Clients&FriendsMemo

Getting By With a Little Help From Friends: United States Supreme Court to Clarify Insider Trading Liability in Tipping Cases

January 27, 2016

On January 19, 2016, the United States Supreme Court granted *certiorari* in *United States v. Salman*, in which the Ninth Circuit Court of Appeals held that the government may prove a "personal benefit" to a tipper of inside information—a necessary element of an insider trading case involving tipping—by showing evidence that an insider made a "gift" of confidential information to a trading relative or friend.[1]

The Supreme Court's attention to this issue is important because many have questioned the government's ability to aggressively pursue insider trading cases involving tipping since the Second Circuit Court of Appeals December 2014 decision in *United States v. Newman*.[2] Indeed, a review of the Supreme Court's seminal 1983 decision in *Dirks v. SEC*,[3] *Newman*, and the Ninth Circuit's recent decision in *United States v. Salman*, respectively, have left unclear the government's burden in insider trading cases involving tipping. *Dirks* held that a tipper will only be liable for insider trading where he or she provides the information for "personal gain" in violation of his or her fiduciary duty. However, the Court in *Dirks* did not define fully what constitutes "personal gain." In December 2014, the Second Circuit held in *United States v. Newman* that to prove such "personal gain," the government must present evidence "of an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[4] However, in *Salman*, the Ninth Circuit took a different approach by holding that the government may prove a benefit to the tipper merely by showing evidence that an insider gifted confidential information to a trading friend or relative.[5]

The Supreme Court's decision in *Salman* could provide much needed clarity concerning when insider trading liability may exist in tipping cases, especially those involving family and friends.

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1 792 F.3d 1087, 1093 (9th Cir. 2015).

2 773 F.3d 438 (2d Cir. 2014).

3 463 U.S. 646 (1983).

4 *Newman*, 773 F.3d at 452.

5 *Salman*, 792 F.3d at 1093-94.

Dirks v. SEC: The Supreme Court Explains That A Tipper's "Personal Gain" Is Required For Insider Trading Liability

In *Dirks v. SEC*, 463 U.S. 646 (1983), the Supreme Court held that "[n]ot only are insiders forbidden by their fiduciary relationship [to the corporation's shareholders] from personally using undisclosed corporate information to their advantage, but they also may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain."[6] While *Dirks* made clear that personal gain was an essential element of proving liability in an insider trading case involving tipping, *Dirks* and its progeny have left unclear what constitutes sufficient evidence of such gain. The personal gain is clearest when an insider shares material, nonpublic information with an outsider in exchange for a pecuniary benefit. Yet, in other instances, an insider may "gift" such information to a close relative or friend so that individual can trade on the information.[7] Specifically, the Court said in *Dirks* that a personal benefit can be inferred where there are "objective facts and circumstances that often justify such an inference," such as where the "relationship between the insider and the recipient that suggests a *quid pro quo* from the latter."[8] The U.S. Department of Justice ("DOJ") and the U.S. Securities and Exchange Commission ("SEC") have argued that even in cases involving "remote tippees," or outsiders who are many steps removed from corporate insiders, evidence of a friendly or familial relationship between the tipper and tippee satisfies the burden of proving personal benefit.[9] Thus, in a 2014 case involving trading in advance of GSI Commerce's acquisition by eBay, the SEC brought and settled insider trading charges against three tippees who received insider information from friends or family, even where it was doubtful the SEC could prove that the original source received a personal benefit from sharing the information.[10]

U.S. v. Newman: The Second Circuit Appears To Make It More Difficult For the Government To Pursue Tipping Cases

In December 2014, the Second Circuit issued a decision which appeared to deal a serious blow to the government's prosecution of remote tippees when it reversed the convictions of Todd Newman and Anthony Chiasson.[11] At trial, the government proved that Newman and Chiasson received and traded on insider information from several financial analysts, who in turn had received that

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6 463 U.S. 646, 659 (1983).

7 *Id.* at 664.

8 *Id.*

9 *See, e.g.*, *Newman*, 773 F.3d at 451-52; *Salman*, 792 F.3d at 1089.

10 *See* U.S. SEC. & EXCH. COMM'N, *SEC Charges Six Individuals With Insider Trading in Stock of E-Commerce Company Prior to Acquisition by eBay* (Apr. 25, 2014) *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541642140#.VlizNNLF-nk.

