The Law of Insider Trading: A Primer For Investment Managers

"Insiders" of an issuer, such as officers, directors, attorneys and other special classes of persons, are never permitted to trade on material non-public information concerning the issuer. Persons who are not "insiders", such as fund managers, investors, analysts, investment advisers, etc., are prohibited from trading in an issuer's securities while in possession of material non-public information about the issuer when such non-insiders obtain the information through the breach of a duty either by the person who transmitted the information or by the recipient of the information who is seeking to trade on the basis of it. Thus, for a non-insider to be liable for trading on the basis of inside information, the information must be "material", and "non-public", and the non-insider must know or have reason to know that the information was disclosed through the breach of a "duty". We will discuss these concepts below.

This article will focus on the laws, regulations and cases pertaining to insider trading by fund managers and other members of the financial community.

DISCUSSION

A. *Is the Information Non-Public?*

In determining whether you are in possession of Inside Information you should first ask yourself whether the information is public. If information is public, you are permitted to trade on the basis of it and you need not consider whether it is also "material" or whether the information was disclosed or obtained through a breach of a duty. For information to be deemed "public," it must be disseminated in a manner making it generally available to the investing public.[1] Obviously, if the information has been published in the financial press or is disclosed in the issuer's filings with the Securities and Exchange Commission ("SEC"), it is public. Information furnished by an issuer in a webcast or conference call which is publicly announced in advance and made available to analysts, investment managers and the general investing public also would be deemed public.[2] On the other hand, information provided by an officer of the issuer in a one-on-one private conversation with an analyst, fund manager, etc. would generally not be deemed public information.[3]

Rumors

Rumors do not necessarily constitute public information. You must be very careful when you are in possession of a rumor concerning the issuer. If the so-called "rumor" is reported as a rumor in the financial press, then you can consider it public. However, if it is not reported in the financial press or in an SEC filing, you run the risk that the information is non-public and, if it is both material and was disclosed, directly or indirectly, through the breach of a duty, you may be prohibited from trading on the basis of it. One way to determine whether a "rumor" is publicly available would be to call the issuer's public relations officer and ask him or her if the company has publicly confirmed or denied the rumor. You should *not* contact any officer or employee of the issuer to determine the *accuracy* of a rumor because a confirmation or a denial of the rumor could, in itself, be non-public information.

B. *Is the Information Material?*

[1] *In the Matter of Certain Trading In the Common Stock of Faberge*, 45 S.E.C. 249 (May 25, 1973).

[2] Securities Act of 1933, Release No. 33-7881, dated August 15, 2000 ("SEC Release"), p. 11.
[3] SEC Release, p. 11

In order to be subject to the prohibition against trading on the basis of Inside Information, the information must not only be non-public, but it must also be "material." Determining what constitutes "material" information is not an easy task. In the seminal case of *TSC Industries, Inc. v. Northway, Inc.*, the U.S. Supreme Court set forth a standard of materiality. Information is material if "there [is] a substantial likelihood that the disclosure of an omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available."[4] Accordingly, information is material if it would "significantly alter the total mix of information currently available regarding the security."[5] Subsequent to the *TSC* ruling, the Association for Investment Management and Research ("AIMR") came out with what may be considered a clearer definition of materiality which expands upon the Supreme Court's statements: "information is material if its disclosure would be likely to have an impact on the price of a security or if reasonable investors would want to know the information before making an investment decision."[6] The issue of materiality may be characterized as a mixed question of law and fact involving application of a legal standard to a particular set of facts,[7] and, as such, there is no bright line test from a legal perspective to assist in determining what is material. As a general rule of thumb, if you consider the information to be important, it is probably "material."

The SEC has stated that one kind of information -- earnings guidance -- is virtually always material:

> One common situation that raises special concerns about selective disclosure has been the practice of securities analysts seeking "guidance" from issuers regarding earning forecasts. When an issuer official engages in a private discussion with an analyst who is seeking guidance about earnings estimates, he or she takes on a high degree of risk under Regulation FD [17 C.F.R. §240.100][8]. If the issuer official communicates selectively to the analyst nonpublic information that the company's anticipated earnings will be higher than, lower than, or even the same as what analysts have been forecasting, the issuer likely will have violated Regulation FD. This is true whether the information about earnings is communicated expressly or through indirect "guidance," the meaning of which is apparent though implied. Similarly, an issuer cannot render material information immaterial simply by breaking it into ostensibly non-material pieces.[9]

The bottom line is that analysts and fund managers should no longer seek confirmation of their own projections about the issuer from the issuer.

The SEC has enumerated other types of information and events, in addition to earnings information, which are likely to be considered material, including the following:

- Mergers, acquisitions, tender offers, joint ventures, or changes in assets;
- New products or discoveries;
- Developments regarding customers or suppliers (e.g., acquisition or loss of a contract);
- Changes in control or in management;
- Changes in auditors, or auditor notification that issuer may no longer rely on the audit report; and
- Events regarding the issuer's securities:
  - Defaults
  - Redemptions
  - Splits
  - Repurchase plans

[4] *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 96 S.Ct. 2126 (1976).
[5] *TSC* at 449.
[6] *See* Association for Investment Management and Research (7th Edition, 1996).
[7] *TSC* at 450.
[8] Regulation FD prohibits the selective disclosure of information by an issuer and certain of its officers (*see* p.5, *infra*).
[9] SEC Release, p. 11.

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- Changes in dividends
- Changes in rights of holders
- Sales of securities
- Bankruptcies/receiverships.[10]

The Mosaic Theory

In 2000, the SEC adopted Regulation FD[11] to prevent the practice of selective disclosure by issuers to market professionals, including analysts and investment managers. While Regulation FD governs the activities of issuers who release information, and not the analysts and investment managers who receive it, the Release issued by the SEC in connection with the promulgation of Regulation FD provides helpful guidance to such analysts, investment managers and other market professionals.

The SEC explains in its Release that, under the so-called "mosaic" theory, an analyst or investment manager is permitted to "put together pieces of public information and non-material, non-public information to create a mosaic from which a material, non-public conclusion may be drawn."[12] For example, you may be aware from an issuer's SEC filings that it is highly dependent upon the supply of cashmere wool from India, and you may have learned of an earthquake in Kashmir which has severely disrupted production of cashmere, all of which is public information. Based upon that information, you may draw the conclusion that the issuer's earnings for the next quarter or year are likely to fall dramatically which may be a forecast that the issuer has not publicly disseminated and is not widely shared in the financial markets. Under this example, you would be permitted to trade on the basis of your conclusion.

You must be careful to differentiate between non-public conclusions *which you may have drawn* and obtaining *confirmation from the issuer* of such conclusions. If, in the above example, you called the issuer's Chief Financial Officer to confirm your projection of the effect of the earthquake in Kashmir on the issuer's future earnings, and you received a confirmation or a denial from that officer, such confirmation or denial may, in itself, constitute material, non-public information which would prevent you from trading in the issuer's stock.

