

## Second Circuit Issues Landmark Decision Limiting Insider Trading Liability of "Remote Tippees"

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On December 10, 2014, the Second Circuit Court of Appeals in New York reversed a set of insider trading convictions and reined in government prosecutions of insider traders who are outside the company in which stock is traded and receive their information second or third hand. *U.S. v. Newman and Chiasson* (13-1837). The case, which has been closely followed in the investment and legal communities, reestablishes the significance of the Supreme Court's decisions in *Chiarella v. U.S.* (1980) and *Dirks v. SEC* (1983), and alters the current landscape for persons trading on market intelligence.

Specifically, the ruling requires that for the government to establish criminal insider trading liability under SEC Rule 10b-5, it must prove that the person trading on inside information actually knew (a) that the information emanated from the subject company in breach of a duty and (b) that the party leaking the information stood to gain a "personal benefit" by doing so. In the absence of a showing that the trader knew both matters beyond a reasonable doubt, there is no criminal insider trading violation.

In its decision, the Second Circuit returned the law to certain bedrock principles set down by the Supreme Court in *Dirks* and *Chiarella* that the lower courts have since strayed from. The court rejected the notion of information parity in the marketplace and emphasized that the rules under Section 10(b) of the Securities Exchange Act "stop well short of prohibiting all trading on material non-public information" and instead allow "persons who acquire and act on information about companies to profit from the information they generate." In its ruling, the court also expressed some exasperation with recent insider trading prosecutions, which increasingly target remote tippees many levels removed from corporate insiders, with no indictment or prosecution of the insiders who allegedly gained from the leak. Indeed, that was what happened here, where the company tippers were not prosecuted but became prosecution witnesses.

### The Facts and Convictions

The prosecutions began when the government discovered that a group of analysts from a number of hedge funds had obtained and shared material, nonpublic information from two publicly-traded technology companies (Dell and NVIDIA). The information eventually made its way to the hedge fund portfolio managers, who in turn made trades in the tech stocks and netted millions in profits for their funds, and who were then prosecuted in the case.

The portfolio managers were three and four steps removed from the corporate insiders who leaked the information; there was no evidence that they were even aware of the source of the inside information. Nevertheless, the government had charged them criminally for insider trading reasoning that as sophisticated traders, they must have known that the information was disclosed by corporate insiders in breach of a fiduciary duty, and not for any legitimate corporate purpose. The jury convicted the two managers, and the court sentenced them to 54 and 78 months in prison, respectively, with millions in fines and restitution ordered.

### Insider Trading Liability

The court reviewed the law that corporate insiders may not trade on material, non-public information because they owe, and by trading violate, a special relationship of trust and confidence vis-à-vis the corporate shareholders. Similarly, insider trading occurs when a corporate insider shares information with an outsider in exchange for a direct or indirect personal benefit and the outsider trades on the information. Here, the court required that the government prove beyond a reasonable doubt that the ultimate trader knew that the corporate insider breached a duty in sharing the information and knew that the corporate insider received a personal benefit from the

release of the information. Because there was no evidence that the ultimate traders knew whether the insider who gave the information stood to gain, the convictions had to be overturned and dismissed. The court also found that the evidence was insufficient to establish that the insiders received a personal benefit upon which any liability could be based.

## Personal Benefit

In so ruling, the court also gave some long overdue guidance on what constitutes “personal benefit” to the leaking insider in the context of personal relationships between the insider and the recipient of the information. Here, returning to Supreme Court precedent, the court explained that “personal benefit” is broadly defined to include not only cash or similar gain by the corporate insider, but also any expected benefit that could go so far as to include the benefit one would obtain from making a gift to a close friend or relative such that the transactions “resemble trading by the insider himself followed by a gift of the profits to the recipient.” The court explained that when the information is passed on to a contact, there must be “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.” The court cautioned, however, that the standard, although permissive, does not go so far as to establish a personal benefit by the mere fact of a friendship, particularly of a casual or social nature. The evidence presented established that the Dell insider had known the analyst he gave the inside information to from business school and had looked to the analyst for professional advice but that the two were not close friends. The NVIDIA insider and the analyst he shared the information with were “family friends” that had met through their church. The court concluded that these relationships were insufficient to confer a benefit to the insider as, if they were, “practically anything would qualify.”

The court rejected the government’s request to permit the jury to infer from the circumstances that some benefit was provided to (or anticipated by) the insiders. Here, the court noted that to side with the government would be to render the necessary “personal benefit” element a nullity.

## The Road Ahead

While the decision does nothing for the two hedge funds that were forced to shut down as a result of the weight of the prosecution, it may offer some relief to many in the investment community whose trading activity has been unduly chilled by the fear of prosecution for trading on market intelligence. The decision will also hopefully cause prosecutors to return their focus to core insider trading violations. We fully anticipate that the government will seek review of this far-reaching decision by the Supreme Court.

Finally, it should be remembered that the Newman case is about criminal prosecutions of remote tippees under SEC Rule 10b-5. The company tippers at Dell and NVIDIA who released inside information committed unlawful acts, which violated duties they owed to their employers and, if they had also received a personal benefit, would have violated Rule 10b-5 as well. But the government, for reasons of its own, chose not to prosecute the company tippers.

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