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Client Alert

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Friends and Family: Keeping Loved Ones Safe from Insider Trading Temptations

The holidays are in full swing, and now is the perfect time for executives to renew their determination to protect family and friends by not sharing work secrets with them, even indirectly or obliquely.

Each year, corporate officers, directors, employees, and service providers get caught up in insider trading investigations for which they are a potential source of the material, nonpublic information the government believes inspired trading. Corporate executives and other business professionals might feel confident that their own moral compasses will steer them clear of insider trading or tipping liability. But as the cases described in this article demonstrate, refraining from trading on material, nonpublic information is not necessarily enough to protect against potential insider trading liability. And although most executives and business professionals would never think of engaging in schemes to tip others who would then trade, it is not enough to merely refrain from intentionally tipping others.

While no industry is immune, the pharmaceutical industry is particularly susceptible to this risk. Although pharmaceutical companies typically are careful with potential material, nonpublic information, with strict procedures limiting access to news about drug approvals, clinical trials, and other important developments, the securities of pharmaceutical companies frequently appear in insider trading and tipping violations. One assessment counted that 22% of the individuals charged with insider trading between 2008 and 2012 were linked to trading in health-care stocks.[1] For this year's update to our inadvertent-tipping series of articles, we focus on the pharmaceutical industry.[2] The lessons, however, are universal.

Even when individuals are not charged, enduring intrusive government investigations can be painful, distracting, and expensive—especially if family members or friends are involved. The possibility of unwittingly tipping someone, potentially a relative or friend, merits paying close attention to the level of detail business professionals provide to others about their day-to-day jobs. As holiday events continue, here is a quick reminder of just how careful corporate executives and service providers must be to avoid putting themselves, and their loved ones, at risk.

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The Law

In order to understand the cases, it is important to know some basic information about insider trading liability—both for trading and for tipping. The United States Securities and Exchange Commission brings dozens of enforcement cases each year in this subject area. Between highly sophisticated data analytic tools and a vibrant whistleblower reward program, the SEC learns of many potential violations, even those involving relatively small trades.

The SEC often uses only circumstantial evidence to prove its allegations and can prove its case by merely a preponderance of the evidence. SEC charges can result in monetary sanctions, and the court or administrative law judge may also impose orders including a bar against serving as an officer or director in public companies in the future. The most egregious cases may also attract criminal prosecution, which can mean jail time in addition to harsh monetary penalties, although prosecutors must be able to prove their allegations beyond a reasonable doubt.[3]

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.

This duty applies, for example, to public company insiders—executives, as well as service providers, who are required by company policy 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.[4] The Supreme Court stated in 1983 that the benefit element could be satisfied by showing a pecuniary or reputational benefit, or merely by showing "a gift of confidential information to a trading relative or friend."[5] In one pharmaceutical case that is currently pending, the SEC's claims recently survived a motion to dismiss even though the SEC merely alleged "[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."[6] The 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.[7]

The duty can also arise if a person outside of the company learns information about the company in a context where he or she is obligated to keep the information confidential, and instead the person "misappropriates" the information and executes securities trades or tips others who trade.[8] In 2000, the SEC implemented Exchange Act Rule 10b5-2, which specifies that certain relationships are automatically presumed to create a "duty of trust or confidence." The rule specifically mentions spouses, children, siblings, and those with whom the tippee has a history, pattern, or practice of sharing confidences.

These seemingly tedious legal theories become paramount when the government spots suspicious trading and traces relationships back to an officer, director, or service provider who the government views as the potential tipper. Sometimes the information appears to have flowed through multiple people before someone traded, and so the government examines each potential link in the chain. If the government goes forward after a stressful, costly, and time-consuming investigation, the executive may be:

- charged for violating the law by tipping the trader,
- identified as a person who confided in the trader, or

- alluded to as the unwitting source of the trader's misappropriated information.

While the latter is obviously preferable, none of these scenarios is pleasant. Even having one's name omitted from a complaint can be cold comfort for an executive who sees friends or relatives charged in the case.

