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Informational Cronyism

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ESSAY

Informational Cronyism

Donald C. Langevoort*

I. The Issues in *Salman*

If Maher Kara, the Citigroup analyst at the center of the *Salman* case now before the Supreme Court,[1] was forbidden under SEC Rule 10b-5 from trading securities for his own account while in possession of the valuable secrets to which his job gave him access, should he instead be able to give that information to family members simply in order to enrich them? I suspect that to anyone unfamiliar with the fine line drawing of federal insider trading law, the answer is clearly no. There is probably no more common form of corruption than generously shoveling the fruits of power and privilege to family and close friends.[2] Cultures lacking a strong rule of law make it an art form.

Fortunately, that intuition conforms to the text of the Supreme Court precedent most directly on point, *Dirks v. SEC*.[3] Justice Powell's 1983 opinion for the Court makes benefit to the tipper a crucial element of joint tipper-tippee liability, but then explicitly, if somewhat awkwardly, says the necessary benefit exists when the tip is a "gift . . . to a trading relative or friend."[4] Justice Powell—a former corporate lawyer no doubt familiar with the corrosiveness of family and crony favoritism—presumably included that language knowing full well that such behavior was a quintessential form of fiduciary breach of the duty of

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1. United States v. Salman, 792 F.3d 1087 (9th Cir. 2015), *cert. granted*, 136 S. Ct. 899 (2016).

2. On the "tunneling" of assets to friends, family, and self, see, e.g., Simon Johnson et al., *Tunneling*, 90 AM. ECON. REV. 22, 22-23 (2000); Randall Morck & Bernard Yeung, *Agency Problems in Large Family Business Groups*, 27 ENTREPRENEURSHIP THEORY & PRAC. 367, 369 (2003). On insider trading as corruption, see generally Sung Hui Kim, *Insider Trading as Private Corruption*, 61 UCLA L. REV. 928 (2014) (developing a theory of insider trading liability as a form of corruption).

3. 463 U.S. 646 (1983).

4. *Id.* at 662, 664. The *Dirks* test has two parts, the first of which is breach of fiduciary duty for personal benefit by the tipper. *Id.* at 660, 663-64. The second requires that the tippee knows or should know of that breach. *Id.* at 660. The Court gives three examples of types of benefit that satisfy the test, of which gift-giving is the third. *Id.* at 664.

loyalty.[5] *Salman*, then, should be an easy case for the Court. The Ninth Circuit got it absolutely right.

Salman is only noteworthy because the Ninth Circuit's approach to personal benefit conflicts with the Second Circuit's 2014 decision in *United States v. Newman*,[6] which offered a revisionist reading of *Dirks*, thus setting up the inconsistency in the law that the Court is now being asked to resolve. *Newman* redefines the "family and friends" benefit, limiting it to situations where there is an "exchange that is objective, consequential and represents at least a potential gain of a pecuniary or similarly valuable nature."[7] To be sure, the facts of *Salman* might satisfy even that standard given how the Kara family seems to look out for each other, but the Ninth Circuit took pains to reject entirely the Second Circuit's heavy-handed editing and Salman's reliance on it.[8]

The Government's strategy in arguing *Salman* thus seems straightforward: urge the Court to read and apply *Dirks* literally, without any gloss. It is difficult to believe that a majority of the Court really wants to announce to the world that in the struggle between fiduciary duty and family-style greed, greed wins. Insider trading enforcement is about political symbolism, a branding of American-style regulation through narratives that punish an excess of greed or abuse of privilege,[9] albeit within a doctrinal framework necessarily tied to deception in order to justify fraud liability under Rule 10b-5. The facts of *Salman* reek of arrogance and infidelity.

