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Supreme Court Confirms Expansive View of Insider Trading

By Clay Wheeler and John Sanders

Perhaps the most serious charge that could be leveled against a reader of this blog is that of being engaged in or associated with "insider trading." The allegation alone is enough to derail or end a promising career. Successful compliance requires an understanding of the law and your obligations under it. In light of recent developments regarding insider trading, including the first Supreme Court decision to address the crime in 20 years,[1] we encourage you to read this article in its entirety and contact us with any questions you may have. **Insider Trading: The Tradition** Section 10(b) of the Securities Exchange Act of 1934[2] and Rule 10b-5[3] promulgated thereunder prohibit insider trading. The basic elements of insider trading are: (i) engaging in a securities transaction, (ii) while in possession of material, non-public information, (iii) in violation of a duty to refrain from doing so. The paradigm case discussing the so-called "classical" theory of insider trading is *Chiarella v. U.S.*[4] In *Chiarella*, an employee of a publishing firm was charged with insider trading after using advance notice of a takeover bid to trade. Chiarella's conviction was reversed by the Supreme Court after the Court focused on the requirement of a duty running from the trader to the shareholders of the corporate entity "owning" the material, non-public information. Thus, a successful prosecution under the classical theory usually involves a corporate insider trading in shares of his or her employer while in possession of material, non-public information (*e.g.*, advance notice of a merger). After *Chiarella*, an important development in the law has been the extension of liability to persons who receive tips from insiders, i.e., individuals whose duty to refrain from trading is derived or inherited from the corporate insider's duty. Thus, not only may insiders be liable for insider trading under rule 10b-5, but those to whom they pass tips, either directly (tippees) or through others (remote tippees) may be liable if they trade on such tips. Because tippee and remote tippee liability is more difficult to grasp and more likely to affect our readers, this article will primarily, but not exclusively, focus on individuals in those circumstances. In a pattern that has repeated itself over the years, courts broadened the scope of insider trading by developing a second, "complementary" [5] theory of insider trading – the "misappropriation" theory. This theory "targets person[s] who are not corporate insiders but to whom material non-public information has been entrusted in confidence and who breach a fiduciary duty to the source of the information to gain personal profit in the securities market."[6] The seminal case in the articulation of the misappropriation theory is *U.S. v. O'Hagan* . In O'Hagan, a partner at a large law firm (but not ours) obtained and traded on information given to attorneys in the firm who were representing a client in a tender offer. The Supreme Court held that "A person who trades in securities for personal profit, using confidential information misappropriated in breach of a fiduciary duty to the source of the information, may be held liable for violating § 10(b) and Rule 10b-5."[7] In practical terms, under the misappropriation theory, individuals who come into possession of material, non-public information while providing services to corporate clients, such as the attorney in *O'Hagan* [8] may be held liable.

Joining *Chiarella* and *O'Hagan* in making up the traditional core of insider trading law is *Dirks v. SEC*.[9] In *Dirks,* the Supreme Court attempted to set a limit on the scope of insider trading.[10] Dirks was a securities analyst who learned from a former insurance company insider that the company was committing fraud and was on the verge of financial ruin.[11] Dirks investigated and disclosed this information to several people, including a reporter and clients who traded on the information.[12] Dirks was held liable for insider trading, but appealed.[13] The overturning of Dirks's liability centered on the fact that the corporate insider had disclosed the fraud to Dirks purely by a desire to expose the fraud, rather than to obtain any financial or other personal benefit. The Court held: In determining whether a tippee is under an obligation to disclose or abstain, it is necessary to determine whether the insider's "tip" constituted a breach of the insider's fiduciary duty. Whether disclosure is a breach of duty depends in large part on the personal benefit the insider receives as a result of the disclosure. Absent an improper purpose, there is no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.[14] Furthermore, *Dirks* introduced the idea that a tippee has to be actually aware of the tipper's breach or presented with sufficient facts so that the tippee will be deemed aware. In this way, *Dirks* created a "personal benefit" element related to the tipper. After *Dirks*, prosecutors were generally confident they could prove this benefit existed as long as there was a *quid pro quo* or a moderately close relationship between tipper and tippee. **Newman: A Disruption** *Chiarella*, *O'Hagan* , and *Dirks* guided the law of insider trading largely uninterrupted for nearly 20 years. Then came a decision from the Second Circuit, the so-called "Mother Court" [15] of securities law, but an underling of the Supreme Court, called *U.S. v. Newman*.[16] *Newman* involved a hedge fund portfolio manager who was part of an information-sharing cohort of analysts and portfolio managers.[17] By the time Newman received the tip, he was "four levels removed from the insider tippers," (*i.e.*, a remote tippee).[18] The tippers were insiders at technology companies who had provided information to what the court termed "casual acquaintances," who in turn passed those tips on. Citing *Dirks* repeatedly for support, the U.S. 2nd Circuit Court of Appeals emphasized that government must prove the tipper received "a personal benefit" and that the tippee knew of that benefit. [19] In *Newman*, the Second Circuit concluded that "the mere fact of friendship" was insufficient to give rise to the required personal benefit to the tipper. Instead, the court required "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." Despite the fact that the 2nd Circuit cited its adherence to *Dirks* in overturning Newman's conviction, it was clear to all that by raising the bar for the evidence required to meet the *Dirks* "personal benefit" requirement, the opinion suggested a serious new limitation on insider trading law. Moreover, the prosecutors were denied a rehearing *en banc* and a Supreme Court writ of certiorari. This meant *Newman* would remain law in the most significant federal circuit for securities law until further notice. One attorney called *Newman* "a well-deserved generational setback for the Government."[20] The predicted effect of *Newman* was that the government would be forced to prove that someone charged with insider trading knew that she was trading on non-public, material information and that "the tipper's goal in disclosing information is to obtain money, property, or something of tangible value."[21] This heightened burden led to the reversal of more than a dozen insider trading convictions,[22] and pending cases were dropped.[23] **Salman: The Expansive View of Insider**