11 *See* Jodi L. Avergun and Douglas H. Fischer, *Friends With Benefits: Second Circuit Overturns Newman and Chiasson Convictions And Raises the Government's Burden in Insider Trading Cases Against Tippees*, BLOOMBERG CORPORATE LAW AND ACCOUNTABILITY REPORT, Dec. 12, 2014.

information through a chain of other sources. The government argued at trial that the jury could infer that the corporate insiders received a personal benefit because sharing the inside information with a former classmate and colleague and a "family friend" conferred a personal benefit to the tippers. In particular, because the tippers maintained a social relationship with the tippees, including receiving occasional career advice, a personal benefit to the tipper could be found.[12] On December 17, 2012, a jury found Newman and Chiasson guilty of insider trading.

On appeal, the Second Circuit reversed the convictions, holding that to the extent a personal benefit may be inferred from a relationship between the tipper and tippee, "such an inference 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."[13] In other words, there must be "evidence of 'a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the [latter].'"[14] The Second Circuit further explained that, while the government cannot prove a personal benefit to the tipper simply based on the "ephemeral" value of the friendship between the tipper and tippee, the government need not prove the tipping resulted in immediate pecuniary gain.[15] Otherwise, the court explained, the personal benefit requirement would be rendered null as the government could satisfy its burden by proving only that "two individuals were alumni of the same school or attended the same church."[16]

Following the Second Circuit's decision, the DOJ filed a petition for *certiorari* with the United States Supreme Court in which it asked the Court to address "whether the [Second Circuit] erroneously departed from this Court's decision in *Dirks* by holding that liability under a gifting theory requires "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."[17] The Supreme Court denied the DOJ's petition.

The decision in *Newman* and the Supreme Court's denial appeared to undermine significantly the government's ability to prosecute aggressively tipper and tippee insider trading cases. In the wake

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[12] *Id.* at 452.

[13] *Id.*

[14] *Id.* (quoting *United States v. Jiau*, 734 F.3d 147, 153 (2d Cir. 2013).

[15] *Id.* The Second Circuit cited several cases in which evidence of a *quid pro quo* between the tipper and tippee was sufficient to show a benefit to the tipper, even though there was no pecuniary gain to the tipper. *See SEC v. Yun*, 327 F.3d 1263, 1280 (11th Cir. 2003) (finding evidence of personal benefit where tipper and tippee worked closely together in real estate deals and commonly split commissions on various real estate transactions); *SEC v. Sargent*, 229 F.3d 68, 77 (1st Cir. 2000) (finding evidence of personal benefit when the tipper passed information to a friend who referred others to the tipper for dental work).

[16] *Id.* at 452.

[17] Petition for Writ of Certiorari, *United States v. Newman*, *cert denied*, No. 15-137 (U.S. Oct. 5, 2015).

of *Newman*, Judge Andrew L. Carter, Jr. of the Southern District of New York vacated four defendants' guilty pleas, explaining that the Court "was skeptical that the pleas were sufficient in light of *Newman's* clarification of the personal benefit and tippee knowledge requirements of tipping liability for insider trading."[18] And in October 2015, the U.S. Attorney for the Southern District of New York, Preet Bharara, moved to dismiss insider trading charges against seven individuals connected to SAC Capital Advisors.[19] Bharara stated that, in light of *Newman*, "insisting on maintaining guilty pleas in these cases would not be in the interests of justice."[20] More recently, the SEC agreed that it would not oppose the return of a $21.5 million settlement paid by Newman's and Chiasson's hedge fund, Level Global Investors LP, which the fund had moved to vacate on the basis of *Newman's* reversal.[21]

However, some district courts have read *Newman* more narrowly. For example, in *United States v. Gupta*, Judge Jed S. Rakoff of the Southern District of New York rejected Rajat Gupta's argument that *Newman* "requires that a tipper (here Gupta) receive from his tippee ([Raj] Rajaratnam) a 'quid pro quo' in the form of a potential gain of a pecuniary or similarly valuable nature."[22] In that case, the court held that a *quid pro quo* is not required to establish a personal benefit, referencing the Second Circuit's use of the phrase "or an intention to benefit the [latter]" in *Newman*.[23] Thus, while *Newman* has presented hurdles for the government, it has not completely undermined the DOJ's and SEC's ability to pursue tipping cases.[24]

***United States v. Salman*: The Ninth Circuit Boosts The Government In Tipping Cases**

In *United States v. Salman*, the government proved that defendant Salman traded on material, nonpublic information he obtained through a chain of tips originating with his brother-in-law. Maher Kara, an investment banker, testified at trial to having shared confidential information about certain mergers and acquisitions with, and to help financially, his brother, Michael Kara.[25] Michael then shared this information with defendant Salman, Michael's brother-in-law, and encouraged Salman to trade on the information.[26] The government also presented evidence that the Kara brothers were

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[18] *United States v. Conradt*, 2015 U.S. Dist. LEXIS 16263, *2-3 (S.D.N.Y. Jan. 22, 2015).

