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'SEC v. Obus': Second Circuit Clarifies Standards for Insider Trading

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The line separating legitimate research from improper inside information can at times be hard to find. The U.S. Court of Appeals for the Second Circuit recently issued an important insider trading decision, *SEC v. Obus*, which provides some clarity.[1] In doing so, however, the court seemingly expanded the scope of potential liability for tippees who might lack actual knowledge that information was disclosed improperly or that the inside source provided information in exchange for personal benefit, even though proof of personal benefit is required to pursue the insider.

Background

The SEC brought insider trading charges against Thomas Strickland, an employee of GE Capital, and two employees of Wynnefield Capital, Peter Black and Nelson Obus. The SEC alleged that Strickland "tipped" his college friend Black about the possible acquisition of SunSource Inc. by Allied Capital Corporation which GE Capital was financing. Black in turn passed this information to Obus, who allegedly traded SunSource stock based on it.

The SEC alleged that all three defendants were liable under both the "classical" and "misappropriation" theories of insider trading. Under the classical theory, the SEC alleged that Strickland owed a fiduciary duty to SunSource as a "temporary insider" not to disclose confidential information about the acquisition. Under the misappropriation theory, the SEC claimed that Strickland breached a duty he owed his employer, GE Capital, to keep information about SunSource's acquisition confidential.

The U.S. District Court for the Southern District of New York granted summary judgment for the defendants. The court found that the classical theory failed because the SEC could not prove that GE Capital or Strickland owed a fiduciary duty to SunSource at the time the information was passed. Similarly, the misappropriation theory failed because although Strickland owed a fiduciary duty to his employer, GE Capital, the SEC had failed to establish facts sufficient to prove that Strickland breached that duty where, after an internal investigation, GE Capital did not consider itself to be a victim of the breach.

The SEC appealed only with respect to the misappropriation theory. The Second Circuit found that the SEC's evidence created genuine issues of material fact as to each defendant's liability, and therefore summary judgment was erroneous. In doing so, the court (1) clarified the elements of tipper-tippee liability; (2) adopted a relaxed view of the scienter requirement for both tippers and tippees; (3) found that the SEC must prove the tipper received a "personal benefit" in both misappropriation and classical theories of insider trading, but warned this is not a difficult element for the SEC to prove; and (4) left open the question of whether the tippee can be held liable without having knowledge that the inside source received a personal benefit.

Tipper-Tippee Liability

The lack of clarity in insider trading law arises because insider trading is not expressly forbidden by specific federal statute; rather, it has developed through judicial interpretations of Section 10(b)'s prohibition on "deceptive" conduct and securities fraud prohibited under Rule 10b-5. Courts have found that under certain circumstances, the purchase or sale of securities based on inside information disclosed in violation of a fiduciary duty may constitute insider trading under two theories, referred to as the classical and misappropriation theories.

> The court in 'Obus' seemingly expanded the scope of potential liability for tippees who might lack actual knowledge that information was disclosed improperly.

Under the classical theory, a corporate insider is prohibited from trading shares of that corporation based on material non-

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public information in violation of a fiduciary duty owed to shareholders. Under the misappropriation theory, an "outsider" can be held liable for misappropriating confidential information in breach of a duty of confidence owed to the source of the information. Both theories also extend to situations where the insider or misappropriator does not trade on the information, but reveals it to another person who trades. This is known as "tipper-tippee" liability.

In *Obus*, the Second Circuit clarified the elements of insider trading in a tipper-tippee scenario, and in doing so, made clear that tippee liability is derivative of tipper liability. In other words, a tippee cannot be liable for insider trading if the tipper's disclosure was not wrongful. The court held that under both classical and misappropriation theories, tipper-tippee liability requires the SEC prove that:

> (1) the tipper had a duty to keep material non-public information confidential; (2) the tipper breached that duty by intentionally or recklessly relaying the information to a tippee who could use the information in connection with securities trading; and (3) the tipper received a personal benefit from the tip.

Tippee liability requires that:

> (1) the tipper breached a duty by tipping confidential information; (2) the tippee knew or had reason to know that the tippee improperly obtained the information (i.e., that the information was obtained through the tipper's breach); and (3) the tippee, while in knowing possession of the material non-public information, used the information by trading or by tipping for his own benefit.

Tipper and Tippee Knowledge

The decision also brought clarity to the requisite "scienter" that the tipper and tippee must have to be found liable for insider trading. The Second Circuit held that "in every insider trading case, at the moment of tipping or trading, just as in securities fraud cases across the board, the unlawful actor must know or be reckless in not knowing that the conduct was deceptive." In the case of a tipper, he must (1) tip deliberately or recklessly (though not through negligence); (2) know that the information is nonpublic and material or act with reckless disregard of the nature of the information; and (3) know or be reckless in not knowing that disclosing this information violates a fiduciary duty or similar duty of confidence.

