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## Outsider Hacking and Insider Trading: The Expansion of Liability Absent a Fiduciary Duty

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OUTSIDER HACKING AND INSIDER TRADING: THE  
EXPANSION OF LIABILITY ABSENT A FIDUCIARY DUTY

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ABSTRACT

*In January 2008, the United States District Court for the Southern District of New York held that trading put options of a company's stock based on inside information allegedly obtained by hacking into a computer network did not violate antifraud provisions of federal securities law. The court ruled that the defendant's alleged "hacking and trading" did not amount to a violation of section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, promulgated thereunder, because there was no proof the hacker breached a fiduciary duty in obtaining the information. The United States Court of Appeals for the Second Circuit overturned the District Court's decision, finding that a breach of fiduciary duty was not required for computer hacking to be "deceptive." This article evaluates the Second Circuit's decision in S.E.C. v. Dorozhko in light of the assumption that liability under the misappropriation theory requires a breach of fiduciary duty. This article also explores how the Second Circuit's decision may potentially expand section 10(b) liability to a wider range of parties who take advantage of access to material nonpublic information by trading securities based on that information.*

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## INTRODUCTION

Hacking into a computer system to obtain financial information and trading securities based on that information may be illegal, but whether it constitutes insider trading under section 10(b) of the Securities Exchange Act of 1934 is a different matter. In 2008, the United States District Court for the Southern District of New York held that a Ukrainian hacker who made almost \$300,000 through “hacking and trading” did not violate section 10(b) and Rule 10b-5 because there was no proof the hacker breached a fiduciary duty in obtaining the information.<sup>1</sup> However, the Second Circuit Court of Appeals reversed the trial court and held that a breach of fiduciary duty was not required for such “hacking and trading” to be a violation of section 10(b) and Rule 10b-5.<sup>2</sup>

The Second Circuit’s opinion expands the definition of insider trading under section 10(b) of the Securities Exchange Act of 1934, extending liability to defendants who did not breach a fiduciary duty in obtaining the inside information.<sup>3</sup> This decision challenges the

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<sup>1</sup> S.E.C. v. Dorozhko, 606 F. Supp. 2d 321, 324 (S.D.N.Y. 2008).

<sup>2</sup> S.E.C. v. Dorozhko, 574 F.3d 42, 51 (2d Cir. 2009).

<sup>3</sup> Martin Flumenbaum & Brad S. Karp, *Fiduciary Duty and “Deceptive” Fraudulent Conduct under Rule 10(b)*, N.Y. L.J., Aug. 31, 2009, at 3.

common assumption, gathered from a line of United States Supreme Court cases,<sup>4</sup> that liability under the misappropriation theory requires a breach of fiduciary duty. The decision also differs from the dicta and holdings of three other circuit court decisions.<sup>5</sup>

This Article examines and evaluates the Second Circuit's decision in light of Supreme Court precedent and the assumption that liability under the misappropriation theory requires a breach of fiduciary duty. This Article then compares the Second Circuit's decision to the differing circuit court rulings addressing this issue. Finally, this Article explores the implications of the Second Circuit's decision and provides practice pointers based on these implications.

#### I. INSIDER TRADING UNDER SECTION 10(B) OF THE SECURITIES EXCHANGE ACT OF 1934

Section 10(b) of the Securities Exchange Act of 1934 permits the U.S. Securities and Exchange Commission (SEC) to promulgate rules and regulations to protect the public and investors by prohibiting the "use or employ" of "any manipulative or deceptive device or contrivance" in connection with the purchase or sale of securities.<sup>6</sup> Rule 10b-5, which implements this provision, prohibits any act or omission resulting in fraud or deceit in connection with the purchase

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<sup>4</sup> See generally *Chiarella v. United States*, 445 U.S. 222 (1980) (holding that the mere possession of nonpublic market information did not result in a duty to disclose under § 10(b)); *United States v. O'Hagan*, 521 U.S. 642 (1997) (adopting the misappropriation theory); *S.E.C. v. Zandford*, 535 U.S. 813 (2002) (holding that a securities broker who traded securities under his client's account and transferred the proceeds to his own account, amounted to a scheme to defraud that was "in connection with" the security transactions within the meaning of § 10(b)).

