

# Client Alert

Special Matters and Government Investigations Practice Group

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## Loose Lips Still Sink Ships: Inadvertent Tipping Risks Under the New Administration

Although the markets happily march to new heights under the current administration's promises of fewer regulations and the prospect of imminent tax reform, no one should approach this year's holiday season with a relaxed attitude toward protecting material nonpublic information. To the contrary, for corporate directors, officers, employees, and service providers, it's time for renewed resolve to talk about something other than work secrets over the holidays. We expect that the SEC and federal prosecutors will continue pursuing cases against traders who misappropriate material non-public information from unwitting family members, friends, or employers.

Combating insider trading has long been an important enforcement priority, and President Trump recently tweeted the current administration's mantra: "I will cut Regs but make penalties severe when caught cheating!"<sup>1</sup> Securities and Exchange Commission Chairman Jay Clayton also told Congress in September that insider trading remains a top enforcement priority.<sup>2</sup> And the United States Supreme Court's *U.S. v. Salman* decision this time last year reaffirmed that insiders who provide a tip merely as "a gift of confidential information to a trading relative or friend" may be liable.<sup>3</sup> This year, the Court of Appeals for the Second Circuit held that — even if the tipper and tippee are not relatives or close friends — this "personal benefit test" for tipper liability is met if the person communicating the material nonpublic information expected the tippee to trade on it.<sup>4</sup> That opinion effectively ended a period of uncertainty created in 2014 by the Second Circuit's *U.S. v. Newman* decision.<sup>5</sup> It is now clear that tipping cases are alive and well.

In keeping with prior annual installments, which have become their own sort of holiday tradition,<sup>6</sup> this Client Alert provides highlights of inadvertent-tipping cases from the past twelve months. We focus on risks for "inadvertent tippers" because people who read our missives typically do not set out to violate the law. These fresh examples demonstrate how carelessness can turn into career-threatening encounters with the SEC or the Department of Justice. In a happy turn of events, this year also gave us a positive example of one senior executive who held fast to best practices and ultimately helped his close friend—and perhaps himself—avoid sanctions.

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## Spouses Stealing Company Secrets

The most painful cases seem to involve spouses who trade based on information learned, or discovered, at home. This year, the SEC brought several cases against husbands who allegedly used confidential information obtained from their wives to trade ahead of market-moving company announcements.

In one case, a husband allegedly traded ahead of a pending merger.<sup>7</sup> In another case, a husband allegedly misappropriated non-public information about the FDA-approval status of a particular drug.<sup>8</sup>

A third example involved the husband of a corporate law firm associate, who was arrested on July 12 and charged by federal prosecutors and the SEC with using information obtained from his wife to trade ahead of two merger announcements. The defendant's wife worked on teams at her law firm that facilitated the separate acquisitions of Mattress Firm Holding Corp. and of Stillwater Mining Company. On October 30, the husband pled guilty to one count of securities fraud and agreed to forfeit \$119,428.50, representing proceeds from his trades. He is scheduled to be sentenced in March 2018.<sup>9</sup>

The criminal complaint in the third example cited documents from certain telephone service providers and records from the wife's law firm detailing the time she worked on the two matters. The government also obtained information from an internet service provider that apparently included the defendant's internet browser and search histories. Based on that collection of information, prosecutors were able to match up the timing of merger negotiations, the couple's communications, the husband's online activity, and his trading. Of particular interest, the government alleged that the husband searched for the phrase "insider trading with international account" the day before he purchased some of the options at issue. The government alleged that the husband then viewed online articles titled "U.S. Insider Trading Enforcement Goes Global" and "Want to Commit Insider Trading? Here's How Not to Do It."<sup>10</sup>

Throughout the proceedings, the defendant and his wife insisted the wife did nothing wrong. To date, she has not been named in the government's charging documents, although media reports suggest she no longer works at the law firm.<sup>11</sup>

## Failure to Be Forthright with FINRA

In addition to cases involving family members, the SEC has continued filing charges against friends and business contacts who misappropriated material non-public information. For example, the SEC brought related cases this year against two accountants in circumstances underscoring that the failure to be honest with regulators from the outset will leave the government less willing to give even inadvertent tippers a complete pass.

