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The Impact of *United States v. Newman* on the Use by Investment Advisers of Information Resources

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As part of their research process, investment managers gather information from a wide variety of sources. Those sources include: (i) executives and employees of public companies; (ii) competitors; (iii) distributors and suppliers; (iv) sell-side analysts; (v) expert networks; (vi) employees of other investment managers; and (vii) other industry contacts (Information Resources). For some advisers, access to such sources of information is a critical component of their investment program. However, in recent years, these sources of information have come under intense legal and regulatory scrutiny. Both the Department of Justice and the Securities and Exchange Commission have investigated and prosecuted a large number of insider trading cases, and with a seemingly high rate of success. Given such scrutiny, many investment advisers have expended a great deal of resources in an effort to ensure that their employees comply with their legal obligations.

Recently, the United States Court of Appeals for the Second Circuit reversed two high-profile insider trading convictions in *United States v. Newman.*[1] The defendants in *Newman* had been convicted of trading on inside information that they had obtained from analysts who were multiple levels removed from the source of the inside information. In reversing those convictions, the Second Circuit applied a legal standard for so-called "tippee liability" that many have suggested will materially impact the government's ability to investigate and prosecute insider trading cases, including those involving paid consultants retained by investment managers. Indeed, in its petition for rehearing, the Department of Justice warned that the *Newman* decision "will dramatically limit the Government's ability to prosecute some of the most common, culpable, and market-threatening forms of insider trading."[2] The SEC predicted that the decision will weaken the agency's "ability to effectively police and deter insider trading."[3] The Wall Street Journal characterized the holding as a "blow to the Justice Department's Wall Street crackdown."[4]

Numerous articles have been published regarding the impact of the *Newman* decision. Most of these articles approach the topic from the point of view of counsel defending against an insider trading charge. This article, however, considers the holding's impact on the day-to-day business of an investment adviser. As noted below, there may be a temptation on the part of some investment advisers to scale back

their policies and procedures governing the use of Information Resources based on the view that the risk of tippee liability has materially decreased given the legal standard for such liability laid down by the Second Circuit in the *Newman* decision. However, for a number of reasons, including that such a decision could be interpreted as an effort to consciously avoid knowledge about an adviser's Information Resources, advisers would be wise to resist such temptation.

1. *United States v. Newman*: The Facts

In Newman, portfolio managers Todd Newman of Diamondback Capital LLC (Diamondback Capital) and Anthony Chiasson of Level Global Investors LP (Level Global) were charged with insider trading in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b—5 promulgated thereunder. Specifically, the government alleged that a group of financial analysts exchanged nonpublic information that had been communicated from certain Dell and Nvidia employees to others before the release of those companies' quarterly earnings statements.[5] Newman and Chiasson were each a so-called "remote tippee," that is, they were not the immediate tippee who received the information at issue. In fact, both men were multiple layers removed from the corporate insiders at Dell and Nvidia alleged to have initially leaked the information.[6]

The Dell Tip

Rob Ray was an employee in Dell's investor relations department between 2007 and 2009.[7] For eight quarters in a row, Ray disclosed Dell's consolidated earnings numbers to Sandy Goyal, an analyst at Neuberger Berman who had previously worked at Dell and went to business school with Ray.[8] Goyal's primary contact at Dell was not Ray, but rather was another employee in Dell's investor relations department. The information Ray provided Goyal consisted of key portions of Dell's earnings results, including revenues, margins, and operating expenses.[9] This information was communicated in conversations between Ray and Goyal that took place at night and on weekends rather than during normal business hours. Goyal testified that he "didn't press" Ray for information, but told Ray that he was in Nueberger's "research department" and wanted to check the accuracy of his financial models.[10] There was no evidence that Ray knew Goyal was sharing information with anyone else.

After receiving information from Ray, Goyal shared it with an analyst at Diamondback, Jesse Tortora.[11] Tortora knew that the information he was receiving from Goyal originated with a Dell insider (though he did not know the identity of the insider), and he shared that fact—as well as the rest of the information he had learned about the company's financials—with Diamondback manager Todd Newman.[12] Tortora also disclosed the information to another friend of his and analyst at Level Global, Sam Adondakis, who, in turn, shared it with Anthony Chiasson.[13] In short, the information had gone from Dell to Goyal to Tortora to Newman and Adondakis to Chiasson. According to the government, in exchange for the information, Newman authorized $175,000 in payments to Goyal through a "sham" consulting arrangement with Goyal's wife, but did not authorize or make any payments to Ray.[14] The government contended that "Newman would have no reason to pay Goyal such a large sum if Goyal's contact at Dell had been authorized to disclose that information to investors."[15]

