Westlaw Journal
WHITE-COLLAR CRIME
Litigation News and Analysis • Legislation • Regulation • Expert Commentary
VOLUME 29, ISSUE 9 / JUNE 2015

EXPERT ANALYSIS

United States v. Newman: Road Bump In Insider-Trading Prosecutions

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The 2nd U.S. Circuit Court of Appeals sent shock waves through the realm of insider-trading prosecutions with its decision in *United States v. Newman*, 773 F.3d 438 (2014). On the heels of a successful string of insider-trading prosecutions, the U.S. attorney's office for the U.S. District Court for the Southern District of New York suffered a setback in *Newman*, which (depending on one's perspective) either merely clarified existing standards or imposed heightened ones on the government. These standards particularly relate to the "personal benefit" element required in insider-trading cases.

Since the decision, defendants have seized the opportunity — with mixed results — to stave off prosecution by wrapping themselves in *Newman's* protections.

UNITED STATES V. NEWMAN

In *Newman*, the 2nd U.S. Circuit Court of Appeals addressed the convictions of two hedge fund portfolio managers who were convicted for participating in an insider-trading scheme. The government's case stemmed from its wide investigation of insider-trading activity at hedge funds. The government alleged that a group of financial analysts had exchanged inside information regarding company earnings at Dell and Nvidia that they had received both directly and indirectly from company insiders.

These analysts then passed this information on to their portfolio managers, including defendants Todd Newman and Anthony Chiasson. Newman, a portfolio manager at Diamondback Capital Management LLC, and Chiasson, a portfolio manager at Level Global Investors, executed trades in Dell and Nvidia and earned profits for their respective funds.

At trial, the defendants contended that as "downstream" traders they were multiple degrees away from the original company insider-tipper, did not even know the insider and further did not know whether the corporate insiders provided the inside information in exchange for a personal benefit.

The trial judge rejected the defendants' contention that there had been no evidence that the corporate insiders provided information in exchange for a personal benefit. The judge also refused to instruct the jury that, even if the corporate insiders had received a personal benefit, the defendants must have known about it. Rather, the judge instructed the jury only that the defendants must have known that the material, nonpublic information upon which the defendants traded was disclosed by the insider in violation of a duty of confidentiality. The jury convicted both defendants under that standard.

The 2nd Circuit reversed and in doing so raised the bar on insider trading twofold, confirming that a defendant must know of the insider's personal benefit and further clarifying the standard for a "personal benefit" to the insider.

First, the court relied upon the U.S. Supreme Court's decision in *Dirks v. Securities and Exchange Commission*, 463 U.S. 646 (1983), and held that tippees must know not only that an insider disclosed confidential information but also that the insider did so in exchange for a personal benefit. As the court stated, "thus, without establishing that the tippee knows of the personal benefit received by the insider in exchange for the disclosure, the government cannot meet its burden of showing that the tippee knew of a breach." *Newman*, 773 F.3d at 448.

The court rejected the government's contention that knowledge of a breach of the duty of confidentiality without knowledge of the personal benefit is sufficient to impose criminal liability.

In particular, the court specifically noted that the Supreme Court in *Dirks* had rejected an "absolute bar on tippee trading." Any liability for a tippee "derives only from the tipper's breach of the fiduciary duty, *not* from trading on material, non-public information." The court emphasized this point, providing a mini civics lesson in insider trading, when it noted that, "although the government might like the law to be different, nothing in the law requires a symmetry of information in the nation's securities markets." The court explained that "insider trading liability is based upon breaches of fiduciary duty, not informational asymmetries."

Second, having determined that the instruction was erroneous, the court then turned to the evidence of personal benefit. With respect to the Dell tips, the evidence showed that the insider and first tippee were friends, the insider sought "career advice" from the tippee (both before and after the tips) and the tippee also advised the insider on a wide range of topics. With respect to the Nvidia tips, the evidence showed that the insider and tippee were "family friends." The court noted that if "this was a 'benefit,' practically anything would qualify."

At trial, the defendants contended that as "downstream" traders they were multiple degrees away from the original company insider-tipper.

