Linklaters

December 2016

U.S. Supreme Court Rejects Need for Pecuniary Benefit to Tipper to Hold Tippee Liable for Insider Trading

Contents

A tippee who trades on inside information may be liable even where the tipper received no potential pecuniary gain, according to a unanimous U.S. Supreme Court decision, handed down on December 6, 2016. In *Salman v. United States*, the Supreme Court resolved a U.S. federal appellate court split as to whether tippee liability could attach if the tipper did not provide the material non-public information with the expectation of monetary gain. In so doing, the Supreme Court handed a significant victory to enforcers and rejected the U.S. Court of Appeals for the Second Circuit's 2014 landmark decision in *United States v. Newman*, which had held that tippee liability attached only if the tipper had a meaningfully close relationship with the tippee and provided information resulting in a potential pecuniary gain to the tipper.

In *Salman*, the defendant, Bassam Salman, was convicted after making $1.5 million in profits by trading on inside information he received indirectly from his brother-in-law. The Supreme Court rejected Salman's argument that tippee liability did not attach because the tipper had no potential for pecuniary gain in disclosing the information. Instead, the Court reiterated its 1983 holding in *Dirks v. U.S. Securities and Exchange Commission* that a personal benefit to the tipper exists whenever he or she discloses inside information to a relative or friend and expects that trading on that information will ensue.

Some ambiguity remains as to how exactly a tipper must personally benefit for tippee liability to attach. In fact, the Supreme Court stated, "[i]t remains the case that '[d]etermining whether an insider personally benefits from a particular disclosure, a question of fact, will not always be easy for courts.'" However, *Salman* makes clear that providing inside information to a friend or relative with the expectation that he or she will trade based on that information is sufficient to establish a breach of fiduciary duty which allows tippee liability to attach for all future tippees who are aware of the breach.

Background on Insider Trading Regulations

Under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the Securities and Exchange Commission, individuals are prohibited from using material, non-public, inside information in connection with the purchase and sale of securities. Violation of this prohibition can result in criminal and civil liability.

Under the anti-fraud provisions of the U.S. securities laws, a tipper is someone who provides material non-public information in breach of his or her fiduciary duty, and a tippee is someone who improperly receives such information.

Tippees who receive inside information engage in securities fraud if they trade on the information with knowledge that the tipper disclosed the information in violation of a fiduciary duty.

The Supreme Court's decision in *Dirks*, which addresses tippee liability, held that a tipper violates a fiduciary duty when he or she discloses inside information for personal benefit and expects trading to ensue. That case broadly defined personal benefit to include situations where a tipper gifts confidential information to a friend or relative.

The U.S. Court of Appeals for the Second Circuit appeared to challenge *Dirks*' interpretation of personal benefit in *Newman* when it held that personal benefit to a tipper required some potential pecuniary gain and that friendship or a familial relationship would not suffice. The *Newman* court criticized the government for "the doctrinal novelty of its recent insider trading prosecutions, which are increasingly targeted at remote tippees many levels removed from corporate insiders." Under *Newman*, a tippee would not be liable for securities fraud in the absence of the tipper's potential pecuniary gain because, without this, the tipper would not have violated a fiduciary duty.

The Supreme Court Opinion

In *Salman*, the government prosecuted a defendant who traded in securities based upon material non-public information he gained indirectly from an insider at Citigroup. Salman's brother-in-law, Maher Kara, an investment banker at Citigroup, shared inside, material, non-public information with his brother Michael Kara, who then passed the information on to Salman. Maher Kara knew that his brother was using the information to trade in securities, but was not aware that his brother was sharing the information with Salman.

Salman was convicted of one count of conspiracy to commit securities fraud and four counts of securities fraud, but appealed the decision, arguing that tippee liability did not attach. Specifically, Salman asserted that the tipper did not violate his fiduciary duty as there was no potential for him to obtain a pecuniary gain in sharing the information, and, therefore, he did not personally benefit.

Both the court of appeals and the Supreme Court rejected this argument and affirmed the convictions. The Supreme Court recognized that tippee liability can

only attach when a tipper violates his or her fiduciary duty by enjoying a personal benefit, but resolved the case by relying on language in *Dirks* stating that a tipper enjoys a personal benefit when he or she gifts inside information to a "trading relative or friend." In this case, Maher Kara violated his fiduciary duty when he shared inside information with his brother. Salman, who received this inside information, knew that Maher Kara had violated his fiduciary duty, yet he proceeded to trade on the information, thereby committing securities fraud. The Supreme Court concluded that gifting inside information to a relative is materially equivalent to personally trading on the inside information and gifting the proceeds: "[w]hen a tipper gives inside information to 'a trading relative or friend,' the jury can infer that the tipper meant to provide the equivalent of a cash gift."

The Supreme Court, however, rejected the Government's argument that a gift of inside information to *any* individual, not just a friend or relative, is enough of a personal benefit for tippee liability to attach.

Conclusion

The Supreme Court's opinion in *Salman* rejects the U.S. Court of Appeals for the Second Circuit's attempt to narrow tippee liability for insider trading and reiterates support for the *Dirks* interpretation of personal benefit to a tipper who is a friend or relative of the tippee. Sharing inside information with a friend or family member is sufficient to breach a fiduciary duty and places the receiving individual at risk of liability for securities fraud should he or she choose to trade on it. This case highlights the importance of instituting appropriate policies and controls to protect inside information, exercising caution before trading based upon non-public information, and, when investigating or defending an allegation of insider trading, carefully examining the relevant facts to determine whether an insider personally benefitted from a particular disclosure.

Please do not hesitate to reach out to any of your Linklaters contacts for further discussion or for advice.

Authors: James Warnot, Paul Hessler, Adam Lurie, Douglas Tween, Kate Machan, and Ishita Kala

Contacts

For further information please contact:

James Warnot
Partner
(+1) 212 903 9028

james.warnot@linklaters.com

Paul Hessler
Partner
(+1) 212 903 9132

paul.hessler@linklaters.com

Adam Lurie
Partner
(+1) 202 654 9227

adam.lurie@linklaters.com

Douglas Tween
Partner
(+1) 212 903 9072

douglas.tween@linklaters.com

Kate Machan
Associate
(+1) 212 903 9289

kate.machan@linklaters.com

Ishita Kala
Law Clerk
(+1) 212 903 9047

ishita.kala@linklaters.com

Linklaters LLP
1345 Avenue of the Americas
New York, NY 10105

Telephone (+1) 212 903 9000
Facsimile (+1) 212 903 9100