<sup>5</sup> See generally *Regents of California v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 389 (5th Cir. 2007) (stating that the Supreme Court "has established that a device, such as a scheme, is not 'deceptive' unless it involves breach of some duty of candid disclosure"); *United States v. Bryan*, 58 F.3d 933, 951 (4th Cir. 1995) (suggesting mere thieves do not violate § 10(b) and Rule 10b-5 by trading on stolen information); *S.E.C. v. Cherif*, 933 F.2d 403, 411 (7th Cir. 1991) (stating that defendant's argument of being a "mere thief" was "[t]he only possible barrier to application of the misappropriation theory").

<sup>6</sup> 15 U.S.C. § 78j(b) (2006).

or sale of securities.<sup>7</sup>

The Supreme Court has established that there are two complimentary theories of insider trading, each with a fiduciary principle at its core.<sup>8</sup> Under the “traditional theory” of insider trading liability, corporate insiders violate section 10(b) and Rule 10b-5 when they trade their corporation’s securities while having knowledge of material, nonpublic information.<sup>9</sup> The Supreme Court has expanded on this theory, holding that a corporate insider violates section 10(b) by giving a “tip” to an outsider for the purpose of having the outsider trade, and the outsider does trade.<sup>10</sup> However, the tippee is only liable under section 10(b) for trading on material nonpublic information if the tippee is aware or should have been aware that the tipper breached his fiduciary duty to the shareholders by disclosing the information to the tippee.<sup>11</sup>

In *United States v. O’Hagan*, the Supreme Court adopted the “misappropriation theory” of liability under section 10(b) and Rule 10b-5. Under this theory, a person outside the corporation violates section 10(b) and Rule 10b-5 when he misappropriates material nonpublic information for the purpose of trading securities without disclosing the use of the corporation’s material nonpublic information.<sup>12</sup> Instead of relying on a fiduciary relationship between the company insider and purchaser or seller of the company’s stock, the misappropriation theory bases liability on a “fiduciary-turned-trader’s deception of those who entrusted him with access to confidential information.”<sup>13</sup>

Although fiduciary principles underlie both theories of insider trading, the SEC continues to bring complaints under section 10(b) and Rule 10b-5 regardless of whether a fiduciary-like duty has been breached. Supreme Court precedent is therefore important because it sets the boundaries for such prosecution.

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<sup>7</sup> 17 C.F.R. § 240.10b-5 (2010).

<sup>8</sup> *United States v. O’Hagan*, 521 U.S. 642, 651-52 (1997).

<sup>9</sup> *Id.*

<sup>10</sup> *Dirks v. S.E.C.*, 463 U.S. 646, 660 (1983).

<sup>11</sup> *Id.*

<sup>12</sup> *O’Hagan*, 521 U.S. at 652.

<sup>13</sup> *Id.*

## II. THE DISTRICT COURT DETERMINES DOROZHKO DID NOT VIOLATE SECTION 10(B) OF THE SECURITIES EXCHANGE ACT OF 1934

In October 2007, Oleksandr Dorozhko, a Ukrainian national, hacked into the computer network of Thomson Financial, Inc., obtaining access to IMS Health, Inc.'s soon-to-be-released negative earnings announcement.<sup>14</sup> Based on this information, Dorozhko purchased all available put options in IMS Health, totaling \$41,670.90.<sup>15</sup> When the market opened the morning following the release of IMS Health's third quarter earnings to the public, the stock plummeted and Dorozhko sold all of his 630 IMS Health put options, realizing a net profit of \$286,456.59 overnight.<sup>16</sup>

