

Insider Trading & Disclosure Update

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Figuring prominently in this Update is the recent Second Circuit decision reversing the insider trading convictions of “downstream tippees” Todd Newman and Anthony Chiasson. The Court’s decision materially alters the basis for tippee liability and may significantly curtail the Government’s ability to bring large-scale enforcement proceedings against tippees going forward. In this Update, we also focus on the Securities and Exchange Commission’s use of administrative actions to bring insider trading enforcement proceedings and pending court challenges to this practice, and we highlight the SEC’s pursuit of non-scienter based violations. Finally, we are excited to present in this Update our first feature article on insider trading-related developments in a foreign jurisdiction.

We hope that you find this Update useful and informative, and we look forward to bringing you further news and analysis in future issues.

Sincerely,
The Editorial Board

Caselaw & Market Updates

Second Circuit Limits Scope of Tippee Insider Trading Liability

On December 10, 2014, the Second Circuit Court of Appeals handed down a landmark decision defining the scope of “remote tippee” liability under insider trading law.¹ The Second Circuit held that a tippee must know that an insider disclosed confidential information in exchange for a personal benefit. In so holding, the Court resoundingly rejected the Government’s theory that knowledge of a breach of the duty

of confidentiality alone, without knowledge of a personal benefit, is sufficient to impose criminal liability. In addition, and perhaps even more significantly, the Court ruled that while a personal benefit may be inferred from a personal relationship between the tipper and tippee, such an inference can only be established by proof of a “meaningfully close personal relationship” where the exchange of the personal

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benefit is “objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.”² In overturning Newman and Chiasson’s convictions, the Court has sharply curtailed liability for tippees and brought into question the Government’s ability to bring large-scale criminal or civil insider trading cases with tippees that are far removed from the inside tipper.

Background

Newman and Chiasson were portfolio managers at Diamondback Capital Management, LLC and Level Global Investors, L.P., respectively, who were alleged to have traded on inside information obtained by employees of Dell Inc. and Nvidia Corporation. Neither defendant was alleged to

need know only of the former.”³

The District Court instructed the jury that the Government only needed to prove that Newman and Chiasson knew that the information “was originally disclosed by the insider in violation of a duty of confidentiality.”⁴

The Second Circuit’s Decision

The Second Circuit ruled that the District Court’s jury instructions were in error. The Court’s opinion noted that “Newman and Chiasson were several steps removed from the corporate insiders,”⁵ and either three or four levels removed from the inside tippers.⁶ The opinion stated that “the Government has not cited, nor have we found, a single case in which tippees as remote as Newman and Chiasson

In overturning Newman and Chiasson’s convictions, the Court has sharply curtailed liability for tippees and brought into question the Government’s ability to bring large-scale criminal or civil insider trading cases with tippees.

have had any direct contact with the corporate insiders who disclosed the inside information.

Newman and Chiasson requested a jury instruction that the Government was required to prove that the tippee knew that the tipper received a personal benefit, but the District Court found that a “tipper’s breach of fiduciary duty and receipt of a personal benefit are separate elements and that the tippee

have been held criminally liable for insider trading.”⁷

In overturning the convictions of Newman and Chiasson, the Court found that the “exchange of confidential information for personal benefit is not separate from an insider’s fiduciary breach; it is the fiduciary breach that triggers liability for securities fraud under Rule 10b-5 [under the Exchange Act].”⁸ Therefore, the Court found

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that the Government must establish that “the tippee knows of the personal benefit received by the insider in exchange for the disclosure.”⁹ The Court held that to find a tippee criminally liable, the Government must prove each of the following elements: (1) the corporate insider was entrusted with a fiduciary duty; (2) the corporate insider breached his fiduciary duty by disclosing confidential information to a tippee in exchange for a personal benefit; (3) the tippee knew of the tipper’s breach (that is, he knew the information was confidential and divulged for personal benefit); and (4) the tippee still used that information to trade in a security or tip another individual for personal benefit.¹⁰

The Court went on to hold that the personal benefit received “must be of some consequence.”¹¹ Significantly, the Court held that an inference of personal benefit based on the personal relationship between tipper and tippee is “impermissible in the absence of proof of 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.”¹² In the case of *Newman and Chiasson*, the Court found the evidence of the alleged personal benefit—alleged “career advice” given and evidence of an alleged casual acquaintance between the alleged tipper and tippee

—was “scant” and insufficient to meet the Court’s objective-and-consequential standard.

The Court further limited the inferences that could be made from the specific nature of the information being shared by finding that “even if detail and specificity could support an inference as to the *nature* of the source, it cannot, without more, permit an inference as to the source’s improper *motive* for disclosure.”¹³ Under this standard, the Court found that the Government’s evidence regarding *Newman and Chiasson*’s knowledge of the tippers’ personal benefit was insufficient to sustain their convictions on either the substantive insider trading counts or the related conspiracy count.

Implications of the Decision

The Second Circuit’s decision in the *Newman/Chiasson* case has far-reaching implications for the Government’s ability to bring large-scale insider trading cases. In prosecuting its recent spate of insider trading cases, the Government has often used tippers as cooperators in an effort to convict the tippees that actually traded on the information. Often, as in the case of Messrs. *Newman and Chiasson*, these tippees were several levels removed from the tippers’ original disclosures. Going forward, it will be more challenging for civil enforcement authorities and criminal prosecutors to find evidence that a remote tippee knew the tipper

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received a significant personal benefit in exchange for inside information.

The Second Circuit's ruling may also have widespread consequences for all tippee liability, even if the tippee is in direct contact with the tipper. The Court strongly suggests that the benefit must be significant, resulting in either immediate or future pecuniary gain.

of SAC Capital portfolio manager Michael Steinberg, whose case was also tried before the District Court judge presiding over the *Newman/Chiasson* case. The Government had added Mr. Steinberg to a superseding indictment in the Newman and Chiasson prosecution, even after those defendants had already been

Prosecutors as well as the SEC will no longer be able to bring an insider trading case alleging a vague reputational benefit that can be implied by the personal relationship between tipper and tippee.

Prosecutors as well as the SEC will no longer be able to bring a case alleging a vague reputational benefit that may be implied by the personal relationship between tipper and tippee.

As discussed elsewhere in this Update, the SEC recently dropped its downstream tippee insider trading action involving trading in shares of Herbalife Ltd. The Court's decision also will likely affect many of the U.S. Attorney's convictions currently on appeal, including, most notably, that

convicted, an exercise in judicial forum shopping that did not go unnoticed by the Second Circuit. In a December 31, 2014 order, the Second Circuit granted Mr. Steinberg's unopposed request to delay his appeal while prosecutors grapple with the Court's acquittal of Messrs. Newman and Chiasson and presumably decide whether to appeal the dismissal of the charges. It is also possible that other individuals who have already pled guilty to insider trading charges may seek to have their pleas withdrawn. ■

SEC Focus on MD&A Trends and Uncertainties Disclosure

On August 21, 2014, Bank of America ("BOA") entered into a \$16.65 billion settlement with the U.S. Department of Justice ("DOJ") to resolve federal and state claims over BOA's sales of mortgage-backed securities. As part

of the settlement with the DOJ, BOA entered into a \$20 million civil settlement with the SEC in which BOA admitted that it failed to disclose to investors known uncertainties potentially adversely affecting its future income

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arising from its exposure to repurchase claims on securitized mortgage loans.

The SEC claimed that BOA had failed to include disclosure regarding known trends or uncertainties, as well as material changes to any trends or uncertainties previously disclosed, in the Management’s Discussion and Analysis of Financial Condition and Results of Operations (“MD&A”) section of its periodic filings as required by Item 303 of Regulation S-K. In contrast to the SEC’s frequent use of Rule 10b-5 disclosure-based proceedings, which are predicated on a claim that the subject disclosure was knowingly misleading, the SEC brought its action against BOA

SEC interpretive guidance from 1989 states that one of the objectives of this rule is to allow the reader to evaluate whether a company’s past performance is indicative of its future performance. Instruction 3 to Item 303(a) is critical to compliance with this requirement. The instruction requires the MD&A to focus “on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition.” The SEC has made clear its view that companies should prepare the MD&A mindful of the fact that material forward-looking

In contrast to the SEC’s frequent use of Rule 10b-5 disclosure-based proceedings, the SEC brought its action against Bank of America under Section 13(a) of the Exchange Act, which does not require a finding of knowingly culpable conduct.

under Section 13(a) of the Exchange Act, which does not require a finding of scienter or otherwise knowingly culpable conduct.

