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Insider Trading Law After *Salman v. United States*

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In *Salman v. United States*,[1] decided on December 6, 2016, the Supreme Court upheld a conviction for criminal violations of insider trading laws. The Court, however, declined to adopt the expansive theories of insider trading advanced by the government and expressed skepticism about those theories at oral argument. *Salman* provides an appropriate occasion to describe what Judge Rakoff referred to as the "topsy-turvy" way in which insider trading law has developed. [2] We trace the evolution of the law up to and including *Salman* and discuss five potential defenses that exist even after the Supreme Court's decision.

As discussed below, the Supreme Court long ago rejected the government's equal-access theory of insider trading, and instead required a breach of a duty of trust and confidence to support insider trading liability. The breach must involve a personal benefit to the insider or "misappropriator." When insiders or misappropriators trade on material nonpublic information, the Supreme Court's breach-of-duty requirement will rarely pose an obstacle to liability. In addition, the government's burden may not be particularly difficult in the case of a tip in exchange for a financial benefit to the tipper or a tip to a close friend or relative who trades.

As soon as other tippees enter the picture, however, the burden becomes much more difficult for the government. The Second Circuit's decision in *United States v. Newman*,[3] in both tone and its articulation of the governing principles, reflected exasperation with the government's pursuit of remote tippees on paper-thin grounds. *Newman*'s (i) requirement that the government prove that the tippee knew (or, in a civil case, at least should have known) that the source tipped the information for the source's personal benefit, (ii) its limitation on who counts as a "friend" for insider trading purposes, and (iii) its requirement of "an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature" in the case of tips to persons other than close friends and relatives survive *Salman*, as does the Second Circuit's expressed concern about the "doctrinal novelty" of the government's prosecutions of remote tippees. As a result, even after the government's win in *Salman*, the government will often have great difficulty prosecuting tippees who are many levels removed from the source of the information.

[1] Slip op. No. 15-628 (S.Ct. Dec. 6, 2016).

[2] United States v. Whitman, 904 F. Supp. 2d 363, 371 (S.D.N.Y. 2012).

[3] 773 F.3d 438 (2014), *cert. denied*, 136 S.Ct. 242 (2015).

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I. Introduction

Insider trading law is one of many examples of Congress providing no meaningful guidance and the courts largely inventing the law. In 1934, Congress enacted the Securities Exchange Act, the first major federal securities statute to regulate secondary market trading. Section 9 of the Securities Exchange Act defined with specificity a number of prohibited forms of manipulation and deception (principally wash sales, matched orders, engaging in a series of transactions with the specific intent of raising or depressing the price of a security, inducing the purchase of securities through misrepresentations or omissions, and spreading false rumors). Section 10(b) then authorized the Securities and Exchange Commission ("SEC" or "the Commission") to prohibit or regulate any other "manipulative or deceptive device or contrivance." Neither section addressed insider trading as such, and nothing in the language or legislative history of Section 10(b) suggests that Congress had insider trading in mind when it adopted Section 10(b). Divining the elements of an insider trading violation from the language or legislative history of Section 10(b), or indeed the legislative history of the entire Securities Exchange Act, is quite the impossible task.

II. *In re Cady, Roberts & Co.* (1961) — The SEC Finds in Section 10(b) a Broad Prohibition Against Trading on Material Nonpublic Information

In 1959, Robert Gintel, a partner at Cady, Roberts & Co., a broker-dealer, learned from a director of Curtiss-Wright Corporation that the company was cutting its dividend. The director who provided the information to Gintel also happened to be employed by Cady, Roberts. Upon receiving the information and before the information was made public, Gintel caused 21 accounts to sell their Curtiss-Wright shares. The Commission learned of the conduct and was appalled, but figuring out why Gintel was prohibited from trading was a challenge. After all, Gintel was not himself an insider, and he had no relationship to the persons who purchased the Curtiss-Wright Corporation shares that his clients sold.

Writing for the Commission in its 1961 *Cady Roberts* decision, SEC Chairman William Cary described it as a "case of first impression and one of signal importance in our administration of the Federal securities acts."[4] In the nearly three decades of its existence up to that time, the Commission had not had a prior occasion to consider whether a broker (or other person), after receiving nonpublic information from a director of a public company, was prohibited from trading on the basis of that information.

With nothing better in hand to address the conduct, the Commission found in Section 10(b) a nearly limitless grant of authority to prohibit any securities-related conduct it thought unfair. Chairman Cary found in Section 10(b) a prohibition against "the infinite variety of devices by which undue advantage may be taken of investors and others."[5] He waxed poetic about the breadth of conduct embraced by the prohibition

[4] *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).
[5] *Id.* at 911.

against fraud, writing, "It might be said of fraud that age cannot wither, nor custom stale its infinite variety."[6]

Insider trading was unlawful, according to the Commission, because of one's access to information intended to be available only for a corporate purpose and the "inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing."[7] Explaining why the prohibition against insider trading was not limited to insiders, he explained that the Commission was "not circumscribed by fine distinctions and rigid classifications."[8] The Commission found that Mr. Gintel had committed a fraud by causing the accounts over which he had discretionary authority to sell their Curtiss-Wright shares before the market knew of the dividend cut. Fortunately for Mr. Gintel, those were the days of a kinder, gentler SEC: the Commission suspended him for a mere 20 days.

The Commission's view that Section 10(b) prohibited anyone from trading on material nonpublic information, sometimes referred to as the equal-access-to-information theory, was adopted by the lower courts. In *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (*en banc*), *cert. denied*, 394 U.S. 976 (1969), the Second Circuit — the "Mother Court" for securities cases — agreed with the Commission's position that:

> anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.

(emphasis added). That standard, however, was destined not to survive Supreme Court scrutiny twenty years later.

III. *Chiarella v. United States* (1981) — To Satisfy the Element of Deception in Section 10(b), the Government Must Prove a Breach of Duty Arising From a Relationship of Trust and Confidence

1. *The Lower Courts' Acceptance of the SEC's Equal-Access Theory of Insider Trading*

In the mid-1970s, at a time when securities firms and their law firms relied heavily on financial printers to print their documents, Vincent Chiarella worked as a "markup man" in the composing room of a well-known financial printer in downtown Manhattan. He selected type fonts and page layouts and then passed the manuscripts on to be set in type. Chiarella, however, was no ordinary markup man. He was a knowledgeable stock trader who often spoke with his broker 10 to 15 times a day. His career choice appears to have been based less on a love of type fonts and more on an interest in gaining a trading edge.

