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INSIDER TRADING

How Fund Managers Can Handle Insider Trading Risks After U.S. *v. Chow*

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Few areas of the law are in greater need of clear judicial guidance than insider trading, and tipper-tippee liability occupies perhaps the haziest corner of insider trading law. For fund managers, avoiding tipper-tippee liability involves asking questions without clear answers: Is this information material nonpublic information (MNPI)? Did the source violate a fiduciary duty by providing the information? Did the source get a "personal benefit" in exchange for the information?

Over the years, courts have tried – but largely failed – to offer meaningful guidance. In U.S. *v. Chow*, the Second Circuit had another chance to clarify those lingering uncertainties. By affirming Benjamin Chow's conviction for insider trading, however, the court arguably injected more uncertainty into the already fuzzy doctrine. Of note, the court's opinion muddied the standard for assessing whether the alleged tipper had a fiduciary duty to the issuer, what counts as a breach of that duty and what sort of personal benefit the tipper must receive to trigger liability.

This article analyzes what *Chow* means for tipper-tippee liability, what the risks facing private fund managers are and what practices managers can adopt to mitigate those risks.

For more on insider trading, see "Although *Martoma* May Have Been Put to Rest, the Debate Over the 'Personal Benefit' Test Continues" (Sep. 6. 2018).

Insider Trading Law

The legal foundation for the prohibition on insider trading is a bit murky. There is, for example, no statute explicitly prohibiting insider trading. Rather, insider trading prosecutions are brought under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, neither of which uses the phrase "insider trading." Instead, those provisions ban the use of "manipulative and deceptive devices" or other fraud in trading securities.

See "Insider Trading Statute and Other Recommendations From the Bharara Task Force" (Mar. 19, 2020).

From its meager statutory and regulatory origins, insider trading law emerged through judicial decisions interpreting the general antifraud provisions. The core of the doctrine that developed is simple: trading on inside information is prohibited if it was based on MNPI obtained in breach of a duty of trust or confidence.

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Almost all insider trading cases fall into one of three categories. The first category – known as the "classical theory" of insider trading – involves a corporate insider who trades on MNPI learned on the job. Those cases are relatively straightforward; corporate insiders have a duty not to use their positions to trade on MNPI. An honest securities market could not exist if that conduct was permitted.

See our two-part series "How Can Hedge Fund Managers Apply the Law of Insider Trading to Address Hedge Fund Industry-Specific Insider Trading Risks?": Part One (Aug. 7, 2013); and Part Two (Aug. 15, 2013).

So-called "misappropriation" cases involve someone other than a traditional corporate insider. In those cases, an outsider trades on MNPI obtained or misappropriated from a party to whom the outsider owes a fiduciary or quasi-fiduciary duty. Often the outsider is a service professional – for example, an investment banker, lawyer or accountant – whose service allows special access to confidential information and on whom the corporation relies to act for its benefit.

See "When Does Talking to Corporate Insiders or Advisors Cross the Line into Tipper or Tippee Liability Under the Misappropriation Theory of Insider Trading?" (Jan. 10, 2013).

The third category is tipper-tippee cases, which are more complicated and can arise under either the classical or misappropriation theory. Their defining feature is that a "tipper" passes MNPI to a "tippee," who then trades on that information. Illegal tipping happens when the tipper violates a fiduciary duty owed to the company by passing the information and gets some "personal benefit" from doing so. For tippees, there is an added requirement that the tippee must know that the tipper violated a fiduciary duty by giving the tip.

Recent Developments in Tipper-Tippee Liability

The government's renewed focus on insider trading after the financial crisis of 2007 gave courts – particularly the Second Circuit – ample opportunity to tinker with the standard for tipper-tippee liability.

The 2014 case *U.S. v. Newman*, for example, added new gloss to the personal benefit requirement. In that case, the Second Circuit held that a gift of confidential information counts as a personal benefit only if:

- the tipper and tippee had a "meaningfully close personal relationship"; and
- the tipper received something of a "pecuniary or similarly valuable nature."

In other words, passing a tip to a friend who had offered "career advice" would not be enough, under *Newman*, to show that the tipper personally benefited.

See our two part series on the Supreme Court's denial of certiorari in *Newman*: "Favors Insider Trading Defense" (Oct. 29, 2015); and "Complicates Insider Trading Prosecution" (Nov. 5, 2015).

Two years later, the Supreme Court (Court) in *Salman v. U.S.* cut back on *Newman*'s understanding of the personal benefit test. The question in that case was whether a tippee who received a tip from a relative could be convicted of insider trading even though the

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relative never received any "money or property in exchange for the tips." The Court's answer was "yes." In reaching that answer, the Court abrogated *Newman*'s requirement that a "tipper must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift to family or friends." The Court did not say, however, whether, as *Newman* intimated, a "meaningfully close personal relationship" was necessary for tipper-tippee liability when the tipper gifts the information to the tippee.

See "Supreme Court's Ruling in *Salman v. U.S.* Affirms the Importance of a Tipper's 'Personal Benefit' for Insider Trading, but Also Creates Uncertainty" (Feb. 9, 2017).