One of the two respondents worked for an accounting firm that provided tax accounting services to Sun Healthcare Group Inc. Between April and June 2012, the accountant doing work for Sun Healthcare disclosed material non-public information to the other respondent, who was also a personal friend, regarding the pending acquisition of Genesis Healthcare Inc. The accountant disclosed the information to her friend while consulting him regarding tax issues relating to the pending merger. The deal was announced publicly on June 20, 2012.<sup>12</sup>

The SEC's charging documents alleged that the accountant working with Sun Healthcare expected her friend to keep the information in confidence and that the friend knew the information should not be used for trading purposes. The friend nevertheless purchased shares of Sun Healthcare stock and tipped a third person. After the merger was announced, the friend and his tippee sold Sun Healthcare stock and realized gains of a combined \$39,082. The SEC's settled administrative proceeding against the friend required him to disgorge the \$39,082, plus interest, and to pay a matching civil penalty of \$39,082. The friend was also barred from appearing or practicing before the SEC as an accountant.<sup>13</sup>

Separately, the SEC also brought an administrative case against the accountant who divulged the information, not for acting as a tipper but rather for improper professional conduct under the SEC's Rules of Practice. This charging decision followed from the accountant's failure to disclose information in a FINRA inquiry about trading after the merger. As is common following any publicly announced merger, FINRA contacted the accountant—presumably an insider for purposes of the transaction—to ask if she recognized any names among a list of those who traded company securities in advance of the announcement. The friend's name appeared on FINRA's list. According to the SEC, the friend confessed to the accountant that he had traded based on information from their confidential conversations and that he had tipped another person. According to the SEC, the accountant nevertheless told FINRA she had no information about any of the traders on FINRA's list.<sup>14</sup>

It is not clear from the charging documents whether the accountant intentionally sought to evade insider trading accusations by not flagging her friend's trades for FINRA. Based on how long these types of trade-inquiry lists can be, it is possible the accountant even overlooked her friend's name. But once she knew about the friend's trades, the accountant no doubt should have taken a closer look at the list and considered hiring counsel and/or affirmatively cooperating with regulators. Based on the fact that the SEC noted her cooperation in the charging documents, it appears the accountant did at some point take these steps, although she may have avoided being charged altogether had she flagged her friend's name in response to FINRA's inquiry. Ultimately, she was also barred from appearing or practicing before the SEC, with the right to reapply after one year. The SEC reasoned that misleading FINRA was "improper professional conduct" for an accountant and a violation of the SEC's Rules of Practice.<sup>15</sup>

## **The Tempted Therapist**

Over the years, the SEC has brought inadvertent-tipping cases even in the most confidential settings. We reported several years ago about a tip that was misappropriated by a fellow Alcoholics Anonymous member.<sup>16</sup> Just last week, the SEC charged a therapist for trading on information he learned from a client during therapy sessions.<sup>17</sup> According to the SEC's complaint in the case, which was settled upon filing, the therapist provided his patient with a "Therapist Information and Disclosure Statement" when they began the counseling arrangement, providing assurance of the therapist's obligation to maintain the confidentiality of the information shared by the patient during counseling sessions. In July 2015, the patient allegedly confirmed with the therapist again that everything discussed during their sessions would remain confidential. The patient then disclosed that the patient's employer, Zulily, Inc., was in discussions to be acquired by Liberty Interactive. Over the next several weeks, the therapist purchased more than \$28,000 of Zulily shares, each purchase coming after another counseling session with the patient. After the deal was announced on August 17, 2015, the therapist allegedly sold all of his Zulily shares, making a profit of \$10,227.73.

Without admitting or denying the SEC's allegations, the therapist agreed to disgorge his profits, plus interest, and pay a matching \$10,227.73 civil penalty. As awkward as it may seem in the moment, even therapists and other trusted personal advisors need reminders that keeping information confidential includes not using the information to trade ahead of big corporate news.

