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Second Circuit Rules for Defendants in Landmark Insider Trading Case

Yesterday, the United States Court of Appeals for the Second Circuit issued a long-anticipated ruling dismissing with prejudice indictments against two insider trading defendants in *United States* v. *Newman*. Two aspects of the decision are particularly important. First, the Court ruled that the government must prove that a remote tippee knows of the personal benefit received by a tipper in exchange for disclosing nonpublic information. Second, the Court held that the government must prove that the personal benefit is "of some consequence," and determined that the benefits alleged by the government in *United States* v. *Newman* were not sufficient to support a conviction. The ruling likely will have major ramifications for the future prosecutions of insider trading cases in the Second Circuit.

The Newman and Chiasson Case

In *United States* v. *Newman*, the Second Circuit considered appeals from the insider trading convictions of Todd Newman, a former portfolio manager at Diamondback Capital Management, LLC, and Anthony Chiasson, a former portfolio manager at Level Global Investors, LP.[1] Newman and Chiasson were accused of trading Dell and NVIDIA securities based upon material, nonpublic information they received from their respective analysts. According to the testimony elicited during trial, the allegedly material, nonpublic information originated within Dell and NVIDIA, but it passed through numerous intermediaries before it was received by Newman and Chiasson, who contended that there was insufficient evidence that the tipper received any personal benefit in exchange for the tip, and, in any event, that they certainly did not know of any such benefit. Newman and Chiasson were each convicted after a five-week trial. They appealed to the Second Circuit, arguing, among other points, that they were convicted based on an improper jury instruction and that the evidence was insufficient to support their convictions.

The Supreme Court's Decision in *Dirks* v. *SEC*

The Second Circuit agreed with Newman and Chiasson, concluding that the jury instructions were improper and that the evidence was insufficient to sustain a conviction. The opinion turned on the Court's reading of *Dirks* v. *SEC*, a thirty-one-year old Supreme Court decision. 463 U.S. 646 (1983).

[1] Paul, Weiss was counsel for Anthony Chiasson on this appeal and was lead counsel at the Second Circuit argument.

In *Dirks*, the Supreme Court held that, under the "classical theory" of insider trading liability,[2] tippers are liable—and, by extension, tippees are liable—only when tippers breach a duty to the shareholders of a publicly traded company. *Dirks,* 463 U.S. at 660. Before deciding *Dirks*, the Supreme Court had held in *Chiarella* v. *United States* that, without more, trading on material, nonpublic information is not illegal, as there is no "general duty between all participants in market transactions to forgo actions based on material, nonpublic information." 445 U.S. 222, 233 (1980). *Dirks* built on *Chiarella* by setting forth when a tippee has a duty to disclose or abstain from trading on material, nonpublic information: a duty arises "only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know there has been a breach." *Dirks,* 463 U.S. at 660. Put another way, the tippee's duty derives from the tipper's duty, and the tipper's duty is created because of a fiduciary relationship with shareholders.

Further, according to *Dirks*, courts will look to whether the tipper received a personal benefit to determine if the tipper breached a duty by disclosing nonpublic information. *Id.* at 662. Courts have defined "personal benefit" quite broadly.

The Second Circuit's Opinion

In directing that the indictment be dismissed, the Court's opinion clarified the standard set out in *Dirks*. The Court— Circuit Judges Ralph K. Winter, Jr., Peter W. Hall, and Barrington D. Parker—held that a tippee must know of the personal benefit received by the tipper. The Court explained that it was not sufficient for the government to show that the tippee received information that was material and nonpublic, or that the tipper was an insider, or even that the tipper breached a duty to the source of the information. "[W]hile we have not yet been presented with the question of whether the tippee's knowledge of a tipper's breach requires knowledge of the tipper's personal benefit," the Court wrote, "the answer follows naturally from *Dirks*." Based on *Dirks*'s explanation of the nature of an insider's fiduciary breach, "we conclude that a tippee's knowledge of the insider's breach necessarily requires that the insider disclosed confidential information in exchange for personal benefit."

