ILLEGAL TIPPING AND INSIDER TRADING AFTER *NEWMAN*

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I. Introduction

In seeking rehearing and an *en banc* hearing before the Second Circuit Court of Appeals the Manhattan U.S. Attorney's Office told the Court that the panel decision in *U.S. v. Newman,* Case Nos. 13-1837, 13-1917 (2nd Cir. December 10, 2014), would undermine the ability of law enforcement to effectively police the securities markets for insider trading. Petition of the United States of America for Rehearing and Rehearing *En Banc,* filed January 23, 2015 ("Petition for Rehearing") at 22. The Securities and Exchange Commission ("SEC"), in an *amicus* brief, concurred. Brief for the SEC as Amicus Curiae Supporting the Petition of the United States for Rehearing or Rehearing En Banc, filed January 29, 2015 ("SEC Brief") at 11. The Court denied the request for rehearing. *Newman* is the law, at least in the Second Circuit.

Unless *Newman* is overturned by the Supreme Court, the decision will remain the law in the Second Circuit and perhaps others in view of the Court's influence in securities law. The impact of *Newman* thus becomes a critical issue for SEC enforcement. To assess the potential impact of *Newman* on SEC enforcement five key points should be considered: 1) the decision in *Dirks,* the predicate for *Newman*; 2) *Newman;* 3) *Salaman;* 4) Other cases; 5); the Petition for Certiorari filed in the Supreme Court by the government; and 6) analysis.

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This article was republished in Law 360. It is as of August 2015

II. Background: *SEC v. Dirks*

Newman follows the Supreme Court's decision: *Dirks v. SEC,* 463 U.S. 646 (1983 according to the Second Circuit. The government claims otherwise. Thus, to understand *Newman* it is critical to analyze *Dirks.*

Ray Dirks was an analyst. One of the companies he followed was Equity Funding of America, a large insurance company. During the course of his work in 1973 Mr. Dirks had discussions with Equity Funding executive Ronald Secrist. During those conversations Mr. Secrist claimed that his company had falsified its financial condition and was in reality in financial distress, contrary to its published financial information. He urged Mr. Dirks to investigate and publicize the information.

During the course of his investigation Mr. Dirks openly discussed the information he had received. Those discussions included five investment advisers who liquidated over $16 million in Equity Funding shares following the conversations. Ray Dirks and his firm did not own shares of Equity Funding.

As the inquiry proceeded, the share price of Equity Funding tumbled. Eventually the New York Stock Exchange halted trading. The California insurance authorities impounded the firm's records. Then the SEC opened an investigation. Eventually Equity funding tumbled into bankruptcy.

The SEC charged Ray Dirks with insider trading since he had told others the Secrist information who in fact traded. An SEC administrative law judge concluded that the analyst had violated Securities Act Section 17(a) and Exchange Act Section 10(b). The SEC affirmed that conclusion on appeal but only imposed a censure in view of his role in uncovering what it described as a

"massive fraud." The Court of Appeals for the District of Columbia Circuit affirmed in a 2-1 decision.

The Supreme Court reversed. Justice Powell, writing for the majority, began by noting that not all breaches of fiduciary duty in connection with a securities transaction are not violations of Section 10(b) and Rule 10b-5. To the contrary there must be manipulation or deception. In an insider trading case this comes from the "'inherent unfairness involved where one takes advantage' of 'information intended to be available only for a corporate purpose and not for the personal benefit of anyone.'" (internal citation omitted). Accordingly, an insider violates the Rule and Section only where that person fails to disclose the inside information before trading and making "secret profits."

Tippees, however, do not have the fiduciary duties of corporate insiders. The SEC claimed that the tippee "inherits" an obligation not to trade. That rule, however, differs little from the view the Court previously rejected in *U.S. v. Chiarella,* 430 U.S. 452 (1977) that the antifraud provisions require equal information among all traders.

However, under *Chiarella* the Court held, "some tippees must assume an insider's duty to the shareholders not because they receive inside information, but rather because it has been made available to them *improperly."* (emphasis original). Thus a tippee only has a duty when that person knows or should know that there has been a breach.

Not every transmission of inside information, however, results in a breach. For example, in some instances an official may mistakenly think the information has already been disclosed. The test is whether the insider personally will "benefit, directly or indirectly, from the disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a

breach by the insider, there is no derivative breach." The Court went on to explain that the answer to the question turns on "objective criteria, *i.e.* whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings." In support of this the Court cited, among other things, *Brandy, Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 Harv. L. Rev. 322, 348 (1979) for the proposition that "The theory . . is that the insider, by giving the information out selectively, is in effect selling the information to its recipient for cash, reciprocal information, or other things of value for himself . . ." The Court went on to explain that there "are objective facts and circumstances that often justify such an inference. For example, there may be a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient. 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. The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient."

In this case it is clear that Mr. Secrist did not breach his duty. There was no monetary or personal benefit and no gift. To the contrary the purpose was to expose a fraud. Therefore there was no breach by Mr. Dirks and no violation of the law.