What makes the right advocacy strategy a bit harder is that both prosecutors and the SEC have chafed under *Dirks* since its inception and find it

5. Justice Powell would probably agree. While this Essay leaves most of the story of how *Dirks* came to be to Adam Pritchard's legal archaeology, Justice Powell apparently started from the belief that the insider-fiduciary's faithless motivation (including gift-giving) is sufficient to establish liability. A.C. Pritchard, Dirks *and the Genesis of Personal Benefit*, 68 SMU L. REV. 857, 862 (2015). The objective "personal benefit" add-on was Justice O'Connor's idea. *Id.* at 865-66. Justice Powell's elaboration of the three kinds of benefits softens this accommodation, presumably to make clear that benefit to the tipper is just evidence of corrupt intent, a category that includes family cronyism. So even Justice Powell—the founding father of tipper-tippee liability—would likely favor liability in *Salman.*

6. 773 F.3d 438 (2d Cir. 2014), *cert. denied*, 136 S. Ct. 242 (2015). *Newman* seems correct on one basic point: the tippee must be sufficiently aware of a benefit, not just that there was some kind of breach of confidentiality. *Id.* at 447-50.

7. *Id.* at 452.

8. United States v. Salman, 792 F.3d 1087, 1093 (9th Cir. 2015), *cert. granted*, 136 S. Ct. 899 (2016).

9. *See, e.g.*, Donald C. Langevoort, *Rereading* Cady, Roberts*: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1320-21 (1999). For a more recent account of both the law and the politics of insider trading enforcement, see DONALD C. LANGEVOORT, SELLING HOPE, SELLING RISK: CORPORATIONS, WALL STREET, AND THE DILEMMAS OF INVESTOR PROTECTION 64-66 (2016).

unnecessarily restrictive. Thus, while winning the case is of first-order importance, nudging the Court to endorse a flexible standard for tipper-tippee liability is also a goal. This is not just a self-serving tactic for making tipping cases easier for the government to win. The *Dirks* test has long been criticized as substantively incoherent from a wide variety of perspectives;[10] even Richard Epstein's recent neoconservative restatement of insider trading law in light of *Newman* has little good to say about it conceptually.[11] As we shall see, this test has not held up well over time.

There is much at stake here. The Second Circuit's narrowing of personal benefit was not in the intra-familial context, but instead in the murky world of selective disclosure from company insiders to analysts and portfolio managers.[12] Sometimes there are quid pro quos, sometimes not. *Newman* gave a green light to tips that lack "a pecuniary or similarly valuable nature."[13] That is frustrating to government enforcers, who see all sorts of mischief in such cronyism. Many (perhaps most) insider tips are at the very least arrogant displays of status and power: high-level insiders display their dominance, lesser ones their access. The motivation behind such displays is some diffuse combination of ego basking and the expectation that favors are often repaid. Before *Newman*, it could reasonably be assumed that these motivations fit snugly between *Dirks*' second and third types of benefits: reputational and gift-giving.[14] *Newman* implies otherwise, however. The Second Circuit's language is pernicious in a wide variety of professional settings that involve fiduciary disloyalty without any visible return promise. Under any sensible reading of *Dirks*, there should be liability when an insider plays a corrupted Santa Claus with corporate secrets, even if the relationship is not of the "best friend forever" variety.

So that frames the tactical question for the Government: how to win its case against Salman and prompt language in the opinion that repudiates *Newman* on selective disclosure and gift-giving or—even better—softens *Dirks*' insistence on personal benefit. In the hands of a thoughtful Justice, the crafting of such an opinion without doing violence to the core of the earlier precedent would not be hard. Personal benefit makes some sense because it ties tipping to trading as twin forms of fiduciary disloyalty. As noted, the cronyism of gift-based tipping puts it easily in the disloyalty category.

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10. *See* 18 DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT AND PREVENTION § 4:5 (West 2016).
11. Richard A. Epstein, *Returning to Common-Law Principles of Insider Trading After* United States v. Newman, 125 YALE L.J. 1482, 1508-10 (2016). Epstein sees *Salman* as a relatively easy case on its facts. *Id.* at 1528.
12. *Newman*, 773 F.3d at 443-44.
13. *Id.* at 452.
14. *See Dirks*, 463 U.S. at 663-64.

