Article: Insider Trading After United States v. Newman, the Second Circuit’s Landmark Decision Limiting Liability of Downstream Recipients of Insider Information


The Second Circuit recently dealt a major setback to federal prosecutors’ recent crackdown on insider trading, overturning two high-profile convictions and simultaneously placing the most significant new limits on insider trading liability in decades. The classic tipper-tippee scenario in insider trading prosecutions involves a corporate insider (the tipper) who, in exchange for a personal benefit, discloses material nonpublic information to an outsider (the tippee), who subsequently trades on the basis of this information (or passes the information to another tippee). For years, courts have permitted increasingly remote tippees to become ensnared, based on increasingly vague “personal benefits” allegedly received by tipplers.

The Second Circuit’s decision in United States v. Newman addressed both issues. It substantially reduced the potential liability of remote tippees by holding that a tippee cannot be convicted unless the tippee “knows of the personal benefit received by the insider in exchange for the disclosure.” In addition, Newman held the “personal benefit” received by the tipper “must be of some consequence” and must be a true quid pro quo, rejecting the notion that mere friendship and association could meet this requirement.

Supported by the SEC, the government sought re-consideration and re-hearing en banc, but the Second Circuit has denied both requests. Barring Supreme Court review or action by Congress, the Newman decision will guide insider trading actions for the foreseeable future.

An Overview of Tipper-Tippee Insider Trading Liability
In recent years, federal investigators from both the SEC and DOJ have substantially increased their scrutiny of alleged insider trading. In 2014 alone, the SEC filed insider trading actions against 111 individuals or entities, while the DOJ brought related criminal charges against 20 individuals or entities. The Government has been overwhelmingly successful in this pursuit, including against high-profile defendants like The Galleon Group’s Raj Rajaratnam and S.A.C. Capital Advisors’ Mathew Martoma. From 2009 through July 2014, U.S. Attorneys for the Southern District of New York did not suffer a single trial defeat in insider trading actions. Todd Newman and Anthony Chiasson’s convictions in United States v. Newman continued this winning streak.

The insider trading theory advanced by prosecutors in Newman and similar cases rests on the Supreme Court’s 30-year-old decision in Dirks v. SEC, 463 U.S. 646 (1983). Under Dirks, a tipper’s liability is grounded in breaching a fiduciary duty by receiving a personal benefit in exchange for the disclosure of material, nonpublic information. In other words, “absent some personal gain, there has been no breach of duty” and thus no tipper liability. Dirks, 463 U.S. at 662. Dirks also made clear that the tippee’s liability is derivative. That is, a tippee is liable for insider trading only if (1) the tipper breaches his fiduciary duty and (2) the tippee “knows or should know” about this breach. Id. at 660.
However, the Second Circuit’s recent decision in United States v. Newman reversed course and evidenced concern by the courts about potential prosecutorial overreach. Rebutting the “doctrinal novelty of [the Government’s] recent insider trading prosecutions, which increasingly target[…]remote tippees many levels removed from corporate insiders,” the Second Circuit vacated Newman and Chiasson’s convictions and imposed substantial new burdens in proving insider trading allegations.

The Second Circuit Limits and Clarifies Tipper-Tippee Liability
Factually, United States v. Newman fits the prototypical securities fraud profile—two high-profile New York hedge fund managers charged with trading in and profiting from Dell and NVIDIA stock on the basis of insider information, with profits from the trades in excess of $72 million. The tip concerning the Dell stock originated from a Dell insider who disclosed the company’s nonpublic earnings to a third party analyst, who then disclosed the information to another analyst, who in turn shared the tip with defendant Newman and another third party, who then passed the information along to defendant Chiasson. Newman and Chiasson were thus very remote tippees, three and four levels removed from the initial tipper at Dell. The NVIDIA tip weaved its way through a similar maze of intermediaries, with Newman and Chiasson once again four levels removed from the insider-tipper at NVIDIA.

The Government brought charges against Newman and Chiasson, arguing that as “sophisticated traders,” Newman and Chiasson either knew or should have known the insider-tippers at Dell and NVIDIA had disclosed material nonpublic information in breach of their fiduciary duties to Dell and NVIDIA. Newman and Chiasson argued that the insiders at Dell and NVIDIA did not breach their fiduciary duties because they did not receive any benefit in exchange for their tips, and that even if they had received a personal benefit, there was no evidence that defendants had any knowledge of it. Defendants asked the trial judge to instruct the jury that any tippee liability was contingent on proof of defendants’ knowledge of the tippers receiving personal benefits in exchange for the insider information they disclosed.

Judge Richard Sullivan of the United States District Court for the Southern District of New York denied defendants’ requested jury instruction. Judge Sullivan instead charged that defendants could be found guilty if they “knew the information [they] obtained had been disclosed in breach of a duty.” Separately, Judge Sullivan instructed the jury that the Government had to prove the insiders “breached [the fiduciary duty] of trust and confidence by disclosing material, nonpublic information.” Critically, this latter instruction made no reference to the connection between a fiduciary breach and the receipt of a personal benefit. Under these instructions, if the Government could prove beyond a reasonable doubt that defendants had knowledge of the insiders’ fiduciary breaches—which was simply defined as the act of disclosing material, nonpublic information—the jury must find defendants guilty. The jury so found, and Newman and Chiasson appealed.

