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Sour Grapes From Delphi: Judge Rakoff Is At It Again in *SEC v. Payton*

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No one has more earned the title "The Honorable" than United States District Court Judge Jed S. Rakoff – champion of the public interest and foil for those insiders who cheat, purloin or embezzle corporate or market information to grab a quick buck. If you are a crook and you appear before Judge Rakoff, remember that memorable line in the opening scene of *The Gladiator,* "people should know when they're conquered." If you are a government agency lacking vigor in law enforcement, admonishment may be your fate before Judge Rakoff. Occasionally, however, even the The Honorables need to be coaxed into conformity with the gentle prod of that Latin elegancy: *mandamus*.

Having been recently so coaxed (albeit by an interlocutory appeal rather than mandamus), it seems as though this seasoned jurist once again is at risk of direction by the Second Circuit that those senior jurists mean what they say, whether "obvious" or not, and will not countenance lip service rather than fidelity to their mandates. In *Newman*, the Second Circuit ordered that the "personal relationship" ingredient of an insider-tippee claim had to be spiced with "objective" and "consequential" evidence of at least the potential of cash passing hands or a like "pecuniary" gain. When petitioned to excise that panel locution, the Second Circuit denied to do so *en banc.*

Insider trading may be a form of embezzlement, cheating and financially delighting on the purloined, but human beings charged with such misconduct should not be shackled to a defense of months or years for allegedly doing so unless the government can *plead and prove*, by objective and consequential evidence, a pecuniary *quid pro quo* known by the misconductee. Judge Rakoff disagrees. Is it time for the Second Circuit to revisit the need to command that Judge Rakoff cabin his claim on the sort of tippee personal knowledge that justifies maintenance of an SEC insider fraud claim?

Initial Foray

In late 2011, United States District Court Judge Jed S. Rakoff famously made news when he refused to approve a consent order that the Securities and Exchange Commission had reached with Citigroup. *SEC v. Citigroup Global Mkts, Inc.*, 827 F. Supp. 328 (S.D.N.Y. 2011). His November 28, 2011 opinion and order stated that, because Citigroup entered into the consent order without admitting or denying the underlying allegations, there was an insufficient evidentiary basis for the court to determine whether the requested relief was justified under a fair, reasonable and adequate standard. *Id.* at 332. He thus held that the consent order was not fair, reasonable or adequate, refused to approve it, and instead set a trial date for the case. *Id.* at 335. Both the SEC and Citigroup

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filed appeals with the Second Circuit; the SEC alternatively sought to mandamus Judge Rakoff. Although Judge Rakoff refused to stay the district court proceeding, the Second Circuit, stepped in and granted a stay.

Finding that it had jurisdiction to consider the parties' interlocutory appeals pursuant to 28 U.S.C. § 1292(a)(1), the Second Circuit held that, "[a]bsent a substantial basis in the record for concluding that [a] proposed consent decree does not meet" the requirements of being "fair and reasonable" or that the "public interest would not be disserved" by approval of the order, a "district court is required to enter the order." *SEC v. Citigroup Global Mkts, Inc.*, 752 F.3d 285, 294 (2d Cir. 2014). The appellate court went on to find that the district court had abused its discretion by requiring that the SEC establish the "truth" of its allegations against Citigroup as a condition for approving the consent decree. *Id.* at 295. The Second Circuit thus vacated the order and remanded the case to the district court, *id.* at 298, with one member of the panel suggesting that he would have preferred to just reverse and enter the consent decree, *id.* (Lohier, J. concurring).