[19] Matthew Goldstein, *U.S. Prosecutor to Drop Insider Trading Cases Against Seven,* N.Y. TIMES (Oct. 22, 2015).

[20] *Id.*

[21] *See* Mot. to Vacate, *SEC v. Adondakis*, No. 1:12-cv-00409 (S.D.N.Y. Dec. 22, 2014).

[22] *United States v. Gupta*, 2015 U.S. Dist. LEXIS 86635, *4 (S.D.N.Y. July 2, 2015).

[23] *Id.* at *5.

[24] *See also Securities and Exchange Commission v. Megalli*, case no. 1:13-cv-03783 (N.D. Ga. Sept. 24, 2015) (stating that "Newman has made waves, but the court is not convinced it is a total sea change.").

[25] *Salman*, 792 F.3d at 1092.

[26] *Id.* at 1089.

particularly close—for example, that Michael Kara helped to pay for Maher's college and stood in for their father at Maher's wedding.[27] The jury found Salman guilty of insider trading.

On appeal, Salman urged the Ninth Circuit to adopt *Newman* and rule that the government's evidence regarding the relationship between Maher and Michael was insufficient for a jury to find that Maher disclosed the inside information to his brother in exchange for a personal benefit.[28] The Ninth Circuit panel, however—on which Judge Rakoff of the Southern District of New York sat by designation—affirmed the district court's judgment, finding that Salman's reading of *Newman* was too narrow.[29] The Ninth Circuit reasoned that Salman's reading of *Newman* would depart too far from *Dirks*, which explained that liability may exist where the "insider makes a gift of confidential information to a trading relative or friend."[30] The Ninth Circuit further explained that if Salman's argument prevailed, a corporate insider could disclose confidential information to trading relatives, provided only that the insider asked for no "tangible" compensation in return.[31] The Ninth Circuit did not expressly disagree with *Newman*, but rejected Salman's argument that *Newman* requires proof of "tangible" gain to the tipper.[32]

The Supreme Court Grants *Certiorari* in *Salman* Over the DOJ's Objection

On January 19, 2016, the Supreme Court agreed to hear Salman's appeal. In his petition for *certiorari*, Salman urged the Court to address the following question:

> Does the personal benefit to the insider that is necessary to establish insider trading under *Dirks v. SEC*, 463 U.S. 646 (1983), require 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 is it enough that the insider and the tippee shared a close family relationship, as the Ninth Circuit held in this case?[33]

The DOJ, which had unsuccessfully petitioned for the Supreme Court to grant a writ of *certiorari* in *Newman*, opposed Salman's petition. In doing so, the DOJ argued that the

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[27] *Id.*

[28] *Id.* at 1093.

[29] *Id.*

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

[31] *Id.*

[32] It is noteworthy that the evidence that Salman knew of personal benefit to the tipper was much stronger than in *Newman*, where one of the defendants did not even know the identity of the original tipper.

[33] Petition for Writ of Certiorari, *Salman v. United States*, *cert granted*, No. 15-628 (U.S. Jan. 19, 2016).

Salman decision is correct and wholly consistent with *Dirks*.[34] The Supreme Court could hear oral arguments in *Salman* as early as April.

Conclusion

The government's opposition to *certiorari* in *Salman* suggests it is concerned that the Supreme Court could render a decision consistent with *Newman*. Indeed, if the Supreme Court holds that demonstrating a personal benefit requires evidence of a *quid pro quo* or pecuniary gain to the tipper, the DOJ's and SEC's prosecutions of insider trading violations in tipping cases will be significantly hampered. On the other hand, should the Court affirm Salman's conviction and adopt the Ninth Circuit's "personal benefit" test, the DOJ and the SEC may feel emboldened to continue their aggressive pursuit of insider trading violations in tipping cases. Either way, the Supreme Court's decision is likely to provide a more definitive view concerning when insider trading liability will exist in tipping cases.

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[34] Opposition to Petition, *Salman v. United States*, *cert granted*, No. 15-628 (U.S. Jan. 19, 2016).