UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION Plaintiff, v. DARYL M. PAYTON and BENJAMIN DURANT III, Defendants.	14 Civ. 4644 (JSR) **ECF CASE**

MEMORANDUM OF LAW IN SUPPORT OF DEFENDANTS' MOTION TO DISMISS

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Benjamin Durant III and Daryl M. Payton respectfully submit this memorandum of law in support of their motion pursuant to Fed. R. Civ. P. 12(b)(6) to dismiss the Security and Exchange Commission's ("SEC") Complaint, dated June 25, 2014 ("Complaint" or "Compl."), for failure to state a claim.

PRELIMINARY STATEMENT

The Complaint fails to satisfy the basic pleading requirements for a misappropriation insider trading scheme against remote tippees Durant and Payton (the "Defendants"). Among other things, the Complaint fails to allege the existence of a personal benefit to the tipper and the Defendants' knowledge of that personal benefit.

In December 2014, the Second Circuit spoke authoritatively on the law of insider trading in United States v. Newman, 773 F.3d 438 (2d Cir. 2014). The opinion raised three important issues that impact the instant matter distinctly and definitively. *First*, the elements required to prove insider trading liability are the same in both classical and misappropriation insider trading cases. *Second*, a remote tippee's liability for insider trading requires the tipper to have disclosed confidential information in exchange for a personal benefit, thereby breaching a fiduciary or similar duty. *Third*, the remote tippee must know of the tipper's breach; that is, he must know that the tipper received a personal benefit in exchange for the disclosure. Allegations that a tippee is merely aware that a tipper breached a duty of confidentiality to the source of the information are insufficient to state a claim for tippee liability because "the exchange of confidential information for personal benefit is not separate from an insider's fiduciary breach; it *is* the fiduciary breach that triggers liability for securities fraud under [17 C.F.R. § 240.]10b-5." Id. at 448–49. (emphasis in original).

In this case, the SEC was required—but failed—to allege facts necessary to plead that the alleged tipper disclosed the information in exchange for a benefit *and* that Durant and Payton

each knew that the information they supposedly received was disclosed in exchange for such a benefit. Specifically, the Complaint fails to plead (1) that the tipper, Trent Martin, received a personal benefit from the first-level tippee, Thomas Conradt, (2) that Durant or Payton knew of the benefit to Martin, and (3) that Durant and Payton knew of Martin's alleged duty of trust and confidence to Michael Dallas (the alleged source) or Martin's misappropriation of the information in breach of that duty. Absent any one of these essential elements, let alone all three, the Complaint is deficient on its face and should be dismissed.

FACTUAL ALLEGATIONS

The SEC alleges an insider trading misappropriation scheme in violation of Section 10(b) of the Securities Exchange Act of 1934 involving IBM's acquisition of SPSS, Inc. ("Acquisition") against Defendants as follows.

Michael Dallas—who was not charged with wrongdoing in the criminal matter and is not a party herein—worked as a junior associate at Cravath, Swaine & Moore LLP ("Cravath") and was a member of the law firm's mergers and acquisitions ("M&A") group. (Compl. ¶ 21). When Cravath assigned Dallas to work on the Acquisition, on or about May 26, 2009, it was his first time working on a merger from "start to finish." (Compl. ¶ 21). During his work, Dallas learned material, nonpublic information about the transaction, including the anticipated (per share) purchase price and the identity of the participants in the transaction ("Information"). (Compl. at 23). As an attorney, Dallas had a duty to keep the Information confidential. Id.

Approximately seven months before Dallas began working on the Acquisition, Dallas became friends with nonparty Trent Martin, an equities salesman. The SEC alleges that in this seven-month span, Martin and Dallas developed a history of sharing confidences and established a duty of trust and confidence between them. (Compl. ¶¶ 28–33). In May 2009, Dallas, feeling concerned about his lack of experience in M&A work, sought moral support from Martin

regarding his new assignment on the Acquisition and, in the process, disclosed the Information to Martin. (Compl. ¶¶ 44–45).

Martin allegedly misappropriated the Information and made trades on it, netting profits of $7,625. (Compl. ¶ 52). On an unspecified date prior to June 24, 2009, Martin allegedly disclosed some of the Information then known to him (and later supplemented it) to his roommate, friend and nonparty Thomas Conradt, a registered representative at a Connecticut broker-dealer ("Broker"). (Compl. ¶ 55). The Complaint lacks any allegation that Conradt gave Martin anything in exchange for the information, nor does it even allege that Martin told Conradt from whom or under what circumstances he had obtained the Information.

