Wall Street LAWYER
Securities in the Electronic Age

February 2011 ■ Volume 15 ■ Issue 2

Insider Trading Update: Active Enforcement & Big Cases Mark Past Six Months

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Insider trading enforcement over the last six months has been extraordinarily active. In addition to pursuing traditional insider trading cases involving tipping and trading by corporate employees, the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ) have continued to develop allegations involving hedge funds, and most recently, they have targeted so-called expert networks. A number of high-profile cases have been filed or settled since mid-year, and more are sure to come. The major developments are set out below.

Expert Networks Take the Headlines

Recently, insider trading investigations have focused on the use of expert-network firms which connect investment professionals with expert consultants in various fields relevant to investment decision-making. At issue is whether the firms provide information that is merely difficult to obtain but lawful, or constitutes dissemination of material nonpublic information, in violation of insider trading laws.

On November 2, the DOJ and SEC announced criminal and civil insider trading charges against French doctor Yves Benhamou. Benhamou served on the steering committee that oversaw clinical trials of a new hepatitis drug being developed by a pharmaceutical company. At the same time, Benhamou had a consulting relationship with hedge funds that invested in healthcare-related securities. According to the complaints, Benhamou tipped a hedge fund portfolio manager about adverse test results from the clinical trials, and the hedge fund sold its shares in the pharmaceutical company. The price of the pharmaceutical company shares declined when the adverse test results were subsequently announced. The hedge fund allegedly avoided a loss of $30 million.[1]

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Wall Street Lawyer

West LegalEdcenter
610 Opperman Drive
Eagan, MN 55123

One Year Subscription ■ 12 Issues ■ $618.30
(ISSN#: 1095-2985)

Details of the SEC's and DOJ's wider pursuit of expert network firms began to emerge shortly thereafter, when the *Wall Street Journal* reported that John Kinnucan of Broadband Research, in an email to several clients, openly rebuffed an FBI overture to cooperate in an ongoing investigation by making recorded phone calls with one of his research contacts.[2] In the following weeks, Kinnucan received subpoenas from the FBI and SEC.[3]

Shortly thereafter, on November 22, the FBI executed search warrants at the offices of three hedge funds in New York, Connecticut, and Massachusetts.[4] The U.S. Attorney's Office and SEC also issued subpoenas to several mutual funds and hedge funds.

On November 24, the U.S. Attorney's Office filed criminal charges against an expert network firm employee, Don Ching Trang Chu. The criminal complaint alleges that the defendant arranged for public-company insiders to provide hedge fund clients with advance information on public-company financial performance.[5]

On December 15, federal prosecutors charged four other individuals connected to an expert consultant network. Three consultants and one expert-network firm employee are alleged to have tipped material nonpublic information to hedge funds and mutual funds.[6] The information included sales data about popular technology products and significant technology companies.

Finally, on December 29, authorities arrested Winifred Jiau, a consultant who allegedly provided material nonpublic information concerning the financial performance of certain technology companies, making her the seventh individual charged in the latest string of cases involving expert consulting networks.[7]

The cases involving consultant networks raise a number of significant issues for institutional investors. While consultants can provide helpful information that does not run afoul of insider trading laws, there is also a risk that in certain cases individuals can cross the line into prohibited conduct. In light of the government's focus on expert consultants, many firms are re-evaluating their policies and procedures on the use of such networks in an effort to reduce the risk of inadvertent receipt of material nonpublic information in breach of a duty.

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Finally, another notable aspect of these cases is what the complaints reveal about the investigations that led to the arrests. Many of the allegations are derived from recorded conversations between the defendants and cooperating witnesses that appear to have been developed through earlier investigations, including the *Galleon* case. The continued use by the government of cooperators and recorded conversations means that care must be exercised to ensure that communications conform to appropriate standards.

Developments in Notable Cases

There have been recent developments in a number of cases since mid-year.

