13-1837-cr(L)

13-1917-cr(con)

IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT

UNITED STATES OF AMERICA,

Appellee,

—against—

TODD NEWMAN, ANTHONY CHIASSON,

Defendants-Appellants,

JON HORVATH, DANNY KUO, HYUNG G. LIM, MICHAEL STEINBERG,

Defendants.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF AMICUS CURIAE LAW PROFESSORS STEPHEN BAINBRIDGE, M. TODD HENDERSON, AND JONATHAN MACEY IN OPPOSITION TO THE UNITED STATES OF AMERICA'S PETITION FOR REHEARING OR REHEARING EN BANC

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PRELIMINARY STATEMENT

The panel's opinion in *Newman* is both a correct application of the personal benefit test adopted by the Supreme Court in *Dirks v. SEC* and an important corrective to the government's drive to expand the limits of insider trading liability. As the *Dirks* court appreciated, in the economically critical area of analyst-insider communication, a liability standard that is overly broad or unclear will deter market participants from seeking quality information on which to trade and thereby damage the healthy functioning of capital markets. The Supreme Court fashioned the personal benefit test accordingly, to draw a clear line between permissible and impermissible information gathering, so that analysts and investors would know when trading was permissible and not be needlessly deterred from seeking the best information available to them.

The government now seeks to dilute the Supreme Court's test to the point where it would become, in the *Newman* court's words, "a nullity." *Newman* op. at 22. Under the government's interpretation of personal benefit, almost any non-public insider disclosure could qualify, and the recipient of information would have no way of determining when trading on that information was permitted. The government's misreading of *Dirks* would fundamentally undermine the policy imperatives that led the Supreme Court to adopt the personal benefit test as an important market-protective limit on insider trading liability, and would deter

valuable analyst-insider communications, to the detriment of the market and of all market participants.

INTEREST OF AMICI[1]

Professors Stephen Bainbridge (UCLA Law School), M. Todd Henderson (Chicago Law School), and Jonathan Macey (Yale Law School) are distinguished scholars of federal securities law and policy. Each has a particular research interest in insider trading regulation and has published work on the policies behind and the market implications of insider trading laws. Given their deep experience and study of the field, the professors have an interest in supporting the panel opinion in *United States v. Newman* as a correct application of Supreme Court precedent, and in explaining the importance of that holding, and the precedent that it applies, for the regulation of the securities markets.

I.

NEWMAN DOES NOT IMPERIL THE INTEGRITY OF THE SECURITIES MARKETS; IT PROTECTS THEIR INTEGRITY

The government, and the SEC as amicus, argue that the *Newman* panel misconstrued the *Dirks* personal benefit test, improperly limiting their ability to prosecute insider trading and so, they contend, threatening the integrity of the

[1] This brief is filed by leave of the Court, granted February 24, 2015. No counsel for any party authored this brief in part or in whole, and no counsel for any party contributed money to fund preparing or submitting this brief. Counsel for amicus curiae is the only entity or person who contributed money intended to fund the preparation and submission of this brief.

securities markets. Govt. Br. at 22-25, SEC Br. at 12-15. Far from endangering the integrity of the markets, the *Newman* opinion correctly applies the Supreme Court's personal benefit test—a test founded in the Supreme Court's explicit determination that the market must be protected from the chilling effects of standardless liability for insider trading. The threat to market integrity comes not from *Newman*'s correct application of the personal benefit test, but from the government's and the SEC's campaign to make *Dirks*'*s* "personal benefit requirement . . . a nullity." *Newman* op. at 22.

A. The Supreme Court adopted the personal benefit test to protect analyst-insider communication against the chilling effect of standardless prosecution

In *Dirks v. Securities and Exchange Commission*, 463 U.S. 646 (1983), the Supreme Court articulated the factors that must be shown in order to impose liability on a recipient of material, non-public information for insider trading under Exchange Act Section 10(b). It held that the recipient has an actionable duty not to trade on material non-public information only if (1) the insider breached a duty by disclosing the information, and (2) the recipient was aware of the insider's breach of that duty. *Id.* at 660 (holding that liability attaches only if the recipient "knows or should know" of the insider's breach).