[6] *Id.* at 911 n. 12.
[7] *Id.* at 912.
[8] *Id.*

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Among the documents Chiarella handled as a markup man were documents provided by tender offerors in connection with their takeover bids. The names of the targets were coded, but Chiarella used his market knowledge to deduce the actual targets. He then purchased shares of the target companies before the tender offers were announced. Once the tender offers were announced and the price of the stocks rose, he sold his shares for a significant profit. He did so in five different tender offers in a 15-month period before the SEC came knocking at his door, after which he lost his job, entered into a consent decree, and agreed to disgorge his profits. That was not enough for the U.S. Attorney, however, which brought criminal charges against Chiarella on the equal-access theory, i.e., that anyone in possession of material nonpublic information must disclose it or abstain from trading.

Chiarella was convicted and he appealed to the Second Circuit. His principal argument was that because the information he learned came from offerors he had no duty to the shareholders of the offerees (the target companies) in whose shares he traded. The Second Circuit acknowledged that he was not an insider of the companies in whose securities he traded but found it irrelevant. It stated, "That appellant was not an insider of the companies whose securities he traded is true, but irrelevant. A financial printer such as Chiarella is as inside the market itself as one could be."[9]

Quoting from its decision in *Texas Gulf Sulphur*, the court stated that the prohibition against insider trading was based "in policy on the justifiable expectations of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information." Judge Meskill dissented on the ground that prior cases involved either "an insider, the tippee of an insider, or one standing in a special relationship with other traders," and here Chiarella was none of those.[10]

2. *The Supreme Court Rejects the Government's Position and Requires a Breach of Duty Arising from a Relationship of Trust and Confidence*

The Supreme Court granted cert. The timing was good for Mr. Chiarella. By the time *Chiarella* wound its way to the Supreme Court, it had become clear that the Court did not share the government's expansive view of Section 10(b), which had become the principal basis on which securities class actions were being filed. In 1977, the Court held that Section 10(b) does not reach conduct that is merely unfair — the conduct must be fraudulent or manipulative.[11] The year before, it held that in a private damage action Section 10(b) requires proof of scienter, not merely negligent or even grossly negligent conduct,[12] and in 1980, it held that the Commission was subject to the same burden.[13] Anyone reading the tea leaves could see that by the late 1970s and early 1980s, the Court was looking to limit, not expand, the reach of Section 10(b).

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[9] 588 F.2d 1358, 1364 (2d Cir. 1978).

[10] *Id.* at 1373.

[11] Santa Fe Industries v. Green, 430 U.S. 462 (1977).

[12] Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

[13] Aaron v. SEC, 446 U.S. 680 (1980).

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Justice Powell wrote the decision for the Court's majority. He stated that the issue was "whether silence may constitute a manipulative or deceptive device or contrivance."[14] By silence, he meant the failure of the person with material nonpublic information to disclose it before trading, which had the effect of making the trading unlawful. He acknowledged that "neither the legislative history nor the statute itself affords specific guidance for the resolution of this case."[15] Finding no guidance in the language of the statute or its legislative history, he turned to the law of fraud.[16] He stated:

> [O]ne who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information "that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them."[17]

Further,

> [A]dministrative and judicial interpretations have established that silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b) despite the absence of statutory language or legislative history specifically addressing the legality of nondisclosure. But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction.[18]

Thus, after *Chiarella*, proof that someone traded on material nonpublic information was no longer enough to show that the trading was unlawful. Instead, identifying a "duty to disclose" arising from a "relationship of trust and confidence between the parties to a transaction" became essential.[19] The Court reversed Chiarella's conviction, stating that with regard to the sellers of the securities that he purchased, he "was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions."[20]

The Court did not reach the issue, later addressed in *United States v. O'Hagan* (discussed below), whether Chiarella could have been convicted on an alternative fraud theory — that his trading was fraudulent because he had breached a duty to his employer by misappropriating information entrusted to his employer by the

[14] Chiarella v. United States, 445 U.S. 222, 226 (1980).

[15] *Id.*

[16] In United States v. Whitman, 904 F. Supp. 2d 363, 369 (S.D.N.Y. 2012), the court held that whether there is a violation of a fiduciary-like duty of trust and confidence for insider trading purposes is a matter of federal common law rather than state law.

[17] 445 at 228.

[18] *Id.* at 230.

[19] The relationship of trust and confidence is the means by which the Court found that silence was deceptive. In the case of direct deception, such a relationship may not be necessary in an insider trading case. *See* SEC v. Dorozhko, 574 F.3d 42 (2d Cir. 2009) (where a defendant deliberately misrepresented himself in order to gain access to material nonpublic information, which he then used to trade, the government need not prove a relationship of trust and confidence).

[20] 445 U.S. at 232–33.

offerors. The issue there would have been whether a breach to one person (the employer) could support a charge of fraud involving others (the persons with whom Chiarella traded). Since the government had not presented that theory below, Justice Powell concluded that the Court should leave that issue to another day.

IV. *Dirks v. SEC* (1983) — The Breach of Duty Must Involve Conduct for the Insider's Benefit, but a Gift of Information to a Trading Relative or Friend Counts as a Benefit to the Insider

1. *The Lead-up — The Challenge to Imposing Liability on Tippees After Chiarella*

Insider trading cases often involve trading not by insiders but by tippees, such as Mr. Gintel in the Commission's *Cady, Roberts* case. Such persons may receive information from insiders (or others), but they do not have the same fiduciary or similar relationship of trust and confidence with shareholders that an insider has with a company's shareholders. *Chiarella* did not address the law regarding tippee trading, but its rejection of the government's equal-access theory called into question the basis for tippee liability. If, as *Chiarella* makes clear, there is no general duty not to trade on material nonpublic information and if tippees ordinarily are not fiduciaries, on what basis, if any, are tippees prohibited from trading?

In March 1973, Ronald Secrist, an individual who had recently been fired from his job at a company that Equity Funding had acquired, called Raymond Dirks, a prominent analyst who provided investment advice about the insurance industry. Secrist told Dirks that an Equity Funding subsidiary was creating fake insurance policies to inflate its sales figures and selling partnerships in nonexistent real estate. He also said that its top officers had Mafia connections that they used to threaten the lives of employees who objected to the fabrications. Dirks began conducting his own investigation and, along the way, spoke to a number of former and current employees of Equity Funding and to a number of investors and other members of the investment community. Not surprisingly, some of the people with whom he shared his concerns sold their shares.