In the case of a tippee, he must (1) know or recklessly disregard the fact that the tipped information was material and nonpublic; and (2) "know or have reason to know" that the confidential information was disclosed in breach of a duty; in other words, that the information was transmitted improperly (and thus through deception). Determining whether the tippee knew or had reason to know that the tipper breached a duty is a "fact-specific inquiry turning on the tippee's own knowledge and sophistication, and on whether the tipper's conduct raised red flags that confidential information was being transmitted improperly." The court further explained that downstream tippee liability "may also result from conscious avoidance," and endorsed the view of *SEC v. Musella*, which found that the scienter element was satisfied where tippees at the end of a chain "did not ask [about the source of the information] because they did not want to know."[2]

Personal Benefit Element

In *SEC v. Dirks*, a classical insider trading case, the Supreme Court found that mere disclosure of material, nonpublic information by itself is insufficient to constitute a breach of an insider's fiduciary duties.[3] Rather, to determine whether an insider breached a fiduciary duty, courts are required to "focus on objective criteria, i.e., whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings" or even the satisfaction of making a valuable gift to a relative or close friend.[4] Thus, *Dirks* made clear that under the classical theory, the SEC must show that the tipper received a personal benefit to assess whether the disclosure was for an improper purpose. The *Dirks* "personal benefit test" serves to distinguish nonculpable unauthorized disclosures from culpable ones.

Dirks, however, left open the question of whether the personal benefit test applied to misappropriating tippers as well. The SEC has argued that the personal benefit test is not applicable to misappropriation cases, and several district courts agreed.[5] *Obus* closed the door on the question, at least in the Second Circuit. The court found that "the Supreme Court's tipping liability doctrine was developed in a classical case, *Dirks*, but the same analysis governs in a misappropriation theory."

Ambiguity surrounding the definition of "personal benefit," however, has made the *Dirks* test difficult to apply. Following *Dirks*, circuit courts have generally required only a minimal showing by the SEC that a tipper received a personal benefit from the tippee. In *SEC v. Yun*, the U.S. Court of Appeals for the Eleventh Circuit found that evidence that the tipper and tippee were "'friendly,' worked together for several years, and split commissions on various real estate transactions" was "sufficient for a jury reasonably to conclude" that the tipper expected to benefit through maintaining a good relationship with the tippee.[6]

> Although the government must always prove that the tipper received a personal benefit for a material disclosure of inside information, this element may possibly be satisfied by showing simply that it was disclosed to a friend.

Similarly, in *SEC v. Maio*, the U.S. Court of Appeals for the Seventh Circuit found that the tipper received a personal benefit from gifting information about a corporate merger to a close friend.[7] And, in *SEC v. Warde*, the Second Circuit held that the "close friendship" between the alleged tipper and tippee suggested that the tip was "intended to benefit" the tippee and might establish a sufficient personal benefit.[8]

Obus further watered down the personal benefit test, finding the "undisputed fact that Strickland and Black were friends from college" was sufficient evidence that Strickland may have received a benefit from tipping Black. The court said that the term "personal benefit" has a "broad definition" and that the SEC's burden in proving that the tipper received a personal benefit is "not a high one."

Thus, although *Obus* found that the SEC must prove that the tipper benefited personally from disclosing nonpublic information under the misappropriation theory, it

makes clear that the *Dirks* personal benefit test is not difficult to satisfy.

Knowledge of Tipper's Benefit

Imagine that an analyst discloses information from a source in Asia that he paid under the table to a good friend at a hedge fund. The hedge fund recipient concludes that the information he received is material and nonpublic, but does not ask the analyst where the information came from. Can the hedge fund recipient be found liable for insider trading where he had no knowledge that the source was paid for information?

In *Dirks*, the Supreme Court held that a tippee could be liable only "where the tippee knows or should know" that the tipper breached a duty by relaying information.[9] *Dirks* did not address, however, what evidence is sufficient to show that the tippee knew or had reason to know that information was obtained in breach of duty.

