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Will The New Insider Trading Enforcement Strategy Survive?

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The securities bar is eagerly waiting to learn if United States v. Newman[1] — the Second Circuit's decision limiting the reach of insider trading law — will survive the U.S. Supreme Court's ruling in Salman v. United States this term.[2] Yet the government has already found a creative way to sidestep Newman's requirement that a defendant who trades on inside information must know that the insider passed the information in return for a pecuniary benefit. In two recent cases, United States v. Valvani[3] and SEC v. Cooperman,[4] the U.S. Department of Justice and U.S. Securities and Exchange Commission have skirted apparent Newman-related proof problems by arguing, in essence, that the original tippee stole the information from the insider by breaching a promise not to share or trade on it. By recasting the insider from a co-conspiring tipper to a victim who was taken advantage of by the trader, the government has charged cases without alleging that the insider received any benefit — avoiding Newman entirely.

Arlo Devlin-Brown

While the government's new strategy is innovative, its viability is an open question. As discussed below, the government's approach marks a significant expansion of the "misappropriation" theory of insider trading described by the Supreme Court in United States v. O'Hagan.[5] That theory, originally covering corporate fiduciaries such as law firms and investment banks that traded on information given to them in obvious confidence, is now being expanded to cover vague breaches of unclear duties or agreements. Valvani, for example, is based on a hedge fund consultant's implicit representation that he wouldn't trade on inside information improperly given to him by a government insider with whom he was friendly.[6] Cases built on breaches of this sort may have less jury appeal than paradigmatic misappropriation cases, and the government's efforts to expand the theory to cover the very sort of criminal prosecutions and enforcement actions that Newman effectively barred may invite significant judicial scrutiny.

David Kornblau

Newman Limited Insider Trading Prosecutions to Cases Where the Insider Received a Pecuniary Benefit

Brian Richman

The Second Circuit's decision in Newman imposed sharp limits on insider trading prosecutions, disturbing the settled expectation of not only the government but many in the defense bar. Prior to Newman, it had been widely understood that a defendant could be prosecuted for insider trading only where the insider breached a duty to his employer in return for a personal benefit. But such a benefit was easy to establish. In

Dirks v. SEC, the Supreme Court had held that the benefit need not be monetary and included the intangible benefit of making a "gift" of insider information "to a trading relative or friend."[7] Relying on Dirks, prosecutors and regulators brought cases, affirmed on appeal, where the benefits received by the insider were relatively amorphous, such as access to an investment club[8] or currying favor with one's boss.[9]

In Newman, however, the Second Circuit reined in the expansive view of personal benefit, holding that the government must prove that the original insider gave confidential information to a tippee in exchange for a personal benefit that is "objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[10] The "ephemeral benefit" of the tippee's friendship is not enough.[11] Equally significant, the Second Circuit further held that the government must prove that each defendant, even if many levels down a tipping chain from the insider, knew that the insider provided the information in return for a qualifying personal benefit.[12]

Not surprisingly, Newman's twin holdings requiring a pecuniary benefit and requiring each defendant to have knowledge of that benefit created significant hurdles for prosecutors and regulators. After Newman, enforcement authorities were even compelled to voluntarily dismiss several pending insider trading cases.[13] The Supreme Court may loosen Newman's personal benefit requirement in Salman v. United States, to be decided this term.[14] But, regardless of how the Supreme Court rules, prosecutors and regulators will still need to prove that downstream tippees knew that the original source of the inside information received a personal benefit, an aspect of Newman's holding that has gone unchallenged. And, in any event, the government is not waiting around for Salman.

Through a Novel Expansion of Misappropriation Theory, the Government Has Identified an Enforcement Strategy that Avoids Newman

Instead, the government is attempting to avoid Newman's roadblocks by broadly expanding the misappropriation theory of insider trading. Insider trading comes in two related flavors. The first, referred to as "classical," applies when a company insider trades on material nonpublic information[15] or gives such information to another person in return for a personal benefit.[16] The second, known as misappropriation, applies when an outsider is given confidential information for a legitimate and limited purpose but breaches his duty to the source of the information by trading on it for personal gain.[17] The doctrine has traditionally been applied in the prosecution of corporate fiduciaries who breach clear fiduciary duties, like a lawyer or banker trading confidential information entrusted by a client.[18] Accordingly, the insider in a misappropriation case is a victim, not a co-conspirator.

But as two recent cases make clear, the government is expanding misappropriation theory beyond traditional fiduciaries to charge conduct that otherwise could not be reached post-Newman. In United States v. Valvani, prosecutors alleged that Sanjay Valvani, an investment adviser, hired a political intelligence consultant to provide information about the likelihood of U.S. Food and Drug Administration action on certain new drug applications.[19] According to the indictment, the consultant received material nonpublic information from a friend of his who worked at the FDA and was not permitted to disclose this information. The consultant then passed the FDA insider's information to Valvani, who traded on it. But what was the evidence that the FDA insider passed the information to the consultant in return for a pecuniary benefit, as required by Newman? And what was the evidence that Valvani, the downstream tippee, knew of any such benefit? The indictment failed to allege any benefit to the FDA insider, much less that Valvani had any understanding of the insider's motivations. Under Newman, these deficiencies would appear be fatal: without a pecuniary benefit to the insider, known to the downstream tippee, there is no crime for the government to prosecute.