## **A Terrible End for the Tippy Tipper**

This year also brought an update on a case we first highlighted in 2014, involving a now-former law firm partner who represented King Pharmaceuticals.<sup>18</sup> The SEC's complaint alleged that, during an August 2010 dinner at his home with his financial advisor, the attorney "drank several glasses of wine and became intoxicated. He blurted out to [the advisor], 'It would be nice to be King for a day.'" The advisor then conducted trades for himself and others, realizing a profit after Pfizer, Inc. announced it was acquiring King Pharmaceuticals.<sup>19</sup>

In an indictment unsealed in August 2016, the U.S. Attorney's Office for the Eastern District of New York charged the partner (and the advisor) with securities fraud and securities fraud conspiracy.<sup>20</sup> The criminal case ultimately went to trial in March of this year. During closing arguments, the partner's attorney argued that the comment made at dinner was accidental and that the advisor had later deduced on his own that the merger was in the works. Federal prosecutors argued, however, that the partner likely said more about the pending merger during the dinner conversation. So, after nearly seven years of scrutiny, the case hinged in part on a jury's speculation into how much the partner may have divulged about the pending merger or whether the single statement noted above was deemed sufficient.<sup>21</sup>

At sentencing, the federal prosecutor argued that insider trading by lawyers was a "profound problem." The government sought a prison term of 51 to 64 months. The partner was instead given three years of probation, a \$50,000 civil fine, and was ordered to disgorge profits from the trades in his account. All this, based on what may have been a single sentence uttered in a brief lapse of discretion. According to media reports, the partner's own attorney wept during the sentencing proceedings, stating that deterrence for lawyers is "absolutely served" when the charges are first filed.<sup>22</sup>

## Best Practices Just Might Save You

Once in a while, the law illustrates how to do things correctly, even though the enforcement process leading to the lesson was painful beyond words. After several years of investigation and administrative litigation, an SEC administrative law judge this past April dismissed insider trading allegations against an Atlanta-based commercial real estate developer. The SEC's Division of Enforcement had argued that the chief operating officer of a company in discussions to be acquired leaked information regarding the pending transaction to a friend, who in turn tipped the developer. After a hearing on the merits, however, the administrative law judge found no evidence that either of the alleged tips took place.<sup>23</sup>

From the Division of Enforcement's perspective, the circumstantial evidence and legal position seemed strong. The trades at issue took place in advance of an announcement that NCR Corporation would purchase fellow point-of-sale technology firm Radiant Systems, Inc. through a tender offer. (Insider trading involving a tender offer does not need to involve a breach of duty, making it easier for the SEC to prove a violation.) The SEC alleged that Radiant's COO leaked details about the pending deal to a longtime friend, who then passed that news on to the developer. During the two weeks before NCR and Radiant announced their transaction publicly, the COO, his friend, and the developer communicated frequently by phone, text, and in person. Also during that time, the developer purchased approximately \$2.1 million of Radiant stock, selling all of it after the deal was announced, and realizing gains of approximately \$744,000. This circumstantial evidence formed the SEC's case.

Rather than alleging the developer heard about the deal directly from the COO, the government instead argued that the developer was aware of the relationship between Radiant's COO and the close friend, and that he "knew or had reason to know that the information [the developer received from the friend] had been acquired directly or indirectly from Radiant, or an officer or employee thereof."<sup>24</sup>

The SEC did not charge the COO or his close friend with tipping, but did charge the developer for trading, thereby ensnaring all three in years of government investigation leading to the developer's administrative trial. Ultimately, the administrative law judge dismissed the SEC's charges against the developer, finding that the frequent calls, texts, and meetings the SEC cited were consistent with the three individuals' typical communications patterns, and that the COO's business practices demonstrated his extensive efforts to maintain the confidentiality of material non-public information.