Dirks also spoke to the SEC and *The Wall Street Journal*. After *The Wall Street Journal* published a front-page story based on information Dirks provided and after the SEC filed a complaint against Equity Funding, the company went into receivership. The author of *The Wall Street Journal* article was nominated for a Pulitzer Prize. In an extraordinarily bad exercise of enforcement discretion by the SEC, however, Dirks found himself the subject of an SEC enforcement action.

Echoing its decision in *Cady Roberts*, the SEC censured Dirks on the ground that anyone who comes into possession of material nonpublic information from an insider has a duty to disclose or refrain from trading. On appeal, Dirks argued that the SEC's theory was inconsistent with *Chiarella*, that Equity Funding's insiders had no duty to keep information about a fraud confidential, and that he had no duty not to share the information with others who might trade on it. In a decision that produced three separate opinions, including a dissent, the D.C. Circuit affirmed the SEC's decision. The Supreme Court granted cert.

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2. The Decision

a. A Tippee May Inherit an Insider's Duty Not to Trade, but Only if the Tippee Knows or Should Know of the Insider's Breach

In an opinion again written by Justice Powell, the Supreme Court reversed and created a detailed framework for analyzing insider trading issues that applies even today. The Court began by rejecting the SEC's theory as inconsistent with *Chiarella.* It stated, "We were explicit in *Chiarella* in saying that there can be no duty to disclose where the person who has traded on inside information 'was not [the corporation's] agent, … was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence.'"[21] It said that the SEC's theory, like its unsuccessful arguments in *Chiarella*, "appears rooted in the idea that the antifraud provisions require equal information among all traders."[22] *Chiarella*, however, "repudiate[d] any notion that all traders must enjoy equal information before trading …."[23]

The Court, however, stated that "[t]he need for a ban on some tippee trading is clear."[24] It acknowledged that the requirement in *Chiarella* "of a specific relationship between the shareholders and the individual trading on inside information has created analytical difficulties for the SEC and courts in policing tippees who trade on inside information" because the typical tippee "has no such relationships."[25] Lacking statutory language or legislative history to provide guidance, the Court then created the following standard for tippee liability:

> [A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.[26]

The focus, the Court stated, was "on policing insiders and what they do … rather than on policing information *per se* and its possession …."[27] Tippees may have liability when they receive a tip from an insider, but if they do, it is because of their participation in a breach by the insider.

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[21] Dirks v. SEC, 463 U.S. 646, 654 (1983), quoting *Chiarella*, 445 U.S. at 232.

[22] *Id.* at 657.

[23] *Id.*

[24] *Id.* at 659.

[25] *Id.* at 655.

[26] *Id.* at 660. The Court quoted SEC Commissioner Smith's concurring opinion in *In re* Investors Management Co., 44 S.E.C. 633, 651 (1971), in which he said: "[T]ippee responsibility must be related back to insider responsibility by a necessary finding that the tippee knew the information was given to him in breach of a duty by a person having a special relationship to the issuer not to disclose the information …." In SEC v. Obus, 693 F.3d 276, 288 (2d Cir. 2012), the Second Circuit held that in the case of a tipping chain, i) tippers are potentially liable if they know or have reason to know that they have tipped information to someone who is likely either to trade on it or disseminate the information further for the first tippee's benefit, ii) the first tippee is potentially liable if she knows or has reason to know that the information was obtained and transmitted through a breach and intentionally or recklessly tips the information further for her own benefit, and iii) the final tippee is potentially liable if he knows or has reason to know that the information was obtained through a breach and trades while in knowing possession of the information.

[27] *Id.* at 663 (quoting SEC Commissioner Smith's concurring opinion in *Investors Management Co.*, 44 S.E.C. at 648).

b. There Is No Breach Unless the Insider Tips for the Insider's, Not the Tippee's, Personal Benefit

The requirement that there be a breach by the tipper, however, still begged the question of what constitutes a breach by the tipper in providing the information. Here, the Court created the "personal benefit" test. It stated that "the test is whether the insider personally will benefit, directly or indirectly, from his disclosure."[28] It added:

> Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.[29]

With regard to examples of a personal benefit to the tipper, it quoted a *Harvard Law Review* article referring to an insider "selling the information to its recipient for cash, reciprocal information, or other things of value for himself …."[30] It also referred to a "reputational benefit that will translate into future earnings."[31]

c. A Gift to a Trading Relative or Friend Counts as a Benefit to the Insider

The Court, however, also realized that the requirement of a benefit to the tipper could create a significant gap in the law — tips provided not for the insider's benefit but for the benefit of the tippee. The Court did not eliminate that gap, but it limited it by stating that an insider's gift to a trading friend or relative counts as a benefit to the insider:

> The 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.[32]

Thus *Dirks* treats tips differently depending on whether they are tips to trading relatives and friends, on the one hand, or tips to someone else, on the other. Under the most natural reading of *Dirks*, gifts of information to trading relatives and friends satisfy the personal benefit test but gifts to strangers do not.

d. Certain "Outsiders" May Be "Insiders"

Dirks also stated that insider trading liability could extend to outsiders that "have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes."[33] It gave as examples underwriters, accountants, lawyers, and consultants.

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[28] *Id.* at 662.
[29] *Id.*
[30] *Id*. at 663–64, quoting Brudney, INSIDERS, OUTSIDERS, AND INFORMATIONAL ADVANTAGES UNDER THE FEDERAL SECURITIES LAWS, 93 HARV. L. REV. 322, 348 (1979).
[31] *Id.* at 663.
[32] *Id.* at 664.
[33] *Id.* at 655 n.14.

e. The Policy Underlying *Dirks* — Protecting Those in the Business of Ferreting Out Information

The Court explained that its personal benefit standard was supported by policy considerations related to the need to protect market analysts, who are in the business of ferreting out information to inform their analyses. It stated that the SEC's proposed standard "would have an inhibiting influence on the role of market analysts," who "ferret out and analyze information" by "meeting with and questioning corporate officers and others who are insiders."[34] Materiality is an amorphous standard, and the personal benefit test was needed, in the Court's view, in part because assessing the materiality of disclosures was too uncertain a basis for liability: "[I]t may not be clear—either to the corporate insider or to the recipient analyst — whether the information will be viewed as material nonpublic information."[35] Acknowledging that determining when an insider personally benefits from a particular disclosure "will not always be easy for courts,"[36] it nevertheless concluded that the personal benefit test was "essential … to have a guiding principle for those whose daily activities must be limited and instructed by the SEC's inside-trading rules …." Since Secrist had tipped Dirks to expose a fraud rather than to benefit personally, the Court reversed the SEC's sanction.

Dirks and *Chiarella* remain the two most widely cited insider trading cases. Absent misappropriation, discussed below, they provide the framework for analyzing all insider trading cases that have come after them.

