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Mind the Gap(s): Solutions for Defining Tipper-Tippee Liability and the Personal Benefit Test Post-Salman v. United States

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Abstract

The Supreme Court's decision in Salman v. United States reaffirmed (and indeed, clarified) the central holding of Dirks v. SEC that no additional pecuniary or reputational gain is needed when an insider gives information to a "trading relative or friend." While this was considered a win for prosecutors, the Court chose to abstain from considering more complex questions regarding tipper-tippee liability. Namely, the Court provided no guidance on what constitutes a "friend" or "trading relative" nor how a tippee "should know" whether information was improperly disclosed. Without any clear standards, prosecutors and courts have wide discretion to determine whether these criteria are met, which is often a case-specific and fact-intensive inquiry. Anticipating some of these difficulties, this Note proposes some objective criteria for courts to consider when determining whether the criteria in Salman has been satisfied. This promotes a uniform state of tipper-tippee liability and avoids uncertainty about the outcomes in future insider trading cases.

KEYWORDS: Tipper, Tippee, Insider Trading, Personal Benefit, Corporate Board, Fiduciary Duty

MIND THE GAP(S): SOLUTIONS FOR DEFINING TIPPER-TIPPEE LIABILITY AND THE PERSONAL BENEFIT TEST POST-*SALMAN V. UNITED STATES*

Matthew Williams[*]

ABSTRACT

The Supreme Court's decision in *Salman v. United States* reaffirmed (and indeed, clarified) the central holding of *Dirks v. SEC* that no additional pecuniary or reputational gain is needed when an insider gives information to a "trading relative or friend." While this was considered a win for prosecutors, the Court chose to abstain from considering more complex questions regarding tipper-tippee liability. Namely, the Court provided no guidance on what constitutes a "friend" or "trading relative" nor how a tippee "should know" whether information was improperly disclosed. Without any clear standards, prosecutors and courts have wide discretion to determine whether these criteria are met, which is often a case-specific and fact-intensive inquiry. Anticipating some of these difficulties, this Note proposes some objective criteria for courts to consider when determining whether the criteria in *Salman* has been satisfied. This promotes a uniform state of tipper-tippee liability and avoids uncertainty about the outcomes in future insider trading cases.

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INTRODUCTION

An investor begins a new job at an investment company, where he is very eager to succeed. Confused with some of the more technical aspects of his new position, he asks his sister, a chemist, for advice on understanding the industry. During their conversation, the investor unintentionally reveals information about a pending merger. Unbeknownst to the investor, his sister passes this information to a friend, and both trade on this information. Should the investor be liable for insider trading when he did not know his sister was trading? What about the friend who trades and did not know that the information was confidential? What if the friend had a suspicion about the source of the information, but this suspicion was unconfirmed?[1]

The answer to this hypothetical hinges on the question of whether a court finds that the trader lacked the requisite knowledge to be held liable. The Supreme Court's recent case, *Salman v. United States*, was

1. These facts are similar to those of Salman v. United States, 137 S. Ct. 420 (2016).

considered a win for prosecutors, but the decision provides little clarity for those on the fringes of this intricate doctrine. The outcome in the scenario described above may turn on a fact as simple as whether or not the investor's sister and her friend were merely "family friends," and further, how a lower court interprets this phrase.[2] As with many Supreme Court decisions, commentators and practitioners are able to discern inconsistencies within precedent and anticipate many of the questions that the Court's rulings leave unanswered. This Note accordingly anticipates some of these issues and offers solutions consistent with the Supreme Court's rationale for assigning insider trading liability.

Part I of this Note discusses the history giving rise to congressional action to curb fraudulent securities trading. Part I also describes one of the prominent doctrines of insider trading liability, namely the classical theory. Part II analyzes the most recent Supreme Court case on insider trading and highlights some of the uncertainties courts face in determining liability. Part II describes these problems, including the difficulty of defining what constitutes a friend or family member for the purpose of determining liability, and what constitutes sufficient "knowledge" of an improper disclosure of confidential information. Part III proposes new criteria for courts to consider when assigning liability. These criteria aim to clarify some of the confusion that prior insider trading cases have created and promote uniformity in enforcing standards of liability in the lower courts.

I. THE DEVELOPMENT OF INSIDER TRADING LAW

A. HISTORY AND INTERPRETATION OF RULE 10B-5

Before the enactment of the Securities Exchange Act of 1934 (the Exchange Act),[3] securities exchanges were largely treated as private clubs. Courts deferred to the exchanges to determine their own rules governing membership criteria, discipline, and management.[4] As

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2. *See* United States v. Newman, 773 F.3d 438, 452 (2d Cir. 2014).

3. Pub. L. No. 73-291, 48 Stat. 881 (1934) (codified at 15 U.S.C. § 78a (2012)).

4. At this time, the courts generally deferred to the by-laws and internal regulations for discipline for its members. *See, e.g.*, Belton v. Hatch, 17 N.E. 225, 225–26 (N.Y. 1888) ("Their decision involves the legal relations to each other of the members composing the association of the New York Stock Exchange, and the extent and validity

securities trading became more significant to the American financial system, Congress intervened to curb fraudulent behavior in the exchanges.[5] Despite the enactment of what was then Section 16(b) of the Exchange Act, laws against insider trading were largely ineffective in capturing the sort of insider trading that occurs today.[6] As a result, courts looked to Section 10(b) of the Exchange Act.[7]

Section 10(b) states that a party is guilty of insider trading when it "use[s] or employ[s], in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of" the rules promulgated by the Securities and Exchange Commission (SEC).[8] Using the authority delegated by Section 10(b), the SEC promulgated Rule 10b-5, which makes it illegal for a party "[t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."[9] Judicial interpretations of Rule 10b-5 have endorsed the "classical" theory of insider trading: namely that, corporate insiders violate Rule 10b-5 when they purchase or sell securities on the basis of material, nonpublic information.

