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What to Look For in Tomorrow's Supreme Court Argument in Key Insider Trading Case

For the first time in nearly twenty years, the United States Supreme Court will hear oral argument tomorrow in a case directly addressing the scope of insider trading liability. The question before the Court in *Salman v. United States* is technically a somewhat narrow one: whether a gift of confidential information to a trading friend or relative constitutes the type of personal benefit necessary to give rise to insider trading liability. The implications of the Court's decision, however, will likely be far broader than that.

In *Salman*, the Court will consider the meaning of the personal benefit requirement first articulated in the Court's 1983 seminal insider trading case, *Dirks v. SEC*.[1] Although the personal benefit requirement was intended by the Court to provide a "guiding principle" to market participants,[2] it has been the subject of much debate and uncertainty since the Second Circuit's landmark 2014 decision in *United States v. Newman*.[3]

Salman provides the Court an opportunity to provide some much-needed clarity. It remains to be seen, however, whether the Court will try to limit its holding to the narrow set of facts presented (*i.e.*, the sufficiency of a "gift" of confidential information to a friend or relative) or more broadly address, and potentially expand or restrict, the scope of the personal benefit requirement. The Court could even revisit the need for the personal benefit requirement altogether. Thus, while the Court will almost certainly use *Salman* to clarify the contours of insider trading liability, there is also the potential for the Court to significantly alter the current landscape.

Factual Background on Salman

Salman was a "remote" tippee who was convicted after trial of trading on material, nonpublic information about impending mergers and acquisitions. The tipper, Maher Kara, was an investment banker who provided confidential information about corporate transactions he was working on to his brother, Michael Kara. Michael used the information to execute trades for himself and provided the information to Salman (whose sister was engaged to and later married Maher). Salman, in turn, also traded on the information.[4]

Maher pled guilty and testified at trial that he initially shared information with his brother on the understanding that his brother was not trading on it.[5] However, at some point, Michael began asking Maher specific questions focused on particular companies about which Maher had confidential information.[6] At that point, Maher suspected his brother Michael was trading on the information but nevertheless continued to tip him.[7] Maher testified that he knowingly tipped Michael with the intent that Michael benefit from the information and "to get [Michael] off [his] back[.]"[8]

The district court in *Salman* instructed the jury that to convict Salman of insider trading, it needed to find, among other elements, that (1) the insider (here, Maher) personally benefitted from the disclosure of material, nonpublic information, and (2) Salman knew that the insider had personally benefitted from the disclosure.[9] The district court instructed the jury that "personal benefit" to the insider could include "the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend. The benefit does not need to be financial or tangible in nature."[10]

The Existing Legal Framework

The Supreme Court has repeatedly rejected a "parity of information" theory, holding that there is no "general duty between all participants in market transactions to forgo actions based on material, nonpublic information."[11] Accordingly, a person who knowingly receives material, nonpublic information from a corporate insider and trades on it does not, without more, commit securities fraud. Put differently, a duty to refrain from trading does not arise merely from the receipt of material, nonpublic information from an insider. Whether such a duty exists depends on the particular circumstances under which the information was acquired.

In *Dirks*, the Court explained when such a duty arises. The Court held that under the "classical theory" of insider trading, a duty arises only when the information has been improperly obtained—that is, when the tipper has provided information in breach of a fiduciary duty to shareholders.[12] The Court viewed it as "essential" that there be a "guiding principle" for market participants "whose daily activities must be limited and instructed by the SEC's inside-trading rules."[13] Accordingly, the Court held that the "test" for determining whether such a breach has occurred is "whether the insider personally will benefit, directly or indirectly, from his disclosure."[14] "Absent some personal gain" by the insider, there has been no breach and thus no duty to refrain from trading.[15]

This personal benefit test, according to the Court, requires courts to focus on "objective criteria," such as whether the insider obtains "a pecuniary gain or a reputational benefit that will translate into future earnings."[16] The Court explained that "objective facts and circumstances [will] often justify such an inference":

> For example, there may be 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. 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 tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.[17]

Prior to the Second Circuit's decision in *Newman*, the personal benefit requirement was generally not perceived as imposing a particularly high bar. Non-pecuniary benefits, including friendship and "gifts" of information, were generally viewed as sufficient to constitute a personal benefit that triggered a duty to abstain from trading.

