

Client Alert

Special Matters & Government Investigations Practice Group

October 8, 2015

Post-Newman Reality: Investigations Involving Unwitting “Tips” to Close Friends and Relatives Will Continue

Earlier this week, the United States Supreme Court declined to hear the federal government’s appeal of the ruling by the Court of Appeals for the Second Circuit in *U.S. v. Newman*. This leaves intact the Second Circuit’s *quid pro quo* standard for showing that a tipper received the type of personal benefit sufficient to create criminal insider trading liability. It also leaves in place the apparent split on this issue that was created by the Ninth Circuit’s *U.S. v. Salman* decision in July.

But do not let the recent surge of media attention distract you. Even under the heightened *Newman* standard for proving tipper/tippee cases, the Securities and Exchange Commission and criminal authorities will continue investigating individuals they believe traded on material nonpublic information purloined from an “insider.” As a result, corporate insiders and service providers must stay vigilant with material nonpublic information to avoid the time, financial, and emotional costs of being dragged into an investigation focused on trading by friends and relatives.

As in our prior annual installments,¹ this article chronicles the misfortunes and lessons learned from cases involving inadvertent tippers filed during the past year. It reminds executives, consultants, lawyers, and others privy to material nonpublic information during their jobs to keep that client and business information confidential.

Year-in and year-out, these cases remind us that it is not enough for corporate insiders to simply refrain from trading on the nonpublic information they learn at work. Confiding that information in a loved one or trusted confidant may seem harmless, but the possibility always exists that they might trade on that information or pass it on to someone else.

The Law – Perhaps In Flux

The SEC brings dozens of cases each year alleging insider trading violations.² The federal securities laws restrict insider trading and tipping in two ways: through a general antifraud statute, and through a statute prohibiting insider trading during tender offers. The prohibition against trading involving tender offers does not require proof that the trader breached a duty, and therefore is easier for the SEC to prove than a general antifraud violation, which does require proof of violation of a duty.

For more information, contact:

Dixie L. Johnson

+1 202 626 8984
djohnson@kslaw.com

Matthew B. Hanson

+1 202 626 2904
mhanson@kslaw.com

King & Spalding LLP
Washington, D.C.

1700 Pennsylvania Ave., NW
Washington, D.C. 20006-4707
Tel: +1 202 737 0500
Fax: +1 202 626 3737

www.kslaw.com

This duty applies, for example, to public company insiders — executives, as well as service providers, who are required by company policy (and sometimes by law or ethical obligations) to use information obtained in the course of business solely for corporate purposes. An insider can be liable for tipping if the government can prove a *quid pro quo*, that the tipper intended to benefit personally by tipping someone else.³ The Supreme Court also stated in 1983 that the benefit element could be satisfied merely by showing “a gift of confidential information to a trading relative or friend.”⁴

Until recently, courts typically embraced the concept advocated by the SEC that the agency could plead insider trading cases by alleging a bare minimum of facts on the benefit element.⁵ In December 2014, the Second Circuit’s *U.S. v. Newman* ruling vacated the insider-trading convictions of two hedge fund managers and held that the government had neither shown nor sufficiently alleged that the sources of the tips in that case had received the type of personal benefit required to create insider trading liability.⁶ The court held that there must be “a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature. In other words, ... ‘a relationship between the insider and the recipient that suggests a *quid pro quo* from the [latter].’”⁷ The government appealed that decision to the Supreme Court. Earlier this week, the Court included *Newman* on a long list of cases for which it denied petitions for a writ of certiorari.⁸

The duty can also arise separately, however, if a person outside of the company learns information about the company in a context where the person knows he or she is obligated to keep the information confidential. Insider trading liability arises where that person nonetheless “misappropriates” the information by trading securities personally or by tipping others who trade.⁹ In 2000, the SEC implemented Exchange Act Rule 10b5-2, specifying that certain relationships are automatically presumed to create a “duty of trust or confidence,” specifically mentioning spouses, parents, children, siblings, and those with whom the tippee has a history, pattern, or practice of sharing confidences. Trading on or tipping information received in the context of such relationships is presumed to be an act of misappropriation.

