SULLIVAN & CROMWELL LLP

December 11, 2014

Scope of Criminal Insider Trading Liability for Remote Tippees

United States v. *Newman*: Second Circuit Reverses Insider Trading Convictions; Requires That Tippee Know of Benefit Received by Insider; Strengthens Evidentiary Showing Required To Prove Benefit

SUMMARY

On December 10, 2014, the United States Court of Appeals for the Second Circuit issued an important decision narrowing the scope of so-called tippee liability—the liability of individuals who, though not insiders, receive material, non-public information from insiders either directly or indirectly and trade on the basis of that information. In reversing the insider trading convictions of two hedge fund portfolio managers, the Second Circuit rejected the legal theory pursued by the Government in a number of recent prosecutions of remote tippees, holding that criminal insider trading liability does not attach to a tippee who trades on the basis of material, non-public information unless the tippee knows that the insider disclosed the information in exchange for a "personal benefit." *United States* v. *Newman*, No. 13–1837–cr (L) (2d Cir. Dec. 10, 2014). As an independent ground for reversal, the Court found that the Government had failed to establish the required personal benefit through the evidence it had offered, which showed only ephemeral benefits, such as "career advice" provided by the tippee to the tipper, or a casual friendship between the tipper and tippee.

After *Newman*, prosecutors will face higher hurdles in imposing insider trading liability on tippees who did not participate in or know of the circumstances surrounding the original disclosure by the tipper. The decision also indicates that provision of inside information to casual friends or acquaintances, absent some receipt by the insider of a pecuniary or similarly valuable benefit, should not result in criminal liability. The Second Circuit's ruling should not, however, significantly impact prosecutions of *quid pro quo* exchanges of inside information in return for sufficient personal benefit.

BACKGROUND

The charges against Todd Newman, a portfolio manager at Diamondback Capital Management, LLC, and Anthony Chiasson, a portfolio manager at Level Global Investors, L.P., arose from the extensive probe conducted by the United States Attorney for the Southern District of New York into suspected insider trading at a number of hedge funds. The indictment charged that between approximately 2007 and 2009, a group of hedge fund analysts exchanged material, non-public information obtained both directly and indirectly from insiders at Dell, Inc. and NVIDIA Corporation and then provided that information to portfolio managers at their respective funds. According to the indictment, the managers, including Newman and Chiasson, executed transactions in Dell and NVIDIA stock based at least in part on this information. On the basis of these allegations, the Government charged Newman and Chiasson with (i) securities fraud, in violation of sections 10(b) and 32 of the Securities Exchange Act of 1934, Securities and Exchange Commission Rules 10b-5 and 10b5-2, and 18 U.S.C. § 2; and (ii) conspiracy to commit securities fraud, in violation of 18 U.S.C. § 371.

During a six-week jury trial held in 2012 in the Southern District of New York, the Government offered evidence that Newman and Chiasson were, respectively, three and four levels removed from the inside tipper at Dell and were each four levels removed from the inside tipper at NVIDIA. The Government did not offer any evidence that Newman or Chiasson knew of the benefits—which were shown to consist of casual friendship and career advice—furnished to the insiders in exchange for providing inside information. On December 17, 2012, the jury convicted Newman and Chiasson on all counts.

DISCUSSION

In a unanimous decision authored by Judge Barrington Parker, the Second Circuit reversed Newman's and Chiasson's convictions on all counts, and ordered dismissal of the indictment with prejudice as it pertained to them, on two independent grounds: (i) that the Government had failed to prove that Newman and Chiasson knew that the alleged insiders received personal benefits in exchange for disclosing the information on which the defendants had traded; and (ii) that the evidence of personal benefit received by the insiders was insufficient as a matter of law.

With respect to the first ground for reversal, the Second Circuit relied primarily on *Dirks* v. *S.E.C.*, 463 U.S. 646 (1983), the Supreme Court's seminal pronouncement on the insider trading liability of tippees. The Second Circuit explained that pursuant to *Dirks*, the liability of a tippee derives solely from the insider's, or tipper's, breach of a fiduciary or other duty to keep the information confidential. Under *Dirks*, simple disclosure does not establish a breach of duty that would support insider trading liability unless the insider receives a personal benefit in exchange for the disclosure. In addition, and as the Government conceded in *Newman*, a tippee is liable under *Dirks* only if he knows that the insider has made the disclosure in breach of a duty. Accordingly, the Second Circuit held that, because the tipper's breach

depends on his receipt of a benefit, it "follow[ed] naturally" that the Government cannot establish a tippee's knowledge of such a breach without demonstrating his knowledge of that benefit.

