Regulatory and Enforcement Alert

Second Circuit Holds NDA Establishes Duty of Trust and Confidence Even in Arm's-Length Negotiations to Uphold Insider Trading Conviction

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On April 6, 2021, the Second Circuit affirmed the insider trading conviction of an individual (Chow), who engaged in arm's-length negotiations on behalf of a potential acquiror and provided material nonpublic information to a tippee, in breach of nondisclosure agreements with the potential target. In *United States v. Chow*, the Second Circuit held that because Chow had entered into NDAs with the target, he was a "temporary insider" and so subject to the prohibitions against insider trading pursuant to 15 U.S.C. §§ 78j(b) and 78ff and SEC Rules 10b-5 and 10b5-2. The *Chow* decision reinforces the Court's prior decision in *United States v. Kosinski*, 976 F.3d 135 (2d Cir. 2020), that an NDA can establish a duty of trust and confidence and expands this duty of confidentiality to a potential acquiror and target engaging in arm's-length negotiations. The *Chow* decision also further defines the contours of the personal-benefit requirement—holding that evidence that the tipper *intended* to benefit the tippee is sufficient.

This case involved the failed acquisition of an Oregon-based semiconductor manufacturer by a Chinese State-owned private equity firm, where Chow was a managing director who led the transaction negotiations. During the course of the negotiations, Chow signed two NDAs with the target that stated the parties would not "disclose, commercialize, or use any Proprietary Information of the other Party" except for use in the potential transaction, and that "[t]he fact of the exploration and evaluation of a potential strategic relationship between the Parties shall be deemed 'Confidential' and subject to the protections of [the NDA] as Proprietary Information." In breach of the NDAs, on multiple occasions, Chow allegedly provided information about the transaction to the tippee, a social acquaintance and former business colleague. In turn, the tippee purchased large amounts of the target's shares, and then sold approximately half of those shares on the day the merger was announced. The Committee on Foreign Investment in the United States subsequently blocked the merger, which was never consummated.

At trial, a jury convicted Chow of some, but not all, of the insider trading counts concerning the tippee's purchases and sale of the target's shares. On appeal, Chow argued that the government failed to prove that he owed the target a duty sufficient to implicate principles of insider trading and that the district court erred in instructing the jury that NDAs create such a duty as a matter of law.

The Second Circuit disagreed. Citing the Supreme Court's decision in *United States v. O'Hagan*, 521 U.S. 642, 651–52 (1997), the Court noted that the insider trading laws apply to two types of individuals—company officials

or employees who are considered "insiders," and "outsiders" "who nonetheless owe a duty of nondisclosure to the company and who misappropriate its confidential information for securities-trading purposes." Under the "misappropriation theory" of insider trading, the Second Circuit reaffirmed its prior decision in *Kosinski*, 976 F.3d at 144, that an individual who enters into an NDA becomes a "temporary insider" subject to the legal duty of confidentiality—even where the company and the individual have an arm's-length relationship as opposing parties to a potential transaction. Thus, relying on *Kosinski*, the *Chow* Court held that it was not an error for the District Court to have instructed the jury that Chow was subject to the duty of nondisclosure as a matter of law.

The Second Circuit also rejected Chow's arguments that the government failed to prove he intentionally breached the NDAs, that he disclosed any information that was material and nonpublic, or that in disclosing any information to the tippee he sought or received any personal benefit. The Court reaffirmed the standard set forth in *United States v. Martoma*, 894 F.3d 64, 74, 76 (2d Cir. 2017) (which was later amended in "Martoma II," *United States v. Martoma*, 869 F.3d 58, 65 (2d Cir. 2018)), for establishing a personal benefit, which essentially circumscribed the Second Circuit's earlier holding on the issue in *United States v. Newman*, 773 F.3d 438, 452 (2d Cir. 2014) (vacating insider trading convictions for lack of personal benefit where government failed to prove a "meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature"). Here, the Second Circuit reiterated that "the personal benefit element is satisfied where there is evidence that the tipper intend[ed] to benefit the . . . recipient" and noted that "the evidentiary bar is not a high one." Detailing the network contacts, professional assistance—and wine and cigars—that Chow received from the tippee, the Second Circuit concluded that there was sufficient evidence to support the inference that Chow disclosed material nonpublic information to his acquaintance with the intent that the tippee would use the information to purchase shares of the target company.

Finally, the Court also rejected Chow's challenges to his convictions for securities fraud and conspiracy to commit such fraud under 18 U.S.C. §§ 371 and 1348. Citing again to *O'Hagan*, the Court held that "[a] fiduciary who [pretends] loyalty to the principal while secretly converting the principal's information for personal gain . . . dupes or defrauds the principal." Although Chow was charged with insider trading under both the criminal securities fraud provisions added in the 2002 Sarbanes-Oxley Act ("Title 18 securities fraud") and traditional insider trading principles under the Securities Exchange Act ("Title 15 securities fraud"), unlike the defendants in *United States v. Blaszczak*, 947 F.3d 19 (2d Cir. Dec. 30, 2019) (vacated and remanded by *Blaszczak v. United States*, 141 S.Ct. 1040 (2021)), Chow was convicted under both the Title 18 and Title 15 charges. Accordingly, the *Chow* Court did not weigh in on the controversy over the elements required to prove insider trading under a Title 18 theory of securities fraud, and instead simply held that the evidence, including the timing of Chow's communications with the tippee relative to both the acquisition negotiations and the tippee's trades, supported the verdict that the two individuals intentionally executed a scheme to commit securities fraud.

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