

Report from Washington

Salman v. United States: Supreme Court Considers the Scope of Tipper/Tippee Liability Under the Securities Exchange Act of 1934

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Introduction

“[W]e all have our own interests and purposes behind giving gifts. Some of those might be very practical and pragmatic. Some of them might be more altruistic. But we give gifts for individual interests and purposes. . . . It’s the exact opposite of using corporate information for corporate purposes. I’m using it for my own personal purposes.”

– Justice Kagan

The Supreme Court heard oral arguments last week, on October 5, 2016, in *Salman v. United States*, No. 15-628, a case requiring the Court to answer a question at the center of many insider trading prosecutions: whether the personal benefit necessary to establish liability under *Dirks v. SEC*, 463 U.S. 646 (1983) requires proof of “an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature,” as the Second Circuit held in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), *cert. denied*, No. 15-137 (U.S. Oct. 5, 2015), or only that the insider and the tippee shared a close family relationship, as the Ninth Circuit held in this case, *United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015), *cert. granted*, 84 U.S.L.W. 3401 (U.S. Jan. 19, 2016) (No. 15-628).

Although no federal statute or regulation expressly prohibits insider trading, courts have construed Section 10(b)—a “catch-all clause” in the Securities Exchange Act of 1934 (the “1934 Act”)—to prohibit insider trading as a type of securities fraud. *See Newman*, 773 F.3d at 445. Today, under *Dirks*, determining whether trades executed by someone who has received material nonpublic information (a “tippee”) qualifies as a type of fraud prohibited by the 1934 Act “depends in large part on the purpose of the [insider’s] disclosure.” 463 U.S. at 662. *Dirks* held that liability can only attach where the insider personally benefited directly or indirectly from the disclosure. *Id.* If the insider received no personal benefit from the disclosure, then there has been no breach of duty to stockholders, and no derivative breach can be attributed to tippees who trade on the information. *Id.* Thus, showing that the disclosing insider personally benefited from the tip is critical to establishing insider trading liability.

As the Supreme Court acknowledged, however, “[d]etermining whether an insider personally benefits from a particular disclosure [] will not always be easy,” *id.* at 664, and decisions from the Second and Ninth Circuits have recently split on this issue. The Second Circuit has interpreted “personal benefit” to require “proof of . . . 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. Conversely, the Ninth Circuit has declined to require “at least a potential gain of a pecuniary or similarly valuable nature,” holding instead that gifts of material nonpublic information to friends or relatives satisfy the personal benefit requirement. 792 F.3d at 1093-94. The Court’s decision in *Salman* should resolve the split between the Second and Ninth Circuits and provide guidance on the types of personal benefits that can trigger tipper/tippee insider trading liability. But, with only eight justices, it is also possible for the Court to divide four to four, which would set no precedent, leave the Ninth Circuit decision in place, and fail to resolve the circuit split.

Case Background

When the Supreme Court examined insider trading in *Dirks*, the Court reiterated that a duty to disclose material nonpublic information before trading “does not arise from the mere possession of nonpublic market information.” 463 U.S. at 654. Instead, for liability to attach, there must be a breach of fiduciary duty in connection with a securities transaction that involves “manipulation or deception,” such as the “inherent unfairness involved when one takes advantage of information intended to be available only for a corporate purpose.” *Id.* Insiders have fiduciary obligations arising from their relationship with the company that prohibit them from using the company’s undisclosed information for personal gain, and federal law bars insiders from doing “indirectly by means of any other person any act made unlawful by the federal securities laws.” *Id.* at 659. Relatedly, while tippees may have no inherent fiduciary obligations, they assume them when an insider discloses information to the tippee in breach of the insider’s fiduciary duty and the tippee knows or should know of the breach. *Id.* at 660. Thus, a tippee’s obligation is derivative of the insider’s, and liability will attach to a tippee only where the insider’s tip breached a fiduciary duty owed by the insider to the company. *Id.* at 661.

In determining whether insiders breached their fiduciary obligations by divulging material nonpublic information to tippees, the Second Circuit recently held that “the mere fact of a friendship, particularly of a casual or social nature” between the insider and tippee is insufficient to show that the insider personally benefitted from providing the tip. *Newman*, 773 F.3d at 451-52. In *Newman*, the Second Circuit overturned insider trading convictions for two hedge fund managers who profited through tips they received from their analysts,

“[T]he analogy is the antitrust laws . . . [e]xactly what’s criminal and what’s civil and so forth has been developed by courts over a long time. This statute’s been around since the ‘30s, and we have courts developing law in it. And I believe the marketplace pays a lot of attention to that. And virtually every court, I think, but this one has held that this does extend to a tipper giving inside information to a close relative. . . . [S]uddenly to take the minority [view] . . . is really more likely to change the law that people have come to rely upon than it is to keep it.”

