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INSIDER TRADING

# Friends With Benefits: Second Circuit Overturns Newman and Chiasson Convictions And Raises the Government's Burden in Insider Trading Cases Against Tippees

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In a blow to insider trading prosecutions against downstream recipients of inside information, on Dec. 10 the U.S. Court of Appeals for the Second Circuit overturned the May 2013 convictions of Todd Newman and Anthony Chiasson (see related story, page 1711). In its watershed opinion, the court ruled that ''in order to sustain a conviction for insider trading, the Government must prove beyond a reasonable doubt that the tippee knew that an insider disclosed confidential information in exchange for a personal benefit.'' Importantly, the court chided the government for the ''doctrinal novelty of its recent insider trading prosecutions, which are increasingly targeted at remote tippees many levels removed from corporate insiders.''

As a result of the ruling, both the Department of Justice and the Securities and Exchange Commission are likely to face significant hurdles to successfully prosecuting insider trading cases where the tippee is several degrees removed from the insider. These challenges could force the government to reconsider its aggressive approach toward downstream tippees.

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## Previously Muddled Standards for Establishing Tippee Liability

It is well-established that trading based upon material nonpublic information only violates Section 10(b) of the Securities and Exchange Act of 1934 and Rule 10-b5 when that information was obtained in violation of a duty of trust and confidence owed to another party. *See, e.g., Dirks v. SEC*, 463 U.S. 646, 654-49 (1983). However, the standards for determining when a breach has occurred and when the tippee has knowledge of the breach have been unclear.

The genesis of the issue in *United States v. Newman* can be traced back to *Dirks*,[1] which introduced a new analysis for determining when a breach of duty had occurred. Dirks was an officer of a broker-dealer who learned about fraud within a life insurance company, Equity Funding, from a former officer of the insurance company. Dirks alerted his clients to the fraud, and those clients sold their interests in Equity Funding. The court explained that whether an insider's disclosure of material nonpublic information constituted a breach of duty depends upon ''whether the insider will benefit, directly or indirectly, from his disclosure. Absent some

[1] 463 U.S. 646 (1983).

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personal gain, there has been no breach of duty to stockholders. Absent a breach by the insider, there is no derivative breach.''[2]

Some commentators and litigants have read *Dirks* as reasoning that if one does not know of the tipper's personal gain, then one could not know of the tipper's breach. Thus, in their view, *Dirks* arguably requires that the government prove a tippee's knowledge of a benefit to the tipper who violated a fiduciary duty. Others, however, view *Dirks* as requiring the government to prove that the tipper received some benefit, but not prove that the tippee knew of that benefit. Lower courts have been inconsistent in their interpretations of *Dirks*, so it was unclear whether the government was required to prove a tippee's knowledge of the tipper's benefit when the tippee was several degrees removed from the tipper. In some cases within the Second Circuit, the court has required the government to demonstrate that a tippee knew of the benefit to the tipper.[3] However, in other cases in the Second Circuit, courts did not mention that requirement.[4]

In 2012, the Second Circuit decided *SEC v. Obus*, a significant insider trading case, but did not explicitly address whether the government must establish a tippee's knowledge of the benefit gained by the original tipper.[5] In *Obus*, the insider, Stickland, was an employee of GE Capital who learned about Allied Capital Corporation's planned acquisition of SunSource, Inc by virtue of his work performing diligence on SunSource on behalf of Allied Capital. Strickland allegedly tipped his college friend, Black, about the acquisition. Black, in turn, allegedly tipped his colleague, Obus, who traded in SunSource stock. Evidence was contradictory as to whether Obus had been told about the impending acquisition and, if so, whether he knew the identity of the original source of that information. The district court held that the SEC ''failed to present sufficient evidence that Obus subjectively believed the information he received was obtained in breach of a fiduciary duty.''[6] On appeal, the Second Circuit stated that for a tipper to be held liable, the government must demonstrate that he or she received a benefit for breaching a duty of trust and confidence. But with respect to establishing tippees' liability, the court did not explicitly mention any requirement to establish a tippee's knowledge of the benefit to a tipper. Rather, the court held that a tippee ''must know or have reason to know that the information was obtained and transmitted through a breach.'' Applying its holding to Obus, the Second Circuit held that there was sufficient evidence ''to allow a jury to infer that Obus was aware that Strickland's position with GE Capital exposed Strickland to information that Strickland should have kept confidential.''[7]

