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Newman and *Salman* : New Boundaries Set on Insider Trading

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Two recent decisions by the United States Courts of Appeals for Second and Ninth Circuits address the scope of tippee liability arising out of the corporate insider's breach of fiduciary duty.[1] In addressing the scope of tippee liability, both courts focused on the second element of the tippee liability test, which requires that the corporate insider breach his fiduciary duty by disclosing confidential information to a tippee in exchange for a *personal benefit*. The Second Circuit took a narrow approach in addressing this second element and held that the government had to prove that the tippee *knew* that the tipper received a personal benefit, beyond the existence of a casual friendship, in exchange for the disclosure.[2] On the other hand, the Ninth Circuit decision subsequently addressed circumstances in which a personal or familial relationship between a tipper and insider could satisfy the "personal benefit" requirement.[3] The Ninth Circuit held that a tippee's knowledge that the tipper received confidential information from an insider with whom the tipper shared a close relationship was sufficient to meet the "personal benefit" test. These recent appellate decisions provide critical guidance for individuals subject to investigations involving tippee liability arising out of insider trading allegations.

In *U.S. v Newman*, the Second Circuit overturned the conviction of two individuals charged with insider trading. Significantly, this decision sets forth the limit at which the Second Circuit will uphold tippee liability by holding, *inter alia*, that the existence of a casual friendship alone does *not* satisfy personal benefit requirement of insider trading liability. In *Newman*, the Second Circuit overturned the conviction of two individuals charged with insider trading. The decision seemingly re-draws the figurative line in the sand in the context of the tipper and tippee liability chain. The Second Circuit based its decision upon two findings. The first was that the government failed to meet its evidentiary burden to establish that the tippee knew of the insider, and that the tipper derived a personal benefit from giving the tip.[4] The second holding, more procedural in nature, was the Court's determination that the district court had committed harmful error by failing to instruct the jury regarding the government's burden of proof of those two facts.[5] The ruling created a ping of uncertainty among a recent string of successful insider trading cases brought by the government in the district courts, particularly the Southern District

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[1] The Supreme Court held in *Dirks v. S.E.C.*, 463 U.S. 646 (1983) that the following elements must be satisfied for there to be a finding of tipper and tippee liability: (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.

[2] *U.S. v. Newman*, 773 F.3d 438 (2d Cir. N.Y. 2014), *cert denied*, 136 S. Ct. 242 (October 5, 2015)

[3] *U.S. v. Salman*, 792 F.3d 1087 (9th Cir. Cal. 2015)

[4] *U.S. v. Newman*, 773 F.3d at 448.

[5] *Id.* at 450.

of New York, and undoubtedly will draw an increased level of scrutiny to insider trading prosecutions brought within the Second Circuit.

While all the above was happening on the East Coast, out on the West Coast Salman was awaiting appellate review of his conviction for insider trading. No doubt sensing an opportunity, he sought and was granted permission to file a supplemental pleading, in light of *Newman*. Seeking to exploit the dust raised by *Newman*, Salman requested the Ninth Circuit to revisit its own position on the standard of proof required for an insider trading conviction. Despite the Second Circuit's restriction on tippee liability, the Ninth Circuit had no hesitation in finding that the government had in fact met its burden of proof, by establishing that the tipper had made a gift of confidential information to a trading relative or friend, the latter being well aware that the former was breaching a duty of confidentiality and deriving a benefit therefrom.[6]

Insider trading is largely a judicial construct, punishable as a violation of the general anti-fraud provisions of the 1934 Securities Exchange Act. Liability is predicated on the notion that insider trading is proscribed by Section 10(b).[7] Section 10(b) of the 1934 Act prohibits the use of "any manipulative or deceptive device or contrivance in contravention of such rules and regulation as the Commission may prescribe…" in connection with the purchase or sale of any security. Naturally, Rule 10b-5, promulgated by the S.E.C. long ago, mimics Section 10(b)'s language, and is an adjunct to the statutory prohibition found here.

