ALERTS

Second Circuit Clarifies Insider Trading Liability of Tippees

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In its highly anticipated decision in *U.S. v. Newman*, the U.S. Court of Appeals for the Second Circuit held on Dec. 10 that to sustain insider trading charges against a tippee who trades on material nonpublic information, the government must prove that the tippee knew that the tipper disclosed the information in breach of a duty of trust and confidence in order to receive a personal benefit. The court further explained that the benefit must be objective and consequential. In doing so, the court criticized the government for "the doctrinal novelty of its recent insider trading prosecutions," which the court described as "increasingly targeted at remote tippees many levels removed from corporate insiders." Slip op. at 14. Even more importantly, the court cleared up legal questions that for years had allowed the government to assert expansive views of insider trading liability that produced countless guilty pleas and settlements in cases involving increasingly remote tippees and amorphous benefits. In particular, *Newman* directly contradicts the long-standing position of prosecutors and the Securities and Exchange Commission ("SEC") that mere ephemeral benefits would suffice to constitute the breach, and that the tippee need not know that a personal benefit was the quid pro quo for the improper disclosure. Accordingly, the decision is expected to present new obstacles to criminal prosecutions and SEC enforcement actions alleging insider trading violations, particularly against remote tippees.

Second Circuit's Analysis

Newman involves appeals from the insider trading convictions of Todd Newman and Anthony Chiasson, portfolio managers at separate hedge funds that traded Dell and Nvidia securities. At trial, the government presented evidence that a group of financial analysts exchanged information they obtained directly, or, more often, indirectly from Dell and Nvidia insiders about those companies' quarterly earnings before those results were publicly announced. Ultimately, the nonpublic earnings information was passed to Newman and Chiasson, who were three or four levels removed from the original tippers. The government alleged that the defendants were not permitted to trade on that information because the insiders had disclosed it in breach of their duties of trust and confidence to their respective corporations, and that the defendants knew the insiders had committed such a breach.

At trial, the parties disagreed over whether the government also needed to prove that the defendants knew that the insiders disclosed the information in order to obtain a personal benefit. At the urging of the government, the trial court declined to impose that requirement via a jury instruction. The U.S. Supreme Court, however, had explained in *Dirks v. SEC* that tippees could be liable for insider trading only where the tipper would "personally … benefit, directly or indirectly, from his disclosure." 463 U.S. 646, 662 (1983). In last week's decision, the Second Circuit held that the district court erred by failing to require the government to prove that the defendants, as remote tippees, knew that such a personal benefit existed. That result, the court explained, "follows naturally" from *Dirks*, which "counsels us that the exchange of confidential information for personal benefit is not separate from the tipper's fiduciary breach; it *is* the fiduciary breach." Slip op. at 14 (emphasis in original). The court added that the tippee need not know "the details of the insider's disclosure of information," such as "how information was disclosed" or "the identity of the insiders," so long as the defendant tippee "understands that some benefit is being provided in return for the information." *Id.* at 17 n.3.

Rather than merely remanding the case back to the district court for a retrial based on the correct jury instruction, the Second Circuit went further by holding that even if the lower court had correctly instructed the jury, the government's evidence was "simply too thin" to permit a finding that the Dell and Nvidia insiders received a personal benefit in this case. *Id.* at 21. While the opinion acknowledges that courts have broadly defined "personal benefit," and that even a reputational benefit may suffice, it explains that friendship alone — especially if merely casual or social — is

not enough. *Id.* at 21-22. Rather, there must be "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." *Id.* at 22. Regarding the Dell insider and his first-level tippee, the court noted that each denied any quid pro quo arrangement and testified that their relationship — which essentially consisted of the first-level tippee's providing career advice and assistance over the course of years — predated the insider's disclosures and would have been the same even absent any disclosures by the Dell insider. *Id.* at 23. The Nvidia facts involved "even more scant" evidence of a benefit, as the insider and first-level tippee were nothing more than "family friends" who "occasionally" socialized together, and the insider did not know that the tippee (much less downstream tippees like Newman or Chiasson) was trading on the information. *Id.* In doing so, the court breathes new life into the personal benefit element, which was previously found to have been satisfied based on even the most perfunctory allegations and evidence. (Indeed, the Second Circuit itself had held that "it *may be presumed* that the tippee's interest in the information is, in contemporary jargon, not for nothing." *U.S. v. Libera*, 989 F.2d 596, 600 (1993) (emphasis added).)