“[The COO] knew that as an officer of Radiant, he could not pass insider information to others and that dismissal for cause and imprisonment for a term of years could result from trading on insider information. He also understood that he should avoid the appearance of improper trading and even a Commission investigation could have serious repercussions. [The COO] was further aware during the merger negotiations that if he were to divulge insider information, he could lose the millions of dollars he stood to gain from the merger with NCR. He also agreed that his business reputation would be harmed if it were determined that he divulged confidential information. [The COO] thus additionally acknowledged that in 2011, he was ‘careful not to get even close to the line in violating this policy.’”

The decision also tracks several best practices that led to the administrative law judge’s finding that the COO did not actually leak news of the pending tender offer to the close friend.

“[The COO] took care to comply with Radiant’s insider trading policy. He testified that, as a general matter, if he received a business call while with a friend, he would ‘step away’ from the friend. And if the call concerned inside information, his practice was to ‘make sure that [he] was in a closed environment in front of nobody.’”

The administrative law judge also found that the friend “radiated peace and calm [and] was unshakeable and credible in his testimony” when he denied having, or passing, information about the tender offer. Combined with the SEC’s lack of direct evidence of what was conveyed during the communications at issue, and with the COO’s and friends’ credibility during the hearing, the COO’s typical practices with non-public information were enough to show that the SEC had not met its burden.

## Conclusion

With this year’s examples in mind, senior executives, lawyers, accountants, consultants, and others who encounter material non-public information in their day-to-day work should take the following points to heart.

- Establishing best practices and sticking to them is critical. Even when government investigators refuse to concede their theories, being able to point to consistently observed best practices with nonpublic information may be your most valuable defense.
- Your spouse may not be as familiar as you are with the host of risks posed by trading on material non-public information. Take this opportunity to sensitize them.
- If you ever slip up and divulge material nonpublic information, make sure to let your confidant know that it is for their ears only and that they should neither trade on the information nor share it with others — even other family members or close friends.
- Take particular care around those in your friend and family circles who you know are active traders. What some see as just an interesting tidbit of corporate trivia could strike active traders as a tempting source of quick profits.
- It is not wise to ignore a name you recognize on one of FINRA’s post-merger trading inquiry lists. If you see a name you recognize, you should provide the information you have and, if necessary, seek counsel.

- Executives should choose accountants, brokers, consultants, lawyers, and other advisors — including therapists — who demonstrate that they are sensitive to the risks created by trading on confidential information.
- Do not be fooled by the media focus on large-dollar insider trading cases against money managers and professional investors. Insider trading cases are filed every year against individuals whose profits (or losses avoided) were minimal and who are not involved in sharing stock tips as part of their line of business.
- Remind others on your work teams involved with nonpublic information that it is everyone's responsibility on the team, regardless of seniority, to keep the information confidential.
- Consider updating your company's insider trading policies to reflect recent case law. Many corporate policies focus more on trading than they do on tipping. This year's cases are useful in reminding executives, employees, and directors once again of the dangers of talking shop outside of the office.

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*This alert provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice. In some jurisdictions, this may be considered "Attorney Advertising."*

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<sup>1</sup> Donald J. Trump (@realDonaldTrump), Twitter (Dec. 8, 2017, 7:18 AM), <https://twitter.com/realdonaldtrump/status/939152197090148352>.

<sup>2</sup> *Oversight of the U.S. Securities and Exchange Commission: Hearing Before the Comm. on Banking, Housing, and Urban Affairs*, 115th Cong. (Sept. 26, 2017) (statement of Chairman Jay Clayton) ("The SEC is committed to taking action against those who breach their duties – and subvert our markets – in pursuit of personal gain, having charged more than 700 defendants in civil insider trading cases since fiscal year 2010."). Despite the discussion in recent weeks about a year-over-year decline in the number of SEC enforcement actions brought during 2017, insider trading cases were one category that nearly kept pace with last year's totals. See U.S. Securities and Exchange Commission Division of Enforcement, *Annual Report: A Look Back at Fiscal Year 2017*, at 15 (Nov. 15, 2017), <https://www.sec.gov/files/enforcement-annual-report-2017.pdf>.