Justice Powell was deeply concerned with the idea of imposing liability where the tippee was unaware that the information derived from fiduciary misuse.[15] (He also held an overly rosy view of the role of investment analysts in the financial markets, writing more than a decade before recognition of the pervasiveness of analyst conflicts of interest became commonplace.[16]) But the work of providing protection to tippees who act in good faith should be left mainly to the awareness requirement, the second step in the *Dirks* test. The sensible approach is to acknowledge that fiduciary irresponsibility comes in forms both subtle and blatant, inside families and in business settings. Any disloyalty should suffice, so long as the tippee is in a position to understand that the disloyalty motivated the tip. The next two sections will elaborate on this and offer some other ideas that could be worked into an opinion making *Salman* a new and better *Dirks*.

II. The Road to *Salman*

As the foregoing comments on *Salman*, *Newman*, and *Dirks* show, insider trading law is still a work in progress. Some underappreciated turning points as the law has wobbled between an excess of ambition and undue restriction are worth noting.

Contemporary insider trading jurisprudence starts not with *Dirks* but with *Chiarella v. United States*,[17] three years earlier. There, the Court—in a seminal opinion by Justice Powell—established that insider trading liability under Rule 10b-5 derives from the insider's breach of fiduciary duty to other marketplace traders.[18] The standard doctrinal story is that the decisions in the *Chiarella* and *Dirks* cases were repudiations of the SEC's theretofore boundless "parity of information" approach to insider trading liability, supposedly promising all investors a level playing field in terms of information access.[19] But parity of information oversimplified the official position at the time, which was severely tested by the recognition that much insider trading was based on market information, the supposed lifeblood of Wall Street.[20] The SEC wanted some combination of access and awareness of impropriety to determine who could trade or not. The clearest formulation of this came in a 1971 administrative

15. *Id.* at 662-63.

16. *Id.* at 658. For a discussion of analyst conflicts and insider trading, see LANGEVOORT, INSIDER TRADING, *supra* note 10, § 11:2-3.

17. 445 U.S. 222 (1980).

18. *Id.* at 230.

19. *Chiarella* was quite clear in rejecting the parity approach. 445 U.S. at 233.

20. *See generally* Arthur Fleischer, Jr. et al., *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798 (1973) (setting forth challenges to insider trading doctrine when secrets involve knowledge of future marketplace activity, such as a tender offer).

proceeding, *In re Investors Management Co.*[21] This awareness/fairness-based approach made it easy to hold tippees liable, without much further inquiry.

Because of the subsequent reformulation of the law by the Supreme Court, that SEC opinion can be put in the historical dustbin. Not so the concurrence by Commissioner Richard Smith, who was an establishment conservative much like Justice Powell in background and demeanor. As Justice Powell would a decade later, Commissioner Smith insisted that *duty* was the key to insider trading liability.[22] Accordingly, he crafted an approach to tipper-tippee liability based on the tipper's breach of duty, with tippee liability deriving from the tipper's breach.[23] Justice Powell even explicitly gave Smith credit for this in *Dirks*.[24] But there is a key difference between the two opinions. While Smith clearly saw the insider's fiduciary duty as significant, he did not believe it was the only possible source of duty. For example, Smith said that the non-fiduciary theft of information would also violate a duty to the issuer (and thus trigger tippee liability); otherwise too troubling a loophole would be left open in insider trading law.[25]

Had Justice Powell similarly been willing to treat duty as flexible enough to extend beyond the fiduciary principle when the misuse of information was patently wrongful, tipper-tippee law would have taken a different and better course. Instead, now tightly locked into the fiduciary framework, the Court had to find a way to "fiduciarize" tippees who otherwise have no relationship with the company whose shares they are trading.[26] The solution was the two-part *Dirks* test now at issue in *Salman*. In other words, the *Dirks* test is not an ad hoc judicial expression of preferred insider trading policy but rather an effort to describe when the actions of tipper and tippee are knit together closely enough to charge the tippee with breach of the tipper's fiduciary duty. That is worth keeping in mind.

