August 1, 2021

Day Pitney White Collar Roundup - August 2021 Edition

Insider Trading Goes Inside Out With New SEC Shadow Trading Claim

Think you understand insider trading? Perhaps you will want to reassess after you consider this fact pattern.

> *Matthew works for biopharmaceutical Company A. Matthew's employer informs him that Company A will be acquired by mega pharmaceutical Company B at a significant premium. Before the transaction is announced publicly, Matthew buys call options in Company C, a competitor of Company A. Matthew has no inside information of and owes no duties to Company C. Is that insider trading?*

Yes, according to the Securities and Exchange Commission (SEC), which in mid-August filed an enforcement action against Matthew Panuwat, nearly five years to the day after his purchase of call options in Incyte Corporation, a competitor of his employer, Medivation Inc., a midsized biopharmaceutical company. According to the SEC complaint, the defendant breached his "duty to refrain from using Medivation's proprietary information for his own personal gain."

The activity alleged here is called "shadow trading," and the idea that it might constitute insider trading has been the subject of research and debate for some time. But that approach is untested, and this is believed to be the SEC's first pursuit of a shadow insider trading case in court.

That the defendant's securities trade had no impact on his employer, the acquiring company, or their stock price or investors was of no moment to the SEC in bringing the action. The defendant is alleged to have deceived his employer, which entrusted him with access to insider information, and to have used that insider information to his benefit in making a securities transaction.

The SEC's complaint alleges several factors in support of a *misappropriation theory* of insider trading against Panuwat. These include that Medivation's investment banker made a presentation (which Panuwat saw) that specifically discussed parallels with its close competitor, Incyte; Panuwat had signed a confidentiality agreement, which included the company's insider trading policy, prohibiting him from using material nonpublic information to trade in securities of his employer "or the securities of another publicly traded company, including all … competitors of" his employer; Panuwat was an experienced securities trader, and he bought the call options expecting that news of the transaction would not only boost his employer's stock price but also boost its close competitor's stock price (which indeed increased by approximately 8 percent after news of the acquisition became public).

The case will be closely watched for any notable court rulings on this new approach to insider trading. In the meantime, it also should cause employers to consider whether their insider trading policies address shadow trading—and whether they should.

The Doctor Will (Not) See You Now: DOJ Clamps Down on Telemedicine Fraud

In August, the Department of Justice (DOJ) announced that a New Jersey grand jury had issued a superseding indictment accusing the owner of several telemedicine companies of submitting more than $784 million in fraudulent claims to Medicare. The case was billed as one of the largest Medicare fraud schemes ever charged by the federal government.

The owner, Creaghan Harry, along with two co-conspirators, was previously charged with paying and receiving kickbacks, conspiring to defraud the United States, and conspiring to commit money laundering. Following guilty pleas from the co-conspirators, the grand jury issued a superseding indictment charging Harry with conspiracy to commit healthcare fraud, wire fraud and income tax evasion.

As alleged in the superseding indictment, Harry operated several telemedicine companies that solicited kickbacks and bribes from durable medical equipment (DME) suppliers and marketers in exchange for orders for DME braces and medications. The kickbacks and bribes were paid to shell companies opened in the names of straw owners and were later used to pay physicians to write medically unnecessary orders for the braces and medications. In all, Medicare is alleged to have paid more than $247 million in fraudulent claims to Harry's companies. Harry is also alleged to have used the proceeds of this scheme to live a lavish lifestyle without paying taxes on the income.

Harry's initial prosecution was part of a wave of DOJ charges in 2019 against telemedicine and DME marketing executives who allegedly participated in healthcare fraud schemes involving more than $1.2 billion in losses. But concerns over the potential for further fraud persist, particularly given the increased reliance on telemedicine during the pandemic. The Office of Inspector General of Health and Human Services, for example, announced earlier this year that it is conducting "significant oversight work" assessing the use of telemedicine. In other words, expect this to be a continued area of focus for regulators.

Former Netflix Engineers May Soon See If Orange Really Is the New Black

In a case that could serve as inspiration for a new series, the SEC has filed charges against three former Netflix software engineers and their associates asserting insider trading based on proprietary Netflix information. According to the SEC's release, former Netflix engineer Sung Mo "Jay" Jun allegedly shared nonpublic information on the growth in Netflix's subscriber base in advance of the streaming service publicly reporting that key information in its quarterly earnings announcements. His brother, Joon Mo Jun, and his friend Junwoo Chon allegedly used the tipped information to trade before Netflix's quarterly announcements. After Sung Mo Jun stopped working for Netflix, the SEC asserts that he nonetheless continued tipping his brother and friend with subscriber base growth information passed to him by two other Netflix employees, and also traded with this information.

The SEC alleges the cast of characters used several methods to avoid discovery, including communicating through encrypted messaging apps and paying kickbacks through cash payments. Ultimately, however, the scheme proved to be a House of Cards. In the end, it was the defendants' statistically improbable success in trading that did them in. The Market Abuse Unit's Analysis and Detection Center employed data analysis tools to uncover the alleged scheme and to build a case against the participants.

