No. 14-29

IN THE

Supreme Court of the United States

DOUGLAS F. WHITMAN,

Petitioner,

—v.—

UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR PROFESSOR STEPHEN M. BAINBRIDGE AS *AMICUS CURIAE* SUPPORTING PETITIONER

SHAWN PATRICK REGAN*
PATRICK L. ROBSON
JOSEPH J. SALTARELLI
MICHAEL B. KRUSE
JOSHUA S. PASTER
HUNTON & WILLIAMS LLP
200 Park Avenue
New York, New York 10166
(212) 309-1000
sregan@hunton.com

**Counsel of Record*

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QUESTION PRESENTED

Whether, in a criminal prosecution for insider trading under § 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b), the scope of a corporate insider's "fiduciary duty" is defined by state corporation law, or—as the court below held—by some judge-made "federal common law of fiduciary duty."

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INTEREST OF AMICUS CURIAE

Amicus Stephen M. Bainbridge is the William D. Warren Professor of Law at The University of California at Los Angeles School of Law. He teaches and writes extensively in the areas of corporation law and securities regulation. He is a prolific author and has written several law review articles examining the application of fiduciary duty principles to insider trading regulation, most notably *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189 (1995). In 2008, 2011, and 2012 Professor Bainbridge was named by Directorship Magazine as among the 100 most influential people in the field of corporate governance. In 2008, he received the Rutter Award for Excellence in Teaching. He graduated Western Maryland College with an A.B. in 1980, and the University of Virginia with both a Master of Science in Chemistry in 1980 and a Juris Doctor in 1983. *Amicus* is interested in this appeal to clarify the proper role of state law in defining the fiduciary duty element of insider trading. The views expressed herein are those of *Amicus*; institutional affiliation is provided for identification purposes only.[1]

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[1] Petitioner filed a letter with the Clerk of the Court providing blanket consent to the filing of amicus briefs pursuant to Rule 37.3(a). A letter from counsel for respondent consenting to the filing of this brief has been filed with the Clerk of the Court. No counsel for a party authored this brief in whole or in part, and no party or counsel for a party made a monetary contribution intended to fund the preparation or submission of the brief. No person other than *amicus curiae* or his counsel made a monetary contribution to the preparation or submission of this brief.

SUMMARY OF ARGUMENT

This Petition presents, *inter alia*, the question of whether the "fiduciary duty" element of securities fraud is to be defined by existing state law or crafted *ad hoc* as a new area of federal common law. The Second Circuit's approach—"implicitly assuming" a federal rule shall govern so as to achieve "uniformity"—is squarely contrary to core tenets of federalism and the precedents of this Court, which limit the circumstances in which federal courts may create a common law rule of decision. (*See* Part I, *infra*.) The Second Circuit's approach also conflicts with the law of other circuits, some of which look to state law to define "fiduciary duty" and some of which suggest courts may look to state law to develop federal common law. When, as here, the stakes involve not only livelihoods but also potential loss of liberty turning on unpredictable and inconsistent approaches (and outcomes), the conflict should be resolved. (*See* Part II, *infra*.) Finally, because the basis for the federal insider trading prohibition is the protection of property interests in corporate information and because this Court's precedents have consistently recognized the preeminence of states with respect to corporation law and property rights, absent action by policymaking branches of government, the fiduciary duty element of insider trading should be defined under state law, not by virtue of emergent notions of federal common law. (*See* Part III, *infra*.)

I. The Decision Below Is Squarely Contrary to Core Tenets of Federalism and the Precedents of This Court.

1. Under our Constitution "the federal lawmaking power is vested in the legislative, not the judicial, branch of government." *Nw. Airlines, Inc.* v. *Transp. Workers Union*, 451 U.S. 77, 95 (1981).

"Federal 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." *Milwaukee* v. *Illinois*, 451 U.S. 304, 312 (1981); *Erie R.R.* v. *Tompkins*, 304 U.S. 64 (1938).