The case of *SEC v. Monarch Fund*[13], which involved a claim against an investment advisor for trading on inside information, contains language which further supports the mosaic theory and also evinces a certain deference accorded to analysts who gather information concerning public companies. In that case, the U.S. Court of Appeals for the Second Circuit reversed a finding of liability against an investment manager. In the course of its decision, the court stated the following:

> All reasonable investors seek to obtain as much information as they can before purchasing or selling a security. Investors will usually consult a broker, having confidence that such a professional keeps abreast of the market, including the information circulated regarding specific securities, and will rely upon the information given to them by their broker. Therefore, investment advisors seek to obtain as much information including rumors regarding a security as they can so that they may properly advise their clients.
>
> Since [the defendant] was the investment adviser for his family investment companies, it was his duty to trade in securities that he thought had attractive investment potential. It was for this reason that he made inquiries in the investment community to get information that he thought would be helpful in determining the efficacy of investments to be made for the clients he represented[14].

[10] SEC Release, pp. 10-11.
[11] 17 C.F.R. § 240.100.
[12] Standards of Practice for Investor Relations, National Investor Relations Institute (2d Edition, January 2001), p. 51.
[13] 608F 2d 938 (2d Cir. 1979)
[14] 602 F.2 at 942-943.

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In holding that the defendant investment adviser was not liable for trading on the information he had learned, the Court also noted that the investment adviser had "testified that no one had told him that the rumors circulating in the market place…constituted corporate inside information. Indeed, the evidence indicated that rumors of [the alleged inside information] were circulating throughout the over-the-counter-community."[15]

The Court in the *Monarch Fund* case also noted that the adviser's liability depends upon whether the information involved "is of a specific or general nature."[16] "This determination is important," stated the court, "because it directly bears upon the level of risk taken by an investor. Certainly the ability of a court to find a violation of the securities laws diminishes in proportion to the extent that the disclosed information is so general that the recipient thereof is still 'undertaking a substantial economic risk that his tempting target will prove to be a "white elephant."[17]

The SEC, in its release adopting Regulation FD, specifically acknowledged the validity of the "mosaic" process and stated that the staff was not attempting to prevent an astute analyst from reaching material conclusions about a company.[18] The United States Supreme Court also has recognized the legitimate role played by investment analysts in contacting company officials to obtain information necessary to investment decisions.[19] The SEC stated in its Release that Regulation FD is designed to prohibit officers of an issuer from selectively disclosing information and is not intended to focus on "whether an analyst, through some combination of persistence, knowledge, and insight, regards as material information whose significance is not apparent to the reasonable investor."[20] On the other hand, analysts and fund managers must be careful not to "cajole a corporate spokesman into selectively disclosing material information."[21] In this regard, it would be beneficial to have a written insider trading policy containing procedures for addressing the receipt of material, non-public information. Such policies are required to be maintained by registered investment advisers.

C. *Was the Information Obtained Through the Breach of a Duty?*

If you are in possession of material, non-public information, the question of whether or not you may still trade on the basis of such information depends upon how you received it. As a general rule, if you received the information, directly or indirectly, through a person who was under a duty not to disclose it and you knew or should have known that the disclosure was made in breach of the duty, you would not be permitted to trade on the basis of that information.[22]

i. Breaches by Insiders

The traditional prohibition against insider trading prohibits trading in the securities of a public company, i.e., an "issuer," while in possession of information about the issuer which is received, directly or indirectly, from an "insider" of the issuer who discloses that information through a breach of a duty. The concept of an "insider" is broad. It includes officers, directors, members, and employees of the issuer. In addition, a person can be a "temporary insider" if he or she enters into a special confidential relationship in the course of performing services for the issuer and, as a result, is given access to information solely for the issuer's purposes. A temporary insider can include, among others, a company's attorneys, accountants, consultants, bank lending officers, and the employees of such organizations.

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[15] 608 F 2d at 943.
[16] 608 F 2d at 942. (*citing United States v. Chiarella*, 588 F. 2d 1358, 1366-67 [(2d Cir.)], *cert. granted*, 441 U.S. 942, 99 S. Ct. 2158, 60 L.ED.2d 1043 [1979].
[17] 608 F 2d at 402.
[18] SEC Release, p. 11.
[19] *SEC v. Dirks,* 463 U.S. 646, 658-659 (1983).
[20] SEC Release, p. 11.

[21] "The Twilight Zone Of Disclosure: A Prospective on the SEC's Selective Disclosure Rules," Groskaufmanis, K. and Anixt, D., p. 15.
[22] *SEC v. Dirks*, 463 U.S. at 660.

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There are various contexts in which a person breaches a duty by transmitting material, non-public information. An officer of an issuer violates his duty if he intentionally transmits material, non-public information concerning the company without any justifiable business purpose and the officer knows or should know that the recipient of the information will trade in the issuer's securities after receiving such information.[23] A secretary of a law firm working on a merger breaches her duty to the law firm and the client by revealing information about the issuer which is the subject of the merger.

It is not always easy to determine whether an insider has breached a duty by disclosing material, non-public information. In a leading case decided by the U.S. Supreme Court several years ago, *SEC v. Dirks*, the Court held that a former officer of an issuer who disclosed non-public information to an analyst concerning a fraud involving the issuer did not breach a fiduciary duty because the officer did not benefit from the disclosure.[24] Since the former officer did not breach a duty in disclosing the information, the Court held that the analyst did not violate the insider trading laws by conveying the information to his clients who sold the stock based on the information.[25]

Based upon the *Dirks* case, the SEC has made some very novel arguments to attempt to demonstrate that the disclosing party benefited from the disclosure and therefore breached his or her duty. For example, in the case of *SEC v. Stevens*, the SEC argued that the Chief Executive Officer ("CEO") of an issuer had violated the insider trading laws by tipping analysts concerning an upcoming quarterly earnings drop. The SEC argued that the CEO's benefit for tipping the information was to avoid an unpleasant earnings surprise which would be injurious to the CEO's professional reputation among financial analysts.[26]

There are situations in which a fund manager has a relationship with an Issuer or an officer or employee of an Issuer which imposes a duty of trust or confidence on the part of the manager. If the fund manager receives material non-public information about the Issuer as result of that relationship, the fund manager is prohibited from trading in the Issuer's securities. For example, if a fund manager sits on a creditors' committee of an Issuer that is in bankruptcy and learns material non-public information about the Issuer in the course of that role, the fund manager would not be permitted to purchase or sell that Issuer's securities. Similarly, if an Investment Fund is approached to make a loan to an Issuer or to make a large investment in the Issuer (sometimes referred to as a private investment in public entity or a "PIPE") the Investment Fund may be prohibited from trading in the securities of the Issuer until the loan or the PIPE transaction is disclosed to the general investing public.[27] The SEC has promulgated a rule which specifies certain relationships which create a "duty of trust or confidence" for the purposes of restricting the use or disclosure of information obtained in the course of such relationships.[28]

[23] *Sec v. Dirks*, 463 U.S. at 659.
[24] 463 U.S. at 662.
[25] 463 U.S. at 667.

[26] 91 Civ. 1869, SEC Litig. Rel. No. 12813 (March 19, 1990).
[27] In *SEC v. Cuban*, 620 F.3d 551 (2010), the United States Court of Appeals for the Fifth Circuit reinstated the SEC's complaint in an enforcement action which alleged insider trading based on information concerning a PIPE.
[28] Rule 10b-5-2 promulgated under the Securities Exchange Act of 1934, as amended, 17 C.F.R. §240.10b5-2.

