its subsidiaries as being criminally responsible for its employees' insider trading offenses, asserting that this scheme was "made possible by institutional practices that encouraged the widespread solicitation and use of illegal inside information."[34] The touchstone of the indictment was S.A.C. Capital's alleged "institutional indifference"[35] to insider trading that was "without known precedent in the hedge fund industry."[36] Specifically, the allegations asserted that S.A.C. Capital and its management firms pursued the hiring of portfolio managers (PMs) and research analysts (RAs)[37] who had "proven access to public company contacts likely to possess [i]nside [i]nformation."[38] Further, it is claimed that S.A.C. Capital "failed to employ effective compliance procedures or practices" in order to deter its PMs and RAs from committing insider trading.[39]

With respect to the insider trading scheme, Bharara asserted that S.A.C. Capital's employees were given financial incentives to recommend to

29. *See generally* Complaint, SEC v. CR Intrinsic Investors, et al., No. 12 CV 8466 (S.D.N.Y. 2012), *available at* http://www.sec.gov/litigation/complaints/2012/comp-pr2012-237.pdf.

30. Cohen is anonymously referred to in the complaint as "Portfolio Manager A". *See generally id.* at 5.

31. While Cohen denied any misconduct, Martoma pleaded not guilty. Van Voris, *supra* note 28.

32. Sealed Indictment, *supra* note 7, paras. 35–43.

33. *Id.* paras. 36–43 (alleging that S.A.C. Capital and its management firms allegedly "did use and employ manipulative and deceptive devices and contrivances" in connection with the purchase and sale of securities.); *see also* 15 U.S.C. § 78ff (2012); 15 U.S.C § 78j(b); 17 C.F.R. §§ 240.10b-5 & 240.10b5 (1951).

34. Sealed Indictment, *supra* note 7, para. 1.

35. *Id.*

36. *Id.*

37. *Id.* para. 5. Throughout the indictment, Bharara refers to these positions as "SAC PMs" and "SAC RAs".

38. *Id.* para. 6.

39. *Id.*

Cohen[40] "high conviction" trading ideas that would give these portfolio managers an "edge" over other investors.[41] Furthermore, Cohen and S.A.C. Capital repeatedly failed to question the PMs' trading proposals, even if they "appeared to be based on [i]nsider [i]nformation."[42] In turn, Bharara asserted that the collective practices of S.A.C. Capital and Cohen "fostered a business culture . . . in which there is no meaningful commitment to ensure that such 'edge' came from legitimate research and not [i]nside [i]nformation."[43] These illegal practices had the effect of "hundred of millions of dollars in illegal profits and avoided losses at the expense of the members of the investing public."[44]

According to the indictment, the individual defendants—Wes Wang, Richard Choo-Beng Lee,[45] Jon Horvath, Noah Freeman, Donald Longueuil, Mathew Martoma, and Richard Lee[46]—were indicted on respective charges of wire fraud.[47] Of these seven defendants, only Jon Horvath, Mathew Martoma, and CB Lee had contact with Cohen relating to their respective insider trading charges.[48]

As established by the indictment, Cohen and S.A.C. Capital put an emphasis on hiring PMs and RAs that had an "edge" based partially on their "company contacts in their respective sectors,"[49] with no compliance measure to prevent these candidates from using their contacts to acquire non-public, material information.[50] After S.A.C. Capital approved prospective SAC PMs and RAs for hiring, it conducted a due diligence review.[51] For example, the due diligence report for Jon Horvath characterized his company contacts as a "key strength" in which he "min[ed] his industry contact network for datapoints."[52] Similarly, Mathew Martoma's due diligence report noted his health care "industry contacts

40. *Id.* para. 2. While Cohen was not indicted, the moniker "SAC Owner" is used throughout the indictment to describe his presence during the timeline of these charges.

41. *Id.* para. 6. The term "edge" is used throughout the indictment to suggest the presence of insider information.

42. *Id.*

43. *Id.* para. 7.

44. *Id.*

45. Richard Choo-Beng Lee is referenced at all relevant times in the document as "CB Lee." *Id.* para. 14b.

46. This Note will only discuss four of the individual defendants—Jon Horvath, CB Lee, Mathew Martoma and Richard Lee (R. Lee)—and their insider trading schemes as they concern some involvement of Cohen.

47. Sealed Indictment, *supra* note 7, para. 14.

48. These are the only three defendants in which the "SAC Owner" was referred to with respect to their allegations. In relation to R. Lee, Cohen had no alleged contact but did play a role in his hiring. *See generally id.*

49. *Id.* para. 17.

50. *Id.* para. 16.

51. *Id.* para. 18. This included "interviewing the candidate's references, prior employers and others, in part to identify the strength of the candidate's industry contact networks."

52. *Id.*

beyond management" and a personal "network of doctors in the field."[53] The indictment emphasized that neither Horvath's nor Martoma's reports included any reference to the probability that he would have or had actually used insider contacts to make impermissible trades on behalf of S.A.C. Capital.[54] In one instance, S.A.C. Capital hired a candidate who had a history of insider trading—R. Lee. In particular, Cohen received a warning from one of R. Lee's coworkers that R. Lee was known for being part of the hedge fund's "insider trading group."[55] Despite further caution expressed by S.A.C. Capital's legal department, Cohen proceeded to hire R. Lee.[56]

Among the insider trading charges made against S.A.C. Capital and its individual defendants, the contents of the allegation reflect that Cohen had contact with Horvath, Martoma, and CB Lee in connection with their misconduct.[57] These defendants, and how their misconduct relates to Cohen, will be discussed in turn.

A. HORVATH

Jon Horvath, employed by Sigma Capital from 2006 to 2011, was an SAC RA who specialized in technology.[58] On August 18, 2008, Horvath gained information from an insider at Dell that the company's earnings would be below market expectations.[59] Horvath relayed this information to his portfolio manager Michael Steinberg,[60] and in turn he shorted shares of Dell stock in Steinberg's portfolio.[61] On August 26, 2008, Steinberg relayed to Horvath that Cohen wanted Horvath to discuss his Dell information with a different SAC PM who had a contrarian view of Dell's financial position.[62] About an hour later, Horvath responded in an email to both Steinberg and the bullish SAC PM that he had a contact at Dell who verified his pessimistic view of the company's future performance, noting

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53. *Id.*

54. *Id.* Prosecutors emphasized that the due diligence reports made no reference to their "ethics, integrity, compliance or whether [they] had or was likely to use the referenced contacts to obtain or make trades based on [i]nsider [i]nformation."

55. *Id.* para. 19.

56. *Id.*

57. *See generally id.*

58. On September 28, 2012, Horvath pled guilty to charges of conspiracy and securities fraud for insider trading he committed while at Sigma Capital. These charges came in connection with insider trading with respect to Dell Inc. in August 2008 and NVIDIA Corporation in May 2009, in which Horvath obtained and provided inside information about these companies to Steinberg, who initiated subsequent trades. *Id.* para. 14c.

59. *Id.* para. 32a.

60. Mr. Steinberg also received an indictment in this case, but his relevance to this Note is as an intermediary between Horvath and Cohen. *Id.* para. 14c.

61. *Id.* para. 32a.