III. The Decision in *Newman*

Todd Newman and Anthony Chiasson, remote tippees, three to four steps removed from the source of the inside information about pending earnings announcements for Dell, Inc. and NVIDIA, were convicted of insider trading. In reviewing their convictions the Second Circuit stated: " We note that the Government has not cited, nor have we found, a single case in which

tippees as remote as Newman and Chiasson have been held criminally liable for insider trading." *U.S. v. Newman,* Nos. 13-1837-cr, 13-1917 (2nd Cir. Decided December 10, 2014). The Second Circuit drew a clear line regarding the requirements for tipper liability using the "personal benefit" test crafted for the protection of analysts by the Supreme Court in *Dirks v. S.E.C.,* 463 U.S. 646 (1983). The convictions were reversed.

Todd Newman and Anthony Chaisson were portfolio managers at, respectively, Diamondback Capital Management, LLC and Level Global Investors, L.P. Both were convicted of insider trading in the shares of Dell and NVIDIA following a six week trial. Both were remote tippees. With regard to the trading in Dell, the inside information went down a chain: Company employee Rob Ray transmitted the earnings information to analyst Sandy Goyal, who in turn tipped Diamondback analyst Jesse Tortora who then told Mr. Newman and Global Level analyst Sam Adondukis who told Mr. Chaisson. Each portfolio manager traded.

The inside information regarding NVIDIA traveled a similar, lengthy path to the two portfolio managers. It began with company insider Hyung Lim who passed the information to Danny Kuno who furnished it to Messrs. Tortora and Adondukis who transmitted it to, respectively, Mr. Newman and Mr. Chaisson. Each portfolio manager traded in NVIDA shares.

At the close of the evidence each defendant made Rule 29 motions for acquittal, arguing that tippee liability derives from that of the tipper. Since here there was no evidence that the corporate insiders obtained a personal benefit the charges should be dismissed. The District Court reserved judgment and sent the case to the jury for consideration based on its instructions. The defendants argued that the jury charge on tippee liability should include the element of knowledge of a personal benefit received by the insider. The Court gave the jury an alternate

instruction which stated in part that the Government had to prove that the insider "intentionally breached that duty of trust and confidence by disclosing material nonpublic information for their own benefit." The instructions also stated that the defendant had to "know that it [the inside information] was originally disclosed by the insider in violation of a duty of confidentiality." The jury found both defendants guilty of insider trading.

The Second Circuit disagreed. The Court held that the jury instructions were inadequate and that the evidence on tippee liability was insufficient. Accordingly, the convictions were reversed and the charges dismissed with prejudice.

The Court began its analysis by reviewing the basic tenants of the classical and misappropriation theories of insider trading. The elements of tipping liability are the same regardless of the theory utilized, according to the Court. Under *Dirks* the test for determining if there has been a breach of fiduciary duty is "'whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, *there has been no breach of duty* . . .'" the Court stated, quoting *Dirks.* The tippee's liability stems directly from that of the insider. Since the disclosure of inside information alone is not a breach, "without establishing that the tippee knows of the personal benefit received by the insider in exchange for the disclosure, the Government cannot meet its burden of showing that the tippee knew of a breach."

In reaching its conclusion the Court held that "nothing in the law requires a symmetry of information in the nation's securities markets." That notion was repudiated years ago in *Chiarella v. U.S.,* 445 U.S. 222 (1980). While efficient capital markets depend on the protection of property rights in information, they also "require that persons who acquire and act on information about companies be able to profit from the information they generate." It is for this

reason that both *Chiarella* and *Dirks* held that insider trading liability is based on breaches of fiduciary duty, not on "informational asymmetries."

Based on these principles, the elements of tippee liability are: (1) the corporate insider had a fiduciary-like duty; "(2) the corporate insider breached his duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit; (3) the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit; and (4) the tippee still used that information to trade. .." Since the jury instructions did not incorporate these elements they were incorrect.

Finally, in reviewing the sufficiency of the evidence, the Court gave definition to the personal benefit test. That test is broadly defined to include pecuniary gain and also reputational benefit that will translate into future earnings and the benefit one would obtain from making a gift of confidential information to a relative or friend. While the test is broad it does not include, as the Government argued, "the mere fact of a friendship, particularly of a casual or social nature." A personal benefit can be inferred from a personal relationship but "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. In other words . . . this 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." (internal quotes omitted). Here the evidence is not sufficient to meet this test. The Second Circuit subsequently denied a motion for rehearing by the U.S. Attorney.

IV. *Salman*

The only circuit decision to consider *Newman* is a ruling by the Ninth Circuit in *U.S. v. Salman,* No. 14-10204 (9th Cir. Filed July 6, 2015). Interestingly, the opinion for the Court was written by Judge Rakoff, sitting by designation who also wrote *Salman* discussed below.

Maher Kara joined Citigroup's healthcare investment banking group in 2002. His brother-in-law is Defendant-Appellant Bassam Yacoub Salman. Over a period of years Maher began discussing information about his job with his brother Michael who traded on it.

The year after Maher began at Citigroup he became engaged to Mr. Salman's sister, Saswan Salman. As the families became close, Michael began sharing the inside information with Mr. Salman who traded through the joint account of his wife's sister and her husband, Karim Bayyouk. The profits were split. At one point Mr. Salman asked Michael where the information came from and was told.

Brothers Maher and Michael had a close and mutually beneficial relationship, according to the evidence. For example, Michael helped pay for Maher's college and aided him in a number of other ways. At one point Michael called and asked for assistance with a debt. Maher refused to furnish him with cash but did give him inside information. Mr. Salman was aware of this relationship, according to the evidence introduced at trial.

