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Second Circuit Narrows Definition of Insider Trading

By Catherine McCaw

The Court's controversial decision in *United States v. Newman* potentially raises the bar for prosecutors in future insider trading cases.

A controversial appellate court ruling in the high-profile insider trading case *United States v. Newman*, 773 F.3d 438 (2014), recently rattled federal prosecutors and got the attention of Wall Street and the financial community nationwide. A federal jury had previously convicted two traders, Todd Newman and Anthony Chiasson, of trading on inside information about publicly traded companies that they had received through a group of rogue Wall Street analysts. The group of analysts formed what they referred to as a "Fight Club," trading inside information within their circle, and then passing the information along to portfolio managers at their funds. Newman and Chiasson, who worked at two different hedge funds, were two of these portfolio managers.

The Second Circuit Court of Appeals overturned the convictions, dealing a loss to prosecutors in the Southern District of New York, potentially making it more difficult for future insider trading prosecutions. The ruling could also raise the bar for prosecutors by requiring authorities to prove that a defendant knew that the insider who provided the tip personally benefited by doing so, even if the defendant is several steps removed from the insider. In addition, the case limited what can be considered a personal benefit, shedding light on a seedy corner of Wall Street, where non-public information is so routinely passed around in advance of its public release that someone trading on it can now potentially avoid liability by claiming to be several steps removed from its origin. In the wake of *Newman*, calls for the enactment of a focused and powerful insider trading statute have become widespread in both the legal and financial communities.

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Overview of Insider Trading Law

Federal prosecutors use the same basic legal tools to bring criminal insider trading prosecutions that private investors use to seek damages on a class-wide basis for securities fraud: Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. Rule 10b-5 prohibits the use of "any device, scheme, or artifice to defraud." Violation of Section 10(b) and Rule 10b-5 can give rise to criminal sanctions where the defendant is shown to have acted "willfully."

Section 10(b) and Rule 10b-5 do not specifically mention insider trading. Instead, Congress and the Securities and Exchange Commission intended Section 10(b) and Rule 10b-5 to be catchall provisions prohibiting a wide variety of fraudulent activity, and left considerable latitude to the courts to define the types of behavior prohibited and to develop standards for enforcement. In accordance with Congress and the SEC's intent, courts have interpreted these laws broadly, and a variety of court-made doctrines have arisen that prohibit certain types of fraudulent activity, including insider trading.

Courts have crafted rules that govern when a person can be criminally liable for insider trading. This doctrine began with the premise that corporate insiders owe a fiduciary duty to the company's shareholders and that they violate that duty if they personally profit by trading on inside information at their shareholders' expense. Similarly, insiders violate their fiduciary duty – and thus can be criminally liable — if they profit by sharing that information with a third party outside their corporation. Courts have also held that someone who receives a tip from an insider and trades on that information can be held criminally liable. But tippees' criminal liability derives from the insider's liability — they can only be held liable if the information came from an insider who breached a fiduciary duty by disclosing inside information and received a benefit in return.

United States v. Newman

Against this backdrop, federal prosecutors brought charges against Newman and Chiasson for trading on inside information that they had received about two technology companies, Dell and NVIDIA. Both Newman and Chiasson were three to four degrees removed from the person who originally received information from an insider, and they received the information after it passed through multiple hands within the investment community.

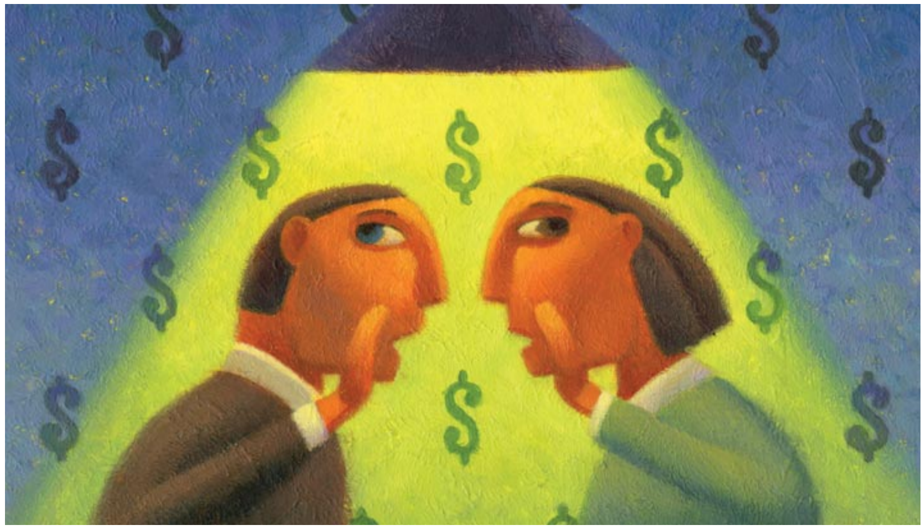
With respect to the information from Dell, Rob Ray, who worked in Dell's investor relations department, originally provided the information to Sandy Goyal. Goyal and Ray both attended business school and worked at Dell together. The information concerning NVIDIA was passed along by Chris Choi, who worked in NVIDIA's finance unit, to Hyung Lim, the original tippee, whom Choi knew socially. Goyal and Choi then shared this information with a number of people within their professional networks.

