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Salman v. United States:

The Supreme Court Leaves More Questions About Insider Trading Law Than It Answers

Alexandra A.E. Shapiro and Daniel J. O'Neill[1]

In December 2016, the Supreme Court decided *Salman v. United States*, its first insider trading case in nearly twenty years.[2] Defendants and prosecutors had battled for decades over the boundary between lawful and unlawful trading, especially in "tipping" cases, where an insider (the "tipper") does not personally trade, but instead provides material nonpublic information to a corporate outsider (the "tippee") who uses it to trade. By taking the *Salman* case, the Court seemed poised to provide some much needed definition.

The *Salman* opinion, however, decided only one narrow issue and broke little ground. The Court held that insider trading liability can attach where one gives a "gift" of inside information to a relative, without expecting any pecuniary benefit in return. In so doing, the Court merely repeated and reaffirmed language from an earlier decision. The Court avoided the many difficult questions that are sure to arise as lower courts grapple with scenarios other than the brother-to-brother tip presented in *Salman*.

The Personal Benefit Requirement

Salman arose out of a Circuit split over insider trading law's personal benefit requirement, which originated in the Supreme Court's 1983 decision in *Dirks*.[3]

Federal insider trading prosecutions are typically brought under Section 10(b) of the Securities Exchange Act of 1934, which is a general anti-fraud provision.[4] It does not expressly prohibit the purchase or sale of securities on the basis of material nonpublic information, let alone "tipping" inside information to another.

The Supreme Court has consistently rejected government efforts to read a "parity-of-information rule" into Section 10(b), holding that the statute does not impose an unqualified prohibition on insider trading.[5] Instead, the "fraud" for

purposes of Section 10(b) emanates from common law duties, whether the unique fiduciary duty that an insider owes his company's shareholders or a duty of confidentiality owed to the source of the information.[6] Individuals who are bound by those duties must either disclose material nonpublic information before trading or abstain from trading altogether.[7] But outsiders who come into possession of inside information are not automatically prohibited from trading, because they owe no such duties.

In *Dirks*, the Court examined these principles in the context of insider tipping. The Court held that while insiders may not personally trade on corporate information for their advantage, they also "may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain."[8] A tippee also may not trade, the Court explained, because he inherits the insider's duty to disclose or abstain and thus risks becoming "a participant after the fact in the insider's breach of a fiduciary duty."[9]

Critically, the Court held that not all disclosures of inside information give rise to liability for the tipper or tippee. "[T]he test is whether the insider personally will benefit, directly or indirectly from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivate breach."[10]

Dirks explains what the "personal benefit" requirement entails. "[C]ourts are not required to read the parties' minds," the Court said, but instead should "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."[11] The Court said that a personal benefit can be inferred if there is "a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient."[12] And further, "[t]he 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."[13]

Salman and *Newman*

The insider in *Salman* was Maher Kara, an investment banker at Citigroup, who disclosed nonpublic information about upcoming client deals to his brother, Michael Kara. Michael traded on the information and disclosed it to Bassam Salman, who traded as well. Salman was convicted of insider trading in the Northern District of California and sentenced to three years' imprisonment.

The central issue in Salman's appeal was whether Maher had disclosed the information to Michael for a personal benefit. Although they had a "very close relationship," Maher initially disclosed information to Michael to vent about work or to discuss potential treatments for their dying father – not so that Michael could trade.[14] And even when Maher suspected that Michael was trading on the information, Maher never received anything tangible in return.[15]

While Salman's appeal was pending, the Court of Appeals for the Second Circuit, where the vast majority of insider trading cases are brought, issued an important decision about *Dirks*' personal benefit requirement. In *United States v. Newman*, the Second Circuit substantially raised the bar for prosecutors to prove the personal benefit element.[16] The defendants in that case were hedge fund portfolio managers who had received information fourth- or fifth-hand through analysts at their funds. The tips started with two different insiders: one disclosed information to a business school acquaintance in exchange for "career advice," and the other disclosed information to a friend from church.