In its enforcement action, the SEC claimed that BOA’s disclosures did not adequately address Item 303(a) of Regulation S-K, which requires the MD&A in annual reports on Form 10-K to provide “information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations.”

information regarding known material trends and uncertainties is required to be disclosed as part of the required discussion of those matters and the analysis of their effects.

Item 303(b) of Regulation S-K requires interim reports on Form 10-Q to include analogous disclosure with a focus on “a discussion of material changes in those items specifically listed in Item 303(a)” other than the impact of inflation and changing prices on operations. In its settlement with BOA, the SEC emphasized that Item 303(b)

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requires “material changes to each and every specific disclosure requirement contained in paragraph (a), with the noted exception, [to] be discussed” and made clear that, as required by its 1989 guidance, disclosure of a known trend, demand, commitment, event or uncertainty is required unless management determines either (1) it is not reasonably likely to occur; or (2) if management is unable to make that determination, the event is not reasonably likely to have a material adverse effect on the company’s financial condition or results of operations.

The backdrop to the BOA MD&A settlement, as with the other larger settlements BOA entered into, was the accelerating decline of its residential mortgage investments during the economic downturn. In connection with residential mortgage sales from 2004 to 2008, BOA made various contractual representations and warranties to purchasers of mortgage-backed securitization facilities regarding the underlying quality of the mortgage loans. In the event of a breach of these representations or warranties, the loan purchaser had the right to demand that BOA repurchase the related mortgage at its outstanding unpaid principal balance. During 2008 and 2009, uncertainty grew regarding whether the future repurchase obligations, which had become increasingly significant, would have a material effect on BOA’s future income; however, BOA’s Forms 10-Q for

the second and third quarters of 2009 did not discuss this uncertainty.

Although somewhat unusual, the BOA case does not represent a wholly novel use of Section 13(a) as an enforcement tool. In the early 1990s, the SEC commenced an administrative proceeding against Caterpillar Inc. (“Caterpillar”),¹⁴ citing a failure by Caterpillar to disclose in its Exchange Act reports information related to future uncertainties regarding the impact that the operations of its wholly owned Brazilian subsidiary had on Caterpillar as a whole. In that matter, the SEC found that although Caterpillar’s Brazilian subsidiary accounted for an outsized portion of the overall company’s 1989 profitability, neither its Form 10-K for 1989 nor its Form 10-Q for the first quarter of 1990 discussed the magnitude of the subsidiary’s impact, or the political and economic uncertainty in Brazil that had led Caterpillar’s senior management to begin providing separate updates to the Caterpillar board of directors relating to the potential future negative impact of currency reform in Brazil. According to the SEC, this failure to integrate the discussion that management was engaged in at the board level into its public disclosures “left investors with an incomplete picture of Caterpillar’s financial condition and results of operations and denied them the opportunity to see the company ‘through the eyes of management.’”¹⁵

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The SEC's use of Section 13(a) to bring its civil violation claim against BOA provides another proof point of the SEC's willingness to use the broad array of enforcement tools at its disposal. Further, the action underscores the importance of maintaining effective disclosure policies

and practices. Specifically, a reporting company's best defense against an allegation that its trend and uncertainty disclosure was deficient is to maintain a vigorous process to ensure compliance with MD&A rules and applicable SEC guidance. ■

The Ian Hannam Decision: Important Lessons for UK-Listed Companies and Advisers

One of the most high-profile market abuse cases in the United Kingdom in recent years has concluded with the Upper Tribunal (a review body for decisions of the UK market regulator and part of the UK's administrative justice system) finding that a senior investment banker at J.P. Morgan had engaged in market abuse by disclosing "inside information" (in the context of the EU market abuse regime applicable in the UK) other than in the proper course of his employment, profession or duties. The judgment is the first detailed judicial assessment of a number of points relating to the definition of inside information and the circumstances in which selective disclosure would be considered improper disclosure. In particular, it is the first judicial interpretation of the exemption from the market abuse offence of disclosing inside information to another person other than in the proper course of employment, profession or duties.

The Law

In general, under UK and EU law, market abuse comprises insider trading (or "insider dealing") and market manipulation. Inside information, which is the currency of insider dealing, means information that is precise, nonpublic and likely to have a significant impact on the price of a financial instrument. Market manipulation can take the form of transactions or orders to trade that give false or misleading signals regarding the supply of, demand for or price of the security or secure the price of a security at an abnormal or artificial level; transactions or orders to trade that employ any form of deception or contrivance; or dissemination of information by any means that gives or is likely to give false or misleading signals to the market about the security. Under EU law, the prohibition on disclosure of inside information in the context of market abuse does not apply if the disclosure is made

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in the normal course of a person's employment, profession or duties (among other circumstances).

The Background

The case revolved around two e-mail messages sent in 2008 to business contacts by Ian Hannam, who at the time was Global Co-Head of UK Capital Markets at J.P. Morgan in London and one of the most prominent London investment bankers operating in the natural resources sector. The e-mail messages contained information obtained by Mr. Hannam in the course of providing advisory services to his client, Heritage Oil Plc ("Heritage Oil"), a London-listed oil and gas exploration and production company, which had exploration projects in Uganda and the Kurdistan Region of Iraq.

The first e-mail message, sent to the Minister for Oil in the Kurdish Regional Government, consisted of an update on discussions between a potential acquirer of Heritage Oil and an estimate of the per-share value of the acquisition offer. The second e-mail message, which also blind copied another third-party adviser, included as a postscript: "PS— Tony [Buckingham, Heritage Oil's CEO] has just found oil and it is looking good."

In 2012, the UK Financial Services Authority (now the Financial Conduct Authority, or "FCA") concluded that, in sending these e-mail messages, Mr. Hannam had engaged in market abuse through improper disclosure of inside

information and fined him a penalty of £450,000. In reaching this conclusion, the FCA accepted that there was no intention on the part of Mr. Hannam to commit market abuse or any evidence of personal gain or trading in Heritage shares as a result of the disclosure.

Mr. Hannam subsequently sought a review of the FCA's decision by the Upper Tribunal, asserting that the relevant information did not constitute inside information and, that, even if it were considered inside information, he had properly disclosed it in the course of his employment.

The Upper Tribunal's Conclusions

In upholding the original verdict of the FCA, the Upper Tribunal provided valuable analysis on the method of assessing whether nonpublic information constitutes inside information: (1) when assessing the price sensitivity of non-public information in determining, on an *ex ante* basis, whether a reasonable investor would base an investment decision on the information, the likely (*i.e.*, "real prospect") effect on price must be taken into account, and the information must be such that it is possible to predict the direction of the price movement; (2) when information refers to future circumstances or events that may reasonably be expected to occur, there must be a "realistic prospect" of that circumstance or event occurring (*i.e.*, more than remote but not necessarily

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a better than even chance); and (3) inaccuracies in non-public information do not preclude that information from constituting inside information insofar as parts of it are accurate.

In considering under what circumstances disclosure of inside information to another person would be considered to be made in the proper course of employment, profession or duties, the Upper Tribunal arrived at the following conclusions: (1) the recipient should be subject to express confidentiality obligations and understand that the information is (or may be) inside information; and (2) to the extent the relevant information relates to a prospective bid for a listed company,

The decision also addressed the ability of a listed company to delay disclosure of material inside information, which otherwise must be disclosed as soon as possible. The Upper Tribunal accepted that a listed company could delay such disclosure in order to allow for a period of verification by the company to ensure that, when an announcement is ultimately made, it is not misleading, provided that the listed company restricts its employees from trading in the company's shares until public disclosure is made.

**Implications for Listed Companies
and Advisers**

Information about future events may now be more likely to be regarded as

Under the UK market abuse regime, forward-looking information may now be more likely to be regarded as inside information, but the findings of the Upper Tribunal may broaden the circumstances in which listed companies may legitimately delay disclosure.

such disclosure must not result in a breach of the UK Takeover Code restrictions on disclosing such information.