Federal courts are constitutionally constrained not merely from defining federal statutory terms in a manner contrary to an explicit statutory provision; they are equally constrained from fashioning a federal common law rule to "supplement" a comprehensive and detailed federal statute. *O'Melveny & Myers* v. *FDIC*, 512 U.S. 79, 85 (1994). "[M]atters left unaddressed in such a scheme are presumably left subject to the disposition provided by state law." *Id.* (citing *Nw. Airlines*, 451 U.S. 77, 97 (1981); *Milwaukee*, 451 U.S. at 319).

Circumstances rebutting this presumption and justifying "judicial creation of a special federal rule" are "few and restricted," *O'Melveny*, 512 U.S. at 87 (citing *Wheeldin* v. *Wheeler*, 373 U.S. 647, 651 (1963)), "limited to situations where there is a 'significant *conflict* between some federal policy or interest and the use of state law.'" *Id.* (emphasis added) (quoting *Wallis v. Pan Am Petroleum Corp.*, 384 U.S. 63, 68 (1966)). As this Court emphasized in *O'Melveny*, the "cases uniformly require the existence of such a conflict as a *precondition* for recognition of a

federal rule of decision." 512 U.S. at 87 (emphasis added) (citing *Kamen* v. *Kemper Fin. Servs., Inc.*, 500 U.S. 90, 98 (1991); *Boyle* v. *United Techs. Corp.*, 487 U.S. 500, 508 (1988); *United States* v. *Kimbell Foods, Inc.*, 440 U.S. 715, 728 (1979)).

2. The Second Circuit below reaffirmed its contrary approach, holding that creation of a federal common law of corporate fiduciary duty is justified, Pet. App. 15a, because (i) in the view of the Second Circuit, prior cases of this Court "implicitly assumed" the relevant duty springs from federal law and (ii) "idiosyncratic differences in state law would thwart the goal of providing national uniformity in securities markets." *Steginsky* v. *Xcelera, Inc.*, 741 F.3d 365, 371 (2d Cir. 2014) (cited at Pet. App. 15a).

As to the first ground, neither the Constitution nor this Court's jurisprudence support the proposition that federal courts shall create law based on a perceived "implicit assumption." Indeed, Second Circuit law is squarely at odds with this Court's jurisprudence that creation of federal common law is limited to a specified "few and restricted" circumstances. *O'Melveny*, 512 U.S. at 87. No case supports a theory that lower courts should create federal common law simply because those courts believe prior cases of this Court "implicitly assume" they could do so.[2] Similarly, this Court has rejected paeans to "uniformity" as the "most generic (and lightly invoked) of alleged federal interests" and

[2] The basis for finding such "implicit assumption" is dubious. The district court observed that the Court's cases have "described … and defined" fiduciary duty "without ever referencing state law." Pet. App. 33a. Notably absent from this Court's cases, however, is any affirmative description or reference to federal common law. *Id.*

insufficient to authorize creation of federal common law. *O'Melveny*, 512 U.S. at 88 ("Uniformity of law might facilitate … nationwide litigation of these suits, eliminating state-by-state research and reducing uncertainty—but if the avoidance of those ordinary consequences qualified as an identifiable federal interest, we would be awash in 'federal common-law' rules.").

II. The Law of the Second Circuit Conflicts with the Law of Other Circuits.

In *Dirks* v. *S.E.C.,* 463 U.S. 646, 659-60 (1983), this Court explained that a tippee's liability for insider trading derives from the tipper's "fiduciary" duty to shareholders either to disclose material nonpublic information to a counterparty before trading or to abstain from trading. "A tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information *only* when the insider has breached his fiduciary duty to the shareholders …."[3] *Id.* (emphasis added).

