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WHITE-COLLAR CRIME

Expert Analysis

Second Circuit to Resolve Split on Insider Trading

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The law of insider trading is effectively the product of the common-law judicial interpretation of the broad terms of Section 10(b) of the Securities Exchange Act and Rule 10b-5. Thus, it is perhaps not surprising that defining insider trading law's precise boundaries has been the subject of a fair amount of controversy over the years.[1] One such controversy is teed up for resolution by the U.S. Court of Appeals for the Second Circuit in *United States v. Newman*,[2] part of the recent spate of insider trading prosecutions brought by Southern District of New York federal prosecutors. The central issue on appeal has divided trial courts in the district: whether to be found guilty of insider trading a "tippee" must know that the insider who disclosed the information received a personal benefit for doing so.

Basics of Insider Trading Law

Typically, criminal insider trading cases are brought under one of two primary theories. Under the "classical" theory, a corporate insider commits insider trading when he either trades on material, non-public information in violation of the duty of trust and confidence owed to the shareholders of the corporation, or discloses such information to an outsider who trades on the information. In the latter instance, the tippee or outside recipient of the confidential information also is liable for insider trading where the tipper has breached his fiduciary duty to the company and its shareholders by disclosing such information to the tippee in return for some personal benefit, and the tippee is aware of the breach.

Under the second primary theory of insider trading liability, the misappropriation theory, an outsider to whom material non-public information is entrusted in confidence—examples include lawyers or underwriters—may be guilty of insider trading when such person trades on or tips others who trade on such information in breach of the duty owed to the source of the information.[3] Such individual engages in deception in violation of Section 10(b) and Rule 10b-5 by pretending loyalty to the source of the information while secretly using the information for his own gain, and a tippee inherits the tipper's duty when aware of the tipper's breach of the duty of loyalty.

Southern District Decisions

Two recent decisions from the Southern District of New York diverge on the required state of mind for tippee liability under the classical theory of insider trading. In *United States v. Whitman*,[4] the defendant Doug Whitman was indicted for trading on information that he received from tippees who had, in turn, obtained the information from employees at a number of corporations including Polycom Inc., Google Inc. and Marvell Technology Inc. One of the questions confronted by the court in instructing the jury was whether the government was required to prove that the defendant-tippee, Whitman, had to know that the information was originally obtained from an insider who not only breached a duty of confidentiality in disclosing such information, but also did so in ex-change for some personal benefit.

Southern District Judge Jed S. Rakoff answered this question in the affirmative, holding that a general understanding that the insider personally benefited from the unauthorized disclosure, as opposed to details of the benefit, is all that is required. Rakoff acknowledged that where a tippee is two or three times removed from the source of the information, the government may have difficulty in proving such knowledge. "If, however, this is an unfortunate 'loophole,' it is a product of the topsy-turvy way the law of insider trading has developed in the courts and cannot be cured short of legislation."[5] Rakoff's decision is in accord with recent decisions of two other Southern District of New York judges.[6]

Whitman was ultimately convicted and sentenced to 24 months imprisonment. Despite Rakoff's ruling, one of the several issues Whitman raises in his appeal, currently pending before the Second Circuit, is a challenge to the language the district court used in instructing the jury regarding the personal benefit requirement.[7]

Six months after Rakoff's decision in *Whitman*, Southern District Judge Richard J. Sullivan reached the opposite conclusion in *United States v. Newman*. In that case, hedge fund traders Todd Newman and Anthony Chiasson were found guilty of illegally trading on financial data from various technology companies before the information was made publicly available. The defendants were alleged to have received the tips from a group of analysts who obtained the information from company insiders. Following conviction at trial, the court sentenced Chiasson to six-and-a-half years imprisonment, and sentenced Newman to four-and-a-half years.