62. *Id.*

to keep this revelation secret.[63] The email also noted that the gross margin for Dell would fall short by "50-80 bps [basis points]."[64] This email was forwarded to Cohen's research trader who assisted him in trading technology stock. The trader then called Cohen and forwarded the email to him personally.[65] As a result, Cohen began selling the Dell shares in his portfolio, closing out his entire $12.5 million position and avoiding losses of about $1.7 million.[66] Two days later, Dell publicly announced earnings that aligned with Horvath's tip of below market expectations.[67] For his gratitude to his employees, Cohen emailed Steinberg's group, including Horvath stating, "[n]ice job on [D]ell."[68]

B. MARTOMA

Mathew Martoma, employed by CR Intrinsic from 2006 to 2010, was a SAC PM specializing in health care.[69] On April 11–12, 2008, Cohen exchanged emails with two CR Intrinsic health care analysts about information[70] regarding an Alzheimer's disease drug trial being run by Elan and Wyeth.[71] After a series of follow-ups regarding the clinical investigator at the drug trial, both analysts opined to Cohen that it '"was possible but unlikely"' that the '"final data"' would be statistically significant.[72] Not only did Cohen fail to question the CR Intrinsic analysts paid consultation for the information about the non-public drug trial data, he directed Martoma to substantiate the information presented by the clinical investigator.[73] On July 17, 2008, Martoma allegedly acquired "negative

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63. *Id.* Specifically, Martoma stated he had "a 2nd hand read from someone at the company—this is 3rd quarter I have gotten this read from them and it has been very good in the last two quarters. . . . Please keep to yourself as obviously not well known."

64. *Id.*

65. *Id.* paras. 29, 32a.

66. *Id.* paras. 29–30, 32a.

67. *Id.* paras. 30, 32a.

68. *Id.*

69. *Id.* paras. 11, 14f. On December 21, 2012, a grand jury indicted Martoma, charging him with insider trading with respect to shares of Elan Corporation, plc and Wyeth.

70. These two analysts, referred to in the indictment as "Analyst 1" and "Analyst 2" obtained information about this trial through a paid consultation with a clinical investigator. *Id.* paras. 18, 21d.

71. As of July 2008, S.A.C. Capital owned over $700 million worth of Elan American Depository Receipts ("ADRs") and Wyeth common stock, which was the hedge fund's largest position in equity securities. *Id.* paras. 27, 31a.

72. The analysts further concluded that it was not "unreasonable" to believe that the clinical investigator was amongst a "small # of ppl [who] have seen the [Drug Trial] data." *Id.* paras. 19, 21d.

73. Cohen clearly recognized Martoma's strength in the health care sector, noting that it "seems like Mat [Martoma] has a lot of good relationships in this arena" when discussing the drug trial with the two CR Intrinsic analysts. *Id.* para. 21e. In addition, the CR Intrinsic analysts complained in emails with each other that Martoma was "telling ppl he has black edge"—a phrase the indictment asserts is "[i]nside [i]nformation – with respect to the outcome of the Drug Trial." *Id.*

[i]nside [i]nformation" from a doctor involved with the drug trial connected to the business of Elan and Wyeth.[74] On July 19, 2008, Martoma went to Michigan to meet with the doctor personally.[75] The next day, Martoma called Cohen, who in turn began selling the fund's cumulative $700 million position in Elan and Wyeth, shorting about $260 million worth of stock.[76] This action was taken about a week before the public announcement of the drug trial results.[77] As a result of Martoma's tip and the subsequent trade, S.A.C. Capital profits and avoided losses from this insider trading scheme totaled about $276 million.[78]

C. Lee

CB Lee, employed by S.A.C. Capital LLC from 1999 to 2003 and then Sigma Capital from 2003 to 2004, was an SAC RA technology specialist.[79] During his time at these two S.A.C. Capital entities, CB Lee provided illegal insider tips to both his SAC PM and Cohen.[80] The indictment asserts that with respect to traders like CB Lee, Cohen failed to inquire about candidates "who at minimum implied that their 'edge' was based on sources of [i]nside [i]nformation."[81] Consistent with his business practices dating back to when he worked for Sigma Capital in 2004,[82] CB Lee provided tips to people at Sigma Capital on January 16, 2009, noting that a "friend of [his] cousin" who "work[ed] for Dell finance" told him "to avoid the stock for Q2, because Q2 is gonna [sic] be horrible."[83] Although CB Lee no longer worked for SAC Capital,[84] he contacted Cohen as late as June 2009 regarding trading suggestions on particular companies, in return for any profits made on the proposed tips.[85] Specifically, CB Lee represented that he knew sales and finance personnel at NVIDIA who "gave him information relating to quarterly earnings."[86] It remains to be seen if Cohen acted upon CB Lee's offer.

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74. *Id.* para. 31a.

75. *Id.*

76. *Id.* para. 31e.

77. Cohen allegedly made the trades on July 21, 2008. The public announcement of the drug trial did not come until July 29, 2008. *Id.*

78. *Id.*

79. *Id.* para. 14b.

80. CB Lee eventually pleaded guilty on October 13, 2009 to "conspiracy to commit securities fraud and wire fraud relating to trading recommendations based on [i]nside [i]nformation" that he provided to Sigma Capital during and after his tenure there. *Id.*

81. *Id.* para. 22.

82. When contacting either his SAC PM or Cohen, CB Lee would refer to his source of insider information as "my guy," "my contact," or "my check" at the relevant company. *Id.* para. 34a.

83. *Id.* para. 32c.

84. By 2008, CB Lee was operating his own hedge fund. *Id.*

85. *Id.* para. 22.

86. While the allegations do not suggest what Cohen did with this information, it is reasonable to infer that Cohen could have used CB Lee's Sigma Capital tips, along with Horvath's, to avoid Dell's below market expectations. *Cf id.* paras. 22, 32a. Even if Cohen did not act upon CB Lee's

While S.A.C. Capital is charged with "employ[ing] limited compliance measures designed to prevent insider trading by SAC PMs or SAC RAs,"[87] Cohen is alleged to have encouraged a policy of "not discussing [i]nside information too openly, rather than not seeking or trading on such information in the first place."[88] For example, an email communicated to Cohen by a SAC PM at CR Intrinsic back on June 11, 2008 described why a certain company contact did not go through with certain acquisitions.[89] On May 3, 2009, a second email from the same CR Intrinsic employee detailed that he was "very comfortable that this qtr [sic] is going to be solid vs [sic] current consensus and guidance" and that he was "getting coffee on tues [sic] afternoon with the guy who runs north American generics business."[90] Cohen simply replied, "Let's talk later."[91] In addition, on July 29, 2009, a new SAC PM[92] sent an instant message to Cohen, which detailed a tip he received on Nokia stock.[93] The PM further wrote that the head of S.A.C. Capital's compliance department "was giving [him] Rules 101 yesterday – so [he] [wouldn't] be saying much[.] [T]oo scary."[94] Cohen did not act on or respond to this message or the contents therein.[95]

Despite Cohen's connections to both the alleged culture of misconduct and to various traders' charges of insider trading, he was not formally indicted.[96] Even if Cohen has not faced any personal liability thus far, his firm is subject to another hefty settlement with federal authorities; federal prosecutors have recently proposed settling the criminal case for anywhere between $1.5 billion to $2 billion.[97] However, even if Cohen had to pay both of these settlements out of his own pocket, he would still stand to walk away a free man with a net worth around $7.7 billion.[98]

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contacts, he "did not express any concern about CB Lee's proposed sources of information during these conversations." *Id.* para. 22.

87. *Id.* para. 24.

88. *Id.* para. 23.

89. *Id.* para. 21a.