Despite *Obus*'s silence on any requirement that the government prove a tippee's knowledge of a benefit to the tipper, Judge Rakoff of the U.S. District Court of the Southern District of New York held, in a post-*Obus* case, that *Dirks* requires the government to show the tippee ''understands that some benefit, however modest, is being provided [to the tipper] in return for the information.''[8] In his opinion, Judge Rakoff described *Obus* as ''Delphic,'' observing that, under *Obus*, the government had to demonstrate that a tipper received a personal benefit to prove the tipper's liability. He persuasively reasoned that ''if the only way to know whether the tipper is violating the law is to know whether the tipper is anticipating something in return for the unauthorized disclosure, then the tippee must have knowledge that such self-dealing occurred, for without such a knowledge requirement, the tippee does not know if there has been an 'improper' disclosure of inside information.'' Judge Rakoff recognized that knowledge of a tipper's benefit could be difficult to establish with respect to tippees several links down a tipping chain, but dismissed this concern as ''a product of the topsy-turvy like way the law of insider trading has developed in the courts.''[9]

## 'United States v. Newman': The Second Circuit Requires the Government To Demonstrate a Tippee's Knowledge Of the Tipper's Benefit

In *United States v. Newman*, the U.S. Attorney's Office for the Southern District of New York prosecuted several members of an alleged insider trading ring, including Anthony Chiasson and Todd Newman. Chiasson was a hedge fund portfolio manager who allegedly received insider information from several analysts, who in turn had received that information through a chain of other sources. The government alleged that Chiasson was the fifth person in a tipping chain concerning Dell. Importantly, the government did not allege that Chiasson knew the identity of the insider, but rather alleged that given the circumstances and content of the tip (information on Dell's upcoming financials), and Chiasson's knowledge the information originated from a Dell insider, he must have known the information was tipped in violation of a duty. The government also alleged that Chiasson traded on material nonpublic information about NVIDIA that he received through a similar five-link tipping chain. Unlike with the Dell tipping chain, Chiasson knew that the NVIDIA information had originated from an employee of NVIDIA, although he did not know the insider personally. The government alleged Newman was involved in tipping chains similar to the ones from which Chiasson received information.

The district court instructed the jury that the government had to prove (1) that the insiders had a ''fiduciary or other relationship of trust and confidence'' with their corporations; (2) that they ''breached that duty of trust and confidence by disclosing material, nonpublic information''; (3) that they ''personally benefitted in some way'' from the disclosure; (4) ''that the defendant you are considering knew the information he obtained had been disclosed in a breach of duty''; and (5) that the defendant used the information to purchase a security. After receiving these instructions, the jury convicted Chi-

[2] *Id.* at 662.

[3] *See, e.g.*, United States v. Whitman, 904 F. Supp. 2d 363 (S.D.N.Y. 2012); United States v. Rajaratanam, 802 F. Supp. 2d 491 (S.D.N.Y. 2011); State Teachers Ret. Bd. v. Fluor Corp., 592 F. Supp. 592 (S.D.N.Y. 1984).

[4] *See, e.g.*, United States v. Jiau, 734 F.3d 147 (2d Cir. 2013); United States v. Libera, 989 F.2d 596 (2d Cir. 1993).

[5] 693 F.3d 276 (2d Cir. 2012).

[6] *Id.* at 284.

[7] *Id.* at 293.

[8] *Whitman*, 904 F. Supp. 2d at 371.

[9] *Id.* at 372.

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asson and Newman for insider trading and conspiracy to commit the same.

Chiasson and Newman argued on appeal that the jury instruction were improper because the court did not require the government to prove that the defendants knew that the insiders received a benefit for violating their respective duties of trust and confidence. Chiasson and Newman argued that under the instructions, ''a defendant could be convicted merely if he knew that an insider had divulged information that was required to be kept confidential.''[10] Such a consequence, they argued, ignored *Dirks*, which establishes that a benefit to the tipper is a prerequisite to finding the tipper has breached a duty. To support their position that not all unauthorized disclosures constitute breaches of a duty of trust and confidence, Chiasson and Newman pointed to the SEC's adoption of Regulation FD, which prohibits selective disclosures that do not necessarily entail the breach of a duty of confidence and trust. Because material nonpublic information can be leaked without implicating a breach of duty, Chiasson and Newman argued, the government must prove the defendants' knowledge of the one factor that establishes a breach has occurred—the personal benefit gained by the tipper. Additionally, Newman and Chiasson argued that the Exchange Act's requirement that a violation be ''willful,'' as well as traditional criminal law principles of *mens rea*, require a defendant to know all the facts that make an act illegal in order to be convicted.

