KEY POINTS

- In the US, for a remote tippee to be liable, he must know that the insider who disclosed confidential information to the first tippee received a personal benefit for doing so.
- In contrast, neither EU law nor any of the provisions of the national laws of Member States implementing it require a breach of duty. It is enough that the person concerned has dealt on the basis of material non-public information.

Feature

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US insider trading v EU insider dealing: a difference more than in name

In December 2014, a three-judge panel of the United States Court of Appeals for the Second Circuit in New York (the Second Circuit) upheld the appeals of hedge fund managers Todd Newman and Anthony Chiasson against their insider trading convictions.[1] The decision clarified the circumstances in which individuals, specifically tippees, will be liable for insider trading under US law and will have (and has already had) important implications for other actions being pursued and contemplated by the Securities and Exchange Commission (SEC) and US Department of Justice (DOJ).[2] The case also serves as the latest reminder that the legal frameworks relating to insider trading in the US and insider dealing in the EU differ in much more than name.

THE FACTS

In December 2012, a jury in the United States District Court for the Southern District of New York convicted Newman and Chiasson of conspiracy to commit securities fraud, as well as the commission of securities fraud in violation of s 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and SEC Rule 10b-5. The jury found that Newman and Chiasson had traded shares of NVIDIA Corporation and Dell Inc.,[3] in 2008 and 2009, after having received the companies' unreleased earnings statements through a chain of contacts.

At trial, the Government presented evidence that an employee in the investor relations department at Dell informed a Neuberger Berman analyst about Dell's earnings, which were not yet public. The Dell employee allegedly received the benefit of "career advice" in exchange for providing the confidential information to the Neuberger Berman analyst. The information changed hands several times before it reached Chiasson, who took a short position in approximately 8.6 million shares of Dell. The government also presented evidence that a similar chain of contacts, beginning with a company insider, gave Newman and Chiasson a preview of NVIDIA Corporation's earnings for the first quarter of fiscal year 2010. Newman and Chiasson then traded upon this information, winning profits of approximately $4m and $68m, respectively, from their trades in Dell and NVIDIA stock.[4]

When delivering his instructions on the law to the jury, the trial court judge did not include an instruction that the jury would have to find that Newman and Chiasson knew that the Dell and NVIDIA insiders received a benefit for divulging material non-public information in order to find the tippee defendants guilty of insider trading.[5] Following their convictions and sentencing, the defendants appealed to the Second Circuit, arguing that the trial judge had erred by not instructing the jury on this essential element, and that the DOJ had not proven that Newman or Chiasson were aware of any such benefit received by the insiders.

THE SECOND CIRCUIT'S DECISION

The Second Circuit, which has jurisdiction over the majority of US insider trading prosecutions, agreed with the defendants, overturning their convictions and holding that tippee liability includes the element that "the tippee knew of the tipper's breach, that is, he knew the information was confidential and *divulged for personal benefit*."[6]

In doing so, the Second Circuit resolved the relatively narrow but important and longstanding question of whether the Government must prove that a remote tippee knew that the insider who disclosed confidential information to the first tippee received a personal benefit for doing so. As discussed further below, there is much greater potential for such questions to arise for determination by the Courts (where cases are contested) in the US than in EU jurisdictions, where the meaning of insider dealing and other market abuse infringements are much more prescriptively and explicitly defined.

Noting that the issue was one of first impression and calling its past guidance "somewhat Delphic" on the elements of tippee liability, the Second Circuit concluded that "the answer follows naturally from *Dirks* [*v S.E.C.*]".[7] In *Dirks*, the Supreme Court held that an insider's disclosure of confidential information alone is not a breach for the purposes of insider trading, but that it is the "exchange of confidential information for personal benefit" that amounts to the fiduciary breach triggering liability for insider trading.[8] The Second Circuit reasoned that because a tippee is liable only if he knows of the breach of the fiduciary duty, and the insider's receipt of a personal benefit is, in turn, a critical element of that fiduciary breach, it follows that the tippee must know about the personal benefit to the tipper in order to be liable for insider trading.[9] Consolidating its findings with guidance from previous cases, the Second Circuit laid out the necessary elements for insider trading liability against a tippee:

> "(1) the corporate insider was entrusted 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, that is, he knew the information was confidential and divulged for personal benefit; and (4) the tippee still used that information to trade in a security or tip another individual for personal benefit."

IMPLICATIONS FOR US INSIDER TRADING PROSECUTIONS

The DOJ and SEC had pursued a number of cases on insider trading theories similar to

that in *Newman*, ie, without a showing that the tippee knew about the fact of a personal benefit to the tipper. This includes a number of other extant and contemplated insider trading prosecutions and administrative proceedings, which were placed on hold pending the Second Circuit's decision, including the prosecution of Whittier Trust Company research analyst Danny Kuo and the SEC administrative proceeding against Steven A Cohen, the founder of SAC Capital. The DOJ has asked the Second Circuit to reconsider its ruling, and may eventually petition to the United States Supreme Court to seek reversal of this new legal standard depending on the outcome. However, for now at least, the Second Circuit's decision that the government is required to prove this element of the tippee's knowledge will make pursuing claims against tippees who are removed from the initial information exchange significantly more challenging.

