2014 WL 3401635 (U.S.) (Appellate Petition, Motion and Filing)
Supreme Court of the United States.

Douglas F. WHITMAN, Petitioner,
v.
UNITED STATES OF AMERICA, Respondent.

No. 14-29.
July 8, 2014.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

Petition for a Writ of Certiorari

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***i** QUESTIONS PRESENTED

1. Whether, in a prosecution for insider trading under § 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b), the relevant inside information must have been a "significant factor" in the defendant's decision to buy or sell, or whether - as the court below held - mere "knowing possession" of inside information suffices for a criminal conviction.

2. Whether, in a prosecution for insider trading under § 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b), the "fiduciary duty" element must be proved under well-established principles of state law, or whether - as the court below held - courts may define and impose the applicable fiduciary duty as a matter of federal common law.

3. Whether exculpatory testimony given by a witness during a deposition in a closely related federal enforcement proceeding is admissible under Federal Rule of Evidence 804(b) in a subsequent criminal trial when the witness is unavailable, or whether - as the court below held - such testimony may be excluded merely because it was given in a civil rather than criminal proceeding.

***II PARTIES TO THE PROCEEDINGS**

Petitioner, Douglas F. Whitman, was the defendant-appellant below.

Respondent, the United States of America, was the appellee below.

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***1** Petitioner, Douglas F. Whitman, respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit.

OPINIONS BELOW

The Second Circuit's unpublished opinion is available at 2014 WL 628143, and is reproduced at Petition Appendix (Pet. App.) 1a. The district court's opinion is reported at 904 F. Supp. 2d 363 (S.D.N.Y. 2012), and is reproduced at Pet. App. 24a.

JURISDICTION

The Second Circuit entered its judgment on February 19, 2014, and denied a petition for rehearing en banc by order dated April 22, 2014. This Court has jurisdiction over this timely filed petition pursuant to 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS

Section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange … (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may ***2** prescribe as necessary or appropriate in the public interest or for the protection of investors.

Federal Rule of Evidence 804(b)(1) provides:

> The following are not excluded by the rule against hearsay if the declarant is unavailable as a witness: (1) Former Testimony. Testimony that: (A) was given as a witness at a trial, hearing, or lawful deposition, whether given during the current proceeding or a different one; and (B) is now offered against a party who had - or, in a civil case, whose predecessor in interest had - an opportunity and similar motive to develop it by direct, cross-, or redirect examination.

INTRODUCTION

This case presents three critical questions of federal securities and evidentiary law on which the circuits are deeply split. On each question, the Second Circuit has diverged from the holdings of all other circuits to consider the issue, as well as this Court's precedents, adopting a view particularly favorable to prosecutors. As a result, it has created a hollow version of the crime of securities fraud unique to that circuit, under which individuals may be convicted without proof that they intentionally traded on inside information, and indeed despite evidence showing to the contrary. Unless this Court resolves these splits, the Second Circuit will continue to be a haven for insider trading prosecutions, casting a shadow over the entire industry of research analysis, an industry this Court has recognized is "necessary to the preservation of a healthy market." *Dirks v. SEC,* 463 U.S. 646, 658 (1983).

First, the decision below deepens an existing conflict among the circuits as to whether the offense of ***3** insider trading requires proof of causation. Four circuits have held, following the language of the federal securities statute and the traditional presumption in favor of causation, that to establish insider trading the government must prove not only that the defendant received inside information but also that the information was a causal or "significant factor" in a particular trading decision. *United States v. Anderson,* 533 F.3d 623, 630 (8th Cir. 2008); *SEC v. Lipson,* 278 F.3d 656, 660-61 (7th Cir. 2002); *United States v. Smith,* 155 F.3d 1051, 1066 (9th Cir. 1998); *SEC v. Adler,* 137 F.3d 1325, 1337-38 (11th Cir. 1998). The Second Circuit alone holds to the contrary that the government need not offer *any* evidence of causation, but may sustain its burden of proof merely by showing that the defendant "knowing[ly] possess[ed]" inside information regarding the relevant companies at the time of the trades. Pet. App. 15a. That holding, repeatedly reaffirmed by the Second Circuit (including here) despite

its rejection by every other circuit to consider it, vastly expands the scope of the offense of insider trading, to cover wholly innocent conduct, and fundamentally transforms it into a type of strict liability crime. Nothing in the statutory language or this Court's opinions countenances such a result.

Second, the decision below diverges from opinions of other circuits, and of this Court, concerning the source of the "fiduciary duty" element of securities fraud. The First, Fourth, and Seventh Circuits have all held that courts must look to well-established principles of state corporate law to define the necessary fiduciary duty. *SEC v. Tambone,* 597 F.3d 436, 448 (1st Cir. 2010) (en banc); *Fortson v. Winstead, McGuire, Sechrest & Minick,* 961 F.2d 469, 472 (4th Cir. 1992); *Jordan v. Duff & Phelps, Inc.,* 815 F.2d 429, 436 (7th Cir. 1987). The Second Circuit, however, ***4** holds that this duty should be crafted by federal courts as a matter of federal common law, without regard to state law. Pet. App. 15a. This holding is inconsistent with a long line of this Court's precedent admonishing that "where a gap in the federal securities laws must be bridged … federal courts should incorporate *state* law." *Kamen v. Kemper Fin. Servs., Inc.,* 500 U.S. 90, 108 (1991). It also renders the nature of the offense of securities fraud entirely uncertain and continually changeable, allowing as it does any court to decide within the context of any case that a fiduciary duty exists sufficient to support conviction, even if that duty is not imposed by the State in which the defendant conducts business.