In vacating the defendants' convictions, the Second Circuit held that the government must prove that the tippee knew the insider had disclosed information for a personal benefit.[17] The Court held that the government had failed to prove that knowledge given the defendants' remoteness from the original tip and the frequency with which the same kind of information is legitimately disseminated by corporations.[18]

But it was *Newman*'s second holding that drove Salman's appeal. The Second Circuit held that the government may not "prove the receipt of a personal benefit by the mere fact of a friendship, particularly of a casual or social nature," because

> ***Salman failed to provide clarity about how the personal benefit test applies when there is no tangible exchange and the relationship between the tipper and tippee is more attenuated.***

that renders the element "a nullity."[19] For the tipper's personal benefit to be inferred from the relationship between the tipper and tippee, the Court held, they must have had "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."[20]

Relying on *Newman*, Salman argued to the Ninth Circuit that the relationship between Maher and Michael by itself could not demonstrate a personal benefit, and that there was no evidence that Maher's disclosures to Michael were for any tangible benefit. The Ninth Circuit rejected Salman's argument as inconsistent with *Dirks*.[21]

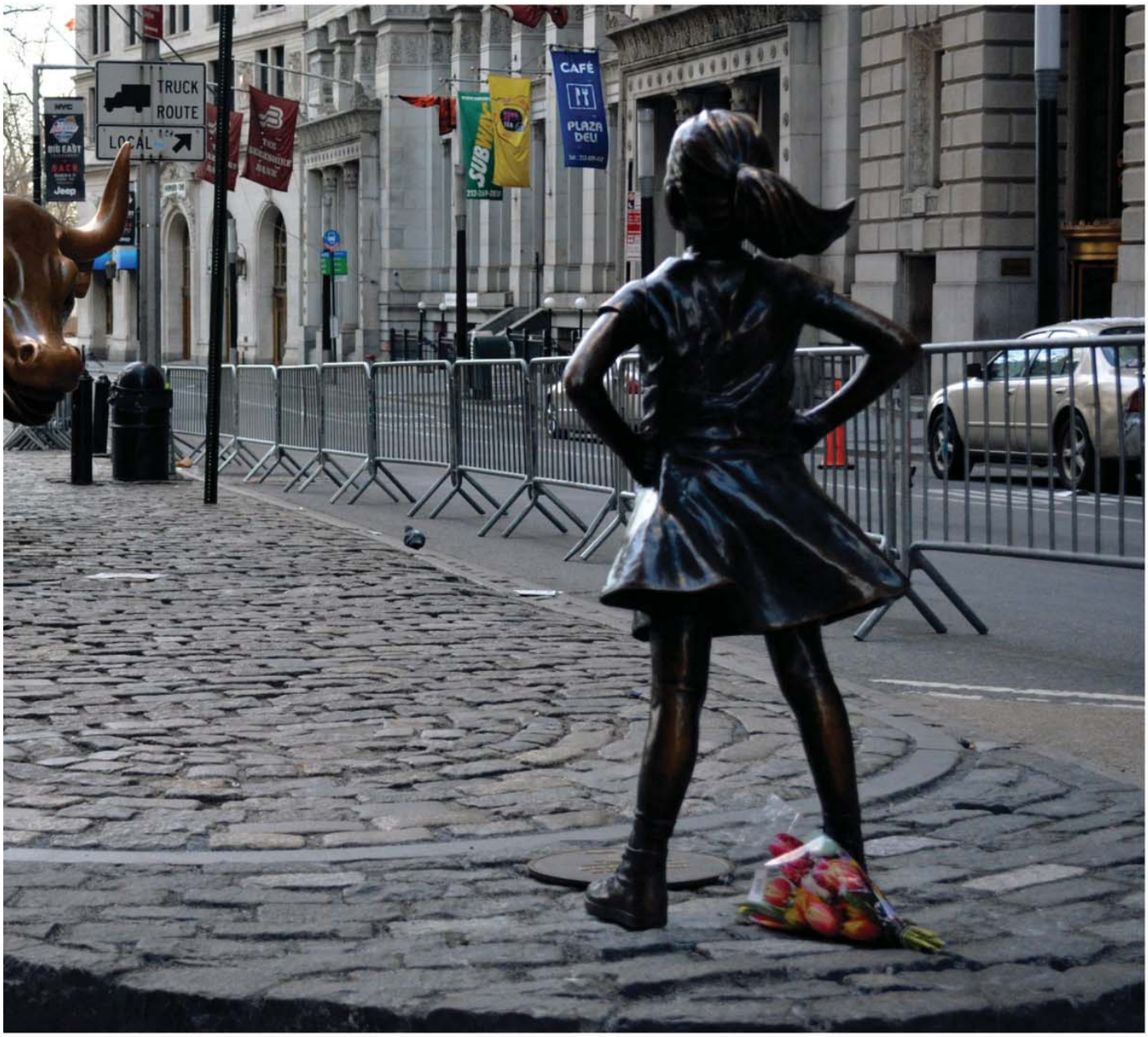
The Supreme Court granted *certiorari*. In his briefs and at oral argument, Salman argued that prosecutors and lower courts had watered down the "personal benefit" standard in the years since *Dirks*, and that constitutional principles of separation-of-powers and due process compelled a standard that is both unambiguous and narrowly drawn. Salman urged that the tipping crime be limited to those cases where an insider provides a tip in exchange for pecuniary gain.

