

## CLIENT MEMORANDUM

# The Second Circuit Issues Groundbreaking Insider Trading Decision

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On December 10, 2014, the United States Court of Appeals for the Second Circuit issued a groundbreaking decision in *United States v. Newman et al.*, setting boundaries on insider trading law and limiting the Government's ability to pursue those who trade following receipt of information absent evidence that the recipient knew that the information had been disclosed for an improper motive. The Second Circuit's decision vacated the criminal convictions of two hedge fund managers who were alleged tippees, Todd Newman and Anthony Chiasson, and also ordered the district court to dismiss the indictment with prejudice.

Characterizing the overreach of the Government's unprecedented effort to jail investment professionals who traded following receipt of third- and fourth-hand information without knowing either the information's source or the existence of any improper motive to the disclosure as a "doctrinal novelty," the Court attempted to provide the guidance it noted was sorely needed. At oral argument Judge Barrington Parker stated: "we sit in the financial capital of the world and the amorphous theory that [the Government has in this case] gives precious little guidance to all these institutions, all these hedge funds out there who are trying to come up with some bright-line rules about what can and what cannot be done. . . . Isn't the whole legal community and the financial community served by having a rule that says the person [the Government] want[s] to send to jail has to know the benefit?"

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The decision articulated three key points on insider trading law. First, in order to convict an alleged tippee, the Government must prove that the tippee knew that the inside information had been disclosed in breach of a duty of trust or confidence and in exchange for personal gain. Second, the Court of Appeals significantly raised the bar on what constitutes a sufficient personal benefit to the tipper to be deemed a *quid pro quo*. The Government may no longer contend that a mere “friendship” between the tipper and tippee provides a sufficient basis to show that the tipper disclosed information for an improper purpose. Third, the specificity and timing of information alone is insufficient to satisfy the Government’s burden of proving the tippee’s knowledge that the information was disclosed in breach of a duty and for personal gain.

### Background

In December 2012, Todd Newman and Anthony Chiasson were convicted of insider trading for trading on material nonpublic information that they received third- and fourth-hand from company insiders at Dell and NVIDIA. In each instance, neither Newman nor Chiasson, nor their analysts who allegedly shared insider information with them, knew the identity of the original sources of information, let alone that the sources had violated a duty of confidentiality or received a personal benefit in exchange for providing this information.

The Dell insider, Rob Ray of Dell’s investor relations department, allegedly shared inside information about Dell’s earnings numbers in advance of their public disclosure with Sandy Goyal, an analyst at a hedge fund. Goyal, in turn, passed the information to Jesse Tortora, Newman’s analyst. Tortora passed the information to Newman as well as to several of his friends, including Spyridon Adondakis, Chiasson’s analyst, who subsequently passed it to Chiasson. Ray and Goyal were acquaintances who attended the same business school and had previously worked together at Dell. According to the Government, Ray sought and received “career advice” from Goyal, which constituted a personal benefit that he received in exchange for tipping Goyal about Dell’s earnings numbers.

The NVIDIA insider, Chris Choi of NVIDIA’s finance unit, tipped inside information about NVIDIA’s earnings to Hyung Lim, who passed it to Danny Kuo, an analyst at a hedge fund. Kuo subsequently passed it to, among others, Tortora and Adondakis, who passed it to Newman and Chiasson, respectively. The Government alleged that Choi and Lim were “church friends,” which was supposedly sufficient to establish that Choi received a personal benefit for tipping Lim.

Even though tippee liability is derived from tipper liability, the Government did not charge Ray or Choi “administratively, civilly, or criminally for insider trading or any other wrongdoing.”<sup>1</sup>

The Government argued that Newman and Chiasson were guilty of insider trading because “as sophisticated traders, they must have known that information was disclosed by insiders in breach of a fiduciary duty, and not for any legitimate corporate purpose.”<sup>2</sup> The Government maintained that it did not need to prove that Newman and Chiasson knew that the insider received a personal benefit for disclosing the inside information; rather, just that they knew that the company insiders had breached a duty of confidentiality. The district court agreed, and instructed the jury that the Government must prove only that defendants “must have known that [the inside information] was originally disclosed by the insider in

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violation of a duty of confidentiality.”<sup>3</sup> The judge did not instruct the jury that Newman and Chiasson must have known Ray and Choi disclosed the information in exchange for personal gain.

A jury convicted Newman and Chiasson of all counts. Newman and Chiasson appealed on the grounds that the Government needed to prove that they were aware of the personal benefit provided to Ray and Choi and that there was insufficient evidence that the tippers received a personal benefit in exchange for disclosing inside information.