Newman and Chiasson eventually received and traded on this material non-public information. At trial, the government argued that because of their experience in the finance industry, Newman and Chiasson must have known that the information was disclosed by insiders in breach of their fiduciary duty, rather than just an innocent stock tip. A federal jury agreed, and both men were convicted of insider trading. Newman and Chiasson appealed to the Second Circuit.

The Second Circuit Imposes New Restrictions on Prosecutions

On appeal, the Second Circuit decided two issues, both of which could have important ramifications for future insider trading prosecutions. First, the Second Circuit examined whether Newman and Chiasson could be found guilty of securities fraud when they received a tip that was three or four levels removed from the original tipper. The government argued that it needed to show only that Newman and Chiasson traded on material non-public information that an insider had disclosed in return for a personal benefit. The government argued that it did not need to show that Newman and Chiasson knew that the insider received a benefit for disclosing the information. The mere fact that they traded on the information was enough. The Second Circuit disagreed. It held that insider trading defendants can only be found guilty if the government shows that they knew or should have known that the insider received a personal benefit for the information. Perhaps even more disturbing, the Second Circuit found that despite their sophistication and strong connections to Wall Street, Newman and Chiasson could not have concluded that something illicit was going on based on the timing and frequency of the stock tips they typically receive.

More controversially, the Second Circuit conducted a highly technical examination



of the benefit that insider tippers Ray and Choi had received and found it insufficient to support a conviction for insider trading. Newman and Chiasson could be found guilty only if Ray and Choi had disclosed inside information in return for a "personal benefit." Prior cases had held that an insider had to receive a "personal benefit," but defined that benefit broadly, stating that a "reputational benefit that will translate into future earnings or the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend." The Second Circuit examined the nature of the relationships between Ray and Goyal and between Choi and Lim and concluded that the friendships were too casual for Ray or Choi to have derived a true "personal benefit" from tipping. In the Second Circuit's view, were this enough to count as a "personal benefit," virtually anything could, rendering the requirement a nullity. Instead, it held that if the government wishes to show a personal benefit through a personal relationship, "such an inference is impermissible in the absence of proof of a meaningfully

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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."

Analysis

In the wake of the Second Circuit's decision, many respected commentators have found the Court's result to be dangerously out of step with the realities of insider trading as it is practiced today. The United States Attorney's Office for the Southern District of New York, in a petition for the Second Circuit to rehear the case *en banc* (with all the judges hearing it, not just a panel), "[p]ut simply, if the opinion stands, the panel's erroneous redefinition of the personal benefit requirement will dramatically limit the government's ability to prosecute some of the most common, culpable and market-threatening forms of insider trading."

It is unclear what steps the government will take in response to the decision. The Second Circuit recently denied the government's request to review its decision as a full court *en banc*, meaning that the government's only legal resort in this case is to petition the Supreme Court to hear the case. Of course it is never a certainty that the Supreme Court would take the government's petition, but, at this time, it is unclear whether the government will even petition the Supreme Court. Nearly six months after *Newman* made it harder to win insider trading cases, in a June 5 letter to the Court, federal prosecutors said they are "still considering" whether to seek Supreme Court review of the decision.

Many commentators have suggested that the Second Circuit's decision and the facts of *Newman* demonstrate just how pervasive a "tipping" culture is on Wall Street and that the state of the law is inadequate to combat insider trading. Ray and Choi freely disclosed material, non-public information to acquaintances, apparently without expecting anything in return. At trial, multiple Wall Street insiders testified that companies routinely leak financial results to select analysts, or even provide them with feedback concerning the accuracy of their models when analyzing the company's earnings. The problem for institutional investors then, is that there are people trading with greater information to which they do not have access.

Recently, Representative Jim Himes of Connecticut introduced a bipartisan bill that would define insider trading as a crime separate and apart from Section 10(b). It would have the effect not only of undoing the Second Circuit's holding in *Newman*, but also of codifying and expanding the reach of insider trading prohibitions. Commentators have noted that such a statute could also be fairer to criminal defendants because it would give them more notice about what is and is not illegal than the judicially-made prohibitions in place today. Time will tell whether any legislation gets passed, but if *Newman* prods Congress to pass an insider trading statute at long last, it will have had at least some positive effect.

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