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In The Peak Of A Hedge Fund Asset Crisis, The Supreme Court Might Have Just "Broke The Camel's Back" For Investor Confidence In Hedge Funds

By Alvaro Pereira, L.L.M. Candidate 2016 | November 13, 2015

The Supreme Court rejected the petition for certiorari in *United States v. Newman* last month—a case about insider trading. In so doing it reaffirmed the Second Circuit Court of Appeals' decision, which held that liability for insider trading requires proof of (1) that the discloser received a personal benefit, and (2) that the person receiving the information ("tippee") knew about that benefit. This position not only troubles prosecutors in current insider trading cases and investigations, but is also likely to intensify the current hedge fund asset crisis by calling the credibility of the whole system into question among investors.

In a jury trial in the Southern District of New York, federal prosecutors presented evidence that Todd Newman and Anthony Chiasson (among others) were involved in insider trading. Pursuant to the evidence, it was found that these hedge fund managers received financial information from insiders about Dell and NVIDIA before that information was made available to the public—allowing them to earn millions of dollars in trades during the 2008 fiscal year. Accordingly, they were convicted in 2013 for conspiracy to commit insider trading.

The verdict was a red flag on Wall Street because it allowed a conviction with a reduced burden of proof for insider trading from the previous standard set forth in *Dirks v. SEC*. According to the Government (and the District Court), it is sufficient proof that the insider breached a duty when there is evidence that the information was used by the tippee—not that the tippee new there was some kind of personal benefit to the discloser.

Nevertheless, in December 2014, the Second Circuit Court of Appeals reversed the decision for lack of evidence that the tippee knew of a personal benefit to the discloser. The Court's opinion "prompted the dismissal of cases against five people, including four who had pledged guilty". However, the residual effects of the decision were felt beyond those specific cases.

Hedge funds experienced the biggest decline in assets since the financial crisis of 2008 as a result of investors' fears that proving insider trading would be more difficult in light of the Second Circuit's increased standard of proof called for in *Newman*.

Although currently the hedge fund asset crisis is primarily linked to market volatility, there are reasons to believe that the Second Circuit decision exacerbated the crisis. For investors, a system that relies on who can access insider information is less beneficial than one that rewards smart movements in equal conditions. These practices are, in fact, the cornerstone for market instability.

The Supreme Court had the last word in this matter and a unique opportunity to restore the trust of investors because this case allowed it to reformulate the doctrine for inside trading. It could have taken the opportunity to restore the standard to one that made it easier for prosecutors to

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prove insider trading and make investors more confident such scrupulous business practices would be rooted out.

Nevertheless, the high Court rejected the petition for certiorari without comment, creating what U.S. Attorney Preet Bharara calls "an obvious roadmap for unscrupulous investors."