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INSIDER TRADING

The Newman-Chiasson Decision: Cold Comfort for Hedge Fund Managers

By Justin S. Weddle and Elnaz Zarrini
Brown Rudnick

Last week, the Second Circuit issued its highly anticipated decision reversing the insider trading convictions of former Level Global Investors LP manager Anthony Chiasson and former Diamondback Capital Management LLC manager Todd Newman. The decision sent a clear message to prosecutors – namely, that the prosecution of Newman and Chiasson was flawed and that its broad theories of culpability in insider trading cases needed to be significantly cut back. But for hedge fund managers deciding how to conduct themselves in the world, what is the takeaway from the Newman-Chiasson decision? Unfortunately, not much, since the decision does not bring clarity to the critical question faced by market participants – can I trade on this information without risking investigation and prosecution? Despite the decision's clarification of some legal principles, the risk of investigation or prosecution remains an intensely fact-based judgment call.

The Newman-Chiasson Decision

The government prosecuted Newman and Chiasson for trading on inside information that had been passed to them through several layers of intervening people. The tips involved confidential earnings numbers for certain periods in 2008 for Dell and NVIDIA. Newman and Chiasson traded on this pre-release information, earning between them a total of $72 million. There was no evidence that either Newman or Chiasson knew the sources of the inside information at either company, and indeed, they were three and four levels removed from having any contact with those corporate insiders. *United States v. Newman,* No. 13-1837-CR, slip op. at 5 (2d Cir. Dec. 10, 2014). Although the Second Circuit stated that the corporate insiders themselves "have yet to be charged administratively, civilly, or criminally for insider trading or any other wrongdoing," Newman and Chiasson have endured years of investigation and prosecution. Id. at 6. The charges were originally made public in January 2012, they were convicted in December of that year after a six-week trial, and the conviction was not reversed until two years later.

The Second Circuit's decision had three main components. First, it clarified that, to establish insider trading, the government must prove that the defendant knew that the tipper received a personal benefit for providing the tip. Second, it found that the evidence presented at trial to convict Newman and Chiasson was insufficient to establish that either knew of any benefit. And third, it clawed back on the government's broad reading of the types of things that might constitute a personal benefit.

Defendant's Knowledge of a Personal Benefit Is Required

In clarifying the elements, the Second Circuit resolved a disagreement among District Judges in the Southern District of New York and elsewhere, and found that the Judge presiding over the Newman-Chiasson trial, Southern District Judge Richard Sullivan, incorrectly instructed the jury on the applicable law. At trial, Judge Sullivan denied the defendants' request that the jury be instructed that the defendants must know of a personal benefit to the insider, and instead simply instructed the jury that the insider must in fact receive a personal benefit (regardless of the defendants' knowledge). The Second Circuit panel unanimously found that the instruction was erroneous because "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." Slip op. at 4.

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The Second Circuit grounded its decision on the Supreme Court's opinion in *Dirks v. S.E.C.* In *Dirks*, the Supreme Court addressed the liability of a tippee analyst, Raymond Dirks, who received material nonpublic information about possible fraud at an insurance company from one of the insurance company's former officers. 436 U.S. 646, 648-49 (1983). Dirks relayed the information to some of his clients who were investors in the insurance company, and some of them, in turn, sold their shares based on the tip. The Supreme Court rejected the SEC's theory that a tippee must refrain from trading "whenever he receives inside information from an insider," articulating instead that the test for determining whether the corporate insider has breached his fiduciary duty "is whether the insider [has benefitted], directly or indirectly, from his disclosure. *Absent some personal gain*, there has been no breach of duty. . . ." *Id.* at 662 (emphasis added). In *Dirks*, the corporate insider provided the confidential information to expose a fraud in the company and not for any personal benefit, and thus, the Supreme Court found the insider had not breached his duty to the company's shareholders and that Dirks could not be held liable as a tippee.

Therefore, based on *Dirks*, the Second Circuit re-cast, for purposes of insider trading liability, the analysis of breach of duty, finding that without a benefit to the insider, there is no breach of duty. By extension, then, the Second Circuit found that unless the tippee knows of a personal benefit, the tippee does not know of a breach of duty and cannot be guilty of a crime.

There Was Insufficient Evidence that Newman or Chiasson Knew of a Personal Benefit

In addition to clarifying the legal standards, the Second Circuit analyzed the facts presented at the trial and found them wanting. As the Second Circuit described it:

> Adondakis [a tippee who provided information to Chiasson] said that he did not know what the relationship between the insider and the first-level tippee was, nor was he aware of any personal benefits exchanged for the information, nor did he communicate any such information to Chiasson. Adondakis testified that he merely told Chiasson that Goyal [another tippee] "was talking to someone within Dell," and that a friend of a friend of Tortora's [another tippee] would be getting NVIDIA information. Tr. 1708, 1878. Adondakis further testified that he did not specifically tell Chiasson that the source of the NVIDIA information worked at NVIDIA. Similarly, Tortora testified that, while he was aware Goyal received information from someone at Dell who had access to "overall" financial numbers, he was not aware of the insider's name, or position, or the circumstances of how Goyal obtained the information. Tortora further testified that he did not know whether Choi [the insider at NVIDIA] received a personal benefit for disclosing inside information regarding NVIDIA.