Conradt worked with Defendants Payton and Durant at the Broker. The SEC alleges that, on or about July 1, 2009, Conradt provided the Information to Payton. (Compl. ¶ 63). The SEC's allegations with respect to Durant are less clear and, in fact, entirely contradictory. One paragraph alleges that Conradt learned that the Information had been passed to Durant, on or about July 1, 2009, with no explanation of who disclosed the Information to Durant and how Conradt learned of this disclosure. (Compl. ¶ 63). Another paragraph claims that, on or prior to July 20, 2009, Conradt "disclosed" the Information to Durant. (Compl. ¶ 65). On a date left unspecified in the Complaint, Conradt allegedly informed Durant and Payton that his friend and roommate had disclosed the Information to him. (Compl. at 66). The Complaint is bereft of any allegation that Conradt told Durant or Payton (1) from whom Martin received the Information, (2) the nature of Martin's relationship with Dallas, or (3) whether Martin received anything from Conradt in exchange for disclosing the Information.

Between July 20 and July 24, 2009, both Payton and Durant allegedly traded in SPSS securities through their personal accounts at the Broker, which were open to inspection by

anyone at the Broker. (Compl. ¶¶ 67–72). On July 28, 2009, IBM's acquisition of SPSS was announced, allegedly netting Durant and Payton profits of approximately $53,000 and $243,000, respectively. (Compl. ¶ 73).

ARGUMENT

I. Standard of Review

To prevail on a motion to dismiss under Federal Rule of Civil Procedure 12(b)(6), the moving party must establish that the complaint fails to state a cause of action. "[A] formulaic recitation of the elements of a cause of action will not do . . . [The] [f]actual allegations must be enough to raise a right to relief above the speculative level." Bell Atl. Corp. v. Twombley, 550 U.S. 544, 555, 127 S. Ct. 1955 (2007). Where a complaint asserts no more than legal conclusions or "[t]hreadbare recitals of a cause of action supported by mere conclusory statements," it cannot withstand a motion to dismiss. Ashcroft v. Iqbal, 556 U.S. 662, 678, 129 S. Ct. 1937 (2009).

The SEC's insider trading allegations sound in fraud. See Newman, 773 F.3d at 445 (stating that "insider trading is a type of securities fraud"); see also SEC v. Collins & Aikman Corp., 524 F. Supp. 2d 477, 484 (S.D.N.Y. 2007). Accordingly, the Complaint is also subject to the heightened pleading requirements of Federal Rule of Civil Procedure 9(b), which requires a plaintiff alleging fraud to "state with particularity the circumstances constituting fraud." Fed. R. Civ. P. 9(b).

II. The Complaint Fails to Plead the Elements of Insider Trading

In Newman, the Second Circuit clearly and succinctly set forth the required elements of tippee liability:

> [T]o sustain an insider trading conviction against a tippee, the Government must prove each of the following elements . . . that (1) the corporate insider was entrusted with a fiduciary duty; (2) the corporate insider breached his fiduciary duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit; (3) the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit; and (4) the tippee still used that information to trade in a security or tip another individual for personal benefit.

773 F.3d at 450. There can be no question that Newman applies and is controlling in this case. The basic elements it sets forth for pleading an insider trading claim apply with equal force to both civil and criminal cases. See United States v. Gansman, 657 F.3d 85, 91 n.7 (2d Cir. 2011) ("The basic elements of proof for insider trading are the same for civil and criminal enforcement actions, but criminal enforcement differs principally with respect to the required intent and burden of proof.") (citing United States v. Cassese, 428 F.3d 92, 98 (2d Cir. 2005)). The Newman court also expressly cited Dirks v. SEC and other civil cases in analyzing and discussing the elements of insider trading claims generally. See, e.g., Newman, 773 F.3d at 446 (citing SEC v. Obus, 693 F.3d 276 (2d Cir. 2012); 447–49 (discussing Dirks, 463 U.S. 646, 103 S. Ct. 3255 (1983)); 453 (discussing Dirks, SEC v. Yun, 327 F.3d 1263 (11th Cir. 2003), and SEC v. Sargent, 229 F.3d 68 (1st Cir. 2000)).

