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Expert Analysis

The Lessons of 'Lyon' on Insider Trading Liability

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The Securities and Exchange Commission (SEC) has a long history of aggressively pushing the boundaries of insider trading liability. One such campaign gave rise to what has become known as the "misappropriation theory," a now well-established doctrine that expanded the net of the insider trading laws to capture individuals who are not traditional "corporate insiders."[1] The misappropriation theory and its expansive application by the SEC create many pitfalls for professional trading firms such as hedge funds that simultaneously pursue both public and private investments in the same issuer. U.S. District Court for the Southern District of New York Judge Sidney H. Stein's recent opinion in *SEC v. Lyon*[2] illustrates the dangers to professional investors who engage in such parallel trading strategies without a clear understanding of this complex and sometimes counterintuitive area of the securities laws.

'SEC v. Lyon'

In *Lyon*, the SEC relied on the misappropriation theory to bring insider trading charges against hedge fund Gryphon Partners and its chief investment officer (collectively, Gryphon) for allegedly short-selling the shares of several public companies while in possession of inside information about the fact that the companies were going to issue new shares through Private Investment in Public Equity (PIPE) offerings. A PIPE is a capital-raising technique that involves a public company issuing additional shares through a private offering, often at a discount to the prevailing market price. An announcement of a PIPE can cause the company's public share price to decrease because, among other things, such offerings result in shareholder dilution and are often seen by the market as a sign that the issuer is facing financial difficulties.[3] The SEC alleged that Gryphon profited on the inside information about the impending PIPEs by covering its short positions after the deals were announced and the market prices of the issuers' securities declined as a result. The issuers provided Gryphon with the non-public information about the PIPEs in an effort to solicit it to invest in those offerings.

The SEC had to rely on the misappropriation theory because Gryphon was not affiliated with the PIPE issuers and was therefore not an "insider." Under the misappropriation theory a defendant engages in insider trading when it (1) possesses material, non-public information; (2) which it had a duty to keep confidential; and (3) subsequently breaches its duty by acting on or improperly revealing the information in question.[4] Both the SEC and Gryphon moved for summary judgment based on, among other things, the contention that there was no genuine issue of material fact as to whether Gryphon had a duty to keep the information about the PIPEs confidential. In the SEC's view it was beyond dispute that a duty existed; in Gryphon's view it was beyond dispute that there was none. Ultimately, the court denied both parties' summary judgment motions.[5]

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The court's analysis, however, endorsed two particularly aggressive theories that were advanced by the SEC. First, the SEC argued that Gryphon had knowingly accepted an explicit duty to keep the PIPE information confidential in situations where there was no written contract or other direct evidence establishing that Gryphon had affirmatively agreed to do so.[6] Second, the SEC argued that under the misappropriation theory, there is no requirement that the alleged insider trader receive a benefit by breaching its duty of confidentiality. The SEC made this argument despite the existence of case law that establishes that such a requirement exists, at the very least, in "classical theory" insider trading cases involving true corporate insiders.[7]

Duty of Confidentiality

In *Lyon*, the SEC proffered the following evidence that a duty of confidentiality existed: (1) Gryphon received offering materials that were marked confidential and in some instances contained a statement that said acceptance of the materials constituted an agreement to keep them confidential; (2) testimony by placement agents who solicited Gryphon to participate in some of the PIPEs that their routine practice was to ask potential investors to verbally agree to confidentiality; and (3) Gryphon signed a purchase agreement with a confidentiality clause after it established its short position in the relevant security.

The court began its analysis by recognizing that a duty of confidentiality cannot be created "simply because confidential information was thrust on a recipient without obtaining an explicit confidentiality agreement."[8] Given the sophistication of the parties, the court could have viewed the lack of a written agreement spelling out Gryphon's alleged confidentiality obligations as strong evidence that no such agreement existed. The court opted for a different approach. In its view, the SEC was not only entitled to proceed to trial, but had presented "very strong" evidence which made out a "formidable case" that Gryphon knowingly agreed to keep the information confidential. Thus, while the court did not grant either party's summary judgment motion, it expressed clear support for the SEC's interpretation of the evidence on the confidentiality issue.

Lack of a Personal Benefit

Gryphon also sought summary judgment on one of the insider trading counts by arguing that the SEC could not establish that it had received a personal or financial benefit from trading on the alleged material, non-public information. Gryphon contended that because it held equal long and short positions in the PIPE issuer's securities during the time frame of the alleged insider trading, its position was "net neutral" and could not have yielded a profit. In crafting this creative argument, Gryphon relied on a long line of cases that state that when a corporate insider tips another party who subsequently trades, there is no breach of a duty and therefore no insider trading unless the tipper received a personal benefit through his actions.