V. *United States. v. O'Hagan* (1997) — "Misappropriators" Also May Not Trade on Material Nonpublic Information

James Herman O'Hagan, a partner in the law firm of Dorsey & Whitney, was not a model lawyer. After learning that his firm was representing Grand Met in an as-yet-undisclosed potential tender offer for the common stock of the Pillsbury, he became the largest individual purchaser of Pillsbury call options. When the tender offer was announced, he sold the call options for $4.3 million.

Undoubtedly O'Hagan hoped not to be caught, but when he was caught, he raised the same defense that Vincent Chiarella raised — O'Hagan obtained information through the offeror and had no fiduciary or similar relationship with the target company shareholders with whom he traded. Although O'Hagan was convicted, the Eighth Circuit agreed with his arguments and reversed. The Supreme Court, which had declined to rule on the viability of the misappropriation theory in *Chiarella*, granted cert.

Justice Ginsburg, writing for the Court's majority in *O'Hagan*, agreed with the government that a person who uses confidential information misappropriated from the source of the information is guilty of violating Section 10(b) even though he owed no duty to the persons with whom he traded.[37] In a "classical" insider trading case, the *sine qua non* of the violation is wrongdoing *by* the source of the information in

[34] *Id.* at 658–59.
[35] *Id.* at 662.
[36] *Id.* at 664.
[37] United States v. O'Hagan, 521 U.S. 642 (1977).

disclosing it for his or her personal benefit; in a misappropriation case, the essence of the violation is wrongdoing *against* the source of the information by betraying an agreement or understanding that the information would be kept confidential and not be used to trade. Under the misappropriation theory, an outsider may be liable for insider trading "when he misappropriates confidential information for securities trading purposes, in breach of a fiduciary duty owed to the source of the information," rather than to the persons with whom he trades.[38] Misappropriation satisfies the requirement of "deception" in Section 10(b), the Court stated, because the conduct by the misappropriator involves "feigning fidelity to the source of information,"[39] and deception can be practiced on one person even though the resultant harm is to another.[40]

O'Hagan had another problem as well that Chiarella did not face. After the Court's decision in *Chiarella*, the SEC adopted Rule 14e-3.[41] Rule 14e-3 prohibits persons from trading while in possession of material nonpublic information regarding a tender offer regardless of whether the trader owed a preexisting fiduciary duty to anyone. The Supreme Court upheld the rule, which is confined to information related to tender offers.

Three years after *O'Hagan*, the SEC adopted Rule 10b5-2, which provides a nonexclusive definition of misappropriation based on violation of (1) an agreement to maintain information in confidence, (2) a history, pattern, or practice such that the recipient "knows or reasonably should know" that the person communicating the information expected the recipient would maintain its confidentiality, or (3) an exchange of information involving a spouse, parent, child, or sibling.[42]

Although the issue did not arise in *O'Hagan*, lower courts have held that a misappropriator's tippee may also have liability if the misappropriator tips for a personal benefit.[43]

VI. *United States v. Newman* (2014) — The Difficulty of Proving that Remote Tippees Violated Insider Trading Laws

1. *The Government's Crackdown on Hedge Fund Managers*

Hedge fund managers have been among the most frequent targets in both criminal and civil insider trading cases.[44] Over the last decade, federal prosecutors in New

[38] *Id.* at 652.

[39] *Id*. at 655.

[40] *Id*. at 656. For example, under the misappropriation theory, an insider of one company, who in the course of his employment learns of confidential information about another company, may be liable if he trades in the securities of that other company. *E.g.,* SEC v. Talbot, 530 F.3d 1085 (9th Cir. 2008).

[41] 17 C.F.R. § 240.14e-3. In connection with tender offers, Section 14(e) authorizes the Commission to prescribe means reasonably designed to "prevent" acts and practices that are fraudulent. Such acts or practices need not themselves be fraudulent. *See O'Hagan*, 521 U.S. at 672–73.

[42] 17 C.F.R. §240.10b5-2. In United States v. McGee, 763 F.3d 304 (3d Cir. 2014), the Third Circuit held that Rule 10b5-2(b)(2) is a valid exercise of the SEC's rulemaking authority. On the other hand, the rule's application to a person who agrees to keep information confidential but does not agree to refrain from trading is arguably open to question. *See* SEC v. Cuban, 620 F.3d 551 (5th Cir. 2010).

[43] *E.g.,* SEC v. Yun, 327 F.3d 1263 (11th Cir. 2003) ("[T]he SEC must establish that all tippers, both insider and outsiders, intend to benefit from their disclosure of confidential information ….").

York have obtained more than 90 convictions involving insider trading, many of which involve otherwise successful hedge fund managers.[45] For the period 2010 to 2014 alone, the SEC's "spotlight" on insider trading includes cases against nearly 40 hedge fund managers, hedge funds, and those who allegedly tipped them.[46] The Second Circuit's decision in *United States v. Newman*[47] involved the reversal of criminal convictions of two hedge fund managers, and is essential to understanding both the issues in *Salman* (discussed below) and the government's burden, at least in the Second Circuit, in post-*Salman* cases, especially in cases involving remote tippees.

Todd Newman invested primarily in technology stocks for Diamond Capital Management, a hedge fund based in Stanford, Connecticut. Early in the morning of January 8, 2012, more than a half-dozen FBI agents and members of the local police department showed up at his home, handcuffed him, and told him he was being arrested for insider trading. The gist of the charge was that an investor relations employee at a public company shared nonpublic information about the company's earnings with an analyst at an investment adviser, who shared the information with an analyst at Diamondback, who shared the information with Newman, who traded. In addition, an employee in the finance unit of a second public company provided information to a friend the insider knew from church, who passed the information on to a financial analyst, who passed the information on to some friends who were also analysts, who passed the information on to Newman, who traded.

