Shapiro Arato

INSIDER TRADING AFTER *SALMAN*

Alexandra A.E. Shapiro

September 28, 2017

Presentation Overview

I. **Background**
   A. Statutes and SEC rules
   B. Classical theory of insider trading (*Chiarella*)
   C. The tipping offense (*Dirks*)
   D. Misappropriation theory (*O'Hagan*)
   E. Summary of Classical and Misappropriation Theories
   F. Tipper/Tippee Liability
   G. Enforcement

II. ***Newman*, *Salman*, and Beyond**
   A. *United States v. Newman* (2d Cir.)
   B. *United States v. Salman* (9th Cir.)
   C. *Salman* in the Supreme Court
   D. Aftermath and Implications

Statutes and SEC Rules

Section 10(b) of '34 Act:

- General anti-fraud provision
- 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 Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors"
- No mention of insider trading

Rule 10b-5:

- Prohibits (a) schemes to defraud; (b) untrue statements or material omissions in connection with purchase or sale of any security and (c) practices that "operate as a fraud or deceit on any person"

Statutes and SEC Rules

Rule 10b5-1:

- Defines trading "on the basis of" material non-public information to include trading while aware of such information, subject to certain defenses

Rule 10b5-2:

- Defines duties of trust and confidence in "misappropriation" cases

Statutes and SEC Rules

***See also*:**

- **Section 16 of ’34 Act**
  - Short-swing profits by insiders inure to issuer
  - Provides for private civil action by issuer
- **Section 14(e)**
  - Prohibits fraud in connection with tender offers
- **Rule 14e-3**
  - Prohibits insider trading in connection with tender offers

Statutes and SEC Rules

Section 32(a) of ’34 Act:

- “Any person who ***willfully violates*** any provision of this chapter ... or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this chapter, ... shall upon conviction be fined not more than **$5,000,000**, or imprisoned not more than **20 years** ...; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation”

Classical Theory of Insider Trading

***Chiarella v. U.S.*, 445 U.S. 222 (1980)**

- Financial printer traded in takeover targets
- Rejects "parity of information" theory
- Outlines so-called "classical theory" of insider trading:
  - No general duty to disclose or refrain from trading merely because of possession of MNPI
  - Prohibition requires duty arising from "relationship of trust and confidence between parties to a transaction" – i.e., corporate insiders and the company's shareholders
  - Trading by insider on MNPI "deceptive" under Section 10(b) because insider is using information for personal benefit
  - Insider must "disclose or abstain"
- Conviction vacated because defendant owed shareholders no duty

The Tipping Offense

***Dirks v. SEC*, 463 U.S. 646 (1983)**

- Reaffirms no general duty not to trade on MNPI, calling the disclose-or-abstain rule "extraordinary"
- Insiders not only prohibited from personally using corporate information to their advantage "but they may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain"
- Tippee inherits insider's duty to disclose or abstain. Tippee becomes "a participant after the fact in the insider's breach of a fiduciary duty"
- Not all disclosures give rise to liability. "[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"

The Tipping Offense

- *Dirks'* "personal benefit" test:
  - Doesn't require "read[ing] the parties' minds"
  - Focus on "objective criteria," e.g., whether insider "receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or reputational benefit that will translate into future earnings"
  - "Objective facts and circumstances ... often justify such an inference":
    - "quid pro quo" relationship between tipper and tippee
    - intention to benefit tippee
    - "gift of confidential information to trading relative or friend"
- References to pecuniary gain (e.g., "secret profits," "future earnings") throughout opinion

The Tipping Offense

- The *Dirks* Court expressed concern that a broader rule would inhibit market analysts who "ferret out and analyze information" through discussions with corporate insiders
- *Dirks* addresses tippee liability in an unusual context – a whistleblower revealing a massive fraud with no expectation of monetary benefit and no gift of information; therefore, tippee not liable