90. *Id.*

91. If anything, this evidence demonstrates Cohen's adherence to minimal discussion of insider information. *Cf. id.*

92. This anonymous individual is referred to in the indictment as the "New PM." *Id.* para. 23.

93. *Id.*

94. *Id.*

95. *Id.*

96. Similar to S.A.C. Capital's civil case, Cohen has denied any wrongdoing in response to the criminal indictment of his firm. *See* Paul M. Barrett, *Targeting SAC: When Prosecutors Charge Companies with Crimes*, BUSINESSWEEK.COM (July 26, 2013), http://www.businessweek.com/articles/2013-07-26/targeting-sac-when-prosecutors-charge-companies-with-crimes.

97. S.A.C. Capital, which currently holds about $10 billion in assets, would stand to lose up to $2.6 billion with the proposed criminal settlement and the previously settled civil case with the SEC. Michael Rothfeld et al., *Prosecutors Pursue Big SAC Settlement*, WALL ST. J.COM (Sept. 25, 2013), http://stream.wsj.com/story/markets/SS-2-5/SS-2-336611/.

98. Forbes notes that Cohen's net worth remains at $10.3 billion. *See Steve Cohen*, FORBES.COM, http://www.forbes.com/profile/steve-cohen/ (last visited Sept. 28, 2013).

II. JURISPRUDENCE OF LAW

In order to determine why Cohen was not indicted, it is necessary to examine the relevant statutory charges that were brought against the S.A.C. Capital entities and the four relevant individuals who were connected to Cohen. While the indictment includes five total counts, the majority of the alleged insider-trading scheme pertains to the one count of wire fraud.[99] A principal can be held liable under Title 18 of the United States Code—including wire fraud[100] —when they commit or aid and abet the commission of an offense.[101] Wire fraud is codified under section 1343 of Title 18 of the United States Code. An individual who commits wire fraud "devise[s] or intend[s] to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, transmits or causes to be transmitted by means of wire . . . in interstate or foreign commerce, any writings . . . for the purpose of executing such scheme."[102] Therefore, the government must prove that there was (1) a scheme to defraud, involving (2) money or property, and (3) the use of interstate wires to further that scheme.[103] While this charge seems reasonable to prove against individuals like Jon Horvath, CB Lee, Mathew Martoma, and R. Lee, Cohen's case is more tenuous. It may appear that Cohen was involved in the insider trading schemes of these individual defendants, but it is difficult to see how his conduct reflects that he "devised . . . [a] scheme . . . for obtaining money . . . by means of false or fraudulent pretenses [and] representations."[104] The indictment reflects that the individual defendants were directly involved in acquiring insider information and making trades based on that information.[105] Conversely, Cohen's alleged hiring practices and email conversations with employees do not provide enough evidence that he purposefully devised an insider trading scheme.[106] In fact, Cohen had the research traders responsible for his portfolios execute the illicit trades.[107] In addition, the relevant SEC violations also use direct language for the commission of the offense, which would appear to limit any vicarious liability to be imposed on Cohen.[108]

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99. Sealed Indictment, *supra* note 7, paras. 1–35.
100. 18 U.S.C. § 1343 (2012).
101. *Id.* § 2.
102. *Id.* § 1343.
103. *See* United States v. Victor Teicher & Co., 726 F. Supp. 1424, 1434–35 (S.D.N.Y. 1989); *see also* United States v. Mittelstaedt, 31 F.3d 1208, 1216 (2d Cir. 1994) (establishing similar elements for the federal mail fraud statute).
104. 18 U.S.C. § 1343 (2012).
105. *See generally* Sealed Indictment, *supra* note 7.
106. *Id.* para. 21a.
107. *Id.* para. 32a.
108. *See* 15 U.S.C. § 78ff(a) (2012) (requiring that one "willfully and knowingly makes, or causes to be made," any statement to be filed with respect to securities exchanges); *see also* 15 U.S.C. § 78j (requiring that one directly "effect[s] a short sale" or "stop-loss order" or uses "any manipulative or deceptive device[s]" with the purchase or sale of a security).

An examination of the theoretical distinctions of fraud suggests several alarming statutory flaws. There are two conceptual schools under which fraud has been developed—a morality-based concept and a victim-based concept.[109] Under the morality principle, "fraud requires that an actor seek to deceive another."[110] The *mens rea* requirements are fairly strict,[111] and the requisite liability question evaluates both the actor's culpability in making a false representation and his or her objective in engaging in this conduct.[112] Conversely, the victim-based principle focuses on the harm suffered at the hands of the misconduct. This victim-based principle is comparatively more flexible; it does not require an inquiry into the actor's intentions, but rather defines fraud as "negligent statements or conduct, or perhaps even on duly careful but nonetheless harmful statements or conduct."[113]

Professor Samuel Buell argues that the problem with criminal securities fraud involves disconnect between these two schools of thought.[114] When public officials like Bharara make statements that no actor "is too big to indict, no one is too big to jail,"[115] they appear to advocate the morality-based theory of fraud. On the other hand, the statutes, rules, and doctrine of securities fraud appear to align with the harm-based theory.[116] Throughout Buell's argument, he suggests that the term core fraud is a morality-based concept while misrepresentation is a victim-based concept. Core fraud is "best conceived as requiring purposeful deception."[117] Purpose is required under this account because it best captures an actor's intention to deceive another.[118] Essentially, the deception is a mechanism used towards a goal, and if that goal is not part of an actor's mental state, no fraud exists.[119] While misrepresentation is typically a tort, core fraud "require[s] everything needed to establish a misrepresentation, plus . . . the actor's level of mental state, fault, culpability, or moral blameworthiness."[120] In turn, the commission of core fraud requires scienter.[121] Thus, core fraud statutes,

109. Buell, *supra* note 12, at 515–16.

110. *Id.* at 515.

111. *Id.* Under this theory, "no such thing as no-fault fraud, negligent fraud, or arguably even reckless fraud can exist."

112. *Id.* at 515–16.

113. Naturally, this theory presents an array of legal actions. *Id.* at 516.

114. Or, as Buell puts it, the "duality and, at times, incoherence about the purpose and essence of [] law." *Id.* at 517.

115. Cox, *supra* note 11 ("If you give people a blank check and tell them they have a get-out-of-jail-free card because of their size . . . that's a very dangerous thing.").

116. Buell, *supra* note 12, at 516.

117. *Id.* at 526.

118. *Id.* at 527.

119. *Id.*

120. *Id.* at 529.

121. Scienter is defined as knowledge or belief in the misrepresentation or the knowledge that the actor does not have the basis for their representation. *See* RESTATEMENT (SECOND) OF TORTS § 526 (1977).

which attempt to embody both goals and awareness, face a virtually inevitable evidentiary problem—goals cannot be observed.[122]

The law of insider trading has further clouded the disarray surrounding securities fraud. Essentially, insider trading is an example of non-disclosure fraud.[123] Conceptually, it has ties to both core fraud and misrepresentation. If one has the goal to deceive when trading on an illegal tip, then he or she is defrauding the respective counterparty; if one is reckless as to whether he or she is trading on insider information, then it is more like misrepresentation.[124] While the wire fraud statute that codifies insider trading appears to meet the purposeful aspect of core fraud, the mental state of an actor is not always apparent. In easy cases of insider trading, the mental state is implicit in the actor's conduct.[125] This appears to be why individual defendants such as Horvath, CB Lee, Martoma, and R. Lee were easily indicted; each gained insider information on which he made trades in his respective portfolio(s). The evidentiary burden is more difficult in novel forms of deception, specifically intricate insider trading schemes. Awareness of misconduct can typically be established only by evidence that the actor tried to cover up the scheme or tried to prevent others from seeing the true nature of his or her conduct.[126] In light of this statutory inflexibility, actors like Cohen may have systematically removed themselves so as to render "the definition as faulty and under inclusive."[127]

If federal law enforcement seeks to reconcile its moral basis for fraud with federal securities law, then statutory reconstruction must focus on "specify[ing] the conditions of fault and harm that make[s] imprisonment and other forms of criminal punishment available."[128] In turn, "[a] regime centered on culpability and blameworthiness—in its focus on responsibility for acts of deception—is likely to require not only some scienter but a high level of awareness."[129] To date, wire fraud has at least done an adequate job in identifying what the actor's goal is in using this deceptive practice.[130] However, an appropriate definition of the requisite culpability for fraud is not an easy feat; a restrictive definition can fail to capture the ever-evolving

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122. Buell, *supra* note 12, at 532.