The government, on the other hand, argued for a standard that was even broader than *Dirks*. It contended that liability should attach whenever an insider discloses information for a personal, rather than a corporate, purpose. Under such a standard, all "gifts" of inside information satisfy the personal benefit test, even if the recipient is a complete stranger rather than a relative or friend.[22]

In a unanimous and relatively short opinion issued on December 6, 2016, the Court affirmed Salman's conviction. It held that *Dirks*' rule "that a tipper breaches a fiduciary duty by making a gift of confidential information to 'a trading relative'" was "sufficient to resolve the case at hand," and that pecuniary benefit was not required in those circumstances.[23] "To the extent the Second Circuit

held that the tipper must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift to family or friends," the Court held, "we agree with the Ninth Circuit that this requirement is inconsistent with *Dirks*."[24]

The Court emphasized that its opinion was deliberately "narrow."[25] The Court acknowledged that "in some factual circumstances assessing liability for gift-giving will be difficult" and "'will not always be easy for courts,'" and made clear that it did not intend its decision to resolve other, more "difficult cases."[26]



Issues Salman Leaves Unresolved

Salman failed to provide clarity about how the personal benefit test applies when there is no tangible exchange and the relationship between the tipper and tippee is more attenuated. Although these issues exist mainly at the margins of insider trading cases, they are sure to be litigated in future prosecutions and are already beginning to surface.

a. How close is close?

In *Salman*, the Supreme Court held that *Dirks*' gift-giving language was dispositive because Maher (the insider) had tipped "a close relative, his brother," rendering proof of a pecuniary benefit unnecessary.[27]

In cases involving other family relationships, however, the government and defendants are likely to spar over whether *Salman* applies to all relatives or only those who are "close," like Maher and Michael. Defendants recently received support from the First Circuit, which held that *Salman* "does not foreclose" arguments about the closeness of the tipper and tippee.[28] The Court reasoned

that *Newman*'s holding was that there must be "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," and *Salman* addressed and abrogated only the latter portion, not the "meaningfully close personal relationship" language.

Assuming the First Circuit is correct, *Salman* still offers no guidance for determining which relatives are "close." Is the relationship between in-laws enough to trigger the *Dirks* personal benefit inference? What about the relationship between step-siblings or separated spouses? Or perhaps "closeness" should turn not on the distance between branches on the family tree, but on the emotional affinity between the tipper and tippee. Such a standard would substantially complicate the government's burden of proof, requiring prosecutors to delve deeply into personal histories such as shared vacations, family holidays, and the nature and frequency of emails and phone calls unrelated to securities trading.

b. What is friendship?

Similarly, *Salman* sheds no light on when a non-family member is a "trading friend" within the meaning of *Dirks*.

The Court suggested that some degree of intimacy is required. It declined to adopt the government's broad view that any "gift" of confidential information "is enough to prove securities fraud."[29] And at oral argument the justices seemed troubled by the limitless implications of the government's standard. Justice Sotomayor, for example, noted that the government was ignoring any "difference between friend and acquaintance," and Justice Breyer expressed skepticism that there could be a "personal advantage" in tipping "anyone in the world."[30]

But between strangers and best friends, there are an infinite number of relationships – neighbors, work colleagues, social media connections, college classmates, etc. Surely not all of them qualify, but the precise line remains to be drawn.

This is one of the key issues currently before the Second Circuit in the criminal appeal by former SAC Capital Advisors LP manager Mathew Martoma.[31] The government argued that Martoma received inside information from Sidney Gilman, a neurologist with whom Martoma had occasionally exchanged emails and once shared a cup of coffee. Although the Second Circuit heard oral argument before *Salman* was decided, it instructed the parties to make supplemental submissions addressing *Salman*'s impact after the Supreme Court ruled. Martoma argues that *Salman* left the "meaningfully close personal relationship" part of *Newman* intact and that his relationship with Gilman fails to qualify.[32] The government takes the view that *Salman* abrogated Newman's personal benefit holding in its entirety, and that Martoma and Gilman were sufficiently close in any event.[33]

Martoma's appeal will likely be decided later this year and should establish definitively whether the "meaningfully close personal relationship" requirement of *Newman* survives *Salman*, at least from the Second Circuit's perspective.

c. How much must a tippee in a "gift" scenario know about the personal benefit?

