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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

The SEC Is Cracking Down On Insider Trading By Lawyers

By **Daniel Hawke** (June 12, 2019, 4:55 PM EDT)


Daniel Hawke

A recent series of insider trading actions charging senior lawyers in legal departments of prominent public companies suggests that insider trading by lawyers may be on the rise. Over the past several months, the U.S. Securities and Exchange Commission has brought enforcement actions charging insider trading in advance of earnings announcements by senior lawyers at Apple and SeaWorld. In a third action, filed in early May 2019, the general counsel of Cintas Corporation was an unwitting victim of a house guest, a lifelong friend, who, the SEC alleges, surreptitiously pilfered merger related information from a folder in the lawyer's home office.

These actions are noteworthy not only for the brazenness of the conduct involved, but because they suggest that insider trading by lawyers remains a "profound problem."[1] And, as the case of the Cintas general counsel demonstrates, innocent lawyers may also fall prey to others, such as close friends and family, looking to exploit their access to material nonpublic information, or MNPI.

Insider trading by lawyers and legal personnel is not a new phenomenon. In the 1980s, a wave of high-profile cases sparked debate concerning whether law firms could be held liable for improper trading by their partners and employees under the control person liability provisions of the Securities Exchange Act of 1934.[2]

In recent years, however, a new wave of enforcement actions, coupled with the SEC's development of new technology, and its adoption of the trader-based approach[3] to insider trading investigations, has rekindled the question of whether companies and law firms should be doing more to protect against the misuse of MNPI by lawyers and legal personnel.

Increasingly, the SEC has touted its use of data analysis to identify patterns of suspicious trading and relationships among traders, and "aggressively to root out and identify insider trading by connecting patterns of trading to sources of material nonpublic information."[4] Because legal departments and law firms are repositories of large amounts of MNPI, they are among the first places that regulators look to determine whether a lawyer is the source of prohibited information.

These efforts have resulted in four categories of actions against lawyers and others within legal departments and law firms: in-house counsel, systems access, friends and family, and opportunity cases.

The Apple and SeaWorld In-House Lawyers

On Feb. 13, 2019, the SEC filed an enforcement action charging insider trading violations by Gene Daniel Levoff, the former associate general counsel, senior director of corporate law and corporate secretary of Apple.[5] According to the SEC, Levoff was a member of Apple's disclosure committee, and had access to MNPI about forthcoming quarterly earnings announcements.

The SEC alleges that Levoff traded Apple securities in front of three quarterly earnings announcements in 2015 and 2016, and made more than $380,000 in profits or losses avoided. In one of those instances, Levoff sold $10 million in Apple stock — virtually all of his holdings — over a four-day period in July 2015 before a negative earnings announcement. When the earnings were announced, Apple's stock price fell by 4%. By selling when he did, Levoff avoided losses of $345,000.

The SEC further alleged multiple instances of insider trading by Levoff dating back to 2011, and, to remove any doubt that Levoff knew he was under a duty to abstain from insider trading, the SEC alleged that Levoff was responsible for ensuring compliance with the company's insider trading policies and for "determining the criteria for those employees (including himself) restricted from trading around quarterly earnings announcements."[6]

In April 2019, the SEC filed insider trading charges against Paul Bannon Powers, an associate general counsel and the assistant corporate secretary at SeaWorld.[7] According to the SEC, beginning in 2013 and continuing through the end of 2017, SeaWorld experienced declines in attendance and revenues at its parks. By virtue of his position as associate general counsel and assistant corporate secretary, Powers was made aware that SeaWorld's attendance and revenues for Q2 2018 were stronger than anticipated and would exceed analyst expectations.

On Aug. 1, 2018, Powers received a draft of a company Q2 2018 earnings release detailing strong attendance and revenue. The next day, Powers purchased 18,000 shares of SeaWorld stock. When earnings were announced on Aug. 6, 2018, SeaWorld's share price spiked 17%, resulting in ill-gotten gains to Powers of $64,645.

Fettner — The Snooping House Guest

On May 7, 2019, the SEC filed an insider trading action against Brian Fettner.[8] Fettner was a lifelong friend of the general counsel at Cintas Corporation, headquartered in Cincinnati.

In mid-2016, Cintas was in talks about a potential business combination with G&K Services Inc. The general counsel was one of only a few Cintas senior officers who knew about the merger talks with G&K. The general counsel took home a folder labeled with the code name for the prospective merger that contained a nondisclosure and standstill agreement, as well as other merger-related documents.

In June 2016, Fettner travelled to Cincinnati to play a charity golf tournament, and stayed at the general counsel's home. According to the SEC, "Fettner went into the General Counsel's den to change into his golf shoes. While there, Fettner saw the folder with merger documents on the desk and read at least some of the of the draft nondisclosure agreement between Cintas and G&K."[9]

As they headed out to play golf, Fettner did not disclose to the general counsel that he had seen the merger documents in his house. Fettner then proceeded to buy G&K stock in his ex-wife's and former girlfriend's accounts. He further persuaded his father and another girlfriend to buy G&K stock. Fettner did not inform the general counsel about his G&K stock purchases, or the purchases that he persuaded others to make.

