INSIGHTS

THE CORPORATE & SECURITIES LAW ADVISOR

Volume 29 Number 1, January 2015

SECURITIES ENFORCEMENT

Second Circuit Injects New Life Into *Dirks* Personal Benefit Test in *United States v. Newman*

The Second Circuit's recent decision in United States v. Newman *vacated the convictions of two high-profile insider trading defendants and dealt a blow to the Manhattan U.S. Attorney's Office's five-year assault on insider trading. In so doing, the appeals court returned life to the "personal benefit" test, which the Supreme Court enumerated more than thirty years ago, for establishing when a tipper breaches a fiduciary duty.*

By Avi Weitzman, Daniel P. Chung, and Anna Karamigios

Over thirty years ago, in *Dirks v. SEC*,[1] the U.S. Supreme Court held that an insider trading violation does not occur unless a corporate insider disclosed material nonpublic information in breach of a fiduciary duty. The Court elaborated that the inquiry into whether a fiduciary duty has been breached turns on whether the insider received a "personal benefit" in exchange for disclosing the inside information; absent such a personal benefit, even the unauthorized disclosure of inside information cannot constitute securities fraud. In addition, the Court made clear that a tippee's liability for insider trading is merely derivative of the tipper's liability. Thus, if the tipper did not breach his or her fiduciary duty by disclosing the inside information, the tippee did not violate the securities laws by trading on inside information.

By holding that insider trading is, in essence, an act of self-dealing, *Dirks* rejected an SEC effort to prohibit all trading on material nonpublic information. Since *Dirks*, however, courts have allowed the Government to whittle away steadily at the "personal benefit" requirement, threatening to make it an almost trivial element in insider trading cases. But, with a recent opinion that reversed two high-profile insider trading convictions, the Second Circuit in *United States v. Newman* has reinvigorated the personal benefit requirement. As such, *Newman* presents significant challenges to a recent Government effort to extend the insider-trading prohibition to downstream tippees, with the decision likely to jeopardize a number of such insider trading investigations and convictions.

Dirks and the Personal Benefit Test

Raymond Dirks was a securities analyst who followed the insurance industry.[2] Dirks learned

Avi Weitzman is a partner, Daniel P. Chung is of counsel, and Anna Karamigios is a law clerk, at Gibson Dunn & Crutcher LLP in New York, N.Y.

from a former officer at a publicly-traded insurance company, Equity Funding of America (Equity Funding), that the company's assets were fraudulently overstated and that various regulatory agencies had failed to act despite similar allegations by other company insiders. The whistleblower urged Dirks to investigate and expose the fraud. Dirks confirmed the former officer's allegations by interviewing other corporate employees. He then attempted to expose the fraud through the press, but to no avail because the press feared a libel suit. Dirks disclosed his findings to investors and clients of his firm; they, in turn, sold their shares in the company, causing the price of the company's stock to drop precipitously. The insiders' and Dirks' allegations subsequently were confirmed by California insurance authorities, after which the SEC filed its own complaint against the company and the press publicized the fraud allegations.

Despite exposing the fraud, Dirks was sued by the SEC for aiding and abetting insider trading by Dirks' downstream tippees. The case was brought before an administrative law judge. The SEC found Dirks liable, broadly holding: "Where tippees—regardless of their motivation or occupation—come into possession of material 'corporate information that they know is confidential and know or should know came from a corporate insider,' they must either publicly disclose that information or refrain from trading.'"[3] The Court of Appeals for the District of Columbia Circuit affirmed.

The Supreme Court reversed, holding that Dirks was not liable as a tippee because the whistleblower and other Equity Funding employees with whom Dirks spoke did not breach their fiduciary duties in disclosing the fraud to Dirks. "The tippers received no monetary or personal benefit for revealing Equity Funding's secrets, nor was their purpose to make a gift of valuable information to Dirks."[4] Instead, the tippers were motivated by a desire to expose the fraud. The Court held: "[a]bsent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach by [Dirks or other tippees]."[5]

