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Second Circuit Overturns Insider Trading Convictions of Two Portfolio Managers

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In a blow to the Southern District of New York's impressive run of insider trading convictions, the United States Court of Appeals for the Second Circuit held yesterday that insider trading convictions require the government to prove that the tippee knew that the corporate insider received a personal benefit in exchange for disclosing confidential company information. That was the holding in *United States v. Newman*, where a three-judge panel vacated the convictions of two portfolio managers and remanded the case to the district judge with instructions to dismiss the indictment.

The Second Circuit's ruling clarifies a murky area of insider trading law and puts a limit on the liability of financial analysts, portfolio managers, and others who occasionally trade on information that is not widely available to the public. The Second Circuit summarized the requirements of an insider trading conviction for a tippee as follows:

[T]he Government must prove each of the following elements 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* [*of the tipper*]; and (4) the tippee still used that information to trade in a security or tip another individual for personal benefit.

United States v. Newman, Nos. 13-1837-cr, 13-1917-cr, slip op. at 18 (2d Cir. Dec. 10, 2014) (emphasis added). The decision sets the groundwork for defendant-favorable rulings in ongoing criminal cases that were put on hold pending the ruling in this case. In addition, the ruling is likely to chill future prosecutions of remote tippees because of the added evidentiary burden for the government.

Moving forward from this decision, the government has three primary options. It can ask the Second Circuit to reconsider the case en banc, which could either have the effect of overturning this unfavorable ruling or memorializing it in an en banc decision. The government could also file a petition for a writ of certiorari before the Supreme Court, which has produced both prosecutor- and defendant-friendly rulings in recent criminal cases. Finally, the government could simply accept the Second Circuit's decision in *Newman* and look to curtail the ruling in future cases that present facts more favorable for federal prosecutors.

Case Background

United States v. Newman arose out of a push by prosecutors in the Southern District of New York in the wake of the recent financial crisis to stamp out insider trading at hedge funds. The government alleged that portfolio managers Todd Newman and his co-defendant Anthony Chiasson made $4 million and $68 million for their funds, respectively, in 2008, based on inside information about earnings for Dell and NVIDIA. Both defendants obtained their non-public information through a string of different tippers. For example, Newman received information about NVIDIA from another analyst at his firm, who received the information from a friend, who received the information from another individual, who received the information from the original tipper, an analyst in NVIDIA's finance unit. As a result, Newman and Chiasson were both several steps removed from the corporate insiders who leaked the earnings information: for the Dell earnings numbers, Newman was three levels removed from the original tipper and Chiasson was four levels removed; both were four levels removed from the source of the NVIDIA earnings data. Moreover, neither defendant knew of the original source of the inside information.

A jury ultimately found Newman and Chiasson guilty of violating Section 10(b) and 32 of the Securities Exchange Act of 1934 (codified at 15 U.S.C. §§ 18j(b), 78ff), Securities and Exchange Commission Rules 10b-5 and 10b5-2 (codified at 17 C.F.R. §§ 240.10b-5, 240.10b5-2), and conspiracy to commit securities fraud. Section 10(b) itself does not expressly outlaw insider trading, but instead it bars the use of, "in connection with the purchase or sale of any security[,] . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe . . . ." Courts have interpreted insider trading to be one type of "deceptive device" to violate the securities laws. *See United States v. O'Hagan*, 521 U.S. 642 (1997). Corporate insiders who possess and act on non-public information may be liable for insider trading where they personally benefit from their knowledge. *Id.* The use of non-public information for personal gain is considered a breach of fiduciary duty.

On appeal, the Second Circuit relied on two key principles in reaching its decision in favor of Newman and Chiasson. First is the principle that liability for those who receive tips from insiders flows from the initial breach of fiduciary duty by the insider – not from any independent wrongdoing in acting on otherwise non-public information. *See Chiarella v. United States*, 445 U.S. 222, 230 n.12 (1980) ("The tippee's obligation has been viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty."). Second, liability under Section 10(b) and Rule 10b-5 requires scienter, which has been defined as "a mental state embracing intent to deceive, manipulate or defraud." *Newman*, slip op. at 12 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976)). More specifically, for a criminal conviction, the government must demonstrate that a defendant acted "willfully," which demands that prosecutors show "a realization on the defendant's part that he was doing a wrongful act under the securities laws." *Id.* (quoting *United States v. Cassese*, 428 F.3d 92, 98 (2d Cir. 2005)); *see also* 15 U.S.C. 78ff(a).

Relying on those two tenets of insider trading law, the Second Circuit held that a tippee can only be convicted for insider trading where the evidence demonstrates that he knew the original source of that information – the corporate insider – breached a fiduciary duty by "divulg[ing] the information for personal benefit." *Id.* at 18. As a result, the Second Circuit found that the district judge's jury instructions were erroneous because he failed to instruct the jury that they had to find proof beyond a reasonable doubt that the defendants knew that the corporate insider received a personal benefit for disclosing the inside information. Furthermore, the Circuit determined that the judge's instructional error was not harmless because there was insufficient evidence from which the jury could have found that Newman and Chiasson "inferred from circumstances that some benefit was provided" to the corporate insiders who were the sources of the original tip. *Id*. at 19. Finally, the Second Circuit concluded that even when viewing the evidence in the light most favorable to the government, the prosecution's evidence of any personal benefit flowing to the corporate insiders was severely lacking.

Takeaway

The case is significant for the way it limits the ripple effect of insider information disclosures. In many information leaks, like the one in *Newman*, insider data is repeatedly passed along to different groups of analysts and portfolio managers. While a contrary ruling would have allowed prosecutors to convict anyone who simply knew that the information was confidential and non-public, the Second Circuit rejected this view and reinforced the requirement that a tippee defendant know that the original corporate insider disclosed the information for his or her own personal benefit; *i.e.*, in breach of a fiduciary duty.

This requirement may not be an easy one for prosecutors to satisfy. In *Newman*, the government could not demonstrate that Newman and Chiasson were aware the *sources* of the inside information, let alone the benefits received by those corporate insiders. Moving forward, defendants investigated for acting on tips with insider information will surely latch onto this decision to argue that they did not know the motivations behind those who supplied the tips; that is to say, defendants will argue that they were not aware of any personal benefit that accrued to the insider who was a distant link in the information chain. In certain situations, federal prosecutors could even have trouble demonstrating that the direct recipient of a tip knew that any personal benefit accrued to the corporate insider.