Bloomberg BNA

Securities Regulation & Law Report™

INSIDER TRADING

Supreme Court's Determination of 'Personal Benefit' Test Under Insider Trading Laws Raises Practical Implications for Financial Market Professionals

BY JOSHUA G. HAMILTON AND TIMOTHY D. REYNOLDS

The mere utterance of the phrase ''insider trading investigation'' sends shivers down the spine of any asset manager. However, what makes this phrase even more daunting is the great uncertainty of what actually constitutes a violation in the context of a portfolio manager who traded on information provided by someone else. On October 5, 2016, the Supreme Court will hear oral argument in the case *Salman v. United States* to resolve a recent circuit split between the Second Circuit and Ninth Circuits regarding the lynchpin to tipper/tippee insider trading liability: What constitutes a ''personal benefit'' to a corporate insider sufficient to establish tipper/tippee liability for insider trading under Section 10(b) of the 1934 Exchange Act?

Joshua Hamilton is a partner in the Litigation practice of Paul Hastings and is based in the firm's Los Angeles office. A complex litigator and trial lawyer, Mr. Hamilton concentrates his practice on securities and corporate governance related litigation and investigations, defense of class actions, and representation of companies and senior executives in high-stakes disputes.

Tim Reynolds is an associate in the Litigation practice of Paul Hastings and is based in the firm's Los Angeles office. His practice focuses on securities litigation matters representing multi-national corporations, investment banks, officers, and directors against claims brought under the federal securities laws, blue sky laws, and common law.

Over thirty years, ago the Supreme Court articulated that there should be a ''guiding principle'' for those regulated by the Securities and Exchange Commission to know whether or not their conduct runs afoul of insider trading laws. However, that ambition set forth in *Dirks v. SEC*, 463 U.S. 646 (1983) has thus far not been met as insider trading liability under the law, in practical terms, remains consistently unpredictable in the area of trading on information provided by a third party. The *Salman* decision will thus likely have far-reaching implications for financial market professionals seeking certainty and predictability in determining whether trading on recommendations, rumors, and/or information derived from communications with corporate insiders is permitted or prohibited under the law.

''Rules'' of *Tipper/Tippee Liability After Dirks v. SEC*

Nearly thirty-five years ago, in *Dirks v. SEC*, 463 U.S. 646 (1983), the Supreme Court articulated the principle of ''tipper/tippee'' liability: ''[t]he need for a ban on some tippee trading is clear. Not only are insiders forbidden by their fiduciary relationship 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.'' 463 U.S. at 659-60. A tipper or tippee may therefore be liable for violations of insider trading laws where (1) the tipper

possessed material nonpublic information; (2) the tipper disclosed that information to the tippee in violation of duty; (3) the tippee traded on the basis of that information; (4) *the tipper received a personal benefit*; and (5) the tippee knew or should have known that the tipper breached his fiduciary duty by disclosing the information an receiving a personal benefit for it. *See id.* at 658-661; *see also United States v. Newman*, 773 F.3d 438 (2d. Cir. 2014).

In *Dirks*, the Supreme Court articulated the test for liability hinged on ''whether the insider personally will benefit, directly or indirectly, from his disclosure[,]'' explaining that ''[a]bsent some personal gain, there has been no breach of fiduciary duty [and] absent a breach by the insider, there is no derivative breach.'' *Id.* at 662. The Supreme Court further explained that a direct or indirect benefit ''requires courts to focus on objective criteria, . . . such as a pecuniary gain or a reputational benefit that will translate into future earnings.'' *Id.* at 663.

Critically, the Supreme Court also permitted 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.'' *Id.* at 664 (emphasis added). Seizing upon this dictum, the U.S. Securities & Exchange Commission and criminal prosecutors have successfully expanded liability in tipper-tippee cases to include gifts to family members, friends, and even acquaintances with little to zero objective evidence for a pecuniary gain.

