U.S. Federal Appeals Court Reverses Insider Trading Convictions: Requires Proof of Tippee's Knowledge of Insider's Benefit and Makes it Harder for the Government to Charge Remote Tippees

On Wednesday, December 10, 2014, a three-judge panel of the United States Court of Appeals for the Second Circuit in New York vacated the insider trading convictions of hedge fund managers Todd Newman and Anthony Chiasson, instructing the district court to dismiss all charges against them with prejudice.[1] In this highly anticipated ruling, *United States v. Newman*, the Second Circuit, which has jurisdiction over the majority of the government's insider trading prosecutions, resolved the open legal question of whether the government must prove that a remote tippee knew that the insider who disclosed confidential information to the first tippee received a personal benefit for doing so. The government bet against such a requirement, arguing that this element was not needed in the trial judge's jury instructions for Newman and Chiasson, as well as in several other high profile insider trading cases. The Second Circuit decided against the government, holding that the government is required to prove this element of the tippee's knowledge to secure a conviction, and had not done so, necessitating dismissal. More broadly, the *Newman* court's ruling makes it harder for the government to pursue claims against tippees who are removed from the initial prohibited information exchange.

Overview of Insider Trading Law

No U.S. statute specifically prohibits insider trading. Instead, the criminalization of insider trading has evolved from the securities fraud statute, Section 10(b) of the Securities Exchange Act of 1934 ("Section 10(b)"), along with SEC Rules 10b-5, 10b5-1 and 10b5-2, which generally prohibit the purchase or sale of a security on the basis of material nonpublic information.[2] The broad common law misappropriation theory of insider trading[3] extends insider trading liability to company outsiders who trade on the basis of material nonpublic information in breach of a fiduciary duty or a similar "duty of trust and confidence."[4] Rule 10b5-2 contains a “non-exclusive” list of the circumstances when such a duty arises, including: (1)

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1 *United States v. Newman*, No. 13-1837-cv (L) (2d Cir. Dec. 10, 2014).

2 Rule 10b5-1 specifies that a purchase or sale constitutes trading "on the basis of" material nonpublic information where the person making the purchase or sale was aware of material nonpublic information at the time the purchase or sale was made, regardless of whether the information was used.

3 The traditional theory of insider trading is the classical theory, where a corporate insider, such as a director or officer, or a temporary insider, such as an underwriter, lawyer or accountant, breaches their fiduciary duty to the shareholders by trading on material nonpublic information.

4 *S.E.C. v. Obus*, 693 F.3d 276, 379 (2d Cir. 2012).

pursuant to an agreement to maintain information in confidence; (2) to communications between people with a history, pattern or practice of sharing confidences; or (3) between family members.

Since the first insider trading prosecutions over thirty years ago, case law has been consistent: a tipper is liable for insider trading when they breach their duty to keep material nonpublic information confidential and personally benefit from the tip. A tippee is liable for insider trading when the tipper breaches their duty to keep material nonpublic information confidential, the tippee knows or should know that the material nonpublic information was obtained as a result of the tipper's breach, and the tippee trades on this information or discloses to downstream tippees for a benefit.

Typically, insider trading prosecutions involved the tipper and tippee working together directly, passing nonpublic information in exchange for some benefit. In these circumstances, the benefit to the tipper was easily proven and rarely at issue. Until the instant appeal, the question of whether a remote tippee similarly must be aware that the insider received a benefit in exchange for the breach of confidentiality to be convicted of insider trading had not been decided by the Second Circuit.

Chiasson's and Newman's Insider Trading Convictions

On December 17, 2012, a jury in the United States District Court for the Southern District of New York convicted Newman and Chiasson of conspiracy to commit securities fraud, as well as the commission of securities fraud in violation of Section 10(b) and SEC Rule 10b-5. The jury found that Newman and Chiasson had traded shares of NVIDIA Corporation and Dell Inc.[5] in 2008 and 2009, after having received the companies' unreleased earnings statements through a chain of contacts.

At trial, the government presented evidence that an employee in the investor relations department at Dell informed a Neuberger Berman analyst about Dell's earnings, which were not yet public. The Dell employee allegedly received the benefit of "career advice" in exchange for providing the confidential information to the Neuberger Berman analyst. The information changed hands several times before it reached Chiasson, who then took a short position in approximately 8.6 million shares of Dell. The government also presented evidence that a similar chain of contacts, beginning with a company insider, gave Newman and Chiasson a preview of NVIDIA Corporation's earnings for the first quarter of fiscal year 2010. Newman and Chiasson then traded upon this information, winning profits of approximately $4 million and $68 million, respectively, from their trades in Dell and NVIDIA stock.[6]

When delivering his instructions on the law to the jury, the trial court judge did not include an instruction that the jury would have to find that Newman and Chiasson knew that the Dell and NVIDIA insiders received a benefit for divulging material nonpublic information in order to find the tippee defendants guilty of insider trading.[7] Following their convictions and sentencings, the defendants appealed to the Second Circuit, arguing that the trial judge committed error by not instructing the jury on this essential element and that the government had not proven that Newman or Chiasson were aware of any such benefit received by the insiders.