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ii. Misappropriated Information

There may be circumstances in which information about an issuer is obtained from persons who are not employed by, or owe a duty of confidentiality to, the issuer and, therefore, are not deemed to be insiders or temporary insiders. Such non-insiders may be persons who have, or are employed with companies who have, arms-length dealings with the issuer, such as vendors and suppliers.

If the information obtained from a non-insider is disclosed by the non-insider under circumstances in which the non-insider breaches a fiduciary duty or otherwise commits a fraud, trading on the basis of that information may also constitute a violation of the securities laws. This is the so-called "misappropriation" theory of insider trading liability. That is, the information, which may be material to the stock of an issuer, is "misappropriated" and used to trade. Examples of such misappropriated cases are the "printer" cases, in which an employee of a printing company learns through the information being printed that a company plans to acquire a public company and the employee uses the information to purchase or sell securities of the public company that is to be acquired. Since the printer was hired by the acquiring company, and not the public company, the employee of the printer is not an "insider" or "temporary insider." But the employee has nevertheless defrauded his employer (the printing company) as well as the company that hired the printing company, by using such information to trade. The "misappropriation" of such information is a breach of fiduciary duty and a fraud and is therefore considered a violation of the anti-fraud provisions of the securities laws.[29]

Keep in mind that if the employer, or some other person or entity from whom the information is appropriated, has no objection to the use or disclosure of the information, then there would be no breach of fiduciary duty or fraud in such use or disclosure for the purpose of trading in securities.[30]

iii. Knowledge of Breach of Fiduciary Duty

In order to be liable for trading on inside information, the person conveying the information must do so in breach of a fiduciary duty or otherwise as part of a fraud, and the recipient of the information must know or have reason to know that the information was conveyed to him in breach of a fiduciary duty or otherwise through a fraud. This rule applies when the person conveying the information is an insider of the company whose stock is traded or is an outsider who owes no fiduciary duty to the company whose stock is being traded but misappropriates information concerning the company and conveys it as part of a breach of fiduciary duty or other fraud.[31]

If the source of the information (*i.e.*, the tippee) has breached a duty in disclosing it, the recipient (*i.e.*, the tippee) need not have also breached a fiduciary duty in using or further disclosing the information in order for the tippee to be liable for such use or disclosure. If the tippee uses or discloses information which he knows or should have known has been obtained through a breach, the tippee is deemed to be a participant with the person who breached the fiduciary duty "in a 'co-venture' to breach a duty [and is] held responsible for all the consequences

[29] *See, e.g., S.E.C. v. Materia,* Fed. Sec. L. Rep. (CCH) ¶99583, 1983 WL 1396 (S.D.N.Y.).

[30] Langevoort, pp. 6-31 – 6-33.

[31] Langevoort, p. 4-4, citing *United States v. Chiarella*.

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flowing therefrom" as if the tippee was a fiduciary himself.[32]

On the other hand, if the tipper has not breached a duty in disclosing the information, the tippee will not be liable for using the information to trade in securities unless the tippee's use of the information itself constitutes a breach of some duty. So, if a corporate executive discloses information to an analyst in a context in which the disclosure does not violate company policy, then the analyst does not commit a violation in using the information. But the analyst must be cautious here because, if the corporate executive disclosed material non-public information in a one-on-one conversation with an analyst, there is a strong risk that a regulator or a court will find some way to conclude that the executive breached a duty in doing so, and that, therefore, the analyst participated in the breach by using that information. As one commentator has put it, "[a]bsent facts that would suggest that the insider believed that immediate dissemination of the information was essential and saw the analyst as the only practicable means of publicizing the information – a rare circumstance . . . – the analyst should be on notice that the insider (personally or on the corporation's behalf) is purposely breaching a fiduciary duty by so favoring him."[33]

There are other contexts, aside from disclosures by corporate executives, in which material non-public information is disclosed appropriately. For example, a person might make the disclosure to his or her spouse concerning something he or she learned on the job, and the disclosing party assumed that the spouse would keep the information confidential. The spouse who receives such innocently disclosed information has a duty not to use or disclose it, and the breach of such duty would create liability. So, if the initial disclosure is innocent or otherwise permissible, the recipient will be liable for using it if the recipient engages in a breach of duty by doing so.

[32] Langevoort, p. 6-35.
[33] Langevoort, p.11-9.

Recent Cases Clarifying the Element of Knowledge

1. The *Obus* Case

On September 6, 2012, the Second Circuit Court of Appeals issued a decision that clarified the requirements of scienter, as they pertain to tipper and tippee liability in a civil case brought by the SEC. In the case of *SEC v. Obus*,[34] the Second Circuit considered an appeal of a dismissal of insider trading claims following a grant of summary judgment by the U.S. District Court. In reversing the dismissal, the Second Circuit had to reconcile two apparently inconsistent definitions of scienter, both articulated by the U.S. Supreme Court.

In the case of *Ernst & Ernst v. Hochfelder*, the Supreme Court defined scienter as "a mental state embracing **intent to deceive, manipulate, or defraud**."[35] However, in the case of *Dirks v. SEC*, the Supreme Court indicated that scienter could be satisfied by establishing not only what a tippee actually knew, but also what he "**should have known**."[36] The Second Circuit reconciled these two holdings in *Obus* in deciding whether to uphold the grant of summary judgment in favor of three individual defendants: an insider who, the SEC alleged, gave the initial tip (the "Tipper"); a former college friend of the Tipper

[34] 693 F.3d 276 (2d Cir. 2012).
[35] 425 U.S. 185, 193 & n. 12 (1976) (emphasis added). The Second Circuit has since expanded the definition of scienter to include "reckless disregard for the truth." *SEC v. McNulty*, 137 F.3d 732, 741 (2d Cir. 1998).
[36] 463 U.S. at 660. The articulation of scienter in *Dirks* sounds very close to negligence, which requires a determination not necessarily of what the defendant did actually know, but rather what a reasonable individual in those same circumstances should have known. Yet, the Supreme Court in *Hochfelder* expressly stated that negligence could not satisfy the scienter standard.

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who, the SEC alleged, was the first to receive the inside information (the "First Level Tippee"); and the First Level Tippee's boss who, the SEC alleged, received the inside information from the First Level Tippee (the "Second Level Tippee" and, along with the Tipper and First Level Tippee, the "Defendants").

The Tipper worked for General Electric Capital Corporation ("GE Capital") and, in that capacity, was performing due diligence on behalf of Allied Capital Corporation ("Allied") for its planned acquisition of SunSource, Inc. ("SunSource"). The SEC alleged that the Tipper later told the First Level Tippee of the planned acquisition. The SEC further alleged that the First Level Tippee subsequently communicated word of the potential acquisition to the Second Level Tippee, who, the SEC alleged, then purchased 287,000 shares of SunSource. When Alliance did in fact acquire SunSource several weeks later, the value of the shares nearly doubled. In granting summary judgment in favor of the Defendants, the U.S. District Court determined that the SEC had failed to establish a genuine issue of fact as to whether the Tipper breached his duty to GE Capital and, thus, held that there was no duty for either the First or Second Level Tippee to inherit. "The district court based this finding on GE Capital's internal investigation, which concluded that [the Tipper] had not breached a duty to his employer, and on the fact that SunSource was not placed on GE Capital's Transaction Restricted List until after the SunSource acquisition was publicly announced…The district court further held that the SEC failed to establish facts sufficient for a jury to find that [the Tipper's] conduct was deceptive…and that [even if the Tipper had breached a fiduciary duty to GE capital] the SEC failed to present sufficient evidence [that the Second Level Tippee] 'subjectively believed that the information he received was obtained in breach of a fiduciary duty.'"[37] The Second Circuit reversed and vacated the District Court's ruling.

