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WHITE COLLAR CRIME

Who's the 'Insider' in Insider Trading?



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In the classic insider trading case, it's generally easy to spot the insider. A corporate executive who tips a friend about his company's pending but secret transaction is, if either trades in the company's stock before the information is made public, liable to find himself in the crosshairs of a Justice Department or Securities and Exchange Commission investigation.

But under the misappropriation theory of insider trading, the identity of the ''insider'' may not be quite so clear. Where an individual tips or trades on information learned from someone—anyone—as part of a relationship of trust and confidence, she may find herself in those same government crosshairs. Given the push by enforcement authorities to expand the web of those who may be subject to these relationships, the number of insider trading cases brought under the misappropriation theory can be expected to grow.

But just as this theory expands the universe of potential defendants, as *United States v. Gansman*[1] recently showed, the very same relationship of trust and confidence on which the theory is based may be turned by an alleged tipper into an insider trading defense.

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Theories of Insider Trading

What makes insider trading fraudulent is not the disparity in information between the parties to a trade. That a buyer knows something that the seller doesn't know does not make for securities fraud.[2] The fraud occurs when the purchase or sale is deceptive, that is, at least in the insider trading context, when it results from the breach of a duty.[3]

Whether a duty exists, and whether that duty was breached, depend on the nature of the relationship between the person getting the information and the person giving it. Prosecutors rely upon two theories to es-

[1] 657 F.3d 85 (2d Cir. 2011), 2011 U.S. App. LEXIS 18664.
[2] See *United States v. O'Hagan*, 521 U.S. 642, 662 (1997); *Chiarella v. United States*, 445 U.S. 222, 233 (1980).
[3] Id.; *Dirks v. SEC*, 463 U.S. 646, 654 (1983).

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tablish this breach of duty: the classical theory and the misappropriation theory.

The Classical Theory

The classical theory recognizes two types of relationships giving rise to insider status.

One is the ''permanent'' insider, who is an employee of the issuer whose stock is traded. That definition arguably includes everyone from an office clerk to an officer to the chairman of the board who gains the information by dint of their position with the issuer.[4]

The other is a ''temporary'' insider, who is an agent, such as a lawyer, an accountant, or a publicist, who is given access to sensitive information through a confidential relationship with the issuer. The law imposes on both types of classical insiders a fiduciary duty of trust and confidence to the issuer's shareholders.[5]

In transactions involving the issuer's stock, this duty includes the requirement to abstain from trading or to disclose the information to ''prevent[ ] a corporate insider from taking unfair advantage of . . . uninformed stockholders.''[6]

As for a classical theory tippee, his liability is derivative of the tipper's.[7] The tippee assumes the tipper's duty of trust and confidence when the tippee knows—or should know—that the insider, whether permanent or temporary, has breached her duty in sharing this information.[8]

What Is a Breach? A breach of this duty requires more than the insider sharing information with a third-party tippee and an ensuing trade. The insider-tipper must both intend to benefit from the disclosure and know that the tippee will trade on the information.[9]

In practice, the benefit prong is a low hurdle for the government to clear. The benefit need be neither actual nor even promised. Because the focus is on the tipper's purpose, even if unexpressed, it likely is enough if the tipper is merely hopeful of a benefit.[10] And the benefit need not be something as direct or tangible as cash or reciprocal information. The warm and fuzzy feeling of giving a friend a gift of the information may be benefit enough.[11]

As alleged in the recent indictment filed against Rajat Gupta, even a vague, unspoken hope that the tip may lead to future business may be enough.[12]

The Misappropriation Theory

The misappropriation theory likewise requires a breach of duty, but it is not one owed to the issuer's shareholders. Instead, the duty runs to the source of the information, however unrelated to the issuer.[13]

''Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information.''[14] In recognition of the source of this duty, at least some courts require proof of some injury, actual or potential, to the source of the information.[15]

Relationships Are Varied. The types of relationships covered by the misappropriation theory are varied and broad. Some involve traditional common law fiduciary relationships.[16] Others amount to the ''functional equivalent'' of a fiduciary relationship.[17]

More recently, courts have begun to accept the notion that such relationships can be imposed by agreement.[18]

What all of these relationships have in common are the twin duties of confidentiality and trust/loyalty.[19] The duty of confidentiality precludes the recipient of the information from disclosing it to others, and the duty of trust or loyalty precludes him from trading on it.[20]

Advantage for Prosecutors? The underdeveloped misappropriation theory may make it easier for the government to pursue alleged insider traders. While some

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[4] See, e.g., *SEC v. Falbo*, 14 F. Supp. 2d 508 (S.D.N.Y. 1998) (extending liability to an electrician granted access to the company's executive offices).