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The district court denied Newman's request for re-lease on bail pending appeal, which was based largely on the argument that the court had erred in declining to instruct the jury that it must find the defendants knew the information received originated with a corporate insider who disclosed it for a personal benefit.[8]

The court relied on the Second Circuit's decision in *SEC v. Obus*, a civil misappropriation case in which the Second Circuit set out the elements of tipper liability and tippee liability, including the personal benefit requirement for tipper liability, but not for tippee liability. The court found that the articulation of tipper and tippee liability in *Obus* "makes clear that the tipper's breach of fiduciary duty and receipt of a personal benefit are separate elements and that the tippee need know only of the former."[9]

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Source of the Split—'Dirks'

The split in approach between *Whitman* and *Newman* may be traced to the Supreme Court's 1983 decision in *Dirks v. SEC*, the seminal case examining tippee liability under the classical theory of insider trading.[10] Raymond Dirks was an officer of a broker-dealer that specialized in providing analysis of insurance company securities. Dirks received information from Secrist, a former officer of a life insurer, Equity Funding, that Equity Funding was vastly overvaluing its assets as part of a fraudulent scheme. Dirks investigated the information and corroborated it, and disclosed the information to certain of his clients, some of whom sold their holdings in Equity Funding. The fraud was soon more broadly exposed, and Equity Funding went into receivership.

The SEC later charged Dirks with insider trading, and he was found liable. The Supreme Court reversed, rejecting a proposed rule that merely knowingly obtaining inside information and trading upon it was sufficient to violate the law. Rather, the duty of the tippee, Dirks, not to trade was contingent on the insider, Secrist, violating his own fiduciary duty to Equity Funding in disclosing the information.

The court explained that it was commonplace and helpful to the securities markets "for analysts to ferret out and analyze information…and this is often done by meeting with and questioning corporate officers and others who are insiders."[11] Thus, whether an insider's disclosure of material information is a breach of the duty depends on the purpose of the disclosure, and because the securities laws are intended to eliminate the use of inside information for personal advantage, "the test is whether the insider will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to the stockholders. And absent breach by the insider, there is no derivative breach."[12] On the unusual facts presented, Dirks was thus not liable for insider trading because Secrist's purpose in revealing the information about Equity Funding was clearly not for personal gain, but to expose a fraud.

Second Circuit Appeal

Unlike the appeal in *Whitman*, Newman and Chiasson's appeal focuses primarily on the issue of whether a tippee must have knowledge that the tipper received a personal benefit by disclosing inside information. On June 18, 2013, the Second Circuit reversed the district court and ruled that Newman and Chiasson could remain free on bail pending the resolution of their appeal, effectively finding that the appeal presents a substantial legal question.

In their appellate briefs, the defendants argue that fraud in the insider trading context "derives from the 'inherent unfairness' of a corporate insider taking advantage of corporate information for *personal gain*. In other words, it is the insider's corrupt use of corporate information to benefit himself rather than the company that renders the disclosure improper."[13] Because a tippee derives his liability directly from the tipper, he cannot be held criminally liable unless he has knowledge of the insider's receipt of a personal benefit. Chiasson's brief argues that under *Dirks*, "[t]he exchange of 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."[14]

The National Association of Criminal Defense Lawyers' amicus brief in support of Newman and Chiasson also points out that the requirement of proof of knowledge that the insider disclosed information in exchange for a personal benefit is particularly important in cases involving remote tippees, and emphasizes the central importance in the criminal law of the defendant having knowledge of the facts that render his conduct unlawful.

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In its brief, the government rejects the defendants' reading of *Dirks* to require proof that a tippee knew of the personal benefit, arguing that the tippee's knowledge that the information was disclosed in violation of a duty to the company is sufficient. The government asserts that no circuit court of appeals has ever interpreted *Dirks* to impose such a requirement for tippee liability, and specifically references the Second Circuit's decision in *Obus*. The government likens tippee liability under Section 10(b) to other federal statutes containing elements as to which the government need not prove the defendant's knowledge, such as transporting a minor in interstate commerce, where the defendant need not know the defendant's age.[15]