In an effort to avoid this barrier, the government charged the case as one of misappropriation, portraying the FDA insider not as co-conspirator who had breached his duty, but as a victim who had shared confidential information with his friend, the consultant, on the understanding that he would keep it confidential, only to see his friend betray their friendship and pass it to an investment manager (Valvani) instead. To support this theory, the charging documents alleged that the consultant's history of friendship with the insider created an implicit promise of confidentiality that the consultant violated by relaying information to Valvani. In other words, the consultant misappropriated the material nonpublic information that his FDA insider friend had told him, despite government rules forbidding that disclosure, in what was alleged to be implicit confidence.[20] With the FDA insider a victim, no proof of benefit for the insider's improper disclosure to the consultant was required.

The SEC used a similar tactic to sidestep Newman in SEC v. Cooperman. There, the SEC alleged that a company executive had given Cooperman confidential information about an upcoming sale likely to boost the company's stock price, and that Cooperman had, in one of three telephone calls, orally agreed that he would not trade on it.[21] The company executive was not alleged to have received any benefit, pecuniary or otherwise, in passing the information to Cooperman. Under Newman, this defect would be fatal. But, as in Valvani, the SEC alleged that the company insider was a victim, with Cooperman breaching an alleged (and unrecorded) promise not to act on the insider's disclosure of confidential information. As in Valvani, the Newman problem was neatly avoided.

Will the Novelty of the New Enforcement Strategy Be its Undoing?

While the government's new enforcement strategy is artful, its effectiveness is an open question. For one thing, there is the issue of jury appeal. A lay person can readily intuit the clear transgression of a company insider, passing secret information in return for cash, or a banker or lawyer stealing information entrusted for a clear corporate purpose. But it is harder to muster outrage when an insider willingly (and perhaps improperly) shares secret information and the tippee violates a supposedly implicit (and in the minds of jurors, perhaps dubious) promise not to share the secret information further.[22] A jury may well show greater hesitation in sending to prison or destroying the career of an individual who "misappropriates" his casual friend's improperly shared secrets than a lawyer who betrays the unquestionable confidences of his client.

The SEC's 2013 loss of its insider trading case against Mark Cuban may be evidence of jury skepticism in cases where the supposed misappropriation is less than facially outrageous and is unsupported by a written promise of confidentiality. In that case, the SEC claimed that the CEO of a company in which Cuban had invested called Cuban (unprompted) and told him confidential information that Cuban had not sought.[23] As in Cooperman, the SEC alleged that Cuban then violated a vague supposed oral promise not to trade on the unsolicited tip from the corporate insider.[24] Proof of the promise was shaky at best. Within four hours of deliberation, however, the jury flatly rejected the SEC's claims.[25]

Beyond potentially skeptical juries, the government's expansion of misappropriation theory to avoid Newman may be greeted by a skeptical bench. Courts have repeatedly and recently emphasized that a breach of fiduciary duty is at the core of both the classical and misappropriation theories of insider trading. The Supreme Court premised misappropriation theory liability "on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information,"[26] just as it premised classical liability on a corporate insider's "fiduciary relationship" with the shareholders.[27] And as the Second Circuit ruled in Newman itself, it "is the fiduciary breach that triggers liability," under either theory.[28] In Cooperman and Valvani, the government makes no allegation of a fiduciary relationship at

all.

Courts have permitted some efforts in the past to expand misappropriation theory beyond pure fiduciary relationships, deferring to SEC regulations providing liability when there is a breach of any relationship "of trust or confidence."[29] But the proposition that SEC regulations are entitled to deference when interpreting criminal statutes is not without controversy, and an enforcement strategy that expands the relationship of "trust and confidence" to reach cases that Newman could not may result in courts looking for opportunities to press the brakes.[30] In Valvani, the notion that one has an implicit duty premised on a relationship of "trust and confidence" not to trade on secret information that a friend should not have given in the first place is far from obvious.

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How much prosecutors and regulators need ultimately rely on this new insider trading enforcement strategy depends to a degree on whether Newman remains law. If the Supreme Court in Salman substantially broadens the type of personal benefits that count, one of the drivers for the new theory may be neutralized. But Newman's other holding — that the downstream tippee defendant need know of the benefit to the insider — is not under review in Salman and will continue to pose challenges under the classical insider trading theory. Moreover, from a practical perspective, when an insider tells investigators up and down that he was the victim and was shocked to learn that the person he told company secrets to traded on it — and prosecutors can't prove to the contrary — there will always be an incentive to cast the case as one where information was misappropriated from the insider. It remains to be seen, though, whether the expansionist take on misappropriation theory will survive pressure-testing by juries and courts.