The jury found Mr. Salman guilty on one count of conspiracy and four counts of securities fraud. On appeal, Mr. Salman argued that the evidence was insufficient to meet the requirements of *Newman.* The Ninth Circuit affirmed.

The personal benefit requirement for tippee liability stems from *Dirks v. SEC,* 463U.S. 646 (1983), Judge Rakoff wrote for the Court. There the Court concluded that imposing a duty to

disclose or abstain simply because the person knowingly received inside information "could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market." (citations/internal quotes omitted). The *Dirks* Court then went on to hold that "'the test is whether the insider personally will benefit, directly or indirectly, from his disclosure,'" quoting *Dirks* at 662. In that case the insider has breached his fiduciary duty and the tippee is equally liable if "'the tippee knowns or should have known about that breach,'' *Id.* at 660, *i.e.* knows of the personal benefit." This applies equally to cases based on the misappropriation theory, the Court held.

Key here, Judge Rakoff wrote, is what constitutes a personal benefit. Quoting *Dirks* the Court held that it includes "a pecuniary gain or a reputational benefit that will translate into future earnings . . . [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." (emphasis omitted).

This statement from *Dirks* governs here, the Court held. Maher's disclosures to Michael knowing that he intended to trade in the information is a *Dirks* gift to a relative. Maher testified he intended to give Michael a benefit. Michael testified that he told Mr. Salman the source of the information. In addition, "[g]iven the Kara brothers' close relationship, Salman could readily have inferred Maher's intent to benefit Michael. Thus, there can be no question that, under *Dirks,* the evidence was sufficient . . ."

Finally, Mr. Salman argued that "because there is no evidence that Maher received any such tangible benefit [as described in *Newman*] in exchange for the inside information, or that Salman

knew of any such benefit, the Government failed to carry its burden." The Court responded, stating: "To the extent *Newman* can be read to go so far, we decline to follow it."

V. Other cases

A. Criminal cases

The most immediate impact of *Newman* is on pending criminal and civil cases. This is illustrated by the decisions in *U.S. v. Conradt,* 12 cr. 887 (S.D.N.Y.) and *SEC v. Payton,* Civil Action No. 14 civ 4644 (S.D.N.Y.), two parallel enforcement actions. Both cases center on the acquisition by I.B.M. of SPSS. Both alleged illegal tipping in violation of Exchange Act Section 10(b). Both are based on the same facts. Yet there are opposite results – the criminal charges were dismissed. The SEC charges survived a motion to dismiss and the case is in litigation.

The illegal tip traces to attorney Michael Dallas, an associate in a New York law firm assigned to work on the deal. Mr. Dallas was close friends with broker Trent Martin. The two men had a history of sharing confidential information. Beginning in the spring of 2009 Mr. Dallas told his friend about the SPSS deal. Over time he provided updates. Both men understood that the information they shared regarding their work was non-public and confidential. Both expected that confidentiality would be maintained.

Mr. Martin was roommates with Thomas Conradt, an attorney employed at another New York brokerage firm. T hey had a close, mutually dependent financial relationship with a history of personal favors. Mr. Martin told his roommate about the SSPS deal. Mr. Conradt purchased shares of SPSS prior to the deal announcement on July 28, 2009.

Messrs. Payton and Durant were co-workers of Mr. Conradt. The three men had discussions about Mr. Conradt's roommate – Trent Martin. Each knew that Mr. Martin worked at a brokerage firm. Mr. Conradt told his co-workers that he learned about the SPSS acquisition from his roommate. Messrs. Payton and Durant did not ask more about the roommate. They did purchase shares of SPSS just prior to the public announcement of the deal. In addition, Mr. Conradt is alleged to have tipped David Weishaus and three others who worked at the same brokerage firm. Each tippee traded.

Messrs. Conradt, Weishaus, Martin and Payton were each charged with insider trading. Each pleaded guilty prior to the decision in *Newman*. Following the Second Circuit's decision in *Newman,* Judge Carter vacated the guilty pleas and dismissed the criminal charges. *U.S. v. Conradt,* 12 - 887 (S.D.N.Y. Order Dated January 22, 2005). Under Rule 11(b)(3) of the Federal Rules of Criminal Procedure the district court has an "obligation up through the entry of judgment to vacate a previously-accepted guilty plea and enter a plea of not guilty on behalf of a defendant if it becomes clear that there no longer is a sufficient factual basis for the plea," Judge Carter held. This is in accord with established Second Circuit decisions such as *U.S. v. Calderon,* 343 F. 3d 587, 589-90 (2nd Cir. 2001) which require the court to determine if there is a factual basis for the plea by matching the facts in the record with the legal elements of the crime.