While the ruling will likely not impact the vast majority of the insider trading convictions that were obtained through defendant guilty pleas, attorneys for convicted defendants will undoubtedly review the guilty plea transcripts of clients similarly situated to Chiasson and Newman to determine whether the prosecutors set forth the correct elements of the insider trading charges to which the defendants were pleading guilty.

Historically, the DOJ and SEC have, largely successfully, taken an aggressive approach to the relatively vaguely defined concept of insider trading. It was only earlier in 2014, after a string of 85 consecutive insider trading convictions, that prosecutors in the United States Attorney's Office for the Southern District of New York lost an insider trading trial against Rengan Rajaratnam, brother of Galleon's Raj Rajaratnam, in another remote tippee case.[10]

While the ramifications for the *Newman* decision will continue to be evaluated and endured by the DOJ for some time, the Second Circuit has sent a clear message that the DOJ's insistence on broadening the reach of criminal liability for conduct not clearly criminalised by statute will come under close judicial scrutiny and possible rejection.

COMPARATIVE ANALYSIS: US AND EU MARKET ABUSE FRAMEWORKS

The DOJ's aggressive posture in the *Newman* case stemmed from the fact that insider trading has largely evolved through common law interpreting the securities fraud statute, s 10(b) of the Securities Exchange Act of 1934, along with SEC Rules 10b-5, 10b5-1 and 10b5-2, as applied in this context, leaving some elements of those claims open to interpretation.

Section 10(b) and the rules promulgated thereunder have generally been interpreted to prohibit the purchase or sale of a security on the basis of material non-public information in breach of a duty of trust or confidence.[11] The broad misappropriation theory of insider trading[12] prohibits insider trading by company outsiders who trade on the basis of material non-public information in breach of a fiduciary duty or a similar "duty of trust and confidence" owed to the source of the information. Rule 10b5-2 contains a "non-exclusive" list of the circumstances when such a duty arises. These include transmissions of information pursuant to agreement to maintain that information in confidence, between people with a history, pattern or practice of sharing confidences; or between family members.

Insider trading liability also applies to those who "tip" confidential information to downstream traders (ie, "tippees") who engage in the prohibited trade. Since the first insider trading prosecutions over thirty years ago, the case law with respect to "tipper-tippee" liability has been consistent. A tipper is liable for insider trading when they breach their duty to keep material non-public information confidential, and personally benefits from the tip. A tippee is liable for insider trading when the tipper breaches their duty to keep material non-public information confidential, the tippee knows or should know that the material non-public information was obtained as a result of the tipper's breach, and the tippee trades on this information or discloses to downstream tippees for a benefit.

Typically, insider trading prosecutions involved the tipper and tippee working together directly, passing non-public information in exchange for some form of benefit. In these circumstances, the benefit to the tipper was easily proven and rarely at issue. Until the instant appeal, the question of whether a remote tippee similarly must be aware that the insider received a benefit in exchange for the breach of confidentiality to be convicted of insider trading had not been considered by the courts.

By contrast, in the EU, specific offences of insider dealing are a well-established feature of the statutory criminal law. For example, the specific offence of insider dealing has been in substantively the same form in England and Wales since 1993.[13] Those Member States whose criminal law does not currently provide for such offences are required by the recently approved Directive on Criminal Sanctions for Market Abuse (CSMAD) to enact them by 3 July 2016.

Corresponding, although not necessarily identical, regulatory provisions in other statutes, rules and guidance mean that individuals (or entities) may also face administrative enforcement action for improperly disclosing inside information or dealing on the basis of such information. In the UK, these and other proscribed behaviours are set out in detail in s 118 of the Financial Services and Markets Act 2000 (which transposed into UK law the Market Abuse Directive with effect from July 2005).[14]

The more rigid statutory frameworks in place in the EU provide greater clarity in part as to the components of improper disclosure of inside information and insider dealing (and other proscribed behaviours amounting to market abuse) without diminishing the breadth of circumstances in which individuals or entities may be liable. These more precisely defined prohibitions on particular courses of conduct means that, were action to be taken on similar facts to the *Newman* case in an EU Member State, a different outcome would be likely.

At least three main features of the EU market regime mean that on the same facts, enforcement authorities would be more likely to be able to successfully take action against individuals involved.