In *United States v. Newman*, however, the Second Circuit sought to impose greater limits on the scope of the personal benefit requirement.[18] In *Newman*, a case in which portfolio managers at two hedge funds were convicted after trial of trading on inside information obtained indirectly from insiders at two public companies, the government argued that the personal benefit to the insiders included career advice and friendship.[19] The *Newman* panel held that the evidence was insufficient to support the government's theory that the tippers received any personal benefit in exchange for providing inside information. For evidence of a personal benefit to be sufficient, the Court wrote, there must be "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."[20 21]

The Ninth Circuit's Decision in *Salman*

Relying on *Newman*, which was decided after Salman's conviction, Salman argued before the Ninth Circuit that the jury instructions in his case had been erroneous and that the government had presented no evidence of any "tangible benefit in exchange for the inside information."[22] The Ninth Circuit rejected Salman's argument, observing that "the Government presented direct evidence that the disclosure was intended as a gift of market-sensitive information," and holding that this evidence permitted the jury to infer that the tipper had received a personal benefit for disclosing the information.[23] The Ninth Circuit disagreed with *Newman* to the extent it could be read to require a tangible benefit. In an opinion authored by Judge Jed Rakoff of the Southern District of New York, sitting by designation, the Court explained that: "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.'"[24]

The Arguments Before the Supreme Court

In his briefing before the Supreme Court, Salman has advocated a more restrictive view of personal benefit than *Newman*. In particular, Salman argues that only a *pecuniary* gain can satisfy the personal benefit requirement set forth in *Dirks*. Salman contends that because the purpose of the *Dirks* test is "to capture fraud by the insider,"[25] in order for tipping to be fraudulent, the tipper's motive must be "to obtain *money or property* for himself."[26]

In support of these arguments, Salman contends that the standard applied in his case—that a personal benefit can be the "benefit one would obtain from simply making a gift of confidential information to a trading relative or friend"—is so indeterminate that it does not fulfill *Dirks*' goal of establishing a limiting principle.[27] He further argues that the standard is sufficiently vague that it amounts to an unconstitutional delegation of power to define crimes to prosecutors.[28]

In response, the government argues that the personal benefit test set forth in *Dirks* is intended to distinguish between disclosures of information that are motivated by a corporate (and therefore permissible) purpose and those disclosures of information that are motivated by a personal (and therefore impermissible) purpose. Thus, the government argues, the personal benefit requirement is satisfied when confidential information is disclosed by a tipper acting in the absence of a corporate purpose.[29] In the government's view, because Maher had no corporate purpose for providing information to his brother about the deals he was working on, it was reasonable for the jury to infer that he was doing so for a personal benefit. With respect to Salman's claim that the standard endorsed by the Ninth Circuit is unconstitutionally vague, the government argues that the standard has been applied without difficulty by courts and understood by industry participants since *Dirks* was decided.[30]

Discussion

The personal benefit requirement was expressly intended by the *Dirks* Court to provide a "guiding principle" to investors, analysts and other market participants "whose daily activities must be limited and instructed by the SEC's inside-trading rules."[31] The Court thought it "essential" to provide clear guidance to industry professionals to avoid chilling their communications with company management. Given the current uncertainty surrounding the boundaries of the personal benefit requirement, however, it is difficult to credibly maintain that the *Dirks* test still satisfies that objective.

Salman is asking the Court to impose a bright-line solution: a requirement that the tipper receive a *pecuniary* benefit. The government, on the other hand, argues that where there is no corporate purpose for a disclosure—*e.g.*, when a disclosure is made to a friend or relative—then the disclosure has been made for a personal purpose and is improper under *Dirks*. Thus, in the government's view, no pecuniary or tangible benefit is necessary to infer a personal benefit where a disclosure is made to a friend or relative.

However, even if the Court were to accept the government's approach in the context of a disclosure to a friend or relative, that approach could remain problematic in the context of disclosures to investment professionals. Unlike a disclosure to a friend or relative, there are many corporate, non-personal reasons for disclosures by corporate insiders to market professionals. Indeed, members of management frequently (and appropriately) speak to and meet with analysts and institutional investors, and they do so because they believe it is in the corporation's best interest to do so.

