

U.S. Supreme Court Refuses to Hear Controversial Insider Trading Case

DOJ left with strict standards to prove insider trading under "tipping" theory in the Second Circuit.

On October 5, 2015, the U.S. Supreme Court denied the U.S. Solicitor General's petition for writ of certiorari to review the Second Circuit's controversial 2014 insider trading decision, *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014). The Supreme Court's denial means that *Newman* will remain good law in the Second Circuit—a proposition that has far-reaching implications for future insider trading enforcement.

United States v. Newman

By way of background, *United States v. Newman* was a case in U.S. District Court for the Southern District of New York that involved criminal securities fraud charges against Todd Newman and Anthony Chiasson, both hedge fund managers. Both were charged with violating U.S. securities laws under a "tipping" theory of insider trading, *i.e.*, that company insiders in possession of material nonpublic information (the "tippers") disclosed inside information in breach of a fiduciary duty to outsiders (the "tippees"), who then traded on the basis of the information before it was publicly disclosed.

During a six-week trial in 2013, the Government presented evidence that insiders from two companies disclosed inside information to analysts, who then passed the inside information to Newman and Chiasson, who then traded the companies' stocks. Both were convicted of securities fraud charges. Relying on common law standards most prominently articulated in the Supreme Court's insider trading decision *Dirks v. SEC*, 463 U.S. 646 (1983), the Second Circuit reversed both convictions, holding that the jury instructions were erroneous and the evidence against Newman and Chiasson was insufficient to sustain the charges.

The Supreme Court held in *Dirks* that disclosure of inside information alone is not a breach of fiduciary duty necessary to establish insider trading, but rather rests on whether the insider breached his fiduciary duties, which turns on whether the insider personally benefited from the disclosure. The Second Circuit's interpretation of *Dirks* in *Newman* is significant in two respects.

First, the Second Circuit held that it was not enough for the Government to prove that a tippee knew that an insider disclosed confidential information, but also required proof that

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the tippee knew the insider disclosed the information in exchange for a personal benefit. Thus, under *Newman*, in order to prove an insider trading case against a tippee, the Government must prove beyond a reasonable doubt 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. The Second Circuit held that "the Government presented no evidence that Newman and Chiasson knew that they were trading on information obtained from insiders in violation of those insiders' fiduciary duties," which was fatal to their convictions. *Id.* at 442.

Second, the Second Circuit clarified what is required to prove a "personal benefit," noting that the requirement cannot be satisfied by showing "the mere fact of a friendship, particularly of a casual or social nature" because if the Government could meet its burden "by proving that two individuals were alumni of the same school or attended the same church, the personal benefit requirement would be a nullity." *Id.* at 452. In addressing language in *Dirks* stating that a personal benefit could be inferred from a personal relationship with a friend where the tippee's trades "resemble trading by the insider himself followed by a gift of the profits to the recipient," 480 U.S. at 664, the Second Circuit reasoned that "such an inference is impermissible in the absence of proof 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." *Newman*, 773 F.3d at 452. The Second Circuit found the Government's evidence of any personal benefit—that the insiders were seeking career advice or were "family friends" who met through church—was insufficient to establish the tipper liability from which any tippee liability would derive.

Arguments For and Against Supreme Court Review

The Solicitor General's certiorari petition addressed only the "personal benefit" portion of the *Newman* decision and argued in part that the Second Circuit's "novel test" for establishing a personal benefit created a split among the other circuits' courts and was contrary to the Supreme Court's decision in *Dirks*. Petition for a Writ of Certiorari at 14, *United States v. Newman*, (No. 15-137). Specifically, the Government argued that the Second Circuit's decision could not be reconciled with *Dirks* and instead created a new, stricter personal-benefit test that (1) eliminated the inference of personal benefit identified in *Dirks* arising when an insider freely gives a gift of information to a trading friend or relative without the expectation of receiving money or valuables in return, and (2) created a new requirement that the relationship to a friend or relative be "meaningfully close." The Government also argued that *Newman* was in conflict with decisions from the Ninth and Seventh Circuits and was likely to "embolden[] analysts and other sophisticated market participants to engage in behavior" that violates *Dirks*, which "is particularly intolerable in the circuit that is home to the financial capital of the Nation, if not the world." *Id.* at 33.

In opposing the certiorari petition, Newman and Chiasson argued that the case was inappropriate for Supreme Court review for several reasons. First, Newman and Chiasson pointed out that, because the Government was appealing only the Second Circuit's language on what could constitute a personal benefit, and not also the Second Circuit's determination that the Government was required to prove that Newman and Chiasson knew that they were trading on information obtained from insiders in violation of those insiders' fiduciary duties, the issue before the Supreme Court would not affect the ultimate outcome of the case. Second, Newman and Chiasson explained that the Second Circuit's decision was consistent with *Dirks* and did not conflict with the decisions from the Ninth and Seventh Circuits. Rather, the insider trading cases from those other circuits were factually stronger for the Government. Finally, Newman and Chiasson noted that the Government's assertion that *Newman* threatened the securities markets or the enforcement of securities laws was overblown, with Newman pointing out that "in every case in which we are aware in which the government has litigated *Newman*-based challenges to the personal benefit requirement, the government has prevailed." Brief for Todd Newman in Opp. at 27, *United States v. Newman*, (No. 15-137).