Misappropriation Theory of Insider Trading

***United States v. O'Hagan*, 521 U.S. 642 (1997)**

- Lawyer for takeover acquirer traded in securities of target
  - "Classical" theory inapplicable because O'Hagan owed no duty to target's shareholders
  - O'Hagan charged and convicted under misappropriation theory
- Misappropriation theory applies to corporate "outsiders" who breach duty to source of the information
- Misappropriators "deal in deception," thus satisfying Section 10(b) requirements
- Purchase or sale requirement satisfied because the "fraud is consummated ... when, without disclosure to his principal, [the fiduciary] uses the information to purchase or sell securities. The securities transaction and the breach of duty thus coincide"

Classical Theory - Summary

- **Elements:**
  1. **Corporate "insider"**—officers, directors, employees, and their family. Includes "temporary" insiders.
  2. **Material information**—Objective tests: "reasonable investor" and "total mix" tests. Hindsight focus.
     - **Reasonable Investor:** Is there a substantial likelihood that a reasonable investor would consider information important in making an investment decision?
     - **Total Mix*:*** Would disclosure of information have been viewed by the reasonable investor as having significantly altered the total mix of available information?
     - **E.g.,** Earnings, ratings changes, buy/sell rec's, news stories, M&A activity, management/control changes, new products or discoveries, customer/supplier developments, auditor changes, events involving company's securities (*e.g.*, tender offers, private placement, default, redemption, splits)

Classical Theory - Summary

3. **Nonpublic information**—includes released-but-undigested and "unimpounded" information, and information distributed solely to special persons or groups, rather than broadly disseminated.
4. **Duty**—duty of trust owed by insiders to shareholders; must disclose or abstain from trading.
5. **Scienter**—
    - **Civil:** "Knew or should have known" (material, non-public, breach of duty)
    - **Criminal:** Actual knowledge/conscious avoidance plus "willfulness" – knowledge of general unlawfulness. *United States v. Kaiser*, 609 F.3d 556, 569 (2d Cir. 2010).

Misappropriation Theory - Summary

- **General:** Sweeps beyond traditional "insiders"
  - Bars ***any*** person from misappropriating confidential information to trade securities
- **Elements**
  1. **Material Information**—same as classical theory
  2. **Nonpublic Information**—same as classical theory
  3. **Duty of Trust and Confidence**—duty owed to source of information not to trade based on nonpublic information
     - **Examples:** Duty owed by investment bankers, lawyers, business partners, consultants, journalists, mailroom employees, broker-dealers, and family members.
     - **SEC Rule 10b5-2**: when (1) recipient agrees to maintain information in confidence; (2) history, pattern or practice of sharing confidences; or (3) recipient receives MNPI from family member (unless source did not expect information to be kept confidential) (non-exhaustive list)
  4. **Use/Misappropriation**—possessing material nonpublic information when transacting sufficient. **Practical test**—information was a factor, however small, in buy/sell decision
  5. **Scienter**—same as classical theory

Tipper/Tippee Liability

- *Dirks* principles apply to both classical and misappropriation theory cases.
  - *See*, *e.g.*, *SEC v. Obus*, 693 F.3d 276, 285-86 (2d Cir. 2012)
- **Tipper Liability**
  - Tipper must receive "personal benefit" for tip
  - Other elements above must be met
- **Tippee Liability**
  - Tipper must receive "personal benefit" and other elements above must be met
  - Tippee must know of breach of duty
    - Including "personal benefit" to tipper
    - This is important in "remote tippee" cases

Enforcement Issues

- How is insider trading detected by law enforcement agencies?
- What factors determine whether insider trading cases become criminal?

Newman (2d Cir. 2014)

***United States v. Newman*, 773 F.3d 438 (2d Cir. 2014)**

- Imposed limitations on tipper/tippee cases.
- Defendants were two hedge fund portfolio managers who received MNPI fourth- or fifth-hand through analysts at their funds
- Two tipping chains:
  - Insider at Dell disclosed information to a business school acquaintance, Goyal, allegedly for "career advice." Goyal passed information to an analyst who circulated it to his analyst friends.
  - Insider at NVIDIA disclosed information to a friend from church, who passed it to an analyst who then passed it to the same circle of analysts

Newman (2d Cir. 2014)