The government also argues that there is no real concern that the innocent will be ensnared: "[n]o reasonable person would harbor a settled expectation that he is free to trade securities… based on information that a defendant knows to be not only material and nonpublic, but also to have been disclosed by a company insider in violation of a duty to keep the information confidential."[16]

The debate between the parties is rooted in the unusual circumstances of *Dirks*, where the defendant tipper did not violate any recognized duty to the corporation, Equity Funding, because he disclosed the information not for personal gain, but to blow the whistle on a fraud. Indeed, the law of agency provides that an agent's duty of confidentiality is not absolute and may be superseded when an agent seeks to protect a superior interest. Thus, an agent properly may reveal to law enforcement authorities that the principal is committing or about to commit a crime.[17]

The matter is complicated by a change in the regulatory landscape since the Supreme Court's 1983 decision in *Dirks*. The rather common practice of corporate insiders selectively revealing material information to securities analysts, which the court relied upon in *Dirks*, was forbidden by Regulation FD, which the SEC promulgated in 2000. Arguably, under Reg. FD, all corporate insiders effectively have an obligation to refrain from any selective disclosure of material non-public information, and thus whether or not the insider did so for personal gain no longer determines whether the insider has breached a duty to the corporation and its stockholders.

Chiasson's brief to the Second Circuit addresses head-on the impact of Reg. FD, pointing out how in issuing the regulation, the SEC expressly chose neither to treat selective disclosure as fraudulent, nor to revisit the insider trading issues addressed in *Dirks*. Thus, Chiasson argues, trading on selectively disclosed information "becomes fraudulent only when the insider discloses information for personal gain and the tippee knows that to be so."[18] Interestingly, the government, for its part, argues that Reg. FD is irrelevant because it applies only to information disclosures authorized by the corporation, not disclosures in breach of a duty of confidentiality, as it claims occurred in this case.[19]

Conclusion

The Second Circuit's consideration of the personal benefit requirement for tippee liability promises to play an important role in determining how the "common law" of insider trading will continue to evolve in an ever-changing regulatory and market landscape.

1. See Robert G. Morvillo and Robert J. Anello, "The Evolving Mystery of Illegal Insider Trading," NYLJ (Aug. 3, 2010).
2. 13-1837 (L), 13-1917 (CON) (2d Cir.). One of the defendants in the case was represented at trial by attorneys then with the authors' law firm.
3. See *United States v. O'Hagan*, 521 U.S. 642 (1997).
4. 904 F.Supp.2d 363 (S.D.N.Y. 2012).
5. Id. at 372.
6. See *United States v. Rajaratnam*, 802 F.Supp.2d 491 (S.D.N.Y. 2011); *State Teachers Ret. Board v. Fluor Corp.*, 592 F.Supp. 592 (S.D.N.Y. 1984).
7. Brief for Defendant-Appellant, *United States v. Whitman*, 13-491 (2d Cir. April 15, 2013). Oral argument was held on Nov. 4, 2013.
8. 2013 WL 1943342 (S.D.N.Y. May 7, 2013).
9. Id. at *2.
10. 463 U.S. 646 (1983).
11. 461 U.S. at 658-59.
12. Id. at 662.
13. Brief of Defendant-Appellant Todd Newman, *United States v. Newman*, 13-1837(L), 13-1917(CON) at p. 32 (2d Cir. Aug. 15, 2013) (emphasis in original).
14. Brief for Defendant-Appellant Anthony Chiasson, *United States v. Newman*, 13-1837(L), 13-1917(CON) at p. 35 (2d Cir. Aug. 15, 2013) (emphasis in original).
15. Brief for the United States of America, *United States v. Newman*, 13-1837(L), 13-1917(CON) at p. 44 (2d Cir. Nov. 14, 2013).
16. Id. at pp. 45-46. The government also argues that it adduced ample evidence of knowledge of personal benefit at trial, and thus that any error in the jury instructions was harmless.
17. Restatement 3d of Agency §8.05, Comment c. (2006).
18. Chiasson Brief at p. 29.
19. Government Brief at pp. 48-49.

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