Third, the Second Circuit's decision creates a direct conflict with the Seventh Circuit concerning the interpretation and application of Federal Rule of Evidence 804(b), which allows the introduction of prior testimony of an unavailable witness if the party against whom the testimony is now offered had "an opportunity and similar motive to develop" the testimony in the prior proceeding. Fed. R. Evid. 804(b)(1). The Seventh Circuit held in *United States v. Sklena,* 692 F.3d 725 (7th Cir. 2012), that this rule applies with full force in a criminal case, and that deposition testimony of a witness in a prior related action brought by the government - whether civil or criminal in nature - is admissible in a subsequent criminal trial if the witness becomes unavailable to testify. *Id.* at 731-32. The Second Circuit, by contrast, concluded in the decision below that such testimony was inadmissible merely because it was given in a civil rather than a criminal proceeding, notwithstanding that in both proceedings government attorneys were investigating the same underlying conduct. Pet. App. 6a-8a. That holding is flatly inconsistent with both the language ***5** and purpose of Rule 804(b), and its effect may be - as it was in this case - to preclude the defense from introducing critical exculpatory testimony.

These three rulings together threaten a sea change in federal securities fraud prosecutions. They greatly expand prosecutorial power, making it possible to obtain convictions of anyone who executes a trade after securing what is later deemed to be inside information, even if the information played no role in the trading decision and even if the person who disclosed the information had no recognized duty to refrain from doing so. They also preclude defendants in these cases from using favorable - even plainly exculpatory - testimony from an unavailable witness merely because that testimony was given during a prior civil rather than criminal proceeding. Certiorari should be granted.

STATEMENT OF THE CASE

Petitioner is a research analyst who spent his career analyzing and investing in telecommunications and technology companies. See Pet. App. 24a. In 1994, he founded and thereafter ran a small technology-focused investment firm in California called Whitman Capital. In that role, he followed and traded in the securities of numerous technology companies, among them Marvell Technology Group (a semi-conductor manufacturer), Polycom (a manufacturer of teleconferencing and videoconferencing equipment), and Google (the well-known internet company). See *id.*

To obtain and verify information about the companies in which he traded, petitioner - like other research analysts - regularly reached out to their managers and employees, as well as others associated with the company, including competitors and other ***6** research analysts, to discuss corporate performance and expectations. These inquiries, known in the securities industry as "checks," are generally disliked (and even actively thwarted) by the managers of the target company, who for obvious reasons prefer to control the dissemination of the company's financial information; however, they are generally lawful and appropriate.

Dirks, 463 U.S. at 658. These checks were a regular part of business at Whitman Capital since its founding, and were (insofar as the government's allegations disclosed) conducted lawfully and properly by petitioner for more than a decade.

In an indictment returned in 2012, however, the United States alleged that in 2006 petitioner changed course and entered into a conspiracy to obtain and trade upon "inside information" in violation of § 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b). See Pet. App. 1a. The government did not allege that petitioner had obtained any such information directly from insiders at the companies, but instead, asserted that he had received the information from others who had themselves improperly obtained it from relevant insiders. *Id.* at 24a. In particular, the government relied on the testimony of two cooperating witnesses who claimed to have passed inside information to petitioner: Roomy Khan, a neighbor and acquaintance with experience in securities trading, as well as Karl Motey, a technology consultant who provided independent research analysis. See *id.* at 11a.

1. A jury trial was held over several weeks in August 2012. Pet. App. 24a. Three rulings of the district court were critical to the course of trial and its outcome.

First, the district court instructed the jury that insider trading is established whenever the inside information ***7** is "at least a factor in [the] trading decision[s]." Pet. App. 15a. It rejected petitioner's objection that the government must show that inside information was a "significant factor" in his trades, as is required in other circuits. *Id.* at 15a-16a.

Second, the district court held that the fiduciary duty element of securities fraud is defined by federal common law. Pet. App. 33a. It specifically refused to apply the law of the relevant State, in this case California, where the companies involved had headquarters, the individuals involved lived and worked, and the tips allegedly took place. See, *e.g., id.* at 32a-33a. Under California law, a fiduciary duty is not imposed upon all employees, but only upon those who are "endowed by the board of directors or the bylaws with discretionary power to manage corporate affairs." *E.g., GAB Bus. Servs. Inc. v. Lindsey & Newsom Claim Servs., Inc.,* 83 Cal. App. 4th 409, 420 (2000), *disapproved on other grounds by Reeves v. Hanlon,* 33 Cal. 4th 1140 (2004). Nevertheless, based on its holding that the fiduciary duty element is independently defined as a matter of federal common law, the court instructed the jury that a fiduciary duty is "owed, so far as disclosure of market-sensitive information is concerned, by all employees to their employers and shareholders." Pet. App. 35a.

Third, the district court refused to admit crucial exculpatory testimony that petitioner sought to introduce. Pet. App. 6a-8a. The testimony was from an unavailable witness, Sunil Bhalla, an alleged insider at one of the relevant companies, who prosecutors claimed provided information about the company to Ms. Khan. *Id.* at 6a. He had previously testified under oath - in a deposition, which included direct questions about petitioner, conducted a year earlier by the SEC as part of a related civil insider-trading investigation ***8** - that he did not have any knowledge of petitioner receiving inside information, did not discuss anything with Ms. Khan that was not already public, and did not give Ms. Khan any material nonpublic information. See *id.* at 6a. Notwithstanding that this testimony was directly relevant and critically important to petitioner's defense, the district court refused to admit it under Federal Rule of Evidence 804(b)(1), on the theory that the SEC's motive was investigatory, which in the court's view was unlike the U.S. Attorney's prosecutorial motive. *Id.* at 7a.

These rulings allowed - indeed, effectively required - the jury to convict petitioner despite the absence of evidence that he significantly relied on inside information in executing any trade or that the information had been disclosed in breach of a state-law fiduciary duty, and when the jury was denied an opportunity to hear testimony that directly contradicted the government's key witness. The exclusion of this testimony was especially damaging because Mr. Bhalla and other witnesses for the defense were unavailable to testify themselves, as a result of the government's threat of prosecution, and those witnesses that did appear were limited in their testimony as a result of the district court's orders.

The district court thereafter sentenced petitioner to 24 months in prison, as well as fines and other penalties. Pet. App. 2a.

