III. United States v. Newman*: The Second Circuit Establishes New Limits on Insider Trading Prosecutions*

A. Introduction

In December of 2014, the Second Circuit overturned the insider trading convictions of Todd Newman and Anthony Chiasson, and provided new insight on the elements of tippee insider trading liability.[1] The case resulted from the federal government's prosecution of inside traders at several hedge funds and other investment groups.[2] While the district court originally convicted Newman and Chiasson, the Second Circuit vacated the convictions, holding that the prosecution failed to prove (1) that the corporate insiders received any personal benefit from the transaction, and (2) that Newman and Chaisson "knew that they were trading on information obtained from insiders in violation of those insiders' fiduciary duties."[3] The Second Circuit's holding makes it more difficult for prosecutors to establish insider trading liability.[4]

This Article proceeds as follows. Part B will describe the framework for establishing tippee insider trading liability prior to the Second Circuit's decision in *Newman*. Part C will outline *Newman* and the Second Circuit's holding. Finally, Part D will discuss possible implications of this new precedent.

B. Overview of Applicable Precedent

The standard for tippee liability is articulated generally in three Supreme Court decisions: *Chiarella v. United States*, *Dirks v. SEC*, and *United States v. O'Hagan*, while a fourth case, *SEC v. Obus*, clarifies the standard for remote tippee liability in the Second Circuit.[5]

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[1] *See generally* United States v. Newman, 773 F.3d 438 (2d Cir. 2014).
[2] *Id.* at 442-43.
[3] *Id.*
[4] Ben Protess & Matthew Goldstein, *Appeals Court Deals Setback to Crackdown on Insider Trading*, N.Y. TIMES, Dec. 11, 2014, at A1.
[5] United States v. O'Hagan, 521 U.S. 642, 642-46 (1997); Dirks v. SEC, 463 U.S. 646, 646-48 (1983); Chiarella v. United States, 445 U.S. 222, 222-23 (1980); *SEC v. Obus*, 693 F.3d 276, 279 (2d Cir. 2012).

Insider trading liability derives from Section 10(b) of the Securities Exchange Act of 1934.[6] Section 10(b) prohibits the use "in connection with the purchase or sale of any security . . . [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe."[7] Insider trading is unlawful under this statute because it is "a type of securities fraud proscribed by Section 10(b)."[8] The "classical" theory of insider trading involves a corporate insider who trades "in the corporation's securities on the basis of material, nonpublic information about the corporation," for his or her own benefit.[9] A classical insider trading claim rests on the principle that the corporate insider has breached his or her duty to the corporation's shareholders.[10] Insider trading liability is not limited to corporate insiders, however, as prosecutors can also bring claims under "misappropriation" theory.[11] Under misappropriation theory, "outsiders"—who have no duty to the corporation or its shareholders—may still be liable for insider trading if they "possess[] material non-public information about a corporation and another person uses that information to trade in breach of a duty owed to the owner."[12] Liability under misappropriation theory arises when a corporate "outsider" misappropriates or steals confidential information, and then uses that information to trade securities.[13]

While corporate insiders and misappropriators may be held liable for insider trading for trading based on material, nonpublic information, liability extends to others who trade on such information through "tipper liability" and "tippee liability."[14] When a person in possession of material, nonpublic information (the "tipper") shares the

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[6] *See* Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2012); Nelson S. Ebaugh, *Insider Trading Liability for Tippers and Tippees: A Call for the Consistent Application of the Personal Benefit Test*, 39 TEX. J. BUS. L. 265, 267 (2003).

[7] 15 U.S.C. § 78j(b).

[8] *See Newman*, 773 F.3d at 445.

[9] *Id.*

[10] *See id.*

[11] *Id.* at 445-46.

[12] *Id.*

[13] *Misappropriation Theory*, INVESTOPEDIA, http://www.investopedia.com/terms/m/misappropriation_theory.asp (last visited Mar. 18, 2015), *archived at* http://perma.cc/6TKU-TJGR.

