

Second Circuit Reverses Insider Trading Convictions of Remote Tippees

On December 10, 2014, the United States Court of Appeals for the Second Circuit issued an important and much-anticipated decision that clarified certain aspects of insider trading law, especially with regard to tippees, and made clear its view that the Government had overreached in recent insider trading cases targeting remote tippees.

In [*United States v. Newman and Chiasson*](#), the Court held that in order to sustain an insider trading conviction against a tippee, the Government must prove that the tippee knew that a company insider had disclosed confidential information *and* that the insider did so in exchange for a personal benefit, in violation of the insider's fiduciary duty. The Court then went on to hold that the evidence against the defendants was insufficient in two respects. First, the Government had failed to prove that an insider had received a personal benefit. Second, the Government had failed to prove that the defendants knew that they were trading on information obtained from an insider in breach of the insider's fiduciary duty. Because of those fundamental insufficiencies, the Court not only reversed the convictions, but also dismissed the indictment. The case is over.

The Trial

The Government's evidence at trial showed that Newman and Chiasson, hedge fund portfolio managers, traded on confidential earnings information disclosed by employees of two publicly traded technology companies, Dell and NVIDIA. The information had made its way to Newman and Chiasson through a series of tips. With respect to Dell, a member of the company's investor relations department tipped an analyst at an investment management firm (the first-level tippee), who tipped an analyst at the fund where Newman worked (the second-level tippee), who tipped Newman (a third-level tippee) and an analyst at the fund where Chiasson worked (another third-level tippee), who tipped Chiasson (a fourth-level tippee). With respect to NVIDIA, a member of the company's finance unit tipped a former technology company executive (the first-level tippee), who tipped an analyst at an investment management firm (the second-level tippee), who tipped analysts at the funds where both Newman and Chiasson worked (the third-level tippees), who tipped Newman and Chiasson (the fourth-level tippees).

The Government never charged the insiders at Dell and NVIDIA, but did secure guilty pleas from all the intermediary tippees, some of whom testified as Government witnesses. The Government's theory at trial was that Newman and Chiasson were

criminally liable for insider trading because, as sophisticated traders, they must have known that the information on which they traded had been disclosed by insiders in breach of a fiduciary duty, and not for any legitimate corporate purpose.

Under the Supreme Court's landmark 1983 ruling in *Dirks v. SEC*, in order to prove its case against Newman and Chiasson, the Government was required to show that the Dell and NVIDIA insiders had disclosed confidential information in exchange for a "personal benefit." In an attempt to satisfy that burden, the Government showed that the Dell insider had sought and received "career advice" from the first-level Dell tippee, whom the insider had known for years as a business school classmate and later as a work colleague, and that the NVIDIA insider was a "family friend" of the first-level NVIDIA tippee, having met the tippee through church and occasionally socialized with him.

At the Government's urging, and over the defendants' objection, the trial judge charged the jury that, with respect to the defendants' knowledge, the Government need prove only that Newman and Chiasson knew that the information they had received came from corporate insiders in breach of their fiduciary duty. The judge did not charge the jury that the Government needed to prove that the defendants knew of the personal benefits received by the insiders.

The jury convicted both defendants. Newman was sentenced to 54 months' imprisonment, and ordered to pay a \$1 million fine and to forfeit more than \$700,000. Chiasson was sentenced to 78 months' imprisonment, and ordered to pay a \$5 million fine and to forfeit more than \$1.3 million.

The Second Circuit Decision

On appeal, the Second Circuit rejected virtually every aspect of the Government's case.

First, the Court held that, contrary to the jury instruction urged by the Government, a conviction for insider trading requires proof that the tippee knew that an insider disclosed confidential information *and* that the insider did so in exchange for a personal benefit. The Court concluded that this holding follows directly from the Supreme Court's decision in *Dirks*, which made clear that exchanging confidential information for a personal benefit is the fiduciary breach that is the *sine qua non* of insider trading liability. Therefore, proving that the tippee had knowledge of the insider's fiduciary breach (which the Government conceded was part of its burden) necessarily means proving that the defendant had knowledge of the personal benefit that is part and parcel of that breach.