The Second Circuit's decision in *SEC v. Texas Gulf Sulphur Co.*[10] provides the groundwork for the classical theory. In *Texas Gulf Sulphur*, the defendants' company began drilling in an area with promising amounts of copper and zinc.[11] Several high-level managers and researchers purchased stock and options in the company before revealing their discovery to the trading public.[12] Once news of the mineral

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of the powers reserved by its constitution and by-laws, and conferred upon its officers and committees, in the management of its affairs, and in the control over a member.").

5. Although these exchanges were, to a degree, self-regulated, the Supreme Court held that they are also subject to other types of federal regulations aside from the Exchange Act. *See* Silver v. N.Y. Stock Exch., 373 U.S. 341, 351–57 (1963).

6. Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties Into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1204–05, 1223, 1229 (1995) (noting the limits of Section 16(b); namely, that it does not reach transactions occurring more than six months apart, persons other than those named in the statute, and transactions in securities not registered under Section 12).

7. 15 U.S.C. § 78j (2012).

8. *Id.*

9. 17 C.F.R. § 240.10b-5(c) (2017).

10. 401 F.2d 833 (2d Cir. 1968).

11. *Id.* at 843.

12. *Id.* at 844.

discovery became public, the company's stock price increased from approximately $17.50 per share to $58.25 per share, resulting in large profits for the inside researchers and managers.[13]

The insiders were found to have violated Rule 10b-5 by trading on material, nonpublic information.[14] The court interpreted Rule 10b-5's language on deception and manipulation to mean that Congress intended to prevent fraud and protect investors. Thus, the court concluded that all investors should have "equal access" to material information to be subject to identical market risks.[15] Furthermore, the court held that, under Rule 10b-5, anyone who possesses privileged nonpublic information must either disclose the information to the trading public or refrain from trading based on that information.[16]

In *Chiarella v. United States*,[17] the Supreme Court disavowed the "equal access" rationale and narrowed the application of the classical theory. The defendant in *Chiarella* was an employee at a financial printing company who regularly handled documents concerning large, nonpublic transactions.[18] Although the names of the parties to the transactions were redacted or blank, the defendant deduced the companies' identities, purchased their stock, and then sold the stock at a premium once the pending takeover news was publically announced.[19]

The Court held that convictions under Rule 10b-5 must be based upon fraud, and "there can be no fraud absent a duty to speak."[20] Corporate fiduciaries, or individuals "in whom the sellers had placed their trust and confidence," have a duty to disclose before trading.[21] Finding that the defendant only interacted with the sellers through impersonal market transactions and had no fiduciary relationship to the corporation,

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13. *Id.* at 847.
14. *Id.* at 864.
15. *Id.* at 851–52.
16. *Id.* at 848.
17. 445 U.S. 222 (1980).
18. *Id.* at 224.
19. *Id.*
20. *Id.* at 235. The duty to speak has its roots in the common law tort of deceit. Accordingly, the Court notes that "not every instance of financial unfairness constitutes fraudulent activity." *Id.* at 232; *see also* Robert B. Thompson, *Insider Trading, Investor Harm, and Executive Compensation*, 50 CASE W. RES. L. REV. 291, 294 (1999).
21. *Chiarella*, 445 U.S. at 232.

the Court overturned his conviction.[22] Thus, the classical theory's duty to disclose information or abstain from trading was limited to corporate fiduciaries.

B. The History of Tipper-Tippee Liability

1. Dirks and the Criteria for Tippee Liability

Insiders, however, are not the only parties that may be held liable for trading on material, nonpublic information under Rule 10b-5. In *Dirks v. SEC*,[23] the Supreme Court addressed chains of corporate insiders who provide material, nonpublic information (tippers) to corporate outsiders (tippees). Dirks was an officer of a broker-dealer firm. He received information from a former officer of a corporation who revealed that the corporation had vastly overstated its assets and urged Dirks to investigate and expose this fraud.[24] Dirks verified the claim of fraud by speaking with insiders and asked a reporter to publish a story on the fraud; the reporter refused. In the meantime, Dirks discussed his findings with his clients, many of whom sold their holdings to avoid incurring a loss.[25] The SEC charged Dirks with violating Rule 10b-5, in part relying on dicta in *Chiarella*, stating that tippees assume a duty to disclose or abstain from trading when they know or should know information came from a corporate insider.[26]

The Court, however, reversed Dirks' conviction by analyzing the chain through which tippees assume liability. A tippee acquires the tipper's fiduciary duty to the corporation upon receiving the nonpublic information; therefore, a tippee is liable only if the tipper owes a fiduciary duty to the corporation and the tippee "knows or should know that there has been a breach" of this duty.[27] Furthermore, for a breach of fiduciary duty to exist, the tipper must derive a personal benefit from the disclosure.[28] This personal benefit is equated with implicitly promising to use nonpublic information for only corporate purposes, but then instead

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22. *Id.* at 232–33, 236–37.
23. 463 U.S. 646 (1983).
24. *Id.* at 649.
25. *Id.*
26. *Id.* at 651.
27. *Id.* at 660.
28. *Id.* at 663.

using this information to benefit personally, which deprives the shareholders of the same gains.[29]

Courts may also infer a personal benefit when an insider gives a gift of material, nonpublic information to a "trading relative or friend"; it is as if the tipper used the nonpublic information to trade for a profit and subsequently gifted the proceeds to the recipient.[30] This gift of information is presumed to result in some personal benefit to the tipper—whether the benefit is the satisfaction of helping someone the tipper knows or the knowledge that the tipper's reputation has been enhanced in the eyes of the tippee.[31]

Applying this logic, the *Dirks* Court found that the tipper had not disclosed material, nonpublic information for a benefit; rather, the tipper only wanted to expose his employer's fraud.[32] In the absence of a personal benefit to the initial tipper, there cannot be an initial breach. Without an initial breach, there cannot be a derivative breach by the tippee, and therefore, no liability attaches under Rule 10b-5.

