

Clients & Friends Memo

Supreme Court Justices Appear Hesitant to Narrow the Scope of Insider Trading Liability

October 7, 2016

Since the Second Circuit Court of Appeals' December 2014 decision in *United States v. Newman*,¹ the government's ability to aggressively pursue insider trading cases involving tipping has been in doubt. But, on October 5, the Supreme Court heard oral arguments in *Salman v. United States*,² a case that should clarify the government's burden in proving insider trading cases against tippees and tippees.³

Background

In its seminal 1983 insider trading decision in *Dirks v. SEC*, the Supreme Court held that a tipper of material, non-public information will be liable for insider trading only where he or she provided the information for "personal gain" in violation of his or her fiduciary duty.⁴ However, the Court in *Dirks* did not define fully what constitutes "personal gain." In *Newman*, the Second Circuit held 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." Under *Newman*, a benefit to the tipper such as career advice or friendship is insufficient to establish a personal gain. Because concrete proof of a personal gain can be difficult to come by in cases involving long tipping chains, *Newman* appeared to be a big blow to the prosecution of such cases.

However, many courts have not followed *Newman* closely. Most notably, in *Salman*, the Ninth Circuit took a broader view of personal gain. In *Salman*, the government proved at trial that defendant Bassam 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

¹ 773 F.3d 438 (2d Cir. 2014).

² Case No. 15-628. Oral argument transcript *available at* https://www.supremecourt.gov/oral_arguments/argument_transcripts/2016/15-628_p86a.pdf.

³ <http://www.cadwalader.com/resources/clients-friends-memos/getting-by-with-a-little-help-from-friends-united-states-supreme-court-to-clarify-insider-trading-liability-in-tipping-cases>.

⁴ 463 U.S. 646 (1983).

shared confidential information about certain mergers and acquisitions with, and to help financially, his brother, Michael Kara. Michael Kara then shared this information with Salman, and encouraged Salman to trade upon it. There was no proof at trial of any pecuniary gain for the original tipper (Maher Kara), but the government did present evidence that the Kara brothers shared a very close relationship. The Ninth Circuit upheld Salman's conviction, 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 Thus, *Newman* has not completely undermined the DOJ's and SEC's ability to pursue tipping cases.

Oral Arguments

At oral argument in *Salman*, Salman's counsel urged the Court to adopt a rule similar to *Newman*, whereby a tippee could be held liable only if the government proved the tippee's knowledge of a "tangible" or "concrete" benefit. Salman's counsel argued that insider trading liability must be construed narrowly because no statute specifically defines the parameters of the offense. Several of the Justices expressed skepticism towards these arguments. Justice Sotomayor commented that Congress deliberately used general language to proscribe a broad range of more specific activities and that insider trading fell within the established understanding of fraud prohibited by the statute. And Justice Kagan pointed out that "Congress has shown no indication that it's unhappy" with *Dirks* and the body of insider trading law deriving therefrom. Justice Kagan also noted that *Dirks* did not limit the definition of personal gain to things which are "concrete" or "tangible," but rather stated that the element of personal gain is satisfied when the tipper gives a "gift" of confidential information to a tippee; this point that was echoed by Justice Breyer.

The government advocated for a broader view of "personal gain," arguing that liability should exist when a tipper provides inside information knowing that a tippee would trade on that information. The Justices appeared more receptive to the government's arguments, but still challenged the extent to which the government's proposal would expand liability. Chief Justice Roberts questioned the government's argument, asking why liability should be premised upon the tipper's belief as to whether the tippee would trade. And Justice Sotomayor posited that the government's position was "way out of existing law." The government responded that it did not believe it was asking the Court to go "beyond *Dirks*" and that it would be happy if the Court upheld Salman's conviction and reaffirmed *Dirks*. The government also noted that no court besides the Second Circuit has adopted a standard like the one proposed by Salman.

Comment

The Justices seemed largely unmoved by Salman's arguments that insider trading liability must be construed more narrowly because the offense is not precisely defined by statute. Indeed, Justice Kagan expressed concern that by narrowing the scope of what constitutes insider trading, Salman

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

was asking the Court “essentially to change the rules in a way that threatens that integrity [of the markets].” Therefore, it would be surprising if the Court adopts Salman’s urged limitation on insider trading.

It remains to be seen if the Supreme Court’s ruling will elaborate upon or clarify in some way *Dirks*’ personal gain requirement, or if it simply will maintain the status quo. Either way, it seems likely that *Newman* will go down in history as a speed bump, rather than a serious impediment, to prosecuting insider trading cases involving tipping.

* * *

Jodi L. Avergun	Tel 202-862-2456	jodi.avergun@cwt.com
Joseph V. Moreno	Tel 202-862-2262	joseph.moreno@cwt.com
Douglas H. Fischer	Tel 202-862-2276	douglas.fischer@cwt.com
Alexander Hokenson	Tel 202-862-2249	alexander.hokenson@cwt.com
Emily J. Rockwood	Tel 202-862-2225	emily.rockwood@cwt.com