The SEC alleged in a complaint, filed against Dorozhko on October 29, 2007, that Dorozhko violated section 10(b) and Rule 10b-5 "by either hacking into a computer network and stealing material nonpublic information, or through a more traditionally-recognized means of insider trading such as receiving a tip from a corporate insider."<sup>17</sup> The SEC also obtained "a temporary restraining order freezing the proceeds of Dorozhko's trades."<sup>18</sup>

Relying principally on three Supreme Court opinions (*Chiarella v. United States*,<sup>19</sup> *United States v. O'Hagan*,<sup>20</sup> and *S.E.C. v. Zandford*<sup>21</sup>), the District Court determined that the "deceptive" element of section 10(b) required a breach of a fiduciary duty.<sup>22</sup> The District Court held that such "'hacking and trading' [did] not amount to a violation of section 10(b) and Rule 10b-5 because Dorozhko did not breach any fiduciary or similar duty 'in connection with' the purchase or sale of a

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<sup>14</sup> S.E.C. v. Dorozhko, 606 F. Supp. 2d 321, 323 (S.D.N.Y. 2008).

<sup>15</sup> *Id.*

<sup>16</sup> *Id.* at 326-27.

<sup>17</sup> *Id.* at 322.

<sup>18</sup> *Id.* at 322-23.

<sup>19</sup> *Chiarella v. United States*, 445 U.S. 222 (1980).

<sup>20</sup> *United States v. O'Hagan*, 521 U.S. 642 (1997).

<sup>21</sup> *S.E.C. v. Zandford*, 535 U.S. 813 (2002).

<sup>22</sup> *Dorozhko*, 606 F. Supp. 2d at 323 (citing *Chiarella*, 445 U.S. at 227-30; *O'Hagan*, 521 U.S. at 653-60; *Zandford*, 535 U.S. at 825).

security.”<sup>23</sup> Although the District Court did note that Dorozhko “may have broken the law,” the Court found Dorozhko not liable under section 10(b) “because he owed no fiduciary or similar duty either to the source of his information or those he transacted with in the market.”<sup>24</sup> Soon after, however, the Second Circuit reversed and held that a breach of fiduciary duty is not a required element of a section 10(b) complaint.<sup>25</sup>

### III. THE SECOND CIRCUIT’S DECISION IN LIGHT OF SUPREME COURT PRECEDENT

Prior to the Second Circuit’s decision in *S.E.C. v. Dorozhko*, no federal court had ever held that the theft of material nonpublic information by a corporate outsider who subsequently trades securities based on that information violates section 10(b).<sup>26</sup> The Second Circuit’s decision negates the assumption that liability under the misappropriation theory requires a breach of fiduciary duty. In reaching its conclusion, the Second Circuit relied primarily on the same three Supreme Court decisions relied upon by the District Court in its analysis: *Chiarella v. United States*,<sup>27</sup> *United States v. O’Hagan*,<sup>28</sup> and *S.E.C. v. Zandford*.<sup>29</sup>

In its analysis, the District Court reasoned that the SEC was seeking to revive Justice Blackmun’s dissent in *Chiarella*.<sup>30</sup> The District Court suggested that Dorozhko’s actions were fraudulent within the meaning of section 10(b) because he “stole” the information he traded on.<sup>31</sup> While the District Court relied on *Chiarella* to further support its conclusion that a breach of fiduciary duty was required to uphold a conviction under section 10(b), the Second Circuit read *Chiarella* and

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<sup>23</sup> *Id.* at 324.

<sup>24</sup> *Id.*

<sup>25</sup> *S.E.C. v. Dorozhko*, 574 F.3d 42, 51 (2d Cir. 2009).

<sup>26</sup> *Dorozhko*, 606 F. Supp. 2d at 323.

<sup>27</sup> *Chiarella v. United States*, 445 U.S. 222 (1980).

<sup>28</sup> *United States v. O’Hagan*, 521 U.S. 642 (1997).

<sup>29</sup> *S.E.C. v. Zandford*, 535 U.S. 813 (2002).

<sup>30</sup> *Dorozhko*, 606 F. Supp. 2d at 334.

