



investors remain in limbo: the u.s. supreme court declines to review *u.s. v. newman*

MSK Client Alert

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Summary

In October 2015, the U.S. Supreme Court denied the Solicitor General's petition for review of *United States v. Newman*, which was decided by the Second Circuit Court of Appeals and has greatly limited the government's ability to obtain insider trading convictions in New York and elsewhere in the East. This left unresolved certain potential inconsistencies between the Second Circuit's ruling and an insider trading decision issued by the Ninth Circuit Court of Appeals, which is binding in California and elsewhere in the West. In short, because of the unresolved differences between how the Circuit Courts have approached the law of insider trading, whether or not conduct of an investor will be deemed to constitute insider trading may turn on the State where the government brings its case.

The Cases

In *Newman*, decided in December 2014, the Second Circuit reversed the securities fraud convictions of two portfolio managers who had executed trades for their investment funds based on information obtained indirectly from tipsters at Dell and NVIDIA. The primary questions confronted by the court in *Newman* were (1) did the government need to show the defendants knew that an insider disclosed confidential information in exchange for a personal benefit, and (2) did the evidence presented in that case show that the two defendants had such knowledge?

In addressing both questions, the *Newman* court relied on the Supreme Court's decades-old decision in *Dirks v. S.E.C.*, 463 U.S. 646 (1983). *Dirks* held that a trader may be guilty of a violation of Section 10(b) of the Securities and Exchange Act by trading in securities on the basis of information gained from a corporate insider's breach of his or her fiduciary duty. According to *Dirks*, for the insider to have breached a fiduciary duty relating to the disclosure of material

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non-public information, the insider must have personally benefited, directly or indirectly, from the disclosure of such non-public information. Moreover, for a trader to have violated Section 10(b), the trader must or should have known that there was a breach of fiduciary duty by a corporate insider. Applying these standards, the *Newman* court rejected the government's arguments that it (a) only needed to show that the defendants knew the information they traded on had been disclosed in breach of a duty of confidentiality and (b) did not need to prove that the defendants knew the insider had received a personal benefit. The *Newman* court stated: For purposes of insider trading liability, the insider's disclosure of confidential information, standing alone, is not a breach. Thus, without establishing that the tippee knows of the personal benefit received by the insider in exchange for the disclosure, the Government cannot meet its burden of showing that the tippee knew of a breach. The *Newman* court then determined that the evidence presented was not sufficient because 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." Rather, the government must show at least "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." Further, even if the evidence in the *Newman* case did show a personal benefit to the tippers, the court found that the evidence did not show the defendants had knowledge of any such personal benefit, and that it was not appropriate to infer such knowledge just from the detail and specificity of the information the tippers provided. The court therefore vacated the convictions.

The *Newman* decision was widely recognized as a game-changer for insider trading defendants— the *New York Times* said it "imposed the greatest limits on prosecutors in a generation."^[1]

In July, the Ninth Circuit Court of Appeals, issued its ruling in *United States v. Salman*, taking a narrow view of *Newman*'s holding. In *Salman*, the defendant argued that his conviction did not meet the *Newman* test, claiming that the evidence against him showed only a familial relationship between the tipper and tippee, and arguing that *Newman* held that evidence of such a relationship, by itself, is insufficient to show a personal benefit. The defendant argued that under *Newman*, the government needed to show that the tipper received "at least a potential gain of a pecuniary or similarly valuable nature."

The Ninth Circuit rejected this argument, stating that "[t]o the extent *Newman* can be read to go so far, we decline to follow it." The Ninth Circuit found that the evidence showed the tipper intended to disclose confidential information as a gift to his brother for the purpose of benefitting and providing for him. It held "[p]roof that the insider disclosed material nonpublic information with the intent to benefit a trading relative or friend is sufficient to establish the breach of fiduciary duty element of insider trading." This decision was not necessarily contrary to *Newman*— indeed, the *Salman* court noted that the *Newman* decision recognized that the personal benefit could be the benefit one would obtain from making a gift to a trading relative or friend. However, *Salman* indicated that the Ninth Circuit would not take a broad interpretation of *Newman*.

Shortly after the *Salman* decision was announced, the Solicitor General sought U.S. Supreme Court review of the *Newman* decision, arguing that the standards set forth in *Newman* will "impair the government's ability to protect the fairness and integrity of the securities market." In particular, the government argued that the *Newman* court's requirement that a tipper receive some "consequential" benefit was contrary to the Supreme Court's own rule set forth in *Dirks*, and noted that the Ninth Circuit in *Salman* had declined to apply that requirement.



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The U.S. Supreme Court denied the government's petition in *Newman*, declining to hear the case without any noted dissent. Thus, the *Newman* test remains applicable—at least in the Second Circuit and in New York—and a potential circuit split on the precise requirements of a “personal benefit” remains alive. Therefore, the burden the government must meet to prove insider trading in New York *may* be higher than it is in the Ninth Circuit and California, leading to the possibility that the government may choose to prosecute cases in California when possible.

[1] Protess & Goldstein, “Appeals Court Deals Setback to Crackdown on Insider Trading,” *The New York Times*, December 11, 2014.

ASK MSK

Q: What did the *Newman* court decide?

A: The *Newman* court made it harder for the government to convict people of insider trading. It said that the government needed to show that the person who divulged inside information received a particular benefit of a “pecuniary or similarly valuable nature”—in most cases, money or some other economic benefit, not just friendship. The *Newman* court also said that the government needed to show that the person who traded on insider information knew that the person who divulged the information received the benefit.

Q: How did the *Salman* court's decision differ from *Newman*?

A: The *Salman* court rejected a broad interpretation of *Newman*. Rather than requiring that the government show that the person who divulged inside information did it in exchange for some economic benefit, the *Salman* court said that it was sufficient for the government to show that the person divulged inside information to benefit a family member.

Q: What did the U.S. Supreme Court do?

A: The U.S. Supreme Court declined to hear a challenge to the *Newman* decision brought by the government, or to resolve any conflict between the *Newman* and *Salman* decisions. In effect, the Supreme Court said that, for now, the *Newman* decision will remain the law in the Second Circuit (New York and certain parts of the Northeast) and the *Salman* decision will remain the law in the Ninth Circuit (California and most of the West).