[37] *Id.* at 14.

According to the Second Circuit in *Obus*, for a tipper to be liable, first, "the tipper must tip deliberately or recklessly, not through negligence."[38] The Court explained how this "scienter' requirement differs from mere negligence by offering an example:

> Assume two scenarios with similar facts. In the first, a commuter on a train calls an associate on his cellphone, and, speaking too loudly for the close quarters, discusses confidential information and is overheard by an eavesdropping passenger who then trades on the information. In the second, the commuter's conversation is conducted knowingly within earshot of a passenger who is the commuter's friend and whom he also knows to be a day trader, and the friend then trades on the information. In the first scenario, it is difficult to discern more than negligence and even more difficult to ascertain that the tipper could expect a personal benefit from the inadvertent disclosure. In the second, however, there would seem to be at least a factual question of whether the tipper knew his friend could make use of material non-public information and was reckless in discussing it in front of him.[39]

In order for the tipper to be liable, it also must be shown that the tipper knew, or was reckless in not knowing, that the information is non-public and material. Also, "the tipper must know (or be reckless in not knowing) that to disseminate the information would violate a fiduciary duty."[40] In other words, scienter requires a showing of what the tipper actually knew or recklessly disregarded, not what he **should have known**. Thus, the Court held in *Obus* that the *Hochfelder* scienter standard applies to all elements of tipper liability.

[38] *Obus*, 693 F.3d at 286.
[39] *Id.* at 287
[40] *Id* at 286.

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While the SEC initially alleged that the defendants violated Section 10(b) and Rule 10b-5 on the basis of the classical and misappropriation theories of insider trading liability, it only appealed that portion of the District Court's decision which dismissed the claim based on the theory that the defendants misappropriated the information from GE Capital. The Second Circuit also stated in *Obus* that the "abstain or disclose" rule, as it applies to the misappropriation theory, requires disclosure to the person from whom the information was appropriated, not to the investing public. "Under either theory, if disclosure is impracticable or prohibited by business consideration or by law, the duty is to abstain from trading."[41] The Second Circuit also ruled that the District Court erred in requiring the SEC to prove "'deception' beyond the tip itself. . . . If the jury accepts that a tip of material non-public information occurred and that [the Tipper] acted intentionally or recklessly, [the Tipper] knowingly deceived and defrauded GE Capital. That is all the deception that section 10(b) requires."

However, when determining the liability of a tippee, the court held that "the *Dirks* knows or should know standard pertains to a tippee's knowledge that the tipper breached a duty, either to his corporation's shareholders (under the classical theory) or to his principal (under the misappropriation theory), by relaying confidential information."[42] "*Hochfelder's* requirement of intentional or reckless conduct pertains to the tippee's eventual use of the tip by either trading or further dissemination of the information."[43] In short, the Second Circuit in *Obus* bifurcated the scienter requirement of tippee liability and set a lower bar of liability for tippees than for tippers.

Applying the above principles, the Second Circuit held, first, that the SEC had presented a material issue of fact with respect to the Tipper's potential liability. The Court noted that the SEC alleged facts to support a finding that the Tipper knew he was under "an obligation to keep information about the SunSource/Allied deal confidential" and that there was sufficient circumstantial evidence to support an inference that the Tipper disclosed the potential deal to the First Level Tippee.[44] (The Tipper and the First Level Tippee denied that the Tipper disclosed the proposed deal[45] but the SEC argued that there was sufficient circumstantial evidence to support a finding that the proposed deal was disclosed.) The Second Circuit also concluded that the SEC's allegations were sufficient to present a question of fact as to whether the Tipper acted knowingly or recklessly with respect to the First Level Tippee's ability to use the information to trade in securities.[46] Specifically, the Second Circuit noted that the SEC alleged that because the Tipper knew that the First Level Tippee worked for a company that was already a large holder of Sunsource stock, the First Level Tippee was likely either to purchase additional shares based upon the inside information or relay the information to one of his superiors, as he allegedly did.[47]

With regard to the First and Second Level Tippees, the Court concluded that there were sufficient allegations to support a finding that the First Level Tippee knew or *should have known* that the Tipper breached his fiduciary duty to GE Capital when he informed the First Level Tippee of the SunSource/Allied deal.[48] Among the allegations cited by the Second Circuit were that the First Level Tippee "knew [the Tipper] was involved in developing financing packages for other companies and performing due diligence; and that information about a non-public acquisition would be material inside information that would preclude someone from buying stock."[49] The Second Circuit held that this was "sufficient for a jury to conclude that [the First Level Tippee] knew or had reason to know that

[41] *Id.* at 285.
[42] *Id.* at 288.
[43] *Id.*

[44] *Id.* at 289-91.
[45] The First Level Tippee claimed that the Tipper had only asked questions about SunSource's management and that those questions led the First Level Tippee to suspect that SunSource was considering a transaction that would dilute existing shareholders.
[46] *Id.* at 289-91.
[47] *Id.* at 290.
[48] *Id.* at 290-91.
[49] *Id.* at 292.

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any tip from the [Tipper] on SunSource's acquisition would breach [the Tipper's] fiduciary duty to GE Capital."[50] The First Level Tippee therefore inherited the Tipper's duty, which the Tippee allegedly breached when he allegedly relayed the tip to the Second Level Tippee.[51] The Second Circuit reached this conclusion, in part, because the First Level Tippee was a "sophisticated financial analyst," which is the sort of fact made relevant by the *Dirks* "knows or should know" standard.[52] The Second Circuit also held that the SEC must prove that the tippee derived some personal benefit. Here, it held that the jury could find that the First Level Tippee hoped to curry some favor with his boss by passing along the information.[53]

As with the First Level Tippee, the Second Circuit concluded that the SEC had presented a material question of fact with respect to the liability of the Second Level Tippee, in light of certain alleged comments and phone calls made to the CEO of SunSource indicating that he knew of the impending takeover.[54]

On May 30, 2014, following trial, a unanimous jury rendered a verdict in favor of the defendants, finding that they did not trade on inside information.[55]

In all, the Second Circuit's application of the scienter requirements of both *Hochfelder* and *Dirks* clarifies that a tippee need not have actual knowledge of (or be reckless with respect to) the existence of the tipper's duty, the breach of that duty or the confidentiality of the information. Rather, the SEC now need only show that a tippee knew or should have known of these things, allowing courts to impose liability for something closer to negligence. However, as discussed in the next section, the level of knowledge by the tippee for liability in a *criminal* case is higher.