<sup>31</sup> *Id.*

its dissent in a different light.

In *Chiarella*, an employee of a financial printer used material non-public information to purchase securities offered by acquiring and target corporations.<sup>32</sup> The Supreme Court reversed the defendant's section 10(b) and Rule 10b-5 conviction, because the "mere possession of nonpublic market information" did not result in a duty to disclose under section 10(b).<sup>33</sup> Since the defendant was under no obligation to disclose his knowledge of inside information, the defendant's nondisclosure was not fraud.<sup>34</sup>

The Second Circuit distinguished *Chiarella* as an example of fraud based on nondisclosure while *Dorozhko* dealt with an affirmative misrepresentation.<sup>35</sup> *Chiarella* addressed the "legal effect of the [defendant's] silence"; whether the defendant had a duty to disclose or abstain from trading.<sup>36</sup> Whereas, in *Dorozhko*, the SEC argued that Dorozhko "affirmatively misrepresented himself in order to gain access to material, nonpublic information, which he then used to trade."<sup>37</sup>

In *O'Hagan*, the Supreme Court adopted the misappropriation theory and held that when a person misappropriates confidential information for securities trading purposes in breach of a duty to the source of the information, that person commits fraud "in connection with" a securities transaction, thereby violating section 10(b) and Rule 10b-5.<sup>38</sup> The District Court noted that the *O'Hagan* court's application of the misappropriation theory remained consistent with the traditional theory, in premising "a violation of section 10(b) and Rule 10b-5 on a breach of duty to disclose or abstain."<sup>39</sup> The District Court found significance in the Supreme Court's decision not to adopt Justice Blackmun's dissent in *Chiarella*, noting that the Supreme Court certainly could have chosen to adopt Justice Blackmun's more

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<sup>32</sup> *Chiarella v. United States*, 445 U.S. 222, 224 (1980).

<sup>33</sup> *Id.* at 235.

<sup>34</sup> *Id.*

<sup>35</sup> *S.E.C. v. Dorozhko*, 574 F.3d 42, 47 n.4 (2d Cir. 2009).

<sup>36</sup> *Chiarella*, 445 U.S. at 226.

<sup>37</sup> *Dorozhko*, 574 F.3d at 49.

<sup>38</sup> *United States v. O'Hagan*, 521 U.S. 642, 653 (1997).

<sup>39</sup> *S.E.C. v. Dorozhko*, 606 F. Supp. 2d 321, 336 (S.D.N.Y. 2008).



expansive view of Rule 10b-5.<sup>40</sup> The District Court therefore concluded, based on the Supreme Court's decisions in both *Chiarella* and *O'Hagan*, that a breach of a fiduciary duty was required under both the traditional and misappropriation theory.<sup>41</sup>

In its analysis of *O'Hagan*, the Second Circuit noted that the Supreme Court had found that the defendant "had committed fraud through 'silence' because the defendant had a duty to disclose to the source of the information (his client) that he would trade on the information."<sup>42</sup> Similar to its analysis of *Chiarella*, the Second Circuit attempted to distinguish *O'Hagan* from the *Dorozhko* case on the basis of nondisclosure compared to affirmative misrepresentation. In the view of the Second Circuit, the defendant's "silence" resulted in fraud based on the defendant's fiduciary duty to disclose to the source of the nonpublic information. *O'Hagan*, on the other hand, did not concern an affirmative misrepresentation and the Court did not address whether the defendant would have violated section 10(b) had the defendant not had a fiduciary duty to disclose to the source of the nonpublic information.