123. An actor defrauds the other party in a trade by failing to disclose that they had non-public, material information. *Id.* at 562.

124. *Id.* at 564.

125. *Id.* at 539.

126. *Id.*

127. *Id.* at 520.

128. *Id.* at 519.

129. *Id.* at 534.

130. The statute, which recognizes that actors devise a scheme of fraud to obtain money or property, appears to encapsulate the purpose of insider trading. 18 U.S.C. § 1343 (2012); *see also* Buell, *supra* note 12, at 563 ("[t]he seller/buyer defrauds her counterparty in a trade by not disclosing that she has advantageous inside information—and that her decision to trade is based on that information.").

concept of fraud whereas a flexible definition can be over-inclusive.[131] The issue that remains is what the appropriate culpability requirement would be in order to counter the ingenuity of corporate wrongdoers.[132]

III. HISTORY, APPLICATION, AND EVALUATION OF THE RESPONSIBLE CORPORATE OFFICER (RCO) DOCTRINE

A. THE HISTORY OF THE RCO DOCTRINE IMPOSES LIABILITY ON THOSE FOUND TO BE IN "RESPONSIBLE RELATION" TO CORPORATE MISCONDUCT

The responsible corporate officer (RCO) doctrine is a unique yet rarely used mechanism in criminal law. The doctrine imposes vicarious liability on a corporate officer for the criminal violation of his company or his subordinates. Specifically, the doctrine attaches when the corporate officer has maintained a position of responsibility and authority within the corporation and by means of that position, had the power to prevent the violation and failed to do so.[133] Most notably, the doctrine imposes liability upon officers for the illegal activity of their subordinates, without any proof that the officers were directly involved in or authorized the commission of the offense.[134] In light of the RCO doctrine's imputation of criminal intent, its application has been limited to "public welfare offenses," as it has been traditionally applied to violations of the Food, Drug, and Cosmetics Act (FDCA).[135]

The Supreme Court first applied the RCO doctrine in *United States v. Dotterweich*.[136] Joseph Dotterweich was the president of Buffalo Pharmacal Company, a supply chain distributer of drugs that had purchased drugs from its manufacturers, repacked them under its own label and resold them in interstate commerce.[137] Dotterweich asserted that he did not know the drugs were mislabeled.[138] Both Dotterweich and his company were convicted for violating Section 301(a) of the FDCA, a strict liability offense.[139] The Second Circuit reversed the conviction, reasoning that Congress could not have intended Section 301(a) to apply to individuals like Dotterweich,

131. Buell, *supra* note 12, at 520–21.

132. *Id.* at 531. Available mental states include knowledge, willful blindness, recklessness, gross negligence, negligence and strict liability.

133. *See* United States v. Park, 421 U.S. 658, 673–74 (1975).

134. *See* Kathleen F. Brickey, *Criminal Liability of Corporate Officers for Strict Liability Offenses-Another View*, 35 VAND. L. REV. 1337, 1343 (1984) (noting that *Park* and *Dotterweich* imposed criminal liability upon officers who did not directly participate in the commission of the offense).

135. *See* 21 U.S.C. § 301 et seq. (2012).

136. *See* United States v. Dotterweich, 320 U.S. 277, 285 (1943).

137. *Id.* at 278.

138. *Id.* at 286.

139. *See* 21 U.S.C. § 301(a); *Dotterweich*, 320 U.S. at 278.

pursuant to the "good faith" exception codified in Section 303(c).[140] The Supreme Court upheld the conviction, noting that the statute's foundation in strict liability "dispensed with the conventional requirement for criminal conduct—awareness of some wrongdoing."[141]

The Supreme Court explained its harsh decision by noting that the "circumstances of modern industrialism" have left the public more vulnerable to issues of life and health.[142] In the Supreme Court's recognition of this "larger good," it justified the criminal prosecution of "otherwise innocent" corporate officers like Dotterweich who are "in responsible relation to a public danger."[143] It was further opined that Congress intended for this strict liability to be placed on "those who have at least the opportunity to inform[] themselves" of such violations.[144] Despite the creation of this doctrine, the Supreme Court refused to define the class of corporate officers that would be "in such a responsible relation."[145]

The RCO doctrine and its imposition of strict liability on corporate officers were reaffirmed in *United States v. Park*.[146] In this case, a large national food chain and its president, John Park, were found in violation of Section 301(k) of the FDCA,[147] resulting from a rodent infestation in the company's warehouses.[148] During trial, Park admitted that he was responsible for providing sanitary conditions, but that it was one of many company duties he assigned to "dependable subordinates."[149] Despite this defense, the jury found Park guilty on all counts.[150]

The Fourth Circuit reversed the conviction, noting that *Dotterweich* had dispensed of the traditional element of "awareness of some wrongdoing," but that it had not removed the element of "wrongful action," which is required for due process.[151] The Supreme Court in *Park* rejected the Fourth Circuit's decision that the government had the burden of establishing that Park had engaged in "wrongful action."[152] The Supreme Court found precedent where liability was imposed not only to corporate officers who engaged in misconduct, "but also to those who by virtue of their managerial

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140. This "good faith" exception notes that if a product is received with a guaranty of innocence from the seller, then that product is adulterated or misbranded. *Dotterweich*, 320 U.S. at 278–80.

141. *Id.* at 281.

142. *Id.* at 280.

143. *Id.* at 281 (citing United States v. Balint, 258 U.S. 250, 252 (1922)).

144. *Id.* at 284.

145. *Id.* at 285.

146. United States v. Park, 421 U.S. 658, 671–72 (1975).

147. *Id.*

148. *Id.* at 660.

149. *Id.* at 664.

150. The jury was instructed to find Park liable if he had "a responsible relation to the situation, even though he may not have participated personally . . . . even if he did not consciously do wrong." *Id.* at 665 n.9.

151. *See* United States v. Park, 499 F.2d 839, 842 (4th Cir. 1974), *rev'd*, 421 U.S. 658 (1975).