Tippee liability under *Newman*

- **Tipper**: Tipper must disclose for personal benefit
  - Exchange must be "objective," "consequential," and "represent[] at least a potential gain of a pecuniary or similarly valuable
  - Casual friendship not enough
  - Suggested "gift" insufficient
- **Scienter**: Government must prove **tippee knew** that tipper breached fiduciary duty, *i.e.* that: (1) tipper improperly disclosed confidential information, **and** (2) tipper received personal benefit for tip

Newman (2d Cir. 2014)

The Court's personal benefit holding

- "We have observed that '[p]ersonal benefit is broadly defined to include not only pecuniary gain, but also, *inter alia,* any reputational benefit that will translate into future earnings and the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend.'" (citing *United States v. Jiau*, 734 F.3d 147, 153 (2d Cir. 2013))
- "This standard, although permissive, ***does not suggest that the Government may prove the receipt of a personal benefit by the mere fact of a friendship, particularly of a casual or social nature***. If that were true, and the Government was allowed to meet its burden by proving that two individuals were alumni of the same school or attended the same church, the personal benefit requirement would be a nullity."

Newman (2d Cir. 2014)

The Court's personal benefit holding (cont.)

- "To the extent *Dirks* suggests that a personal benefit may be inferred from a personal relationship between the tipper and 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 that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature***. In other words, as Judge Walker noted in [U.S. v.] *Jiau,* this requires ***evidence of 'a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the [latter].'"***

Newman (2d Cir. 2014)

The Court vacated the convictions

- Jury instructions were deficient because they failed to charge that government must prove defendants knew tippers received a personal benefit for their disclosure
- Evidence of personal benefit insufficient because:
  - The "career advice" Goyal gave the Dell insider was "little more than the encouragement one would generally expect from a fellow alumnus or casual acquaintance"
  - The two church friends "were merely casual acquaintances" and the NVIDIA insider did not receive "anything of value" in return for his disclosure

Newman (2d Cir. 2014)

- Evidence of defendants' knowledge of personal benefit insufficient
  - Defendants knew "next to nothing" about the insiders and any personal benefit they received
  - Court rejected government's argument that jury could infer knowledge of personal benefit because information likely disclosed "for some personal reason rather than for no reason at all"
  - Evidence established that companies "routinely" disclosed information to analysts to assist them with their financial models in advance of earnings announcements
- Government's petition for certiorari denied on October 5, 2015

Salman (9th Cir. 2015)

***United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015)**

- Declined to adopt *Newman*'s personal benefit holding
- The tipping chain:
  - Maher Kara, an investment banker at Citigroup, disclosed MNPI about upcoming deals to his brother, Michael
  - Michael traded on the information and also disclosed it to his brother-in-law, defendant Bassam Salman, who traded
- Maher testified that he shared information with Michael to vent about work or to discuss potential treatments for their dying father. Maher told Michael to keep the information confidential, and Michael swore to Maher "on his daughter's life" that he wasn't trading.
- Later, Michael pestered Maher for information. Maher resisted but ultimately gave in to get Michael "off his back"

Salman (9th Cir. 2015)

- Undisputed that Michael did not pay Maher for the information or give him anything else of value
- District Court instructed jury that "personal benefit" requirement could be satisfied by "the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend"
- Jury convicted Salman on all counts. Salman appealed to Ninth Circuit
- After appeal fully briefed, Second Circuit decided *Newman*, and so parties submitted additional briefing

Salman (9th Cir. 2015)

- The Ninth Circuit (Rakoff, J. (SDNY), sitting by designation) held that the evidence of personal benefit was sufficient: "Maher's disclosure of confidential information to Michael, knowing that he intended to trade on it, was precisely the 'gift of confidential information to a trading relative' that *Dirks* envisioned"
- The Court rejected Salman's argument that *Newman* required more: "To the extent *Newman* can be read to [hold that evidence of a friendship or familial relationship between tipper and tippee, standing alone, is insufficient to demonstrate a personal benefit], 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'"

Salman in the Supreme Court

Salman's arguments

- "Personal benefit" should be limited to pecuniary gain
  - Section 10(b) is not an insider trading statute. Because the Court has implied that the insider trading offense into the statute, separation-of-powers principles dictate a narrow construction.
  - Due process/vagueness principles and the Rule of Lenity also dictate a narrow construction
  - A pecuniary gain standard is consistent with *Dirks*, the Court's other insider trading precedents, Section 16, and similar fraud crimes
- The Section 10(b) insider trading offense should not apply to remote tippees