On remand, Judge Rakoff entered the consent decree. However, he did not do so without letting the world know how he felt about the Second Circuit's decision. While he entered the formulaic judgment that the parties presumably proposed without any modifications in August 2014, he also entered a short opinion, which he began by stating that "[t]hey who must be obeyed have spoken, and this Court's duty is to faithfully fulfill their mandate." *SEC v. Citigroup Global Mkts, Inc.,* 34 F. Supp. 3d 379, 379 (S.D.N.Y. 2014) (footnote omitted). Judge Rakoff acknowledged that the Second Circuit had found that the standard he had articulated in his 2011 rejection of the consent order was "mistaken and/or misapplied," and that the proposed consent order met the standard set out in the Second Circuit's decision and thus had to be approved, but he expressed his fear that, under the Second Circuit's standard, government-proposed settlements would "in practice be subject to no meaningful oversight." *Id.* at 380. Noting that, despite this fear, it would be a "dereliction of [the district court's] duty . . . to seek to evade the dictates of the Court of Appeals," Judge Rakoff concluded his opinion by stating that the Second Circuit "has now fixed the menu, leaving this Court with nothing but sour grapes." *Id.* at 380-81.

Newman Sets the Standard

Fast-forward a few months. On December 10, 2014, the Second Circuit rendered a decision that has been described by the Department of Justice as "substantially chang[ing] the law pertaining to insider trading." Letter from Preet Bharara to Hon. Andrew L. Carter, Jr., *United States v. Conradt*, No. 12 Cr. 887 (ALC) (S.D.N.Y), ECF No. 167 ("US Attorney Letter"). In its decision, the Second Circuit rejected the Department of Justice's attempts to hold alleged remote tippees liable for insider trading when it failed to demonstrate that the alleged tipper had received a personal benefit in exchange for providing the tip and that the remote tippees knew that the tipped information was confidential and divulged for personal benefit. *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014).[1] The Second Circuit declined to send the matter back to the district court for further

[1] The Second Circuit recently rejected the Department of Justice's motion for rehearing or rehearing on banc. *United States v. Newman*, 2015 U.S. App. LEXIS 5788 (2d Cir. Apr. 3, 2015).

proceedings, but rather vacated the convictions and remanded it for the district court to dismiss the indictment with prejudice. *Id*. at 455.

As the whole securities world knows, the Second Circuit did not mince words in describing what was required to demonstrate a personal benefit. In considering whether such a benefit "may be inferred from a personal relationship between the tipper and a tippee, where the tippee's trades resemble trading by the insider himself followed by a gift of the profits to the recipient," the court held that "an inference is *impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature*." *Id*. at 452 (emphasis added). There must be "evidence of 'a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the [latter].'" *Id*. (quoting *United States v. Jiau*, 734 F.3d 147, 153 (2d Cir. 2013)).[2] The Second Circuit also did not equivocate regarding the knowledge issue: the "Government is required to prove beyond a reasonable doubt that [the defendant remote tippees] knew that the insiders received a personal benefit in exchange for disclosing confidential information." 773 F.3d at 453.

The ramifications of *Newman* were felt immediately in the land of insider trading. Eight days after the decision was entered, United States District Court Judge Andrew Carter advised the Department of Justice that he was inclined to vacate the guilty pleas of four alleged remote tippees in a pending case because the court was "skeptical that the pleas were sufficient in light of *Newman*'s clarification of the personal benefit and tippee knowledge requirements." *United States v. Conradt*, 2015 U.S. Dist. LEXIS 16263, at **2-3 (S.D.N.Y. Jan. 22, 2015). The court allowed the Department to submit a brief in support of its position that *Newman* did not apply to insider trading cases prosecuted under a misappropriation (as opposed to a classical) theory, but ended up rejecting that argument and vacating the guilty pleas. *Id*. at *3. In doing so, the court stated that, even if *Newman* did not specifically resolve whether the elements of tipping liability are the same under both classical and misappropriation theories, the court was "swayed by the fact that *Newman*'s unequivocal statement on the point is part of a meticulous and conscientious effort by the Second Circuit to clarify the state of insider-trading law in this Circuit." *Id*. at **3-4.

