
Tebsy Paul
American University Washington College of Law

Follow this and additional works at: http://digitalcommons.wcl.american.edu/aublr

Part of the Banking and Finance Law Commons, Legal Ethics and Professional Responsibility Commons, Secured Transactions Commons, and the Securities Law Commons

Recommended Citation

This Comment is brought to you for free and open access by the Washington College of Law Journals & Law Reviews at Digital Commons @ American University Washington College of Law. It has been accepted for inclusion in American University Business Law Review by an authorized editor of Digital Commons @ American University Washington College of Law. For more information, please contact kclay@wcl.american.edu.
FRIENDS WITH BENEFITS:
ANALYZING THE IMPLICATIONS OF
UNITED STATES V. NEWMAN FOR THE
FUTURE OF INSIDER TRADING

TEBSY PAUL*

In the 2014 case United States v. Newman, a federal appeals court vacated convictions of insider trading and dismissed the indictments against two former hedge fund traders, Todd Newman and Anthony Chiasson. In overturning their convictions, the United States Court of Appeals for the Second Circuit ("Court") held that the U.S. Attorney's Office for the Southern District of New York ("Government") failed to prove that the corporate insiders received a significant benefit for tipping downstream tippees, who were several levels removed from the corporate insiders. The Court also held that the Government failed to show that the defendants had any knowledge of the alleged benefits that the insiders supposedly received. The Court reasoned that the benefit conferred to the tippees must be "of some consequence" so that it is no longer sufficient to show just friendship as a form of benefit. After the ruling, the Government sought a rehearing en banc and argued that the ruling departs from United States Supreme Court and Second Circuit precedent and that it threatens the effective enforcement of securities law, specifically in cases involving remote tippees and tippers. Following the denial for a rehearing by the Second Circuit, the Government filed a petition for writ of certiorari to the Supreme Court which was also denied on October 5, 2015.

This Comment argues that the Court's decision in Newman, requiring a tangible personal benefit, is proper because the decision clarified the

* Staff Member, American University Business Law Review, Volume 5; J.D. Candidate, American University, Washington College of Law, 2016; B.A. Political Science, University at Albany (SUNY), 2013. I would like to thank my editor, Eddy Rivero, as well as the entire American University Business Law Review staff for all your hard work and patience. A special thank you to Christopher Thomas for your continuous encouragement and guidance throughout this process and law school. Most importantly, thank you to my mother Betsy Paul for always supporting and motivating me to pursue my love for writing and law—I am forever grateful for all that you have done and continue to do for me.
requirements necessary to sustain a conviction for remote tippee liability in insider trading cases. The Court’s decision correctly curbed the government’s ability to bring insider trading cases by limiting the Securities and Exchange Commission’s (“SEC”) broad interpretation of existing securities law. The SEC’s broad interpretation has damaged the overall efficiency of the market by limiting the incentives of market participants to obtain information and make informed trading decisions. Furthermore, this Comment will recommend the need for Congress to enact create laws directly criminalizing insider trading behavior.

Introduction ................................................................................................ 110
I. The Evolution of Insider Trading ........................................................... 113
   A. Analyzing the Second Circuit’s Interpretation of Personal Benefits following Dirks v. SEC ............................................. 117
   B. Comparing Tippee Liability through the Classical and Misappropriation Theories ....................................................... 119
III. Newman’s Aftermath: Analyzing the Implications of the Second Circuit’s Decision ................................................................. 123
   A. Heightened Standard Analysis ................................................. 125
   B. Personal Benefits Analysis ...................................................... 126
   C. The Future of Insider Trading Cases Post-Newman .................. 129
IV. Time to Make Some Laws, Congress .................................................. 133
Conclusion ................................................................................................. 135

INTRODUCTION

In the recent decision by the United States Court of Appeals for the Second Circuit (“Second Circuit” or “Court”), United States. v. Newman,¹ the Court reviewed its standard for prosecuting “downstream” or “remote” tippees under Section 10(b) of the Securities Exchange Act and Securities and Exchange Commission’s (“SEC”) Rule 10b-5.² In Newman, the Court vacated the conviction of two “remote tippee”³ hedge fund managers⁴ and

3. See Newman, 773 F.3d at 446 ((explaining the relationship between a “tipper” (“the insider or misappropriator in possession of material nonpublic information”) and a “tippee” (the outsider to whom the tipper discloses such material information, “who
concluded that “the government must show that someone who received inside information and then traded on it . . . knew that the source received a benefit for providing the tip.” This decision is particularly troublesome for the Government because the Court redefined what constitutes a personal benefit, holding that “the mere fact of a friendship” is not enough to justify a charge of insider trading. In Newman, the Court concluded that the career advice and friendship the defendants received or maintained, and thereafter traded on, did not amount to a “personal benefit” that represented a potential gain of a “pecuniary or similarly valuable nature.” This new heightened standard of proof will make it harder for the Government to successfully prosecute future insider trading cases involving remote tippers and tippees.

On January 22, 2015, U.S. Attorney Preet Bharara announced that he would ask for an en banc hearing by the Second Circuit Court of Appeals to review the Court’s landmark ruling in United States v. Newman, then trades on the basis of the information before it is publicly disclosed”).

4. See id. at 455.
6. See Alison Frankel, In Insider Trading Appeal, Justice Department Makes Big Concession, REUTERS (Jan. 26, 2015), http://blogs.reuters.com/alison-frankel/2015/01/26/in-insider-trading-appeal-justice-department-makes-big-concession/ (explaining that a tipster must have a meaningfully-close personal relationship with the initial recipient of confidential information or else stand to receive a pecuniary benefit from the disclosure).
although the request was denied on April 3, 2015. While the Government considers the Second Circuit’s decision in *Newman* to be troublesome, the defense counsel promptly declared the decision a “resounding victory for the rule of law.” The *Newman* decision has already received considerable commentary. Some have expressed full-fledged support, calling the Second Circuit’s decision a well-deserved lesson for the Government, particularly after Bharara’s weak crusades against insider trading. Others have condemned the decision, believing that it “shield[s] from accountability Wall Street’s corrupt culture.”

Prior to the SEC’s creation in 1934, the public had little confidence in the federal government’s ability to regulate the securities market. Prompted by the stock market crash of 1929 and the Great Depression, it was first imperative to rebuild the public’s faith in the capital markets in order to restore the country’s economy. Insider trading regulation began with the implementation of the Securities Act of 1933 (“Securities Act”), which mandated “full and fair disclosure.” The enactment of the Securities Exchange Act of 1934 (“Securities Exchange Act”) followed, and it codified laws for the “disclosure and disgorgement of insider trading profits.”

