

A Non-Insider Trading Case in the District of Massachusetts

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Insider trading prosecutions can be difficult. Because of the haphazard and tortuous growth of insider trading law itself, the prosecutions involve proving lots of different pesky elements. Fiduciary duties, materiality, trading Ugh, the trading. And the materiality! So annoying! If you were a prosecutor, how liberating it would be to bring an insider trading case without worrying about those things.

That thought might have occurred to Carmen Ortiz, the U.S. Attorney for the District of Massachusetts. Late last month, her office filed a criminal complaint against James Dunham with many of the hallmarks of an insider trading case, but without some of those annoying elements. The prosecutors didn't call it an insider trading case, filed under Section 10(b) of the Exchange Act. Instead, they filed it as a mail and wire fraud case. What they did could be important for professional traders and research analysts.

The Allegations

Dunham was formerly the President and COO of Wireless Zone, a retailer that has over 400 Verizon Wireless franchise outlets that sell phones from various manufacturers. The complaint alleges that Dunham had access to confidential information regarding sales, compensation, and product launches at Wireless Zone's 400 locations. For more than three years, without his employer's knowledge, Dunham had a consulting agreement with a Boston financial services firm, Detwiler Fenton & Company, to provide confidential information in exchange for \$2,000 each month. Dunham allegedly spent about an hour a week speaking to a Detwiler analyst using his personal email and cell phone.

The complaint alleges that seven research notes prepared and distributed by Detwiler included information supplied by Dunham, including information regarding the status of certain product launches, the number of new Verizon Wireless subscribers, and sales and return information for specific smartphones. Dunham was allegedly the source for an April 11, 2013 research note in which Detwiler reported that product returns were exceeding sales for the BlackBerry Z10. Following publication of that note, the stock price for RIM dropped seven percent in a single day.

Hmmm

You know what this looks like, right? It looks like a channel-check insider trading case! But what's a channel check? It's not really a technical term, but Bruce Carton at Securities Docket explained it several years ago:

In a channel check, analysts try to glean information about a company's production via interviews with the company's suppliers, distributors, contract manufacturers, and sometimes even current company employees. The goal is to piece together a better picture of the company's performance. Apple, always secretive about its products, is an example of a company where channel checking is reportedly common. Indeed, analyst reports based on channel checks routinely cause Apple stock to dip or surge.

As supply-chain expert Pradheep Sampath of GXS noted on his blog, these interviews typically occur without the target company's permission or participation. Sampath added:

Data collected from these sources is seemingly innocuous when viewed separately. When pieced together, however, these data points from a company's supply chain can deliver startling insights into revenue and future earnings of a company – much in advance of such information becoming publicly available. This practice becomes more pronounced for companies such as Apple that are extremely guarded and secretive about information they make publicly available.

Federal prosecutors and even the SEC, which faces a lower evidentiary standard for its cases, have been pretty circumspect about bringing cases based on channel checks. I think this is mostly because establishing the information's materiality for insider trading purposes can be pretty difficult. Well, is it material? This is a very fact-specific question. If you're talking about two or three stores for a product that sells millions of units, maybe not. But 400 retail locations could give a statistically significant window into how sales for a product are going. Fortunately for the prosecutors here, it doesn't matter.

Where This Case Comes From

This is all speculation, but in the short run, this case almost certainly originated with FINRA. I'm not a betting man, but I *would* bet \$100 that FINRA staff reviewed the trading in RIM before its stock price dropped 7% in April 2013 to see who might have profited or avoided losses from the drop. Perhaps finding none who did so illicitly, FINRA then referred the case to the SEC, anyway. The U.S. Attorney's Office's press release notes the "valuable assistance" given by the SEC, so I'm pretty sure the Commission was at least a way station for this matter. The SEC may have been stuck, too,

without any people who traded RIM based on material, nonpublic information. But it may have led the SEC staff to wonder aloud who could redress this leak of the Detwiler information. Enter Carmen Ortiz's office.

Thinking more broadly, the Dunham case is not completely without precedent. In 2010, the U.S. Attorney's Office for the Southern District of New York charged three public company employees with substantive wire fraud counts and single counts of wire fraud conspiracy and securities fraud conspiracy, but no substantive securities fraud charges. The "Shimoon" criminal complaint alleged that each employee revealed corporate financial data to outside analysts and intentionally violated corporate policy prohibiting such disclosure. An AMD employee allegedly provided "revenue numbers, average sales prices, unit sales for different product lines, gross margin figures, and revenue forecasts for AMD." A Flextronics employee allegedly provided quarterly actual and forecast sales for Apple iPhones and iPods.[1] But the complaint did not accuse the defendants of illicit securities trading. Sound familiar? The defendants eventually pled guilty.

Where Are We Now?

So where are we now? Defcon 3?[2] The *Shimoon* case didn't spawn a long list of imitators. So maybe this James Dunham case is, statistically speaking, another outlier that won't have a large effect on analysts seeking to bolster their research with hard numbers from supply chains. On the other hand, the FBI agent who investigated the Dunham case and signed the affidavit comprising the bulk of the complaint is David Makol, the same agent profiled here by the Wall Street Journal as "The FBI Agent Who 'Flips' Insider Trading Witnesses." He's been around this block before. And check out this quote from Carmen Ortiz: "Sometimes business secrets are sold for use in insider trading; sometimes they are used for other improper purposes. But the sale of confidential business information by corporate insiders – in violation of their duties to employers, business partners, customers, and shareholders – is always wrong and illegal." That sounds like somebody who's ready to file some more cases. If you're in her jurisdiction, watch out.

[1] A good summary and analysis of the complaint can be found at David Siegal, *Charging Expert Network Participants With Wire Fraud*, *New York Law Journal* (Apr. 29, 2011).

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[2] By the way, have you seen War Games recently? If not, please watch this clip. In it, General Beringer assesses the apparent nuclear threat, calmly plugs in some Red Man chewing tobacco, and orders the nation's defense risk alert to be raised from Defcon 4 to Defcon 3. Bear in mind, as far as he knew at that point, Soviet nuclear missiles were *in the air* and 11 minutes from hitting targets in the United States. What would have gotten him to Defcon 2? A more serious danger? Don't try to bluff General Beringer.