Among the Stranger Things described by the SEC in its announcement of the charges was that Sung Mo Jun, his brother and friend together managed to collect approximately $3 million in profits from their trades before the plot was interrupted. Since then, each defendant has consented to entries of judgment enjoining them from violating the charged provisions of the Securities Exchange Act of 1934 and Rule 10b-5 and imposing civil penalties. Significantly, several are also the subjects of a concurrently filed criminal information. As a result, the group's apparent attempt to pull off their own Money Heist using inside information has come to an end.

DOJ's Foreign Lobbying Focus Is FAR(A) From Over

The DOJ recently signaled its continued determination to closely scrutinize foreign business dealings and to prosecute unregistered foreign lobbying activity. In late July, the DOJ announced the unsealing of an indictment charging three individuals—including Thomas J. Barrack, a senior campaign adviser to former President Donald Trump—with acting as unregistered foreign agents of the United Arab Emirates. The indictment described a broad range of activities through which the defendants sought to advance the interests of the UAE, including the insertion of language praising the UAE in speeches to be given by then-candidate Trump and the solicitation by Barrack of a policy "wish list" from UAE officials to be shared with the incoming administration. Such allegations would, if proven, constitute violations of the Foreign Agents Registration Act (FARA), which requires individuals to register with the DOJ prior to serving as agents of a foreign government within the United States.

The Barrack indictment demonstrates an important aspect of FARA enforcement practices: the government's reinvigorated efforts to identify instances in which individuals have subjected themselves to the "direction or control" of a foreign principal. After decades of benign neglect of the FARA statute, the Justice Department's enthusiasm for FARA enforcement soared in recent years, with marquee cases brought against prominent government officials and senior campaign staff. For example, former National Security Adviser Michael Flynn pled guilty to serving as an unregistered agent of the Turkish government, and Paul Manafort, former presidential campaign manager, pled guilty to FARA violations regarding unregistered work on behalf of the Ukrainian government. While Barrack, a longtime business associate of Trump, may have had no official role in the administration, that distinction was of no moment to the DOJ, which alleged that he had considered the UAE his "home team" for purposes of his advocacy.

The government's recent enforcement activity demonstrates that the ambit of FARA extends far beyond government officials. In the past two years, the DOJ has prosecuted private citizens who, like Barrack, operated in quasi-public and quasi-political spaces to advocate for foreign governments (including the governments of China, Ukraine, Russia and Malaysia) in ways that exceed the boundaries of legitimate foreign business dealings. The key factors guiding U.S. enforcement discretion appear to include the level of direction or control exercised by foreign principals over their agents, as compared to the agents' public representations about the nature of their activities. As one DOJ official recently remarked, "[a]s a matter of enforcement priorities, the wider the gap between appearances and reality, the more important FARA registration is." The recent surge in FARA registrations reflects a heightened awareness of the government's efforts to narrow or close this gap.

SEC's Initiative Ensnares Another Company for Earnings Management

In late August, the SEC announced its third settled action arising from the Division of Enforcement's recent Earnings Per Share (EPS) Initiative, which uses data analytics to uncover accounting, disclosure and internal control violations by public companies. The EPS Initiative—which is in line with the division's broader shift to data-driven processes to identify potential misconduct—seeks to curb misleading financial reporting by public companies that conceal weaker-than-expected performance in order to buoy investor confidence. To date, SEC enforcement actions stemming from the EPS Initiative have resulted in more than $12 million in civil penalties for public companies and their executives.

In the latest action, Pennsylvania-based Healthcare Services Group, Inc., agreed to pay $6 million to settle charges that it reported inflated EPS in violation of the financial reporting, books and records, and internal control provisions of the Securities Exchange Act of 1934. Tipped off by data analytics, the division uncovered that Healthcare Services Group failed to timely accrue for and disclose material loss contingencies related to the settlement of private litigation against the company in accordance with U.S. generally accepted accounting principles (GAAP). In failing to record the loss contingencies as required by GAAP, Healthcare Services Group instead reported record-high (but inflated) EPS that met analyst consensus estimates.

The new settlement marks a little less than one year since the division announced its first two settled actions in the EPS Initiative, in September 2020. Together, the settlements are a reminder to issuers to ensure the integrity of their internal reporting processes and to resist the temptation to manage earnings or otherwise distort financial statements. In particular, issuers should be prepared for heightened regulatory scrutiny of a sustained pattern of meeting or exceeding consensus EPS estimates followed by a sudden drop in EPS. As the three EPS-related enforcement actions demonstrate, even small manual adjustments to financial statement items now have the potential to trigger the SEC's EPS data analytics. That is to say, for issuers managing EPS to meet consensus estimates, Big Brother may be watching.

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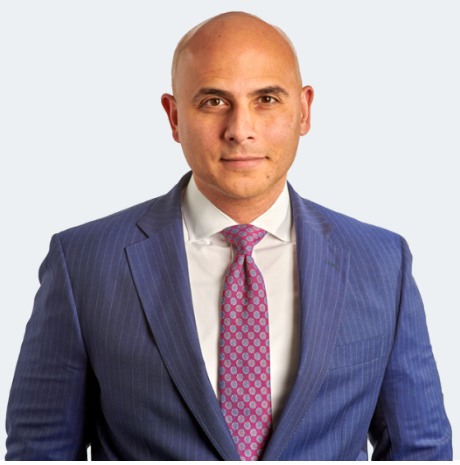

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