

HIGHLIGHTS**Obama Seeks Crackdown on Energy Speculation**

President Obama throws his weight behind efforts to bring down oil prices, asking Congress to boost funding to the Commodity Futures Trading Commission and other regulators and to allow tougher penalties for manipulating energy markets. **Page 840**

SEC, CFTC Adopt Long-Awaited Dodd-Frank Act Swaps Definitions

In a long-awaited development, the Securities and Exchange Commission and the Commodity Futures Trading Commission adopt definitions of “swap dealers,” “major swap participants,” and other entities created by the Dodd-Frank Wall Street Reform and Consumer Protection Act. **Page 804, Page 840**

Chamber, ICI Sue CFTC Over Dual Registration Rule

The U.S. Chamber of Commerce and the Investment Company Institute sue the Commodity Futures Trading Commission in the U.S. District Court for the District of Columbia seeking to overturn an agency rule that requires dual registration of investment company advisers already regulated by the Securities and Exchange Commission or another agency. **Page 842**

New SEC Guidance Directs Staff to Enhance Cost-Benefit Analysis

The Securities and Exchange Commission releases new guidance directing its staff to take up more comprehensive economic analysis throughout the rule-writing process. Under the guidance, both congressionally mandated and discretionary rules must undergo a cost-benefit assessment. **Page 805**

BNA INSIGHTS: JOBS Act Will Simplify IPO Process, Capital Raising

Robert A. Claassen, Jeffrey T. Hartlin, Michael L. Zuppone, William F. Schwiter, and Caroline Hunter, Paul Hastings LLP, write about how the recently enacted Jumpstart Our Business Startups Act will simplify the initial public offering process for many companies and create new ways of raising private capital. **Page 823**

BNA INSIGHTS: Restitution for Corporate Insider Trading Victims

Reed Smith LLP attorneys Pablo Quiñones and Jennifer L. Achilles write about a recent district court decision they say provides a useful roadmap for evaluating potential avenues for restitution to corporations that fall victim to insider trading schemes by their employees. **Page 827**

SPECIAL REPORT: Work Ahead for SEC to Implement JOBS Act

The Jumpstart Our Business Startups Act leaves many open questions for the Securities and Exchange Commission, attorneys say. They predict that the agency is unlikely to meet the mandated deadlines for rulemaking. **Page 830**

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MUTUAL FUNDS: Two GOP lawmakers urge SEC Chairman Mary Schapiro to “conduct a thorough analysis” of the money market mutual fund industry before proposing any reforms. **Page 808**

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BROKER-DEALERS: A federal appeals court affirms the dismissal of a German bank’s New York common law fraud and negligence claims against Goldman Sachs & Co. for allegedly misrepresenting the risks associated with a credit default obligation collateralized by residential mortgage-backed securities. **Page 835**

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BNA Insights

INSIDER TRADING

Restitution for Corporate Victims of Insider Trading: The Skowron Case



BY PABLO QUINONES AND JENNIFER L. ACHILLES

On March 20, 2012, Judge Denise L. Cote of the United States District Court for the Southern District of New York ordered Joseph F. “Chip” Skowron III (“Skowron”) to pay \$10 million in restitution to Morgan Stanley as a corporate victim of Skowron’s insider trading and obstruction of justice schemes. Judge Cote’s decision in *United States v. Skowron*, No. 11 Cr. 699 (DLC), 2012 BL 652827 (S.D.N.Y. Mar. 20, 2012) provides a useful roadmap for evaluating potential avenues for restitution to corporations that fall victim to insider trading schemes by their employees.

