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Supreme Court Declines To Consider Second Circuit's Landmark Insider Trading Ruling

Today, the United States Supreme Court declined to hear the petition for a writ of certiorari (the "Petition") filed by the United States Department of Justice ("DOJ") in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), a landmark decision that dismissed indictments against two insider trading defendants. By declining to hear the Petition, the Supreme Court ensured that the Second Circuit's decision in *Newman* will remain binding in the Second Circuit and influential across the country.

As we explain below, two of *Newman*'s holdings are particularly important: first, that the government must prove that a remote tippee knew or should have known of the personal benefit received by a tipper in exchange for disclosing nonpublic information; and second, that the benefits alleged by the government in *United States v. Newman* were not sufficient to support a conviction, as they were not sufficiently "consequential."

Newman has already had a significant impact on the law of insider trading. In this client alert, we begin by summarizing *Newman*. We next examine how courts have interpreted both of *Newman*'s key holdings. We conclude by looking at how the legal issues addressed in *Newman* might play out in light of the Supreme Court's decision not to hear the Petition filed in *Newman*.

United States v. Newman

In *United States v. Newman*, the Second Circuit considered appeals from the insider trading convictions of Todd Newman, a former portfolio manager at Diamondback Capital Management, LLC, and Anthony Chiasson, a former portfolio manager at Level Global Investors, LP.¹ Newman and Chiasson were accused of trading Dell and NVIDIA securities based upon material, nonpublic information they received from their respective analysts. According to the testimony elicited during trial, the allegedly material, nonpublic information originated within Dell and NVIDIA, but it passed through numerous intermediaries before it was received by Newman and Chiasson. 773 F.3d at 443. They contended that there was insufficient evidence that the tipper received any personal benefit in exchange for the tip, and, in any event, that they certainly did not know of any such benefit. *Id.* at 444. Newman and Chiasson were each convicted after a five-week trial. They appealed to the Second Circuit, arguing, among other points, that they were convicted based on an improper jury instruction and that the evidence was insufficient to support their convictions.

¹ Paul, Weiss was counsel for Anthony Chiasson on this appeal and was lead counsel at the Second Circuit argument.

The Second Circuit agreed with Newman and Chiasson, concluding that the jury instructions were improper and that the evidence was insufficient to sustain a conviction. The opinion turned on the Court's reading of *Dirks v. SEC*, 463 U.S. 646 (1983).

In *Dirks*, the Supreme Court held that, under the “classical theory” of insider trading liability,² tippees are liable—and, by extension, tippees are liable—only when tippers breach a duty to the shareholders of a publicly traded company. 463 U.S. at 660. Before deciding *Dirks*, the Supreme Court had held in *Chiarella v. United States* that, without more, trading on material, nonpublic information is not illegal, as there is no “general duty between all participants in market transactions to forgo actions based on material, nonpublic information.” 445 U.S. 222, 233 (1980). *Dirks* built on *Chiarella* by setting forth when a tippee has a duty to disclose or abstain from trading on material, nonpublic information: a duty arises “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 there has been a breach.” *Dirks*, 463 U.S. at 660. Put another way, the tippee's duty derives from the tipper's duty, and the tipper's duty is created because of a fiduciary relationship with shareholders. Further, according to *Dirks*, courts will look to whether the tipper received a personal benefit to determine if the tipper breached a duty by disclosing nonpublic information. *Id.* at 662.

In *Newman*, the Court explained that it was not sufficient for the government to show that the tippee received information that was material and nonpublic, or that the tipper was an insider, or even that the tipper breached a duty to the source of the information. “[W]hile we have not yet been presented with the question of whether the tippee's knowledge of a tipper's breach requires knowledge of the tipper's personal benefit,” the Court wrote, “the answer follows naturally from *Dirks*.” 773 F.3d at 447. Based on *Dirks*'s explanation of the nature of an insider's fiduciary breach, “we conclude that a tippee's knowledge of the insider's breach necessarily requires knowledge that the insider disclosed confidential information in exchange for personal benefit.” *Id.* at 449.

