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INSIDER TRADING

Recent Cases Reduce the Impact of Newman on Insider Trading Enforcement

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The U.S. Court of Appeals for the Second Circuit, with its high-profile decision in *U.S. v. Newman*, has not enabled investment fund managers and their ilk to commit insider trading with impunity, free from consequence. Although some commentators have taken a contrary view, that perspective is mistaken, as evidenced by a recent district court decision, and may lead some market participants to adopt risky behavior if not corrected. For more on *Newman*, see "*The Newman/Chiasson Decision Continues to Have Implications for Insider Trading Compliance*," The Hedge Fund Law Report, Vol. 8, No. 17 (Apr. 30, 2015).

In April 2015, the Securities and Exchange Commission scored a significant victory in *SEC v. Payton*, obtaining the approval of the Honorable Jed S. Rakoff to pursue a civil enforcement action in the U.S. District Court for the Southern District of New York against two defendants accused of insider trading, notwithstanding the recent *Newman* decision. While some commentators have questioned whether the Payton decision marks the beginning of an "erosion" of the insider trading framework recently overhauled in *Newman* and hailed in many corners of Wall Street, this belief is based upon multiple incorrect assumptions about *Newman* and its import, and both decisions' impact on the hedge fund industry.

This article examines the recent insider trading landscape, discusses the *Payton* decision and explores its impact on the hedge fund community. For more insight from Kleinberg, Kaplan, Wolff & Cohen, see "*Insurance Dedicated Funds Offer Hedge Fund Exposure Plus Tax, Underwriting and Asset Protection Advantages for Investors*," The Hedge Fund Law Report, Vol. 6, No. 28 (Jul. 18, 2013); and "*How Do New Commodities Regulations Impact Hedge Fund Managers with Respect to Registration, Marketing, Trading, Audits and Drafting of Governing Documents?*," The Hedge Fund Law Report, Vol. 5, No. 18 (May 3, 2012).

The Recent Insider Trading Landscape

The *Newman* and *Payton* decisions have taken on a special significance in light of the government's impressive prosecutorial record over the last half-decade. Manhattan prosecutors, for their part, have charged 93 individuals with insider trading since 2009, prevailing in most of the cases. The insider trading actions have been more successful than other white-collar prosecutions, perhaps because there never has been an express legislative edict from Congress explicitly prohibiting insider trading under the federal securities laws. For decades, prosecutors and regulators have interpreted insider trading law aggressively, resulting in the courts' construction of a loosely defined insider trading paradigm. Until recently, it was all but a foregone conclusion that the government – required to establish a tipper's receipt of a personal benefit in exchange for material nonpublic information – could handily meet its burden by showing the existence of a mere casual friendship between the tipper and tippee, without the need to demonstrate that the tippee had knowledge of the benefit. The government did so successfully for years. Then came Newman.

The Second Circuit, which has been instrumental in the development of insider trading law, ostensibly reversed the trajectory of the law when it decided *Newman* in December 2014 and sharpened the meaning of what constitutes insider trading. Prosecutors in *Newman*, a criminal case, alleged that remote tippees Todd Newman, formerly of Diamondback Capital, and Anthony Chiasson, formerly of Level Global, had traded

on material nonpublic information, the original sources of which were employees of publicly traded technology companies. The government established only that the insider and the first intermediary tippee had known each other for years, having both attended business school and worked together, and that the insider sought career advice and assistance from the first tippee. With respect to other tips, the government demonstrated merely that the insider and the first intermediary tippee were family friends and occasionally socialized together. Newman and Chiasson, and even their analysts, knew "next to nothing" about the insiders and nothing about what, if any, personal benefit had been provided to them. For details of the tipping and trading and coverage of the related civil enforcement actions, see "*SEC Files Civil Insider Trading Complaint Against Diamondback Capital Management, Level Global Investors and Seven Individuals Based on Trading in Dell and Nvidia; Diamondback Strikes Non-Prosecution Deal with U.S. Department of Justice and Settles with the SEC for $9 Million*," The Hedge Fund Law Report, Vol. 5, No. 4 (Jan. 26, 2012); and "*SEC's Insider Trading Suit against Former Level Global Trader Illustrates the Risk of Retaining a Former Public Company Employee as a Consultant*," The Hedge Fund Law Report, Vol. 6, No. 47 (Dec. 12, 2013).

