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Insider Trading

In *Salman v. United States*, the Supreme Court recently held that the personal benefit element in an insider trading case can be met solely by showing that a tipper gifted confidential information to a trading friend or relative. The opinion reaffirmed the Court's holding in *Dirks v. SEC* that a tippee isn't liable for trading on inside information unless he participated in some way in the tipper's breach of his fiduciary duty, which occurs where the tipper discloses confidential information in exchange for a personal benefit. Attorneys from Patterson Belknap say that *Salman* rejects the Second Circuit's holding in *United States v. Newman* that the personal benefit element could not be satisfied where a tipper gifts inside information without also receiving something of a pecuniary or similarly valuable nature in return. The lawyers say, however, that the Court's opinion emphasizes that the personal benefit element requires a fact-based inquiry that is not always easily met, indicating that defense attorneys and prosecutors should not give light treatment to the issue in tippee cases where inside information was gifted by tippers.

Supreme Court in *Salman* Says: "This One Is Easy," Reaffirming *Dirks* and Rejecting *Newman*

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The U.S. Supreme Court (Alito, J.) issued a unanimous decision Dec. 6, affirming the Ninth Circuit's decision in *Salman v. United States*, 85 U.S.L.W. 4015, 2016 BL 404946 (U.S. Dec. 6, 2016), an insider trading case concerning tippee liability.

The Court held that the personal benefit element in an insider trading case could be met solely by showing that a tipper had gifted confidential information to a trading friend or relative.

In arriving at that conclusion, the Court ruled that the Second Circuit had misconstrued the Supreme Court's decision in *Dirks v. SEC*, 463 U.S. 646 (1983), when it held in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), that the personal benefit element could not be established based on a gift of confidential information to a trading friend or relative without additional evidence showing an exchange that is ''objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.''

There was much speculation when the Court denied certiorari in *Newman* but granted it in *Salman*, and some believed that this indicated that the rule of *Newman* soon would be law of the land. In fact, it is Judge Jed S. Rakoff's opinion (sitting by designation) from the Ninth Circuit that will now be law of the land, including in the Second Circuit.

Salman is very important to those who practice in the areas of securities law or white-collar defense, as it answers what most believed to be an unresolved question. The Court's opinion makes clear that, in its view, the right answer to the question presented was never in doubt, given the prior holding in *Dirks*.

Uncomplicated Facts

The facts of *Salman* are uncomplicated. The evidence at trial established that Maher Kara, a former investment banker at Citigroup, repeatedly shared with his brother, Mounir ''Michael'' Kara, highly confidential information about mergers and acquisitions involving Citigroup clients. *Salman* at *3. With Maher's knowledge, Michael then traded on the information that he received from his brother. *Id.*

Unbeknownst to Maher, Michael also passed the inside information on to other individuals, including Bassam Salman, who was Michael's friend and Maher's brother-in-law. *Id.* at *4. Salman traded on the information, collecting more than $1.5 million in profits, and was eventually indicted on charges of conspiracy to commit securities fraud and securities fraud. *Id.*

At trial, the evidence showed that Maher and Michael had a ''very close relationship'' in which Michael was like ''a second father'' to his brother. *Id.* Maher testified at Salman's trial that he shared confidential information with Michael to benefit him, expecting that his brother would trade on the information. *Id.*

Michael testified at the trial that he became friends with Salman during the period when Maher was courting Salman's sister, and he also testified that he told Salman that Maher was the source of the inside information. *Id.* Salman was convicted on all counts. *Id.*

Salman appealed to the Ninth Circuit, arguing that his conviction should be reversed based on the Second Circuit's decision in *Newman*.

In *Newman*, the Second Circuit acknowledged that under the Supreme Court's decision in *Dirks*, a jury could infer that a tipper received a personal benefit when he or she ''makes a gift of confidential information to a trading relative or friend.'' However, the Second Circuit had held that such an inference was ''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.'' *Newman*, 773 F.3d at 452.

Salman argued on appeal that his conviction should be reversed because there was no evidence that Maher had received anything of ''a pecuniary or similarly valuable nature'' in exchange for the information or that Salman had known of any such benefit. *Salman* at *5. The Ninth Circuit rejected the argument based on *Newman* and held that, under *Dirks*, the personal benefit requirement could be established solely by virtue of the tipper making a gift of confidential information to a trading relative or friend. *Id.*

The Supreme Court granted certiorari to resolve the tension between the Ninth Circuit's decision and *Newman*.

The Supreme Court's decision affirmed the Ninth Circuit. The decision was unanimous and rendered in a brisk 12 pages.

Straightforward Issue

The Court found the issue—over which so much ink in the legal press has been spilled—to be straightforward, noting that *Dirks* ''easily resolves the narrow issue'' presented on appeal. *Id.* at *6.

