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Alert

Salman Spawns No Sweeping Change in Insider Trading Law

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On Dec. 6, 2016, the U.S. Supreme Court unanimously upheld the insider trading conviction of Bassam Salman, who had received material, nonpublic information from a friend, who, in turn, had been tipped by a family member.[1] The decision, the Supreme Court's first foray into the law of insider trading in nearly two decades, was eagerly awaited by many who anticipated that the Supreme Court could seize the opportunity to overhaul the underpinnings of tipper-tippee liability under the federal securities laws.

Instead, *Salman* ended not with a bang but with a whimper. In a relatively short, narrowly focused opinion, the Supreme Court reaffirmed the so-called "personal benefit" test articulated in *Dirks v. SEC*, 463 U.S. 646 (1983). In *Dirks*, the Supreme Court concluded that a person who tips material, nonpublic information to others must receive a personal benefit from the disclosure for insider trading liability to attach. In *Salman*, the Court held that the Ninth Circuit Court of Appeals had "properly applied *Dirks*" when it concluded that a "tipper benefits personally by making a gift of confidential information to a trading relative or friend."[2]

In so ruling, the Supreme Court quashed the hopes of those who read the Second Circuit Court of Appeals' decision in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), to mean that, to prove an illicit tip, the government must always show that the tipper received a *pecuniary* or other tangible benefit. Although the Supreme Court's decision in *Salman* is important, particularly in the context of tips to family and friends, it is also important to recognize that *Salman* does not cast doubt on the Second Circuit's reversal of the two hedge fund traders' convictions in *Newman*, which rested largely on grounds not addressed in the Supreme Court's opinion. Below we summarize what *Salman* did and did not do.

What *Salman* Did

The tipper-tippee chain in *Salman* involved three individuals linked by bonds of blood or marriage. The tipper, Maher Kara, shared confidential information about upcoming mergers and acquisitions with his older brother, Mounir ("Michael") Kara. The brothers were extremely close siblings, and Maher testified that he tipped his older brother to "help him and to fulfill whatever needs he had."[3] Maher did not receive a pecuniary or tangible benefit from his brother in exchange for the information. Ultimately,

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[1] *Salman v. United States*, No. 15-628, 580 U.S. __ (2016).

[2] *Id.* at 2, 5.

[3] *Id.* at 4.

Michael began sharing the confidential information that he was receiving from Maher with Salman, who was the brother of Maher's then-girlfriend (and later Maher's wife). Salman knew that the information was coming from Maher, and also was aware of the "brothers' close fraternal relationship."[4]

The chief issue that the Ninth Circuit faced was whether Maher received a personal benefit when he disclosed the information to his brother. In other words, can evidence of a "friendship or familial relationship between tipper and tippee," in the absence of a pecuniary or tangible benefit, be sufficient to "demonstrate that the tipper received a benefit"?[5]

In an opinion that would later parallel the Supreme Court's decision, the Ninth Circuit decided that "*Dirks* governs this case."[6] The Ninth Circuit declined to read *Newman* broadly as standing for the proposition that the personal benefit test requires a pecuniary exchange even when the tip is between people who share a friendship or familial relationship, as doing so would have required the court "to depart from the clear holding of *Dirks*."[7] In affirming the Ninth Circuit's decision, the Supreme Court agreed that *Dirks* was controlling. Justice Samuel Alito's opinion for the Court stated that the "narrow issue" presented by Salman's conviction was "easily" resolved by the "commonsense point we made in *Dirks*"; the personal benefit derived by a tipper in Salman's position is akin to a tipper "trading on the information, obtaining the profits, and doling them out to the trading relative."[8] The Court went on to explain that "[t]o the extent the Second Circuit [in *Newman*] held that the tipper must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift to family or friends, we agree with the Ninth Circuit that this requirement is inconsistent with *Dirks.*"[9] By reaffirming its decision in *Dirks,* in essence, *Salman* restores the status quo that has long existed but was briefly thrown into question by *Newman*.

In one respect, *Salman* could be read to cabin potential insider trading liability. In its decision, the Supreme Court repeatedly emphasized that the tip was intended as a gift — that Maher "disclos[ed] confidential information as a gift to his brother *with the expectation that he would trade on it*."[10] Prior case law, including the Second Circuit's decision in *United States v. Libera*, 989 F.2d 596 (2d Cir. 1993), had rejected a requirement that the tipper have knowledge of the tippee's intent to trade on the tip. *Libera* reasoned that the tipper's knowledge that he or she was breaching a duty to the owner of the confidential information "suffices to establish the tipper's expectation that the breach will lead to some kind of a misuse of the information."[11] *Salman* appears to call into doubt the validity of that reasoning and may therefore stand as a barrier to prosecution of tippers who disclose inside information with no expectation that the recipient will trade on the information.

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[4] *United States v. Salman*, 792 F.3d 1087, 1090 (9th Cir. 2015).

[5] *Id.* at 1093.

[6] *Id.* The opinion was written by Judge Jed Rakoff, a senior judge from the Southern District of New York who sat on the Ninth Circuit by designation for the case. Judge Rakoff had previously expressed concern about *Newman*'s potential inconsistency with *Dirks. See, e.g.*, *SEC v. Payton*, 97 F. Supp. 3d 558, 563 (S.D.N.Y. 2015).

[7] *Salman*, 792 F.3d at 1093.

[8] *Salman*, slip op. at 8, 11.

[9] *Id.* at 10.

[10] *Id.* (emphasis added).

