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WHITE-COLLAR CRIME

Expert Analysis

Implications of Second Circuit Reversal Of Insider Trading Convictions

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The Department of Justice has brought few high-profile criminal cases against individuals arising from the 2008-2009 financial crisis. The department's cases have tended to charge large financial institutions, not senior officials. A number of the high-profile cases arising from the collapse of mortgage-backed securities have resulted in civil, not criminal, charges and settlements. And the typical sanction has been the payment of substantial (often multi-billion dollar) sums to the government, not imprisonment.[1]

Amid criticism for what some have seen as insufficient zeal, the insider trading prosecutions brought in recent years in the Southern District of New York have stood out. These cases reached many different financial industry participants—company insiders, research networks, analysts and traders—and often led to charges against senior hedge fund officers. Hedge funds represent a powerful force in financial markets, and these investigations and prosecutions arguably took on outsized importance: These law enforcement efforts came to signify for many people the government's efforts to punish wrongdoing in the financial industry and protect ordinary investors.

In this context, the Second Circuit's recent reversal of the insider trading convictions of portfolio managers Todd Newman and Anthony Chiasson takes on added significance.[2] The decision has already been the subject of considerable commentary, ranging from full-throated approval for the court's rejection of claimed prosecutorial abuse[3] to harsh condemnation of the court's "shield[ing] from accountability Wall Street's corrupt culture by making sophisticated insider trading the perfect crime."[4] On a technical level, the decision clarifies two elements of insider trading liability, namely, (a) the nature of the "personal benefit" of the tipper and (b) the extent of the knowledge required of a tippee to sustain criminal liability.[5] In practical terms, cases against what the Second Circuit calls "remote tippees," that is, individuals several steps removed from the source of the inside information, will be harder to sustain as a result of the Second Circuit's decision.[6]

In this article, after briefly summarizing the holding, we will address two aspects of the decision. First, the Second Circuit's discussion of "personal benefit" to the tipper, a central requirement of tipper/tippee liability, may have the effect of limiting the scope of future tipper/tippee prosecutions generally, not just in the case of remote tippees. Second, the Second Circuit's pointed criticism of what it sees as "the doctrinal novelty of its recent insider trading prosecutions…"[7] may reflect a broader concern over the vagueness of white-collar criminal laws and prosecution theories. In this view, the decision in *United States v. Newman* reflects a common push-pull in white-collar criminal enforcement, in which the judiciary periodically rejects what it sees as prosecutorial overreach.

Decision in 'Newman'

Newman and Chiasson, portfolio managers at separate hedge funds, were found guilty of illegally trading on material, non-public information about two technology companies, Dell and NVIDIA. The information, initially disclosed by company insiders, passed through many hands before reaching the defendants.[8]

The Dell information originated with Rob Ray, an employee in Dell's

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investor relations department. Ray disclosed material, confidential information regarding the company's consolidated earnings numbers to Sandy Goyal, an analyst at Neuberger Berman with whom Ray had attended business school. Goyal shared the information with Jesse Tortora, an analyst at Newman's firm, who in turn gave it to Newman and another analyst at Newman's firm, Spyridon Adondakis. Adondakis then passed on the information to Chiasson. Accordingly, Newman and Chiasson were three and four levels removed, respectively, from the Dell tipper.

The NVIDIA information originated with Chris Choi of NVIDIA's finance unit. Choi disclosed material, confidential information to Hyung Lim, a friend from church who worked in the technology field. Lim passed the information to Danny Kuo, an analyst at another financial firm, who shared the information with fellow analysts from other firms, including Tortora and Adondakis. Tortora and Adondakis then shared the information with Newman and Chiasson, making them each four levels removed from the NVIDIA tipper.

The defendants raised two issues on appeal: First, they challenged the district court's jury instruction, which did not require the government to prove that Newman and Chiasson knew that tippers Ray and Choi had received a personal benefit for disclosing the information; second, they challenged the sufficiency of the evidence as to whether the tippers had, in fact, received a personal benefit for disclosing the material, non-public information at issue in the case.

These issues derive from the test for tipper/tippee liability set forth in *Dirks v. S.E.C.*, the leading case in this area of insider trading liability.[9] Dirks, a controversial Wall Street researcher, obtained information from company insiders about possible fraud at Equity Funding, a high-flying investment firm in the 1960s and 1970s. Dirks passed along the information to clients, who traded on the information before the information from the insiders had been made public. As the information made its way into the market, Equity Funding's stock price dropped sharply, resulting in substantial savings to those clients who sold their shares before the fraud came to light.[10]

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What is striking about *Dirks* is that the decision grew out of an unusual fact pattern: insiders who were seen as having acted as whistleblowers, without any benefit for themselves, unlike the more common situation of some sort of beneficial relationship between tipper and tippee. Faced with these facts, the Supreme Court held that tippers are liable only when they breach a duty by disclosing material, non-public information selfishly, that is in return for a personal benefit, and that tippees in turn are liable only when they trade on such information when the tipper gets such benefit, and they know of the tipper's breach of duty.[11]

The Second Circuit in *Newman* addressed uncertainty left in the Dirks test. On the issue of what knowledge was required of tippees, the court rejected the government's position that knowledge of a tipper's breach of the duty of confidentiality alone—without additional knowledge of the tipper's personal benefit—is sufficient to impose liability. The Second Circuit held, consistent with most of the district courts that had addressed the issue, that the tippee's knowledge of the insider's breach necessarily requires knowledge that the insider disclosed information in exchange for a personal benefit. This result followed from the holding in *Dirks* that tippee liability requires knowledge of the tipper's breach of a duty, and that duty is breached only when the tipper received a personal benefit in exchange for the disclosure.[12]

On the second issue raised on appeal, concerning what is required to constitute a personal benefit, the court agreed with the defendants that the government had presented insufficient evidence on the issue to sustain their convictions. As a result of this ruling, the government was prevented from retrying the defendants.