These conclusions are significant because they represent the first judicial interpretation of the "proper course of employment, profession or duties" exemption in the market abuse offence of disclosing inside information to another person. They provide useful guidance regarding the standards of conduct that companies should expect of their employees and advisers who have access to inside information.

inside information, as the standard for determining whether an event is reasonably expected to occur is relatively low. However, the findings of the Upper Tribunal may broaden the circumstances in which listed companies may legitimately delay announcements. More generally, the conclusion of this disciplinary process once again emphasizes the complexities involved in assessing what information may constitute inside information under the EU market abuse regime and the need for listed companies and their advisers to exercise extreme caution. ■

The Battle for Allergan Sheds Light on Insider Trading in Tender Offers and Raises Questions About Beneficial Ownership Reporting

Valeant Pharmaceuticals International, Inc. (“Valeant”) and Pershing Square Capital Management, L.P.’s (“Pershing Square”) hostile bid for Allergan, Inc. (“Allergan”) seems to have run its course following the announcement of the proposed acquisition of Allergan by Actavis plc—but not before the U.S. District Court for the Central District of California (Southern Division), the court hearing Allergan’s lawsuit alleging that Valeant and Pershing Square engaged in insider trading by purchasing shares of Allergan in violation of Rule 14e-3 under the Exchange Act, shed light on two key aspects of that rule. Apart from the courtroom drama over Allergan’s insider trading allegations, Pershing Square and Valeant’s Schedule 13D

the contentious question of whether the ten-day filing deadline for reporting the accumulation of more than 5% of a voting class of a company’s equity securities on Schedule 13D should be shortened.

Overview of Rule 14e-3

Rule 14e-3 strictly prohibits, subject to certain exceptions, trading or “tipping” on the basis of material non-public information (“MNPI”) concerning a tender offer. In contrast to Rule 10b-5, the prohibition applies whether or not the information was obtained in breach of a duty. Rule 14e-3 reflects the SEC’s long-held position that insiders must either publicly disclose MNPI or refrain from trading. For the rule to

The *Allergan* court articulated preliminary reasoning that elucidates two key aspects of Rule 14e-3: (1) when a bidder takes a “substantial step or steps” toward commencement of a tender offer and (2) when a co-bidder in a tender offer is exempt from the scope of the rule.

disclosure that they had jointly acquired nearly 10% of Allergan’s common stock at the end of the Exchange Act’s ten-day filing period under Regulation 13D-G, without prior notice that they had crossed the 5% beneficial ownership disclosure requirement in Schedule 13D, has added fuel to the fire surrounding

adhere, the confidential information at issue must have been acquired from the person engaging in the tender offer, the issuer of the subject securities, or any officer, director, partner, employee or other person acting on behalf of either the offering person or the issuer. The rule’s prohibition applies once any

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person has taken a substantial step or steps to commence, or has commenced, a tender offer. Rule 14e-3 does not apply, among other circumstances, to purchases on behalf of the offering person or sales to the offering person, or to communications of MNPI relating to the tender offer to a person acting on behalf of the offering person. As discussed later in this article, a “co-bidder” in a tender offer may also constitute an “offering person” for purposes of the exception to the rule’s prohibition. In an order entered on November 4, 2014, the Court articulated preliminary reasoning that elucidates these two key aspects of the rule as applied to the facts of the litigation: (1) when Valeant took a “substantial step or steps” toward commencing a tender offer for Allergan; and (2) whether Pershing Square was really a co-bidder and an offering person and, as such, exempt from the scope of the rule.

Background

The origins of the insider trading litigation (and the takeover attempt itself) lie with a discussion between J. Michael Pearson, Valeant’s CEO, and William Ackman, Pershing Square’s founder and CEO, during which Mr. Pearson disclosed to Mr. Ackman Valeant’s intent to acquire Allergan. In February 2014, Valeant and Pershing Square entered into an agreement pursuant to which the two parties agreed to form a joint venture entity

(“JV”) to facilitate the acquisition of Allergan by Valeant. This “relationship agreement” specifically stated that the parties had not taken a substantial step toward a tender offer for Allergan by entering into the agreement. Thereafter, Pershing Square, through the JV, initially acquired 4% of Allergan’s stock, and then, in the ten days between April 11 and April 21, increased its ownership interest to 9.7%, which the JV disclosed in a timely Schedule 13D filing (having taken full advantage of the ten-day window). Ultimately no formal tender offer was launched between April 22, the date on which Valeant sent its first unsolicited bid to Allergan’s board and CEO, and June 18, the date on which Valeant initiated an unsolicited exchange offer through a wholly owned subsidiary (naming the JV entity and ultimately Pershing Square as co-bidders in the Schedule TO filing with respect to the exchange offer). On August 1, 2014, Allergan filed suit against Valeant, Pershing Square, the JV and Mr. Ackman.

When Do Steps Become Substantial Steps Toward a Tender Offer?

The SEC has stated that for purposes of Rule 14e-3, “substantial steps” include the formulation of a plan or proposal to make a tender offer by the offering person or the person(s) acting on behalf of the offering person, arranging financing for a tender offer, or authorizing negotiations, negotiating or entering into agreements with

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any person to facilitate the tender offer.¹⁶ A general principle for determining whether a person has taken substantial steps toward a tender offer is whether the offering person exhibits a seriousness of purpose such that the prospect of a tender offer has become likely. Courts have found that substantial steps have been taken under a range of circumstances, including (1) when a company has retained a consulting firm, signed a confidentiality agreement and has ongoing meetings with top officers of the target;¹⁷ (2) when an acquiror has taken a large position in the target's stock and the target's CEO has met with the company's advisors to plan its defenses;¹⁸ and (3) where there has been a meeting between executives (including a meeting "from which [one party] realized that the deal had to go down fast") followed by due diligence procedures and entry into a confidentiality agreement.¹⁹

In its November 4, 2014 order, the Court found that Valeant and Pershing Square's strategy and subsequent actions "raised serious questions going to the merits of [plaintiffs'] Rule 14e-3 claim" and therefore allowed the litigation to proceed (although without ordering much of the injunctive relief that Allergan requested).²⁰ In this regard, the Court noted contemporaneous statements by Mr. Ackman at an April 22 investor presentation and deposition testimony in Allergan's

securities litigation as suggesting that the parties may have thought a tender offer would be necessary, or at least likely, to effectuate the takeover.²¹ When considered in light of the various judicially determined indicia of substantial steps described above, the Court found that it would be reasonable to conclude that a tender offer for Allergan shares by Valeant and Pershing Square was in fact likely.

What is a Co-Bidder, and is a Co-Bidder an Offering Person?

The Court determined that, notwithstanding a dearth of guidance directly on point, a co-bidder with MNPI who trades in an issuer's securities does not run afoul of Rule 14e-3.²² In its analysis of this issue, the Court employed a two-step analytical process. First, the Court considered whether Pershing Square was a "co-bidder," reasoning by analogy to SEC guidance as to whether a person constitutes a co-bidder in a tender offer for purposes of Regulation 14D. The relevant Regulation 14D guidance indicates that a person should be considered a co-bidder if that person: (1) played a significant role in initiating, structuring and negotiating the tender offer; (2) acted together with the named bidder; (3) controlled the terms of the offer; (4) was involved in financing the tender offer; and (5) would beneficially own the securities purchased by the named bidder in the tender offer or the assets of

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the target company. Second, the Court considered whether Pershing Square, if a co-bidder, was also an “offering person” for purposes of Rule 14e-3. The Court indicated that labelling a person an “offering person” under Rule 14e-3 must be consistent with Rule 14e-3’s primary purpose of limiting the universe of persons permitted to trade on inside information only to those actually making the tender offer. The Court suggested that, as a practical matter, the analysis on this point could hinge on control-related factors, such as control over the terms of the offer, control over the surviving entity and control over and identity with the named bidder.