In mid-August, G&K announced that it had entered into a merger agreement with Cintas. G&K's stock closed up approximately 17.7%. As a result of Fettner's actions, these accounts realized ill-gotten gains of $250,000.

Systems Access Cases

The SEC has been particularly adept at developing cases involving misuse of access to law firm file and information systems. Typically, these cases involve accessing client file folders in network directories containing information about forthcoming transactions in which the client is involved. In SEC v. Eydelman et al.,[10] the SEC charged a law clerk at a major New York law firm with insider trading in a middleman scheme, in which the clerk accessed files containing information about 13 pending transactions and tipped a middleman, who conveyed the information to a trader.

In SEC v. Temple and Pastro,[11] the SEC charged a law firm network IT manager with using his position to access information about 22 M&A deals, and tipping his brother-in-law. And, in SEC v. Matthew Kluger et al.,[12] perhaps the longest-running insider trading scheme in history, the SEC charged a law firm associate who had worked at four well-known law firms over a 17-year period with tipping on at least eight deals that generated more than $30 million in profits.

Friends and Family Member Cases

Some of the most difficult cases the SEC contends with involve those where the family members of the lawyer exploit the lawyer's access to MNPI. As in the Cintas case where the general counsel was victimized by a lifelong friend, the lawyers in these cases are often unwitting victims of their family members' misconduct.

For example, in SEC v. Fei Yan,[13] the husband of a corporate law firm associate purchased stock and options in advance of two corporate transactions on which his wife was then working. After searching Google for "how sec detect unusual trading," Yan traded stock and options that the SEC promptly detected using its data analysis capabilities.

In SEC v. Dean Goetz,[14] the defendant, himself a lawyer, was the father of a law firm associate who was visiting her parents' home for the holidays. The daughter was working on an impending deal involving a large health care company and worked from various locations around the defendant's home. The defendant misappropriated information about the transaction from his daughter, and purchased 900 shares in the target company's stock, realizing a profit of $11,418.

Opportunity Cases

Opportunity cases are cases in which a lawyer unexpectedly comes into possession of MNPI, and exploits the opportunity by misappropriating (i.e., trading on) the information. These cases are particularly troubling because the lawyer's decision to engage in insider trading also often involves a deliberate breach of professional obligations and a fiduciary duty owed to his or her law firm and its client.[15]

In SEC v. Sudfeld,[16] the SEC charged a real estate partner of a large law firm with insider trading in front of a merger that he learned about when he overheard a conversation between an attorney working on the transaction and their shared legal assistant.

Similarly, in SEC v. Schwinger,[17] the managing partner of the Washington, D.C., office of a large law firm traded in advance of a public announcement that Vastera Inc. was about to be acquired. The partner, who knew that Vastera was a client of the firm, learned of the impending merger while interviewing Vastera's chief counsel, who was seeking to be hired by the law firm as a lateral partner.

Mitigating Risk

Having adopted a zero-tolerance policy when it comes to insider trading by lawyers and legal personnel, the SEC has become highly effective at catching such conduct. Nevertheless, legal departments and law firms can take the following steps to mitigate their exposure to insider trading risk.

Assessing Types of MNPI

The first step in mitigating insider trading risk is knowing what type of MNPI a firm generally possesses, and establishing reasonably designed controls to prevent misuse of the information.

In many law firms, attorneys come into possession of a wide range of material facts. For example, a law firm with a life sciences practice likely possesses information concerning new drug approvals or the results of clinical trials that could be material to a client company. Assessing the nature and extent of MNPI in a law firm provides the foundation for deciding whether or to what extent additional controls are needed.

Improved Controls Over MNPI

Law firms and legal departments should revisit their insider trading policies and procedures and consider whether improvements can be made for how they handle MNPI.

The use of project code words for transactional matters is generally effective at protecting against disclosure of the identities of the parties to the transaction. The risk of disclosure, however, increases if members of the deal team are inconsistent in their use of code words.[18]

Similarly, where law firm attorneys and legal personnel share information in connection with running conflict of interest checks, there is an increased risk of such information being misused. Adopting procedures to shield incoming public company transactional matters from firmwide disclosure can reduce the number of attorneys and employees exposed to MNPI.

File Access on a Need-to-Know Basis

When new project files or client file directories are established, law firms and legal departments should consider restricting access to persons on a need-to-know basis. Establishing a permissions process will prevent employees who are outside the deal team or earnings process from being able to access file folders concerning MNPI.

Consistent Communications About Pretrade Approvals, Blackout Periods and Trading Restrictions

Legal departments and law firms should have robust, up-to-date insider trading policies in place. Requiring employees to periodically acknowledge and certify that they are under a legal duty to maintain the confidentiality of MNPI is central to a meaningful insider trading policy. Reinforcing that policy by consistently communicating about the necessity of pretrade approvals, blackout periods and trading restrictions signals to employees that a law department takes insider trading compliance seriously.

