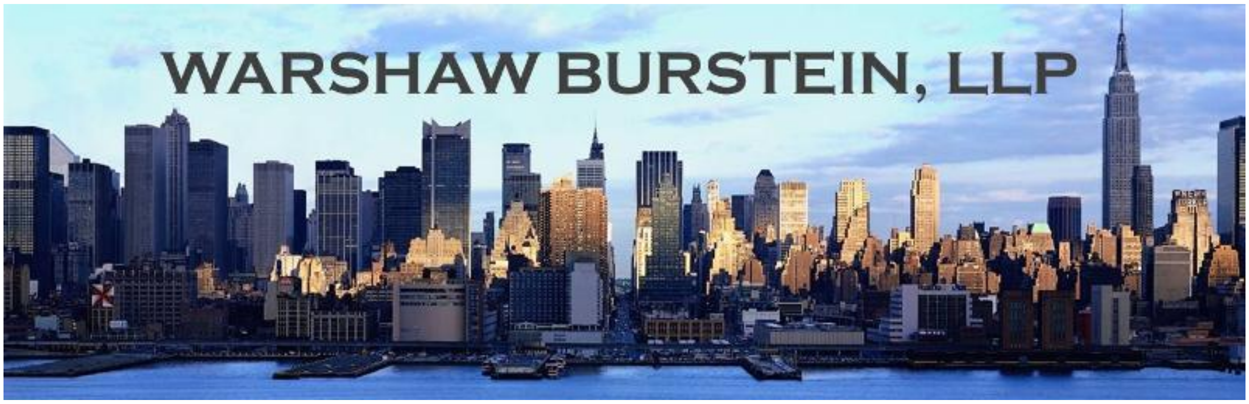

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Client Alert

Second Circuit Clarifies Requirements of Insider Trading Liability for Tippees

In a landmark decision, in *United States v. Newman, et al*,[1] the United States Court of Appeals for the Second Circuit vacated the insider trading convictions of two former portfolio managers who were "remote" tippees, and held that to sustain an insider trading conviction against a tippee, the government must prove that the tippee knew that the insider or tipper disclosed confidential information *and* that the insider or tipper did so in exchange for a "personal benefit." The Court clarified that a tippee can be found guilty only if the government establishes that the tippee knew of the tipper's personal benefit and that the benefit is "objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." Slip Op at 22.

Proceedings in the Trial Court

Todd Newman and Anthony Chiasson, portfolio managers at Diamondback Capital Management, LLC and Level Global Investors, L.P., respectively, were convicted of insider trading[2] in securities of Dell Inc. and Nvidia Corp. based upon material, nonpublic information they received about unreleased earnings reports of those issuers. Newman and Chiasson were "remote" tippees -- three and four steps removed from the tippers, who were the corporate insiders who were the original source of the inside information. The Second Circuit vacated defendants' convictions on the

[1] Nos. 13-1837-cr(L), 13-1917-cr(con) (2d Cir.), *available* here.

[2] Section 10(b) of the Securities Exchange Act of 1934 prohibits the use of any manipulative or deceptive device in connection with the purchase or sale of any security. Although Section 10(b) was designed as a catch-all clause to prevent fraudulent practices, neither Section 10(b) nor the regulations issued pursuant to it, including Rule 10b-5, expressly prohibits insider trading. Rather, the unlawfulness of insider trading is a product of case law, and is predicated on the notion that insider trading is a type of securities fraud proscribed by Section 10(b) and Rule 10b-5.

grounds that the government had not proved that they had been aware of the benefits to the insiders and that the trial court's instruction to the jury on that issue was flawed.

The Second Circuit's Reversal in *Newman* Relies on the *Dirks* Case

The Second Circuit's reversal of Newman and Chiasson's convictions was based, in large part, on the landmark case, *Dirks v. SEC*.[3] In *Dirks,* the Supreme Court rejected the SEC's theory that a tippee must refrain from trading whenever he receives inside information from an insider. The Second Circuit, quoting from the decision in *Dirks,* held: "[t]he tippee's duty to disclose or abstain is derivative from that of the insider's duty. Because the *tipper's* breach of fiduciary duty requires that he personally will benefit, directly or indirectly, from his disclosure, a tippee may not be held liable in the absence of such benefit. Moreover, the Supreme Court held that a tippee may be found liable only when the insider has breached his fiduciary duty . . . *and* the tippee knows or should have known that there has been a breach. (emphasis added) (citations omitted)." Slip Op at 11-12. In other words, courts will look to whether the tipper received a personal benefit to determine if the tipper breached a duty by disclosing nonpublic information; in effect, requiring that the insider "sold" the confidential information in exchange for something of quantifiable value.

In reversing the convictions of Newman and Chiasson, the Second Circuit found no support for the government's contention that "knowledge of a breach of the duty of confidentiality without knowledge of the personal benefit is sufficient to impose criminal liability." Slip Op at 16. In rather strong language, the Second Circuit stated, "[A]lthough the Government might like the law to be different, nothing in the law requires a symmetry of information in the nation's securities markets." Slip Op at 16.

The Second Circuit adopted the *Dirks* definition of breach of fiduciary duty as "a breach of the duty of confidentiality in exchange for a personal benefit," and accordingly, concluded that "a tippee's knowledge of the insider's breach necessarily requires knowledge that the insider disclosed the confidential information in exchange for personal benefit." Slip Op at 16-17. Because the trial court's jury instruction in *Newman* did not require the jury to find knowledge of a personal benefit, it was in error.

In addition to finding that the defendants did not have knowledge of the personal benefit to the tippers, the Second Circuit also found the government's evidence of personal benefit in exchange for providing inside information to be wanting. The Court observed that "[p]ersonal benefit is broadly defined to include not only pecuniary gain, but also, *inter alia,* any reputational benefit that will translate into future earnings and the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend." (citation omitted) Slip Op at 21. The Court continued that the exchange for personal benefit must be one that is "objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." Slip Op at 22.

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[3] 463 U.S. 646 (1983)

The Requirements for an Insider Trading Conviction

The Second Circuit summarized the requirements to sustain an insider trading conviction against 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; and (4) the tippee still used that information to trade in a security or tip another individual for personal benefit. (citations omitted)

Slip Op at 18.

Conclusion

This decision by the Second Circuit clarified both the heavy burden needed to convict tippees, especially remote tippees, of insider trading, as well as the parameters of what constitutes "personal benefit." Although insider trading cases tend to be fact specific, the *Newman* decision may well hamper other insider trading prosecutions, particularly against remote tippees, who undoubtedly will use this decision to proffer the argument that they were not aware of any personal benefit received by the original tipper.

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If you have any questions about what constitutes "personal benefit" or any other aspect of insider trading, please contact Meryl Wiener, any of the undersigned or your regular Warshaw Burstein attorney.

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