Thus, absent a requirement for a pecuniary or tangible benefit, market professionals may be left without the sort of clear guidance the *Dirks* Court viewed as "essential." Instead, those professionals who routinely speak to company management may have no reasonable, objective way to determine whether a particular disclosure was made for a corporate purpose or a personal purpose and therefore whether they are permitted to trade on the information.

Accordingly, if the Court adheres to the personal benefit requirement and determines that a "gift" satisfies that requirement, it may be important for the Court to distinguish between disclosures to a friend or relative and disclosures to a market professional. Even if a tangible or pecuniary benefit is deemed unnecessary in the former setting, it still may be warranted in the latter given the legitimate concerns animating the personal benefit requirement—namely, the need to provide clear guidance to market professionals and avoid chilling lawful and appropriate communications with company management.

Conclusion

In light of recent uncertainty among courts, practitioners and industry participants, and the fact that the Supreme Court has not directly addressed the boundaries of the personal benefit requirement since *Dirks* was decided more than thirty years ago, Wednesday's argument will be closely watched by those on all sides of the debate.

At a minimum, the Court will need to address whether an insider's gift of confidential information to a friend or relative can give rise to insider trading liability. But the Court is also likely to provide much-needed clarity on the overall scope of the personal benefit requirement. Accordingly, observers will be carefully watching the argument for any signs of the Court's leaning on the particular issue presented but also its appetite for a more expansive ruling that could alter—and perhaps even redefine—the boundaries of insider trading.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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1 463 U.S. 646 (1983).

2 *Id.* at 664.

3 Paul, Weiss was appellate counsel for Anthony Chiasson, a co-defendant in *United States v. Newman*.

4 *United States v. Salman*, 792 F.3d 1087, 1089 (9th Cir. 2015).

5 Brief for Pet.'r at 10, *United States v. Salman*, No. 15-628 (S. Ct. May 6, 2016).

6 *Id.* at 10-11.

7 *Id.*

8 *Id. at 11.*

9 *Id.* at 14-15.

10 *Id.* at 15.

11 *Chiarella v. United States*, 445 U.S. 222, 233 (1980).

12 The Supreme Court has recognized two theories of insider trading liability: "classical" and "misappropriation." The "classical theory" of insider trading liability applies when a "corporate insider trades in the securities of his corporation on the basis of material, nonpublic information." *United States v. O'Hagan*, 521 U.S. 642, 651-52 (1997). The "misappropriation theory," by contrast, applies when an investor "misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information." *Id.* at 652.

13 *Dirks*, 463 *U.S.* at 664.

14 *Id.* at 662.

15 *Id.*

16 *Id.* at 663.

17 *Id.* at 664.

18 773 F.3d 438 (2d Cir. 2014).

19 *Id.* at 452-53.

20 *Id.* at 452.

21 Additionally, in *Newman*, the Second Circuit addressed a related question that is not at issue in *Salman*: whether a remote tippee is required to have knowledge of the receipt of a personal benefit by the insider. Based on its reading of *Dirks*, the Second Circuit 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." *Id.* at 452. Although the government sought certiorari on the question of what constitutes a personal benefit, which was denied, the government did not challenge this other aspect of the *Newman* holding and now appears to concede that a tippee is only liable for insider trading if he knows that the insider breached a duty for personal benefit.

22 *Salman*, 792 F.3d at 1093.

23 *Id.* at 1094.

24 *Id.* at 1093-94 (quoting *Dirks*, 463 U.S. at 664).

25 Brief for Pet.'r at 30, *United States v. Salman*, No. 15-628, (S. Ct. May 6, 2016).

26 *Id.* (emphasis added).

27 *Id.* at 40-44.

28 *Id.* at 45.

29 Brief for Resp. at 18-23, *United States v. Salman*, No. 15-628, Resp.'s Br. at 30 (May 6, 2016).

30 *Id.* at 38-41.

31 *Dirks*, 463 U.S. at 664.