[11] 989 F.2d at 600.

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What *Salman* Did Not Do

Congress has never enacted a statute of general application specifically prohibiting insider trading (although there were calls in Congress to do precisely that following the Second Circuit's *Newman* decision). Rather, the prohibition is based upon judicial interpretation of the anti-fraud provisions contained in Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. The defendant in *Salman*, joined by several *amici curiae*, mounted a broad-brush attack on the fairness of subjecting participants in the securities markets to criminal prosecution under federal law based on these judge-made, and frequently amorphous, standards. But, that argument did not catch fire with the Justices. "*Dirks* created a simple and clear 'guiding principle' for determining tippee liability," the Supreme Court found, "and Salman has not demonstrated that either §10(b) itself or the *Dirks* gift-giving standard 'leav[e] great uncertainty about how to estimate the risk posed by a crime' or are plagued by 'hopeless indeterminancy.'"[12] For now, the Court seems content to allow insider trading law to continue to develop in a case-by-case manner, with results varying depending on the vicissitudes of particular fact patterns, rather than to lay down clear categorical rules, or to invite Congress to do so.

In addition, the Supreme Court's decision leaves for another day what "personal benefit" is required for tipper-tippee liability outside the factual scenario presented by *Salman*. The Supreme Court did not address the government's argument that a "gift of confidential information to anyone," not just a family member or friend, should be sufficient to prove insider trading.[13] Accordingly, a gift made to a complete stranger, a mere acquaintance, or a colleague may require a finding of "something of value" to satisfy the personal benefit element, as under *Salman* a jury can only infer a personal benefit where the tipper receives "something of value in exchange for the tip *or* makes a gift of confidential information to a *trading relative or friend*."[14] Indeed, it is not clear that *Salman* abrogates *Newman*'s conclusion that the government's evidence under the facts of that case was "simply too thin to warrant the inference that the corporate insiders received any personal benefit in exchange for their tips."[15] Put differently, *Newman*'s holding that the government may not "prove the receipt of a personal benefit by the *mere fact* of a friendship, particularly of a casual or social nature," may well remain good law, especially in the Second Circuit.[16]

Further, perhaps the most consequential holding of *Newman* — that a *remote* tippee must know that the tipper received a personal benefit in exchange for the tip — remains unchanged.[17] This defense is useful for remote tippees, who, removed at least one level from the initial tip, often do not know or have reason to know whether or not the tipper received some tangible benefit for the disclosure or the relationship between the tipper and initial tippee. The Supreme Court made it clear that "[t]his case does not implicate" that holding of *Newman*.[18] That defense, however, as *Newman* itself makes clear,

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[12] *Salman*, slip op. at 11.

[13] *Id.* at 7.

[14] *Id.* at 2 (emphasis added).

[15] *United States v. Newman*, 773 F.3d 438, 451-52 (2d Cir. 2014).

[16] *Id.* at 452 (emphasis added).

[17] *Id.* at 447.

[18] *Salman,* slip op. at 5, n.1.

will not be available when tippees "consciously avoid[] learning" of the existence of a personal benefit, as the law treats such conscious avoidance as the legal equivalent of actual knowledge.[19]

In fact, *Salman* only explicitly targeted one excerpt of *Newman*: "[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," that requirement is inconsistent with *Dirks*.[20] This result should not have been surprising, as that portion of *Newman* had already been questioned by district courts in the Second Circuit and elsewhere as being either potentially inconsistent with *Dirks* or overbroad.[21]

Conclusion

Ultimately, *Salman* is a narrow holding that does not address tipper-tippee liability outside the scope of trading relatives and friends. For better or for worse, insider trading actions will remain steeped in fact-specific inquiries. For traders who find themselves at the end of an informational chain — i.e., as a potential remote tippee — perhaps the key takeaway from *Salman* is that being unaware of any *pecuniary* benefit between the original tipper and tippee is not a defense if there is enough to place the remote tippee on notice that the original tipper and tippee were relatives or close friends.

Moreover, whatever impact *Salman* may have on the ability of civil and criminal authorities to regulate and prosecute insider trading cases, the decision does not alter the types of policies and procedures that an investment adviser should implement to prevent the misuse of confidential information. Investment advisers should remain vigilant in ensuring that their compliance programs are adequate in structure and adhered to in practice.

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[19] 773 F.3d at 453.

[20] *Salman,* slip op. at 10.

[21] *See, e.g.*, *Payton*, 97 F. Supp. 3d at 563 ("Whether [*Newman'*s pecuniary benefit standard] is the required reading of *Dirks* may not be obvious, and it may not be so easy for a lower court, which is bound to follow both decisions, to reconcile the two."); *SEC v. Megalli*, 157 F. Supp. 3d 1240, 1250 (N.D. Ga. 2015) ("*Newman* recognizes and appears to preserve Second Circuit precedents acknowledging that not all benefits must be immediately pecuniary ... *Newman* has made waves, but the Court is not convinced it is a total sea change."); *United States v. Riley*, 90 F. Supp. 3d 176, 186 (S.D.N.Y. 2015) ("While a court could rule that merely maintaining or furthering a friendship is not a sufficient personal benefit, it is not 'plain' that the Second Circuit has done so already."); *United States v. Gupta*, 111 F. Supp. 3d 557, 559 (S.D.N.Y. 2015) ("While *Newman* arguably narrowed the range of evidence that would support an inference of 'benefit,' it did not purport to overrule any binding precedent, something, indeed, that its panel lacked authority to do.")