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CLIENT MEMORANDUM

U.S. Attorney's Office and SEC Charge Portfolio Manager with Insider Trading; Stretch the Limits of *Newman's* Personal Benefit Standard

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AUTHORS

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On June 15, 2016, the United States Attorney's Office for the Southern District of New York and the Securities and Exchange Commission ("SEC") charged Sanjay Valvani, a portfolio manager with Visium Asset Management, L.P, with insider trading based on material nonpublic information he received from a "political intelligence" consultant he hired to obtain information from the United States Food and Drug Administration ("FDA") about the agency's approval of pending generic drug applications.[1] The charges are unusual in that they do not contend that an "insider" breached a duty in exchange for a personal benefit. Rather than beginning with the insider's conduct, here the charges focus on an alleged breach by the consultant and charge him with tipping Mr. Valvani in breach of the consultant's duty to the FDA "insider" in exchange for being paid a consulting fee by Mr. Valvani. These unique charges lay out a path the Government may seek to follow to aggressively pursue insider trading cases after the Second Circuit's decision in *U.S. v. Newman*.

[1] *See U.S. v. Valvani,* 16-cr-412-SHS (S.D.N.Y. June 15, 2016); *S.E.C. v. Valvani et al.*, 16-cv-4512-KPF (S.D.N.Y. June 15, 2016). The Government also charged the consultant who obtained the nonpublic information, Gordon Johnston, and a subsequent tippee, Christopher Plaford. Mr. Johnston and Mr. Plaford both pled guilty. *See U.S. v. Johnston*, 16-cr-406-ALC (S.D.N.Y. June 13, 2016); *S.E.C. v. Valvani et al.*, 16-cv-4512-KPF (S.D.N.Y. June 15, 2016); *U.S. v. Plaford*, 16-cr-400-RA (S.D.N.Y. June 9, 2016); *S.E.C. v. Plaford*, 16-cv-4511-KPF (S.D.N.Y. June 15, 2016). On June 20, 2016, Mr. Valvani was found dead in an apparent suicide and many of the legal issues at issue in this case will remain unresolved.

The Alleged Insider Trading Scheme

The Government alleged that Mr. Valvani traded on material nonpublic information about the FDA's approval of a generic version of an anticoagulant drug, enoxaparin (Lovenox). Mr. Valvani received the information from Gordon Johnston, a "political intelligence" consultant and former Deputy Director of the FDA's Office of Generic Drugs ("OGD"). Visium Asset Management entered an exclusive consulting agreement with Mr. Johnston and paid him a monthly consulting fee, which totaled hundreds of thousands of dollars over the course of an approximately six-year long consulting relationship.

Mr. Johnston, in turn, solicited confidential and material nonpublic information from a senior official in the OGD (the "FDA Official"). The FDA Official was "friends" with Mr. Johnston and, according to the Indictment, they "had a history, pattern, and practice of sharing confidences with each other relating to, among other things, their careers, families, relationships, and plans for the future." (Indictment ¶ 13.) They worked together at the OGD for over twelve years and Mr. Johnston was the FDA Official's supervisor and "mentor." (*Id.*) Mr. Johnston and the FDA Official maintained a "professional and personal" relationship and were in "frequent" communication. (*Id.*) While the Government alleges that the FDA Official "was subject to the FDA's confidentiality policies and owed the FDA a duty of confidentiality" (Indictment ¶ 12), it does not allege that he breached that duty by speaking with Mr. Johnston. Nor does the Government allege that he provided confidential information in exchange for a personal benefit, to further his friendship with Mr. Johnston, or to give Mr. Johnston a benefit.

Indeed, the Government does not allege that the FDA Official intended to provide confidential information to Mr. Johnston at all. In a parallel civil complaint, the SEC alleged that Mr. Johnston actively deceived the FDA Official when he sought nonpublic information so that the FDA Official would not get suspicious or notice any "red flags." (Compl. ¶¶ 11-14.) Specifically, Mr. Johnston used "indirect" and "triangulating" questions, did not tell the FDA Official that he worked as a consultant, and hid his questions among friendly "banter" and gossip. (*Id.* ¶¶ 13, 52-53, 55.)