Second Circuit Delivers Legal Guidelines for Insider Trading Tippee Liability

The Second Circuit agreed with defendants, vacating their convictions and remanding to the district court with instructions to dismiss all charges with prejudice. In doing so, the Court held that tippee liability includes the element that "the tippee knew of the tipper's breach, that is, he knew the information was confidential and *divulged for personal benefit*."[8]

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5 On October 29, 2013, Dell, Inc. became a private corporation.

6 *Newman*, No. 13-1837-cv (L) at 5.

7 After the jury's guilty verdict, Newman was sentenced to four-and-a-half years in prison and a $1 million dollar fine along with $737,724 in criminal forfeiture. Chiasson was sentenced to six-and-a-half years in prison and a $5 million fine along with $1.38 million in criminal forfeiture. Both remained free on bond pending this appeal.

8 *Newman*, No. 13-1837-cv (L) at 18 (emphasis added).

Noting that the issue was one of first impression for the court and calling its past guidance "somewhat Delphic" on the elements of tippee liability, the court concluded that "the answer follows naturally from *Dirks* [*v. S.E.C.*]."[9] In *Dirks*, the Supreme Court held that an insider's disclosure of confidential information alone is not a breach for the purposes of insider trading, but that it is the "exchange of confidential information for personal benefit " that amounts to the fiduciary breach triggering liability for insider trading. [10] The Second Circuit in *Newman* reasoned that because a tippee is liable only if he knows of the breach of the fiduciary duty, and the insider's receipt of a personal benefit is, in turn, a critical element of that fiduciary breach, it follows that the tippee must know about the personal benefit to the tipper in order commit insider trading.[11]

Accordingly, the court laid out the necessary elements for insider trading liability against a tippee:

> "*(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.*"

Ruling that the failure to instruct the jury as to all of the elements necessary for conviction was reversible error, the Second Circuit then evaluated whether the government proved at trial that the tippers received a benefit that was "objective, consequential, and represent[ed] at least a potential gain of a pecuniary or similarly valuable nature."[12] The court found no such benefit and, even assuming that a benefit was conferred upon the insiders, found that "the government presented absolutely no testimony or any other evidence that Newman and Chiasson knew that . . . those insiders received any benefit in exchange for such disclosures, or even that Newman and Chiasson consciously avoided learning of these facts."[13] Finding the evidence insufficient to sustain convictions for insider trading or conspiracy to commit the same, the Second Circuit concluded that all charges against the defendants must be dismissed.[14]

Impact on Prosecution of Insider Trading Cases

The Second Circuit's decision in *Newman* delivers the most significant blow to date to the DOJ's insider trading prosecution campaign led by the United States Attorney's Office for the Southern District of New York. After a string of 85 consecutive insider trading convictions, earlier this year prosecutors in that office lost an insider trading trial against Rengan Rajaratnam, brother of Galleon's Raj Rajaratnam, in another remote tippee case.[15] In addition, several well-publicized cases have been put on hold pending the disposition of the *Newman* appeal.[16] One such case is the prosecution of Michael Steinberg, the former SAC Capital Manager, whose appeal of a three-year sentence following a conviction for insider trading had been put on hold and then consolidated into the appeal in *Newman*. While the ruling will likely not impact the vast majority of the insider trading convictions that were obtained through defendant guilty pleas, attorneys for convicted defendants will undoubtedly review the guilty plea transcripts of clients similarly situated to Chiasson and Newman to determine whether the prosecutors set forth the correct elements of the insider trading charges to which the defendants pleaded guilty. The DOJ will weigh whether to ask the Second Circuit to reconsider its ruling under an *en banc* panel review, and whether to petition to the United States Supreme Court to seek reversal of this new legal standard.

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9 *Id*. at 14 (citing *Dirks v. S.E.C.*, 463 U.S. 646 (1983)).
10 *Newman,* No. 13-1837-cv (L) at 14 (paraphrasing the Supreme Court's holding in *Dirks*).
11 *Id*. at 16–17.
12 *Id*. at 22 (requiring evidence of "a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the [latter]." *United States v. Jiau*, 734 F.3d 147, 153 (2d Cir. 2013)).
13 *Newman*, No. 13-1837-cv (L) at 24.
14 *Id*. at 28.
15 *See* SDNY Press Release following acquittal of Rengan Rajaratnam, http://www.justice.gov/usao/nys/pressreleases/July14/RenganRajaratnamVerdictStatement.php.
16 Other cases that will proceed after the *Newman* decision include the prosecution of Whittier Trust Company research analyst Danny Kuo and the SEC administrative proceeding against Steven A. Cohen, the founder of SAC Capital.

Although the DOJ will continue to evaluate the ramifications of the *Newman* decision for some time, the Second Circuit sent a clear message that the DOJ's insistence on broadening the reach of criminal liability for conduct not clearly criminalized as insider trading by statute and Supreme Court case law will come under close judicial scrutiny and may be rejected.

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