In both cases, Newman was several steps removed from the corporate insiders who were the sources of the information, and there was no evidence that he was aware of the circumstances surrounding the original tip. That's a challenge for the government under *Dirks* because *Dirks* held that the government had to prove that the tippee knew[48] that the source of the information breached a duty by tipping it. Nevertheless, after a six-week trial and two days of deliberation, the jury convicted Newman. He was sentenced to 54 months in prison and ordered to pay a $1 million

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[44] A partial list of reported decisions involving hedge fund managers includes the following: United States v. Riley, Case No. 15-1541 (2d Cir. Jan. 14, 2016); United States v. Newman, 773 F.3d 438 (2d Cir. 2014), *cert. denied*, No. 15-137 (U.S. Oct. 5, 2015); United States v. Jiau, 734 F.3d 147 (2d Cir. 2013); United States v. Rajarantnam, 719 F.3d 139 (2d Cir. 2013); SEC v. Obus, 693 F.3d 276 (2d Cir. 2012); SEC v. Megalli, 157 F. Supp. 3d 1240 (N.D. Ga. 2015); United States v. Gupta, 111 F. Supp. 3d 557 (S.D.N.Y. 2015); United States v. Steinberg, 21 F. Supp. 3d 309 (S.D.N.Y. 2014); SEC v. Kinnucan, 9 F. Supp. 3d 370 (S.D.N.Y. 2014); SEC v. Rorech, 720 F. Supp. 2d 367 (S.D.N.Y. 2010); SEC v. Lyon, 605 F. Supp. 2d 531 (S.D.N.Y. 2009); and SEC v. Kornman, 391 F. Supp. 2d 477 (N.D. Tex. 2005).

[45] *See* Patricia Hurtado & Michael Keller, *How the Feds Pulled Off the Biggest Insider-Trading Investigation in U.S. History*, BLOOMBERG (June 1, 2016), http://www.bloomberg.com/graphics/2016-insider-trading/.

[46] https://www.sec.gov/spotlight/insidertrading/cases.shtml.

[47] 773 F.3d 438 (2014), *cert. denied*, 136 S.Ct. 242 (2015).

[48] *Dirks* used the formulation "knew or should have known." Lower courts have used the "should have known" standard in civil cases, *e.g.*, SEC v. Obus, 693 F.3d 276, 288 (2d Cir. 2012) ("[A] tipper cannot avoid liability merely by demonstrating that he did not know to a certainty that the person to whom he gave the information would trade on it …. By the same token, there is a valid defense to scienter if the tipper can show that he believed in good faith that the information disclosed to the tippee would not be used for trading purposes"), and have sometimes cited the same standard in criminal cases. *E.g.*, United States v. Hughes, 505 F.3d 578, 593 (6th Cir. 2007). At the oral argument in *Salman*, however, the government conceded that in a criminal case it had to show knowledge by the tippee and not merely that the tippee should have known there was a breach of a fiduciary duty for personal benefit. Transcript of Oral Argument in *Salman v. United States* at 36. This is consistent with the First Circuit's analysis of the issue in *United States v. Parigian*, 824 F.3d 5 (2016), although in that case the court concluded that the defendant had failed to adequately raise the issue and thus had forfeited it.

fine and to forfeit $737,724 in ill-gotten compensation. A co-defendant was sentenced to 78 months in prison and ordered to pay a $5 million fine and to forfeit at least $2 million. Despite the requirement in *Dirks* that the tippee know that the tipper tipped in breach of a duty, the government never charged the tippers in *Newman* with any wrongdoing.

2. The Second Circuit Reigns in the Government

The Second Circuit reversed the convictions of Newman and his co-defendant. Consistent with the discussion above, it began its analysis by stating that the Supreme Court had "rejected the notion of a general duty between all participants in market transactions to forgo actions based on material, nonpublic information,"[49] and instead had "limited the scope of insider trading liability to situations where the insider had a duty to disclose arising from a relationship of trust and confidence between the parties to a transaction."[50] It added, "Although the Government might like the law to be different, nothing in the law requires a symmetry of information in the nation's securities markets"; to the contrary, "[t]he Supreme Court explicitly repudiated this premise not only in *Dirks*, but in a predecessor case, *Chiarella v. United States*.[51] "[I]n both *Chiarella* and *Dirks*," the Second Circuit stated, "the Supreme Court affirmatively established that insider trading liability is based on breaches of fiduciary duty not on informational asymmetries."[52]

With respect to tippees, the Second Circuit stated, the Supreme Court in *Dirks* "rejected the SEC's theory that a recipient of confidential information (i.e. the 'tippee') must refrain from trading whenever he receives inside information from an insider."[53] Rather, under *Dirks*, "a tippee may be found liable only when the insider has breached his fiduciary duty … and the tippee knows or should know that there has been a breach."[54]

a. Knowledge of a Breach of the Duty of Confidentiality Is Not Enough — the Tipper Must Have Tipped for His or Her Personal Benefit, and the Tippee Must Know That

In the Second Circuit, the government argued that all it had to show was that defendants traded on material, nonpublic information that "they knew insiders had disclosed in breach of a duty of confidentiality."[55] Setting aside for the moment how the tippees in *Newman* would have known even that, the Second Circuit stated that was not the standard. Since *Dirks* had made personal benefit the basis for a breach, the Second Circuit stated that "the insider's disclosure of confidential information, standing alone, is not a breach."[56] Breaching a duty of confidentiality may be a breach in other contexts, but under *Dirks* it is not a breach for purposes of establishing insider trading liability. Instead, the Second Circuit held, the government

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[49] 773 F.3d at 445.
[50] *Id.*
[51] *Id.* at 448–49.
[52] *Id.* at 449.
[53] *Id*.
[54] *Id.*
[55] *Id.* at 447.
[56] *Id.* at 448.

must prove "that the tippee knows of the personal benefit received by the insider in exchange for the disclosure …."[57] That was not the basis on which the defendants had been convicted in *Newman*, and that alone would have required reversal and remand.

The Second Circuit, however, did not stop there. At oral argument, Judge Barrington Parker, who later wrote the court's decision, expressed concern about government overreach in its crackdown on hedge funds. He said:

> We sit in the financial capital of the world. And the amorphous theory that you have, that you've tried this case on, gives precious little guidance to all of these institutions, all of these hedge funds out there who are trying to come up with some bright line rules about what can and what cannot be done. And your theory leaves all of these institutions at the mercy of the government, whoever the government chooses to indict ….[58]

Consistent with that concern, the court in its opinion prefaced its analysis by expressing its concern about "the doctrinal novelty of [the government's] recent insider trading prosecutions, which are increasingly targeted at remote tippees many levels removed from corporate insiders."[59] The court then sought to reign in the government by providing a new gloss to other elements that the government has to prove under *Dirks*. We discuss those requirements immediately below.

b. For a Tip to a "Friend" to Constitute a Benefit to the Insider, There Must Be a Meaningfully Close Personal Relationship

With respect to who counts as a "friend" under *Dirks*'s gifts-to-friends-and-relatives analysis, the Second Circuit stated:

> 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 ….[60]

A friendship "of a casual or social nature" does not count.[61]

c. The Benefit to the Tipper Must Be Objective and Consequential and Represent a Potential Pecuniary Gain