2. The Second Circuit affirmed petitioner's conviction. Pet. App. 16a. On causation, the panel - acknowledging a disagreement with other circuits on the issue - held that the government is not required to prove *any* causal nexus between the inside

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information and the challenged trade, but need show only that the defendant was in "knowing possession" of inside information when the trade was executed. *Id.* at ***9** 15a-16a. On fiduciary duty, the panel concluded that the duty is "imposed and defined by federal common law," meaning that a breach may be found - sufficient to support conviction - even when (as here) the law of the relevant State imposed no such duty. *Id.* at 15a. On the admissibility of prior testimony given during related agency proceedings, the panel reasoned that such testimony should be precluded because government attorneys conducting a civil investigation do not have a "similar motive" to develop testimony as do those in a criminal case - even when both proceedings concern the same alleged misconduct. *Id.* at 6a-7a.

REASONS FOR GRANTING THE PETITION

The grounds for certiorari in this case are ample and compelling. On the issues of causation and fiduciary duty for insider trading and the admissibility of prior deposition testimony - which are critical in nearly every securities fraud prosecution across the country - the Second Circuit's holdings diverge dramatically from opinions of other circuits and of this Court. They also invite and indeed may require the conviction of individuals (like petitioner) for conduct that would not constitute a crime in other jurisdictions and without affording the defense an opportunity to present vital exculpatory testimony. Review is urgently needed to bring securities law in the Second Circuit into line with the law in other circuits, as well as this Court's precedents, and to address the serious concerns raised by the judgment below regarding prosecutorial over-reach and the guarantee of fundamental fairness to defendants in securities prosecutions.

*10 I. THE SECOND CIRCUITS HOLDING THAT CAUSATION IS NOT AN ELEMENT OF INSIDER TRADING DEEPENS AN EXISTING CIRCUIT SPLIT ON THE ISSUE AND CONFLICTS WITH OPINIONS OF THIS COURT.

Certiorari should be granted, first, to review the holding below that there is no causation element for the offense of insider trading under § 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b). That holding, unique to the Second Circuit, conflicts directly with opinions of other circuits, and it is contrary to both the text of the statute and this Court's precedents. *Infra* pp. 10-15. It has, moreover, rendered the Second Circuit a haven for securities prosecutions, allowing the government to secure convictions - like petitioner's - that could not have been obtained elsewhere due to a lack of proof that the alleged inside information was a motivating factor in the challenged trades. *Infra* pp. 15-17. To remedy this divide, and ensure that justice does not depend on geography, review is warranted.

1. There can be no doubt, and indeed courts have acknowledged, that the circuits are divided as to the causation standard for insider trading. Four circuits have held that an insider trading charge requires proof that the inside information was a causal factor in the defendant's decision to make the challenged trades. *Anderson,* 533 F.3d at 630; *Lipson,* 278 F.3d at 660-61; *Smith,* 155 F.3d at 1066; *Adler,* 137 F.3d at 1338. These courts recognize that proof of causation is mandated by the terms of the securities fraud statute itself. *E.g., Lipson,* 278 F.3d at 660. The statute does not prohibit the mere receipt of inside information, or all trading in a security while in possession of relevant inside information, but rather precludes specifically the "use or employ" of "any manipulative ***11** or deceptive device or contrivance" in securities trading. 15 U.S.C. § 78j(b). Accordingly, these courts have consistently held that "the government may not rest upon a demonstration that the suspected inside trader bought or sold while in possession of inside information; rather, it must, at a minimum, prove that the suspect used the information in formulating or consummating his trade." *Smith,* 155 F.3d at 1070 n.28; see *Anderson,* 533 F.3d at 630; *Lipson,* 278 F.3d at 660-61; *Adler,* 137 F.3d at 1338.

Two courts, the Ninth and Eleventh Circuits, have clarified further that in criminal prosecutions, beyond a mere "causal connection," the inside information must have been a "significant factor" in the decision to trade. *Anderson,* 533 F.3d at 630; *Smith,* 155 F.3d at 1070 n.28. This standard is appropriate, particularly in the criminal context, to ensure that only "intentional" or "willful" misconduct will lead to loss of liberty. *Anderson,* 533 F.3d at 630; *Smith,* 155 F.3d at 1070 n.28; cf. *Ernst & Ernst*

v. Hochfelder, 425 U.S. 185, 199 (1976) (the language of the securities fraud statute "connotes intentional or willful conduct designed to deceive or defraud investors").

The Second Circuit, by contrast, holds to the contrary that there is *no* causation element in an insider trading charge. *E.g., United States v. Royer,* 549 F.3d 886, 899 (2d Cir. 2008). Rather, the prosecution may sustain its burden of proof merely by showing that the defendant "knowingly possessed" inside information regarding the relevant companies at the time of the trades. *Id.* This approach, which the Second Circuit has justified as "ha[ving] the attribute of simplicity," *United States v. Teicher,* 987 F.2d 112, 120 (2d Cir. 1993), has been reaffirmed by the court in a number of cases (including this one) in the face of repeated challenge and notwithstanding extensive critical ***12** commentary. See generally, *e.g.*, Carol B. Swanson, *Insider Trading Madness: Rule 10b5-1 and the Death of Scienter,* 52 U. Kan. L. Rev. 147, 205 (2003); David W. Jolly, Note, *Knowing Possession vs. Actual Use: Due Process & Social Costs in Civil Insider Trading Actions,* 8 Geo. Mason L. Rev. 233 (1999); Allan Horwich, *Possession Versus Use: Is There a Causation Element in the Prohibition on Insider Trading?,* 52 Bus. Law. 1235 (1997).

The split between the circuits on this issue is thus entrenched and deep. That split has indeed been acknowledged by both the Second Circuit, *Royer,* 549 F.3d at 899, and other courts that have addressed the issue - which have explicitly considered and rejected the Second Circuit's holding, *Lipson,* 278 F.3d at 660-61; *Smith,* 155 F.3d at 1070 n.28; *Adler,* 137 F.3d at 1338. It is now time for this Court to resolve this conflict, and state definitively what standard of causation applies in insider trading prosecutions.

