INSIDER TRADING IN FLUX: EXPLAINING THE SECOND CIRCUIT'S ERROR IN *UNITED STATES v. NEWMAN* AND THE SUPREME COURT'S CORRECTION OF THAT ERROR IN *UNITED STATES v. SALMAN*

INTRODUCTION

On October 5, 2015, the United States Supreme Court denied certiorari in *United States v. Newman*, making official the most lax laws on insider trading the U.S. had ever seen.[1] In this modern age of constant information sharing, *Newman* is a landmark decision. Petitioning for the Second Circuit to rehear the case, the government admitted that the decision was "one of the most significant developments in insider trading law in a generation."[2] For approximately two years, the *Newman* decision was mandatory authority in the Second Circuit—the leading circuit in securities law. *Newman* "dramatically limit[ed] the Government's ability to prosecute some of the most common, culpable, and market-threatening forms of insider trading."[3]

So why is *Newman*

trading by the *Dirks* court.[4] After *Newman*, however, the actions by Director Dan—although morally repugnant—did not violate insider trading law because Dan did not "personally benefit" under the Second Circuit's new standard.[5] Mere friendship no longer satisfied the personal benefit requirement.[6] This hypothetical illustrates why some federal prosecutors and others who are tough on white-collar crime disagreed with the law made in *United States v. Newman*. Proving a demonstrable quid pro quo between a tipper and a tippee is a nearly impossible standard for federal prosecutors to prove beyond a reasonable doubt.[7] The decision created poor law by providing corporate insiders with an avenue to disclose inside information to friends with impunity.

This case note argues that the Second Circuit erred in its decision to make the personal benefit requirement a more demanding standard. This note examines the heightened standard in great detail and explains why it led to frustrated federal prosecutors and, ultimately, corrective action by the U.S. Supreme Court. Part I begins with a history of the law of insider trading. Part II explains how courts interpreted and how federal prosecutors argued the personal benefit requirement in the years preceding the *Newman* decision. Part III studies *United States v. N TD a5h8/2.6l*

Since statutory law only provides this general prohibition, insider trading law has been left to courts to establish through common law. This Part will discuss the landmark cases and theories that have shaped the law of insider trading.

A. Chiarella v. United States *(1980)*

Until 1980, the law of insider trading was muddled. The law did not even distinguish between tippers—those who disclose inside information—and tippees—those who receive the inside information. In a landmark criminal case, *Chiarella v. United States*, the Supreme Court finally made that distinction by establishing different criminal standards for tippers and tippees.[10]

B. Dirks v. S.E.C. *(1983)*

In *Dirks v. S.E.C.*, the Supreme Court adopted the requirement that an insider must personally benefit from disclosing nonpublic information in order to be liable as a tipper.[20] Before the tipper-tippee distinction in *Chiarella*, prosecutors argued that anyone who traded or tipped inside information was guilty of securities fraud.[21] The *Chiarella* Court struck down that argument by ruling "mere possession of nonpublic market information" does not create a duty to publicly disclose or refrain from trading based on the inside information.[22] Continuing with the tipper-tippee distinction just three years later, the Court in *Dirks* focused tipper liability on whether the insider personally benefitted in any way by conveying or trading based on the inside information, and it focused tippee liability on the tippee's knowledge of the breach.[23]

The law generated by *Dirks* was groundbreaking, so the background facts are especially important. Raymond Dirks was an officer at a broker-dealer firm.[24] He received material, nonpublic information from a former officer of an insurance company that the company's assets were overstated as a result of fraudulent corporate practices.[25] Dirks investigated these allegations.[26] Neither he nor his firm traded any of the company's stock, but Dirks did discuss the allegations with his clients and investors.[27] Many clients liquidated their holdings in the company because of this information.[28] As rumors of the alleged fraud spread, the insurance company's stock plummeted.[29] After two weeks, insurance authorities finally investigated the company's records and discovered the fraud.[30] The S.E.C. censured Dirks civilly because of his role as a tippee who did not publicly disclose the inside information.[31] The S.E.C. argued: "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."[32]

20. Dirks. v. S.E.C., 463 U.S. 646, 664 (1983).
21. Eisenberg, *supra* note 7.
22. *Chiarella*, 445 U.S. at 235.
23. *Dirks*, 463 U.S. at 660, 664.
24. *Id.* at 648.
25. *Id.* at 649.
26. *Id.*
27. *Id.*
28. *Dirks*, 463 U.S. at 649.
29. *Id.* at 650.
30. *Id.*
31. *Id.* at 651–52.
32. *Id.* at 651 (citing 21 S.E.C. Docket 1401, 1407 (1981) (footnote omitted) (quoting Chiarella v. U.S., 445 U.S. 222, 230, n. 12 (1980)).

In a landmark 6–3 decision, the Supreme Court ruled in favor of Dirks. Though Dirks was a tippee, even tippee liability must focus on the benefit the *insider* receives.