As noted earlier, the SEC and prosecutors despised the new constraints. They went to work to craft an alternative insider trading liability theory, based on misappropriation as a deceptive breach of fiduciary duty to the source of the information. Once this misappropriation theory gained traction in the lower

21. Inv'rs Mgmt. Co., Exchange Act Release No. 9267, 44 SEC Docket 633, 644 (July 29, 1971).

22. *Id.* at 649-50 (Comm'r Smith, concurring).

23. *Id.*

24. 463 U.S. at 662-63.

25. 44 SEC Docket at 650 n.2 ("A duty not to steal or knowingly receive stolen goods or exercise dominion over goods known to be owned by others exists toward the corporation even without the presence of a special relationship.").

26. 445 U.S. at 230 n.12. For this, the Court cites an ABA Committee Letter, which in turn cites *Schein v. Chasen*, 478 F.2d 817, 822 (2d Cir. 1973), *vacated on other grounds sub nom. Lehman Bros. v. Schein*, 416 U.S. 386 (1974). *Schein* addressed insider trading liability under Florida common law. *Id.* at 820; *see also* LANGEVOORT, INSIDER TRADING, *supra* note 10, § 4:8.

courts, enforcers started arguing that *Dirks'* personal benefit test did not apply at all in misappropriation cases.[27] Rather, noticing how closely the misappropriation theory resembled the analytical structure for honest services fraud under the federal mail and wire fraud statutes,[28] they argued that tippees were essentially trafficking in stolen information, so tippee liability was justifiable as long as the tippee was sufficiently aware of the taint, without regard for any insider benefit. A key win for the enforcers was *United States v. Falcone*, written by then-Judge Sotomayor, a high-profile misappropriation case where the personal benefit issue was essentially ignored.[29] Eventually, this distinction was abandoned—the Second Circuit later ruled that *Dirks* does apply to misappropriation[30]—but the stolen goods idea persists in theory and dicta.[31] As an earlier case that then-Judge Sotomayor relied on in *Falcone* had pointed out, everyone understands that the passage of valuable secrets is "not for nothing."[32] The Supreme Court should keep that in mind in *Salman* too.

Over time, the *Dirks* test itself was applied more and more liberally by the lower courts.[33] The pecuniary-benefit prong of the personal benefit test, for example, has been found satisfied not only by money but also by in-kind conveyances, including a jar of honey, live lobsters, restaurant dinners, and tickets to the musical *Jersey Boys*.[34] Nearly all courts applying the gift prong for personal benefit now at issue in *Salman* have done so liberally, with a few hinting that the simple absence of a legitimate business reason for conveying the information was enough to make it a gift tip.[35] Eventually, there was not much left to the personal benefit test except for showing *some* kind of breach by the

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27. *See* LANGEVOORT, INSIDER TRADING, *supra* note 10, § 6:13 (collecting cases).

28. 18 U.S.C. § 1341, 1343 (2015).

29. 257 F.3d 226, 234-35 (2d Cir. 2001). *Falcone* involved the improper advance distribution of copies of *Business Week* magazine, from which recipients could see what companies would be mentioned favorably or unfavorably, and trade in advance of the market-moving commentary. *Id.* at 227.

30. *See* SEC v. Obus, 693 F.3d 276, 285-88 (2d Cir. 2012).

31. *See* SEC v. Payton, 97 F. Supp. 3d 558, 562 (S.D.N.Y. 2015).

32. United States v. Libera, 989 F.2d 596, 600 (2d Cir. 1993), *cert. denied sub nom.* Sablone v. United States, 510 U.S. 976 (1993).

33. The SEC and prosecutors were emboldened to push back against the strictures of the *Dirks* test by Congress, which passed two insider trading sanction enhancements in 1984 and 1988 on an overwhelming bipartisan basis. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677; Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264. In the course of the former, a House committee expressed its hope that *Dirks* would be read narrowly so as not to exculpate bona fide insider trading abuses. H.R. REP. NO. 98-355, at 14-15 (1983).

