New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
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An ALM Publication
DECEMBER 19, 2014

Changed Landscape in Insider Trading Law: Second Circuit's Newman Decision

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The U.S. Court of Appeals for the Second Circuit recently issued a ground-breaking decision in *United States v. Newman*, finding that to be guilty of insider trading, a tippee of material non-public information (MNPI) must know that the insider who conveyed the information (on which trades were made) did so in exchange for a personal benefit.[1] In its decision, the court also narrowed the definition of what constitutes a "personal benefit," and by doing so, found that the government's evidence of insider trading was insufficient and dismissed the indictment with prejudice.

Because of the circuit's clear decision, the Department of Justice and other regulators face a significant hurdle in bringing future insider trading charges against "remote" tippees, as prosecutors must prove that those tippees—who often do not know the insiders—knew that insiders conveyed the MNPI in exchange for some benefit. *Newman* also makes even immediate tippee cases more difficult to prosecute given the now-limited definition of "personal benefit" of which the tippee must have knowledge.

Applicable Law

The law of insider trading has evolved through judicial interpretation of Section 10(b) of the 1934 Securities Exchange Act and SEC Rule 10b-5 promulgated thereunder. Because Section 10(b) and Rule 10b-5 do not address the elements of insider trading, there has been much litigation both criminally and civilly about what is required to prove an insider trading violation. As a general matter, insider trading prosecutions proceed under either the "classical" theory or "misappropriation" theory of liability.

Under the classical theory, "a corporate insider is prohibited from trading shares of that corporation based on material non-public information in violation of the duty of trust and confidence insiders owe to shareholders."[2] The typical example is when a company officer, owing a duty to the company's shareholders, violates that duty by trading on MNPI obtained prior to its release to the general public. This trading constitutes a "deceptive device" as contemplated by Section 10(b) because the insider's relationship of trust and confidence with the shareholders gives rise to a duty to either disclose the confidential information or abstain from trading.[3]

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According to the misappropriation theory of liability, a person "violates Section 10(b) and Rule 10b-5[] when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[4] This violates Section 10(b) "because the misappropriator engages in deception (as required for liability under that section and Rule 10b-5) by pretending 'loyalty to the principal while secretly converting the principal's information for personal gain.'"[5]

Under either the classical or the misappropriation theory, insiders and misappropriators may violate the law not only by trading on their own behalf, but also by tipping the MNPI to others who trade. Further, the "tippee" may then break the law if he trades on that information or passes it along to others who trade. This doctrine of "tipper" or "tippee" liability was promulgated by the Supreme Court in *Dirks v. SEC*.[6]

Under *Dirks*, a tipper may be liable where he (1) tips (2) material non-public information (3) in breach of a fiduciary duty owed to shareholders (under the classical theory) or to the source of the information (under the misappropriation theory) (4) in exchange for a personal benefit to the tipper.[7] As to this last prong, *Dirks* noted that not all breaches of fiduciary duty are fraudulent; the fraud "derives from the inherent unfairness involved where one takes advantage of information intended to be available only for a corporate purpose and not for the personal benefit of anyone."[8] Thus, one must tip for a personal benefit to break the law: "a purpose of the securities laws was to eliminate use of inside information for personal advantage."[9] The threshold for showing a benefit was traditionally low, and included, as the Second Circuit found in *SEC v. Obus*, friendship and "reputational benefit."[10]

A tippee, or one who receives MNPI, may be liable where (1) the tipper breaches a fiduciary duty to shareholders (under the classical theory) or to the source of the information (under the misappropriation theory) by tipping the confidential information, (2) the tippee knows or should know that the information was obtained through the tipper's breach, and (3) the tippee uses that information either by trading or further tipping it to others for his own benefit.[11] Notably, the aforementioned "knows or should know" standard applies in civil cases. In a criminal case, a tippee must have acted willfully; he must know that the tipper acted wrongfully in improperly breaching a fiduciary duty.[12]

Accordingly, as established in *Dirks*, tippee liability derives from the tipper's own liability; a tippee who knows of the tipper's fraudulent breach inherits the tipper's duty to abstain or disclose.[13] Prior to *Newman*, a disputed issue was whether that tippee must also know that the source of the information made the tip in the expectation of receiving a benefit.

Background to 'Newman'

In *U.S. v. Newman*, the government charged Todd Newman and Anthony Chiasson with several counts of securities fraud based on trading on alleged tips the two had received about Dell and NVIDIA earnings. The government alleged that company insiders breached duties owed to their respective employers by disclosing confidential earnings information before that information was publicly available.

The insiders allegedly conveyed that information to certain analysts and friends who, in turn, passed it through several other layers of analysts, conveying it eventually to Newman and Chiasson—making them "remote" or "downstream" tippees. The government alleged that the company insiders disclosed the information in exchange for career advice and friendship. The criminal trial was conducted before U.S. District Judge Richard J. Sullivan of the Southern District of New York in November and December of 2012.