The Nvidia Tip

Chris Choi worked in Nvidia's finance department and was involved in preparing the company's quarterly financial statements.[16] Unlike Ray, Choi was not a member of the company's investor relations department and was not authorized to speak to investors. Nonetheless, over the course of more than two years, he shared nonpublic information regarding Nvidia's earnings with Hyung Lim, a friend he knew from church.[17] Like the Dell tips, the information Choi provided contained projections of quarterly revenues and gross margins that often proved to be accurate. Lim shared the information

with a friend of his, Danny Kuo, who was an investment analyst that ran in the same circles as Tortora and Adondakis, the analysts at Diamondback and Level Global.[18] By the time the Nvidia tips reached Newman and Chiasson, they had no knowledge of who leaked the Nvidia information, or why or how it was leaked. All told, the tip traveled from the Nvidia insider to his friend at church, to an analyst in California, to analysts at Diamondback and Level Global and finally to Newman and Chiasson.

Newman and Chiasson's Trading

Both Newman and Chiasson traded in Dell and Nvidia securities in advance of those companies' earnings announcements.[19] In 2008, for example, after receiving negative information about Dell, Newman took the largest short position he had ever taken in a single stock during his tenure at Diamondback.[20] In addition, trades were made by both managers within minutes of receiving information about Dell or Nvidia.[21] Though there were instances in which Newman and Chiasson either received information that was inaccurate or made trades that cut against the information that was shared, their trades proved highly profitable. Ultimately, they reaped over $72 million in trading profits.[22]

For providing inside information about their respective companies' quarterly earnings, neither insider received any tangible benefit (such as cash payments). With respect to Rob Ray in the Dell investor relations department, the gravamen of the government's proof at trial was that Sandy Goyal (the analyst at Neuberger) provided Ray with "career advice."[23] Both the insider and Goyal denied any *quid pro qu*o arrangement, and the evidence demonstrated that their relationship predated the flow of inside information.[24] In addition, Goyal testified that he would have provided career advice to Ray even if Ray had not disclosed to him inside information about Dell.[25] The Nvidia facts involved "even more scant" evidence of a benefit, as Chris Choi (the Nvidia insider) and Hyung Lim were nothing more than "family friends" who "occasionally" socialized together, and Choi did not know that Lim (much less downstream tippees like Newman or Chiasson) was trading on the information.[26] Lim received small payments in exchange for passing the information upstream, but Choi—who was providing the information—was neither part of that arrangement, nor aware that Lim was passing information on to others.[27]

2. *United States v. Newman:* *The Holding*

A central issue on appeal in *Newman* was whether the government needed to prove that a defendant knew that the corporate insiders disclosed the information at issue in exchange for a personal benefit. The trial court declined to instruct the jury that a tippee's knowledge of the insider's benefit is a prerequisite to insider trading liability.[28] The government had objected to the instruction for obvious reasons—both Newman and Chiasson were disconnected from the insider tippers by several levels, and there was no evidence at trial that they were even aware of the source of information.

In *Dirks v. SEC,* the US Supreme Court ruled that a tippee could be liable for insider trading only where the tipper would "personally … benefit, directly or indirectly, from his disclosure."[29] The Court in *Dirks* provided some guidance on the types of relationships that could give rise to an inference that a personal benefit was received by the insider. For example, it would be a sufficient personal benefit if the insider's motivation for providing the tip was "pecuniary gain" or "reputational benefit that will translate into future earnings," or to make "a gift of confidential information to a trading relative or friend."[30] Over the course of two decades following *Dirks*, lower courts consistently found that the personal benefit test had been satisfied based on even the most perfunctory allegations and evidence; the mere existence of a preexisting relationship between the tipper and tippee often times sufficed.[31] Indeed, the Second Circuit itself previously had held that "it may be presumed that the tippee's interest in

the information is, in contemporary jargon, not for nothing."[32]

However, in *Newman*, 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 a personal benefit had been received by the corporate insiders in exchange for the disclosure of information to the immediate tippee.[33] According to the court, that result "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."[34] The court went on to add 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," as long as the defendant tippee "understands that some benefit is being provided in return for the information."[35]

Thus, to prove that a remote tippee is liable for insider trading under Section 10(b) and Rule 10b-5 promulgated thereunder, the Second Circuit now requires 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.[36]

In overturning the convictions of Chiasson and Newman, the Court held that even if the evidence the government had presented had been sufficient to permit the inference of a personal benefit, the government failed to prove that the defendant tippees knew that the insiders had received a personal benefit, or even that the information they traded on originated with corporate insiders.[37] 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.[38] 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."[39] 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.[40]

The Second Circuit also concluded 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.[41] While the opinion acknowledges that courts have broadly defined "personal benefit," and that even a reputational benefit may suffice in certain circumstances, the Court concluded that friendship alone—especially if merely casual or social—is not enough.[42] Instead, the court held that "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" is necessary.[43] In the Court's view, the government had failed to satisfy that standard of proof.