Since most executives do not intend to tip others who will trade on material, nonpublic information the executive learned at work, we focus below on examples of cases involving pharmaceutical companies where executives were not charged, although they likely endured years of investigations and career damage. These cases highlight how careful executives must be to safeguard confidential information from friends and family members who might not realize the danger.

Confiding in a Trusted Advisor

Three recent cases illustrate this concept.

Corporate Director Confides in Financial Adviser. In a January 2013 pharmaceutical case, the SEC charged a financial adviser, Kevin L. Dowd, who was a second-hand recipient of an insider's tip and who subsequently passed the tip along to a friend.[9] According to the SEC's complaint, the source of the material, nonpublic information was a director of Princeton-based Pharmasset Inc., a publicly traded clinical-stage pharmaceutical company prior to its acquisition by Gilead Sciences, Inc. The SEC alleged that, during the fall of 2011, the Pharmasset director "informed [a portfolio manager at Mr. Dowd's firm], in confidence as his financial adviser, that Pharmasset was engaged in an auction process involving a sale of the company, had attracted the interest of several large pharmaceutical companies, and was going to be sold." One can see how the director might want to keep his financial adviser informed of potential changes to his income.

Shortly thereafter, the portfolio manager described his knowledge of the potential merger to Mr. Dowd and others in a meeting. According to the SEC's complaint, the portfolio manager and a managing director at their firm instructed Mr. Dowd and others present that they were "prohibited from recommending or trading Pharmasset securities because the office had come into possession of material nonpublic information regarding the sale of Pharmasset."

Despite that warning, Mr. Dowd allegedly tipped a friend, who the SEC claims compensated Mr. Dowd by paying him $35,000 and purchasing a jet ski dock. The SEC charged Mr. Dowd with violating the antifraud and tender offer provisions of the federal securities laws. The SEC's case against Mr. Dowd was stayed in July 2013, pending the resolution of a related criminal case against him. Mr. Dowd later pled guilty to conspiracy to commit securities fraud.[10] As of when this article was finalized, however, the SEC's civil case was still stayed.

While the Pharmasset director's involvement in this investigation might not have been extensive, typical investigations require extensive document productions and testimony from the company, which could not have been welcome. This case shows how far-reaching insider trading liability can spread from a few, seemingly innocuous disclosures made to a trusted adviser like a broker or financial adviser. While investment considerations might have driven the timing, if the director had been able to wait to reveal this information to his financial advisor until after the transaction was announced, the insider trading (and therefore the investigation) would have been avoided.

Corporate Director Confides in Accountant. The acquisition by French pharmaceutical company Sanofi-Aventis of Tennessee-based over-the-counter pharmaceutical distributor Chattem Inc. in 2010 spawned several insider trading cases. In one line of cases, the SEC charged the longtime accountant of a director on the board of Chattem.[11] By November 2009, the Chattem board members allegedly had been advised of Sanofi-Aventis' "serious interest" in

acquiring Chattem. According to the SEC's complaint, during December 2009, one of the Chattem directors consulted his accountant, Thomas Melvin, Jr., to obtain advice on mitigating personal tax liability that would stem from the director's 50,000 Chattem options being automatically exercised as part of the anticipated tender offer. Again, it is easy to understand why the director might initiate this conversation, particularly at the end of a calendar year.

The director apparently took great precautions to secure the information in the accountant's possession. The SEC claimed that "the board member made clear to Melvin that the topic of discussion was confidential" and added that both the director and Mr. Melvin understood that "the board member was disclosing the information solely for purposes of obtaining tax advice." The complaint further stated that Georgia accounting regulations prohibited Mr. Melvin from disclosing, without the client's consent, "any confidential information pertaining to his client obtained in the course of performing professional services." Mr. Melvin allegedly disregarded that duty of confidentiality by tipping four friends, some of whom relayed those tips on yet again.[12] The SEC claimed Mr. Melvin was "responsible for the trading of at least 10 individuals in Chattem securities[.]"

