

Insider Trading Law Remains Murky After High Court Ruling

By **Carmen Germaine**

Law360, New York (December 6, 2016, 10:36 PM EST) -- The U.S. Supreme Court's decision Tuesday upholding the government's insider trading case against Bassam Salman is a victory for prosecutors hampered by the Second Circuit's Newman decision, experts said, but the justices' narrow holding won't resolve the long-standing question of who qualifies as a friend under the court's insider trading precedent.

The high court's unanimous opinion rejected Salman's claims that he couldn't be convicted for insider trading because his brother-in-law Maher Kara received no pecuniary benefit for passing tips. It ruled instead that prosecutors don't need to show that tipsters received concrete benefits for their tips if they gifted information to a relative or friend.

In so holding, the justices partially overturned the Second Circuit's landmark 2014 decision in *U.S. v. Newman*, giving prosecutors a reason to cheer, especially Manhattan feds who have complained that the Newman decision tied their hands by requiring prosecutors to prove insiders received a significant, potentially pecuniary personal benefit in exchange for their tips.

"I think it's a big win for the DOJ and the SEC, and it really clears a path towards more aggressive insider trading enforcement," said Arlo Devlin-Brown, a Covington & Burling LLP partner and former federal prosecutor who helped secure the insider trading conviction of Mathew Martoma.

A Gift to Prosecutors

In Tuesday's decision, Justice Samuel Alito wrote that the court was closely following the Supreme Court's 1983 decision in *Dirks v. SEC*, which held in part that a personal benefit can be inferred when the insider gifts information to a "trading relative or friend." To the extent the Second Circuit held in *Newman* that an insider must receive something of a "pecuniary or similarly valuable nature" in exchange for gifting information, Justice Alito wrote, that requirement "is inconsistent with *Dirks*."

The Newman decision had a distinct effect on insider trading prosecutions in the Second Circuit, forcing Manhattan U.S. Attorney Preet Bharara and his office to drop insider trading cases against a number of defendants. Bharara and other federal prosecutors made no secret of their disdain for the holding.

Morgan Lewis & Bockius LLP partner David Miller said Tuesday's decision in Salman's case turns the clock back on the personal benefit question to before the Newman decision was handed down, making it easier for prosecutors to bring insider trading cases involving friends and relatives.

"It's extremely significant because it puts insider trading enforcement back on a track that was partially derailed by Newman," said Miller, a former federal prosecutor who served in the Southern District of New York.

On Tuesday, Bharara himself said the Salman opinion was a win for prosecutors. He issued a statement calling the decision "a victory for fair markets and those who believe that the system should not be rigged," and said the Supreme Court had "stood up for common sense."

Civil prosecutors were no less enthused: U.S. Securities and Exchange Commission Chair Mary Jo White said Tuesday that her agency was "very pleased" with the ruling and that the opinion "reaffirms our ability to continue to aggressively pursue illegal insider trading and bring wrongdoers to justice."

To many experts, the decision was largely unsurprising. Christopher J. Steskal, chair of Fenwick & West LLP's white collar and regulatory defense practice, said that the Newman decision had created a "ripple" in insider trading law that was largely reversed by the Supreme Court. Indeed, the justices noted that Newman's holding on personal benefit had broken with the 30-year-old Dirks decision.

Who Is a Friend?

But other experts noted that the Supreme Court was explicit that its decision was a narrow one, and not a major reworking of insider trading law.

"We adhere to Dirks, which easily resolves the narrow issue presented here," Justice Alito wrote, saying that Dirks' holding that insiders breach their fiduciary duty by gifting confidential information to "a trading relative" is "sufficient to resolve the case at hand."

Holwell Shuster & Goldberg LLP attorney Daniel Sullivan said that because the facts of the Salman case fit so neatly within the Dirks precedent, the opinion left a lot of ambiguity at the margins of insider trading law.

"It was not a great case for the court to add a whole lot of clarity to the Dirks articulation," said Sullivan, who clerked for the late Justice Antonin Scalia.

In particular, Sullivan and other experts noted, the court didn't spell out how close a relationship must be to satisfy Dirks. And they said that lack of clarity could bring headaches down the road.

"Is an acquaintance enough? Does it need to be a bosom buddy?" Sullivan said.

Elizabeth L. Yingling, a partner at Baker & McKenzie LLP, said that the Newman decision had been written in part to address questions of how close is close enough. The Newman court also said liability could only arise if the insider has a "meaningfully close personal relationship" with the tippee.

"I think that that is what Newman was trying to do, establish in essence what a friend is, which I guess is an odd concern for the law," Yingling said.

Some experts said distinctions between levels of friendship are unlikely to have a huge impact on insider trading prosecutions.

Jonathan Shapiro, a partner at Baker Botts LLP, said that in the majority of insider trading cases decided since *Dirks*, insiders have received a more explicit quid pro quo in exchange for their tips.

And Devlin-Brown said that the holding in *Salman*, that liability arises either if the insider expects a financial benefit or wants to help a friend or relative, covers “nearly the universe of human behavior.” Because the court didn’t specify whether a friendship must be close or meaningful, he said, anything that fits under the “conventional understanding” of friendship will likely suffice.

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— Daniel Sullivan
Holwell Shuster & Goldberg

“I just don’t think, unless you’re talking about extreme outlier situations, that a jury is likely to be held up by, ‘Well, they weren’t good enough friends,’” Devlin-Brown said.