In its review of the facts most relevant to considering whether Pershing Square should be considered a co-bidder and a co-offering person for purposes of Rule 14e-3, the Court noted that Valeant had teamed up with Pershing Square at least in part because of Mr. Ackman’s expertise in handling unsolicited bid situations and to increase the likelihood that a potential transaction would close. Pershing Square played an active role from the beginning of the takeover attempt by helping Valeant craft its acquisition strategy: in their relationship agreement, Valeant agreed to consult with Pershing Square and to consider in good faith Pershing Square’s comments on any actions relating to the takeover attempt. Further, while the economics of the JV were highly structured and were designed ultimately

to give Valeant ownership of Allergan stock purchased by the JV, Valeant had the right under the relationship agreement to require Pershing Square to purchase \$400 million of Valeant stock immediately prior to a transaction—both as means of financing part of the acquisition and demonstrating a continued commitment to the combined entity (as Pershing Square also agreed to hold \$1.5 billion worth of Valeant stock for one year following a transaction). Notwithstanding the foregoing, the Court expressed doubt as to the sufficiency of these facts to elevate Pershing Square from co-bidder to co-offering person status under Rule 14e-3.²³ In its reasoning, the Court touched on Valeant’s apparent control of the final terms of the tender offer and highlighted the fact that Pershing Square would not “actually acquire any Allergan stock through the tender offer.”²⁴

Tension over Schedule 13D Disclosure

An unresolved question that was brought into somewhat sharper relief in the context of the Allergan takeover battle is whether the ten-day initial filing requirement for Schedule 13D filings should be shortened, an issue that has been the subject of debate for several years.²⁵ As noted above, the Valeant/Pershing Square-controlled JV was able to acquire 9.7% of Allergan’s common stock before publicly disclosing the fact that it had exceeded the 5% reporting

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threshold. Further, although not necessarily implicated in this case, critiques of the current beneficial ownership regime have focused on the use of derivatives to accelerate the ability of investors to accumulate economic ownership of shares, thereby arguably sidestepping the reporting requirements of Schedule 13D.²⁶

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) amended Section 13(d)(1) of the Exchange Act to give the SEC new statutory authority to shorten the ten-day filing period for initial Schedule 13D filings, as well as to regulate beneficial ownership reporting of security-based swaps.²⁷ Speaking in December 2011, then-Chairman Mary L. Schapiro indicated that the SEC planned to begin “a broad review of [the] beneficial ownership reporting rules . . . to modernize [those] rules, and [to] consider[] whether they should be changed in light of modern investment strategies and innovative financial products.”²⁸ Chairman Schapiro’s words, uttered over two years before the Valeant/Pershing Square–controlled JV was formed, seem all the more significant in the context of the Allergan takeover battle and the recent spate of shareholder activism.

Case Status and Aftermath

On November 4, 2014, the Court entered an order finding that there were

sufficient questions of fact for Allergan’s case against Valeant and Pershing Square to proceed to trial—although importantly for Valeant and Pershing Square, the Court declined to enjoin Pershing Square from voting shares it beneficially owned at a December 2014 special meeting of Allergan stockholders to vote on a slate of six directors of the nine-person board of directors. On December 29, 2014, Mr. Ackman filed a motion to dismiss this lawsuit on the basis that the plaintiff’s claims had been rendered moot, which may limit the potential for the case to provide further guidance on these issues. Separately, on December 16, 2014, Allergan stockholders who sold common stock between February 25 and April 21, 2014 filed a class action lawsuit against Valeant, Pershing Square, the JV and Mr. Ackman, alleging that Pershing Square and Valeant engaged in insider trading on the basis of MNPI.

In light of Allergan’s definitive agreement to sell itself to Actavis and the early stage of the Allergan class action litigation, definitive guidance on the elements of a Rule 14e-3 insider trading claim remains elusive. However, the Court’s preliminary analysis on the matters discussed above may serve as useful guideposts for other activist investors contemplating similar arrangements and to issuers seeking to oppose their efforts. ■

SEC Ramping Up Use of Administrative Proceedings in Insider Trading Actions

In the face of criticism and courtroom challenges, the SEC has continued to flex its administrative muscle by initiating several recent insider trading cases as administrative proceedings.

The first of these insider trading administrative actions was *In the Matter of Richard O'Leary*.²⁹ The SEC alleges that analyst Richard O'Leary received MNPI relating to publicly traded internet service provider Towerstream Corporation ("Towerstream") and its plans for an underwritten public offering of common stock. The SEC alleges that on January 28, 2013, an advisory group for Towerstream spoke to Mr. O'Leary concerning the participation of his employer, an unregistered investment advisor, as a potential investor, and that Mr. O'Leary's receipt of confidential information was confirmed in an e-mail message dated that same day. On January 29, the day before Towerstream announced the offer to the public, Mr. O'Leary sold 16,500 shares in Towerstream from his wife's and children's brokerage accounts. Following the public announcement of the offer, Towerstream stock dropped from \$3.17 to \$2.95 per share. In connection with his sales, Mr. O'Leary and his family avoided losses of \$6,845. Mr. O'Leary has agreed to settle the action in exchange for a twelve-month suspension from

work in the securities industry, disgorgement, a civil penalty equal to disgorgement and prejudgment interest.

On September 29, the SEC initiated administrative proceedings in *In the Matter of George T. Bolan, Jr. and Joseph C. Ruggieri* against Wells Fargo research analyst George Bolan and Wells Fargo senior trader Joseph Ruggieri on the theory that Mr. Bolan gave Mr. Ruggieri advance notice of rating changes likely to affect stock price.³⁰ Mr. Bolan was responsible for analyzing companies in the health care industry and rating them as "buy," "hold" or "sell." According to the SEC, Mr. Bolan tipped off Mr. Ruggieri to six of the rating changes that Mr. Bolan authored between 2010 and 2011. Mr. Ruggieri, who was paid a percentage of the monthly profit in his trading account, allegedly purchased stock ahead of Mr. Bolan's upgrades and sold stock short ahead of Mr. Bolan's downgrades. Mr. Ruggieri closed his overnight positions shortly after the stock prices moved in response to the publication of Mr. Bolan's reports. The SEC alleges that Mr. Ruggieri generated over \$117,000 in gross profits through these trades. The SEC also claims that Mr. Bolan provided similar MNPI to a second trader, whom the SEC has not identified and who predeceased the proceedings.

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On November 4, the SEC filed an administrative proceeding, *In the Matter of Steven Durrelle Williams*, against the former CEO of wireless technology firm Intellicheck Mobilisa, Inc. (“Intellicheck”).³¹ The SEC alleges that Mr. Williams sold Intellicheck stock prior to the company’s disclosure of unexpectedly weak results for the third quarter of 2012. In mid-September of that year, Mr. Williams was allegedly notified that the company’s lack of defense contracting sales would cause revenues to be lower than anticipated and revealed to several directors that Intellicheck was unlikely to make expected revenues for the quarter. Mr. Williams proceeded to sell approximately 46% of his Intellicheck stock over the next two days. In November, the company announced a \$1.472 million decline in revenue from the third quarter of 2011. Within three days, Intellicheck’s stock price declined by 35.4%. Mr. Williams has agreed to a settlement, including disgorgement, a civil penalty and a two-year bar on serving as an officer or director of a registered issuer.

On November 12, the SEC brought an administrative proceeding against a ViaSat Inc. (“ViaSat”) employee and his business colleague in *In the Matter of Michael S. Geist and Brent E. Taylor*.³² Michael Geist allegedly learned on July 19, 2010 that his employer, ViaSat, a communications company specializing in satellite technology,

had been awarded a contract to supply equipment and services for the U.S. Army’s Blue Force Tracking 2 program. Comtech Telecommunications Corp. (“Comtech”) had been the only other bidder and most market analysts had expected Comtech to win the contract. Mr. Geist purchased ViaSat call options and Comtech put options before ViaSat’s award was announced on July 21 and sold his options after the announcement for a profit of over \$27,000. He also allegedly shared information about the award with a business contact, Brent Taylor, who was then working for a defense contractor. Mr. Taylor and his wife avoided combined losses of approximately \$93,660 by selling their Comtech stock immediately before news of ViaSat’s contract award was released to the public. Both Mr. Geist and Mr. Taylor have offered to settle with the SEC. They face a five-year officer and director bar and will pay disgorgement, civil money penalties and prejudgment interest.³³

Finally, the SEC last month filed an administrative proceeding, *In the Matter of Robert A. Hemm*, arising out of consulting firm Randstad Holding NV’s (“Randstad”) tender offer for SFN Group, Inc. (“SFN”), a workforce solutions provider.³⁴ Robert Hemm’s relative began advising on the tender offer on July 12, 2011. Mr. Hemm allegedly spoke to his relative and purchased 5,000 shares of SFN stock on July 20, hours before Randstad announced the tender offer to

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the public. Two weeks later, Mr. Hemm sold his shares for a profit of \$21,763. The SEC alleged that Mr. Hemm knew that the information he obtained was non-public and that by purchasing SFN shares, he breached the duty of trust and confidence owed to his relative. Mr. Hemm settled the action and will pay disgorgement, a civil money penalty and prejudgment interest.