SEC v. Galleon Management and Related Cases

In *SEC v. Galleon Management*,[8] the U.S. Court of Appeals of the Second Circuit held that a district court may order production to the SEC of wiretap evidence obtained by a defendant in discovery in a parallel criminal proceeding, but that the court's authority is circumscribed. The defendants in *Galleon* had obtained wiretap evidence from prosecutors in the parallel criminal proceeding. The SEC, in its civil action, sought discovery of that evidence, and the district court ordered its production. The Second Circuit, issuing an extraordinary *writ of mandamus*, vacated the district court order. The Court of Appeals held that while production of wiretap evidence is not prohibited, neither is it universally permitted.

In deciding whether production is appropriate, a district court must balance the SEC's interest in obtaining discovery against the defendant's privacy interest. The Court of Appeals held that the district court exceeded its discretion by issuing the discovery order. The Court of Appeals also noted that the issue could have been averted by staying the SEC's civil case pending resolution of the criminal case.

Shortly after the Second Circuit's resolution of the wiretap discovery dispute, four defendants agreed to settle charges.[9] Broker-dealer Schottenfeld Group settled charges that three of its proprietary traders, on the firm's behalf, traded on inside information obtained from an informant. Roomy Khan, a former employee at Galleon, similarly settled charges that she traded on inside information obtained from various sources. In the related case of *SEC v. Santarlas*,[10] former Ropes & Gray attorney Brien Santarlas settled charges that he passed inside information about firm clients to traders also named in *Galleon*.

The district court presiding over the criminal prosecution ultimately upheld the government's use of wiretap evidence.[11] The court rejected the defendants' argument that the government was not entitled to use wiretaps to investigate insider trading under the Federal Wiretap Act. Although the Federal Wiretap Act does not authorize the use of wiretaps to investigate allegations of insider trading alone, wiretaps may be used to investigate allegations of wire fraud. And when an insider trading scheme was conducted using interstate wires, the court found, it qualified as wire fraud. The court further found that the government's use of wiretaps was necessary because the *Galleon* insider trading scheme was primarily conducted through telephone conversations. Once the wiretap evidence was deemed admissible in the criminal proceeding, the SEC revived efforts to obtain the wiretap recordings in the civil suit.

SEC v. Cuban

In an important case regarding the elements of proof in a "misappropriation" insider trading case, the Fifth Circuit in *SEC v. Cuban*[12] reinstated the SEC's case against Mark Cuban, ruling that the district court had erred in dismissing the SEC's case. The SEC's complaint alleged that the CEO of Mamma.com, in which Cuban was a minority shareholder, telephoned Cuban to ask whether he wanted to purchase shares in a planned private investment in public equity (PIPE) offering. The complaint alleged that the CEO prefaced the conversation by saying that the information was confidential and that Cuban agreed. According to the SEC, Cuban grew upset when he learned of the PIPE offering and said to the CEO, "Well, now I'm screwed. I can't sell." Subsequently, Cuban allegedly contacted the sales agent and learned additional confidential details about the offering. Cuban later allegedly sold his entire position in Mamma.com stock before the public announcement of the PIPE offering.

In July 2009, the district court dismissed the SEC's complaint, holding that it did not sufficiently allege an agreement not to trade in Mamma.com shares. The court reasoned that where an agreement serves as the basis for misappropriation-theory liability, that agreement must include not only a promise by the defendant to keep the information confidential, but also an agreement not to trade on it. The SEC's complaint was deficient, according to the district court, because it failed to plead that Cuban agreed to refrain from trading on the information learned during his conversation with the Mamma.com CEO.

