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To: Our Clients and Friends December 10, 2014

Second Circuit Overturns Insider Trading Convictions of "Downstream" Tippees, Clarifying the Standard for Criminal Liability

In a much-anticipated decision, the U.S. Court of Appeals for the Second Circuit today overturned the convictions of two former hedge fund managers charged with conspiracy to commit insider trading and insider trading in violation of section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. *See U.S. v. Newman*, Case No. 13-1837 (2d Cir. Dec. 10, 2014). The court ruled that criminal liability could not be imposed on a "downstream" tippee without proof that the tippee knew the inside information was disclosed by the tipper in exchange for a personal benefit. This ruling is significant in its rejection of federal prosecutors' insider-trading theories.[1]

The two appellants, former Level Global Investors LP manager Anthony Chiasson and former Diamondback Capital Management LLC manager Todd Newman, were convicted in 2012 based on evidence presented by the government that they both traded in Dell Inc. and NVIDIA Corp. stock after receiving tips that originated with technology industry insiders. Chiasson and Newman were not employees or traditional insiders of the companies in whose stock they traded but were "downstream tippees," several steps removed from the corporate insiders.

The government nevertheless argued at trial that it need only prove that the defendants traded on material, nonpublic information they knew insiders had disclosed to someone in breach of a duty of confidentiality. The district court apparently agreed; it refused to instruct the jury that to return a guilty verdict, the jury must find not only that an insider disclosed confidential information, but also that the defendants knew that the insider had done so in exchange for a personal benefit.

[1] On November 10, 2014, in connection with the U.S. Supreme Court's denial of a petition for certiorari in an insider trading case, Justice Scalia issued a statement indicating his receptiveness to hearing a case addressing the question of whether a court owes deference to an executive agency's interpretation of a law that contemplates both criminal and administrative enforcement. For more details, see www.bryancave.com/Courts-May-Be-Too-Deferential-to-SECs-Interpretation-of-Insider-Trading-Laws

In overturning the convictions, the Second Circuit relied heavily on the Supreme Court case of *Dirks v. S.E.C.*, 463 U.S. 646 (1983), which set forth the general principles of insider trading liability for tippers and tippees. In *Dirks*, the Supreme Court noted that corporate insiders are forbidden by their fiduciary relationship from personally using nonpublic corporate information to their advantage and that the test for determining whether the insider has breached his fiduciary duty "is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty . . . ." *Id.* at 662.

Thus, to extend liability to tippees, whose duties are derivative of the tipper's duties, it must also be proven that the insider benefitted. While the government in the *Newman* cases conceded that it had to prove the insider/tipper benefitted, it argued that it was not required to prove that the *defendants knew* that the insider/tipper benefitted. The Second Circuit disagreed, holding that the government had to prove the tippee's knowledge that the tipper had benefitted:

> *Dirks* counsels us that the exchange of confidential information for personal benefit is not separate from an insider's fiduciary breach; it *is* the fiduciary breach that triggers liability for securities fraud under Rule 10b-5. For purposes of insider trading liability, the insider's disclosure of confidential information, standing alone, is not a breach. Thus, without establishing that the tippee knows of the personal benefit received by the insider in exchange for the disclosure, the Government cannot meet its burden of showing that the tippee knew of a breach.

Accordingly, the Second Circuit found that the district court erred in failing to include in the jury instruction the element of the defendant's knowledge of the personal benefit. It held 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." (Emphasis in original).

This decision places significant limits on the government's ability to seek to impose criminal liability on tippees who are several layers removed from the original tipper, and will inhibit prosecutions where the government cannot show the tippee's knowledge of the benefit obtained by the tipper.

For more information about this update, or if you have any questions regarding Bryan Cave's White Collar Defense and Investigations or Securities Litigation and Enforcement Groups, please contact R. Joseph Burby at 404-572-6815 or Ann W. Ferebee at 404-572-5903. To learn more about our White Collar Defense and Investigations Group or Securities Litigation and Enforcement Groups, please visit our website at www.bryancave.com.