152. *Park*, 421 U.S. at 673.

positions or other similar relation to the actor could be deemed responsible for its commission."[153] In this respective class of precedent cases, where the relevant statute dispensed with a "consciousness of wrongdoing," an omission or failure to act was considered sufficient to hold the responsible corporate officer liable.[154] In each of these cases, liability under the doctrine was satisfied by the significance of the agent's relationship to the corporation, which granted the "power to prevent the act complained of."[155] Additionally, the Court noted that the reach of the FDCA and other strict liability statutes imposes a duty not only to remedy such violations but also to implement business practices to prevent their occurrence.[156]

In affirming Park's conviction, the Supreme Court articulated three clear elements of liability under the RCO doctrine. A corporate officer will be liable when (1) "by reason of his position in the corporation," he had (2) "responsibility and authority either to prevent in the first instance, or promptly to correct, the violation complained of," and (3) "failed to do so."[157] Other than clarifying the RCO standard, the Supreme Court in *Park* appeared to expand the reach of the doctrine; while Dotterweich was closely involved in the operations of his small company,[158] Park was the president of a corporation with approximately 36,000 employees and 874 retail outlets, exercising his control through subordinates.[159] Despite the reach of the RCO doctrine to officers in companies of varying sizes and aspects of control, it has been applied only to a limited group of "public welfare" offenses.[160]

B. THE APPLICATION OF THE RCO DOCTRINE TO FEDERAL SECURITIES LAW IS NOT WITHOUT DOCTRINAL AND PRACTICAL CONFLICTS

If current federal securities law were adapted to reflect the elements of the RCO doctrine, it would be easier to indict and potentially prosecute

153. *Id.* at 670.
154. *Id.* at 671.
155. *Id.* (citing State v. Burnham, 128 P. 218 (1912); Overland Cotton Mill Co. v. People, 275 P. 924 (1904); *Cf.* Groff v. State, 85 N.E. 769 (1908); Turner v. State, S.W.2d 236 (1937); People v. Schwartz, 70 P.2d 1017 (1937); Francis Bowe Sayer, *Criminal Responsibility for the Acts of Another*, 43 HARV. L. REV. 689 (1930)).
156. *Id.* at 671–72.
157. *Id.* at 673–74.
158. *See* United States v. Buffalo Pharmacal Co. Inc., 131 F.2d 500, 501 (1942) (noting that Dotterweich was in charge of the general business and instructed his employees to fill orders from physicians).
159. *Park*, 421 U.S. at 660.
160. The Supreme Court in *Dotterweich* appeared to limit the application of the RCO doctrine to those with "responsible relation to a public danger." United States v. Dotterweich, 320 U.S. 277, 281 (1943) (citing United States v. Balint, 258 U.S. 250, 252 (1922)); *see, e.g.*, United States v. MacDonald & Watson Waste Oil Co., 933 F.2d 35, 51–52 (1st Cir. 1991) (concluding that the RCO doctrine should be restricted to "public welfare statutes and regulations" lacking *mens rea* requirements).

corporate principals such as Cohen. In the omission of "awareness of some wrongdoing" and "wrongful action," as championed by *Dotterweich* and *Park*, federal prosecutors would be able to reach corporate principals like Cohen if the officers' inaction in preventing the securities law violations was within their "position in the corporation, responsibility, and authority."[161]

Although federal prosecutors in *United States v. S.A.C. Capital Advisors, L.P., et al* did not indict Cohen, there is sufficient evidence in the complaint that would result in criminal liability under the RCO doctrine, due to Cohen's inaction in preventing his hedge fund and his employees from partaking in this insider-trading scheme. Under the RCO doctrine, Cohen would be held liable if "by reason of his position in the corporation," he had "responsibility and authority either to prevent in the first instance, or promptly to correct, the violation complained of," and "failed to do so."[162] As previously noted, Cohen is the owner and founder of S.A.C. Capital, now called Point72 Asset Management.[163] He serves the company as the CEO and Managing Director.[164] With respect to the operation of the hedge fund, Cohen allocated investment capital among approximately 100 internal portfolios, each which was managed by an SAC PM.[165] Moreover, Cohen himself had sole trading discretion over his own portfolio, the largest one in the entire company.[166] Finally, Cohen required each SAC PM to disclose to him "high conviction" trading ideas—that is, the investment recommendations that the respective PM had great confidence in.[167]

Due to Cohen's aspect of control over the operation of the internal portfolios and his requirement that SAC PMs share "high conviction" trading ideas, it is clear he had the "responsibility and authority" to prevent any securities fraud or insider trading violations by his employees. Additionally, the insider trading schemes involving Dell and Wyeth stock shows that Cohen failed to act when his PMs had information that appeared to be non-public and material. With respect to the Dell trade, Horvath sent an email to Cohen that appeared to hint that the email was both non-public and material.[168] Not only did Cohen refuse to question Horvath about his contact, he sold his entire $12.5 million Dell portfolio within ten minutes of seeing the email, avoiding losses of about $1.7 million.[169] Rather than question Horvath's means of acquiring this information, Cohen emailed

161. *Park*, 421 U.S. at 672–74.
162. *Id.* at 673–74.
163. *Company Overview of S.A.C. Capital Management, LLC*, *supra* note 22.
164. *Id.*
165. Sealed Indictment, *supra* note 7, para. 9.
166. *Id.* para. 11.
167. *Id.*
168. Horvath made sure to note in his email to Steinberg, which was forwarded to Cohen, that the information should be "ke[pt] to yourself as obviously [its] not well known." *Id.* para. 32a.
169. *Id.* paras. 21b, 32a.

Steinberg and Horvath stating, "[n]ice job on [D]ell."[170] Moreover, when Cohen avoided losses by shorting $260 million worth of Wyeth and Elan stock,[171] he never asked his two RAs or Martoma if the information suggesting that the Alzheimer drug trial would fail was acquired legally.[172] Instead, he chose to trust confidential information and the benefits his hedge fund received as a result.[173]

While the RCO doctrine appears to have the benefit of reaching Cohen due to his "position in the corporation, responsibility, and authority," there are several doctrinal inconsistencies that question its effectiveness and fairness. First, if federal securities law were to follow the concepts championed by the Supreme Court in *Dotterweich* and *Park*, then hedge fund managers and other principals of large corporations would have "a positive duty to seek out and remedy violations when they occur" and more importantly, a "duty to implement measures that will ensure violations will not occur."[174] As noted by William Buell, there are many difficulties in identifying the duty to disclose in insider trading law, as "a duty to disclose all informational advantages before trading would sweep too broadly."[175] This rationale has also been supported in *Chiarella v. United States*, in which the Supreme Court reversed the insider trading conviction of an employee of a financial printer, noting that one who used information acquired at work to purchase stock had a duty to disclose to the market as a whole.[176] If the application of the RCO doctrine were to require these immense duties to prevent insider trading violations, then principals such as Cohen would have to publicly disclose all information used to make trades. This would seem to interfere with rewarding those diligent traders who should be encouraged and rewarded in their efforts to legally acquire beneficial information.[177]

Second, the penalties associated with federal securities law are not compatible with the penalties justified under the traditional RCO doctrine cases. As evinced by the Supreme Court in *Morissette v. United States*, the justification for the omission of misconduct and knowledge under the RCO doctrine is that the penalties for public welfare crimes "commonly are relatively small, and conviction does no grave damage to an offender's reputation."[178] This notion is consistent with the penalties imposed in *Dotterweich*, *Park*, and *Morissette*. In *Dotterweich*, the plaintiff was

170. *Id.* para. 32a.
171. *Id.* para. 31a.
172. *See supra* note 70.
173. *Id.*
174. United States v. Park, 421 U.S. 658, 672 (1975).
175. Buell, *supra* note 12, at 562.
176. *See* Chiarella v. United States, 445 U.S. 222, 231–33 (1980).
177. As Buell notes, "[t]here is not, and should not be, a right of equal knowledge in securities markets . . . ." Buell, *supra* note 12, at 562.
178. *See* Morissette v. United States, 342 U.S. 246, 256 (1952).

