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Government Urges the Supreme Court to Significantly Expand Insider Trading Liability

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Two years ago, the Second Circuit Court of Appeals dealt the government a stinging defeat in *United States v. Newman*,¹ an insider trading case that the government stated “will dramatically limit the Government’s ability to prosecute some of the most common, culpable, and market-threatening forms of insider trading,” and that “arguably represents one of the most significant developments in insider trading law in a generation.”² After the government failed to persuade the Supreme Court to grant its petition for certiorari, it appeared that *Newman*, decided by a court that has been described as the “Mother Court” for securities cases,³ would become the law of the land.

In an odd turn of events, however, this week the government filed a brief in another insider trading case, *Salman v. United States*—a case now before the Supreme Court despite the government’s opposition to granting certiorari. The government’s brief asks the Court to adopt a standard that, as we explain below, would effectively reverse the *Newman* standard for insider trading liability and create a bar so low that it is without precedent. We provide the relevant background below and discuss the difficulty of reconciling the government’s position with the Supreme Court’s decision in *Dirks v. SEC*, 463 U.S. 646 (1983).

The *Dirks*’ Personal Benefit Requirement for Insider Trading Liability, and the Treatment of “Gifts” of Confidential Information to Friends and Relatives

Because both *Newman* and *Salman* interpret the Supreme Court’s decision in *Dirks*, that decision provides a useful starting point in the analysis. In *Dirks*, a former officer of Equity Funding, disclosed to Dirks, a securities analyst, that Equity Funding was engaged in a massive fraud. He urged Dirks to verify the fraud and disclose it publicly. Dirks did that, but along the way disclosed the fraud to a number of clients, who liquidated their positions in Equity Funding before the fraud became public. In a curious exercise of its enforcement discretion, the SEC censured Dirks on the theory that whenever tippees “regardless of their motivation or occupation come into possession of material corporate information that they know is confidential and know or should know came from a corporate insider, they must either publicly disclose that information or refrain from trading.”⁴

In reversing, the Supreme Court stated that the SEC’s theory of tippee liability “appears rooted in the idea that the antifraud provisions require equal information among all traders.”⁵ It repeated its rejection of the government’s parity-of-information standard in *Chiarella v. United States*,⁶ stating that “a duty to disclose arises from the relationship between parties... and not merely from one’s ability to acquire information because of his position in the market.”⁷ It stated, “[T]ippee responsibility must be related back to insider responsibility by a necessary finding that the tippee knew the information was given to him in breach of a duty by a person having a special relationship to the issuer not to disclose the information.”⁸

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In what has become the principal source of disagreement between the parties in the *Salman* case, the Supreme Court in *Dirks* also addressed what constitutes a breach of duty by the tipper. The test for breach, the Court stated, requires proof that the insider will personally benefit from the disclosure. The Court stated:

Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach [by the tippee].⁹

In explaining the personal benefit standard, the Court focused on pecuniary gain or other gain that translates into future earnings:

This requires courts to focus on objective criteria, *i.e.*, whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings.¹⁰

The “personal benefit” test was based, in part, on the recognition that stock analysts and others in the business of ferreting out information through frequent discussions with corporate insiders might be subject to too great a risk of liability under the parity-of-information theory or other expansive theories of liability. The Court stated: “Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market.”¹¹

On the other hand, the requirement that the government prove a personal benefit to the insider left a potentially large gap: circumstances in which an insider tips not for her own benefit but for the benefit of the tippee. In recognition of that gap, the Court in *Dirks* stated that a “gift” of confidential information to someone who trades could be actionable as well, but only if it was to a friend or relative and resembled trading by the insider himself followed by a gift of the profits:

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.¹²

That standard was not satisfied in *Dirks* because the person who provided the information to *Dirks* did so to expose a fraud rather than to make a gift of valuable information to a friend or relative.

Newman's Requirement of a Personal Benefit to the Tipper That Is Objective and Consequential, Even in the Case of Tips to Friends

Since taking office in 2009, the U.S. Attorney for the Southern District of New York has charged over 100 defendants in insider trading cases, many of whom are hedge fund managers that were remote tippees. A remote tippee is a tippee of a tippee, and thus is less likely to know than a direct tippee who the original source of the information is and why that person shared confidential information.