Here *Newman* is the controlling case, defining the elements of tipping liability under either the classic or misappropriation theory of insider trading, according to the Court's order. While the Government contended that this statement in *Newman* need not be followed because it is *dicta,* the Court rejected the contention noting that *"Newman's* unequivocal statement on the point is

part of a meticulous and conscientious effort by the Second Circuit to clarify the state of insider-trading law in this Circuit. Accordingly, even assuming *arguendo* that the Government is correct that the cited language in *Newman* [that the personal benefit test applies to both theories of insider trading] is dicta, it is not just any dicta, but emphatic dicta which must be given the utmost consideration." Accordingly, the guilty pleas were vacated. In a subsequent order, dated February 3, 2015, the Court dismissed the indictments without prejudice. Other defendants in criminal cases are either seeking to vacate their guilty pleas or have their conviction reversed on appeal based on *Newman*. *See, e.g.,* SAC Manager's Tipper Says Newman Voids Plea, Sentence, Law 360 (May 5, 2015), available at www.law360.com/articles/651882/print?section=securities

B. SEC cases -- *Payton*

Since *Newman* is based on a construction of Exchange Act Section 10(b) its teachings should apply with equal force in either a criminal or civil action. *See, e.g., U.S. v. O'Hagan,* 521 U.S. 642 (1997) (adopting misappropriation theory of insider trading in criminal case which applies also to civil cases); *see also Aaron v. SEC,* 446 U.S. 680, 691 (1980)(rejecting SEC contention that scienter applies to civil damage actions based on Section 10(b) but not SEC enforcement actions). Nevertheless, in the SEC's civil enforcement action which parallels *Conradt,* Judge Rakoff appears to have drawn a line between civil and criminal insider trading actions in refusing to dismiss the action based on *Newman*. *SEC v. Payton,* Civil Action No. 14 civ 4644 (S.D.N.Y. Opinion issued April 6, 2015). *See also SEC v Conradt,* Civil Action No. 12-cv-08676 (S.D.N.Y.).

In *Payton* Judge Rakoff began by stating that there is a difference between criminal and civil cases. In the former the "court is obliged to define unlawful insider trading narrowly, so as to provide the fair notice that due process requires . . ." In the latter, typically brought by the SEC, "the court is inclined to define unlawful insider trading broadly, so as to effectuate the remedial purposes behind the prohibition of such trading." The Court did not cite any authority for these propositions. Judge Rakoff did, nevertheless, state that to properly plead tippee liability the SEC must set forth facts in its complaint which are sufficient to meet the *Newman* test. Those facts must be construed in favor of the SEC.

Under *Newman* the first question is whether the SEC has sufficiently alleged that Mr. Martin, the tipper, received a personal benefit when furnishing the inside information to his friend, Mr. Conradt. That requirement has been met, Judge Rakoff found, because the SEC alleged that Mr. Conradt had a mutually dependent financial relationship with his friend, a history of personal favors and their expenses were "intertwined." Mr. Conradt "took the lead" in organizing and initially paying for shared expenses. He also assisted his friend with a criminal charge. Later the two men had a conversation in which, according to the complaint, "Martin thanked Conradt for his prior assistance with the criminal legal matter and told Conradt he was happy that Conradt profited from the SPSS trading because Conradt had helped him." These allegations support an inference of a *quid pro quo* relationship, the Court found.

The second critical question is whether the defendants knew of the benefit. Here again, the allegations of the complaint are sufficient, the Court concluded, when all inferences are drawn in favor of the SEC. Those allegations demonstrate that the defendants knew Messrs. Conradt and Martin were friends and roommates and that Mr. Conradt assisted with the criminal matter "This

is enough to raise the reasonable inference that the defendants knew that Martin's relationship with Conradt involved reciprocal benefits," according to Judge Rakoff. This inference is bolstered by the fact that Mr. Durant repeatedly asked Mr. Conradt if additional information could be obtained from his roommate – and it was secured.

Finally, the two defendants took steps to conceal their trading activity while avoiding any discovery of the circumstances surrounding the tip between Messrs. Martin and Conradt. The latter is evidence of "conscious avoidance of details about the source of the inside information and nature of the initial disclosure," according to the Court. Collectively, these allegations are sufficient to survive a motion to dismiss based on *Newman.*

C. Other SEC cases

In the wake of *Newman* the SEC has three apparent options: 1) Comply with *Newman's* pleading requirements; 2) bring its actions as administrative proceedings; or 3) bring actions outside of the Second Circuit where the decision may not be applicable.

1. Cases which follow *Newman*

One option is for the SEC to only bring cases which meet the *Newman* test. The agency followed this approach, at least in part, in two recent cases brought outside of the Second Circuit, *SEC v. Kanodia,* Civil Action No. 15-cv-00479 (D. Conn. Filed April 2, 2015) and *SEC v. Zeringue,* Civil Action No. 3:15-cv-00405 (W.D. La. Filed Feb. 19, 2015) . However, when the Commission amended the complaint in *Zeringue,* adding a new tippee defendant, *Newman* was not followed. *SEC v. Kanodia,* Civil Action No. 15-cv-00479 (D. Conn. Filed April 2, 2015) is an action which names as defendants Amit Kanodia and Iftikar Ahmed, two close friends. The

action centers on the potential acquisition of Cooper Tire and Rubber Company by Apollo Tyres Ltd, which was announced on June 12, 2013 but never consummated. During the negotiations which led to the announcement, Mr. Kanodit was married to the general counsel of Apollo. He misappropriated inside information about the deal from his wife and gave it to Mr. Ahmed who shared it with another Trader. Both Mr. Ahmed and Trader purchased shares of Cooper. When the deal was announced the share price of Cooper increased by 41% compared to its prior day closing price. After liquidating his shares Mr. Ahmed had trading profits of about $1.1 million while Trader netted about $170,000. Each paid a portion of those profits to a firm controlled by Mr. Kanodia, apparently a *Newman quid pro quo*. The complaint alleges violations of Exchange Act Section 10(b). The case is pending. The U.S. Attorney for the District of Connecticut filed parallel criminal charges.