9. See Henning, supra note 5 (stating that prosecutors believe that the *Newman* ruling will tie their hands in pursuing Wall Street crime).
11. *An Outside the Law Prosecutor*, WALL ST. J. (Dec. 10, 2014, 8:18 PM), http://www.wsj.com/articles/an-outside-the-law-prosecutor-1418260680 (noting Bharara’s attempt to “expand the definition of insider trading to whatever he could sell to a jury” as well as exploiting both “public anger against the finance industry as well as the ambiguity in the legal definition of insider trading” when prosecuting insider trading cases).
14. See also id. (suggesting that once Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934, both federal and state prosecutors had “more ammunition to convict inside traders by requiring mandatory disclosure and fair treatment of investors”).
In the 1960s, under its authority granted by Section 10(b) of the Securities Exchange Act ("Section 10(b)"), the SEC and federal courts applied the antifraud principle of SEC Rule 10b-5 to insider trading cases.\(^\text{15}\) The application of Rule 10b-5 effectively allowed the SEC to prosecute securities fraud through administrative actions and federal lawsuits.\(^\text{16}\) Today, the profitable business of illegal insider trading has developed to include cases that are in all types of sectors, like the banking, technology, and pharmaceutical sectors.\(^\text{17}\)

Part I of this Comment provides background on insider trading law by highlighting relevant statutory and case law that have shaped United States' securities law. Part II addresses the potential fallout for the Government's future insider trading cases based on the Second Circuit's decision in Newman. Part III concludes by recommending that Congress draft and implement laws that directly target the current insider trading legal regime to mitigate the illegal profits reaped by insider traders.

I. THE EVOLUTION OF INSIDER TRADING

Throughout the years, the Government has applied various securities laws in an effort to combat insider trading. The Securities Act was applied to insider trading to provide investors with a "full and fair disclosure of character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in sale thereof."\(^\text{18}\) The Securities Exchange

\(^{15}\) 15 U.S.C. § 78a (2012) (making it unlawful for any person through the means of interstate commerce to scheme or defraud or make any untrue statement of a material fact in connection with the purchase or sale of any security); see 17 C.F.R. 240.10b-5 (2015); see also Nelson S. Ebaugh, Insider Trading Liability for Tippers and Tippees: A Call for the Consistent Application of the Personal Benefit Test, 39 TEX. J. BUS. L. 265, 269 (2003), http://www.ebaughlaw.com/uploads/1/1/9/4/11948411/tjbl_article.pdf (stating that the principal tools used by the SEC and private plaintiffs to prosecute insider trading are Section 10(b) of the Securities Exchange Act and Rule 10b-5).

\(^{16}\) See Ebaugh, supra note 15, at 269.

\(^{17}\) See Chris Matthews, How Profitable is Insider Trading, Anyway?, FORTUNE (Oct. 20, 2014, 1:25 PM), http://fortune.com/2014/10/20/insider-trading-profits/ (suggesting insider trading is "insanely" profitable by demonstrating that the median investor betting $200,000 on the basis of an illegal tip can reap $72,000 on that trade—amounting to a thirty-five percent gain with a turnaround period of just twenty-one days); see also Preet Bharara: Insider Trading Is "Rampant" on Wall Street, FRONTLINE (Jan. 7, 2014, 9:41 PM), http://www.pbs.org/wgbh/pages/frontline/business-economy-financial-crisis/to-catch-a-trader/preet-bharara-insider-trading-is-rampant-on-wall-street/ (explaining how Bharara suggests that the hedge fund business is not the only business that insider trading is exploiting).

\(^{18}\) 15 U.S.C. § 77a (2013); see SEC v. Sunbeam Gold Mines Co., 95 F.2d 699, 701 (10th Cir. 1937) (reiterating that the purpose of the Securities Act is to provide full and fair disclosure for investors).
Act strengthened the Securities Act’s prohibitions of fraud in the sale of securities.  


Under SEC Rule 10b5-1, an insider trading violation occurs when there is a purchase or sale of a security on the basis of information that is material, nonpublic, and traded in breach of fiduciary duty. SEC Rule 10b-5 specifies that only untrue statements or omissions of material fact are actionable. "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider [the information] important in deciding how to vote." The "disclose or abstain rule" is premised on case law decided under Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5’s theory of equal access to information.

---


21. Newkirk, supra note 20 (stating that the Insider Trading and Securities Fraud Enforcement Act expanded the Commission’s ability to request testimony and production of documents from foreign security authorities so the Commission could obtain information to assist foreign regulators).


23. Id. § 240.10b-5(b) (2015); see also WILLIAM WANG & MARC STEINBERG, INSIDER TRADING 109 (3d ed. 2010) (explaining that there are two kinds of material information: (1) information about the issuer’s internal affairs, such as its earnings and profits, or (2) information such as knowledge about a forthcoming tender offer for the stock). See generally STEPHEN M. BAINBRIDGE, SECURITIES LAW: INSIDER TRADING 34 (2d ed. 2007).

24. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (noting that this standard does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote).

25. Compare Cady, Roberts & Co., 40 SEC 907 (1961) (extending the “disclose or abstain” rule beyond classical insiders and deciding that a “corporate insider” (anyone that had access to nonpublic information) must abstain from trading in the shares of his
abstain rule” states that “when a public issuer or one of its insiders is in possession of undisclosed material information, the issuer or insider must either disclose the material information before trading in the issuer’s securities or abstain from trading in the issuer’s securities.”

In insider trading cases, the government must establish that the person traded with the requisite scienter while in possession of “nonpublic” information. The distinction between public and nonpublic material operates along a spectrum. At one end is information disclosed by a company through official channels of communication, such as those the SEC mandates; at the other end are cases involving information leaked to the media, Internet, or individuals who have an interest in obtaining the information. Courts have established two theories to determine whether the information is considered public or not. Under the first theory, before insiders can act upon material information, the information must be disclosed by the original source in a manner sufficient to insure its availability to the investing public. In SEC v. Texas Gulf Sulphur Co., the SEC brought an action against the defendants alleging violations of Section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78, and Rule 10b-5. Texas Gulf Sulphur (“TGS”) officials discovered evidence of a major ore deposit, and shortly after, company officials planned to publicly announce the findings in a major press conference. In the days leading up to the

26. See Aaron v. SEC, 446 U.S. 680, 702 (1980) (defining “scienter” as the defendant’s mental state embracing an intent to deceive, manipulate, or defraud); see also Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (holding that “a private cause of action for damages will not lie under [Section] 10(b) and Rule 10b-5 in the absence of any allegation of ‘scienter’ – i.e. intent to deceive, manipulate, or defraud”).


28. See id.

29. See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (holding that not only are directors or management officers of corporation “insiders” within meaning of rule of SEC, so as to be precluded from dealing in stock of corporation, but the rule is also applicable to one possessing information. Thus, anyone “in possession of material inside information” is an “insider” and must “either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect corporate confidence, or he chooses not to do so, must abstain from trading in or recommending securities concerned while such inside information remains undisclosed.”).