In late 2009 and early 2010, Mr. Johnston learned from the FDA Official that the FDA's internal document tracking the progress of generic drug approvals indicated that an enoxaparin generic was "moving" toward approval. (Indictment ¶ 29.) Mr. Johnston understood that this meant an approval was highly likely and would occur within months. (*Id.*) He passed this information to Mr. Valvani, who urged him to provide further updates on the FDA's deliberations. (*Id.*) While Mr. Valvani allegedly "tasked" Mr. Johnston with continuing to contact the FDA to obtain confidential information from the FDA, the Government does not allege that Mr. Valvani knew of any breach by the FDA Official or what the FDA Official's motivation was to disclose the information to Mr. Johnston. (*Id.* ¶¶ 26, 29.) The SEC instead alleged that Mr. Valvani knew that "Johnston would procure information from his former OGD colleagues by asking such indirect and triangulating questions," (Compl. ¶ 62) and "concealed his role as a paid consultant to [an investment adviser]." (*Id.* ¶ 61.)

After receiving the tip from Mr. Johnston, Mr. Valvani increased his fund's long position in Momenta (one of the developers of a generic enoxaparin) and took a short position in Sanofi (the brand manufacturer) and made approximately $25 million in profits when the FDA announced approval of Momenta's generic application in July 2010. (Indictment ¶¶ 30-36.)

The Government Does Not Allege That The FDA Official Received A Personal Benefit

A tippee's liability for insider trading is derivative of the tipper's liability. *See U.S. v. Newman*, 773 F.3d 438, 446 (2d Cir. 2014). The original source of the confidential information, or "tipper," breaches his fiduciary duty in violation of the federal securities laws when "the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, *there is no derivative breach.*" *Dirks v. SEC*, 463 U.S. 646, 662 (1983) (emphasis added). As the Second Circuit reaffirmed in *Newman*, "the exchange of confidential information for personal benefit is not separate from an insider's fiduciary breach; it *is* the fiduciary breach that triggers liability for securities fraud under Rule 10b-5." *Newman*, 773 F.3d at 447-48 (emphasis in original). Because a tippee's liability is derivative, "a tippee may not be liable in the absence of such benefit." *Newman*, 773 F.3d at 446. "[A] tippee may be found liable 'only when the insider has breached his fiduciary duty . . . *and* the tippee knows or should know that there has been a breach." *Id.* (quoting *Dirks*, 463 U.S. at 660) (emphasis in original).

In *U.S. v. Newman*, the Second Circuit heightened the standard for what constitutes a personal benefit, and held that mere friendship, without a *quid pro quo*, is insufficient to establish a personal benefit. *Newman*, 773 F.3d at 452. In *Newman*, the Second Circuit held that there was insufficient evidence that the tippers received a personal benefit in exchange for their tips. *Id*. The Government had argued that one tipper received a personal benefit because he was a "friend" of the tippee and they had attended business school together, worked together, and the tippee provided "career advice" to the tipper. *Id.* The tippee testified that he would have provided career advice even without receiving inside information and the Court noted that "[the tipper] himself disavowed that any such *quid pro quo* existed." *Id.* at 453. The Second Circuit declared, "[i]f this was a 'benefit,' practically anything would qualify." *Id.* at 452.

Mr. Johnston's relationship with the FDA Official is comparable to the tipper-tippee relationship at issue in *Newman*. Mr. Johnston and the FDA Official were "friends" who previously worked together, maintained a "professional and personal" relationship, were in "frequent" communication, and discussed their careers, families, and plans for the future. (Indictment ¶ 13.) Mr. Johnston is not alleged to have provided the FDA Official with a benefit in exchange for information about the FDA's approval of a generic enoxaparin, nor is the FDA Official alleged to have breached a duty of trust or confidence.

To overcome this obstacle to the imposition of insider trading liability, the U.S. Attorney's Office and the SEC treat Mr. Johnston as the initial tipper and focus on his breach of the FDA Official's expectation of confidentiality and the fact that "[i]t was implicit in their relationship that Johnston would not pass this information to an investor" (Compl. ¶ 54), and on Mr. Valvani's payments to Mr. Johnston in exchange for the nonpublic information.

Conclusion

The Government charges against Mr. Valvani indicate that it intends to continue to vigorously pursue insider trading charges even where there is a limited or even nonexistent personal benefit to the inside source. The Government's strategy in *Valvani* appears to be to treat the recipient of confidential information as the tipper and focus on his personal benefit and breach of trust and confidence rather than on the benefit to and breach of duty by the original source. This would chip away at *Newman*'s requirement that the Government prove a personal benefit to the inside source and expand the Government's reach to prosecute insider trading where the Government can argue that there was an understanding of confidentiality between the inside source and tippee, whom the Government would then treat as the "insider." Whether this theory is upheld by the courts is something to be watched closely. In the meanwhile, recipients of information should exercise great care before trading, even when there is no apparent breach of duty for a personal benefit by an inside source.

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