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Client Alert Commentary

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Second Circuit Redefines "Personal Benefit" in Insider Trading Case

Breaking from precedent, the Second Circuit sets a new standard for the personal benefit element of insider trader liability.

On December 10, 2014, the United States Court of Appeals for the Second Circuit reversed the high-profile convictions of two former hedge fund managers, Todd Newman and Anthony Chiasson.[1] The court held that the government failed to make a sufficient showing of "personal benefit" to the insider tipper and that the jury should have been instructed that "the government must prove beyond a reasonable doubt that the tippee knew that an insider disclosed confidential information and that he did so in exchange for a personal benefit."[2] This case represents an important clarification of the relatively low standard courts have used to establish the "personal benefit" element for over 30 years, since the Supreme Court's seminal decision in *Dirks v. SEC,* 463 U.S. 646 (1983). Under the Second Circuit's new ruling, the mere act of giving a gift of confidential information to a trading relative or friend is no longer sufficient to establish the existence of a "personal benefit."[3] Instead, there must now 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."[4]

Background

In December of 2012, Newman and Chiasson were convicted in the United States District Court for the Southern District of New York (SDNY) on charges of securities fraud in violation of sections 10(b) and 32 of the Securities Exchange Act of 1934, SEC Rules 10b-5 and 10b5-2, 18 U.S.C. § 2, and conspiracy to commit securities fraud in violation of 18 U.S.C. § 371.[5] The government alleged that analysts at various hedge funds and investment firms obtained material, non-public information from insiders at Dell and NVIDIA, disclosing those companies' earnings numbers before they were publicly released in Dell's May 2008 and August 2008 earnings announcements and NVIDIA's May 2008 earnings announcements.[6] The government further alleged that these analysts then passed the inside information to Newman and Chiasson, who, in turn, executed trades in Dell and NVIDIA stock, earning approximately US$4 million and US$68 million, respectively, in profits for their respective funds.[7] Newman and Chiasson were four levels removed from the insider tippers and the court found no evidence that either was aware of the source of the inside information.[8] The government charged Newman and Chiasson with wilfully participating in this insider trading scheme by trading in securities based on the inside information these analysts had illicitly obtained.[9]

On appeal, Newman and Chiasson argued that there was no evidence that the corporate insiders provided inside information in exchange for a personal benefit, which is required to establish tipper liability under *Dirks.*[10] Because a tippee's liability derives from the tipper's liability, Newman and Chiasson argued that they could not be found guilty of insider trading where the tippers, Rob Ray of Dell's investor relations

department and Chris Choi of NVIDIA's finance unit, had not been charged administratively, civilly, or criminally for insider trading or any other wrongdoing.[11] Newman and Chiasson also argued that the district court erred in failing to instruct the jury that it must find that a tippee knew that the insider disclosed confidential information in exchange for a personal benefit.[12] Absent such knowledge, they argued, the government could not establish tippee liability under *Dirks.*[13]

Second Circuit Clarifies "Delphic" Discussions on Tippee Liability

The government argued on appeal that Supreme Court precedent required only that the "tippee know that the tipper disclosed information in *breach of a duty,*"[14] rather than a requirement that the tippee know of the personal benefit the insider received in exchange for the disclosure. The Second Circuit flatly rejected this notion. In overturning SDNY's convictions of Newman and Chiasson, the Second Circuit took the opportunity to clarify the precise requirements for tippee liability, noting that the court had been accused of being "somewhat Delphic" in its discussion of what is required to demonstrate tippee liability.[15]

The Second Circuit held that to sustain an insider trading conviction against a tippee, the government must prove each of the following elements beyond a reasonable doubt:

- The corporate insider was entrusted with a fiduciary duty;
- The corporate insider breached his fiduciary duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit;
- The tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit;
- The tippee still used that information to trade in a security or tip another individual for personal benefit.[16]

The court analyzed tippee liability as follows.