34. LANGEVOORT, INSIDER TRADING, *supra* note 10, § 4:6 at 4-12.

35. *See, e.g.*, SEC v. Rubin, No. 91 CIV. 6531(MBM), 1993 WL 405428, at *5 (S.D.N.Y. Oct. 8, 1993).

tipper of his duty of loyalty and the tippee's awareness thereof. And as all of this was happening, the SEC's adoption of Regulation FD in 2000 took direct aim at the kind of selective disclosure to analysts that Justice Powell (naively, I think) had treated as an unqualified good.[36] In sum, *Dirks* has not held up all that well over time.

This chapter of the story culminated in *Newman*. The softening of *Dirks* happened just as there appeared to be a rapid rise in criminal prosecutions in the Southern District of New York and a lengthening of sentences for noncooperators. Even those otherwise disposed to strong insider trading enforcement raised questions about staying within the law's spirit and bounds.[37] So the pushback was no surprise, only its form and intensity. Now the Supreme Court will have its say. Is a stronger *Dirks* needed, or are there other, better ways to address the overcriminalization threat?

III. Other Directions

As noted at the end of Part I, the most satisfying way to interpret *Dirks* today is to say that any deceptive form of corruption or disloyalty by the tipper suffices under the first part of the test, leaving the work of protecting tippees who act in good faith to the second part: the awareness prong. However, the grant of certiorari in *Salman* was only on the first part of the *Dirks* test: the meaning of personal benefit in the family gift-giving setting.

Newman addressed both parts of the test. Under the facts of the case, its holding that the tippees had insufficient awareness of any breach by the tipper is palatable. But the reasoning is pernicious, insisting that prosecutors must prove that the tippee *knew* of the breach. That is not what *Dirks* says. Although *Newman* quotes *Dirks* accurately at the outset that the standard is that the tippee "knows *or should know*" of the breach and benefit,[38] everything in the court's analysis thereafter ignores the word "should." Perhaps *Newman* was thinking just about criminal prosecutions, where the added statutory burden of showing willfulness might justify the more stringent standard of proof. That would be a

36. 17 C.F.R. § 243.100 (2015). Regulation FD makes it unlawful for a high-level insider of a public company to convey material nonpublic information to an analyst, portfolio manager, or large shareholder unless that same information is publicly disclosed at the same time. *Id.*

37. *E.g.*, John C. Coffee, Jr., *Mapping the Future of Insider Trading Law: Of Boundaries, Gaps, and Strategies*, 2013 COLUM. BUS. L. REV. 281, 283-84.

38. United States v. Newman, 773 F.3d 438, 446 (2d Cir. 2014), *cert. denied*, 136 S. Ct. 242 (2015) (emphasis added) (quoting Dirks v. SEC, 463 U.S. 646, 660 (1983)). Interestingly, to "know or have reason to know" are the words Commissioner Smith used in *Investors Management*. Inv'rs Mgmt. Co., Exchange Act Release No. 9267, 44 SEC Docket 633, 649 (July 29, 1971) (Comm'r Smith, concurring).

more fitting reaction to prosecutorial zeal, but the opinion does not indicate that was its reason.[39]

It would be helpful, then, if somewhere in the *Salman* opinion the Court would offer more clarity on the tippee's required state of mind, if only to show that heavy-handedness on the personal benefit prong is unnecessary when there is a fair insistence on awareness of the breach. The Court could do even more good by framing how the inquiry into the tippee's awareness works in criminal cases as opposed to civil ones. To this day, the precise meaning of "willfulness" in securities fraud is inexcusably elusive,[40] yet it represents the most direct connection to the overcriminalization problem that so many see and that animated the Court's recent activism in pruning white-collar crime prosecutions.[41]

Beyond those helpful clarifications, is it plausible that the Court might take this occasion to be far more aggressive and rethink its insider trading jurisprudence entirely? There is much to be said, as Donna Nagy urges,[42] for jettisoning both *Chiarella* and *Dirks* as failed experiments and substituting a more flexible duty to abstain or disclose that includes information wrongfully obtained by theft and conversion—Chief Justice Burger's dissenting approach in *Chiarella*,[43] and Commissioner Smith's in *Investors Management*.[44] This Essay leaves it to Nagy to explain why this is the best way to make sense of insider trading law, especially as it is articulated in the third case of the Supreme Court's insider trading trilogy, *United States v. O'Hagan*.[45] This Court, however, may be too incrementalist for so bold an approach and is more likely to say that any flaws in the doctrinal foundation are for Congress to fix.

