December 7, 2016

Supreme Court: Don't Give Inside Information to Friends or Family

By Bruce A. Ericson, Maria T. Galeno and David G. Keyko

On December 6, the Supreme Court held unanimously that people who trade on inside information can be civilly and criminally liable even if the insider did not receive a concrete financial benefit for the tip, so long as the trader and the insider are friends or family. The decision increases the risk for those tempted to do others the dubious favor of passing along inside information.

- Circuit conflict resolved: Trading on inside info is illegal if a tipper gives tip to friends or family, expecting that they will trade on the tip, even if tipper receives nothing of value in exchange.

- Court affirms its 1983 *Dirks* precedent and disapproves in part Second Circuit's *Newman* decision.

At issue in *Salman v. U.S.*, 2016 WL 7078448 (U.S. Dec. 6, 2016) was the criminal conviction and 36-month sentence of a "tippee," Bassam Salman, who had been convicted for trading on information he received from the brother of his sister's husband. The Court affirmed the conviction even though the insider himself did not make money from the tips, which he had passed along to his brother, who in turn chose to pass them along to Salman, a brother-in-law.

The decision resolves a split between two Courts of Appeals: the Second Circuit and the Ninth Circuit. Both agreed that to sustain a conviction the tipper must expect that the tippee will trade on the information, and both agreed that the tipper had to receive some personal benefit from the tip, but they disagreed as to whether the psychic benefit of making a gift to a friend or family member sufficed. The Second Circuit, in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), held that the gift of a stock tip would sustain a criminal conviction only if the prosecution proved 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 Ninth Circuit, in affirming Salman's conviction, 792 F.3d 1087, disagreed with *Newman*, holding that proof of a gift of confidential information to a trading relative or friend sufficed, even if the tipper himself received nothing of a pecuniary or similarly valuable nature.

At issue was the proper interpretation of *Dirks v. SEC*, 463 U. S. 646 (1983), the case in which the Supreme Court had announced the "personal benefit" requirement for insider trading. Dirks, an officer at a broker-dealer, had learned from an insider named Secrist of massive fraud at a company called Equity

Funding. Dirks blew the whistle, reporting the fraud to *The Wall Street Journal* (which initially declined to publish a story), and urged his clients to dump the stock, which many of them did. Dirks himself and his firm, however, did not own or trade in Equity Funding stock.

The government, like the world at large, was divided between those who thought Dirks a hero (a group that included the DOJ) and those who thought Dirks a scoundrel (a group that included the SEC). The SEC decided that Dirks had aided and abetted violations of the securities laws, but the Supreme Court reversed, three justices dissenting. The Court held that a tippee (such as Dirks) is liable for trading on inside information only if the tippee participates in a breach of the tipper's fiduciary duty, adding that whether the tipper breaches his duty depends in large part on the tipper's purpose in passing the tip to the tippee. Where the tipper personally benefits, the breach is obvious: the tipper has both breached a fiduciary duty and exploited nonpublic information. The Court added that giving a tip to friends or family was essentially the same as profiting oneself from the inside information, and then giving the profits to the tippee as a gift. But in *Dirks*, the tipper, Secrist, had not expected any personal benefit at all, hence no breach of duty by Secrist, and no liability for Dirks.

In the years since 1983, the rule in *Dirks* has been criticized by both sides. Defense counsel have argued that the rule was indeterminate and overbroad, burdening the jury with sorting out the closeness of the relationship between tipper and tippee and the tipper's purpose for disclosure, while allowing the government to avoid having to prove a concrete personal benefit. Prosecutors and plaintiffs have questioned the point of having any personal benefit requirement, arguing that any trading on inside information, regardless of the tipper's motives, tilts the playing field of the marketplace against ordinary investors who lack access to insiders and insider information. Ultimately in *Salman* all eight justices chose the middle ground, affirming *Dirks*, rather than moving in either direction.

The Court's caution in *Salman* may reflect a balancing of concerns. Several justices, at oral argument, voiced a concern that moving in the defense direction could undermine the integrity of the marketplace. Nobody voiced as explicitly a concern about moving in the prosecution direction, but the fact that insider trading law in the United States is largely judge-made (fairly unusual for crimes, which mainly are statutory) may have militated against any sudden expansion of criminal liability beyond those who personally benefit.

If you have any questions about the content of this Alert, please contact the Pillsbury attorney with whom you regularly work, or the attorneys below.

Bruce A. Ericson (bio)
San Francisco
+1.415.983.1560
bruce.ericson@pillsburylaw.com

Maria T. Galeno (bio)
New York
+1.212.858.1833
maria.galeno@pillsburylaw.com

David G. Keyko (bio)
New York
+1.212.858.1604
david.keyko@pillsburylaw.com

William M. Sullivan, Jr. (bio)
Washington, DC
+1.202.663.8027
wsullivan@pillsburylaw.com

David M. Furbush (bio)
San Francisco
+1.415.983.1690
david.furbush@pillsburylaw.com

Mark R. Hellerer (bio)
New York
+1.212.858.1787
mark.hellerer@pillsburylaw.com

Carolina A. Fornos (bio)
New York
+1.212.858.1558
carolina.fornos@pillsburylaw.com

Marc H. Axelbaum (bio)
San Francisco
+1.415.983.1967
marc.axelbaum@pillsburylaw.com