Defense counsel, legal commentators and even Judge Rakoff of the U.S. District Court for the Southern District of New York have expressed concerns about the fairness of the SEC's use of administrative proceedings as well as the SEC's motivation in pursuing more cases in this manner.³⁵ The SEC's use of administrative proceedings also has been subjected to several challenges on constitutional and procedural grounds. The common impetus for these challenges hinges on the perception (or reality) that administrative proceedings provide the SEC with a "home court" advantage and lack many of the important procedural and evidentiary safeguards that are provided in federal court—advantages that include expedited timetables, the absence of a jury and tenure protections for SEC administrative law judges. Earlier last year, a suit filed by money manager, Wing Chau, against the SEC alleged that the administrative proceeding against him was so lacking

in procedural protections that they violated his due process rights. On December 11, however, Judge Kaplan of the U.S. District Court for the Southern District of New York rejected Mr. Chau's complaint, concluding that the defendant's request for relief ran contrary to the statutory review scheme governing SEC adjudications.³⁶ Judge Kaplan held that Mr. Chau could make his procedural and due process arguments within the administrative process itself under which he is afforded the opportunity to appeal to the SEC and then the Second Circuit. In his opinion, Judge Kaplan acknowledged the larger policy concerns raised by defendant's challenge—including the concern that the SEC's use of the administrative process to interpret the federal securities laws diminishes the important role played historically by Article III courts in the development of case law. Although recognizing the legitimacy of the concerns raised, Judge Kaplan noted that "[t]his Court has not considered any views concerning the proper and wise allocation of interpretive functions between the SEC and the courts. Those are policy matters committed to the legislative and executive branches of government."³⁷ The *Chau* decision may impact the outcome of the other pending challenges. ■

Developments To Watch

Section 16(a) and Section 13(d) Reports: SEC Targeting Repeated Late Filers

On September 10, 2014, the SEC announced charges against 28 officers, directors and significant equity holders (including private fund management firms) who repeatedly failed to timely file Section 16 and Section 13(d) beneficial ownership reports.³⁸ Each of the insiders was late on multiple occasions and all but one of those charged settled with the SEC. The SEC does not appear to have targeted every foot fault, but repeat offenders with “especially high rates of filing deficiencies.” The number of missed reports ranged from ten to 70 missed reports, and some of those charged had failed to file even a single report until contacted by the SEC staff. The SEC also charged and settled with six issuers that had either taken on the filing responsibility for Section 16 reports for their insiders but did not submit timely reports (even though all necessary information had been provided to them) or failed to timely disclose violations of Section 16(a) in their Forms 10-K or annual proxy statements. Monetary penalties ranged from \$25,000 to \$120,000 for insiders and \$75,000 to \$150,000 for issuers. The SEC’s orders for these actions emphasize the legislative purpose behind Section 16(a), that the “most

potent weapon against the abuse of insider information is full and prompt publicity,” indicating that their focus may be attributable, in part, to the SEC’s aggressive posture on insider trading.

The SEC proactively identified these repeat offenders using computer-based systems with quantitative analytics and ranking algorithms. This sophisticated enforcement initiative reflects a change from historical practices, in which the SEC had previously generally brought Section 16(a) or Section 13(d) reporting actions in conjunction with another violation (*e.g.*, insider trading, fraud or tax avoidance), often relying on tips from whistleblowers or third-party allegations. Another notable aspect of the initiative is that it does not appear that any of the insiders charged were failing to file in order to hide non-exempt matching transactions.

These enforcement actions are a reminder that corporate insiders and significant shareholders should diligently confirm that all of their Section 16 and Section 13(d) reports (including any amendments) are timely and accurately filed. The SEC has cautioned that an “inadvertent” omission is not an excuse. A reporting violation by itself can result in SEC prosecution

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Section 16(a) and
Section 13(d) Reports:
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and financial penalty, regardless of the reasons for the violations, the intent or value involved, or whether the transaction involved open market

sales and purchases, sales under pre-arranged 10b5-1 trading plans or stock option grants and exercises. ■

SEC Drops Enforcement Action Over Herbalife Trades, Leaving Questions Unanswered

Two of the most significant insider trading developments in recent months arose in the context of the SEC's insider trading actions against two men alleged to have traded on MNPI relating to Herbalife Ltd. ("Herbalife"). While the SEC filed a motion to dismiss its action against alleged "downstream tippee" Jordan Peixoto following the Second Circuit's decision reversing the insider trading convictions of downstream tippees Todd Newman and Anthony Chiasson, the theory underlying the SEC's enforcement action against Mr. Peixoto is interesting because it evidences the SEC's desire to stretch the securities laws to cover trading on the basis of MNPI regarding, but not originating from, the issuer. Moreover, the SEC's procedural approach touched on the controversial topic of whether the SEC should be entitled to bring enforcement actions as administrative proceedings before an administrative law judge rather than as civil actions in federal court.

According to the SEC, on December 19, 2012 Filip Szymik,

the roommate of a former hedge fund analyst at Pershing Square, allegedly tipped his friend Jordan Peixoto that Pershing Square planned to make a public presentation in the near future accusing Herbalife of operating as a pyramid scheme. Mr. Peixoto purchased put options in advance of Pershing Square's December 2012 presentation. When Herbalife's stock price subsequently declined by 39%, Mr. Peixoto realized \$47,100 in allegedly illicit profit through the exercise of some of his options.³⁹ The SEC brought administrative proceedings against both Messrs. Szymik and Peixoto, charging them with insider trading. Mr. Szymik settled the proceeding against him and paid a penalty of \$47,100—the amount of the profit that Mr. Peixoto realized from Mr. Szymik's illegal "tip." Mr. Peixoto, however, not only refused to settle but initiated a federal lawsuit to enjoin the SEC's administrative proceeding against him.

Fundamentally, and even in the absence of the Second Circuit's decision in the *Newman/Chiasson*

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case, the *Peixoto* case presented a legitimate question as to whether either a traditional “insider” theory or a misappropriation theory of liability applies to Mr. Peixoto’s conduct. Neither he nor the source of the information was a corporate insider. Under the misappropriation theory, a corporate outsider can be held liable for the misuse of confidential information obtained in breach of a duty to the source of the information. However, as the Seventh Circuit recently reminded the SEC in the *Heartland Advisors*⁴⁰ case, a claim can only be established where there is an element of deception—typically, the outsider trades on confidential information that was entrusted to him for non-trading purposes, thereby depriving the source of the exclusive use of that information.⁴¹

Here, it would seem that the SEC might have been relying on the theory that Messrs. Peixoto’s and Szymik’s conduct served to deprive Pershing Square of its exclusive use of its own information about its trading strategy. However, Pershing Square had already built a sizeable short position by the time Mr. Peixoto traded on the information and the information that moved the market price of Herbalife was the announcement of that position (which was information that Pershing Square already possessed). As such, it is unclear how Mr. Peixoto’s purchase of options put William

Ackman, Pershing Square’s founder and CEO and the ultimate owner of the information in question, at any disadvantage. Perhaps to avoid this potential pitfall, the SEC premised the deception element of the violation on the alleged confidential relationship between Mr. Szymik and his long-time friend and roommate, the Pershing Square analyst.

