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Insider Trading After 'Newman'—What's Left to Resolve?

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The prosecution of insider trading in the U.S. Court of Appeals for the Second Circuit has been reshaped by the decision in *United States v. Newman*.[1] The appeals court held that the government is required to prove that a recipient, or tippee, of material, non-public information knew that the tipper had received a "personal benefit" for disclosing such information, and, further, the court made it harder for the government to prove that a tipper had received a personal benefit for making the tip—a requirement for tipper/tippee insider trading liability.

From the start, *Newman* has been controversial. The government has assailed *Newman* as an "erroneous redefinition of the personal benefit requirement [that] will dramatically limit the Government's ability to prosecute some of the most common, culpable, and market-threatening forms of insider trading."[2] In contrast, securities law experts have argued that *Newman* set down important limits on liability: The government's expansive view of the personal benefit standard would deter important communications between corporate employees and market analysts and thereby undermine the efficiency and integrity of the capital markets.[3]

On Oct. 5, the U.S. Supreme Court denied the Department of Justice's petition to review the case. *Newman* is thus controlling law in the Second Circuit, at least until the Supreme Court revisits insider trading law, which it last did in 1997.[4] Denial of the department's petition has had a direct effect on pending prosecutions. Most recently, the U.S. Attorney's Office for the Southern District of New York moved to dismiss charges against Michael Steinberg, a former hedge fund portfolio manager, and allowed six cooperating witnesses to withdraw their guilty pleas "in the interests of justice."[5]

In this article, we briefly describe how *Newman* has affected the personal benefit standard in insider trading cases and review how courts have reacted to the holding in *Newman*, and then suggest what issues remain to be resolved. The current uncertainty gives rise to possible challenges to criminal liability on the basis of principles of lenity and separation of powers. We further consider recent thoughtful proposals for legislative reform by two judges in the Southern District, Judges Jed Rakoff and Paul Engelmayer, who explain why further judicial development of insider trading doctrine may not suffice to address the issues left following the Newman decision.

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Personal Benefit Standard

In *Dirks v. SEC*,[6] the Supreme Court made receipt of personal benefit by the tipper a requirement before imposing liability on a tipper or tippee for insider trading. *Dirks* held that personal benefit could be in the form of a monetary or other benefit given to the tipper, or in the nature of a gift the tipper made to a friend or relative.

In *Newman*, the Second Circuit recognized that a personal benefit includes "the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend."[7] However, in a critical passage, the court limited the circumstances in which making a gift of confidential information would qualify as a personal benefit:

> To the extent *Dirks* suggests that a personal benefit may be inferred from a personal relationship between the tipper and tippee, where the tippee's trades resemble trading by the insider himself followed by a *gift* of the profits to the recipient, we hold that such an inference is impermissible in the absence of a 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.[8]

Many commentators have found the court's language in this passage to be confounding. They say that a "gift" by definition is not an "exchange." It is unclear how a gift of confidential information can satisfy the court's "exchange" criterion. Based on this apparent tension, the Justice Department's petition for certiorari argued that *Newman* "rewrote the concept of a 'gift' so as to eliminate it."[9]

Quid Pro Quo

While the government has criticized *Newman* for trying to equate a gift and an exchange, insider trading defendants have seized on *Newman* to argue that the personal benefit standard requires an "exchange," and that a mere gift of inside information is insufficient. Yet, thus far, courts have rejected a reading of *Newman* that would, in effect, negate liability for a gift of material, non-public information from the tipper to a friend or relative.

In *United States v. Gupta*,[10] for example, Rajat Gupta petitioned the court to overturn his conviction for giving Raj Rajaratnam confidential information concerning Goldman Sachs board meetings. Gupta argued that *Newman* "requires that a tipper (here Gupta) receive from his tippee (Rajaratnam) a 'quid pro quo' in the form of a potential gain of a pecuniary or similarly valuable nature," and that the government had failed to make such a showing at trial.[11] Judge Rakoff rejected Gupta's argument, holding that a quid pro quo is not required to establish a personal benefit.

