

The Supreme Court Reaffirms *Dirks* in *Salman*

Yesterday, the U.S. Supreme Court handed down its first major decision on insider trading in over 20 years, and affirmed the conviction of Bassam Salman for violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b–5 thereunder. *United States v. Salman*, No. 15–628 (December 6, 2016). The unanimous opinion, written by Justice Alito for the Court, hewed closely to the Court’s seminal decision on tipping, *Dirks v. SEC*, 463 U.S. 646 (1983). The Court concluded that the facts in *Salman* fell within the “heartland” of *Dirks*, and that the corresponding issues could quickly be resolved by the gift-giving principles of that decision. In doing so, the Court rejected the positions of both parties regarding the scope of insider trading liability, while noting that the Second Circuit’s decision in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), cert. denied, 577 U.S. ____ (2015) had gone too far.

The crux of the Court’s holding confirmed that a tipper could be liable for insider trading when gifting confidential information to a trading relative or friend with the expectation that he would trade on it—even if the benefit inferred from the relationship does not carry an objective pecuniary value. Consequently, a tipper also would be liable if he trades on the information with “full knowledge that it had been improperly disclosed.” At the same time the Court left open important questions regarding its personal benefit test and gifts of inside information.

The Facts

The case centers on three relatives, brothers Maher and Michael Kara and their brother-in-law, Bassam Salman. Maher was an investment banker in Citigroup’s healthcare group, where he focused on mergers and acquisitions. After beginning work at Citigroup, Maher started discussing aspects of his job with Michael, with whom he had “a very close relationship.” Maher relied on Michael’s chemistry background to assist in his newly-acquired job.

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Maher was initially unaware that Michael was using the information shared during their discussions to trade in securities. Later, Maher assisted Michael's trading by sharing information with him about pending deals. Michael, in turn, began furnishing the inside information to his brother-in-law, Mr. Salman, who also used the information to place his own trades. Later Maher tried to discourage his brother's requests for information—who "incessantly" pestered him for it—but nonetheless continued to transmit inside tips. By the time the authorities discovered the brothers' trading, Mr. Salman had gained over \$1.5 million in profits that he split with another relative who had also executed trades on his behalf.

Mr. Salman was indicted on one count of conspiracy to commit securities fraud and four counts of securities fraud. The two Kara brothers, also charged, pleaded guilty and testified against Mr. Salman at his trial. The evidence at trial established the close relationship between the two brothers. Importantly, Maher testified that he offered Michael money but that Michael instead asked for more information. While Maher acceded to the request, he regretted his decision and begged his brother not to trade. Ignoring these requests, Michael traded. Indeed, Michael testified that his brother's tips gave him access to information that was not available to the typical trader. It was this same information that Michael disclosed to Mr. Salman who understood that the information originated from Maher.

The jury returned a verdict of guilty on all counts. Mr. Salman was sentenced to serve 36 months in prison. On appeal, Mr. Salman argued that *Newman* required the reversal of his conviction. The Ninth Circuit rejected that claim, affirming the convictions. The Court granted certiorari to "resolve the tension" between the Ninth Circuit's holding and *Newman*.

Opinion

The Court began by reciting basic principles regarding insider trading, drawn largely from *Dirks* and its progeny. Exchange Act Section 10(b) prohibits "undisclosed trading on inside corporate information by individuals who are under a duty of trust and confidence that prohibits them from secretly using such information for their personal advantage[.]" Justice Alito wrote for the Court. These persons, known as tippers, may not disclose inside information to others (tippees) for trading. A tippee, according to the Court, acquires the duty to disclose or abstain from trading if the tippee knows the information was transmitted in breach of the tipper's duty. Stated differently, liability for the tippee hinges on whether the tipper breached a fiduciary duty and "disclosed the information for a personal benefit" under *Dirks*. That benefit can be inferred when the tipper receives something of value in exchange for the tip or if the insider makes a gift of confidential information to a trading friend or relative.

Mr. Salman argued that an insider's gift of confidential information to a trading relative or friend does not, without more, establish a violation of Exchange Act Section 10(b). *Dirks* dictates that a tipper only violates his or her duty if, according to Mr. Salman, the tipper received a benefit in the form of money, property, or something of tangible value. Mr.

Salman sought to bolster this point by citing to other criminal fraud decisions of the Court which require a pecuniary benefit.

