

The Second Circuit Sets New Hurdles for Insider Trading Convictions

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Under the Second Circuit's new ruling, prosecutors have two large hurdles they must clear to convict under securities laws. First, they must prove that a defendant knew that the source of inside information disclosed tips in exchange for a personal benefit. Second, the definition of "personal benefit" is tightened to something more akin to a quid pro quo exchange.

For years, insider trading cases have been slam dunks for federal prosecutors. The United States Attorney's Office in the Southern District of New York had compiled a remarkable streak of more than eighty insider trading convictions over the past five years. But that record has evaporated thanks to the United States Court of Appeals for the Second Circuit's ruling in *United States v. Newman*, in which the Second Circuit concluded that the district court's jury instructions were improper and that the evidence was insufficient to sustain a conviction.

The Second Circuit relied upon a thirty year old Supreme Court opinion, *Dirks v. SEC*, 463 U.S. 646 (1983), and highlighted the "doctrinal novelty" of many of the government's recent successful insider trading prosecutions in failing to follow *Dirks*. Accordingly, the Court overturned insider trading convictions for Todd Newman and Anthony Chiasson because the defendants did not know they were trading on confidential information received from insiders in violation of those insiders' fiduciary duties. More broadly, however, the Court laid down two new standards in tipping liability cases, both likely to frustrate prosecutors for years to come.

Tougher Disclosure Requirements

Section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission rules 10b-5 and 10b5-1 generally prohibit trading on the basis of material nonpublic information, more conventionally known as insider trading. In addition, federal law also prohibits an individual (the "tipper") from disclosing private information to an outside person (the "tippee"), if the tippee then trades on the basis of this private information. This disclosure—a breach of one's fiduciary duty—is known as tipping liability. As with most crimes, tipping liability requires scienter, a mental state that demonstrates intent to deceive, manipulate, or

defraud. In these cases, the government must show that the defendant acted willfully—i.e., with the realization that what he was doing was a wrongful act under the securities laws.

Until last week, willfulness had been fairly easy to show, and that was one of the principal reasons for the government's string of successes. Prosecutors only had to prove that the defendants traded on confidential information that they knew had been disclosed through a breach of confidentiality. In *Newman*, however, the Second Circuit rejected this position outright. The Court held that a tippee can only be convicted if the government can prove that he knew that the insider disclosed confidential information in exchange for a personal benefit, and one that is "consequential" and potentially pecuniary.

This distinction may seem minor, but its impact is enormous. The government now must prove—beyond a reasonable doubt, no less—that a defendant affirmatively knew about a personal benefit to the source of the confidential information. From the prosecution's perspective, this is a massively challenging prospect.

Tightened "Personal Benefit" Standards

The Second Circuit also clarified the definition of "personal benefit" in the tipping liability context. Previously, the Court had embraced a very broad definition of the term—so broad, in fact, that the government argued that a tip in exchange for "mere friendship" or "career advice" could expose a trader to tipping liability.

The Court retreated from this position and narrowed its standard. Now, to constitute a personal benefit, the prosecution must show an exchange "that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature"—in other words, something akin to a quid pro quo relationship. This, too, complicates a prosecution's case significantly.

Implications of the Ruling

What effect will this ruling have moving forward? Of course, one effect is obvious from the start: prosecutors are going to have a much more difficult time proving tipping liability. But as with many new appellate cases, it may take some time to see how this rule shakes out on the ground in the trial courts. Here are a few things to keep in mind over the next few months and years.

- This ruling may cause some immediate fallout. For example, there are currently several similar cases in New York that are pending for trial or appeal, and these may now result in acquittals or vacated convictions. In fact, some defendants who previously took guilty pleas in cooperation with *Newman* and *Chiasson's* case are considering withdrawing their pleas in light of this decision. Moving forward, look to see the SEC and potential defendants adjusting their behavior and strategies in light of this ruling. In fact, just this week, a New York Federal Judge expressed strong reservations about whether guilty pleas entered by four defendants in an insider trader case related to a \$1.2 billion IBM Corp. acquisition in 2009 should remain in light of *Newman*.
- This is also welcome news for tippees who did not interact directly with the source of the inside information. Although the source of the leak may still be prosecuted as usual, this ruling may shield a more remote party from an indictment. As the *Newman* court noted, the government's recent insider trading wins have been "increasingly targeted at remote tippees many levels removed from corporate insiders." Now, without clear evidence that the insider received a quantifiable benefit and that the tippee was aware of such benefit for providing the information, cases against such "remote tippees" will be tremendously more difficult to prove.

- But, caution should still reign where tippees deal more directly with tipplers. The tippees in this case were as many as three or four steps removed from the tipplers. It is not difficult to imagine the Court coming out the other way if Newman and Chiasson had been dealing with the tipplers themselves.
- One enormous question mark is to what extent the standards expressed in this case will affect the SEC's civil enforcement suits. We will have to wait and see, but traders should still use caution. Because civil suits require a substantially lower burden of proof and lesser standard of intent compared to criminal cases, it is possible that these new rules may offer little protection from a civil suit. Additionally, SEC attorneys will probably emphasize this distinction to courts in an attempt to distinguish their enforcement suits from Newman and Chiasson's criminal case, but whether this tactic is effective remains to be seen.
- Although the Court refined the meaning of a personal benefit, the definition is still purposefully flexible. This case tells us that abstract psychic benefits—friendship, business advice, church relationships—are not enough, but what about anything just short of exchanging money, favors, or goods? We don't yet know, and for that reason clients should exercise care.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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