What SEC Whistleblowers Should Know About Insider Trading and the *Salman* Case

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The Supreme Court recently heard argument in *Salman v. United States* (No. 15-628), a case that may bring some clarity to one highly contested area of insider trading law. Whistleblowers looking to report information on insider trading to the SEC will benefit from a basic understanding of insider trading law leading up to *Salman*.

Prohibitions against insider trading make obvious sense to most of us. There is something intuitively wrong with trading on confidential information—and thus profiting or avoiding a loss—that is not available to the general public. Our federal prisons have among their residents both those who have traded on or tipped others with material, nonpublic information ("insiders" or "tippers") and those who have received tips and traded accordingly ("tippees").

There are various rationales behind the prohibition on all types of insider trading. In addition to the obvious objection that trading on insider information strikes us as fundamentally unfair, the prohibition also reflects concerns about protecting the integrity (and liquidity) of our public markets and the confidentiality of business information. Some of these concerns have led public companies to limit the periods when employees may trade in their company stock (so called "trading windows").

In the parlance of economics, trading on information not known to the general public reflects a kind of information asymmetry, and all types of insider trading reflect that asymmetry.

Broadly speaking, there are two types of "insider trading" cases, only one of which refers to "insider" trading strictly speaking. The classic case of insider trading involves a corporate insider who trades (buys or sells) shares of his own company on the basis of material, nonpublic information that the insider learns in the course of his work activities on behalf of the corporation. The insider has an obvious informational advantage over other shareholders and traders.

The insider can profit from either negative or positive insider information. If the news is good for the corporation, the insider can trade before the price of the stock rises (immediately or with "call options") and thereby profit from the eventual uptick in the stock price. Conversely, if the news is bad for the corporation, the insider can dump stock upon unknowing investors and thereby avoid losses, or more aggressively, can "sell short" the stock or purchase "put options" to sell at a fixed price.

The other broad category of "insider trading" might be more accurately dubbed "*outsider* trading," but is typically referred to as "misappropriation of information" trading. In these cases, an insider learns material, nonpublic information that will affect the stock value of *another* company. The insider learns of the information in the course of working at her own company and "misappropriates" information about another company for her personal gain.

In addition to these categories of "inside" traders are those who learn information from such insiders or those connected to insiders and trade accordingly; that is, the tippees. The scope of their liability is more complicated still, though the Supreme Court may help to clarify that scope in the *Salman* case this term.

Where Whistleblowers Come In

Often, whistleblowers from inside the company whose securities are being traded, or whistleblowers who are otherwise affiliated with persons receiving or providing insider information, approach the SEC with these allegations.

Last year, whistleblowers filed nearly 300 complaints about insider trading with the SEC. Sometimes these allegations result in SEC enforcement actions, but more often they do not. Despite the common intuition that trading on nonpublic information is always unlawful, the law on insider trading is not so straightforward, and many instances of trading on "nonpublic information" do not constitute unlawful insider trading.

Potential SEC whistleblowers and their counsel should familiarize themselves with the potential reach *and* the actual grasp of insider trading laws, laws that vary by jurisdiction and class of trading actors.

Many of the most contested areas of insider trading prosecutions concern the reach of insider trading prohibitions as they relate to the tippee, that is, the non-insider who trades upon nonpublic information. Such a circumstance is before the Supreme Court in *Salman*.

In *Salman*, the defendant was convicted by a jury of securities fraud based upon an insider trading scheme involving his extended family. The defendant in *Salman* was not an insider. Instead, the issue in *Salman* concerns the "personal benefit" requirement for tippee liability under insider trading laws. Through marriages and friendships, the defendant in *Salman* obtained inside information from a person whose brother was an insider at Citigroup. The brother and the defendant mirrored their trading activity based upon the material, nonpublic information received from the insider at Citigroup. Through a series of transfers meant to disguise his activity, the defendant traded on material, nonpublic information several times between 2004 and 2007.