If the decision had ended there, the convictions would have been reversed for the faulty jury instruction and the case would have been remanded to the lower court for

retrial. But the Second Circuit went on to find evidentiary insufficiencies in the Government's case and, as a result, dismissed the indictment.

First, the Second Circuit held that the "career advice" received by the Dell insider and the "family friendship" received by the NVIDIA insider were each insufficient as a matter of law to establish the required personal benefit. According to the Court, the "career advice" was little more than the encouragement one would generally expect of a fellow alumnus or casual acquaintance, such as minor suggestions for drafting a resume and preparing for an interview. The "family friendship" was even more ephemeral; the evidence showed that the insider and first-level tippee were "merely casual acquaintances." If these were "personal benefits" for purposes of insider trading liability, the Court noted, then "practically anything would qualify."

The Court acknowledged that "personal benefit" is a broad concept that includes not only pecuniary gain but also reputational benefit that will translate into future earnings and the benefit one would obtain by making a gift of confidential information to a trading relative or friend. But it is not so broad as to include a mere casual friendship. The Court observed, for example, that simply proving that two individuals were alumni of the same school or attended the same church would be insufficient. According to the Court, the law requires "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." In short, the personal benefit must be "of some consequence."

The Government's failure to prove that the Dell and NVIDIA insiders received a personal benefit meant that the tippees committed no crime, and since tippee liability is derivative of tipper liability, it necessarily followed that none of the tippees committed a crime. For Newman and Chiasson, that meant dismissal of their indictment. It remains to be seen how the Government and the courts will deal with the intermediary tippees – all of whom pleaded guilty to conduct that the Second Circuit has now said did not violate the law.

After addressing the Government's failure to prove personal benefit, the Second Circuit went on to explain another fundamental defect in the Government's case, relating to the defendants' state of mind: there was "absolutely no testimony or any other evidence that [the defendants] knew they were trading on information obtained from insiders, or that those insiders received any benefit in exchange for such disclosures."

The Court noted that Newman and Chiasson were several steps removed from the insiders, and knew next to nothing about them, and nothing at all about what, if any, personal benefits they received. That made for a novel prosecution. Indeed, the Government did not cite, and the Court did not find, a single case in which tippees as

remote as Newman and Chiasson had been held criminally liable for insider trading. Nevertheless, the Government asserted that the specificity, timing, and frequency of the information that Newman and Chiasson received put them on notice that the information originated from a corporate insider who had disclosed the information in breach of a fiduciary duty. But the Court rejected that assertion, observing that portfolio managers regularly receive specific, entirely legitimate financial information concerning public companies. Hedge fund analysts working for portfolio managers routinely develop such information by preparing financial models based on publicly available information and educated assumption. Moreover, analysts routinely receive assistance in their modeling from the public companies themselves, through authorized disclosures. In this case, where the defendants were so far removed from the corporate insiders, and the information they received was consistent with the type of legitimate information they routinely received, the Court found the evidence was insufficient to prove knowledge that the information originated from a corporate insider in breach of a fiduciary duty.

Conclusion

The Second Circuit's decision will no doubt make it more difficult for the Government to secure insider trading convictions against remote tippees. Proving that a remote tippee knew that a corporate insider had improperly disclosed confidential information in exchange for a personal benefit is a challenge in any circumstance. Proving it in the hedge fund context, where, as the Court acknowledged, analysts routinely and legitimately model a company's financial performance, often guided by authorized company disclosures, is especially difficult.

According to the Second Circuit, however, that is the burden that the law requires the Government to shoulder. The Court held fast to the principle that there is no "general duty between all participants in market transactions to forgo actions based on material, nonpublic information." Indeed, "insider trading liability is based on breaches of fiduciary duty, not on informational asymmetries." While Newman and Chiasson may have traded on information not generally available to the public, the Court made clear that such trading is not a crime, absent a breach of fiduciary duty that is known to the trader.

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If you have any questions, please feel free to contact any of your regular contacts at the firm. You may also contact our partners and counsel listed under [White-Collar Defense, Securities Enforcement, and Internal Investigations](#) located in the "Practices" section of our website at <http://www.clearygottlieb.com>.

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