The SEC charged Mr. Melvin and several downstream tippees (some of whom tipped additional people) with violating the antifraud and tender offer provisions of the federal securities laws. As part of his agreement to settle the charges, Mr. Melvin was enjoined from future violations and agreed to pay about $68,000 in disgorgement and interest, as well as a $108,930 civil penalty. Following the federal court settlement, the SEC filed an order to institute administrative proceedings and suspended Melvin from appearing or practicing before the SEC.[13] Since the SEC declined to lift that suspension, Mr. Melvin has attempted—so far unsuccessfully—to appeal it.[14] On October 14, 2014, Mr. Melvin petitioned to have the Commission review his matter.

Undoubtedly, the board member's relationship with his longtime accountant would have been strained by the SEC's insider trading investigation, particularly as it expanded to involve nearly a dozen other tippers and traders and prompted multiple federal court and SEC administrative proceedings.

Marketing Executive Confides in Brother-In-Law. Pharmaceutical company Sanofi-Aventis' purchase of Chattem Inc. also provided the facts for another instructive inadvertent tipping case involving a marketing executive at Chattem.[15] According to the SEC's complaint, the executive had learned by December 2009 that Sanofi would make a tender offer for Chattem. While he was mulling the employment options available to him with the coming tender offer (should he stay and work for foreign managers or take a severance package and look for other work), the executive took a business trip to Bentonville, Arkansas, and coincidentally saw his wife's sister's husband, Andrew Jacobs, there. According to the SEC's complaint, the executive and Andrew Jacobs had become close while working on their MBAs and had discussed "traditionally confidential topics such as impending job changes, promotions, and problems with supervisors after graduate school."

Over drinks, the executive sought Andrew Jacobs' advice as a person who had previously worked for a domestic company acquired by a foreign one. Andrew Jacobs allegedly provided the names of some headhunters he had used in the past and said he would contact some on the executive's behalf. Following the conversation, the executive called his brother-in-law to remind him that their conversation had been confidential, and the SEC claimed Andrew Jacobs "reiterated that he understood that the information was confidential."

The SEC claimed that Andrew Jacobs then tipped his brother Leslie Jacobs and "intended that his brother would purchase Chattem securities when he disclosed the material, non-public information … ." Leslie Jacobs bought 2,000 shares of Chattem later that same week for $136,579.85 and sold them for alleged profits of $49,457.21 after the deal

was publicly announced on December 21, 2009. The executive with the career crisis was not charged, although he undoubtedly experienced a rigorous investigation.

On June 11, 2013 (three and a half years later), the SEC sued Andrew and Leslie Jacobs. Following a six-day trial earlier this year, during which the marketing executive was called to testify, an Ohio jury returned a split verdict in the SEC's favor on the tender offer claim and in the defendants' favor on the general antifraud claim.[16] The U.S. District Court judge presiding in the case has denied several motions from the brothers, including as recently as in late September, to set aside the verdict and to reconsider prior orders in the case.[17]

Loose Lips, Unwitting Tips

Perhaps the most disheartening types of insider trading cases that appear year after year are those where an executive or service provider apparently did not mean to divulge material, nonpublic information but whose boast or complaint about something at work, or whose lax controls over devices or documents,[18] becomes the inspiration for what is ultimately deemed illegal trading. A prime example involved a law firm partner who represented King Pharmaceuticals.[19]

For many years, the attorney and his wife had engaged the services of Tibor Klein, who owned a financial advisory firm, to help the couple with financial planning and to manage their securities accounts, for which they granted Mr. Klein discretionary trading authority. Over the years they also became friends, and the couple hosted Mr. Klein at their home over a weekend in August 2010 to socialize and to review the couple's portfolio. The SEC's complaint alleged that, during a dinner at home that weekend, the attorney "drank several glasses of wine and became intoxicated. He blurted out to Klein, 'It would be nice to be King for a day.'" The SEC alleged that Mr. Klein was aware that King Pharmaceuticals was one of the attorney's clients.