30. See id. at 843.

31. See id. at 844-46.
formal statement announcing the discovery of ore deposits, TGS insiders bought stock or stock options in the company.\textsuperscript{32} Others tipped off outsiders who, in turn, also bought stock in the company.\textsuperscript{33} Upon discovering the scheme, the SEC sued TGS and argued that the company's press release about the discovery was "materially false and misleading" and that TGS officers and employees knew this information was false.\textsuperscript{34} The Second Circuit held that where a formal announcement to the media is revealed, all insider activity must await dissemination of the promised official announcement.\textsuperscript{35}

Under the second theory, information is public when trading causes the information to be integrated into the price of the particular stock. In \textit{United States v. Libera}, the Supreme Court found the defendants guilty of conspiracy and securities fraud for insider trading.\textsuperscript{36} The Government argued that the defendants executed trades in stock based on information in advance copies of \textit{Business Week}.\textsuperscript{37} The defendants' convictions were based on the misappropriation theory, which stated that "one who misappropriates nonpublic information in breach of a fiduciary duty and trades on that information to his own advantage violates Section 10(b) and [SEC] Rule 10b-5."\textsuperscript{38} Although the defendants argued that the advance copies of \textit{Business Week}—containing the information which they used to execute their trades—was based on public information, the Second Circuit disagreed. The Second Circuit held that information may be considered public for Section 10(b) purposes—even though there had been no public announcement and only a small number of people know of it—if trading has caused the information to be fully impounded into the price of the particular stock.\textsuperscript{39}

To ensure a fair market, the "disclose or abstain" rule states that if information is not public, one must either disclose the information before trading on the information or abstain from trading if the information is not released to the public. In accordance with application of the "disclose or

\textsuperscript{32} See id. at 842, 847.
\textsuperscript{33} See id. at 844.
\textsuperscript{34} See id. at 858.
\textsuperscript{35} See id. at 854 (holding that, at a minimum, the defendant should have waited "until the news could reasonably have been expected to appear over the media of widest circulation").
\textsuperscript{36} See United States v. Libera, 989 F.2d 596, 602 (2d Cir. 1993).
\textsuperscript{37} See id. at 598.
\textsuperscript{38} See id. at 599.
\textsuperscript{39} Id. at 601 (agreeing with appellants and stating that information may be considered public for Section 10(b) purposes even though there has been no public announcement and only a small number of people knew about it).
abstain” rule, there must be a determination of whether a fiduciary relationship exists between the inside trader and those with whom he or she is about to trade. Whether an individual has violated a fiduciary duty depends on the nature of the fiduciary relationship that the government is asserting. There are three traditional theories of insider trading liability that this Comment will discuss: the “classical” theory, the “tipper-tippee” theory, and the “misappropriation” theory. These theories all cover different types of fiduciary duties, each with different types of relationships and obligations. Accordingly, when applying these theories, the government has the burden of proving that a person trading on a tip knew or should have known that there was a breach of a duty based on the source of the information.

A. Analyzing the Second Circuit’s Interpretation of Personal Benefits following Dirks v. SEC

In the seminal Supreme Court case, Dirks v. SEC, the Supreme Court held that a prosecutor could charge tippees with insider trading liability if he or she met two conditions: 1) if the tip recipient had reason to believe that when the information was divulged, it was in violation of another’s fiduciary duty; and 2) if the recipient personally gained from acting upon the information. In Dirks, the petitioner worked as a securities analyst at an insurance company. An insider at an investment company urged the petitioner to investigate the investment company after the insider received information that the company was engaging in fraud. In the course of the investigation, neither the petitioner nor his firm traded any

40. E.g., Dirks v. SEC, 463 U.S. 646, 654 (1983) (noting that the duty to disclose does not arise from the mere possession of nonpublic market information, rather it arises from the existence of a fiduciary relationship); see also Chiarella v. United States, 445 U.S. 222, 232-33 (1980) (holding that no duty to disclose could arise since petitioner was not an agent, fiduciary, or person in whom the sellers had placed their trust and confidence).

41. Dirks, 463 U.S. at 660 (“A tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know there has been a breach.”).

42. See id. (noting that the Supreme Court was not suggesting that all tippees were free to trade on material nonpublic information but that a tippee’s duty to disclose or abstain must be derived from the insider’s duty).

43. See id. at 649.

44. See id. (noting that Dirks interviewed several officers and employees of the corporation and the senior management denied any wrongdoing but that certain corporation employees corroborated the charges of fraud).
stock from the company; however, the petitioner did discuss his findings with a number of clients who in turn sold their holdings.\textsuperscript{45} As a result, the company’s stock fell, causing the New York Stock Exchange to halt trading.\textsuperscript{46}

The SEC found that the petitioner had aided and abetted violations of United States’ securities laws, and it censured him.\textsuperscript{47} The Supreme Court reversed the SEC’s judgment and reaffirmed its decision in \textit{Chiarella v. United States}, holding that a duty to disclose “arises from the relationship between parties . . . and not merely from one’s ability to acquire information because of his position in the market.”\textsuperscript{48} The Supreme Court also held that, because the tippers were only motivated by a desire to expose the fraud, there was no personal benefit to the tippers and thus no derivative liability for the petitioner-tippee.\textsuperscript{49} In \textit{Dirks}, the Supreme Court found that the petitioner had no fiduciary duty to the shareholders or officers of the investment company nor was there expectation by the petitioner’s source of information that he would keep the information confidential.\textsuperscript{50} Furthermore, because the petitioner did not misappropriate or illegally obtain the information, the Supreme Court found that there was no actionable violation.\textsuperscript{51}

Since \textit{Dirks}, the Second Circuit has interpreted the \textit{Dirks} “personal benefit test” differently. In \textit{United States v. Rajaratnam} and \textit{United States v. Whitman}, the Second Circuit interpreted \textit{Dirks} to require that the Government prove a tippee’s knowledge of a benefit to the tipper who violated a fiduciary duty.\textsuperscript{52} However, in \textit{United States v. Jiau} and \textit{United

\textsuperscript{45}. See id.
\textsuperscript{46}. See id. at 650.
\textsuperscript{47}. See id. at 650–52.
\textsuperscript{48}. See id. at 657–58 (citing Chiarella v. United States, 445 U.S. 222, 235 (1980), which rejected the SEC’s position that anyone who knowingly receives nonpublic, material information from an insider has a fiduciary duty to disclose before trading).
\textsuperscript{49}. See \textit{Dirks}, 463 U.S. at 663–67 (requiring courts to focus on an objective criterion, “i.e. whether the insider receives a direct or indirect personal benefit from disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings”).
\textsuperscript{50}. See id. at 665.
\textsuperscript{51}. See id.
\textsuperscript{52}. See \textit{United States v. Rajaratnam}, 719 F.3d 139, 158 n. 23 (2d Cir. 2013) (holding that “when an unlawful tip occurs, the tippee is . . . liable if he knows or should know that the information was received from one who breached a fiduciary duty and the tippee traders or tips for personal benefit with the requisite scienter”); \textit{United States v. Whitman}, 904 F. Supp. 2d 363, 374 (S.D.N.Y. 2012) (holding that to be criminally liable for insider trading, a secondary tippee must have a general understanding that the inside information was obtained from an insider who breached a duty of confidentiality in exchange for some personal benefit and that the tippee must
States v. Libera, the Second Circuit interpreted Dirks to require that the Government principally prove that the tipper received some benefit but that the Government did not have to prove that the tippee had knowledge of that benefit. The Second Circuit’s decision in Newman offers a different interpretation of Dirks and brings clarity to an otherwise vague interpretation of establishing personal benefits. Prior to the Newman decision, the legal community has described the personal benefit element for tipper/tippee liability as “broadly defined.”