Slip op. at 24.

The Second Circuit also rejected the government's arguments that guilty knowledge of a benefit could have been inferred from things such as the nature and quality of the information and the regularity with which it was updated. While the Court acknowledged that "information about a firm's finances could certainly be sufficiently detailed and proprietary to permit the inference that the tippee knew that the information came from an inside source," such information does not "without more . . . permit an inference as to that source's improper motive for disclosure." Id. at 27.

The Second Circuit Cuts Back on the Concept of "Personal Benefit"

More important than the Court's analysis of the insufficiency of the evidence is likely the Court's comments regarding what can qualify as a "personal benefit" sufficient to trigger a breach of duty in the insider trading context. The purported benefits put forth by the government in the Newman-Chiasson case show how broadly they understood the concept. As the Court described it:

> As to the Dell tips, the Government established that Goyal [the first-level tippee] and Ray [the

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> insider/tipper] were not "close" friends, but had known each other for years, having both attended business school and worked at Dell together. Further, Ray, who wanted to become a Wall Street analyst like Goyal, sought career advice and assistance from Goyal. The evidence further showed that Goyal advised Ray on a range of topics, from discussing the qualifying examination in order to become a financial analyst to editing Ray's résumé and sending it to a Wall Street recruiter, and that some of this assistance began before Ray began to provide tips about Dell's earnings. The evidence also established that Lim and Choi were "family friends" that had met through church and occasionally socialized together.

Id. at 21. As to this evidence, the Court stated that if "the Government was allowed to meet its burden by proving that two individuals were alumni of the same school or attended the same church, the personal benefit requirement would be a nullity." *Id.* at 21-22.

The Second Circuit thus proceeded to place some limits on "personal benefit" in this context, stating that although a benefit may be inferred by a personal relationship, that is only true where there is "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 22.

Newman-Chiasson Provides Clarity for Prosecutors and Judges, But Not Investors

Although the Second Circuit provides clear guidance for prosecutors and judges regarding the legal standards and the types of facts that may, and may not, satisfy those standards, it is considerably less useful in providing concrete guidance for market participants deciding whether they can trade on information they've learned second- or third-hand. This is because the Second Circuit's standard is one that governs the final outcome of a trial, not the critical question of whether a trader is investigated or prosecuted.

In other words, from the government's point of view, law enforcement will still open investigations based on suspicious trades, and work backward from there. First, they will search for circumstantial or direct evidence linking the trader with an insider. Once the link is established, pursuant to the *Newman-Chiasson* decision, the government will then investigate to find circumstantial or direct evidence of the trader's knowledge of the insider's *motive* for tipping. The search for this evidence is anything but unobtrusive and could last years. In addition, since the ultimate decision on whether to infer a person's knowledge from typically circumstantial evidence is fact-based and entrusted to a jury, even if a person lacked knowledge of a tipper's personal benefit, that might not stop the government from putting that person through a trial and attempting to prove that he or she had that knowledge based on circumstantial evidence.

Indeed, the government no doubt would pursue not only an actual knowledge, but also a willful blindness theory of knowledge. Using a willful blindness theory, the government might attempt to present evidence of "red flags" and of the things that a person did not do in deciding whether to trade on a particular piece of evidence. For example, the government might argue that failing to ask more questions about the source of the information, or failing to undertake diligence inquiries of a firm's connection (personal or otherwise) to the source of the information, is evidence that a defendant understood that there was a high likelihood that the information was inside information, and deliberately avoided confirming that fact and the tipper's motives. Again, these types of determinations are ultimately reached by a jury at the end of a trial, rather than at some earlier stage in a proceeding or investigation. Suffice it to say that neither a trial acquittal, nor a full-scale investigation (even one that does not result in charges), is an ideal outcome for a market trader.

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In short, although the *Newman-Chiasson* decision reins in prosecutors and makes it harder to convict downstream tippees, it provides no bright-line rules for a market participant deciding whether trading on particular information presents an unacceptable risk of investigation or prosecution. If the information is second- or third-hand, or of uncertain origin, the answer will continue to depend on a highly fact-based analysis.

Justin S. Weddle, a former federal prosecutor in the Southern District of New York, is a partner in the white-collar defense and government investigations group at Brown Rudnick.

Elnaz Zarrini is an associate in the litigation and arbitration group at Brown Rudnick.