In September 2010, the Fifth Circuit reversed the district court, holding that it was plausible to infer from the complaint that Cuban had agreed not to trade and that his understanding with the CEO "was more than a simple confidentiality agreement." While it agreed with the district court that the "I'm screwed" statement in isolation did not constitute an agreement not to trade, the Court of Appeals found that there was a reasonable basis to conclude that Cuban's additional efforts to gain confidential information by contacting the sales agent demonstrated that Cuban understood that he could not use the information for his personal benefit. However, the Court declined to decide the broader issue of whether a confidentiality agreement alone can satisfy the duty requirement of insider trading, or whether an express agreement not to trade is also required.

Victories for Hedge Fund Personnel

In two closely watched insider trading cases involving hedge funds, defendants scored significant litigation victories. In September 2010, a hedge fund manager and his codefendants won summary judgment in *SEC v. Obus*.[13] The SEC had alleged that defendant Brad Strickland, an employee of GE Capital Corp., tipped his friend, defendant Peter Black, about an acquisition of SunSource, Inc., and that Black then tipped his boss, defendant Nelson Obus, who allegedly directed the purchase of SunSource stock. The alleged tip occurred during a conversation between Strickland and Black, which the defendants argued constituted a due diligence inquiry into SunSource on the part of Strickland, who noticed that Black's employer was invested in SunSource.

The district court dismissed the claims against all defendants, finding that the SEC failed to adduce enough evidence to demonstrate that defendant Strickland breached a duty under either the classical or misappropriation theories of liability. The record was bereft of any facts to support that Strickland owed a fiduciary duty to the target, SunSource, under the classical theory, because Strickland was not an insider of SunSource and could not have become a temporary insider because his employer was not a fiduciary but rather just one of many banks that was considering a loan to SunSource. The court pointed out that financial institutions typically owe no fiduciary duties to borrowers, and that the arms-length negotiations between transacting parties are antithetical to the concept that either party would owe a fiduciary duty to the other. The court also dismissed the SEC's claims under the misappropriation theory, finding that the evidence, viewed in the light most favorable to the SEC, established that, although Strickland owed a fiduciary duty to his employer, he did not breach that duty.

The court also found that the SEC failed to adduce any evidence of deceptive conduct. In fact, the court noted, defendant Obus openly spoke with SunSource's CEO both before and after he directed the purchase of SunSource stock, therefore negating any inference of deception by someone secretly in possession of material nonpublic information. Furthermore, the factual record was insufficient to prove that Obus subjectively believed that the information he allegedly received was obtained in breach of a fiduciary duty.

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SEC v. Berlacher represents another notable victory for hedge funds.[14] As part of a larger federal investigation of hedge funds alleged to have acted on inside information in shorting PIPE investments, the SEC charged hedge fund manager Robert Berlacher with insider trading. In a 2007 complaint, the SEC alleged that Berlacher, his investment advisory entities, and the hedge funds he managed illegally profited by short-selling four companies' shares while in possession of preannouncement knowledge about those companies' planned PIPE offerings. In September 2010, the district court dismissed the insider trading charges. The court found that the SEC had not proven the materiality element of insider trading because it failed to show that disclosure of the offerings actually affected stock prices.

A Focus on Professionals

The year also brought several insider trading cases involving professionals, including public accountants and lawyers. The latest such case involved charges against an investment banker involved in an insider trading scheme with an attorney in Ernst & Young's Transaction Advisory Group.[15] Banker Richard Hansen allegedly received material nonpublic information concerning five undisclosed pending acquisitions involving Ernst & Young clients by way of a mutual friend.

In another case involving a "big four" partner, the SEC settled insider trading charges against former Deloitte & Touche LLP partner Thomas Flanagan and his son Patrick Flanagan for trading in securities of several Deloitte clients.[16] According to the SEC complaint, Thomas Flanagan illegally traded nine times between 2005 and 2008, each time based on nonpublic information obtained from clients. The trades resulted in illegal profits of more than $430,000. Flanagan also relayed the information to his son who illegally profited as well. The Flanagans agreed to pay approximately $1.1 million to settle the charges. Thomas Flanagan also settled contemporaneous administrative proceedings for violating auditor independence rules.