Newman involved two remote tippee hedge-fund managers who traded in shares of two publicly-held companies and, as a result of those trades, made \$4 million and \$68 million for their respective funds. The original tips were from insiders who shared the information with

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friends. The friends did not trade, but passed the information on to others, and those others passed the information on to yet others, and eventually people at the end of the chain—the two hedge-fund managers—learned the information and used it to trade.

The government alleged that because the insiders shared material nonpublic information with friends, that friendship alone was enough to satisfy the *Dirks*' personal-benefit test. That argument was consistent with the statement in *Dirks* that when an insider tips a friend, "[t]he tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient."

The Second Circuit, however, rejected that reading of *Dirks*. It held, "To the extent *Dirks* suggests that a personal benefit may be inferred from a personal relationship between the tipper and the tippee, where the tippee's trades 'resemble trading by the insider himself followed by a gift of the profits to the recipient ...,' we hold that such an inference is impermissible in the absence of proof of a meaningfully close personal relationship...."¹³ It stated that if the personal benefit test could be satisfied "by the mere fact of friendship, particularly of a casual or social nature ..., the personal benefit requirement would be a nullity."¹⁴

More importantly, the Second Circuit stated that even in the case of a tip to a friend, there had to be proof of "an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."¹⁵ The tipper's gain from the quid pro quo does not have to be "immediately pecuniary," but "the personal benefit received in exchange for confidential information must be of some consequence"—for example, giving the insider access to an investment club where stock tips were routinely discussed or the recipient of the information referred business to the tipper.¹⁶ Providing career advice was not a sufficient personal benefit to the insider in *Newman* because it "was little more than the encouragement one would generally expect of a fellow alumnus or casual acquaintance" and had started long before the insider provided any insider information.¹⁷ Likewise, the "ephemeral" value of the friendship itself, according to *Newman*, is not enough.

For those who wonder why the Second Circuit adopted a narrow reading of *Dirks*, the answer is that the court was concerned that the government was overreaching in its insider trading prosecutions and that the line between lawful and unlawful conduct had become blurred. At oral argument, Judge Barrington Parker said as much:

We sit in the financial capital of the world. And the amorphous theory that you have, that you've tried this case on, gives precious little guidance to all of these institutions, all of these hedge funds out there who are trying to come up with some bright line rules about what can and what cannot be done. And your theory leaves all of these institutions at the mercy of the government, whoever the government chooses to indict. . . .¹⁸

The Ninth Circuit's Rejection of *Newman*

On most days, Judge Rakoff sits as a Senior District Judge for the U.S. District Court for the Southern District of New York, and is thus bound by *Newman* and other Second Circuit precedent. On June 9, 2015, however, he sat by designation on the Ninth Circuit Court of Appeals, heard the appeal in *United States v. Salman*, and subsequently wrote the Ninth Circuit's decision. It gave him an improbable forum to explain the ways in which he found

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the Second Circuit's reasoning flawed and why, on behalf of the Ninth Circuit, he declined to follow it.

In *Salman*, an insider at an investment bank provided information about upcoming mergers and acquisitions to his brother, who both traded and provided the information to Salman, his brother-in-law and friend. Salman traded and was convicted of insider trading. On appeal, he argued that the government had failed to show, as required by *Newman*, that the insider received anything of value for providing the information to his brother. He argued that under *Newman* even a tip to a trading relative or friend requires proof that the insider benefitted.

Judge Rakoff, writing for the Ninth Circuit, stated, "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.'" ¹⁹ He stated that the insider's sharing of information with his brother, knowing that he intended to trade on it, "was precisely the 'gift of confidential information to a trading relative that *Dirks* envisioned."²⁰ Contrary to *Newman*, no proof of a personal benefit to the insider was required in such circumstances.

The Government's Attempt to Greatly Expand Insider Trading Liability

The government's August 1 merits brief in *Salman* now asks the Court to adopt a standard broader than the standards articulated by *Dirks*, *Newman* and even *Salman*. It does so in two critical respects.