2. The *Newman* Case

Since the Supreme Court's 1983 decision in the case of *Dirks v. SEC.*, courts and commentators alike have noted the considerable uncertainty surrounding two key issues concerning tippee liability for insider trading:

i. First, what kind of "personal benefit" must the initial tipper receive in order to establish the tipper's breath of duty when he makes the tip; and
ii. Second, what level of knowledge (if any) must the tippee have of the personal benefit received by the tipper in order to be held derivatively liable for the alleged breach.[56]

In its December 10, 2014 decision in the case of *U.S. v. Newman*,[57] the Second Circuit clarified the requirements for tippee criminal liability. While there are still several questions that remain unanswered, securities traders (and the regulators) now know, based on the *Newman* decision, that a personal benefit to the tipper is a required element before imposing tippee criminal liability and that the tippee must have had some knowledge, or have deliberately avoided knowledge, of the tipper's receipt of such a benefit. The Court also went on to describe the type of benefit which would support a finding of criminal liability, rejecting the argument that the mere existence of a personal relationship between the tipper and tippee allowed for an inference of some intangible benefit.[58] The Second Circuit instead held that there must be "an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable

[50] *Id.*
[51] *Id.*
[52] *Id.* The First Level Tippee's professional experience and expertise made him more qualified to conclude that the Tipper's relaying of the SunSource/Allied deal constituted a breach of the Tipper's fiduciary duty to GE Capital. As a result, according to the Second Circuit, there was a material question of fact as to whether the First Level Tippee "should have known" of the breach.
[53] *Id.* at 292.
[54] *Id.* at 292-93.
[55] *SEC v. Obus, et al*, 06-cv-03150 (dkt. entry no. 163) U.S.D.C., S.D.N.Y., June 2, 2014.
[56] *See U.S. v. Newman*, 773 F. 3d 438 (2014), *cert. denied* 136 S.Ct. 242 (2015) (noting that the court has been accused of being "somewhat Delphic in [its] discussion of what is required to demonstrate tippee liability").
[57] *Id.*
[58] *Id.* at 452.

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nature." [59] Finally, the Second Circuit held that a tippee must have actual knowledge of the benefit (or purposefully avoid such knowledge) to be held criminally liable for insider trading.

Newman involved the transfer of confidential earnings-related information from two corporate insiders to several different layers of tippees.[60] The two defendants in the case, Todd Newman and Anthony Chiasson,[61] were portfolio managers at two different hedge funds and were several layers removed from the initial tippers.[62] The Defendants traded on the confidential information initially disclosed by the insiders and were subsequently convicted by a jury of several counts of insider trading.[63] They appealed their conviction on the ground that the jury instructions provided by the trial court misstated the legal requirements for tippee liability by not requiring the jury to find that the Defendants had knowledge of the personal benefit received by the tipper in order to be held criminally liable.[64] The Second Circuit agreed and reversed the conviction.

Citing the Supreme Court's decision in *Dirks*, the Second Circuit confirmed that the tipper's receipt of a personal benefit was an essential element of the tipper's breach of his or her fiduciary duty.[65] In the absence of the receipt of a personal benefit, the tipper's disclosure of insider information is a mere breach of confidentiality, but not his or her fiduciary duties to the company or its shareholders.[66] Because a tippee's criminal liability for insider trading is derivative of the tipper's breach of fiduciary duty, a tippee cannot be held criminally liable unless the government can show that the tipper received either a "pecuniary gain" or a "reputational benefit that will translate into future earnings."[67] In finding that no such benefit existed in this case, the Second Circuit in *Newman* found that "the circumstantial evidence…was simply too thin to warrant the inference that the corporate insiders received any personal benefit in exchange for their tips."[68] The tippers had casual personal relationships with the first-level tippees, however the Second Circuit concluded that if that alone were sufficient to establish an inference of a personal benefit, "practically anything would qualify."[69] Instead, the Second Circuit defined personal benefit in such a way as to require an actual or potential pecuniary gain or something similarly valuable in nature.[70]

With respect to the tippee's knowledge of the existence of the personal benefit received by the tipper, the Second Circuit again sided with the Defendants, concluding that "well-settled principles of substantive criminal law . . . require[ ] that the defendant know the facts that make his conduct illegal" and that such knowledge "is a necessary element in every crime." [71] In finding that the government had failed to make such a showing in this case, the Court in *Newman* held that "the Government presented absolutely no testimony or any other evidence that Newman and Chiasson knew that they were trading on information obtained from insiders, or that those insiders received any benefit in exchange for such disclosures, or even that Newman and Chiasson consciously avoided learning of these facts."[72] Rather, the evidence showed that the Defendants "knew next to nothing about the insiders and nothing about what, if any, personal benefit had been provided to them."[73] In short, even if the tipper in *Newman* had received a personal benefit in exchange for the disclosure of confidential information, the Defendants could not be held criminally liable as tippees unless they had *actual knowledge (or purposefully*

[59] *Id.* at 452.
[60] *Id.* at 443.
[61] Collectively, the "Defendants."
[62] *Id.* at *443. In fact the chain was four levels: Choi (of the company's finance unit) tipped Lim (a former executive a technology company that Choi knew from church), who then tipped Kuo (an analyst) who then tipped friends, Tortora and Adonakis, who then turned the information over to Newman (the defendant in this case.)
[63] *Id.* at 444.
[64] *Id.* at 445.
[65] *See id.* at 446.
[66] *See id.*
[67] *See id.* at 452.
[68] *See id.* at 451-52.
[69] *See id.* at 452.
[70] *See id.*
[71] *See id.* at 450.
[72] *Id.* at 453.
[73] *Id.*

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avoided knowledge) of the breach and the corresponding benefit received. This holding clarifies an area of law that had previously been open to interpretation and should serve to alleviate the concerns of many in the securities industry that mere negligence on the part of the tippee could support a finding of criminal insider trading liability.

Keep in mind that *Newman* is a criminal case. Despite clarifying several key questions pertaining to the imposition of tippee criminal liability, the Court in *Newman* did leave open the question of whether its holdings extend to cases involving civil liability. Because it was a criminal case, the Second Circuit did not need to address these same issues within the context of a civil insider trading enforcement action by the Securities and Exchange Commission.

In fact, the Court's analysis appears to suggest that its holdings are limited to the criminal context. For example, the Court's conclusions with respect to the required showing of knowledge on the part of the tippee are set against the backdrop of its discussion of "*mens rea*," a distinct concept of criminal law.[74] At no point does the Court preclude the application of its rationale in *Newman* to the civil context, but it has left the door open for the government to argue that the high legal and evidentiary bars set in *Newman* do not pertain to the civil context. In short, the Securities and Exchange Commission and other law enforcement agencies could conceivably argue that *Newman* is limited to the criminal context and that more lenient standards should be applied in civil enforcement actions. As noted in the discussion of the *Obus* case*, supra* at pp. 16-18, the SEC need only prove that a tippee knew or *should have known* that the tipper breached his fiduciary duty and received a personal benefit.

In sum, the Second Circuit has now held that the Government must show the following in order to establish criminal tippee liability for insider trading:

i. the corporate insider was entrusted with a fiduciary duty;
ii. the corporate insider breached this duty by disclosing confidential information to a tippee in exchange for a personal benefit;
iii. the tippee knew that the tipper engaged in a breach of fiduciary and that the tippee received a personal benefit for disclosing the information, and that the informatoin was confidential; and
iv. the tippee used that information to trade in a security or tipped another individual for his or her own personal benefit.[75] (This element will be discussed further in the section below, entitled "The Personal Benefit Requirement."