In *United States v. Salmon*,[12] the U.S. Court of Appeals for the Ninth Circuit also rejected a defendant's argument that a personal benefit always requires a quid pro quo. Interestingly, Judge Rakoff, sitting by designation, wrote the opinion for the Ninth Circuit panel. Salmon was

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a remote tippee—that is, a tippee who is more than one step removed from the original source of insider information—and the corporate insider and his direct tippee were brothers. The tipper did not receive a tangible benefit in exchange for providing his brother material, non-public information. However, the tipper testified that he gave his brother confidential information to "benefit him" and fulfill "whatever needs he had."[13]

Like Gupta, Salmon argued that the government was required to prove that the tipper had obtained a "tangible benefit in exchange for the inside information," but had failed to do so.[14] The Ninth Circuit acknowledged that *Newman* is arguably ambiguous on this point but held that to "the extent *Newman* can be read to go so far, we decline to follow it."[15] The court held that a gift of confidential information to a trading relative or friend suffices to meet the personal benefit requirement. The court also noted that accepting Salmon's argument would have the untenable consequence that insiders could tip their relatives with impunity if they asked for nothing in return.[16]

What Is a Personal Benefit?

Newman made clear what the government must prove about a remote tippee's state of mind—namely, that the tippee knew of the personal benefit to the original tipper—but left uncertainty as to what constitutes a personal benefit. As suggested by the Ninth Circuit's decision in *Salmon*, courts outside the Second Circuit may not accept the limitations suggested by *Newman* and thus may permit a personal benefit to be inferred from personal, professional or other relationships that do not rise to the level of a "meaningfully close relationship." Further, to the extent that *Newman's* personal benefit standard is applied, it is unclear what is required for a "gift" of confidential information to "generate[] an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[17]

Against this backdrop, two distinct arguments arise that may be litigated in future cases. First, the rule of lenity holds that a criminal statute should be strictly construed to provide fair warning of the prohibited conduct. The rule "ensures fair warning by resolving ambiguity in a criminal statute so as to apply it only to conduct clearly covered."[18] When, as with insider trading, the relevant statute or administrative regulation provides little guidance, the rule of lenity applies to the case law that establishes the scope of criminal liability.[19] Because the personal benefit standard remains uncertain, the government could be hard pressed to show that a personal benefit is "clearly covered" by the case law.

Second, the principle of separation of powers may give rise to a distinct, if related, challenge to the current state of judge-made insider trading law. In a 2014 "statement" regarding a denial of certiorari in an insider trading case, Justice Antonin Scalia, joined by Justice Clarence Thomas, signaled his view that "only the *legislature* may define crimes" and, accordingly, "Congress cannot, through ambiguity, effectively leave that function to the courts—much less to the administrative bureaucracy."[20] Because Congress has effectively delegated the definition of insider trading to the courts, the adoption of Scalia's view would result in the wholesale invalidation of criminal (but not necessarily civil) penalties for insider trading. Regardless of its ultimate merits, the separation of powers concerns of Justices Scalia and Thomas reinforce the point that insider trading law—as essentially judge-made criminal law—should be construed narrowly.

A Legislative Fix?

Uncertainty as to what constitutes a personal benefit is exacerbated by the absence of a statute or regulation that defines insider trading. The elements of insider trading have been created by federal judges interpreting the SEC's general prohibition of fraudulent conduct in Rule 10b-5, which does not provide guidance in this respect. Prompted by *Newman*, legislators have introduced three insider trading bills this year. To date, none has gained sufficient traction to be taken up by a committee.