More significantly, although the Second Circuit's discussion in Newman was framed in the classical insider trading context, the Second Circuit has previously held that the elements are the same for misappropriation and classical insider trading cases.[1] In Obus, it stated "[t]he

[1] As far back as United States v. O'Hagan, 521 U.S. 642, 652–53, 117 S. Ct. 2199 (1997), there has been support for the notion that the elements for insider trading under the classical and misappropriation theories should be the same. The Supreme Court recognized that the two theories "are complementary, each addressing efforts to capitalize on nonpublic information through the purchase or sale of securities" and noting that a misappropriator "pretends loyalty to the principal while secretly converting the principal's information for personal gain." Id. at 652, 653–54.

Supreme Court's tipping liability doctrine was developed in a classical case, Dirks, 463 U.S. 646, but the same analysis governs in a misappropriation case." Obus, 693 F.3d at 285–86 (citing United States v. Falcone, 257 F.3d 226, 233 (2d Cir. 2001)). The Circuit reaffirmed its Obus position in Newman when it stated "[t]he elements of tipping liability are the same, regardless of whether the tipper's duty arises under the 'classical' or the 'misappropriation' theory." 773 F.3d at 446.[2] The Honorable Andrew L. Carter, Jr. reaffirmed that position in the instant case's companion criminal proceeding when he held that the "controlling rule of law in the Second Circuit is that the elements of tipping liability are the same" in classical and misappropriation cases and "even if Newman did not specifically resolve the issue, the Court is swayed by the fact that Newman's unequivocal statement on the point is part of a meticulous and conscientious effort by the Second Circuit to clarify the state of insider-trading law in the Circuit." United States v. Conradt, No. 12 Cr. 887, 2015 WL 480419, at *1 (S.D.N.Y. Jan. 22, 2015).

The Second Circuit is not alone in its recognition that misappropriation and classical insider trading cases require the same showing of a personal benefit. In Yun, the Eleventh Circuit held that "there is no reason to distinguish between a tippee who receives confidential information from an insider (under the classical theory) and a tippee who receives such information from an outsider (under the misappropriation theory)" and that treating misappropriation and classical cases differently "unduly dichotomiz[es] the two theories of insider trading liability." 327 F. 3d at 1275–76. Therefore, as Dirks and its progeny have held, in

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[2] It is clear from the opinions in which the term is found that "tipping liability" applies to tipper and tippee liability. See, e.g., Newman, 773 F.3d at 446; Obus, 693 F.3d at 285–86; State Teachers Retirement Bd. v. Fluor Corp., 654 F.2d 843, 855 (2d Cir. 1981) (discussing "tipping liability" against tippee).

misappropriation cases the SEC must prove that the tipper disclosed confidential information in exchange for a personal benefit and that the tippee was aware of that personal benefit.[3]

A. The Complaint Fails to Allege a Personal Benefit to Martin

The Complaint does not allege facts necessary to meet the SEC's obligation to plead that Martin received a personal benefit in exchange for disclosing the Information to Conradt.

The only possible source of personal benefit alleged in the entire Complaint is that Conradt was Martin's roommate and friend. This conclusory allegation does not satisfy the personal benefit requirement under Newman. The Second Circuit was unequivocal in stating that the personal benefit standard "does not suggest that the Government may prove the receipt of a personal benefit by the mere fact of friendship . . . ." Newman, 773 F.3d at 452.[4] It further stated:

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[3] Indeed, the personal benefit requirement serves the critical function of limiting the scope of insider-trading liability from capturing the daily—and market essential—activities of market professionals. It is "commonplace for analysts to ferret out and analyze information" and "the nature of this type of information, and indeed of the markets themselves" is "that such information cannot be made simultaneously available to all of the corporation's stockholders or the public generally." Dirks, 463 U.S. at 658–59 (citations omitted). "Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market." Id. at 658 (internal citations omitted). For this reason, insider-trading liability is not based on "informational asymmetries" but "breaches of fiduciary duty." Newman, 773 F.3d at 449.

[4] The Second Circuit acknowledged that the concept of personal benefit included more than the allegation of friendship; it also included "pecuniary gain" and "any reputational benefit that will translate into future earnings and the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend." Newman, 773 F.3d at 452. This, however, is not alleged to be such a case and thus these tipping motives are not relevant here.