First, a "tippee's liability derives *only* from the tipper's breach of a fiduciary duty, *not* from trading on material, non-public information."[17] Indeed, the securities laws do not contain a general prohibition on trading on material, non-public information.[18] "[I]n both *Chiarella* and *Dirks,* the Supreme Court affirmatively established that insider trading liability is based on breaches of fiduciary duty, not on informational asymmetries."[19] Citing *Dirks,* the Second Circuit noted that the "Supreme Court rejected the SEC's theory that a recipient of confidential information (*i.e.* the tippee) must refrain from trading whenever he receives inside information from an insider."[20]

Second, a "corporate insider has committed no breach of fiduciary duty unless he receives a **personal benefit** in exchange for the disclosure" (emphasis added).[21] The court clarified that under *Dirks, "*the exchange of confidential information for personal benefit is not separate from an insider's fiduciary breach."[22] Instead, "*Dirks* clearly defines a breach of fiduciary duty as a breach of the duty of confidentiality in exchange for a personal benefit."[23] As such, the tipper's breach of fiduciary duty requires that the tipper "personally will benefit, directly or indirectly, from his disclosure."[24] Because a tippee's liability derives from the tipper's liability, a tippee may not be held liable unless a tipper personally benefits in exchange for the disclosure.

Third, even if a tipper has breached his or her fiduciary duty, a tippee is liable only if he or she **knows** or should have known of the breach.[25] Knowledge of a breach of the duty of confidentiality, without knowledge of the personal benefit, is insufficient to impose criminal liability.[26]

High Standard to Establish "Personal Benefit"

In contrast to the minimal evidence other courts have previously used to establish the "personal benefit" element of insider trader liability, the Second Circuit's new ruling sets a higher standard to establish "personal benefit." The court held that the government had presented insufficient evidence of "personal benefit" because insider tippers, Ray and Choi, "were not 'close' friends" and "were merely casual acquaintances" with the first level tippees, Sandy Goyal and Hyung Lim.[27] In determining that the evidence of personal benefit was simply too thin, the Court noted that Goyal and Ray

> *had known each other for years, having both attended business school and worked at Dell together. The evidence further showed that Goyal advised Ray on a range of topics, from discussing the qualifying examination in order to become a financial analyst to editing Ray's resume and sending it to a Wall Street recruiter, and that some of this assistance began before Ray began to provide tips about Dell's earnings. The evidence also established that Lim and Choi were 'family friends' that had met through church and occasionally socialized together.*[28]

Such evidence of friendship and working relationships would likely have been sufficient to establish personal benefit under prior Second Circuit rulings. For example, in *SEC v. Obus,* the Second Circuit held that "the undisputed fact that Strickland and Black were friends from college is sufficient to send to the jury the question of whether Strickland received a benefit from tipping Black."[29] Indeed, prior to this decision the Second Circuit had seemed to presume the existence of a "personal benefit" where the relationship between tipper and tippee is that of a friend or relative. *See, e.g., SEC v. Obus,* 693 F.3d 276 (2d Cir. 2012) ("Personal benefit to the tipper is broadly defined: it includes not only 'pecuniary gain,' such as a cut of the take or a gratuity from the tippee, but also a 'reputational benefit' or the benefit one would obtain from simply 'mak[ing] a gift of confidential information to a trading relative or friend.'"); *see also SEC v. Warde,* 151 F.3d 42, 48-49 (2d Cir. 1998) (finding sufficient showing of personal benefit where "close friendship" suggested that the tip was intended to benefit the tippee). District courts have similarly applied a low standard for establishing "personal benefit."[30]

The Second Circuit's opinion now suggests that courts will need to scrutinize the level of friendship or relationship between the tipper and tippee much more closely in determining the existence of a personal benefit. This opinion rejects the prior prevailing view that receipt of a personal benefit by the mere fact of a friendship is sufficient: "If that were true, and the Government was allowed to meet its burden by proving that two individuals were alumni of the same school or attended the same church, the personal benefit requirement would be a nullity."[31] Now, the government will need to provide evidence of *quid pro quo* and "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***" (emphasis added).[32]

Examples of "Personal Benefit"

While the Second Circuit opinion suggests that mere friendship or familial relationships, without any proof of *quid pro quo,* are insufficient to establish personal benefit, the following examples meet the court's new standard:

- Tangible gifts, such as meals at restaurants, gifts (including iPhones, live lobsters, gift cards, honey jars)[33]
- Access to an investment club where stock tips and insight are routinely discussed[34]

- Close working relationship on real estate deals in which parties commonly split commissions on transactions[35]

- Referrals for services, such as dental work[36]

Surprisingly, the court dismissed the career advice that Goyal gave Ray as "little more than the encouragement one would generally expect of a fellow alumnus or casual acquaintance."[37] In light of the court's opinion in *Newman and Chiasson,* the key to establishing "personal benefit" is showing some form of *quid pro quo* that takes place after the disclosure of confidential information, which could lead to "potential gain of a pecuniary or similarly valuable nature."