The government filed a petition with the Second Circuit for rehearing and rehearing *en banc*, but its petition was denied on April 3, 2015. The government also petitioned for certiorari to the U.S. Supreme Court and the petition was denied on October 5, 2015.[76]

3. The *Whitman* Case

U.S. v Whitman[77] is another case in which the court clarified the level of knowledge required to establish liability for insider trading. Doug Whitman, a trader at a hedge fund, was charged with criminally violating Section 10(b) and Rule 10b-5 for allegedly trading on inside information he received from tippees who had, in turn, obtained information from inside employees at three publicly-held companies. Mr. Whitman was convicted. After the trial, the judge who presided in the case issued an opinion discussing the following three legal issues which he ruled upon in the course of issuing his instructions to the jury:

i. Whether in a criminal prosecution under the federal securities laws, the scope of an employee's duty to keep material

[74] *See id.* at 447.

[75] *Id.* at 450.
[76] *United States v. Newman*, 136 S.Ct. 242 (2015).
[77] 904 F.Supp.2d 363 (S.D.N.Y. 2012).

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non-public information confidential is defined by state or federal law?

ii. Whether a person who receives such information from someone outside the company must, to be criminally liable for trading on such information, 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 exchange for some personal benefit?

iii. Whether even a secondary tippee like Mr. Whitman must, in order to be criminally liable, have a specific intent to defraud the company from which the information emanates of the confidentiality of that information?[78]

Citing *Dirks v. SEC*, the court stated that "a tippee assumes a fiduciary duty to shareholders of a public company not to trade on material nonpublic information if (a) 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 (b) the tippee knows or should have known of the breach." *Id.* at 366.

Press reports about the trial stated that Mr. Whitman testified that he never thought his sources of information possessed secret information about the stocks that he traded. (http://dealbook.nytimes.com/2012/08/20/hedge-fund-manager-whitman-is-found-guilty/.)

According to the complaint filed by the SEC in a related civil case, the defendant's primary source was Roomy Khan, described as an individual investor who was a friend and neighbor of the defendant. The SEC alleged that Khan's sources were an employee of one of the companies about which the alleged inside information pertained and an employee of a public relations firm which provided services to one of the other companies.

The defendant argued that under the law of California the fiduciary duty of confidentiality only applies to upper level employees and that the original tippers in this case did not fall within that category. While the government disputed Mr. Whitman's interpretation of California law, it also argued that federal law and not state law controlled whether or not a duty of confidentiality is imposed, and the court ultimately agreed with the government's position and so instructed the jury.

Discussing the level of knowledge required by a tippee, the judge (in a decision issued prior to the Second Circuit's decision in *Newman*) posed the issue as follows: "what did a secondary tippee, like Mr. Whitman, who obtained his information from the direct tippees, have to know about the tipper's breach of duty to be criminally liable? The Government argued that it needed only to show that the defendant knew (or recklessly disregarded) that the information was conveyed as a result of an unauthorized disclosure by some inside tipper but not that he also knew of any benefit provided to the tipper…" *Id.* at 370.

The court held that, since an element of the violation of "classic" insider trading includes showing that the tipper anticipated something in return for the unauthorized disclosure, "the tippee must have knowledge that such self-dealing occurred, for, without such a knowledge requirement, the tippee does not know if there has been a 'improper' disclosure of inside information." *Id.* at 371. "On the other hand," the court stated, "there is no reason to require that the tippee know the details of the benefit provided; it is sufficient if he understands that some benefit, however modest, is being provided in return for the information." *Id.* Thus, the court instructed the jury that in order to convict Mr. Whitman, it must find that he traded in the securities of a particular company

> on the basis of material nonpublic information about the company, knowing that the information had been obtained from an insider for the company who had provided the information in violation of that insider's duty of trust and

[78] 904 F.Supp.2d at 365.

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> confidence and in exchange for, or in anticipation of a personal benefit.
>
> * * *
>
> As to the defendant's knowledge that the insider has breached the insider's duty of trust and confidentiality in return for some actual or anticipated benefit, it is not necessary that Mr. Whitman know the specific confidentiality rules of a given company or the specific benefit given or anticipated by the insider in return for disclosure of inside information; rather, it is sufficient that the defendant had a general understanding that the insider was improperly disclosing inside information for personal benefit. *Id.* at 371.

The court recognized that "one can imagine cases where a remote tippee's knowledge that the tipper was receiving some sort of benefit might be difficult to prove." *Id.* at 372. (While this might give some comfort to a research analyst or trader who hears a "tip," it also presents the significant risk that the government would attempt to prove, based upon the facts and circumstances, that the recipient had a "general understanding" that the information was initially revealed through a breach of duty by a person who received some kind of benefit.) On appeal from the conviction in *Whitman*, the Second Circuit held that these instructions were not erroneous and affirmed the conviction.[79]

The court then discussed whether the government is required to prove specific intent to defraud and not just that the defendant intended to commit the act which was fraudulent. The court concluded that Rule 10b-5 is a "specific intent" statute for the purposes of criminal liability, and then addressed the question of "what 'specific intent to defraud' means in the context of [an insider trading] case." *Whitman*, 904 F.Supp.2d at 374. The court held that "the heart of the fraud is the breach of the duty of confidentiality owed to both the company and its shareholders, and accordingly the specific intent to defraud must mean, in this context, an intent to deprive the company and its shareholders of the confidentiality of its material nonpublic information." *Id.* at 375. (It is important to note that a criminal violation of Rule 10b-5 requires "willfulness" which is what caused the court to deem the statute to be a "specific intent offense." Consequently, the specific intent requirement would not apply to a claim filed by the Securities and Exchange Commission.)

The court concluded by summarizing his holdings as follows:

i. The scope of an employee's duty to keep material non-public information confidential is defined by federal common law, which imposes a uniform duty on all insiders to maintain the confidentiality of material nonpublic information entrusted to them as part of a relationship of trust and confidence and not to exploit it for personal benefit.
ii. To be held criminally liable, a tippee like Mr. Whitman must have a general understanding that the inside information was obtained from an insider who breached a duty of confidentiality in exchange for some personal benefit, although the tippee need not know the details of the breach or the specific benefit the insider received or anticipated receiving.
iii. To be held criminally liable in a Dirks-like case, a tippee like Mr. Whitman must have a specific intent to defraud the company to which the information relates (and, indirectly, its shareholders) of the confidentiality of that information. *Whitman*, 904 F.Supp.2d at 374.

Based upon the foregoing decisions, in a civil action brought by the SEC, the SEC need only prove that the tippee *should have known* that the information he received was tipped in breach of a fiduciary duty and that the tipper received some kind of personal benefit, whereas in a criminal case, the government must prove that the tippee *knew* that the information was tipped in breach of a fiduciary duty and that the tipper

[79] *U.S. v. Whitman*, 555 Fed.Appx. 98 (2d Cir. 2014).