In a January 28, 2015 letter, the Department of Justice advised the *Conradt* court that, unless the court determined to grant the defendants' motion to dismiss the indictments, "based on the newly-announced standards set forth in *Newman*, and the Court's decision to vacate the guilty pleas of the Government's cooperators," the Department would move to dismiss without prejudice charges against the four individuals whose guilty pleas had been dismissed and the one individual who had pled not-guilty.[3] US Attorney Letter at 2. Orders of *nolle prosequi* were entered as to all of the alleged remote tippees in February 2015.

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[2] The *Newman* court also noted its concerns regarding the "doctrinal novelty" of the government's "recent insider trading prosecutions." 773 F.3d at 448.

[3] Without the benefit of the anticipated testimony of the cooperators who had pled guilty, the Department of Justice stated that "what remains of the Government's evidence on [the] key issues falls short of *Newman's* newly-imposed legal requirements." US Attorney Letter at 1.

While the five alleged remote tippees in the *Conradt* case are off the criminal hook, two of them still face civil insider trading claims by the SEC (the other three settled those claims). And this is where we again find Judge Rakoff making news.

Judge Rakoff Redux

The SEC's case against the two alleged remote tippees – Benjamin Durant III and Daryl Payton – is pending before Judge Rakoff. In September 2014, Judge Rakoff reluctantly agreed to stay the case pending the criminal trial.[4] In February 2015, after the Department of Justice filed its request for *nolle prosequi* orders, Judge Rakoff entered a case management plan in the SEC case, setting the date for defendants' motions to dismiss, discovery deadlines, the date for defendants' motions for summary judgment and the date by which the case must be ready for trial. Civil Case Management Plan, *SEC v. Payton*, No. 14 Civ. 4644 (JSR) (S.D.N.Y. Feb. 3, 2014), ECF No. 23.

Consistent with that schedule, defendants Durant and Payton filed a joint motion to dismiss the claims, arguing that the complaint failed to satisfy basic pleading requirements for a misappropriation insider trading claim against remote tippees, including failing to allege the "existence of a personal benefit to the tipper and the Defendants' knowledge of that personal benefit." Memo. of Law in Support of Defs' Motion to Dismiss at 1, *SEC v. Payton*, No. 14 Civ. 4644 (JSR) (S.D.N.Y. Feb. 23, 2015), ECF No. 29 ("Defs' Memo") at 1. In other words, defendants placed the case squarely in the crosshairs of *Newman.*

The SEC, of course, opposed the motion, making the same argument that the Department of Justice had unsuccessfully made to Judge Carter regarding the inappropriateness of applying the standards developed in *Newman* in connection with a classical insider trading claim to a case based on a misappropriation insider trading claim. SEC's Opp'n to Defs' Mot. to Dismiss at 2, *SEC v. Payton*, No. 14 Civ. 4644 (JSR) (S.D.N.Y. Mar. 9, 2015), ECF No. 33 ("SEC's Opp.). The SEC also argued, that, even if the *Newman* standard applies to a misappropriation claim, the allegations in the agency's amended complaint (filed seven days before the SEC filed its opposition to the motion to dismiss) regarding personal benefit and the knowledge of the defendants satisfied the Supreme Court's decision in *Dirks v. SEC*, 463 U.S. 646 (1983), and "even the most unreasonable reading of *Newman*." SEC's Opp. at 2.

On April 6, 2015, Judge Rakoff issued his opinion and order denying defendants' motion to dismiss. While the opinion starts off following the Second Circuit's lead – Judge Rakoff rejects the SEC's argument that *Newman* does not apply to a misappropriation insider trading claim, *SEC v. Payton*, 2015 U.S. Dist. LEXIS 44732, at *11 (S.D.N.Y. Apr. 6, 2015) – it soon diverts from the Second Circuit's holdings.