In so holding, the Court once again rejected the notion that the federal securities laws require parity of information among investors. The opinion quoted some of the most important language from *Dirks* and *Chiarella*: that there is no "general duty between all participants in market transactions to forgo actions based on material, nonpublic information"; that the law does not require symmetry of information among all participants in the marketplace; that not every instance of "financial unfairness" is punishable under Section 10(b); and that insider trading liability exists only when a duty of confidentiality was breached in

[2] Two theories of insider trading liability are available to prosecutors: the "classical theory" and the "misappropriation theory." The prosecutions of Newman and Chiasson were brought under the "classical theory" of insider trading liability, which applies when a "corporate insider trades in the securities of his corporation on the basis of material, nonpublic information." *United States* v. *O'Hagan*, 521 U.S. 642, 651-52 (1997). The "misappropriation theory," by contrast, applies when an investor "misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information." *Id.* at 652.

exchange for a personal benefit. As such, the Court held that the district court's instruction, which did not require the jury to find knowledge of a personal benefit, was erroneous, and, moreover, that the error was not harmless.

Further, the Court concluded that the evidence was insufficient to support the government's theory that the tipper received any personal benefit in exchange for providing inside information. Although the government contended that the evidence showed that the Dell tipper had sought career advice from the friend who was the initial tippee and that the NVIDIA tipper was a "family friend" of the initial tippee, the Court held that the "circumstantial evidence in this case was simply too thin to warrant the inference that the corporate insiders received any personal benefit in exchange for their tips." If the evidence of personal benefit proffered by the government was enough, the Court explained, "practically anything would qualify." For evidence of a personal benefit to be sufficient, the Court wrote, 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."

The Court also rejected the government's argument that the "specificity, timing, and frequency" of the information received by the defendants were so "overwhelmingly suspicious" that it provided support for the government's theory that the defendants must have known, or consciously avoided knowing, that the information they were receiving was coming from an insider in breach of his duties *and* that the tipper must have received a personal benefit. The Court reasoned that the financial estimates received by the defendants could also be obtained through "legitimate financial modeling using publicly available information and educated assumptions about industry and company trends." It noted trial testimony to the effect that companies' investor relations departments would routinely provide guidance to investment professionals about the accuracy of their models, and evidence showing that companies would routinely "leak" estimates of their earnings data in advance of earnings announcements. While explaining that there could be cases where a defendant receives information that is so "detailed and proprietary" to support an inference that the information must have come from an insider source, the Court concluded that the inference is "unwarranted" with respect to Newman and Chiasson, as they were several layers removed from the source of information and the information they received was similar to information they regularly received through legitimate means.

Conclusion

After *Newman*, it will be considerably more difficult for both the Justice Department and the SEC to win cases involving tips. In particular, the government will likely find it more challenging to prosecute remote tippees for insider trading, especially when the tippees are several levels removed from the source of the information. The opinion focused specifically on recent prosecutions fitting this description: "The Government's overreliance on our prior dicta merely highlights the doctrinal novelty of its recent insider trading prosecutions, which are increasingly targeted at remote tippees many levels removed from corporate insiders."[3] Additionally, it will be more difficult for the government to prove cases where the tipper does not receive money or other material consideration, but instead receives only an intangible benefit or the hope of a future benefit. In future decisions, courts will be forced to grapple with when such benefits support a finding that a trader has engaged in insider trading.

Because of its holdings regarding remote tippees and the personal benefit standard, the opinion has also clarified the rules for investment professionals who regularly trade on information obtained through the marketplace. It is now clear that the tipper must receive a personal benefit "of some consequence" to support a finding of insider trading liability. Additionally, the opinion provides that tippee liability exists only when the tippee knows or should know that the information was confidential and divulged for personal benefit. It is now evident that, going forward, the fact that a remote tippee receives improperly disclosed information, without more, will not be enough to support an insider trading case.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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[3] In the passage in the opinion before this sentence, the Court discussed how, in an attempt to demonstrate that it need not prove that tippees know of the personal benefit received by the tipper, the government's brief had parsed dicta from previous decisions.