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received some form of personal benefit, but the tippee's knowledge of the breach need only be a "general understanding" that a breach had occurred (rather than an understanding of the specific nature of the breach), and the government is not required to prove that the tippee knew the specific nature of the personal benefit received by the tipper.

The Personal Benefit Requirement

On December 6, 2016, the U.S. Supreme Court issued a unanimous decision, in the case of U.S. v. Salman,[80] in which it clarified a key element which the government must prove to establish a charge of insider trading. The Court held that the "personal benefit," which a tipper must receive from the tippee in order to establish liability, may be in the form of a gift to a trading relative or friend.

The case Salman case involved the transfer of confidential information from one brother (the tipper) to another brother (the tippee) which was then passed on to a third person, the defendant Salman, who traded on the information. The tipper-brother did not receive anything of pecuniary value from his tippee-brother; rather, the tipper testified that he tipped the information to his brother because he loved his brother and wanted to "benefit him" and "fulfill [] whatever need he had." The Supreme Court held that, due to the close personal relationship between the tipper and the tippee, the desire of the tipper to make a gift to the tippee was a sufficient "benefit," and it was not necessary for the benefit to have some pecuniary value to the tipper. Relying on an earlier Supreme Court decision, *Dirks v. SEC,*[81] the Court ruled that "when an insider makes a gift of confidential information to a trading relative or friend . . . [t]he tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient." The Court further held that, in such situations, it is not necessary for the government to show that the tipper received something of a "pecuniary or similarly valuable nature."

The defendant in the *Salman* case argued that, in order to satisfy the "personal benefit" requirement, the government was required to prove that the original tipper received "'a pecuniary or similarly valuable nature' in exchange – [and] that [the defendant] knew of such benefit," citing language from the Second Circuit's decision in the *Newman* case in which the court stated that, in exchange for the information being conveyed by the tipper, the tipper must receive "at least a potential gain of a pecuniary or similarly valuable nature . . . ."[82] This language suggested that the tipper's intention merely to make a "gift' of the information to the tippee would not be sufficient to satisfy the requirement that the tipper receive a personal benefit. The Supreme Court laid this question to rest in *Salman* and held that the tipper's intention to make a gift would be sufficient to satisfy the personal benefit requirement.

While the ruling in *Salman* eases somewhat the government's burden of proving insider trading cases, there are still some significant hurdles which the government must overcome in such cases. Apart from showing that the tipper received a benefit or intended to make a gift, the government also must prove that the tippee who traded on the inside information knew or had reason to know that the tipper received the benefit or intended to make a gift, and that the disclosure was made in breach of a duty. Those elements were not in dispute in *Salman* because the person who actually traded (*i.e.*, the tippee of the tippee-brother) was fully aware of the relationship between the two brothers. Also, the Supreme Court itself recognized in its decision that "in some factual circumstances assessing liability for gift-giving will be difficult." Indeed, a significant open question, in light of this decision, is: when does the relationship between the tipper and tippee rise to the level of a "friendship," which would render the tip a "gift" and thereby satisfy the "personal benefit" requirement?

[80] *U.S. v. Salman*, 137 S.Ct. 420 (2016)
[81] 463 U.S. 646 (1983).

[82] 773 F. 3d at 452.

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The *Salman* decision does not, therefore, remove the significant obstacles which the government faces when bringing cases against tippees who are far removed from the source of the original tip. But for the original tippers – and for tippees who are close to the source of the tip -- the government's burden was made somewhat easier as a result of the *Salman* decision.

Some Practical Observations

Whether you receive material, non-public information directly from the person committing the disclosure breach or whether you receive it three steps removed, you are always running the risk that the SEC or another litigant will contend that you knew or should have known that the information you received was obtained or disclosed through the breach of a fiduciary duty. As a practical matter, it is going to be very difficult to determine with any kind of certainty whether a party who disclosed material, non-public information "benefited" from such disclosure and thereby breached his or her duty. Consequently, you should always know the source of material, non-public information concerning an issuer before you trade while in possession of such information. If you have any reason to believe that the information which you received was improperly disclosed, you should not trade and you also should not disclose such information to any other party until it becomes public. This may impose a significant burden, as one commentator has pointed out:

> In an environment where rumors are rampant, any attempt to investigate the source seems impracticable, and would probably be fruitless. Is the only safe course, then, not to trade? For members of the public, this may be possible, but it is hardly a means of encouraging investment. And for investment professionals like arbitrageurs, analysts and stockbrokers…avoiding all trading and recommendations with respect to all stocks about which they hear some suspicious information is hardly feasible.[83]

While the burden of either abstaining from trading or investigating whether the source of the information is significant, the risks of not doing so are equally severe. If the recipient trades on the information, and there is a subsequent significant movement in the stock, a regulatory investigation will most likely ensue, and the cost, in terms of time and money, in responding to the investigation could be substantial, regardless of the innocence of the party who traded on the information. Because of the prospect of such expense, it may be warranted to refrain from trading when the recipient knows or has reason to know that the information which he or she has received is material and non-public, regardless of whether it is known whether or not the information has been disclosed improperly.

4. Field Research and Use of Outside Research Firms

Many hedge fund analysts obtain information about companies in which they are investing by going out into the field and gathering information from retail outlets of the companies they are investing in or speaking with the vendors or suppliers of such companies or other parties whose business may have an impact on the companies' business. With respect to contacting retail outlets of the companies, the issue is whether an analyst is obtaining inside information about the companies. For example, if the analyst's fund is investing in MacDonald's and the analyst walks into a MacDonald's franchise and asks the manager how sales are going, the analyst must realize that he is talking to a company employee who could be deemed an insider. It is probably permissible for the analyst to ask a store manager general questions about the business; but it is probably not permissible to ask the store manager to show him spreadsheets reflecting actual sales figures. In the first situation, the analyst is doing his job in researching the company in which his

[83] Langevoort, p. 4-30.

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fund is investing, and it is likely that the information he obtains is not in itself material but, rather, is "mosaic" information which he is entitled to gather and use; in the latter situation, there is a greater likelihood that the analyst is receiving material non-public information which the store manager should not be disclosing. It is also more likely that, in the latter situation, the store manager is breaching a duty of confidentiality in disclosing such information.

Another scenario is where the analyst approaches persons who are not employees of the company whose stock is being traded, for example, vendors or suppliers of the company his fund is investing in, or some other party which has a relationship with that company. Such persons are not insiders or temporary or quasi-insiders (such as the company's attorneys, accountants or investment bankers) because they do not owe a fiduciary duty to the company whose stock is the subject of the investment. Ordinarily, these outsiders are "fair game" and the information obtained from them may be used by the analyst to trade in the company's stock. There is, however, one significant caveat: if the outsider is breaching a fiduciary duty to his own employer by divulging the information to the analyst, the analyst may be prohibited from trading on the basis of such information. In such a case, the defrauded party is not the shareholder of the company whose stock the fund is purchasing or selling on the basis of such information; rather, based on the misappropriation theory discussed above, the defrauded party is the employer of the person who is divulging the information to the analyst, but the use of such information may still constitute a securities fraud because the information is being used in connection with the purchase or sale of securities. The key to whether or not a fraud has occurred in the "misappropriation" context is whether the employee is, in fact, violating a policy of the employer by divulging the information.

