Hello Newman! (and Chiasson): Second Circuit Decision Raises the Bar for Government to Prove Liability of "Remote Tippees" in Insider Trading Cases

12.15.2014

BY BRIAN P. KEANE, ESQ.

Brian P. Keane, Esq., *Member*

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Introduction

In a groundbreaking decision, the United States Court of Appeals for the Second Circuit has reversed the 2013 insider trading convictions of Todd Newman and Anthony Chiasson. The decision in *United States v. Newman*, No. 13-1837 (2d Cir. Dec. 10, 2014) significantly raises the bar for the government's burden of proof in "remote tippee" insider trading cases. The investment community (as well as government prosecutors) have been eagerly awaiting this decision since oral arguments were heard by the Second Circuit in April 2014. Nearly eight months later, the decision handed down has dealt a severe blow to the government's efforts to push the envelope in prosecuting individuals who trade on inside information but have one or more "layers" between them and the "insider" who initially disclosed the tip (the "tipper").

Background

A brief background on the history of modern insider trading liability is needed to understand the true significance of the *Newman* decision. Three Supreme Court cases form the basis for insider trading liability today.

The starting point of the analysis of the current state of insider trading liability is the Supreme Court's 1980 decision in *Chiarella v. United States*, (445 U.S. 222 (1980)). In *Chiarella*, an employee of a financial printer that printed merger and takeover documents was convicted of insider trading after he traded on material nonpublic information regarding takeovers that he learned while working at the printer. The government's conviction was based on the "parity-of-information" theory, *i.e.,* that anyone who trades on material information that they know is not yet publicly available has engaged in insider trading. The Supreme Court completely rejected the parity-of-information theory, noting that insider trading liability is not simply based on unequal access to material nonpublic information, but "is premised upon a duty to disclose arising from a relationship of trust and confidence between the parties to the transaction." Since there was no such duty between Chiarella and the shareholders of the companies in whose stock he traded, the conviction was reversed.

Three years later, in the seminal case of *Dirks v. SEC* (463 U.S. 646 (1983)), the Court extended its rejection of the parity-of-information theory to tippee cases, where the person who has traded on the material nonpublic information is not the insider, but has received the information from an insider. The facts in *Dirks* are remarkable. Raymond Dirks was an officer in a broker-dealer that specialized in investment advice related to insurance company securities. Dirks received information from a former officer of Equity Funding of America, an investment company primarily engaged in selling life insurance and mutual funds, that Equity Funding was engaging in fraud by vastly overstating its assets. The former insider urged Dirks to investigate and verify the fraud and disclose it to the public. Dirks did just that, and over a two-week period interviewed several officers and employees of Equity Funding. While senior management of the company denied any wrongdoing, the allegations of fraud were corroborated by a number of employees. During his investigation, Dirks urged the *Wall Street Journal* to publish a story reporting the alleged fraud, but it refused to do so. During this time, neither Dirks nor his firm traded any Equity Funding stock, but Dirks also discussed his findings with a number of clients and investors, many of

whom sold their holdings in Equity Funding. During the two weeks of Dirks' investigation, Equity Funding's stock fell from $26 per share to $15 per share, causing the NYSE to halt trading. Only then did the insurance authorities investigate Equity Funding and uncover the fraud. In a twist that is amazing even for the SEC's enforcement division, the SEC did not herald Dirks for his role in exposing the fraud, but instead found that Dirks had aided and abetted violations of US securities laws and censured him.

In its determination to censure Dirks, the SEC sought to exhume a form of the parity-of-information theory as applied to tippees, concluding that "[w]here tippees — regardless of their motivation or occupation — come into possession of material corporate information that they know is confidential and know or should know came from a corporate insider, they must either publicly disclose that information or refrain from trading." Once again, the Supreme Court completely repudiated the SEC's theory. While noting that the "requirement of a specific relationship between the shareholders and the individual trading on inside information has created analytical difficulties for the SEC and courts in policing tippees who trade on inside information," the Court reaffirmed its holding in *Chiarella* that a duty to disclose "arises from the relationship between parties . . . and not merely from one's ability to acquire information because of his position in the market."

The Court stated that this did not mean that all tippees were free to trade on material nonpublic information, but that a tippee's duty to disclose or abstain must be derived from the insider's duty. Under *Dirks*, a tippee inherits the duty of the insider not to trade on material non-public information "only when the insider has breached his fiduciary duty to the shareholders by disclosing the information and the tippee knows or should know that there has been a breach. [In other words,] tippee responsibility must be related back to insider responsibility by a necessary finding that the tippee knew the information was given to him in breach of a duty by a person having a special relationship to the issuer not to disclose the information." The *Dirks* Court then went on to address what constitutes a "breach" by the insider tipper, stating, "the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to the stockholders. And absent a breach by the insider, there is no derivative breach." In *Dirks*, the Court found that because the tippers were only motivated by "a desire to expose the fraud," there was no personal benefit to the tippers and thus no derivative liability for Dirks.

In the third Supreme Court case, *United States v. O'Hagan* (521 U.S. 642 (1997)), the Court closed a gap left by *Chiarella* by adopting the misappropriation theory. *O'Hagan* involved an attorney who traded on material non-public information provided to his law firm by clients. Since O'Hagan had no relationship with and owed no duty to the shareholders of the companies in which he traded, he argued that, under *Chiarella*, he had breached no duty and thus had no insider trading liability. The *O'Hagan* Court clarified that the breach of duty analysis from *Chiarella* applied not only to a breach of duty owed to the shareholders but also to a breach owed to the source of the information. Noting that "[the] deception essential to the misappropriation theory involves feigning fidelity to the source of the information," the Court held that O'Hagan had breached his duty to the law firm and was liable for insider trading.