The personal benefit test is appealing because it provides courts with some objective criteria to determine whether there has been a breach by the tipper.[33] *Dirks* illustrates, however, that not all disclosures of material, nonpublic information are illegal; the Court noted that there must be "manipulation or deception" by the tipper, which directs lower courts to consider the purpose of the disclosure.[34] As shown by the facts in *Dirks*, the Court presumably did not want to discourage insiders and reporters

29. *See id.* at 654.

30. *Id.* at 664.

31. *See* Jill E. Fisch, *Family Ties:* Salman *and the Scope of Insider Trading*, 69 STAN. L. REV. ONLINE 46, 51 (2016) (describing the rationale as to why a benefit is inferred with family and friends).

32. *See Dirks*, 463 U.S. at 667.

33. "[T]he SEC and the courts are not required to read the parties' minds. . . . [The courts must] focus on objective criteria." *Id.* at 663. The personal benefit test was introduced into Justice Powell's majority opinion to balance the subjective criteria of the purpose of the disclosure with more objective factors; namely, whether the disclosure would result in a pecuniary gain. *See* A.C. Pritchard, *Justice Lewis F. Powell, Jr., and the Counterrevolution in the Federal Securities Laws*, 52 DUKE L.J. 841, 941–42 (2003).

34. *Dirks*, 463 U.S. at 654 (quoting Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473 (1977)).

from investigating and exposing corporate fraud.[35] However, requiring an initial breach may be problematic when tippees do not use the nonpublic information in the same way or for the same reason the disclosure was made in the first place.[36]

Without any additional guidance from the Supreme Court, the lower courts were left to their own devices to determine whether certain disclosures and relationships fit within the *Dirks* framework.[37]

2. Subsequent Interpretations of Dirks

The language in *Dirks* led two circuit courts to different applications of the personal benefit test in tipper-tippee liability. In *United States v. Newman*,[38] two hedge fund portfolio managers, Newman and Chiasson, were convicted in the district court for violating Rule 10b-5. In this case, several financial analysts obtained the earnings of two corporations from corporate insiders before the information was publicly announced.[39] The analysts relayed this information to their respective managers, who subsequently traded on this information and made large profits.[40] Newman was three levels removed from the original tipper and Chiasson was four levels removed.[41]

The defendants argued that the government failed to establish tippee liability under *Dirks*. They argued there was no evidence that the initial tippers received any benefit from their disclosure, which precluded the existence of tippee liability further down the line.[42] The defendants also argued that even if the initial tippers received a benefit from their disclosures, the defendants did not know about the benefit.[43] The court agreed that the evidence was insufficient to infer that the defendants knew

35. "Not 'all breaches of fiduciary duty in connection with a securities transaction,' however, come within the ambit of Rule 10b-5." *Id.* at 654 (quoting *Santa Fe Indus., Inc.*, 430 U.S. at 472).

36. *See infra* Part III.

37. *See infra* Part II.

38. 773 F.3d 438 (2014).

39. *Id.* at 443.

40. *Id.*

41. *Id.*

42. *Id.* at 444.

43. *Id.*

of any benefit provided by the insiders' initial disclosures and vacated the convictions.[44]

More notable, however, is the court's finding that the insider-tippers' disclosures did not result in a personal benefit. The court found that the first-insider tipper and tippee were not "friends" even though they attended school together, the tippee edited the tipper's résumé, and gave the tipper career advice and industry contacts.[45] The court held that these favors were not specific enough to find a friendship between the tipper and tippee because the tippee regularly performed similar favors for industry colleagues and fellow college alumni.[46]

The second insider-tipper and tippee attended the same church, occasionally socialized, and were "family friends."[47] The court still viewed this relationship insufficient to infer a friendship.[48] Since the initial tippers were not friends with the tippees, no personal benefits derived from the initial disclosures.[49] Without an initial breach, there could be no derivative breach down the chain of information.[50] To infer a personal benefit, the court held that parties must have a "meaningfully close personal relationship" and engage in an exchange that presents "a potential gain of a pecuniary or similarly valuable nature."[51]

In *Salman v. United States*, the Supreme Court addressed the subsequent question of whether a tipper must additionally benefit when tipping to a friend or family member.[52] The case involved two brothers, one of whom was a corporate insider (Maher) and the other was a corporate outsider (Michael).[53] Maher sought investment advice from Michael because he had studied chemistry in college and could help

44. *Id.* at 451–52.

45. *Id.* at 452.

46. *Id.* at 453. These actions were not enough to be considered a friend under the personal benefit test. Dirks v. SEC, 463 U.S. 646, 664 (1983).

47. *Newman*, 773 F.3d at 452.

48. *Id.* at 452, 455.

49. *Id.* at 455.

50. *Id.*

51. *Id.* at 452. Requiring an additional benefit when *Dirks* stated that there is "exploitation of nonpublic information . . . when an insider makes a gift of confidential information to a trading relative or friend" presumably led the Supreme Court to grant certiorari. *Dirks*, 463 U.S. at 664.

52. 137 S. Ct. 420 (2016).

53. *Id.* at 424.

Maher understand some of the scientific aspects of his job.[54] These conversations eventually lead Maher to disclose pending mergers to Michael, which information Michael used to trade.[55] Although initially unaware of Michael's trading, Maher eventually became aware of Michael's unlawful trading and continued to knowingly provide him with information.[56]

Michael began sharing the information from Maher with his friend, Salman, who also traded on these tips for a large profit.[57] Salman was convicted of violating Rule 10b-5.[58] Salman appealed, arguing that Maher never received any personal benefit by disclosing the nonpublic information to Michael, and therefore no Rule 10b-5 liability could attach to Salman.[59]

The Court disagreed with Salman's argument and affirmed his conviction.[60] The Court overruled the requirement in *Newman* that tips to trading relatives or friends must result in a pecuniary or reputational gain to the tipper.[61] Citing *Dirks*, the Court reiterated that tippers benefit from gifts of nonpublic information to trading relatives or friends because gifts of nonpublic information are equivalent to gifts of cash, which *Dirks* explicitly prohibited.[62] The Court reasoned that Maher impliedly benefited from his tips to Michael under *Dirks*. Salman acquired Maher's duty of trust and confidence from Michael, and breached it by trading on information he knew was improperly disclosed.[63]

Salman effectively returned the status of tipper-tippee liability to a pre-*Newman* state, where there is no burden to prove that a tipper's disclosure to a trading relative or friend must result in additional financial gain.