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[4] The "neither admit nor deny" issue that was Judge Rakoff's focus in the *Citigroup* case was obviously still on his mind during the hearing (which occurred before the Second Circuit's vacatur of his order rejecting the settlement) at which he considered whether to stay the SEC's civil case. In response to the SEC's statement that the agency was "ready to go forward" with the trial "but we don't oppose the motions [to stay] to the extent the Court believes they are appropriate," Judge Rakoff quipped: "So it's the classic SEC position, you neither admit nor deny." Transcript of July 22, 2014 Proceedings at 19, *SEC v. Payton,* No. 14 Civ. 4644 (JSR) (S.D.N.Y. Sept. 24, 2014), ECF No. 16 ("July 22, 2014 Transcript").

A Personal Benefit By Any Other Name . . .

The first sign of this diversion arises out of Judge Rakoff's comparison of the definition of personal benefit found in *Dirks v. SEC*, 463 U.S. 646 (1983), with the Second Circuit's description of what is necessary to demonstrate a personal benefit. Judge Rakoff begins with language from *Dirks*, in which the Supreme Court states that a personal benefit is:

> 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*.

2015 U.S. Dist. LEXIS 44732, at *12 (quoting *Dirks v. SEC*, 463 U.S. at 663-64; emphasis added by Judge Rakoff). After noting that it is "arguably unclear whether the italicized sentence modifies the prior reference to 'pecuniary gain or . . . future earnings,' or is an independent, stand-alone possibility," Judge Rakoff takes a jab at the Second Circuit's holding that an inference of personal benefit based upon a personal relationship is "impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature" by noting that: "[w]hether this is the required reading of *Dirks* may not be obvious, and it may not be so easy for a lower court, which is bound to follow both decisions, to reconcile the two." [5] 2015 U.S. Dist. LEXIS 44732, at **12-14.

While Judge Rakoff goes on to state that the "difficulty" that he has articulated in reconciling *Dirks* and *Newman* "need not [be] confront[ed]" in this case because the SEC's amended complaint "adequately meets any definition of 'benefit' set forth in either *Dirks* or *Newman*," 2015 U.S. Dist. LEXIS 44732, at *14, it is quite clear from the court's analysis of "personal benefit" that Judge Rakoff believes that "they who must be obeyed" got it wrong. Judge Rakoff pays lip-service to the Second Circuit's "more onerous standard of benefit," *id.*, but essentially ignores it in finding that the SEC adequately alleged a personal benefit in the case before him.

The principal allegation made by the SEC in the *Payton* case is that the tipper (Martin) and the tip recipient (Conradt) "shared a close mutually-dependent financial relationship, and had a history of personal favors." *Id.* at *14. Judge Rakoff cites the following allegations as "substantiat[ing]" this "otherwise conclusory statement":

- Martin's and Conradt's expenses were "intertwined";
- Conradt took the lead in organizing and initially paying their shared expenses, including negotiating reductions in their utilities and rent payments;

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[5] This is not the first that that Judge Rakoff has raised questions about a Second Circuit insider trading decision. In *United States v. Whitman*, 904 F. Supp. 2d 363, 371 n.6 (S.D.N.Y. 2012), Judge Rakoff characterized the Second Circuit's statements in *SEC v. Obus*, 693 F.3d 276 (2d Cir. 2012), regarding the personal benefit required in an insider trading case based upon a misappropriation theory, of being "somewhat Delphic." The Second Circuit acknowledged this characterization in *Newman*, stating that "[a]lthough this Court has been accused of being 'somewhat Delphic' in our discussion of what is required to demonstrate tippee liability . . . the Supreme Court was quite clear in *Dirks*." 773 F.3d at 447.

- Conradt assisted Martin with a criminal legal matter that threatened Martin's ability to remain legally in the United States; and
- "Martin thanked Conradt for his prior assistance with the criminal legal matter and told Conradt he was happy that Conradt profited from the . . . trade because Conradt had helped him."

Id. (internal citation omitted). Judge Rakoff notes that, although the last allegation involves a comment by Martin that occurred more than a month after Conradt's trade occurred, "drawing (as required) every reasonable inference in plaintiff's favor," it is "indicative [of] Martin's intent to benefit Conradt at the time of disclosure of the information, as well as evidence a *quid pro quo* relationship." *Id.* at *15.