The Court in *Dirks* emphasized that the personal benefit test did not turn on the parties' subjective intent, but rather is focused on "objective criteria." While the Court did not delineate every way in which the personal benefit test can be satisfied, it identified several examples of sufficient proof, including "pecuniary gain" to the tipper, "a reputational benefit [to the tipper] that will translate into future earnings," and "a gift of confidential information to a trading relative or friend… resembl[ing] trading by the insider himself followed by a gift of the profits to the recipient."[6] Each of these benefits is pecuniary in nature and looks to whether the insider has engaged in self-dealing.[7] The Court created what it believed to be a bright-line rule in order to provide "a guiding principle" for "those whose daily activities must be limited and instructed by the SEC's inside-trading rules."[8] Because, as the SEC acknowledged, "market efficiency in pricing is significantly enhanced by [analysts'] initiatives to ferret out and analyze information,"[9] a personal benefit test is needed to ensure that the insider trading rules do not "have an inhibiting influence on the role of market analysts" who are "necessary to the preservation of a healthy market."[10]

Thus, *Dirks* firmly established two basic principles of insider trading law. *First*, a tipper cannot be held liable for insider trading unless he discloses material nonpublic information in breach of a fiduciary duty—defined to mean in exchange for a personal benefit. *Second*, because tippee liability is derivative of the tipper's liability, a tippee cannot be liable for trading on inside information unless the tipper has breached a fiduciary duty to the company's shareholders.[11]

The SEC predicted little adverse effect to its enforcement program following *Dirks*, stating in a report to Congress: "[w]hile the *Dirks* decision does introduce certain additional elements of proof, and, on occasion, does present certain conceptual challenges in the development of cases, the Commission believes that the decision has not adversely affected, to a significant degree, the Commission's enforcement program against insider trading."[12] Over the following decades, the SEC's prediction proved to be correct.

The Lower Courts Whittle Away at *Dirks*

Since the Supreme Court's ruling in *Dirks*, courts have diminished the *Dirks* personal benefit test. Some courts, for example, have stated that the *Dirks* rule requires only "modest" proof,[13] and that the *Dirks* "bar is not a high one."[14] Indeed, although *Dirks* seemed to contemplate proof of some type of objective pecuniary or pecuniary-like gain to the tipper, the Government succeeded in getting courts to require much less. The Government achieved this by making two examples from *Dirks* broad enough to undo the rule. *First*, because "a gift of confidential information to a trading relative or friend" was sufficient under *Dirks*,[15] the Government classified many tips from insiders to tippees as a "gift" of information. Courts often did not require the Government to prove a particularly close relationship between tipper and tippee, as even casual business or social acquaintances sufficed.[16] So broad did the "gift" exception become that merely alleging the existence of a tipper-tippee relationship was sufficient to warrant a fact-finder's inference that the tipper intended to gift inside information to the tippee.[17] *Second*, because *Dirks* identified a "reputational benefit that will translate into future earnings" as an example of a sufficient personal benefit under *Dirks*,[18] the Government would often simply allege that the tip was a way of enhancing the tipper's reputation or maintaining a networking contact, even absent proof of a resulting pecuniary benefit to the tipper.[19]

As a result of these broadened theories of personal benefit, the *Dirks* rule proved to be a rather ineffective limiting principle in insider trading cases. Even absent any pecuniary benefit to the tipper, insider trading charges were brought against tippers and tippees who traded on material nonpublic information, including downstream tippees who knew neither the identity of the individual tipper nor whether the tipper had personally benefitted from providing the tip. It was the rare case indeed for a court to dismiss insider trading cases for lack of a *Dirks* personal benefit to the tipper.[20] And, until July 2014, the U.S. Attorney's Office for the Southern District of New York had a perfect record of over 80 consecutive insider trading convictions in connection with the Office's unprecedented 5-year assault on insider trading.[21]

The Second Circuit's Effort to Revive the *Dirks* Personal Benefit Test

On December 10, 2014, the United States Court of Appeals for the Second Circuit re-injected life into the *Dirks* personal benefit test in its decision in *United States v. Newman*.[22] In *Newman*, the court overturned the convictions of, and dismissed with prejudice the indictments against, two high-profile insider trading defendants—Anthony Chiasson and Todd Newman. Chiasson and Newman were hedge fund managers who traded in technology stocks: Chiasson at Level Global Investors, L.P., which he co-founded; and Newman at Diamondback Capital Management, LLC, where he worked as a portfolio manager.