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[3] As the district court acknowledged, the question of whether a tippee owed the company a fiduciary duty (and, if so, the scope of such duty) must "not be confused with the question of what is material nonpublic information." Pet. App. 29a. Company policies and agreements to keep information confidential do not necessarily create a fiduciary duty sufficient to support a fraud prosecution, "since a breach of contract does not necessarily involve a[] misrepresentation" (*i.e.*, a fraudulent failure to disclose the breach). Pet. App. 30a-31a. No relevant Federal statute or regulation provides the mere receipt of such information renders one a fiduciary prohibited from trading without disclosure of the information to the counterparty. *Cf.* Pet. App. 28a n.1 (observing that, while other nations have proposed and enacted laws of general applicability against insider trading, "Congress ... has never done so, partly because the SEC has generally opposed such proposals on the ground

Several circuit courts of appeals have held that, because federal securities laws do themselves not provide a basis "for finding a fiduciary or other confidential relationship"[4] any such duty must arise from "some basis outside the securities laws, such as state law." *Fortson* v. *McGuire, Sechrest & Minick*, 961 F.2d 469, 472 (4th Cir. 1992). *See also S.E.C.* v. *Sargent*, 229 F.3d 68, 76 (1st Cir. 2000) (using state law to define fiduciary duty element of insider trading charge); *Jordan* v. *Duff & Phelps, Inc.*, 815 F.2d 429, 436 (7th Cir. 1987). Other circuits have decided that fiduciary relationships may be established under either state or federal law, but have provided less clarity as to when the respective laws will be applied. *See S.E.C.* v. *Cochran*, 214 F.3d 1261, 1265 (10th Cir. 2000); *Camp* v. *Dema*, 948 F.2d 45, 460 (8th Cir. 1991). The Second Circuit alone holds that the fiduciary duty element is to be "defined by federal common law." Pet. App. 15a.

Such inconsistent interpretations beg for resolution. "Fines, lost careers, and even jail terms rest on an uncertain articulation of when fiduciary relationships exist." Richard W. Painter, *et al.*, *Don't Ask, Just Tell: Insider Trading After* United States v.

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that any statutory definition of illegal insider trading would inevitably create 'loopholes' ….'). And nothing in this Court's jurisprudence concludes that recipients of material nonpublic information automatically owe a Federal fiduciary duty. *Accord Nw. Airlines*, *supra*, at 98, n.41 (such a "function of weighing and appraising 'is more appropriately for those who write the laws, rather than for those who interpret them'").

[4] As the district court observed below, "whether labeled a 'fiduciary' duty, a fiduciary-like 'relation of trust and confidence,' or whatever," is of no bearing—the unresolved question remains whether this duty is meant to be defined as a matter of federal common law or applicable state law. Pet. App. 31a-32a.

O'Hagan, 84 VA. L. REV. 153, 188 (1998). *Accord* Stewart, James B., *Common Sense, The Limits of the Law in Insider Trading*, N.Y. TIMES, July 18, 2014, at B1 ("[I]t doesn't seem fair for a person's freedom to depend on an interpretation of the law that even federal judges can't agree on.").

III. Absent Action by the Policymaking Branches, The Fiduciary Duty Element of Insider Trading Should Be Defined Under State Law, Not By Virtue of Emergent Notions of Federal Common Law.

1. The Federal government plainly has a significant and important interest in regulating securities markets. *See* Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1265 (1995) (noting federal government's "comparative advantage in detecting and prosecuting insider trading").

But, as in *O'Melveny*, where this Court flatly rejected the assertion that "high federal interest in th[e] area, confirms the courts' authority to promulgate such common law," 512 U.S. at 88, a general federal interest in regulating the trading of securities cannot be used to overcome the Constitutional presumptions against *federal common law rulemaking by the judicial branch*. To hold otherwise would inevitably render our federal system "awash in federal common-law rules." *O'Melveny*, 512 U.S. at 88.

2. It is significant that, "while insider trading prosecutions are often brought by the federal government and arise under federal statute, insider trading does not directly affect the rights of the

United States or threaten to impose liability on it." Bainbridge, 52 WASH. & LEE L. REV. at 1267. *See O'Melveny*, 512 U.S. at 88 ("The rules of decision at issue here do not govern the primary conduct of the United States or any of its agents or contractors, but affect only the FDIC's rights and liabilities with respect to primary conduct on the part of private actors that has already occurred."). *Accord Miree* v. *Dekalb Cnty.*, 433 U.S. 25, 31 (1977) (holding fact that the United States "has a substantial interest in regulating aircraft travel and promoting air travel safety" insufficient to justify federal rule of decision).