None of these allegations – whether taken alone or together – is adequate to meet the standard set out in *Newman* (or *Dirks*). The first two allegations are based on nothing more than the fact that Martin and Conradt (along with another person) were roommates for thirteen months. To say (as the SEC does) that "[a]s roommates, [their] expenses were intertwined," Amended Complaint ¶ 57, *SEC v. Payton*, No. 14 Civ. 4644 (JSR) (S.D.N.Y. Mar. 7, 2015), ECF No. 37 ("Am. Compl."), is the triumph of legal formulation over common sense and logic. Martin and Conradt were young people sharing an apartment (with a third person) in a city known for its extremely high rents; there is nothing to suggest that they "intertwined" any expenses other than as was necessary to collectively cover their rent and utilities. Likewise, the allegations that the three roommates shared expenses for the apartment and that Conradt paid the apartment bills with Martin and the other roommate reimbursing him for their share, *id.*, come nowhere near to establishing a personal benefit of the sort that the Second Circuit (or *Dirks*) requires. As defendants argued in support of their motion to dismiss, Conradt's actions

> improved Conradt's own living conditions and suggest only that Conradt was a desirable roommate. They bear no relation whatsoever to the tip and do not remotely approach the type of facts that might support an inference that Martin's disclosure of the [tipped information] was in exchange for these "benefits."

Memo. of Law in Support of Defs' Mot. to Dismiss the Am. Compl. and in Further Supp. of Defs' Mot to Dismiss the Original Compl. at 11, *SEC v. Payton*, No. 14 Civ. 4644 (JSR) (S.D.N.Y. Mar. 16, 2015), ECF No. 36 ("Defs' Second Memo").

The last two allegations cited by Judge Rakoff also fail to meet the *Newman*/*Dirks* standard. The SEC alleges that "Martin was arrested and charged with assault after he was involved in a street altercation outside Grand Central Station." Amended Complaint ¶ 59. "Conradt helped Martin deal with this situation" by calling a friend who was clerking for a judge "to help advise Martin on how to deal with his arrest." *Id.* ¶ 60. Conradt, his judicial clerk friend, Martin and the attorney who had provided Martin with the insider information then allegedly had a conversation in which they "discussed the best legal strategy and potential attorneys to hire for Martin." *Id.* This advice is (at best) analogous to the career advice that the Second Circuit found wanting in the *Newman* case. 773 F.3d at 452.

In *Newman*, the Department of Justice alleged that the first-level tippee provided the tipper with career advice on a "range of topics, from discussing the qualifying examination in order to become a financial analyst to editing [the tipper's] résumé and sending it to a Wall Street recruiter." *Id.* The

Second Circuit found that the "career advice" that was provided by the tippee to the tipper (which was more extensive than the one conversation regarding Martin's arrest that is alleged in this case) "was little more than the encouragement one would generally expect of a fellow alumnus or casual acquaintance." *Id*. at 453. In the words of the Second Circuit, "[i]f this was a 'benefit,' practically anything would qualify." *Id*. at 452.

Similarly, the fact that Martin belatedly "thanked Conradt for his prior assistance" and "told Conradt that he was happy that Conradt profited" from the trade he made based on the information Martin provided does not infer a *quid pro quo*. Am. Compl. ¶ 63. An individual thanking a roommate after-the fact for some friendly advice and telling the roommate he is happy the roommate profited from a trade the roommate made based on information the individual provided establishes a friendly roommate relationship – nothing more. *See* 773 F.2d at 452 (receipt of personal benefit is not proved by mere fact of friendship).[6]

Judge Rakoff ended this section of his opinion by stating that

> [m]ore generally, taking all the facts in the complaint as true and drawing all reasonable inferences in favor of the SEC, the Amended Complaint more than sufficiently alleges that Martin and Conradt had a meaningfully close personal relationship and that Martin disclosed the inside information for a personal benefit sufficient to satisfy the *Newman* standard.

