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PERSPECTIVE

The education of Judge Rakoff

By Timothy P. Crudo, Rees F. Morgan and David Anderson

White collar pundits have been atwitter since the 2nd U.S. Circuit Court of Appeals' insider trading decision last December in *U.S. v. Newman*, 773 F.3d 438 (2d Cir. 2014). There the 2nd Circuit held that, to convict a tippee who traded on inside information, the government must prove that he knew that the insider disclosed the information "in exchange for a personal benefit."

While that holding was no surprise, the court seemed to drop a bomb with its explanation of what constitutes a personal benefit. For decades, "personal benefit" had been understood to include a gratuitous gift of a tip from one friend to another. Now under *Newman*, that benefit must be "objective, consequential, and represent[] at least a potential gain of a pecuniary or similarly valuable nature." In other words, the tipper must receive (or expect to receive) "something more than the ephemeral benefit of the [tippee's] friendship." The good vibe of gifting a buddy may no longer be enough.

The 9th U.S. Circuit Court of Appeals' decision last week in *U.S. v. Salman*, 2015 DJDAR 7811 (July 6, 2015), is the ninth reported opinion, and first by an appellate court, to analyze *Newman*. A remarkable one-third of those — including *Salman* — were written by U.S. District Judge Jed Rakoff of the Southern District of New York. Tracing the evolution of Judge Rakoff's view of *Newman* sheds light on both *Newman* and *Salman* and whether there is a split between the two.

It's fair to say that Judge Rakoff is no fan of Newman's suggestion that the tipper's personal benefit must be a pecuniary quid pro quo. In April, he seemed to concede that *Newman* had so narrowed the definition of "personal benefit," although he questioned whether that holding could be squared with *Dirks v. SEC*, 463 U.S. 646 (1983), where the Supreme Court, in "arguably unclear" language, suggested that an insider's "gift of confidential information," without any quid pro quo, could suffice. *SEC v. Payton*, 14-4644 (S.D.N.Y. April 6, 2015). Begrudgingly applying *Newman*'s "more onerous standard," he concluded that the parties' "history of personal favors," including sharing expenses and help the tippee gave the tipper with a prior legal problem, was sufficient to find a pecuniary benefit to the tipper.

By July, Judge Rakoff had taken a more nuanced view of *Newman*, one where the tipper's personal benefit needn't be pecuniary. Referring to *Dirks* and other pre-*Newman* 2nd Circuit authority supporting the position that a tip-as-gift was benefit enough, he determined that "[w]hile *Newman* arguably narrowed the range of evidence that would support an inference of 'benefit,' it did not purport to overrule any binding precedent." *U.S. v. Gupta*, 11-907 (July 2, 2015). Carefully parsing *Newman*'s key language, he found that "a tipper's intention to benefit the tippee is sufficient to satisfy the benefit requirement as far as the tipper is concerned, and no quid pro quo is required." According to Judge Rakoff, the language of *Newman* that has attracted so much attention concerns the evidence needed to establish that a defendant knew of the tipper's benefit, not necessarily what constitutes that benefit in the first place — this despite the fact that this language appears in the section of *Newman* analyzing the latter issue, not the former.

The New York Times
Judge Jed Rakoff, left, in his chambers in New York in April.

Four days after *Gupta*, Judge Rakoff, sitting by designation in the 9th Circuit and unburdened by 2nd Circuit precedent, told us what he really thought of *Newman*. In *U.S. v. Salman*, the insider testified that he gave information to an intermediate tippee (his brother) as a gift. Relying solely on *Dirks*, that was enough for Judge Rakoff. He then dismissed the argument that *Newman* — which "[o]f course … is not binding on us" — requires a pecuniary benefit: "To the extent *Newman* can be read to go so far, we decline to follow it. Doing so would require us to depart from the clear holding in *Dirks*" — the same holding that he found "arguably unclear" in Payton only three months before.

That left the question of whether there was sufficient evidence to support the inference that Salman, who had gotten the information from Brother No. 2, knew that the initial tip had been a gift. No evidence suggested that anyone told Salman that it was. There was testimony only that Salman knew that Brother No. 1 was the insider/tipper, that Salman agreed to "protect" him from exposure, and that Salman knew the brothers were close — as demonstrated by the fact that Salman was an in-law of their "close knit" clan and saw one brother cry at the other's wedding. Salman therefore "must have known" that the tipping brother "inten[ded] to benefit" the other.

The 9th Circuit opinion did not cite any authority, including *Newman*, on this point, and it is questionable whether this sort of evidence would have satisfied even *Gupta*'s reading of *Newman*'s standard to prove a remote tippee's knowledge of the benefit. While Salman involved close family relationships rather than the casual social connections in *Newman*, it still raises the concerns expressed in *Newman* that a criminal conviction requiring proof that the defendant acted with the intent to defraud can depend on a standardless judgment about the bonds of all manner of personal relationships, especially since the disclosure of confidential information itself is not always wrongful or even suspicious. There is a real danger when a criminal conviction hinges on whether a groom's best man is the weepy sort or not.

Do we now have a circuit split? Maybe. In the 9th Circuit, a gift is a sufficient personal benefit for insider trading liability. Judge Rakoff's opinion in *Gupta* suggests that *Newman* may not be inconsistent with that view, but it is not unreasonable to read it otherwise. We may not have to wait long for clarification. Briefing is complete in the 2nd Circuit in *U.S. v. Martoma*, 14-3599 (May 26, 2015), which tees up whether "*Newman* brought an end to the salad days when an allegation of friendship was enough" to convict a tippee. We're betting that the 2nd Circuit will clarify *Newman* and what it really means by "personal benefit," probably in a way that will be more to Judge Rakoff's liking. In reversing the judgment against the tippee *Dirks*, the Supreme Court determined that there had been no personal benefit where the "tippers received no monetary or personal benefit for revealing [the company]'s secrets, nor was their purpose to make a gift of valuable information," which seems inconsistent with a reading of *Newman* that a gift doesn't count (emphasis added).

Whatever the Martoma opinion holds, we can at least safely predict that it won't be written by Judge Jed Rakoff.

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