The recent SEC enforcement actions against lawyers suggest that lawyer insider trading may be on the rise. While little can be done to stop someone who deliberately violates professional obligations and circumvents employer policies and procedures, legal departments and law firms seeking to mitigate their exposure to such conduct should consider revisiting their insider trading policies and should evaluate whether additional training is needed to protect against the risk of insider trading by their employees.

Training lawyers to secure MNPI within their control, and to be aware of circumstances in which those around them may seek to exploit their access to information, is key to avoiding the severe reputational and legal consequences that can result from an insider trading investigation. Education concerning the effectiveness of the SEC's improved surveillance capability and the SEC's new approaches to insider trading investigations can go a long way to instilling apprehension and deterring would-be violators.

Daniel M. Hawke is a partner at Arnold & Porter, and the former head of the Market Abuse Unit of the SEC's Division of Enforcement.

Disclosure: While at the SEC, the author supervised some of the cases discussed in this article (SEC v. Eydelman et al., SEC v. Temple and Pastro, SEC v. Matthew Kluger et al., SEC v. Dean Goetz and SEC v. Sudfeld).

[1] W. Gorta, "Ex-Hunton Atty Avoids Jail for Wine-Fueled Insider Trading," Law360 (Sept. 26, 2017) (quoting government lawyer as saying "insider trading by lawyers [is] a 'profound problem'").

[2] 15 U.S.C. § 78t; see, e.g., Breeden Says Law Firms Lack Safeguards, 22 Sec. Reg. & L. Rep. (BNA) No. 38 at 1373, 1375 (Sept. 28, 1990) ("There is evidence that individual law firms are not taking the problem seriously"); Philip R. Lochner, Jr., Lawyers and Insider Trading, Speech before the Securities Law Committee of the Federal Bar Association, National Press Club, Washington, D.C. (Jan. 24, 1991) ("Law firms can be found liable for insider trading by partners or employees under the common law principle of respondeat superior, or pursuant to Section 20(a) of the [Securities Exchange Act of 1934], which imposes liability on controlling persons"); Peter M. O. Wong, Insider Trading Regulation of Law Firms: Expanding ITSFEA's Policy and Procedures Requirement, 44 Hastings L. J. 1159 (1993) citing Requirements of Insider Trading Act Go Beyond Securities Firms, Lynch Says, 21 Sec. Reg. & L. Rep. (BNA) No. 2, at 65 (Jan. 13, 1989) ("there could be a case where the mere fact that a firm failed to establish any policies and procedures whatsoever would be deemed to be reckless conduct").

[3] D. Hawke & L. D'Allaird, The SEC's "Trader-Based Approach to Insider Trading Enforcement," Law360 (Sept. 7, 2016); see also T. Ehret, SEC's advanced data analytics helps detect even the smallest illicit market activity, Reuters (June 30, 2017).

[4] SEC Press Release, "Software Executive and Three Friends Charged with Insider Trading," Rel. No. 2016-121, June 16, 2016.

[5] SEC v. Gene Daniel Levoff, Lit. Rel. No. 24399 (Feb. 13, 2019).

[6] Levoff Complaint at ¶ 2.

[7] SEC v. Paul Bannon Powers, Lit. Rel. No. 24448 (April 10, 2019).

[8] SEC v. Fettner, Lit. Rel. No. 24468 (May 14, 2019).

[9] Fettner Complaint at ¶ 16.

[10] SEC v. Vladimir Eydelman and Steven Metro, Lit. Rel. No. 22948 (March 20, 2014).

[11] SEC v. Jeffrey J. Temple and Benedict M. Pastro, Lit. Rel. No. 21765 (Dec. 10, 2010).

[12] SEC v. Matthew H. Kluger and Garrett D. Bauer, Lit. Rel. No. 21917 (April 6, 2011).

[13] SEC v. Fei Yan, Lit. Rel. No. 24225 (Aug. 3, 2018).

[14] SEC v. Dean A. Goetz, Lit Rel. No. 21990 (June 6, 2011).

[15] See, e.g., U.S. v. O'Hagan, 521 U.S. 642 (1997) (finding that law firm partner breached fiduciary duty owed to law firm by misappropriating material nonpublic information).

[16] SEC v. Herbert K. Sudfeld Jr. et al., Lit. Rel. No. 23305 (July 16, 2015).

[17] SEC v. David A. Schwinger, Lit. Rel. No. 20152 (June 13, 2007).

[18] See e.g., SEC v. Goetz, Complaint at ¶ 15 ("Significantly, unlike other deal-related documents circulated among members of the Abbott-EYE deal team, the draft schedules that Daughter worked on at her parents' home did not substitute a code name for EYE to preserve confidentiality and identified the company by name").