B. Comparing Tippee Liability through the Classical and Misappropriation Theories

In Newman, the Second Circuit and prosecutors assessed the Defendant’s liability through different theories of liability, and after the Second Circuit put forth its decision, New York judges began to follow suit. With this large-scale response, the Department of Justice (“DOJ”) quickly sought to curb Newman’s effect by arguing that the decision only applied to “classical” insider trading cases and not to cases brought under the “misappropriation” theory. However, the elements of tipping liability are the same regardless of whether the tipper’s duty arose under the classical or

have a specific intent to defraud the company to which the information relates).

53. See United States v. Jiau, 734 F.3d 147, 153 (2d Cir. 2013) (holding that “[t]he existence 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]’ may be sufficient to justify an inference of personal benefit.” (citing Dirks, 463 U.S. at 664)); United States v. Libera, 989 F.2d 596, 600 (2d Cir. 1993) (implying that the breach of a fiduciary duty in return for some benefit was required to establish liability; it is not necessary to establish that the tipper must specifically know that their breach of a fiduciary duty will lead to trading.).


55. See e.g., United States v. Conradt, No. 12-cr-887, 2015 U.S. Dist. LEXIS 16263, at *2-4 (S.D.N.Y. Jan. 22, 2015) (noting that the presiding judge rejected the government’s argument that any reference to the misappropriation theory in Newman was dicta and that prior Second Circuit decisions have held that the misappropriation theory does not require the tipper to receive any personal benefit to be liable for insider trading).

56. Id.; see also Gov’t’s Mem. Law Supp. Suff. Def’s’ Guilty Pleas at 1, 4, United States v. Durant, No. 12-cr-887 (S.D.N.Y. Jan. 12, 2015) (explaining the DOJ’s position that because the Durant prosecution is founded on the “misappropriation” theory of insider trading, and Newman involved a prosecution based on the “classical” theory of insider trading, the Newman holding will not affect the Durant case).
the misappropriation theory.\textsuperscript{57}

The Supreme Court endorsed the classical theory of insider trading in the 1980 case, \textit{Chiarella v. United States}. Under the classical theory, a corporate insider violates the anti-fraud provision by trading a corporation’s securities “on the basis of material, nonpublic information” about the corporation.\textsuperscript{58} In \textit{Chiarella}, the petitioner was convicted by the Second Circuit for violating Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5.\textsuperscript{59} While working for a financial printer, the petitioner handled announcements of corporate takeover bids.\textsuperscript{60} Without disclosing his knowledge, the petitioner purchased the targeted company stock and sold the shares immediately after the takeover attempts were publicized.\textsuperscript{61} The Supreme Court held that the petitioner had not violated the duty to disclose material information because no relationship of trust or confidence existed between petitioner and the shareholders.\textsuperscript{62}

\textit{Chiarella} limited the scope of insider trading liability to individuals who not only possessed material, nonpublic information but also to those who possessed a duty to disclose based on a relationship of trust and confidence between the parties.\textsuperscript{63} Since \textit{Chiarella}, however, the Courts no longer limited the duty to disclose or abstain under the classical theory to “traditional” corporate insiders, such as officers and directors. The Supreme Court in \textit{Dirks v. SEC} extended the duty to disclose or abstain to outsiders who can obtain status as “temporary insiders.”\textsuperscript{64}

A defendant is guilty of violating the misappropriation theory when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.\textsuperscript{65} Unlike the

\begin{itemize}
\item \textsuperscript{57} \textit{Id.}; see also \textit{SEC v. Obus}, 693 F.3d 276, 285–86 (2d Cir. 2012) (stating that “[o]ne who has a fiduciary duty of trust and confidence to shareholders (classical theory) or to a source of confidential information (misappropriation theory) and is in receipt of material non-public information has a duty to abstain from trading or to disclose the information publicly”).
\item \textsuperscript{59} \textit{Chiarella} v. \textit{United States}, 445 U.S. 222, 225 (1980).
\item \textsuperscript{60} \textit{Id.} at 224.
\item \textsuperscript{61} \textit{Id.}
\item \textsuperscript{62} \textit{Id.} at 232–33.
\item \textsuperscript{63} Bainbridge, \textit{supra} note 23, at 52.
\item \textsuperscript{64} \textit{Dirks v. SEC}, 463 U.S. 646 (1983); see also \textit{Insider Trading: A Primer}, \textit{KATTEMUCHINROSENMAN LLP} (Oct. 26, 2009), https://www.kattenlaw.com/Insider-Trading-A-Primer-10-26-2009 (explaining that a temporary insider is someone who enters into a special confidential relationship with an issuer, and as a result is given access to confidential relationship).
\item \textsuperscript{65} \textit{See} Kramer Ortman, \textit{SEC v. Bauer: If the Glove Fits, It’s Insider Trading}, 63 \textit{CATH. U.L. REV.} 1075, 1082 (2014) (stating that under the misappropriation theory, “a
classical theory, the misappropriation theory imposes a duty on corporate "outsiders." In United States v. O'Hagan, the respondent-attorney purchased common stock and call options of a potential takeover target based upon nonpublic information. During the representation, the respondent purchased call options for the other company's stock and sold those options at a significant profit. Because the respondent was neither an officer nor had any relation to the target company, the classical theory of insider trading did not apply. However, the Supreme Court held that the respondent was guilty of insider trading because he owed a fiduciary duty to his law firm, and when he used his law firm's confidential information to trade, he misappropriated such information to the disadvantage of his firm. Therefore, the Supreme Court held that a corporate outsider is guilty of insider trading "when he misappropriates confidential information... in breach of a fiduciary duty owed to the source of information."

Courts no longer restrict insider trading to either "corporate insiders" or to "corporate outsiders." Instead courts have expanded insider trading liability to include both insiders ("the tipper") in possession of the material, nonpublic information, and outsiders ("the tippee") who receive the information from the insider and use the information received to trade.

II. FACTS AND PROCEEDINGS OF UNITED STATES V. NEWMAN

Defendants Todd Newman and Anthony Chiasson (collectively "Defendants") appealed their convictions, entered by the United States District Court for the Southern District of New York, following a trial on charges of conspiracy to commit insider trading in violation of 18 U.S.C. § 371, § 10(b) and § 32 of the Securities Exchange Act, SEC Rules 10b-5 and 10b5-2, and 18 U.S.C. § 2. The Second Circuit reversed the lower court's convictions and held that the Government failed to present sufficient evidence that the Defendants willfully engaged in substantive fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information.