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[1] 773 F.3d 438 (2d Cir. 2014), cert. denied, 136 S. Ct. 242 (2015).

[2] 136 S. Ct. 899 (2016), granting cert. to 792 F.3d 1087 (9th Cir. 2015).

[3] No. 16-cr-412-SHS (S.D.N.Y. filed June 15, 2016); see also SEC v. Valvani, No. 16-cv-4512-KPF (S.D.N.Y. filed June 15, 2016).

[4] No. 2:16-CV-05043 (E.D. Pa. filed Sept. 21, 2016).

[5] 521 U.S. 642 (1997).

[6] See Indictment ¶ 28, United States v. Valvani, No. 16-cr-412-SHS (S.D.N.Y. June 15, 2016) (alleging that the political consultant "understood" that the government insider "expected that [he] would maintain the confidentiality of the information . . . by virtue of their relationship").

[7] 463 U.S. 646, 664 (1983).

[8] See United States v. Jiau, 734 F.3d 147, 153 (2d Cir. 2013).

[9] See SEC v. Obus, 693 F.3d 276, 292 (2d Cir. 2012).

[10] United States v. Newman, 773 F.3d 438, 452 (2d Cir. 2014), cert. denied, 136 S. Ct. 242 (2015).

[11] Id. (citing Jiau, 734 F.3d at 153).

[12] Id. at 450.

[13] See, e.g., United States v. Conradt, No. 12 Cr. 887 (ALC) (S.D.N.Y. Feb. 3, 2015) (dismissing charges against five defendants); Ed Beeson, Bharara Drops Steinberg Insider Trading Case After Newman, Law360 (Oct. 22, 2015), http://www.law360.com/articles/717819/bharara-drops-steinberg-insider-trading-case-after-newman (noting that the U.S. Attorney's Office dropped charges against seven defendants); see also, e.g., Gregory T. Bolan, Initial Decision Release No. 877 (ALJ Sept. 14, 2015) (dismissing an administrative proceeding in light of Newman), review granted, Securities Act Release No. 9985, Exchange Act Release No. 76,614 (Dec. 10, 2015).

[14] 136 S. Ct. 899.

[15] Chiarella v. United States, 445 U.S. 222, 227-35 (1980).

[16] Dirks, 463 U.S. at 663.

[17] O'Hagan, 521 U.S. at 652.

[18] See, e.g., Id. at 659; United States v. McDermott, 245 F.3d 133, 138 (2d Cir. 2001).

[19] See Indictment, supra note 6, ¶ 10.

[20] See Information ¶¶ 21-22, United States v. Johnston, 16 Cr. 406 (S.D.N.Y. June 13, 2016).

[21] See, e.g., Complaint ¶¶ 33-34, SEC v. Cooperman, No. 2:16-CV-05043 (E.D. Pa. Sept. 21, 2016).

[22] Jurors may well be skeptical of insiders who, upon being found to have given materially non-public information to a friend who made money off it, conveniently claim that they understood that the friend was not going to pass the improperly disclosed information any further. In short, while it is no doubt easier for the government to secure the cooperation of insiders treated as victims and not co-conspirators, jurors may be skeptical of such role shifts -- and punish the government accordingly -- if the trial evidence does not support that they are genuine.

[23] SEC v. Cuban, 620 F.3d 551, 555 (5th Cir. 2010).

[24] See id. at 557-58.

[25] Jess Davis, Jury Hands Cuban Win in SEC Insider Trading Case, Law360 (Oct. 16, 2013), http://www.law360.com/articles/480898/jury-hands-cuban-the-win-in-sec-s-insider-trading-case.

[26] O'Hagan, 521 U.S. at 652.

[27] Dirks, 463 U.S. at 654 (emphasis added) (citing Chiarella, 445 U.S. at 227-35).

[28] Newman, 773 F.3d at 448 (second emphasis added).

[29] See, e.g.,United States v. McGee, 763 F.3d 304, 314 n.6, 315-16 (3d Cir. 2014) (Alcoholics Anonymous sponsor breached "trust and confidence" of information shared by mentee), cert. denied, 135 S. Ct. 1402 (2015).

[30] See, e.g., Whitman v. United States, 135 S. Ct. 352, 353 (2014) (Scalia, J., statement respecting the denial of cert.) (indicating, in the context of an SEC regulation, a "receptive[ness] to granting" certiorari on whether agency regulations that interpret statutes with criminal implications are entitled to deference). See generally Esquivel-Quintana v. Lynch, 810 F.3d 1019, 1027-32 (6th Cir. 2016) (Sutton, J., concurring in part, dissenting in part) (explaining the Constitutional issues with deferring to an agency regulation that interprets a statute with criminal implications), cert. petition docketed, No. 16-54 (U.S. July 11, 2016); Carter v. Welles-Bowen Realty, Inc., 736 F.3d 722, 729-36 (6th Cir. 2013) (Sutton, J., concurring) (same).

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