The Future of Insider Trading
The Supreme Court and *Salman*

Thomas O. Gorman
Dorsey & Whitney LLP

www.secactions.com

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INTRODUCTION

- **The Supreme Court's decision in *Bassam Yacoub Salman v. United States*, No. 15-628 (S. Ct. Jan. 19, 2016) may well be the most significant insider trading case in years**
- **The USAO in Manhattan told the Court that *Salman's* predecessor – *U.S. v. Newman*, 773 F. 3d 838 (2d Cir. 2014) – might constitute the end of insider trading prosecutions**
- **While the two cases are not identical they are similar – both center on the application of the "personal benefit" test articulated in *Dirks v. SEC*, 463 U.S. 646 (1983)**

INTRODUCTION

- **To examine *Salman* and its potential significance, five points will be considered:**
  - **1) The decision in *Dirks***
  - **2) *Newman* and illegal tipping**
  - **3) The impact of *Newman***
  - **4) The decision in *Salman***
  - **5) The application of *Salman***
  - **6) The briefs in *Salman***

DIRKS

- *Dirks* centered on whether a tippee has an obligation to disclose or abstain from trading which hinges on whether the insider's tip is a breach of duty
- The facts: Ray Dirks was an analyst;
  - He discovered what was probably one of the largest frauds at the time in the late 1970s – Equity Funding
  - He learned the information from insider Ronald Secrist
  - While he approached regulatory authorities and news outlets, no action was taken
  - Finally he told his clients who traded
  - The SEC charged him with insider trading and found him liable
  - The D.C. Circuit affirmed

DIRKS

- The Supreme Court reversed
- The Supreme Court began its analysis by noting that not all trading while in possession of insider trading is illegal
  - There is no parity of information requirement in the securities markets
- To that end the Court sought to draw a bright line between that which is legal and that which is not; that question in turn centers on whether the insider will benefit directly or indirectly from the disclosure
- This line is derived from the Section 10(b) element of deception
- Only deception by the insider breaches the statue; that deception arises from a breach of duty for a personal benefit; absent a personal benefit there is no breach of duty
  - In drawing this line, the Court looked to its decision in *Chiarella v. United States*, 445 U.S. 222 (1980).

DIRKS

- The question must be considered based on the objective evidence
- The focus is on whether the insider will obtain a benefit that will translate into future earning
- In this context the relationship between the insider and the tippee may suggest a quid pro quo
- The elements of fiduciary duty and exploitation are also present when a gift is made to a trading relative or friend such that the trade resembles the insider himself profiting
- Here neither Secrist nor Dirks transmitted the information for a personal benefit; thus there was no breach of duty

NEWMAN

- **In *Newman* the Second Circuit in 2014 also sought to draw a line**
- **Facts: The defendants were Todd Newman and Anthony Chiassons, both remote tippees 3 to 4 steps down from the source of the information, a Dell. Inc. employee**
- **The tips involved concerned Dell, Inc. and NVIDIA**
- **Each defendant was a portfolio manager at different hedge funds; each obtained the information through others who passed it on from the source**

NEWMAN

- **On appeal the Second Circuit noted that there was no criminal insider trading case where third and fourth tier tippees were convicted as in *Newman***
- **The court began its analysis by discussing the classic and misappropriation theories of insider trading**

NEWMAN

- The court cited *Dirks,* stating that there is no breach of fiduciary duty absent a personal benefit to the insider
- Stated differently, simply disclosing the information is not a breach
- Indeed, there is no requirement of parity of information in the securities markets as *Dirks* held

NEWMAN

- The elements of tippee liability are thus:
  - 1) the corporate insider has a fiduciary like duty
  - 2) the insider breached his duty by disclosing the inside information to the tippee
  - 3) the tippee knew of the breach and that the insider got a personal benefit
  - 4) the tippee trades

NEWMAN

- **The jury instructions did not mention the personal benefit test and were thus inadequate**
- **In reviewing the sufficiency of the evidence the court defined the personal benefit test**
  - **It includes pecuniary gain and reputational benefit that can translate into future earnings**
  - **It includes the benefit one would obtain from making a gift to a friend or relative**
  - **While a benefit can be inferred from a personal relationship, that inference in not permitted absent proof of a meaningfully close personal relationship that guarantees an exchange that is objective, consequential and represents at least a potential gain of a pecuniary or similar value or nature – that is, it suggests a *quid pro quo***