The initial complaint in *Zeringue* followed the same approach. The complaint named as defendants Scott Zeringue and Jessie Roberts. Mr. Zeringue was the vice president of construction operations at Shaw Group, Inc., an energy construction company. Mr. Roberts is his brother-in-law. The action centers on the acquisition of Shaw by Chicago Bridge & Iron on February 13, 2013. Prior to that time Mr. Zeringue learned of the then pending deal through his employment. He purchased 125 shares of Shaw, told his brother-in-law about the deal and asked him to purchase additional shares for him. Mr. Roberts made purchases, and tipped Friend A and a relative of that person. Both traded. Overall Mr. Roberts had trading profits of $765,000 while the other traders profits totaled $154,000. Mr. Roberts paid his brother-in-law $30,000 for the tip, an allegation clearly intended to meet the *Newman* test.

Subsequently, the SEC amended its complaint, adding Billy Joe Adcox, Jr. as a defendant. Mr. Adcox is employed as a pharmaceutical salesman. He is, according to the complaint, a "long-time friend" of Mr. Roberts. Mr. Roberts told his long-time friend about the then pending deal. In doing so "Roberts told Adcox he had learned the information from his brother-in-law, a Shaw insider." Mr. Adcox traded while in possession of the information. He had $28,000 in trading profits. Mr. Adcox also tipped another individual who traded.

The SEC does not detail allegations focused on the *Newman* personal benefit test in describing the Roberts-Adcox tip. Rather, the allegations are limited to a claim that Mr. Adcox learned the information came from a corporate insider. While these allegations may meet the pre-*Newman* version of the personal benefit test, there is a clear absence of any *quid pro quo* claim here. The district court will thus be faced with a complaint which in part meets the *Newman* test and in part does not. The complaint alleges violations of Exchange Act Section 10(b). The case is in litigation. *See* Lit. Rel. No. 23215 (March 6, 2015).

2. Administrative proceedings

A second option for the SEC is to avoid the potential impact of the decision by filing its insider trading cases in an administrative forum. While the SEC traditionally brings insider trading cases in district court, in the four months prior to *Newman* the agency filed seven insider trading actions as administrative proceedings. All but one was settled at the time of filing (here). The remaining proceeding was later dismissed by the Enforcement Division after it was discovered that key witnesses had left the country.

The apparent trend toward a greater use of administrative proceedings spawned a number of suits against the agency, raising constitutional issues (here). To date only one the suit by Raji Gupta was successful, and it predated the late 2014 trend. *Gupta v. SEC,* 796 F. Supp. 2d 503 (S.D.N.Y. 2011). There the SEC initiated an administrative proceeding alleging insider trading, Mr. Gupta filed suit alleging a denial of equal protection because every other insider trading case stemming from the expert network investigations had been brought in district court. Judge Rakoff agreed and issed an injunction. The Commission dismissed the case and filed its traditional civil injunctive action. Later Mr. Gupta was convicted on criminal insider trading charges.

Following *Newman* brought an insider trading case in an administrative forum. *In the Matter of Charles L. Hill, Jr.,* Adm. Proc. File No. 3-16383 (Feb. 11, 2015). The action centered on the tender offer by NCR Corporation for Radiant Systems, Inc., announced on July 11, 2011 after the close of the markets. The deal began in early May 2011when NCR's CEO called the CEO of Radiant and expressed an interest in a possible deal. Later that month Radiant's board authorized discussions. Following discussions and due diligence the deal was structured as a tender offer in an agreement executed on July 11, 2011. Radiant's COO, the brother of the CEO, learned about the deal in early May. Subsequently, he continued to discuss the matter with his brother. COO also negotiated his employment terms in the event that the deal was consummated.

COO had a Friend with whom he shared material, non-public information about the pending tender offer. COO had known Friend since childhood. They routinely shared confidential information. Friend also knew the position COO held at Radiant. Friend had a close personal relationship with Charles Hill. While the two frequently spoke, there is no allegation that they

routinely exchanged confidential information. During the deal period the Order alleges that Friend furnished Mr. Hill with material, non-public information about the pending tender offer for Radiant. Mr. Hill "was aware of the relationship" between Friend and COO. Mr. Hill was also acquainted with COO.

Mr. Hill made a series of purchases of Radiant stock beginning on June 1, 2011. Eventually he acquired over 100,000 shares of a stock he had not purchased over the last four years. By July 8, 2011 the shares had a value of over $2.2 million. At the time of the purchases Mr. Hill knew, or had reason to know, that the information he obtained was material and non-public, according to the Order. He also had reason to know it came directly or indirectly from Radiant, or an officer, director or employee of the company. There is no allegation that Friend received any benefit for transmitting the information.

The SEC avoided the *Newman* issue, however, by only charging the case as a violation of Exchange Act Section 14(e), not 10(b). The Order thus alleges that each of the purchases was made after NCR had taken substantial steps to commence the tender offer, in accord with Section 14(e). Following the deal announcement the share price of Radiant increased over 30%. Mr. Hill had profits of about $744,000. The proceeding will be set for hearing.

