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**SEC v. OBUS AND THE EVOLVING LAW
OF TIPPEE LIABILITY IN INSIDER
TRADING CASES**

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I. INTRODUCTION

Just when one would have thought that there could truly be nothing new under the sun with respect to insider trading, there have been some important recent developments in the area of tippee liability with potentially far reaching consequences for investment professionals. The Second Circuit's decision last year in *SEC v. Obus*, 693 F.3d 276 (2d Cir. 2012), seemingly re-wrote the law of tippee liability in the Second Circuit to make clear that to be liable for insider trading a tippee need not have knowledge of the tipper's receipt of a benefit – or did it?¹ Two district court decisions in the Southern District of New York have wrestled with *Obus* and reached differing conclusions as to what it means.² In one of those cases, *United States v. Newman*, Nos. 13-1837(L) & 13-1917 (Con) (2d Cir. June 18, 2013), the Second Circuit granted bail pending appeal to the defendant-appellants reflecting that the appeal presented a substantial question that, if resolved in their favor, would result in a reversal of their convictions for insider trading.

The prohibition against insider trading in the federal securities laws is premised on the notion that insider trading is a type of securities fraud prohibited by Section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b). Insider trading in breach of a duty of trust or confidence is a form of a “manipulative and deceptive device” prohibited by Section 10(b).³ As a general matter, U.S. courts have rejected any requirement of parity of information among all traders in securities. In the landmark case of *Dirks v. SEC*, 463 U.S. 646 (1983), the Supreme Court made clear that it was “repudiating any notion that all traders must enjoy equal information before trading.” *Id.* at 657. Insider trading law is based on an insider's misuse of material non-public information for personal advantage in breach of his or her fiduciary duty to shareholders. The Court explained that “a purpose of the securities laws was to eliminate use of inside information for personal advantage. Thus, the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. *Absent*

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1. Ironically, the term “obus” appears to be of French origin meaning “bombshell.” See <http://dictionary.reverso.net/french-english/obus> (last visited July 9, 2013).
 2. William F. Johnson, *Galleon-Era Cases Shape Insider Trading Landscape* 249 N.Y.L.J. 84 (May 2, 2013) (discussing the split on the issue of tippee knowledge in the Southern District of New York).
 3. Ralph C. Ferrara et al., *FERRARA ON INSIDER TRADING AND THE WALL* 1-8 (2013 ed.) (discussing how the SEC's Release accompanying Rule 10b5-1 described insider trading as “a manipulative and deceptive device”).

some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.” Id. at 662 (emphasis added) (internal citations omitted).

As a general matter, there are two theories of insider trading: the classical theory and the misappropriation theory.⁴ Under the classical theory, an insider – who has been entrusted with material non-public information and has a duty to shareholders to refrain from trading on that information for his personal benefit – either trades on the information himself or discloses the information to a tippee who trades. The misappropriation theory applies these same concepts and expands them to “outsiders” who are entrusted with material non-public information as part of a fiduciary (or fiduciary-like) relationship of trust and confidence even though they are not corporate insiders. *See United States v. O’Hagan*, 521 U.S. 642, 652 (1997). By way of example, such outsiders to whom the misappropriation applies would include lawyers and bankers among others.

What is tippee liability? In the parlance of insider trading, a “tippee” receives material non-public information from a non-trading insider and in turn trades on the basis of the information.⁵ The prohibition against insider trading by a tippee is predicated on and derived from the liability of the tipper. Insiders may not give material non-public information “to an outsider for the same improper purpose of exploiting the information for their personal gain.” *Dirks*, 463 U.S. at 659. “The tippee’s obligation has been viewed as arising from his role as a participant after the fact in the insider’s breach of fiduciary duty.” *Id.* (quoting *Chiarella v. United States*, 445 U.S. 222, 230 n.12 (1980)). So, for example, if a tipper unwittingly disclosed material non-public information to a third party without any personal benefit – say for example an insider riding on the subway carelessly mentions something to a co-worker about a pending

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4. Donald C. Langevoort, “*Fine Distinctions*” in *the Contemporary Law of Insider Trading* Georgetown Law and Legal Theory Research Paper No. 13-032 at 28 (2013) (“The classical and misappropriation theories are simply two inventive compromise solutions to the deception puzzle, embraced because they do what courts have thought to be important work in sustaining the expressive campaign against insider trading.”) As Professor Langevoort notes, the Second Circuit expanded the law of insider trading to include computer hacking in *SEC v. Dorozhko*, 574 F.3d 42 (2d Cir. 2009), even though the conduct did not necessarily fit within either the classical or misappropriation theories. Langevoort, at 27-28.
 5. *See generally* Donald C. Langevoort, INSIDER TRADING: REGULATION, ENFORCEMENT AND PREVENTION § 4 (20013 ed.).

corporate deal that a third-party happens to overhear and trades on – that would not result in liability for insider trading.