[14] *See* Kathleen Coles, *The Dilemma of the Remote Tippee*, 41 GONZ. L. REV. 181, 198-200 (2006); *see also* Dirks v. SEC, 463 U.S. 646, 659 (1983).

information with another (the "tippee") for the purpose of trading for personal benefit, insider trading liability extends to both parties.[15]

Case law further clarifies the elements of an insider trading claim and the burden on prosecutors seeking to bring insider trading charges. In *Chiarella*, the Court determined that, in order for prosecutors to establish insider trading liability under Section 10(b) of the Securities Exchange Act of 1934, they must show that the defendant had "a duty to disclose arising from a relationship of trust and confidence between parties to the transaction."[16] The *Dirks* case applied this duty requirement to tippees, firmly establishing that a tippee's liability derives from the insider's liability.[17] The Court held that "a tippee assumes a fiduciary duty to the shareholders . . . only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach."[18] Finally, in *O'Hagan*, the Court held that the duty requirement for establishing tippee liability may arise not only from the extension of a fiduciary duty to the shareholders, but also from a duty to the source of the information.[19]

Prior to the Second Circuit's decision in *Newman*, prosecutors in the Second Circuit seeking to establish tippee liability had to prove that "(1) the tipper breached a duty by tipping confidential information; (2) the tippee knew or had reason to know that the tippee improperly obtained the information (*i.e.*, that the information was obtained through the tipper's breach); and (3) the tippee, while in knowing possession of the material non-public information, used the information by trading or by tipping for his own benefit."[20]

C. *United States v. Newman*

This case involved two defendants, Todd Newman and Anthony Chiasson, convicted by the district court on charges of securities fraud under Section 10(b) and Section 32 of the Securities Exchange Act of 1934, and Securities and Exchange Commission

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[15] *See* Coles, *supra* note 14, at 198-99.
[16] Chiarella v. United States, 445 U.S. 222, 230 (1980) (defining the "duty" requirement for insider trading liability).
[17] *Dirks*, 463 U.S. at 660.
[18] *Id.*
[19] United States v. O'Hagan, 521 U.S. 642, 651-53 (1997).
[20] SEC v. Obus, 693 F.3d 276, 289 (2d Cir. 2012).

("SEC") Rules 10b-5 and 10b5-2.[21] The defendants appealed those convictions, and the Second Circuit vacated the convictions on December 10, 2014.[22] Both defendants were hedge fund executives who were removed several steps from the insider tippers, so the Second Circuit's decision focused on "remote tippee" liability.[23]

The charges arose from a government investigation into several hedge funds suspected of insider trading activity.[24] The insider tippers in this case were a Dell Inc. ("Dell") investor relations employee named Rob Ray, and a NVidia Corporation ("NVidia") accounting manager named Chris Choi, both of whom passed information along a chain of tippees that eventually led to Newman and Chiasson.[25] Ray initially passed information to Sandy Goyal, an analyst at Neuberger Berman, whom he knew from business school.[26] The prosecution asserted that Ray received "career counseling" from Goyal in exchange for the inside information.[27] The prosecution similarly asserted that Choi initially passed inside information about NVidia to a fellow churchgoer, Hyung Lim, and that Choi received the benefit of Lim's friendship in exchange for the information.[28] Both Goyal and Lim went on to pass the inside information from Dell and NVidia along the chain of tippees that led to Newman and Chiasson, who were both "three [or] four levels removed from the inside tipper."[29]

During Newman and Chiasson's 2012 trial, U.S. District Court Judge Richard Sullivan instructed the jury that insider trading tippee liability required proof that the defendants were aware that their trades were based on improperly disclosed confidential information:

> To meet its burden, the [G]overnment must also prove beyond a reasonable doubt that the defendant you are considering knew that the material, nonpublic information had been disclosed by the insider in breach of a duty of trust and confidence. The mere receipt of material, nonpublic information by a defendant, and

[21] United States v. Newman, 773 F.3d 438, 442 (2d Cir. 2014).
[22] *Id.* at 455.
[23] *See id.* at 448.
[24] *Id.* at 443.
[25] *Id.*
[26] *Id.*
[27] *Id.* at 452.
[28] *Id.*
[29] *Id.* at 443.