<sup>3</sup> *Salman v. United States*, No. 15-628, slip op. (U.S. Dec. 6, 2016) (holding that a tipper's gift of confidential, inside information to his brother constituted a sufficient personal benefit to support an insider trading conviction of the brother's friend — who had also married the tipper's sister — without additional proof that the tipper received money, property, or something of tangible value in exchange for the tip).

<sup>4</sup> *United States v. Martoma*, No. 14-3599 (2d Cir. 2017) ("[W]e hold that an insider or tipper personally benefits from a disclosure of inside information whenever the information was disclosed 'with the expectation that [the recipient] would trade on it,' and the disclosure 'resemble[s] trading by the insider followed by a gift of the profits to the recipient,' whether or not there was a 'meaningfully close personal relationship' between the tipper and tippee." (internal citations omitted)).

<sup>5</sup> *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014).

<sup>6</sup> We welcome this year's Guest Author, Richard H. Walker, to King & Spalding and to this tradition, and we thank again last year's Guest Author, Alana Griffin. This Client Alert is part of a series on the subject of inadvertent tipping. See, e.g., Dixie L. Johnson, Alana L. Griffin, & Matthew B. Hanson, *Avoid Inadvertent Tipping This Holiday Season*, LAW360, Dec. 21, 2016; Dixie L. Johnson & Matthew B. Hanson, *Post-Newman Reality: Investigations Involving Unwitting "Tips" to Close Friends and Relatives Will Continue*, King & Spalding LLP Client Alert, Oct. 8, 2015, <http://www.kslaw.com/imageserver/KSPublic/library/publication/ca100815.pdf>; Dixie L. Johnson & Matthew B. Hanson, *Friends and Family: Keeping Loved Ones Safe from Insider Trading Temptations*, King & Spalding LLP Client Alert, Dec. 8, 2014, <http://www.kslaw.com/imageserver/KSPublic/library/publication/ca120814.pdf>; Dixie L. Johnson, *Maintaining Client Confidences During the*

*Holidays: Avoiding Accidental Tipping*, Fried, Frank, Harris, Shriver & Jacobson LLP, Dec. 23, 2013, <http://www.lexology.com/library/detail.aspx?g=2a508b8b-9a5d-416f-ba11-751bf9e39665>; Dixie L. Johnson & Matthew B. Hanson, *Accidental Tipping: The Wrong Kind of Holiday Present for Family and Friends*, Fried, Frank, Harris, Shriver & Jacobson LLP, Dec. 14, 2012, <http://www.lexology.com/library/detail.aspx?g=4fc139d8-63bc-4662-8ef5-c257f9f14f51>; Dixie L. Johnson & Robert Greffenius, *Topics to Avoid in Holiday Conversation: Religion? Politics? Work!*, Fried, Frank, Harris, Shriver & Jacobson LLP, Nov. 30, 2011, <http://www.lexology.com/library/detail.aspx?g=7597e965-e49a-4e76-a1d0-6193196dab02>; Dixie L. Johnson and Robert Greffenius, *Insider Trading by Friends and Family: When the SEC Alleges Tipping*, BUSINESS LAW TODAY, Aug. 2011, <http://apps.americanbar.org/buslaw/blt/content/2011/08/article-johnson-greffenius.shtml>.

<sup>7</sup> *SEC Charges Four Individuals with Insider Trading in Stock of International Rectifier Corporation*, SEC Litigation Release No. 23901 (Aug. 11, 2017), <https://www.sec.gov/litigation/litreleases/2017/lr23901.htm>.

<sup>8</sup> *SEC Charges Three with Insider Trading in Stock of Ariad Pharmaceuticals, Inc.*, SEC Litigation Release No. 23868 (June 27, 2017), <https://www.sec.gov/litigation/litreleases/2017/lr23868.htm>.

<sup>9</sup> *Cambridge, Massachusetts, Man Pleads Guilty In Manhattan Federal Court To Insider Trading*, U.S. Attorney's Office for the Southern District of New York (Oct. 30, 2017), <https://www.justice.gov/usao-sdny/pr/cambridge-massachusetts-man-pleads-guilty-manhattan-federal-court-insider-trading>.

