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Hedge Funds and Material Nonpublic Information: The Role of Deception, Duty, Breach, Personal Benefit and Knowledge in Creating Liability

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The last thing hedge funds need is another wake up call about the risks of liability for trading on the basis of material nonpublic information. But if they did, a July 17 article in the *Wall Street Journal* would provide it. According to the article, the SEC is investigating nearly four dozen hedge funds, asset managers and other firms to determine whether they traded on material nonpublic information concerning a change in Medicare reimbursement rates.[1] If so, it appears that the material nonpublic information, if any, may have originated from a staffer on the House Ways and Means Committee, was then communicated to a law firm lobbyist, was further communicated by the lobbyist to a political intelligence firm, and finally, was communicated to clients who traded. According to an April 3, 2013 *Wall Street Journal* article, the political intelligence firm issued a flash report to clients on April 1, 2013 at 3:42 p.m.—18 minutes before the market closed and 35 minutes before the government announced that the Centers for Medicare and Medicaid Services would increase reimbursements by 3.3%, rather than reduce them 2.3%, as initially proposed.[2] Shares in several large insurance firms rose as much as 6% in the last 18 minutes of trading.

We discuss below what remote tippees, which may involve hedge funds and other investment firms that are often several steps removed from the original source of the information, would need to know for liability to arise. Along the way, we touch on the other elements relevant to liability as well -- fraud, duty, breach, and personal benefit. The burden on the government is an exceptionally challenging one in the case of remote tippees, and the Supreme Court intended that to protect market participants in the business of acquiring, ferreting out and analyzing vast amounts of information.

The Supreme Court and Tippee Liability: Five Answers and Three Open Questions

Federal statutes do not directly prohibit insider trading or other trading while in possession of material nonpublic information. As a result, it has fallen on the courts to determine when the antifraud provisions of federal securities laws prohibit such trading. These statutes address fraud—not insider trading as such—and the challenge has long been to define the circumstances in which trading while in possession of material nonpublic information amounts to fraud. As discussed below, from a fraud perspective, the issue is not so much whether the person who trades is a corporate insider, but whether the communication or use of material nonpublic information involves a breach of duty. The issue for the tippee—such as a hedge fund or investment adviser—is whether the tippee knows, or at least should have known, of the breach that resulted in the tippee acquiring material nonpublic information.

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1. Chiarella's Focus on Deception and a Fiduciary or Similar Duty Owed by Insiders to Shareholders. The starting point for the modern-day analysis of insider trading liability is the Supreme Court's 1980 decision in *Chiarella v. United States,* 445 U.S. 222 (1980). *Chiarella* reversed the conviction of an employee who, based on information that he learned while working at a company that printed takeover documents, purchased stocks he deduced would be the subject of takeover offers. The government successfully tried the case based on the SEC's parity-of-information theory, which held that anyone who trades with knowledge of material nonpublic information violates the federal securities laws if he knows the market did not have access to such information. But the government lost when the case reached the Supreme Court.

The core problem with the parity-of-information theory, the Court explained, is that it has nothing to do with fraud. A shareholder may be defrauded when an insider trades while in possession of material nonpublic information, but that is because the insider is a fiduciary who has a duty to disclose or refrain from trading. The same is not true when persons without a fiduciary or similar relationship trade. "[L]iability," the Court stated,"is premised upon a duty to disclose arising from a relationship of trust and confidence between the parties to a transaction."[3] Because Chiarella had no such relationship with shareholders, the Court reversed his conviction. At least since *Chiarella*, the violation of a duty arising from a relationship of trust and confidence—and not merely unequal access to material nonpublic information—is central to the analysis of whether trading violates the federal securities laws.

2. Dirks' Focus on the Tippee's Knowledge of a Breach by the Insider. Three years after the decision in *Chiarella*, the Supreme Court put an exclamation mark on its rejection of the SEC's parity-of-information theory and addressed when a tippee inherits the duty owed by an insider to shareholders. *Dirks v. SEC,* 463 U.S. 646 (1983). In *Dirks*, Ronald Secrist, a former officer of Equity Funding, disclosed to Raymond Dirks, an officer of a New York broker-dealer, that Equity Funding was engaged in fraud. He urged Dirks to verify the fraud and disclose it publicly. Dirks did just that, but along the way also disclosed the fraud to a number of clients, who liquidated their positions in Equity Funding before the fraud became public. The SEC censured Dirks on the theory that whenever tippees "regardless of their motivation or occupation come into possession of material corporate information that they know is confidential and know or should know came from a corporate insider, they must either publicly disclose that information or refrain from trading."[4]

In reversing, the Supreme Court stated that the SEC's theory of tippee liability—like its theory of direct liability in *Chiarella*—mistakenly "appears rooted in the idea that the antifraud provisions require equal information among all traders."[5] It reaffirmed that "a duty to disclose arises from the relationship between parties . . . and not merely from one's ability to acquire information because of his position in the market."[6] It stated that a tippee inherits the duty not to trade on material nonpublic information "only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the *tippee knows or should know that there has been a breach*." (emphasis added)[7] "'[T]ippee responsibility must be related back to insider responsibility by a necessary finding that the tippee *knew the information was given to him in breach of a duty* by a person having a special relationship to the issuer not to disclose the information.'" (emphasis added) [8]