67. Id.
68. See id. at 653-54, 666.
69. Id. at 652.
70. See Dirks v. SEC, 463 U.S. 646, 659 (1983) (stating that "not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they may not give such information to an outsider for the same improper purpose of exploiting the information to their personal gain").
insider trading or in a conspiracy to commit insider trading in violation of federal securities laws.\textsuperscript{72}

On January 18, 2012, the Government unsealed charges against the Defendants and several other investment professionals.\textsuperscript{73} This case focused on the Government’s accusation that the Defendants were liable for insider trading after they received information from financial analysts about Dell Inc. (“Dell”) and Nvidia Corporation’s (“Nvidia”) earning numbers before the numbers were publicly released by the corporations and, using that information, executed trade deals.\textsuperscript{74} However, the Defendants were several steps removed from the corporate insiders, and there was no evidence that either was aware of the source of the inside information.\textsuperscript{75}

The Government alleged that the Defendants were “criminal liability for insider trading because, as sophisticated traders, they should have known that the information was disclosed by insiders in breach of a fiduciary duty, and not for any legitimate corporate purpose.”\textsuperscript{76} On the other hand, counsel for the Defendants argued that there was no evidence that the corporate insiders provided inside information in exchange for a personal benefit, which was required by law to establish tipper liability.\textsuperscript{77}

The district court instructed the jury to consider whether the Government had proven, beyond a reasonable doubt, that the Defendants knew the information they received was originally disclosed by an insider, in violation of a duty of confidentiality.\textsuperscript{78} On December 17, 2012, the jury returned a verdict of guilty on all counts, and the Defendants appealed the verdict.\textsuperscript{79}

\begin{itemize}
\item \textsuperscript{72} Id. at 442.
\item \textsuperscript{73} Id. at 443.
\item \textsuperscript{74} Id. (stating that Newman and Chiasson earned approximately $4 million and $68 million respectively in profits after receiving the inside information from their portfolio managers).
\item \textsuperscript{75} Id. But see Petition of the United States for Rehearing and Rehearing \textit{En Banc} at 6-7, United States v. Newman, 773 F.3d 438 (2d Cir. 2014) (No. 13-1837) [hereinafter United States Petition Rehearing \textit{En Banc}] (describing purposeful steps Newman and Chiasson took to avoid learning where the real source of information came from that they in return traded on and made a profit from).
\item \textsuperscript{76} Newman, 773 F.3d at 443–44.
\item \textsuperscript{77} Id. at 444 (asserting that in the defendant’s case, because a tippee’s liability derives from the liability of the tipper, defendants could not be held liable since no personal benefit was found).
\item \textsuperscript{78} See id. (stating further that “[t]he mere receipt of material, nonpublic information by a defendant, and even trading on that information, is not sufficient; he must have known that it was originally disclosed by the insider in violation of a duty of confidentiality”).
\item \textsuperscript{79} Id.
\end{itemize}
FRIENDS WITH BENEFITS

On appeal, the Second Circuit held that to sustain an insider trading conviction against the tippee, the Government must prove each of the following: 1) the corporation entrusted the insider with a fiduciary duty; 2) the corporate insider breached his fiduciary 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 of fiduciary duty; and 4) the tippee still used that information to trade in a security or further tip another individual for personal benefit. The Second Circuit concluded that the Government’s evidence of casual acquaintances between a tipper and tippee, as well as offers of generic career advice and occasional socializing, was insufficient to prove the necessary personal benefit to the insider. Instead, the Second Circuit found that the Government could infer a benefit only upon “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.” The Second Circuit also found that the Defendants did not know of any benefit received by the tipper. The Court vacated the convictions and remanded the case to the district court to dismiss the indictments with prejudice as they pertained to the Defendants.

III. Newman’s Aftermath: Analyzing the Implications of the Second Circuit’s Decision

In overturning the defendant’s convictions, the Second Circuit presented a much-needed return to fairness and “sanity” in the judicial system.

80. Newman, 773 F.3d at 448 (rejecting the government’s contention “that knowledge of a breach of the duty of confidentiality without knowledge of the personal benefit is sufficient to impose criminal liability”).

81. Id. at 452 (stating that if Court were to accept that two individuals who were alumni of the same school or attended the same church as a personal benefit, then the personal benefit requirement would be a void and any relationship can be inferred as a personal benefit).

82. Id. But see United States v. Jiau, 734 F.3d 147, 153 (2d Cir. 2013) (holding that “personal benefit is broadly defined to include not only pecuniary gain, but also, inter alia, any reputational benefit that will translate into future earnings”).

83. Newman, 773 F.3d at 455.

Attorney Preet Bharara has racked up more than eighty successful insider trading convictions in the past seven years,\(^{85}\) providing him with an impressive track record and earning himself the reputation as the sheriff of Wall Street.\(^{86}\) To some critics, Bharara’s prosecution of insider trading has focused on successfully arguing that traders “didn’t really have to know that the information they were trading on was the illegal variety.”\(^{87}\) Instead, it was good enough for prosecutors to establish that traders should have known the information was illegal\(^{88}\) and to rely on something as nebulous as friendship to prove the existence of a benefit in lieu of providing that traders paid off their sources to obtain the illegal information.\(^{89}\) The *Newman* decision successfully puts an end to Bharara’s overreaching prosecution of insider trading and reminds the Government that not everyone who trades on nonpublic information is guilty of insider trading.

After *Newman*, the Second Circuit’s decision forces the Government and prosecutors to reconsider bringing cases against remote tippees for trading insider information.\(^{90}\) Now prosecutors’ focus on insider trading are directed much more towards guilt than money.\(^{91}\) Under *Newman*, liability would arise from the insider’s intent to benefit the person who receives the inside information: the tippee.\(^{92}\) Therefore, a tipper who trades based on


\(^{86.}\) See An Outside the Law Prosecutor, supra note 11.

\(^{87.}\) See Gasparino, supra note 84.

\(^{88.}\) Id.; see also *Newman*, 773 F.3d at 443–44 (2d Cir. 2014) (noting the Government’s argument that Newman and Chiasson were criminally liable for insider trading because, as sophisticated traders, they should have known the information they were trading on was illegal).

\(^{89.}\) See Gasparino, supra note 84.

\(^{90.}\) See Henning, supra note 5 (stating that the DOJ is fighting to minimize the impact of the opinion, which raised the bar on what the government must show to establish a violation for trading on confidential information).

\(^{91.}\) See Matt Levine, What’s Next for Insider Trading Law?, BLOOMBERG VIEW (Dec. 11, 2014, 6:17 PM), http://www.bloombergview.com/articles/2014-12-11/whats-next-for-insider-trading-law (stating “if you provably [sic] knew that you were corruptly obtaining information, then you go to jail, but if you just made a lot of money trading and got some tainted tips, you just have to give the money back”).

\(^{92.}\) See Mark S. Nelson, SEC to Back U.S. Attorney’s Try to Uproad Newman, SEC.
inside information must then give the illegal gains to a friend to be guilty of insider trading.  

A. Heightened Standard Analysis

Although the Newman case comes as a blow to prosecutors for future insider trading cases, it clarifies the muddled standards for establishing tippee liability within the Second Circuit.  

In the past, the Second Circuit has articulated two opposing rationales for establishing personal benefit. In some cases, the Court construed Dirks to require that the government prove a tippee’s knowledge of a benefit to the tipper who violated a fiduciary duty; however, in others, the Court viewed Dirks as requiring the government to prove that the tipper received some benefit but that it did not have to not prove that the tippee knew of that benefit.