The Second Circuit largely ducked that question in *U.S. v. Martoma* in 2017. The court held that, under *Newman*, a jury could infer a personal benefit from either:

- a meaningful close relationship between tipper and tippee; or
- other evidence suggesting that the tipper "intended to benefit [the tippee] with the inside information."

In *Martoma*, it was enough to show an intent to benefit that the tippee paid the tipper "$70,000 in consulting fees." The court left unanswered, however, whether a tipper who gifts information to an acquaintance without receiving any actual benefit could be convicted of insider trading.

See "HFLR Panel Identifies Best Practices for Avoiding Insider Trading Liability in the Aftermath of *Martoma*" (Jan. 18, 2018).

Decided in September 2020, *U.S. v. Kosinski* added color to the duty element of insider trading, although it is not a tipper-tippee case. The defendant in that case was an investigator in a clinical trial for a pharmaceutical company. While supervising the trial, the defendant breached his agreement with the company by buying $250,000 in company stock and selling that stock when he learned that the drug being tested had dangerous side effects. When affirming the resulting insider trading conviction, the Second Circuit ruled that the defendant had assumed "a duty of confidentiality" by contracting with the company to not reveal any confidential information. That duty of confidentiality was itself enough to create a fiduciary duty.

For analysis of another recent insider trading case, see "Supreme Court Directs Second Circuit to Take a Fresh Look at Insider Trading Prosecution" (Feb. 25, 2021).

The *Chow* Decision

Chow, decided on April 6, 2021, is the latest word from the Second Circuit on tipper-tippee liability. The case began when regulators started investigating trading in Lattice Semiconductor Corporation (Lattice) stock. During that investigation, Michael Yin's trading raised red flags. Over several months in 2016, Yin had bought and then sold more than seven million shares, netting about $5 million in profit.

As it turned out, Yin was an acquaintance of Chow, who worked for the Chinese state-owned private equity firm that was trying to acquire Lattice. Chow led negotiations over the potential acquisition and signed two

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nondisclosure agreements (NDAs) with Lattice. The NDAs required both Lattice and Chow to keep the negotiations secret and not disclose the other party's proprietary information.

After reports surfaced that an unidentified Chinese buyer was pursuing Lattice, Yin contacted Chow to set up a meeting. Over the next few months, Chow and Yin met several times and communicated by phone and text. In those conversations, Chow told Yin that he was pursuing an acquisition of a semiconductor company on the West Coast. Yin also seems to have learned the rough timing of when a deal might be completed. It is unclear whether Chow ever told Yin that the target company was Lattice. What is clear, however, is that Yin bought hundreds of thousands of shares of Lattice stock right after speaking with Chow.

The interactions were not entirely one-sided. At one point, Chow asked Yin, who worked for a venture capital firm, for some reports on the semiconductor industry and for leads on possible partners for a new venture. Yin also sent Chow wine and cigars to congratulate him on the new venture.

Eventually, Chow and Lattice announced they had reached an agreement. Lattice's stock skyrocketed, and Yin sold about half his shares for a hefty profit.

Chow was ultimately indicted on twelve counts of insider trading and convicted on six. (Parallel criminal and civil enforcement actions are pending against Yin on the same theory of insider trading the government pursued against Chow.) At sentencing, the probation office's report noted that there was nothing to suggest that Chow profited or received other benefits from his crimes. The district court also concluded that Chow did not have a "fiduciary or quasi-fiduciary" relationship with Lattice. Chow was sentenced to 78 to 97 months in prison.

The Second Circuit affirmed Chow's conviction, rejecting his argument that his lack of a fiduciary or quasi-fiduciary duty precluded an insider trading conviction. For the court, Chow's signing of the NDAs with Lattice was enough to create "a duty of trust or confidence," which was all the court thought necessary for insider trading. The court also thought that Yin's knowledge about the Lattice negotiations, together with the volume and timing of his trades, supported the inference that Chow revealed MNPI. In addition, the favors Yin did Chow – and the gifts of wine and cigars – evinced Chow's intent to benefit Yin and thus satisfied the personal-benefit requirement.

For a look at NDAs in a different context, see "How ILPA's Model NDA Could Change Preliminary Due Diligence Practices" (Jun. 10, 2021).

What *Chow* Means for Tipper-Tippee Liability

Consciously or not, *Chow* has stretched tipper-tippee liability to its furthest extent yet.

The Fiduciary Relationship Requirement

A key element of tipper-tippee liability is that the tipper must have a fiduciary or quasi-fiduciary relationship with the company. The hallmark of a fiduciary relationship is that one party works for the benefit of the other and

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under the other's control. Even in *Kosinski*, in which the court relied, in part, on a confidentiality agreement to find a "fiduciary-like" relationship, the company had placed "trust and confidence" in the defendant, who was under the company's control, to run its clinical trial; the confidentiality agreements furthered that relationship.

