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Expert Analysis

'Salman': Supreme Court to Examine 'Personal Benefit' for Tipping Liability

By **Margaret A. Dale**

And **Mark D. Harris**

In recent years, both the Securities and Exchange Commission and the Department of Justice have become highly aggressive in their efforts to combat insider trading, leading to many high-profile victories as well as a few losses. Increasingly, so-called "remote" tippees who are several levels removed from the corporate insider, or tipper, have become targets of these enforcement actions. The standards for deciding when a remote tippee is permitted to trade in nonpublic market information, however, are still unsettled. A few weeks ago, the U.S. Supreme Court agreed to review the Ninth Circuit's decision in *United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015), on the question of what type of "personal benefit" to the corporate insider is necessary to establish a claim for insider trading. *Salman v. United States*, — S. Ct. —, 2016 WL 207256, at *1 (2016) (No. 15-628). In all likelihood, the Supreme Court's decision will have a profound impact on future prosecutions of insider-trading cases.

Liability Under 'Dirks v. SEC'

In the seminal Supreme Court case of *Dirks v. SEC*, 463 U.S. 646 (1983), the court laid out the contours of tipping liability for insider trading under the antifraud provisions of the federal securities laws. The court began by reaffirming its prior decisions that the duty to refrain from trading on material nonpublic information arises from the existence of a fiduciary relationship between the corporate insider and the company, not from the mere possession of such information. To hold otherwise, the court explained, would "amount to recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information." Id. at 655 (internal quotations omitted).

The court specifically rejected the SEC's position that a tippee "inherits" an insider's fiduciary duty simply by virtue of receiving insider information. Id. at 655-56.[1] Agreeing that some tippee trading should be prohibited, the court explained that an insider who is forbidden from personally using material nonpublic information to the insider's advantage is also barred from providing that same information to an outsider for personal gain. Likewise, transactions by those who "knowingly participate with the fiduciary in such a breach" are as forbidden as those on behalf of the fiduciary himself. Id. at 659. In these ways, a tippee's duty—whether to disclose or abstain from trading—is derivative of the insider's duty. Id.

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The test for a violation of that duty is whether the insider will derive some personal benefit—direct or indirect—from the tip, for without some gain, there is no breach. Id. at 662. This test requires courts to focus on "objective criteria," such as whether the corporate insider receives a monetary advantage or other benefit, such as reputational, that can result in future earnings. Moreover, certain facts and circumstances justify such an inference, such as "a relationship between the insider and the recipient that suggests a quid pro quo from the latter," or also when the "insider makes a gift of confidential information to a trading relative or friend" such that the "tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient." 463 U.S. at 663-64.

Decision in 'U.S. v. Newman'

In *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), the U.S. Court of Appeals for the Second Circuit tackled the question of how to apply the standard for "personal benefit." The case involved a group of analysts at hedge funds who obtained material nonpublic information from employees at publicly traded companies, and then shared that information with each other and with portfolio managers at their companies. Id. at 443. Todd Newman and Anthony Chiasson, the two defendants charged, were portfolio managers who received that information from a chain of analysts at different firms, and then traded on it. Id. Thus, Newman and Chiasson were three or four levels removed from the original tipper and the first tippee, and there was no evidence that either was aware of the source of the inside information. Id.

The U.S. Attorney's Office for the Southern District of New York maintained that Newman and Chiasson were criminally liable because, as sophisticated traders, they "must have known that information was disclosed by insiders in breach of a fiduciary duty." Id. at 443-44.[2] Both Newman and Chiasson were found guilty on all counts.

To the surprise of many observers, the Second Circuit reversed the convictions. The court began by emphasizing that under *Dirks*, a "tippee's liability derives only from the tipper's breach of a fiduciary duty," and that the corporate insider (or tipper) has committed no breach unless

MARGARET A. DALE *and* MARK D. HARRIS *are partners in Proskauer's litigation department.* MASSIEL PEDREIRA, *an associate at the firm, assisted in the preparation of this article.*

a personal benefit is received in exchange for the tip. Id. at 447. While recognizing that the standard for a personal benefit is "permissive," the court rejected the argument that proof of any casual friendship or social relationship (as existed between the insider and the tippee in that case) would suffice. Id. Were that so, "practically anything would qualify." Id. at 452. Rather, the relationship must be significant enough that the exchange of the tip is "objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." Id.

The government contended that the Newman decision would "dramatically limit [its] ability to prosecute some of the most common, culpable, and market-threatening forms of insider trading."[3] It unsuccessfully sought reconsideration and rehearing en banc, and then review by the Supreme Court, but all were denied.