convicted for shipping "adulterated and misbranded" drugs, which is a misdemeanor, resulting in imprisonment for no longer than one year and a $1,000 fine.[179] In *Park*, the plaintiff was found guilty for five counts under 331(k) of the FDCA, resulting in a $50 fine for each count.[180] In *Morissette*, the plaintiff, in stealing government property, was subject either to two months imprisonment or a $200 fine.[181] Unlike the penalties imposed in these cases, the counts cited in S.A.C. Capital's indictment are far graver. For example, under 18 U.S.C. § 1343, the penalties include a fine or imprisonment for up to twenty years, or both.[182] If criminal penalties for insider trading and securities law violations are reserved for serious forms of wrongdoing, then the law needs to "specify the conditions of fault and harm that make imprisonment and other forms of criminal punishment available."[183] As the RCO doctrine stands, simply punishing an officer for their "position in the corporation, responsibility, and authority" would fail to show why their conduct is more reprehensible than someone who intended to let insider trading occur, as opposed to failing to act in preventing the misconduct. Moreover, since the RCO doctrine is invoked in circumstances under which there is a threat to public health and welfare, insider trading and securities law violations fail to posit such a sweeping form of harm on victims of these schemes.[184] Due to these aforementioned doctrinal inconsistencies, it seems unlikely that such an encapsulating strict-liability provision like the RCO doctrine could be feasibly incorporated and accepted into federal securities and insider trading law.

IV. HISTORY, APPLICATION, AND EVALUATION OF THE WILLFUL BLINDNESS DOCTRINE

A. THE HISTORY OF THE "WILLFUL BLINDNESS" DOCTRINE IMPUTES KNOWLEDGE WHERE ONE "DELIBERATELY AVOIDS" KNOWLEDGE OF MISCONDUCT

The "willful blindness" standard, known in some circuits as "conscious avoidance," is a jury instruction that is used in federal fraud prosecutions. The two leading cases that use this jury instruction are *United States v. Svoboda* in the Second Circuit[185] and *United States v. Jewell* in the Ninth

179. *See* 21 U.S.C. §§ 331(a), 333(a)(1) (2012).
180. *See* 21 U.S.C. §§ 331(k), 333(a)–(b).
181. *See* 18 U.S.C. § 641 (2012).
182. *See* 18 U.S.C. § 1343.
183. Buell, *supra* note 12, at 519.
184. Buell questions how much and what kind of harm is sufficient to make a fraud case "really criminal." *Id.* at 538 n.78 (critiquing the 2010 U.S. Sentencing Guidelines Manual's dollars lost to the victim metric as "crude.").
185. *See* U.S. v. Svoboda, 347 F.3d 471 (2d Cir. 2003), *cert. summarily denied*, U.S. v. Robles, 541 U.S. 1044 (2004).

Circuit.[186] In *Svoboda*, Michael Robles and his friend Richard Svoboda were charged with engaging "in a conspiracy to commit securities and tender offer fraud" that occurred between November 1994 and December 1997.[187] During that time, Svododa was a "credit policy officer[] at Nations Bank[,]" who was responsible for structuring and approving corporate loans to clients.[188] Within the scope of his employment, Svodoba was "privy to confidential information" about certain securities and tender offers of Nation Bank's clients.[189] In turn, Svodoba relayed this confidential information to Robles, who made trades based on these tips and shared the profits with Svodoba.[190] While Svodoba reached a plea deal and testified that Robles knew the information was illegal, Robles denied any knowledge of the illegality of the source material.[191] Since Robles was being prosecuted under 18 U.S.C. § 371, three essential elements needed to be proven: (1) an agreement among two or more people; (2) the defendant's knowing and willful joinder in that conspiracy; and (3) commission of an overt act in furtherance of the conspiracy by at least one of the alleged co-conspirators.[192]

In analyzing these elements, the Second Circuit introduced the "conscious avoidance doctrine," in which "a defendant's knowledge of a fact required to prove the defendant's guilt may be found when the jury 'is persuaded that the defendant consciously avoided learning that fact while aware of a high probability of its existence.'"[193] Additionally, this jury instruction "permits a finding of knowledge even where there is no evidence that the defendant possessed actual knowledge."[194] In attacking the "conscious avoidance" jury instruction, Robles noted a prior decision that stated that the Second Circuit "do[es] not permit the doctrine to be used to prove intent to participate in the conspiracy."[195] The Second Circuit rejected this contention, noting that if intent to participate could not be proven by the doctrine with respect to one conspirator, then the necessary proof of intent to participate by at least two conspirators would be lacking.[196] In affirming the District Court's "conscious of avoidance" jury instruction, the Second Circuit noted that there was "no reason why the factfinder may not rely on conscious avoidance to satisfy at least the

186. *See* U.S. v. Jewell, 532 F.2d 697 (9th Cir. 1976), *cert. denied*, 426 U.S. 951 (1976).
187. *Svoboda*, 347 F.3d at 475.
188. *Id.*
189. *Id.*
190. *Id.*
191. *Id.*
192. *Id.* at 476 (referencing United States v. Pickney, 85 F.3d 4, 8 (2d Cir. 1996)) (citation omitted).
193. *Id.* at 477 (citing United States v. Samaria, 239 F.3d 228, 239 (2d Cir 2001)) (citation omitted).
194. *Id.* at 477–78 (quoting United States v. Ferrarini, 219 F.3d 145, 154 (2d Cir. 2000)).
195. *Id.* at 478 (quoting United States v. Reyes, 302 F.3d 48, 64 (2d Cir. 2002)).
196. *Id.*

knowledge component of intent to participate in a conspiracy."[197] In dismissing Robles argument, the Second Circuit found that the District Court did not err in the application of the "conscious avoidance" instruction, which requires, "1) the defendant asserts the lack of some specific aspect of knowledge required for conviction, . . . and 2) . . . the evidence is such that . . . beyond a reasonable doubt . . . that [the defendant] was aware of a high probability [of the fact in dispute] and consciously avoided confirming that fact[.]"[198]

In *Jewell*, the defendant appealed a conviction in which he entered the United States driving a car that contained 110 pounds of marijuana worth $6,250 that was hidden in a secret compartment between the trunk and rear seat.[199] During the appeal, the issue was how the knowledge requirement is applied to 21 U.S.C. § 841, which is considered a "general intent crime."[200] The Ninth Circuit acknowledged precedent which stated that "the statute is violated only if possession is accompanied both by knowledge of the nature of the act and also by the intent 'to manufacture, distribute, or dispense.'"[201] During the course of the appeal, the defendant defined "knowingly" as positive knowledge that a controlled substance is involved.[202] In turn, defendant argued that although there was testimony that he knew about the secret compartment, he did not know that there was a controlled substance stored there, justifying his acquittal.[203] While the District Court rejected the defendant's contention, and gave a jury instruction that knowledge could be proven where, "his ignorance in that regard was solely and entirely the result of his having made a conscious purpose to disregard the nature of that which was in the vehicle, with a conscious purpose to avoid learning the truth."[204] Despite defendant's contentions that the statute required actual knowledge, the Ninth Circuit upheld the jury instruction. The *Jewell* court stated that, "'[d]eliberate ignorance' instructions have been approved in prosecutions under criminal statutes prohibiting 'knowing' conduct [in] Second, Sixth, Seventh, and Tenth Circuits."[205] More specifically, the court noted that by granting the defendant's acquittal, they would go against two circuits that have approved the "deliberate ignorance" instructions with respect to 21 U.S.C. § 841.[206] In concluding, the Ninth Circuit noted that "deliberate ignorance" only differs from positive knowledge as it

197. *Id.* at 479.
198. *Id.* at 480 (quoting United States v. Ferrarini, 219 F.3d 145, 154) (citations omitted).
199. U.S. v. Jewell, 532 F.2d 697, 698 (9th Cir. 1976).
200. *Id.*
201. *Id.* (quoting United States v. Clark, 475 F.2d 240, 248–49 (2d Cir. 1973)).
202. *See id.*
203. *Id.* at 699.
204. *Id.* at 700.
205. *Id.* at 702.
206. *Id.* at 703.