At the trial's conclusion, the defendants argued that the court should instruct the jury that in order to find the defendants guilty, the jury had to conclude that the defendants knew the insiders breached a duty in providing the information to the immediate tippees and knew that the insiders did so in exchange for a personal benefit. Sullivan acknowledged that the defendant's arguments were supportable by *Dirks*, but found that *Obus* did not support the personal-benefit instruction the defendants sought.[14] The jury found both defendants guilty.

The Appeal

On appeal, Newman and Chiasson argued that a tippee's trading on MNPI is illegal only if the insider fraudulently breached a fiduciary duty, and the tippee inherited that duty by knowing of the breach and that it was fraudulent.[15] The defendants argued that because a tippee must know that the insider fraudulently breached a duty, and because a fraudulent breach "is defined to require a personal benefit to the tipper," then the tippee "must know of the benefit in order to know there has been a breach."[16]

Accordingly, the defendants contended that the district court erred in not instructing the jury that they must find that the defendants knew of a personal benefit. The defendants further argued that because there was insufficient evidence of a personal benefit—such as mere "career advice" among casual acquaintances—and, even if there was, there was no evidence that the defendants knew that the insiders conveyed the information in exchange for a personal benefit, the guilty verdicts should be overturned.[17]

The government countered that neither the Supreme Court nor the Second Circuit had required a

showing that a tippee knew that the insider conveyed confidential information in exchange for a benefit.[18] It argued that the government was only required to prove that the defendants were able to distinguish the insider's conduct as culpable rather than innocent.[19] The government relied on recent circuit decisions, including *Obus* and *U.S. v. Jiau*, 734 F.3d 147 (2d Cir. 2013), in arguing that the law only requires that the tippee know the insider breached his duties in conveying the MNPI to tippees.[20] In any event, the government contended that if the jury instruction was erroneous, it was harmless error because "the jury…would have found that the defendants inferred from the circumstances that some benefit was provided to (or anticipated by) the insiders."[21]

Holding and Implications

The Second Circuit sided with the defendants, holding that: "to sustain a conviction for insider trading, the government must prove beyond a reasonable doubt that the tippee knew that an insider disclosed confidential information and that he did so in exchange for a personal benefit."[22] The court also found that the government's evidence of personal benefit was insufficient, and that even if there was sufficient evidence, the government presented no evidence that the defendants knew of a benefit.[23] Accordingly, the court reversed the convictions and remanded with instructions to dismiss the indictment with prejudice—a significant blow for the government's future enforcement efforts.

In making its findings, the court relied on *Dirks*, and distinguished *Jiau*, in concluding that a "tippee's knowledge of the insider's breach necessarily requires knowledge that the insider disclosed confidential information in exchange for a personal benefit."[24] It is now settled that to sustain an insider trading conviction against a tippee, the government must prove:

(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 a personal benefit; and (4) the tippee still used that information to trade in a security or tip another individual for personal benefit.[25]

Further, in rejecting the government's trial evidence of personal benefit, the court found that while personal benefit is broadly defined, it "does not suggest that the government may prove the receipt of a personal benefit by the mere fact of a friendship, particularly of a casual or social nature."[26] There must be a "meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similar valuable nature."[27] Given the casual relationships involved, the court found that a jury could not find a personal benefit here. Moreover, even if there were the requisite benefit, the court ruled that there was no evidence that the defendants knew of it.[28] The court specifically rejected the government's argument that the jury could have found that the defendants knew the insiders disclosed the information "for some personal reason," because *Dirks* rejected such a premise.[29]

Assuming there is no successful appeal by the government, *Newman's* impact cannot be understated. First, *Newman* is potentially dispositive of the appeal of former SAC portfolio manager, Michael Steinberg, who was convicted of insider trading in December 2013 after a month-long trial. Steinberg traded securities based on fourth-hand information that his research analyst, Jon Horvath, had obtained from analysts at other investment firms. The Newman/Chiasson and Steinberg cases included the same "tipping chain" of analysts who obtained information from others who, in turn, obtained the information from the Dell and NVIDIA insiders. Notably, Judge Sullivan also presided over the Steinberg trial and similarly rejected Steinberg's proposed instruction that the jury must find that Steinberg knew the insiders received a personal benefit in order to convict. Given the identity of issues and overlapping facts, it is very likely Steinberg's conviction will now be reversed.

