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Second Circuit Reaffirms That Standard Confidentiality Agreements Can Create a Relationship of Trust and Confidence for Insider Trading Purposes

The question of whether and when a party can trade in securities when subject to an NDA is one that market participants frequently face. Recently, in *United States* v. *Chow*, 993 F.3d 125 (2d Cir. 2021), the Second Circuit offered important guidance on this topic when it affirmed the insider trading conviction of the managing director of an investment firm that was seeking to acquire a publicly traded company. The defendant's firm and public company had entered into a nondisclosure agreement ("NDA") requiring the firm to use any material nonpublic information ("MNPI") obtained from the potential target *solely* for purposes of evaluating a potential acquisition. In violation of that restriction, the defendant disclosed MNPI to a business associate, who traded in the company's securities and realized a $5 million profit.

Although *Chow* addressed several insider trading and other issues, this client alert addresses the one aspect of the decision that has particular practical implications for market participants. Specifically, the court held that an NDA merely requiring a party to keep information confidential—even if the NDA does not have an express trading prohibition—is sufficient to create a relationship of trust and confidence, a necessary element of an insider trading charge. In reaching that conclusion, the Second Circuit reaffirmed its prior holdings on this subject, but made the point even clearer.[1]

Market participants who enter into standard NDAs of this sort—requiring the recipient of MNPI to keep information confidential but not expressly barring trading—have not always agreed on whether a contractual obligation to keep information confidential is sufficient to create an obligation not to trade on such information or to pass such information on to another who trades on it. *Chow* leaves no room for doubt that, at least in the Second Circuit, a standard NDA can, and most likely will, impose such an obligation. Even parties outside the Second Circuit (New York, Connecticut, Vermont) would do well to abide by this holding given the court's prominent role in shaping securities law jurisprudence nationally.

Proceedings in the Trial Court

The defendant, Benjamin Chow, was the managing director of an investment firm. That firm was considering the acquisition of a publicly traded target company. Chow led the negotiations between his firm and the target company. In connection with those negotiations, Chow signed an NDA on behalf of his firm. In the NDA, Chow's firm agreed not to disclose the target company's proprietary information or the existence of the merger negotiations. Those negotiations did not result in an acquisition.

Chow then left his investment firm to start his own fund. Chow's new fund and the target company entered into a second NDA. The terms of that NDA were substantially similar to the prior NDA with Chow's former firm. The target company announced that it would be acquired by Chow's fund. Following that announcement, the price of the stock of the target rose by 18%. The acquisition, however, did not receive required regulatory approval and consequently never occurred.

An investigation by the Financial Industry Regulatory Authority found that while the second NDA was in effect, Chow had communicated with an associate of his concerning the merger. The associate bought stock in the target company before the contemplated acquisition was announced. Following the announcement, the associate sold that stock. He realized a profit of nearly $5 million. As a result, Chow was convicted of insider trading and related crimes.

Chow's Appeal to the Second Circuit

Chow raised several challenges to his conviction on appeal. As relevant here, the Second Circuit considered Chow's argument that the government had not proved the "relationship of trust and confidence" element of an insider trading charge. It is a basic tenet of insider trading law that in order for a party to violate the law by misappropriating information and trading on it, the party must misappropriate information it obtained through a relationship of trust and confidence with the source. In Chow's case, he contended that by entering into the NDA at issue, he had only an arm's-length relationship with the target company, not a fiduciary-like relationship based on trust and confidence. Accordingly, Chow argued that any violation constituted, at most, a breach of contract.

The Second Circuit rejected these arguments. Citing the Supreme Court's decision in *United States* v. *O'Hagan*, 521 U.S. 642, 651–52 (1997), *Chow* observed that insider trading laws apply to both "insiders" (company officials or employees) and "outsiders" who "owe a duty of nondisclosure to the company and who misappropriate its confidential information for securities-trading purposes."[2] The Second Circuit explained that the NDAs Chow had signed with the target company created a legal duty of confidentiality not to share the information about the impending acquisition under the misappropriation theory of insider trading.[3] In reaching that conclusion, the Second Circuit relied on its recent decision in *United States* v. *Kosinski*, 976 F.3d 135, 145 (2d Cir. 2020), *petition for cert. filed*, No. 12-1161 (U.S. Feb. 23, 2021), which held that individuals who enter into confidentiality agreements pursuant to which they are given access to company information that they agree not to disclose become "temporary insiders" with fiduciary-like duties.[4]

Based on these principles, the Second Circuit concluded that Chow, by virtue of the NDAs he had entered into with the target company, became a temporary insider of the company and thus was obligated to keep any MNPI he obtained confidential. The Second Circuit further found that there was sufficient evidence to show that Chow had breached that duty by disclosing information about the impending acquisition to Yin.[5]

Standard NDAs Can Impose an Obligation Not to Trade

The Second Circuit's decision in *Chow* did not necessarily break new ground, but it did speak with greater clarity on the significance of the breach of an NDA for insider trading purposes. Specifically, *Chow* confirms that, at least in the Second Circuit, a standard NDA—even one that lacks an explicit prohibition against trading—is sufficient to impose a duty not to trade on MNPI and not to pass on MNPI to someone else who trades on the information.

Commentators and market participants alike have questioned whether standard NDAs that have no express trading prohibitions impose an obligation not to trade for insider trading purposes. And given the contractual nature of the relationship, good arguments might be made to support the conclusion that there is no prohibition on trading. But *Chow* seems to answer that question in the affirmative: in holding explicitly that an NDA is sufficient to create a relationship of trust and confidence—and that in violating that NDA, a party can be subject to insider trading liability—the Second Circuit made clear that parties subject to basic contractual confidentiality obligations may be subject to insider trading charges.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content.

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1 The Fifth Circuit came close to addressing this issue in the Securities and Exchange Commission's (SEC) insider trading case against Mark Cuban but did not squarely decide it. Cuban argued on appeal that a confidentiality agreement was alone insufficient to create a duty to disclose or abstain from trading under the misappropriation theory of insider trading. The Fifth Circuit did not reach this argument because it found that the SEC plausibly alleged Cuban had expressly agreed not to trade on the MNPI. *S.E.C.* v. *Cuban*, 620 F.3d 551, 557 (5th Cir. 2010).

2 *Chow*, 993 F.3d at 136–37.

3 *Id.* at 139.

4 *See id.* at 138–39.

5 Chow did not seek *en banc* rehearing of the decision, and as of this writing, has not sought Supreme Court review, though the time to seek review has not yet expired.