Rather, as reflected generally by the history of this Court's jurisprudence and specifically by the fact that the law of insider trading is premised on fiduciary duty, the basis for insider trading prohibitions is the protection of *a corporation's property interests in confidential information*. *See Chiarella* v. *United States*, 445 U.S. 222, 235 n.20 (1980); *Dirks,* 463 U.S. at 659-60 (basis for restricting outsider tippee's trading on material nonpublic information is that tippee assumes a fiduciary duty to shareholders); *see also*, *e.g.*, *United States* v. *Chestman*, 947 F.2d 551, 576-78 (2d Cir. 1991) (Winter, J. concurring), *cert. denied*, 112 S. Ct. 1759 (1992); *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 1961 WL 59902 (1961) (insiders breached duty to shareholders by purchasing shares before disclosure of nonpublic material information); Frank H. Easterbrook, *Insider Trading Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 317-20; Bainbridge at 1257 ("If one accepts protection of property rights as the rationale for regulating insider trading, it becomes quite difficult to discern any compelling federal interest in [prohibiting insider trading].").

3. The fact that the basis for regulating inside trading is the protection of property rights undercuts the Second Circuit's approach and rationale. That is:

> The property rights rationale makes it obvious that the federal insider trading prohibition has nothing to do with disclosure or fraud. Instead, like the trade secrets rules, the insider trading prohibition is mainly concerned with preventing employees and other fiduciaries from using information belonging to the corporation for personal gain.

Bainbridge, 52 WASH. & LEE L. REV. at 1257.

4. While legitimate federal interests and efficiency of enforcement "justifies a federal prohibition of insider trading, it does not justify creating a unique federal definition" of fiduciary duty. *Id.* at 1266. Rather, even with the federal interests in prohibiting insider trading, the creation of a federal common law definition of fiduciary duty is proper only where the "application of state law would frustrate specific objectives of the federal programs." *United States* v. *Kimbell Foods*, 440 U.S. 715, 728 (1979). As the Court has explained:

> In deciding whether rules of federal common law should be fashioned, normally the guiding principle is that a significant conflict between some federal policy or interest and the use of state law in the premises must first be specifically shown. It is by no means enough that, as we may assume, Congress could, under the Constitution, readily enact a complete code of law governing transactions in federal

> mineral leases among private parties. Whether latent federal power should be exercised to displace state law is primarily a decision for Congress.

Miree, 433 U.S. at 31-32 (quoting *Wallis*, 384 U.S. at 71).

The opinions below reversed the settled presumption—that "federal courts should incorporate state law into federal common law" where a gap in federal securities laws must be bridged,[5] *Kamen* v. *Kemper Fin. Servs., Inc.*, 500 U.S. 90, 108 (1991)—reasoning that because no case "expressly held" that the fiduciary duty was defined by state law, it could assume that the fiduciary duty "is a matter of federal common law." Pet. App. 33a. The Second Circuit's approach is not premised on a "significant conflict" between federal policy and use of state law. *See supra*, *Part I* (noting the infirmity of the "uniformity" rationale).

5. Application of state law is particularly apt for defining corporate fiduciary duty because "[s]tate law is the font of corporate fiduciary duty." Bainbridge, 52 WASH. & LEE L. REV. at 1261. As this Court made clear in *Burks* v. *Lasker,* 441 U.S. 471 (1979), although "in certain areas … federal statutes authorize the federal courts to fashion" common law, "[c]orporation law … is not such an area." *Id*. at 477. And "where a gap in the federal securities laws must be bridged by a rule that bears on the … powers

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[5] This presumption becomes particularly weighty in areas where private parties have entered into legal relationships with the expectation that state law would govern their rights and obligations. "Corporation law is one such area." *Kamen*, 500 U.S. at 98.

within the corporation, federal courts should incorporate *state* law ...." *Kamen*, 500 U.S. at 108 (emphasis in original); *accord Santa Fe Indus., Inc.* v. *Green*, 430 U.S. 462, 479 (1977) ("Corporations are creatures of state law, and ... state law ... governs[s] the internal affairs of the corporation.").