Decision in 'U.S. v. Salman'

Six months after *Newman*, the U.S. Court of Appeals for the Ninth Circuit reached a very different conclusion when it affirmed a conviction for insider trading and conspiracy in *United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015). In that case, the government alleged that the tipper, an investment banker, provided material nonpublic information to his older brother, a broker, about upcoming mergers and acquisitions of the bank's clients. Id. at 1089. The brother, in turn, began to share the information with Bassam Yacoub Salman, whose sister had become engaged to and then married the original tipper. Id. The brother encouraged Salman to "mirror image" his trading activity based on the information provided by the tipper.[4]

The government presented evidence at trial that Salman knew that the information had originated from the tipper, and that Salman and the brother had "agreed" to protect the tipper by destroying evidence of their trading. Id. Additionally, the government showed that the tipper and his brother enjoyed a "close and mutually beneficial relationship," with the brother paying for the tipper's college tuition and standing in for their father at the tipper's wedding to Salman's sister. Id. At trial, the tipper testified that he provided the information to his brother to "benefit him" and to "fulfill whatever needs he had." Id. at 1089.

Based on this evidence, a jury found Salman guilty on all counts. Salman appealed, urging the Ninth Circuit to adopt *Newman* and hold that the government's evidence was insufficient to find that the tipper disclosed the information to his brother in exchange for a personal benefit; or, if he did, that Salman was not aware of the benefit.[5] Id. at 1090.

The Ninth Circuit affirmed the conviction. After articulating the test for tippee liability and defining what constitutes a "personal benefit," the court zeroed in on a line from *Dirks* itself, where the Supreme Court stated that "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." 792 F.3d at 1092 (citing *Dirks*, 464 U.S. at 663-64) (emphasis added). In the Ninth Circuit's view, the tipper's disclosure of material nonpublic information to his brother, knowing that the latter intended to trade on it, was exactly the kind of "gift" to a "trading relative" that *Dirks* anticipated. Id.

> The Supreme Court could harmonize 'Newman' and 'Salman,' drawing a distinction between the tippers and defendants in 'Newman,' who were three or four levels removed from each other, and had (in the Second Circuit's view) weak ties to one another, and the tipper and the defendant in 'Salman,' who were members of a close extended family.

The court conceded that *Newman* should not be "lightly ignore[d]." Id. But it rejected the Second Circuit's decision to the extent it held that in the context of a friendship or familial relationship, there must be evidence of a specific, tangible benefit to be gained by the tipper. Id. at 1093. If, as Salman argued, direct evidence that the disclosure of information was intended as a "gift" was insufficient, then "a corporate insider or other person in possession of confidential and proprietary information would be free to disclose that information to her relatives, and they would be free to trade on it, provided that [the tipper] asked for no tangible compensation in return." Id. at 1094. In the Ninth Circuit's view, that could not be the law.

The Supreme Court

The Supreme Court agreed to review the following question in *Salman*:

> Does the personal benefit to the insider that is necessary to establish insider trading under *Dirks v. SEC*, require proof of "an exchange that is objective, consequential, and represents at least a potential gain of pecuniary or similarly valuable nature," as the Second Circuit held in *United States v. Newman*, or is it enough that the insider and the tippee shared a close family relationship as the Ninth Circuit held in this case?

Pet. for Writ of Cert. in Salman v. United States, — S. Ct. — (No. 15-628).[6]

There has been much speculation as to why the Supreme Court agreed to review *Salman* after turning down *Newman* only a few months earlier. Perhaps it took the creation of an explicit conflict between the Second and Ninth Circuits to persuade the court to intervene. It is also possible that the court questioned *Salman's* holding while agreeing broadly with *Newman's*. Then again, the court could harmonize the two decisions, drawing a distinction between the tippers and defendants in *Newman*, who were three or four levels removed from each other, and had (in the Second Circuit's view) weak ties to one another, and the tipper and the defendant in *Salman*, who were members of a close extended family. Whatever the outcome, the Supreme Court's decision will surely be dissected by prosecutors and defense counsel alike and influence the future of insider-trading enforcement actions and prosecutions for years to come.

1. The court also noted that to impose a duty to disclose or abstain in all cases could have an "inhibiting influence on the role of market analysts," who commonly "ferret out and analyze information" and whose role the SEC has recognized as necessary to the preservation of a healthy market. 463 U.S. at 658. *Newman* echoed that point.

2. The district court declined to instruct the jury that it must find that the defendants knew of the personal benefit received by the insiders, notwithstanding supporting language in *Dirks*, because it believed that the Second Circuit held that such knowledge was not an element of the offense. *Newman*, 773 F.3d at 444. The Second Circuit rejected that interpretation of its precedent, and held that the requisite proof of the defendants' knowledge was insufficient.

3. Pet. for Reh'g and Reh'g En Banc, *United States v. Newman*, 2015 WL 1064423, at *3.

4. Instead of trading in his own account, Salman arranged to deposit money through a series of transactions into an account held in the name of his wife's sister and her husband. 792 F.3d at 1089. Salman would pass the tips he received to the husband who would then trade in the account. Id.

5. While Salman's appeal was pending, the Second Circuit decided *Newman*. The Ninth Circuit permitted Salman to file a supplemental brief raising *Newman*. Id. at 1090.

6. The court declined to review a second question involving the definition of willful blindness.