The Supreme Court expressly stated that the *Salman* decision "does not implicate" *Newman*'s first holding, which requires the government to prove that a remote tippee knew that the insider disclosed the information to personally benefit himself or herself.[34] This strongly suggests that the Supreme Court agrees with the Second Circuit on that point. In fact, the government did not challenge the knowledge holding when it (unsuccessfully) sought *certiorari* in *Newman* and conceded at oral argument in *Salman* that it must prove the tippee's knowledge of personal benefit.[35]

What level of knowledge is required, however, remains open for debate. Must the tippee know the precise benefit received, or is it sufficient if he knows what *type* of benefit that motivated the insider (*e.g.*, cash or a family relationship)? Or is it sufficient if the tippee knows simply that *some* benefit

was involved? Courts have come to different conclusions about how specific the tippee's knowledge of the insider's personal benefit must be.[36]

And even assuming the most basic form of knowledge, what proof of that knowledge is required? In *Newman*, for example, the government contended that "the specificity, timing, and frequency" of the information the defendants received was so "overwhelmingly suspicious" that they "must have known, or deliberately avoided knowing, that . . . insiders disclosed the information in exchange for a personal benefit."[37] The Second Circuit swiftly rejected that argument, holding that the nature of the information "cannot, without more, permit an inference as to th[e] source's improper motive for disclosure."[38]

Although direct tippees will seldom be able to plausibly deny knowledge of the tipper's personal benefit, these lingering uncertainties post-*Salman* provide strong arguments for remote tippees like the defendants in *Newman*, who often do not know the specific circumstances of the initial disclosure or even the identity of the source.

Conclusion

Unlike the European Union and many other countries, the United States lacks a federal criminal statute that specifically proscribes insider trading. Investors and securities traders thus depend on the judiciary to delineate the boundaries of the criminal offense. Much remains undefined in the wake of *Salman*, making it difficult to advise clients but opening several avenues of defense after charges are brought. These issues are likely to percolate in the lower courts for some time until the Supreme Court weighs in again.

Notes

1. The authors represented the petitioner in *Salman* and defendants in *United States v. Newman* and *United States v. Goffer*, discussed *infra*. Ms. Shapiro also represents the appellants in *United States v. Martoma* and *United States v. Whitman*.
2. 137 S. Ct. 420 (2016).
3. *Dirks v. SEC*, 463 U.S. 646 (1983).

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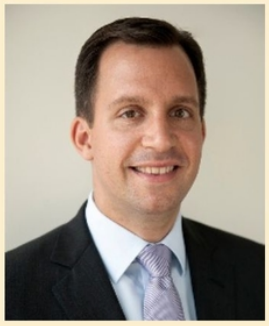
About the Author



Alexandra A.E. Shapiro *is a partner and co-founder of* ***Shapiro Arato LLP****, a New York litigation boutique firm. Her practice focuses principally on white collar defense and appeals. Over the past decade, Ms. Shapiro has won a series of appellate victories in significant cases for clients convicted of insider trading, tax fraud, accounting fraud, wire fraud, and obstruction of justice. She is a Past President of the New York Council of Defense Lawyers, a non-profit association of criminal defense lawyers practicing in the federal courts in New York. She has also served as Deputy Chief Appellate Attorney in the U.S. Attorney's Office for the Southern District of New York and clerked for Justice Ruth Bader Ginsburg of the Supreme Court of the United States.*

Daniel J. O'Neill *is counsel at* ***Shapiro Arato LLP****. He represents clients in white collar criminal matters at the investigatory, trial and appellate levels, and in complex civil litigation. He also has extensive experience conducting internal investigations for corporate boards and management.*