IMPACT OF *NEWMAN*

- ***Newman*** **had an immediate impact on tipping cases**
- **One example stems from two parallel cases: *U.S. v Conradt*, No. 12-cr-00887 (S.D.N.Y.) and *SEC v. Payton*, No. 14-civ-4644 (S.D.N.Y.)**
  - **Both center on the acquisition by IBM of SPSS**
  - **The tip traces to attorney Michael Dallas, an associate at a NYC law firm**
  - **He was friends with Trent Martin; the men had a history of sharing confidential information; Dallas tipped Martin**

IMPACT OF *NEWMAN*

- **Martin was roommates with Thomas Conradt an attorney at a brokerage firm; the two had a very close relationship; Martin tipped Conradt**
- **Conradt worked at the broker with Payton and Durant; Conradt tipped his fellow workers; all traded**
- **While Conradt asked Martin about the information source, the coworkers did not**
- **Conradt also tipped David Weishaus and others at the broker; all traded**

IMPACT OF *NEWMAN*

- **The criminal case: Conradt, Weishaus, Martin and Payton were all charged and pleaded guilty prior to *Newman***
- **Subsequently, the guilty pleas were vacated based on *Newman***

THE IMPACT OF *NEWMAN*

- **The SEC based its civil enforcement action against the same traders on the same facts**
  - **First a motion to dismiss was brought**
  - **Judge Rakoff denied the motion**
    - **The court began by emphasizing the difference between criminal and civil cases**
    - **Turning to *Newman* the court stated that the first question is to determine if Martin, the tipper obtained a personal benefit; since there was a history of personal favors and their expenses were "intertwined," and the court found that Martin had obtained a personal benefit**
    - **The second question is if the defendant knew of the benefit; here again the allegations were sufficient that since Conradt and Martin were friends and roommates and Conradt had helped his friend with certain matters; this presents a situation suggesting that there were reciprocal befits**
    - **Finally there was evidence the defendants tried to conceal their trading activity**

THE IMPACT OF *NEWMAN*

- **After *Salman* was decided in an opinion written by Judge Rakoff (sitting by designation) *Payton* was tried to a jury**
- **The jury instructions broadly defined personal benefit to include not just a monetary gain but also other things such as "the benefit one would obtain from simply making a gift to a trading friend"**
- **The court accepted the definition suggested by the SEC which permitted the benefit to flow to *either* the insider or the tippee**
- **The jury returned a verdict in favor of the SEC**

SALMAN

- **Facts: This action also centers on a remote tippee**
  - **The action focuses on brothers Michael and Maher Kara and their brother-in-law Bassam Salman**
  - **The insider trading charges stem from trading on 4 transactions**
  - **Brothers Kara had a complex relationship**
  - **Maher worked at Citi Healthcare Group**
  - **Initially he sought help from brother Michael since he had no experience in the area**
  - **Eventually Michael, who traded securities, began asking more pointed questions about stocks and pushing his brother for information**

SALMAN

- **Michael taught brother Salman to trade**
- **He also passed along information he got from Maher**
- **The informational flow can be tracked as follows:**

Tipper →	Direct Tippee →	Remote Tippee →	Remote Tippee
Maher Kara	Michael Kara	Bassam Salman	Salman Family Member

SALMAN

- **Maher and Michael testified at trial for the government**
- **Maher testified that he would reveal information to his brother just to silence him**
- **Michael testified that he obtained the information, traded and passed it to his brother-in-law**
- **The jury found Salman guilty**
- **The Ninth Circuit, in an opinion written by Judge Rakoff, affirmed**

SALMAN

- Like the Second Circuit in *Newman*, the Ninth Circuit claims to have followed *Dirks*
- The test under that decision is whether the insider will personally benefit directly or indirectly and if the tippee knows or should have known about the breach
- Key is the personal benefit
  - It includes a pecuniary gain or reputational benefit that will translate into future earnings
  - It also exists where there is a gift to a trading relative or friend

SALMAN

- **Here the tipper disclosed the information knowing it would be used to trade, making a *Dirks*-type gift**
- **Here this was admitted in the testimony**
- **Defendant argued there is no evidence that Maher received any tangible benefit as described in *Newman***
- **The court held that if *Newman* went that far it would decline to follow**

