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Alert Memo

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Second Circuit Clarifies Standards for Insider Trading Claims

In the latest of a string of litigation victories it has scored in the Second Circuit, the Securities and Exchange Commission convinced a panel of the Second Circuit on September 6, 2012, to vacate a district court's grant of summary judgment to the defendants in *Securities and Exchange Commission v. Obus*, No. 10 Civ. 4749. In so doing, the Circuit clarified, and to some extent modified, the standards for tipper/tippee insider trading under the misappropriation theory.

The SEC alleged that Thomas Strickland, an employee of General Electric Capital Corporation ("GE Capital"), tipped a friend of his, Peter Black, who worked for a hedge fund, about a planned acquisition of Sunsource, Inc., by Allied Capital Corporation, that GE Capital was financing. The SEC alleged that Black relayed the tip to his boss, Nelson Obus, who then traded on the information. The SEC argued that all three participants were liable under the misappropriation theory, alleging that Strickland owed a fiduciary duty to GE Capital to keep the information about the acquisition confidential, that he breached this duty by disclosing the information to Black, and that Black and Obus knew or should have known that Strickland was breaching a duty by providing the tip.

The district court granted summary judgment to defendants, holding that the SEC had failed to establish facts sufficient for a jury to find that: (1) Strickland breached a duty to GE Capital; (2) Strickland's conduct was deceptive; or (3) Obus subjectively believed that the information he received was obtained in breach of a fiduciary duty.

On appeal, the Second Circuit vacated the district court's decision. In the opinion, the Court clarified the elements of tipper/tippee liability. It held that tipper liability requires 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." The holding with respect to "personal benefit" is potentially significant. Prior to *Obus*, it was not clear in the Second Circuit whether liability under the misappropriation theory required proof of personal benefit, and the SEC consistently argued that it did not. The Circuit appears to have closed the door on this issue.

The Court further held that liability for securities fraud requires proof of scienter and that "[i]n 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." But, the Court adopted a seemingly relaxed standard for establishing scienter. In the case of a tipper, to survive summary judgment, the SEC need only establish that the tipper tipped deliberately or recklessly (and not negligently), that she knew the information that was the subject of the tip was non-public and material, and that she knew or was reckless in not knowing that the tip was a violation of fiduciary duty. In the case of the tippee, the SEC need only establish that she knew that the tipped information was material and non-public and knew or should have known that the tipper had breached her fiduciary duty in making the tip to survive summary judgment. The Court noted that the "knew or should have known" language was similar to a negligence standard, but ruled that a negligence standard of knowledge of the breach of duty was not inconsistent with the general rule that negligence does not satisfy Section 10(b)'s scienter requirement: so long as the tippee intentionally or recklessly traded while in knowing possession of material non-public information, the SEC need only show that the tippee should have known of the breach of duty and not that she actually knew of it.

The Court employed broad language in its explication of insider trading law. The Court held that in the case of a tipper the first and second aspects of scienter (deliberate tip with knowledge that the information is material and non-public) can often be deduced from evidence the tipper acted for her own personal benefit and then ruled that the term "personal benefit" has a "broad definition" and that the "bar is not a high one." It also ruled that the fact the tipper and the tippee were friends from college was enough to permit the question of personal benefit to survive summary judgment. The Court also held that a tipper cannot avoid liability merely by demonstrating that he did not know to a certainty that the person to whom he gave the information would trade on it. As to the tippee, the SEC does not need to prove that she knew that the tipper was violating a fiduciary duty. It is enough that the tipper's conduct raised red flags that confidential information was being transmitted improperly.

Thus, read expansively, *Obus* might expand tippee liability – it will be a rare case in which a trade is effected unintentionally. It also might expand tipper liability, permitting cases to survive summary judgment when there is no evidence the defendant knew the tipped information was material other than that he gave it to a friend. At the same time, the facts of *Obus*, as they were described by the Court, did not require the Court to decide whether such evidence (absent anything more) would be enough to survive summary judgment.

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