The Second Circuit held that, in order to demonstrate insider trading, the prosecution must show a "meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of pecuniary or similarly valuable nature." The Court observed that if the parties' relationship and career advice constituted a cognizable benefit, then "practically anything would qualify," concluding that 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," and that, ultimately, prosecutors failed to provide evidence of "a relationship between the insider and the recipient that suggests a quid pro quo from the latter." Highlighting the "doctrinal novelty" of the government's recent insider trading prosecutions, the Second Circuit also held that prosecutors must establish that the defendants "knew that the tippers received a personal benefit" in order to demonstrate insider trading. See "*Second Circuit Overturns Newman and Chiasson Convictions, Raising Government's Burden of Proof in Tippee Liability Insider Trading Cases*," The Hedge Fund Law Report, Vol. 7, No. 47 (Dec. 18, 2014).

Seemingly a watershed moment, legal analysts "cheer[ed] the clarity that the appeals court provided . . . regarding what the government must prove to win an insider trading case" and celebrated that, thanks to Newman, "insider trading has been clearly defined." One commentator asserted that *Newman* was a "win for Wall Street" and a "blueprint of how to operate within the letter of the law," and that "[t]he less you know the better." The commentator even concluded that the new insider trading rules may make it "easier to cheat." The *Newman* decision certainly made the government's effort to curtail securities fraud and insider trading more difficult. Since *Newman*, in fact, insider trading charges against seven people have been overturned by judges or simply dropped by prosecutors. However, the foregoing commentators' analyses miss the mark, and the *Payton* decision may have put the brakes on the post-*Newman* momentum.

Payton: Defendants' Achilles Heel

In *Payton*, the SEC alleged that Daryl M. Payton and Benjamin Durant, III engaged in insider trading when Michael Dallas, an associate at Cravath, Swaine & Moore, repeatedly shared with his friend, Trent Martin, material nonpublic information about IBM's impending $1.2 billion acquisition of SPSS Inc. (SPSS), including the anticipated transaction price and the identities of the acquiring and target companies, all with the expectation that Martin would keep the information confidential and not trade on it. Martin purportedly conveyed the information to his roommate, Thomas Conradt, a broker who allegedly provided the acquisition information to his colleagues, including Payton and Durant, who were also brokers. Payton and Durant, several levels downstream from Dallas, then traded in SPSS securities.

The government initially charged Payton and Durant with criminal insider trading for trading on the confidential information concerning IBM's acquisition of

SPSS. In the aftermath of Newman, federal prosecutors dropped the criminal charges against Payton and Durant following the trial court's conclusion that Martin, the original tipper, did not receive a personal benefit. The SEC proceeded with civil insider trading charges, claiming that the defendants violated the general anti-fraud provisions of the securities laws, including Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, which prompted the defendants to move to dismiss the complaint on the basis of Newman. The defendants' central arguments were that the SEC failed to plead adequately that Martin received a personal benefit for disclosing the confidential information to his immediate tippee, Conradt, and that the defendants had knowledge of any personal benefit.

The *Payton* court found itself torn between competing definitions of "personal benefit." In 1983, in *Dirks v. SEC*, also a civil case, the U.S. Supreme Court defined personal benefit as "a pecuniary gain or a reputational benefit that will translate into future earnings. . . . For example, there may be a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the particular recipient. The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend." However, in *Newman*, the Second Circuit held that, to the extent *Dirks* suggests that a benefit may be inferred from a personal relationship, such an inference is impermissible in the absence of proof of an objective, consequential and pecuniary benefit to the tipper. While the *Dirks* definition may not be crystal clear and difficult to reconcile with the *Newman* definition, the *Payton* court determined that the SEC adequately alleged a benefit under either definition, even the more onerous standard set forth in *Newman*.

Judge Rakoff ruled in *Payton* that Martin received a personal benefit for disclosing to Conradt material nonpublic information about the SPSS acquisition. Specifically, the SEC's complaint alleged that Martin and Conradt "shared a close mutually-dependent financial relationship, and had a history of personal favors." To substantiate this otherwise conclusory statement, the SEC alleged that their expenses were intertwined; that Conradt took the lead in organizing and initially paying their shared expenses; and that he negotiated reductions in their utilities and rent payments. Conradt also assisted Martin with a criminal matter that threatened Martin's ability to remain in the United States legally and, subsequently, Martin "thanked Conradt for his prior assistance with the criminal legal matter and told Conradt he was happy that Conradt profited from the SPSS trading because Conradt had helped him." Drawing every reasonable inference in the SEC's favor – as required on a motion for dismissal – the court found that, consistent with *Newman*, the foregoing factual allegations reflect a quid pro quo relationship between Martin and Conradt and are indicative of Martin's intent to benefit Conradt at the time of disclosure of the SPSS information.