Some have argued that the *quid pro quo* requirement of *Newman* would also apply to cases based on the “misappropriation” theory.¹⁰ An SEC administrative law judge also dismissed a “misappropriation” case against a stock trader on September 14, 2015, applying the *Newman* standard and finding, in part, that “the ‘friendship’ and working relationship between [the tipper and tippee] was not a meaningful, close, or personal one.”¹¹ Where the tippers and tippees are purely business acquaintances, this may limit actions against the insider-tippers and the outsiders who trade on the nonpublic information. To the extent, however, that the tippers and tippees are immediate family members or close enough friends that the SEC could argue they had a “history, pattern, or practice of sharing confidences,” it is likely the government will still pursue cases.

What could get lost in the debate about the scope of insider trading liability is that simply bragging to or confiding in a close friend or relative might still open an executive up to potentially being: (1) investigated, which is bad enough by itself, (2) targeted as a suspected tipper, (3) mentioned in SEC court papers charging others, or (4) alluded to as an unwitting tipper in a case brought against others. None of these is a desirable situation, and all three can be avoided by simply staying mum about nonpublic developments at the office.

Romance Gone Wrong

A case the SEC filed on September 9, 2015 — the same day that the Supreme Court set a date for when it would consider whether to grant the *Newman* appeal — is one sign that these types of cases will not go away simply because *Newman* arguably raises the bar for proving the “personal benefit” element of a tipping case. The SEC charged a father, son, and friend, based on allegations that the father misappropriated information from a long-time romantic interest and tipped the son, the friend, and others to trade.¹²

The SEC’s complaint argued that the 73-year-old father, John McEnery III, traded ahead of GE Healthcare’s announced acquisition of the biotechnology company Clariant, Inc. The SEC alleged that McEnery learned about the nonpublic

merger discussions from a friend who was a Senior Director at Clariant and was involved in the due diligence team for the transaction. The Senior Director and McEnery “had dated on and off since the early 1990s, and she had lived with McEnery III for several years in his Santa Cruz, California home.” The SEC alleged that the two “had a history of sharing confidences” and that McEnery therefore owed the Senior Director a duty of trust and confidence with respect to the information she divulged to him.

Based on the information he learned from the Clariant Senior Director, McEnery purchased Clariant stock and allegedly recommended to family and friends that they do the same. In one exchange that was incorporated into the SEC’s complaint, McEnery’s son wrote to his father in email, “No announcement today. Stock went up a few cents.” McEnery allegedly wrote back, “Thursday!” and the son replied, “Sweet.” The SEC’s complaint alleged that the family and friends “knew or were reckless in not knowing that the information McEnery III shared with them came from a Clariant insider and that McEnery III had received or misappropriated the confidential information in breach of a duty.”

McEnery, his son, and the friend agreed to settle the investigation against them without admitting or denying the allegations.¹³ McEnery agreed to pay disgorgement of \$32,482, prejudgment interest of \$4,919.25, and a civil penalty of \$64,156. His son agreed to pay disgorgement of \$3,288, prejudgment interest of \$497.92, and a penalty of \$3,288. McEnery’s friend charged in the matter agreed to pay disgorgement of \$28,386, prejudgment interest of \$4,081.87, and a penalty of \$28,386.

The Senior Director was not named in the complaint, and she remained anonymous in the SEC’s court papers and press release announcing the settled charges. It is highly likely, however, that the SEC Staff spent quality time with the Senior Director and her company through document demands and sworn testimony as part of their investigation. In cases like this one, one must understand at the outset that the Staff is asking questions in order to discern whether the tipper also should be charged. To the extent that *Newman* raises the bar that prosecutors and SEC enforcement attorneys must prove in insider trading cases, they arguably would no longer be able to plead a case against individuals like the Senior Director by simply stating that they had a long-standing personal relationship with the illegal traders. In other words, *Newman* could provide comfort that unwitting tipplers like this will not face liability themselves unless they received a *quid pro quo* benefit for providing the information. But the investigation to determine whether a *quid pro quo* benefit existed would be painful in and of itself.