Following the aforementioned trio of Supreme Court cases, it appeared well established that for tippee liability, the government must prove that *the tippee knew both* (1) that the tipper had provided the tippee with material nonpublic information in breach of a duty (a duty to the shareholders in the classical theory of insider trading and to the source of information in the misappropriation theory of insider trading), and (2) that the tipper received or anticipated receiving a personal benefit. However, a 2012 decision by the Second Circuit in *SEC v. Obus* (693 F.3d 276 (2d Cir. 2012)) appeared to relax the burden of proof in remote tippee cases.

Obus involved a so-called tipping chain, with the initial tipper and two sequential tippees. In *Obus*, an employee of GE Capital obtained information that GE had been approached by Allied Capital Corp. to obtain financing for a planned, but yet to be announced, acquisition of SunSource Inc., a publicly traded company. The GE employee tipped his college friend, an analyst at Wynnefield Capital, which was a large holder of SunSource stock, about the proposed acquisition of SunSource. The analyst in turn relayed the information to his boss, Nelson Obus. Obus then caused Wynnefield to purchase a large block of SunSource stock (approximately 5% of the outstanding stock) prior to the public announcement of the acquisition, resulting in a profit of over $1.3 million after the deal was announced. In the decision, the *Obus* court summarized the

requirements of tipper and tippee liability as follows:

[To] be liable for insider trading "a tipper must (1) tip (2) material non-public information (3) in breach of a fiduciary duty of confidentiality owed to shareholders (classical theory) or the source of the information (misappropriation theory) (4) for personal benefit to the tipper. . . . Tippee liability requires that (1) the tipper breached a duty by tipping confidential information; (2) the tippee knew or had reason to know that the tipper improperly obtained the information (*i.e.*, that the information was obtained through the tipper's breach); and (3) the tippee, while in knowing possession of the material non-public information, used the information by trading or by tipping for his own benefit.

Importantly, the *Obus* Court's summary of tippee liability did not state that the tippee must have knowledge that the tipper received a personal benefit. As a remote tippee case, *Obus* thus opened the door for government prosecutors to argue that remote tippee liability does *not* require that the remote tippee know that the tipper received a personal benefit.

United States v. Newman

One such case in which government prosecutors sought to rely on the *Obus* case to impose criminal liability upon a remote tippee is *United States v. Newman*, which was tried in the Southern District of New York. In *Newman*, Todd Newman and Anthony Chiasson were former hedge fund managers who traded on inside information about Dell Inc. and NVIDIA Corporation. Both Newman and Chiasson were several degrees removed from the original corporate insider tippers, and thus were remote tippees. Chiasson purportedly did not even know the identity of the tippers. At trial, the government argued for and, based on *Obus*, the Court gave the jury an instruction that did not require the government to prove that the defendants knew that the insider tippers received a personal benefit for tipping the inside information. Both Newman and Chiasson were convicted of insider trading.

The convictions were appealed, and on April 22, 2014, the Second Circuit Court of Appeals heard oral arguments that were focused predominantly on the question of whether a remote tippee must know that the tipper received a personal benefit. On December 10, 2014, the Second Circuit rendered its decision and definitively answered the question in the affirmative, stating, "[We] conclude that, in order to sustain a conviction for insider trading, the Government must prove beyond a reasonable doubt that the tippee knew that an insider disclosed confidential information *and* that he did so in exchange for a personal benefit."

In its decision, the Court noted that the government relied on dicta in a number of post-*Dirks* decisions by the Second Circuit (including *Obus*) in which the Court described the elements of tippee liability without specifically stating that the tippee must know of the tipper's personal benefit. The Court went on to state, "[B]y selectively parsing this dictum, the Government seeks to revive the absolute bar on tippee trading that the Supreme Court explicitly rejected in Dirks. . . . [T]he Supreme Court was quite clear in Dirks. First, the tippee's liability derives only from the tipper's breach of a fiduciary duty, not from trading on material non-public information. Second, the corporate insider has committed no breach of fiduciary duty unless he receives a personal benefit in exchange for the disclosure. Third, even in the presence of a tipper's breach, a tippee is liable only if he knows or should have known of the breach." The Court further stated that if the government does not establish that the tippee knew of the personal benefit received by the insider in exchange for the information, the government has not met its burden of showing that the tippee knew of the breach.

The Court went on to find that, even viewed in the light most favorable to the government, there was no evidence that would allow a reasonable jury to find beyond a reasonable doubt that either Newman or Chiasson knew of any personal benefit received by the insider tippers. Accordingly, the Court vacated the convictions and remanded the case to the district court to dismiss the indictment with prejudice.

Conclusion

We would expect this decision to have a direct impact on the government's future decisions to bring actions against remote tippees who are several degrees removed from the tipper. In fact, the *Newman* Court even

appeared to chastise the government when it stated, “[T]he Government’s overreliance on our prior dicta merely highlights the doctrinal novelty of its recent insider trading prosecutions, which are increasingly targeted at remote tippees many levels removed from corporate insiders. . . We note that the Government has not cited, nor have we found, a single case in which tippees as remote as Newman and Chiasson have been held criminally liable for insider trading.”

If you have any questions about this topic, please contact the author(s) or your principal Mintz Levin attorney.

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4495-1214-NAT-CORP