— Justice Breyer

who had in turn received the tips from corporate insiders. *Id.* at 442-43. There, the Second Circuit found that the “casual acquaintance” relationship between the analysts and the insiders was insufficient to establish that the insiders received a “personal benefit” from tipping the analysts, which precluded any derivative liability from attaching to the hedge fund managers. *Id.* at 452-55. Although the Second Circuit recognized that certain non-pecuniary gains can satisfy the “personal benefit” requirement—including “any reputational benefit that will translate into future earnings,” or “the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend”—the Second Circuit declined to infer a personal benefit to the insider 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.” *Id.* at 452. In the Second Circuit’s view, holding otherwise would make the personal benefit requirement a nullity as “practically anything would qualify.” *Id.*

Before the Second Circuit announced its decision in *Newman*, federal prosecutors secured criminal convictions in the United States District Court for the Northern District of California against Bassam Salman for profitable trades that he had made using material nonpublic information obtained from Michael Kara, a close friend who had gleaned the information from his brother, Maher Kara, an investment banker entrusted with the information as part of his job. *Salman*, 792 F.3d at 1088-89. Maher and Michael pled guilty to insider trading charges, but Salman took his case to trial. To establish that the insider personally benefited from his tips—as required to sustain derivative liability against Salman—prosecutors presented evidence that Maher and Michael “enjoyed a close and mutually beneficial relationship.” *Id.* at 1089. Michael had helped pay for Maher’s college, stood in for their deceased father when Maher got married, and helped Maher succeed at his job by coaching him in basic science. *Id.* Indeed, Maher testified that he gave Michael the material nonpublic information to “benefit him” and “fulfill [] whatever needs he had.” *Id.* at 1089. The jury found this evidence established that Maher personally benefited from giving his brother material nonpublic information which, when combined with the “substantial circumstantial evidence” introduced to show that Salman knew of Maher’s breach, was sufficient to sustain Salman’s convictions. *United States v. Salman*, No. CR-11-0625 EMC, 2013 WL 6655176, at *5-7 (N.D. Cal. Dec. 17, 2013), *aff’d*, 792 F.3d 1087 (9th Cir. 2015).

While Salman’s appeal to the Ninth Circuit was pending, the Second Circuit announced its holding in *Newman*, and Salman obtained leave to file a supplemental brief arguing that the government had not presented sufficient evidence to show that Maher had received a personal benefit when he disclosed material nonpublic information to his brother. *Salman*,

792 F.3d at 1090. In his appeal, Salman pointed to the Second Circuit’s decision in *Newman* to argue that *Dirks* requires more than a close personal relationship between insider and tippee to satisfy the personal benefit requirement for insider trading liability. *Id.* at 1091-92. In drafting the Ninth Circuit’s opinion, Judge Rakoff—Senior District Judge for the U.S. District Court for the Southern District of New York, sitting on the Ninth Circuit by designation—acknowledged that the Ninth Circuit “would not lightly ignore the most recent ruling of our sister circuit in an area of law that it has frequently encountered,” but declined to follow *Newman* to the extent it could be read to require evidence that the insider receive “at least a potential gain of a pecuniary or similarly valuable nature.” *Id.* at 1093-94. In the Ninth Circuit’s view, requiring an insider to receive “any such tangible benefit in exchange for the inside information” would “depart from the clear holding of *Dirks* that the element of breach of fiduciary duty is met where an insider makes a gift of confidential information to a trading relative or friend.” *Id.*

On January 19, 2016, the Supreme Court granted Salman’s petition for a writ of certiorari on the narrow question of whether evidence showing a close family relationship between the insider and the tippee is sufficient to establish that the insider personally benefited by disclosing material nonpublic information, or whether something more, representing at least a potential gain of a pecuniary or similarly valuable nature, is required.