The Court's decision in *Burks* is illustrative. 441 U.S. 471 (1979). *Burks* involved claims under the Investment Company Act. *Id.* at 477-78. Although the cause of action clearly arose under federal law, the Court held that state law applied with respect to inherent questions concerning termination of derivative claims thereunder because application of state law did not pose a "significant threat to any identifiable federal policy or interest" and state law "is the font of corporate director's powers." *Id.* at 478-79. *See also Karmen v. Kemper Fin. Servs.*, 500 U.S. 90 (1991). *Accord Desylva* v. *Ballentine*, 351 U.S. 570, 580 (1956) (holding state law defined "children" in the Copyright Act and that "The scope of a federal right is, of course, a federal question, but that does not mean that its content is not to be determined by state, rather than federal law. This is especially true where a statute deals with [a subject about which] there is no federal law [and] which is primarily a matter of state concern.") (internal citations omitted); *Seaboard Air Line Ry.* v. *Kenney*, 240 U.S. 489, 493-94 (1916) (holding state law defined "next of kin" in Employers' Liability Act, and stating "the absence of a definition in the act of Congress plainly indicates the purpose of Congress to leave the determination of that question to the state law," and that no "such extreme" displacement of state law can "possibly be attributed to the act of Congress without express and unambiguous provisions rendering such conclusion necessary.").

The Court's analysis in *Santa Fe* is also insightful. There the "essence of the complaint" was that "shareholders were treated unfairly by a fiduciary," 430 U.S. at 477—the very essence of the claim in insider trading cases. In light of the fact that state law defines and provides remedies for breach of fiduciary duty and Rule 10b-5 is concerned with disclosure and fraud, not breach of fiduciary duty, this Court declined to create a federal common law of fiduciary duty under Rule 10b-5. *Id*. at 478-79.

6. Adoption of state law fiduciary duties as the rule of decision ensures that courts "ask the right questions because those duties are defined by reference to whether the agent's conduct threatens the principal's property rights in information." Bainbridge, 52 WASH. & LEE L. REV. at 1268. And the fact that state fiduciary duty laws rely on deep wells of precedent will aid both courts, *post hoc*, and persons, *a priori*, to discern informed answers to those questions. *See Anspec Co.* v. *Johnson Controls, Inc.*, 922 F.2d 1240, 1250 (6th Cir. 1991) (Kennedy, J., concurring); *see also Commissioner* v. *Stern*, 357 U.S. 39, 45 (1958) (rejecting argument that state law should be displaced for sake of uniformity given "a flexible body of pertinent state law continuously being adapted to changing circumstances").

By contrast, the Second Circuit's approach amounts to an unfettered definition that will allow the imposition of federal criminal liability when it "feels" like an insider trading violation has occurred. Such a "facile approach to federal-common-law-making," *O'Melveny*, 512 U.S. at 89, must be especially troubling in the context of potential criminal liability. *See Chiarella* v. *United States*, 445 U.S. 222 (1980). *See also* Painter, *et al.*, 84 VA. L. REV. at 188 ("lack of

clarity" in such law "raises concerns of constitutional proportion in the criminal context."); Pet. App. 28a (observing the prohibition of insider trading already "has developed in a somewhat *ad hoc* manner, leaving many unanswered questions"); Pet. 23-25.

As Professor Bainbridge has written:

> In sum, it is appropriate for insider trading to be regulated by the federal government. There is no reason, however, for that regulation to take the form of a unique nationwide rule of federal common law. Instead, the fiduciary duty element required by the federal definition of insider trading should be supplied solely by state corporate law.

52 WASH. & LEE L. REV. at 1268.

CONCLUSION

For the foregoing reasons, as well as the reasons set forth by Petitioner, the petition for a writ of certiorari should be granted and the Second Circuit's decision reversed.

Respectfully submitted,

SHAWN PATRICK REGAN*
PATRICK L. ROBSON
JOSEPH J. SALTARELLI
MICHAEL B. KRUSE
JOSHUA S. PASTER
HUNTON & WILLIAMS LLP
200 Park Ave.
New York, NY 10166
(212) 309-1000
sregan@hunton.com

**Counsel of Record*

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