2014 WL 3945566 (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.
August 8, 2014.

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

Brief of Amicus Curiae Allan Horwich in Support of Petition for a Writ of Certiorari

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*1 INTEREST OF *AMICUS CURIAE* [1]

Amicus is a law professor whose scholarship and teaching focus on the federal securities laws and in particular the law of insider trading under the Securities Exchange Act of 1934. *Amicus* has published scholarly articles on the law of insider trading for nearly two decades, including articles directly addressing the first question presented in the Petition for a Writ of Certiorari. *Amicus* has a full-time appointment as Professor of Practice at Northwestern University School of Law, where he teaches courses in securities regulation and securities law enforcement. [2]

This brief presents *amicus*'s position that this Court should grant the petition as to Question 1, [3] reverse the Second Circuit's decision, and hold that a necessary element of a claim of insider trading in violation of Section 10(b) of the Securities Exchange Act is that material ***2** nonpublic information on which the charge is based was a significant factor in the defendant's decision to trade - it is not enough that the defendant merely knew the information.

SUMMARY OF THE ARGUMENT

The Second Circuit permits conviction for insider trading when tainted information was known to the defendant even if it was not a significant factor in his decision to trade. This rule is inconsistent with the foundation for the prohibition on trading based on material nonpublic information. A necessary condition of liability is that an investor actually took advantage of tainted information in trading.

Contravening a prior ruling by this Court, the flawed Second Circuit rule discourages efforts by analysts and professional traders, as well as nonprofessional Investors, to discover information in order to make trading decisions. This inhibition unjustifiably impairs the efficiency of the securities markets, contrary to a goal of the federal securities laws. Application of the Second Circuit rule also effectively imposes a parity-of-information requirement - that information known to the trader be known to the market as a whole before he can trade - that this Court explicitly rejected when it first addressed insider trading under the securities laws.

*3 ARGUMENT

I. AN ESSENTIAL ELEMENT OF AN INSIDER TRADING PROSECUTION IS THAT MATERIAL NONPUBLIC INFORMATION BE "A SIGNIFICANT FACTOR" IN THE DEFENDANT'S DECISION TO TRADE

A. The Insider Trading Prohibition Is Designed to Bar *Use* of Information Tainted in its Origin, Not Mere Knowledge of Such Information

The circuits are split on whether a necessary element of unlawful insider trading is a finding that material nonpublic information was used by the defendant, that is, was a significant factor in the defendant's decision to trade. Pet. at 10-12. This split is traceable in part to judicial consideration of *amicus*'s 1997 article, *Possession Versus Use: Is There a Causation Element in the Prohibition on Insider Trading?*, 52 Bus. Law. 1235 (1997), which argued that a causation test is an essential element of a charge of insider trading in violation of Section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b). There *amicus* demonstrated that to be unlawful the trading must have been based on material nonpublic information, that is, that the defendant *actually used* the information in deciding to trade. There is no liability for mere knowledge of material nonpublic information at the time of the trade, regardless of how that information was obtained. *Id.* at 1268-78.

The prohibition on insider trading imposed under Section 10(b) is grounded in the prevention of exploitation, to preclude insiders from taking advantage of corporate information. Horwich, 52 Bus. Law. at 1241-45. Thus, ***4** the seminal modern common law case, *Brophy v. Cities Service Co.*, 70 A.2d 5, 8 (Del. Ch. 1949), held that a corporation's executive secretary who acquired secret corporate information is a fiduciary who "cannot use that information for his own personal gain," and that it is wrongful for a person in a fiduciary position, in breach of his duty, to "use[] his knowledge to make a profit for himself."