Further, the *Newman* panel concluded that the evidence was insufficient to support the government's theory that the tipper received any personal benefit in exchange for providing inside information. Although the government contended that the evidence showed that the Dell tipper had sought career advice from the friend who was the initial tippee and that the NVIDIA tipper was a “family friend” of the initial tippee, the Court held that the “circumstantial evidence in this case was simply too thin to warrant

² Two theories of insider trading liability are available to prosecutors: the “classical theory” and the “misappropriation theory.” The prosecutions of Newman and Chiasson were brought under the “classical theory” of insider trading liability, which applies when a “corporate insider trades in the securities of his corporation on the basis of material, nonpublic information.” *United States v. O'Hagan*, 521 U.S. 642, 651-52 (1997). The “misappropriation theory,” by contrast, applies when an investor “misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.” *Id.* at 652.

the inference that the corporate insiders received any personal benefit in exchange for their tips.” If the evidence of personal benefit proffered by the government was enough, the Court explained, “practically anything would qualify.” *Id.* at 451-52. For evidence of a personal benefit to be sufficient, the Court wrote, there must be “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.” *Id.* at 452.]

Developments Since *Newman*

With respect to both of the key holdings of *Newman*—i.e., that tippees either must have known or should have known of the personal benefit received by the tipper, and that the personal benefit received by the tipper must be “consequential”—there have been significant developments since *Newman* was decided in December 2014. We summarize some of the most important of these developments below.

Tippees’ Knowledge of the Personal Benefit Received by the Tipper

Newman’s holding that a tippee must have known or should have known of the personal benefit in a classical insider trading case has not been subject to significant challenges. To begin with, the Petition did not challenge this holding. Moreover, we are not aware of any court that has disagreed with this holding.

Additionally, courts have applied the tippee knowledge holding of *Newman*—which adjudicated a case brought under the “classical” theory of insider trading—to misappropriation cases. While the USAO and the SEC have sought to limit *Newman* to only those cases brought under the “classical” theory, courts have rejected those arguments. *Newman* explained that “[t]he elements of tipping liability are the same, regardless of whether the tipper’s duty arises under the ‘classical’ or the ‘misappropriation’ theory.” *Id.* at 446. Courts have adopted this proposition as if it were part of *Newman*’s holding. In *United States v. Conradt*, Judge Carter wrote that “even if *Newman* did not specifically resolve the issue [of its application to misappropriation cases], 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 Second Circuit to clarify the state of insider-trading law in this Circuit.” No. 12 CR. 887 ALC, 2015 WL 480419, at *1 (S.D.N.Y. Jan. 22, 2015). Because it concluded that the evidence presented by the government was insufficient under *Newman*, the court in *Conradt* vacated the guilty pleas previously entered by four defendants.³ *Id.* Similarly, Judge

³ In addition to their successful attempts to vacate their guilty pleas, defendants Thomas Conradt and David Weinhaus also sought to vacate the settlement agreements they had entered into with the SEC to resolve civil charges related to the same trading. See *SEC v. Conradt*, No. 12 Civ. 8676(JSR), 2015 WL 4486234 (S.D.N.Y. July 23, 2015). They argued that the settlement agreements should be vacated because they were based on guilty pleas that had been vacated and because they were based on law that had changed, in light of *Newman*. Judge Rakoff denied their motion. He explained as follows:

Rakoff rejected the SEC's argument that *Newman* did not apply to misappropriation cases, reasoning that *Newman*'s statements on this point "seem so clearly intended to give guidance to the lower courts of this Circuit that this Court takes them as binding." *SEC v. Payton*, No. 14 CIV. 4644, 2015 WL 1538454, at *2-3 (S.D.N.Y. Apr. 6, 2015). An SEC ALJ has also concluded that knowledge of a personal benefit must be proven in misappropriation cases. See Gregory T. Bolan & Joseph C. Ruggieri, Administrative Proceedings Ruling Release No. 2309, Administrative Proceeding File No. 3-16178 (ALJ Feb. 12, 2015) (order).

Two decisions, however, suggest that *Newman*'s requirements for *proving* tippee knowledge have not changed the standard for *pleading* tippee knowledge in civil cases. In *SEC v. Jafar*, in separate trades executed six months apart, two defendants purchased large holdings in two biotechnology companies, in both instances shortly before a journalist from the *Financial Post* reported that the companies were engaged in merger negotiations. *SEC v. One or More Unknown Traders in Sec. of Onyx Pharm., Inc.*, No. 13-CV-4645 JPO, 2014 WL 5026153, at *1 (S.D.N.Y. Sept. 29, 2014) *reconsideration denied sub nom. SEC v. Jafar*, No. 13-CV-4645 JPO, 2015 WL 3604228 (S.D.N.Y. June 8, 2015). The SEC alleged that the defendants traded on inside information, but the complaint did not allege the tipper or the nature of the benefit received by the tipper—the allegations were based entirely on the suspicious circumstances of the trades. 2015 WL 3604228, at *1. Judge Oetken denied a motion to dismiss, reasoning that, since the SEC did not know the identity of the tipper, it could not have pleaded facts about the defendants' knowledge of the tipper's personal benefit. *Jafar* held that, even without any allegation about the nature of the tip, "the parallel nature of the alleged events, just six months apart, strongly supports an inference that Defendants, experienced traders, knew or should have known that the tipper received a personal benefit in exchange for the tip." *Id.* at *6.