Conclusion

While in some respects, the Second Circuit's decision merely restates what the U.S. Supreme Court held over 30 years ago in *Dirks* on the elements of tippee liability, this decision presents a clear break with past decisions on what conduct will establish the critical element of "personal benefit." The court's opinion has clarified that a mere acquaintance is insufficient to establish personal benefit. Now, prosecutors will need to show "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." Just how "close" of a friend or how strong of a working or familial relationship is needed to establish "personal benefit" under the Second Circuit's new standard remains to be seen.

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Endnotes

1 *United States v. Newman and Chiasson,* Nos. 13-1837-cr (L), 13-1917-cr (con) (2d Cir. Dec. 10, 2014).

2 *See id.* at *4.

3 *See id.* at *21-23.

4 *See id.* at *22.

5 *See id.* at *2.

6 *See id.* at *5.

7 *See id.*

8 *See id.*

9 *See id.* at *3-4.

10 *See id.* at *6.

11 *See id.*

12 *See id.* at *4.

13 *See id.* at *7.

14 *See id.* at *13 (citing Gov't Br. at 40).

15 *See id.* at *13.

16 *See id.* at *18.

17 *See id.* at *13 (citing *Chiarella v. United States,* 445 U.S. 222, 233 (1980)).

18 *See id.* at *16 (citing *United States v. Chestman,* 947 F.2d 551, 578 (2d Cir. 1991) (Winter, J., concurring) ("The policy rationale [for prohibiting insider trading] stops well short of prohibiting all trading on material nonpublic information.").

19 *See id.* at *16.

20 *See id.* at *11-12 (internal quotation marks omitted).

21 *See id.* at *13-14.

22 *See id.* at *14 (citing *Dirks v. SEC,* 463 U.S. 646 (1983)).

23 *See id.* at *16 (citing *Dirks,* 463 U.S. at 662).

24 *See id.* at *11.

25 *See id.* at *14.

26 *See id.* at *15-16.

27 *See id.* at *21-23.

28 *See id.* at *21.

29 *See SEC v. Obus,* 693 F.3d 276, 291 (2d Cir. 2012).

30 *See, e.g., SEC v. One or More Unknown Traders In the Sec. of Onyx Pharma.,* 296 F.R.D. 241 (S.D.N.Y. 2013) (citing *Dirks v. SEC,* 463 U.S. 646, 663-64 (1983) ("The personal benefit to the tipper can be any type of benefit, including the satisfaction of making a gift to a relative or friend."); *see also United States v. Whitman,* 904 F. Supp. 2d 363, 374, n.7 (S.D.N.Y. 2012) ("the benefit does not need to be financial or tangible in nature; it could include, for example, maintaining a useful networking contact, improving the reputation or power within the company, obtaining future financial benefits, or just maintaining or furthering a friendship."); *SEC v. Blackwell,* 291 F. Supp. 2d 673, 692 (S.D. Ohio 2003) ("a mere allegation that the insider has disclosed material non-public information is sufficient to create a legal inference that the insider intended to provide a gift to the recipient of the information, thereby establishing the personal benefit requirement." Personal benefit adequately pled based on allegations that tipper "made gifts of confidential information to family members and close friends.").

[31] *See Newman and Chiasson,* Nos. 13-1837-cr (L), 13-1917-cr (con), at *21-22 (2d Cir. Dec. 10, 2014).

[32] *See id.* at *22.

[33] *See id.* at *15, 22; *see also United States v. Jiau,* 734 F.3d 147, 153 (2d Cir. 2013) ("The benefits to Nguyen from tipping were manifold. Jiau treated him to meals at restaurants and gave him gifts including an iPhone, live lobsters, a gift card, and a jar of honey. She also provided Nguyen with insider information about other stocks and the two formed an investment club….In joining the investment club, Ng entered into a relationship of *quid pro quo* with Jiau, and thus had the opportunity to access information that could yield future pecuniary gain.").

[34] *See Newman and Chiasson,* Nos. 13-1837-cr (L), 13-1917-cr (con), at *22 (2d Cir. Dec. 10, 2014) (citing *United States v. Jiau,* 734 F.3d 147, 153 (2d Cir. 2013).

[35] *See id.* at *22 (citing *SEC v. Yun,* 327 F.3d 1263, 1280 (11th Cir. 2003)).

[36] *See id.* at *22-23 (citing *SEC v. Sargent,* 229 F.3d 68, 77 (1st Cir. 2000)).

[37] *See id.* at *23.