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SECOND CIRCUIT CASE SHOWS HOW CONFIDENTIALITY PACT MAY SUPPORT INSIDER TRADING CHARGES

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A recent decision by the U.S. Court of Appeals for the Second Circuit shows how an investor's entering into a confidentiality agreement with an issuer of securities may support insider trading charges against the investor.

The decision, *United States v. Kosinski*, No. 18-3065 (2d Cir., Sept. 22, 2020), did not create new law in the Second Circuit. But the court did reaffirm its earlier holding that by agreeing to keep confidential information provided by an issuer, a trader had taken on a fiduciary-like duty to the issuer sufficient to support insider trading charges under section 10(b) of the Securities Exchange Act of 1934. And it rejected the argument that to create the requisite duty, the agreement needed to have a no-trading provision as well as a confidentiality provision.

What creates a sufficient duty has been a hotly disputed issue in insider trading law in recent years. It elicited heightened attention during the SEC's case against billionaire Dallas Mavericks owner Mark Cuban, where the SEC's charges were based in part on an alleged promise by Cuban to maintain confidentiality as to information provided by issuer Mamma.com.

But Cuban's case did not resolve that issue as a legal matter. Rather, the U.S. Court of Appeals for the Fifth Circuit, without addressing all of the legal questions posed, held that the SEC had alleged enough to support a finding that Cuban had agreed both to maintain confidentiality and not to trade, so that the case could go to a jury. It did, and the jury acquitted Cuban on the facts.

Kosinski makes clear that in the Second Circuit, the SEC would not need to allege a promise not to trade, and that a duty of confidentiality is sufficient.

Some brief background on insider trading law: There are two principal theories of insider trading liability: (i) the classical theory, where a corporate officer or director or other obvious insider (including "temporary insider" such as an investment banker working for a company) trades on material non-public information; and (ii) the misappropriation theory, where someone acquires inside information about a company and trades on it in violation of a duty other than the normal duty owed by a corporate insider to the company's shareholders.

In cases under the misappropriation theory, the key question is often, to whom did the alleged insider trader owe a duty, and how did that duty arise?

In *United States v. O'Hagan*, 521 U.S. 642 (1997), where the Supreme Court adopted the misappropriation theory, the trader was a lawyer representing a buyer in a corporate acquisition, who traded in the stock of the target company. As counsel for the buyer, he did not owe a duty to the target company, since he was not the target's lawyer. But he did owe a duty to his law firm and his client not to trade on information he gathered in working on their behalf to benefit himself financially. That was enough to create liability for insider trading.

A number of cases, including Cuban's, have raised scenarios where a company approached a potential investor about a private placement. In such situations, companies often ask potential investors to sign confidentiality agreements, or to agree orally to confidentiality, which the SEC argues creates a sufficient duty to the company.

The same question arises in any factual scenario under the misappropriation theory. The Second Circuit has held that an agreement to keep information confidential is sufficient. It took that approach in *United States v. Falcone*, 257 F.3d 226 (2d Cir. 2001), where there was no written confidentiality agreement, only an understanding regarding confidentiality communicated by a magazine distributor to wholesalers.

And last month, it reaffirmed that view in *Kosinski*. The defendant was not a traditional corporate insider, but rather an outside doctor working as a principal investigator for a clinical trial for a cardiac drug. The case was brought under the misappropriation theory, but the court held that the defendant's conviction could be sustained under both that approach and the classical theory, which it described as "overlapping" theories of liability.

It found that the defendant's role as drug-trial investigator was encompassed within the term temporary insider under the classical theory. And it found his agreement to maintain confidentiality sufficient to support liability under the misappropriation theory. It specifically rejected arguments that something more than a promise to keep information confidential, such as a promise not to trade on or use the information, was required to create the necessary duty, making clear that a confidentiality agreement, even without a no-trading provision, can give rise to a duty sufficient to trigger insider trading liability.

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