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The Circuits Are Split: Are Tangible Benefits Required for Insider Trading Liability?

The Ninth Circuit's recent decision calls into question the Second Circuit's definition of "personal benefit" for insider trading liability in criminal prosecutions.

On July 6, 2015, United States District Court Judge Jed S. Rakoff authored a Ninth Circuit opinion that signalled increased skepticism about the weighty "personal benefit" requirement established by the Second Circuit last December in *United States v. Newman*¹ for "tippee" liability under the insider trading laws. In *United States v. Salman*,² Judge Rakoff — who happened to be sitting on the Ninth Circuit by designation — articulated a narrower definition of the personal benefit requirement for tippee liability than the one adopted by the Second Circuit in *Newman*. At base, the Ninth Circuit concluded that, if inside confidential information is passed among close friends or family members, the benefit is essentially presumed, and additional evidence beyond the relationship is unnecessary to prove that benefit. By contrast, in *Newman*, the Second Circuit held that, such an inference is insufficient absent proof of a close personal relationship that generates an exchange that is tangible or has pecuniary value. With his pen, Judge Rakoff may have set up a circuit split ripe for Supreme Court review on an issue of utmost import.

Second Circuit's *Newman* Decision Sets High Bar for "Personal Benefit"

Reversing the convictions of two former hedge fund managers, Todd Newman (*Newman*) and Anthony Chiasson (*Chiasson*) last December, the Second Circuit held in *United States v. Newman* that the government failed to make a sufficient showing of "personal benefit" to the insider-tipper and that the jury should have been instructed that "the government must prove beyond a reasonable doubt that the tippee knew that an insider disclosed confidential information and that he did so in exchange for a personal benefit."³ *Newman* and *Chiasson* were charged with trading on material non-public information obtained from a tipping chain that began with insider-tippers, Rob Ray and Chris Choi, who "were not 'close' friends" and "were merely casual acquaintances" with the first level tippees, Sandy Goyal and Hyung Lim.⁴ The first level tippees testified that they did not provide anything of value to the insider tippers.⁵ Under precedent that derived from the United States Supreme Court's seminal decision in *Dirks v. SEC*, 463 U.S. 646 (1983), such evidence of a friendship or a working relationship would likely have been sufficient to meet the "personal benefit" requirement. *Newman* walked *Dirks* back and held that mere acquaintance is insufficient to establish personal benefit and the act of giving a gift of confidential information to a trading relative or friend was inadequate to establish a personal benefit.⁶ Instead, "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."⁷

Judge Rakoff's Decision in *SEC v. Payton and Durant*

Of course, the principal prohibition against insider trading, SEC Rule 10b-5, can be enforced criminally by the United States Department of Justice, and civilly by the Securities and Exchange Commission (SEC). Four months after the *Newman* decision, Judge Rakoff declined to dismiss an SEC enforcement action against two financial professionals after his colleague on the United States District Court for the Southern District of New York, Judge Andrew Carter, vacated previously accepted guilty pleas against the same two defendants.⁸

The defendants in the criminal case and in the SEC enforcement action, Daryl Payton (Payton) and Benjamin Durant (Durant), were both registered representatives with a New York broker dealer.⁹ In both actions the two were charged with using inside information to purchase stock in the target of a planned acquisition. As alleged in the SEC's complaint, the original tipper, Trent Martin, received the information from a lawyer friend who worked on the transaction. In violation of a duty owed to the lawyer, Martin then provided the material non-public information to his roommate, Thomas Conratt, who worked at the same broker dealer as Payton and Durant. The SEC claimed that Martin and Conratt shared a "close, mutually-dependent financial relationship, and had a history of personal favors."¹⁰ Conratt then tipped Payton and Durant, two brokers who worked at the same brokerage firm with Conratt. Payton and Durant bought stock in the target on the basis of the tip from Conratt. According to the SEC, Conratt told Payton and Durant that his roommate Martin had told him about the acquisition; Payton and Durant did not ask why Martin gave the information to Conratt or how Martin received the information. Specifically, the SEC's complaint alleged that the defendants (1) knew that Martin was the source of the tip to Conratt; (2) knew that Conratt and Martin were friends and roommates; and (3) knew of unrelated legal problems that Martin had and Conratt's assistance with those problems.

