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Hedge Fund Lawyers Unsure How To Comply With Newman

By **Stephanie Russell-Kraft**

Law360, New York (April 20, 2015, 3:03 PM ET) -- While hedge fund managers may have initially seen the Second Circuit's landmark Newman decision on insider trading as a victory, the ruling's fallout has since left their compliance attorneys uncertain about what sort of trading activity is legal and what isn't.

The appellate court's U.S. v. Newman ruling, which in December reversed the convictions of two hedge fund managers, certainly raised the bar for prosecutors to prove illegal insider trading. The court found that in order to establish liability, the government must show a tipper received a significant personal benefit for the tip and that the tippee knew about the benefit.

But attorneys who counsel hedge funds say the fallout from the ruling is starting to suggest that the change in insider trading law isn't as cut-and-dried as they may have originally thought. In other words, compliance officers shouldn’t be too quick to start changing firm policies, according to Sam Lieberman, partner at Sadis Goldberg LLP.

"It's a little hard to tell clients that Newman will provide them with certainty that there's a higher standard for personal benefit," Lieberman said. "I can advise them that it's a requirement that it be more meaningful, but it's hard to tell them that, unless it's a tangible financial benefit, they're in the clear."

One phrase in particular has given both prosecutors and defense attorneys the most trouble. According to the Second Circuit opinion, a personal benefit cannot be based on friendship unless that friendship "generates an exchange that is objective, consequential and represents at least a potential gain of a pecuniary or similarly valuable nature."

At a panel event on securities litigation and enforcement in Manhattan on Thursday, Sullivan & Cromwell LLP partner Steven Peikin joined Assistant U.S. Attorney Katherine R. Goldstein in expressing frustration over the Second Circuit’s lack of clarity. The word "consequential," he said, has been the most difficult not only to understand but explain to his clients.

"I have no idea what that means," he said.

Marc Elovitz, head of the regulatory compliance group in Schulte Roth & Zabel LLP's hedge fund practice, told Law360 the term raises "real ambiguity." Before the Second Circuit's decision, he might have argued that the benefits alleged in the Newman insider trading case itself were consequential, he said.

And Lieberman, who felt confident he understood that language when the Second Circuit's opinion was published, said he has since come to fear the degree to which U.S. Department of Justice prosecutors and the U.S. Securities and Exchange Commission might still "chip away" at it.

"It may not have the impact that we hoped it did," he said.

Lieberman pointed to two recent decisions in New York's Southern District that have added to the uncertainty about the decision.

In March, U.S. District Judge Valerie Caproni **declined to reverse** the insider trading conviction of former Foundry Networks Inc. executive David Riley because he had obtained "concrete" benefits in exchange for tips about the computer equipment company. The Second Circuit did not specifically rule that maintaining a friendship could not be circumstantial evidence that the tipper and tippee had a "quid pro quo relationship," Judge Caproni said.

Earlier this month, **U.S. District Judge Jed Rakoff ruled** that two former brokers accused of trading on inside information about a $1.2 billion IBM Corp. acquisition must face civil charges despite the fact that they were freed of the criminal charges against them in January when a court ruled the government's charges didn't meet Newman's heightened standard.

The civil charges, which were brought by the SEC, face a lower standard of evidence. But some hedge funds see the discrepancy between the two cases as another sign of uncertainty.

"These are examples of district court judges going out of their way to stretch Newman to give the government a chance to move forward on personal benefit in a way that you may not have expected after reading [the decision]," Lieberman said.

From a compliance perspective, rulings like Rakoff's in the wake of Newman has only emphasized and highlighted the uncertainties in the realm of insider trading, according to Elovitz.

"Talk about uncertainty," Elovitz said. "The criminal case goes away and the SEC case is allowed to proceed. That doesn't help you organize your business."

When his clients ask him about the impact of Newman, Elovitz said he hasn't been able to tell them how much specifically has changed. Hedge fund managers won't be changing their compliance strategies until there is a much greater degree of clarity, he added.

"There's no shorthand that you can use when dealing with these issues," Elovitz said.

David Miller, partner at Morgan Lewis & Bockius LLP and former assistant U.S. attorney in New York's Southern District, said the Newman ruling definitely made it more difficult to prosecute tippees and that it will likely result in fewer criminal insider trading cases being brought in the future.

Nevertheless, he has cautioned clients not to see the language in the opinion as any sort of loophole for their compliance programs.

"I think in the insider trading area, it behooves clients to be cautious in their activities regardless of the personal benefit language," Miller said.

Lieberman said he takes a similar approach with his own hedge fund clients.

"The best guidance that we end up giving is that if it's a close call, avoid trading," he said. "It's just not worth the regulatory risk."

--Additional reporting by Max Stendahl and Cara Salvatore. Editing by John Quinn and Katherine Rautenberg.