Other SEC insider trading cases brought after *Newman* were filed in Federal district court. The reason the SEC halted what appeared to be a trend beginning in stemming from the fall of 2014 is unclear. The question of using the administrative forum in lieu of district court remains controversial however. Recently, at Senate hearings on the SEC budget, Chair White was questioned about the issue. Days later a paper titled "Division of Enforcement Approach to Forum Selection in Contested Actions" appeared on the Division's website. While it enumerates

factors considered by the Division when selecting a venue for its enforcement actions, it offers little real insight into the process (here).

3. Other select post *Newman* cases

The Commission has filed at least three other post-*Newman* insider trading cases involving tips through May 1, 2015. Only one of those actions is in the Second Circuit where *Newman* is controlling precedent. These cases largely fail to head the teachings of *Newman. SEC v. Xia,* Civil Action No. 23249 (S.D.N.Y. Filed April 29, 2015) is a "suspicious trading" case. As with most of these actions it is based on little more than trading and timing. The action centers on the merger of two Chinese e-commerce companies, 58.com and ganji.com, announced on April 14, 2015. Prior to that date the two defendants, Dr. Xiaoyu Xia and Ms. Yanting Hu, residents of Beijing, China, purchased out-of-the-money call options in 58.com between the time of the agreement and the announcement. Each defendant is connected to the financial industry in China. There are no allegations regarding the source of the information or any *quid pro quo* type personal benefit. The complaint alleges violations of Exchange Act Section 10(b). Despite the paucity of the allegations the SEC did, as is typical in these actions, obtain an asset freeze over the U.S. brokerage accounts used. The Court also issued an order to show cause why a preliminary injunction should not issue. *See* Lit. Rel. No. 23249 (April 29, 2015).

A second pending case focuses on an insider trading ring where the allegations of the Commission's complaint appear to at least partially satisfy *Newman. SEC v. Gray,* Civil Action No. 15-cv-00551 (N. D. Cal. Filed Feb. 5, 2015). Named as defendant are: John Gray, a one-time equity research analyst and representative at Barclays Capital; Christian Keller, a financial

analyst first at Applied Materials and later a vice president of IR at Ravi; Kyle Martin, at one time employed at a car dealership; and Aaron Shepard, self- employed.

Beginning in 2009, and continuing for the next three years, Messrs. Gray and Keller led an insider trading ring The ring traded on information from Mr. Keller's employer such as a potential acquisition and earnings announcements. Mr. Gray acted as the hub between the two men and was primarily responsible for placing the trades. The three men divided the profits from the trading. Disposable telephones were used as part of the efforts to conceal the ring.

Mr. Grey also tipped Aaron Shepard. While Mr. Shepard apparently knew that he was receiving inside information there is no allegation regarding his knowledge of a personal benefit. The complaint alleges violations of Exchange Act Sections 10(b) and 14(e) by Messrs. Gray, Keller and Martin. Mr. Sheppard was charged with violations of Exchange Act Section 10(b).

Messrs. Gray, Keller and Martin settled with the Commission. Each consented to the entry of a permanent injunction prohibiting future violations of the Sections cited in the complaint. Mr. Gray agreed to pay disgorgement of $287,487.55, prejudgment interest and a penalty of $448,876.02 and will be barred from the securities business and participating in any penny stock offering. Mr. Keller will pay disgorgement of $52,000, prejudgment interest and a penalty of $417,468.73 (total profits from transactions placed through Mr. Martin's account) and will be barred from serving as an officer or director for 10 years. Mr. Martin will pay disgorgement of $243,276.10, plus prejudgment interest. No penalty was imposed based on his cooperation. Mr. Sheppard also settled, consenting to the entry of a permanent injunction based on Exchange Act Section 10(b). He will also pay disgorgement of $161,388.36 along with prejudgment interest. No penalty was assessed in view of his cooperation.

Finally, *SEC v. Epstein,* Civil Action No. 15-cv-0506 (E.D. Pa. Filed February 3, 2015) is an insider trading action based on the misappropriation theory. It unclear if the case is based on a tipping or a misappropriation of the information by the trader theory. If the former, the complaint fails to satisfy *Newman.* If the latter, the personal benefit analysis is inapplicable.

The case centers on the acquisition of Harleysville Group, Inc., an insurer of small and midsized businesses and individuals in Harleysville, Pennsylvania, by Nationwide Mutual Insurance Company. The deal was announced on September 29, 2011.

During the due diligence on the deal in August 2011 Girlfriend, a legal assistant working on the deal, told her live-in Boyfriend of 8 years about the transaction which had been causing her to work nights and weekends. The complaint alleges that the couple had a relationship of trust and confidence and that the information was shared with Boyfriend in that context.

Boyfriend in turn told his father, defendant Joel Epstein. The two men had a close personal relationship and worked at the Epstein tire store together. When the information was shared Mr. Epstein, an avid stock trader, instructed his son not to mention the subject again. He also began purchasing shares. Mr. Epstein told four friends about the deal, instructing each to purchase 1,000 shares. Each did as instructed. After the deal announcement the share price rose, closing up 87% compare to the prior day's close. Mr. Epstein had trading profits of $113,501. The four tippees had trading profits of $123,511.

The complaint notes that Boyfriend had a relationship of trust and confidence with his father, suggesting, but not stating, that the information would remain confidential. It also states, however, that father was an avid stock trader, suggesting, but not stating, that the transmission

may have been an illegal tip. If the communication was the former, *Newman* would not apply – use of the information by Mr. Epstein would be a misappropriation. If the latter, then *Newman* would apply. The complaint alleges violations of Section 10(b).