Recently, several judges in the Southern District of New York have held that the government is required to prove "tippee knowledge of each element, including the personal benefit, of the [insider's] breach."[10] At the *Rajaratnam* trial, Judge Richard Holwell instructed the jury that "[t]he government must show that [the defendant] knew that…an insider would directly or indirectly obtain some personal benefit from the disclosure [of material, nonpublic information]."[11]

Similarly, during the *United States v. Whitman* trial, Judge Jed Rakoff instructed the jury that for Whitman—a remote tippee—to be found guilty of insider trading, the government must prove that he traded "knowing" that the information had been obtained from an insider in exchange for some actual or anticipated personal benefit.[12] Rakoff explained that the government need not prove that the tippee knew "the specific benefit"; rather, it is sufficient he had a "general understanding that the insider was improperly disclosing inside information for personal benefit."[13] The tippee's knowledge of personal benefit can also be established through proof of the tippee's willful blindness or conscious avoidance to the "obvious fact" that the tipper's disclosure was in exchange for personal benefit.[14]

Obus, however, read *Dirks* broadly to find that circumstantial evidence can be used to show that the tippee knew or should have known that a duty has been breached, without expressly stating that a showing is required that the tippee knew that the tipper obtained a personal benefit from the disclosure. The court concluded that a jury could find that Obus, the final alleged tippee in the chain, knew or had reason to know that Strickland breached a duty to GE Capital by disclosing the SunSource information to Black.

The court reasoned there was evidence that (1) the tippee knew that the source worked for GE Capital; (2) the tippee was a sophisticated financial player; (3) the tippee called SunSource's CFO the day he allegedly received the tip, demonstrating that he believed the information was credible and thus originated with someone entrusted with confidential information; and (4) the tippee recognized that the source might lose his job as a result of the information he had conveyed, demonstrating the tippee's knowledge that the source acted improperly. The court did not, however, address whether a case against Obus could stand in the absence of proof of Obus' knowledge of Strickland's friendship with Black.

Both *Obus* and *Dirks* make clear that the tippee "must know or have reason to know" that the tipper breached a duty of confidence when he disclosed confidential information. But *Obus* leaves open the possibility that the hedge fund recipient in our hypothetical may be found liable despite having no actual knowledge that the inside source was paid or received some personal benefit in any context. Recently, however, Rakoff interpreted *Obus* to find that the tippee's knowledge that the "disclosure of inside information was unauthorized is sufficient for liability in a misappropriation case," but in a classical case, "the tippee must have knowledge" that "self-dealing [in the form of a personal benefit] occurred."[15] He reasoned that "without such a knowledge requirement, the tippee does not know if there has been an 'improper' disclosure."

Conclusion

Obus can be read to expand tipper-tippee liability. Although the government must always prove that the tipper received a personal benefit for a material disclosure of inside information, this element may possibly be satisfied by showing simply that it was disclosed to a friend. Moreover, neither the tipper nor the tippee must have actual knowledge that the information was disclosed in breach of a duty of confidentiality. A tipper can be found to have breached a duty if the disclosure was made with reckless disregard of the confidential or material nonpublic nature of the information. A tippee can be found to have the requisite knowledge of a breach where circumstantial evidence showed that the tippee was a sophisticated investor and red flags permit the inference that he should have known that the information was disclosed improperly.

Obus should serve as a warning to investors who make trading decisions based in part on information from third parties. Upon receiving arguably material and confidential information about a public company, investors must always be careful to consider the ultimate source of that information, how it was obtained, and whether there were any red flags suggesting that it might have been disclosed in violation of a duty of confidentiality. The more sophisticated the investor and valuable the information, the more likely it is that a court will infer knowledge of a breach.

1. *SEC v. Obus*, 693 F.3d 276 (2d Cir. Sept. 6, 2012).
2. Id. at *31 (quoting *SEC v. Musella*, 678 F.Supp. 1060, 1063 (S.D.N.Y. 1988)).
3. 463 U.S. 646 (1983).
4. Id. at 663-64.
5. See, e.g., *SEC v. Musella*, 748 F.Supp. 1028 (S.D.N.Y. 1989); *SEC v. Willis*, 777 F.Supp. 1165, 1172 n.7 (S.D.N.Y. 1991).
6. 327 F.3d 1263, 1280 (11th Cir. 2003).
7. 51 F.3d at 623, 632 (7th Cir. 1995).
8. 151 F.3d 42, 48-49 (2d Cir. 1998).
9. *Dirks*, 463 U.S. at 660.
10. *United States v. Rajaratnam*, 802 F.Supp.2d 491, 498-99 (S.D.N.Y. 2011).
11. Tr. 5623:9-12, *United States v. Rajaratnam*, No. 09-cr-1184 (S.D.N.Y. April 25, 2011).
12. Tr. 2950:5-12, *United States v. Whitman*, No. 12-cr-00125 (S.D.N.Y. Aug. 17, 2012).
13. *Whitman,* Tr. 2952:17-25.
14. *Whitman,* Tr. 2953:1-9.
15. *United States v. Whitman*, 2012 U.S. Dist. LEXIS 163138, at *18-20 (S.D.N.Y. Nov. 14, 2012).

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