Securities Regulation Daily Wrap Up, TOP STORY—2d Cir.: Insider trading convictions overturned, no personal benefit to tipper, (Dec. 10, 2014)

Securities Regulation Daily Wrap Up

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By Jim Hamilton, J.D., LL.M.

In an eagerly awaited opinion in one of the most important insider trading actions in years, a unanimous Second Circuit panel vacated the insider trading convictions of two hedge fund portfolio managers because there was no evidence that the managers knew they were trading on information obtained from insiders, or that those insiders received any benefit in exchange for the disclosures, or even that the portfolio managers consciously avoided learning of these facts. Because the government failed to present sufficient evidence that the portfolio managers willfully engaged in substantive insider trading, or a conspiracy to commit insider trading, in violation of the federal securities laws, their convictions were reversed and remanded with instructions to dismiss the indictment with prejudice (*U.S. v. Newman*, December 10, 2014, Parker, B.).

Government's proof fell short. The government alleged that a cohort of analysts at various hedge funds and investment firms obtained material, inside information from employees of publicly traded technology companies, shared it with each other, and then passed this information via a tippee chain of analysts to the portfolio managers at their respective firms.

The court found the jury instruction was defective because it was not communicated to the jury that the Government had to prove beyond a reasonable doubt that the defendants knew the tipper received a personal benefit for the disclosure. 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 in exchange for a personal benefit. The evidence was insufficient to sustain a guilty verdict against the portfolio managers for two reasons. First, the evidence of any personal benefit received by the alleged insiders was insufficient to establish the tipper liability from which purported tippee liability would derive. Second, even assuming the scant evidence offered on the issue of personal benefit was sufficient (it was not), the government presented no evidence that the portfolio managers knew that they were trading on information obtained from insiders in violation of those insiders' fiduciary duties.

Tippee liability for insider trading requires proof of a personal benefit to the insider and the tippee must know of the personal benefit received by the insider in exchange for the disclosure. As a result, in order to sustain an insider trading conviction against a tippee, the government must prove that the corporate insider was entrusted with a fiduciary duty and breached that duty by disclosing confidential information to a tippee in exchange for a personal benefit and the tippee knew of the tipper's breach, that is, knew the information was confidential and divulged for personal benefit, and the tippee still used that information to trade in a security or tip another individual for personal benefit.

What is a personal benefit? The court said that the circumstantial evidence in this case was too thin to warrant the inference that the corporate insiders received any personal benefit in exchange for their tips.

While personal benefit has been broadly defined to go beyond a pecuniary benefit, noted the court, the government may not prove the receipt of a personal benefit by the mere fact of a friendship, particularly of a casual or social nature. If the government was allowed to meet its burden by proving that two individuals were alumni of the same school or attended the same church, the court posited, the personal benefit requirement would be rendered null.

The personal benefit received in exchange for confidential information must be of some consequence. Here, the career advice that the first analyst-tippee in the chain gave to the insider-tipper was little more than the

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encouragement one might expect of a fellow alumnus or casual acquaintance. Crucially, the analyst testified that he would have given the tipper advice without receiving information because he routinely did so for industry colleagues.

Moreover, the evidence showed the analyst began giving the tipper career advice over a year before the tipper began providing any insider information. The court concluded that it would not be possible under the circumstances for a jury in a criminal trial to find beyond a reasonable doubt that the insider-tipper received a personal benefit in exchange for the disclosure of confidential information.

Inferred knowledge. The court also found that no jury could have found beyond a reasonable doubt that the portfolio managers knew, or deliberately avoided knowing, that the information originated with corporate insiders. Analysts at hedge funds, the court noted, often estimate revenue, gross margin, earnings per share and other metrics via legitimate financial models that incorporate publicly available information and their educated guesses.

In this case, where the financial information is of a type often predicted by analysts' models, and the remote tippees are several levels removed from the source, the inference that the portfolio managers knew, or should have known, that the information originated with a corporate insider is unwarranted.

The case is No. 13-1837.

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