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Non-Disclosure Agreements and Insider Trading: The Second Circuit Clarifies the Scope of Criminal Liability

In this edition of their White-Collar Crime column, Elkan Abramowitz and Jonathan S. Sack discuss a recent insider trading decision in the Second Circuit, 'United States v. Chow', that illustrates the judicial shaping of insider trading law.

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Since at least the early 19th century, federal courts have declined to hear charges brought as common law crimes. In *United States v. Hudson and Goodwin*, 11 U.S. 32 (1812), the U.S. Supreme Court made clear that, in order to be prosecuted in federal court, a defendant must be charged with a crime defined by Congress and enacted into federal law.

The crime of insider trading, though derived from §10(b) of the Securities Exchange Act of 1934, has struck observers over the years as being more akin to a common law crime, with key elements being shaped chiefly by federal judges. Cases that deal with cutting-edge issues in insider trading law typically turn on construing prior court decisions and policy arguments rather than a parsing of Congress's terse wording. This jurisprudence contrasts with recent Supreme Court decisions such as *Yates v. United States*, 574 U.S. 528 (2015), which have centered on a close reading of statutory text.

A recent insider trading decision in the Second Circuit illustrates the judicial shaping of insider trading law. In *United States v. Chow*, 993 F.3d 125 (2d Cir. 2021), the Second Circuit affirmed the conviction of an individual who was charged with unlawfully passing confidential information to an associate, who traded on the information. The defendant learned the information while conducting due diligence on a potential corporate transaction. By tipping a friend, the defendant violated a standard non-disclosure agreement (NDA).

In this article, after briefly considering basic contours of federal insider trading law, we discuss the holding in *Chow*, including its reliance on another recent Second Circuit decision, *United States v. Kosinski*, 976 F.3d 135 (2d Cir. 2020). In *Kosinski* and then in *Chow*, the Second Circuit explained its reasons for treating a breach of a contractual non-disclosure obligation as equivalent to a breach of fiduciary duty for purposes of insider trading liability. We then briefly consider how these recent decisions may reflect a tension with mail and wire fraud case law, which resists treating a contract breach as a basis for criminal liability.

Insider Trading

Insider trading charges have traditionally been brought pursuant to §10(b) of the Securities Exchange Act of 1934. Section 10(b) provides that "it shall be unlawful for any person … in connection with the sale of any security … [to use] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." 15 U.S.C. §78j(b). SEC Rule 10b-5, adopted in 1942, defines "manipulative or deceptive device" as including engaging in any act "which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. §240.10b-5. The statute and regulation make no reference to insider trading or trading on material non-public information (MNPI).

In *Chiarella v. United States*, 445 U.S. 222 (1980), the Supreme Court rejected a "level playing field" theory of liability under which anyone who traded on the basis of MNPI would be liable for insider trading. Instead, the court held that such trading, to be unlawful, required a breach of a duty of trust and confidence. In the most common situation, which has come to be known as the "classical" theory of insider trading, a corporate insider (for example, an officer or director) buys or sells company stock based on MNPI. Such trading violates the insider's duties because "a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation." Id. at 228. Under these circumstances, the corporate insider would improperly take advantage of uninformed stockholders. Id. at 228-29.

In *United States v. O'Hagan*, 521 U.S. 642 (1997), the Supreme Court addressed trading based on MNPI that did not fit the mold of classical theory. That case concerned an attorney at a law firm that represented a company planning to launch a tender offer for the shares of another company. The attorney traded stock in the target company based on MNPI he learned while working at the law firm. Id. at 647-48. The court held that insider trading liability properly rested on a "misappropriation" theory. Under that theory, an individual violates §10(b) when he or she trades on the basis of MNPI that the individual had a duty to use only for the benefit of the source of the information. In *O'Hagan*, while the defendant was not an insider of the company whose stock he traded, he nonetheless violated a duty of trust and confidence—in this case, a duty to his law firm and the law firm's client. The misappropriation theory "premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information." Id. at 652.

'United States v. Chow'

In *United States v. Chow*, the defendant, Benjamin Chow, was a managing director of an investment firm that was seeking to acquire a publicly-traded semiconductor company (the company). Chow led negotiations with the company's CEO and signed an NDA in which Chow agreed not to disclose proprietary information, including the existence of the negotiations. After the company rejected three offers from the investment firm, Chow told the company that he was leaving the investment firm to start his own fund. The company then entered another NDA with Chow, with identical terms to the first NDA, and Chow's fund was granted a period of exclusivity during which the company would not consider other acquisition offers. After multiple offers, the company announced that it was being acquired by Chow's fund, and the company's stock price rose 18%. *Chow*, 993 F.3d at 129-31.