The SEC responded by arguing that this case law only applied in "classical theory" insider trading cases and that there was no "personal benefit" requirement under the misappropriation theory. The SEC's argument did not turn on the fact that *Lyon* was not a tipper-tippee case, but instead suggested that all misappropriation theory cases lacked this element. The court once again sided with the SEC, stating that it would be "extremely hesitant" to impose a benefit requirement in a misappropriation theory case because the U.S. Court of Appeals for the Second Circuit has never done so and has instead "strongly implied" in dicta that such a requirement does not exist.[9] The court based its conclusion on the Second Circuit's opinion in *United States v. Libera*, which described the elements that must be established for tipper-tipper liability under the misappropriation theory as: "(i) a breach by the tipper of a duty owed to the owner of the nonpublic information; and (ii)

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the tippee's knowledge that the tipper had breached the duty."[10] Apparently, the court interpreted the Second Circuit's failure to mention the "personal benefit" requirement as an endorsement of the proposition that no such element exists, at least in misappropriation theory cases.[11]

Despite the court's view in *Lyon*, a strong argument can be made that *Libera* has no relevance whatsoever to the debate over whether the personal benefit element continues to exist under the misappropriation theory. *Libera* did not contain any meaningful discussion of the personal benefit requirement and there was clear evidence of a financial benefit to the tipper in that case.[12]

Well before *Libera* was decided, in *Dirks v. SEC*, the Supreme Court rebuffed the SEC's attempts to establish a rule that "anyone who knowingly received nonpublic material information from an insider has a fiduciary duty to disclose before trading."[13] *Dirks* instead adopted the personal benefit requirement in an effort to draw a bright line that would avoid imposing insider trading liability in situations where an individual trades after receiving material non-public information from a corporate insider who provided it to them for a legitimate business purpose or even carelessly, but not for personal gain.[14] The fact that *Dirks* was a classical theory insider trading case in no way undermines the wisdom of this approach. It seems unlikely that the Second Circuit intended to eviscerate this rule for "misappropriation" cases without explicitly saying so, based on the ambiguous "dicta" in *Libera*.

Perhaps for this reason, the court in *Lyon* ultimately did not rest its decision to deny Gryphon's summary judgment on its skeptical view of the continued viability of the personal benefit requirement. Instead, the court found that there was a triable issue of fact as to whether Gryphon benefited from its trading irrespective of whether its position was "net neutral." The *Lyon* court's willingness to accept the SEC's argument and its interpretation of the *Libera* decision nonetheless highlight the lack of a clear set of rules in this area. As a result, professional investors such as hedge funds could potentially find themselves liable for insider trading without having accepted a duty of confidentiality or, worse yet, without even having traded.

For example, consider a situation where a hedge fund that has been solicited to participate in a PIPE discusses the proposed transaction with another fund, either to solicit that fund's opinion about the investment or to see if it might be interested in investing itself. If the fund that shares the information has breached the terms of a written or oral confidentiality agreement and the second fund trades in the public company's securities, both could arguably be held liable for insider trading under the misappropriation theory—Fund 1 as a tipper and Fund 2 as a tippee.[15]

Traditionally, there would be no violation in this situation because the tipper did not receive any personal or economic benefit in exchange for disclosing the information. Under the SEC's theory as endorsed by *Lyon*, where no such "personal benefit" is required, both funds could be liable even if Fund 1 had nothing to gain by sharing the information and Fund 2 never agreed to keep the information confidential. This is exactly the type of result that the Supreme Court was seeking to avoid when it first adopted the personal benefit requirement in *Dirks*.

Risks to Professional Investors

Lyon reflects the SEC's continued willingness to stretch the boundaries of insider trading liability, especially under the misappropriation theory. It also highlights danger areas for professional investors such as hedge funds that engage in trading strategies with both public and private aspects. The court's opinion illustrates just how easily a hedge fund might find itself bound by a duty of confidentiality, which amounts to a duty not to trade, even before it signs a confidentiality agreement.[16] By encouraging the SEC to rely on indirect evidence of confidentiality agreements, *Lyon* increases the possibility that hedge funds might inadvertently cross "over the wall" as a result of even preliminary discussions concerning private securities transactions. The court's rejection of the "personal benefit" requirement further complicates this legal minefield by allowing for the possibility that funds may face insider trading liability as a result of having material, non-public information thrust upon them unsolicited by other market participants who have carelessly breached a duty of confidentiality.