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54. *Id.*
55. *Id.*
56. *Id.*
57. *Id.* at 424–25.
58. *Id.* at 425.
59. *Id.*
60. *Id.* at 428–29.
61. *Id.* at 428.
62. *Id.* at 427–28.
63. *Id.* at 428.

II. THE STATUS OF TIPPER-TIPPEE LIABILITY UNDER THE CLASSICAL THEORY POST-*SALMAN*

A. QUESTIONS REMAINING AFTER *SALMAN*

While *Salman* reaffirms the prohibition against trading based on material, nonpublic information provided to a friend or family member as a gift, some commentators called the *Salman* decision a "rubber-stamping of the 33-year-old *Dirks* precedent," indicating that *Salman* was a "[h]ollow win" for federal prosecutors.[64] Based on the narrow holding in *Salman*, prosecutors are indeed left with several unanswered questions and uncertain standards regarding the current state of tipper-tippee liability under the classical theory of Rule 10b-5.

1. What Constitutes "Knowledge" of the Initial Breach?

First, *Salman* does not address what level or sort of knowledge the tippee must have of the initial breach to assume fiduciary duty to a corporation. In *Newman*, the court cited *Dirks* and circuit precedent to hold that when there is an exchange of material, nonpublic information, the tippee must "know[] of the personal benefit received by the insider."[65] The Court in *Salman* did not specify what constitutes "knowledge" of the initial tipper's breach to assume the insider's fiduciary duties. Rather, the Court noted that *Newman* required knowledge, but declined to give any additional guidance as to what level or type of knowledge a tippee must have regarding the personal benefit the initial tipper derives from disclosing.[66]

There is further confusion regarding the standard of knowledge when examining the proposition for which the Court in *Salman* cites *Dirks*. The tippee assumes the duty not to trade on material, nonpublic information if

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64. *See, e.g.*, Michael D. Guttentag, *Salman Insider-Trading Case a Hollow Win for Prosecutors*, COLUM. L. SCH.: BLUE SKY BLOG (Dec. 14, 2016), http://clsbluesky.law.columbia.edu/2016/12/14/salman-insider-trading-case-a-hollow-win-for-prosecutors/ [https://perma.cc/33FH-ECYH].

65. United States v. Newman, 773 F.3d 438, 448 (2014). The court stated that if the government does not establish this element, it "cannot meet its burden of showing that the tippee knew of a breach." *Id.*

66. The Court explicitly declined to examine this issue. *Salman*, 137 S. Ct. at 425 n.1.

the tippee "*knows or should know* that there has been a breach."[67] However, the Court in *Salman* cited *Dirks* for the proposition that the tippee acquires the duty of trust and confidence if the tippee "knows the information was disclosed in breach of the tipper's duty";[68] notably absent is the phrase "should know." It is ambiguous whether the Court purposefully modified the requirement in *Dirks*, or whether the Court's omission was unintended, and thus only misquoted *Dirks*.

As a result of this uncertainty, prosecuting remote tippees is made potentially more difficult. These remote tippees may not know the initial source of the nonpublic information, and therefore would not know if the tipper derived any benefit from the initial disclosure. This could complicate prosecution as it affords remote tippees the affirmative defense of plausible deniability.[69] Moreover, if the new standard of tippee knowledge omits "should know," then even constructive knowledge of a breach may not be enough to convict.

2. Classification and Criteria of Relationships Permitting an Inference of a Personal Benefit

Salman did not provide guidance as to the criteria that courts should use in analyzing relationships to infer a personal benefit. In *Salman*, the Court noted that Maher and Michael were brothers, the "very close relationship" they shared, and their repeated trading transactions.[70] Therefore, the Court found the nature of their relationship permitted an inference of a personal benefit.[71]

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67. Dirks v. SEC, 463 U.S. 646, 660 (1983) (emphasis added).

68. *Salman*, 137 S. Ct. at 423.

69. *See, e.g.*, Stephen M. Bainbridge, *US Supreme Court's 'Salman v. US' Decision Answers One Insider-Trading Question, Leaves Others Unresolved*, WFL LEGAL PULSE (Dec. 8, 2016), https://wlflegalpulse.com/2016/12/08/us-supreme-courts-salman-v-us-decision-answers-one-insider-trading-question-leaves-others-unresolved [https://perma.cc/C9BQ-L3YD].

70. *Salman*, 137 S. Ct. at 424. It is uncertain why the Court emphasized the closeness of their relationship. A generous reading could see this as an implicit endorsement of *Newman*'s requirement for how close two parties must be to infer a benefit while still rejecting the need for pecuniary gain between friends and family. However, a narrower reading could find that this is only mentioned in passing, and thus irrelevant because their relationship falls within the two relationships in *Dirks*.

71. *Id.* at 427–29.

Since *Salman* did not address how courts should analyze relationships, two issues remain. First, whether a tipper's disclosure of information to a person other than a trading relative or friend who subsequently trades is actionable under *Dirks* and *Salman*.[72] *Newman* explicitly ruled out casual social relationships between tippers and tippees as sufficient to infer the existence of a friendship, and instead embraced a more stringent standard.[73] When examining this standard of friendship, it is worth noting the sorts of activities that *Newman* explicitly found insufficient to infer a friendship: common favors that tippees provide to a large group (of friends or alumni), occasionally meeting at large social events, or historically being "family friends."[74] Thus, *Newman* draws a distinct line: absent a meaningful relationship or an objective personal benefit (e.g., cash), there can be no inference of a personal benefit to the tipper, and thus no Rule 10b-5 liability. *Salman*, however, only restated the two relationships in *Dirks* and does not offer any guidance regarding how to analyze tips provided to those outside the tipper's family or friends.[75] The analysis for traders who are considered neither friends nor family is therefore left for the lower courts to decide.