Prior to *Obus*, it appeared that for the government to prove a tippee liable for insider trading the tippee must know *both*: (1) that the tipper had provided him or her with material non-public information in breach of a duty and (2) that the tipper received or anticipated receiving a personal benefit. See *United States v. Rajaratnam*, 802 F. Supp.2d 491, 498-99 (S.D.N.Y. 2011) (the government must prove “tippee knowledge of *each element* including the personal benefit, of the [insider’s] breach”); see also *State Teachers Retirement Board v. Flour Corporation*, 592 F. Supp. 592, 594 (S.D.N.Y. 1984). *Obus* has raised questions as to whether this remains the law.

II. THE SECOND CIRCUIT’S DECISION IN *SEC v. OBUS*

In *Obus*, the Second Circuit discussed at length the standards for tippee liability under the insider trading laws. The procedural posture of the case was an appeal by the SEC from a grant of summary judgment in favor of the defendants. While the SEC had proceeded against the defendants on both the classical and misappropriation theories of insider trading, *Obus*, 693 F.3d at 279, the SEC appealed only the grant of summary judgment under the misappropriation theory, *id.* at 285. The narrow holding of the Court was that the “SEC’s evidence created genuine issues of material fact as to each defendant’s liability under the misappropriation theory” and thus the Court vacated the grant of summary judgment in favor of the defendants and remanded the case to the district court. *Id.* at 279. Although the opinion purportedly addresses liability only under the misappropriation theory, the decision contains sweeping language that could be read to apply to tippee liability generally under either the classical theory of insider trading or the misappropriation theory.

Obus involved a tipping chain. Viewed in the light most favorable to the SEC, the facts were as follows. Thomas Bradley Strickland was “an assistant vice president and underwriter” at GE Capital. *Id.* at 279. GE Capital had been approached by Allied Capital to obtain financing for Allied’s planned acquisition of SunSource, a publicly traded company. Strickland was part of the GE Capital team working on the financing proposal and during “the course of his work, Strickland learned non-public information about SunSource, including the basic fact that SunSource was about to be acquired by Allied.” *Id.* Strickland tipped his college friend Peter Black that Allied was about to acquire SunSource. *Id.* at 280. Black worked as an analyst at Wynnefield Capital – a company that

managed a group of hedge funds and was a large holder of SunSource stock. *Id.* Black, in turn, immediately relayed the information he received from Strickland to his boss, Nelson Obus. *Id.* at 281. Obus then called SunSource’s CEO, Maurice Andrien, and told him, among other things, that “a little birdie in Connecticut” had told Obus that “you guys are planning to sell the company to a financial buyer.” *Id.* Andrien replied “who would tell you something like that?” to which Obus responded, “GE.” *Id.* When Black learned of Obus’s call to the SunSource CEO, Black was “shocked” and said to him that his friend – Strickland – “is going to be fired.” *Id.* Obus assured Black that if Strickland were fired, he would help him find another job on Wall Street or offer him a job at Wynnefield. *Id.* Two weeks after this conversation, a trader at Cantor Fitzgerald called Wynnefield offering to sell 50,000 shares of SunSource stock at \$5.00 per share. Wynnefield counteroffered at \$4.75 per share, and ultimately purchased a total block of 287,000 shares – roughly 5% of the outstanding SunSource common stock – at that price. *Id.* at 282. Eleven days later, Allied publicly announced that it was acquiring SunSource for \$10.38 per share in cash or stock. SunSource’s stock closed at \$9.50 per share on the date of the announcement resulting in a “paper profit to Wynnefield of over \$1.3 million.” *Id.*

The SEC proceeded against Strickland, Black and Obus under both the classical and misappropriation theories. *Id.* at 283. The SEC alleged that through his work at GE Capital, Strickland had become a temporary insider of SunSource and thus owed a duty to SunSource’s shareholders not to share material non-public information. *Id.* “Under the misappropriation theory, the SEC claimed that Strickland had a duty to GE Capital, his employer, to keep information about SunSource’s acquisition confidential, and that he breached that duty by tipping Black.” *Id.*

The Second Circuit stated that to be liable for insider trading “a tipper must (1) tip (2) material non-public information (3) in breach of a fiduciary duty of confidentiality owed to shareholders (classical theory) or the source of the information (misappropriation theory) (4) for personal benefit to the tipper.” *Id.* at 286. As for the tippee’s liability, the Court concluded that “[t]ippee 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.” *Id.* at 289. Of note, the Court’s summary of tippee liability did

not include any mention that the tippee must have knowledge that the tipper received a personal benefit.