2. Review would, however, be warranted even absent a circuit split. That is because the Second Circuit's holding, that no proof of causation is required to establish insider trading, is plainly inconsistent with opinions of this Court discussing the nature of securities fraud and outlining the elements of that offense under federal law.

Those opinions, including the seminal decision in *Dirks v. SEC,* 463 U.S. 646 (1983), squarely reject the proposition that mere possession of inside information is sufficient to prove securities fraud. See *id.* at 559-60; see also *United States v. O'Hagan,* 521 U.S. 642, 656 (1997); *Chiarella v. United States,* 445 U.S. 222, 227 (1980). They instead interpret the language of the securities statute - which prohibits the "use or employ" of a "manipulative or deceptive device" in securities trades, 15 U.S.C. § 78j(b) - as requiring ***13** proof that the defendant both received inside information *and* intentionally employed that information in making a trade. See, *e.g., Dirks,* 463 U.S. at 659-60. While the precise formulations of this requirement differ among the cases - the defendant must "exploit[ ]" the information, *id.*, "take advantage" of it, *Chiarella,* 445 U.S. at 227, or simply "use[ ]" it, *O'Hagan,* 521 U.S. at 656 - they all require that the information play a causal, motivating role in a trading decision before a violation will be found.

This principle is consistent with a long line of decisions addressing securities fraud under the common law. Those decisions, which have informed this Court's interpretation of the federal securities statute, see, *e.g., Dirks,* 463 U.S. at 653-54, recognize that because these claims target intentional misconduct - *i.e.*, affirmative deception designed to take advantage of another - the traditional presumption in favor of a causation element applies. See Horwich, *supra,* at 1242-48 (citing cases). In the insider trading context, this means that the inside information must have been not only knowingly obtained but also affirmatively misused to gain a profit. *Id.*; see also *Chiarella,* 445 U.S. at 234-35 (although § 10(b) "is aptly described as a catchall provision," "what it catches must be fraud"); *Santa Fe Indus., Inc. v. Green,* 430 U.S. 462, 473 (1977) (the "language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception").

The Second Circuit's holding runs counter to these opinions. The "knowing possession" rule expands the statute to cover situations where a person has received inside information but has no intention of exploiting it to gain an unfair advantage over other shareholders, and "go[es] a long way toward making ***14** insider trading a strict liability crime," *Smith,* 155 F.3d at 1068 & n.25 - contrary to both this Court's admonitions and the history of the securities statute. Indeed, by effectively eliminating the causation element of insider trading, the Second Circuit has in essence returned to the mere possession or "information" theory of insider trading that this Court has specifically rejected. See *Dirks,* 463 U.S. at 657 (citing *Chiarella,* 445 U.S. at 235 n.20); see also Swanson, *supra*, at 207.

The Second Circuit has suggested that its standard is justified by the "oft-quoted maxim," stated in *Chiarella,* 445 U.S. at 227, that "one with a fiduciary or similar duty to hold material nonpublic information in confidence must either 'disclose or abstain' with regard to trading." *Teicher,* 987 F.2d at 120. However, as other courts have recognized, *Chiarella*'s credo does not mean that a person who receives inside information must "disclose or abstain" from *all* trading; it instead prohibits trading "*on the basis of material nonpublic information.*" *Smith,* 155 F.3d at 1069 (emphasis omitted). The Second Circuit has also said that the "knowing possession" standard "has the attribute of simplicity," and that "as a matter of policy" requiring proof of causation could "frustrate" attempts at prosecution. 987 F.2d at 120-21. But a desire for simplicity and ease of prosecution does not justify reading elements out of the statute. To the contrary, doubts about the reach of a criminal statute should be resolved, not in favor of simplifying the prosecutor's job, but "in favor of the defendant." *Adamo Wrecking Co. v. United States,* 434 U.S. 275, 285 (1978). [1]

***15** There is, in short, simply no way to reconcile the Second Circuit's approach with this Court's precedent. Certiorari should be granted to address the issue and correct that circuit's mistaken interpretation of federal securities law.

3. Review is all the more appropriate in light of the critical importance of this issue. Whether the defendant relied upon the inside information in a trading decision is nearly always in dispute in insider trading cases, see, *e.g., Smith,* 155 F.3d at 1069-70, and the standard for causation will thus inevitably be relevant in each of the many securities prosecutions commenced every year. The issue will in many cases be potentially dispositive. It certainly was here: given the dearth of evidence that petitioner relied upon the alleged inside information in making any of the challenged trades, he likely would have been acquitted had the jury been instructed (as petitioner requested) that it would need to find that the inside information was a "significant factor" in his trades. See Pet. App. 15a-16a. Particularly in the electronic age, when a research analyst now receives from a wide range of sources a constant stream of (often unsolicited) information - some of which will be correct and meaningful but much of which will be unverifiable or simply wrong and ignored - a causation standard is essential to distinguish between criminal and innocent conduct.

This case indeed serves as a perfect example of the direct and immensely damaging consequence of the Second Circuit's position. Under that view, a defendant may be convicted of insider trading, and sentenced to years of imprisonment, merely because he or she happened to receive what may be inside information about a company in which the defendant was trading, regardless of whether the defendant relied ***16** on the information, recognized its relevance, or even viewed it as accurate. *Royer,* 549 F.3d at 899. In no other jurisdiction across the country would a defendant be subject to conviction in this situation. Yet, in the Second Circuit, defendants can be and are convicted in such circumstances. *Id.*; see also Pet. App. 15a-16a.