The Court opined that *Dirks* explained that a tippee would be exposed to liability for trading on inside information only if the tippee participated in a breach of the tipper's fiduciary duty. *Id.*

Whether the tipper breached a fiduciary duty depended, in turn, largely on the purpose of the disclosure to the tippee, and in particular on whether the insider

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personally benefited, either directly or indirectly, from the disclosure. *Id.*

The Court noted that *Dirks* made clear that a personal benefit could be shown ''when an insider makes a gift of confidential information to a trading relative or friend.'' *Id.* at *7. In such instances, the ''tip and trade resemble trading by the *insider* followed by a gift of the profits to the recipient.'' *Id.* (emphasis added).

By analogy, the Court observed that ''Maher would have breached his duty had he personally traded on the information here himself then given the proceeds as a gift to his brother'' and ''[i]t is obvious that Maher would personally benefit in that situation.'' *Id.* Maher ''effectively achieved the same result by disclosing the information to Michael, and allowing him to trade on it.'' *Id.*

The Court concluded that the Second Circuit's *Newman* decision had misconstrued *Dirks* to the extent that it held that a tipper ''must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift to family or friends.'' *Id.* at *7 and *8.

The Supreme Court also rejected Salman's contention that *Dirks*'s standard regarding gifts was unconstitutionally vague as applied to his case. *Id.* at *8.

The Court characterized *Dirks* as creating ''a simple and clear 'guiding principle' for determining tippee liability,'' and it noted that the facts giving rise to this case were ''in the heartland of *Dirks*'s rule concerning gifts.'' *Id.*

The Court did acknowledge, however, that the fact issue of whether an insider personally benefits from a particular disclosure ''will not always be easy for courts.'' *Id.*

While the Supreme Court's decision in *Salman* overrules the Second Circuit's *Newman* decision in part, it leaves other aspects of the decision intact.

The Court did overrule *Newman*'s holding that a tipper's gift of inside information to a trading friend or relative was insufficient to establish the personal benefit element absent ''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.'' *Newman*, 773 F.3d at 452. This complicated formulation will no longer be the legal standard for whether there has been a breach of a fiduciary duty.

But as the Court noted, the Second Circuit also reversed the *Newman* defendants' convictions because the Government failed to introduce evidence showing that the defendants knew that the information they traded on came from insiders and that the insiders had received a personal benefit in exchange for the tips. *Salman* at *9 n.1. The Court explained that *Salman* did not involve those issues.

This observation may explain why the Court declined to grant certiorari in *Newman* back in October 2015—the Court's ruling would not have been outcome determinative because the Second Circuit's reversal was based on several alternative grounds. In other words, even if the Supreme Court had granted certiorari and reversed the Second Circuit on the legal standard in *Newman*, the defendants in *Newman* still would have been not guilty of insider trading. Therefore, this aspect of *Newman*—which complicates the charging of remote tippee cases—continues to limit the reach of insider trading liability.

Personal Benefit Framework

The Court briefly addressed (in a footnote) the question of whether the ''personal-benefit framework'' established in *Dirks* applies not only in insider trading cases brought under the classical theory (like *Dirks*, where an insider or his tippee trades in the securities of the insider's corporation), but in misappropriation cases where a person steals such information in breach of a duty owed not to the corporation but to the source of the information (often an employer or client). *Id.* at n.2.

Because the parties did not dispute the application of the personal-benefit framework to this case, the Supreme Court did not resolve this question. *Id.* This leaves open the possibility that a different test from *Dirks* could apply in the misappropriation context.

The Court's decision in *Salman* also demonstrates that defense attorneys and the government should not give light treatment to the personal benefit requirement in tippee cases.

As the Court acknowledged, whether a tipper received a personal benefit is a fact-based inquiry that ''will not always be easy for courts.'' *Id.* at *8.

Even though *Newman*'s legal standard will not govern, the decision still stands as a reminder to those who practice in this area that the need for the tipper to receive a benefit is not an empty formalism, but an essential element of liability in tippee cases that may not always be satisfied.

Finally, because it found this case to be squarely within the heartland of *Dirks*, the Court did not need to address the Government's argument that a ''gift of confidential information to *anyone*, not just a 'trading relative or friend,' is enough to prove securities fraud.'' *Id.* at *6 (emphasis added).

However, the Court's discussion of *Dirks* suggests that the Court left open the possibility that such a case might fall within the scope of that decision's reasoning.

As the Court noted, the personal benefit requirement is met where an insider gifts confidential information to a trading relative or friend because the trade and tip are akin to a situation in which the tipper trades on the inside information and gifts the proceeds to the friend or relative.

The Court did not address why that analogy should be limited to gifts to friends or relatives, rather than gifts made to any person. By not resolving this big question, the Court avoided giving additional guidance to litigants and attorneys.

The Supreme Court's jurisprudence in this area has always taken steps to prevent the mere trading on nonpublic information, standing alone, from being a violation of law. But given the uncertainty that remains in this area of law, clients should act very carefully and avoid trading based on nonpublic information in order to avoid being the next test case for prosecutors.