The Government disagreed. Relying on *Dirks*, the Government claimed that a gift of confidential information to anyone, not just a trading relative or friend, may be prohibited. Under this rendition of the rule, furnishing inside information to *anyone* who intends to trade is insider trading and would trigger a violation. This is because the tipper personally benefits whenever there is a disclosure of corporate information for a noncorporate purpose, according to the Government.

“We adhere to *Dirks*,” Justice Alito wrote in rejecting the position of each party. In that decision “we explained that a tippee is exposed to liability for trading on inside information only if the tippee participates in a breach of the tipper’s fiduciary duty. Whether the tipper breached that duty depends ‘in large part on the purpose of the disclosure’ to the tippee,” according to the Court (internal citations omitted). The test is whether the insider will personally benefit from the disclosure. If there is no personal benefit, there is no breach of duty. Under *Dirks*, the determination of whether a personal benefit has been received requires an examination of the objective criteria, such as a pecuniary gain or a reputational boost that may translate to such a benefit in the future. That benefit may be inferred from the facts and circumstances underlying the relationship.

The exploitation of inside information can also occur where there is a gift of that information to a trading relative or friend under *Dirks*, the Court held. This is because “in such cases, ‘[t]he tip and trade resemble trading by the insider followed by a gift of the profits to the recipient[.]’” the Court stated (internal citations omitted). In *Dirks*, the tippers did not receive any money or benefit, and their purpose was not to make a gift. Thus, there was no liability.

The gift-giving principles of *Dirks* easily resolved this case, according to the Court. “As Salman’s counsel acknowledged at oral argument, Maher would have breached his duty had he personally traded on the information here himself then given the proceeds as a gift to his brother.” In this case “Maher effectively achieved the same result by disclosing the information to Michael, and allowing him to trade on it[.]” the Court concluded. The tipper benefits under either set of circumstances. Insofar as *Newman* required that the benefit be pecuniary or something similar, “we agree with the Ninth Circuit that this requirement is inconsistent with *Dirks*[.]” the Court concluded.

Analysis and Considerations

In *Salman*, the Court adhered closely to *Dirks*, affirming and reiterating its basic principles regarding tipper liability. Those principles make it clear that liability stems from a breach of duty resulting in a personal benefit, measured by an assessment of the objective facts. Liability also results from gifting inside information to a trading friend or relative—circumstances which support an inference that the insider obtains a personal benefit. By reiterating these principles, the Court strictly followed the bright line drawn in

Dirks between the permissible and the impermissible—not every communication of inside information is a violation of Section 10(b). Rather, a violation only occurs when a tipper breaches a duty and obtains a resulting personal benefit or a tipper gifts inside information to a friend or relative.

In reaching its determination, the Court rejected the claim of each party despite suggestions that their respective positions somehow echoed *Dirks*. Petitioner reiterated the teachings of *Newman* in claiming that a gift alone is not enough, arguing that the benefit to the tipper must be pecuniary in nature. The Government argued that any communication of inside information to any trader resulted in liability—a position which tended to eliminate the line drawn in *Dirks*. The Justices noted during oral argument, and reiterated in their opinion, that neither position was consistent with *Dirks*.

While adhering to *Dirks* and reaffirming the basic principles of that decision, the Court's opinion left open other important issues. In rejecting the Government's claim that a gift of inside information to anyone is sufficient and Mr. Salman's claim that a pecuniary benefit must be received, the Court left undefined critical questions. For example, in *Salman* the close relationships permitted the inference of a personal benefit to Maher. A similar relationship between a "friend" and the tipper may also support a comparable inference.

Conversely, if the "friend" is a casual acquaintance, colleague, or associate, a *Salman*-type inference may not be justified. *Salman* left open this question and deflected other fact-intensive issues regarding the personal benefit, the relationships between the parties, and the inferences that might be drawn. In the future, these issues are likely to become critical in assessing tipper-tippee liability for insider trading. *Salman* may thus raise more questions than it resolved.

This Alert is an expanded version of a blog post previously written by Mr. Gorman. The original version of this Alert can be found on www.secactions.com. We trust that this analysis is helpful when navigating the contours of the Court's holding in *Salman* and considering its potential implications. Note that this Alert does not constitute legal advice, establish an attorney-client relationship, or create any duty of Dorsey to any reader.