It is all but certain that, given its uniquely lax (effectively non-existent) causation standard, the Second Circuit will become a haven for federal securities fraud prosecutions. This indeed appears to be occurring. In reported cases from 2009 through 2013, district courts within the Second Circuit hosted 68% of all criminal prosecutions for insider trading, and 46% of all SEC civil enforcement actions. See *Insider Trading,* Appendices (2009, 2010, 2011, 2012, 2013) (annual reviews). Many of these cases - including this one - involve companies and conduct entirely outside of the Second Circuit, and were presumably filed in that circuit only because of the extremely favorable state of the law for prosecutors. Notably, had this case been tried (as petitioner requested) in the Ninth Circuit, where all of the relevant companies and individuals were based or resided, and where all of the relevant conduct occurred, the "significant factor" causation standard of that circuit would have applied, and petitioner would likely have been acquitted.

The U.S. Attorney for the Southern District of New York in fact recently heralded "80 insider trading convictions without a single defeat." Ben Protess & Matthew Goldstein, *Appeals Judges Hint at Doubts in Insider Case,* N.Y. Times, Apr. 23, 2014, at A1. Both the number of securities cases brought in the Second Circuit and the government's remarkable conviction rate are, no doubt, attributable in large ***17** part to the Second Circuit's unique rejection of a causation requirement.

This trend has created an especially untenable situation for research analysts, like petitioner. Particularly since the market downturn of 2008, such professional analysts are increasingly targets for prosecution in the Second Circuit. As this Court recognized in *Dirks,* limiting the reach of § 10(b) to intentional fraud is crucial to avoid an "inhibiting influence on the role of market analysts," whose jobs necessarily entail seeking out information on securities, including "by meeting with and questioning corporate officers and others who are insiders." 463 U.S. at 658. Indeed, in order to do their jobs, professional research analysts must seek out large volumes of information about securities from a multitude of sources, of varying degrees of reliability and of uncertain origin, making it extremely difficult to avoid entirely exposure to information that may have originated from an inside source - exposure that may now, under the Second Circuit's rule, subject them to criminal prosecution even if they did not rely on the information in making any trade. By effectively removing the causation and scienter elements of insider trading and criminalizing the mere knowing possession of inside information by market participants, the Second Circuit has cast a shadow over the entire industry of research analysis, an industry that this Court has said "is necessary to the preservation of a healthy market." *Id.*

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In sum, the Second Circuit's causation holding sharply conflicts with every other circuit to have addressed the issue, conflicts with the statute and this Court's precedent, and threatens serious detrimental consequences to the law of insider trading. Those ***18** conflicts, and the risks they present, can and should be resolved by this Court. [2]

II. THE SECOND CIRCUIT'S HOLDING THAT THE FIDUCIARY DUTY ELEMENT OF INSIDER TRADING IS DEFINED BY FEDERAL COMMON LAW, RATHER THAN STATE LAW, WIDENS A CIRCUIT SPLIT ON THE ISSUE AND CONFLICTS WITH OPINIONS OF THIS COURT.

A second question presented by this case, whether the fiduciary duty element of securities fraud is defined by existing state law or should be crafted *ad hoc* as a matter of federal common law, similarly warrants review. That issue has divided the circuits, and the Second Circuit's position - holding, unlike all other circuits, that federal common law governs - is patently inconsistent with precedent from this Court. *Infra* pp. 18-22. As importantly, the Second Circuit's approach raises fundamental concerns of federalism, fair notice, and due process that should be addressed by this Court. *Infra* pp. 22-25.

1. There is a clear circuit split concerning the fiduciary duty element of securities fraud. Several ***19** courts of appeals, including the First, Fourth, and Seventh Circuits, have held that in deciding whether a fiduciary duty exists, such that the use or disclosure of nonpublic company information may be deemed illegal under the federal securities statute, courts should look to the law of the relevant state. *Tambone,* 597 F.3d at 448; *Fortson,* 961 F.2d at 472; *Jordan,* 815 F.2d at 436. These courts reason that, because neither the securities fraud statute nor the implementing regulations define when the fiduciary duty arises, it "must come from a fiduciary relation outside securities law." *Barker v. Henderson, Franklin, Starnes & Holt,* 797 F.2d 490, 496 (7th Cir. 1986). In other words, it must be "based on state law." *Jordan,* 815 F.2d at 436.

By contrast, the Second Circuit - again, only the Second Circuit - holds that the fiduciary duty "is imposed and defined by federal common law." Pet. App. 15a. That duty is, in the Second Circuit's view, to be created by courts on a case-by-case basis, guided but not limited by decisions of other courts, including those addressing fiduciary duty under state law. See *Steginsky v. Xcelera, Inc.,* 741 F.3d 365, 371 (2d Cir. 2014); see also Pet. App. 15a. Indeed, under this approach, a fiduciary duty could be found to exist even in circumstances where (as in this case) applicable state law affirmatively holds that *no* such duty may be recognized. See *id.* at 32a.

Two other circuits take yet another, hybrid view. Rejecting both approaches discussed above, the Eighth and Tenth Circuits hold that "[f]iduciary relationships and their concomitant duty to disclose may be established by state *or* federal law." *Camp v. Dema,* 948 F.2d 455, 460 (8th Cir. 1991) (emphasis added); see also *SEC v. Cochran,* 214 F.3d 1261, 1264 (10th Cir. 2000). While it is somewhat unclear from ***20** these opinions which law is to be applied in any given case, they seem to contemplate that state law will govern unless a separate federal statute or regulation is applicable and creates a fiduciary-like duty, see,

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e.g., Camp, 948 F.2d at 460 - thereby avoiding the need (as under the Second Circuit's holding) for courts to engage in federal common lawmaking.

The split among the circuits is thus clear and deep. While these cases concern different versions of the offense of securities fraud, they all address the same fiduciary duty element under the same federal statute, and they reach diametrically opposed conclusions regarding it - with the Second Circuit alone holding that in all cases federal common law defines and imposes that duty. Pet. App. 15a; see also *SEC v. Sargent,* 229 F.3d 68, 76 (1st Cir. 2000) (incorporating state law to define the fiduciary duty element of an insider trading charge).