On appeal, Newman and Chiasson argued the district court erred by failing to instruct the jury that the Government must prove the defendants had knowledge of the tippers’ personal benefit, and argued there was insufficient evidence supporting the alleged personal benefits the Dell and NVIDIA tippers received.

The Government argued the convictions should be upheld if Newman and Chiasson merely
possessed knowledge that an insider-tipper disclosed information in breach of a duty of confidentiality, and that the “specificity, timing, and frequency” of the information provided to Newman and Chiasson about Dell and NVIDIA “were so overwhelmingly suspicious” that defendants “must have known, or deliberately avoided knowing” that the tips originated with corporate insiders who disclosed the information in exchange for a personal benefit. In the Government’s view, this constructive or imputed knowledge of the tippers’ benefits sufficed to prove even the knowledge requirement. As to the sufficiency of the evidence regarding a personal benefit, the Government argued the tippers at Dell and NVIDIA had received “career advice” and reputational benefits, which the Government argued was sufficient under a recent Second Circuit case holding that “personal benefit is broadly defined to include not only pecuniary gain but also, inter alia, any reputational benefit that will translate into future earnings.” United States v. Jiau, 734 F.3d 147,153 (2d Cir. 2013).

The Second Circuit largely accepted defendants’ arguments, holding that “a tippee’s knowledge of the insider’s breach necessarily requires knowledge that the insider disclosed confidential information in exchange for personal benefit.” The Court also rejected the Government’s theory that the information defendants obtained was sufficiently suspicious to support constructive knowledge of the insiders’ disclosures and benefits. Although the Court acknowledged that “information about a firm’s finances could certainly be sufficiently detailed and proprietary” to support an inference of knowledge, it found no such evidence existed in Newman.

In addition, the Court concluded that the insider-tippers did not actually receive any personal benefit in exchange for their tips. Rejecting the Government’s showing as to personal benefits received by the insiders, the Second Circuit concluded that if generalized career advice and friendship were sufficient personal benefits, “practically anything would qualify.” The Court instead held that the law requires “an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.” Put more directly, the Government must establish a relationship between the tipper and tippee that “suggests a quid pro quo from the latter.”

The Broader Impact of United States v. Newman

Newman was a resounding victory for insider trading defendants, and its impact is already being felt. By requiring proof of a “consequential” personal benefit given in quid pro quo for an insider’s tip, the Second Circuit heightened the evidentiary burden necessary to establish a tipper’s fiduciary breach and thus liability. Moreover, a tippee must now be shown to possess knowledge of the tipper’s personal benefit, a further hurdle to tippee-based insider trading convictions. The impact of this latter ruling is particularly significant, as remote tippees are unlikely to even know the tipper’s identity, let alone whether the tipper actually received a benefit in exchange for his tip.

The pool of potential insider trading defendants is thus dramatically reduced. Corporate law scholar Stephen Bainbridge has opined that Newman not only “finally put a judicial cap on [the prosecutor’s] quest to expand the definition of insider trading to capture virtually every information asymmetry,” but also derailed “highly aggressive ‘interpretations’ of the law that lacked a firm foundation in existing law.”

Newman also raises new questions that have yet to be answered. For example, the Second Circuit provided little guidance as to what precisely constitutes a “personal benefit” for
purposes of liability. Lawyers and judges will continue to wrestle with the meaning of a “consequential” benefit for years to come. Furthermore, though the court rejected the Government’s theory of constructive knowledge in this specific case, it did not foreclose constructive knowledge as a basis for liability in future cases involving “overwhelmingly suspicious” information. This vague dicta, too, will surely be contested in subsequent litigations.

Recognizing the significance of Newman on future prosecutions, the Government sought reconsideration and requested en banc review. On April 4, 2015, the Second Circuit denied both requests. It is expected that the Government will seek review by the Supreme Court, its last procedural option to undo the Newman decision. In the meantime, district courts have begun to apply Newman to pending insider trading cases. Judge Jed S. Rakoff of the Southern District of New York recently avoided answering a key post-Newman question: whether Newman applies to criminal prosecutions only, or also to SEC civil enforcement actions. In SEC v. Payton, Judge Rakoff held that, regardless of whether Newman applies to civil enforcement actions, the SEC’s complaint satisfied Newman by alleging “a meaningfully close personal relationship” and that the tipper “disclosed the inside information for a personal benefit sufficient to satisfy the Newman standard.” --- F. Supp. 3d ---, 2015 WL 1538454 (S.D.N.Y. April 6, 2016).

Concurrently, members of Congress have responded to Newman with proposals to overturn it and even to expand insider trading law further. Representative Stephen F. Lynch (D-MA) has proposed a bill that would completely eliminate the requirement that a tipper receive a personal benefit in exchange for his or her tip. This would expand the law even beyond the pre-Newman state, exponentially expanding the universe of potential insider trading defendants. A separate bill proposed by Senators Jack Reed (D-RH) and Robert Menendez (D-NJ) would make it illegal to trade on any information that is “not publicly available” except for “information that the person has independently developed from publicly available sources.” Accordingly, these two proposals seek far more than the mere overturn of Newman; rather, they attempt to vastly redefine the contours of tipper-tippee liability in particular, and insider trading liability more generally. These bills are in the early stages and whether, and in what form, they might actually become law remains uncertain. However, these prompt and aggressive proposals signify Congressional dissatisfaction with the Second Circuit’s decision, and suggest that the victory in Newman, even if not disturbed by the Supreme Court, may ultimately be pyrrhic.