Testing the Limits of "Inside Information"

In September, the SEC filed insider trading charges against two railroad company employees and their relatives.[17] The case has sparked some debate about the contours of the materiality of information that employees observe in the course of their employment. The SEC alleges that the defendants made more than $1 million in profits by trading on and tipping material nonpublic information about the planned takeover of their employer. The defendants allegedly gleaned the information from observations made on the job: they noticed people dressed in business attire touring the rail yards, heard other employees discuss a possible acquisition, and assisted in responding to requests for asset valuations. The SEC alleged that the defendant employees signed their employer's code of conduct prohibiting them from trading or tipping while in possession of material nonpublic information about their employer, including merger and acquisition information. By trading on and tipping information learned while at work, the SEC claims, the defendant employees breached their fiduciary duties to their employer. In November, one defendant settled the SEC's claims against him, and in December, the others moved to dismiss the claims.

NOTES

1. *SEC v. Benhamou*, No. 10-CV-8266 (S.D.N.Y. filed Nov. 2, 2010).
2. Susan Pulliam *et al.*, "U.S. in Vast Insider Trading Probe," Wall St. J. (Nov. 20, 2010).
3. *E.g.* Susan Pulliam, "Reluctant Analyst Pressured by the FBI," Wall St. J. (Dec. 4, 2010); Katya Wachtel, "John Kinnucan Gets SEC Subpoena Over Galleon CEO's Brother's Hedge Fund," Business Insider (Dec. 15, 2010).
4. Susan Pulliam *et al.*, "Hedge Funds raided in Probe," Wall St. J. (Nov. 22, 2010).
5. *U.S. v. Dung Ching Trang Chu*, No. 1:10mj2625, (S.D.N.Y. filed Nov. 23, 2010).
6. *U.S. v. Shimmon*, No. 1:10mj2823, (S.D.N.Y. filed Dec. 15, 2010).
7. *U.S. v. Jiau*, No. 10-mj-02900 (S.D.N.Y. filed Dec. 23, 2010).
8. *SEC v. Galleon*, No. 10-462-cv (2d Cir. Sep. 29, 2010), available at *S.E.C. v. Rajaratnam*, 622 F.3d 159 (2d Cir. 2010).
9. *SEC v. Galleon Management, LP*, No. 09-CV-8811 (S.D.N.Y. filed Oct. 16, 2009), available at *SECURITIES AND EXCHANGE COMMISSION, Plaintiff, v. GALLEON MANAGEMENT, LP, Raj Rajaratnam, Rajiv Goel, Anil Kumar, Danielle Chiesi, Mark Kurland, Robert Moffat, and New Castle Funds LLC, Defendants*., 2009 WL 3329053 (S.D. N.Y. 2009).
10. *SEC v. Santarlas*, No. 09-CV-10100 (S.D.N.Y. filed Dec. 10, 2009).
11. Memorandum Opinion and Order, *U.S. v. Rajaratnam*, 2010 WL 3219333, at *1 (S.D. N.Y. 2010).
12. *S.E.C. v. Cuban*, 620 F.3d 551, Fed. Sec. L. Rep. (CCH) P 95864 (5th Cir. 2010).
13. *S.E.C. v. Obus,* Fed. Sec. L. Rep. (CCH) P 95902, 2010 WL 3703846 (S.D. N.Y. 2010).
14. Final Judgment, *S.E.C. v. Berlacher*, Fed. Sec. L. Rep. (CCH) P 95943, 2010 WL 3566790 (E.D. Pa. 2010).
15. *SEC v. Hansen*, No. 10-CV-5050 (E.D. Pa. filed Sept. 27, 2010).
16. *SEC v. Flanagan*, No. 10-CV-4885 (N.D. Ill. filed Aug. 4, 2010).
17. *SEC v. Steffes*, No. 01 Civ. 06266 (N.D. Ill. filed Sept. 30, 2010).