To resolve the action Mr. Epstein consented to the entry of a final judgment of permanent injunction based on the Section cited in the complaint. In addition, he agreed to pay disgorgement of $237,014 which includes the profits of the four individuals he tipped, prejudgment interest and a civil penalty of $237,014. *See* Lit. Rel. No. 23187 (Feb. 3, 2015).

VI. The Supreme Court

The Government filed its long awaited Petition for a Writ of Certiorari with the Supreme Court in the *Newman* insider trading case. The Petition presents three key issues which were generally presaged in the request for rehearing *en banc*: 1) The Second Circuit's decision is contrary to *Dirks,* adding an impermissible gloss to the personal benefit test; 2) *Newman* conflicts with decisions in other circuits; and 3) policy reasons counsel that the Court reverse the decision and remand it to the lower courts for reconsideration. Petition for a Wirt of Certiorari filed in *US. v. Newman* (S.Ct. Filed August 31, 2015).

The sole question presented for resolution by the High Court "is whether the court of appeals erroneously departed from this Court's decision in *Dirks* by holding that liability under a gifting theory 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," according to the Petition.

Following a lengthy recitation of the facts, which centered on trading in the shares of Dell and NVIDIA by down the chain tippees, the Petition argues that *Newman* added an impermissible "gloss" to *Dirks.* Trading on the basis of inside information by a corporate insider "qualifies as a deceptive device, within the meaning of Section 10(b), because it violates the relationship of trust and confidence that exists between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position . . ." the Petition states (citations and internal quotations omitted). A corporate insider must either publically disclose the information or abstain from trading.

Dirks focused on the scope of "tipper-tippee" insider trading liability. While the securities laws do not require a parity of information, they do bar some tipping. The key is whether the insider will personally benefit from the disclosure, the Government told the Court while quoting *Dirks*: "The Court identified two different sets of cases in which a factfinder may infer from 'objective facts and circumstances' the existence of such a benefit . . . First, 'there may be a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient.'" That could be a pecuniary gain or reputational benefit that will translate into future earnings. "Second, '[t]he 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,' as [t]he tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient . . .'" the Petition notes, quoting *Dirks.*

Newman is "irreconcilable" with the test enunciated by *Dirks.* The Second Circuit altered the *Dirks* test by holding that while a personal benefit may be inferred from the "a personal relationship between the tipper and tippee, where the tippee's trades 'resemble trading by the

insider himself followed by a gift of the profits to the recipient . . . 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 lest a potential gain of a pecuniary or similarly valuable nature,'" the Petition argues while quoting *Newman.* It is this new formulation of the *Dirks* test which presents the difficulty. *Dirks,* the Petition argues, allowed a inference of a personal benefit when either the insider expects something in return or there is a gift. While *Newman* acknowledged both, the Government argues that it eliminated the second by tying the "gift" theory to receiving something – essentially a *quid pro quo. Newman* also limited this category by requiring that the relationship be "meaningfully close," another restriction which is contrary to *Dirks.*

The Second Circuit's decision also conflicts with that of other circuits. The primary case cited is *U.S. v Salman,* 2015 WL 4068903 (9th Cir. July 6, 2015). There, in an opinion by Judge Rakoff sitting by designation (here), the court rejected the notion that "unless the government proves that the insider receives something consequential for disclosing confidential information . . ." the proof is not sufficient. While Defendant Salman relied on *Newman* in arguing that evidence of friendship or familial relation alone is not sufficient, and that there must be a tangible benefit between the tipper and tippee, the Ninth Circuit rejected the proposition, creating a conflict.

Similarly, the Seventh Circuit in *SEC v. Maio,* 51 F. 3d 623 (7th Cir 1995) rejected that notion. There the court found that an insider's disclosure of inside information was an improper gift. In reaching its conclusion the court rejected a defense contention that the disclosure was not improper because the insider did not receive any direct or indirect personal benefit as a result of the tip.

Finally, the Petition argued that the "erroneous redefinition of personal benefit" will harm the securities markets. By eliminating the use of inside information for personal advantage *Dirks* sought to ensure the fair and honest workings of the securities markets. *Newman* undercuts this goal. The decision will also negatively affect the activities of analysts. This is because if "certain analysts sidestep [the hard job of analyzing a company] by siphoning secret information from insiders. . . then other analysts will be discouraged . . ." Accordingly, *Newman* should be reversed and remanded the government told the High Court.

VII. Analysis

One critical question regarding *Newman* is whether the Supreme Court will decide to review the case. The Petition presents a compelling argument that the Second Circuit's decision is contrary to *Dirks* and will disrupt law enforcement in an important area. At the same time others believe that *Newman* follows *Dirks. See, e.g.,* Adam Pritchard, History Says Newman Is Faithful to Dirks, Law 360, Http://law360.com/articles/691289/print?section-securities (A/17/15), summarizing *Dirks* and the Genesis of Personal Benefit by Mr. Pritchard. University of Michigan Law and Economics Research Paper Series, Paper No. 15-011 (2015). Others, such as Judge Rakoff and the Ninth Circuit do not.

