

### Major Reversal of Insider Trading Convictions After Trial: Second Circuit Sets High Bar for Tippee Liability

The United States Court of Appeals today reversed the convictions for insider trading of Todd Newman and Anthony Chiasson.<sup>1</sup> The Court held that the government was required to prove, but did not, that the defendants knew that the insider who disclosed the confidential information did so in exchange for a personal benefit. The district court did not instruct the jury that this was an element of insider trading, and the government introduced insufficient evidence on this point (as well as on the issue of whether the insider received a personal benefit). As a result, the convictions are reversed and the indictments are dismissed.<sup>2</sup> This is a major reversal for the U.S. Attorney's Office for the Southern District of New York, and it clarifies a rule of law that will make prosecution of remote tippees more difficult than it had been before.

At trial, the government presented evidence that financial analysts received inside information from employees at Dell and NVIDIA about upcoming earnings announcements. The analysts passed the information along to the defendants, who were portfolio managers at hedge funds. The defendants then executed trades that earned a total of \$72 million in profits for their hedge funds. There was no evidence that the defendants were aware of the source of the inside information, and the Court of Appeals found that the defendants were three or four levels removed from the insiders who originally breached their fiduciary duties by disclosing the information.<sup>3</sup> The Court suggested that this and other recent insider trading prosecutions were novel; it knew of no case in which "a tippee as remote as the defendants had been held criminally liable."<sup>4</sup>

Defendants asked the district court to grant a motion for acquittal pursuant to Rule 29 in the absence of any evidence that the defendants knew that the insiders had received a personal benefit in exchange for the inside information. In the alternative, they asked the district court to charge the jury that the defendants could be convicted of insider trading only if they knew that the insiders had received a personal benefit in exchange for the inside information. Absent such knowledge, they contended that they were not participants in the tippers' breaches of fiduciary duty to Dell and NVIDIA.<sup>5</sup>

The district court declined to grant the Rule 29 motion or to give the jury charge requested by the defendants. Instead, the district court charged that the jury needed to find only that (i) the tippers breached their fiduciary duty by disclosing inside information, and (ii) that the recipients of the information – the defendants – knew that the information had been disclosed in breach of a duty of trust or confidence. The jury did not have to find that the defendants knew that the tippers received a benefit for making the disclosure.<sup>6</sup>

Insider trading is not codified; there is no "insider trading statute." A common law has developed construing the meaning of SEC Rule 10b-5, which generally prohibits securities fraud. Therefore, the Second Circuit's analysis looked at the relevant case law concerning tipping liability. The seminal Supreme Court decision about tippee liability is *Dirks v. S.E.C.*, 463 U.S. 646 (1983), which holds in substance that a corporate insider will have breached his fiduciary duty only when he or she has received some personal gain for the breach of duty. The tippee's duty not to trade on inside

<sup>1</sup> *United States v. Newman*, No. 13-1837-cr (L) (2d Cir. Dec. 10, 2014).

<sup>2</sup> *Id.* at 4

<sup>3</sup> *Id.* at 5-6.

<sup>4</sup> *Id.* at 14-15.

<sup>5</sup> *Id.* at 6-7

<sup>6</sup> *Id.* at 7-8.

information, *Dirks* held, is derivative of the insider's duty; without some personal benefit to the tipper, there is no liability on the part of the tippee. Both the defense and the government agreed that tippee liability, therefore, requires proof of a personal benefit to the insider.<sup>7</sup>

The question presented here, however, is whether the defendants needed to be aware of the personal benefit received by the tipper. The Court recognized that it "ha[d] 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," but it concluded that "the answer follows naturally from *Dirks*." Essentially, because the receipt of the personal benefit is a key component of the breach of the fiduciary duty, and because the tippee is liable only if he knows of the breach of the fiduciary duty, it logically follows that the tippee must know about the receipt of the personal benefit. The Court rejected and distinguished the government's interpretation of prior Second Circuit authorities – many of which did not state this as a requirement for insider trading – as "overreliance on . . . prior dicta." The Court viewed its rule as "comport[ing] with well-settled principles of substantive criminal law" inasmuch as defendants must know the facts that make their conduct illegal.<sup>8</sup>