On November 22, 2010, the FBI executed search warrants at both hedge funds. Although neither Chiasson nor Newman was arrested at the time, their hedge funds suffered significant reputational and financial harm, and by the end of 2012, both were shuttered. Thereafter, on January 18, 2012, Chiasson and Newman were arrested for allegedly trading Dell and Nvidia stock based on material nonpublic information that originated from insiders at those companies. Their hedge funds were alleged to have reaped $72 million in illicit profits, making this one of the largest insider trading prosecutions to date. Chiasson and Newman both proceeded to and were convicted at trial on multiple counts of securities fraud. Chiasson and Newman were sentenced to 6 ½ years and 4 ½ years in prison, respectively.

At trial, the evidence showed that both Chiasson and Newman traded on information provided by insiders at Dell and Nvidia, that the tips were relayed to them from their respective analysts, and that as a result, Chiasson and Newman were multiple levels removed from the original tippers. The Dell tip originated from an employee in Dell's investor relations department, who disclosed Dell's earnings information to Sandy Goyal, an analyst at another investment company, who in turn provided the information to Jesse Tortora, an analyst at Diamondback. Tortora then relayed the information to his portfolio manager, Newman, and other analysts, including Sam Adondakis at Level Global. Adondakis then shared the information with Chiasson. Thus, Newman and Chiasson were respectively three and four levels removed from the original Dell insider.

***The Government failed to present sufficient evidence that either corporate tipper received a personal benefit under* Dirks.**

The Nvidia tip originated from an employee at Nvidia's finance unit, who disclosed Nvidia's earnings information to a social friend from church, who in turn shared the information with Danny Kuo, an analyst at Whittier Trust. Kuo then tipped the information to a group of analysts, including Tortora and Adondakis, who shared the information with Newman and Chiasson. Thus, Newman and Chiasson were both four levels removed from the original Nvidia tipper.

On appeal, Chiasson and Newman challenged the sufficiency of the evidence at trial as well as the jury instructions.

Sufficiency of the Evidence

Chiasson and Newman argued that the evidence at trial was insufficient to show that the insiders at Dell and Nvidia breached their fiduciary duties to their respective companies under *Dirks*. At trial, the Government offered evidence that Goyal had provided "career advice" to the Dell tipper in exchange for disclosing Dell earnings. But Goyal testified that he gave the Dell insider career advice even before he received inside information about Dell, and that he would have given the advice even if the Dell insider had never shared the information. With respect to the Nvidia tipper, the Government claimed that the tipper gifted the inside information to his church friend, but the evidence showed that the friend did not provide anything of value in return and that the tipper did not know the church friend was trading Nvidia stock (which the church friend in fact had not done during the relevant time period). Chiasson and Newman thus argued that neither the Nvidia tipper nor the Dell tipper received a sufficient personal benefit to have breached their fiduciary duties.

The Second Circuit agreed, and held that the Government failed to present sufficient evidence that either corporate tipper received a personal benefit under *Dirks*. The Court explained that the Government must prove 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."[23] Though the tipper's gain "need not be *immediately* pecuniary," it must be "of some consequence."[24] The Court rejected the argument that the "mere fact of a friendship, particularly of a casual or social nature" is sufficient to show a benefit to the tipper, noting that "[i]f this was benefit, practically anything would qualify."[25] The Second Circuit accordingly found that the "career advice" the Dell insider received from Goyal was "little more than the encouragement one would generally expect of a … casual acquaintance," and that there was no *quid pro quo* because Goyal provided the Dell insider career advice irrespective of any tip.[26] Similarly, the Court found that the Nvidia insider and his church friend were "merely casual acquaintances" and that the evidence did not establish a history of personal favors between the two that would suffice under *Dirks*.[27]

Jury Instructions

Chiasson and Newman also argued that, even if there was sufficient evidence of benefit to the tippers, the District Court's jury instructions erroneously permitted conviction without any proof that Chiasson and Newman, as downstream tippees, *knew* that the tip was provided by the corporate insider in exchange for a benefit. The Second Circuit agreed, holding that the District Court should have instructed the jury that the Government must prove beyond a reasonable doubt that Chiasson and Newman had knowledge that the insider provided a tip in exchange for a personal benefit.