As reiterated by the *Newman* court, and as found in many prior cases, liability for insider trading exists under either the "classical" or the "misappropriation" theories. The classical theory states that a corporate insider violates Section 10(b) and Rule 10b-5 by his own trading in the corporation's securities on the basis of material, nonpublic information.[8] Liability arises from the special relationship of trust that exists between the shareholders of the corporation and those insiders who possess material, nonpublic information not yet available to the broad market. Insiders therefore have "a duty to disclose [or to abstain from trading] because of the necessity of preventing a corporation insider from …tak[ing] advantage of… uninformed…stockholders."[9]

In contradistinction, yet intersecting with the classical theory, the misappropriation theory expands to those outside the executive suite who do not have a fiduciary or special relationship to a corporation or its shareholders, yet are in possession of material, non-public information about the corporation. When these ostensible outsiders trade on that information to their gain, they incur liability on the theory that, essentially, they misappropriate knowledge that does not belong to them. [10]

As the classical and misappropriation theories have evolved over the decades, the Supreme Court has extended insider trading liability via the tipper and tippee relationship.[11] Tipping liability, as the *Newman* court elucidated, reaches situations where "the insider or

[6] *U.S. v. Salman* 792 F.3d at 1093
[7] *Chiarella v. United States*, 445 U.S. 222, 226-30 (1980).
[8] *Id.* at 230.
[9] *Id.* at 228-29 (citation omitted).
[10] *United States v. O'Hagan*, 521 U.S. 642, 652-53 (1997).
[11] *Dirks*, supra.

misappropriator in possession of material nonpublic information (the "tipper") does not himself trade but discloses the information to an outsider (a "tippee") who then trades on the basis of the information before it is publicly disclosed.[12] This was seized upon by the Second Circuit in *Newman*, which pointed to Supreme Court dicta that "[t]he tippee's duty to disclose or abstain is derivative from that of the insider's duty", and, because "the tipper's breach of duty requires that he personally will benefit, directly or indirectly, from his disclosure, a tippee may not be held liable in the absence of such benefit." Thus, in *Newman* the tribunal held that "a tippee may be found liable only when the insider has breached his fiduciary duty…*and* the tippee knows or should know that there has been a breach."[13]

In *Newman*, the Second Circuit noted that the government's case relied upon evidence that showed the defendants had traded on material, non-public information obtained from analysts at their respective hedge funds. It was clear that the defendants were several levels removed from the original tipper at the subject technology firms, Dell and Nvidia. In the first instance, a Dell employee initially disclosed Dell's earning information to one analyst unrelated to the defendants' firm, who then revealed the earnings to an analyst employed at Newman's fund, who later on reported the information to Newman, and then to yet more analysts at Chiasson's fund, who finally gave Chiasson the insider scoop. Regarding the Nvidia trades in question, a member of Nvidia's finance unit disclosed the firm's earnings to a social friend from his church, who then shared the information with an analyst at another financial advisor, and then that analyst tipped a group of analysts at both Newman's and Chiasson's firms, who ultimately informed the defendants.

Drawing from the Supreme Court's holding in *Dirks*, the *Newman* defendants argued that the government failed to present sufficient evidence that the tippers received a "personal benefit" from the disclosure.[14] Specifically, innocuous career advice given to the Dell tipper did not give rise to a level to satisfy the "personal benefit" analysis laid out in *Dirks.* Further, the government did not offer any evidence that the insider in the Nvidia received any sort of benefit at all.

In reversing the convictions, the Second Circuit revitalized the "benefit" analysis of *Dirks*, holding that the prosecution "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.[15]

Applying the clarified test to the appeal before it, the Second Circuit found that the district court's instruction failed to accurately advise the jury of the law. The district court incorrectly charged the jury that the government had to prove: (1) that the insiders had a

[12] *United States v. Newman*, 773 F.3d at 446
[13] *Id.* (internal quotation omitted)
[14] Under *Dirks v. S.E.C.*, 463 U.S. at 662 a tipper has breached their fiduciary duty if the insider personally will benefit, directly or indirectly, from his disclosure. Further, the tippee's duty is derivative of the tipper's duty. *Id.* at 659-62.
[15] *Id.* at 450.