Even Unwitting Tips Can Travel

Two cases from the past year show that it is not always the initial family or friend confidant who trades on material nonpublic information. In both of these cases, the actual trading was two or more steps removed from the insider. These cases serve as reminders that avoiding an insider trading investigation is about more than simply trusting that those around you will not themselves trade on material nonpublic information. The impossibility of controlling for the actions of friends-of-friends and others you may never have even met makes refraining from sharing at all, and protecting sources from which others might purloin information, the best choice.

Husband’s Fund-Manager Business Contacts

On April 2, 2015, the SEC filed a civil case against Amit Kanodia, an entrepreneur and private equity investor from Brookline, Massachusetts, along with his longtime friend Iftikar Ahmed, a general partner of the venture capital firm Oak Investment Partners.¹⁴ According to the SEC’s complaint, Kanodia was married to the then-general counsel of Indian tire company Apollo Tyres Ltd. Kanodia allegedly learned from his wife about Apollo’s efforts to acquire Ohio-based Cooper Tire and Rubber Company.

The SEC claimed that Kanodia tipped Ahmed and another individual repeatedly about the merger developments as he learned about them. While Kanodia was not accused of trading on the material nonpublic information himself, the SEC

alleged that Ahmed purchased approximately \$2.5 million worth of Cooper Tire stock and out-of-the-money options in several accounts leading up to the merger announcement. On June 12, 2013, the two companies announced that Apollo would purchase Cooper Tire for \$35 per share, more than 42% higher than Cooper Tire stock's June 11 closing price of \$24.56. Ahmed then liquidated his Cooper Tire holdings after the merger was announced, allegedly generating more than \$1.1 million in illegal profits. The other tippee, another close friend of Kanodia who was not named in the SEC's complaint, allegedly engaged in a trading pattern that also mirrored material nonpublic developments in the merger negotiations. The SEC stated that this other tippee realized nearly \$170,000 in profits from the trading. Both of Kanodia's alleged tippees later made substantial payments to Lincoln Charitable Foundation, which the SEC claimed were kickbacks being paid to a "supposed charity" managed by Kanodia.

The same day that the SEC announced it had filed its civil complaint, both Kanodia and Ahmed were arrested and charged with one count of criminal securities fraud for their actions.¹⁵ As in the SEC's complaint, the second tippee remained anonymous in the criminal accusations. Ahmed reportedly fled the country after the SEC later filed separate charges against him in a case alleging fraud in relation to his work at the venture capital fund.¹⁶

The SEC complaint and the DOJ's announcement of the criminal insider trading charges provided very few specifics about how Kanodia had obtained the material nonpublic information from his wife. The SEC stated simply that she was "intimately involved in the acquisition on behalf of her employer" and that "[a]t certain times during the period of Apollo's negotiations to acquire Cooper Tire, Kanodia and his wife resided at a hotel in New York, New York." The complaint then matched up key turning points in the merger negotiations to records of phone calls and text messages between Kanodia and the alleged tippees, followed by the tippees' trading. The complaint also described Kanodia's wife as Apollo's "then-general counsel" and noted that she and Kanodia were married "during the relevant time period." While it is not clear if these references reflect that the wife may have lost her job or perhaps separated from Kanodia, it is not hard to imagine the toll that this case took on both her career and marriage.

Boyfriend's Stock-Trading Father

A second case from 2015 reiterates how insider trading can sometimes occur multiple steps removed from a seemingly innocuous disclosure to a loved one. In the SEC's case against Joel Epstein, the 80-year-old owner of a Philadelphia tire store, the material nonpublic information started with a legal assistant for the law firm working on a merger between Nationwide Mutual Insurance Co. and the Pennsylvania-based insurance company Harleysville Group, Inc.¹⁷ According to the SEC's complaint, the legal assistant told her live-in boyfriend that the reason she had been working lots of nights and weekends was because she was working on a pending merger between Nationwide and Harleysville. Without telling the legal assistant, the boyfriend passed that information on to his father, Epstein, who the SEC described as an "active stock trader." The two men worked together at the family tire store. Epstein reportedly told his son, "don't ever mention this again" and "we never talked."

While the boyfriend himself did not purchase Harleysville stock, the SEC alleged that Epstein misappropriated the nonpublic information by trading ahead of the upcoming deal and tipping four others, including his two sons-in-law, who also traded. They allegedly made about \$236,000 collectively from the trades after the merger was announced on September 29, 2011 and the Harleysville stock gained 87% over its close on September 28.