Shortly after the announcement, however, the U.S. government blocked the proposed acquisition based on concerns about technology transfer to Chow's fund, which was controlled by the Chinese government. Separately, FINRA observed unusual trading in the company's stock and discovered that Chow had communicated frequently with Michael Yin, who controlled five brokerage accounts that bought stock in the Company before announcement of the intended acquisition. The trading records showed that, during Chow's negotiation to acquire the Company, Yin purchased about four million shares before announcement of the proposed acquisition, which he sold a short time later—for a profit of almost $5 million. Id. at 131-33.

In May 2017, a grand jury returned an indictment that charged Chow with insider trading on a misappropriation theory. According to the indictment, Chow breached a duty of confidentiality owed to the company under NDAs by passing MNPI to Yin, who then bought stock in advance of the acquisition announcement. Following a trial in the Southern District of New York, a jury convicted Chow of six counts of insider trading, and Chow was sentenced to three months' imprisonment. Id. at 128.

On appeal, Chow argued that because he had entered into an NDA with the company as an arm's-length counterparty, who did not owe a fiduciary-like duty to the company, his breach of the NDA was not a proper basis for insider trading liability. In that view, his violation of the NDA was, at worst, a breach of contract, not a breach of duty that could properly support criminal liability.

Contractual Duty of Confidentiality

The Second Circuit disagreed and held that by signing the NDAs, Chow had assumed a duty of trust sufficient to give rise to criminal liability. The court relied to a large extent on its recent decision in *United States v. Kosinski*, 976 F.3d 135 (2d Cir. 2020). In that case, the defendant, a medical expert, had entered into a contract to serve as an investigator in a pharmaceutical company's clinical trial of a new drug. Despite signing multiple NDAs with the pharmaceutical company, the defendant bought and sold shares in the company based on information he learned from the clinical trials. Id. at 139.

In *Kosinski*, the defendant argued that his contractual obligation of confidentiality was not equivalent to the kind of duty of trust and confidence necessary to give rise to insider trading liability. The Second Circuit rejected that view, holding that the defendant's "explicit acceptance of a duty of confidentiality" through the NDAs made him essentially a "temporary insider" of the company and established a fiduciary duty, which Kosinski violated by trading on MNPI. Id. at 145-46.

The panel in *Chow* at oral argument recognized a difference between the operative facts in *Chow* and *Kosinski*: Chow entered into an NDA with the company as an arm's-length counterparty, whereas Kosinski was a medical advisor to the pharmaceutical company, entrusted with sensitive health-related information, and not simply a counterparty to an NDA. Ultimately, however, that distinction was not regarded as dispositive. In *Chow,* the Second Circuit held that breach of an obligation grounded in contract, even one entered into strictly at arm's length, is a proper basis for insider trading liability under the misappropriation theory. *Chow*, 993 F.3d at 138-39.

In *Chow* and *Kosinski*, the Second Circuit found support for this conclusion in *Dirks v. S.E.C.*, 463 U.S. 646 (1983)—particularly in footnote 14, which addressed temporary company insiders. In the course of explaining the basis for "tipper" and "tippee" liability, the court noted that *Chiarella*'s "requirement of a specific relationship between the shareholders and the individual trading on inside information has created analytical difficulties for the SEC and courts … ." *Dirks*, 463 U.S. at 655. The court then wrote in a footnote that certain outsiders of a company, such as accountants or lawyers, who legitimately receive confidential information, "may become fiduciaries of the shareholders" by "enter[ing] into a special confidential relationship in the conduct of the business;" and that, in this view, a temporary insider would be regarded "more properly as a tipper than a tippee." Id. at 655 n.14. Building on the substance of footnote 14 in *Dirks*, the Second Circuit in *Chow* held that even though Chow was not a traditional insider, by signing the NDAs he assumed the sort of "special confidential relationship" that made him a temporary insider of the Company. *Chow*, 993 F.3d at 137-38.

The Second Circuit in *Chow* and *Kosinski* also looked to SEC Rule 10b5-2, which provides that a "duty of trust or confidence" exists, "[w]henever a person agrees to maintain information in confidence." See 17 C.F.R. §240.10b5-2. Though not the principal basis of decision, the Rule was cited in *Chow* to reject the defendant's argument that "the misappropriation theory cannot be applied where the company and the individual have an arm's-length relationship." *Chow*, 993 F.3d at 138.

Conclusion

In *Chow*, the Second Circuit did not address an issue raised by the defendant—namely, that affirming Chow's conviction, premised on a breach of contract, would run afoul of the Second Circuit's holding in *United States ex rel. O'Donnell v. Countrywide Home Loans*, 822 F.3d 650 (2d Cir. 2016), which held that a breach of contract, even an intentional breach, was not a valid basis for a mail or wire fraud charge. Under *Countrywide*, an intentional breach of contract can only amount to fraud if "a contractual promise is made with no intent ever to perform it." Id. at 662. In *Kosinski* and *Chow*, the Second Circuit, extending a different body of law, under a different statute, did not express the same reservation about relying on a contractual breach as an essential basis for criminal charges. The extent to which this tension influences future cases remains to be seen.

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