The Court further couched its conclusion in "well-settled principles" prohibiting criminal liability where a defendant does not "know the facts that make his conduct illegal." The Court stressed that under the federal securities laws, only "willful" violations—whereby the defendant "realiz[es] . . . that he was doing a wrongful act"—are subject to criminal prosecution, and reasoned that a fulsome knowledge requirement "is particularly appropriate in insider trading cases."

In reaching its holding, the Second Circuit rejected the Government's contention that the "specificity, timing, and frequency" of the information provided to Newman and Chiasson warranted inferences that the defendants knew or should have known that the information had been disclosed by corporate insiders in exchange for a benefit. The Court found such inferences impermissible in light of evidence that the defendants could have believed that the information originated from permissible sources, such as sophisticated financial modeling programs or authorized disclosures by investor relations personnel to potential investors.

With respect to the second ground for reversal, the Second Circuit held that the Government had failed to prove that the insiders who provided the information on which Newman and Chiasson traded "received any personal benefit in exchange for their tips." Distinguishing its prior holding that the existence of a friendship or expected reputational gain could provide the basis for such a benefit to a tippee, *see United States* v. *Jiau*, 734 F.3d 147, 153 (2d Cir. 2013), the Court deemed "the mere fact of a friendship" insufficient to constitute a benefit. Rather, the Court concluded that benefit is inferable from a personal relationship only in the presence of "an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." The Court specified that this showing "requires 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.'" Applying this standard, the Court deemed insufficient the evidence of career advice and casual friendship provided to the Dell and NVIDIA tippers in *Newman*.

IMPLICATIONS

Newman will make future prosecution of both remote and immediate tippees significantly more difficult in several respects.

- First, the decision clarifies that, within the Second Circuit, a tippee can be held criminally liable for insider trading only if she knew of the benefit, such as monetary payments or gifts, received by an insider in exchange for the insider's disclosure of material, non-public information.
- Second, the decision makes clear that the mere content, timing, specificity, or other circumstances of a disclosure cannot substitute for such knowledge of a personal benefit, at least not where information bearing similar characteristics could plausibly have become available to the defendant through legitimate channels, such as sophisticated financial modeling tools used to analyze publicly available information.

- Third, *Newman* elevates the evidentiary showing required in tippee prosecutions, regardless of the degree of separation between the tipper and the tippee, to prove that the tippee received a benefit. Casual friendship between a tippee and a tipper will not suffice, and the Government may need to offer evidence of a *quid pro quo*.

Newman may result in a retrenchment in the scope of tippee liability marked out through recent insider trading prosecutions. Indeed, the Second Circuit contrasted the "doctrinal novelty" of recent Government actions "targeted at remote tippees many levels removed from corporate insiders" with its prior decisions upholding convictions where defendant tippees participated directly in a tipper's breach or were "explicitly apprised" of a tipper's benefit by an intermediary tippee. As examples of this line of cases, the Court cited *United States* v. *Falcone*, 257 F.3d 226 (2d Cir. 2001), where an intermediary tippee had described "the details of the scheme" to the defendant, a remote tippee; *S.E.C.* v. *Warde*, 151 F.3d 42 (2d Cir. 1998), where evidence indicated that the tipper and tippee "engaged in parallel trading of the inside information and 'discussed not only the inside information, but also the best way to profit from it'"; and *United States* v. *Mylett*, 97 F.3d 663 (2d Cir. 1996), where the tippee was the direct recipient of inside information.

The Government has indicated that it is considering its options for further appellate review. Consideration of the case by the full Second Circuit would be a rare event, as the Court typically sits *en banc* to hear only one or two cases per year. The Government could seek discretionary review by the U.S. Supreme Court. The possibility also exists that Congress might seek to amend the securities laws to address the issue determined in *Newman*.

Assuming that any challenge to *Newman* proves unsuccessful and that Congress does not amend the securities laws, then this decision likely will substantially limit the Government's efforts to prosecute remote tippees and may refocus insider trading investigations on the direct participants in suspected unlawful conduct.

* * *

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 800 lawyers on four continents, with four offices in the United States, including its headquarters in New York, three offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future related publications from Nathalie-Claire Chiavaroli (+1-212-558-3976; chiavarolin@sullcrom.com) in our New York office.

CONTACTS

New York

Nicolas Bourtin	+1-212-558-3920	bourtinn@sullcrom.com
Brian T. Frawley	+1-212-558-4983	frawleyb@sullcrom.com
Robert J. Giuffra Jr.	+1-212-558-3121	giuffrar@sullcrom.com
Steven R. Peikin	+1-212-558-7228	peikins@sullcrom.com
Karen Patton Seymour	+1-212-558-3196	seymourk@sullcrom.com
Alexander J. Willscher	+1-212-558-4104	willschera@sullcrom.com