> even trading on that information, is not sufficient; he must have known that it was originally disclosed by the insider in violation of a duty of confidentiality.[30]

Based on this instruction, the jury returned a guilty verdict on all counts.[31]

On appeal, the Second Circuit held that the district court's jury instructions were erroneous, and that "in order to sustain a conviction for insider trading, the Government must prove beyond a reasonable doubt that the tippee knew that an insider disclosed confidential information *and* that he did so in exchange for a personal benefit."[32] The Second Circuit emphasized the "personal benefit" requirement, stating that "a breach of the duty of confidentiality is not fraudulent unless the tipper acts for personal benefit."[33] The opinion clarified that the government could not satisfy the "personal benefit" requirement by showing a mere "casual or social" relationship.[34] According to the Second Circuit, allowing these sorts of social relationships to satisfy the personal benefit requirement would essentially nullify the requirement.[35]

The Second Circuit further held that the prosecution failed to prove that Newman and Chiasson knew the tippers exchanged the information in breach of a duty.[36] The Second Circuit went on to criticize the prosecution's "overreliance" on prior dicta, noting the "doctrinal novelty of its recent insider trading prosecutions, which are increasingly targeted at remote tippees many levels removed from corporate insiders."[37] The court pointed out that, in previous cases, "tippees as remote as Newman and Chiasson have [never] been held criminally liable for insider trading."[38]

In light of the Second Circuit's decision, the new standard for tippee liability requires the prosecution to prove that "(1) the corporate insider was entrusted with a fiduciary duty; (2) the corporate insider breached his fiduciary duty by (a) disclosing confidential information

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[30] *Id.* at 444 (citation omitted).
[31] *Id.*
[32] *Id.* at 442.
[33] *Id.* at 450.
[34] *Id.* at 452.
[35] *Id.*
[36] *Id.* at 442.
[37] *Id.* at 448.
[38] *Id.*

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."[39] The Second Circuit's clarification of the insider trading liability standard, in conjunction with its characterization of the government's recent insider trading prosecutions, has sparked reactions across the legal and business communities.[40]

D. Implications and Reactions

While this decision makes it more difficult for prosecutors to establish remote tippee liability, it is important to note that liability for corporate insiders trading on nonpublic material information or disclosing information for personal benefit remains unchanged.[41] Furthermore, this decision is only binding precedent in the Second Circuit.[42]

Some observers fear that the *Newman* decision will curtail insider trading prosecutions, and thereby encourage corporate executives to play "fast and loose" with corporate information.[43] Under *Newman*, corporate insiders may legally divulge material, nonpublic information as long as they receive nothing in return, even if the recipients trade on that information.[44] In the words of one observer, the *Newman* decision places the "greatest limits on prosecutors in a generation," [45] allowing corporate insiders who exchange information

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[39] *Id.* at 450.

[40] *See* Alison Frankel, *Insider Trading Prosecutions Were Hollow at the Core - 2nd Circuit*, REUTERS BLOG (Dec. 11, 2014), http://blogs.reuters.com/alison-frankel/2014/12/11/insider-trading-prosecutions-were-hollow-at-the-core-2nd-circuit, *archived at* http://perma.cc/F9FC-MNXH; Peter J. Henning, *Fallout for the S.E.C. and the Justice Dept. from the Insider Trading Ruling*, N.Y. TIMES DEALBOOK (Dec. 15, 2014, 2:13 PM), http://dealbook.nytimes.com/2014/12/15/fallout-for-the-s-e-c-and-the-justice-dept-from-the-insider-trading-ruling/, *archived at* http://perma.cc/GSY8-KGG8; John F. Savarese, *Second Circuit Overturns Insider Trading Convictions*, HARVARD L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (Dec. 16, 2014, 2:20 PM), http://blogs.law.harvard.edu/corpgov/2014/12/16/second-circuit-overturns-insider-trading-convictions, *archived at* http://perma.cc/E2BJ-3H4T.

[41] Savarese, *supra* note 40.

[42] *See* Frankel, *supra* note 40.

[43] *See* Henning, *supra* note 40.