The Newman decision correctly reins in both a prosecutor’s ability to bring cases involving insider trading and his or her ability to target remote tippees whose actions are tangentially related to the illegal activity. In Newman, the Government continued to overextend insider trading culpability precedent set by courts by relying heavily on prior dicta favorable to their position, instead of analyzing tippee liability in view of the courts’ framework.

The Court in Newman correctly rejected the Government’s argument that it only had to prove that the Defendants traded on material, nonpublic information that they knew insiders had disclosed in breach of a duty of confidentiality. Instead, the Court ruled that the Defendants were guilty of insider trading if they were aware that insiders at technology companies were improperly leaking confidential information to hedge funds in exchange for some personal benefit. While the Defendants profited from


93. See id.

94. Protess, supra note 10 (concluding that the appellate decision “drew a new and more defined line that curtails the boundaries of insider trading liability”).

95. See, e.g., United States v. Rajaratnam, 719 F.3d 139 (2d Cir. 2013).

96. See, e.g., United States v. Jiau, 734 F.3d 147 (2d Cir. 2013); United States v. Libera, 989 F.2d 596 (2d Cir. 1993).

97. See United States v. Newman, 773 F.3d 438, 448 (2d Cir. 2014) (noting the Government’s reliance on insider trading cases involving “tippees who directly participated in the tippers breach” and applying these cases to insider trading prosecutions of “remote tippees many levels removed from corporate insiders”).

98. See id. at 447–48 (demonstrating that the Government cites Dirks for the proposition that the Supreme Court only required that the “tippee know that the tipper disclosed information in breach of a duty” (citing Dirks, 463 U.S. at 660)).

99. See id. at 438.
the nonpublic information, the Court found the Defendants so far removed from the initial tips at Dell and NVIDIA that they could not have known of any breach of fiduciary duty in exchange for a benefit. The *Newman* decision is important for convicting remote tippees for the crime of insider trading because it defines the mens rea required for insider trading, namely that the defendant knew of the breach of fiduciary duty for a personal benefit. In *Newman*, the Defendants were four or five people removed from the original source of the inside information. The Court believed this was similar to a situation where a trader, who receives a tip and trades on it, is unaware that his conduct is wrongful because he was unaware of the original source.

This heightened standard imposes the highest burden on the Government and forces prosecutors to reconsider its decision to charge tippees with unmerited accusations. Prosecutors argue that the *Newman* ruling encourages "higher-ranking traders to distance themselves from insider trading leaks, even when reaping big profits from the tips." However, in the case of *Newman*, it is plausible to believe that the Defendants did not know the information was traded on a nonpublic basis for a personal benefit. What started as an illegal tip—exchanged between insiders at the technology companies—wound its way through a network of traders and then reached the Defendants, who were at the end of a long chain of traders.

**B. Personal Benefits Analysis**

In the *Newman* decision, the Second Circuit revisited the Supreme Court's *Dirks*’ "personal benefit" definition, and it added an unprecedented limitation that now drastically limits the Government's ongoing, frivolous prosecution of remote tippees. As mentioned above, in *Dirks*, the Supreme Court held that a breach of fiduciary duty was a breach of confidentiality in exchange for a personal benefit. It further explained that the tipper's breach of fiduciary duty required that the tipper "[will] personally benefit, directly or indirectly, from his disclosure."
In the past, prosecutors have successfully argued that mere friendship is enough to prove that a tipper received an indirect benefit from passing on an illegal tip to a friend.\textsuperscript{106} However, post-\textit{Newman}, the Government will have to prove 1) the existence 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,"\textsuperscript{107} and 2) that, as stated above, the tippee had knowledge that the tipper received some benefit for the information shared in breach of a fiduciary duty.\textsuperscript{108}

In \textit{Newman}, the Government argued that the benefit received for the Dell insiders who worked together—and who previously attended business school together—was career advice.\textsuperscript{109} The Government also attempted to establish personal benefits in the NVIDIA tipping chain by arguing that the insiders were close friends who socialized and attended church together.\textsuperscript{110} The Second Circuit deemed the Government's evidence of personal benefit insufficient to establish insider trading liability.\textsuperscript{111} After the Second Circuit's decision in \textit{Newman}, the Court affirmed the basis for a claim of fraudulent breach, namely that the Government must also show that the tipper's gain "received in exchange for confidential information must be of some consequence."\textsuperscript{112} Further, the \textit{Newman} court set a high evidentiary burden for the Government by expressly declaring that, without direct proof of a tippee's knowledge of a benefit to the tipper, such knowledge may not be inferred by virtue of a personal relationship between the tipper and tippee.

\textsuperscript{106} See, \textit{e.g.}, SEC v. Obus, 693 F.3d 276, 285 (2d Cir. 2012) ("Personal benefit to the tipper is broadly defined: it includes not only 'pecuniary gain,' such as a cut of the take or a gratuity from the tippee, but also a 'reputational benefit' or the benefit one would obtain from simply 'mak[ing] a gift of confidential information to a trading relative or friend.'" (citing \textit{Dirks v. SEC}, 463 U.S. at 663–64 (1983)); see also SEC v. Warde, 151 F.3d 42, 48–49 (2d Cir. 1998) (finding a sufficient showing of personal benefit where a "close friendship" suggested that the tip was intended to benefit the tippee). \textit{See generally Protess, supra} note 10.

\textsuperscript{107} United States v. Newman, 773 F.3d 438, 452 (2d Cir. 2014) (explaining that this often manifests in "a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the [latter]").

\textsuperscript{108} \textit{Id.} at 448.

\textsuperscript{109} \textit{Id.} at 452–53.

\textsuperscript{110} United States Petition for Rehearing \textit{En Banc}, supra note 75, at 6.

\textsuperscript{111} \textit{Newman}, 773 F.3d at 455 (stating that "where the evidence viewed in the light most favorable to the prosecution gives equal or nearly equal circumstantial support to a theory of innocence as a theory of guilt, that evidence necessarily fails to establish guilt beyond a reasonable doubt").

\textsuperscript{112} \textit{Id.} at 452.
The Court’s decision stating that mere friendship is no longer sufficient evidence of a personal benefit heightens the standard for establishing personal benefit. However, the Second Circuit needs a further step to clarify what type of evidence then satisfies this heightened standard.113 The defense counsel can assert that anything short of a wiretap or coerced information from an informant—that proves the existence of a mutually beneficial friendship—does not satisfy the form of evidence to establish liability.114

The Second Circuit’s established heightened standard in Newman draws a somewhat clearer line for the requirements of insider trading liability, and it provides a framework to determine what qualifies as a “personal benefit.” In the past, the Second Circuit has faced some confusion on tippee liability, which may have contributed to the Government’s successful ability to charge virtually anyone with insider trading so long as he or she traded using material, nonpublic information.115 Yet, since the Supreme Court’s decision in Dirks v. SEC, the Second Circuit has struggled to define what constitutes a “personal benefit.” As a result of the “delphic”116 discussion on the type of personal benefits necessary to establish tippee liability, the Government has been able to pick and choose from the dicta that provide the strongest support for its case.117 The Newman decision correctly reinforces that tippee liability is established by the tippee when he or she knows the information on which he or she is trading was acquired through a breach of a fiduciary duty in exchange for a meaningful personal benefit. As the Second Circuit concludes, if the Court were to hold that the Government’s proof of personal benefit was established through casual friendships and career advice, then practically anything would qualify as a

113. Brief of Petitioner for Rehearing and Rehearing En Banc at 14, United States v. Newman, F.3d 438 (2d Cir. 2014) (No. 13-1837) (“It is best uncertain how courts would determine the evidence necessary to satisfy such a standard.”).

