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The return to business as usual for insider trading litigation

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A federal appeals court, in *U.S. Securities and Exchange Commission v. Christopher Clark*, recently reversed a lower court's decision and remanded the case for a jury trial on civil insider trading claims based on suspicious trading and circumstantial evidence, with no direct proof of wrongdoing by the defendant.

With this new ruling, the Securities and Exchange Commission's broad, evidentiary arsenal remains intact and at its disposal.

The facts

The factual background is straightforward.

The Securities and Exchange Commission (the "SEC") alleged that Christopher Clark ("Clark") traded on material nonpublic information relating to Corporate Executive Board, Inc. ("CEB"), claiming that Clark received inside, advance information about a potential merger from his brother-in-law and CEB's corporate controller, William Wright ("Wright").

The lower court's decision seemed to suggest that direct evidence of wrongdoing and not just red flags may be required to sustain the allegations against insider trading defendants.

The SEC zeroed in on this trading with the use of electronic surveillance software, and later asserted that Clark and Wright communicated a number of times in the month before the confidential merger, and that to finance the trades, Clark emptied his wife's retirement account, borrowed money from a credit union and took a loan against his car. Clark then bought highly speculative, out-of-the-money call options after allegedly learning about the expected acquisition of CEB.

The legal standard

Section 10(b) of the Securities Exchange Act of 1934 and the SEC's corresponding Rule 10b-5 prohibit individuals under a duty of trust and confidence from utilizing material corporate information, not disclosed to the public, for personal advantage. A tippee's liability for insider trading hinges on whether the tipper breached a fiduciary obligation by disclosing the information.

The SEC, to impose civil liability, must establish by a preponderance of the evidence that the tippee knew the information was revealed in breach of the tipper's duty and traded anyway. Conjecture that the defendant committed insider trading is insufficient as a matter of law.

The courts' decisions

At the lower court, a federal judge dismissed this lawsuit on the grounds that the SEC presented only speculative evidence that Wright had nonpublic information before his apparent flurry of risky but successful stock trading, and that there was inadequate evidence giving rise to an inference that Clark committed insider trading.

Contrary to the common wisdom, the lower court's decision seemed to suggest that direct evidence of wrongdoing and not just red flags may be required to sustain the allegations against insider trading defendants such as Clark.

Declining to impose this evidentiary hurdle, the U.S. Court of Appeals for the Fourth Circuit reversed the lower court's decision. The appeals court held that the evidence had to be viewed in the light most favorable to the SEC as the non-moving party. The SEC had provided evidence that on November 3, 2016, Wright discussed with CEB's chief accounting officer, a close friend of Wright, what effect a merger would have on CEB's publicly-traded stock, which Clark then held.

In addition, in early December 2016, Wright began emailing employment recruiters and stated he had been working on the merger, although these emails were later characterized as mere "puffery." The appeals court concluded that a jury could reasonably have concluded that Wright had inside information about the merger before Clark started purchasing call options on the day the board approved the merger on December 9, 2016.

There was also evidence from which a reasonable jury could have determined that Wright passed inside information about the merger to Clark before December 9, 2016 — the day that Clark began trading and that CEB's board accepted the merger offer.

Clark, until those transactions, had only once before traded in CEB call options, nearly a decade earlier, but in prior years he always had bought put options, betting on the company's value to go down.

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The court of appeals noted that Clark took extraordinary measures to finance the purchase of these call options and bought them ten times in less than a month; Clark advised his son to make similar purchases and later lied to the Federal Bureau of Investigation about whether he had done so; and the trades proved remarkably lucrative, netting Clark hundreds of thousands of dollars.

Consistent with well-settled precedent, the court of appeals held that because a defendant rarely makes a confession or leaves behind direct evidence of wrongdoing, the SEC may present circumstantial evidence to satisfy its burden of proof in a civil insider trading case. Circumstantial evidence is not only sufficient, but also may be more certain and persuasive than direct proof in many instances.

Since the federal rules ordinarily require that juries, not judges, adjudicate cases, and without deciding whether Clark actually violated insider trading laws, the appellate court ruled that, viewing the evidence most favorably to the SEC, a reasonable jury could infer that Clark engaged in impermissible insider trading.

The appeals court reversed the lower court's decision granting summary judgment to Clark, and remanded the matter for further proceedings.

Key takeaways

There are two primary takeaways from the *Clark* decision.

First, this case highlights the role played by the SEC's Market Abuse Unit, which utilizes technology to review billions of trading records and seeks to identify suspicious trading, patterns and connections. The Market Abuse Unit, which has expanded the net of insider trading inquiries, originally identified Clark's trades and kicked off this investigation.

Second, the *Clark* decision makes clear that, as before, the SEC need not rely on direct evidence to show insider trading but may continue to rely on circumstantial proof, suspicious trading and red flags, especially in civil enforcement proceedings.

This ruling is another feather in the cap for the SEC, making it that much easier for regulators to root out what they believe to be insider trading.

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