With respect to the key issue in *Newman*, whether the defendants were aware of a benefit to the tipper (Martin), Judge Rakoff found the allegations sufficient under a "knowing or reckless" standard. Judge Rakoff wrote, "[t]his is enough to raise the reasonable inference that the defendants knew that Martin's relationship with Conratt involved reciprocal benefits."¹¹ Judge Rakoff distinguished the case against Payton and Durant from *Newman*, where the defendants "'knew next to nothing' about the tippers, were unaware of the circumstances of how the information was obtained, and 'did not know what the relationship between the [tipper] and the first-level tippee was.'" Judge Rakoff noted the SEC's allegations that Payton and Durant never asked why Martin shared inside information with Conratt or how Martin learned of the information in the first place. In light of Payton's and Durant's market sophistication and knowledge, Rakoff held that an adverse inference could be drawn that the defendants had recklessly avoided discovering additional details.

Ninth Circuit's *Salman* Decision Undercuts *Newman*

Newman was decided while Bassam Yacoub Salman's (Salman) conviction was on appeal before the Ninth Circuit. Affirming the insider trading conviction of Salman on July 6, 2015, Judge Rakoff — a United States District Judge for the Southern District of New York, who by chance was sitting by designation on the Ninth Circuit — wrote for the *Salman* court and called into question the Second Circuit's high bar for "personal benefit" to insider tippers.¹² In contrast to the "merely casual acquaintance" relationships between tippers and tippees in *Newman*, the key players in *Salman* were part of a very close-knit family.¹³ Maher Kara (Maher), a former investment banker who provided information about healthcare deals to his older brother, Michael Kara (Michael), who traded on the information, testified that he "love[d] [his] brother very much" and that he gave Michael the information to "benefit him" and "fulfill[] whatever needs he had."¹⁴ Salman began receiving the inside information as family when his sister, Suzie Salman, became engaged to Maher. Salman was convicted of insider trading after the government presented evidence that

Maher and Michael had a close and mutually beneficial relationship, that Salman was aware that Maher was the source of the inside information, and that the Salmans and Karas were tightly knit families.¹⁵

On appeal, Salman argued that the evidence of a mere family relationship alone was insufficient to establish a tipper's "personal benefit" of a tangible or pecuniary nature, as set forth in *Newman*.¹⁶ The Ninth Circuit rejected that argument and affirmed Salman's conviction, explaining that Maher's disclosure of confidential information to Michael, knowing that Michael intended to trade on the inside information, was precisely the "gift of confidential information to a trading relative" that *Dirks v. SEC* had envisioned.¹⁷ While not directly rejecting the *Newman* decision, Judge Rakoff nonetheless cautioned against taking too literal a view of the Second Circuit's decision:

Salman argues that because there is no evidence that Maher received any such tangible benefit in exchange for the inside information, or that Salman knew of any such benefit, the Government failed to carry its burden.

To the extent *Newman* can be read to go so far, we decline to follow it.

...

If Salman's theory were accepted and this evidence found to be insufficient, then a corporate insider or other person in possession of confidential and proprietary information would be free to disclose that information to her relatives, and they would be free to trade on it, provided only that she asked for no tangible compensation in return. Proof that the insider disclosed material non-public information with the intent to benefit a trading relative or friend is sufficient to establish the breach of fiduciary duty element of insider trading.¹⁸

Salman's Impact on Future Insider Trading Cases

Judge Rakoff's decision has likely caused the circuit split that could allow the Supreme Court to finally provide some clarity to the increasingly complicated and complex law of insider trading. The Supreme Court likely will need to consider and refine their 30 year-old decision in *Dirks* and decide how "close" of a friend or how strong of a working or familial relationship is needed to establish personal benefit and the nature of that benefit. The vehicle for Supreme Court review will likely be the Second Circuit's decision in *Newman*. Given the importance of Judge Rakoff's perspective on white collar crime, generally, and insider trading law, specifically, the *Salman* decision provides the first, powerful headwind to the longevity of *Newman*. Whether other Circuits or the Supreme Court follow suit remains to be seen.

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Endnotes

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- ¹ *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014).
 - ² *United States v. Salman*, No. 14-10204 (9th Cir. July 6, 2015).
 - ³ *Newman*, 773 F.3d at 441.
 - ⁴ *Id.* at 452.
 - ⁵ *Id.* at 453.
 - ⁶ *Id.* at 452.

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- ⁷ *Id.*
- ⁸ *United States v. Conradt*, 12 Cr. 887 (ALC) (S.D.N.Y. Jan. 22, 2015).
- ⁹ *SEC v. Payton and Durant*, No. 14-cv-4644, 2015 WL 1538454 (S.D.N.Y. Apr. 6, 2015).
- ¹⁰ *Id.* at *2.
- ¹¹ *Id.* at *5.
- ¹² *See Salman*, No. 14-10204, at *6-15.
- ¹³ *Id.* at *5.
- ¹⁴ *Id.*
- ¹⁵ *Id.* at *5-6.
- ¹⁶ *Id.* at *13.
- ¹⁷ *Id.* at *10.
- ¹⁸ *Id.* at *13-14.