Therefore, *Dirks v. S.E.C.* dramatically changed the landscape of insider trading. Just three years earlier, before *Chiarella*, courts did not even distinguish between tippers and tippees. After *Dirks*, courts had well-defined tests for establishing both tipper and tippee liability and a generous suggestion from the Supreme Court about how to satisfy the personal benefit requirement.

II. THE PERSONAL BENEFIT REQUIREMENT POST-DIRKS

In the years after *Dirks*, the government successfully argued the personal benefit requirement down to a loose, easily-satisfied standard. The *Dirks* Court stated: "The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider *makes a gift* of confidential information *to a trading relative or friend*."[41] Prosecutors seized on that language, citing it repeatedly to courts as evidence that a tip to a friend satisfies the personal

In *United States v. Whitman*, the expert court on securities law—the

III. UNITED STATES V. NEWMAN

A. Facts

Todd Newman ("Newman") and Anthony Chiasson ("Chiasson") were two high-profile portfolio managers at hedge funds.[56] Newman was a portfolio manager at Diamondback Capital Management, LLC ("Diamondback"), and Chiasson managed accounts at Level Global Investors, L.P. ("Level Global").[57] At trial, the Government presented evidence that lower-level financial analysts obtained information both directly and indirectly from corporate insiders at two publicly traded computer technology companies, Dell and NVIDIA.[58]

These lower-level analysts obtained reliable information about Dell's earnings numbers before they were publicly released in May 2008 and August 2008; the analysts also knew NVIDIA's May 2008 earnings report before it was publicly released.[59] The analysts passed this inside information along to their superiors, Newman and Chiasson, who then executed trades of Dell and NVIDIA stock based on this inside information.[60] Their hedge funds made over $72 million as a result of these trades.[61]

The flow of information, or "tipping chain," is important to analyze the

C. The Appeal

Newman and Chiasson raised several issues on appeal to the Second Circuit, but two core issues dramatically changed the legal landscape of insider trading: the personal benefit requirement and the tippee's knowledge requirement.

1. The Personal Benefit Requirement

As explained in Part II of this case note, the personal benefit requirement eroded away after *Dirks*. In *Newman*, the insiders at Dell and NVIDIA shared material nonpublic information with friends, and so the Government argued that this gift of inside information to friends satisfied the personal benefit requirement.[81] Courts routinely accepted such an argument in the years preceding *Newman*.[82] The Second Circuit, however, "emphatically rejected" this position in *Newman*:

> To the extent *Dirks* suggests that a personal benefit may be inferred from a personal relationship between the tipper and tippee . . . we hold that such an inference is impermissible in the absence of 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. [T]his requires evidence of a 'relationship between the insider and the recipient that *suggests a quid pro quo from the latter, or an intention to benefit the [latter]*.'[83]

This Second Circuit position is a major departure from the post-*Dirks* personal benefit requirement. Although the tipper's benefit "need not be *immediately* pecuniary," the personal benefit "must be of some consequence."[84]

The required quid pro quo or intention to benefit was not present in *Newman*. Because the tippee, Goyal, only gave the tipper, Ray, minor suggestions on a résumé and offered advice before an interview, evidence of a personal benefit was scant in the Dell tipping chain.[85] Goyal testified that he would have given Ray such career advice regardless of the inside information, and Ray himself denied that any quid pro quo existed.[86] In the NVIDIA chain, no history of personal favors or quid pro quo.[87] Therefore, a quid pro quo did not exist in *Newman*, and so the personal benefit requirement was unsatisfied.

After *Newman*, the personal benefit requirement was no longer loose and prosecution-friendly. It was a stiff burden to satisfy.

2. Tippee's Knowledge

Until the *Newman* decision, courts—particularly the Second Circuit—were "somewhat Delphic" on the law of tippee liability.[88] In *Dirks*, the Supreme Court was clear that, even in the presence of a tipper's breach, a tippee is liable only if he "knows or should know that there has been a breach."[89] But must the tippee also have knowledge that the tipper personally benefitted from the breach? Yes, according to the *Newman* court.[90] The Second Circuit thinks this follows naturally from *Dirks*:Fs9ss9owlowsN sfils9s na6.(s9)d.9(f)-4g(N)-sffbi na6.l9(f)-.9(f)-ty37-6.3(2)5.3(s)-

whether any personal benefit was involved.[97] Nor did Tortora know wheth.

Salman traded through a brokerage account held by his brother-in-law, Bayyouk.[117] From 2004 to 2007, "Bayyouk and Michael Kara executed nearly identical trades in securities issued by Citigroup clients shortly before the announcement of major transactions. As a result of these trades, Salman and Bayyouk's account grew from $396,000 to approximately $2.1 million."[118]

B. Procedural Posture

Salman was found guilty by a jury on four counts of securities fraud and one count of conspiracy to commit securities fraud; he was sentenced to three years in prison.[119] Salman appealed his conviction, but he did not challenge the sufficiency of the evidence.