Oral Argument Highlights

The oral argument focused on each party’s test for determining when a tipper received a “personal benefit” in exchange for material nonpublic information. Petitioner contended that the insider must receive a concrete benefit. In particular, the insider must receive either a pecuniary benefit, or something that may translate into a financial benefit (e.g., a reputational benefit with monetary value). Petitioner offered two primary defenses for this formulation. First, criminal statutes are generally construed narrowly, and the elements ought to clearly demarcate what is and is not illegal. According to Petitioner, a broader formulation would be ambiguous, and thus would subject market participants to unpredictable prosecutions. Second, it is well-accepted that not all trading on material nonpublic information is unlawful. Petitioner reasoned that if the satisfaction one experiences from sharing information and helping another were sufficient, then the “personal benefit” element would always be satisfied when information is intentionally shared. All information sharing would *ipso facto* be illegal. But Petitioner cautioned that his rule would not permit all information sharing among family members. For example, because family members are often financially inter-dependent, benefiting a family member could, in some instances, financially benefit the tipping insider.

“It’s hazy. It’s kind of a hazy line to draw, isn’t it, between something that you characterize as a gift and something that would be characterized as social interaction.”

— Justice Roberts

The government took a different view, arguing that the 1934 Act broadly prohibits giving information to another—whether a relative, friend, or even a casual acquaintance—“for that person to be able to profit on it.” Responding to questions from the bench, the government conceded that the tipping insider must know that the tippee will trade upon the information for criminal liability to attach. In support of its position, the government asserted that the obligation giving rise to the cause of action for insider trading tracks the common law duty of “loyalty,” which is breached when one uses information for a personal reason. In addition, the government argued that a broad construction is necessary as a policy matter to prevent insiders from freely sharing information with friends and family, which could disrupt markets.

During oral argument, the Justices posed several hypotheticals to evaluate how the parties’ competing frameworks would assign liability in different scenarios. For example, responding to Petitioner’s contention that an insider must receive some tangible gain in order to satisfy the personal benefit requirement, Justice Kagan asked about an insider who planned to give a friend money, but decided to provide valuable nonpublic information instead. By contrast, in a hypothetical posed to the government, Chief Justice Roberts underscored that not all information sharing is done for personal gain: suppose an individual asks a friend to join him for a weekend retreat, and the friend declines, explaining that he has to work on an important transaction for Google. In Chief Justice Roberts’ hypothetical, even if the tippee trades on the material nonpublic information, the insider did not offer the information as a gift or otherwise benefit from the disclosure. Throughout the oral argument, it was clear that the Justices were trying to reconcile two competing concerns. The Justices appeared to support the notion that an insider need not receive a tangible, immediate financial benefit in exchange for disclosing material nonpublic information. But certain Justices appeared wary of a test that could expose all sharing of material nonpublic information to potential liability. If the personal benefit element is to serve as a limiting principle, it must be given a more precise and workable definition.

The Justices also appeared to grapple with a number of other issues. In *Dirks*, the Supreme Court expressly stated the “elements of fiduciary duty and exploitation of nonpublic information . . . exist when an insider makes a gift of confidential information to a trading relative or friend” because the “tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.” 463 U.S. at 664. Although this clear pronouncement would appear to foreclose Petitioner’s narrow framing, it was not central to the *Dirks* holding and thus could be considered non-binding dicta. Additionally, Justice Breyer engaged in a line of questioning aimed at resolving whether information-sharing with a relative ought to

be treated differently. He posited that helping a relative may be analogous to helping one's self, thus creating a special rule inapplicable to a scenario where an insider assists a friend or casual acquaintance. Given the number of issues in play, and the varied responses of the Justices, whether a clear majority exists in support of a particular formulation remains uncertain.

Potential Implications

By providing guidance on the types of personal benefits that can trigger criminal insider trading liability, the Court's decision should clarify the type of evidence the government must present in prosecuting tipper/tippee insider trading cases. This in turn will affect the scope and nature of future government prosecutions. For example, requiring evidence that the insider received (or expected to receive) a tangible benefit to sustain tipper/tippee insider trading liability might create situations where insiders could tip friends and family without recourse under the 1934 Act—an outcome the Court may be hesitant to facilitate. That said, the issue before the Court is a narrow one, and a number of important insider trading elements will likely remain unchanged: not all forms of information sharing are prohibited, and the knowledge elements that must be established to sustain tipper/tippee liability in a given case are beyond the scope of the question presented to the Court. Ultimately, by clarifying what constitutes an insider's "personal benefit," the Supreme Court's decision could alleviate the uncertainty that has arisen in the wake of the split between the Second and Ninth Circuits, but how this translates into practice will depend on the approach the Court adopts. Given the Supreme Court's current composition, it is also possible that no majority position emerges, which would leave the law in an ambiguous state. If the Court is unable to articulate a more precise and workable definition, it may spur Congress to enact legislation that provides a definition by statute.

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