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July 2009

Second Circuit Endorses SEC's Expansive View of Insider Trading

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Recently, the U.S. Securities and Exchange Commission (the "SEC") has sought to expand the scope of insider trading liability.[1] Last week's Second Circuit decision in *SEC v. Dorozhko*[2] appears to have advanced that goal by eliminating the need to prove a key element in insider trading cases involving affirmative misrepresentations. Specifically, the *Dorozhko* Court ruled that a computer hacker can be liable for insider trading even if he did not violate any fiduciary duty in obtaining the material, non-public information upon which he traded. At least in the Second Circuit, this decision alters the insider trading jurisprudence regarding duty that has developed over the last thirty years. Although the decision does not impact insider trading cases involving omissions rather than affirmative misrepresentations, it will likely embolden the SEC in its efforts to further extend the reach of insider trading law.

Traditional Insider Trading Jurisprudence: Two Theories

Insider trading has been charged at the federal level under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. Rule 10b-5 requires two elements to be established: (1) that a person employed a device or contrivance, or engaged in an act, practice, or course of business which operates as a fraud or deceit upon any person; and (2) that such conduct was in connection with the purchase or sale of a security.[3] Prior to *Dorozhko*, in order to meet the first element, it was necessary to establish that a fiduciary or confidential relationship existed between the trader and the information source, and that the information at issue was both material and non-public.

Courts developed two theories of insider trading under Rule 10b-5, known as the classical theory and the misappropriation theory. Under the classical theory, insider trading occurs when a corporate insider trades in the securities of his or her corporation on the basis of material, non-public information.[4] A corporate insider is entrusted with confidential information by virtue of his or her position, and in return owes fiduciary duties to the shareholders not to use that information for personal gain.[5]

Of course, this formulation fails to reach outsiders who use confidential information in ways that do not violate any duty owed to corporate shareholders. Urged by the SEC and prosecutors, courts developed a theory that did not draw an insider/outsider distinction. The resulting misappropriation theory bases insider trading liability on the trader's deception of those who entrusted him or her with confidential information. The Supreme Court formally endorsed the misappropriation theory of insider

trading liability under Rule 10b-5 in *United States v. O'Hagan*.[6] The misappropriation theory, the Court emphasized, is necessary to protect the integrity of the securities markets against abuses by outsiders who have access to confidential information, but who owe no fiduciary duty to shareholders.[7]

The *Dorozhko* decision limits *O'Hagan* and its progeny to omission cases, and has established a new theory for evaluating cases of affirmative misrepresentation.

Dorozhko's Definition of "Deceptive" Removes Duty Requirement

The defendant in *Dorozhko* opened an online trading account in which he deposited $42,500 in October 2007. Shortly thereafter, an anonymous hacker gained access to earnings data for IMS Health, Inc. ("IMS") from the servers of Thomson Financial, Inc., the company providing investor relations and web-hosting services to IMS. Within an hour of the hacker's obtaining this information, the defendant used his online trading account for the first time, purchasing almost $42,000 of IMS put options, essentially betting that IMS stock would decline significantly in the near future. Later the same day, IMS announced that its earnings were 28% below analysts' expectations. When the market opened the next morning, the price of IMS stock dropped by about a third and defendant sold his put options, realizing a profit of approximately $286,000. The SEC alleged that the anonymous hacker was the defendant, and charged him with insider trading.

Relying upon the Supreme Court's decisions in *Chiarella*, *O'Hagan*, and *SEC v. Zandford*, the District Court dismissed the action by holding that absent a fiduciary duty, the conduct was not "deceptive" within the meaning of Section 10(b).[8]

In vacating the District Court's order, the Second Circuit rejected the District Court's conclusion that *Chiarella*, *O'Hagan*, and *Zandford* established a requirement that any "deceptive device" requires a breach of fiduciary duty.[9] The Court held that those cases applied only in the context of omissions, and that in the case of affirmative misrepresentations, no such duty was necessary. The Second Circuit focused its analysis on "whether the 'device' in this case—computer hacking—could be 'deceptive' within the ordinary meaning of that term."[10] The Court adopted the SEC's proposed interpretation, i.e. that "'misrepresentations are fraudulent, but . . . silence is fraudulent only if there is a duty to disclose.'"[11] The Court remanded the case to allow the District Court to determine whether the hacker had engaged in false identification by representing himself as an authorized user, which the Second Circuit found would be "plainly 'deceptive' within the ordinary meaning of the word," or had simply exploited a weakness within an electronic network in order to gain access, which the Second Circuit stated might be "mere theft" rather than deception.[12]