"home circuit" by arguing the *Newman* court erred by putting too heavy a burden on the government to prosecute insider trading.[128]

Because of the new personal benefit requirement articulated in *Newman*, Salman argued the familial relationship between Maher and Michael in his case was insufficient, standing alone, to satisfy the standard.[129] Salman argued that Maher, the tipper, needed to receive a benefit of "at least a potential gain of a pecuniary or similarly valuable nature" to satisfy *Newman*'s personal benefit requirement.[130] Because Maher did not receive any tangible benefit by disclosing the inside information to his brother, SalfTd 01(ef)2.4(i)4. T reco5-1(y)102ytrer-4.5(e)11.3(r

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exchange for his tip."[145] hl

courts—including the Ninth Circuit in *Salman*—flatly rejected *Newman* by declining to follow it.[159] The courts that were most hostile to *Newman* were the

New York, described *Newman* as "a potential bonanza for friends and family of rich people with access to material nonpublic information."[165] *Newman* is unfair to legitimate analysts and honest investors who do not have access to such nonpublic information. The decision discourages diligent financial analysis and, instead, incentivizes choosing the right "golf buddies."

This blatant unfairness destroys public confidence in the integrity of the securities markets.

> Such activity [] strips investors of confidence that the markets are fair and open. While some 'informational disparity is inevitable in the securities markets,' a rational investor will 'hesitate to venture capital' in a rigged game—one in which he faces a systematic 'informational disadvantage' vis-à-vis insiders and their chosen beneficiaries that can never 'be overcome with research or skill.'[166]

Newman indeed reduces the securities markets to a "rigged game" by making tippee liability impossible to prosecute for all practicable purposes; corporate insiders and their friends can trade with impunity on inside information.[167]

filled with instances where the public wants to know, not just how you might benefit, but how your family might benefit? . . . Because they think very often, though it depends on families, *to help a close family member is like helping yourself*."[187]

In its decision, the Court indeed abandoned *Newman*'s rationale and reverted to *Dirks*'s gift theory "which easily resolve[d] the narrow issue" presented in the *Salman* case.[188] Justice Samuel Alito authored the opinion for a unanimous Court.[189] "Our discussion of gift giving resolves this case . . . *Dirks* makes clear that a tipper breaches a fiduciary duty by making a gift of

Court could have—but unfortunately didn't—provided clarification of the vague personal benefit standard.

Because Congress has forever shirked its duty in this area of law, perhaps it is time for legislators to statutorily define and incriminate insider trading. When introducing the Stop Illegal Insider Trading Act to the Senate, Senator Jack Reed summed up the problem that has been created by the common law: "The need for this legislation is long overdue because, in the absence of a statutory definition, an inconsistent and complicated body of common law has developed as the courts have used varying interpretations of anti-fraud statutes in order to decide insider trading cases."[194] Even Judge Barrington Parker of the Second Circuit Court of Appeals noted during *Newman*'s oral argument that "the government's position on key points of the law seems to vary based depending on which judge you're talking to."[195] Professor Thomas Lee Hazen from the University of North Carolina School of Law summarized the effect of congressional inaction best: "[V]irtually everyone is now in agreement that we'd be a lot better off if Congress would simply bite the bullet and define [insider trading] . . . the situation is a mess. That's how you end up with cases like Newman."[196]

Thus, leaving insider trading doctrine to common law led to confusion and uncertainty. Despite the Supreme Court's recent rebuke of *Newman*, it may be time for Congress to provide certainty by fashioning a clear definition and prohibition of "insider trading"—one that endorses *Dirks*'s gift theory as reaffirmed in *Salman*. Although it may be mere political grandstanding, the reader should watch for legislative response to recent years of insider trading confusion.

CONCLUSION

The Second Circuit erred by creating a stricter personal benefit requirement and tippee knowledge requirement for insider trading cases. *Newman* heightened the personal benefit test to a required showing of quid pro quo or at least "an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[197] Furthermore, for a tippee to be liable, *Newman* required showing a tippee had knowledge of the insider's personal benefit from the disclosure.

The case directly conflicts with the Supreme Court in *Dirks* by collapsing the carefully fashioned two-prong personal benefit test into a mere quid pro quo requirement. The strict tippee knowledge requirement does not comport with reality because details of the insider's personal benefit do not get passed down the tippee chain. Thus, tippee liability is impossible to prosecute for all practicable purposes. *Newman* furthermore sets perverse policy incentives by undermining fundamental fairness and eroding public confidence in the securities markets. Finally, the landmark decision wreaked havoc on insider trading investigations and prosecutions during the two years it served as controlling precedent in the Second Circuit. Preet Bharara was forced to drop charges in the high-profile SAC Capital insider trading scheme as a result of *Newman*, and the Department of Justice abandoned many other investigations.

Recently in *Salman*, the Ninth Circuit split from *Newman*, and the Supreme Court granted certiorari to resolve the befuddled state of insider

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