[5] *O'Hagan*, 521 U.S. at 652.

[6] *Chiarella*, 445 U.S. at 228.

[7] *Dirks*, 463 U.S. at 659.

[8] Id. at 660.

[9] Id. at 659 (''Whether disclosure is a breach of duty therefore depends in large part on the purpose of the disclosure . . . . [T]he test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders.''); see also *Gansman* (conscious avoidance sufficient to establish knowledge that tippee would trade).

[10] Id. at 659.

[11] See *SEC v. Warde*, 151 F.3d 42, 48 (2d Cir. 1998); see also, e.g., *SEC v. Yun*, 327 F.3d 1263 (11th Cir. 2003) (tipper intended to maintain good relationship with tippee); *State Teachers Retirement Board. v. Fluor Corp.*, 576 F. Supp. 1116, 1121 (S.D.N.Y. 1983) (jury could infer a reputational benefit that employee-tipper might obtain from sharing information with analyst).

[12] *United States v. Gupta*, No. 1:11-cr-00907, indictment at 11 (S.D.N.Y. Sept. 25, 2011) (''Gupta benefitted and hoped to benefit from his friendship and business relationships with Rajaratnam in various ways, some of which were financial.'').

[13] See, e.g., *Carpenter v. United States*, 484 U.S. 19 (1987) (newspaper reporter who reported on stocks owed duty to newspaper).

[14] *O'Hagan*, 521 U.S. at 652.

[15] See, e.g., *United States v. Newman*, 664 F.2d 12, 18 (2d Cir. 1981) (trading drove up price of shares of company, making it a less attractive target); *United States v. Willis*, 737 F. Supp. 269, 274 (S.D.N.Y. 1990) (psychiatrist ''jeopardized the psychiatrist-patient relationship and put at risk the patient's financial investment in psychiatric treatment'').

[16] See, e.g., *O'Hagan* (attorney-client); *United States v. Falcone*, 257 F.3d 226 (2d Cir. 2001) (employer-employee); *Willis* (psychiatrist-patient).

[17] See, e.g., *United States v. Chestman*, 947 F.2d 551, 569 (2d Cir. 1991) (en banc) (family relationships).

[18] See, e.g., *SEC v. Cuban*, 620 F.3d 551 (5th Cir. 2010); *United States v. Corbin*, 729 F. Supp. 2d 607, 614 (S.D.N.Y. 2010); *SEC v. Nothern*, 598 F. Supp. 2d 167 (D. Mass. 2009).

[19] See *Cuban*, 634 F. Supp. at 723 (N.D. Tex. 2009), reversed on other grounds, 620 F.3d 551 (5th Cir. 2010) (''the essence of the misappropriation theory is the . . . breach of a duty owed to the source to keep the information confidential and not to use it for personal benefit'') (citing *O'Hagan*, 521 U.S. at 652); but see *United States v. Kim*, 184 F. Supp. 2d 1006, 1011 (N.D. Cal. 2002) (imposing additional requirement that recipient of information be in position of superiority, dominance, or control).

[20] *Cuban*, 634 F. Supp. 2d at 725; see also *Dirks*, 463 U.S. at 659-60.

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courts hold prosecutors to prove the same elements that are required under the classical theory, others have not required the government to demonstrate that the tipper intended to benefit the tippee and knew that she would trade.[21]

For these latter courts, a knowing breach of the duty is enough: ''It may be presumed that the tippee's interest in the information is, in contemporary jargon, not for nothing.''[22] No court has offered a clear explanation as to why the government's burden should be any easier under the misappropriation theory.[23]

Rule 10b5-2

In 2000, the SEC promulgated Rule 10b5-2 to adopt a ''broader approach . . . for determining when family or personal relationships create 'duties of trust or confidence' under the misappropriation theory.''[24]

Under the rule, a duty of trust or confidence exists whenever:

- a person agrees to maintain information in confidence;
- the parties have a ''history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the . . . information expects that the recipient will maintain its confidentiality''; or
- a person obtains information from a spouse, parent, child, or sibling, although the defendant may rebut the presumption. [25]

With respect to the second prong, the rule does not limit the duty by the nature of the information historically shared, although the SEC has observed that ''evidence about the type of confidences shared in the past might be relevant to determining the reasonableness of the expectation of confidence.''[26]

The commission also believed that the third prong's bright-line rule would ''mitigate, to some degree, the need to examine the details of particular relationships in the course of investigating suspected insider trading.''[27]

