SULLIVAN & CROMWELL LLP

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DOJ and SEC Bring Insider Trading Charges for Use of Confidential Government Information Obtained by Consultant

Cases Continue Trend of Insider Trading Charges Based on Material Non-Public Government Information Obtained Through Government Source

SUMMARY

On May 24, 2017, the United States Attorney for the Southern District of New York announced the arrests and criminal indictment of four individuals for alleged insider trading on the basis of confidential information about upcoming federal government actions that was obtained from a government employee. A fifth defendant pleaded guilty and is cooperating with prosecutors. Four of the five individuals also were named in a civil complaint filed by the Securities and Exchange Commission for the same conduct.

Theodore Huber, Robert Olan and Jordan Fogel served as investment professionals at an investment adviser to funds focused primarily on the healthcare sector. The three individuals allegedly traded on the basis of material non-public information provided to them by David Blaszczak, a "political intelligence" consultant with expertise in, and connections to, the Centers for Medicare & Medicaid Services ("CMS"), the federal agency that sets Medicare reimbursement rates. Blaszczak allegedly received confidential information on multiple occasions from Christopher Worrall, then a senior staff member at CMS, regarding pending changes to Medicare reimbursement rates. The public announcements of the rate changes moved the markets for certain healthcare stocks. In total, trades made based on this information are alleged to have resulted in over $3.9 million in ill-gotten gains for funds managed or traded by Huber, Olan and Fogel.

These charges follow the 2014 SEC disclosure of its pursuit of enforcement actions related to a potential leak of reimbursement rates announced by CMS. Specifically, in a 2014 subpoena enforcement action filed against the House Ways and Means Committee and the staff director of its Health Subcommittee, the SEC had revealed details of criminal and civil insider trading investigations arising from a potential leak of reimbursement rates announced by CMS.

BACKGROUND

Section 10(b) of the Securities Exchange Act of 1934, as amended, has been interpreted to prohibit individuals who owe a duty of trust and confidence from trading on material, non-public information in breach of that duty.[1] These individuals also may not "tip" such inside information to others for the purposes of trading. A tipper breaches his fiduciary duty when he discloses material, non-public information for a "personal benefit."[2] A tippee who receives and trades on such information can also be liable for insider trading if "the tippee knows or should know that there has been a breach [of the insider's fiduciary duty]."[3] The Stop Trading on Congressional Knowledge (STOCK) Act of 2012 codified that executive branch employees have a duty "to the United States government and the citizens of the United States" with respect to material non-public information that they obtain in their official capacities.[4]

In December 2014, the Second Circuit questioned the validity of these settled principles when, in *United States* v. *Newman,* it purported to place new limits on the scope of tippee liability.[5] *Newman* held that a tippee can be liable only if he knew that the tipper had received a "personal benefit" of a "pecuniary or similarly valuable nature" in exchange for the information. *Newman* raised questions about what constituted such a "pecuniary" benefit and whether recipients of mere gifts of information from friends or relatives were now insulated from tippee liability. In December 2016, however, the U.S. Supreme Court limited *Newman's* holding with respect to what may constitute a sufficient "personal benefit" to a tipper. in *Salman* v. *United States* the Court held that a tipper has liability for insider trading when he "receives a direct or indirect personal benefit from the disclosure," including a non-pecuniary benefit such as "making a gift of confidential information to a trading relative or friend."[6]

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1 15 U.S.C. § 78j(b); *United States* v. *O'Hagan*, 521 U.S. 642, 650-52 (1997).

2 *Dirks* v. *SEC*, 463 U.S. 646, 663 (1983).

3 *Id.* at 660.

4 Section 21A of the Exchange Act as amended by Section 9 of the STOCK Act.

5 773 F.3d 438 (2d Cir. 2014).

6 *Salman* v. *United States*, 137 S. Ct. 420, 425 (2016) (quoting *Dirks*, 463 U.S. at 663-64).

Trend in Cases Involving Misuse of Confidential Government Information

In November 2015, the SEC announced it had entered into a settlement order with Marwood Group Research LLC ("Marwood"), a political intelligence research and consultancy firm, requiring it to pay $375,000 and admit fault in connection with its mishandling of potentially material non-public information regarding CMS reimbursement rates announcements. However, the Marwood settlement did not address any potential liability under the STOCK Act, nor did the SEC pursue an insider trading enforcement action against any customer of Marwood that had received the research.[7]

Separately, in June 2016, the SEC and the DOJ announced insider trading charges against two hedge fund managers and their source, a former government official accused of deceptively obtaining confidential information from employees of the U.S. Food and Drug Administration.[8]