The first day the markets opened after that weekend visit, August 16, 2010, Mr. Klein purchased King Pharmaceuticals shares for himself and for his clients, including for the attorney's account. Mr. Klein also allegedly called his high school friend Michael Shechtman, a stockbroker, who then opened an options trading account and purchased both options (for himself) and stock (for his wife's account) in King Pharmaceuticals. On October 12, 2010, when Pfizer Inc. officially announced it was acquiring King Pharmaceuticals, Mr. Klein sold the King Pharmaceuticals securities he had purchased, realizing $8,824 for himself and $319,550 for his clients, including $15,500 for the attorney. Mr. Shechtman liquidated his stock and options holdings the day of the announcement and on October 15, allegedly realizing $109,040.53 from his trades. Three years later, on September 19, 2013, the SEC charged Messrs. Klein and Shechtman, for trading on information about King Pharmaceuticals that the SEC alleged Mr. Klein misappropriated from a client. Mr. Shechtman settled with the SEC in January 2014 and, in November, pled guilty to one count of conspiracy to commit securities fraud.[20]

While the attorney was likely relieved not to be named in the complaint himself, his identity was revealed in salacious media reports about the events, multiplying the nightmare.

Conclusion

The SEC and criminal prosecutors have made headlines in recent years bringing charges against multiple individuals based on SAC Capital's bets on pharmaceutical companies Elan Corp. and Wyeth LLC. Additionally, recent media reports have disclosed ongoing government investigations into whether information was improperly leaked from the Centers for Medicare and Medicaid Services to Wall Street traders.[21] But insider trading is not only the stuff of insiders intentionally flouting federal law or professional traders cleverly coaxing secrets out of pharmaceutical industry professionals. In the pharmaceutical industry, as in others, information about potential corporate mergers, acquisitions,

or anticipated financial performance often provides the tinder for insider trading. Advance knowledge of progress with drug trials and regulatory approval processes (or the lack thereof) has also been a source of some of the most high-profile insider trading cases related to the pharmaceutical industry, including the cases against SAC Capital Advisors and its former portfolio manager Mathew Martoma.[22]

As this small collection of recent cases illustrates, insider trading investigations frequently focus on executives and managers who either unintentionally divulged material, nonpublic information or who specifically told someone they were sharing information in confidence. Here are a few concrete steps pharmaceutical company executives can take to help prevent friends and family from committing and being charged for insider trading:

- Avoid oversharing, even if it boosts your ego or calms your anxiety.
- If you feel you have overshared, make sure to reiterate that the information was divulged in confidence and that it should not be used for trading.
- Choose professional advisers wisely. The impetus of some SEC investigations is not that an insider has over-shared, but that a trusted adviser subsequently revealed material information the insider expected would be kept in confidence. To guard against exposure in these types of cases, executives should choose accountants, brokers, financial advisers, lawyers, and other agents who demonstrate that they are sensitive to the risks created by divulging confidential information.
- Guard your nonpublic work information with password protections or other systems that prevent wandering eyes from learning too much.
- Keep your wits about you during office holiday celebrations. Large work gatherings often bring together colleagues who can talk at length about confidential developments within a company. But when those events include non-employee guests, or when they are held in public venues, the possibility exists for someone to overhear material, nonpublic information and use it as the basis for subsequent trading.

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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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[1] David Voreacos, *Florida Man Admits Insider Trading for Passing Gilead Tip*, BLOOMBERG NEWS (Sept. 30, 2013), http://www.bloomberg.com/news/2013-09-30/florida-man-admits-insider-trading-for-passing-gilead-tip.html.

[2] This alert is part of a series of articles on the subject of inadvertent tipping. *See, e.g.*, Dixie L. Johnson and Robert Greffenius, *Insider Trading by Friends and Family: When the SEC Alleges Tipping*, BUSINESS LAW TODAY (Aug. 2011).