This raises the second question of what factors courts should consider when determining whether two parties are friends or trading relatives for the purposes of inferring a personal benefit to the tipper.[76] In holding that Salman assumed the fiduciary duty, the Court emphasized how close Salman was with Maher and Michael, but did not specify whether Salman assumed the duty as a "*friend*" or as a "*trading relative*."[77] The Court mentioned in passing that Maher married Salman's

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72. *See infra* Part II.B.

73. United States v. Newman, 773 F.3d 438, 452 (2014).

74. *Id.* at 452–53, 455. Despite classifying the tipper and tippee as "family friends," the court does not specify how long the families knew each other, nor what interactions the tipper and the tippee previously had in the family context. *Id.* at 452.

75. *Compare Salman*, 137 S. Ct. at 427–29 ("Our [previous] discussion of gift giving resolves this case."), *with Newman*, 773 F.3d at 452 ("[T]he mere fact of a friendship, particularly of a casual or social nature" was insufficient to show a personal benefit to the tipper, observing that "[i]f this was a 'benefit,' practically anything would qualify.").

76. *See* Jen Wieczner, *Here's What the Supreme Court Insider Trading Ruling Means for Hedge Funds*, FORTUNE (Dec. 6, 2016), http://fortune.com/2016/12/06/supreme-court-insider-trading-salman-hedge-fund/ [https://perma.cc/N7VM-8JT8].

77. *See Salman*, 137 S. Ct. at 427 (emphasis in original) (quoting Dirks v. SEC, 463 U.S. 646, 664 (1983)).

sister.[78] Although Salman knew of Maher's initial breach and acquired the fiduciary duty through Michael, the question remains whether Salman was considered a "relative" of the brothers by marriage.[79]

If Salman acquired Maher's fiduciary duty as a friend, this would provide some clarity to lower courts about the types of interactions and length of relationship tippers and tippees could have to infer that there was a personal benefit to the tipper. However, if Salman acquired this duty as a family member, the meaning of "*trading relative*" would apply to members outside the immediate family, raising more questions as to which familial relationships would lend an inference of a personal benefit under the classical theory. This also raises the question as to what types of social interactions a tipper would need to have with a family member to infer a benefit.[80]

Finally, it is still unclear how courts should determine whether tippers and tippees are "friends." Courts are free to choose what factors to consider and how much weight to give them—i.e. how long tippers and tippees have known each other, how often they interacted, and the context in which they interacted, among many other case-specific considerations.

B. THE LIMITS OF *SALMAN*

A few hypotheticals best demonstrate the issues that are left unanswered. Take, for example, a scenario where a Chief Executive Officer (CEO) regularly works out with a personal trainer. During their workout sessions, the CEO reveals that he is stressed about his company's merger. The personal trainer then uses this nonpublic information to trade.

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78. *Id.* at 421.

79. Implicit in the Court's decision is that Salman could have only been a friend or relative to acquire Michaels's derived fiduciary duty. There is no mention of any pecuniary or reputational gain that Michael received in exchange for the tips he gave to Salman. Therefore, for Michael to have breached his acquired duty, he must have received a personal benefit from tipping Salman. The facts state that Michael "became friends with Salman." *Id.* at 425. However, the Court did not state whether Michael began tipping Salman before or after Maher's marriage to Salman's sister. The Court paradoxically refers to Salman as Maher's brother-in-law, but as Michael's friend. *Id.* at 424.

80. Part II.B, *infra*, discusses the role of being a family member in a personal benefit analysis.

Assume further that the personal trainer is not considered the CEO's friend or relative.[81]

Since the personal trainer is not a trading relative or friend, the government would need to prove that the CEO received a direct or indirect personal benefit that will "translate into future earnings" under *Dirks*.[82] While the benefit of physical health is important, the "personal benefit" requirement is essentially a placeholder for self-dealing, and the disclosure to the personal trainer does not seem to provide any financial or reputational benefit to the CEO nor detract from any corporate earnings.[83] Without applying *Newman*'s "meaningful[] relationship" standard or a requirement that the personal trainer should know that this information is confidential, this disclosure would likely not result in either the CEO or the personal trainer being found liable under the classical theory.[84]

To understand how problems arise regarding tippees who are multiple levels removed from the initial tipper, consider the following example. An insider at a corporation discloses a potential merger to his former college roommate. The former roommate then tells his girlfriend, who then tells her friend, and that friend subsequently trades. Assume further that this trader does not know the initial insider who first shared the tip or the former college roommate. While in the *Salman* case, Salman knew the benefits Maher and Michael received from their relationship, the Court did not need to comment further on the requirement that the

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81. *See, e.g.*, Stephen M. Bainbridge, *Andrew Verstein on the Salman Personal Benefit Standard for Tipping Liability*, PROFESSORBAINBRIDGE.COM (Jan. 2, 2017), http://www.professorbainbridge.com/professorbainbridgecom/2017/01/andrew-verstein-on-the-salman-personal-benefit-standard-for-tipping-liability.html [https://perma.cc/2KX8-UQVQ].

82. *Dirks*, 463 U.S. at 663.

83. *See id.* at 663–64. The idea of "self dealing" is that the party who possesses inside information receives either a pecuniary or reputational gain that may result in profits. *See id.* at 663. Therefore, physical health would not likely fall within this framework.