114. See Protes, supra note 10 (quoting Jonathan R. Streeter, a lawyer at Dechert who was one of the prosecutors under Bharara in the case of United States v. Rajaratnam: “It used to be all the government had to do to prove a benefit was show the people involved were friends—and now they must show a tangible benefit, and that’s a big change”).

115. See Newman, 773 F.3d at 448 (addressing what the court terms as “the doctrinal novelty of [the Government’s] recent insider trading prosecutions,” especially those targeting remote tippees); see also Elkan Abramowitz & Jonathan Sack, Implications of Reversal of Insider Trading Convictions; White-Collar Crime, N.Y. L.J. (Jan. 6, 2015) (suggesting that the Court believes the Government was essentially attempting to pin liability on the defendants based on “informational asymmetry”).


117. Id.
benefit.118

*Newman* presents an even stricter return to the *Dirks* holding, with the Second Circuit concluding that, “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.”119 The Court rejected the Government’s argument that they can impose liability can be imposed upon a defendant, based solely on the knowledge of a breach of fiduciary duty. If the Government’s request for an en banc rehearing is successful, then the prosecutors may argue that a broader interpretation of *Dirks* should be the standard for establishing a personal benefit. However, this argument will likely fail because it seeks to continue the Government’s track record of picking and choosing case law interpretations beneficial to their position.120 Ultimately, the Government’s request for an en banc rehearing was denied by the Second Circuit,121 and the Government filed a petition for a writ of certiorari on July 30, 2015.122 The Supreme Court denied certiorari with no explanation on October 5, 2015.123 As of now, the *Newman* decision firmly establishes that the Government must show that the tippee knew of the personal benefit gained by the tipper in breach of a fiduciary duty.

**C. The Future of Insider Trading Cases Post-Newman**

The Second Circuit’s decision in *Newman* will undoubtedly curb the number of cases the Government plans to pursue for insider trading. On the heels of the *Newman* decision, the Defendants who were former employees of Wells Fargo, and who shared inside information of a forthcoming ratings change via e-mail, have now requested the SEC’s

118. *Id.* at 452.
119. *Id.* at 442.
120. *See id.* at 447.
dismissal of administrative charges. The Defendants alleged that the benefit was only "their friendship and positive feedback given to the tipper's managers." The SEC contended that the Defendants gave two traders a "sneak preview into [the] upcoming ratings changes and provided them an unfair and illegal advantage on the rest of the markets." Post-Newman, the Defendants have filed motions to dismiss, stating that the SEC's case is "fatally flawed in light of the appeal-court ruling, because the agency can’t show . . . [that] the former Wells Fargo analyst, tipped for a personal benefit." Ruggieri's case was ultimately dismissed, and the judge held that while the SEC established that the defendant traded on tips he received, there was no proof that the tipper in this case received anything of benefit.

In another case, United States v. Conradt, the Government accused five friends of illegally trading based on a secondhand tip about IBM’s plan to acquire SPSS, a software company, for $1.2 billion in 2009. In Conradt, the Government argued that the defendant, Trent Martin received an


126. See SEC Press Release on Wells Fargo Employees, supra note 125.

127. See Eaglesham, supra note 124.


“indirect gift of confidential information.” On January 29, 2015, U.S. District Judge Andrew Carter granted U.S. prosecutors’ request to drop insider trading charges against the five defendants but allowed the government to reassert its charges if it successfully challenged *Newman*. During a hearing, the prosecutors stated that “they couldn’t prove their case under a new framework that was set by a pivotal appeals court ruling in December,” referring to *Newman*. They further stated that the *Newman* decision would “dramatically limit the [G]overnment’s ability to prosecute some of the most common culpable and market threatening forms of insider trading.” The IBM case is the first case prosecutors dropped following the *Newman* decision, and it could potentially provide a road map for others challenging the Government in future cases concerning insider trading.

As demonstrated above, *Newman*’s requirement of a “meaningful benefit” has already forced both courts and the prosecutors to reconsider cases where there is not enough evidence to prove beyond a reasonable doubt that the defendants are liable for insider trading. The *Newman* decision puts an end to the Government’s recent crusade against insider trading, where the Government has frequently stretched precedent and presented scant evidence that, taken together, formed legally conclusory cases. In the case of remote tippees, the Second Circuit has correctly required the Government to prove its case with solid evidence demonstrating that the defendants knew of a breach of fiduciary duty in exchange for a personal benefit amounting to more than just a casual

130. See Pavlo, supra note 129.
133. Id.
135. See An Outside the Law Prosecutor, supra note 11 (opining that the *Newman* reversal finally put a judicial cap to Bharara’s quest to expand the definition of “insider trading” to capture nearly every information asymmetry and virtual presumption of guilt).
136. Chung, supra note 7 (stating that, until the *Newman* decision, “the Government had chipped away at the *Dirks* benefit test, including by deeming the test satisfied where the tip was in exchange for “maintaining a useful networking contact” (citing United States v. Whitman, 904 F. Supp. 2d 363, 372 (S.D.N.Y. 2012)) or merely “making a gift of information to a friend” (citing SEC v. Obus, 693 F.3d 276, 291 (2d Cir. 2012)).
friendship.

The Second Circuit’s decision in Newman directly impacted another major case, United States v. Steinberg.\footnote{137} Michael Steinberg, the former portfolio manager of S.A.C. Capital Advisors, L.P. (“SAC Capital”), was convicted in 2013 after a jury found him guilty of generating $1.9 million in illegal profits for SAC Capital.\footnote{138} The Southern District of New York sentenced him to three-and-a-half years in prison for conspiracy to commit securities fraud and four counts of securities fraud.\footnote{139} In light of the new Newman standard for charging remote tippees with insider trading, Steinberg’s conviction will likely be overturned by the Government because he traded part of the same information that did not constitute an illegal tip for the Defendants in Newman.\footnote{140} Others who plead guilty and testified as cooperating witnesses in the trials of the Defendants and Steinberg may also seek to withdraw their guilty pleas.\footnote{141}

Contrary to the Government’s belief, the Newman decision does not shield hedge fund managers from liability when trading on confidential information they receive, by claiming they did not know the identity of the original source.\footnote{142} The Government can bring a successful claim of remote insider trading liability by proving that a person knowingly ignored red flags about the questionable nature of the information and did not avoid learning too much: also known as “the ostrich instruction.”\footnote{143} The Newman


138. See DOJ Press Release on SAC Capital, supra note 137.

139. Id.; see also Matthew Goldstein, Ex-Trader at SAC Fund is Sentenced to 3 Years, N.Y. TIMES (May 16, 2014, 12:55 PM), http://dealbook.nytimes.com/2014/05/16/ex-sac-capital-trader-steinberg-sentenced-to-3-12-years/?_r=0 (quoting Judge Sullivan stating that Steinberg’s prison sentence and $2 million fine, “was necessary to send a message to others on Wall Street that insider trading is not a trivial crime”).

