

ClientAlert

Intellectual Property

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Court Rejects “Hot News” Protection for Stock Recommendations

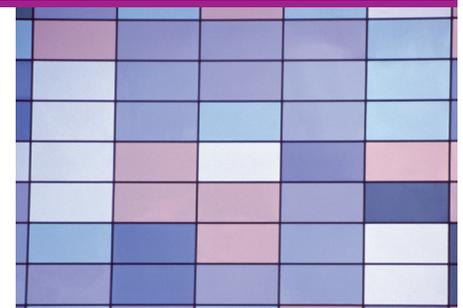
The Court of Appeals for the Second Circuit ruled in *Barclays Capital Inc. v. Theflyonthewall.com, Inc.*, No. 10-1372-cv (June 20, 2011) that a financial news service did not misappropriate analyst research by publishing stock recommendations on its website. The Court held that the Copyright Act preempted the “hot news” misappropriation claims brought by financial institutions to protect such ratings information.

Background

The plaintiffs in the case—Barclays Capital, Merrill Lynch and Morgan Stanley (collectively, the “Firms”)—engage in extensive research about the business prospects of publicly traded companies, the securities of those companies and the industries in which those companies are engaged.¹ The Firms summarize the results of their research in reports that contain recommendations on the wisdom of purchasing, holding or selling securities of the subject companies.² Each morning before the principal US securities markets open, the Firms circulate their reports and recommendations for that day to clients and prospective clients, giving the recipients an informational advantage over non-recipients with respect to possible trading in the securities.³ The Firms profit from the preparation and circulation of the reports and recommendations, in part, by earning brokerage commissions when a recipient turns to the Firm to execute a trade in the shares of the company being reported on.⁴

The defendant, Theflyonthewall.com, obtained information about the Firms’ recommendations (and those of 62 other firms) before the Firms purposely made them available to the general public and before exchanges for trading in those shares opened for the day.⁵ By making these ratings changes available to a wider audience, the defendant reduced the informational and trading advantage of the Firms’ clients who were authorized recipients of the reports, and recipients of the information were less likely to trade securities using the brokerage services of the Firms.⁶

The Firms sued Theflyonthewall.com, alleging two causes of action: (1) copyright infringement for the verbatim copying and dissemination of the Firms’ reports and (2) misappropriation of the Firms’ securities recommendations. After a bench trial, the district court ruled that the defendant was liable both for copyright infringement of the reports (which defendant effectively conceded at trial) and for “hot news” misappropriation of the stock recommendations. Defendant appealed only the misappropriation finding.



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The Copyright Act Preempts the Firms' Misappropriation Claims

The Second Circuit confined its inquiry to the question of whether the Firms' state misappropriation claims were preempted by Section 301 of the Copyright Act. The court found only one judicial decision that addressed the preemption issues raised in the appeal—*National Basketball Association v. Motorola, Inc.*, 105 F.3d 841 (2d Cir. 1997) ("*NBA*"), a case involving the passing of sports scores and other statistical information over pagers. As articulated in *NBA*, the Copyright Act preempts a state-law claim:

- If the claim seeks to vindicate a legal or equitable right that is equivalent to one of the rights already protected by the federal Copyright Act (the "general scope requirement"); and
- If the work in question is of the type of work protected by the Copyright Act (the "subject matter requirement").⁷

The Second Circuit concluded that the Firms' claims satisfied both elements.

There is, however, a narrow "exemption from preemption," as the court put it—"hot news" misappropriation. Generally, a misappropriation claim is not preempted by the copyright law if an "extra element" is required instead of or in addition to the acts of reproduction, performance, distribution or display.⁸ In the case of a "hot news" misappropriation claim, *NBA* suggested a five-part test: such a claim is not preempted where (1) the plaintiff generates or gathers information at a cost; (2) the information is time-sensitive; (3) a defendant's use of the information constitutes free riding on the plaintiff's efforts; (4) the defendant is in direct competition with a product or service offered by the plaintiffs; and (5) the ability of other parties to free-ride on the efforts of the plaintiff or others would so reduce the incentive to produce the product or service that its existence or quality would be substantially threatened. *NBA*, 105 F.3d at 845. Applying this five-part test, the district court in *Barclays Capital* concluded that the "extra element" test was satisfied and that the Firms' "hot news" misappropriation claims survived preemption.

The Second Circuit reversed. The court found that the five-part test stated in *NBA* was not binding law, but merely dicta. Rather than identify a set of required and specific extra elements essential to a non-preempted "hot news" claim, *NBA* was opining about a hypothetical set of circumstances—not present in that case—that might give rise to such a claim.⁹ Because *NBA* concluded no such claim could be established, the decision could not bind subsequent courts.¹⁰

Theflyonthewall.com Was Not "Free Riding"

The Second Circuit found that the Firms' misappropriation claim failed for the same reason that the claim failed in *NBA*: The defendant was not "free-riding." Rather than acquire their recommendations as required for "hot news," the Firms created their recommendations using expertise and experience.¹¹ Moreover, the defendant was not passing off the stock recommendations as its own; instead, it was clearly identifying the stock recommendations as originating from the Firms.¹² The court found no meaningful difference between the defendant's conduct and "what appears to be unexceptional and easily recognized behavior by members of the traditional news media."¹³ Finally, the court found that the defendant did not appear to divert to itself (or to brokers in league with it) a significant portion of the Firms' brokerage commissions earned in connection with their stock recommendations.¹⁴ Accordingly, the court reversed the judgment of the district court and remanded with instructions to dismiss the Firms' misappropriation claims.

In clarifying that *NBA* did not state the law on "hot news" misappropriation, the Second Circuit was concerned that the "hot news" tort be narrowly defined and not give rise to a confusing patchwork of state claims exempt from preemption.¹⁵ This is not to say that stock ratings information can never be protected by the misappropriation doctrine. The court acknowledged that there might be circumstances where such protection is appropriate, for example, if one firm were to collect and disseminate to some portion of the public facts about securities recommendations in the brokerage industry and another firm were to copy those facts and pass them off as its own.¹⁶ Such circumstances, however, were lacking here.

The Takeaway

The decision has significant implications for financial institutions that seek to protect time-sensitive information contained in their analyst reports. It underscores the importance of non-disclosure agreements and data security measures in protecting otherwise unprotectible factual information from public dissemination.

The decision is also significant for news services—not just relatively small outfits like Theflyonthewall.com, but also traditional media outlets and Internet news aggregators that seek to offer such information to their customers and the public at large. The Second Circuit ultimately concluded that a firm's ability to make news—by issuing a recommendation that is likely to affect the market price of a security—"does not give rise to a right for it to control who breaks that news and how."¹⁷

- 1 Op. 4-5.
- 2 Op. 5.
- 3 Op. 5-6.
- 4 Op. 6.
- 5 Op. 6.
- 6 Op. 6-7.
- 7 Op. 36-40.
- 8 Op. 40.
- 9 Op. 53 n.32.
- 10 Op. 53 n.32.
- 11 Op. 62.
- 12 Op. 62.
- 13 Op. 63.
- 14 Op. 64-66.
- 15 Op. 47-50.
- 16 See Op. 68.
- 17 Op. 71.

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