



Payton Begins to Clarify Newman Aftermath

Southern District allows SEC tipper-tippee case

DOUGLAS A. RAPPAPORT, PARTNER, AND CHRISTINA PRUSAK CHIANESE, ASSOCIATE, AKIN GUMP

Uncertainty surrounding insider trading liability and the severe consequences associated with a violation present challenges for legal and compliance personnel in evaluating and assessing risks. While there can be no question that illegal insider trading can have devastating consequences, the exact line between permissible and impermissible trading is often far from clear, particularly where information passes indirectly from tipper to tippee. A recent decision from the Second Circuit Court of Appeals attempted to provide further clarity and guidance, particularly with respect to the benefit and knowledge requirements. As lower courts begin to apply this new precedent, however, they underscore that the legal landscape remains far from settled.

The Second Circuit's *Newman* Decision

In December 2014, the Second Circuit issued a decision in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), which attempted to better delineate the boundaries of insider trading liability in tipper-tippee scenarios. The case involved insider trading convictions of Todd Newman, a portfolio manager at Diamondback Capital Management, and Anthony Chiasson, a portfolio manager at Level Global Investors. Both defendants had been convicted in connection with their trading in the securities of Dell and NVIDIA based on material non-public information that they obtained from their firms' analysts, who in turn received the information via a multi-level disclosure chain originating with Dell and NVIDIA insiders. Although Newman and Chiasson were three and four levels removed from the original tippers, the government argued that they must have known that the information originated from insiders in breach of their fiduciary duty and not for any legitimate purpose.

The Second Circuit rejected this theory and, reversing the convictions, dismissed the charges against Newman and Chiasson, finding insufficient evidence to sustain the convictions. In so doing, the Second Circuit clarified the standard for insider trading liability. Specifically, the *Newman* court held that insider trading requires that: (1) the personal benefit provided to the tipper – which has long been recognised as a necessary precondition for tipper-tippee liability – must amount to a potential gain to the tipper of a pecuniary or similarly valuable nature and must resemble a *quid pro quo*; and (2) that a tippee defendant must know that the insider received a personal benefit.

The *Newman* decision has been the subject of much commentary and has led the government to abandon prosecution of some criminal cases in which the evidence of the personal benefit to the tipper, or the tippee's knowledge of the benefit, was deemed insufficient under *Newman*. After

the decision was announced, the US Attorney for the Southern District of New York stated that the decision "interprets the securities laws in a way that will limit the ability to prosecute people who trade on leaked inside information" and "narrow[s] what has constituted illegal insider trading."

Payton distinguishes *Newman* in SEC Enforcement Action

In the immediate aftermath of the *Newman* decision, many speculated as to the potential breadth and impact of the opinion. Lower courts applying the decision have begun to clarify its import in different contexts. For example, the most recent decision, *SEC v. Payton*, No. 14 Civ. 4644 (S.D.N.Y. Apr. 6, 2015) authored by Judge Jed S. Rakoff, sheds light on *Newman's* application in the SEC civil enforcement context.

The *Payton* decision considered the SEC's allegations that traders Daryl Payton and Benjamin Durant III of Euro Pacific Capital improperly traded software company SPSS, Inc.'s stock based on material non-public information regarding the company's pending acquisition by IBM. Payton and Durant allegedly received the tips from their Euro Pacific colleague Thomas Conradt, who in turn received them from his roommate, Trent Martin. Martin, in turn, originally learned of details regarding the IBM acquisition from a law firm associate working on the SPSS/IBM deal. In February 2015, the US Attorney's Office for the Southern District of New York dropped the criminal insider trading charges pending against defendants Payton and Durant in light of *Newman*, but the SEC had continued with its civil enforcement proceedings against these same defendants.

In motion practice before Judge Rakoff, the SEC argued that *Newman* should be confined to criminal proceedings. Significantly, Judge Rakoff rejected this argument, holding that the principles of *Newman* apply to both criminal Department of Justice prosecutions and civil SEC proceedings. In his opinion, however, Judge Rakoff emphasised the different *mens rea* requirements for criminal and civil insider trading liability, with the former requiring wilful or knowing conduct and the latter requiring only recklessness. The lower civil recklessness standard helped inform Judge Rakoff's assessment of the sufficiency of the pleaded facts before him in *Payton* and ultimately influenced his decision to allow the case to proceed.

In upholding the SEC's complaint, Judge Rakoff emphasised that the facts at issue in *Payton* were substantially different from those in *Newman*. He found that the SEC alleged a close and financially dependent relationship between Conradt and Martin, including Conradt's leadership in managing and negotiating their living expenses and Conradt's

role in assisting Martin with a criminal legal matter. Martin allegedly thanked Conradt for such assistance while simultaneously making reference to profits realised by Conradt from the SPSS trading. The court concluded that these allegations were sufficient to suggest a *quid pro quo* and a cognisable personal benefit to Martin in exchange for the inside information. The court also found sufficient allegations of the downstream tippers' knowledge of these reciprocal benefits insofar as both Payton and Durant were alleged to be aware of the friendship and exchange of information between Conradt and Martin, and were further alleged to have consciously avoided discovering additional details surrounding the tip. The court also noted that Payton and Durant took multiple steps to conceal their own trading in SPSS securities, which strengthened the inference of bad intent. As a result, the court denied the defendants' motion to dismiss the SEC's civil complaint.

The evolving landscape

The court's ruling may signal that *Newman* will have less of a limiting effect in the SEC civil enforcement context, where intent requirements are more relaxed, than in criminal cases. The impact of *Newman* in any particular case, however, will continue to turn heavily on the admissible evidence of a sufficient personal benefit and the downstream tippers' knowledge of the benefit. The *Payton* ruling also demonstrates that courts will be willing to distinguish the facts in *Newman*, as appropriate, when factual differences might meet the *Newman* standard, but this merely reflects the normal process of case-by-case adjudication.

It must be remembered, moreover, that the *Payton* decision involved a motion to dismiss for which all facts alleged were assumed true and all reasonable inferences made in favour of the SEC. *Newman*, by contrast, was an appeal from judgments of conviction following a jury trial and the development of a fulsome factual record. At the very least, this recent decision underscores that, despite *Newman*, in cases with a sufficient evidentiary predicate, the government retains powerful tools, including civil enforcement, as means of policing tipper-tippee theories of insider trading liability.

For this reason and others, *Payton* underscores that, from a compliance perspective, the best course remains to thoroughly evaluate any trading scenario presenting even a colourable risk of insider trading liability and err on the side of caution. With the law far from clear and the stakes high, careful evaluation of liability exposure through consultation with legal and compliance personnel are essential to guarding against exposure as the law in this area continues to develop. **THFJ**