Epstein agreed to a final judgment in federal court, permanently enjoining him from violating Exchange Act Section 10(b) and Rule 10b-5 and requiring him to pay disgorgement of \$237,014, prejudgment interest of \$21,599, and a civil penalty matching the disgorgement amount.

While the legal assistant involved in this matter was not monetarily sanctioned, she was likely a key witness in the investigation being built against her long-time boyfriend's elderly father. This case illustrates that the SEC's insider trading focus stretches to so-called temporary insiders like lawyers, accountants, and bankers who take on a fiduciary

duty to their clients as part of doing their jobs. It also shows that an investigation can encircle junior employees in these roles just as easily as the senior managers involved in a transaction.

Conclusion

The Supreme Court's denial of cert in the *Newman* case will undoubtedly change prosecutors' and SEC enforcement attorneys' calculations for investigations involving iterative tips among business colleagues. Manhattan U.S. Attorney Preet Bharara told reporters on October 5 that the *Newman* decision would make it harder to bring criminal cases directly against an executive who tips friends and family members.¹⁸ While that may be helpful in defending executives, it does not insulate executives from becoming ensnared in an investigation to determine if a tip occurred and a *quid pro quo* was given.

Additionally, the split still exists between the Second and Ninth Circuits that many believed would convince the Supreme Court to take the *Newman* appeal.¹⁹ It is possible that the Department of Justice and the SEC might simply bring cases more frequently in jurisdictions not bound by *Newman* to further sharpen this circuit split. Regardless of where the courts land on the level of personal benefit the government must prove, however, the show will go on for cases where the tippers and tippees involved were the types of close friends and relatives that can be characterized as relationships of trust or confidence.

As this year's collection of cases shows, material nonpublic information can sometimes pass from one confidant to another in ways the initial source of the information did not anticipate. Additionally, the SEC has shown a continued willingness to pursue these cases against individuals outside of the circle of top-level executives. With those points in mind, here are some specific steps that insiders can take to avoid finding themselves, their friends, or their family members swept up in an insider trading investigation:

- 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.
- Be mindful of what you share in casual conversation with loved ones, even those closest to you. If you share nonpublic information casually with them, it may not be clear that you are sharing particularly sensitive information. Your loved ones might relay that same information on to others in a similarly casual way. Educate them about the risks.
- 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.
- 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.

Celebrating more than 130 years of service, King & Spalding is an international law firm that represents a broad array of clients, including half of the Fortune Global 100, with 900 lawyers in 18 offices in the United States, Europe, the Middle East and Asia. The firm has handled matters in over 160 countries on six continents and is consistently recognized for the results it obtains, uncompromising commitment to quality and dedication to understanding the business and culture of its clients. More information is available at www.kslaw.com.

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."

¹ This Client Alert is part of a series of articles on the subject of inadvertent tipping. *See, e.g.*, 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>.

² Increasingly, the SEC has shown a willingness to bring these insider trading cases in their own administrative forum, rather than filing the cases in federal court, which arguably gives the SEC Staff some additional advantages in proving their cases. *See* SEC Press Release, *SEC Proposes to Amend Rules Governing Administrative Proceedings*, Securities and Exchange Commission (Sept. 24, 2015) (proposing to amend the SEC's Rules of Practice for administrative proceedings to, among other things, extend the time before a hearing occurs in "appropriate cases," permit parties to take witness depositions during discovery, and require parties to submit filings and serve each other electronically in administrative proceedings) <http://www.sec.gov/news/pressrelease/2015-209.html>; *see also* Sarah N. Lynch, *U.S. SEC proposes reforms to in-house trials on heels of criticism by defense bar*, REUTERS (Sept. 24, 2015) (reporting opinions from several members of the defense bar that the proposed changes were too limited) <http://www.reuters.com/article/2015/09/24/sec-trials-rules-idUSL1N11U32820150924>.

³ *See generally Dirks v. SEC*, 463 U.S. 646 (1983).

⁴ *Id.* at 663–64.

