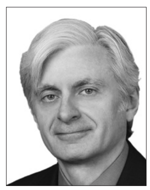
New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM
An ALM Publication
VOLUME 251—NO. 53
THURSDAY, MARCH 20, 2014

Outside Counsel

Expert Analysis

Grappling With 'Personal Benefit' Question in Insider Trading Law



By **George A. Borden** And **John S. Williams**

On Feb. 19, a U.S. Court of Appeals for the Second Circuit panel passed on an opportunity to address an issue in insider trading law on which two of the Southern District's most prominent judges have reached opposite conclusions. The issue is whether a tippee who trades on inside information must know that the insider who tipped the information received a personal benefit for doing so. In *United States v. Whitman*—the case decided by the Second Circuit in February—Judge Jed Rakoff ruled that the answer is yes.[1]

In another case that the Second Circuit will hear in April, *United States v. Newman*, Judge Richard Sullivan held that the answer is no. The panel in the Whitman appeal (of Judges Jon O. Newman, Peter W. Hall, and Gerard E. Lynch), found that it did not need to reach the tippee-knowledge issue because the defendant was convicted despite getting the benefit of Rakoff's more pro-defendant instruction. It affirmed Doug Whitman's conviction in a non-precedential summary order,[2] leaving it to the panel in the Newman appeal to resolve the disagreement.

Chains of Tippers and Tippees

Insider trading is one of the most complex areas of the law, and many questions remain open even decades after the Supreme Court's major decisions in the area. One of the unclear areas is how the law applies to long chains of tippers and tippees. *Whitman* and *Newman*, which both arose on the peripheries of the sprawling Galleon insider-trading investigation, illustrate this problem. Whitman allegedly obtained inside information about Polycom and Google from a neighbor, Roomy Khan, who in turn had received it from a Polycom insider and a friend at a firm who handled investor relations for Google. The government also alleged that Whitman got inside information about Marvell from a consultant (who in turn got it from Marvell insiders) and about Cisco from a friend (who in turn got it from his neighbor). Newman also involves a similar long chain.

The defendants in both cases asked for a jury instruction that would have required the jury to find that the defendants knew that the insiders had exchanged material non-public information for personal benefits. Rakoff gave the instruction in *Whitman* (although Whitman appealed in part on the ground that the instruction was not clear enough, an argument the Second Circuit rejected). Sullivan declined to give the instruction.

The issue that divides these judges has its roots in *Dirks v. United States*,[3] the Supreme Court's seminal case on chains of insider trading. Raymond Dirks was an investment advisor who learned of a fraud being perpetrated by the management of a company from a former officer of that company. The former officer was trying to blow the whistle on the fraud, and he urged Dirks to publicize it. Dirks tried, but no one was interested in publishing the story. In the meantime, Dirks also told his clients about the fraud, and they traded on the information. After the fraud was revealed and Dirks was proved right, his reward was to be censured by the Securities and Exchange Commission for insider trading. Although Dirks did not trade on the information, the SEC found that he violated Rule 10b-5 by tipping his clients.

The Supreme Court reversed the decision against Dirks. It perceived the case as an effort by the SEC to resuscitate its argument that all traders should have equality of information, an argument the Supreme Court had rejected earlier in *Chiarella v. United States*.[4] The court held that tippees can be liable for insider trading not merely based on receiving inside information, but

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rather only where "it has been made available to them improperly."[5] The Dirks court then reasoned that tippee liability requires that the insider/tipper breach a fiduciary duty to his company and the tippee "knows or should know there has been a breach."[6]

The court recognized that not all releases of inside information are wrongful, and it believed there should be no violation if the release was for a proper purpose but the recipient then traded on the information. The SEC argued that it would be too easy for tippers to concoct purportedly proper purposes for their tips, but the court tried to solve this problem by instructing that the determination of whether the tipper's purpose was proper should turn on the "objective" fact of whether the tipper received "a direct or indirect personal benefit from the disclosure."[7]

Application of 'Dirks'

How exactly these principles should apply to real cases has left the lower courts in some confusion for the last 30 years. The most significant recent Second Circuit case applying *Dirks* is *SEC v. Obus*.[8] In that case, a first tipper passed the information to a college friend, Peter Black, who passed it to his boss, Nelson Obus, who traded on it. The district court granted summary judgment in favor of the defendants. The Second Circuit vacated that decision and held that the evidence was sufficient to require a trial. But exactly what *Obus* requires for tippee liability has proved controversial.