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3. The "Personal Benefit" Standard for a Tipper's Breach. What constitutes a breach by the tipper? The Supreme Court in *Dirks* addressed this as well. The test for breach, the Court stated, "is *whether the insider personally will benefit*, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach [by the tippee]." (emphasis added)[9] Personal gain can be "a pecuniary gain or a reputational benefit that will translate into future earnings."[10] It can also be "a gift of confidential information to a trading relative or friend" in which "[t]he tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient."[11] But the person providing the information had to tip for some type of personal benefit. Because Secrist received no monetary or personal benefit for revealing the Equity Funding fraud, and his purpose was not to make a gift of valuable information to Dirks, Secrist did not breach a duty to Equity Funding shareholders and Dirks did not inherit a duty from Secrist.

4. The Supreme Court's Concern about Protecting Market Participants in the Business of Ferretting Out and Analyzing Information. Significantly for hedge funds, the Supreme Court in *Dirks* was keenly aware of the difficulty market participants would face if liability could arise merely from trading on material nonpublic information and that concern informed the Court's demanding test for tippee liability. After all, materiality is a fuzzy term, and there will often be disagreements about whether information is or is not material. Even a corporate official may mistakenly think that the information is not material.[12] Imposing a duty based on mere possession of material nonpublic information could have an inhibiting effect on analysts who "ferret out and analyze information," which "is necessary for the preservation of a healthy market."[13] The Court recognized that determining whether an insider personally benefits from a particular disclosure could be difficult for courts. But it viewed the personal benefit test as an essential "guiding principle" for limiting liability.[14]

5. Recognition of the Misappropriation Theory Based on Deception of the Source of the Information. In *United States v. O'Hagan*, 521 U.S. 642 (1997), the Supreme Court clarified that the *Chiarella* breach of duty analysis applied not only to a breach of duty owed to shareholders, but also to a breach owed to the source of the information —in that case a breach by an attorney to his law firm by using confidential information provided by a client to the law firm. The deception element that both *Chiarella* and *Dirks* held was essential to fraud was equally critical to the Court's adoption of the misappropriate theory in *O'Hagan.* It was simply that under the misappropriation theory, the deceived party was the source of the information rather than shareholders (since an outsider owed no duty to shareholders). "The deception essential to the misappropriation theory involves feigning fidelity to the source of the information."[15]

In the aggregate, the three cases stand for the following five principles:

1. There is no insider-trading liability without deception. Deception is necessary because the federal securities laws prohibit fraud, not unfair trading.
2. In the classic insider-trading case, deception arises from the insider's breach of a duty owed to shareholders. Because the insider has a duty to shareholders, the failure to disclose before trading on material nonpublic information is fraudulent.

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3. For there to be a breach, the insider must have violated the duty by acting for personal benefit—for a pecuniary gain, a reputational benefit, or in the case of friends and relatives, a gift of information that resembles trading by the insider himself and a gift of the proceeds to a friend or relative.
4. For the tippee of an insider to be liable, it must have known or at the very least should have known that the insider breached his or her duty when he disclosed the information.
5. A misappropriator of information can be liable as well, but there too there must be deception. The difference is that the deceived party is the source of the information rather than shareholders.

Three key questions are left open by the Supreme Court's trilogy.

First, what must the tippee know about the insider's breach for it to have liability? The Supreme Court itself said in *Dirks* that it must have known (or at least should have known) there has been a breach, so that is not the open question. The open question is whether it must have known the facts that make it a breach—*i.e.,* that the insider tipped for personal gain. Given the centrality of personal benefit to the breach analysis, it is difficult to see how a tippee could know of a breach without knowing that the insider tipped for a personal benefit.

Second, is the standard for tippee liability knowledge or is "should have known" enough. The Supreme Court in *Dirks* used a "know or should know" formulation, but in the very next sentence stated that tippee responsibility arises because "the tippee *knew* the information was given to him in breach of a duty." (emphasis added)[16]

Third, what are the standards for tippee liability in a misappropriation case? (The *Dirks* tippee opinion involved a classical insider-trading case rather than a misappropriation case.) Must the person who misappropriated the information also have done so for personal gain and must the tippee have known that as well?

It has fallen to the lower courts to decide these issues.

Lower Courts and Tippee Liability: Two Questions Answered, One Awaiting Decision

In *SEC v. Obus,* 693 F.3d 276 (2d Cir. 2012), the Second Circuit answered two of the open questions. On the issue of whether tippee knowledge of the breach is required, or whether a "should have known" standard is enough, the court stated, "tippee liability can be established if a tippee knew or had reason to know that confidential information was initially obtained and transmitted improperly (and thus through deception), and if the tippee intentionally or recklessly traded while in knowing possession of that information."[17] In the case of chains of tippees, "the first tippee must both know or have reason to know that the information was obtained and transmitted through a breach, and intentionally or recklessly tip the information further for her own benefit," and "the final tippee must both know or have reason to know that the information was obtained through a breach. . . ."[18] Thus, at least in the Second Circuit (where most insider-trading cases are brought) in civil as opposed to criminal cases, tippee liability can be based on a "reason to know" standard.

