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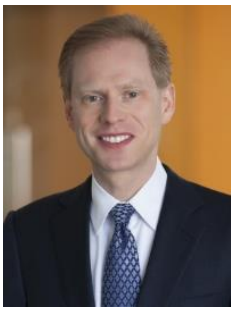
Putting The Brakes On Newman: 3 Recent Rakoff Decisions

By **David I. Miller and Nathan J. Hochman** (July 30, 2015, 3:46 PM EDT)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The Second Circuit's landmark decision in United States v. Newman[1] has unleashed a flood of commentary predicting a sea change in insider trading prosecutions. But Newman's holding arguably raises as many questions as it answers, notably over what level of evidence is needed to show that an insider who disclosed material nonpublic information (MNPI) in breach of a fiduciary duty did so in exchange for a "personal benefit." In highlighting the complexity of Newman's holding, U.S. District Judge Jed S. Rakoff of the Southern District of New York has issued three decisions in the last four months — including one where he sat by designation on the Ninth Circuit — that may limit Newman's ultimate impact in future insider trading cases. Indeed, in the government's petition for a writ of certiorari in Newman, which was filed July 30, 2015, the government cites to and uses Judge Rakoff's recent decisions to support its arguments to the U.S. Supreme Court.

Applicable Law

In the absence of a federal statute, insider trading law has developed through judicial interpretation of Securities Exchange Act Section 10(b) and Rule 10b-5. Insider trading prosecutions generally proceed under one of two theories of liability: the "classical" theory or the "misappropriation" theory. Under the classical theory, "a corporate insider is prohibited from trading shares of that corporation based on material nonpublic information in violation of the duty of trust and confidence insiders owe to shareholders."[2] Under the misappropriation theory, a violation of Section 10(b) and Rule 10b-5 occurs when any person "misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[3]

In Dirks v. SEC,[4] the Supreme Court extended insider trading liability to those who "tip" inside information in breach of their fiduciary duty. As Dirks found, however, "[a]ll disclosures of confidential corporate information are not inconsistent with the duty insiders owe to shareholders."[5] Rather, whether there has been "a breach of duty therefore depends in large part on the purpose of the disclosure."[6]

Dirks held that the tipper must "receive[] a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or reputational benefit that will translate into future earnings."[7] Indeed, the

Second Circuit would later note in SEC v. Obus that the Dirks benefit encompasses not only formal quid pro quo relationships, but also the benefit obtained by "'mak[ing] a gift of confidential information to a trading relative or friend.'"[8]

Dirks also extended insider trading liability to "tippees" where: (1) the tipper breached a fiduciary duty by tipping MNPI; (2) the tippee knew or should have known of the tipper's breach of fiduciary duty; and (3) the tippee traded on the MNPI or further tipped it to others for a personal benefit.[9] Tippee liability is thus derivative of tipper liability, since a tippee who knows or should know of the tipper's breach of fiduciary duty inherits the tipper's duty to abstain or disclose.[10] Dirks did not specify, however, whether a tippee must know that the tipper conveyed the MNPI in exchange for a personal benefit, and there has been much litigation, particularly in the Southern District of New York, about whether that level of knowledge was required to establish culpability.

United States v. Newman

This question was answered by the Second Circuit in United States v. Newman, in which the Court held that a tippee only knows of the tipper's breach of fiduciary duty if "he knew the information was confidential *and* divulged for personal benefit."[11] Defendants Todd Newman and Anthony Chiasson were "remote" or "downstream" tippees charged with trading on MNPI they received from other tippees concerning earnings information at Dell and Nvidia. At trial, Newman and Chiasson urged the court to adopt jury instructions that predicated guilt upon a showing that they knew the insiders tipped the MNPI in exchange for a personal benefit. U.S. District Judge Richard J. Sullivan found that although such an instruction could be supported by Dirks, he was obliged to follow the Second Circuit's decision in Obus, which, it was argued, only required that the tippee knew of a tipper's breach of duty to establish scienter.[12] Newman and Chiasson were convicted at trial.

The Second Circuit reversed both convictions. The court agreed with defendants that knowledge of a tipper's breach of fiduciary duty required knowledge that the confidential tip was made in exchange for a personal benefit.[13] The court further held that a personal benefit cannot be inferred "by the mere fact of a friendship," but must be established through "proof of a meaningfully close relationship that generates an exchange that is objective, consequential, and that represents at least a potential gain of a pecuniary or similarly valuable nature."[14] In reaching this conclusion, the court did not distinguish or discuss Obus, which held — based on Dirks's observation that "a gift of confidential information to a trading relative or friend" may justify an inference of personal benefit[15] — that evidence of the tipper and tippee's relationship as "friends from college" was sufficient to overcome summary judgment on the question of personal benefit.