In light of its reasoning, the Court also noted that other than the district judge who presided at this trial, the other district judges in the Southern District have all held that the tippee must know of the personal benefit in order to be liable.<sup>9</sup>

The Court held that to sustain an insider trading conviction against a tippee, the Government must prove each of the following elements beyond a reasonable doubt: 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.<sup>10</sup>

The Court ruled that the failure to so instruct the jury was not harmless error. The Court proceeded to dismiss the indictment entirely because of the absence of significant evidence at trial that the tippers actually received any personal benefit in exchange for their tips.<sup>11</sup> The exchange between the insider and the tippee must be "objective, consequential, and represent[] at least a potential gain of a pecuniary or similarly valuable nature," requiring evidence "of a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the [latter]."<sup>12</sup>

The Court continued:

Even assuming that the scant evidence described above was sufficient to permit the inference of a personal benefit . . . the government presented absolutely no testimony or any other evidence that [the defendants] knew that they were trading on information obtained from insiders, or that those insiders received any benefit in exchange for such disclosures, or even that [the defendants] consciously avoided learning of these facts.<sup>13</sup>

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7 *Id.* at 9-12.

8 *Id.* at 13-18.

9 The Court suggested in a footnote that the government opportunistically added another defendant – Matthew Steinberg – to this indictment only after the district court ruled that knowledge of a personal benefit was not required, suggesting that the government engaged in forum shopping. See *id.* at 17 n.5. (Steinberg's case, also on appeal, may now be reversed.)

10 *Id.* at 18.

11 *Id.* at 19-28.

12 *Id.* at 22 (quoting *United States v. Jiau*, 734 F.3d 147, 152-53 (2d Cir. 2013)).

13 *Id.* at 24.

The Government contended that the specificity, timing, and frequency of the updates provided to the defendants were so suspicious that they warranted material inferences supporting an inference that the defendants knew a personal benefit must have been given to the tippers for the information. The Court rejected this argument because (1) the information could have been legitimately obtained from Dell and NVIDIA by those who passed along the information to the defendants and (2) investor relations personnel at these firms routinely leaked earnings data. Moreover, even if the circumstances of the information provided to the defendants supported an inference as to the nature of the source of the information (*i.e.*, that it came from insiders), the detail and specificity of the information could not, by itself, permit an inference as to the source's improper motive.<sup>14</sup>

This is a very significant ruling that redefines or at least clarifies the elements required for tippee liability. To be sure, many district courts had required knowledge of a personal benefit, such as the *Rengan Rajaratnam* prosecution, where this requirement helped lead to the defendant's acquittal. However, the law was far from clear prior to today's decision.<sup>15</sup> The Court's factual analysis of the sufficiency of the evidence also makes it clear that it will be difficult for the government to establish liability for remote tippees, like the defendants in this case, because such tippees will rarely, if ever, know the reason for the tippers' disclosure of the confidential information. In many cases it will also be hard for the government to show the more explicit *quid pro quo* between the insider and the initial tippee that the Court seems to require.

It remains to be seen whether the government will seek further appellate review of this decision (the United States Attorney has said this step is being considered), either through a motion for rehearing en banc or through a petition for certiorari to the United States Supreme Court, but both seem like possible outcomes given the limits placed on insider trading prosecutions by today's decision. It also seems inevitable that some defendants who did not know of the tippee's receipt of a personal benefit but who nevertheless pleaded guilty during the course of the recent insider trading investigation that swept up Newman and Chiasson will seek some form of post-conviction relief. The decision also may prompt further calls for congressional action: if we are going to punish insider trading with criminal sanctions, it makes sense to have a statute that clearly defines the crime, for the benefit of all concerned and in order to avoid outcomes like today's decision.

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<sup>14</sup> *Id.* at 25-27.

<sup>15</sup> Even the Court today was constrained to acknowledge that it "has been accused of being 'somewhat Delphic' in [its] discussion of what is required to demonstrate tippee liability." *Id.* at 13 (quoting *United States v. Whitman*, 904 F. Supp. 2d 363, 371 n.6 (S.D.N.Y. 2012)).

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