SUPREME COURT

- **Before the Supreme Court each side continues to claim it is faithfully following *Dirks***
- **Petitioner**
  - **Begins by asking the court to draw a clear line between illegal tipping and legal trading – the same approach as *Dirks* and *Newman***
  - **<u>The issue for decision is</u>: Whether *Dirks* requires proof of an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature or is it enough that the insider and tippee share a close family relationship**

SUPREME COURT

- **Petitioner**
  - **The argument opens with the familiar canon that only Congress can define criminal conduct**
  - **This is a repeated theme of the Court**
  - **Statutory language: Section 10(b) of the Securities Exchange Act does not address insider trading**
    - **This point has been an important limiting principle for the Court**
    - **This is consistent with *Dirks*' conclusion that only some persons under some circumstances will be barred from trading while in possession of inside information**

SUPREME COURT

- **Benefit: The test for assessing the benefit is objection in keeping with the notion of establishing a guiding rule**
- **The focus is on a pecuniary gain or reputational benefit that will translate into future earning**
  - ***Dirks* viewed gain as a benefit, profit**
  - **The quid pro quo of the exploitation is for tangible benefits flowing to the insider**
- **This case does not involve securities fraud; Maher did not trade or get a kickback**
  - **Maher transmitted the information only to get his brother off his back**

SUPREME COURT

- **Petitioner**
  - **Defining personal benefit as pecuniary gain is consistent with the constitutional limits here**
    - **This is a criminal statute that must be strictly construed**
    - **It would be a violation of due process to take someone's liberty based on a vague statute**
  - **The standard used by the Ninth Circuit here undermines *Dirks*' notion of drawing a line**
    - **Any suggestion that the personal benefit can be met with a psychic gain would render the notion impermissibly vague**
    - **Enforcement on this basis is impermissible**

SUPREME COURT

- **Respondent**
  - **The government frames the issue as: Whether under *Dirks* a tipper personally benefits and thereby breaches his fiduciary duty by disclosing confidential information to tippee as a gift for use in securities trading**
  - **The government begins and ends with *Dirks*, barely mentioning *Newman***
  - **Deception: The corporate insider violates the statute and is deceptive by violating the relationship of trust and confidence that exists with the shareholders**
    - **The misappropriation theory is built on a similar notion**

SUPREME COURT

- *Dirks* concluded that it was not a violation of the securities laws to trade to expose a fraud – the Court rejected a “broad” theory of liability implicit in the decision finding *Dirks* liable
  - That theory would have required equal access to information
  - But the Court found that the corporate insider violates Section 10(b) when information made available for a corporate purpose only is taken advantage of by trading without disclosing

SUPREME COURT

- **Respondent**
  - **The duty of a tippee is derivative of the that of the insider – the tippee assumed the fiduciary duty of the insider**
  - **The key question then become if the insider will personally benefit**
    - **This question must be considered on the objective facts**
    - **For example what there a quid pro quo**
    - **Or was there a gift**

SUPREME COURT

- **Petitioner**
  - **Based on these principles the personal benefit test is met when the insider discloses the information without a corporate purpose**
  - **Since the insider only has the use of the information for a corporate purpose he breaches Section 10(b) when trading for himself; the same is true when the tippee trades**
  - **Thus if the insider gave a gift of information for trading and a business justification for the gift is absent –Section 10(b) is violated**
  - **Finally the phrase "friend or relative" is only an example in *Dirks* – a gift to anyone for trading violates Section 10(b)**

ANALYSIS

- **Both sides claim to be following *Dirks***
- **Yet their views are radically different: Petitioner has limited the personal benefit to one that is pecuniary; Respondent makes it apply to any gift to anyone who may trade**
- **Petitioner's view is quite limited; the government's argument is virtually open ended**
- **The positions of the parties appear to etch the outer edges of liability**
- **The Court has repeatedly followed precedent suggesting *Dirks* will be affirmed**

TAKEAWAYS

- Look for the Court to
  - Retain the notion of a gift
  - Reject the government's open ended theory
  - Tie the concept to something real and possibly tangible
  - Limit it by the nature of the relationships