Salman in the Supreme Court

The government's arguments

- The "gift" language in *Dirks* is clear and has been the law for more than 30 years
- The personal benefit test is satisfied whenever an insider discloses information for a personal, rather than a corporate, purpose
  - Not limited to "gifts"
  - Not limited to disclosures to relatives or friends
  - Not vague, because "[t]he line between a corporate purpose and a personal one is readily intelligible"
- Congress has endorsed *Dirks*' personal benefit holding by legislating in the area of insider trading in ways that build on, rather than repeal, the Court's precedents

Salman in the Supreme Court

Supreme Court's Ruling (137 S. Ct. 420 (2016))

- The Court rejected Salman's argument that an insider must receive a pecuniary quid-pro-quo from a tippee for there to be a sufficient personal benefit. The Court found that *Dirks* made clear that a tipper breaches a fiduciary duty—and receives a personal benefit—by making a gift of confidential information to a "trading relative or friend."
- In applying *Dirks*, the Court held that "Maher, a tipper, provided inside information to a close relative, his brother Michael. *Dirks* makes clear that a tipper breaches a fiduciary duty by making a gift of confidential information to 'a trading relative,' and that rule is sufficient to resolve the case at hand."
- The Court declined to adopt the government's broader argument that "a tipper personally benefits whenever the tipper discloses confidential trading information for a noncorporate purpose."
- Second Circuit's holding in *Newman*: "[t]o 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 . . . we agree with the Ninth Circuit that this requirement is inconsistent with *Dirks*."

Salman in the Supreme Court

- **Significance**: *Salman* overrules *Newman*'s requirement that there must be proof of a quid pro quo exchange between tipper and tippee "that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature" where the tipper and tippee are close relatives or close friends.
  - But it left lower courts with a number of questions as to the holding's scope, and the continuing validity of other important aspects of *Newman*

Aftermath and Implications

Does *Salman* clear everything up? What does this mean for *Newman*?

- In cases premised upon friendship, does the relationship still need to be "meaningfully close" to support a *Salman* "gift" theory?
  - *United States v. Bray*, --- F.3d ----, 2017 WL 727556 (1st Cir. 2017):
    - "*Salman* did not . . . discuss the Second Circuit's 'meaningfully close personal relationship' language, presumably because the tipper in the case 'provided inside information to a close relative,' namely 'his brother.'"
    - "*Salman* does not foreclose [an] argument" that "an informational exchange between casual, as opposed to close, friends does not meet *Dirks*'s personal benefit requirement." *Id*. at *5 n.5.
  - In 2-1 decision (discussed next), Second Circuit says no.
    - *United States v. Martoma*, 2017 WL 3611518 (2d Cir. Aug. 23, 2017)

Aftermath and Implications

***United States v. Martoma*, 2017 WL 3611518 (2d Cir. Aug. 23, 2017)**

- Defendant was SAC portfolio manager alleged to have traded on MNPI about results of clinical trial for drug to treat Alzheimer's disease
- Pecuniary benefit vs friendship theory at trial
  - SAC paid consulting fees to doctor, but he got no fee for the alleged tip of the results
  - Government argued that they were "friends"
  - Jury instruction: permitted finding personal benefit if doctor provided information "as a gift with the goal of maintaining or developing a personal friendship"
    - Trial took place before *Newman* was decided
- Martoma argued that there was insufficient evidence of a personal benefit under *Newman*, and that at a minimum he was entitled to a new trial because the jury instruction did not satisfy *Newman*'s personal benefit test

Aftermath and Implications

- Appeal pending when *Salman* decided; court ordered supplemental briefing and re-argument
- Martoma argued that *Newman*'s "close personal relationship" test survives *Salman*
- Divided panel rejected Martoma's argument and created a new "personal benefit" test
- Majority opinion (by Katzman, C.J., joined by Chin, J.):
  - Acknowledged that *Salman* did not "expressly overrule" *Newman*'s meaningfully close personal relationship test" and that "that aspect of *Newman* was not at issue in *Salman*"
  - Nonetheless found that aspect of *Newman* "no longer good law" because it believed *Salman* "fundamentally altered the analysis" underlying *Newman*
  - New "gift" test: personal benefit element satisfied whenever insider discloses MNPI with the expectation that the recipient will trade on it and the "disclosure resembles trading by the insider followed by a gift of the profits to the recipient."