The court further held that even if the evidence had been sufficient to permit the inference of a personal benefit, the government failed to prove that the defendant tippees knew — or consciously avoided learning — that the insiders had received a personal benefit, or even that the information they traded on originated with corporate insiders. The court expressly rejected the government's contention that the "specificity, timing, and frequency" of the earnings information was sufficiently suspicious to prove the defendants' knowledge. While acknowledging that "[i]n general, information about a firm's finances could certainly be sufficiently detailed and proprietary to permit the inference that the tippee knew that the information came from an inside source," the court held that in the case before it, such an inference was not warranted, in part because the information was "of a nature regularly and accurately predicted by analyst modeling." Slip op. at 27. Further, even if the quality of the disclosed information could support an inference that a tippee knew that the information came from an insider, it would not be sufficient to show that the source had an improper motive for disclosing it. *Id.*

Impact of the Decision

Newman doubtlessly will have a significant impact on criminal and SEC enforcement cases involving tippee liability for insider trading. By clarifying the need to prove a personal benefit, as well as knowledge by both tipper and tippee of the existence of the benefit, and by emphasizing the degree to which the benefit must be concrete and consequential, the court has put prosecutors on notice that their recent (and not so recent) practice of glossing over those requirements will likely no longer stand. *Newman* has also put to rest the SEC's position that the personal benefit requirement should only apply to corporate insiders (under the so-called "classical" theory) and not to non-insider tippers who misappropriate information. As the court of appeals expressly stated: "The elements of tipping liability are the same, regardless of whether the tipper's duty arises under the 'classical' or the 'misappropriation' theory." Slip op. at 11. Whether these hurdles dampen the government's growing appetite for pursuing insider trading cases, including cases against remote tippees, remains to be seen.

Meanwhile, portfolio managers and other financial professionals should bear in mind that they and their firms must remain vigilant with respect to material nonpublic information, while understanding the types of circumstances where the tests regarding personal benefit and knowledge of the personal benefit may be satisfied. It remains the law that one who has a duty to keep material nonpublic information confidential must refrain from trading and may not disclose such information to tippees in exchange for a personal benefit. And the decision makes clear that remote tippees can be held liable if they consciously avoid learning that information they receive was illicitly provided in exchange for the requisite benefit. *See* slip op. at 24, 27.

Additional Guidance

SRZ attorneys will offer our clients additional insights regarding *Newman* and related insider trading issues during an upcoming webinar. SRZ attorneys have also authored an easy-to-use, comprehensive treatise offering an explanation of both the basics and complexities of insider trading law, *Insider Trading Law and Compliance Answer Book 2015* (Practising Law Institute).

Authored by Eric A. Bensky, Harry S. Davis, Marc E. Elovitz, Martin L. Perschetz, Howard Schiffman, Gary Stein and Jeffrey F. Robertson .

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

Related People

Harry Davis

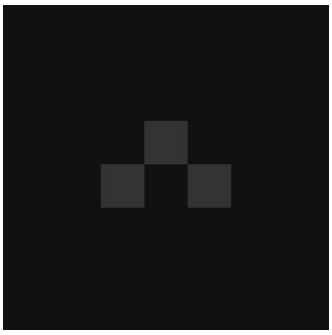
Partner

New York

Marc Elovitz

Partner

New York



Martin Perschetz

Of Counsel

New York

Howard Schiffman

Partner

Washington, DC

Jeffrey (Jeff) F. Robertson

Special Counsel

Washington, DC

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