Schulte Roth&Zabel

Alert

Newman's Aftermath: District Court Vacates Four Insider Trading Guilty Pleas; Government Seeks Rehearing in Second Circuit

January 27, 2015

Last week saw two significant developments for insider trading law stemming from the Second Circuit's important decision in *U.S. v. Newman*, 773 F.3d 438 (2d Cir. 2014). First, the government was dealt a significant loss when, on Jan. 22, 2015, U.S. District Judge Andrew L. Carter, Jr. vacated four insider trading defendants' guilty pleas in the wake of *Newman* and rejected the government's argument that the *Newman* decision does not apply to cases prosecuted under the so-called "misappropriation" theory of insider trading liability. Second, the next day, the government filed a petition for panel rehearing and rehearing *en banc* in *Newman*, seeking reversal of the Second Circuit's earlier decision vacating the convictions of defendants Todd Newman and Anthony Chiasson and dismissing their indictments with prejudice. Earlier this week, the SEC indicated its support of the U.S. Attorney's Office's position by filing a motion seeking to submit an *amicus curiae* (friend of the court) brief in support of the petition for rehearing in *Newman*.

These developments make clear that *Newman* is, as the government states in its petition for rehearing, "one of the most significant developments in insider trading law in a generation" (Petition, at 22-23) and suggest that the full impact of *Newman* on insider trading law still remains to be seen. These and further developments involving *Newman* should be closely followed by financial professionals and compliance personnel. *Newman* and its progeny will be important not just in criminal insider trading cases but in civil cases brought by the SEC as well as in investigations conducted by securities regulators.

***U.S. v. Newman* and the Requirements that the Government Prove a Tippee's Knowledge of the Personal Benefit Obtained by the Tipper and that the Personal Benefit Must be Objective and Consequential**

As explained in our Dec. 15, 2014 *Alert*, in *U.S. v. Newman*, the Second Circuit breathed new life into the "personal benefit" element of insider trading claims, holding both that the government must prove that a tippee (including a remote tippee) knew of the personal benefit obtained by the tipper and that the benefit had to be objective and consequential and not merely the result of a casual relationship between the tipper and his or her immediate tippee.

Although *Newman* was a criminal case, the Court made no effort to limit its holding to criminal cases and both the U.S. Attorney's Office and the SEC have reacted to *Newman*'s holding with concern. Even though *Newman* was decided barely a month ago, we are already seeing the ramifications of that important decision.

***U.S. v. Conradt* and the Application of *Newman* in Misappropriation Cases**

Judge Carter's order vacating the guilty pleas of four defendants in *U.S. v. Conradt* is significant because it is the first case where a Court has applied *Newman*'s holding to insider trading cases brought under the broader "misappropriation" theory, where liability depends upon a breach of a duty of trust or confidence to the source of the information and need not involve a breach by a corporate insider. Cases like *Newman,* which depend upon a breach of fiduciary duty to the issuer's shareholders, are brought under the "classical" theory of insider trading. Although both theories are derived from Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5 promulgated thereunder, the source of the duty owed by a person possessing confidential business information differs. The U.S. Supreme Court, in *Chiarella v. U.S.*, 445 U.S. 222, 230 n.12 (1980) and *Dirks v. SEC*, 463 U.S. 646, 654 (1983), explained that the classical theory applies to corporate insiders who owe a fiduciary duty to corporate shareholders not to exploit confidential corporate information for a personal benefit. In contrast, the misappropriation theory goes well beyond "insiders" of an issuer, applying instead to anyone who misuses information entrusted to that person in confidence (such as through execution of a confidentiality agreement) or other duty to the source of the information (sometimes referred to as a "fiduciary-like" duty). *See U.S. v. O'Hagan*, 521 U.S. 642, 652 (1997).

The defendants in *Newman* were prosecuted under the classical theory of insider trading; they allegedly received unreleased quarterly earnings reports from a group of analysts who had, in turn, received those reports from corporate insiders at Dell and NVIDIA. In *Newman*, the Second Circuit held that the government must prove that the defendants — Todd Newman and Anthony Chiasson, portfolio managers for different investment advisors — knew that the insiders disclosed confidential information in exchange for a personal benefit. 773 F.3d at 449. The Second Circuit also rejected the government's extremely broad definition of what constitutes a "personal benefit" in the absence of a direct pecuniary benefit to the tipper, holding that there must be at least "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." *Id.* at 452.

In *Conradt*, the government seized upon the fact that *Newman* was prosecuted under the classical theory to argue that *Newman*'s holding did not apply to insider trading cases brought under the misappropriation theory. *Conradt* involves insider trading charges brought against four defendants who allegedly traded on material non-public information regarding a planned acquisition by IBM of software company SPSS Inc. The information originated from an associate at an outside law firm retained by IBM, thus requiring the government to rely on the misappropriation theory. Each of the four defendants entered guilty pleas, but the Court advised the parties in December 2014 (shortly after *Newman* was decided) that it was inclined to vacate those guilty pleas as legally insufficient "in light of *Newman*'s clarification of the personal benefit and tippee knowledge requirements of tipping liability for insider trading." Order, *U.S. v. Conradt, et al.*, No. 12-CR-887 (ALC), at 1-2 (S.D.N.Y. Jan. 22, 2015). Although the government recognized that *Newman* had stated that the tests for insider trading were the same under the classical and misappropriation theories, the government opposed undoing the defendants' guilty pleas, arguing that any reference to the misappropriation theory in *Newman* was dicta and that prior Second Circuit decisions have held that the misappropriation theory does not require the tipper to receive any personal benefit to be liable for insider trading.