The defendant's conviction was sustained by the district court and again sustained last year by the Ninth Circuit. The Supreme Court will now decide whether this conviction was justified by the facts of the case. And to do that, the Court will likely wrestle with the body of insider trading law that has developed to bring us to *Salman*.

The prohibition on insider trading originally emanates from Section 10(b) of the Securities Exchange Act of 1934, which makes it unlawful for "any person … [t]o use or employ, in connection with the purchase or sale or any security…, any manipulative or deceptive device…." Hardly sufficient by itself to define what is or is not insider trading, the SEC's rule-making authority empowers it to define the prohibition further.

SEC Rule 10b-5 makes it unlawful to, through interstate commerce, "employ any … scheme … to defraud … in connection with the purchase or sale of any security." The SEC has interpreted this language broadly to prohibit what most people would consider to be trading on inside or nonpublic information.

One classic pillar of jurisprudence in this area has been the so-called "disclose or abstain" rule, dating back to the 1960s. In most respects, the rule makes perfect sense. It originally held that any person trading for his own account in the securities of a corporation who has access to nonpublic information intended only to be available for a corporate purpose may not trade on that information. As the Second Circuit held in *SEC v. Texas Gulf Sulphur Co.*, "anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence … must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed."

Though the idea articulated in *Texas Gulf* is simple enough, the question of what class or classes of persons are bound by the disclose-or-abstain rule is not so simple. For several decades, courts have narrowed the scope of this idea with a focus on duties and obligations that attend to different types of tippers and tippees in different scenarios.

In *Chiarella v. United States*, the Supreme Court held that a printer working as a "markup man" at a financial print shop who gleaned information about pending corporate takeover bids from sensitive documents he was handling, and then traded based upon that information, did not violate laws against insider trading by doing so. Reversing his conviction, the Court held that the printer was under no obligation to disclose the information to the public (to the contrary, it would be improper for him to do so) and also under no obligation imposed by insider trading laws

to abstain from trading on it. The Court noted that "not every instance of financial unfairness constitutes fraudulent activity under § 10(b)."

Shortly thereafter, the Court decided *Dirks v. S.E.C.* In *Dirks*, an insider contacted well-known securities analyst Raymond Dirks to disclose fraudulent conduct at the insider's company. Dirks took the information and did his own further investigation. During that investigation, however, Dirks openly discussed the insider information he obtained directly from the insider with various clients and investors, many of whom acted on that information by trading in that company's securities. For this, he was convicted under insider trading laws.

In reversing his conviction, the Court expressed concern over "imposing a duty to disclose or abstain" on persons such as market analysts whose role in markets is considered necessary. It did, however, recognize the "need for a ban on some tippee trading," and held that "[n]ot only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain." This reduced to a test: does "the insider [ ] benefit, directly or indirectly, from his disclosure;" where he does, he acts in breach of his fiduciary duty to his company's shareholders. And for the tippee: he is equally liable "if the tippee knows or should know that there has been [such] a breach."

Much turns on the definition of "personal benefit" that constitutes the breach of the fiduciary duty that must underlie an action against either the tippee or the tipper. In *Dirks*, the Court defined it to include "a pecuniary gain or a reputational benefit that will translate into future earning," but also added that "the elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend."

The Ninth Circuit in *Salman* relied upon *Dirks* to determine that the disclosure of material, nonpublic information by the Citigroup employee to his brother, "knowing that he intended to trade on it," was "precisely the 'gift of confidential information to a trading relative' that *Dirks* envisioned." What remains contested in many courts is to what extent the government must show that the tipper stands to receive a "personal benefit" of a "pecuniary or similarly valuable nature" and what a "similarly valuable nature" should mean.

Potential SEC whistleblowers should apply their allegations to the body of insider trading law that has developed in their jurisdiction before assuming that the SEC has legal authority to bring an enforcement action based on the information. That means talking to an attorney familiar with the body of law. And stay tuned for the Supreme Court ruling in *Salman* next year.