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'Lyon' Lessons

Lyon is the latest example of the increased regulatory risks inherent in trading strategies that involve overlapping public and private investments in the same issuer. These risks can be reduced, however, if counsel advising professional investors involved in these types of transactions are cognizant of the relevant legal landscape. Below are some practice points on how to help avoid the pitfalls described above:

- First, to the extent that a professional trading firm is involved in both private and public investments in the same publicly traded company, it would be wise to consider the implementation of ethical walls that separate individuals who may be exposed to material, non-public information from individuals who are making public investment decisions. While ethical walls are not feasible in every organization, when constructed properly they can go a long way toward inoculating entities from insider trading liability in these types of situations.[17]
- Second, firms that are approached about potential private transactions involving public companies should make clear at the outset that they do not want to receive material, non-public information and that they are not agreeing to keep confidential any information that they do receive. This statement should be made clearly and be well-documented. In addition, firms would be well-advised to have written policies and procedures placing their employees on notice that they do not have the authority to agree to keep information confidential except through a written contract that has been approved by in-house counsel. This will help avoid an ambiguous factual record regarding exactly when a confidentiality agreement has been consummated.
- Third, firms should adopt written policies and procedures that instruct employees to notify in-house counsel immediately if they are given material, non-public information about a public company. Even the unsolicited receipt of such information carries the danger that the firm may be exposed to insider trading liability if it trades in the company's securities. In these situations, obtaining advice from competent counsel is the best way for a firm to ensure that it is proceeding in a manner that will avoid a potentially long and costly investigation or litigation with the SEC.

1. See generally *United States v. O'Hagan*, 521 U.S. 642 (1997).
2. 605 F.Supp.2d 531 (S.D.N.Y. 2009).
3. See George S. Canellos & Joshua R. Pater, "Federal Courts Consider SEC's Strategy in PIPE Cases," NYLJ, Dec. 21, 2007 (describing market impact of PIPEs).
4. *Lyon*, 605 F.Supp.2d at 541.
5. The issues in the *Lyon* case were never resolved by a fact-finder because the parties entered into a settlement shortly after summary judgment was denied. See SEC Litigation Release No. 21175 (Aug. 12, 2009). Consistent with the SEC's practices regarding settlements, the defendants agreed to an injunction, disgorgement of profits and a fine without admitting to any wrongdoing.
6. Of the four transactions charged by the SEC, only one involved allegations that Gryphon had signed a written confidentiality agreement at the time it shorted the PIPE issuer's shares. Id. at 544.
7. See *Dirks v. SEC*, 463 U.S. 646 (1983); See also Jeffrey Plotkin, "The Tipper Benefit Test Under the Misappropriation Theory," NYLJ, Aug. 15, 2003 (discussing other instances where the SEC has argued that a personal benefit is not required to establish insider trading under the misappropriation theory).
8. *Lyon*, 605 F.Supp.2d at 544. See also *United States v. Chestman*, 947 F.2d 551, 567 (2d Cir. 1991) ("[A] fiduciary duty cannot be imposed unilaterally by entrusting a person with confidential information.").
9. See *Lyon*, 605 F.Supp.2d at 548-549.
10. *United States v. Libera*, 989 F.2d 596, 600 (2d. Cir. 1993).
11. See *Lyon*, 605 F.Supp.2d at 549 n.7 (quoting *SEC v. Sargent*, 229 F.3d 68, 77 (1st Cir. 2000)).
12. *Libera*, 989 F.2d at 601 (noting that the tipper was paid in cash for the inside information he shared with the tippee).
13. *Dirks*, 463 U.S. at 656.
14. Id. at 662.
15. Of course the SEC would still need to prove that Fund #2 knew or recklessly disregarded the fact that Fund #1 had breached a duty of confidentiality. See *Libera*, 989 F.2d at 600. That being said, the SEC would likely expect that, as a sophisticated investor, Fund #2 must have been aware or deliberately avoided knowledge of the fact that some sort of confidentiality agreement existed.
16. The SEC's view, as set forth in Rule 10b5-2, is that a sufficient duty exists to provide a basis for insider trading liability under the misappropriation theory "[w]henever a person agrees to maintain information in confidence." 17 C.F.R. §240.10b5-2(b)(1). This position has not been without controversy. For example, a court in the Northern District of Texas recently held that a confidentiality agreement without an express undertaking not to use the confidential information cannot create a sufficient duty to establish insider trading under the misappropriation theory. See *SEC v. Cuban*, 2009 WL 2096166, at 11-13 (N.D. Tex. July 17, 2009). The court found that, to the extent that the SEC stated otherwise when it promulgated Rule 10b5-2, it exceeded its rulemaking authority. Id.
17. See 17 C.F.R. §240.10b5-1(c)(2) (providing a defense to insider trading liability for organizations that have set up appropriate ethical walls around employees possessing material, non-public information).

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