Aftermath and Implications

- Dissent by Judge Pooler:
  - Panel lacked authority to overrule *Newman* without en banc hearing
  - Majority's test strips longstanding personal benefit rule of its limiting power and radically alters insider-trading law for the worse
  - Majority's view exactly mirrors the government's argument in *Salman*, which the Supreme Court expressly declined to adopt: "that a gift of confidential information to anyone, not just a 'trading relative or friend, is enough to prove securities fraud."
- Petition for rehearing en banc is due October 6, 2017

Aftermath and Implications

- Must the government prove that a remote tippee knew "that the insider disclosed information in exchange for personal benefit," as *Newman* held?
  - This aspect of *Newman* is unaffected by *Salman*. *See Salman*, 137 S. Ct. at 425 n.1 ("This case does not implicate those [knowledge] issues.").
  - Some recent SDNY courts faced with that issue on § 2255 have not applied the knowledge requirement very strictly.
    - E.g., *Kimelman*, *Rajaratnam*
  - This issue is probably more significant in criminal than civil cases, where "knew or should have known" is the standard under *Dirks*. (*E.g.*, *Payton*).

Aftermath and Implications

- Government's insider trading enforcement efforts re-invigorated?
- What will the future hold?
- What arguments should defendants be making about personal benefit, especially outside Second Circuit?
  - *Martoma* is wrongly decided; government should be required to prove either a pecuniary benefit or a gift to a close personal friend or relative
  - In remote tippee cases, government must prove tippee's knowledge of the personal benefit

Alexandra A.E. Shapiro

New York
T 212.257.4881
ashapiro@shapiroarato.com

Alexandra Shapiro is a partner and co-founder of Shapiro Arato LLP, a New York litigation boutique.

Alexandra is an experienced trial lawyer and appellate advocate. She has tried many cases and argued numerous appeals in federal and state appellate courts, including *Salman v. United States*, a major insider trading case in the Supreme Court of the United States.

Alexandra has won a series of appellate reversals of criminal convictions in significant white collar prosecutions. Most recently, she procured a new trial for Dean Skelos, the former New York State Senate Majority Leader. Her victories include appellate judgments of acquittal in three cases (two overturned convictions for insider trading and one reversed a tax shelter fraud conviction), as well as several decisions granting new trials for clients who had been convicted of tax crimes, securities fraud, accounting fraud, public corruption, and obstruction of justice.

Alexandra A.E. Shapiro

- Alexandra is currently representing several clients in Second Circuit appeals from insider-trading convictions, including businessman William Walters, former investment banker Sean Stewart, and former SAC portfolio manager Mathew Martoma.
- Alexandra has also conducted internal investigations on behalf of corporations, corporate boards, and Audit Committees. She has assisted clients in developing and implementing regulatory compliance programs. She served as President of the New York Council of Defense Lawyers, a not-for-profit professional association of about 250 experienced lawyers whose principal area of practice is the defense of criminal cases in the federal courts in New York.
- Prior to co-founding her firm in 2009, Alexandra was a partner of Latham & Watkins LLP, and before that, an Assistant U.S. Attorney in the Southern District of New York, where she also served as Deputy Chief Appellate Attorney. She clerked for Justice Ruth Bader Ginsburg of the Supreme Court of the U.S. and for Judge Stephen F. Williams of the U.S. Court of Appeals for the D.C. Circuit, and served as an attorney-adviser in the Office of Legal Counsel of the U.S. Department of Justice.
- Alexandra received her J.D. from Columbia University School of Law; she graduated first in her class and was an articles editor of the *Columbia Law Review*. She received her B.A. from Williams College, graduating *magna cum laude* and with Honors in History.