Trading Strikes Back *Newman*'s holding concerning what qualifies as a personal benefit to the tipper was reversed last week when the Supreme Court issued its opinion in *Salman v. United States*.[24] Before the Supreme Court issued its opinion, in *Salman*, only the most ardent securities law gurus followed the case. So, some background may be helpful. Salman was convicted after trading on material, non-public information received from a friend, who had received the information from Salman's brother-in-law. Thus, Salman was prosecuted as a remote tippee. He argued that he could not "be held liable as a tippee because the tipper (his brother-in-law, who worked on M&A matters at an investment bank) did not personally receive money or property in exchange for the tips."[25] In a strong rebuke, the Supreme Court held, "To the extent that the Second Circuit in *Newman* held that the tipper must also receive something of a "pecuniary or similarly valuable nature" in exchange for a gift to a trading relative, that rule is inconsistent with *Dirks*."[26] Justice Alito succinctly explained "a tippee's liability for trading on inside information hinges on whether the tipper breached a fiduciary duty" and that duty is breached "when the tipper discloses the inside information for a personal benefit." [27] Such a personal benefit can be inferred where the tip is made "to a trading relative or friend." [28] **Why Salman Matters** By allowing a generous inference of a benefit to the tipper based on a personal relationship alone, the Supreme Court in *Salman* reestablished the old order of things – an expansive scope for insider trading prosecutions. We understand that investment advisers are more likely than others to come into contact with corporate insiders, as well as those with whom corporate insiders speak in confidence. You know these individuals as professionals, former schoolmates, and even friends and family members. In discussing your work, it is quite possible that non-public, material information may be intentionally or inadvertently tipped to you. Your livelihood and liberty may depend on how well you understand your legal obligations when that happens. Fortunately, when you have questions about the rules regarding insider trading, we're here to assist. ***Clay Wheeler*** *is a partner in Kilpatrick's Raleigh and Winston-Salem offices .* ***John Sanders*** *is an associate based in the firm's Winston-Salem office.* [1] Greg Stohr and Patricia Hurtado, *The Supreme Court Will Hear Its First Insider-Trading Case in 20 Years,* Bloomberg (Oct. 4, 2016), https://www.bloomberg.com/politics/articles/2016-10-04/wall-street-watching-as-u-s-high-court-tackles-insider-trading. [2] 15 U.S.C. 78j (2016). [3] 17 CFR 270.10b-5 (2016). [4] *Chiarella v. U.S.*, 445 U.S. 222 (1980). [5] *U.S. v. O'Hagan* , 521 U.S. 642, 643 (1997). [6] *SEC v. Obus*, 693 F.3d 276, 284 (2d Cir. 2012). [7] *O'Hagan* , at 642. [8] *Id.* [9] *Dirks v. SEC*, 463 U.S. 646 (1983). [10] *Id.* at 646. [11] *Id.* [12] *Id.* [13] *Id.* [14] *Id.* at 647. [15] James D. Zirin, American Bar Association, *The Mother Court: A.K.A., the Southern District Court of New York,* http://www.americanbar.org/publications/tyl/topics/legal-history/the-mother-court-aka-southern-district-court-new-york.html [16] *U.S. v. Newman*, 773 F.3d 438 (2d Cir. 2014) [17] *Id.* at 443. [18] *Id.* [19] *Id.* at 450. [20] Jon Eisenberg, *How the United States v. Newman Changes the Law,* Harvard Law School Forum on Corporate Governance and Financial Regulation (May 3, 2015), https://corpgov.law.harvard.edu/2015/05/03/how-united-states-v-newman-changes-the-law/. [21] *Salman v. U.S.*, available at https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=2&ved=0ahUKEwihloXYvu_QAhVBjpAKHflsCIIQFggjMAE&url=https%3A%2F%2Fwww.supremecourt.gov%2Fopinions%2F16pdf%2F15-628_m6ho.pdf&usg=AFQjCNGY28IXIk-a-h-Nuvi5EXSHC6XW6g&sig2=Ydo5oy44CzIMDuCxjMluzA&bvm=bv.141320020,d.eWE (The opinion presents

and rejects this argument from Salman before stating that the rule from *Newman* is inconsistent with precedent) [22] Greg Stohr and Patricia Hurtado, *The Supreme Court Will Hear Its First Insider-Trading Case in 20 Years,* Bloomberg (Oct. 4, 2016), https://www.bloomberg.com/politics/articles/2016-10-04/wall-street-watching-as-u-s-high-court-tackles-insider-trading. [23] Patricia Hurtado, *SAC Capital's Steinberg Gets Insider Trading Charges Dropped,* Bloomberg (Oct. 23, 2015), https://www.bloomberg.com/news/articles/2015-10-22/u-s-drops-charges-against-sac-capital-s-michael-steinberg. [24] *Salman, supra* note 21. [25] *Id.* [26] *Id.* [27] *Id.* [28] *Id.*