Murphy & McGonigle LLP partner Steven Feldman, a former Manhattan federal prosecutor, noted that the Supreme Court itself said there could still be circumstances where assessing liability for gifting

information could be difficult. Justice Alito said in the opinion that there was “no need for us to address those difficult cases today” because *Salman*’s case fit easily inside of *Dirks*.

At oral arguments, the justices asked where the line would be drawn between different relationships, with Justice Sonia Sotomayor asking if there was “a difference between friend and acquaintance.”

Other recent cases have involved tips passed between roommates and romantic partners; an SEC judge in September 2015 dismissed claims against a former Wells Fargo Securities LLC trader after finding that although the man traded on tips from an analyst at the firm, the agency couldn’t show the analyst had benefited from the exchange. While the SEC will have an easier time challenging that order post-*Salman*, the trader has maintained that he and the analyst were merely co-workers, not friends.

Even the *Newman* case itself illustrates some potential hurdles for future prosecutions. The Second Circuit noted that the tips Todd Newman and Anthony Chiasson received originated from an insider who tipped a colleague who attended the same business school — but who wasn’t a “close” friend — and a tipper who passed information to a family friend he had met in church.

If the government were able to infer an insider received a personal benefit from gifting information “by proving that two individuals were alumni of the same school or attended the same church, the personal benefit requirement would be a nullity,” the Second Circuit said.

Although the Supreme Court’s Tuesday decision was explicit that a personal benefit can indeed be inferred when insiders gift information to friends, the justices didn’t opine on whether, say, an acquaintance from a church rises to the level of a friend.

Sullivan noted that the justices also were silent on what kind of proof prosecutors will need in order to show the nature of the relationship between an insider and a tippee or establish that the insider intended to gift the proceeds of the illicit trade.

And by allowing prosecutors to infer a benefit on the basis of personal relationships, Shapiro said, the high court has left insider trading in a “strange state of affairs.”

“We’re going to continue to have this world of ambiguity for what is a fundamentally transactional offense, and we’re going to continue to have excessive reliance on evidence,” Shapiro said.

Another Newman Hurdle

Experts noted that the Supreme Court also left untouched Newman’s holding that tippees must know that the insider received a personal benefit in order to be held liable for trading on inside information. In a footnote, Justice Alito said that the Salman case “does not implicate those issues.”

“By the Supreme Court pointing that aspect of Newman out, I think that’s at least an implicit indication that the Supreme Court agrees that the government still has to produce that evidence,” Yingling said.

Many experts said that the knowledge aspect of Newman, while significant, was not a significant break from prior law. Steskal said knowledge of the insider’s breach has always been an element of insider trading liability in some form or another.

“That’s a real element and a real limitation on the government’s ability to try insider trading cases, but to me that’s not a new limitation,” Steskal said.

But there is some evidence that the Newman configuration of the knowledge requirement, that tippees must know their information came from an insider who derived a personal benefit, has held prosecutors in the Second Circuit back in some cases.

After all, even though the Salman decision overturned part of the Newman holding, Newman's and Chiasson’s convictions would still be vacated because the Second Circuit found they had no knowledge that the insiders had benefited from passing tips.

In another case, golfer Phil Mickelson in May was named as a relief defendant in a civil insider trading case brought by the SEC after the agency alleged he traded on information that sports bettor William “Billy” Walters received from former Dean Foods Co. chairman Thomas Davis, but escaped criminal charges. Although neither Bharara nor SEC Enforcement Division Director Andrew Ceresney would comment on the decision not to charge Mickelson with insider trading, Bharara ruefully acknowledged Newman’s shadow in his remarks on the case.

“Several offices, including mine, have come to the view that there is conduct that is nefarious and that undermines faith in the markets and undermines the fairness of the markets that will not be able to be prosecuted because of the Newman decision,” Bharara said.

But prosecutors likely would still be unable to charge Mickelson even with the Salman decision in hand: The SEC complaint and criminal indictment suggested that Mickelson made trades after Walters called

and texted him with inside information, but was otherwise unaware of Davis' role or that Walters had passed benefits back to Davis in exchange for the info.

Insider Trading's Murky Future

Tamar Frankel, a professor at Boston University School of Law, said that the decision also doesn't touch instances where an insider inadvertently passes on information without expecting that the recipient will trade on the tip, as when a lawyer or analyst mentions they've been working on a merger to a close friend.

In the future, she said, the Supreme Court will continue to grapple with balancing the risks of prosecuting such inadvertent behavior against the benefits of protecting markets.

"You can't have people be under the sofa at all times," Frankel said.

Ultimately, experts said that while the case will likely have a significant impact on insider trading prosecutions, especially in the busy Second Circuit, there are plenty more issues in insider trading law that remain unresolved.

"There's a lot to insider trading law, so there's still all kinds of issues that remain for people to fight about in the insider trading world," Feldman said.

The government is represented by Ian Heath Gershengorn, Anne K. Small, Sanket J. Bulsara, Michael A. Conley, Jacob H. Stillman, David D. Lisitza, Michael R. Dreeben, Elaine J. Goldenberg and Ross B. Goldman.

Salman is represented by Alexandra A.E. Shapiro and Daniel J. O'Neill of Shapiro Arato LLP, and John D. Cline of the Law Office of John D. Cline.

The case is *Salman v. U.S.*, case number 15-628, in the Supreme Court of the United States.

--Editing by Mark Lebetkin and Aaron Pelc.