> [t]o the extent Dirks suggests that a personal benefit may be inferred from a personal relationship between the tipper and tippee, where the tippee's trades 'resemble trading by the insider himself followed by a gift of the profits to the recipient,' we hold that such an inference is impermissible in the absence of 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.

Id. (quoting Dirks, 463 U.S. at 664). The Newman court required *more* than simply averring that the tipper and tippee were friends. For example, in United States v. Jiau, 734 F. 3d 147, 153 (2d Cir. 2013), the personal benefit received in exchange for the information was "something more than the ephemeral benefit of the value of Jiau's friendship" because the breacher *also* obtained access to an investment club where stock tips were discussed. Newman, 773 F.3d at 452. By joining the investment club, the breacher entered into a "relationship of *quid pro quo* with Jiau" and thus had the opportunity to access information that could provide a pecuniary gain. Id. In Jiau, therefore, there was a tangible benefit. To be sure, Newman does not foreclose the idea that tipping a friend can lead to insider trading liability, but it does not permit the SEC, as it has done in this case, to simply pronounce the tipper and tippee as friends and stop at that. For "friendship" to suffice, the SEC must establish a connection between the benefits conferred in the context of the friendship and the tip. Anything less does not meet the *quid pro quo* standard.

In the instant case, the Complaint fails to plead any tangible benefit or *quid pro quo* that Martin received from Conradt. It also fails to allege any evidence connecting the friendship/roommate status to the alleged tip. Without an allegation of facts sufficient to demonstrate that that the tip of the confidential information was made in the course of "a meaningfully close, personal relationship that generate[d] an exchange that [was] objective, consequential, and represent[ed] at least a potential gain of a pecuniary or similarly valuable nature," the SEC has failed to satisfy its burden. Id. The conclusory assertion that Martin and

Conradt were "friend(s) and roommate(s)" falls well short of that standard.[5] (Compl. ¶ 66). Accordingly, the Complaint is insufficient as a matter of law and must be dismissed.

B. The Complaint Fails to Plead that Either Payton or Durant Knew that Martin Received a Benefit in Exchange for the Information

Not only does the Complaint fail to plead that Martin *received* a personal benefit cognizable under federal securities law, it is devoid of any allegation that Defendants *knew* that Martin was receiving a benefit. The Newman court held that tippee liability requires a showing that "the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit." 773 F.3d at 450. Absent such a showing, there can be no liability. The SEC's failure to plead any facts—much less facts with sufficient particularity to satisfy Rule 9(b)—regarding Durant's or Payton's knowledge of a personal benefit is fatal to the Complaint.

Nowhere in its eighteen-page Complaint does the SEC allege that Conradt, or anyone else, informed Durant or Payton that Martin provided the Information in exchange for a personal benefit. Instead, the Complaint asserts in conclusory fashion Durant's and Payton's (incomplete) knowledge of the source when it alleges that "[a]t the time Conradt disclosed this information to Durant and Payton, he also informed them that his friend and roommate had disclosed the

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[5] So too does the Complaint's vague allegation that, on or about June 22, 2009, Conradt, an unlicensed attorney, assisted Martin with an unspecified legal problem that "had possible legal implications for Martin's ability to remain in the United States." (Complaint ¶ 54). The Complaint does not allege that this service was in any way in exchange for Martin's provision of the Information. In fact, the Complaint notes that Conradt had a history of acting on behalf of Martin and the other roommates that predated the allegations in the Complaint. This is precisely the type of assistance that one would "generally expect" that roommates would have provided one another and that supports the reasonable inference that Conradt would have assisted Martin without expecting or seeking any benefit in return. See Newman, 773 F.3d at 453.

information to him." (Compl. ¶ 66). This is woefully insufficient to allege, with particularity, Durant and Payton's knowledge of any personal benefit Martin received from Conradt. For this reason alone, the Complaint is deficient and this Court should dismiss it. See Newman, 773 F.3d at 455 ("[E]ven if detail and specificity [of the tip] could support an inference as to the *nature* of the source, it cannot, without more, permit an inference as to that source's improper *motive* for disclosure.") (emphasis in original).