With respect to the nature of the personal benefit received by the tipper, the court stated there had to be "an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[62] As an example, it said that giving the tipper access to an investment club where stock tips were routinely discussed could be such a benefit.[63] Providing career advice to a

[57] *Id.*
[58] Transcript of Oral Argument in *United States v. Newman* at 49–50.
[59] 773 F.3d at 448.
[60] *Id.* at 452.
[61] *Id.*
[62] *Id.*
[63] *Id.*

tipper was not a sufficient personal benefit because it "was little more than the encouragement one would generally expect of a fellow alumnus or casual acquaintance" and had started long before the insider provided any insider information.[64]

d. Even a Tip to a Friend Might Not Be Enough

The court then did something that was confusing and arguably inconsistent with the analysis in *Dirks* of gifts to trading friends and relatives. With respect to the principle that a gift to a trading friend or relative satisfies the *Dirks* personal benefit requirement, it stated: "[W]e hold that such an inference is impermissible in the absence 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."[65] That language seemed to mean that even in the case of a meaningfully close personal relationship (i.e., a friendship), the government had to prove, contrary to *Dirks*, a significant benefit to the insider over and above the gift itself.

On the other hand, the Second Circuit then used language that suggested that was not what it meant. It stated that the government had to present 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]*."[66] (emphasis added). The italicized portion is consistent with the distinction in *Dirks*: Tips to strangers require proof of a quid pro quo benefitting the insider, but an intent to benefit a friend through the gift of information is enough even in the absence of a quid pro quo.[67] Apart from being confusing, this part of the decision was not essential to the court's reversal in *Newman* because there was no evidence that the defendants "knew that they were trading on information obtained from insiders, or that those insiders received any benefit in exchange for such disclosures …."[68]

Summarizing the requirements, the Second Circuit stated that in a criminal prosecution for insider trading, the government must prove:

> (1) the corporate insider was entrusted with a fiduciary duty; (2) the corporate insider breached his fiduciary duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit; (3) the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit; and (4)

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[64] *Id.* at 453.
[65] *Id.*
[66] *Id.*
[67] In SEC v. Holley, Civ. Action No. 11-0205 (D.N.J. Sept. 21, 2015), a district court read *Newman* to hold that a gift of information to a relative is actionable, without proof of a separate benefit to the tipper, if the information was provided by the tipper to confer a benefit on the relative. In *United States v. Gupta*, 111 F. Supp. 3d 557 (S.D.N.Y. 2016), Judge Rakoff read *Newman* to impose liability on an insider who tips information to a friend with an intention to benefit the friend, regardless of whether the insider obtains any benefit from the tip. He stated that *Newman*'s language regarding the benefit to the insider was intended only to set forth what a remote tippee had to know for the remote tippee to be liable.
[68] 773 F.3d at 453.

the tippee still used that information to trade in a security or tip another individual for personal benefit.[69]

3. The Government's Fear That Newman Would Undermine Its Insider Trading Prosecutions

The government was alarmed by *Newman's* arguable departure from the gift analysis in *Dirks*, and it petitioned for rehearing before the full Second Circuit. In its petition for rehearing, it stated that the decision in *Newman* "will dramatically limit the Government's ability to prosecute some of the most common, culpable, and market-threatening forms of insider trading."[70] The government stated that the *Newman* opinion's "exchange-based pecuniary limitation on what constitutes a personal benefit … arguably represents one of the most significant developments in insider trading law in a generation."[71] It added that the Second Circuit had eliminated *Dirks*'s recognition "that an improper but uncompensated gift of information by an insider suffices," and had created "a set of novel confounding criteria for the type of 'exchange' that will now be required before an insider's deliberate transmission of valuable inside information to a friend or relative could be punishable under the laws against insider trading."[72] After *Newman*, the U.S. Attorney for the Southern District of New York agreed to dismiss charges and convictions of seven individuals,[73] a federal district court threw out the guilty pleas to insider trading of four individuals,[74] and other defendants moved to have their convictions vacated as well.

The SEC, in its *amicus* brief in support of the government's petition for rehearing, stated that rehearing should be granted because the panel's decision "states that evidence of friendship between an insider who tips and his tippee is insufficient to support an inference that the insider derived a personal benefit from the tipping — a requirement for liability."[75] It stated that contrary to the Second Circuit's decision, "The Commission has long held the position that *Dirks* does not require the insider to obtain an economic benefit from the tip, and that it is sufficient if the insider makes a gift of confidential information to a trading relative or friend."[76] Further, "The SEC has litigated numerous insider trading claims in this circuit where the only personal benefit to the tipper apparent from the decisions was providing inside information to a friend,"[77] that an even larger number of cases had been settled on that basis, and that the panel's "narrowed benefit standard" could limit the SEC's ability to pursue similar violators in this circuit in future cases.[78]

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[69] *Id.* at 450.
[70] U.S. Petition for Rehearing at 3.
[71] *Id.* at 22–23.
[72] *Id.* at 14.
[73] *See* Matthew Goldstein, *U.S. Prosecutor to Drop Insider Trading Cases Against Seven*, N.Y. TIMES (Oct. 22, 2015).
[74] *See* Cara Salvatore, *4 Insider Trading Guilty Pleas Vacated in Wake of Newman*, Law360 (Jan. 22, 2015).
[75] SEC Amicus Brief in Support of Petition for Rehearing at 22–23.
[76] *Id.* at 5.
[77] *Id.* at 11.
[78] *Id.* at 12.

The Second Circuit, however, denied rehearing without explanation,[79] and the Supreme Court denied the government's subsequent petition for cert.

VII. *Salman v. United States* (2016) — The Court Reaffirms *Dirks*, but Makes Clear that the Government's Burden in Remote Tippee Cases Remains Challenging

1. Judge Rakoff's Ninth Circuit Decision Affirming the Conviction

Maher Kara worked on healthcare investments for the investment banking group at a large bank. From late 2004 through early 2007, he shared confidential information about upcoming mergers and acquisitions with his brother Michael, who traded on that information. Michael shared the information with Bassam Yacoub Salman, who was Michael's friend and Maher's brother-in-law (as a result of Maher's marriage to Salman's sister). Salman also traded on the information.

All three were caught and charged with criminal violations of insider trading laws. Maher and Michael pled guilty, but Salman went to trial. After he was convicted, Salman argued to the Ninth Circuit that the government's evidence was insufficient under *Newman* because under *Newman* a gift of information to a trading relative was not enough absent proof that the gift was for the benefit of the insider.