"encompasses a calculated effort to avoid the sanctions of the statute while violating its substance."[207]

B. THE APPLICATION OF THE WILLFUL BLINDNESS DOCTRINE ENCOURAGES CREATIVE CIRCUMVENTION AND OVER-DISCLOSURE

If lawmakers were to adopt a willful blindness or conscious avoidance *mens rea* requirement into federal securities law, the reach of the respective statutes would be sufficient to indict Cohen and likely hold him liable. Under section 78ff(a) of the Exchange Act, a person is held liable for securities fraud when that person "willfully and knowingly makes, or causes to be made," any statement to be filed with respect to securities exchanges.[208]

Liability for insider trading is codified under section 78j of the Exchange Act, in which one directly "effect[s] a short sale" or "stop-loss order" or uses "any manipulative or deceptive device[s]" with the purchase or sale of a security and violates the Exchange Act.[209] If section 78ff(a) added the language "or deliberately ignores"[210] or "or willfully blinds" to supplement the knowledge requirement, it would serve to reach corporate individuals like Cohen who avert their eyes to misconduct. As noted by the indictment, Cohen "fostered a culture that focused on not discussing [i]nside [i]nformation too openly, rather than not seeking or trading on such information in the first place."[211] Aside from ignoring the inherently cryptic sources that both Horvath and Martoma used in their respective trading recommendations for Dell[212] and Wyeth,[213] Cohen used tactics such as diverting or not responding to communications containing suspicious information.[214]

The benefits of applying the willful blindness doctrine to federal securities law are readily apparent. By prohibiting principals from deliberately avoiding the trading misconduct of their employees, the willful blindness doctrine would serve as a less restrictive evidentiary burden and

207. *Id.* at 704 n.19 (citing United States v. Sarantos, 455 F.2d 877, 881 (2d Cir. 1972), which noted that the purpose of deliberate ignorance is "to prevent an individual . . . from circumventing criminal sanctions merely by deliberately closing his eyes to the obvious risk that he is engaging in unlawful conduct.").

208. 15 U.S.C. § 78ff(a) (2012).

209. *Id.* §§ 78j(a)(1), (b).

210. This is an adoption of the "deliberate ignorance" instruction discussed by the Ninth Circuit in *Jewell*. *See generally Jewell,* 532 F.2d.

211. Sealed Indictment, *supra* note 7, para. 23.

212. *Id.* paras. 21b, 32a.

213. *Id.* paras. 21d–e.

214. In one instance, Cohen did not respond to an email in which a SAC PM implied he received inside information and in turn would short Nokia stock. In another, Cohen responded "[l]et's talk later" to an employee who claimed confidence in a company's quarterly performance in lieu of meeting with a company insider. *Id.* paras. 21a, 23.

an impetus in self-regulation. The presence of the willful blindness doctrine would likely motivate Cohen himself to ensure a more stringent compliance department [215] and more effective due diligence investigations in employment[216] to correct his hedge fund's "institutional indifference" to insider trading.

Despite the benefit of imposing more of a threat of criminal liability on principals, the presence of the willful blindness doctrine in federal securities law would create both judicial and practical problems. The Supreme Court has never specified the scienter requirement for holding someone criminally liable for securities fraud. The lower federal courts have rendered a varied array of opinions that make an interpretive mess of the *mens rea* required for securities crimes.[217] These results have ranged from willfulness with awareness of a wrongful act,[218] to specific intent to defraud with the knowledge or willful blindness to its falsity,[219] or even as far as specific intent to defraud while acting recklessly, with an undefined meaning of recklessness.[220] While scholars have argued that clarity needs to be made of this interpretive disorder,[221] defining the *mens rea* in specific terms such as "willful blindness" is at odds with the need for flexibility in the law of fraud.[222] In turn, there is a grave risk in defining securities fraud too rigidly.[223]

In addition, this newfound presence of vicarious liability for consciously avoiding securities violations places an impractical burden on principals moving forward. While self-regulation would be a potential goal

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215. From a limited number of S.A.C. Capital's compliance department's internal investigations, it was merely confirmed that suspicious language in correspondence was merely "inartfully drafted." *Id.* para. 28.

216. The due diligence process made no reference to ethics, integrity, compliance or the candidate's tendency to make trades on inside information. *Id.* para. 18.

217. *See* Michael L. Siegel, *Bringing Coherence to Mens Rea Analysis for Securities-Related Offenses*, 2006 WIS. L. REV. 1563, 1590–98 (2006) (analyzing several cases to convey the inconsistencies between federal courts in defining "willfulness" in federal securities law).

218. United States v. Kaiser, 609 F.3d 556, 567–70 (2d Cir. 2010); United States v. Reyes, 577 F.3d 1069, 1079–80 (9th Cir. 2009); United States v. Peltz, 433 F.2d 48, 54–55 (2d Cir. 1970).

219. United States v. Gentile, 530 F.2d 461, 469–70 (2d Cir. 1976); United States v. Mackay, 491 F.2d 616, 623 (10th Cir. 1973); United States v. Amick, 439 F.2d 351, 363–64 (7th Cir. 1971); United States v. Benjamin, 328 F.2d 854, 862–63 (2d Cir. 1964).

220. United States v. Tarallo, 380 F.3d 1174, 1188–89, 1189 n.5 (9th Cir. 2004); United States v. Sawyer, 799 F.2d 1494, 1501–02 (11th Cir. 1986); United States v. Farris, 614 F.2d 634, 638 (9th Cir. 1979); United States v. Henderson, 446 F.2d 960, 966 (8th Cir. 1971); Elbel v. United States, 364 F.2d 127, 133–34 (10th Cir. 1966).

221. *See generally* Siegel, *supra* note 217 (arguing for the coherence of *mens rea* analysis by means of a clear understanding of the choices in criminal securities law violations).

222. Buell, *supra* note 12, at 520 (noting that fraud involves misconduct that "is characterized by inventiveness."). *See also* Samuel W. Buell, *Novel Criminal Fraud*, 61 N.Y.U. L. REV. 1971, 1972 (2006) ("Instability in the law of fraud is structural.").

223. If fraud is narrowly defined to specific behaviors, new behaviors will arise that will expose the flaws in the statutory construction. Buell, *supra* note 12, at 520.

of this new doctrine,[224] it may keep principals from their other corporate responsibilities, including making a profit for shareholders.[225] If corporate principals seek to prevent themselves from being willfully blind to a potential regulation, they will likely adhere to the "disclose or abstain" rule.[226] Over-disclosure would appear to be at odds with the general premise that the public isn't entitled to free flowing material public information within the securities markets.[227]Abstaining from trading on any risky tip would impede the incentive to use efficient trading strategies such as the mosaic theory of trading.[228]

In addition, a more risk-adverse investment firm or hedge fund would stand to lose investors due to an overly cautious approach in developing a profitable mosaic of non-public and public information. The willful blindness doctrine may bring a regime of deterrence in securities law that the general public would seek, but without a more flexible approach to imposing the threat of criminal liability on principals, both judicial and practical conflicts render the doctrine impractical.