In addressing the scope of the insider's duty to refrain from disclosing material, non-public information, the Court emphasized that not "[a]ll disclosures

of confidential corporate information are [ ] inconsistent with the duty insiders owe to shareholders." *Id.* at 662. The distinction between fraudulent disclosure, in breach of that duty, and permissible disclosure, turns on the purpose for which disclosure is made. *Id.* The "personal benefit" test is the litmus test used to gauge the underlying purpose that motivates the insider to disclose information. Unless the insider "personally benefits" from the disclosure, there is no breach of duty, and so no derivative liability if the recipient of the information trades. *Id.* at 662, 664.

The Court based these rules firmly on precedent and statutory text, and also on an explicit policy determination to protect the market from the threat of prosecutorial over-reaching. In *Dirks*, as in other seminal insider trading cases, *see Chiarella v. United States*, 445 U.S. 222 (1980), the SEC advocated for a far broader liability rule than the Supreme Court was willing to countenance. *Dirks*, 463 U.S. at 655-68. The SEC took the position that "anyone who knowingly receives nonpublic material information" should be barred from trading based on that information, without regard to the propriety or purpose of the underlying insider disclosure. *Id.* at 656.

The Supreme Court rejected the SEC's proposed interpretation of Section 10(b) based both on its prior precedent in *Chiarella* and on the explicit policy ground that the SEC's rule would impair "the preservation of a healthy market."

Id. at 658. The Court reasoned that the broad threat of securities fraud liability under the SEC's rule would chill the flow of information between insiders and securities analysts, which the Court recognized as providing important social benefits to market participants:

> imposing a duty to disclose or abstain [from trading] solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which . . . is necessary to the preservation of a healthy market.

Id.; see further id. at n18.

As the Supreme Court explains in *Dirks*, analysts have an important role in protecting the integrity of the market, by testing insiders on the accuracy of corporate representations, and even by detecting outright corporate fraud. *See id.* at 658, n18; *see also, e.g.*, Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. Rev. 1589, 1610 (1999) (arguing that the *Dirks* "rule is justifiable because it encourages market analysts to expend resources to develop socially valuable information about firms and thereby promote market efficiency). By "meeting with and questioning corporate officers and others who are insiders," analysts "ferret out" and help to "reveal[ ] information that corporations may have reason to withhold from the public." *Id.* at 658, n18. The information they obtain and pass on to their clients enables more accurate pricing in capital markets and helps to

assure that capital will ultimately be allocated to the highest value users. *See, e.g., Dirks*, 463 U.S. at 658-59 (analysts use inside information to make "judgments as to the market worth of a corporations securities," which are "made available . . . to clients of the firm," not "to the public generally"), n17 (by contributing to more efficient pricing, analysts' activities benefit market participants in general); Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 Harv. L. Rev. 322, 341 (1979) (explaining how analysts contribute to the accuracy of market pricing). The Court [in *Dirks*] made quite clear that it viewed a large portion of those contacts as entirely legitimate, even when—as in the case of investment analysts—the purpose of the meetings is to gather data for making investment decisions.").

Broad prohibitions against trading based on material, non-public information—such as the SEC's proposed interpretation of Section 10(b) in *Dirks*—ultimately damage the overall health of the market, because they limit the incentives of market participants to seek out information on which to trade:

> [T]he incentive to acquire information in the first place goes down if the opportunity to profit by virtue of superior information is eliminated. And if there is no incentive to acquire information, markets lose their function of providing price signals to diverse participants in the economy.

Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law, 253-254 (1996) (explaining the economic reasons why insider trading law

must permit trading based on information to which only some traders have access); *see, e.g.,* Bainbridge, 52 SMU L. Rev. at 1610; Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 Wash. & Lee L. Rev. 1189, 1257 (1995) (explaining that the *Dirks* rule creates positive incentives to develop information on firms); Brudney, 93 Harv. L. Rev. at 327, 341 ("To meet the costs of thus pursuing and analyzing information, a return must be offered . . . . Hence, market efficiency will be enhanced if persons are encouraged (by receiving the rewards of the bargain resulting from informational advantages thus obtained) to seek such advantages, for purposes of either buying or selling particular securities."). Investors will not hire analysts to "ferret out" information from insiders, and as a result that information will never reach the market, if investors are at peril of prosecution for trading on the information so acquired. *See, e.g.,* Easterbrook & Fischel at 253-54; *Dirks* 463 U.S. at 658, n17, n18 (SEC's broad view of insider liability, applicable without regard to the purpose of the insider disclosure, "could have serious ramifications on reporting by analysts of investment views").