These concepts were reflected in early federal decisions under SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2014). Horwich, 52 Bus. Law. at 1245-50. In the seminal federal law decision, *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961), the SEC applied Rule 10b-5 to insider trading based on the "inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing." *Cady, Roberts* was the starting point for the analysis in this Court's first insider trading decision, *Chiarella v. United States*, 445 U.S. 222 (1980). Drawing on *Cady, Roberts*, the Court held that the insider relationship gives rise to a duty to disclose because of the necessity of preventing an insider from "taking unfair advantage of the uninformed minority stockholders." *Id.* at 228-29 (quoting *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 829 (D. Del. 1951)). As the SEC did in *Cady, Roberts*, the Court relied on common law precedents. 445 U.S. at 228 nn.9-10.

The crucial words in *Brophy* and *Chiarella* (just to name two cases) - "use" and "take advantage of" - have a plain import. One uses or takes advantage, that is to say exploits, only when consciously basing the investment decision on the tainted (*e.g.*, improperly tipped) ***5** information.[4] The erroneous ruling in the present case can trace its lineage to the Second Circuit case, *United States v. Teicher*, 987 F.2d 112 (2d Cir. 1993), which rejected the use test in dictum. The Second Circuit there took a sweeping view of the law, endorsing the SEC's mere possession standard and allowed simplicity in application to trump reasoned precedent. The Petition succinctly summarizes some of the flaws in *Teicher*. Pet. at 11, 14. *See also* Horwich, 52 Bus. Law. at 1250-52 (critiquing the reasoning in *Teicher*).

A trading decision driven by *properly* obtained information neither takes advantage of nor uses information improperly obtained, even if the defendant happens to be aware of *other* information tainted in its receipt. The prohibition under Section 10(b) should be triggered only where the improperly obtained information motivates the decision to trade.

B. The Second Circuit's "Mere Possession" Test Is Unsupported by Either the SEC's Attempt to Redefine the Law or Congress's Narrow Imposition of Penalty Authority in the Civil Remedy Context

Soon after publication of *amicus*'s 1997 article, two Courts of Appeal essentially adopted the approach advocated there. *SEC v. Adler*, 137 F.3d 1325,1337 (11th Cir. 1998) ("Supreme Court dicta and the lower court precedent suggest that the use test

is the appropriate ***6** test"); and *United States v. Smith*, 155 F.3d 1051, 1069 (9th Cir. 1998) ("Rule 10b-5 entails a 'use' requirement").

Responding quickly to the setbacks suffered by the civil and criminal enforcement authorities, the SEC sought to change the law by adopting SEC Rule 10b5-1. There the SEC purported to define trading "on the basis of" material nonpublic information to mean that "the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale." Rule 10b5-1(b), 17 C.F.R. § 240.10b5-1(b)(2014), adopted in Selective Disclosure and Insider Trading, Securities Act Release No. 7881, 65 Fed. Reg. 51716 (Aug. 24, 2000). In other words, the SEC sought to expand the prohibition beyond what the courts had said Section 10(b) could reach. [5] *See* Pet at 18 n.2. Applied by its terms, Rule 10b5-1 would impose the absurd result thai; an insider who decides on Sunday to place a trade on Monday morning and then learns material nonpublic information later on Sunday is deemed to have traded "based on" that new information and thus to have violated Section 10(b) if he follows through with the planned trade on Monday.

***7** Neither the SEC's flawed rulemaking nor prosecutorial persistence have persuaded courts outside the Second Circuit to rethink the threshold of liability. Nor does the statute itself provide support for the Second Circuit position. When Congress enacted civil penalties for unlawful insider trading where the defendant was in "possession of material, nonpublic information" it expressly conditioned the penalty on the existence of an independent substantive violation. [6] That is, looking solely at the statutory language (unaided by the SEC's attempt to change the law), mere possession of material nonpublic information is *not* sufficient to impose a civil penalty. [7] *A fortiori* possession of material nonpublic information, without more, even if tainted in its receipt, is not sufficient to sustain a criminal conviction.