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On the issue of whether personal benefit is also necessary in a misappropriation case, the Second Circuit in *Obus* stated that the "personal benefit" test applies to both classical insider-trading cases and to misappropriation cases.[19]

The third open issue, whether the tippee must know that the information was tipped for personal benefit, is pending in *United States v. Horvath, et al.,* Nos. 13-1837 and 13-1917 (2d Cir.), which was argued to the Second Circuit on April 22, 2014. In that case, involving criminal convictions, the government argued that a tippee's knowledge of an insider's breach, rather than knowledge of a personal benefit, is enough to support liability. The defendants argue that because personal benefit is essential to showing a breach, the tippee must know "that an insider provided confidential information for personal gain."[20] The Second Circuit has not issued a decision, but the general consensus was that the argument went well for the defendants. Judge Parker's rhetorical question directed to the government's counsel during the argument may indicate where the court ultimately comes out:

> We sit in the financial capital of the world. And the amorphous theory that you have, that you've tried this case on, gives precious little guidance to all of these institutions, all of these hedge funds out there who are trying to come up with some bright line rules about what can and what cannot be done. And your theory leaves all of these institutions at the mercy of the government, whoever the government chooses to indict. . . . Isn't the whole community, the legal community and the financial community, served by having a rule that says the person you all want to send to jail has to know of the benefit?[21]

Might such a knowledge-of-personal-benefit requirement be exceedingly difficult for the government to prove in cases involving remote tippees? Yes, but as Judge Rakoff said in *United States v. Whitman,* 904 F. Supp.2d 363, 372 (S.D.N.Y. 1972), that "is a product of the topsy-turvy way the law of insider trading has developed in the courts. . . ."

Conclusion

We began by saying that the government's burden of proof against a remote tippee, such as a hedge fund that may often be a third- or fourth-tier tippee with little knowledge of how the information passed down the chain, should be an exceedingly difficult one. How difficult? At a minimum, in a civil case the government must show that the tippee knew or had reason to know that the material nonpublic information it received was passed to it through a breach of duty by an insider or a misappropriator of the information. In a criminal case, the government must show that the tippee actually knew that same information. While the issue remains pending at the moment, the better view is that the government will also have to show that the remote tippee knew (in a criminal case) or had reason to know (in a civil case) that the tipper disclosed the information for the personal benefit of the tipper. In a case where information allegedly goes from a House staffer, to a law firm lobbyist, to a political intelligence firm, and ultimately to clients of the firm, that would appear to be a steep burden indeed with regard to the entities that ultimately traded.

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[1] Brody Mullins and Andrew Ackerman, "SEC Widens Trading Probe to Investment Firms: Regulators Focus on Health-Care Stocks Ahead of Government Announcement," *The Wall Street Journal* (July 17, 2014).
[2] Brody Mullins and Tom McGinty, "Tip on Policy Shift Jolted Health Shares," *The Wall Street Journal* (Apr. 3, 2013). *See also, e.g.,* Jen Christensen, "Government Reverses Plan to Cut Medicare Advantage Rate," CNN (Apr. 2, 2013).
[3] 445 U.S. at 230.
[4] 463 U.S. at 651.
[5] *Id.* at 657.
[6] *Id.* at 658.
[7] *Id.* at 660.
[8] *Id.* at 661, quoting Commissioner's Smith's concurring opinion in *In re Investors Management Co.,* 44 S.E.C. 633 (1971).
[9] *Id.* at 662.
[10] *Id.* at 663.
[11] *Id.* at 664.
[12] *Id.*
[13] *Id.* at 658.
[14] *Id.*
[15] *Id.* at 655.
[16] 463 U.S. at 661.
[17] 693 F.3d at 288.
[18] *Id.*
[19] *Id.* at 286.

[20] As support for their position, they argue not only that it is compelled by the Supreme Court's analysis in *Dirks*, but that it is supported by the district court's decisions in *United States v. Whitman,* 904 F. Supp. 2d 363 (S.D.N.Y. 2012); *United States v. Rajaratman,* 802 F. Supp.2d 491 (S.D.N.Y. 2011); *Hernandez v. United States,* 450 F. Supp. 2d 1112 (C.D. Cal. 2006); *United States v. Santoro,* 647 F. Supp. 153 (E.D.N.Y. 1986), *rev'd on other grounds, United States v. Davidoff,* 845 F.2d 1151 (2d Cir. 1988); *State Teachers Ret. Bd. v. Fluor Corp.,* 592 F. Supp. 592 (S.D.N.Y. 1984);

[21] Oral Argument Tr. 49-50.