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Supreme Court Revisits Insider-Trading Liability

***Salman** reaffirms **Dirks** and holds that a "gift" of inside information to a trading relative or friend continues to meet the personal-benefit requirement.*

The *Salman* Prosecution

In 2011, Bassam Yacoub Salman was indicted on four counts of securities fraud and one count of conspiracy to commit securities fraud.[1] At trial, the government produced evidence showing that Salman had received material, nonpublic information about healthcare deals from Mounir "Michael" Kara, who had in turn received that information from Michael's brother and Salman's brother-in-law, Maher Kara, an investment banker at the time. The government further showed that Salman used the inside information to net US$1.5 million in trading profits.

The government also introduced evidence about the relationship among the brothers. Specifically, Maher testified that he "loved his brother very much" and that he gave Michael the information to "benefit him" and "fulfill whatever needs he had."[2] Maher also testified that, on one occasion, Michael asked Maher for a "favor," requesting "information," and, when "Michael turned down Maher's offer of money, Maher gave him a tip about an upcoming acquisition instead."[3] Before Maher started disclosing inside information, he became engaged to Salman's sister. During the engagement, the Kara and Salman families grew close, with Salman and Michael becoming "fast friends."[4]

A jury convicted Salman on all counts.

The Circuit Split: *Newman* and *Salman*

At the time Salman appealed his conviction, it was well established — since the Supreme Court's seminal decision in *Dirks v. United States* — that, for insider trading to occur, an insider had to personally benefit, directly or indirectly, from the disclosure of inside information.[5] In *Dirks*, the Supreme Court explained that the benefit could be "a pecuniary gain or a reputational benefit that will translate into future earnings."[6] And, the Court continued, the benefit could be inferred, such as when there is "a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient."[7] Thus, a tipper or tippee could be liable for insider trading if the "insider makes a gift of confidential information to a trading relative or friend."[8] In that situation, "[t]he tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient," and so a finding of personal benefit to the insider is appropriate.[9] Presumably because of *Dirks*, Salman initially did not challenge his conviction based on a lack of evidence of a personal benefit.

While Salman's appeal was pending, the Second Circuit added its own gloss to the *Dirks* personal-benefit rule in *United States v. Newman*.[10] Although the Second Circuit recounted the language above from *Dirks*,

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it went on to hold that an inference of personal benefit is "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."[11] That holding appeared to provide a viable defense to insiders who share information with friends or family members without receiving any identifiable benefit, as well as to tippees who receive inside information by way of such an insider.

The Ninth Circuit allowed supplemental briefing on *Newman*, and Salman urged the court to apply what he viewed as *Newman*'s holding — that "evidence of a friendship or familial relationship between tipper and tippee, standing alone, is insufficient to demonstrate that the tipper received a benefit."[12] In particular, Salman argued that, because there was no evidence in his case that the insider—Maher—received "a potential gain of a pecuniary or similarly valuable nature," the evidence was insufficient to support his conviction.[13] In an opinion authored by Senior District Judge Rakoff of the Southern District of New York, who was sitting by designation, the Ninth Circuit swiftly rejected Salman's argument: "To the extent *Newman* can be read to go so far, we decline to follow it. Doing so would require us to 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.'"[14]

The Supreme Court Weighs in

Reaffirming *Dirks*

After declining to grant certiorari in *Newman*, despite the government's request, the Supreme Court used *Salman* to enter the fray. In a unanimous opinion by Justice Alito, the Court reaffirmed what seemed to have been clear all along: "when a tipper gives inside information to 'a trading relative or friend,' the jury can infer that the tipper meant to provide the equivalent of a cash gift."[15] Such an inference is appropriate, the Court explained, because "a gift of trading information is the same thing as trading by the tipper followed by a gift of the proceeds."[16]

The Court reached this conclusion by "adher[ing] to *Dirks*, which," in the Court's view, "easily resolve[d] the narrow issue presented here."[17] The Court relied, in particular, on the discussion of gift giving in *Dirks* noted above. The holding in *Dirks*, the Court continued, "makes clear" that "a tipper breaches a fiduciary duty by making a gift of confidential information to 'a trading relative.'"[18]

Applying that rule to this case, the Court had little trouble upholding Salman's conviction. As the Court explained, "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,"[19] and "Maher effectively achieved the same result by disclosing the information to Michael, and allowing him to trade on it."[20]

As for *Newman*, the Court concluded that, "[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, *Newman*, 773 F.3d, at 452, we agree with the Ninth Circuit that this requirement is inconsistent with *Dirks*."[21]