In *Zandford*, the Supreme Court held that a securities broker who traded securities under his client's account and transferred the proceeds to his own account, committed a scheme to defraud that was "in connection with" the securities transactions within the meaning of section 10(b).<sup>43</sup> Although the District Court conceded that *Zandford* stood for "the proposition that Dorozhko's alleged scheme was 'in connection with' the purchase or sale of securities," it stopped short of

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<sup>40</sup> *Id.* Justice Blackmun views section 10(b) as a "catchall" provision designed to protect investors from unknown risks. *Chiarella*, 445 U.S. at 246 (Blackmun, J., dissenting). In his view, the court's approach in *Chiarella*, "advance[d] an interpretation of § 10(b) and Rule 10b-5 that stops short of their full implications." *Id.* at 247. Justice Blackmun would have instead held "that persons having access to confidential material information that is not legally available to others generally are prohibited by Rule 10b-5 from engaging in schemes to exploit their structural informational advantage through trading in affected securities." *Id.* at 251.

<sup>41</sup> *Dorozhko*, 606 F. Supp. 2d at 336.

<sup>42</sup> *S.E.C. v. Dorozhko*, 574 F.3d 42, 47 (2d Cir. 2009).

<sup>43</sup> *S.E.C. v. Zandford*, 535 U.S. 813 (2002).

finding Dorozhko's alleged scheme "deceptive."<sup>44</sup> The District Court relied on Justice Stevens' reiterations that "Zandford's section 10(b) violation was predicated on his breach of fiduciary duty" to suggest "that there can be no 'deception,' and therefore no liability under section 10(b), absent the existence and breach of a fiduciary duty."<sup>45</sup> The Second Circuit did not address this part of the District Court's analysis. However, based on the Second Circuit's final conclusion, it appears that the Second Circuit did not find the *Zandford* decision to be dispositive as to whether Dorozhko's alleged scheme was "deceptive."

While the District Court relied on these three decisions to conclude the "deceptive" element of section 10(b) requires a breach of fiduciary duty, the Second Circuit concluded that "none of the Supreme Court opinions relied upon by the District Court . . . establishes a fiduciary-duty requirement as an element of every violation of section 10(b)."<sup>46</sup> Instead, the Second Circuit reasoned that "nondisclosure in breach of a fiduciary duty" merely satisfies section 10(b)'s requirement of a "deceptive device or contrivance," and therefore does not "require a fiduciary relationship as an element of an actionable securities claim under section 10(b)."<sup>47</sup> By concluding that a fiduciary relationship was not a required element of an actionable securities claim under section 10(b), the Second Circuit was free to adopt the SEC's theory of fraud and determine that an affirmative misrepresentation to gain access to material, nonpublic information and then trade on that information could be "deceptive."

#### IV. CIRCUIT SPLIT

The Second Circuit is the first federal court to hold that theft of material nonpublic information by a corporate outsider and subsequent trading on that information violates section 10(b) and Rule 10b-5. Three other Circuit Courts have addressed this issue and appear

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<sup>44</sup> *Dorozhko*, 606 F. Supp. 2d at 338.

<sup>45</sup> *Id.*

<sup>46</sup> *Dorozhko*, 574 F.3d at 48.

<sup>47</sup> *Id.* at 49.

to side with the District Court's decision that section 10(b) and Rule 10b-5 always require a breach of a fiduciary duty.

The dicta contained in opinions by the Fourth and Seventh Circuits suggest that thieves of material nonpublic information do not violate section 10(b) or Rule 10b-5 when they trade on the basis of that information. In *S.E.C. v. Cherif*, a former employee of an investment bank secretly kept his key card and broke into the bank's offices on a number of occasions to steal information on pending corporate transactions.<sup>48</sup> He then traded securities on the basis of that information, making a profit.<sup>49</sup> Though the Seventh Circuit sustained Cherif's conviction on the grounds that an employee's duty to a former employer is not extinguished upon termination, the court did comment on Cherif's argument that he was a "mere thief" who owed no duty to anyone.<sup>50</sup> The Seventh Circuit remarked that Cherif's argument of being a "mere thief" was "[t]he only possible barrier to application of the misappropriation theory."<sup>51</sup>