The path leading to Skowron’s criminal conviction and obligation to pay restitution to the victims of his

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crimes is well documented in court filings. Shortly after earning his medical and doctorate degrees from Yale University, Skowron abandoned his medical career to seek “the pot of gold at the end of the hedge fund rainbow.”¹ Skowron eventually became a prominent portfolio manager for FrontPoint Partners LLC (“FrontPoint”), a multi-billion dollar hedge fund that was acquired by Morgan Stanley in 2006.²

While working for Morgan Stanley at FrontPoint, Skowron used his personal relationship with a well-regarded medical doctor, Yves Benhamou (“Benhamou”), to gain secret inside information about Human Genome Science, Inc.’s (“HGSI”) clinical drug trials of Albuferon.³ In late 2007 and early 2008, Benhamou tipped Skowron about serious adverse results in the clinical trials and, before HGSI publicly disclosed the negative results, Skowron caused the healthcare portfolios he managed to sell millions of shares of HGSI to unsuspecting buyers, avoiding approximately \$30 million in losses for Morgan Stanley and FrontPoint.⁴ Following those trades, the Securities and Exchange Commission (“SEC”) initiated an investigation and Morgan Stanley began an internal investigation. In the months that followed, Skowron repeatedly lied to Morgan Stanley and the SEC about his dealings with Benhamou and the discussions they had about the HGSI clinical trials of Albuferon.⁵ Skowron also convinced Benhamou to lie about their misconduct to Morgan Stanley and the government.⁶ Skowron’s lies began to come to light when the FBI arrested Benhamou on November 1, 2010.

Skowron’s Sentence

In August 2011, Skowron pleaded guilty to a one-count Information charging him with conspiracy to commit securities fraud and obstruct justice. At sentencing, several corporate victims sought restitution from Skowron. The Mandatory Victim Restitution Act (“MVRA”) provides for mandatory restitution in all sentencing proceedings for convictions of certain offenses

¹ Sentencing Memorandum by Joseph F. Skowron, III, entered Nov. 4, 2011, Ex. 5 at 2 (Criminal Docket Entry Number (“Dkt. No.”) 21).

² Sentencing Memorandum by USA as to Joseph F. Skowron, III, entered Nov. 14, 2011, Ex. A at 2 (Dkt. No. 22).

³ *Id.*

⁴ *Id.*

⁵ *Id.*

⁶ *Id.*

against property in which an identifiable victim has suffered a pecuniary loss.⁷ Restitution is required for offenses committed by fraud or deceit when the victim has suffered a financial loss.⁸ Prior to Skowron's sentencing hearing, Morgan Stanley, FrontPoint, HGSI, and the counterparties to the illegal trades—Deutsche Bank Securities ("Deutsche Bank"), Galleon Group ("Galleon"), The D.E. Shaw Group ("D.E. Shaw"), T. Rowe Price, and First New York Securities ("First New York")—all submitted victim impact statements requesting restitution for losses incurred as a result of Skowron's conduct.

On November 18, 2011, Skowron was sentenced to five years in prison and three years of supervised release. The Court also ordered Skowron to pay a \$150,000 fine, \$5 million in forfeiture and nearly \$6 million in restitution. This initial restitution order benefited the five corporate victims who were counterparties to illegal bulk trades caused by Skowron shortly before HGSI publicly disclosed the adverse events in the clinical drug trials. In particular, Judge Cote awarded approximately \$2.4 million to Deutsche Bank; \$1.5 million to Galleon; \$1 million to D.E. Shaw; \$877,000 to T. Rowe Price; and \$107,000 to First New York Securities.⁹ The Court also permitted Morgan Stanley and others to file their claims for restitution on a set schedule after the sentencing hearing.¹⁰

Morgan Stanley's Request for Restitution Under the MVRA

On December 14, 2011, Morgan Stanley asked the Court to award it approximately \$44.8 million in restitution from Skowron—approximately \$33 million in connection with the disgorgement amount Morgan Stanley paid to the SEC; \$3.8 million in legal fees and costs Morgan Stanley paid during the investigation and prosecution of Skowron; and \$8 million representing a percentage of the compensation Morgan Stanley paid Skowron during the time he participated in the offense of conviction. FrontPoint assigned its claims to Morgan Stanley.