84. In *Salman*, the government argued for a broader definition of personal benefit to include "noncorporate purpose[s]," which under a broad reading, could possibly have included the alleged benefit here. *Salman*, 137 S. Ct. at 426. However, under the current framework, these questions may even hinge on how many times they have discussed work. *See* SEC v. Maxwell, 341 F. Supp. 2d 941, 949 (S.D. Ohio 2004) (disclosing a merger to a longtime barber did not violate Rule 10b-5 because there was no discernable benefit to the tipper).

tippees must know of the insider's benefit derived from disclosure.[85] However, in this example, the trader does not know of any personal benefit that the initial tipper receives. Without proof that the remote tippees knew of the initial breach, the government would have a difficult time proving a remote tippee's knowledge of the breach under *Salman*.[86]

The ambiguity regarding whether or not a tippee "should know" of the tipper's breach further complicates the issue. For example, consider three friends in a social setting: a known corporate insider, a woman, and the woman's boyfriend. Neither the woman nor her boyfriend are active traders, and although they each know where the other individuals work, they never discuss their work. However, the insider and the boyfriend go to a restaurant for lunch where the insider discloses a future merger, receives a call, and suddenly leaves. The boyfriend then tells his girlfriend about the merger, and she later trades on this information. While it is clear that she *should know* of a breach (after all, it was the same company where the insider works), under *Salman* it is unclear whether constructive knowledge is sufficient to impose liability.[87]

Finally, the Court did not define the contours of the family and friends to whom a gift constitutes a personal benefit. For example, take the case of estranged siblings who do not maintain any sort of active relationship or contact. However, by accident the insider-sibling accidentally e-mails his estranged sibling a tip regarding a potential merger from his work account. The tippee-sibling subsequently trades. Since there was no intended gift of proceeds to the tipper in the disclosure, the question depends on whether the existence of a biological relationship is sufficient to establish an inference of an improper benefit.[88] In analyzing liability, courts tend to emphasize the closeness of the tippers and tippees' relationship, even in familial relationships, to infer a personal

85. *Salman*, 137 S. Ct. at 427–28.

86. *See* Avi Weitzman et al., *Right Back Where We Started From? In* Salman*, the Supreme Court Clarifies the "Personal Benefit" Test but Otherwise Leaves Undisturbed Insider Trading Contours*, GIBSON, DUNN & CRUTCHER LLP (Dec. 7, 2016), https://www.gibsondunn.com/right-back-where-we-started-from-in-salman-the-supreme-court-clarifies-the-personal-benefit-test-but-otherwise-leaves-undisturbed-insider-trading-contours/ [https://perma.cc/G8LA-TXSU].

87. *Salman*, 137 S. Ct. at 425 n.1.

88. Indeed, this question could extend to encompass estranged cousins, or even the status of in-laws as in *Salman*.

benefit. However, the weight that courts should give to a mere familial tie in a personal benefit analysis is uncertain.

A similar scenario to the case above illustrates the difficulty in defining what constitutes a "friend." Imagine a corporate insider comes home late from a bar and accidentally posts a public status to his Facebook page revealing insider information. Someone who the man is friends with on Facebook, but has never actually met and never spoken with in person, reads this information and trades. There is no personal benefit to the tipper by his accidental disclosure[89]—which then raises the question as to what objective criteria courts should consider when classifying this sort of relationships and determining whether someone is a "friend."[90] While the standard in *Newman* would most likely indicate that the tipper received a benefit, other circuits are free to interpret "friend" in a more loose or casual sense.

In sum, *Salman*'s narrow holding and ambiguous language leaves many important questions unanswered.

III. THE NEED FOR MORE COMPLETE DEFINITIONS OF "KNOWLEDGE" AND "PERSONAL BENEFIT"

Courts have found the personal benefit requirement fulfilled even without any pecuniary or reputational gain.[91] However, the Supreme Court and the SEC have yet to provide guiding principles for courts to follow when imposing liability under the personal benefit test. Indeed, the SEC already provided guidance by promulgating a non-exhaustive list of criteria in Rule 10b5-2 when there is a "duty of trust and confidence" in misappropriation cases.[92] Therefore, it is preferable to introduce objective criteria for courts to use with the personal benefit test.

In other securities cases, the Supreme Court has introduced multi-factor tests to determine whether a venture is an "investment contract" under the Securities Act of 1933, or whether an instrument is a "security"

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89. Suppose that the Facebook friend did not offer cash, favors, or could enhance the tipper's relationship in any social circles.

90. *See* Bainbridge, *supra* note 69.

91. *See, e.g.*, SEC v. Yun, 327 F.3d 1263, 1270 (11th Cir. 2003) (maintaining a strong professional relationship is enough to infer a benefit).

92. 17 C.F.R. § 240.10b5-2 (2017). The Court in *Dirks* and *Salman* appear to be closing the similar loop for the classical theory by determining when there are personal benefits.

under the Exchange Act.[93] Accordingly, this Note proposes several factors for courts to consider in determining whether relationships satisfy the personal benefit requirement under the classical theory of tipper and tippee liability[94]:

(a) immediate family members as defined in Rule 10b-2(b)(3)[95] and with whom the tipper maintains consistent contact, subject to the defenses therein;
(b) roommates, or people with whom the tipper has a living arrangement that is planned to last for at least a year;
(c) friends with whom the tipper has had a relationship of consistent, personal, and meaningful contact;[96]
(d) parties in settings who know or should know that material, nonpublic information is being discussed;
(e) parties where the tipper has disclosed the nonpublic information with the primary intent to expose a corporate fraud and the tippee trades contrary to this intent, with no subsequent liability to the tipper.

Each of these criteria will be discussed in turn.