⁵ For example, one complaint filed in 2013 survived a motion to dismiss with the simple claim that, "[u]pon information and belief, any and all material, nonpublic information that the Defendants received [...] was disclosed to them by a person or persons who tipped such information with the expectation of receiving a benefit." *SEC v. One or More Unknown Traders in the Sec. of Onyx Pharm., Inc.*, First Amended Complaint ¶ 184, No. 1:13-cv-4645 (S.D.N.Y. Dec. 23, 2013). The district court allowed the SEC's complaint to go forward even though the SEC made no direct allegations about how the tip took place, who provided the tip, or what the expected benefit was. *Id.*, Opinion and Order, 2014 WL 5026153 (Sept. 29, 2014). Following the Second Circuit's Newman decision, the defendants asked for a reconsideration of their motion to dismiss. The court denied that motion, reasoning that "while the Second Circuit's holding in Newman may make it more difficult for the SEC to ultimately prevail on its insider trading claims in this action, it does not render those claims implausible at the motion to dismiss stage." *Id.*, Opinion and Order, 2015 WL 3604228, at *7 (June 8, 2015). The district court held that, "The Amended Complaint states sufficient facts from which the Court can reasonably infer that Defendants acted unlawfully." *Id.*

⁶ *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014).

⁷ *Id.* at 452 (citing *United States v. Jiau*, 734 F.3d 147, 153 (2d Cir. 2013)).

⁸ The Supreme Court's announcement included no additional commentary on the case. Orders List (Oct. 5, 2015), http://www.supremecourt.gov/orders/courtorders/100515zor_4f15.pdf.

⁹ *SEC v. Cuban*, Summary Judgment Memorandum Opinion and Order, No. 3:08-cv-2050-D, 2013 WL 791405, at *7 (N.D. Tex. Mar. 5, 2013) (quoting *United States v. O'Hagan*, 521 U.S. 642, 652–53 (1997)).

¹⁰ *See, e.g.*, Jon Eisenberg, *How United States v. Newman Changes The Law*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (May 3, 2015), <http://corpgov.law.harvard.edu/2015/05/03/how-united-states-v-newman-changes-the-law/>.

¹¹ *In the Matter of Gregory T. Bolan, Jr.*, Admin. Proceeding File No. 3-16178 (SEC Initial Decision Sept. 14, 2015) at 35–47. Note that the SEC argued in this case that the tipper, a stock analyst, misappropriated the nonpublic information and that the tippee, a stock trader, used the information that had already been misappropriated. Query whether the case would have come out differently if the SEC was able to allege that the trader himself had misappropriated the confidential information.

¹² *SEC v. McEnery III*, Complaint, 5:15-cv-04091 (N.D. Cal. filed Sept. 9, 2015).

¹³ SEC Litigation Release No. 23338 (Sept. 9, 2015), <https://www.sec.gov/litigation/litreleases/2015/lr23338.htm>.

¹⁴ *SEC v. Kanodia*, Complaint, 15-cv-00479 (D. Conn. filed Apr. 2, 2015).

¹⁵ *Brookline Man and Connecticut Fund Manager Arrested for Million Dollar Insider Trading Scheme*, United States Attorney's Office for the District of Massachusetts (Apr. 2, 2015), <http://www.justice.gov/usao-ma/pr/brookline-man-and-connecticut-fund-manager-arrested-million-dollar-insider-trading-scheme>.

¹⁶ Cara Salvatore, *Willkie Farr Drops Fugitive Client In Insider Trading Case*, LAW 360 (June 2, 2015), <https://www.law360.com/articles/662584>.

¹⁷ *SEC v. Epstein*, Complaint, 15-cv-0506 (E.D. Pa. filed Feb. 3, 2015).

¹⁸ See Ed Beeson, *Feds To Rethink Insider Trading Strategy After Newman Snub*, LAW360 (Oct. 5, 2015) <http://www.law360.com/articles/711045/feds-to-rethink-insider-trading-strategy-after-newman-snub>.

¹⁹ See Stephanie Russell-Kraft, *Rakoff Looms Over DOJ's Newman Appeal Decision*, LAW360 (July 28, 2015), <http://www.law360.com/securities/articles/684515>.