The court explained that a "personal benefit" may "include not only pecuniary gain, but also, *inter alia*, any reputational benefits 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." Yet such a standard does not mean that all the government must prove is "the mere fact of a friendship, particularly of a casual or social nature." Rather, an inference of personal benefit from a personal relationship "is impermissible in the absence of 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." Thus, to maintain a conviction, the evidence of benefit must be "of some consequence," resembling "a relationship between the insider and the recipient that suggests a quid pro quo" or an intention to confer a future benefit.

Ultimately, the court found that the evidence in connection with any personal benefit incurred by the Dell and Nvidia insiders was insufficient to meet this standard. Further, the court determined that, even if the evidence was sufficient, there was no evidence whatsoever that Newman and Chiasson knew that they were trading on inside information or that any insiders obtained personal benefits in exchange for the disclosures.

REQUEST FOR RECONSIDERATION AND REHEARING

Following the reversal of the convictions of Newman and Chiasson, the government immediately issued a press release attempting to diminish the opinion's importance, stating that "the decision affects only a subset of our recent cases."[1] Yet on Jan. 23 the government filed a petition for rehearing and rehearing *en banc*. *United States v. Newman*, No. 13-1917, *petition for reh'g and reh'g en banc filed* (2d Cir. Jan. 23, 2015).

In filing the petition, the government sought review of only that portion of the opinion that defined and clarified the standard for "personal benefit" and did not challenge the panel's holding that a downstream tippee knew of the personal benefit received by the insider. The government asserted that the opinion "redefines a critical element of insider-trading liability" and that this "new definition is deeply confounding."

On April 3 the panel and the 2nd Circuit denied the requests for rehearing. The government has 90 days to file a petition for writ of *certiorari* to the Supreme Court and is currently reviewing whether to do so.

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NEWMAN'S WAKE

The fallout from the 2nd Circuit's decision continues and threatens to affect not just future enforcement actions, but pending prosecutions.

Notable among those cases is that of Michael Steinberg of S.A.C. Capital Advisors LLC, who was convicted in the same insider-trading scheme as Todd Newman and Anthony Chiasson and whose jury was instructed with the same instruction that the court found erroneous in *Newman*. On April 7 Steinberg filed an unopposed motion to hold appeal in abeyance, noting that "the government is currently reviewing whether to petition the United States Supreme Court for a writ of *certiorari*" in *Newman* and asserting that if the 2nd Circuit's decision stands, *Newman* compels the overturning of the conviction in his case. *United States v. Steinberg*, No. 14-2141, *motion to hold appeal in further abeyance filed* (2d Cir. Apr. 7, 2015).

Indeed, another S.A.C. employee, Mathew Martoma, who was convicted in a related insider-trading scheme, has relied on *Newman's* personal-benefit holding in his pending 2nd Circuit appeal in arguing for reversal of his conviction. *See United States v. Martoma*, No. 14-3599, 2015 WL 493793, *appellant brief filed* (2d Cir. Feb. 2, 2015).

Just a week after the 2nd Circuit's ruling, a judge in the Southern District of New York questioned whether there was sufficient factual basis for guilty pleas that were entered in an insider-trading prosecution before the *Newman* decision. Following submissions from the parties, the court in *United States v. Conradt*, No. 12 CR 887 (ALC), 2015 WL 480419 (S.D.N.Y. Jan. 22, 2015), vacated four guilty pleas in an insider-trading prosecution involving tips related to a 2009 acquisition by IBM. The government argued that the *Newman* decision was limited to prosecutions under the classical theory of insider trading, which applies in circumstances in which insiders, who owe a fiduciary duty to shareholders, exploit confidential information for a personal benefit.

The court rejected the government's contention that knowledge of a breach of the duty of confidentiality without knowledge of the personal benefit is sufficient to impose criminal liability.

The four individuals in *Conradt* received confidential information from a lawyer representing IBM and were prosecuted under a misappropriation theory, which expands liability to an "outsider" who trades on information entrusted to that person in confidence.

