



Kevin McAdam

Partner
303.295.8267
Denver
kcmcadam@hollandhart.com



Brian Hoffman

Partner
303.295.8043
Denver, Washington, DC
bnhoffman@hollandhart.com

Newman Cert. A Potential Tipping Point For Insider Trading Liability

Insight — 8/21/2015

In recent years, the U.S. Department of Justice (DOJ) and Securities and Exchange Commission (SEC) have zealously pursued potential insider trading. After a long string of high-profile successes, the government faces significant roadblocks created last year by the Second Circuit in its momentous *U.S. v. Newman* decision. On July 30, 2015, the Solicitor General petitioned the U.S. Supreme Court to overturn *Newman*. If the Supreme Court grants cert., the resulting decision likely will mark a critical development in insider trading law. These evolutions affect entities, which must craft and implement insider trading policies, and individual market participants alike.

Insider Trading Liability Pre-*Newman*

Insider trading liability arises when an individual trades on material nonpublic information in violation of a duty. The Supreme Court's landmark 1983 opinion in *Dirks v. SEC* established the framework for tipping liability. The Court explained that tippee liability depends on tipper liability and that a tipper can be liable for insider trading only when (s)he personally benefits from the disclosure of material nonpublic information to a tippee, even if the personal benefit is merely in the form of a "gift of confidential information to a trading relative or friend."

For decades after *Dirks*, the DOJ and SEC employed the personal benefit test expansively to pursue tippees who had received inside information from friends, relatives, or even casual acquaintances in exchange for virtually nothing tangible in return. Indeed, in recent years, the DOJ's enforcement focused on long tipping chains, where supposed material nonpublic information passed through numerous individuals having only vague connections to each other before the alleged insider trading occurred.

***Newman's* Narrow Scope of Liability**

Newman involved an attenuated tipping chain spanning multiple individuals. The chain led to two former hedge-fund managers, who allegedly traded on the passed material nonpublic information. The evidence at trial showed that the insiders and the first-level tippees were only "casual acquaintances" and that no financial or tangible benefit was provided in exchange for the tips. Although this evidence may have been sufficient in years past, the Second Circuit held that the chain of liability here broke at its first link.

The Court held that liability requires "proof 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.” Because the relationship between the insiders and first-level tippees in *Newman* did not involve such an exchange, liability could not be imputed to the downstream tippees (the defendants).

Reactions to this decision by the Second Circuit, widely regarded as a leader in insider trading jurisprudence, were immediate and polarized. Defense counsel pounced on the decision, claiming it undermined prior convictions and refuted pending charges. In contrast, the DOJ balked at the decision, seeking *en banc* review (which was denied) and ultimately petitioning the Supreme Court to accept cert.

Supreme Possibilities with *Newman*

The Solicitor General's petition argues that *Newman*: runs afoul of preexisting insider trading law as announced in *Dirks*; conflicts with the recent Ninth Circuit's *Salman* decision (and an older decision by another circuit court); and creates the potential for serious harm to the markets. If the Supreme Court accepts cert. and considers these arguments, its decision could significantly impact the scope of insider trading liability in tipping cases.

A New(man) Day for Dirks?

The Solicitor General's petition highlights *Newman*'s apparent departure from *Dirks*. Indeed, *Newman* requires an “exchange” of something tangible and valuable, whereas *Dirks* discusses the “gifting” of confidential information. The Supreme Court could sharply curtail government overreach in insider trading enforcement by upholding *Newman*'s requirement of some sort of quid pro quo. After all, the Court could reason, insider trading requires a breach of a duty owed to the source of the information, which necessarily occurs only when the defendant prioritizes his/her own interests above those being served.

On the flip side, the Supreme Court could hold that *Newman* goes too far. The Court thus could reaffirm *Dirks*, effectively undoing *Newman*. Or the Court could more clearly articulate what “facts and circumstances” to consider when ruling on the sufficiency of a personal benefit in light of the tipper's and tippee's relationship.

However the Supreme Court rules on this point if it accepts cert., insider trading jurisprudence – not to mention the evenhanded selection of insider trading cases warranting prosecution – could benefit from a clearly defined personal benefit test.

Salman Swam Upstream from Newman?

Although circuit splits are not a prerequisite to Supreme Court review, they always help. Knowing this, the Solicitor General also argues that the Ninth Circuit's July 2015 *U.S. v. Salman* decision “rejected the novel personal-benefits test fashioned by the [*Newman*] court.”

Salman arose from an insider trading scheme involving members of an

extended family. The original tipper worked for an investment bank and provided alleged material nonpublic information to his brother, supposedly knowing that the brother would trade on the information. The tippee brother passed the information to Salman, whose sister was engaged to (and later married) the original tipper.

Salman argued that, under *Newman*, he was not liable because the original tipper did not exchange the inside information with his brother for a monetary or similarly valuable benefit. The Ninth Circuit disagreed. It determined that the original tipper gifted the information to his brother which, given their close familial relationship, was a sufficient personal benefit under *Dirks*.

The Ninth Circuit specifically refused to follow *Newman* “[t]o the extent [it] can be read to go so far” as to hold that evidence of a family relationship alone is insufficient to show personal benefit. In other words, if close friends or family members share inside information, a personal benefit may be presumed; no need exists to provide evidence beyond the relationship itself.

The Supreme Court may not view the situation as plainly as it is described in the Solicitor General's petition. *Salman* involved a tip among close family members, which stands in stark contrast to *Newman*'s long tipping chain of individuals with loose personal relationships. This distinction might point towards a more clearly articulated test where the sufficiency of the alleged personal benefit received in exchange for the tip depends, in part, on the nature of the relationship between the tipper and tippee.

That said, appearance of a circuit split is strengthened by the intriguing twist that well-known Judge Rakoff, of the Southern District of New York (within the Second Circuit), authored the *Salman* decision while sitting by designation in the Ninth Circuit. Moreover, the DOJ dug up a 1995 decision from the Seventh Circuit, which rejected the defendant's argument that he did not receive a personal benefit and instead held him liable because he had no “legitimate reason” for disclosing the information.

Whether or not *Salman* created a true circuit split, it certainly provided significant fodder for the Solicitor General's cert. petition.

Newman Harms the Markets?

The Solicitor General further asserts that leaving *Newman* unchecked will harm the markets since, at least in theory, liability can be intentionally avoided in the Second Circuit so long as the tippee does not provide a tangibly valuable benefit in exchange for the inside information. On the other hand, the Supreme Court might perceive less of a market risk if it agrees with the Second Circuit's apparent, unspoken premise that the DOJ overstepped when pursuing criminal insider trading liability against remote, downstream tippees. Resolution of this point may lie in the eye of the beholder, with each side decrying the market harms caused by other viewpoints.

Fingers Crossed for Clarity

The *Newman* petition gives the Supreme Court an important opportunity to clarify insider trading tipping liability. The Supreme Court could answer (a) whether, and what kind of, a personal benefit a tipper must receive; and (b) whether the requisite benefit is dependent on the existence of a family or other close relationship when proving insider trading liability. Absent precision on these matters, individuals should not be dragged into protracted investigations and litigation because even the specter of insider trading liability carries potentially life-changing financial, professional, and personal ramifications.

We are monitoring these developments closely, as Holland & Hart regularly advises entities and individuals on insider trading matters. A ruling on the cert. petition likely will come this fall and, if accepted, a decision likely would follow oral arguments, both in the first half of 2016.