In fact, the meaning of *Obus* is at the center of the disagreement between Rakoff and Sullivan. In his opinion in the Whitman case, Rakoff called *Obus* "somewhat Delphic"[9]; Sullivan, when confronted with Rakoff's opinion, wrote in *Newman* that Rakoff's Whitman opinion "ignor[ed] [*Obus*] almost entirely" and tried to "simply wish[] a Second Circuit precedent away."[10]

The Obus court wrote that tipper liability requires that the tipper receive a personal benefit, but did not mention that as a requirement for tippee liability.[11] When it discussed the liability of Obus, the ultimate tippee and trader, the court stated that the SEC was required to show that Obus "knew or had reason to know" that the information was obtained through a breach of fiduciary duty, but did not mention any personal benefit requirement.

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Personal Benefit

Which brings us back to Whitman and Newman. Both argued they had no idea who the inside tippers were or why the insiders disclosed the inside information. They admitted they knew that the analysts from whom they received their information had sources inside the companies, but they did not know whether any of them received a personal benefit. That is why a jury instruction on whether the defendants knew that the insiders had received a personal benefit was critical.

In *Whitman*, Rakoff gave just such an instruction. He drew a distinction between the classical and misappropriation theories of insider trading. He acknowledged that the Second Circuit has held that in misappropriation cases, "the tippee's knowledge that disclosure of the inside information was unauthorized is sufficient for liability…." In his view, however, this rule is dictated by the purpose of the misappropriation theory, which is to "protect property rights" in the information. In contrast, the classical theory of insider trading—which is at issue in *Whitman* and *Newman*—is premised on the need to protect shareholders against self-dealing by insiders, and therefore "[t]he element of self-dealing, in the form of a personal benefit…must be present."[12] And, "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."[13]

Sullivan disagreed. He instructed the jury in *Newman* that to convict, it had to find only (1) that the insiders did personally benefit, and (2) that the defendants knew that the insiders breached a duty of trust and confidence owed to their companies. Sullivan explained that *Obus* "makes clear that the tipper's breach of fiduciary duty and receipt of a personal benefit are separate elements and that the tippee need know only of the former."[14] He further wrote that "*Obus* strongly suggests that, at least with respect to tippee scienter, the difference between misappropriation and classical insider trading cases is immaterial." And, he concluded, "while the question of a tippee's knowledge of personal benefit may not have been directly presented in *Obus*, it was directly decided by that case, which clearly enumerates the elements of tippee liability in the form of a holding."

Now we must wait several more months for the Second Circuit to settle this interesting and important issue.

1. In an earlier case, *United States v. Rajaratnam*, 802 F.Supp.2d 491 (S.D.N.Y. 2011), then-Judge Richard Holwell reached the same conclusion.
2. *United States v. Whitman*, No. 13-491-cr, 2014 WL 68143 (2d Cir. Feb. 19, 2014).
3. 463 U.S. 646 (1983).
4. 445 U.S. 222 (1980).
5. 463 U.S. at 660.
6. 463 U.S. at 660.
7. 463 U.S. at 663.
8. 693 F.3d 276 (2d Cir. 2012).
9. See *United States v. Whitman*, 2012 WL 5505080, at *9 n.6 (S.D.N.Y. Nov. 19, 2012) (Rakoff, J.).
10. 2013 WL 1943342, at *2 (S.D.N.Y. May 7, 2013).
11. 693 F.3d at 289.
12. 2012 WL 5505080, at *5.
13. 2012 WL 5505080, at *6.
14. 2013 WL 1943342, at *2.