Notes

1. The authors represented the petitioner in *Salman* and defendants in *United States v. Newman* and *United States v. Goffer*, discussed *infra*. Ms. Shapiro also represents the appellants in *United States v. Martoma* and *United States v. Whitman*.
2. 137 S. Ct. 420 (2016).
3. *Dirks v. SEC*, 463 U.S. 646 (1983).
4. 15 U.S.C. § 78j(b). It prohibits using or employing "in connection with the purchase or sale of any [registered or non-registered] security" "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange Commission] may prescribe as necessary or appropriate in the public interest or for the protection of investors." Rule 10b–5, similarly, prohibits "any device, scheme, or artifice to defraud"; untrue statements or material omissions in connection with purchase or sale of any security; and practices that "operate as a fraud or deceit upon any person." 17 C.F.R. § 240.10b–5.
5. *Dirks*, 463 U.S. at 656-57; *Chiarella v. United States*, 445 U.S. 222, 233-35 (1980).
6. The Supreme Court developed the "classical" insider-shareholder theory of insider trading first. *See Chiarella*, 445 U.S. at 230. The later-developed "misappropriation" theory focuses on the duty of trust and confidence that can arise in many relationships, such as that between a lawyer and his client. *See United States v. O'Hagan*, 521 U.S. 642, 653-59 (1997).
7. *Chiarella*, 445 U.S. at 227.
8. *Dirks*, 463 U.S. at 659.
9. *Id.* (internal quotation marks omitted).
10. *Id.* at 663.
11. *Id.*
12. *Id.* at 664.
13. *Id.*
14. *Salman*, 137 S. Ct. at 424.
15. *Id.* at 425.
16. 773 F.3d 438 (2d Cir. 2014).
17. *Id.* at 448-49.
18. *Id.* at 453-54.
19. *Id.* at 452.
20. *Id.*
21. 792 F.3d 1087 (9th Cir. 2015). Curiously, the opinion was written by Judge Jed S. Rakoff of the Southern District of New York, sitting by designation.
22. 137 S.Ct. at 426.
23. *Id.* at 427-28.
24. *Id.* at 428.
25. *Id.* at 427.
26. *Id.* at 428–29 (quoting *Dirks*, 463 U.S. at 664).
27. *Id.* at 424, 427.
28. *United States v. Bray,* 853 F.3d 18, 26 n.5 (1st Cir. 2017)
29. *Salman*, 137 S.Ct. at 426.
30. Oral Arg. Tr. (Oct. 5, 2016) at 27-29, 48.
31. The issue was also litigated in the First Circuit in *Bray*, discussed *supra*. The Court held that the evidence was sufficient to establish a "close relationship" because the tipper testified he was "good friends" with the tippee; they had "known each other for fifteen years" and "often socialized with each other at the club, dined with each other at local bars and restaurants, and even took each other's counsel." 853 F.3d at 27.
32. *See United States v. Martoma*, No. 14-3599 (2d Cir.) Dkt. Nos. 152, 158.
33. *See United States v. Martoma*, No. 14-3599 (2d Cir.) Dkt. Nos. 151, 157.
34. *Salman*, 137 S. Ct. at 425 n.1.
35. Oral Arg. Tr. (Oct. 5, 2016) at 36. The government also acknowledged that this knowledge may be more difficult to prove for the tippee "at the end of the chain . . . than the ones earlier in the chain." *Id.*
36. *Compare United States v. Rajaratnam*, 802 F. Supp. 2d 491, 498-99 (S.D.N.Y. 2011) ("[K]nowledge of tipper breach [of fiduciary duty] ... necessitates tippee knowledge of each element, including the personal benefit, of the tipper's breach.") (internal quotation marks omitted), *with United States v. Goffer*, No. 10-CR-56-1 (RJS), 2017 WL 203229, at *17 (S.D.N.Y. Jan. 17, 2017) ("[T]he tippee need only have known of the tipper's receipt of *a* personal benefit, not that the tippee knew of the *specific* personal benefit actually received by the insider.") (emphasis in original); *United States v. Whitman*, 904 F. Supp. 2d 363, 371 (S.D.N.Y. 2012) ("[I]t is not necessary that [the defendant] know the specific confidentiality rules of a given company or the specific benefit given or anticipated by the insider in return for disclosure of inside information; rather, it is sufficient that the defendant had a general understanding that the insider was improperly disclosing inside information for personal benefit."). Whitman filed a *habeas corpus* petition post-*Newman* and appealed the district court's denial of that petition. The appeal is still pending before the Second Circuit and implicates how close a relationship has to be for a friendship/gift case as well as the knowledge-of-personal-benefit requirement.
37. *Newman*, 773 F.3d at 454.
38. *Id.* at 455.