In challenging the SEC’s use of administrative procedure, Mr. Peixoto joined a group of defendants who have challenged the SEC’s practice. Mr. Peixoto’s complaint made several arguments against the use of administrative proceedings under these circumstances. As a purely legal matter, Mr. Peixoto argued that tenure protections for SEC administrative law judges violate Article II of the Constitution, citing the Supreme Court’s 2010 holding in which it struck down the limitations on the removal of Public Company Accounting Oversight Board members that had been included in the Sarbanes-Oxley Act of 2002.⁴² He also asserted that the SEC’s use of an administrative proceeding violated his rights to equal protection and to due process by “unfairly and unconstitutionally” singling him out for disparate treatment—because, since the passage of the Dodd-Frank Act, the SEC had filed 156 insider trading proceedings against nonregulated defendants in federal court but had pursued cases using administrative

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proceedings against only two similarly situated defendants.⁴³ Citing SEC Director of Enforcement Andrew Ceresney's public statements from June 2014, Mr. Peixoto argued that the SEC chose to use an administrative proceeding to compel him to settle, arguing that "[t]he mere specter of the process renders submission from the defendant because the process is rigged against him."⁴⁴

The SEC's pursuit of its novel theory in an administrative setting

raised precisely the concerns Judge Rakoff expressed in a recent speech—"that the law in such cases would effectively be made, not by neutral federal courts, but by S.E.C. administrative judges."⁴⁵ The SEC's motion to dismiss and the expected withdrawal of Mr. Peixoto's case will leave untested—for the time being—the validity of the SEC's theory and use of administrative actions in these types of enforcement proceedings. ■

**SDNY to Investors: Properly Crafted Risk Factors
Serve as Adequate Warning**

In a case decided in June 2014, the U.S. District Court for the Southern District of New York dismissed a putative class action brought on behalf of investors who purchased Velocity Shares Daily 2x VIX Short Term Exchange Traded Notes, a type of debt security tied to equities futures on the S&P 500 market index, which was offered by Credit Suisse AG ("Credit Suisse") beginning in 2010.⁴⁶ The complaint against Credit Suisse alleged that the pricing supplements relating to the offering of the exchange-traded notes contained material misstatements and omissions necessary for the disclosure documents not to be misleading.

The Court ruled that Credit Suisse had adequately warned investors of

the security's risks. The Court engaged in a useful summary of the standard for disclosure of material information by issuers, finding that the determination of the materiality of a misstatement or omission depends on whether the defendants' representations, taken together and in context, would have misled a reasonable investor. The Court valued the "plain English warnings" and the "mathematical examples" contained in the risk factors⁴⁷ and elsewhere in the document and reiterated that determinations of materiality cannot be based on a "backward-looking assessment" of the registration statement.⁴⁸

The case serves as a reminder that issuers, underwriters and the lawyers

**SDNY to Investors:
Properly Crafted Risk
Factors Serve as Adequate
Warning**

who advise them, should carefully consider the risks inherent in the security being offered as well as the risks associated with the issuer of the securities and ensure that those risks are adequately reflected in the risk factor and other disclosure

throughout the offering document. The disclosure of these risks should be tailored to the particular security and issuer; the specificity of the disclosure in this case was in part the basis for the favorable result for Credit Suisse. ■

SEC Annual Report for 2014 Highlights Enforcement Trends

The SEC recently announced a record 755 enforcement actions filed in fiscal year 2014, as well as orders totaling \$4.16 billion in disgorgement and penalties.⁴⁹ Included in the total are 80 individuals charged with insider trading, who ranged from a former hedge fund trader to an accountant to a group of golfing buddies and friends. As part of its announcement, the SEC highlighted its efforts to implement and develop “next generation analytical tools to help identify patterns of suspicious trading.”⁵⁰

The SEC has recently been touting its use of new analytical tools which enable it to look for patterns and relationships between traders. At a recent Securities Docket forum, Daniel M. Hawke, Chief of the Enforcement Division Market Abuse Unit, noted that the new technology permits the SEC to analyze an immense amount of data in a way that focuses on information about potential connections between traders⁵¹ and allows the SEC to shift away from a “one-off” approach to investigations

to a more “trader-based approach” that focuses on discerning trading patterns across groups of individuals. Hawke also noted that insider trading remains a focus for the Division of Enforcement.

The SEC’s Annual Report also highlighted that it had charged over 135 parties with reporting and disclosure violations. Thirty-four individuals and companies were also charged with violations of laws requiring prompt reporting of holdings and transactions in company stock under Section 16 or 13(d) of the Exchange Act. These charges were part of a “new initiative using quantitative analytics to identify especially high rates of filing deficiencies.”⁵² The SEC further highlighted its heightened efforts to uphold disclosure standards for municipal securities. Actions included the announcement of the Municipalities Continuing Disclosure Cooperation Initiative to “encourage[] and reward[] self-reporting of certain violations by municipal issuers and underwriters.”⁵³ ■

Scalia Issues Open Invitation to Challenges That Could Clarify Scope of Insider Trading Law

In a November 2014 statement issued in connection with the Supreme Court's denial of certiorari in *Whitman v. United States*,⁵⁴ an insider trading case based on Section 10(b) of the Exchange Act, Justice Scalia indicated that he would be "receptive" to granting a petition for a writ of certiorari to the Supreme Court that "properly present[s]" the question of whether a court "owe[s] deference to an executive agency's interpretation of a law that contemplates both criminal and administrative enforcement"—as the insider trading laws do.⁵⁵ Justice Scalia's clearly-stated argument that "only the legislature may define crimes and fix punishments" effectively sets out the terms on which at least he would engage with the question of the scope of administrative agencies' discretion to "create (and uncreate) new crimes" through their interpretation of ambiguous statutory language—seeming to challenge the perceived creeping power of the modern regulatory state.

In his statement, Justice Scalia dismissed the Government's position that the SEC's interpretation of Section 10(b) of the Exchange Act should be accorded so-called "*Chevron* deference."⁵⁶ Citing the rule of lenity, Justice Scalia indicated that the Government's theory in the *Newman* case (*i.e.*, proving mere "knowing possession" of inside information

suffices for a criminal conviction) would "upend ordinary principles of interpretation" of criminal statutes, as that rule of construction requires interpreters to resolve ambiguity in criminal laws in favor of defendants. Deferring to the prosecuting branch's expansive views of these statutes, Justice Scalia wrote, "would turn [their] normal construction . . . upside-down, replacing the doctrine of lenity with a doctrine of severity."⁵⁷

Some commentators have recognized and welcomed Justice Scalia's statement as an opportunity to clarify the parameters of insider trading law and rein in a pattern of enforcement of the insider trading laws that some believe has wandered too far from the enforcement activity permitted under the statute. The opening lines of Justice Scalia's statement suggest that he shares this view. "A court owes no deference to the prosecution's interpretation of a criminal law," Justice Scalia writes, suggesting that the administrative agency promulgating a rule and the prosecuting authority enforcing or litigating that rule have a shared interest in ensuring a clear path to judgment and that it is the role of the courts to step in where the ambiguity left by the legislative branch threatens individual liberty. ■

Notable Cases and Enforcement Actions

The following notable cases and enforcement actions from the last several months demonstrate the SEC and DOJ's aggressive focus on enforcement and prosecution of insider trading and other securities violations.

*In re Sherman:*⁵⁸ In late July 2014, the SEC announced charges against Marc Sherman and Edward L. Cummings, the CEO and former CFO, respectively, of QSGI Inc. ("QSGI"), a computer equipment company, for misrepresenting the company's internal controls over financial reporting ("ICFR") to external auditors and investors. Specifically, the SEC alleges that Sherman and Cummings misrepresented that Sherman had participated in assessing the effectiveness of QSGI's ICFR in the company's 2008 Form 10-K and 10-K/A. Sherman and Cummings are also alleged to have falsely represented that they had evaluated the company's ICFR and that all significant deficiencies had been disclosed to QSGI's external auditors, a requirement under Section 302 of the Sarbanes-Oxley Act. The two executives allegedly misled auditors by withholding information about inadequate inventory controls which existed in QSGI's Minnesota operations that resulted in the acceleration of the recognition of certain inventory and accounts receivables in the company's

books. These actions were taken to maximize the amount of money the company could borrow from its main creditor. Mr. Cummings has agreed to settle the charges by paying a \$23,000 penalty as well as accepting an officer-and-director bar and suspension from practicing as an accountant on behalf of any entity regulated by the SEC for five years. Mr. Sherman has not settled and intends to litigate his charges in a separate administrative proceeding.

