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Susan Schwab Heyman's Post

Defining the Boundaries of Insider Trading

Posted by Susan Schwab Heyman on 08/11/2015 at 10:11 AM



The Second Circuit Court of Appeals recently put the brakes on the Government's successful string of insider trading prosecutions by reversing the convictions of two downstream tippees, Todd Newman and Anthony Chiasson.

In *United States v. Newman*, the Court criticized the government's "over-reliance on our prior dicta" and its "doctrinal novelty" in prosecuting remote tippees many levels removed from the corporate insiders. The court reversed the convictions on two grounds. First, the Court held that the government did not sustain its burden of proving that either defendant knew that the insiders received a personal benefit in exchange for the confidential information. And second, the Court held that the government had not proven that the insiders received a personal benefit of "some consequence." According to the Court, mere proof of friendship is insufficient to establish tippee liability, particularly when the friendship is casual in nature.



Newman and Chiasson were portfolio managers at hedge funds who earned millions of dollars for their funds by trading on the basis of confidential earnings data that they received from their financial analysts. The analysts had received this confidential information from insiders at Dell and NVIDIA. The government presented evidence that the Dell insider and the first tippee analyst were friends and that the insider sought advice, including career advice, from the analyst.

In support of its reversal, the court explained that this type of advice was little more than one would expect from a casual acquaintance or alumnus and therefore did not establish the requisite benefit required for tipping liability. Even if this circumstantial evidence would suffice to establish a personal benefit, the convictions would still have been reversed as the government did not prove beyond a reasonable doubt that the trading tippees knew that a personal benefit was provided in exchange for the information.

Not surprisingly, since the *Newman* decision, several competing bills have been introduced to Congress urging the adoption of a clear definition of insider trading. In particular, Senators Jack Reed of Rhode Island and Bob Menendez of New Jersey introduced the *Stop Illegal Insider Trading Act*, which would broadly prohibit transactions in securities based on material non-public information. Under this proposed legislation it would be irrelevant whether a trader knew of an insider's fiduciary duty or any benefit received. Rather, the inquiry would simply focus on whether the trader knew or had reason to know that he or she had an unfair advantage in being given material, confidential information.

If our highly polarized Congress does not enact legislation, the Securities and Exchange Commission (the "SEC") has the authority to promulgate rules interpreting any ambiguity in the federal securities laws, including insider trading. Contrary to the Second Circuit, the SEC believes that the disclosure of "valuable information to another person for securities trading purposes "is itself an improper exploitation of the information by the insider, regardless of whether the transfer is motivated by an expectation of a *quid pro quo* if there is an "intention to benefit the particular recipient." If the SEC adopts a rule which includes this expanded definition of the personal benefit, it may effectively broaden the scope of insider trading liability even in the Second Circuit.

The government recently sought *certiorari* from the Supreme Court in an effort to overturn the *Newman* decision. The government advanced three main arguments in its petition. First, the government argued that the Second Circuit erroneously departed from Supreme Court precedent by not recognizing a personal benefit when an insider gifts information to a trading relative or friend without expecting anything in return. Second, the government explained that the Second Circuit opinion conflicts with a recent Ninth Circuit decision which held that a gift of information to a trading relative is sufficient to establish a personal

benefit. Finally, the government contended that the narrow definition of personal benefit will harm investors and threaten the effective enforcement of the securities laws.

The laws regarding downstream tippees will remain murky, and it will be harder to prosecute this form of market-threatening insider trading, unless the Supreme Court reverses the *Newman* decision, Congress enacts legislation, or the SEC promulgates a rule clarifying the personal benefit standard.