Limited Jurisprudence. Rule 10b5-2 jurisprudence has yet to attain critical mass, and the breadth of its impact, particularly in criminal cases, remains to be seen. One district court faulted the rule's first prong for seeking to impose liability on a ''mere confidentiality'' agreement rather than requiring also a promise of non-use. Because both aspects were necessary to prove a breach, the court determined that this aspect of the rule ''would exceed the SEC's § 10(b) authority to proscribe conduct that is deceptive.''[28]

The third prong survived a challenge that the rule ''improperly shift[ed] the burden of proof to a criminal defendant to disprove the duty element of a misappropriation in certain familial situations.''[29] The court rejected the argument, reasoning that, because the defendant had available an affirmative defense to show that no such duty existed, the presumption did not shift the government's burden.[30]

Duty of Trust and Confidence As a Defense

Given ''the paucity of jurisprudence on the question of what constitutes a relationship of 'trust and confidence' and the inherently fact-bound nature of determining whether such a duty exists,''[31] the government can be expected to try to apply the misappropriation theory broadly.

Some prosecutors have even utilized the misappropriation theory's generic ''duty of trust and confidence'' in prototypically classical contexts. In *United States v. Reed*,[32] a board director told his son about a potential merger of the father's company, and the son traded on that information. Because there was insufficient evidence that the father had breached his duty of loyalty by intending that his son trade on the information, the government reverted to the misappropriation theory, alleging that the two men had a relationship of trust and confidence that the son breached when he traded: ''The relationship between Reed and his father was particularly close; the two men frequently discussed business affairs with the expectation that Reed would keep his father's confidences.''[33] The allegation that the son had breached his duty to the father was enough to get the case to the jury.

Adds Impediment. The misappropriation theory expands which ''insiders'' the government can reach, but in doing so it creates an additional evidentiary hurdle for prosecutors. While the classical theory is premised upon a fiduciary duty that is established as a matter of law, the misappropriation theory requires more extensive proof.

In *Chestman*, a pre-Rule 10b5-2 case, Chestman, a broker, traded on information received from his client about an impending tender offer for the client's wife's family business. The client had received the information from his wife along with instructions not to tell anyone. The government alleged that the husband misappropriated this information in breach of a fiduciary

[21] Compare, e.g., *SEC v. Yun,* 327 F.3d 1263 (11th Cir. 2003) (applying classical theory requirements) with *United States v. Evans,* 486 F.3d 315, 323-24 (7th Cir. 2007), and *Falcone*, 257 F.3d at 231-32 (2d Cir. 2001).

[22] *Falcone*, 257 F.3d at 231 (quoting *United States v. Libera,* 989 F.2d 596, 600 (2d Cir. 1993)); see also *United States v. McDermott,* 245 F.3d 133, 138 (2d Cir. 2001).

[23] See Donald C. Langevoort, *Insider Trading Regulation, Enforcement, and Prevention* (2011), § 6:13.

[24] Selective Disclosure and Insider Trading, release nos. 33-7881, 34-43154, IC-24599, 17 C.F.R. Parts 230, 240, 243, and 249, 2000 SEC LEXIS 1672 at *91, Part III.B.1 (Aug. 15, 2000).

[25] 17 C.F.R. 240.10b5-2(b).

[26] 2000 SEC LEXIS 1672 at *96.

[27] Id. at *93.

[28] *Cuban*, 634 F. Supp. 2d at 730-31. (The Fifth Circuit declined to address this point on appeal. *Cuban*, 620 F.3d at 558.) Cf. *Corbin*, 729 F. Supp. 2d at 615 (applying first prong of the rule).

[29] Id. at 619.

[30] Id. at 619; but see *SEC v. Lipson*, 278 F.3d 656, 661 (7th Cir. 2002) (noting that presumption may not be available in criminal case) (citing *United States v. Smith*, 155 F.3d 1051, 1069 (9th Cir. 1998)).

[31] *Cuban*, 620 F.3d at 557.

[32] 601 F. Supp. 685 (S.D.N.Y. 1985), reversed on other grounds, 773 F.2d 477 (2d Cir. 1985).

[33] Id. at 690.

duty owed to his wife and her family, and Chestman was convicted as a tippee. But the Second Circuit, overturning the conviction, determined that the government had not established the required duty: ''Kinship alone does not create the necessary relationship.''[34]

Unlike the father-son relationship in *Reed*, the government did not present evidence that the husband and wife had a history of sharing business information with the expectation that the husband would keep it confidential.[35] Although the jury was presented with ''unremarkable testimony that [husband] and [wife] shared and maintained generic confidences,'' the court said, ''the jury was not told the nature of these past disclosures and therefore it could not reasonably find a relationship that inspired fiduciary, rather than normal marital, obligations.''[36]