2. It should be no surprise that the Second Circuit's approach diverges from other circuits, as that approach blatantly conflicts with this Court's precedent. It has been clear at least since *Erie Railroad v. Tompkins,* 304 U.S. 64 (1938), that "[f]ederal courts, unlike state courts, are not general common-law courts and do not possess a general power to develop and apply their own rules of decision." *City of Milwaukee v. Illinois,* 451 U.S. 304, 312 (1981). Under the Constitution, "the federal lawmaking power is vested in the legislative, not the judicial, branch of government." *Nw. Airlines, Inc. v. Transport Workers Union of Am., AFL-CIO,* 451 U.S. 77, 95 (1981). Therefore, as this Court has repeatedly said, the circumstances calling for "judicial creation of a special federal rule" are "few and restricted." *O'Melveny & Myers v. FDIC,* 512 U.S. 79, 87 (1994) (quoting *Wheeldin v. Wheeler,* 373 U.S. 647, 651 (1963)). Only ***21** when there is a "significant conflict between some federal policy or interest and the use of state law" is the creation of federal common law rules justified. *Wallis v. Pan Am. Petroleum Corp.,* 384 U.S. 63, 68 (1966); see also *Boyle v. United Techs. Corp.,* 487 U.S. 500, 507-08 (1988).

This rule bears particular force for the law of corporate fiduciary duties, because "[c]orporations are creatures of state law, and … state law … govern[s] the internal affairs of the corporation." *Santa Fe,* 430 U.S. at 479. While "in certain areas … federal statutes authorize the federal courts to fashion a complete body of federal law," "[c]orporation law … is *not* such an area." *Burks v. Lasher,* 441 U.S. 471, 477 (1979) (emphasis added). In particular, this Court has explained that, "where a gap in the federal securities laws must be bridged by a rule that bears on the … powers within the corporation, federal courts should incorporate *state* law." *Kamen,* 500 U.S. at 108. These decisions confirm that "State law is the 'font' of corporate fiduciary duties." Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition,* 52 Wash. & Lee L. Rev. 1189, 1261 (1995).

Notwithstanding these decisions, the Second Circuit has stated that resort to federal common law is appropriate in its view because "insider trading cases … have implicitly assumed that the relevant duty springs from federal law" and "looking to idiosyncratic differences in state law would thwart the goal of promoting national uniformity in securities markets." *Steginsky,* 741 F.3d at 371. Neither point withstands scrutiny. Far from implicitly assuming that the applicable fiduciary duty is defined as a matter of federal common law, this Court's precedents implicitly reject that very position, instructing courts instead to ***22** fill the interstices of federal securities laws by incorporating state corporate law. *Kamen,* 500 U.S. at 108. And this Court has specifically and repeatedly characterized uniformity of federal law - "that most generic (and lightly invoked) of alleged federal interests" - as insufficient to authorize the creation of independent federal common law. *O'Melveny,* 512 U.S. at 88.

The Second Circuit's decision, quite simply, cannot be reconciled with this Court's precedent. Certiorari should be granted to address this conflict, and correct the Second Circuit's badly misguided view of federal common law and the fiduciary duty element of securities fraud.

3. The need for review is underscored, and rendered even more urgent, by the exceptional importance of this issue. The Second Circuit's holding implicates serious constitutional concerns regarding federalism, separation of powers, and the due process rights of defendants.

It has long been recognized, as a core component of federalism in our constitutional structure of government, that States hold principal and often exclusive authority to regulate the affairs of corporations that are formed under their laws. See, *e.g., Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.,* 552 U.S. 148, 161 (2008). The rule that federal courts are to apply the

law of the States when addressing such matters, even when a federal statute otherwise governs, is a crucial check against federal encroachment into these traditional areas of state control. See *id.*; see also Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism,* 56 Vand. L. Rev. 859 (2003). Particularly with respect to issues concerning the relationship between corporations and their employees ***23** and shareholders, and the duties owed by each party to others, federal courts must be especially "reluctant" to intrude, given the risk of "federaliz[ing] … the law of corporations." *Santa Fe,* 430 U.S. at 478-79.

The decision below infringes directly on this principle. It would allow a federal court to effectively displace state law and define when and whether a "fiduciary duty" arises. Pet. App. 15a. A court could, indeed, hold that a fiduciary duty exists even when the governing law of the relevant State declares unequivocally that it does not. See *id.* at 32a-33a. It is difficult to imagine a more direct assault on the authority of States to manage their corporations' affairs, or a clearer violation of "our Federalism." *Younger v. Harris,* 401 U.S. 37, 44 (1971).

The Second Circuit's holding also does serious violence to "clarity and certainty in the criminal law." *Burrage v. United States,* 134 S. Ct. 881, 891 (2014). "State corporate law, evolved over decades and frequently codified in state statutes, is well developed and easily discovered and applied," *Anspec Co. v. Johnson Controls, Inc.,* 922 F.2d 1240, 1250 (6th Cir. 1991) (Kennedy, J., concurring), and thus places clear limits on the scope of potential liability under federal securities law. On the other hand, neither the securities fraud statute nor the implementing regulations define the scope of the fiduciary duty, or the situations in which it arises, and there is no well-developed federal common law of fiduciary duties. Holding that federal courts need not look to state law therefore gives broad power to the federal judiciary to define and impose novel duties with little limit, including in criminal prosecutions.

This raises, in turn, troubling due process concerns. Under the Second Circuit's decision, an individual ***24** could be found to have breached a fiduciary duty - supporting a securities fraud conviction - even if that duty had never previously been recognized and even if the individual had no reason to expect that it would. Pet. App. 15a; see *id.* at 32a-33a. There would simply be no way in this circumstance for a person to know in advance, with any certainty, whether or not he or she owes a duty of confidentiality to a company or whether the use or disclosure of corporate information may expose him or her to criminal liability. Only through the course of *post hoc* adjudication of a securities fraud charge can individuals know the standard that governed their conduct, and if that conduct is deemed a crime.