II. THE SECOND CIRCUIT'S TEST IS DETRIMENTAL TO THE EFFICIENT FUNCTIONING OF THE SECURITIES MARKETS

The Second Circuit's flawed "possession" test has a pernicious effect on the securities markets. The potential ***8** threat of application of the possession test inhibits trading decisions, undermines the efficiency of the securities markets, and effectively revives the rejected "parity-of-information" rule.

A. The Second Circuit Test Inhibits the Efficiency of the Securities Markets

Investors who do research before making an investment in a security seek information about the issuer of the security from a variety of sources, some; of which are undeniably public, such as the *Wall Street Journal* and readily available research services such as *Morningstar*. Others seek an edge on their fellow investors by digging deeper, such as by visiting facilities and reading obscure publications. In some cases they may speak to persons with information that may not be public in the sense of having been widely disseminated. Some of these sources may be insiders or persons who have spoken to company insiders. [8] The investors may even receive information they did not seek and should not have been provided. Of course, no one can erase his own memory.

Under the correct "significant factor" test an investor is on notice that he is subject to liability if his trading decision was based on material information that he obtained improperly. Apart from the difficulty in determining *ex ante* whether information was tainted, this is a fair, workable standard grounded in established legal ***9** principles. Under the Second Circuit standard, however, the trader is subject to liability if he possesses *any* fact that he received improperly and it is later determined that this fact - on which he placed little or no weight in deciding to trade - was material.

The broad Second Circuit standard creates a conundrum. Because real time judgments about materiality are often uncertain [9] and a materiality assessment is frequently influenced by hindsight bias, [10] an investor facing application of the Second Circuit test will tend not to trade even though the facts on which he would have relied had he traded were untainted, *i.e.*, were ***10**

not the product of an unlawful tip. The possession of a fact that might later be deemed material, but on which the investor placed little, if any, weight causes him to forego the transaction. As the Petition explains, this inhibition has nationwide impact because of the government's proclivity to bring insider trading prosecutions in the Second Circuit, where the law favors the prosecution. Pet. at 16-17.

An investor's decision not to trade, because of fear of the application of the Second Circuit test, both deprives him of the benefit of the legitimate fruits of his investigatory labor and, perhaps more important, deprives the market of the liquidity and direction that the trader would have provided to the market if he had traded influenced by the insights he had *lawfully* developed. As petitioner notes, this is at odds with the role of the analyst that was acknowledged and preserved by this Court in *Dirks*, 463 U.S. at 658. Pet. at 2, 17. The Second Circuit rule undermines the incentive to ferret out nuggets of information through diligent research and assemble a mosaic from disparate sources, which this Court sought to foster by fashioning the standard of tipper and tippee liability in *Dirks*.

The effective exclusion from the market of the trading activity of any informed investor impairs the efficiency of the markets. Section 10(b) is part of a legislative scheme that was designed to advance the "federal interest in protecting the integrity and efficient operation of the market for nationally traded securities." *Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 78 (2006). The Second Circuit's overbroad application of the prohibition on insider trading closes the door on many persons whose trading would make the markets ***11** more efficient, without any deception or unfairness. The markets are worse off for this inhibition.

B. The Second Circuit Test Effectively Reinstates the Parity-of-Information Rule Rejected by This Court

The Second Circuit's approach effectively revives a concept that was explicitly rejected by this Court nearly thirty-five years ago. This Court held that the securities laws do not impose a principle of information parity requiring that all investors must have equal access to information. [11] *Chiarella*, 445 U.S. at 233 ("neither the Congress nor the Commission ever has adopted a parity-of-information rule"). The Second Circuit rule imposes a strong disincentive to trade when the defendant knows *anything* nonpublic that *might* be material, because trading while in possession of that information may subject him to a criminal conviction. Thus, he will trade *only* when the public already has any information he has that might be material. This is exactly what the parity-of-information rule would have required; reviving it would further impair the efficiency of the securities markets.

*12 CONCLUSION

The Court should grant the petition at least as to Question 1.