[3] For example, on April 10, 2014, a judge in the Southern District of New York accepted a proposed settlement in which SAC Capital Advisors agreed to pay a record $1.8 billion to settle civil and criminal charges. *See* Nate Raymond and Emily Flitter, *U.S.*

judge accepts SAC guilty plea, approves $1.2 bln deal, REUTERS (Apr. 10, 2014), http://www.reuters.com/article/2014/04/11/saccapital-crime-idUSL2N0N218M20140411. The criminal investigation of SAC Capital also ensnared several individuals, including Mathew Martoma, who was ordered to report to jail this month after being sentenced in September to nine years in prison. Bob Van Voris, *SAC Capital's Martoma Ordered to Report to Miami Prison*, BLOOMBERG NEWS (Nov. 17, 2014), http://www.bloomberg.com/news/2014-11-18/sac-capital-s-martoma-ordered-to-report-to-miami-prison.html.

[4] *See generally Dirks v. SEC*, 463 U.S. 646 (1983).

[5] *Id.* at 663–64.

[6] *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).

[7] *Id.*, Opinion and Order, 2014 WL 5026153 (Sept. 29, 2014).

[8] *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)).

[9] *SEC v. Dowd*, No. 13-cv-00494 (D.N.J. filed Jan. 25, 2013).

[10] David Voreacos, *Florida Man Admits Insider Trading for Passing Gilead Tip*, BLOOMBERG NEWS (Sept. 30, 2013), http://www.bloomberg.com/news/2013-09-30/florida-man-admits-insider-trading-for-passing-gilead-tip.html.

[11] *SEC v Melvin*, No. 1:12-cv-2984 (N.D. Ga. filed Aug. 28, 2012).

[12] The benefit alleged for some of the tips was merely that the tipper was "furthering his personal relationship" with the tippee. *See, e.g.*, *id.* ¶ 69.

[13] *In re Melvin*, Order Instituting Proceedings, Admin. Proc. File No. 3-15659 (Dec. 20, 2013).

[14] *Id.*, Initial Decision (Sept. 22, 2014) (ordering that Melvin be "permanently disqualified from practice before the Securities and Exchange Commission pursuant to Rule 102(e)(3)(iii) of the Commission's Rules of Practice.").

[15] *SEC v. Jacobs*, Complaint, No. 1:13-cv-1289 (N.D. Ohio June 11, 2013).

[16] *Id.*, Jury Verdict (Mar. 7, 2014).

[17] *See* Stewart Bishop, *Brothers Still Can't Duck Chattem Insider Trading Verdict*, LAW360 (Sept. 26, 2014), http://www.law360.com/articles/581326/brothers-still-can-t-duck-chattem-insider-trading-verdict.

[18] In the case *SEC v. Goetz*, No. 11CV1220-IEG-NLS (S.D. Cal. filed June 3, 2011), attorney Dean A. Goetz was charged for allegedly misappropriating material, nonpublic information from documents his daughter brought with her during a two-week stay during the 2008 holidays. Mr. Goetz's daughter, who was also a lawyer, worked on aspects of due diligence for an as-yet-unannounced merger while visiting her parents. Without his daughter knowing, Mr. Goetz allegedly misappropriated information from her documents and purchased shares in one of the companies the day the merger was scheduled to be announced.

[19] *SEC v. Klein*, No. 9:13-cv-80954 (S.D. Fla. filed Sept. 19, 2013).

[20] Michael Lipkin, *Broker Pleads Guilty After SEC BigLaw Tipster Case*, LAW360 (Nov. 5, 2014), http://www.law360.com/whitecollar/articles/593962?nl_pk=c0cf10dd-5cbd-427e-bce3-96b7b7456e42.

[21] Brody Mullins, Susan Pulliam, & Christopher Weaver, *Insider-Trading Probe Focuses on Medicare Agency*, WALL ST. JOURN. (Oct. 28, 2014), http://online.wsj.com/articles/insider-trading-probe-focuses-on-medicare-agency-1414540043.

[22] *United States v. S.A.C. Capital Advisors, L.P.*, Unsealed Indictment, No. 13-CRIM-541 (S.D.N.Y. July 25, 2013); Patrick Radden Keefe, *The Empire of Edge*, THE NEW YORKER (Oct. 13, 2014), http://www.newyorker.com/magazine/2014/10/13/empire-edge.