Second Circuit: Court Vacates Insider Trading Convictions in Landmark Case

In *United States* v. *Newman et al.*, the U.S. Court of Appeals for the Second Circuit held 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 *and* that he did so in exchange for a personal benefit."[1] This landmark decision heightens the standard for prosecuting individuals who are not directly connected to the source of confidential information in insider trading cases, and calls into question a number of criminal convictions and guilty pleas secured by the office of the U.S. Attorney for the Southern District of New York.

I. Background

In connection with an ongoing investigation into suspected insider trading activity at hedge funds, in August 2012 the Government secured a grand jury indictment against Todd Newman, a portfolio manager at Diamondback Capital Management, and Anthony Chiasson, a portfolio manager at Level Global Investors. The defendants were charged with conspiring to commit securities fraud in violation of 18 U.S.C. § 371, and with violating Sections 10(b) and 32 of the Securities Exchange Act of 1934, SEC Rules 10b-5 and 10b5-2 and 18 U.S.C. § 2. During a six-week trial before Judge Richard Sullivan, the Government alleged that a group of financial analysts exchanged information they received both directly and indirectly from company insiders at Dell Inc. and NVIDIA Corp. regarding earnings, and these analysts then passed the information to portfolio managers, including Newman and Chiasson, who executed trades based on this information and reaped millions in profits. Although some of the tippers in the chain of information had not been charged with any wrongdoing, the Government charged Newman and Chiasson with insider trading, arguing that as sophisticated traders they must have known the information they received was in breach of a fiduciary duty.[2]

Newman and Chiasson moved for a judgment of acquittal under Federal Rule of Criminal Procedure 29, arguing the Government had not presented evidence that the corporate insiders provided inside information in exchange for a personal benefit as required under *Dirks* v. *S.E.C.*[3] Newman and Chiasson argued that because a tippee's liability derives from the liability of the tipper, they could not be found guilty of insider trading. The defendants also argued that even if the insiders did receive a personal benefit, the Government did not present evidence showing the defendants knew of this benefit and therefore could not be convicted. Alternatively, the defendants argued that the court should instruct the jury that it must find that the defendants knew that the corporate insiders disclosed confidential information in exchange for a personal benefit in order to find guilt. The district court reserved decision on the Rule 29 motions and did not give the requested jury instruction. The jury found the defendants guilty on all counts and the defendants appealed. A unanimous panel of the Second Circuit reversed the convictions and directed that the indictment be dismissed with prejudice.[4]

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1 2014 WL 6911278, at *1 (2d Cir. Dec. 10, 2014), *also available at* http://www.ca2.uscourts.gov/decisions/isysquery/6f4b85b9-9ff9-4fdc-8e2e-5109500989b7/1/doc/13-1837_opn.pdf#xml=http://www.ca2.uscourts.gov/decisions/isysquery/6f4b85b9-9ff9-4fdc-8e2e-5109500989b7/1/hilite/.

2 *Id.* at *2.

3 463 U.S. 646, 672 (1983) (requiring that an insider have "the improper purpose of personal gain" to show a breach of fiduciary duty owed to shareholders and establish insider trading liability).

4 *Newman*, at *14.

II. Second Circuit Concludes that Government Must Prove Both that the Tippee Knew the Information was Confidential *and* that it was Divulged for a Personal Benefit

Under traditional insider trading analysis, there is no general duty to abstain from trading on material, non-public information. Instead, the duty to disclose or abstain from trading is derivative from that of the insider's duty. The law has developed so that insiders who have breached a duty of confidentiality to shareholders by disclosing information and who have received a personal benefit in exchange for disclosing may be liable for securities fraud. Individuals (tippees) who receive information from insiders and who know of the insider's breach of confidentiality and use that information for personal gain may also be criminally liable since their duty derives from that of the insider.[5]

It is the fiduciary breach by an insider that triggers liability for securities fraud. An insider's disclosure of confidential information standing alone is not a breach. In *Newman,* the Court of Appeals held that, without establishing that the tippee knows of the personal benefit received by the insider in exchange for the disclosure of confidential information, there is no proof that the tippee knew of a breach. The result is that the Government must now prove 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 the information to trade in a security or tip another individual for personal benefit."[6]

The Court of Appeals held that the district court's jury instructions were insufficient because the jury was not instructed that the government had to prove beyond a reasonable doubt that Newman and Chiasson "knew that the tippers received a personal benefit for their disclosure."[7] The court found this error was not harmless, and that the evidence presented was insufficient to sustain a guilty verdict because the Government's evidence of personal benefits received from the alleged insiders was "insufficient to establish the tipper liability from which the defendants' tippee liability would derive."[8] Moreover, even assuming that the evidence was sufficient, the court held that the Government did not present any evidence to show that Newman and Chiasson knew they were trading on inside information "obtained from insiders in violation of those insiders' fiduciary duties" as Chiasson and Newman barely knew anything about the Dell and NVIDIA insiders.[9] The convictions were vacated and the court instructed the district court to dismiss the indictment with prejudice with respect to Newman and Chiasson.

III. Landmark Decision with Reverberating Effects on Securities Law

In its decision, the Second Circuit noted that every other district court judge in the Southern District of New York (except for the trial judge) that has confronted the question of whether proving a tippee's knowledge of the insider's breach requires knowledge that the insider disclosed the information in exchange for a personal benefit has found such knowledge necessary to establish liability. This includes the 2014 case *United States* v. *Rajaratnam* in which a federal judge ruled during trial that the Government failed to prove the defendant had knowledge of the personal benefits given to insiders.[10]

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5 *Id.* at *4-*5.

6 *Id.* at *8.

7 *Id.*

8 *Id.* at *1.

9 *Id.* at *1, *11.

10 *See id.* at *8; Nate Raymond, "Two counts tossed in Rajaratnam brother's insider trading trial," REUTERS, July 1, 2014,

The court also noted that its conclusion comports with traditional principles of criminal law by requiring that defendants know the facts that make their conduct illegal.[11] In addition to changing the landscape of insider trading liability, this decision may have a direct impact on another case, *United States* v. *Steinberg*, in which the same district court judge adopted the standard used in Newman and Chiasson's case.[12] This precedent will have a large impact on how insider trading cases are prosecuted in the future, especially in cases where the tippee is not directly connected to an insider, and may result in more convictions being overturned in light of the heightened standard.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Dana Walsh at 212.701.3142 or dwalsh@cahill.com.

http://www.reuters.com/article/2014/07/01/us-usa-insidertrading-rajaratnam-idUSKBN0F65EU20140701.

11 *Newman*, at *8.

12 *See* 2014 WL 20111685, at *8 (S.D.N.Y. May 15, 2014).