Judge Carter rejected the government's argument. In doing so, the Court first noted that both *Newman* and an earlier Second Circuit decision, *SEC v. Obus*, 693 F.3d 276 (2d Cir. 2012), make clear that "the elements of tipping liability are the same, regardless of whether the tipper's duty arises under the

'classical' or the 'misappropriation' theory." Order, at 2 (quoting *Newman*, 773 F.3d at 446 (internal quotation marks omitted)). The Court also noted that "even if *Newman* did not specifically resolve the issue" the "emphatic dicta" in *Newman* addressing the issue was part of a "meticulous and conscientious effort by the Second Circuit to clarify the state of insider-trading law" and should be given effect. *Id.* Further, the Court indicated that it disagreed with the government's position on the merits, as well as the government's reliance on earlier Second Circuit case law, particularly *U.S. v. Libera*, 989 F.2d 596 (2d Cir. 1993), finding that such case law is consistent with *Newman*'s holding and that "the relevant language from [*Libera*] has itself been construed to be mere implication in dicta." Order, at 3 n.1. As a result, the Court vacated the four defendants' guilty pleas and noted that it will later address two other defendants' motions to dismiss the charges against them on the basis of *Newman*.

The Government's Petition for Rehearing in *Newman*

The government's petition for rehearing protests that *Newman* will usher in a new, defense-friendly era for insider trading law. The government is asking that the case be reheard either by the original three-judge panel that issued the opinion or by all 13 active judges on the Second Circuit sitting *en banc*. Noting that it is the "law enforcement agency specifically charged by Congress with civil enforcement of the federal securities laws," the SEC has submitted a motion seeking leave to file an *amicus* brief in support of the U.S. Attorney's Office's efforts to have *Newman* reversed. Motion, at 1.

Notably, the government's petition does not challenge *Newman*'s principal holding that "a tippee's knowledge of the insider's breach necessarily requires knowledge that the insider disclosed confidential information in exchange for personal benefit." *Newman*, 773 F.3d at 449. Instead, the government's petition assails what it characterizes as the Second Circuit's "deeply confounding" redefinition of the personal benefit that a tipper must receive in exchange for an improper disclosure of corporate information. Petition, at 2. The government argues that *Newman*'s required showing of "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" for the tipper (*Newman*, 773 F.3d at 452) is contrary to the Supreme Court's holding in *Dirks*, claiming that "an improper but uncompensated gift of information by an insider" suffices for liability under *Dirks*. Petition, at 14. The government argues that, contrary to the panel's determination, the evidence was sufficient to show that the insiders at Dell and NVIDIA personally benefitted from their disclosures of information to the immediate tippees. Further, the government claims that a retrial of Newman and Chiasson is warranted even under *Newman*'s knowledge requirement for tippees because "the evidence was sufficient to show that the defendants knew or consciously avoided knowing that the insider-tippers acted for personal benefit." Petition, at 19.

Petitions for rehearing are rarely granted, especially in the Second Circuit and especially where, as in *Newman*, the original panel decision was unanimous. Indeed, of the twelve different regional Federal Circuit Courts across the country, the Second Circuit traditionally has been least likely to hear a case *en banc*, having granted *en banc* review in fewer than one case per year from 2001 to 2010.[1] The Second Circuit has reheard *en banc* two insider trading cases in the last 47 years (*U.S. v. Chestman*, 947 F.2d 551 (2d Cir. 1991); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968)), but in both cases the three-judge panel that initially heard the appeal was divided, whereas the panel's decision in *Newman* was unanimous. Petitions for rehearing *en banc* are only granted where "[a] majority of the circuit judges

[1] *See* SECOND CIRCUIT COURTS COMM., EN BANC PRACTICES IN THE SECOND CIRCUIT: TIME FOR A CHANGE?, 5 (2011), available at http://www.federalbarcouncil.org/vg/custom/uploads/pdfs/En_Banc_Report.pdf.

who are in regular active service and who are not disqualified" find that either "(1) en banc consideration is necessary to secure or maintain uniformity of the court's decisions; or (2) the proceeding involves a question of exceptional importance." Fed. R. App. Proc. 35(a). The Court is not required to rule on the government's petition in any particular time frame.

If the government does not succeed in getting *Newman* overturned or modified through its petition for rehearing, it might file a petition for a writ of certiorari seeking review by the U.S. Supreme Court. The government would have ninety (90) days following the denial of its petition for rehearing or an entry of judgment subsequent to a rehearing to file a petition for a writ of certiorari.

Authored by Harry S. Davis, Gary Stein, David K. Momborquette, Martin L. Perschetz, Howard Schiffman, Marc E. Elovitz, Barry A. Bohrer, Eric A. Bensky, Peter H. White and *Francis A. Marsico*.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.