In another court of appeals case, *United States v. Bryan*, the Fourth Circuit suggested even more forcefully that mere thieves do not violate section 10(b) and Rule 10b-5 by trading on stolen information.<sup>52</sup> The defendant, a former director of the West Virginia Lottery, used confidential information about forthcoming contracts to purchase shares in companies that did business with the West Virginia Lottery.<sup>53</sup> The Fourth Circuit reversed the District Court's decision, choosing not to adopt the misappropriation theory in part because the theory would lead future courts to expand and eventually abandon the concept of fiduciary duty that lay at the heart of section 10(b).<sup>54</sup> The Fourth Circuit predicted that courts would eventually be forced to abandon the requirement of a fiduciary duty all together and hold that mere thieves violated the misappropriation theory.<sup>55</sup>

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<sup>48</sup> *S.E.C. v. Cherif*, 933 F.2d 403, 406-07 (7th Cir. 1991).

<sup>49</sup> *Id.*

<sup>50</sup> *Id.* at 411.

<sup>51</sup> *Id.*

<sup>52</sup> *United States v. Bryan*, 58 F.3d 933, 951 (4th Cir. 1995).

<sup>53</sup> *Id.* at 939.

<sup>54</sup> *Id.* at 951.

<sup>55</sup> *Id.*

Although both the Fourth and Seventh Circuits seem to suggest that “mere thieves” of material nonpublic information do not violate section 10(b) or Rule 10b-5 when they trade on the basis of that information, it should be noted that both of these cases were decided before *O’Hagan* and the adoption of the misappropriation theory by the Supreme Court. The pre-dating of *O’Hagan* combined with the fact that these comments were included in the dicta of these court of appeals cases raises doubt as to the authority of these cases.

The Fifth Circuit, however, held a breach of a fiduciary duty is a required element of a section 10(b) violation. In *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, the Fifth Circuit discussed how the Supreme Court “has established that a device, such as a scheme, is not ‘deceptive’ unless it involves breach of some duty of candid disclosure.”<sup>56</sup> The Fifth Circuit made this observation relying on the same precedent as that of the District Court in *Dorozhko*.

In summary, there is a circuit split as to whether a fiduciary duty is a required element of a section 10(b) violation: In the Second Circuit, the SEC need not prove a breach of a fiduciary duty; but in the Fourth, Fifth, and Seventh Circuits, the SEC must prove such a breach. In fact, the Second Circuit even comments that “[a]t least one of [its] sister circuits has made the same observation [as the District Court] relying on the same precedent.”<sup>57</sup>

## V. IMPLICATIONS OF THE SECOND CIRCUIT’S DECISION

The Second Circuit appears to have opened the door to a legal theory that computer hacking in connection with insider trading may sometimes be “deceptive” under section 10(b), while rejecting the idea that “deceptive” actions under section 10(b) can only occur through a violation of a fiduciary duty. Under the prior liability regime, a “paradoxical situation” existed where a person who obtained material nonpublic information “legally” could be held liable under criminal

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<sup>56</sup> *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 389 (5th Cir. 2007).

<sup>57</sup> *S.E.C. v. Dorozhko*, 574 F.3d 42, 48 (2d Cir. 2009) (referring to the Fifth Circuit’s decision in *Regents of the Univ. of Cal.*, 482 F.3d 372).

and civil securities law for trading on such information, whereas a thief, acting illegally, might not be.<sup>58</sup> Without the Second Circuit's ruling, this situation would continue to be exploited by information thieves because there would be no associated consequence, under section 10(b) and Rule 10b-5 liability, if the thief were to trade on such information.<sup>59</sup> Even the District Court was aware of this situation, commenting that "[t]his case highlights a potential gap arising from reliance on fiduciary principles in the legal analysis that courts have employed to define insider trading."<sup>60</sup>

Under the reasoning used by the Second Circuit, the SEC will be able to bring its insider trading cases under the affirmative misrepresentation category to avoid having to show a breach of duty by the defendant.<sup>61</sup> This newfound ability may result in broader enforceability under section 10(b), exposing more defendants to potential civil liability under the securities law.<sup>62</sup> Both the District Court and Second Circuit noted that such "hacking and trading" schemes have typically been prosecuted under federal and state criminal statutes. The SEC will now be able to pursue cases of computer hacking as violations of federal securities laws in addition to violations of other federal and state criminal statutes. Thus, this decision will provide the SEC wide latitude in determining how to address securities-related misconduct, at least within the Second Circuit.