The government, on the other hand, argued that *Dirks* requires only that the government prove the tipper received a personal benefit—not that the tippee knew of that benefit. It pointed to several cases, including *Obus*, where the government was not required to prove the tippee's knowledge of a benefit received by the tipper. The government argued that requiring proof that each successive tippee knew the insider benefitted would allow tippees who knew of the insider's breach of duty—but not the benefit obtained by the insider—to escape liability.''[11]

On appeal, the Second Circuit accepted Newman's and Chiasson's arguments, holding that ''in order to sustain a conviction for insider trading, the Government must prove beyond a reasonable doubt that the tippee knew that an insider disclosed confidential information in exchange for a personal benefit.''[12] The court explained that under *Dirks*, the tipper's breach of a fiduciary duty triggers insider trading liability. That breach is established by showing the benefit received by the tipper. Therefore, to establish that the tippee knew of the tipper's breach, the government must show that the tippee knew of the personal benefit gained by the tipper. The court rejected the government's position that ''liability may be imposed upon a defendant based only on knowledge of a breach of the duty of confidentiality,'' remarking that it is easy to envision an instance in which a trader received a tip, but was unaware his conduct was illegal.

The court questioned the Government's recent practice, which it characterized as a ''doctrinal novelty'' of prosecuting remote tippees, explaining that it was not aware of ''a single case in which tippees as remote as Newman and Chiasson have been held criminally liable for insider trading.'' Importantly, the court set forth a high evidentiary burden for the government to prove a tippee's knowledge of the benefit obtained by a tipper. It held that without direct proof of a tippee's knowledge of a benefit to the tipper, such knowledge may not be inferred by virtue of a personal relationship between the tipper and tippee ''absent proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of pecuniary or similarly valuable nature.'' In Newman's and Chiasson's cases, ''career advice'' between a tippee and tipper higher up the tipping chain was insufficient to satisfy this burden.

## The Future of Insider Trading Prosecutions Against Remote Tippees

It is reasonable to expect that the Second Circuit's opinion will give pause to those prosecutors and regulators who were previously inclined to prosecute remote tippees of inside information. *Newman's* explicit requirement to prove that a tippee knew of the tipper's benefit and its high evidentiary burden for demonstrating that knowledge will make such prosecutions difficult. Indeed, short of a wiretap or a complicit cooperating informant, it is difficult to conceive of what types of evidence would be sufficient to establish knowledge of the tipper's benefit with respect to a tippee who was four or five degrees removed from the original source, as was the case with Chiasson and Newman.

Given the lower burden of proof in civil cases, *Newman* may not preclude the SEC from bringing charges against downstream tippees in administrative and civil cases. Nonetheless, after *Newman*, the SEC will need to prove by a preponderance of the evidence that tippees knew of the benefit received by tippers, a fact the SEC has previously argued it need not establish. Certainly this new burden will at the very least change the SEC's calculus about charging tippees. Consider, for example, the SEC's 2014 announcement that it was charging six individuals involved in insider trading in advance of GSI Commerce's acquisition by eBay.[13] Three of the six individuals charged in that matter were third or fourth degree tippees, with each of whom the SEC settled charges in administrative proceedings. The cease-and-desist orders against the downstream tippees lack facts demonstrating that the tippees knew of the benefit to the original tippers. It is questionable whether given the burden set forth in *Newman*, the SEC would still be able to extract settlements from those third and fourth degree tippees. Interestingly, the SEC entered into its first non-prosecution agreement with one fourth degree tippee—possibly in recognition that it would have had difficulty proving that tippee's knowledge of a breach of duty.

[10] United States v. Newman, Brief for Appellant-Defendant Anthony Chiasson at 50, No. 13-1837 (2d Cir., Aug. 15, 2013).

[11] United States v. Newman, Brief for the United States of America at 56-57, No. 13-1837 (2d Cir., Nov. 14, 2013).

[12] United States v. Newman, Nos. 13-1837, 13-1917 (2d Cir. Dec. 10, 2014).

[13] See U.S. SEC. & EXCH. COMM'N, *SEC Charges Six Individuals With Insider Trading in Stock of E-Commerce Company Prior to Acquisition by eBay* (Apr. 25, 2014) *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541642140#.VIizNNLF-nk.

## Conclusion

The Second Circuit's statement in dicta that ''nothing in the law requires a symmetry of information in the nation's securities markets'' seems like a shot across the bow of prosecutors and regulators who—at least according to the defense bar—have been increasingly aggressive in pursuing insider trading cases against remote tippees in recent years. Time will tell if they heed the court's warning.

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