Proskauer

Insider Trading for Dummies: Judge Rakoff Tries to Simplify the Law

Corporate Defense and Disputes Blog on **December 10, 2018**

A lot of ink has been spilled over the crime of insider trading, which – in the view of U.S. District Judge Jed Rakoff – "is a straightforward concept that some courts have managed to complicate." In his recent decision in *United States v. Pinto-Thomaz* (S.D.N.Y. Dec. 6, 2018), Judge Rakoff attempts to simplify insider-trading law by returning to its roots: embezzlement, and use of stolen property.

According to Judge Rakoff, "insider trading is a variation of the species of fraud known as embezzlement," in which someone else's property – material confidential information – is taken and either used by the embezzler for his or her own benefit or passed on to a third party who knows that the property was stolen, but nevertheless uses it to buy or sell securities. This formulation of the violation avoids an issue that has bedeviled courts in recent years: whether the initial discloser of the confidential information received a "personal benefit" from the disclosure and, if so, whether that benefit was sufficient to sustain a violation of the securities laws.

In Judge Rakoff's view, liability should turn on the *purpose* for which the confidential information was used or disclosed. The user or discloser can be liable if he or she acted "for personal advantage," but not if he or she acted for "a corporate or otherwise permissible purpose."

Whether courts will gravitate toward this simple standard remains to be seen. The Supreme Court had an opportunity to adopt such a test in its most recent insider-trading case – *United States v. Salman* (2016) – but it did not do so (although it did not reject the test, either).

The Personal-Benefit Standard

Insider-trading liability under the Securities Exchange Act of 1934 arises only if securities are bought or sold on the basis of material, nonpublic information used or obtained in breach of a fiduciary duty or a duty of trust or confidence owed to the shareholders of the issuer or to the source of the information. Under current case law, that breach of duty depends on whether the misappropriator received a personal benefit from using or providing the information.

The "personal benefit" standard first arose in the Supreme Court's 1983 decision in *Dirks v. SEC* and was fleshed out in subsequent rulings in the *Newman*, *Salman*, and *Martoma* cases.

- ***Dirks.*** The *Dirks* case established the framework for tippee liability. The Supreme Court held that a tippee's liability derives from the liability of his or her tipper – and that a tipper breaches a fiduciary duty by disclosing confidential information only if he or she benefits directly or indirectly from the disclosure. The Court gave examples of such a personal benefit, including "a pecuniary gain," "a reputational benefit that will translate into future earnings," "a relationship between the [tipper] and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient," or "a gift of confidential information to a trading relative or friend" where "[t]he tip and trade resemble trading by the [tipper] himself followed by a gift of the profits to the recipient."
- ***Newman.*** In 2014, the Second Circuit announced a more rigorous construction of *Dirks*'s personal-benefit requirement. The court ruled in *United States v. Newman* that, to the extent "a personal benefit may be inferred from a personal relationship between the tipper and tippee," rather than from a direct *quid pro quo*, "such 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."
- ***Salman.*** Two years later, the Supreme Court decided *Salman v. United States* (2016), which involved a family relationship. The tipper had allegedly provided confidential business information to his brother, and the brother had then tipped Salman (the trader), whose sister had become engaged to and later married the original tipper. The Court reemphasized *Dirks*'s holding that "a tipper breaches a fiduciary duty by making a gift of confidential information to 'a trading relative'" and added: "when a tipper gives inside information to 'a trading relative or friend,' the jury can infer that the tipper meant to provide the equivalent of a cash gift." The Court rejected Salman's reliance on *Newman* for the proposition that the tipper must receive an objective, consequential personal benefit representing an actual or

potential pecuniary gain. Rather, the Court held that, "[t]o the extent the Second Circuit held that the tipper must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift to family or friends, . . . this requirement is inconsistent with *Dirks*."

- ***Martoma*.** In the aftermath of *Salman*, the Second Circuit returned to tipper/tippee liability in 2017 and 2018 in *United States v. Martoma*, which involved a hedge-fund analyst who had received material nonpublic information about drug trials from a doctor involved in those trials. In a 2-to-1 decision, the majority held that *Salman* not only had rejected *Newman*'s requirement of a "pecuniary or similarly valuable" personal benefit, but also had undermined that case's requirement that the tipper and tippee share "a meaningfully close personal relationship" (an issue not presented in *Salman*, where clear familial relationships had existed). The majority later retreated a bit in an amended decision and ruled that, "because there are many ways to establish a personal benefit, we conclude that we need not decide whether *Newman*'s gloss on the gift theory is inconsistent with *Salman*." The requisite relationship can be established by proving "either [*i*] that the tipper and tippee shared a relationship suggesting a *quid pro quo* or [*ii*] that the tipper gifted confidential information with the intention to benefit the tippee." Neither of those two scenarios requires proof of "any type of personal relationship."

Judge Rakoff's *Pinto-Thomaz* Decision

In Judge Rakoff's view, all of this judicial hand-wringing about personal benefits and tipper/tippee relationships is unnecessary and unproductive. The Supreme Court recognized in *United States v. O'Hagan* (1997) that undisclosed misappropriation of material, nonpublic information, "in violation of a fiduciary duty, . . . constitutes fraud akin to embezzlement – the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another." And, adds Judge Rakoff, "if the embezzler, instead of trading on the information himself, passes on the information to someone who knows it is misappropriated information but still intends to use it in connection with the purchase or sale of securities, that 'tippee' is likewise liable, just as any knowing receiver of stolen goods would be. It is just that simple – or, conceptually, should be."

Judge Rakoff surveys the case law starting with *Dirks* and concludes that the Supreme Court did not mean to suggest that "'personal benefit' consisted of any particular type of benefit, but only that it was a benefit grounded in using company information for personal advantage, as opposed to a corporate or otherwise permissible purposes (such as whistleblowing)" – as was the situation in *Dirks*. "While use of the term 'personal purpose' or 'personal advantage,' rather than 'personal benefit,' could perhaps have averted subsequent confusion, *Dirks* was quite clear as to the wide breadth of its understanding of a personal benefit."

Analysis

Judge Rakoff's articulation of a purpose test – personal purpose vs. corporate purpose – does appear to simplify the analysis and would avoid some of the philosophical gymnastics that have enlivened insider-trading law (such as whether wine, live lobsters, steak dinners, massage parlors, or college friendships can constitute the requisite "personal benefit"). But will it work?

The Government had proposed such a test in *Salman*, when it urged the Supreme Court to adopt a broad distinction between disclosure for corporate purposes and disclosure for noncorporate purposes – and to hold that any disclosure for a noncorporate purpose satisfies *Dirks.* But the Court did not bite. It unanimously applied the *Dirks* standard and affirmed Salman's conviction.

The fact that the Court did not reconsider the *Dirks* test in *Salman* does not necessarily mean that the Court disagreed with the standard that the Government had proposed. Perhaps the Court simply saw no need to rethink *Dirks* in order to decide the case before it. Perhaps the desirability of a unanimous decision outweighed any potential inclination to tinker with longstanding precedent. Other possibilities also exist. And, of course, the Court did not overtly *reject* the Government's proposal.

But any court tempted by Judge Rakoff's corporate-purpose test might need to grapple with the Supreme Court's sidestepping that argument in *Salman* and the Court's unanimous reiteration of the *Dirks* standard. We will see how other courts react to the *Pinto-Thomaz* decision in the future.

View Original