A. IMMEDIATE FAMILY MEMBERS

The need for a criteria addressing what constitutes a family member is clear. Case law has not defined what constitutes a relative, and courts have wide latitude in interpreting case law, statutes, and previous rulings. This proposed understanding gives outward boundaries to the definition of "relative" by relating it to the previously defined relationships in Rule

93. SEC v. W.J. Howey Co., 328 U.S. 293 (1946); Reves v. Ernst & Young, 496 U.S. 56 (1990).

94. *Cf.* Sara Almousa, *Friends with Benefits? Clarifying the Role Relationships Play in Satisfying the Personal Benefit Requirement Under Tipper-Tippee Liability*, 23 GEO. MASON L. REV. 1251, 1274–77 (2016). While the author proposes some criteria to resolve the issues at hand, it does not establish enough objective criteria to resolve the hypotheticals in Part II.B, and still gives too much leeway to courts in interpreting the proposed regulations.

95. 17 C.F.R. § 240.10b5-2(b)(3). These relationships include: "Whenever a person receives or obtains material, nonpublic information from his or her *spouse, parent, child, or sibling*." *Id.* (emphasis added).

96. *See* Almousa, *supra* note 94, at 1274.

10b5-2, while also providing a rebuttable presumption that the tipper received any personal benefit from the disclosure.[97]

Furthermore, this understanding of "relative" would not cover disclosures between estranged siblings, as the tippee may rebut this presumption under the exemption in Rule 10b5-2(b)(3) by not having a history of sharing confidences. This presumption is also consistent with the language in *Dirks* because the accidental disclosure to the tippee would not be the equivalent of trading and then giving a gift of cash proceeds, which is what the Court contemplated when it held that gifts to relatives also result in a personal benefit to the tipper.[98]

B. ROOMMATES

The relationship between roommates is more difficult to define. For instance, renters may sublease their apartments for a matter of mere weeks, which would not produce the level of perceived closeness as articulated in *Dirks* or *Newman*. This proposed interpretation creates a rule that instructs courts to consider objective criteria, for example, the length of lease agreements. It also comports with the logic in *Dirks* of giving a gift of cash proceeds; roommates may be occasionally short on cash for their obligations as tenants, and a tipper's gift of nonpublic information could result in a benefit that translates into cash to cover her obligations. Furthermore, the criterion is present- and forward-looking in that past living arrangements of a year or longer do not allow the inference of a personal benefit. If a tipper tips a former roommate (as in the hypothetical above) or someone with whom she has lived less than a year, a court may still impose liability as a "friend" under *Dirks*.[99]

C. PEOPLE WITH WHOM THE TIPPER HAS MEANINGFUL CONTACT

This interpretation codifies the standard in *Newman*. This criterion proposes an objective analysis of how the tipper and tippee interact—which precludes courts from giving too much consideration to casual social interactions or favors the tippee provides to a larger, non-trading

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97. 17 C.F.R. 240.10b5-2(b)(3) (2017). The statute provides for an exemption if a tippee can prove that she did not know the tipper was the source of the information, that there was no pattern or history of sharing confidences, and there was no explicit agreement to keep the information confidential. *Id.*

98. Dirks v. SEC, 463 U.S. 646, 664 (1983).

99. *See generally* Almousa, *supra* note 94, at 1274–75.

audience. This still affords courts discretion to decide what constitutes "regular" contact, as parties may become close quickly, thus leading the tipper to share nonpublic information for the purpose of improving the budding relationship.

Furthermore, this criterion precludes liability from unintentional disclosures to random parties, such as disclosures through a Facebook status to a large, but anonymous audience. This approach is consistent with the logic in *Dirks*, which presumably did not intend for tippers to be liable if they accidentally disclose nonpublic information to an anonymous audience. Any relationships not encompassed by this criterion would be rare, as it is difficult to imagine a case where a tipper would intend a gift of cash proceeds for a stranger.

D. Parties Who Know or Should Know Material, Nonpublic Information is Being Discussed

This interpretation provides a "catch-all" provision for Rule 10b-5 liability, as it adds context to judge whether a tippee "should know" there was a breach. Moreover, it codifies the situations where an individual acquires nonpublic information through a confidential relationship or through temporary relationships with a corporation, thus prohibiting them from trading.[100] This interpretation risks creating ambiguity, however, and a few hypotheticals illustrate the outer limits that this Note contemplates.

Imagine a corporation hires a catering service to cater its corporate picnic. Picnic attendees would not expect the caterers to eavesdrop as they discuss corporate business at the event, and therefore would not change the content of their conversation when a caterer member is present. Under the current classical theory, an eavesdropping caterer who hears nonpublic information and subsequently trades would not be liable under Rule 10b-5; the source did not receive any pecuniary or reputational benefit from "disclosing" under *Dirks*, the tippers are not friends with the tippees, and the caterer did not enter into a relationship with the corporation for a "special confidential relationship in the conduct of the business," such as lawyers or accountants.[101]

The proposed interpretation, however, imposes these "temporary insiders" with the same fiduciary duties as the insiders by adding the

100. *Dirks*, 463 U.S. at 655 n.14.

101. *Id.*

context in which they acquire the nonpublic information to the court's analysis. Under these facts, any caterers at least "should know" that company information may be discussed since it is a corporate event. This interpretation would also result in a stronger case against the girlfriend whose boyfriend tips her of their friend's company's merger.[102] There, the parties never discussed these matters, but a sudden revelation of the merger would arguably give her *at least* constructive knowledge that the information was nonpublic and therefore that she should not trade on it.

Context, however, may be ambiguous as to how an unintended tippee acquires information. Imagine a student is walking down the street and he overhears two men discussing an upcoming merger. He does not recognize either of the men. The men then enter a building that the student knows belongs exclusively to a certain corporation. The student uses the information he overheard to trade. Under this criterion, the student's liability would turn on whether or not the student "should know" that the information is nonpublic. Although "should know" seems to leave wide discretion to the courts, the analysis here turns on objective factors: whether the student saw them swipe their employee cards to enter the building (which grants exclusive access only to employees); whether the student overheard them say that they were employees of the company;[103] whether they were wearing any company paraphernalia, etc.