[44] *Id.*

[45] Protess & Goldstein, *supra* note 4.

as a favor to a friend or colleague to escape liability.[46] The decision has sparked fear that executives may engage in insider trading, and then escape liability by contriving circumstances that appear devoid of a "tangible" personal benefit to the executive.[47]

These observations, however, may be irrelevant if the government appeals the decision.[48] The government is exploring "options for further appellate review," which may include an appeal to the Supreme Court.[49] On January 25, 2015, the government filed a petition asking the Second Circuit to review its decision in *Newman* en banc.[50] On April 3, 2015, the Second Circuit denied the government's petition, leaving the government with the sole option of filing a petition for writ of certiorari in the Supreme Court.[51]

The *Newman* decision has already had an effect in states outside of the Second Circuit, such as California and Massachusetts.[52] While the Second Circuit's decision is binding only in that circuit, one industry expert noted that "the 2nd Circuit is the leading appeals court for insider trading . . . [s]o disregarding it comes with some peril."[53] Should the Second Circuit decision stand, several other convicted inside traders—convicted in earlier cases in connection with information passed along by Ray and Choi—could see their convictions vacated.[54] Prosecutors had already obtained several guilty pleas from defendants who benefited from information received from Ray and

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[46] *See* Henning, *supra* note 40.
[47] *Id.*
[48] *See* Protess & Goldstein, *supra* note 4.
[49] *Id.*
[50] Alison Frankel, *In Insider Trading Appeal, Justice Department Makes Big Concession*, REUTERS BLOG (Jan. 26, 2015), http://blogs.reuters.com/alison-frankel/2015/01/26/in-insider-trading-appeal-justice-department-makes-big-concession/, *archived at* http://perma.cc/K4C5-5RXR.
[51] Sigal P. Mandelker & Jonathan E. Richman, *Second Circuit Denies DOJ's Reqeust for En Banc Review of Newman; Leaves Landmark Insider Trading Decision in Place*, LEXOLOGY (Apr. 3, 2015), http://www.lexology.com/library/detail.aspx?g=210b7ac9-5d56-495a-bf10-1eecdcdd9ef8, *archived at* http://perma.cc/6SCM-TPFT.
[52] *See* Nate Raymond, *NY Insider Trading Ruling Tests Prosecutors Beyond Wall Street*, REUTERS (Jan. 26, 2015, 7:16 AM), http://www.reuters.com/article/2015/01/26/usa-insidertrading-idINKBN0KZ18C20150126, *archived at* http://perma.cc/9UA2-MV7V.
[53] *Id.* (internal quotation marks omitted).
[54] *See* Frankel, *supra* note 40.

Choi, prior to the December 10th *Newman* decision.[55] One defendant, Michael Steinberg, convicted following a jury trial before the same district court judge as Newman and Chiasson, with the same erroneous jury instruction, will likely have his conviction vacated.[56] Furthermore, Newman and Chiasson could seek withdrawal of the SEC's civil charges against them.[57]

E. Conclusion

The Second Circuit's decision sets a more onerous burden for prosecutors seeking to establish remote tippee liability in insider trading claims.[58] The decision, binding in the Second Circuit and influential in other circuits, now explicitly requires prosecutors to prove that (1) the tipper benefited personally from divulging the material, nonpublic information, and (2) that tippees had knowledge of such a benefit.[59] The *Newman* decision had the immediate impact of vacating the convictions for Newman and Chiasson, as well as offering potential recourse for similarly convicted defendants.[60] Some industry analysts worry that this higher standard will curb prosecutions for insider trading, and encourage deceptive practices to achieve inside trading benefits while circumventing the law.[61] Other observers emphasize that the decision may be reversed by the Second Circuit en banc or the Supreme Court.[62] In many important ways, *Newman*'s legacy is yet undecided.

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[55] *Id.*
[56] *Id.*
[57] Henning, *supra* note 40.
[58] *See supra* text accompanying notes 41-47.
[59] *See* United States v. Newman, 773 F.3d 438, 442 (2d Cir. 2014).
[60] *See supra* text accompanying notes 53-55.
[61] *See supra* text accompanying notes 43-47.
[62] *See supra* text accompanying notes 48-50.
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