

Second Circuit Raises the Bar for Proving Tippee Liability

Wednesday, the U.S. Court of Appeals for the Second Circuit vacated the criminal insider trading convictions of two former hedge fund managers, and in doing so, clarified the elements required to prove an insider trading charge against a “tippee.” The Court held that the government must prove that an individual *knew* that a company insider had disclosed confidential information in exchange for a personal benefit, and also heightened the standard for proving a personal benefit. This decision is being seen as a “sweeping” blow to the government’s recent successes in prosecuting insider trading.

The Decision

The *Newman* decision arises out of a Spring 2013 criminal insider trading trial in the Southern District of New York. At trial, the government alleged that a group of financial analysts exchanged nonpublic financial information that they received from Dell and NVIDIA employees prior to those companies’ quarterly earnings announcements. Specifically, Todd Newman, a former portfolio manager at Diamondback Capital Management, LLC, and Anthony Chiasson, a former portfolio manager at Level Global Investors, L.P., were charged with receiving confidential information about Dell’s and NVIDIA’s quarterly earnings through a series of intermediaries, and trading on that information prior to its public release. The two portfolio managers’ trades in Dell and NVIDIA stock resulted in a combined \$72 million in profits for their respective funds.

Both Newman and Chiasson were “remote tippees” that were three or four steps removed from the corporate insiders alleged to have leaked the nonpublic information. According to the Court, neither Newman nor Chiasson spoke directly to the insiders, and the government presented no evidence to suggest that either defendant was aware of the sources of the inside information. At the close of evidence, the defendants moved for a judgment of acquittal. Central to their argument was that the government did not meet its burden to prove that either defendant acted with the required state of mind. The defendants argued that the government must prove not only that they traded on material nonpublic information while knowing that the corporate insider breached a duty of confidentiality in providing that information, but also that the defendants knew, at the time of trading, that the insiders provided this information in exchange for a personal benefit. The trial court rejected this argument, citing the Second Circuit’s recent decision in *SEC v. Obus*, 693 F.3d 276 (2d Cir. 2012), which recited the elements of tippee liability without stating that knowledge of a personal benefit to an insider was required. Newman and Chiasson each were sentenced to years in prison, and ordered to disgorge profits and pay penalties.

Wednesday, the Second Circuit reversed the trial court and dismissed the indictment with prejudice, foreclosing a retrial. Relying on the Supreme Court’s decades-old opinion in *Dirks v. SEC*, 463 U.S. 646 (1983), the Second Circuit stressed that “the exchange of confidential information for personal benefit is not separate from an insider’s fiduciary breach; it is the fiduciary breach that triggers liability for securities fraud under Rule 10b-5.” Thus, proof of a remote tippee’s knowledge of the insider’s breach of a duty of confidentiality—an element clearly enunciated in *Dirks*—“necessarily requires knowledge that the insider disclosed confidential information in exchange for a personal benefit.”

The Court also heightened the standard for what constitutes a personal benefit, holding that the mere existence of a personal relationship—however attenuated—is not enough. The Court reasoned, “to the extent *Dirks* suggests that a personal benefit may be inferred from a personal relationship between the tipper and tippee, where the tippee’s trades ‘resemble trading by the insider himself followed by a gift of the profits to the recipient,’ . . . we hold that such an inference is impermissible in the absence of 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.” Because the government did

not offer evidence of such a *quid pro quo*, let alone evidence that Newman or Chiasson knew that the corporate insiders at Dell or NVIDIA derived a personal benefit from passing the inside information, the Court held that the government had not met its evidentiary burden of proof.

Practical Implications

Newman is a significant decision that undoubtedly hinders the government's recent attempts to extend the traditional reach of the insider trading laws. This case will make it more difficult to prosecute insider trading cases, especially in the context of downstream tippees where the tippee is several steps removed from the source of the inside information, or in which there is no tangible benefit exchanged. In fact, the Court took note of the "doctrinal novelty" of the government's recent insider trading prosecutions, which are "increasingly targeted at remote tippees many levels removed from corporate insiders." It also sharply rejected the notion that the insider trading laws are a means for the government to correct perceived information imbalances in the market, stressing that "insider trading liability is based on breaches of fiduciary duty, not informational asymmetries."

Although the test set forth in *Newman* appears to apply equally to criminal and civil insider trading claims, the long-term impact of *Newman* is still unclear. Given that civil and criminal cases bear a different standard of proof, it remains to be seen how courts will interpret, in both the criminal and civil context, the extent of evidence necessary to establish (1) that the insider received a "personal benefit," and (2) the tippee's knowledge of that benefit. Indeed, *Newman* is unlikely to be the last word on these issues, as the government may petition for rehearing of the appeal *en banc*, or appeal the ruling to the Supreme Court.

Despite the doctrinal significance of the ruling, *Newman* does not change best practices for market participants. Legal and compliance departments should continue to be vigilant in monitoring trading activity and encouraging an open dialogue with employees regarding the receipt of material nonpublic information.

For more information regarding this decision and its potential impact on your business, please contact your usual Ropes & Gray attorney.