Of course, analyst-insider communications must still remain within the bounds of the law. *Id.* at 661-62. Insiders may not disclose non-public information in violation of their duties to shareholders, and a recipient may not trade on information that he knows was so disclosed. *Id.* But, as the Supreme

Court emphasized in *Dirks*, not "[a]ll disclosures of confidential corporate information are [ ] inconsistent with the duty insiders owe to shareholders." *Id.*

With these market realities in mind, the Supreme Court fashioned the personal benefit test to provide a necessary "limiting principle" for fraud liability and a meaningful "guiding principle for those [analysts, insiders and investors] whose daily activities must be limited and instructed by the SEC's insider trading rules." *Id.* at 664. The test was to be administrable based on "objective criteria"—the receipt of personal benefit—that would indicate that the insider had, in fact, acted for an impermissible purpose, and enable "corporate insiders [and] analysts [to] be sure when the line is crossed." *Id.* at 663, n17.

Dirks' message is unequivocal. To effectively protect the socially beneficial activities of market participants operating under the eye of the SEC, requires definite and objective limits on the scope of insider trading liability. Without those "legal limitations, market participants are forced to rely on the reasonableness of the SEC's litigation strategy" as their only assurance that their activities will not be subject to prosecution. *Dirks*, 463 U.S. at 664 n24. And that, as the Supreme Court observed, "can be hazardous." *Id.*

B. *Newman* is a correct application of *Dirks*' personal benefit test; the government's proposed rule, in contrast, would defeat the purposes of the test and chill valuable analyst-insider communication

Newman is a straightforward and correct application of *Dirks*. In particular, *Newman* correctly rejected the government's contention that the "mere fact of a friendship" between the insider and the recipient of information is legally sufficient evidence that the insider sought a personal benefit. *Newman* op. at 22. The function of the personal benefit test is to gauge whether a disclosure was made for an improper purpose. *See Dirks*, 463 U.S. at 661-664. Unlike the personal benefit test, the fact that an analyst can be characterized as a social "friend" of the insider who discloses information, does nothing to illuminate the purpose for which the disclosure was actually made.

Moreover, the rule advocated by the government and the SEC would undermine in a fundamental way the policy purpose for which the Supreme Court adopted the personal benefit test. If mere evidence of "friendship" is presumptive evidence of personal benefit, then virtually all disclosures are potentially subject to prosecution, because insiders are far more likely to be involved in discussion of their companies with people they know than with strangers. As such, analysts and insiders who are engaged in industry activity that the Supreme Court correctly understands to be normal, socially beneficial, and important to the integrity of capital markets, and that it explicitly seeks to protect, would operate at peril of

prosecution for securities fraud simply because they talk regularly, have common friends with whom they socialize, or have some other point of social interaction that could lead to their characterization as "friends." Based only on such arbitrary and amorphous facts, the disclosure of material information in good faith, or for a permissible purpose under Rule 10b, *see id.* at 661-62, would become presumptively criminal. That rule would have the same predictable chilling effect on analyst-insider communications that the Supreme Court set out to avoid in *Dirks*. It cannot possibly be what the Supreme Court intended.[2]

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[2] Notably, the SEC itself conceded the significant chilling effects of insider trading liability on analyst-insider communications in the course of promulgating Regulation FD to address the "selective [*i.e.* non-public] disclosure" of material information (conduct the SEC could not reach as insider trading, given the Dirks' personal benefit test). Selective Disclosure and Insider Trading, S.E.C. Release Nos. 33–7881, 34–43154, and IC–24599, 73 SEC Docket 3, 2000 WL 1201556, at *5, n16 (August 15, 2000). Regulation FD requires that when a public company discloses material non-public information to securities market professionals such as stock analysts or holders of its securities who may trade on the information, the company must make public disclosure of the information so that all market participants acquire the information simultaneously. *Id*. at *6. The rule applies only to the issuer of securities, not other market participants, and it expressly creates no private liability for employees or agents of the issuer. Id. In its Comments on adoption of the rule, the SEC observed that "if we were successful in enforcement actions charging selective disclosures as a form of fraudulent insider trading, the interrorem effect of that success (and the consequent chilling effect on issuers) would certainly be far greater than the impact of the more measured approach we adopt today [in regulation FD]." *Id*. n16. Without a robust personal benefit test, however, the entire field of insider disclosure becomes subject to potential prosecution, with the same chilling effects that the SEC acknowledged in its Regulation FD commentary. *See Dirks*, 463 U.S. at 664 n24.