In addition, while there is no allegation in *Payton* that the defendants knew specifically about Conradt's help with the criminal charge, Judge Rakoff ruled that the SEC sufficiently alleged defendants' knowledge of a personal benefit. According to the SEC, the defendants knew that Martin was the source of the tip to Conradt, and they were aware that Martin and Conradt were friends and roommates. Payton purportedly knew of Martin's assault arrest. The SEC also alleged that Durant repeatedly asked Conradt if Martin had given him any additional information. The court stated that these allegations were enough to raise a reasonable inference that the defendants knew that Martin's relationship with Conradt involved the exchange of reciprocal benefits, and that Durant knew that Conradt and Martin had a meaningfully close relationship such that they would continue to exchange confidential information about the SPSS acquisition.

In contrast to the facts in *Newman*, where the defendants knew "next to nothing" about the tippers, the first-level tippees or the circumstances surrounding the tips, the *Payton* complaint alleged that the defendants knew the basic circumstances concerning the SPSS tip and that they recklessly avoided discovering additional details. Despite their market sophistication and their knowledge that Conradt learned the information from Martin, defendants purportedly failed to ask Conradt why Martin shared the inside information with him or

how Martin learned about the information in the first place. Additionally, defendants allegedly took steps to conceal their trading in SPSS securities by avoiding a paper trail at a lunch meeting with Conradt, by agreeing not to discuss their trading with anyone else and by lying to their employer about the origins of their interest in SPSS securities. Payton also allegedly transferred his holdings, including his SPSS securities, from his employer to another brokerage firm and misrepresented himself to be in the real estate business in order to avoid any controls the new firm had in place for monitoring members of the securities industry.

The court concluded that the SEC's complaint adequately alleged that defendants knew or recklessly disregarded that Martin received a personal benefit for disclosing the confidential information to Conradt and that Martin, in so doing, breached a duty of trust and confidence to the owner of the information. Accordingly, the court denied the defendants' dismissal motion and ruled that Newman did not preclude the enforcement action from going forward.

Payton's Significance and Impact on the Fund Community

The *Payton* decision represents the first direct effort to apply *Newman* to a civil insider trading case and demonstrates that the *Newman* decision is not as beneficial to hedge funds and Wall Street as assumed by some commentators. *Newman* admittedly has thrown a monkey wrench into the law of insider trading. But analysts' claims that *Newman* clarified the law and that "[t]he less you know the better," or that the new insider trading rules make it "easier to cheat," are simply not true. Some market participants certainly believe that remote tippees and others that wrongfully trade on material nonpublic information possess a "get out of jail free" card due to *Newman*, but that perception is untrue and dangerous to the longevity of a hedge fund for many reasons.

First, the Second Circuit in *Newman* did not clarify the law sufficiently, let alone crystallize the definition of insider trading, such that investment funds can modify their conduct in any meaningful way. In *Payton*, for instance, the court was unable to identify with precision the controlling definition of personal benefit, struggling to reconcile the definition set forth in *Dirks* – arguably prohibiting gifts of confidential information to loved ones – and the higher standard laid out in *Newman* – requiring evidence of an "objective," "consequential" and "pecuniary or other valuable" benefit to the tipper. *Payton* acknowledged that the definition of personal benefit – specifically the terms "objective, consequential or valuable benefit" – was "not obvious." Expressing frustration, Judge Rakoff pointedly stated in *Payton* that "if unlawful insider trading is to be properly deterred, it must be adequately defined."

Not surprisingly, given the unclear definitions, a federal judge in another matter recently left intact the criminal insider trading conviction of David Riley on the ground that he passed confidential information concerning Foundry Networks, Inc. in exchange for friendship, networking contacts, and job and investment advice, which arguably are not so distinct from the personal benefits found to be inadequate in Newman. The definitions of personal benefit and insider trading continue to be malleable enough for the SEC to pursue insider trading claims aggressively, even if prosecutors lack sufficient evidence to pursue criminal charges. Notwithstanding *Payton* – and *Newman* and other cases, for that matter – there remains a discernible uncertainty in defining what actions constitute insider trading in the hedge fund world.

Second, *Payton* materially differs from criminal proceedings such as Newman, and consequently the frequency and success of civil insider trading actions likely will not be impacted as much as criminal proceedings brought against those in the hedge fund field. In order to establish criminal liability for securities fraud, the government must show that the defendant acted with scienter, which has been defined as "a mental state embracing intent to deceive, manipulate or defraud." This willfulness ordinarily is defined "as a realization on the defendant's part that he was doing a wrongful act under the securities laws." Although an individual is guilty of criminal insider trading only if that person committed the securities violation knowingly

and purposefully, *Payton* confirms the well-established rule that an individual may be civilly liable for insider trading if the person committed the offense "recklessly" or "in heedless disregard of the probable consequences." In other words, in a civil case, the SEC can prove liability merely by alleging that a tippee "should have known" of the personal benefit to the original tipper.

