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SEC insider trading trial loss unlikely to change agency approach

By Mark D. Lytle, Colin T. Missett

In a rare move, a federal judge in the Eastern District of Virginia granted a mid-trial motion to dismiss for a SEC insider trading case, finding the SEC had not met its burden by a preponderance of the evidence.

What's the Impact?

- The agency is very likely to appeal what it may view as simply an outlier decision; if the SEC prevails, the ultimate legal impact of this decision may be minimal
- Despite the outcome, SEC's Market Abuse Unit will continue to originate insider trading investigations solely on the basis of suspicious trading patterns identified through SEC's own data analytical tools
- The risks and potential consequences of insider trading enforcement actions remain as significant as ever, and businesses must maintain robust insider trading compliance programs

On December 13, 2021, U.S. District Judge Claude M. Hilton of the U.S. District Court for the Eastern District of Virginia issued a mid-trial dismissal of the U.S. Securities and Exchange

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Commission's (SEC's) insider trading case against a mortgage broker.[1] The defendant mortgage broker, Christopher Clark, was alleged to have been tipped information by his brother-in-law about a potential merger involving the brother-in-law's employer. In the pre-trial briefing, SEC argued that on the basis of this tipped information, Clark and his son made "highly suspicious" trades, including "nearly $40,000 of well out-of-the-money, short-term call options."[2] The SEC further alleged that for "most of these options, including all of the most out-of-the-money options they purchased, they were the only investors in the entire world willing to buy such risky options," and the riskiness of their trading only became more aggressive as the merger approached.

But Judge Hilton looked past the risk of the trading, instead focusing on the lack of evidence of transmission of insider information, finding "there's just simply no circumstantial evidence here that gives rise to an inference that he received the insider information, as has been alleged here," and further noting "[w]e talk about highly suspicious trading; that's not the evidence."[3] Judge Hilton also discounted the relevance of Clark's improbable success rate weighed in connection with the lengths he went to find financing for his trades, including opening lines of credit and mortgaging his car, opining that "this wasn't a man who was desperate for money" and that at all times "during this entire situation and before, his assets far exceeded his liabilities."

Despite these findings—delivered via a mid-trial oral ruling—the SEC may still feel confident in its chances to prevail on appeal. As the SEC argued pre-trial, courts "have repeatedly ruled that evidence of suspicious trading that coincides with communications between the alleged tippee and tipper should go to the jury, often on facts much weaker than those here." And, although the SEC did not have the communications Clark exchanged with his brother-in-law—because the SEC alleged he "conveniently" lost "his phone just days before he was supposed to surrender it"—the SEC presented evidence that for eight of Clark's eleven earning trades for which the SEC has communications records, he spoke with his brother-in-law in advance of trading. In addition to losing his phone, the SEC also alleged that "Clark lied to the FBI about the reasons for his trading, his communications with his son about trading in CEB, and his relationship with Wright."

Moreover, even if the SEC does not prevail on appeal (or decides not to appeal), the agency will likely view this result as a minor blip on an otherwise extremely strong track record of bringing cases the agency originates using its own data analytical tools to identify suspicious trading patterns. The SEC's Market Abuse Unit, created in 2010 to focus on identifying "large-scale and organized insider trading and market manipulation schemes," utilizes "some unique technology to aid in the investigations."[4] The "Analysis and Detection Center" within the Market Abuse Unit

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[1] Complaint, ECF No. 1, at ¶¶ 1–2, *SEC v. Clark*, No. 20-cv-1529 (E.D. Va. Dec. 11, 2020).

[2] SEC's Memorandum of Law in Opposition to Clark's Motion for Summary Judgment, ECF No. 110, at 20, *SEC v. Clark*, No. 20-cv-1529 (E.D. Va. Nov. 5, 2021).

[3] "SEC Handed Rare Mid-trial Defeat In Insider Trading Case," Law360 (December 14, 2021).

[4] Robert S. Khuzami, Director of Division of Enforcement, U.S. SEC, "Remarks at News Conference Announcing

"uses data analysis tools to detect suspicious trading patterns, such as improbably successful trading across different securities over time."[5] The SEC uses these tools to identify cases on its own without the need for traditional tips, complaints, and referrals from outside sources. Given the success the SEC has had in settling and prevailing in litigation in these cases, the agency is unlikely to change course based on one trial result, especially given its apparent belief in the strength of the evidence in this case.

This trial result should not change anything about how financial firms, companies, and individual investors approach insider trading compliance. In light of the SEC's high success rate in these cases and the collateral consequences they bring to their subjects in the form of unwanted media attention, significant reputational consequences, and litigation costs, the risks of insider trading are as high as ever. It is, therefore, incumbent on financial firms that trade or companies that maintain material non-public information to have a robust insider trading policy and compliance program.

For more information on the content of this alert, please contact your Nixon Peabody attorney or:

Mark D. Lytle
202.585.8435
mlytle@nixonpeabody.com

Colin T. Missett
617.345.1029
cmissett@nixonpeabody.com

Enforcement Cooperation Initiative and New Senior Leaders" (Jan. 13, 2010).

[5] Division of Enforcement 2020 Annual Report, U.S. SEC.