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Reversing Convictions, Second Circuit Clarifies Scope of Tippee's Required Knowledge in Insider Trading Cases

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On December 10, 2014, the Second Circuit reversed insider trading convictions of two former hedge fund managers, holding that, to sustain a conviction for insider trading, the government must prove a tippee who trades on the basis of material non-public information had knowledge that the tipper not only disclosed confidential inside information, but also that he did so in exchange for a personal benefit. *United States v. Newman*, Index Nos. 13?1837?cr (L), 13?1917?cr (con) (2d Cir. Dec. 10, 2014).

The ruling emphasizes that tippee liability "derives only from the tipper's breach of a fiduciary duty, not from trading on material, non-public information," a corporate insider has committed no breach of fiduciary duty "unless he receives a personal benefit in exchange for the disclosure," and a "tippee is liable only if he knows or should have known of the breach." (While the court's opinion uses the phrase "knows or should have known" several times, the court's apparent articulation of its holding uses a knowledge requirement, not "should have known.")

At trial, the government presented evidence that a group of financial analysts received material, non-public information from employees at two publicly-traded technology companies and passed that information to the defendants — Todd Newman and Anthony Chiasson. The government alleged the defendants subsequently made trades based on the inside information, earning significant profits for their respective funds. There was no evidence, however, that either Newman or Chiasson was aware of the sources of the inside information or the sources' motives for disclosure.

On appeal, the Second Circuit rejected the government's position that knowledge of a breach of the duty of confidentiality, without more, was sufficient to impose criminal liability. "Although the government might like the law to be different, nothing in the law requires a symmetry of information in the nation's securities markets," the court admonished.

To sustain an insider trading conviction against a tippee going forward, the court explained, the government must prove each of the following elements beyond a reasonable doubt:

1. The corporate insider was entrusted with a fiduciary duty;

2. The corporate insider breached his fiduciary duty by disclosing confidential information to a tippee in exchange for a personal benefit;
3. The tippee knew of the tipper's breach (*i.e.*, he "knew" the information was confidential and divulged for personal benefit); and
4. The tippee used the information to trade in a security or tip another individual for personal benefit.

The reversal of the convictions by the Second Circuit is a significant loss for United States Attorney Preet Bharara, who has been aggressive in pursuing insider trading cases against a broad spectrum of defendants.

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