DECEMBER 2016

COMMENTARY

U.S. Supreme Court Clarifies Standards for "Tippee" Insider Trading Liability

On December 6, 2016, the U.S. Supreme Court addressed a disagreement in the lower courts regarding the scope of insider trading liability for "tippees"—individuals who trade in a corporate security based on material nonpublic information received from corporate insiders. Under *Dirks v. S.E.C.*, 463 U.S. 646 (1983), tippee liability can exist only if the tipper personally benefited from the disclosure of the inside information. In *Salman v. United States*, 580 U.S. ___ (2016), authored by Justice Alito, the Court unanimously concluded that a tipper's gift of inside information to a trading friend or relative suffices to satisfy this personal benefit element for insider trading liability—even if the tipper did not receive a pecuniary or tangible benefit in return.

Salman is most notable for rejecting the Second Circuit's narrow view of tippee liability, announced in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), which required the U.S. government to prove that the tipper received a pecuniary or similar benefit for liability to attach. However, it is also notable that the Court refrained from adopting the very broad interpretation proposed by the government, which would have imposed liability whenever the tipper discloses inside information to anyone for any noncorporate purpose. As a result, the Court's decision leaves a good deal of uncertainty concerning the scope of tippee liability—leaving courts and litigants to grapple with what kinds of benefits to tippers resulting from disclosures will give rise to such liability.

The Personal-Benefits Test for "Tippee" Insider Trading Liability

In *Dirks v. S.E.C.*, 463 U.S. 646 (1983), the Supreme Court held that tippees will be liable for insider trading only when "the insider receives a direct or indirect personal benefit from the disclosure" of the material nonpublic information at issue. To determine liability under this test, *Dirks* directed courts to examine "objective criteria," such as whether the tipper's disclosure resulted in a "pecuniary gain or a reputational benefit that will translate into future earnings." The Court observed that liability under this standard could attach when "an insider makes a gift of confidential information to a trading relative or friend," since the "tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient." Yet, *Dirks* acknowledged that "[d]etermining whether an insider personally benefits from a particular disclosure, a question of fact, will not always be easy for courts."

While prosecutors vigorously pursued tippees in the decades after *Dirks*, a recent Second Circuit decision created significant uncertainty regarding the scope of tippee liability. In *United States v. Newman*, the Second Circuit adopted a narrow reading of the *Dirks* personal-benefits test, holding that a tipper's "gift" of inside information to another person will give rise to liability only when there is "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."

The *Salman* Case

In 2011, Bassam Salman was indicted for insider trading as a tippee. The ultimate source of the inside information was Maher Kara, a former Citigroup insider. Maher shared inside information with his brother, Michael Kara, with the knowledge that Michael intended to trade on that information. Michael, in turn, shared this inside information with Bassam Salman, who was Michael's friend and Maher's brother-in-law. Salman traded on this information, knowing that the information came from Maher and that Maher intended to benefit Michael by his disclosure.

Salman was convicted, and he appealed to the Ninth Circuit. He argued that his conviction should be reversed based on the Second Circuit's *Newman* decision, since Maher had not received any benefit of "a pecuniary or similarly valuable nature" in exchange for providing tips to Michael. The Ninth Circuit rejected this argument and declined to follow *Newman*'s narrow reading of the personal-benefits test. The Supreme Court granted certiorari to resolve the tension between the Ninth Circuit's decision and *Newman*.

The Court's Decision

In a unanimous decision, the Supreme Court rejected *Newman*'s narrow view of liability and affirmed Salman's conviction. The Court reasoned that *Dirks*'s "discussion of gift giving resolves this case." It explained that "when a tipper gives inside information to 'a trading relative or friend,'" the tipper "benefits personally because giving a gift of trading information is the same thing as trading by the tipper followed by a gift of the proceeds." Therefore, because Maher disclosed inside information "as a gift to his brother with the expectation that [his brother] would trade on it," Maher personally benefitted from the disclosure—which in turn rendered Salman, who knew these facts, liable. The Court rejected *Newman* to the extent it required any additional benefit to the tipper to be shown in these circumstances, such as a benefit of a "'pecuniary or similarly valuable nature.'"

At the same time, the Court also declined the government's invitation to go beyond *Dirks* and adopt an expansive reading of the personal-benefits test. The government argued that "a gift of confidential information to anyone, not just a 'trading relative or friend,' is enough to prove securities fraud," and that "a tipper personally benefits whenever the tipper discloses confidential trading information for a noncorporate purpose," whether to a "friend, a family member, or anyone else." The Court found it unnecessary to pass on this argument, deeming *Dirks*'s more limited discussion of gift-giving sufficient to resolve the case. As a result, the Court's opinion leaves a number of open questions, such as how to draw the line between a "friend" and an acquaintance, and what sorts of intangible or psychic benefits to a tipper might be deemed to satisfy the "personal benefit" requirement of *Dirks*.

It is also worth noting that the Court had no occasion to question *Newman*'s alternative holding that conviction of an indirect tippee such as Salman requires proof that the tippee had knowledge that the tipper personally benefited from the disclosure of the inside information—a rule that is of particular significance when, as has often been the case in recent years, the government pursues the prosecution of remote tippees. In *Salman*, this element did not play a major role, because the evidence established that Salman knew that the tipper Maher had "improperly disclosed" the inside information to his brother Michael.

Having thus provided little guidance beyond the "trading relative or friend" language of *Dirks*, the Court acknowledged that "in some factual circumstances[,] assessing liability for gift-giving will be difficult." The Court recognized that, just as in the wake of *Dirks*, lower courts will be left to grapple with the thorny "fact[ual]" question of "whether an insider personally benefits from a particular disclosure"—which "will not always be easy for courts."

Takeaways and Implications

Salman changes little in terms of how individuals and entities should conduct themselves in handling sensitive corporate information. Often discussions regarding insider trading focus on theories of liability, but the goal of all individuals and entities should be to avoid being investigated in the first instance. Investigations are costly in terms of time, money, and reputations. While the questionable trading is often done by individuals, when the matter is investigated and a case is filed, the matter is often known by the name of the corporation whose stock was traded. That corporation often would also have had to expend considerable time and resources responding to FINRA and then to an SEC request for chronologies and documents. Additionally, the potential for entity violations does exist if the entity carelessly mishandled the material nonpublic information in its control. For individuals, the harm of an investigation that can lead to loss of employment, impaired reputation, and direct financial costs of defense is clear and direct, even in instances where the individual is ultimately not charged by the government.

The best advice for entities continues to be to have policies, systems, and training with the goal of avoiding even questions that could lead to a governmental investigation. Individuals should recognize that there is no such thing as flying under the radar with the government, both in terms of dollar amounts of trades and in terms of government surveillance and other resources for finding potential violations. The SEC now uses data analytics and can detect aberrational trading in seconds, doing investigative work in the blink of an eye that previously took months. Simply put, they can much more easily detect trading anomalies and suspicious patterns than in the past, and the chances of not even being investigated have been greatly reduced.

The SEC, which has the lower civil standard in litigation, and criminal authorities will now be emboldened to continue to explore the outer contours of insider trading liability. The best advice is to avoid being the test case.

Conclusion

In sum, the Supreme Court's decision leaves many questions unanswered regarding what kinds of personal benefits to a tipper will suffice to render the tippee liable for insider trading. But for companies, as always, the ultimate takeaway is to be attentive to instituting and maintaining policies, systems, and training that will ensure the prevention of questionable activity that could attract an investigation.

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