To similar effect, Judge Rakoff held that the SEC had sufficiently pleaded that the remote tippees knew of the personal benefit received by the tipper, even though the complaint had not specifically alleged that the remote tippees knew of the benefit. See *Payton*, 2015 WL 1538454, at *1. In *Payton*, the SEC alleged that the tipper and the first-level tippee were close friends, and that the first-level tippee had assisted the tipper with a criminal matter involving the tipper. *Payton* acknowledged that *Newman* lays out an

Even if (contrary to the Court's view) *Newman* could be read to materially change the law, relief under Rule 60(b) is not intended to allow one side of a settlement agreement to obtain the benefits of finality while placing the other side at risk that future judicial decisions will deprive them of the benefit of their bargain. When it comes to civil settlements, a deal is a deal, absent far more compelling circumstances than are here presented.

Id. at *2.

“onerous standard” for showing that a remote tippee knew of the tipper’s receipt of a personal benefit. *Id.* However, a footnote noted that “where matters are peculiarly with the defendant’s knowledge, slightly relaxed pleading standards are appropriate.” *Id.* at n.3. It therefore held that the remote tippees’ respective knowledge of the circumstances of the tip—in particular, knowledge that the tip came from the tipper, and that the tipper and tippee were close friends—was enough to raise an inference that the remote tippees knew that the relationship between the tipper and first-level tippee “involved reciprocal benefits,” even though the remote tippees did not know of the first-level tippee’s assistance with the tipper’s criminal matter. *Id.* at *5.

Sufficiency of Evidence To Establish That the Tipper Received a Personal Benefit

While *Newman*’s holding relating to tippees’ knowledge of a personal benefit has largely avoided criticism, its holding relating to what evidence is sufficient to establish a personal benefit has been the subject of debate. In addition to the Petition filed by the DOJ, multiple courts have distinguished the facts—and pushed back against aggressive readings—of this aspect of *Newman*. At the heart of the issue is a question that is still unresolved after *Newman*: when does evidence of a non-tangible gain satisfy the personal benefit requirement?

Importantly, an administrative law judge (“ALJ”) from the SEC has applied *Newman*’s definition of personal benefit to dismiss charges brought by the SEC’s Division of Enforcement (the “Division”). See Gregory T. Bolan & Joseph C. Ruggieri, Administrative Proceedings Initial Decision Release No. 877, Administrative Proceeding File No. 3-16178 (ALJ Sept. 14, 2015) (initial decision). The Division had alleged that Ruggieri, a former trader at Wells Fargo Securities LLC, traded on material, nonpublic tips from Bolan, a Wells Fargo research analyst, concerning forthcoming ratings changes for six stocks prior to their public dissemination in 2010 and 2011. As noted above, ALJ Jason S. Patil first explained that *Newman*’s personal benefit standard applies to misappropriation cases. Then, though he found that Ruggieri had traded on four of these stocks based on tips from Bolan, ALJ Patil dismissed the charges because the Division did not prove, under the standard set forth in *Newman*, that Bolan had received a personal benefit in exchange for the alleged tips. While the Division argued that Ruggieri had provided a benefit to Bolan by mentoring him, providing positive feedback to him, and acting as his friend, ALJ Patil concluded that the evidence was insufficient, under *Newman*, to prove that that Ruggieri provided any of the alleged benefits to Bolan because of Bolan’s tips.

In other instances, however, courts have raised questions about *Newman*’s standard for when evidence of a personal benefit is sufficient. Of particular importance, one Circuit court has expressly declined to follow *Newman*’s holding—or, at least, a defendant’s interpretation of *Newman*’s holding. In *United States v. Salman*, the tipper (Maher) worked for Citi’s health care group, and passed nonpublic information about impending mergers involving Citi’s clients to his brother (Michael), who in turn passed it to the defendant (Salman), whose sister had married Maher. No. 14-10204, 2015 WL 4068903 (9th Cir.

July 6, 2015). The defendant Salman argued, based on *Newman*, “that because there is no evidence that Maher received any such tangible benefit in exchange for the inside information, or that Salman knew of any such benefit, the Government failed to carry its burden.” *Id.* at *6. Judge Rakoff, sitting by designation on a Ninth Circuit panel, wrote the opinion rejecting the defendant’s argument:

To the extent *Newman* can be read to go so far, we decline to follow it. Doing so would require us to depart from the clear holding of *Dirks* that the element of breach of fiduciary duty is met where an ‘insider makes a gift of confidential information to a trading relative or friend.’