C. The Complaint Fails to Allege with Particularity that Defendants Knew or Had Reason to Know that the Information Was Obtained in Violation of a Duty to the Source

It is axiomatic that a defendant must know or have reason to know that the alleged material non-public information was obtained and disclosed in breach of a duty to the source of the information. See, e.g., Dirks, 463 U.S. at 660; Jiau, 734 F.3d at 152–53; Falcone, 257 F.3d at 234. Although the SEC need not establish that a tippee knew the exact source of the information or the details about how the tippee obtained the information, Rule 10b-5 requires that in order to be found liable for insider trading, the defendant must "'subjectively believe that the information received was obtained in breach of a fiduciary duty.'" SEC v. Thrasher, 152 F. Supp. 2d 291, 305 (S.D.N.Y. 2001) (quoting U.S. v. Mylett, 97 F.3d 663, 668 (2d Cir. 1996)). This element is especially important in cases such as this one involving allegations of insider trading against remote tippees where the SEC is required to plead specific facts regarding Defendants' scienter. Accidental or negligent violations are not actionable. United States v. Temple, 447 F.3d 130, 137 (2d Cir. 2006). As the Newman Court noted, "'it is easy to imagine a . . . trader who receives a tip and is unaware that his conduct was illegal and therefore wrongful.'" Id. at 450 (quoting United States v. Kaiser, 609 F.3d 556, 559 (2d Cir. 2010)). Here, the SEC does not plead what is required to defeat a motion to dismiss.

Even accepting the factual allegations in the Complaint as true, the SEC does not, and cannot, allege Payton and Durant were aware of any duty Martin breached in disclosing the information to Conradt. The Complaint asserts only that Conradt told Durant and Payton that the source of the Information was his roommate and friend. It lacks any allegation that Conradt told Defendants where the information came from or that the individual who tipped him had done so in violation of a duty. *Cf.* Thrasher, 152 F. Supp. 2d at 305 (denying summary judgment where the tipper told the tippee-defendant that he was providing "privileged, inside information that came from a source inside" the company). While the Complaint lays out Dallas's and Martin's personal history, it fails utterly to allege that Durant or Payton learned any of these facts before they were charged by the SEC and they themselves read the Complaint. Thus, it fails to allege with particularity any facts to support the threadbare legal conclusion that Defendants "knew or had reason to know that the Insider Information tipped by Conradt had been initially obtained and transmitted improperly, in breach of a fiduciary duty or duty of trust and confidence." (Compl. ¶ 84). The Court need not accept this unsupported allegation. See Iqbal, 556 U.S. at 678.

D. The Complaint Fails to Allege with Particularity an Insider Trading Scheme against Durant

Additionally, and apart from the application of Newman, the Complaint fails to allege facts with sufficient particularity to show Durant's involvement with a misappropriation scheme at all. The Complaint is woefully confused on the issue of who provided information to Durant. Paragraph 3 of the Complaint generically states that "Conradt tipped several other registered representatives associated with the Broker, including David J. Weishuas . . . as well as Defendants Payton and Durant," but paragraph 63 alleges that Conradt "learned that the information had also been communicated to Durant . . . ." (Compl ¶ 63). It simply cannot be

that Conradt both tipped Durant and "[a]t about the same time" learned that Durant was tipped. Id. Either Conradt tipped Durant or he did not; the SEC and its Complaint cannot have it both ways.

The Complaint alleges contradictory positions on a crucial issue, the identity of the person who tipped Durant. Ergo, it is not sufficiently pled to allow Durant to understand the charges against him. Because the Court must accept the allegations as accurate, see SEC v. Wyly, 788 F. Supp. 2d 92, 101 (S.D.N.Y. 2011), the Court must accept that Conradt learned that Durant was tipped, and also that Conradt tipped Durant. This leaves Durant in the impossible position of not knowing who the SEC is going to try to prove provided Durant with the information and whether the SEC is alleging fraud at all. Under one completely legitimate reading, there is no allegation of fraud as to Durant because reading the Complaint does not put Durant on notice that he was *improperly* tipped. It merely alleges that Conradt learned that Durant knew the same information Conradt did, but not how. Where the SEC has pled contradictory theories, one of which lacks any allegation of improper conduct, the Complaint cannot truly be said to allege fraud. Where the Complaint does not allege fraud with particularity, it fails to satisfy Rule 9. With this failure, the Court should dismiss the Complaint.

CONCLUSION

For the foregoing reasons, the Court should dismiss the Complaint.

Dated: New York, New York
February 23, 2015

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