The Supreme Court's certiorari denial was not accompanied by an opinion.

Implications

The Supreme Court's certiorari denial ensures that at least for the foreseeable future, the *Newman* decision will reverberate in insider trading cases throughout the federal circuits. As other courts resolve similar challenges by insider trading defendants to the Government's proof of a personal benefit, it is unclear whether, and to what extent, other circuit courts will follow the Second Circuit's decision on what evidence will be sufficient to establish a personal benefit under *Dirks*. For example, following the *Newman* decision, Judge Jed S. Rakoff, a U.S. District Judge for the Southern District of New York who was sitting by designation in the Ninth Circuit, addressed the personal-benefit issue in *United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015). *Salman* involved an insider trading scheme involving tips shared among the defendant and his extended family. Relying on the common law standards articulated in *Dirks*, Judge Rakoff upheld the insider trading conviction, reiterating that "[p]roof that the insider disclosed material nonpublic information with the intent to benefit a trading relative or friend is sufficient" to show a breach of fiduciary duty. Judge Rakoff's Ninth Circuit opinion stated that, to the extent *Newman* could be read to hold that "evidence of a friendship or familial relationship between tipper and tippee, standing alone, is insufficient" to show a personal benefit because "the exchange of information must include 'at least a potential gain of a pecuniary or similarly valuable nature,'" the Ninth Circuit would decline to follow the Second Circuit. *Salman*, 792 F.3d at 1093 (quoting *Newman*, 773 F.3d at 452).

Regardless of whether other courts choose to follow the Second Circuit, the Securities and Exchange Commission ("SEC") and Department of Justice ("DOJ") will have to satisfy *Newman*'s evidentiary standards to prove tipping insider trading cases brought in the Second Circuit, including those cases brought within the Southern District of New York, traditionally the favored venue for high profile securities fraud enforcement actions and prosecutions.

The SEC has said that *Newman*'s "narrowed definition of personal benefit and lack of clarity about the evidence required for establishing such benefit could negatively affect the SEC's ability to bring insider trading actions." Amicus Curiae Brief for SEC in Support of Petition for Rehearing En Banc at 2, *United States v. Newman*, No. 13-1837(L) (2d Cir. Jan. 29, 2015). Andrew Ceresney, the SEC's Director of Enforcement, reportedly noted, in response to *Newman* and reaffirming the SEC's commitment to bringing meritorious insider trading cases, that the SEC has a lower burden of proof because it brings civil, as opposed to criminal cases, and could always bring its enforcement actions in other circuits and its own administrative courts. See Stephanie Russell-Kraft, *SEC's Ceresney Isn't Sweating 2nd Circ.'s Newman Ruling*, Law360 (Feb. 10, 2015). However, *Newman* may still prove to be problematic to the SEC's enforcement efforts notwithstanding the lower burden of proof and ability to bring enforcement actions in other forums. Last month, for example, Administrative Law Judge Jason Patil dismissed insider trading claims brought by the SEC against an individual because Judge Patil found that the SEC's evidence of "career mentorship," "positive feedback," and the relationship between the insider and the tippee did not satisfy the SEC's burden to prove a personal benefit as required by *Newman* and *Dirks*. See *In the Matter of Gregory T. Bolan, Jr. & Joseph C. Ruggieri*, Release No. 877, 2015 WL 5316569 (ALJ Sept. 14, 2015) (initial decision).

The DOJ has said that the *Newman* standard for establishing a personal benefit "will dramatically limit the government's ability to prosecute some of the most common culpable and market threatening forms of insider trading." Appellee Petition for Rehearing and Rehearing En Banc at 3, *United States v. Newman*, No. 13-1837(L) (2d Cir. Jan. 23, 2015). Preet Bharara, the U.S. Attorney for the Southern District of New York, has opined that because of *Newman*, "there's a category of conduct that arguably will go unpunished moving forward." Sam Hananel, *Supreme Court Declines to Review Insider Trading Case*, ABCNews, Oct. 5, 2015. DOJ must now undertake the task of reviewing and defending the validity of its tipping insider trading convictions and guilty pleas, and it is anticipated that other criminal convictions could be overturned. In particular, the conviction of former SAC Capital Advisors LP portfolio manager Michael Steinberg may not survive *Newman*. Steinberg was charged for trading on some of the same information as Newman and Chiasson, and the Second Circuit agreed to stay Steinberg's appeal pending resolution of the Supreme Court's review of *Newman*.

The full reach of *Newman*'s impact remains to be seen. The SEC and DOJ may bring more insider trading cases in jurisdictions outside of the Second Circuit in the hopes of developing more favorable case law regarding what is required to establish a "personal benefit" for tipping insider trading liability. Whether prosecutors in the Second Circuit will try to prosecute executives who tip friends and family for insider trading is unclear, and the full reach of *Newman* will be further developed as district and circuit courts address the wave of challenges to criminal convictions that were based on a pre-*Newman* theory of tipping insider trading. Also, the fact that the Supreme Court refused to hear the *Newman* case does not preclude the Supreme Court from resolving the personal benefit standard in the future—perhaps after a more obvious circuit court split develops or in a context where the issue is dispositive to the outcome of the case.

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