III. WHAT DOES *OBUS* MEAN?

In two recent criminal insider trading cases in the Southern District of New York interpreting *Obus*, the Court came to different conclusions as to precisely what *Obus* means and what a tippee must know for the tippee to be criminally liable for insider trading. In *United States v. Whitman*, 904 F. Supp.2d 363 (S.D.N.Y. 2012), a district judge in a classical insider trading case held that the tippee must know that the tipper received or expected to receive a personal benefit. *Id.* at 371. Yet, in *United States v. Newman*, a different district judge reached the opposite conclusion in another classical insider trading case, holding that the law “does *not* require that [a] [d]efendant had knowledge that the insider obtained a personal benefit” but only that the tipper breached a fiduciary duty. 2013 WL 1943342, * 2 (S.D.N.Y. May 7, 2013) (emphasis added).

So what does *Obus* mean? The Court in *Whitman* remarked in a footnote that *Obus* is “somewhat Delphic” with regard to the question of the tippee’s knowledge “suggesting, on the one hand, that even in a civil misappropriation case, the tipper is liable only if he ‘received a personal benefit from the tip,’ but on the other hand, that tippee liability, even in a civil case, requires that ‘the tippee knew or had reason to know...that the information was obtained through tipper’s breach.’” 904 F. Supp.2d at 371 n.6.

At first blush, one possible interpretation of *Obus* is to distinguish it as a civil insider trading case. Under this reading of *Obus*, the Second Circuit’s statements about tippee liability would be confined to civil insider trading cases and have no bearing on criminal insider trading liability. Therefore, the conventional thinking – that a tippee must know that the tipper received an improper personal benefit – at least for criminal liability to attach is still valid.⁶ However, it should be noted that *Dirks* itself was a civil insider trading case, and subsequent criminal cases have applied these same principles with a higher standard of *mens*

6. Langevoort, *supra* note 4 at 25 n. 79 (“*Obus* was not a criminal case, and there is good authority, at least in the Second Circuit, for believing that the standard of proof for criminal insider trading would be higher as to a tippee. So we should not assume that its teachings necessarily lead to a greater risk of criminal prosecution.”) (internal citations omitted).

rea – willfulness – rather than the scienter standard used in civil cases (recklessness; i.e., an extreme departure from the ordinary standard of care). Thus, any attempt to distinguish *Obus* as a civil insider trading case would seem somewhat unsatisfactory.

A second possible interpretation of *Obus* is that *Obus* is a misappropriation case. Therefore, whatever *Obus* means it is limited to misappropriation cases and does not apply to classical insider cases. This is seemingly the approach taken by the District Court in *Whitman* although the Court did not address *Obus* head on. 904 F. Supp.2d at 366. Of note, *Obus* was decided after the trial in *Whitman*. *Id.* at 371 n. 6. The *Whitman* Court distinguished the Second Circuit authority in misappropriation cases — which had suggested that a benefit to the tipper was not required as an element of the insider trading offense under the misappropriation theory⁷ – as inapposite to a classical insider trading case which requires proof of a benefit to the tipper. The *Whitman* Court explained that the purpose of the misappropriation theory “is to protect property rights in information Thus, the tippee’s knowledge that disclosure of the inside information was unauthorized is sufficient for liability in a misappropriation case.” *Id.* at 370. The *Whitman* Court noted that by contrast the purpose of a classical insider prosecution is different. It is “to protect shareholders against self-dealing by an insider who exploits for his own gain the duty of confidentiality he owes to his company and its shareholders.” *Id.* at 370-71. For this reason, “[t]he element of self-dealing, in the form of a personal benefit – whether immediate or anticipated, and whether substantial or very modest – must be present” in a classical insider trading case. *Id.* at 371. The Court concluded that “if the only way to know whether the tipper is violating the law is to know whether the tipper is anticipating something in return for the unauthorized disclosure, then 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 an ‘improper’ disclosure of inside information.” *Id.* at 371.