> ***Nothing in the law requires a symmetry of information in the nation's securities markets.***

The Court rejected the notion that sophisticated traders like Chiasson and Newman "must have known" that certain information is disclosed in breach of a fiduciary duty, and not for any legitimate corporate purpose.[28] To the contrary, the Court emphasized that the evidence at trial showed that investor relations personnel at both companies "routinely 'leaked' earnings data in advance of quarterly earnings."[29] Because Chiasson and Newman knew "next to nothing" about any personal benefit to the insiders at Dell and Nvidia, they did not have the intent to violate the securities laws, even if they were knowingly trading on material nonpublic information.[30] As the Court emphasized, "[a]lthough the Government might like the law to be different, nothing in the law requires a symmetry of information in the nation's securities markets."[31]

Practical Implications

Newman is a welcome course correction that will likely have ripple effects far beyond the facts of that particular case. *Newman* reinvigorates the Supreme Court's effort in *Dirks* to provide a "guiding principle" to investment professionals as to the reach of the insider trading prohibitions. In so doing, *Newman* also made it more difficult, in two important respects, for the Government to meet its burden of proof, particularly in connection with the Government's recent campaign to investigate and prosecute remote-tippees—a campaign that the Second Circuit found notable for its "doctrinal novelty."[32] *First*, it will be more challenging to pursue insider trading charges against professional traders who are remote tippees, as such traders often make quick trading decisions based on information without necessarily knowing the source of the information. While the Second Circuit left open the possibility that this element could be satisfied with evidence that the remote tippee consciously avoided learning of the personal benefit to the tipper, *Newman* nonetheless raises the bar for remote-tippee prosecutions.

Second, the Government will now find it difficult to establish the requisite personal benefit to the tipper under *Dirks* if there is no direct *quid pro quo*, since allegations of intangible future benefits, such as reputational or networking benefits that do not result in "at least a potential gain of a pecuniary or similarly valuable nature," may prove insufficient to establish the necessary breach of a fiduciary duty. This will have implications that reach beyond the remote-tippee context to include investigations and prosecutions of tippers and direct tippees, because a tippee's liability for insider trading is merely derivative of the tipper's liability.

It is not surprising, therefore, that top Government officials and regulators already have spoken out against the *Newman* ruling. United States Attorney Preet Bharara has warned that the ruling "will limit the ability to prosecute people who trade on leaked inside information," and has signaled his Office's intent to seek either a panel rehearing or rehearing *en banc*. (The U.S. Attorney's Office has obtained additional time, until January 23, 2015, to determine whether to seek any such rehearing.) In addition, courts in the Second Circuit have suggested that the ruling may jeopardize other convictions. For example, SDNY Judge Andrew L. Carter, Jr. has publicly called into question whether four other insider trading convictions can stand following the *Newman* ruling,[33] and Judge Richard J. Sullivan, who presided over the Newman and Chiasson trial, suggested that the guilty pleas of some of the cooperating witnesses against Newman and Chiasson may now have to be withdrawn.[34] And, although the *Newman* ruling was a criminal case, the SEC appears to acknowledge its application in the civil context, recently having dismissed its administrative insider trading case against a defendant accused of profiting from a tip that a hedge fund was about to announce its negative view of a publicly-traded company.[35] Undoubtedly, at least for the time being, the *Newman* ruling will continue to have significant repercussions for criminal and civil insider trading cases in the Second Circuit.