3. Ramifications of *Newman*

For now, *Newman* has established the standard for tippee liability in the Second Circuit, which recently denied the government's petition for rehearing *en banc* of the decision.

Nonetheless, in wake of the *Newman* decision, some investment advisers may contemplate loosening their policies and procedures governing the use of

Information Resources, reasoning that the standard adopted by the Second Circuit makes it much more difficult for the government to prove tippee liability, especially if the tippee is layers removed from the tipper. However, there are a number of reasons why managers should continue to maintain robust policies and procedures in this area, and remain vigilant regarding the use of Information Resources, regardless of whether *Newman* lowers the risk of a tippee liability.

For instance, at least in the short term, there is no reason to conclude that the SEC will not continue to allocate a lot of resources to investigating and prosecuting insider trading violations by investment managers. Despite the rhetoric in the SEC's court papers, SEC enforcement head Andrew Ceresney has publicly stated with respect to the *Newman* decision that "[o]bviously it's a significant case but I think the upshot is you know we have brought 5 or 6 insider trading cases since that case came out. We are going to continue to bring insider trading cases. This is obviously a significant case; it has important implications, but we will continue to be active in this area."[44]

Further, *Newman* is not the law of the land, and other circuits may reach different conclusions than the Second Circuit did in that case. In addition, representatives of both the House and Senate have introduced legislation that would curtail the holding in *Newman* and, in some instances, actually expand the scope of insider trading liability under the federal securities laws.

Moreover, the SEC's burden of proof in a civil enforcement proceeding is substantially lower than that of the government in a criminal insider trading case. The SEC need only prove that a defendant acted recklessly in disregarding the receipt of a personal benefit by an insider, whereas a defendant must have acted "willfully" to be criminally liable. In the context of insider trading, this is a distinction with a difference.

Already, one federal judge has recognized that civil liability may still exist where criminal liability may be absent under *Newman*.[45] Specifically, criminal insider trading charges against former brokers Daryl Payton and Benjamin Durant were dropped in January 2015 after prosecutors determined that their allegations fell short of the Second Circuit's newly-imposed legal requirement of knowledge of the insider tipper's personal benefit. However, United States District Judge Jed Rakoff recently ruled that those same brokers must still face charges from the SEC, even though there is no allegation the defendants knew specifically about the insider's personal benefit.[46] According to Judge Rakoff, the SEC need not plead that the defendants "knew specifically" about the personal benefit received by the insider under the civil knowledge standard. Instead, the allegations that the remote tippees knew (i) the identity of the source of the tip; (ii) that the tipper and the first-level tippee were friends and roommates; and (iii) that the immediate tippee (who was an attorney) had assisted the tipper after he was arrested on an assault charge, "raise[d] the reasonable inference that the defendants knew that [the tipper's] relationship with [the first-level tippee] involved reciprocal benefits."

In short, investment managers' use of Information Resources likely will continue to receive the same level of regulatory scrutiny—at least from the SEC—as they did prior to *Newman*.

In addition, both the civil and criminal authorities likely will now focus more of their attention during an investigation on determining whether a tipper has received a personal benefit. As noted above, that prong had been a relatively easy element to plead, and therefore, the government did not expend a great amount of time developing the facts to support a conclusion that a tipper received a personal benefit. That likely will change, and such facts may exist in more cases than some have predicted.

Further, the result of *Newman* may very well be an increase in the scrutiny of an investment advisers' internal compliance program. That is so because the court in *Newman* noted that a tippee could still be held liable on the basis of "conscious avoidance." Conscious avoidance (also known as willful blindness) has been described by one commentator as the government's "most powerful prosecutorial tool."[47]

The "traditional rationale for this doctrine is that defendants who behave in this manner are just as culpable as those who have actual knowledge . . . . It is also said that persons who know enough to blind themselves to direct proof of critical facts in effect have actual knowledge of those facts."[48] There are two basic requirements to proving conscious avoidance: (i) the defendant must be aware of a "high probability" of a disputed fact; and (ii) the defendant must take deliberate actions to avoid learning that fact.[49] Applied in the context of insider trading cases, conscious avoidance could be used to demonstrate the scienter of a tippee who receives information and makes a deliberate choice not to ask questions about its source.[50] It can be proved where evidence of the defendant's involvement "is *so overwhelmingly suspicious* that the defendant's failure to question suspicious circumstances establishes the defendant's purposeful contrivance to avoid guilty knowledge."[51]

As discussed above, proving a remote tippee's knowledge of an upstream personal benefit—especially where the source of information is several layers removed from that tippee—could be difficult, if not impossible in many cases. And where proof of a tippee's actual knowledge of a tipper benefit is scant or wholly absent, the focus of the government's inquiry is likely to be whether there was conscious avoidance of knowledge of a personal benefit. In that scenario, investigators will want to establish what, if any, actions an adviser took to avoid knowledge regarding the sources of information accessed by its investment professionals. A loosening of a manager's internal controls governing the use of Information Resources heightens the risk that investigators will conclude that a manager sought to consciously avoid the relevant circumstances surrounding its investment team's research gathering process. Accordingly, managers should resist the temptation to roll back their compliance protocols in this area.