This second interpretation would seem inconsistent with other language in the *Obus* opinion which plainly states that the tipper’s receipt of “a personal benefit from the tip” is an element of the offense even in a misappropriation case. 693 F.3d at 289. In addition, the Court in *Obus*

7. See *United States v. Falcone*, 257 F.3d 226, 234 (2d Cir. 2001), *United States v. Mylett*, 97 F.3d 663, 668 (2d Cir. 1996), and *United States v. Libera*, 989 F.2d 596, 600 (2d Cir. 1993).

reasoned that although “[t]he Supreme Court’s tipping liability doctrine was developed in a classical case,” *Dirks*, “the same analysis governs in a misappropriation case,” which would logically suggest that a personal benefit to the tipper is an element under either the classical or misappropriation theory. *Id.* at 285-86.⁸ Further, such a distinction between cases brought under classical theory and misappropriation theory could yield some very odd results. Under this reading, a person who receives a tip from the CFO (a classic insider) would need to know that the CFO received a personal benefit. Yet, by contrast, a person who receives the same tip from an outside accountant (misappropriation theory) would not need to know that there was a benefit to the tipper. Finally, as the SEC’s complaint in *Obus* itself demonstrates, the lines between classical and misappropriation theory blur, and the two theories are not mutually exclusive. In fact, the SEC’s complaint in *Obus* charged the defendants with violations of the insider trading laws under both the classical and misappropriation theories.

A third possible interpretation of *Obus* is that it did not change the law of tippee liability at all. When the *Obus* spoke of the liability of the tippee, it made clear that the tippee must know or have “reason to know that the tippee improperly obtained the information (*i.e.*, that the information was obtained through the tipper’s breach). . .” *Id.* at 289. Under this interpretation, subsumed within the tippee’s knowledge of the tipper’s breach is the implicit notion that the tippee must also know that the tipper received a personal benefit. By definition, there can be no breach of the tipper’s fiduciary duty without the tipper’s receipt of a personal benefit. Accordingly, the tippee must have knowledge of the benefit to the tipper. While such an interpretation would appear to have the benefit of doctrinal consistency with the reasoning of *Dirks*, it is somewhat difficult to square such an interpretation with the other language in *Obus*.

A fourth possible interpretation of *Obus* is that the Court meant what it said when it stated that a tippee need not know of the tipper’s receipt of a personal benefit and that this applies equally to classical insider trading

8. See Michael S. Schachter & Alison R. Levine, *SEC v. Obus: Second Circuit Clarified Standards for Insider Trading* 248 N.Y.L.J. 117 at 2 (December 18, 2012) (“The SEC has argued that the personal benefit test is not applicable to misappropriation cases, and several district courts agreed. *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.”)

cases and misappropriation cases. This is the position the District Court took in *Newman* which involved a classical insider trading case. Under this interpretation, while the receipt of a personal benefit by the tipper is still an element of the offense – and without it neither the tipper nor the tippee can be liable for insider trading – the tippee need not have knowledge of the personal benefit to the tipper for either civil or criminal liability for insider trading to attach. While such an interpretation would appear to be the most natural reading of *Obus*, this interpretation would seem to push the law of insider trading to new limits beyond that envisioned by the Supreme Court in *Dirks* and would dramatically reduce the *mens rea* required for criminal insider trading liability by a tippee especially in cases involving more remote downstream tippees. After all, insider trading is a type of securities fraud grounded in the anti-fraud provisions of the Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. The breach of a fiduciary duty for a personal benefit would seem to be the touchstone for fraud. The *Dirks* Court went to great lengths to distinguish between fraudulent conduct for personal gain, which is unlawful, from permissible conduct by analysts ferreting out information. Knowledge on the part of the tippee that the tipper received a personal benefit – which is the basis for the tipper’s liability – would seem to be required for liability. The Court in *Dirks* also made clear that tippees could only be liable for insider trading if they “knowingly participate with the fiduciary in such a breach. . .” *Dirks*, 463 U.S. at 659. The knowing participation requirement would seem to extend to both the breach of fiduciary duty and personal benefit which the *Dirks* Court equated as an essential part of the breach of duty. Furthermore, doing away with the requirement that the tippee have knowledge of the benefit to the tipper would make the standard for tippee liability more lenient than the standard for tipper liability which would seem not only manifestly unfair but logically inconsistent since the tippee’s liability is derived from the tipper.

This fourth interpretation would also seem to push the law dangerously close toward the parity of information approach explicitly rejected by the Court in *Dirks*. The Court in *Dirks* refused to adopt such an approach because “[i]mposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market.” *Id.* at 658. The Supreme Court in *Dirks* recognized the benefits of analysts “meeting with and questioning corporate officers and others who are insiders” and wanted to encourage such discussions.

Id. at 658. By eliminating the requirement that the tippee know of the tipper's receipt of a benefit, this fourth interpretation puts investment professionals at greater risk for insider trading investigation, enforcement actions, and possible criminal prosecution. Such an interpretation would likely have a serious chilling effect on investment professionals.

IV. CONCLUSION

Whatever *Obus* means is open to serious debate as is demonstrated by the differing interpretations of it by the District Court in *Newman* and *Whitman*. The Second Circuit will have occasion to revisit the law of tippee liability as it considers the appeal in *Newman*.

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