In this light, the thoughtful comments of two Southern District judges deserve close attention. In April 2015, Judge Rakoff gave a speech arguing that the current approach to insider trading law is deficient because the standards of liability for civil and criminal cases pull judges in opposite directions. In a criminal insider trading case, the rule of lenity requires judges to construe the law narrowly. By contrast, in a civil insider trading case, well-settled principles of interpretation require a broad construction of the law to effect its remedial or regulatory purposes. Judge Rakoff proposed that two separate insider trading statutes, a narrow criminal statute and broad civil statute, that would address rule of lenity and separation of powers objections in the criminal context, while permitting a broader, more flexible standard of civil liability.[21]

In October 2015, Judge Engelmayer's speech addressed practical problems caused by the uncertainty of insider trading law. He considered the perspective of a hedge fund compliance officer after *Newman*. Suppose that traders at the hedge fund obtained material, non-public information, in his scenario, "which is traceable to an insider but where there's no evidence of an exchange or pecuniary benefit" to the insider, which arguably makes trading on the information permissible under *Newman*. Judge Engelmayer observed that market forces may pressure the compliance officer to permit trading in *Newman's* "grey area," risking a "race to the bottom" in which "less scrupulous analysts who are willing to harvest information by means previously thought to be unlawful will benefit." Meanwhile, firms with a "more robust compliance culture" would lose out, creating troubling incentives.[22]

Judge Engelmayer also questioned whether it made sense "to ask, as the measure of liability, whether [a] remote tippee is aware whether the insider at the start of the chain stood to receive, in exchange for his disclosure, a benefit from the person closest to him." He suggested that liability should turn not on the existence of a personal benefit but on whether the tippee knew that the tipper had disclosed the information for an improper purpose.

Ultimately, Judge Engelmayer observed that federal judges are not in a good position to make that determination. Judges "lack the institutional competence" to address "problems not presented by the case at hand." Further, because judges are constrained by decades of insider trading precedent, they lack the authority to shift the focus of tipper/tippee liability away from the personal benefit standard. Like Judge Rakoff, Judge Engelmayer proposed an insider trading statute as the best way forward.

Conclusion

Almost a year after *Newman*, the contours of the personal benefit standard and tipper/tippee liability remain unclear. The changes and uncertainty wrought by *Newman* are likely to affect, and limit, the cases brought by prosecutors, at least on the margin, and may breathe life into defense arguments that previously stood less chance of success. In addition, while legislation is a remote possibility, the comments of experienced federal judges may lead, at a minimum, to greater consideration of legislation than we have seen in the past.

1. 773 F.3d 438 (2d Cir. 2014).
2. Petition for Rehearing and Rehearing En Banc, *United States v. Newman* (2d Cir. 2014) (No. 13-1837), at 3.
3. Brief of Amicus Curiae Law Professors in Opposition to Petition for Rehearing, *United States v. Newman* (2d Cir. 2014) (No. 13-1837).
4. See *United States v. O'Hagan*, 521 U.S. 642 (1997).
5. Press Release of SDNY USAO, No. 15-272 (Oct. 22, 2015).
6. 463 U.S. 646 (1983).
7. *Newman*, 773 F.3d at 452.
8. Id. at 452 (emphasis added and brackets in original) (quotations and citations omitted).
9. Petition for a Writ of Certiorari, *United States v. Newman* (July 2015).
10. *United States v. Gupta*, 11 Cr. 907, 2015 WL 4036158 (S.D.N.Y. July 2, 2015).
11. Id. at *1, *2 (quotations omitted).
12. 792 F.3d 1087 (9th Cir. 2015).
13. Id. at 1088.
14. Id. at 1093.
15. Id.
16. Id. at 1094.
17. *Newman*, 773 F.3d at 452.
18. *United States v. Lanier*, 520 U.S. 259, 266 (1997).
19. Id.
20. *Whitman v. United States*, 574 U.S. __ (2014) (Statement of Scalia, J.) (emphasis in original).
21. Judge Jed S. Rakoff, Speech at Conference on Corporate Crime and Financial Misdealing at New York University Law School (April 17, 2015).
22. Judge Paul A. Engelmayer, Speech at Securities and Litigation Enforcement Institute of the New York City Bar (Oct. 16, 2015).