In its brief opinion, the District Court, quoting *Newman*, stated that "the elements of tipping liability are the same, regardless of whether the tipper's duty arises under the 'classical' or the 'misappropriation' theory." Moreover, the court noted that even if this language in *Newman* was dictum, "the court is swayed by the fact that *Newman's* unequivocal statement on the point is part of a meticulous and conscientious effort by the 2nd Circuit to clarify the state of insider-trading law in this circuit."

Although the four individuals in *Conradt* successfully invoked *Newman* to vacate their guilty pleas, in the SEC's civil action against two of the alleged conspirators, U.S. District Judge Jed Rakoff refused to dismiss the complaint on the basis of the defendants' argument that *Newman* compelled dismissal because of the lack of a "personal benefit."

In denying the motion to dismiss, the court raised questions regarding *Newman's* interpretation and treatment of the Supreme Court's decision in *Dirks*, noting that whether the 2nd Circuit's interpretation "is the required reading of *Dirks* may not be obvious." *SEC v. Payton*, No. 14 CIV 4644, 2015 WL 1538454, at *4. (S.D.N.Y. Apr. 6, 2015).

Nevertheless, the court determined that the complaint had sufficiently alleged such a personal benefit under *Newman*. Further, the court made clear the distinction between criminal prosecutions and civil proceedings, noting that in the absence of clear congressional action, the definition of insider trading is defined by the courts, sometimes narrowly in the criminal context and sometimes more broadly in the civil one. The court noted the different standards of intent — willfully as opposed to recklessly — and "with respect to the motion here pending, that distinction arguably makes a difference."

Of course, *Newman* has not proved to be a panacea for all defendants convicted in insider-trading prosecutions. In *United States v. Riley*, No. 13-CR-339, 2015 WL 891675, at *1 (S.D.N.Y. Mar. 3, 2015), the court noted that, although its jury instructions would have been different if

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it had the benefit of *Newman*, the result — conviction — would have been the same given the evidence adduced at trial. The court in *Riley* found that the company insider-tipper had obtained a personal benefit from providing information to the tippee. Notably, he obtained help with his side business, investment advice and help in securing a job, all of which demonstrated that there was a *quid pro quo* relationship.

Similarly, in an order without opinion, the District Court in *United States v. DeCinces*, No. 12-CR-0269 (C.D. Cal. Jan. 23, 2015), denied the defendants' motions to dismiss the indictment, raising challenges based on *Newman*. In that case, Doug DeCinces, the alleged tippeee and a former third baseman for the Baltimore Orioles, and co-defendant, James Mazzo, the alleged corporate insider-tipper, asserted that the two had merely a "close friendship" and did not allege the requisite *quid pro quo* to establish the requisite "personal benefit" for an insider-trading conviction. The defendants distinguished the one allegation that DeCinces "helped" Mazzo purchase a house by noting that there were no allegations that it was a "*quid pro quo*" or that DeCinces funded the purchase or that Mazzo paid less as a result of the help.

Ultimately, although *Newman* certainly does not foreclose insider-trading prosecutions, defendants can look favorably to the decision as a means to challenge downstream tippee cases in which the individual defendants may have no knowledge of any personal benefit received by the tipper. They also may be able to more easily challenge cases in which the personal relationship between the insider-tipper and tippee resides in the "frinds zone" without any *quid pro quo* relationship.

The fallout from the 2nd Circuit's decision continues and threatens to affect not just future enforcement actions, but pending prosecutions.

Of course, the U.S. attorney for the Southern District of New York may file a petition for a writ of *certiorari,* and the court may take up the issue. Then the lower courts most certainly will not have had a final word on "personal benefits" in insider-trading prosecutions.

NOTES

[1] Press Release, U.S. Dep't of Justice, State-ment of Manhattan U.S. Attorney Preet Bharara on the U.S. Court of Appeals 2nd Circuit Decision in *U.S. v. Todd Newman and Anthony Chiasson* (Dec. 10, 2014)*, available at* http://www.justice.gov/usao/nys/pressreleases/December14/StatementReNewmanChiasson2ndCir.php (last accessed on Apr. 13, 2015).

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