First, is that neither EU law nor any of the provisions of the national laws of Member States implementing it require a breach of

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duty. Instead, in the EU it is enough that the person concerned has dealt on the basis of material non-public information. There is no requirement corresponding with that in the US for the person dealing or the person from whom the information was derived to have been in breach of a duty of some kind. This is particularly important for tippees and other people who receive material information from true insiders.

Secondly, as has now been confirmed in the *Newman* case, a person only engages in insider trading under the US regime if they know or should have known that particular factual criteria are satisfied. By contrast, in the EU (at least under the regulatory regime), no such mental element is required to be established in order for them to be held to have engaged in insider dealing. They may do so by dealing on the basis of information which is objectively inside information whether or not they know the information is confidential and the tipper received a benefit for passing on the information.

Thirdly, although formal tests of when non-public information is "material" or "price sensitive" are not fundamentally different conceptually, experience indicates that they are different in application, with the US applying higher thresholds of materiality. This is cancelled out to some extent by more stringent standards under US law about when information is regarded as "public", which require market participants to wait until after the information has become public in the ordinary sense before trading in order that the information can be integrated into the stock price.

As a final point, and although it would have no bearing in a case analogous to *Newman*, the range of financial instruments covered by the EU market abuse regime is substantially wider than that falling within the ambit of the US framework. Where the US scope is limited to securities and securities-based derivatives, the EU law applies to other financial instruments traded on a regulated market (not only securities) and derivatives on them, thus bringing commodity futures and derivatives within reach.[15] Indeed, when the provisions of the EU Market Abuse Regulation enter into force in July 2016, its scope will expand still further to include insider dealing in financial instruments traded on multilateral trading facilities or organised trading facilities, and thus OTC derivatives which are not securities linked.

CONCLUSION

The *Newman* decision brings some degree of predictability to the parameters of judge-made insider trading law when it comes to the prosecution of downstream tippees in the US. It seems unlikely that any appeal of this decision will reverse the outcome – *Newman* was decided by a respected three-judge panel and the underlying issues lack the split among appellate courts often important to securing a review by the US Supreme Court. However, the SEC has said that insider trading enforcement remains a priority, and that it will seek to access more favourable courts in which to bring such actions while continuing to pursue them as administrative proceedings. The US government may also turn to other vehicles to pursue remote tippees, such as bringing insider trading charges under mail or wire fraud statutes. And, media reports suggest that Congress may enact legislation to overturn *Newman*. Thus, it remains to be seen how the fallout from *Newman* impacts insider trading enforcement in the US in the long term. ■

1 *United States v Newman*, No 13-1837-cv (L) (2d Cir. Dec 10, 2014).

2 The DOJ and SEC share jurisdiction over insider trading enforcement, however, the DOJ has exclusive jurisdiction to prosecute such cases criminally.

3 On 29 October 2013, Dell, Inc. became a private corporation.

4 *Newman*, No 13-1837-cv (L) at 5.

5 After the jury's guilty verdict, Judge Sullivan sentenced Newman to four-and-a-half years in prison and a $1m dollar fine along with $737,724 in criminal forfeiture. Chiasson was sentenced to six-and-a-half years in prison and a $5m dollar fine along with $1.38m in criminal forfeiture.

6 *Newman*, No 13-1837-cv (L) at 18 (emphasis added).

7 *Id*. at 14 (citing *Dirks v S.E.C.*, 463 U.S. 646 (1983)).

8 *Newman*, No 13-1837-cv (L) at 14 (paraphrasing the Supreme Court's holding in *Dirks*).

9 *Id*. at 16-17.

10 *See* http://dealbook.nytimes.com/2014/07/09/daniel-gitner-the-defender-who-ended-prosecutors-winning-streak-in-trading-cases/?_r=0.

11 Rule 10b5-1 specifies that a purchase or sale constitutes trading "on the basis of" material non-public information where the person making the purchase or sale was aware of material non-public information at the time the purchase or sale was made, regardless of whether the information was used.

12 The traditional theory of insider trading is the classical theory, where a corporate insider, such as a director or officer, or a temporary insider, such as an underwriter, lawyer or accountant, breaches their fiduciary duty to the shareholders by trading on material non-public information.

13 Part V, Criminal Justice Act 1993.

14 See Part VIII, Financial Services and Markets Act 2000.

15 The Dodd-Frank Act amended the Commodities Exchange Act to prohibit any deceptive device or contrivance in connection with a swap, future or cash contract in contravention of CFTC rules. Under this new law, the CFTC promulgated Rule 180.1(a)(1)-(3), which is expressly patterned on SEC Rule l0b-5, and prohibits trading on the basis of material non-public information obtained through fraud or deceit or in breach of a pre-existing duty.

Further Reading:

- When worlds collide: insider dealing regimes experience tectonic shift towards global enforcement [2013] 7 JIBFL 436.
- Company disclosure and selective briefing of investment analysts [2013] 11 JIBFL 699.
- Lexis PSL: Corporate Crime: Insider dealing.