39. A simpler solution would have been simply to correct the trial judge, who had said that tippee knowledge need not extend to the benefit, only the breach. *See Newman*, 773 F.3d at 447-48 (discussing trial court ruling).

40. Section 32 of the Securities Exchange Act, 15 U.S.C. § 78ff (2015), makes criminal liability depend on a showing of willfulness, above and beyond the violation itself. Precisely what that means has long been unclear. *See generally* Samuel W. Buell, *What Is Securities Fraud?*, 61 DUKE L.J. 511, 555-60 (2011) (discussing the meaning of fraud for criminal prosecutions).

41. Other recent cases demonstrate a concern with white-collar crime overbreadth. *See McDonnell v. United States*, 136 S. Ct. 2355 (2016) (overturning governor's bribery conviction for overbroad interpretation of "official act"); *Yates v. United States*, 135 S. Ct. 1074 (2015) (refusing to treat disposal of fish as criminal destruction of records); and *Skilling v. United States*, 561 U.S. 358 (2010) (narrowing honest services fraud standard for corporate misbehavior).

42. Donna M. Nagy, *Beyond* Dirks*: Gratuitous Tipping and Insider Trading*, 42 J. CORP. L. (forthcoming 2016).

43. Chiarella v. United States, 445 U.S. 222, 240 (1980) (Burger, C.J., dissenting).

44. *See supra* text accompanying notes 21-25.

45. 521 U.S. 642 (1997) (upholding misappropriation theory for insider trading liability).

The possibility of a legislative solution surely will be in the Court's mind whatever it does. Since *Chiarella*, the Court has been frustrated at Congress and the SEC for leaving nearly all the fashioning of securities fraud law, particularly insider trading law, to the courts.[46] The Court will likely express this frustration yet again in *Salman*. Only Congress has the authority to do what really needs to be done: create an insider trading prohibition, not as an awkward derivative of the law of deceit, but rather as a distinct form of market abuse. Since *Newman*, efforts in that direction have begun. If the Court wanted to be entirely strategic, it could simply render a horrible decision to pressure Congress to act (what contract scholars call a penalty default interpretation).[47]

Of course, putting the law of insider trading up for political bidding is not necessarily the route to a better place. If insider trading is worth prohibiting, however, the prohibition should cover all tippees who are aware that the information has come to them in a visibly wrongful way, whether by breach of fiduciary duty, sale of the information, gratuitous conveyance, or theft. A pending bill in the House of Representatives by Congressman Jim Himes proposes a good step in this direction.[48] Above all, there should be a meaningful separation between criminal insider trading and that which can be remedied only through civil enforcement.

Legislation is for the future, however—if ever. For now, it is difficult to imagine anyone genuinely opposed to deeming what Maher Kara or Bassam Salman did unlawful insider trading.[49] Read judiciously, *Dirks* concurs. Hopefully the Court will not make a bigger mess of things by suggesting otherwise.

46. *See Chiarella*, 445 U.S. at 233-34.

47. *See, e.g.*, Scott Baker & Kimberly D. Krawiec, *The Penalty Default Canon*, 72 GEO. WASH. L. REV. 663, 664 (2004).

48. H.R. 1625, 114th Cong. § 2 (2015) (creating liability for any person who trades on material nonpublic information if such person "knows, or recklessly disregards, that such information has been obtained wrongfully, or . . . [that using it to trade securities] would constitute a wrongful use of such information").

49. Unless they think insider trading should not be unlawful in the first place.