While Newman has unquestionably changed the landscape of insider trading law, Judge Rakoff's recent instructive decisions have set the stage for a closer analysis of Newman's potential effect on future insider trading cases.

SEC v. Payton

In SEC v. Payton,[16] Judge Rakoff denied a motion to dismiss by two remote tippees accused of trading on inside information concerning IBM's 2009 acquisition of SPSS Inc. Defendants argued that under Newman, the SEC failed to adequately allege either that the original tipper received a personal benefit in exchange for disclosing the MNPI, or that defendants knew of any such benefit.

As an initial matter, Judge Rakoff observed that it was far from obvious whether the personal benefit

articulated in Dirks required, in the words of Newman, "an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." Further, Judge Rakoff noted that while Dirks presented quid pro quo and friendship as distinct examples of relationships that may give rise to an inference of personal benefit, Newman seemed to conflate them, suggesting that personal benefit can only be inferred from friendship "where there is evidence that it is generally akin to quid pro quo."[17]

Judge Rakoff held that even under the "more onerous standard of benefit" in Newman, the SEC had adequately alleged personal benefit, because, inter alia, the direct tippee provided the tipper with legal and financial assistance. Moreover, even though the remote tippees had no specific knowledge of a personal benefit, they knew, inter alia, that (1) the tipper was the source of the inside information, (2) the tipper and tippee were friends and roommates, and (3) the tipper had legal troubles. This circumstantial knowledge was sufficient, at least under the burden of proof in a civil action, "to raise the reasonable inference that the defendants know that [tipper's] relationship with [tippee] involved reciprocal benefits."[18] Thus, Payton recognized a tension between Newman and Dirks, but it also potentially limited Newman's implications where circumstantial evidence suggests that a remote tippee had knowledge of a benefit to the tipper.

United States v. Gupta

Rajat Gupta, a former director of Goldman Sachs, was convicted in 2012 of three counts of securities fraud in connection with conveying MNPI to his friend and business partner Raj Rajaratnam, founder of the Galleon Group hedge fund (and himself convicted of insider trading in 2011). In March 2015, Gupta moved to vacate his sentence, arguing that the district court's jury instruction concerning personal benefit was erroneous because Newman required that the benefit be conveyed to the tipper, not the tippee. Judge Rakoff was unmoved, holding that Dirks, Jiau and Newman all acknowledged that a benefit flowing from the tipper to the tippee could also satisfy the personal benefit requirement. To that end, the court found that "a tipper's intention to benefit the tippee is sufficient to satisfy the benefit requirement so far as the tipper is concerned, and no quid pro quo is required."[19] And in Gupta's case, the MNPI Gupta bestowed upon Rajaratnam was plentiful.

Further, Judge Rakoff held that even if the pecuniary benefit language of Newman did require such a benefit to the tipper, Gupta's guilt was overwhelming, because the evidence clearly showed that Rajaratnam had provided Gupta with financial favors in exchange for inside information.

United States v. Salman

Most recently, in United States v. Salman,[20] Judge Rakoff — sitting by designation on the Ninth Circuit — held that Newman's personal benefit language must be interpreted in a narrower way than others might attempt to use it, and that to the extent Newman cannot be interpreted so narrowly, the Ninth Circuit would reject it. Defendant Salman, a remote tippee, had received and traded on MNPI from his brother-in-law Michael Kara, who in turn had obtained the information from his older brother Maher, an investment banker at Citigroup. Evidence showed that Salman was aware that the MNPI originated with Maher, and that from 2004 to 2007, Salman and Michael had profited from trading in securities issued by Citigroup clients just before major transactions were announced. Salman was convicted at trial.

On appeal, Salman argued that under Newman, the evidence was insufficient to show that Maher had tipped the information to his brother in exchange for a pecuniary personal benefit, or that Salman knew

of any such benefit. Judge Rakoff dismissed this argument as a strained misreading of Newman, holding that Newman did not seek to undermine Dirks' crucial observation that a tipper may obtain a personal benefit when (s)he "makes a gift of confidential information to a trading relative or friend." Otherwise, as Judge Rakoff noted, "a corporate insider ... would be free to disclose [MNPI] to her relatives, and they would be free to trade on it, provided only that she asked for no tangible compensation in return."

