

Client Update

Second Circuit Restores Teeth to Insider Trading Personal Benefit Requirement

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In a landmark decision providing much needed clarity as to the contours of remote tippee liability for insider trading actions, the Second Circuit Court of Appeals yesterday ruled that a tippee must know that an insider disclosed confidential information in exchange for a personal benefit.¹ In reversing the insider trading convictions of Todd Newman and Anthony Chiasson, who were downstream tippees, the Second Circuit resoundingly rejected the Government's theory that knowledge of a breach of the duty of confidentiality alone, without knowledge of the personal benefit, is sufficient to impose criminal liability. In addition, and perhaps even more significantly, the Court ruled that while a personal benefit may be inferred from a personal relationship between the tipper and tippee, such an inference can only be established by proof of a "meaningfully close personal relationship" where the exchange of the personal benefit is "objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." In overturning Newman and Chiasson's convictions, the Court has sharply curtailed liability for tippees and brought into question the government's ability to bring large-scale criminal or civil insider trading cases with tippees that are far removed from the inside tipper.

BACKGROUND

Newman and Chiasson were portfolio managers at Diamondback Capital Management, LLC and Level Global Investors, L.P., respectively, who were alleged to have traded on inside information obtained by employees of Dell, Inc. and Nvidia Corp. Notably, they were not alleged to have any direct contact with the corporate insiders who disclosed the inside information.

Newman and Chiasson requested a jury instruction that the Government was required to prove that the tippee knew that the tipper received a personal

¹ *United States v. Newman and Chiasson*, Case Nos. 13-1837-cr; 13-1917-cr (2d Cir. Dec. 10, 2014).

benefit, but the District Court found that a “tipper’s breach of fiduciary duty and receipt of a personal benefit are separate elements and that the tippee need know only of the former.”² The District Court instructed the jury that the Government only needed to prove that Newman and Chiasson knew that the information “was originally disclosed by the insider in violation of a duty of confidentiality.”³

THE SECOND CIRCUIT’S OPINION

The Second Circuit ruled that the District Court’s jury instructions were in error. The Court’s opinion noted that “Newman and Chiasson were several steps removed from the corporate insiders,”⁴ either three or four levels removed from the inside tippers.⁵ The opinion stated that “the Government has not cited, nor have we found, a single case in which tippees as remote as Newman and Chiasson have been held criminally liable for insider trading.”⁶

In overturning the convictions of Newman and Chiasson, the Court found 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.”⁷ Therefore, the Court found that the Government must establish that “the tippee knows of the personal benefit received by the insider in exchange for the disclosure.”⁸ The Court held that to find a tippee criminally liable, the Government must prove each of the following elements:

- (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 that information to trade in a security or tip another individual for personal benefit.⁹

² *United States v. Newman*, 2013 WL 1943342 at *2. (S.D.N.Y. May 7, 2013).

³ *United States v. Newman and Chiasson*, Case Nos. 13-1837-cr; 13-1917-cr, at 8 (2d Cir. Dec. 10, 2014).

⁴ *Id.* at 5.

⁵ *Id.* at 6.

⁶ *Id.* at 15.

⁷ *Id.* at 14.

⁸ *Id.*

⁹ *Id.* at 18.

In addition to finding that the tippee must have knowledge of the tipper's personal benefit, the Court found that the personal benefit received "must be of some consequence."¹⁰ The Court held that an inference of personal benefit based on the personal relationship between tipper and tippee 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."¹¹ The Court further limited the inferences that could be made from the specific nature of the information being shared by finding that "even if detail and specificity could support an inference as to the *nature* of the source, it cannot, without more, permit an inference as to the source's improper *motive* for disclosure."¹² Under this standard the Court found that the Government's evidence of Newman and Chiasson's knowledge of the tippers' personal benefit was insufficient to sustain their convictions on either the substantive insider trading counts or the conspiracy count.

IMPLICATIONS

The Second Circuit's ruling has far-reaching implications for the Government's ability to bring large-scale insider trading cases. In prosecuting its recent spate of insider trading cases, the government has often used tippers as cooperators in an effort to convict the tippees that actually traded on the information. Often, as in *Newman and Chiasson*, these tippees were three or four levels removed from the tippers' original disclosures. It will be extremely challenging for criminal prosecutors to find evidence that a remote tippee knew the tipper received a significant personal benefit in exchange for inside information.

The Second Circuit's ruling may also have widespread consequences for all tippee liability, even if the tippee is directly in contact with the tipper. The Court strongly suggests that the benefit must be significant, resulting in either immediate or future pecuniary gain. Prosecutors will no longer be able to bring a case alleging a vague reputational benefit that can be implied by the personal relationship between tipper and tippee.

The Court's decision will likely affect many of the U.S. Attorney's convictions currently on appeal, including, most notably, that of SAC Capital portfolio manager Michael Steinberg, whose case was also tried before Judge Sullivan because the government added Mr. Steinberg to a superseding indictment in the Newman and Chiasson prosecution, even after those defendants had already

¹⁰ *Id.* at 22.

¹¹ *Id.*

¹² *Id.* at 27.

been convicted, an exercise in judge-shopping that did not go unnoticed by the Panel. Many other individuals who have already pled guilty may also seek to have their pleas withdrawn.

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Please do not hesitate to contact us with any questions.