2015 U.S. Dist. LEXIS 44732, at *15. But none of the other allegations made by the SEC adds any more substance to the relationship between Martin and Conradt than is set out above.[7] Nor do any of the allegations raise questions of fact over which reasonable minds could differ. In short, in allowing the SEC's action to proceed, Judge Rakoff ignores the clear holding of *Newman* that the allegations made by the SEC in this case, even if true, utterly fail to demonstrate "an exchange that is objective, consequential, and represents a least a potential gain of a pecuniary or similarly valuable nature." *See* 773 F.3d at 452.

A Little (Irrelevant) Knowledge Is Found to Go a Long Way

Having determined that the SEC's allegations sufficiently supported an inference of a personal benefit to Martin, Judge Rakoff then takes on the knowledge requirement – and again diverts from *Newman*.

As articulated by the Second Circuit in the *Newman* (criminal) proceeding, the "Government is required to prove beyond a reasonable doubt that [the remote tippees] knew that the insiders

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[6] And, as defendants noted in support of their motion to dismiss, this after-the-fact call "at an unspecified time after the announcement" does not cure the fact that "Martin's tip to Conradt occurred *before* the alleged 'legal strategy' discussion, and therefore cannot establish that Martin disclosed the [insider information] in return for the 'benefit' of that discussion." Defs' Second Memo at 11 n.4 (emphasis in original).

[7] The additional SEC allegations include that Martin and Conradt (*i*) "shared the apartment common space," (*ii*) "two to three times a week . . . ate dinner together and/or watched television," (*iii*) "discussed their professional and social lives," and (*iv*) "socialized outside of the apartment." Am. Compl. ¶ 56. The SEC also alleged that Conradt arranged certain repairs at the apartment involving a broken "buzzer," a ceiling leak and wall outlets. *Id*. ¶ 58.

received a personal benefit in exchange for disclosing confidential information." 773 F.3d at 453. As the Second Court further explained, the Government must prove that the tipper breached a duty by disclosing confidential information to a tippee in exchange for a personal benefit and that the "tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit." *Id.* at 450.

Judge Rakoff's analysis on the knowledge issue ties to a discussion of the distinction between criminal and civil insider trading proceedings:

> Sometimes . . . cases are criminal prosecutions, in which circumstance a court is obliged to define unlawful insider trading narrowly, so as to provide the fair notice that due process requires before a person may be placed in jeopardy of imprisonment. Other times . . . cases are civil proceedings . . . in which circumstance a court is inclined to define unlawful insider trading broadly, so as to effectuate the remedial purposes behind the prohibition of such trading.

2015 U.S. Dist. LEXIS 44732, at *3. He goes on to state that any tensions between the two types of proceedings

> can to some degree be mitigated by focusing on differences of intent. Specifically, while a person is guilty of criminal insider trading only if that person committed the offense "willfully," i.e., knowingly and purposely, a person may be civilly liable if that person committed the offense recklessly, that is, in heedless disregard of the probable consequences.

Id. at *3. With that distinction in mind, Judge Rakoff finds that the SEC's allegations that defendants "had knowledge of a benefit" are "sufficient to meet the civil standard of 'knowing or reckless.'" *Id.* at *16.

While Judge Rakoff may have appropriately parsed the distinction between criminal and civil intent, his finding that the allegations made by the SEC on the knowledge point are sufficient to meet the knowing or reckless standard is not consistent with the *Newman* standard. Acknowledging that the SEC does not allege that defendants "knew specifically about Conradt's help to Martin on the criminal charge," Judge Rakoff summarizes the SEC's allegations regarding defendants' knowledge as follows:

- Both defendants knew that Martin was the source of the tip to Conradt;
- Both defendants knew that Conradt and Martin were friends and roommates;
- One defendant (Payton) knew of Martin's assault arrest;
- One defendant (Durant) repeatedly asked Conradt if Martin had given him any more information, "indicating that [Durant] knew that Conradt and Martin had a close enough relationship that they would continue to exchange inside information"; and
- Conradt continued to provide defendants with more specific information about the acquisition.