First, it argues that a "gift" of confidential information to *anyone*, not merely to a trading relative or friend, satisfies *Dirks*. The brief states: "*Dirks* personal-benefit test encompasses a gift to *any* person with the expectation that the information will be used for trading, not just to a 'trading relative or friend.'" ²¹ "[T]he tipper can give a gift to impress his associates, or because of vanity about his generosity.... Any suggestion that giving gifts does not confer something of value on the tipper thus would be blind to social and cultural realities."²² "A gift of confidential corporate information to an acquaintance, a household employee, or even a stranger is just as unauthorized, and just as contrary to the interests of the corporation and shareholders, as a gift to someone with whom the tipper has a closer relationship."²³

Second, the government argues that when an insider provides information to a third party other than for a corporate purpose, the insider must be viewed as having provided the information for the insider's personal benefit, thus eliminating the more plausible inference in many cases that it was provided for the tippee's benefit. The government's brief states that the "absence of any corporate purpose for acting" justifies the "consequent inference of personal benefit."²⁴ Further, "The existence of 'personal benefit' is simply the flip side of the absence of a corporate purpose."²⁵ "[I]f the evidence establishes that the insider gave a gift of information for trading and that a business justification for the disclosure is absent, the factfinder need not investigate the exact nature of the personal reasons that drove the tipper to decide to confer such a gift."²⁶ "Because of the variety of motives and rewards from giving a gift of information for trading, however, the personal-benefit requirement properly focuses on whether the tipper is serving a corporate purpose, not on the question of what the gifting tipper obtains for himself from his misuse of information."²⁷

By arguing that anything that lacks a corporate purpose is a "gift" and that a gift of confidential information to anyone (whether or not a friend or relative) is a potential insider trading violation, the government is seeking to turn back the clock to a standard almost

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identical to the parity-of-information standard that the Supreme Court rejected first in *Chiarella* and then in *Dirks*. Even before *Chiarella*, the government did not argue that providing information for legitimate corporate purposes violates insider trading law. By now calling everything that does not have a corporate purpose a “gift,” the government uses what was clearly designed as a narrow exception to the *Dirks* “personal benefit” requirement to a complete nullification of that requirement. Not surprisingly, the government fails to point to a single case in the 33 years since *Dirks* was decided that applied the *Dirks*’ gift analysis to anyone other than a friend or relative.

Of course, one possibility is that the government has taken an especially aggressive position in the Supreme Court, but would also be elated with a “compromise” that had the effect of undoing the *Newman* gift/personal benefit analysis, while still leaving intact an interpretation of *Dirks* that is more faithful to the language in *Dirks* than the position urged by the government in its brief. The government is well aware that a majority of the Court is more likely to follow the natural reading of its precedent than to expand or narrow that precedent.²⁸ If either government strategy succeeds—which, of course, might not happen—the stinging defeat the government suffered in *Newman* will have been undone despite the government’s opposition to granting the petition for cert in *Salman*. In addition, Senior District Court Judge Rakoff will have accomplished a most remarkable feat: disagreeing with the Second Circuit in a rare appearance as a designated Ninth Circuit judge, thereby creating a circuit court conflict that made it far more likely the Court would accept certiorari, and ultimately being vindicated by the Supreme Court itself.

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¹ United States v. Newman, 773 F.3d 438 (2d Cir. 2014), cert. denied, 136 S.Ct. 242 (2015).

² Petition of the United States of America for Rehearing and Rehearing En Banc in United States v. Newman at 3, 22-23 (Jan. 23, 2015).

³ Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 762 (1975) (Blackmun, J., dissenting).

⁴ 463 U.S. at 651.

⁵ *Id.* at 657.

⁶ 445 U.S. 222 (1980).

⁷ 463 U.S. at 658.

⁸ *Id.* at 661, quoting Commissioner Smith's concurring opinion in *In re Investors Management Co.*, 44 S.E.C. 633 (1971).

⁹ *Id.* at 662.

¹⁰ *Id.* at 663.

¹¹ *Id.* at 658.

¹² *Id.* at 664.

¹³ 773 F.3d at 452.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.* at 453.

¹⁸ Oral Argument Tr. 49-50.

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

²⁰ *Id.* at 1092.

²¹ Brief for the United States at 27.

²² *Id.* at 26.

²³ *Id.* at 27.

²⁴ *Id.* at 19.

²⁵ *Id.* at 19.

²⁶ *Id.* at 25.

²⁷ *Id.*

²⁸ That is one of the principal lessons of *Halliburton v. Erica P. John Fund, Inc.*, 134 S.Ct. 2398 (2014), in which the Supreme Court elected to follow its widely-criticized 4-2 fraud-on-the-market opinion in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), while providing clarification in areas not addressed by the opinion.