Life Line. As *Gansman* recently showed, the breadth of the misappropriation theory may also present the defendant with a line of defense. As an attorney at an accounting firm, Gansman regularly received advance information about his firm's clients' transactions. Gansman shared this information with his paramour, Donna Murdoch, who used it to trade. At the close of his trial, Gansman requested a theory-of-the-case jury instruction stating that his position was that any information he had shared had been exchanged in a relationship of trust and confidence and that he had not expected Murdoch to trade.[37]

The trial court denied Gansman's request, instead giving an abbreviated instruction that ''according to [Gansman], any material non[-]public information that Murdoch may have received from him was shared with her as part of a relationship in which they shared work and personal confidences.''[38]

In affirming the conviction, the Second Circuit held that the district court's instruction was sufficient and further noted that there was ample evidence that Gansman knew or should have known that Murdoch was trading on the information he gave her. Nonetheless, the court also stated that it would not have been error to give Gansman's proposed instruction. Noting that the SEC has recognized situations under the misappropriation theory where a tippee but not the tipper may be held liable, the court observed that Gansman ''could have been properly acquitted of the crime with which he was charged if the trier of fact had agreed with his theory.''[39]

Although Gansman was prosecuted under the misappropriation theory, there is no reason why a duty of confidence and trust between tipper and tippee could not also provide a defense to a tipper charged under the classical theory.

Expansion of Relationships. At first glance, *Gansman* is not particularly remarkable. After all, the defendant was simply attempting to counter the government's contention that he knew the tippee would trade on the information he shared with her. And even if Gansman had proven his version of their historical relationship, it would not preclude the jury finding that he had shared this particular information so that Murdoch could trade on it. Indeed, the court noted, ''Evidence of a history of confidentiality between parties can be outweighed by other evidence that a tipper understood the specific information in question would be used by the tippee for securities trading purposes.''[40]

Nevertheless, the decision demonstrates that the expansion of relationships giving rise to insider trading liability may also expand defense opportunities. The further the government pushes the concept of ''duty'' to capture downstream traders under the misappropriation theory as in *Reed*, the more opportunity it creates for other defendants like Gansman to use that broad framework to establish that duty as a defense. Indeed, had Murdoch been Gansman's wife rather than his girlfriend, it would have raised a further question whether he would have been entitled to a Rule 10b5-2 instruction requiring the jury to presume the existence of a relationship of trust and confidence between the two.

In any event, the existence of such a duty would have turned Murdoch's trading from a derivative breach of Gansman's duty to the accounting firm into a breach of her duty to Gansman—thus converting Gansman from a tipper defendant into an unwitting victim.

This defense may be particularly apt in those cases where the fact of the tip is not readily disputable. As discussed above, the government must prove the tipper breached the duty of both confidentiality and loyalty. Gansman conceded that he breached the first by sharing the information with Murdoch,[41] but he was still able to argue, albeit unsuccessfully, that his confidential relationship with her precluded a breach of the second.

The hard part likely will be in proving that a relationship of trust and confidence existed between tipper and tippee. Employment agreements and manuals, training materials, blackout periods, no-trading policies, nondisclosure agreements, e-mails from the general counsel's office, and similar evidence are the stock-in-trade of prosecutors seeking to prove a duty of confidentiality and loyalty between an individual and his employer or client.[42]

Ironically, it is in the classical cases—where that relationship is presumed as a matter of law—where this type of documentary proof may be easiest to find. This evidence is generally not available for a party—whether a defendant (*Gansman*) or the government (*Chestman*)—trying to establish that same relationship between friends or family. As is often the case, the proof may well come down to the testimony of the tipper-defendant against that of the tippee-cooperator.[43]

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[34] *Chestman*, 947 F.2d at 570.
[35] Id. at 570–71.
[36] Id.
[37] *Gansman*, at *5-6.
[38] Id. at *11.
[39] Id. at *15.
[40] Id. at *16 n.9.
[41] Id. at *8.
[42] See, e.g., *SEC v. Materia*, 745 F.2d 197, 199 n.1 (2d Cir. 1984) (warnings posted that information was confidential and copies of policy distributed to all employees); *SEC v. Kornman*, 391 F. Supp. 2d 477, 480 (N.D. Tex. 2005) (confidentiality provision required in memorandum after each client meeting and all employees required to sign a strict policy prohibiting disclosure or use of confidential information).
[43] See *Gansman* at *8 n.6 (Murdoch agreed to cooperate against Gansman).

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Conclusion

In all likelihood, the misappropriation theory will continue to be used primarily by criminal prosecutors and civil regulators to expand the reach of insider trading prosecutions. Nevertheless, that tool remains a double-edged sword that could provide an opportunistic defendant with a defense under the right circumstances.