Skowron opposed Morgan Stanley's claim for restitution, claiming that Morgan Stanley was not a "victim" under the MVRA and, in any event, had significantly overstated its losses.¹¹

Skowron argued that Morgan Stanley was not a "victim" because its claimed losses were not proximately caused by Skowron's criminal conduct but, rather, by "a chain of intervening events," including "the public disclosure and dissemination of the allegations" against Skowron and "the legally permitted decision of third parties to withdraw their investments from FrontPoint."¹²

Judge Cote rejected Skowron's argument, holding that Skowron's offense of conviction "directly and

proximately harmed Morgan Stanley" because "FrontPoint, a Morgan Stanley entity, was the vehicle or 'mechanism' through which Skowron committed his crimes."¹³

Judge Cote's reasoning followed a recent line of 2011 Second Circuit decisions that defined the contours of the causal nexus required to claim status as a "victim" under the MVRA.¹⁴ Having concluded that Morgan Stanley was a "victim" within the meaning of the MVRA, the Court next analyzed whether Morgan Stanley was entitled to recover the three types of restitution it had requested.

Restitution of 'Ill-Gotten Gains'

With respect to the approximately \$33 million the company had disgorged to the SEC, Judge Cote sided with Skowron. Although it was clearly Skowron's conduct that caused Morgan Stanley to disgorge the \$33 million to the SEC, Skowron's illegal insider trading also allowed Morgan Stanley to avoid losing the funds in the first instance. Accordingly, the Court found that this money represented "ill-gotten gains," which Morgan Stanley was not entitled by law to retain.¹⁵

Restitution of Legal Fees and Costs

The Court's decision that Morgan Stanley should recover \$3.8 million in legal fees and costs from Skowron was also fairly straightforward. Morgan Stanley sought to recover the legal fees and costs it paid to (i) interact with the SEC and the Department of Justice during their parallel investigations of Skowron; (ii) conduct its own internal investigation; (iii) retain counsel for FrontPoint's portfolio managers and employees during the

¹³ *Skowron*, 2012 BL 65827, at *10 (internal citation omitted).

¹⁴ See *United States v. Archer*, — F.3d —, 2011 BL 239983, at *34 (2d Cir. Sept. 20, 2011) (clients who paid a corrupt immigration lawyer convicted of visa fraud were victims under the MVRA because their payments were the mechanism through which the lawyer profited from his conspiracy); *United States v. Bengis*, 631 F.3d 33, 40 (2d Cir. 2011) (South Africa was a victim under the MVRA because the conspiracy to which the defendant pled guilty facilitated the illegal harvesting of South African lobsters and allowed it to go undetected); *United States v. Paul*, 634 F.3d 668, 677 (2d Cir. 2011) (financial institutions that provided margin loans were victims under the MVRA because the defendant borrowed money on margin as part of his stock manipulation scheme that he was unable to repay).

¹⁵ *Skowron*, 2012 BL 65827, at *13-14.

Note to Readers

The editors of *Securities Regulation & Law Report* invite the submission for publication of articles of interest to practitioners.

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⁷ 18 U.S.C. §§ 3663A(c)(1)(A)(ii) and 3663A(c)(1)(B)(2011).

⁸ *Id.*

⁹ Declaration of Joshua H. Epstein in Opposition to Morgan Stanley's Claim for Restitution, entered Jan. 6, 2012, Ex. G, Sentencing Transcript at 9-10 (Dkt. No. 34).

¹⁰ *United States v. Skowron*, No. 11 Cr. 699 (DLC), 2012 BL 65827, at *3 (S.D.N.Y. Mar. 20, 2012).

¹¹ Response by Joseph F. Skowron, III, Letter in Opposition to Morgan Stanley's Claim for Restitution, entered Jan. 6, 2012 at 1 (Dkt. No. 33) ("Skowron Letter Opposing Restitution").