*In re Monness et al.:*⁵⁹ On August 20, 2014, Monness, Crespi, Hardt & Co., Inc. ("MCH"), a registered broker-dealer and boutique equity research firm, agreed to settle SEC charges by paying a \$150,000 civil penalty without admitting or denying the SEC's findings. The SEC had initiated administrative proceedings against MCH for failing to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI. The SEC took issue with MCH failing to enforce two of its written compliance procedures, which required the firm to maintain a restricted securities list and required employees to submit a report of their securities transactions. Additionally, MCH failed to adopt written policies and procedures to address the potential risk created by the firm's Idea Dinner and Corporate Access programs, which the firm had

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established and provided as services to its existing and prospective customers. These weaknesses were first identified in 2011 by the SEC's Office of Compliance, Inspections, and Examinations, to which MCH promptly responded with remedial actions.

SEC v. O'Neill et al.:⁶⁰ The SEC filed a complaint in the U.S. District Court for the District of Massachusetts on August 18, 2014 alleging that Patrick O'Neill, former senior vice president and senior credit officer at Eastern Bank Corporation, learned that his company was planning to acquire Wainwright Bank & Trust Company ("Wainwright") and tipped Robert H. Bray, a fellow golfer and country club member. Based on this MNPI, Mr. Bray purchased 31,000 shares of Wainwright before the June 29 announcement of the acquisition. During the few months after the announcement, Mr. Bray then sold all of his shares in Wainwright, receiving approximately \$300,000 in illicit gains. The SEC's lawsuit comes after an investigation initiated by the SEC, in which Messrs. O'Neill and Bray were both called to testify but asserted their Fifth Amendment privileges against self-incrimination for every question that was asked of them.

SEC v. Contorinis:⁶¹ On October 20, 2014, Joseph Contorinis, a former director at Jefferies & Company ("Jefferies") who received multiple tips regarding an acquisition of

a supermarket chain and used the information to execute trades on behalf of a Jefferies fund, filed a petition with the Supreme Court to reverse a Second Circuit decision that requires him to pay \$7.2 million in disgorgement fees on the profits realized by the fund. The Second Circuit held that monies subject to disgorgement include all proceeds realized from an illegal activity, whether or not personally retained by the trader, reasoning that otherwise, wrongdoers would be able to escape disgorgement by giving away their ill-gotten gains.⁶² However, Mr. Contorinis argues that he never received, possessed, or controlled the profits of the Jefferies fund, and therefore he should not be responsible for these payments. He also claims that the Second Circuit's decision is inconsistent with long-standing precedent, which could make it ripe for Supreme Court review.

In the Matter of Hampton Roads Bankshares, Inc.:⁶³ and *In the Matter of Neal A. Petrovich CPA*:⁶⁴ The SEC filed and settled administrative actions against Hampton Roads Bankshares, Inc. ("Hampton Roads"), a bank-holding company, and Neal Petrovich, its former CFO, for allegedly violating the federal securities laws by improperly accounting for a deferred tax asset (the "DTA") that, according to the SEC, was not fully realizable because of the company's deteriorating loan portfolio. The SEC's order alleges that the company and its former CFO incorrectly determined

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that no valuation allowance was required against the DTA for the year-end 2009 by relying on projections that the company would become profitable again in 2011 and would utilize the DTA within the applicable period. Internal bank documents, however, revealed that in late 2009 and the first half of 2010, the bank's loan portfolio was continuing to deteriorate thus indicating that loan losses would continue. The company did not disclose this fact. Without admitting or denying the findings, Hampton Roads consented to the entry of an order that it violated the reporting, books and records, and internal control provision of the federal securities laws and agreed to pay a penalty of \$200,000. The former CFO also resolved the proceedings and consented to the entry of a cease and desist order and agreed to pay a \$25,000 fine. The case is a vivid example of the SEC's broken windows approach—pursuing violations for non-scienter-based conduct against smaller financial institutions.

SEC v. Lucarelli:⁶⁵ In the first of a series of rapid-fire enforcement actions brought against a range of actors beyond typical corporate insiders and Wall Street traders, on August 26, Michael Anthony Dupre Lucarelli was charged with trading ahead of a variety of corporate announcements, including earnings results, M&A and tender offer activity and the results of clinical drug trials, in each case based on draft press releases of the public company clients

of the investor relations firm for which he worked. Mr. Lucarelli is accused of trading ahead of over 20 corporate announcements in under a year's time, reaping illicit profits of nearly \$1 million. The complaint also alleges that Mr. Lucarelli attempted to hide his behavior by repeatedly providing false information about his employment when setting up the brokerage accounts used to make the illegal trades.

SEC v. Braverman:⁶⁶ Less than three weeks after charging Mr. Lucarelli, the SEC charged Dimitry Braverman, a senior IT professional at the silicon valley law firm Wilson Sonsini Goodrich & Rosati, with trading in the securities of eight firm clients ahead of M&A announcements. Despite profits of only approximately \$300,000 over a four-year span, which time period included an 18-month hiatus in trading, and the use of foreign family member's brokerage accounts, Mr. Braverman was unable to avoid detection by the SEC's increasingly sophisticated electronic capabilities due to the similar and suspicious pattern of each of the trades. Mr. Braverman is charged with breaching his duty of confidentiality, as well as ignoring various firm policies, by accessing client databases and both trading and tipping on the basis of the MNPI that he reviewed.

SEC v. Tamayo:⁶⁷ Just three days after charging Mr. Braverman, the SEC charged Frank Tamayo with facilitating

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an insider trading scheme that yielded over \$5.6 million in illegal profits. Mr. Tamayo is accused of facilitating the scheme by obtaining MNPI with respect to pending corporate transactions from a friend who stole the information from the law firm at which he worked and sharing that information, typically by writing the ticker symbol on a napkin or Post-it® note, with another friend and stockbroker in the middle of Grand Central Station. The information was then used to trade on behalf of

Mr. Tamayo and others. Despite the use of various forensic counter measures by the scheme participants, including the ingestion of the Post-it® notes by Mr. Tamayo and intentionally ensuring that Mr. Tamayo's friend (the source) and Mr. Tamayo's broker never came into direct contact with one another, the SEC has brought charges against all three men. Clearly, Post-it® notes are no match for the SEC's Advanced Bluesheet Analysis Program or Center for Quantitative and Risk Analytics. ■