There have been several criminal prosecutions involving a hedge fund's use of outside research firms to provide information about public companies.[84] Such research firms typically pay individuals at various companies to provide information that may be useful to hedge funds in making investment decisions. The risk of using such research firms is that the people whom the research firms are paying to provide the information may be violating the disclosure policies of the companies where they work. If they are, the breach of the disclosure policies may constitute a fraud, and if that breach is made for the purpose of conveying information that is passed on to others who are using it to trade in securities, the practice may involve a violation of the securities laws. This may be a problem not only for the employees conveying the information and the research firm which is paying them for the information; it also may be a problem for the hedge funds which retain the research firms to obtain the information.

Keep in mind that the prohibition on using misappropriated information applies regardless of the level of the employee (*i.e.*, president, secretary, paralegal, janitor, etc.) who engages in a misappropriation.[85]

Even if the pieces of information that a research firm is gathering are not in themselves material, there may still be liability for using the information if it is disclosed in breach of a fiduciary duty. Materiality is an essential element to establish liability for trading on inside information because, when inside information is used, the defrauded party is the investor with whom the person in possession of the information trades, and that investor is only defrauded if the undisclosed information would have been material to his investment decision. But, under the misappropriation theory, the defrauded party is the person or entity from whom the information was misappropriated, and that party is defrauded regardless of whether the information that was misappropriated is material to an investment decision concerning the stock which is purchased on the basis of such information. Nevertheless, two Courts which

[84] Chad Bray and Jenny Strasburg, Suspect is Exception: She's Still Locked Up, *The Wall Street Journal*, March 30, 2011 at 1.
[85] Langevoort, p. 6-18 – 6-18.1.

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have addressed the issue of materiality in the context of misappropriated information have held that the standard for materiality is whether the information would affect the market price of the stock.[86]

One other item to keep in mind about field research is that the person seeking the information should not use fraud or deception to obtain it.[87] One form of fraud, discussed above, is where an employee breaches a duty of loyalty to his employer by disclosing information that his employer does not want disclosed. Another potential fraudulent practice would arise if the person seeking to obtain the information from an employee uses deceptive means to obtaining it, such as misrepresenting one's identity or the purpose for which the information is being sought in order to induce the person into disclosing the information. An analyst need not disclose his affiliation or his purposes when he seeks information, but he should not make affirmative false representations about his affiliation or purpose.

D. *Investor-Affiliates of Companies in Which Funds Are Invested*

Hedge Funds should avoid having investors in the funds who are affiliated with the companies they are investing in. While such investors are usually passive and not involved in investment decisions, there is a greater risk of being the subject of an insider trading regulatory investigation if a fund has traded in stock shortly before a significant movement in the price of the stock and one or more of the investors in the fund is affiliated with the company. At a minimum, the fund will have the burden of convincing the regulator that the investor-affiliate did not convey material non-public information to the fund manager.

E. *"Possession" verses "Use" of Information*

You should also be aware that the SEC takes the position that a party who is in *possession* of improperly obtained material, non-public information concerning an issuer may not trade in the issuer's securities regardless of whether the trade was *based upon* the information. In Rule 10b5-1 promulgated by the SEC under Section 10(b) of the Exchange Act, the states that insider trading liability requires that the person trade "on the basis of" improperly obtained material nonpublic information. However, the Rule defines "on the basis of" as "aware[ness] of the material nonpublic information when the person made the purchase or sale.".[88] Thus, according to the SEC, mere possession of the information while trading is sufficient to establish liability. The SEC Rule permits a person to establish an affirmative defense to the element of trading "on the basis of" the information if the person demonstrate that, before making the purchase or sale, the person: "i. Entered into a binding contract to purchase or sell the security, ii. instructed another person to purchase or sell the security for the instructing person's account; or iii. adopted a written plan for trading securities."[89] The Courts which have addressed this issue, however, have taken a different view from the SEC, as reflected in the excerpt below from the Second Circuit's Summary Order in the *Whitman* case:

> [T]he district court instructed the jury that inside information must be "at least a factor" in Whitman's trading decision. Whitman does not dispute that under the law of this Circuit, he was entitled to no more favorable instruction, but argues that we should adopt the law of the Ninth Circuit, which dictates that a defendant is only liable if inside information was a "significant factor" in an investment choice. United States v. Smith, 155 F.3d 1051, 1066 (9th Cir. 1998). As Whitman acknowledges, his proposed change in circuit law could be adopted only by the Court sitting en

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[86] *United States v. Mylett*, 97 F.3d 663, 667 (2d Cir. 1996); *United States v. Libera,* 989 F.2d 596, 600 (2d Cir. 1993).
[87] Langevoort, pp. 6-40 – 6-41.
[88] Rule 10b5-1(b), 17 C.F.R. §240.10b5-1(b).
[89] Rule 10b5-1(c)(A), 17 C.F.R. §240.10b5-1(c)(A).

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banc. Absent such review, we are bound by controlling circuit precedent just as the district court was. We therefore find no error in the instruction.[90]

F. *Special Rule Governing Information About Tender Offers*

There is a special, stricter insider trading rule[91] which pertains to non-public information about impending tender offers. In order for a person in possession of non-public information concerning an impending tender offer to be held liable for trading on the basis of such information, it is not necessary to demonstrate that the recipient knew or had reason to know that the information was transmitted in breach of a duty. Rather, it need only be established that the recipient knew or had reason to know that the information he received was non-public and was acquired, directly or indirectly, from the company which is the subject of the proposed tender offer or from the company planning to make the tender offer.

G. *Penalties*

Penalties for communicating or trading on the basis of Inside Information are severe. Violators may be subject to criminal penalties[92] as well as civil penalties (*i.e.*, the person who committed the violation, can be sued for up to three times the profit gained or loss avoided as a result of such unlawful purchase, sale or communication; while the person or entity that directly or indirectly *controlled* the person who committed the violation[93] can be sued for the greater of $1,000,000 or three times the amount of the profit gained or loss avoided as a result of such controlling person's liability)[94]. Moreover, there may be other penalties that flow from being found guilty from insider trading in the event the violator is also a member of a self-regulatory organization, such as the Financial Industry Regulatory Authority or the National Futures Association.

CONCLUSION

Trading on the basis of Inside Information can have significant consequences. Unfortunately, it is not always clear what constitutes Inside Information. While the SEC has provided some guidance and has clarified certain aspects concerning insider trading, it has not developed bright line tests which apply to each circumstance. As such, if there is any doubt as to the appropriateness of trading on any given information, it must be reviewed carefully and a determination should be made on a case-by-case basis.

For more information on the topic discussed, contact **Ralph A. Siciliano** at **siciliano@thsh.com**.

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[90] Summary Order in *Whitman*, p. 15.
[91] Rule 14e-3(a), 17C.F.R.§240. 14e-3(a).
[92] Section 32 of the Securities Exchange Act of 1934, as amended, 15 U.S.C. §78ff.
[93] The SEC must establish the controlling person knew or recklessly disregarded the fact that a controlled person was likely to engage in the act constituting the violation and failed to take appropriate steps to prevent such act.
[94] Sections 21A(a)(2) and (3) of the Securities Exchange Act of 1934, as amended, 15 U.S.C. §§78u-1(a)(2) and (a)(3).

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