This is flatly inconsistent with constitutional due process. "A fundamental principle in our legal system is that laws which regulate persons or entities must give fair notice of conduct that is forbidden or required." *FCC v. Fox Television Stations, Inc.,* 132 S. Ct. 2307, 2317 (2012). Federal courts that seize power to create common law fiduciary duties - and thus define the contours of criminal law - trample the notion that due process requires clarity in the law. The Second Circuit's decision creates an intolerable level of uncertainty for a criminal statute, and fails to "give fair warning of the conduct" that it makes a crime. *Bouie v. City of Columbia,* 378 U.S. 347, 350 (1964).

These concerns are exemplified by this case. There is no doubt that, under the applicable state law of California, alleged "insiders" in this case could not have been found to owe a fiduciary duty or to have breached such a duty by disclosing the information. ***25** See Pet. App. 32a.[3] Petitioner therefore had no reason to think at the time of the alleged offense, even assuming (contrary to the evidence) that he knew that the information he received was nonpublic and disclosed without authorization by those individuals, that the disclosure was illegal or that he may be precluded from trading in the relevant securities. To nevertheless hold at trial that such a duty existed, and that petitioner violated federal securities law by executing trades after receiving the information, is to convict him of conduct that did not constitute a crime when committed. Due process flatly forbids that result.

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The Second Circuit's fiduciary duty holding plainly conflicts with decisions of other circuits, contravenes this Court's binding precedent, presents troubling federalism and due process concerns, and adds unnecessary and intolerable uncertainty to insider trading prosecutions. This issue warrants review.

***26 III. THE SECOND CIRCUIT'S HOLDING THAT PRIOR TESTIMONY OF AN UNAVAILABLE DEFENSE WITNESS IS INADMISSIBLE IN A CRIMINAL CASE, WHEN THAT TESTIMONY WAS GIVEN IN A RELATED CIVIL PROCEEDING, CREATES A CIRCUIT SPLIT ON THE ISSUE AND CONFLICTS WITH FEDERAL RULE OF EVIDENCE 804(b)(1).**

Compounding the problems created by these rulings on securities law, and further justifying review, is the Second Circuit's interpretation of Federal Rule of Evidence 804(b)(1). That interpretation, which would preclude a defendant from introducing testimony from an unavailable witness if that testimony was given in a civil rather than criminal proceeding, conflicts directly with the holding of at least one other circuit, as well as the language and spirit of the rule. *Infra* pp. 26-29. It would also have disastrous consequences for criminal defendants in the Second Circuit - as it did for petitioner - by denying them an opportunity to present testimony in their defense, even when (as here) the testimony is critically relevant and plainly exculpatory. *Infra* pp. 29-31.

1. The decision below clearly conflicts with the holding of the Seventh Circuit in *United States v. Sklena,* 692 F.3d 725 (7th Cir. 2012). In *Sklena,* the Seventh Circuit ruled that prior testimony of a witness in a related administrative proceeding is admissible against the government in a subsequent criminal proceeding under Rule 804(b) when the witness is unavailable during trial. *Id.* at 731-32. The mere fact that one proceeding is criminal and the other civil, the court explained, does not mean that government attorneys in the two proceedings have different motivations, and thus cannot support exclusion of the ***27** testimony under the rule. *Id.* Whatever differences may otherwise exist between civil and criminal proceedings, when they are both directed towards "investigating the same underlying conduct with an eye to taking enforcement action," the attorneys in both plainly have a "similar motive" to examine the defendant, rendering the testimony admissible against the government in a subsequent trial if the witness is unavailable. *Id.*

The Second Circuit, however, concluded to the contrary in the decision below. It held that testimony from a prior SEC deposition of Sunil Bhalla, taken as part of a civil investigation of the same conduct at issue in the criminal proceedings, was inadmissible because it "was taken with an investigatory motive that differed from the adversarial motive that would be present at trial," and the SEC attorney did not engage in extensive cross-examination. Pet. App. 7a. The Second Circuit reached this conclusion notwithstanding the fact that the SEC and prosecutors worked in tandem during the civil and criminal proceedings, and that SEC attorneys specifically asked Mr. Bhalla during the deposition about the conduct at issue in the criminal case. Doc. 97, at 3-4, No. 12-cr-125 (S.D.N.Y. filed Aug. 13, 2012). In other words, notwithstanding that the attorneys in both proceedings were "investigating the same underlying conduct with an eye to taking enforcement action," and "needed to prove the same allegations," *Sklena,* 692 F.3d at 731-32, the court in this case deemed the deposition testimony inadmissible because it was given in a civil rather than a criminal proceeding.

The Second Circuit did not attempt to distinguish *Sklena,* and indeed did not even mention the Seventh Circuit's opinion. For good reason: *Sklena* cannot be distinguished. The Second and Seventh Circuits are ***28** clearly split over the interpretation of Rule 804(b), which warrants review by this Court.

2. The Second Circuit's holding, moreover, contravenes the text of Rule 804(b). That rule provides that prior deposition testimony from an unavailable witness is admissible when "offered against a party who had … an opportunity and *similar* motive to develop it." Fed. R. Evid. 804(b)(1) (emphasis added). This language does not require that a party had the *same* motive and opportunity to examine the witness; it requires only that the party had a "similar" motive. 30C Michael H. Graham, *Federal Practice and Procedure* § 7073 (interim ed. 2011).

That standard is plainly satisfied where, as here, in both cases federal officials are investigating precisely the same conduct and have the same underlying law-enforcement objective because they are addressing the legality of that conduct with the same witness. See *id.* ("Generally speaking, a similar motive would have existed at the prior hearing when the issue at the prior hearing and at the current hearing are substantially similar."). Merely because one proceeding was civil in nature and one was criminal does not alter the fact that the United States shares in both cases the same objective of enforcing the federal securities laws. *Id.*; cf. *id.* ("[A] decision by counsel not to cross-examine at any prior hearing or to do so only to a limited extent, no matter how much practical sense the decision makes, does not appear to affect [admissibility under Rule 804(b)].").