By contract, in *Chow*, Chow never worked for Lattice's benefit or under its control. The entire transaction – including the confidentiality obligations – was reciprocal: neither Lattice nor Chow controlled or relied on the other or worked for anyone's benefit but their own, and the NDAs merely facilitated an ordinary business deal. Yet, *Chow* glided over those critical elements of a fiduciary relationship by treating all confidentiality obligations alike. By doing so, the court expanded the universe of tippers (and tippees) exposed to insider trading liability.

The Breach Element

Chow also gave a new spin on the breach element of tipper-tippee liability. That element requires the tipper to disclose MNPI in violation of a fiduciary duty owed to the company. Chow did so, according to the court, by telling Yin about "the progress of merger negotiations." There was sparse evidence, however, that Chow told Yin anything about Lattice specifically. Chow seems to have told Yin about a nondescript deal in the western U.S. in the semiconductor industry, and from that, Yin figured out that Lattice was the target. In fact, Yin seems to have deduced that Chow's firm was pursuing a deal with Lattice from a news report that a Chinese buyer was targeting Lattice.

Although it was not unreasonable to infer that much of Yin's knowledge came from Chow, the court's focus on Yin's knowledge – not what Chow told Yin – risks converting a tipper's vague description of business plans to a particularly clever tippee into an insider trading violation.

The Personal Benefit Test

Finally, *Chow* solidified the Second Circuit's retreat from *Newman*'s vision of the personal-benefit test. As in *Martoma*, there was no evidence of a meaningfully close personal relationship here. Unlike *Martoma*, however, there was also no direct financial payment between Chow and Yin. Thus, *Chow* is the first post-*Newman* case upholding a conviction in which there was neither a meaningfully close personal relationship nor a direct payment from tippee to tipper.

Implications for Fund Managers

Chow and the ongoing cases against Yin hold important warnings for fund managers. Traders rely on information and savvy. That information often comes from professional acquaintances, independent research or any number of other sources. After *Chow*, any time a trader's source has an ordinary NDA with a company, there is potential insider trading liability. Therefore, it is more important than ever for fund managers to stay vigilant whenever they receive information from third parties.

To avoid tipper-tippee liability in the wake of *Chow*, fund managers should institutionalize that vigilance by taking the following steps.

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Set and Enforce Clear Insider Trading Policies

Fund managers should have formal written policies against insider trading. Those policies should be clear, concise and accessible to all employees.

At a minimum, insider trading policies should:

- offer examples of permissible and impermissible trades;
- list warning flags for employees to watch for;
- warn employees about the consequences of violating the policies; and
- provide a contact person to help employees with any questions.

Funds should update their insider trading policies to include new guidance from regulators or courts. After *Chow*, for example, funds should consider adding a section on the risks of trading on information from any source with an NDA.

See "Advisers Must Have Strong Insider Trading Controls or Risk SEC Sanctions" (Apr. 2, 2020).

Hold Periodic Training Sessions

Written policies do little good when not combined with training. That is particularly true for policies aimed at curbing tipper-tippee liability. There is just too much gray area in the law to assume employees understand written policies.

Effective training should:

- review the substance of and reasoning behind the policies against insider trading;
- explain what employees should do if they think a trade could be illegal;
- run through real-life examples of insider trading convictions and have employees identify what they would have done differently; and
- emphasize that conscious avoidance is unacceptable and that every employee must actively guard against insider trading by asking questions and acting on any warning signs.

Training should be mandatory, and fund managers should retain all training materials and have employees sign certificates of completion after each session. During training, employees should be reminded of the contact person who can help with any questions or concerns, and employees should be encouraged to reach out if there is a concern.

See "How to Avoid Five Common Duty to Supervise Traps: Respond to Red Flags; Implement Reasonable Policies and Procedures; and Conduct Adequate Training (Part Three of Three)" (Sep. 20, 2018); and "Early and Often: Compliance Training Pays Big Dividends for Private Fund Advisers" (Jul. 8, 2009).

Institute Robust Checks on Third-Party Consultants

Any fund manager that uses third-party consultants must have clear procedures for ensuring that they do not expose the manager to insider trading liability. Some procedures to consider include:

- conducting preliminary conflicts checks for all third-party consultants, focusing on past employment, familial or other meaningful relationships, as well as

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any prior NDAs or other confidentiality agreements the consultant is bound by;
- asking consultants to provide the manager with a copy of their compliance policies, and assessing those policies for potential gaps; and
- having consultants review and agree to follow the manager's insider trading policies.

Instill a Culture of Vigilance

Above all else, fund managers should strive to build a culture of active monitoring of insider trading risks. Policies, procedures and training are effective only if employees follow through in practice – and it is easy to let complacency develop. Fighting complacency requires continual emphasis by leadership on the importance of identifying and investigating warning signs. It also requires funds managers to lead by example; avoid rewarding (legally) risky trades or compliance shortcuts; and take swift action whenever an inappropriate trade is made.

See "Leveraging Policies and Culture: A Recipe for Success" (Jun. 3, 2021).

By taking these steps to prevent, identify and remedy problems, managers can adapt to any change in the law and navigate the legal uncertainty that *Chow* and other insider trading decisions have let linger.

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