Securities Regulation Daily Wrap Up, TOP STORY—U.S.: Petition asks High Court to address 2d Circuit's 'awareness of duty' requirement, (Sept. 19, 2017)

Securities Regulation Daily Wrap Up

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By Rodney F. Tonkovic, J.D.

A new petition for certiorari asks the Supreme Court to clarify how scienter is demonstrated in insider trading claims brought under the misappropriation theory. The petitioner asserts that the Second Circuit's requirement for proof of a defendant's "awareness of a duty" burdens the plaintiff and negates established law that recklessness is sufficient to establish scienter (*Veleron Holding, B.V. v. Morgan Stanley*, September 5, 2017).

In 2007, petitioner Veleron Holding, B.V. financed an investment in an auto parts supplier called Magna International with a $1.2 billion loan from BNP Paribas. The loan was secured by Veleron's shares in Magna. Later, and independently of the Veleron-BNP transaction, respondent Morgan Stanley executed an agency disposal agreement with BNP and also agreed to take on 8.1 percent of any loss to BNP if Veleron defaulted and the collateral fell short.

During the September 2008 financial crisis, Magna's stock value fell, and BNP issued margin calls on September 29 and 30 demanding that Veleron pay $113.8 million. Veleron was unable to meet the margin call and requested restructuring. On October 3, 2008, after Veleron did not pay, Morgan Stanley, at BNP's direction, liquidated the pledged collateral. In the meantime, however, Morgan Stanley attempted to cover its own exposure to further declines in the price of Magna shares by shorting the stock on September 30 and October 1.

Veleron claimed at trial that Morgan Stanley's short-selling constituted insider trading that depressed Magna's stock price and reduced the proceeds of the liquidation. The claim went to a jury, which returned a unanimous verdict that while Morgan Stanley had traded while in the knowing possession of material, nonpublic information in breach of a duty of confidentiality, had not acted with scienter. The district court's jury instruction allowed that "[g]ood faith on the part of Morgan Stanley is a complete defense to a contention that Morgan Stanley acted with a culpable state of mind." It further instructed the jury that Veleron bore the burden of proving that Morgan Stanley acted with the requisite scienter and not in good faith.

The Second Circuit affirmed, in a summary order. Veleron argued that the burden should have been on Morgan Stanley to prove good faith as an affirmative defense to be raised after the elements for liability had been proven. The panel disagreed, ruling that proof of scienter was part of the affirmative case. Trading while in "knowing possession" of inside information is sufficient to establish that the trades were made on the basis of the inside information. But it does not establish awareness of any duty.

Petition. The petition asks whether a plaintiff prosecuting a misappropriation theory insider trading claim establishes scienter by proving that: (1) the defendant knowingly possessed material, nonpublic information; (2) the defendant owed a duty to keep such information confidential; and (3) the defendant breached its duty by trading on the basis of that information. And, whether the plaintiff must also prove that the defendant was aware of its duty at the time it traded.

The petition argues that by requiring proof of an "awareness of a duty" in order to establish scienter, the Second Circuit impermissibly burdens the plaintiff with having to establish lack of good faith and limits the scope of liability by excluding recklessness. In contrast, the Court, in *U.S. v. O'Hagan*, the petition says, established that to show scienter for insider trading under a misappropriation theory of insider trading, a plaintiff only needs to demonstrate that the defendant knowingly possessed material, nonpublic information, and that it traded in breach of a duty to keep that information confidential.

Prior to this case, the petition says, the Second Circuit applied the *O'Hagan* standard. No requirement of a defendant's awareness of a duty to hold nonpublic information in confidence is found in *O'Hagan* or in other circuit cases that follow it, and the Second Circuit's "awareness" holding is plainly erroneous, the petition maintains. Moreover, Veleron was improperly burdened with having to disprove Morgan Stanley's good faith rationale for trading. The evidence overwhelmingly established scienter and did not even address a single good faith defense. But for the flawed jury instruction, the petition contends, the jury would have found scienter.

Next, while the Supreme Court has yet to definitively hold that recklessness will satisfy the scienter element in an insider trading claim, many appellate courts, including the Second Circuit, have done so. Requiring an awareness of duty and proof of lack of good faith, as was done in this case, compels plaintiffs to prove a culpable state of mind that exceeds recklessness.

In conclusion, the petition argues that this case provides an ideal opportunity for the Court to clarify the contours of scienter in insider trading cases. Leaving the decision below in place would undermine core policy goals and create perverse incentives, the petition says. The Second Circuit's holding would also severely limit enforcement of insider trading rules because actual knowledge is difficult to prove.

The petition is No. 17-363.

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Companies: Veleron Holding, B.V.; Morgan Stanley

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