V. AN INDUSTRY SPECIFIC STATUTE

The respective applications of both strict liability and a heightened *mens rea* requirement for principals in securities fraud and insider trading regulation have illustrated doctrinal and practical conflicts. As previously noted, it would eventually be rendered outdated by the ever-evolving concept of fraud or result in hyper-deterrent regulation that would infringe upon the very incentive of gaining informational advantages. The law may need to reach principals like Cohen who carefully veil their misconduct, but also needs to be flexibile so as to ensure that the principal's indirect operation of a proper and efficient oversight system through subordinates will not result in criminal liability. Despite the individual flaws of both the RCO and willful blindness doctrines, pulling elements from each doctrine can form a practical statutory proposal. To address the fear of sweeping change across all federal securities fraud, an industry specific statute

224. *See* Jodi L. Short & Michael W. Toffel, *Making Self-Regulation More Than Merely Symbolic: The Critical Role of the Legal Environment*, 55 ADMIN. SCI. Q. 361, 361 (2010) ("We find that organizations are more likely to follow through on their commitments to self-regulate when they (and their competitors) are subject to heavy regulatory surveillance and when they adopt self-regulation in the absence of an explicit threat of sanctions.").

225. This would also cause controversy by extending the duties of officers to shareholders. *See* United States v. Schiff, 602 F.3d 152, 162–63 (3d Cir. 2010) (stating that a duty to disclose under Rule 10b-5 is not derived from an executive's fiduciary relationship to shareholders).

226. That is, by disclosing the inside information to the counterparty if they seek to trade or abstain from trading at all, there is no deception. Buell, *supra* note 12, at 562.

227. *Id.* (stating that diligent traders should be encouraged and rewarded).

228. *Cf. id.* at 569 (noting that disclosure regulation seeks to make markets attractive by streaming efficient information and protecting investors).

regulating only principals of hedge funds, investment banks and brokerage firms may be in order.[229]

In creating this industry-specific statute, the statutory construction would follow the language of sections 78ff(a) of the Exchange Act. Thus, the proposed language under 78ff(a) would be when a principal, "willfully and knowingly *or by deliberate avoidance* makes, or causes to be made," any fraudulent securities exchanges. In addition, liability under a modified section 78j would reflect principal liability for those who "effect a short sale or to use or employ any stop-loss order" or "to use or employ any stop-loss order." Under section 78ff(a) of the Exchange Act, a person is held liable for securities fraud when that person "willfully and knowingly makes, or causes to be made," any statement to be filed with respect to securities exchanges.[230] One might wonder where protection from liability may arise, but the answer can be found in an inverse of the language derived from the RCO doctrine. If an exception were added to exempt a principal's inaction in preventing a securities fraud or insider trading violation where the misconduct, it would be in circumstances where the principal had no responsible relation or authority to prevent the misconduct from occurring.

The exception would read: "A principal's failure to prevent the offense is exempted, when, *by reason of his position in the corporation*, they had *no responsibility and authority to prevent . . . or promptly to correct, the violation complained of*."[231] Although a marriage between two different doctrines of criminal law, there have been cases that have applied the RCO doctrine to statutes with *mens rea* requirements.[232] In addition, the implementation of a "responsible relation" standard to a culpability requirement would allow the RCO doctrine to function as intended outside the realm of strict liability—to isolate meaningful contact with misconduct, as a principal in a large corporation can seek to minimize the appearance of such contact with minimal evidence of communication.[233] In turn, if a

229. Industry specific regulation of principals is not unheard of in this day and age. The "Holding Individuals Accountable and Deterring Money Laundering Act" seeks to "target top brass at firms that come under scrutiny for their anti-money laundering controls." *See* Rachel Louise Ensign & Michael R. Crittenden, *New Anti-Money Laundering Bill Targets Bank Executives*, WALL ST. J.COM (Oct 23, 2013, 1:36 PM), http://blogs.wsj.com/riskandcompliance/2013/10/23/new-anti-money-laundering-bill-targets-bank-executives/.

230. 15 U.S.C. § 78ff(a) (2012).

231. This modification of the RCO doctrine's "responsible relation" requirement is adopted from the Supreme Court's creation in *Park* of the three elements for liability. United States v. Park, 421 U.S. 658, 671–72 (1975).

232. *See* United States v. Iverson, 162 F.3d 1015 (9th Cir. 1998) (applying the RCO doctrine and convicting the president of a chemical company for violations of the Clean Water Act, in which actors are prohibited from "knowing" releases of pollutants into protected waters).

233. *See* Amad Kushner, Comment, *Applying The Responsible Corporate Officer Doctrine Outside the Public Welfare Context*, 93 J. CRIM. L. & CRIMINOLOGY 681, 697 (2003) (arguing that the RCO doctrine should be reevaluated as a general theory of criminal liability of corporate officers).

principal were to ensure and efficiently delegate a strong compliance and disclosure program where subordinates are properly monitored, a principal's inaction to prevent a securities law violation would be absolved.[234] Ultimately, the combination of elements from both the RCO doctrine and the willful blindness doctrine in constructing an industry-specific statute serves to impose a threat of criminal liability on principals for the misconduct of their company's subordinates while leaving enough flexibility for rationalized oversight and regulation.

CONCLUSION

Since its inception, federal securities law has failed to reach corporate principals and impose criminal liability. Much of this is attributed to the legislative intent of keeping criminal fraud a morality-based crime that requires purposeful deceit.[235] In addition, federal securities law needs to stay flexible to combat the inventive means of those who commit securities fraud and insider trading.[236] In turn, it is difficult to hold someone vicariously liable for these crimes without evidence of a purpose to defraud. The analysis of the RCO doctrine shows that while it would impose vicarious liability for principals who are in a "responsible relation" to misconduct, the presence of strict liability in the doctrine causes some doctrinal problems to arise.[237] In addition, the willful blindness doctrine would impose a wider degree of culpability for securities violations. Conversely, the windfall of its adoption would result in either new schemes that render the *mens rea* as under-inclusive or alternatively, hyper-deterrent resulting in over-disclosure in securities markets.[238]

Taking into account those limitations, an industry-specific statutory construction targeting securities firms that incorporates language from both the RCO doctrine and the willful blindness doctrine may provide enough flexibility to ensure both deterrence and reasonable self-regulation.[239] While this statutory construction may be subject to amendment as new fraud schemes arise, the current lack of accountability of principals who blind themselves to corporate misconduct has created public unrest.[240] Until people like Cohen are held accountable, securities markets will be vulnerable to future securities fraud and insider trading schemes, which

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234. This is consistent with the result of *Park*, where the Supreme Court found liability in part because Park knew that he delegated unreliable subordinates to correct the rat infestation. *Park*, 421 U.S. at 677–78.

235. Buell, *supra* note 12, at 526–29.

236. *Id.* at 520 (noting that fraud involves misconduct that "is characterized by inventiveness.").

237. *See supra* Part III. B.

238. *See supra* Part IV. B.

239. *See supra* Part V.

240. Cox, *supra* note 11 ("If you give people a blank check and tell them they have a get-out-of-jail-free card because of their size . . .that's a very dangerous thing.").

may ultimately led to a lemons market, and thus, an economy that will struggle from a dearth of investor participation.[241]

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241. Legislative inaction on this front would serve to defeat the goals of securities regulation, which is to "force information into the open to create investment markets that are informationally efficient and protective of investors, and that are therefore more attractive to capital." Buell, *supra* note 12, at 569.

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