<sup>10</sup> *U.S. v. Yan*, 17-mag-5156 (S.D.N.Y. July 12, 2017), <https://www.justice.gov/usao-sdny/press-release/file/980156/download>.

<sup>11</sup> *See, e.g., Pete Brush, Husband Of Ex-Linklaters Associate Cops To Illegal Trades*, LAW360, Oct. 30, 2017, <https://www.law360.com/articles/979750/husband-of-ex-linklaters-associate-cops-to-illegal-trades>.

<sup>12</sup> *In the Matter of Shelly R. McGuire, CPA*, SEC Administrative Proceeding File No. 3-17805 (Jan. 23, 2017), <https://www.sec.gov/litigation/admin/2017/34-79855.pdf>; *In the Matter of Donald P. Jones, CPA*, SEC Administrative Proceeding File No. 3-17806 (Jan. 23, 2017), <https://www.sec.gov/litigation/admin/2017/34-79856.pdf>.

<sup>13</sup> *In the Matter of Donald P. Jones, CPA*, SEC Administrative Proceeding File No. 3-17806 (Jan. 23, 2017), <https://www.sec.gov/litigation/admin/2017/34-79856.pdf>.

<sup>14</sup> *In the Matter of Shelly R. McGuire, CPA*, SEC Administrative Proceeding File No. 3-17805 (Jan. 23, 2017), <https://www.sec.gov/litigation/admin/2017/34-79855.pdf>.

<sup>15</sup> The SEC's charging document stated, "In 2012, Section ET 54 of the AICPA Code of Professional Conduct stated, among other things, that '[t]o maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.'" The SEC reasoned that the accountant's actions violated this professional standard and, therefore, Rule 102(e)(1)(ii) of the Commission's Rules of Practice.

<sup>16</sup> *SEC v. McGee*, No. 12-cv-1296 (E.D. Pa. Mar. 13, 2012), <https://www.sec.gov/litigation/complaints/2012/comp22288.pdf>.

<sup>17</sup> *SEC v. Peer*, No. 2:17-cv-01865 (W.D. Wash. Dec. 14, 2017), <https://www.sec.gov/litigation/complaints/2017/comp24012.pdf>.

<sup>18</sup> *SEC v. Klein*, No. 9:13-cv-80954 (S.D. Fla. filed Sept. 19, 2013), <https://www.sec.gov/litigation/complaints/2013/comp-pr2013-188.pdf>.

<sup>19</sup> *SEC v. Klein*, No. 9:13-cv-80954 (S.D. Fla. filed Sept. 19, 2013), <https://www.sec.gov/litigation/complaints/2013/comp-pr2013-188.pdf>.

<sup>20</sup> *Long Island Investment Advisor And Law Firm Attorney Indicted In Insider Trading Scheme*, U.S. Attorney's Office for the Eastern District of New York (Aug. 10, 2016), <https://www.justice.gov/usao-edny/pr/long-island-investment-advisor-and-law-firm-attorney-indicted-insider-trading-scheme>.

<sup>21</sup> Stewart Bishop, *Ex-Hunton Patent Atty Convicted Of Insider Trading*, LAW360, Mar. 15, 2017, <https://www.law360.com/articles/902137>.

<sup>22</sup> William Gorta, *Ex-Hunton Atty Avoids Jail For Wine-Fueled Insider Trading*, LAW360, Sept. 26, 2017, <https://www.law360.com/articles/967990/ex-hunton-atty-avoids-jail-for-wine-fueled-insider-trading>.

<sup>23</sup> *In the Matter of Charles L. Hill, Jr.*, SEC Initial Decision Release No. 1123 (Apr. 18, 2017), <https://www.sec.gov/alj/aljdec/2017/id1123jeg.pdf>.

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<sup>24</sup> *In the Matter of Charles L. Hill, Jr.*, SEC Administrative Proceeding File No. 3-16383 (Feb. 11, 2015), <https://www.sec.gov/litigation/admin/2015/34-74249.pdf>.