"fiduciary or other relationship of trust and confidence" with their corporations; (2) that they "breached that duty of trust and confidence by disclosing material, nonpublic information"; (3) that they "personally benefited in some way" from the disclosure; (4) "that the defendant… knew the information he obtained had been disclosed in breach of a duty"; and (5) that the defendant used the information to purchase a security. By omitting the key element "in exchange for personal benefit", the Second Circuit reasoned that a juror "might have concluded that a defendant could be criminally liable for insider trading merely if such defendant knew that an insider had divulged information that was required to be kept confidential." The Second Circuit cited *Dirks* and reiterated that "a breach of confidentiality is not fraudulent unless the tipper acts for personal benefit, that is to say, there is no breach unless the tipper 'is in effect selling information to its recipient for cash, reciprocal information, or other things of value for himself.'" The improper jury instruction, coupled with the government's dearth of evidence on the subject proved to be the fatal blow to upholding the convictions.[16]

Hoping for an identical result, the defendant in *Salman* attempted to persuade the Ninth Circuit to apply the same standard as announced in *Newman*. However, as outlined by Judge Rakoff (a New York district judge sitting by designation on the Ninth Circuit panel) in the opinion, even assuming *arguendo* that the *Newman* holding was binding upon the Ninth Circuit (which, of course, it is not), *Salman* is clearly distinguishable.

In *Salman*, the Ninth Circuit was confronted with a defendant who allegedly traded upon inside information he purportedly obtained through the close relationship he had with his brother-in-law, Michael Kara. Michael Kara was also trading on non-public information he had obtained through his brother, a member of Citigroup's healthcare investment banking group, Maher Kara. As the tribunal noted, the evidence was clear that "Salman knew full well that Maher Kara was the source of the information." Moreover, "Michael and Maher Kara enjoyed a close and mutually beneficial relationship", and "Salman was aware of the Kara brothers' close fraternal relationship."[17]

Focusing upon the "personal benefit" requirement derived from in *Dirks*, the Ninth Circuit further emphasized the Supreme Court's holding, quoting the following passage from *Dirks:* The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend."[18] Accordingly, applying the Supreme Court maxims of *Dirks* to the appeal at hand, the tribunal held that Maher's disclosure of confidential information to his brother, with awareness that the latter intended to trade on it, "was precisely the gift of confidential information to a trading relative that *Dirks* envisioned."[19] It only flowed logically that given the Kara brothers' close relationship, and Salman's knowledge of that relationship, Salman could have readily inferred Maher's intent to benefit Michael.[20]

[16] *Id.*
[17] *United States v. Salman*, 792 F.3d at 1090.
[18] *Id* at 1092, quoting *Dirks v. S.E.C.*, 463 U.S. at 664.
[19] *Id*. internal quotations omitted.
[20] *Id.*

Providing the utmost level of clarity, the *Salman* court distinguished itself from the circumstances in *Newman*, observing that the nature of the relationship between the *Newman* tipper and tippee was far more nebulous than the relationship present in *Salman*. Employing its sister court's language, the Ninth Circuit declared as follows:

> The Second Circuit held that [the] evidence was insufficient to establish that either [tippers] received a personal benefit in exchange for the tip. It noted that although the "personal benefit" standard is "permissive," it "does not suggest that the Government may prove the receipt of personal benefit by the mere fact of a friendship, particularly of a casual or social nature." Instead, to the extent that "a personal benefit may be inferred from a personal relationship between the tipper and tippee,…such an inference is impermissible in the absence of proof of a meaningfully close personal relationship that generals an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." [21]

Taken in the broader context, it appears that while the Second Circuit has applied the brakes to the Government's high speed pursuit of market malefactors. Notwithstanding, the Ninth Circuit assures prosecutors that they need not toss out the play book on insider trading. Moving forward, any individual subject to government investigation or indictment must now asses the applicability of the heightened standard of proof set forth in *Newman*, while still being aware of the Ninth Circuit's adherence to a more traditional approach to the government's evidentiary burden. The critical lesson to be drawn from these two decisions is that the government will be required to establish a "meaningful close personal relationship" in the tipper/tippee chain in order to trigger tippee liability in the context of insider trading.

As this writing went to publication, the U.S. Supreme Court announced it would grant review in *Salman*. This step is a clear indication that at least some of the Justices are concerned that *Salman* and *Newman* represent divergent views, and thus need to be reconciled in order to bring clarity to the law of insider trading; specifically the "personal benefit" analysis. As always, the Supreme Court shall have the last word, and we can reasonably expect that definitive ruling by the end of the Court's term in late June of this year.

[21] *United States v. Salman*, 792 F.3d at 1093, citing *United States v. Newman*, 773 F.3d at 452.