The government's and the SEC's contrary arguments misread *Dirks*. They rely on *Dirks*' statement that "mak[ing] a gift of confidential information to a trading relative or friend" would establish that the insider was using the information for personal benefit. *See* Govt Br. at 12-13, SEC Br. at 9-10. It does not follow from that statement that disclosure of confidential information to a "friend" is a personal benefit per se. The inference would be nonsensical, for reasons already discussed—the recipient's status as a "friend" does nothing to indicate whether the insider, in fact, made the disclosure for the purpose of enriching the particular friend (and therefore in violation of a duty), or for a permissible purpose. All the Supreme Court observed in *Dirks* is that an insider whose purpose is to personally enrich a friend, obtains an impermissible personal benefit just as surely as an insider who personally trades on the information. *Id.* at 664 ("making a gift of confidential information to a trading relative or friend . . . resemble[s] trading by the insider himself followed by a gift of the profits to the recipient"). The Court was not endorsing the proposition that an insider who discloses inside information to a "friend" is therefore seeking a personal benefit.

C. Like *Dirks, Newman* protects the integrity of the market by limiting prosecutorial discretion and providing meaningful guidance to market participants

As *Dirks*' repeatedly underscores, market integrity is not threatened by definite rules of conduct, or rational, policy-based limitations on the government's

discretion to prosecute insider trading. 463 U.S. at 658 n17, 661-664, n24. It is threatened by prosecutorial discretion that lacks clear limits, by vague rules under which "neither corporate insiders nor analysts can be sure when the line is crossed," and by permitting the government to treat normal, socially beneficial industry activity as presumptively criminal. *Id.* at 658-59, n17, 661-664, n24. The *Dirks* court fashioned the personal benefit rule accordingly.

The *Newman* panel, correctly recognizing that the government would make "a nullity" of the personal benefit rule, *Newman* op. at 22, simply respected *Dirks*'s precedent. *Newman* protects the integrity of the market by placing a meaningful and objective limit on the scope of insider trading liability, allowing investors analysts and insiders to function with reasonable certainty and security about whether their conduct violates the law. In contrast, the government's version of the personal benefit test fails to supply a standard to which market participants can reasonably conform their conduct. A recipient of information who tries to determine whether he or she is presently under a duty not to trade will find that there is no clear answer, because even the most nebulous of social relationships with the source of the information might be construed as a sufficient basis for liability.

The SEC and the government complain that *Newman* will make it more difficult to prove securities fraud against recipients of inside information. *See*

Govt. Br. at 22-25, SEC Br. at 12-15. They contend that if some market participants are able to trade based on the disclosure of inside information to a favored few, there could be adverse effects on the perceived fairness of the market, and a decline in "investor confidence." Govt. Br. at SEC Br. at 13-14.

Dirks considered substantially identical arguments for broad insider trading liability and decided them against the SEC. As the Supreme Court held in *Chiarella*, and reaffirmed in *Dirks*, Section 10(b) is not intended to promote market participants' fair or equal access to information. *Dirks*, 463 U.S. at 656-57; *Chiarella*, 445 U.S. at 231-32, n14; 235, n20. It regulates narrowly against fraud and dishonesty. The line between fraudulent and permissible disclosures was drawn by *Dirks* to place a definite limit on liability, and prevent the chilling of socially beneficial industry activity. If the SEC or the government believes it is important to prosecute trading by recipients of inside information even when the insider receives no provable personal benefit, then their remedy lies with Congress, not with this Court.

CONCLUSION

The Petition for Rehearing and Rehearing *En Banc* should be denied.

Dated: New York, New York
February 25, 2015

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