Id. (quoting *Dirks*, 463 U.S. at 664.) In *Salman*, the panel wrote, “the Government presented direct evidence that the disclosure was intended as a gift of market-sensitive information,” and this evidence permitted the jury to infer that the tipper had received a personal benefit for disclosing the information. *Id.* In effect, *Salman* wrote, if *Newman* had held that the tipper must always receive a tangible personal benefit, it would be inconsistent with *Dirks*. *See id.*

The different results in *Salman* and *Newman* can be explained by factual distinctions between the cases: in *Newman*, an investment analyst and an IR employee exchanged information little different from that routinely discussed by analysts and IR employees; in *Salman*, family members exchanged highly confidential information rarely discussed in the absence of improper behavior. Nevertheless, the DOJ argued in the Petition that *Salman* had created a circuit split between the Second Circuit and the Ninth Circuit.

Additionally, a recent decision from the Southern District of New York—again written by Judge Rakoff—has drawn a distinction between the evidence required to establish tippee liability and the evidence required to establish tipper liability. *United States v. Gupta* considered the petition for a writ of habeas corpus filed by Rajat Gupta, who was convicted of providing, while serving on Goldman Sachs’ board, confidential information about Goldman Sachs to the hedge fund manager Raj Rajaratnam. No. 11 Cr. 907(JSR), 2015 WL 4036158 (S.D.N.Y. July 2, 2015). Gupta argued that, under *Newman*, his casual friendship with Rajaratnam was insufficient to establish that he received a personal benefit for the tip he provided. Judge Rakoff rejected Gupta’s argument. He wrote that the standard in *Newman* does not govern issues of *tipper* liability, as *Newman* was concerned with what a *tippee* must know about the tipper’s personal benefit. For tippers such as Gupta, Judge Rakoff wrote, an “intention to benefit” the tippee is sufficient, even without evidence of a “quid pro quo” and without evidence of the type of “meaningfully close relationship” required by *Newman*. *Id.* at *3. The court’s opinion then explained that, in any event, even if *Newman*’s standard does govern the liability of tippers, the personal relationship and business connections between Gupta and Rajaratnam satisfied *Newman*’s “meaningfully close relationship” standard. *Id.* at *4.

Other cases have simply distinguished *Newman* on its facts. For instance, a recent decision from the Southern District of New York rejected a defendant tipper's argument that a pre-*Newman* jury instruction was "plain error." *United States v. Riley*, No. 13-CR-339-1, 2015 WL 891675 (S.D.N.Y. Mar. 3, 2015). According to the jury instruction at issue in *Riley*, a tip provided for the purpose of "maintaining or furthering a friendship" satisfied the personal benefit requirement. *Id.* at *4. The defendant tipper argued that this instruction was not permitted under *Newman*, as it allowed the jury to find that he had received a personal benefit solely because he was friends with the tippee. *See id.* Judge Caproni held, among other things, that the defendant tipper had not been prejudiced by the jury instruction, as he had clearly received a personal benefit resulting from his friendship with the tippee. The court wrote that a tip given to a close friend is "circumstantial evidence that the friendship is a *quid pro quo* relationship." *Id.* at *5. The opinion then described three concrete benefits received by the tipper on account of the tippee's friendship: assistance with finding his next job, networking opportunities, and investment advice. *Id.* at *6-*8. The court concluded that "[e]ven if none of the specific benefits that [the tipper] provided to Riley were sufficient standing alone to satisfy *Newman's* 'personal benefit' standard, the totality of the circumstances clearly" meet the *Newman* threshold. *Id.* at *8. As such, the court refused to grant the defendant's motion for a new trial.

Conclusion

Given the Supreme Court's decision not to hear *Newman*, *Newman* will remain binding precedent in the Second Circuit. Accordingly, for insider trading cases brought in New York, Connecticut, and Vermont, *Newman* will govern cases addressing issues of tippee liability. Moreover, given the Second Circuit's reputation in the area of securities law, it is likely that *Newman* will influence the law of insider trading in other circuits as well, even though the decision is not binding outside of the Second Circuit.

That said, much remains for district courts and courts of appeal to work out. Of particular importance, courts will likely continue to struggle with the question of when non-tangible benefits are sufficient to satisfy the "personal benefit" standard. Unless and until the Supreme Court steps in to provide clarity on the many thorny issues raised by insider trading cases, uncertainty will remain.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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