As to the Dell tip, the government argued chiefly that, in the context of a friendship, Goyal provided career advice to Ray which was sufficient to constitute a personal benefit. According to the government, the evidence showed that Ray and Goyal had known each other for years, knew each other's wives, talked about vacationing together and spoke frequently, "often for long periods of time, late at night while each of them was at home." The government pointed to Goyal's job-related assistance to Ray, which included "providing advice, reviewing Ray's resume, sending it to a Wall Street recruiter, and recommending Ray to a potential employer";[13] on a particular day, according to the government, after receiving vital confidential information, Goyal sent Ray a "pitch" to use in a job interview.[14]

As to the NVIDIA tip, the government relied chiefly on the relationship between Lim and Choi, not an exchange of cash or gifts. Citing

evidence that Lim told Choi he was trading NVIDIA stock, the government argued that "Choi's tips resembled 'trading by the insider himself followed by a gift of the profits to the recipient,'" as required by *Dirks*.[15]

The court rejected the government's position, holding that "[t]he circumstantial evidence in the case was simply too thin to warrant the inference that the corporate insiders received any personal benefit in exchange for their tips."[16]

Personal Benefit Holding

The Second Circuit's holding on personal benefit has the potential of limiting the scope of liability—not just in remote tippee cases, but in cases of tippers and tippees generally. Under the Newman decision, to satisfy the personal benefit requirement, the relationship between tipper and first-level tippee must involve "an exchange," and an exchange that "suggests a quid pro quo from the [tippee]…."[17]

In *Newman*, the Second Circuit described the state of the law as "permissive," noting its comment in 2012 that "[i]n light of the broad definition of personal benefit set forth in *Dirks*, th[e] bar is not a high one."[18] Courts were interpreting the term "personal benefit" broadly to include pecuniary gain as well as "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."[19]

The holding in *Newman* should raise the bar for future prosecutions. The Second Circuit held that the personal benefit requirement was not met "by the mere fact of friendship, particularly of a casual or social nature." The court observed that if evidence of two individuals attending the same school or church were deemed sufficient, the personal benefit requirement would essentially be nullified.[20]

Rather, "in order to form the basis for a fraudulent breach, the personal benefit received in exchange for confidential information must be of some consequence." An inference of personal benefit from a relationship between tipper and tippee is not permissible absent "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."[21] As with other elements of insider trading, case law will determine what the tighter standard means in practice.

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Conclusion

In *Newman*, the Second Circuit did not set out simply to decide the cases immediately before it and to clarify key elements of insider trading liability; the court also wished to address what it termed "the doctrinal novelty of [the government's] recent insider trading prosecutions," especially those targeting remote tippees.[22] In the court's view, the government was in effect pursuing a theory of liability based on informational asymmetry, which had been rejected by prior case law.[23]

The Second Circuit's concern with the government's theory of prosecution is reminiscent of those occasions when the Supreme Court has called a halt to what it viewed as a misreading of a broad criminal statute and overzealous prosecution, notably, in the area of honest services mail and wire fraud,[24] though other examples can be found.[25] At these moments, the judicial and executive branches of government are speaking to one another, with Congress sometimes adding its voice, and the constitutional framework of separate powers seems real and vital. Time will tell how the dialogue turns out on the scope of liability for insider trading.

1. See Elkan Abramowitz and Jonathan S. Sack, "The 'Civilizing' of White-Collar Criminal Enforcement," NYLJ (May 7, 2013); Elkan Abramowitz and Jonathan S. Sack, "Why So Few Individuals? Government's Prosecution of Corporate Misconduct," NYLJ (March 5, 2013).
2. *United States v. Newman*, ___ F.3d ___, 2014 WL 6911278 (2d Cir. Dec. 10, 2014).
3. Opinion, "An Outside the Law Prosecutor," The Wall Street Journal (Dec. 10, 2014).
4. William K. Black, "The Second Circuit Makes Sophisticated Insider Trading the Perfect Crime," New Economic Perspectives Blog (Dec. 11, 2014).
5. Robert J. Anello and Richard F. Albert, "Second Circuit to Resolve Split on Insider Trading," NYLJ (Dec. 3, 2013).
6. Randall Eliason, "Got a Hot Stock Tip? Second Circuit Clarifies the Law of Insider Trading," Sidebars Blog (Dec. 24, 2014).
7. 2014 WL 6911278 at *6.
8. Unless otherwise noted, the facts set forth in this article are taken from the Second Circuit's decision. Id. at **1, 10-11.
9. 463 U.S. 646 (1983).
10. Id. at 650.
11. Id. at 654, 661.
12. 2014 WL 6911278 at *6, 8.
13. Brief for the United States of America, *United States v. Horvath*, 2013 WL 6163307, ** 85-88 (Nov. 14, 2013).
14. Id. at *16.
15. Id. at *89-90.
16. 2014 WL 6911278 at *10.
17. Id.
18. *SEC v. Obus*, 693 F.3d 276, 292 (2d Cir. 2012).
19. *United States v. Jiau*, 734 F.3d 147, 153 (2d Cir. 2013).
20. 2014 WL 6911278 at *10.
21. Id.
22. Id. at *6.
23. Id. at *7.
24. *Skilling v. United States*, 561 U.S. 358 (2010); *McNally v. United States*, 483 U.S. 350 (1987).
25. *Ratzlaf v. United States*, 510 U.S. 65 (1994).