In Major Ruling, Appeals Court Sharply Narrows Reach of Insider Trading Law

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On December 10, 2014, the U.S. Court of Appeals for the Second Circuit reversed insider trading convictions against two former hedge fund managers, and in the process sharply limited two key doctrines underpinning many recent SEC and Department of Justice insider trading cases. *U.S. v. Newman and Chiasson* (Nos. 13-1837-cr , Dec. 10, 2014). At the trial in 2013, the government alleged that analysts at hedge funds managed by defendants Todd Newman and Anthony Chiasson had illegally obtained information from insiders at Dell and NVIDIA, which the analysts passed along to Newman and Chiasson, who then traded based on the information. In Wednesday's eagerly awaited decision, the three judge panel in New York reversed defendants' convictions, holding that the government should have been required to prove that Newman and Chiasson knew that the original source of the information, the corporate insiders, had disclosed the information improperly *and* in exchange for a personal benefit. Further, the court held that the government had failed to show that the personal benefit received by the insiders was "consequential" and pecuniary in nature, as opposed merely to a more amorphous benefit such as "friendship."

The prosecution grew out of a far-reaching investigation of hedge fund insider trading spearheaded by Manhattan U.S. Attorney Preet Bharara. In its 2012 indictment, the U.S. Attorney's Office alleged that insiders at Dell and NVIDIA tipped a web of analysts, who passed on nonpublic information about upcoming earnings to analysts at the two hedge funds where Newman and Chiasson worked. The analysts passed that information to Newman and Chiasson, without telling them who the source of the information was. Newman and Chiasson then traded in Dell and NVIDIA securities, reaping $4 million and $68 million in profits, respectively.

In reversing the convictions, the appeals court found that there was no evidence that defendants knew they were trading on information obtained from insiders in breach of the insiders' fiduciary duties. Moreover, the court rejected the government's theory that, as sophisticated traders, the defendants "must have known" that the information came from corporate insiders who disclosed the inside information in exchange for a personal benefit. Instead, the court found that the government had to prove that the defendants (i) knew that the source breached a fiduciary duty in disclosing the information, *and* (ii) knew that the source received a personal benefit for providing the information.

Although the court acknowledged that case law concerning tippee liability for insider trading was somewhat muddled, the court also highlighted the "doctrinal novelty" of many of the government's recent insider trading cases. The court suggested that in its zeal to root out insider trading, the government had failed to properly follow the Supreme Court's landmark decision in *Dirks v. SEC*, 463 U.S. 646 (1983), which established many of the contours of modern insider trading law. The court rebuked the government for bringing cases under a theory of what it wished the law was, not based on what a proper reading of *Dirks* shows the law actually is.

Because the Second Circuit traditionally has had such a major impact on the development of insider trading law that governs both criminal DOJ and civil SEC cases, there is no doubt that the *Newman* decision will, in cases involving tipper-tippee liability, cause the SEC and DOJ to dial back pursuit of tippees who did not directly interact with the source of the inside information (so-called "remote tippees"). And as the *Newman* court noted, the government's insider trading cases in fact have been "increasingly targeted at remote tippees many levels removed from corporate insiders." Going forward, unless the government has clear evidence that the insider received a measurable benefit (such as a monetary kickback), and that the tippee knew that the insider received such a benefit for providing the information, cases against remote tippees will be much more difficult for the DOJ and SEC to prove.

Moreover, the court's dramatic narrowing of what can constitute a personal benefit also will make even cases against first-level tippees more difficult. Previously, the SEC and DOJ have argued that a reputational benefit, such as enhancing a social friendship, was enough of a benefit. Under *Newman*, if the government cannot show that the tipper received "at least a potential gain of a pecuniary or similarly valuable nature," the personal benefit element will not be met and the tippee cannot be found liable. Thus, for instance, in a case where an insider intentionally tips a casual friend knowing the person will trade, but receives nothing valuable in return, the tippee/trader is not liable.

In sum, although the *Newman* case is a blow to governmental pursuit of insider trading cases, we should expect that the DOJ and SEC will still continue to pursue them, and that the government will be particularly focused on developing evidence showing that alleged tippers received a valuable personal benefit and that the traders knew of the benefit.

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