The Knowledge Requirement Remains

Importantly, the Court left undisturbed another key aspect of *Newman*. The Second Circuit also held that "a tippee's knowledge of the insider's breach necessarily requires knowledge that the insider disclosed confidential information in exchange for personal benefit."[22] *Salman* did not provide the Court occasion to address that aspect of the Second Circuit's *Newman* decision and, as a result, it remains good law.[23] Indeed, at oral argument, the government appeared to concede this requirement: "We need to be able to

show that the tippee ... had knowledge that the information originated in a circumstance in which there was a breach of fiduciary duty for personal benefit."[24]

Implications of *Salman*

While long awaited, the ultimate importance of the decision is modest. The Court's "narrow" decision — as in *Dirks* — is limited to situations in which the recipient of information is a trading relative or friend. Although the government urged the Court to adopt a broader rule — "that a gift of confidential information to anyone, not just a 'trading relative or friend,' is enough to prove securities fraud"[25] — the Court declined the invitation. Conversely, while Salman argued that *Dirks*' gift-giving standard is ambiguous and difficult to apply, the Court only acknowledged the possibility that there might be cases in which the facts make assessing gift-giving liability more "difficult."[26] In rejecting both parties' more expansive arguments, and in declining to say much more than that *Dirks* is still the law and this case falls within the "heartland" of that decision,[27] the Court left the more difficult questions about the outer bounds of insider-trading liability for another day.

To the extent the Second Circuit's decision in *Newman* slowed the pace of insider-trading prosecutions, that lull is now likely to end. The government has a clear path forward when bringing insider-trading charges even when an insider's personal benefit is intangible. That path will also likely breathe new life into enforcement actions by the Securities and Exchange Commission (SEC), in addition to the Commodity Futures Trading Commission (CFTC), which has recently started to pursue insider-trading cases.[28] Moreover, although the Court simply reaffirmed what it had long ago said, the *Salman* decision could be viewed by some government officials as an invitation to push the limits of insider-trading liability and the inferences a jury can be asked to draw.

Although *Salman* does not speak to the knowledge requirement, the decision does address the inferences that can be drawn from a close relationship between insiders and tippees. And although it is doubtful the government going forward will seriously dispute the need to prove a tippee's knowledge of personal benefit to the insider, what type of evidence is sufficient to meet the knowledge requirement remains ripe for further litigation. This litigation potential is especially true for situations in which the relationship between the inside tipper and the ultimate tippee is more remote.[29] As a result, in these "remote tippee" cases, the government may try to rely more heavily on the inferences of knowledge that can be drawn from circumstantial evidence, such as relationships and shared histories. The degree to which these inferences will be permitted remains to be seen. Notably, however, although proof of knowledge is required, the government can meet its burden by showing that the final tippee knew, had reason to know, or consciously avoided knowing that the insider received a personal benefit in exchange for the information provided.[30] One thing is for sure: the Supreme Court's "gift" to regulators this holiday season is little more than a "re-gift."

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Endnotes

[1] *United States v. Salman*, 792 F.3d 1087, 1088 (9th Cir. 2015).

[2] *Id.* at 1089 (brackets omitted).

[3] *Id.*

[4] *Id.*

[5] *See Dirks v. Securities and Exchange Comm'n*, 463 U.S. 646, 662 (1983).

[6] *Id.* at 663.

[7] *Id.* at 664.

[8] *Id.*

[9] *Id.*

[10] 773 F.3d 438 (2d Cir. 2014).

[11] *Id.* at 452.

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

[13] *Id.*

[14] *Id.* (quoting *Dirks*, 463 U.S. at 664).

[15] *Salman v. United States*, No. 15-628, Slip Op. at 10.

[16] *Id.*

[17] *Id.* at 8.

[18] *Id.* at 9.

[19] *Id.*

[20] *Id.*

[21] *Id.* at 10.

[22] *Newman*, 773 F.3d at 449.

[23] *See* Slip Op. at 3 n.1 ("The Second Circuit also reversed the Newman defendants' convictions because the Government introduced no evidence that the defendants knew the information they traded on came from insiders or that the insiders received a personal benefit in exchange for the tips. 773 F. 3d, at 453–454. This case does not implicate those issues.").

[24] *Salman* Oral Arg. Tr. 36, lines 10–15.

[25] Slip Op. at 7.

[26] *Id.* at 11.

[27] *Id.*

[28] Using authority enacted pursuant to the Dodd-Frank Act, see 7 U.S.C. §§ 6c(a) and 9, the CFTC may now bring insider-trading actions based on misappropriation of confidential information. Under 17 C.F.R. § 180.1, the application of that authority is guided by case law applying the language of SEC Rule 10b-5.

[29] *Salman* Oral Arg. Tr. 36, lines 11–13 ("[P]erhaps at the end of the chain [it] will be more difficult [to prove the requisite knowledge] than [for] the ones earlier in the chain.").

[30] *Securities and Exchange Comm'n v. Obus*, 693 F.3d 276, 288–289 (2d Cir. 2012).