¹² *Id.* at 12.

investigation; and, (iv) retain counsel to represent Skowron during the time he falsely claimed to be innocent.¹⁶

Skowron argued that Morgan Stanley should be limited to \$788,561.07—the amount it paid in attorneys' fees in connection with the government's criminal investigation. According to Skowron, the legal fees Morgan Stanley incurred in connection with the SEC investigation should be excluded because they were not tied to the investigation and prosecution of the criminal case.¹⁷ Judge Cote disposed of Skowron's argument by distinguishing *United States v. Levis*, 2011 BL 34701 (S.D.N.Y. Feb. 10, 2011), a case in which the court denied the employer's request for restitution of legal costs related to an SEC investigation and the employer's own internal investigation. In *Levis*, the fees were not recoverable as restitution because "the investigations arose out of circumstances essentially independent of the conduct underlying the defendant's conviction."¹⁸ In contrast, the Court found that the criminal prosecution of Skowron for securities fraud rested on essentially the same conduct as the SEC's civil case. Moreover, the Court held that Morgan Stanley's ability to pursue the legal fees it paid through other means could not "forestall operation of the MVRA's mandatory restitution provisions."¹⁹

Restitution of Skowron's Compensation

The most significant victory for Morgan Stanley was the Court's finding that Morgan Stanley could recover 20 percent of the compensation it paid to Skowron, totaling over \$6.4 million. Skowron argued that no portion of his \$32.1 million in compensation was recoverable as restitution because his compensation was not caused by his criminal conduct but, rather, his employment agreement. The Court noted, however, that Skowron actively deceived Morgan Stanley during its internal investigation and its attempts to cooperate with the SEC, prolonging his employment and his sizeable compensation.²⁰

Skowron also argued that his case was distinguishable from cases awarding employers a portion of the

defendants' compensation because, in those cases, the defendants were prosecuted for honest services fraud. In *United States v. Bahel*, 662 F.3d 610, 649 (2d Cir. 2011), for example, as well as in *United States v. Sapoznik*, 161 F.3d 1117 (7th Cir. 1998) and *United States v. Crawley*, 533 F.3d 349 (5th Cir. 2008), the defendants' underlying crimes were "about hurting the employer by not doing the job required."²¹ According to Skowron, his case was different because his crimes were directed at investors and the SEC—not Morgan Stanley. The Court disagreed, and instead focused on whether Skowron's conduct resulted in a direct loss to Morgan Stanley's property—namely, deprivation of money to which it was entitled. The Court held that Skowron's compensation fell within the restitution available under the MVRA because "Skowron's insider trading and obstruction schemes deprived Morgan Stanley of honest services for which it paid."²² Accordingly, the Court found that restitution of 20 percent of Skowron's total compensation approximated "the difference in value between the honest services for which Morgan Stanley paid and what it received as a result of Skowron's offense."²³ Skowron has indicated he will appeal the decision.²⁴ Skowron has also asked Judge Cote for a stay pending appeal of her decision requiring the immediate payment of approximately \$10 million in restitution.²⁵

Conclusion

Judge Cote's decision in *Skowron* is a significant victory for corporate victims of insider trading schemes. Going forward, companies embroiled in securities fraud investigations caused by a rogue employee should carefully consider their ability to recover restitution under the MVRA. Courts have been, and continue to be, willing to award restitution to fraud victims—both individual and corporate victims alike.

²¹ Skowron Letter Opposing Restitution at 16.

²² *Skowron*, 2012 BL 65827, at *25.

²³ *Id.* at *27.

²⁴ Notice of Appeal by Joseph F. Skowron, III from Opinion & Order, entered March 30, 2012 (Dkt. 38).

²⁵ Letter Motion for a Stay Pending Appeal by Skowron's counsel, dated April 13, 2012 (Dkt. 42). In seeking a stay, Skowron primarily claimed that the Court erred in finding that (i) 20 percent of his salary was Morgan Stanley's property, (ii) the offense of conviction caused Morgan Stanley to pay his salary, and (iii) Morgan Stanley was entitled to restitution for fees associated solely with the SEC's investigation.

¹⁶ *Id.* at *15.

¹⁷ Skowron Letter Opposing Restitution at 22-24.

¹⁸ *Skowron*, 2012 BL 65827, at *20 (citing *Levis*, 2011 BL 34701, at *5).

¹⁹ *Id.*, at *20.

²⁰ *Id.* at *22-23.