Id. at **16-17. Judge Rakoff finds that these anemic allegations are "enough to raise the reasonable inference that the defendants knew that Martin's relationship with Conradt involved reciprocal benefits." *Id.* at *16.

In trying to distinguish the allegations in this case from *Newman*, Judge Rakoff states that, whereas the *Newman* defendants "'knew next to nothing' about the tippers, were unaware of the circumstances of how the information was obtained, and 'did not know what the relationship between the [tipper] and the first-level tippee was,'" in this case, the defendants "knew the basic circumstances surrounding the tip." *Id*. at *17 (quoting 773 F.3d at 453-54).

Contrary to Judge Rakoff's statement, however, it is hard to find a distinction between the level of knowledge of the defendants in this case and that of those in *Newman* as it relates to knowledge of a personal benefit. Even if the SEC's allegations regarding what the defendants in this case knew are true, none of the information they knew gave them any clue regarding whether Martin received a personal benefit for passing information on to Conradt. How would knowledge that Conradt and the Martin were friends and roommates and knowledge (by only one defendant in any event) that Martin had been arrested for assault lead anyone to infer that Martin received a personal benefit for passing on confidential information? And asking for (and receiving) more information from Conradt only confirms that the requesting defendant knew that Conradt and Martin were friends – not that there was a personal benefit passing from Conradt to Martin.

Judge Rakoff goes on to note that the SEC also alleged that, "[d]espite their market sophistication and their knowledge that Conradt learned the information from Martin, they did not ask Conradt why Martin shared the insider information or how Martin learned of it in the first place." 2015 U.S. Dist. LEXIS 44732, at **17-18 (citing Amended Complaint ¶ 70). Judge Rakoff finds that these allegations allow the court to draw an "adverse inference from their conscious avoidance of details about the source of the inside information and nature of the initial disclosure. *Id*. at *18. The same "conscious avoidance" argument was, of course, made regarding the defendants in *Newman*. *See* Pet. of the United States of America for Reh'g and Reh'g *En Banc* at 21, *United States v. Newman*, No. 1301837 (2d Cir. Dec. 23, 2014), ECF 279 ("a jury could infer" that "Newman and Chiasson consciously avoided learning of" facts that would have alerted them that the information on which they were trading was obtained from insiders or that "those insiders received [a] benefit in exchange for such disclosures"). And it was addressed by the Second Circuit. Allowing that information about a firm's finances "could be sufficiently detailed and proprietary to permit the inference that the tippee knew that the information came from an inside source," the Second Circuit found that

> where the financial information is of a nature regularly and accurately predicted by analyst modeling, and the tippees are several levels removed from the source, the inference that defendants knew, or should have known, that the information originated with a corporate insider is unwarranted.
>
> Moreover, even if detail and specificity could support an inference as to the *nature* of the source, it cannot, without more, permit an inference as to that source's improper *motive* for disclosure.

773 F.3d. at 455 (emphasis in original).

Judge Rakoff's analysis of the knowledge element is based on the very same faulted allegations that he found inferred a personal benefit and thus suffers from the same limitations. Put another way, even

if one assumes that all of the SEC's allegations regarding personal benefit are true and that Durant and Payton knew of each of these facts, they would know nothing that would tell them that there was a personal benefit passing to Martin as a *quid pro quo* for the information – because the allegations do not sufficiently allege a personal benefit. Such allegations "cannot, without more, permit an inference as to [the] source's improper motive for disclosure." [8]

Where Now?