Footnotes

1 Pursuant to Supreme Court Rule 37, *amicus* represents that he authored this brief in its entirety on his own behalf and that none of the parties or their counsel, nor any other person or entity other than *amicus*, made a monetary contribution intended to fund the preparation or submission of this brief; that all parties were provided notice of *amicus*'s intention to file this brief at least 10 days before its due date; and that all parties have consented to the filing of this brief and/or have filed with the Court a blanket consent authorizing such a brief.

2 *Amicus* is also a partner in the law firm Schiff Hardin LLP. His participation as *amicus* and counsel of record is solely in the capacity described in the text.

3 At this time *amicus* is not addressing the second and third questions presented by the Petition.

4 This *amicus* brief does not address *what* circumstances taint the receipt of information, it only explains that use of tainted information must be shown in order to convict.

5 It is beyond the scope of this brief to address all the flaws in the SEC's rule. *See, e.g.*, Allan Horwich, *The Origin, Application, Validity, and Potential Misuse of Rule 10b5-1*, 62 Bus. Law. 913, 944-49 (2007) (enumerating flaws in Rule 10b5-1 as an exercise of the SEC's rulemaking power); Donna M. Nagy, *The "Possession vs. Use" Debate in the Context of Securities Trading by Traditional*

Insiders: Why Silence Can Never be Golden, 67 U. Cinn. L. Rev. 1129, 1135, 1195-96 (1999) ("if *Adler* was correct in holding that Section 10(b)'s deception requirement forecloses liability in the absence of a causal connection, the SEC would lack the authority under this provision to promulgate a rule with knowing possession as the operative standard") (footnote omitted).

6 *See, e.g.*, Section 21A(a)(1) of the Securities Exchange Act, 15 U.S. C. § 78u-1(a)(1) ("Whenever it shall appear to the Commission that any persons has *violated any provision of this title* or the rules or regulations thereunder by purchasing or selling any security … w*hile in possession* of material, nonpublic information ….") (emphasis added)

7 *But see* Donald C. Langevoort, Insider Trading: Regulation, Enforcement & Prevention § 3:13, at 3-35 (2014) (citing SEC testimony during the hearings on the legislation to conclude that "the legislative history is clear that this language was chosen to reflect precedent that makes motivation insignificant in determining insider trading liability," but then noting that *Adler* rejected this reading of the law).

8 The framework of this discussion is the classical situation presented in *Dirks v. SEC,* 463 U.S. 646 (1983); it also applies in the context of the misappropriation theory enunciated in *United States v. O'Hagan,* 521 U.S. 642 (1997).

9 *See* James D. Cox et al., Securities Regulation Cases and Materials 620 (7th ed. 2013) ("Outside of litigation, considering whether an item is material and thus must be disclosed is frequently an ulcerating experience"); Stephen J. Choi, et al., Securities Regulation: Cases and Analysis 50 (3d ed. 2012) ("Unfortunately, determining whether a particular morsel of information is material is often an uncertain process"); *see also Matrixx Initiatives, Inc. v. Siracusano,* 131 S. Ct. 1309 (2011) (rejecting bright line test of statistical significance for when a fact is material).

10 *See* Mitu Gulati et al., *Fraud by Hindsight,* 98 Nw. U. L. Rev. 773, 790 (2004) (footnotes omitted):

[W]ith materiality the question [of hindsight bias] is simply whether the occurrence of the bad event biases the ex post evaluation of a prior warning. The hindsight bias directly implicates this kind of judgment. After the material event occurs, the warning sign will come to seem like a clear harbinger of the adversity that followed. Numerous studies of the hindsight bias reveal that knowing the outcome makes the antecedents seem more significant than was actually the case.

11 This now-discredited concept was expressed most notably in *SEC v. Texas Gulf Sulphur Co.,* 401 F.2d 833, 851-52 (2d Cir. 1968) (relying on a perceived "Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions").

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