A second question focus on whether there will be a significant circuit split. Many read *Salman* as rejecting *Newman.* While the decision on its face purports to reject the more stringent test of the decision, in assessing the evidence in the case it seems to closely approximate the *Newman* standard, suggesting that the difference is one of degree – precisely how much evidence is required to establish the personal benefit test?

The impact of *Newman* on the SEC and the DOJ in bringing cases may be significant. If the decision is adopted and followed by other circuits it will clearly make pleading and prevailing in

an illegal tipping case more difficult. Whether it will have the devastating impact projected by the Manhattan U.S. Attorney when trying to persuade the Second Circuit to revisit the decision is doubtful at best. Cases such as *Kanodia, Zeringue* and *Gray* suggest that in many instances the SEC will be able to plead facts regarding a *quid pro quo* of the type specified in *Newman.* While the benefit may not be as explicit as in those cases in each instance, no doubt enforcement officials will develop evidence demonstrating that there was a benefit to the person furnishing the inside information which was known to the recipient who traded. Indeed, it seems incongruous to suggest that a person would essentially steal material non-public information – breach a duty of trust and confidence and take information entrusted to them for a specific reason – risk a violation of the law and then just give it away. Viewed in this context the act of illegally tipping at least suggests there is some benefit, although it may be difficult to prove that the tippee knew about in some instances. Accordingly, there should be little doubt that enforcement officials will to continue bring illegal tipping cases.

The SEC may, however, take steps to avoid *Newman.* One approach is to try and differentiate between criminal and civil actions. While *Payton* suggests this approach, a more careful examination of the case, coupled with consideration of similar efforts in the past, suggests that this approach is flawed. In the initial paragraphs of the *Payton* decision where this distinction is made, Judge Rakoff fails to cite any authority. That is consistent with the balance of the ruling which is little more than an effort to use the civil pleading rules which govern a motion to dismiss to draw every possible inference in favor of the plaintiff-SEC. In straining for every inference the Court may well have exceeded the limits of the plausibility test crafted by the Supreme Court in *Ashcroft v. Iqbal,* 129 S.Ct. 1937 (2009) and *Bell Atlantic v.Twombly,* 127 S.Ct. 1955 (2007) which governs basic pleading standards. Under those decisions – setting aside

the more stringent Rule 9(b) fraud standards which apply here –the complaint must be plausible. Here that means that there must be plausible evidence of a personal benefit, *quid pro quo*. At best, that evidence in *Payson* is strained.

More fundamental is the proposition that *Newman* is based on a construction of Section 10(b). There is nothing in the language of that Section which supports a distinction of the type *Payton* attempts to create. To the contrary, prior efforts to evade similar constructions of Section 10(b) viewed as unfavorable by SEC enforcement officials have failed. *See, e.g., Aaron v. SEC,* 446 U.S. 680, 69 (1976)(rejecting SEC contention that scienter requirement imposed on private Section 10(b) actions in *Ernst & Ernst v. Hochfleder,* 425 U.S. 185 (1976) based on the language of the statute did not apply to a Section 10(b) SEC enforcement action); *U.S. v. O'Hagan,* 521 U.S. 642 (1997) (adopting misappropriation theory of insider trading in criminal case which also applies in SEC cases).

A second, would be to bring insider trading cases in an administrative forum. Following *Newman*, however, the SEC has not demonstrated an inclination to follow this path. While the agency did bring a series of those actions in that forum in the fourth quarter of 2014 as previously noted, that trend seems to have halted. Whether the SEC will return to that approach in view of the repeated law suits challenging its forum selection decisions and negative public comment is at best unclear.

Finally, since many of the SEC's insider trading cases are not in the Second Circuit, the Commission may in cases outside that Circuit plead the *Newman* personal benefit test where it has the facts but challenge the ruling in other instances. Although the Second Circuit stated that its ruling is based squarely on the Supreme Court's decision in *Dirks,* the SEC could challenge

that position, perhaps in a fashion suggested by the Manhattan U.S. Attorney's Office in its petition for rehearing. There the Government argued, with the support of the SEC, that the requirement of a *quid pro quo* exceeds *Dirks.* This could eventually result in a Circuit split which might lead to a definitive definition by the Supreme Court.

For cases which can only be brought in the Second Circuit, the SEC may decide to bring the action as an administrative proceeding. By selecting that forum the SEC could plead the elements of tipping and the personal benefit test of *Dirks* in a fashion consistent with its interpretation of the law. This approach would be consistent with the SEC's recently released memorandum on forum selection. There the agency gave notice that it may select an administrative forum for its cases where there are important questions regarding the securities laws to be resolved. While those cases would be subject to review by a Federal Court of Appeals, the Commission can be expected to argue on appeal that its determination is entitled to deference. *Markowski v. SEC,* 274 F. 3d 552 (D.C. Cir. 2001)(deferring to SEC interpretation of Exchange Act Section 10(b) in a market manipulation case). This approach could also eventually result in a Circuit split resulting in a determination by the Supreme Court.

Before choosing this approach, however, the SEC might be well advised to consider the results from the last time it selected this path. *Dirks* was initially brought as an SEC administrative proceeding. The D.C. Circuit upheld its determination that Ray Dirks engaged in illegal tipping. The Supreme Court, however, reversed in an opinion which first announced the personal benefit test – a ruling the *Newman* Court says is the predicate for its determination.