Aside from the context, there are questions as to whether a tippee's subjective knowledge of corporate insiders could result in liability. For example, take a law student ignorant of the who's who of the corporate world and a partner in a law firm who regularly interacts with high-level corporate employees. Both walk into a pub and see a man and a woman talking at the bar, both of whom are CEOs. The law student, unaware who the man and the woman are, approaches the bar, eavesdrops on their conversation, learns about an upcoming tender offer, and uses the information to trade for a large profit. The partner also enters and recognizes the two sitting at the bar. The partner approaches the CEOs and eavesdrops, learns about the tender offer, and subsequently trades for an even larger profit.

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102. *See supra* Part II.B.

103. If neither of the men worked for the company but were instead visiting for a meeting regarding the merger, then the student could argue that he had no knowledge of the initial breach, and thus would not be liable. *See* United States v. Newman, 773 F.3d 438, 448–49 (2d Cir. 2014).

Under the current state of insider trading liability, the law student would not be liable. He does not know the identity of the CEOs, and could reasonably assume that high-level employees would not be discussing such private information in public. Absent any other contextual clues, there is no reason the law student should know the information being discussed was private, and thus would not be liable. Conversely, the partner would be liable; she knows that the two individuals were CEOs, purposefully sought them out at the bar, and eavesdropped. She at least "should know" that they were discussing nonpublic information when she learned of the tender offer.

One critique of these contrary outcomes is whether there should be a heightened duty on those who should know nonpublic information is being discussed.[104] However, it seems appropriate to hold those who know, or have reasons to know, that nonpublic information is being discussed to a higher standard of liability. Courts are still able to look to objective factors in assigning liability.[105] Here, for example, a court may examine whether the partner previously worked with the CEOs on any transactions, interacted socially, or investigated whether the tender offer was public on her electronic devices.[106]

E. Parties Where the Tipper Has Explicitly Disclosed the Nonpublic Information for a Non-personal Benefit

Oddly enough, the holding in *Dirks* results in an anomaly: an insider may disclose nonpublic information for a non-personal benefit and the tippee may use this information for personal purposes without incurring Rule 10b-5 liability. To illustrate this point, take the facts of *Dirks*: an insider discloses an uninvestigated but actual corporate fraud to an investigator. Further assume that the corporation committing fraud is

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104. For example, the partner here could investigate whether the tender offer was public before trading to avoid liability.

105. For example, tort law already imposes a heightened obligation based on a party's subjective knowledge and skill. *See, e.g.*, Sunset Beach Invs., LLC v. Kimley-Horn & Assocs., 207 So. 3d 1012, 1014 (Fla. Dist. Ct. App. 2017) (professional license creates a special duty).

106. If the partner had investigated whether the tender offer was public, learned that the tender offer was not public, and yet still chose to trade, then it would seem appropriate to hold that she should have known that the conversation between CEOs was a breach.

about to merge with a target corporation.[107] However, instead of investigating and exposing the corporate fraud, the investigator decides to buy shares in the target corporation and sells them for a profit when the merger is announced.

Under *Dirks* and *Salman*, there would be no Rule 10b-5 liability. The insider did not receive a personal benefit by receiving a pecuniary or reputational gain or by disclosing to a friend or relative; rather, the insider disclosed the nonpublic information to a stranger. Without this initial breach, there could be no derivative breach by the investigator, regardless of what he does with the information, as there must be an initial breach for there to be subsequent liability.[108]

The criterion proposed in this Note addresses this anomaly. While the Court in *Dirks* sought to avoid "reading the parties' minds," a court may still look to the context behind the tipper's disclosure to determine if he intended to disclose a fraud. A court may consider factors such as whether the insider knew the investigator prior to the disclosure (and thus had a history of any quid pro quo exchanges), whether the investigator promises to publish an article praising the insider and resulting in a reputational benefit, or whether the investigator promises to recommend any future clients to the tipper. If the court found that the insider was sufficiently altruistic in his disclosure to an investigator, he would be free of any liability. Thus, only the investigator could be liable for purposefully profiting from the disclosure.

A criticism of this interpretation is that it does not adequately address "mixed disclosures," or the idea that a disclosure is intentionally made to expose a fraud, yet results in a personal benefit. *Dirks* is problematic in this regard as it does not state whether the insider must intend to receive a gain by disclosing.[109] For example, an insider chooses to disclose fraud, but later receives a reputational benefit from his honorable disclosure. However, in examining the context in which the tipper discloses the

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107. Dirks v. SEC, 463 U.S. 646, 647–48, 666–67 (1983).

108. *Id.* at 662. Interestingly, this would not result in any liability under the criteria for the misappropriation theory because the disclosure was not made in confidence, there were no patterns of sharing confidences, and the parties were not related. *See* 17 C.F.R. § 240.10b5-2 (2017).

109. "This requires courts to focus on objective criteria, *i.e.*, whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings." *Dirks*, 463 U.S. at 663 (emphasis in original).

information, this criterion addresses this concern by looking to the tipper's primary intent at the time of disclosure. Moreover, as a matter of public policy, courts should not impose liability when the benefits of the disclosure to the public at large outweigh the harm or personal benefits to the tipper.[110]

CONCLUSION

As shown, the role of relationships in tipper-tippee liability is in flux. Current insider trading jurisprudence opts to leave these questions to courts, which "may not always be easy."[111] Such wide discretion in answering these questions can lead to inconsistent outcomes and does not put defendants sufficiently on notice of their liability. This Note anticipatorily addresses these issues and proposes guidelines with the objectives of providing more clarity for courts and giving defendants sufficient notice of instances when they may be liable under the criminal provisions of Section 10(b) of the Exchange Act. By considering the proposed criteria, courts may begin the difficult task of unpacking the currently unclear cases of liability for insider trading.

110. *See id.* at 676–77 (Blackmun, J., dissenting).
111. United States v. Salman, 137 S. Ct. 420, 429 (2016) (citing *Dirks*, 463 U.S. at 664).