Curiously, one of the three judges who heard the appeal was Judge Jed S. Rakoff. On most days, Judge Rakoff sits as a Senior District Judge for the U.S. District Court for the Southern District of New York, and is thus bound by *Newman* and other Second Circuit precedents. Indeed, the Second Circuit had reversed Judge Rakoff in a number of high-profile cases.[80] On June 9, 2015, however, he sat by designation on the Ninth Circuit Court of Appeals, heard the appeal of *United States v. Salman*, and subsequently wrote the Ninth Circuit's decision. It gave him an improbable forum in which to sit in judgment on the Second Circuit's decision in *Newman*.

Writing for the Ninth Circuit, Judge Rakoff stated that *Dirks* was dispositive of the issue raised by Salman and required that his conviction be affirmed: "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."[81] There could be no question, the court said, that "under *Dirks*, the evidence was sufficient for the jury to find that Maher disclosed the information in breach of his fiduciary duties and that Salman knew as much."[82]

Since the Ninth Circuit was not required to follow Second Circuit precedent, Judge Rakoff did not resolve whether *Newman* required more, but he said that "[t]o the extent *Newman* can be read to go so far [i.e., to require a personal benefit over and

[79] United States v. Newman, Nos. 13-1837, 13-1917 (2d Cir. Apr. 3, 2015).

[80] In May 2016, the Second Circuit reversed a $1.27 billion penalty that Judge Rakoff had imposed on a large bank. United States v. Countrywide Home Loans, Inc., 822 F.3d 650 (2d Cir. 2016). In 2015, it reversed a holding that the New York state law banning surcharges on credit card purchases was unconstitutional. Expressions Hair Design v. Schneiderman, 808 F.3d 118 (2d Cir. 2015). In 2014, it ruled that Judge Rakoff had abused his discretion in blocking a fraud settlement between the SEC and a large bank. SEC v. Citigroup Global Markets, Inc., 752 F.3d 285 (2d Cir. 2014).

[81] United States v. Salman, 792 F.3d 1087, 1092 (9th Cir. 2015).

[82] *Id.*

above the gift to a friend or relative], we decline to follow it. Doing so would require us to depart from the clear holding in *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.'"[83] He added: "Proof that the insider disclosed material nonpublic information with the intent to benefit a trading relative or friend is sufficient to establish the breach of fiduciary duty element of insider trading."[84]

Salman petitioned the Supreme Court for cert, arguing that the Ninth Circuit's decision in *Salman* conflicted with the Second Circuit's decision in *Newman*, and that the Court should resolve the conflict in favor of *Newman.* The government, which had urged the Court to grant cert in *Newman*, urged it to deny cert in *Salman*. The Court, however, did the opposite. After denying cert in *Newman*, it granted it in *Salman*.

2. *The Supreme Court's Affirmance of the Conviction Based on Dirks*

Despite the government's opposition, the grant of the petition turned out to be good news for the government. Writing for a unanimous Court, Judge Alito stated that the Ninth Circuit properly applied *Dirks* to affirm Salman's conviction. He stated: "*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."[85] In fact, Judge Alito stated that *Dirks* "easily" resolved the issue before the court.[86] He added: "Salman's conduct is in the heartland of *Dirks*'s rule concerning gifts."[87]

Like the Ninth Circuit, the Supreme Court did not state that the Second Circuit in *Newman* had required a benefit over and above a gift to a friend or relative, but stated, "[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*."[88] Similarly, in explaining why it had granted cert in *Salman*, it said not that the Ninth Circuit's decision conflicted with *Newman,* but that the decisions were in "tension."[89]

The decision in *Salman* is an important victory for the government because it held, contrary to some of the language in *Newman*, that in the case of a gift to a friend or relative, the government does not have to show a personal benefit to the tipper over and above the gift. In all other respects, however, the decision leaves the law in the same state it was before *Salman* and after *Newman.*

[83] *Id.* at 1093.
[84] *Id.* at 1094.
[85] Salman v. United States, slip op. at 9.
[86] *Id.* at 8.
[87] *Id.* at 11.
[88] *Id.* at 10.
[89] *Id.* at 6.

3. *The Court's Decision Not to Adopt the Government's Expansive Theories of Liability*

As we pointed out in an earlier article,[90] after the Supreme Court granted cert in *Salman*, the government saw it as an opportunity to argue for a significant expansion of the law on insider trading — well beyond anything supported by the Supreme Court's prior precedents, the Ninth Circuit's decision in *Salman*, or other lower court precedents.

First, it urged the Court to adopt a standard that a gift of confidential information to anyone, not just a trading relative or friend, is enough to prove an insider trading violation. The Supreme Court did not adopt that standard, no lower court has adopted that standard, and it is inconsistent with a fair reading of *Dirks*. In response to the argument, Justice Alito said to counsel for the government: "It doesn't seem to me that your argument is much more consistent with *Dirks*" than the argument by *Salman's* counsel.[91] Justice Breyer added that the statement in *Dirks* that the element of a violation exists when an insider makes a gift of confidential information to a trading relative or friend "doesn't sound as if the writer of those words had in mind any person in the world."[92] Asked whether there was even a single circuit court case holding that a gift to someone other than a friend or relative met the *Dirks* personal benefit standard, government counsel fell back on a case that he acknowledged "involve two people who were close friends …."[93]

Second, the government urged the Supreme Court to hold that a "gift" arises whenever the tipper discloses confidential trading information for a "non-corporate purpose." The Court also provided no support for that standard. At oral argument, Justice Kennedy said to government counsel: "Isn't it something of a stretch to say that the circumstances you describe … are all gifts?"[94] Chief Justice Roberts stated that if an insider told a social acquaintance that he couldn't join them because "I'm working on this Google thing, or something like that," "you wouldn't call that a gift. You'd call it a social interchange ….[M]aybe it's … something he should have been more careful about saying, but it's quite different than a gift. And it seems to me that, however you read *Dirks*, it certainly doesn't go beyond gifts."[95]

4. *The Government's Acknowledgment That in a Criminal Case the Tipper Must Share the Information for the Purpose of Tippee Trading and the Tipper Must Know That the Tippee Would, Not Merely Could, Trade*

At oral argument, government counsel introduced an element into the government's burden in insider trading cases that had not been a major focus of the lower courts. He stated that the burden is on the government to prove that the information was

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[90] Jon Eisenberg et al., *Government Urges Expansion of Insider Trading Liability*, INSIGHTS (Sept. 2016).

[91] Transcript of Oral Argument in *Salman v. United States* at 28.

[92] *Id*.

[93] *Id.* at 43.

[94] *Id*. at 24.