Notes

1. 463 U.S. 646 (1983).
2. *Id.* at 648.
3. *Id.* at 651 (citation omitted).
4. *Id.* at 667.
5. *Id.* at 662.
6. *Id.* at 663-64.
7. *Id.* at 664 ("[T]he insider, by giving the information out selectively, is in effect selling the information.") (quotation marks omitted).
8. *Id.*
9. *Id.* at 658 n.17.
10. *Id.* at 658.
11. Although *Dirks* concerned insider trading under the classical theory of insider trading, where a corporate insider trades or tips inside information in breach of his or her fiduciary duties to the company's shareholders, the rule in *Dirks* has been extended to apply as well to "misappropriation theory" cases, where a corporate outsider (such as a lawyer, accountant, or consultant) misappropriates confidential information for use in securities trading. *See, e.g.*, *SEC v. Obus*, 693 F.3d 276 (2d Cir. 2012); *SEC v. Yun*, 327 F.3d 1263 (11th Cir. 2003). *But see SEC v. Sargent*, 229 F.3d 68, 77 (1st Cir. 2000).
12. *See* Donald C. Langevoort, Insider Trading: Regulation, Enforcement, and Prevention, app. B (2014).
13. *United States v. Jiau*, 734 F.3d 147, 153 (2d Cir. 2013).
14. *Obus*, 693 F.3d at 292.
15. *See Dirks*, 463 U.S. at 664.
16. *In re Lohmann*, Exchange Act Release No. 48092 (June 26, 2003) (tipper and tippee were "friendly, if casual, office acquaintances" and the tipper allegedly gained "the personal satisfaction of his generosity and the admiration" of his younger colleague); *SEC v. Yun*, 327 F.3d at 1280 (tipper and tippee were "friendly" co-workers who sometimes split commissions in real estate transactions).
17. *See SEC v. Maio*, 51 F.3d 623, 633 (7th Cir. 1995) ("Absent some legitimate reason for Ferrero's disclosure … the inference that Ferrero's disclosure was an improper gift of confidential corporate information is unassailable. After all, he did not have to make any disclosure, so why tell Maio anything?"); *SEC v. Blackwell*, 291 F. Supp. 2d 673, 692 (S.D. Ohio 2003) ("A mere allegation that the insider has disclosed material non-public information is sufficient to create a legal inference that the insider intended to provide a gift to the recipient of the information, thereby establishing the personal benefit requirement."); *SEC v. Blackman*, 3:99-1072, 2000 WL 868770, at *9 (M.D. Tenn. May 26, 2000) ("[T]he legal inference is that the mere fact of Deragon's disclosure of this information sufficiently alleges a gift by him to the other defendants so as to satisfy the personal benefit requirement of *Dirks*."); *SEC v. Palermo*, 99 CIV 10067, 2001 WL 1160612, at *7 (S.D.N.Y. Oct. 2, 2001) ("Mr. Palermo admits that he and the Ehrlich brothers were friends. Thus, if the factfinder were to conclude that one or both Ehrlich brothers provided confidential information about EBS to Mr. Palermo, [the personal-benefit] element would be satisfied."); *SEC v. Rubin*, 91 CIV 6531, 1993 WL 405428, at *5 (S.D.N.Y. Oct. 8, 1993) ("The relationship here of customer and broker was sufficient itself to create the inference of an intent to benefit, absent evidence of an identifiable proper motive to disclose the information in question.").
18. *See Dirks*, 463 U.S. at 663.
19. *See, e.g.*, *United States v. Whitman*, 904 F. Supp. 2d 363, 372 n.7 (S.D.N.Y. 2012) (stating that *Dirks* personal benefit "need not be

financial or tangible in nature; it could include, for example, maintaining a useful networking contact, improving the reputation or power within the company, … or just maintaining or furthering a friendship."); *Sargent*, 229 F.3d at 77 (tip to "maintain a useful networking contact" was sufficient under *Dirks*).

20. *But see, e.g.*, *SEC v. Maxwell*, 341 F. Supp. 2d 941, 949 (S.D. Ohio 2004) (dismissing case where corporate officer received no personal benefit from providing inside information to his barber).

21. Christopher M. Matthews, "Jury Acquits Rengan Rajaratnam in Insider-Trading Case," Wall Street Journal, July 8, 2014.

22. *United States v. Newman*, Nos. 13-1837-cr (L), 13-1917-cr (con), 2014 WL 6911278 (Dec. 10, 2014).

23. *Id.* at *10.

24. *Id.*

25. *Id.*

26. *Id.* at *11.

27. *Id.*

28. *Id.* at *12.

29. *Id.* at *13.

30. *Id.* at *11.

31. *Id.* at *6.

32. As the *Newman* opinion noted, the Government's misreading of earlier Second Circuit cases "highlights the doctrinal novelty of its recent insider trading prosecutions, which are increasingly targeted at remote tippees many levels removed from corporate insiders." *Id*. at *6.

33. Larry Neumeister, "New York judge plans to toss 4 guilty pleas in insider-trading case after appeals court ruling," Associated Press, Dec. 18, 2014.

34. Nate Raymond and Aruna Viswanatha, "Insider Trading Defendants May Pull Please As Prosecutors Scramble," Reuters, Dec. 11, 2014.

35. James Sterngold, "Charges Dropped After Insider-Trading Ruling," Wall Street Journal, Dec. 15, 2014.