The Second Circuit's holding plainly requires something more than the "similar" motive demanded by the rule. After all, an administrative enforcement proceeding is as close to a criminal prosecution as one can get without an indictment. If cross-examination during an SEC enforcement proceeding that is parallel ***29** to a criminal prosecution does not satisfy the "similar motive" requirement, it is difficult to see what would, other than an identical proceeding. The effect of this approach is that the only admissible prior testimony would come from a criminal case, which would effectively change the text of Rule 804(b)(1), and its consistent interpretation by courts and commentators. See *id.* The Second Circuit's position clearly cannot be accepted.

3. This issue is, moreover, of vital importance in criminal cases. In investigating alleged insider trading, the SEC often works in tandem with the U.S. Attorney's office to conduct related civil and criminal enforcement actions. See Randy S. Eckers, Note, *Unjust Justice in Parallel Proceedings: Preventing Circumvention of Criminal Discovery Rules,* 27 Hofstra L. Rev. 109 (1998); Kathleen M. Graber et al., *Securities Fraud,* 30 Am. Crim. L. Rev. 909, 957 (1993). Other agencies use the same dual enforcement mechanism, developing evidence in civil enforcement proceedings while the U.S. Attorney aims at criminal prosecution. See generally, Natalie M. Duval, Note, *Towards Fair and Effective Environmental Enforcement: Coordinating Investigations and Information Exchange in Parallel Proceedings,* 16 Harv. Envtl. L. Rev. 535 (1992).

Yet, under the Second Circuit's rule, any testimony given in these proceedings - even if directly exculpatory - could be excluded in a subsequent criminal proceeding. Prosecutors could rely on agency officials to conduct initial fact-finding and deposition of potential witnesses, and through that process could identify those who might offer testimony favorable to the defense. Those witnesses could then be denied immunity to testify at the criminal defendant's trial. This would essentially ensure that the witnesses' testimony ***30** would not be available to the defense, as the witnesses would invariably (and properly) invoke their privilege against self-incrimination and, under the Second Circuit's holding, their prior deposition statements would be inadmissible. See Pet. App. 7a-8a.

This case demonstrates these risks in stark relief. The SEC worked in tandem with the U.S. Attorney's Office to conduct parallel enforcement actions against petitioner and others, including Mr. Bhalla. See Pet. App. 6a-8a. In fact, one of the prosecutors who presented evidence to petitioner's grand jury was an SEC staff attorney who had previously worked on related SEC proceedings. Doc. 97, at 3, No. 12-cr-125 (S.D.N.Y. filed Aug. 13, 2012). As part of these parallel proceedings, the SEC deposed Mr. Bhalla, who testified - consistent with petitioner's account, but contrary to that of the prosecution's key witness at trial, Ms. Khan - that he had never shared relevant inside information with Ms. Khan and had no knowledge of inside information being provided to petitioner. Pet. App. 6a-7a. At trial, the government was able and allowed to present Ms. Khan's account in full, after agreeing to a plea arrangement with her. See *id.* at 7a-12a. It did not, however, reach an agreement with Mr. Bhalla and (despite defense requests) refused to grant him even limited immunity to allow him to testify at trial; as a result, in light of Mr. Bhalla's invocation of the privilege against self-incrimination, he could not be called as a witness at trial. *Id.* at 6a-7a.

The *only* way petitioner could have presented Mr. Bhalla's account to the jury - which flatly contradicted Ms. Khan's testimony for the government - was through introduction of the prior deposition testimony. He was, however, denied his right to do so as a ***31** result of the holding below that Rule 804(b) does not allow such testimony when it was given in a prior civil proceeding. Pet. App. 7a. That holding is not only inconsistent with the Rule's language, as discussed above, but effectively prevented petitioner from making his case to the jury. Mr. Bhalla's testimony would have directly contradicted the key government witness's assertion that petitioner received inside information and, if accepted by the jury, could have supported complete acquittal.

With the government's systematic use of parallel civil and criminal enforcement, the issue of prior exculpatory testimony obtained during civil enforcement proceedings will be a recurring issue. This Court should resolve this issue now to ensure that defendants in these circumstances are not deprived of crucial exculpatory evidence and prevented from receiving a fair trial.

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The Second Circuit's prior testimony ruling blatantly conflicts with the rule in the Seventh Circuit, runs afoul of the text and plain intent of Rule 804(b)(1), and unfairly prevents defendants from presenting crucial evidence. This issue, like the others presented in this case, warrants review.

***32 CONCLUSION**

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Footnotes

* Counsel of Record

1 In any event, no evidence suggests that the causation or "significant factor" test has proven difficult to administer in the circuits that have adopted it. *See Smith,* 155 F.3d at 1069.

2 That the SEC has adopted a rule stating that a trade will be considered "on the basis of" inside information if the defendant "was aware of the material nonpublic information" at the time of the transaction, Rule 10b5-1, 17 C.F.R. § 240.10b5-1, does nothing to lessen the need for this Court's review. For one thing, the circuit split on the causation issue has continued to persist after that rule was adopted. *See, e.g., SEC v. Ginsburg,* 362 F.3d 1292, 1297-98 (11th Cir. 2004); *Anderson,* 533 F.3d at 630. Further, to the extent the SEC's rule may be viewed as endorsing the "knowing possession" standard, it is entitled to no deference - particularly in a criminal case - because it is contrary to the statutory text and decisions of this Court. *See, e.g., Anderson,* 533 F.3d at 630.

3 Although the government has suggested that another jurisdiction's law might apply, or that some of the alleged insiders might be deemed "fiduciaries" even under California law, the district court found the government failed to raise claims concerning other law. *See* Pet. App. 32a n.3. In addition, the court of appeals never suggested, despite the government's arguments, that the application of federal common law rather than California law might be deemed non-prejudicial or harmless. *Id.* at 15a.

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