The SEC's argument in *Dorozhko* that violation of a duty is not a required element of insider trading in an affirmative misrepresentation case is similar to arguments being made by the Department of Justice in recent criminal insider trading prosecutions. For example, in *United States v. Mahaffy*, the District Court for the Eastern District of New York found that Section 1348 of the 2002 Sarbanes-Oxley Act[13] requires prosecutors to prove fewer elements than Rule 10b-5. The court interpreted Section 1348 to require only 1) a scheme or artifice to defraud; 2) connection with a security; and 3) fraudulent intent.[14] The *Mahaffy* Court, analogizing Section 1348 to an honest services fraud case, lowered the burden for showing a "scheme or artifice to defraud" by holding that the defendant need only make a material misrepresentation, not violate a duty of confidence.[15]

The Paul Hastings Team

If you have any questions concerning these developing issues, please do not hesitate to contact any of the Paul Hastings lawyers below. We have a strong team of experienced enforcement and regulatory lawyers that includes former prosecutors and SEC regulators. Members of our practice regularly represent clients in connection with investigations and actions brought by the SEC, the Department of Justice, the New York Attorney General's Office, FINRA, NASAA, and numerous other state attorneys general and regulatory organizations.

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[1] *See*, *e.g.*, *SEC v. Rorech*, No. 09-CV-4329 (S.D.N.Y. filed May 5, 2009) (the first insider trading case brought over previously-unregulated credit default swap agreements, based upon the SEC's rationale that these agreements are "security-based swap agreements" subject to the Exchange Act's anti-fraud provisions).

[2] No. 08-0201-cv, 2009 U.S. App. LEXIS 16057 (2d Cir. July 22, 2009).

[3] 17 C.F.R. § 240.10b-5. In addition to Rule 10b-5, the Exchange Act includes two narrower insider trading provisions limited to tender offers and short-swing profits by corporate officers. See 15 U.S.C. § 78n(e); 17 C.F.R. § 240.14e-3 (prohibiting trades based on material non-public information during a tender offer); 15 U.S.C. § 78p(b) (prohibiting profits realized in less than six months by directors or officers of a corporation and those holding greater than ten percent of the total outstanding shares).

[4] *See United States v. O'Hagan*, 521 U.S. 642 (1997).

[5] *Chiarella v. United States*, 445 U.S. 222, 228-229 (1980).

[6] *United States v. O'Hagan*, 521 U.S. 642 (1997).

[7] *Id.* at 653.

[8] *SEC v. Dorozhko*, 606 F. Supp. 2d 321, 338-39 (S.D.N.Y. 2008) (relying upon *Chiarella* 445 U.S. at 228, *O'Hagan*, and *SEC v. Zandford*, 535 U.S. 813 (2002)).

[9] *Dorozhko*, 2009 U.S. App. LEXIS 16057, at *16-18.

[10] *Id.* at *7. The Second Circuit was satisfied with the District Court's conclusions that the hacking was a "device or contrivance," "in connection with" the purchase or sale of securities, and not "manipulative" within the meaning of Section 10(b). *Id.* at *8 n.3.

[11] *Id.* at *19 (quoting SEC's appellate brief).

[12] *Id.* at *24.

[13] 18 U.S.C. § 1348 (2002) (making it a crime to "knowingly execute[], or attempt[] to execute, a scheme or artifice to defraud any person in connection with any security . . . or . . . obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of any security.").

[14] *United States v. Mahaffy*, No. 05-CR-613, 2006 U.S. Dist. LEXIS 53577, at *34-49 (E.D.N.Y. Aug. 2, 2006).

[15] *See id.* at *37-38 (citing *United States v. Rybicki*, 354 F.3d 124, 127 (2d Cir. 2003)).