

As Insider Trading Enforcement Surges, the Scope of Fiduciary Duties Comes Into Focus

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High-profile charges of insider trading are dominating the headlines at an unprecedented pace. As federal prosecutors face pressure from Congress to take action in the aftermath of the financial crisis, insider trading has moved to the forefront of their enforcement priorities. This is not surprising. Insider trading cases—which typically involve a relatively small number of defendants, witnesses, and key pieces of evidence—are often simpler to investigate and prosecute than allegations of systemic fraud at large institutions. Moreover, they offer prosecutors the benefit of placing an individual at the center of the trial, rather than a faceless corporation.

In 2011, the Securities and Exchange Commission brought a record number of 67 insider trading actions, and will exceed that total in 2012. The Justice Department also has pursued prosecutions at a rapid pace. Since late 2009, the US Attorney's Office for the Southern District of New York has charged 66 individuals with insider trading. None has been acquitted and 60—over 90% of the total—have either pled guilty or been convicted. (The other six cases are pending.) The high-profile convictions of Galleon Management LLP founder Raj Rajaratnam and former McKinsey & Co. chief Rajat Gupta have attracted the most attention. But the federal dragnet has swept far more broadly to include dozens of other financial professionals, such as Broadband Research analyst John Kinnucan and Bristol-Myers Squibb Co. assistant treasurer Robert Ramnarine, as well as attorneys at prominent law firms.

Insider trading is defined as the trading of a security while possessing material nonpublic information obtained in breach of a fiduciary or functionally equivalent legal duty. *Dirks v. SEC*, 463 US 646, 660 (1983); see Securities Exchange Act of 1934 § 10(b), 15 USC § 78j(b), SEC Rule 10b-5, 17 CFR § 240.10b-5. The offense comes in two forms. “Classical” insider trading occurs when an

insider trades on secret information taken in violation of a fiduciary duty to the company. *Chiarella v. United States*, 445 US 222 (1980). “Misappropriation” occurs when a person trades on information misappropriated from a party to whom that person owes a fiduciary duty (e.g., an attorney trading on a client's information). *United States v. O'Hagan*, 521 US 642 (1997). In either scenario, the government must prove that the defendant traded on material nonpublic information and that a fiduciary duty was breached.

Despite the long history of insider trading law, a key aspect of this standard has received little attention: Is the relevant fiduciary duty a creation of federal or state law? The answer is critical because, as Professor Stephen Bainbridge has explained, the federal prohibition on insider trading is an “empty shell”—its force and substance depends entirely upon the fiduciary duty with which it is filled. Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 Wash. & Lee L. Rev. 1189 (1995).

The government consistently argues that the fiduciary duty derives exclusively from federal law. This position dates back to a famous SEC opinion, *In re Cady, Roberts & Co.*, holding that Section 10(b) and Rule 10b-5 establish a “wholly new and far-reaching body of Federal corporation law” that prohibits “misleading or deceptive activities” even if they are not “sufficient to sustain a common law action for fraud.” 40 SEC. 907, 1961 WL 60638 at *3-4 (Nov. 8, 1961). Under this approach, the existence of the duty depends on the practical significance of the insider's relationship to the corporation, without regard to whether any state's laws would treat that relationship as significant. *Id.* at *4.

This approach is inconsistent with the Supreme Court's general “reluctance to federalize” the law of corporations, *Santa Fe Indus. v. Green*, 430 US 462, 479 (1977), and

its refusal to hold a defendant liable for trading on secret information unless the information was acquired in violation of a fiduciary duty, *Dirks*, 463 US at 653-55. The better reasoned view is that the fiduciary duty, and the circumstances establishing a breach, are governed by state law. In other words, as the Seventh Circuit has held, the federal standard for establishing an insider trading violation requires the government to prove that the insider (1) breached a fiduciary duty, as defined by state law, and (2) traded on material nonpublic information for the purpose of securing a personal benefit, as defined by federal law. *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 496 (7th Cir. 1986); *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429, 436 (7th Cir. 1987). To determine which state's laws apply, the court simply should follow the conflict-of-law rules in the forum state in which the prosecution is being conducted.

The question whether federal or state law controls the fiduciary duty may make a critical difference. A federal standard potentially criminalizes any use of insider information that can be deemed misleading or inappropriate, without regard to the actual legal obligations of the insider to the corporation. By contrast, state law typically defines fiduciary duties with more precision.

The accelerating pace of insider trading prosecutions will force courts to reengage on this question. The answer that they provide will have far-ranging impacts on individual exposure to liability throughout the financial industry.

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