Notes

1. *United States v. Newman and Chiasson*, Nos. 13-1837-cr, 13-1917-cr (2d Cir. Dec. 10, 2014).
2. *Id.* at 22.
3. *United States v. Newman*, 2013 WL 1943342 at *2 (S.D.N.Y. May 7, 2013).
4. *United States v. Newman and Chiasson*, Nos. 13-1837-cr, 13-1917-cr, at 8 (2d Cir. Dec. 10, 2014).
5. *Id.* at 5.
6. *Id.* at 6.
7. *Id.* at 15.
8. *Id.* at 14.
9. *Id.*
10. *Id.* at 18.
11. *Id.* at 22.
12. *Id.*
13. *Id.* at 27.
14. *In the Matter of Caterpillar Inc.*, Release No. 33-7692 (March 31, 1992).
15. *Id.*
16. SEC Release No. 33-6239, n. 33 (Sept. 4, 1980).
17. *S.E.C. v. Mayhew*, 121 F.3d 44 (2d Cir. 1997).
18. *S.E.C. v. Warde*, 151 F.3d 42 (2d Cir. 1998).
19. *S.E.C. v. Ginsburg*, 362 F.3d 1292 (11th Cir. 2004).
20. See Order Granting In Part Motion For Preliminary Injunction (Document 234), *Allergan, Inc. v. Valeant Pharmaceuticals International, Inc.*, No. 8:14-cv-01214-DOC-AN (Nov. 4, 2014).
21. *Id.* at 7.
22. *Id.* at 17 *et seq.*
23. *Id.* at 21.
24. *Id.*
25. See Letter from Wachtell, Lipton, Rosen & Katz LLP to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (Mar. 7, 2011), re: Petition for Rulemaking Under Section 13 of the Securities Exchange Act of 1934, <http://www.sec.gov/rules/petitions/2011/petn4-624.pdf>; *but see* "Point/Counterpoint," *The Activist Report*, vol. 2, no. 4 (Apr. 2012), <http://www.13dmonitor.com/Article.aspx?id=11> (comments of Charles Penner, Partner and Chief Legal Officer of JANA Partners LLC arguing against shortening the ten-day period), and Lucian A. Bebchuk and Robert J. Jackson, Jr., "The Law and Economics of Blockholder Disclosure," *Harvard Business Law Review*, vol. 2, no. 1, pp. 39–60 (2012), <http://www.hblr.org/wp-content/uploads/2012/07/hlb207.pdf>.
26. See Letter from Wachtell, Lipton, Rosen & Katz LLP to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (Mar. 7, 2011), re: Petition for Rulemaking Under Section 13 of the Securities Exchange Act of 1934, <http://www.sec.gov/rules/petitions/2011/petn4-624.pdf>; *but see* "Point/Counterpoint," *The Activist Report*, vol. 2, no. 4 (Apr. 2012), <http://www.13dmonitor.com/Article.aspx?id=11> (comments of David Katz, Partner of Wachtell, Lipton, Rosen & Katz LLP).
27. Dodd-Frank Wall Street Reform and Consumer Protection Act § 929R, 12 U.S.C § 5201 (2010).
28. Mary L. Schapiro, Chairman, U.S. Securities and Exchange Commission, Remarks at the Transatlantic Corporate Governance Dialogue, Washington, D.C. (Dec. 15, 2011), <http://www.sec.gov/news/speech/2011/spch121511mls.htm> (last visited Nov. 18, 2014).
29. *In the Matter of Richard O'Leary*, Adm. Proc. File No. 3-16166 (September 25, 2014).
30. *In the Matter of George T. Bolan, Jr.*, Adm. Proc. File No. 3-16178 (September 29, 2014).
31. *In the Matter of Steven Durrelle Williams*, Adm. Proc. File No. 3-16246 (November 4, 2014).
32. *In the Matter of Michael S. Geist and Brent E. Taylor*, Adm. Proc. File No. 3-16269 (November 12, 2014).
33. The SEC has also brought two administrative proceedings related to alleged insider trading of options in nutritional supplement company Herbalife, *In the Matter of Filip Szymik and In the Matter of Jordan Peixoto*. See *infra*, *SEC Drops Enforcement Action Over Herbalife Trades, Leaving Questions Unanswered*.
34. *In the Matter of Robert A. Hemm*, Adm. Proc. File No. 3-16298 (December 5, 2014).
35. See, e.g., Judge Jed S. Rakoff, *Is the S.E.C. Becoming a Law Unto Itself?*, Keynote Address at the PLI Securities Regulation Institute (Nov. 5, 2014).
36. *Chau v. SEC*, No. 14-cv-1903 (S.D.N.Y. Dec. 11, 2014).
37. *Id.* at 35-36.
38. See Press Release, *SEC Announces Charges Against Corporate Insiders for Violating Laws Requiring Prompt Reporting of Transactions and Holdings: Nearly Three Dozen Charged in Enforcement Initiative to Root Out Repeated Late Filers* (Sept. 10, 2014), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542904678#.VFqB2Kl9VeA>
39. Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934 and Notice of Hearing, *In re: Jordan Peixoto*, SEC Release No. 34-73263, Adm. Proc. File No. 3-16184 (September 30, 2014), ¶¶ 28–29.

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40. Decision and Order Granting Jilaine H. Bauer's Motion for Summary Judgment (Doc. 483) and Dismissing Case, *S.E.C. v. Heartland Advisors Inc. et al.*, No. 03-CV-1427 (E.D. Wis. Aug. 29, 2014) 06 WL 2547090, ¶ 2.
41. *S.E.C. v. Bauer*, 723 F.3d 758, 769 (7th Cir. 2013). See also *United States v. O'Hagan*, 521 U.S. 642, 655 (1997) (in which the Supreme Court indicated that "[b]ecause the deception essential to the theory involves feigning fidelity to the information's source, if the fiduciary discloses to the source that he plans to trade on the information, there is no 'deceptive device' and thus no § 10(b) violation.")
42. *Free Enterprise Fund v. Pub. Co. Accounting Oversight Bd.*, 561 U.S. 477 (2010).
43. Complaint for Declaratory and Injunctive Relief and Demand for Jury Trial, *Peixoto v. SEC*, No. 14-8364 (S.D.N.Y. Oct. 20, 2014), ¶ 11.
44. *Id.* at ¶ 15.
45. Judge Jed S. Rakoff, Is the S.E.C. Becoming a Law unto Itself?, Keynote Address at the PLI Securities Regulation Institute (Nov. 5, 2014).
46. *In re TVIX Securities Litigation*, No. 12-cv-04191 (LTS) (S.D.N.Y. Jun. 9, 2014).
47. *Id.* at 8, 10.
48. *Id.* at 7.
49. Press Release, *SEC's FY 2014 Enforcement Actions Span Securities Industry and Include First-Ever Cases* (Oct. 16, 2014), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543184660>.
50. *Id.*
51. Securities Docket Securities Enforcement Forum, October 14, 2014, Four Seasons Hotel, Washington, D.C.
52. *Supra* note 49.
53. *Id.*
54. *Douglas F. Whitman v. U.S.*, No. 14-29 (statement of Scalia, J.), 574 U.S. ____ (2014) (November 10, 2014).
55. Violations of Section 10(b) and the rules and regulations thereunder are subject to criminal prosecution, see Section 32 of the Exchange Act, and to civil enforcement proceedings, see Section 21A of the Exchange Act.
56. *Douglas F. Whitman v. U.S.*, No. 14-29 (statement of Scalia, J. at p. 2), 574 U.S. ____ (2014) (November 10, 2014). (citing *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984)).
57. *Douglas F. Whitman v. U.S.*, No. 14-29 (statement of Scalia, J. at p. 2), 574 U.S. ____ (2014) (November 10, 2014). (citing *Crandon v. United States*, 494 U.S. 152, 178 (1990) (Scalia, J., concurring in judgment)).
58. Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, *In the Matter of Marc Sherman*, No. 3-15992 (July 30, 2014) 2014 WL 3735560, available at <http://www.sec.gov/litigation/admin/2014/34-72723.pdf>; <http://www.sec.gov/litigation/admin/2014/34-72722.pdf>; Order Instituting Public Administrative and Cease-and-Desist Proceedings Pursuant to Sections 4C and 21C of the Securities and Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, *In the Matter of Edward L. Cummings, CPA*, No. 3-15991 (July 30, 2014) 2014 WL 3735559, available at <http://www.sec.gov/litigation/admin/2014/34-72723.pdf>.
59. Order Instituting Cease-and-Desist Proceedings, Pursuant to Section 15(b) and 21C of the Securities and Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, *In the Matter of Monness, Crespi, Hardt & Co., Inc.*, No. 3-16025 (Aug. 20, 2014) 2014 WL 4090466, available at <http://www.sec.gov/litigation/admin/2014/34-72886.pdf>.
60. Complaint, SEC v. J. Patrick O'Neill and Robert H. Bray, No. 14-CV-13381 (D. Mass. August 18, 2014) 2014 WL 4059786, available at <http://www.sec.gov/litigation/complaints/2014/comp-pr2014-169.pdf>.
61. Petition for a Writ of Certiorari, *SEC v. Contorinis* (No. 14-471), 2014 WL 5396183 (Oct. 20, 2014).
62. *SEC v. Contorinis*, 743 F.2d 296 (2d Cir. 2014).
63. *In the Matter of Hampton Roads Bankshares, Inc.*, Adm. Proc. File No. 3-16296 (Dec. 5, 2014).
64. *In the Matter of Neal A. Petrovich, CPA*, Adm. Proc. File No. 3-16297 (Dec. 5, 2014).
65. Complaint, SEC v. Michael Anthony Dupre Lucarelli, No. 14-CV-6933 (S.D.N.Y. August 26, 2014), 2014 WL 4210263.
66. Complaint, SEC v. Dimitry Braverman and Vitaly Pupynin, No. 14-CV-7482 (S.D. Fla September 16, 2014), 2014 WL 4627799.
67. Complaint, SEC v. Frank Tamayo, No. 3:14-CV-05844 (D. N.J. September 19, 2014), 2014 WL 4702284.

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