As Judge Carter correctly observed in considering the effect of the *Newman* **d**ecision on the guilty pleas in this case: the *Newman* decision is part of a "meticulous and conscientious effort by the Second Circuit to clarify the state of insider-trading law in this Circuit." 2015 U.S. Dist. LEXIS 16263, at **3-4. Judge Rakoff does not appear to have gotten the same message; his decision is a step-backwards.[9]

While he purports to be following "those who must be obeyed," Judge Rakoff's basic disagreement with the "more onerous standard" set out in *Newman* filters through in his forced efforts to circumvent it. Perhaps the root of this disagreement can be gleaned from the first paragraph of his decision in this case, where he states that

> [a]s a general matter, there is nothing esoteric about insider trading. It is a form of cheating, of using purloined or embezzled information to gain an unfair trading advantage. The United States securities markets – the comparative honesty of which is one of our nation's great business assets – cannot tolerate such cheating if those markets are to retain the confidence of investors and the public alike.

2015 U.S. Dist. LEXIS 44732, at **1-2.

It is unlikely that any of us would quarrel with this sentiment – cheating and using purloined or embezzled information cannot be tolerated. But the focus must be on what makes a person a cheater or user of purloined or embezzled information. As the Second Circuit (citing *Chiarella v. United States*, 445 U.S. 222, 233 (1980)) has made clear, a tippee's liability is not derived from trading on material, non-public information: "the tippee's liability derives only from the tipper's breach of a fiduciary duty," which breach occurs when the tipper discloses "confidential information to a tippee in exchange for a personal benefit." 773 F.3d at 447, 450. And a tippee is liable only if he or she uses the information while knowing that the "information was confidential and divulged for personal benefit." *Id.*

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[8] Judge Rakoff also points to the "multiple steps to conceal their own trading" that were allegedly taken by the defendants as "further evidence of defendants' knowledge that the inside information was the product of a breach of duty." 2015 U.S. Dist. LEXIS 44732, at *18. As noted by the defendants in their motion to dismiss argument, these after-the-fact allegations say nothing about the defendants "mental state at the time of the trades." Defs' Second Memo at 18. Moreover, whatever defendants may have done after the fact cannot create a personal benefit if there was none.

[9] Indeed, Judge Rakoff states that, because Congress has failed to take action to define insider trading, "courts must proceed on a case-by-case basis." 2015 U.S. Dist. LEXIS 44732, at *2. But, this is precisely what the Second Circuit was trying to avoid by clarifying the benefit and knowledge elements in *Newman*.

To ignore these elements or give them short shrift by allowing largely irrelevant allegations to suffice to establish the requisite personal benefit to the tipper and knowledge of the tippee of the personal benefit is to edge closer to a "parity-of-information" standard whereby traders would have to refrain from trading whenever they had material, non-public information. The Second Circuit has clearly confirmed that there is no parity-of-information standard; a tippee is not required to refrain "from trading 'whenever he receives inside information from an insider.'" 773 F.3d at 446 (quoting *Dirks*, 463 U.S. at 655).

Some might argue that Judge Rakoff's ruling, even if not consistent with *Newman,* is not that big a deal – it is only a ruling on a motion to dismiss. Defendants will have an opportunity to counter the inferences he has drawn in summary judgment motions and, if they do not prevail, at a trial. Ultimately they will be able to appeal any adverse decision to the Second Court.

But all of this "opportunity" comes at very great expense.

Both of the defendants in this case originally appeared pro se in this civil proceeding. *See* July 22, 2014 Transcript at 2. One of them was represented by Federal Defenders of New York in the criminal proceeding, *id*. at 5, and the other was represented by Criminal Justice Act Counsel, *id*. at 6. While defendants were represented by prominent law firms in their motions to dismiss before Judge Rakoff, we can only hope that those attorneys will be involved in the on-going proceedings and will stay the distance of an appeal. And even aside from the monetary expense, there is the personal toll that will be taken by years of litigation if they choose to defend themselves.

The unfortunate outcome of Judge Rakoff's decision may be to force two individuals who have not engaged in any wrongdoing under the prevailing standard to choose between spending the next few years of their lives (and whatever savings they have) battling with the SEC in court (with or without counsel) or settling a matter even though they committed no wrong. It is unfortunate that they must face such a decision.