In other words, since *Dirks*, the ''personal benefit'' requirement became at best a very low hurdle for prosecutors to clear, and a worst, stripped the *Dirks* test of any real meaning. *See, e.g., SEC v. Blackwell*, 291 F. Supp. 2d 673, 692 (S.D. Ohio 2003) (''disclosed material non-public information, [standing] alone'' is sufficient to establish personal benefit); *SEC v. Blackman*, No. 3:99-1072, 2000 WL 868770, at *9 (M.D. Tenn. May 26, 2000 (mere fact of disclosure sufficiently alleges ''gift'' to satisfy personal benefit requirement of *Dirks*); *SEC v. Downe*, 969 F. Supp. 149, 156 (S.D.N.Y. 1997) (personal benefit established from testimony that a tipper was motivated by ''ego''), *aff'd sub nom. SEC v. Warde*, 151 F.3d 42, 48-49 (2d. Cir. 1998); *SEC v. Yun*, 327 F.3d 1263, 1280-81 (11th Cir. 2003) (inferring personal benefit from ''friendly'' relationship between coworkers).

The Second Circuit's Decision in *United States v. Newman*

In 2014, the Second Circuit decided *United States v. Newman*, 773 F.3d 438 (2d. Cir. 2014). The Second Circuit reversed the insider trading convictions of two hedge fund portfolio managers who had traded on nonpublic earnings information concerning two companies they had received indirectly from corporate insiders. The two hedge fund managers had allegedly received material non-public information, but they stood many links afar from the corporate insider who was the source of the allegedly illicit earnings results. The Second Circuit held that to sustain an ''insider trading conviction against a tippee, the Government must prove . . . (1) the corporate insider was entrusted with a fiduciary duty; (2) the corporate insider breached his fiduciary duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit; (3) the tippee knew of the tipper's breach, that is, he knew the inform was confidential and *divulged for a personal benefit*; and (4) the tippee still used that information to trade in a security or tip another individual for personal benefit.'' *Newman*, 773 F.3d at 450. The Second Circuit further elaborated that only a ''meaningfully close personal relationship that generates an exchange that is objective, consequential, and represent at least a potential gain of a pecuniary or similarly valuable nature [will suffice].'' *Id.*

Ninth Circuit Decision in *United States v. Salman Creates Circuit Split*

The *Salman* case before the Supreme Court presents a different fact pattern than *Newman*, but likewise implicates the ''personal benefit'' test. As described in the court filings, Mr. Salman's future brother-in-law joined the healthcare investment banking group at Citigroup in 2002. The brother-in-law, Maher Kara, shared confidential information regarding Citigroup's clients with his brother Michael Kara. Michael Kara traded on the information. Michael Kara subsequently became friends with Mr. Salman and Michael Kara provided Mr. Salman with some of the tips Maher was giving to Michael. Mr. Salman then traded on the information. Following a jury trial, Mr. Salman was found guilty as a remote tippee. On appeal, the Ninth Circuit, relying on *Dirks*, affirmed, finding that the case was a prime example where a personal benefit can be established when the insider makes a gift of confidential information to a trading relative or friend. *See United States v. Salman*, 792 F.3d 1087, 1092. [In *United States v. Parigian*, 824 F.3d 5, 16 (2016), the First Circuit acknowledged the circuit split between the 2nd and 9th Circuit regarding the standard for ''personal benefit,'' stating that the 9th Circuit interpretation in *Salman* was more aligned with 1st Circuit precedent, but avoided the issue by finding a personal benefit met under either standard.]

A circuit split thus emerged concerning the ''personal benefit'' test articulated in *Dirks*. The Supreme Court granted *certiorari* on the following question:

> Whether the personal benefit to the insider that is necessary to establish insider trading under *Dirks v. SEC*, 463 U.S. 646 (1983), requires 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* 136 S. Ct. 242 (2015), or whether it is enough that the insider and the tippee shared a close family relationship, as the Ninth Circuit held in *United States v. Salman*.

The Supreme Court's Decision in Salman Will Have Far-Reaching Implications For Financial Market Professionals

Over the past 35 years, prior to *Newman,* government agencies relied upon the ''gift'' of confidential information to trading relatives or friends, or the vague presumption that by giving a tip, the tipper receives an enhanced reputation in social circles, to establish the per-

   ISSN 0037-0665

sonal benefit requirement under *Dirks*. The decision in *Newman* changed that in the Second Circuit, resulting in many convictions being overturned and ending the long winning streak of the Department of Justice in the Southern District of New York in insider trading cases.