This standard is significantly lower and more lenient than the criminal standard, which may explain why the *Newman* defendants were exonerated in their criminal action but the *Payton* defendants – who allegedly recklessly avoided discovering details about the source of the confidential information and the nature of the initial disclosure – remain embroiled in civil litigation. In view of the different liability standards, *Payton* proves that a regulator can seek to make its case against an investment fund trader or analyst in a civil enforcement action by showing that the individuals, even if remote tippees without privity to the source of the information, were aware of red flags and should have known of the original tipper's personal benefit.

Third, Wall Street should not conclude from *Payton*, or even *Newman*, that it is immune from criminal liability for insider trading if the tippees have no direct knowledge of the wrongdoing. Notwithstanding the result in Payton and the dismissal of the criminal charges in the matter, the Second Circuit in Newman made clear that defendants several levels removed from the original tipper may still be criminally responsible for insider trading if they "consciously" or "deliberately" avoided learning the true facts of the wrongdoing. In fact, on April 23, 2015, a corporate executive, John Johnson, pled guilty to insider trading even though he did not know the identity of the original source of the tipped information; Johnson, though, admitted that he consciously avoided knowing that the intermediary, a hedge fund analyst, engaged in what Johnson assumed was a "horse trade" with the original tipper, someone he presumed was a high-ranking executive at the company.

On the heels of this plea, the Second Circuit in another matter upheld the criminal conviction of Doug Whitman, the founder of hedge fund Whitman Capital LLC. Whitman was found to have traded on inside information about Polycom, Google and Marvell, and his intermediary sources obtained the confidential information from employees of those companies. While Whitman testified that he was not aware of the original sources of the information or whether the sources received any benefit in return for the tipped information, Whitman called the intermediary tipper "Ms. Google" and told another witness that the tipper "had a mole" at Google, but that she lost the contact because she did not have "enough sense to go out and buy her some really nice present" and "to take care of her for giving her the information." Whitman also teased the tipper that she should have used "an untraceable skype phone number" to call her Polycom source in order to "get a good call on Polycom." Additionally, Whitman told the other tipper that he failed to "protect" his Marvell source who "got in trouble" at the company. The jury concluded that Whitman closed his eyes to the illegal channels used by the tippers to obtain confidential information, and that he deliberately determined not to draw obvious conclusions about their wrongdoing. Consistent with *Newman* and in spite of *Payton*, individuals cannot put their heads in the sand and close their eyes to insider trading in the hopes of escaping criminal liability.

Fourth, *Payton*, in a sense, is good for those in the hedge fund business that may run afoul of the insider trading laws. If *Newman* and its progeny somehow foreclosed the possibility of regulators bringing successful insider trading actions in the federal courts, there very well could be significant blowback to hedge fund folks that find themselves in the regulators' cross hairs. The SEC frequently looks to its own in-house courts to adjudicate insider trading cases and in recent years has been far more successful before administrative law judges than district court judges. Often criticized as constitutionally dubious, these administrative actions are compressed, expedited proceedings. Discovery is limited. Dispositive motions are less available. There is no right to a jury. The rules of evidence are much looser in the administrative court, where unreliable hearsay evidence is allowed. The administrative judges' final decisions are not so final and are subject to de novo review by SEC commissioners, even though the agency itself makes the decision to initiate the enforcement action in the first place. If

the SEC's administrative court had decided *SEC v. Obus* – where the defendant accused of insider trading ultimately was found to be not liable by the Second Circuit – it is doubtful the result would have been the same. Absent the unintended wiggle room found in the *Newman* and *Payton* decisions, defendants accused of insider trading could likely find themselves up against an even more frustrated SEC, more often in the SEC's own administrative law court, with the odds stacked against them.

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The *Payton* decision has shed light on what Payton, Durant and Riley now know: *Newman* was not the death knell of insider trading law but, rather, a very large bump in the road. *Newman's* definition of personal benefit remains unclear and potentially contradicts Supreme Court precedent, leaving unpredictability in its wake. Given the recklessness and conscious avoidance standards, hedge fund managers, traders and analysts will be hard-pressed to rely on *Newman* in conducting their business. A hedge fund prosecution, even a civil enforcement action or perhaps an insider trading investigation, can still cause investors to flock for the exit and can mean the beginning of the end for an investment fund. Given everything at stake, hedge funds should not be cheering the *Newman* decision. The decision certainly should not affect responsible funds' compliance protocols. In actuality, the decision is potentially good for only one group: insider trading defendants.

Payton undoubtedly will not be the last success story for the SEC, and more individuals in the hedge fund world will continue to see that *Newman* is not as clear or helpful as many folks believe it to be.

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