Second, the government will be hard-pressed to prosecute future remote tippees because defendants like Newman, Chiasson, and Steinberg are layers removed from the company insider. Rather than simply proving that a tippee knew that the insider breached a duty of confidentiality in disseminating the MNPI—which often can be proved by the nature of the information and circumstances of its conveyance—the government must prove that that tippee knew that the

insider, whom they may not know and have no details about, did so in exchange for a personal benefit. This will be exceedingly difficult.

Indeed, without evidence—whether by wiretap, consensual recording, email and/or cooperator testimony—demonstrating the remote tippee knew that an insider received some kind of benefit, the government would be forced to argue that as a sophisticated individual, the defendant must have known that an insider would not give "something for nothing" (i.e., the defendant knows the "rules of the game"). But as discussed above, *Newman* specifically rejected this argument.

Third, *Newman* has an even broader impact beyond remote tippee cases. Because the court elevated the standard for what constitutes a personal benefit of which the tippee must have knowledge—by requiring some potential pecuniary gain for the insider (even in the friendship context) in disclosing the information—the court has made even immediate tippee cases more difficult for the government to prosecute.

Accordingly, because of the substantial hurdles presented by *Newman*, it can be expected that the government will prosecute significantly fewer remote tippee, and potentially even immediate tippee, insider trading cases in the future.

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1. *United States v. Newman*, __ F.3d __, Nos. 13–1837–cr (L), 13–1917–cr (con), 2014 WL 6911278 (2d. Cir. Dec. 10, 2014).

2. *SEC v. Obus*, 693 F.3d 276, 284 (2d Cir. 2012) (citing *Chiarella v. United States*, 445 U.S. 222, 228 (1980)).

3. *Chiarella*, 445 U.S. at 228-229; Dirks v. SEC, 463 U.S. 646, 653-54 (1983).

4. *United States v. O'Hagan*, 521 U.S. 642, 650-52 (1997).

5. *Obus*, 693 F.3d at 284-85 (quoting *O'Hagan*, 521 U.S. at 653).

6. 463 U.S. 646 (1983).

7. Id. at 653-54, 656-57; *Obus*, 693 F.3d at 286.

8. *Dirks*, 463 U.S. at 654 (internal quotations omitted).

9. Id. at 662 (internal quotations, citations omitted).

10. *Obus*, 693 F.3d at 285, 292 ("In light of the broad definition of personal benefit set forth in *Dirks*, this bar is not a high one.").

11. *Dirks*, 463 U.S. at 660-61; *Obus*, 693 F.3d at 287-88.

12. See 15 U.S.C. §78ff(a).

13. *Dirks*, 463 U.S. at 659-661, 664.

14. *U.S. v. Newman*, 1:12-cr-00121-RJS-2, Docket No. 215, pp. 3594-3605 (S.D.N.Y. Dec. 10, 2012).

15. Brief of Defendant Appellant Todd Newman, *U.S. v. Newman*, 13-1837(L), 13-1917(CON) at pp. 30-31 (2d Cir. Aug. 15, 2013) ("Newman Brief"); Brief of Defendant Appellant Anthony Chiasson, *U.S. v. Newman*, 13-1837(L), 13-1917(CON) at pp. 21-22 (2d Cir. Aug. 15, 2013) (Chiasson Brief).

16. Reply Brief of Defendant Appellant Todd Newman, *U.S. v. Newman*, 13-1837(L), 13-1917(CON) at p. 16 (2d Cir. Dec. 18, 2013).

17. Newman Brief at pp. 40-42, 47-52; Chiasson Brief at pp. 42-49.

18. Brief of Appellee United States of America, *U.S. v. Newman*, 13-1837(L), 13-1917(CON) at pp. 35, 41-45 (2d Cir. Aug. 15, 2013) (U.S. Brief).

19. Id. at pp. 35, 45-47.

20. U.S. Brief at pp. 36, 43, 53. The defendants disputed the government's reliance on *Obus*, arguing that the parties in *Obus* did not brief the issue of knowledge of a personal benefit, and therefore the court did not need to rule on it. See Newman Brief at p. 37; Chiasson Brief at pp. 37-39.

21. U.S. Brief at pp. 64-65.

22. *Newman*, 2014 WL 6911278, at *1 (emphasis in original).

23. Id.

24. Id. at *8.

25. Id.

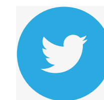
26. Id. at *10.

27. Id.

28. Id. at 11.

29. Id. at 12. Notably, the court also agreed with the defendants that under the circumstances of this case, the information was not so suspicious that the defendants knew, or consciously avoided knowing, that the information came from insiders or was disclosed in breach of a duty.

David I. Miller *and* ***Ryan D. Nassau*** *discuss the recent ground-breaking decision "United States v. Newman," where the U.S. Court of Appeals for the Second Circuit found that to be guilty of insider trading, a tippee of material non-public information must know that the insider who conveyed the information (on which trades were made) did so in exchange for a personal benefit.*



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