The Second Circuit's decision also has the potential to expand section 10(b) liability to a wider range of parties who take advantage of access to material nonpublic information and trade securities based on

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<sup>58</sup> Carolyn Silane, *Electronic Data Theft: A Legal Loophole for Illegally-Obtained Information—A Comparative Analysis of U.S. and E.U. Insider Trading Law*, 5 SETON HALL CIRCUIT REV. 333, 363 (2009).

<sup>59</sup> *Id.* However, such hackers may still be liable under mail or wire fraud, 18 U.S.C. § 1341 (2006 & Supp. II 2008) or 18 U.S.C. § 1343 (2006 & Supp. II 2008), and the Computer Fraud and Abuse Act, 18 U.S.C. § 1030 (2006 & Supp. II 2008).

<sup>60</sup> *S.E.C. v. Dorozhko*, 606 F. Supp. 2d 321, 323 (S.D.N.Y. 2008).

<sup>61</sup> Peter Henning, *On the SEC, Mark Cuban, and a Man Named Dorozhko*, WALL ST. J., Jul. 28, 2009, <http://blogs.wsj.com/law/2009/07/28/on-the-sec-mark-cuban-and-a-man-named-dorozhko/>.

<sup>62</sup> Flumenbaum & Karp, *supra* note 3.

that information. Anyone who deceptively obtains information and trades securities based on that information may be subjected to enforcement or liability, regardless of their relationship to the issuer of the information. Under this new regime, securities traders will need to be cautious as to how they come into possession of confidential information. If they do so in a manner that could be viewed as “deceptive,” then trading securities based on that information could violate the securities laws, regardless of whether any duty was breached.

### CONCLUSION

The Second Circuit’s decision appears to have expanded the Supreme Court’s definition of insider trading and extended section 10(b) liability to a wider range of parties who trade securities based on access to material nonpublic information. This decision has opened the door to a legal theory that computer hacking in connection with insider trading may sometimes be “deceptive” under section 10(b), while foreclosing the argument that “deceptive” actions under section 10(b) can only occur through a violation of a fiduciary duty. The impact of this decision, however, is minimized by the lack of a clear and consistent theory of insider trading liability as to the fiduciary duty requirement among the circuit courts. Given the split on this issue between the Second Circuit and the Fourth, Fifth, and Seventh Circuits, it is possible that the Supreme Court will review this issue in the near future. Until this issue is resolved by the Supreme Court or Congress intervenes, securities traders will have to monitor how they come into possession of confidential information. If the information is obtained in a manner that could be viewed as “deceptive,” then trading securities based on that information could violate section 10(b) of the Securities Exchange Act of 1934.

### PRACTICE POINTERS

- When using material, nonpublic information to purchase or sell securities, traders should be aware of whether they have a fiduciary duty to the source of the information or whether there is such a duty between the source of the information and a third party. If a

fiduciary duty does exist, a trader should not purchase or sell securities based on the information without disclosure.

- Even if no fiduciary duty exists, traders should still monitor the manner in which material, nonpublic information is obtained if such information is used to purchase or sell securities. If the information was obtained in a manner that could be viewed as “deceptive,” then trading securities based on that information could violate section 10(b) and Rule 10b-5 and the trader should therefore abstain from trading on the information.
- Even if a trade based on material, nonpublic information does not violate section 10(b) and Rule 10b-5, traders should still consider the reputational damage and significant legal expenses they may incur in defending such trades. In addition, traders should consider other potential legal consequences (e.g., mail or wire fraud, traditional theft theories, or other tort actions) that may arise through use of the material, nonpublic information.