ALLEGED CIVIL AND CRIMINAL VIOLATIONS

Trading liability

The SEC's complaint and the U.S. Attorney's Office's indictment focus on trades made by Huber, Olan and Fogel, each made in advance of three specific CMS announcements regarding changes to reimbursement rates for certain medical procedures. In each case, the charging documents allege that Worrall provided Blaszczak with notice (prior to any public disclosure) of the revised rates and the timing of the announcements via calls, text messages and in-person meetings, and that Blaszczak subsequently communicated this information to Huber, Olan or Fogel.[9] For each of the three CMS announcements at issue, the reimbursement rate changes were to affect a small set of companies with exposure to the specialty procedures or treatments covered by the decision. Huber, Olan or Fogel are alleged to have traded in the securities of companies affected by those revised rates in advance of CMS' public announcements.

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7 *See* Sullivan & Cromwell LLP memo to clients: *SEC Settles with Research Firm over Mishandling of Insider Information* (Dec. 1, 2015), available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_SEC_Settles_with_Research_Firm_over_Mishandling_of_Insider_Information.pdf

8 *See Hedge Fund Managers and Former Government Official Charged in $32 Million Insider Trading Scheme*, SEC Press Release 2016-119 (June 15, 2016), available at https://www.sec.gov/news/pressrelease/2016-119.html. *See also Hedge Fund Portfolio Manager Sanjay Valvani And Former Portfolio Manager Stefan Lumiere Charged In Manhattan Federal Court*, U.S. Attorney's Office for the Southern District of New York Press Release (June 15, 2016), available at https://www.justice.gov/usao-sdny/pr/hedge-fund-portfolio-manager-sanjay-valvani-and-former-portfolio-manager-stefan-lumiere.

9 *See* Compl. ¶ 62.

Government employee liability under STOCK Act

The charging documents allege that Worrall violated a statutory duty under the STOCK Act in sharing information with Blaszczak regarding impending CMS announcements, and became a "tipper" for purposes of insider trading liability.[10] In exchange for providing this material non-public information, Blaszczak is alleged to have given Worrall pecuniary benefit in the form of employment or business opportunities, including a job interview that Blaszczak helped to arrange that allowed Worrall to negotiate for a promotion at his employer. However, Worrall is not alleged to have received monetary compensation from Blaszczak or to have ultimately accepted any employment or business opportunity from Blaszczak.[11] The charging documents also allege that Worrall and Blaszczak had a "close personal friendship" and suggest that Worrall need not have received any pecuniary benefit to create insider trading liability, consistent with the *Salman* holding.

Consultant liability

Blaszczak is alleged to have passed the material non-public information regarding CMS announcements to Huber, Olan and Fogel, who had retained Blaszczak and his advisory firm as consultants and paid at least $193,000 in fees over the time period at issue.[12] The charging documents further allege that Huber, Olan and Fogel knew or should have known that Blaszczak sourced his information from CMS employees, citing an email from Fogel stating "there is a closed-door meeting next week and Blaszczak has a guy there."[13] No specific allegations are made, however, that Huber, Olan or Fogel knew of any personal benefit provided by Blaszczak or others to the CMS source.

In connection with these allegations, the SEC's complaint seeks to enjoin Worrall, Blaszczak, Huber and Fogel from further impermissible conduct, and to compel disgorgement of any ill-gotten gains along with civil penalties. The U.S. Attorney charged Worrall, Blaszczak, Huber and Olan with, among other things, securities fraud, conversion of U.S. property, and wire fraud.

IMPLICATIONS

Continuing recent enforcement trends, these complaints and indictments present a potential expanded area of insider trading enforcement. In particular, the allegations raise questions regarding:

(1) The circumstances under which material non-public information sufficient to charge an insider trading violation may come from government sources;

(2) The boundaries, if any, on the scope of what may constitute a "pecuniary benefit" to a tipper, such as providing introductions that may lead to potential employment opportunities;

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10 *See* Indictment ¶ 15.

11 *See* Compl. ¶ 5.

12 *See* Compl. ¶ 4.

13 *See* Compl. ¶ 53.

(3) The boundaries, if any, on the types of "personal relationships" that may serve as the basis for a criminal or civil charge under the holdings set forth in *Salman*; and

(4) The degree of knowledge that an indirect tippee must have has regarding any personal benefit received by the original source of such inside information.

For funds, traders, research consultants and other market participants, these developments underscore the continuing risks associated with trading undertaken on the basis of information obtained from private or government sources. Such information later may be characterized as "material, non-public information," regardless of whether the information is tied to any obvious, clear or identifiable transfer of value or benefit to the source or provider of the information.

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