140. See Goldstein, supra note 139.

141. Henning, supra note 5.


143. See United States v. Goffer, 721 F.3d 113, 124–27 (2d Cir. 2013) (concluding that evidence relating to knowledge and conscious avoidance in tipping chain cases was sufficient to establish tippee scienter); see also id. (explaining that the “ostrich instruction” allows a jury to find defendants “can violate the law by putting their heads in the sand when it came to knowing how the information was obtained”).}
ruling puts pressure on the DOJ and the SEC to show that there was something more tangible passed to the tipper by the tippee than just the "warm feeling" of helping out a friend. However, cases in which a tippee directly gave something of value to a tipper will be largely unaffected.

Ultimately, the *Newman* prosecution presents a "problematic theme in the recent government policy of pursuing the end users of inside information rather than the source." As the *Newman* Court noted, the Government has not yet charged the corporate insiders that leaked the material, nonpublic information with insider trading.

**IV. TIME TO MAKE SOME LAWS, CONGRESS**

The absence of laws, directly criminalizing insider trading, leaves loopholes in securities law to the advantage of defendants when they are appealing convictions of insider trading. Although the SEC designed Section 10(b) of the Securities Exchange Act as a catch-all clause to prevent fraud, it does not prohibit insider trading. Instead, the Government has used Section 10(b) to prosecute cases by rationalizing that insider trading is a type of securities fraud proscribed by Section 10(b) and SEC Rule 10b-5. The lack of laws specifically tailored to insider trading has essentially allowed judges to wield insider trading precedents the way they see fit.

In these cases, it is important to keep in mind the big picture; investors are being prosecuted by the government for conduct that Congress is either unwilling or unable to define. And, if this is not troublesome enough, the

---


145. See generally United States v. Rajaratnam, 719 F.3d 139, 160 (2d Cir. 2013) (holding the defendant guilty of insider trading where the government had sufficient information to prove the defendant received tips personally from insiders and provided money and other benefits to them).


DOJ and the SEC continue to prosecute insider trading cases while simultaneously aiming to expand the boundaries of insider trading on theories that lack precedent. Prosecutors have lost sight of their initial goal—improving the fairness of the markets for investors—and instead, they have crusaded against big corporations and hedge fund managers in a half-hearted effort to mitigate insider trading.

The implications of these frivolous crusades are that investors begin to pull back from market participation for fear of becoming the next victim of overzealous prosecutors. This outcome is why it is crucial for Congress to clearly define what constitutes insider trading activity. Congress has had the opportunity to address insider trading on numerous occasions in the past, but it has repeatedly declined to do so. While the SEC can refine its rules, it would be far more effective for Congress to take the lead and make laws defining and criminalizing insider trading.

As Supreme Court Justice Antonin Scalia wrote last year in the denial to grant writ of certiorari for *Whitman v. United States*, “Congress cannot, through ambiguity, effectively leave that function [of defining crimes and fixing punishments] to the courts—much less to an administrative bureaucracy.”

---

148. United States v. Newman, 773 F.3d 438, 448 (2d Cir. 2014) (“[T]he Government’s overreliance on our prior dicta merely highlights the doctrinal novelty of its recent insider trading prosecutions [...]”).

149. See Cronan, supra note 146 (citing the Newman decision as “some good news for the financial industry, especially hedge funds, arbitrage funds, and other financial entities, that may come into possession of information about public companies where it is difficult to determine if the information is non-public and where the ultimate source is unknown and may be several steps removed from the trader himself”).

150. See Harvey L. Pitt et al., *Problems of Enforcement in the Multinational Securities Market*, 9 U. PA. J. INT’L L. 375, 382 n.11 (1987) (suggesting Congress specifically declined to define insider trading, while passing the Insider Trading Sanctions Acts of 1984, to avoid a debate over the definition that could have stalled passage of the entire legislative package); see also H.R. REP. No. 100-910, at 11 (1988) (demonstrating Congress’ refusal to adopt a definition of insider trading when it enacted the Insider Trading and Securities Fraud Enforcement Act of 1988 because “the court-drawn parameters of insider trading have established clear guidelines for the vast majority of traditional insider trading cases [...]” Accordingly, the Committee [did] not intend to alter the substantive law with respect to insider trading with this legislation.”).


Congress has taken limited steps so far to address insider trading in light of the *Newman* decision. On February 27, 2015, Representative Stephen F. Lynch of Massachusetts introduced the “Ban Insider Trading Act,” and Senators Jack Reed of Rhode Island and Robert Menendez of New Jersey introduced the “Stop Illegal Insider Trading Act” on March 11, 2015. Although these pieces of legislation are a step in the right direction, these acts could do more harm than good. The Senate bill makes it unclear what type of information is prohibited but allows trading on information received from “publicly available sources.” The House bill defines “material information as that which would be likely to have a significant effect on the price of a security” without specifying how a “significant” effect is determined. According to the proposed legislation, the Judiciary Branch will still be primarily responsible for defining the scope of prohibition. The issue with urging Congress to make laws specifically prohibiting insider trading is the low chance of success in passing the law and determining if a zero-tolerance policy will make it more difficult to decipher the line between permissible and illegal trades.

**CONCLUSION**

The Second Circuit’s decision in *Newman* is undoubtedly a landmark decision for insider trading cases, especially if courts decide future cases in accordance with *Newman*. In some respects, the Second Circuit merely restates what the Supreme Court held over thirty years ago in *Dirks* on the elements of tippee liability. However, *Newman* presents the added requirement of determining what conduct establishes the critical element of personal benefit thus breaking from past decisions of the Second Circuit. By narrowing the elements prosecutors use to define personal benefit, the Court effectively guarantees that the Government will bring cases for remote tippee liability only after ensuring that sufficient evidence is present to prove the remote tippee’s liability. Furthermore, it is important for the

---


154. *Id.* (explaining that both the Senate bill and House bill would make it illegal to trade on securities based on information that an individual knows or should have known was nonpublic).

155. *Id.*

156. *Id.*

157. *Id.*

158. *See id.*

159. *See supra* Part IIIA (analyzing the heightened standard and its implications).

160. *See supra* Part IIIB (discussing the elements of personal benefits under
Government to keep in mind that it can still pursue cases based on personal relationships like friendship so long as there is some evidence of the benefit received by the tipper was considered valuable.\textsuperscript{161}

Although it is understandable why the SEC and the DOJ objected to the heightened standards \textit{Newman} imposes, the decision does not present an insurmountable hurdle. Instead, the Government simply needs to ensure that it has something more tangible than just friendship to sustain a conviction for remote tippee liability.\textsuperscript{162}

\begin{flushleft}
\textit{Newman}.  \\
\textsuperscript{161} \textit{Id.}  \\
\textsuperscript{162} \textit{Id.}
\end{flushleft}