In *Salman*, the Appellant Defendant urges the Supreme Court to reverse the Ninth Circuit decision, and to restrict liability in insider trading cases to situations where the tipper sought a pecuniary gain. In other words, Salman urges the Supreme Court to adopt the Second Circuit standard under *Newman*. The government responds that the personal benefit test under *Dirks* was properly applied by the Ninth Circuit, noting that the personal benefit to a trading relative or friend is necessary to address insider trading violations for ''personal'' as opposed to ''corporate'' purposes. Should the Supreme Court determine to tighten the reins by requiring the government to provide objective proof of a pecuniary gain as was required in *Newman*, civil charges by the SEC and criminal prosecution for violations of insider trading laws would require the government to establish objective proof of a personal gain, or the potential for such a gain—a much more difficult hurdle than a gift or an improved reputation in a social circle. [While not available to the SEC, as an alternative, federal criminal prosecutors may try to bring similar insider trading cases under entirely different statutes that may not require the government to provide objective proof of a personal benefit to the tipper. *See, e.g.*, *U.S. v. Melvin*, 143 F. Supp. 3d 1354, 1374-75 (N.D. Ga. 2015) (permitting criminal complaint for insider trading scheme to proceed under 18 U.S.C. § 1348 and finding that the government need only allege the elements sufficient to state a claim under § 1348, and not the elements for tipper liability under Section 10(b) of the Exchange Act), *appeal filed*, *Melvin v. U.S.*, No. 16-12061-D (11th Cir. Apr. 29, 2016).] As the government has attempted to do in post-*Newman* cases, this will result in sometimes strained efforts to tie a pecuniary benefit between family members to the tip.

Among asset managers and other investment professionals trying to understand whether insider trading laws are implicated, the critical issue they are looking for is certainty. Indeed, industry participants and high-profile investors recognize the importance of the Supreme Court's decision in *Salman* as reflected by amicus briefs submitted to the United States Supreme Court by the Securities Industry and Financial Market Association (''SIFMA''), the Center on the Administration of Criminal Law at New York University, and Mark Cuban. [SIFMA does not take a position on the particulars of the case, however, SIFMA's brief as *Amicus Curiae* points out the importance of clear and definite laws for a functioning securities market and asks the Supreme Court to reaffirm ''that those who receive company information may act on the information unless they are aware that a tipper disclosed the information in order to obtain a personal benefit of a 'pecuniary or similarly valuable nature.' '' *See* Brief of Amicus Curiae Securities Industry and Financial Markets Association in Support of Neither Party, 2016 WL 2865582, at *24 (quoting *United States v. Newman*, 773 F.3d at 452).]

Fund managers and other financial market professionals regularly conduct in-depth investigations in a company before making a substantial financial investment. These investigations may include meeting with company executives, conducting channel checks and ferreting out information from the professionals' network of industry experts. Indeed, the Supreme Court made clear in *Dirks*, it is ''commonplace for analysts to ferret out and analyze information,'' including ''by meeting with and questioning corporate officers and others who are [corporate] insiders.'' 463 U.S. at 658.

Under current jurisprudence in the Ninth Circuit, however, financial analysts, hedge fund managers, and other market participants must be mindful of each and every relationship in their network before making an investment decision. In addition to ensuring that controls are in place such that they are not exposed to material non-public information, these market professionals must query whether a relationship with a corporate insider is sufficiently close to warrant a finding of personal benefit to the insider should the individual decide to trade in a company's securities following being exposed to information. However, sometimes despite all appropriate precautions, a trader may have unwittingly used material non-public information in connection with a trade. Therefore, as *Dirks* correctly recognized, it is paramount for financial market participants to have clear and consistent rules governing liability—what constitutes illegal activity versus what conduct will not rise to illegal activity under the securities laws. *See id.* at 664. While after nearly 35 years, the Supreme Court may finally provide the answer, depending on the outcome, there is also the possibility that the Court's decision will result in a requirement of a case-by-case inquiry into the depth of the ''closeness'' of the particular relationship.