Notably, in a fascinating move by a Southern District jurist, Judge Rakoff held that to the extent Newman sought to create a standard in conflict with Dirks, "we decline to follow it."[21] While Judge Rakoff may have been unable to create a circuit split from his position as a Southern District jurist, sitting by designation in the Ninth Circuit, he may have just achieved that result.

Conclusion

Judge Rakoff's three post-Newman decisions demonstrate that Newman's implications are anything but settled. Absent a ruling from the Supreme Court, litigants are likely to argue for years whether Newman merely clarified Dirks in favor of the defense bar, or imposed an evidentiary standard for personal benefit that may be at odds with the Supreme Court. The fact that Judge Rakoff's decision in Salman was issued from the Ninth Circuit heightens the prospect of a circuit split. Indeed, the government's July 30, 2015, petition for a writ of certiorari, which argues that Newman's definition of personal benefit — requiring a potential pecuniary exchange even for a tipper's gift of confidential information to a trading relative or friend — is contrary to Dirks, cited to Salman as evidence of a circuit split (and referenced Payton's reasoning in the petition's analysis.[22] Until the courts offer further guidance, federal prosecutors and the U.S. Securities and Exchange Commission may seek to use Payton, Gupta and/or Salman as a response to the growing number of insider trading defendants seeking to use Newman as an escape hatch.

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[1] 773 F.3d 438 (2d Cir. 2014).

[2] SEC v. Obus, 693 F.3d 276, 284 (2d Cir. 2012) (citing Chiarella v. United States, 445 U.S. 222, 228 (1980)). Such trading constitutes a "deceptive device" under Section 10(b) because it violates the insider's relationship of trust and confidence with shareholders. See Dirks v. SEC, 463 U.S. 646, 653-54 (1983); Chiarella, 445 U.S. at 228-29.

[3] United States v. O'Hagan, 521 U.S. 642, 652 (1997). Misappropriation violates Section 10(b) "because the misappropriator engages in deception … by pretending 'loyalty to the principal while secretly

converting the principal's information for personal gain.'" Obus, 693 F.3d at 284-85 (quoting O'Hagan, 521 U.S. at 653).

[4] 463 U.S. 646 (1983).

[5] Id., 463 U.S. at 661-62.

[6] Id., 463 U.S. at 662.

[7] Id., 463 U.S. at 663.

[8] Obus, 693 F.3d at 285 (quoting Dirks, 463 U.S. at 664).

[9] Dirks, 463 U.S. at 660-61.

[10] Dirks, 463 U.S. at 660-61.

[11] 773 F.3d 438, 450 (2d Cir. 2014) (emphasis added).

[12] See United States v. Newman, 1:12-cr-00121-RJS-2, Docket No. 215, pp. 3594-3605 (S.D.N.Y. Dec. 10, 2012).

[13] Newman, 773 F.3d at 447-49 ("[W]e conclude that a tippee's knowledge of the insider's breach necessarily requires knowledge that the insider disclosed confidential information in exchange for personal benefit.").

[14] Id., 773 F.3d at 452.

[15] Obus, 693 F.3d at 285 (quoting Dirks, 463 U.S. at 664).

[16] No. 14 Civ. 4644, 2015 WL 1538454 (S.D.N.Y. Apr. 6, 2015).

[17] Id., 2015 WL 1538454 at *4, *4 n.2.

[18] Id., 2015 WL 1538454 at *5. Judge Rakoff further distinguished Newman by noting that, in Payton, defendants not only knew the "basic circumstances" of the tip but also "recklessly avoided discovering additional details," which allowed the court to draw an adverse inference from defendant's conscious avoidance. 2015 WL 1538454 at *6 (citing Obus, 693 F.3d at 276 ("[T]ippee liability may also result from conscious avoidance.")).

[19] United States v. Gupta, No. 11 Cr. 907(JSR), 2015 WL 4036158 at *3 (S.D.N.Y. July 2, 2015).

[20] No. 14-10204, 2015 WL 4068903 (9th Cir. July 6, 2015).

[21] Id., 2015 WL 4068903 at *6.

[22] The government's petition does not challenge Newman's finding that a tippee must know that a tipper received a personal benefit.