[95] *Id.* at 25.

shared for the purpose of trading by the tippee.[96] In response to a question by Chief Justice Roberts, government counsel stated: "[T]he burden is on the government to show that the information was given for a purpose of trading and that it was in breach of fiduciary duty."[97] Justice Sotomayor questioned the wisdom of the government's concession because "then you have to prove that the tippee knew that the tipper thought it would be traded."[98] Counsel responded: "Yes, and I don't think that's a very difficult burden because in most of these situations, it's obvious why it's being done."[99]

Government counsel also had the following colloquy with Justice Kagan with respect to the requirement that the tipper know that the tippee would, and not merely might or could, trade:

> Justice Kagan: You've used a couple of times the phrase "knowledge" or "anticipation."
>
> Mr. Dreeban: Yes.
>
> Justice Kagan: That there would be trading.
>
> Mr. Dreeban: Yes.
>
> Justice Kagan: So is — is that something more than he thinks there could be —
>
> Mr. Dreeban: Yes.
>
> Justice Kagan: — he thinks there — I mean, he thinks there would be? Is it as strong as that?
>
> Mr. Dreeban: Yes.[100]

5. *Three Critical Elements of Newman Remain Intact*

In addition, the Court left undisturbed three critical elements of *Newman* — essentially everything in the decision other than its suggestion that the government had to prove a benefit to an insider over and above a gift to a trading friend or relative.

First, the Court codified the government's concession — which the government had resisted prior to the Second Circuit's decision in *Newman* — that to establish a defendant's criminal liability as a tippee, the government must prove that the tippee knew "that the tipper disclosed the information for a personal benefit and that the tipper expected trading to ensue."[101] At oral argument, the government's counsel acknowledged: "We need to be able to show that the tippee, perhaps at the end of the chain will be more difficult than the ones earlier in the chain, had knowledge that

[96] On the other hand, if the tippee "misappropriated" the information by using the information in violation of an understanding that the tippee would not use it, the tippee might have liability under the misappropriation theory even though the tipper would not have liability. *Id.* at 44.

[97] *Id.* at 26.

[98] *Id.* at 39.

[99] *Id.*

[100] *Id.* at 37.

[101] *Id.* at 8.

the information originated in circumstances in which there was a breach of fiduciary duty for personal benefit."[102] He added that the tippee "has to know [the tip] came from an insider in breach of a fiduciary duty and for personal benefit …."[103] When Justice Ginsburg asked government counsel if "should have known" would be enough, he said that in a criminal case knowledge or conscious avoidance is required.[104] He also acknowledged that recklessness is not enough in a criminal insider trading case.[105]

Second, the decision leaves intact the Second Circuit's statement in *Newman* that for someone to be deemed a "friend" under the *Dirks* gift analysis, he or she must have a "meaningfully close personal relationship" with the insider; the court in *Newman* stated that friendships of a "casual or social" nature are not enough.

Third, in cases not involving tips to relatives and friends, the decision leaves intact the Second Circuit's requirement that the insider's personal benefit be "objective, consequential, and represent[] at least a potential gain of a pecuniary or similarly valuable nature." Soft exchanges — for example, career advice — are not enough.

VIII. Five Potential Defenses After *Salman*

The cases discussed above demonstrate the central importance of the "breach of duty" requirement in insider trading cases. Indeed, each of the cases focuses not on the meaning of material nonpublic information but on the nature of the breach of duty requirement. *Chiarella* held that the duty must arise from a relationship of trust and confidence rather than a general duty not to trade on material nonpublic information; *Dirks* applied that requirement in the context of trading by a tippee, and held that for the tippee to be liable, the insider who provided the information must have acted for the insider's personal benefit; *O'Hagan* permitted the deception element to be satisfied when the government proves that the person trading "misappropriated" the information; and *Salman* reaffirmed that a gift of information to a trading relative is sufficient to satisfy the *Dirks* personal benefit requirement.

The law leaves at least five potential "gaps" that may provide a defense even when a person trades on the basis of material nonpublic information. These gaps involve tips to persons other than friends and relatives, limitations on who is a "friend" for insider trading purposes, limitations on the types of communications that constitute gifts, the nature of the exchange necessary to show a *Dirks* personal benefit when the tip is to a person other than a close friend or relative, and challenges associated with proving remote tippee liability.

First, an insider's tip to a person other than a friend or relative and without a personal benefit to the insider does not appear to be actionable under *Dirks*. The government urged the Court to close this gap in *Salman*, but it failed. It might try again in another case, but at oral argument the government was unable to point to a single case holding that gifts to persons other than friends or relatives satisfy the

[102] *Id.* at 36.
[103] *Id.* at 51.
[104] *Id.* For an example of a discussion of conscious avoidance in an insider trading case, *see, e.g.,* SEC v. Megalli, 157 F. Supp. 3d 1240, 1252–54 (N.D. Ga. 2015).
[105] Salman v. United States at 51.

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Dirks personal benefit requirement. Much of the language in *Dirks* appears inconsistent with the government's argument, and the justices who expressed a view at oral argument in *Salman* appeared skeptical that gifts to persons other than friends or relatives satisfied the personal benefit requirement.

Second, while gifts to friends and relatives may constitute a personal benefit to the insider under *Dirks*, not every social acquaintance is a friend. In *Newman*, the Second Circuit held that there must be a meaningfully close relationship for *Dirks*'s gift-to-friends analysis to apply. It said that relationships of a casual or social nature are not enough.

Third, not every communication of information by an insider to a friend or relative constitutes a "gift" under *Dirks*. In *Salman*, the government urged the Court to hold that any disclosure of confidential information for a noncorporate purpose is an actionable "gift" for insider trading purposes, but it failed to convince the Court to adopt that position. An insider who carelessly shares information and the person who trades on it might not have any liability for insider trading even if the insider has breached a duty of confidentiality by disclosing the information. The government might try to prove that the recipient of the information "misappropriated" the information by trading, but in many cases there may not be an agreement or understanding necessary to support the application of a misappropriation theory.

Fourth, in the absence of a gift to a friend or relative or misappropriation, the *Dirks* "personal benefit" requirement is a demanding one. Under *Newman*, the benefit to the insider who shares information must be "an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."

Finally, and perhaps most importantly, the above standards pose particular difficulties for the government in cases against remote tippees — tippees who are several levels removed from the original tip. For remote tippee liability to arise, the remote tippee must have known (or in a civil case at least should have known) that the source of the information breached a duty and acted for his or her personal benefit. Remote tippees often will not know enough about the circumstances surrounding the original tip for the government to charge or prove that level of culpability.

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