The Second Circuit’s decision not only vacated Newman’s and Chiasson’s convictions, but ordered the district court to dismiss the indictment with prejudice because it found insufficient evidence to support the verdict. The Court reasoned that (1) the district court had incorrectly instructed the jury regarding the Government’s need to prove that Newman and Chiasson were aware of a personal benefit provided to the company insider and (2) the Government failed to present sufficient evidence that the defendants willfully engaged in insider trading because there was insufficient evidence that (a) the insiders received a personal benefit in exchange for disclosing inside information and (b) that Newman and Chiasson knew or should have known that they were trading on information that insiders disclosed in exchange for a personal benefit.<sup>4</sup>

### Tippee Liability

The Court in *Newman* based its decision primarily on a close reading of the Supreme Court’s decision in *Dirks v. SEC*.<sup>5</sup> In that case, the Supreme Court addressed the liability of a tippee analyst who received material nonpublic information about possible fraud at a company from one of the company’s former officers. The analyst relayed that information to some of his clients who in turn sold their shares. In dismissing the SEC’s case against the analyst for aiding and abetting securities fraud, the Court articulated the general principle of tipping liability where an outsider (“tippee”) trades on material nonpublic information received from a company insider or misappropriator (“tipper”). According to *Dirks*, an insider breaches his fiduciary duty in violation of the federal securities laws when “the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, *there is no derivative breach*.”<sup>6</sup> A tippee’s duty to refrain from trading on inside information is derived from the insider’s duty and the tippee is liable “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 that there has been a breach.”<sup>7</sup>

In *Newman*, the Government argued that, while tippee liability required proof of a personal benefit to the insider, it needed to prove only that remote tippees knew that the “insiders had disclosed information in breach of a duty of confidentiality.”<sup>8</sup> The Government contended that *Dirks* “only required that the ‘tippee know that the tipper disclosed information in *breach of a duty*.”<sup>9</sup> The Government relied on recent cases that lacked language explicitly including knowledge of the tipper’s personal benefit as an element of tippee liability.<sup>10</sup>

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The Second Circuit rejected the Government's position and harkened back to the language of *Dirks*. The Court noted that "*Dirks* clearly defines a breach of fiduciary duty as a breach of the duty of confidentiality in exchange for a personal benefit" and "[a]ccordingly 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."<sup>11</sup> The Second Circuit then articulated a five-part test for tippee liability:

[W]e hold that to sustain an insider trading conviction against a tippee, the Government must prove each of the following elements beyond a reasonable doubt: that (1) the corporate insider was entrusted with a fiduciary duty; (2) the corporate insider breached his fiduciary duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit; (3) the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit; and (4) the tippee still used that information to trade in a security or tip another individual for personal benefit.<sup>12</sup>

The Court thus found that the Government had failed to meet its burden in *Newman* because there was insufficient evidence that Newman and Chiasson knew about any alleged personal benefit to the tippers. The Court also found that the Government's evidence of any personal benefit received by the insiders was insufficient to establish tipper liability from which Chiasson and Newman's purported tippee liability would derive.

### The Personal Benefit Standard

*Newman* also heightened the standard for what constitutes a "personal benefit" under the *Dirks* personal benefit test, and held that mere friendship, without a *quid pro quo*, is insufficient to establish a personal benefit. The Court held that while a "personal benefit" is broadly defined and may include a reputational benefit or the benefit one would receive for making a gift of confidential information to a friend, it is not limitless and requires more than "the mere fact of friendship."<sup>13</sup> Rather, a personal benefit "requires evidence of 'a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the [latter].'"<sup>14</sup> The Court noted that if "the Government was allowed to meet its burden by proving that two individuals were alumni of the same school or attended the same church, the personal benefit requirement [from *Dirks*] would be a nullity."<sup>15</sup>

Thus, the Court found that the "career advice" that Goyal gave the Dell insider, Ray, was insufficient because Goyal testified that he would have given Ray the same advice even if he did not receive any inside information, as he would have done with any friend or colleague.<sup>16</sup> Additionally, Goyal had been giving career advice for more than a year before Ray provided any inside information, so the advice could not have been a *quid pro quo* for the disclosure.<sup>17</sup> Similarly, there was insufficient evidence that the NVIDIA insider, Choi, received a personal benefit because Choi and Lim were "merely casual acquaintances" with no evidence of "loans or personal favors between the two."<sup>18</sup> The Second Circuit noted, "[i]f this was a 'benefit,' practically anything would qualify."<sup>19</sup>

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### Mere Specificity and Timing of Information is Insufficient to Establish an Inference of Insider Trading