4. Conclusion

Whatever the impact of the case may be on the ability of civil and criminal authorities to regulate and prosecute insider trading cases, advisers should not misinterpret the holding of the case to green light an investment structure that insulates advisers from information. Advisers should remain vigilant in ensuring that compliance programs covering Information Resources are both adequate and adhered to.

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NOTES

1 *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014).

2 Petition of the United States of America for Rehearing and Rehearing *En Banc*, *United States v. Newman*, No. 13-1837-cr(L) (2d Cir., filed Jan. 23, 2015), at 3.

3 Brief for the Securities Exchange Commission as *Amicus Curiae* Supporting the Petition of the United States for Rehearing or Rehearing *En Banc*, *United States v. Newman*, No. 13-1837-cr(L) (2d Cir., filed Nov. 14, 2013), at 2.

4 Christopher M. Mathews, "Court Overturns Insider-Trading Convictions, a Blow to Justice Department," *The Wall Street Journal*, Dec. 10, 2014.

5 *Newman*, 773 F.3d at 443.

6 *Id.*

7 Brief for the United States, *United States v. Newman*, No. 13-1837-cr(L) (2d Cir., filed Nov. 14, 2013) (Government's Brief), at 18.

8 *Id.*

9 *Id.* at 6.

10 Brief for Defendant-Appellant Todd Newman, *United States v. Newman*, No. 13-1837-cr(L) (2d Cir., filed Aug. 15, 2013), at 10.

11 *Newman*, 773 F.3d at 443.

12 *Id.*

13 *Id.*

14 *Government's Brief* at 19.

15 *Id.*

16 *Newman,* 773 F.3d at 443.

17 *Id.*

18 *Id.*

19 *Id.* at 454.

20 *Government's Brief* at 20.

21 *Id.* at 21.

22 *Newman,* 773 F.3d at 443.

23 *Id.* at 453.

24 *Id.*

25 *Id.*

26 *Id.*

27 Brief for Defendant-Appellant Anthony Chiasson, *United States v. Newman*, No. 13-1837-cr(L) (2d Cir., filed Aug. 15, 2013), at 11.

28 At the time, a majority of district courts that had considered the issue had concluded that proof of a remote tippee's knowledge of the tipper's personal benefit was not required.

29 *Dirks v. S.E.C.*, 463 U.S. 646 at 662 (1983).

30 *Id.* at 663-64.

31 *See, e.g., S.E.C. v. Obus*, 693 F.3d 276, 292 (2d Cir. 2012) ("In light of the broad definition of personal benefit set forth in *Dirks,* this bar is not a high one.")

32 *U.S. v. Libera*, 989 F.2d 596, 600 (1993).

33 *Newman*, 773 F.3d at 442.

34 *Id.* at 447-48.

35 *Id.* at 449 n.3.

36 *Id.* at 450.

37 *Id.* at 452.

38 *Id.* at 454.

39 *Id.* at 455.

40 *Id.*

41 *Id.* at 451-52.

42 *Id.* at 452.

43 *Id.*

44 Andrew Ceresney, Remarks at the Practicing Law Institute Panel: Growing Anxiety with No Relief in Sight–Enforcement and Litigation (Feb. 10, 2015).

45 *See S.E.C. v. Payton*, __ F.3d __, 2015 WL 1538454, at *1 (S.D.N.Y. Apr. 6, 2015) (discussing the lower standard of recklessness in civil insider trading cases).

46 *Id.* at 5-6.

47 Benjamin Fischer, "Insider Trading and Conscious Avoidance: Handling The Government's Most Powerful Prosecutorial Tool" *Forbes Insider* (Dec. 23, 2013).

48 *Global-Tech Appliances, Inc. v. SEB S.A.,* 131 S. Ct. 2060, 2068-69 (2011) (citations omitted).

49 *See United States v. Svoboda*, 347 F.3d 471, 480 (2d Cir. 2003).

50 *See S.E.C. v. Musella*, 678 F.Supp. 1060 (S.D.N.Y. 1998).

51 *Svoboda*, 347 F.3d at 480.