Significantly, the Second Circuit rejected the Government's attempt to infer a trader's knowledge of an insider's personal benefit based on circumstantial evidence of the "overwhelmingly suspicious" specificity and timing of the trades.<sup>20</sup> The Government argued that Newman and Chiasson must have known, or deliberately avoided knowing, that the Dell and NVIDIA information was disclosed in exchange for a personal benefit because of the detailed nature, accuracy, and number of updates they received in the weeks leading up to the companies' earnings announcements.<sup>21</sup>

The Second Circuit found that, on the contrary, the evidence established that hedge fund analysts routinely discuss earnings estimates with companies based on publicly available information and that Dell and NVIDIA frequently leaked information to assist analysts with their financial models.<sup>22</sup> Accordingly, the Court held that the evidence could not support an inference that the defendants knew – or should have known – that corporate insiders released the information, nor could it support an inference that the defendants knew – or should have known – that the sources' motive for disclosure was improper.<sup>23</sup>

### Implications on the STOCK Act

Notably, the Second Circuit's clarification on tippee liability and personal benefit should apply equally to prosecutions under the Stop Trading On Congressional Knowledge ("STOCK") Act. The STOCK Act applies the insider trading prohibitions pursuant to the Securities Exchange Act of 1934 and Rule 10b-5 to federal officials and their employees. As such, each Member of Congress and employees of Congress, and any executive branch employee, judicial officer, or judicial employee "owes a duty arising from a relationship of trust and confidence to the Congress, the United States Government and the citizens of the United States with respect to material, nonpublic information derived from such person's position[.]"<sup>24</sup>

While the STOCK Act seeks to impose upon federal employees the same duty of trust and confidence that a corporate insider owes to shareholders, it does not permit prosecution absent proof of all of the elements that cause insider trading to be deemed securities fraud, including the elements articulated by the *Newman* court. After *Newman*, the Government must prove that a tippee who trades based on political intelligence knew that the federal official disclosed information in exchange for a personal benefit.

### Conclusion

The Second Circuit's decision in *Newman* limits the Government's ability to prosecute investment professionals who make trading decisions based in part on material nonpublic information absent evidence that the investment professional knew that the information had been disclosed in breach of a duty of trust or confidence and in exchange for a personal benefit. Where investment professionals may be several levels removed from the source of the information, this will prove to be a very difficult hurdle for the Government to overcome.

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While the *Newman* decision provides clarity regarding insider trading liability, it may not be the end of the story. The U.S. Attorney's Office for the Southern District of New York stated that they "are still assessing the Court's decision, which appears in our view to narrow what has constituted illegal insider trading, and are considering our options for further appellate review."<sup>25</sup> Regardless of any appeal, however, the decision will have an immediate impact on both the Department of Justice and the Securities and Exchange Commission's insider trading programs and is likely to lead both agencies to reevaluate their inventory of investigations and pending cases.

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<sup>1</sup> *United States v. Newman et al.*, Nos. 13-1837-cr(L), 13-1917-cr(con), at \*6 (2d Cir. Dec. 10, 2014).

<sup>2</sup> *Id.*

<sup>3</sup> *Id.* at \*8 (quoting Tr. 4033:14-22.)

<sup>4</sup> *Id.* at \*4.

<sup>5</sup> *Dirks v. SEC*, 463 U.S. 646 (1983).

<sup>6</sup> *Id.* at 662 (emphasis added).

<sup>7</sup> *Id.* at 660.

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<sup>8</sup> *Newman*, Nos. 13-1837-cr(L), 13-1917-cr(con), at \*12-13.

<sup>9</sup> *Id.* (citing Gov't Br. at 58) (emphasis added).

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* at \*16-17.

<sup>12</sup> *Id.* at 18.

<sup>13</sup> *Id.* at \*21.

<sup>14</sup> *Id.* (quoting *United States v. Jiau*, 734 F. 3d 147, 153 (2d Cir. 2013)).

<sup>15</sup> *Id.*

<sup>16</sup> *Id.* at \*23.

<sup>17</sup> *Id.*

<sup>18</sup> *Id.* at \*23.

<sup>19</sup> *Id.* at \*21.

<sup>20</sup> *Id.* at \*25.

<sup>21</sup> *Id.*

<sup>22</sup> *Id.* at \*25-27.

<sup>23</sup> *Id.* at \*27.

<sup>24</sup> See Stop Trading On Congressional Knowledge Act, 112 P.L. 105, 126 Stat. 292-93, 297-98.

<sup>25</sup> See Statement Of Manhattan U.S. Attorney Preet Bharara On The U.S. Court Of Appeals Second Circuit Decision In U.S. v. Todd Newman And Anthony Chiasson, Dec. 10, 2014, available [here](#).