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A Salman Swimming Downstream: Salman v. United States and Remote Tippee Liability

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Cody S. Barnett, *KLJ Articles Editor*[1]

Martin Shkreli dubiously stepped into the national spotlight as "the poster boy for greedy drug company executives."[2] Shkreli's company, Turing Pharmaceuticals, purchased a drug used for treating toxoplasmosis, a disease that can be fatal to H.I.V. patients.[3] Subsequently, Turing Pharmaceuticals raised the price of this drug from less than $20 per tablet to over $750 per tablet—a 3,750% increase.[4] As a result, Shkreli emerged as "the most reviled person in America."[5] Poor publicity, however, proved the least of Shkreli's problems. In December, the Securities and Exchange Commission charged Shkreli with securities fraud.[6]

Shkreli represents the latest public figure in the Commission's crosshairs. Recall also the Commission's investigation into Martha Stewart's "timely" stock sale in 2001.[7] Since the Great Depression, the Commission has wielded a vast arsenal in combating fraudulent market activity. Yet the outer edges of the Commission's enforcement authority remain fuzzy. Specifically, what happens when someone who receives confidential information shares that information with another party, and this third party subsequently trades on the basis of that confidential information? This October term, the Supreme Court will clarify this question in *Salman v. United States*, wherein the Court will determine what liability a downstream "remote tippee"[8] faces when trading on inside information.

In 1934, Congress enacted the Securities Exchange Act. The Act empowered the Commission to enforce several anti-fraud provisions. Section 10(b) in particular contains broad, vague language.[9] Under this sweeping authority, the Commission promulgated

Kentucky Law Journal
University of Kentucky
College of Law
Lexington, KY 40506-0048

(859) 257-4747

editors@kentuckylawjournal.org

Rule 10b-5. Rule 10b-5 delineated three categories of what constituted a "manipulative or deceptive device" under § 10(b).[10] Despite the Rule's modest beginnings,[11] Rule 10b-5 now serves as the Commission's most widely used tool in regulating insider trading.[12]

Yet neither § 10(b) nor Rule 10b-5 directly prohibit insider trading. Instead, the United States Supreme Court has developed an elaborate interpretive framework for § 10(b) and Rule 10b-5. As a result, many commentators consider Rule 10b-5 a "judicial oak which has grown from little more than a legislative acorn."[13] "[I]t is difficult to think of another instance in the entire *corpus juris* in which the interaction of the legislative, administrative rulemaking, and judicial processes has produced so much from so little."[14]

These humble roots have not stunted Rule 10b-5's growth. The Commission continually wields Rule 10b-5 against bad market actors. Targets are not just limited to interior decorators and pharmaceutical executives, either; Bassam Salman drew the Commission's ire in 2011. Salman had received a material tip on corporate information from family.[15] Maher Kara worked as an investment banker at Citigroup.[16] He provided confidential information to his brother, Mounir "Michael" Kara.[17] Michael, in turn, passed this information along to his brother-in-law, Bassam Salman.[18] By using this information, Salman was able to earn over $1.7 million.[19] Inevitably, the government realized the collusion and, in September 2011, charged Salman with securities fraud under Rule 10b-5.[20] At trial, a jury convicted Salman on all counts.[21] The Ninth Circuit Court of Appeals affirmed Salman's conviction on a theory directly conflicting with the Second Circuit Court of Appeals's decision in *United States v. Newman*.[22] This split in authority attracted the Supreme Court's attention; in January 2016, the Supreme Court granted certiorari.[23] The Court has scheduled oral argument for October 5.[24]

Salman v. United States provides a unique opportunity whereby the Supreme Court can finally address the disparate branches of the "judicial oak." For the first time, the Court will address liability for "remote tippees"—tippees who do not receive inside information from an insider, but rather from another tippee in a chain. What must the government prove when establishing liability for these downstream tippees?

The Supreme Court first confronted liability for tippees in *Dirks v. SEC*.[25] There, corporate insider Ronald Secrist disclosed corporate fraud to Raymond Dirks, an investment analyst.[26] Dirks tried investigating the claims but faced significant opposition at every turn.[27] He did, however, disclose the information to various clients.[28] These investors sold off securities in the fraudulent company just before the allegations went public and stock prices plummeted as a result.[29] The Securities and Exchange Commission subsequently censured Dirks for his role in the process, stating: "[w]here 'tippees'—regardless of their motivation or occupation—come into material 'corporate information that they know is confidential and know or should know came from a corporate insider,' they must either publicly disclose that information or refrain from trading."[30]

The Court refused to impose a general duty on tippees to disclose material information or abstain from trading. Such a broad holding would "have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market."[31] Instead, the Supreme Court held that a tippee inherits a duty to disclose or abstain only when "the insider's 'tip' constituted a breach of fiduciary duty."[32] The test for determining if an insider has breached his or her fiduciary duty turns upon "whether the insider personally will benefit, directly or indirectly, from [the] disclosure."[33] Rule 10b-5 saddles a tippee with liability only when the tippee knows about this "personal benefit" to the insider.

Dirks's holding left unanswered what to do about remote tippees. Does a tippee once, twice, even *thrice* removed from the original insider's tip need to know about that original insider's personal benefit? The Court remained silent on this point for nearly thirty years. Then along came Todd Newman. In 2012, the government charged Newman with securities fraud under Rule 10b-5.[34] Newman, however, occupied a position four times removed from the original tip.[35] Initially, corporate insider Rob Ray leaked information to analyst Sam Goyal; Goyal passed this information down to fellow analyst Jesse Tortora.[36] Tortora kept the chain going by tipping Spyridon Adondakis, and, finally, Adondakis tipped Newman.[37] Relying on *Dirks*, Newman advanced two arguments. First, Newman argued that Ray, the insider, did not personally benefit from starting the tipping chain.[38] Second, even if Ray did benefit, the government did not demonstrate that Newman, the remote tippee, *knew* that Ray personally benefited.[39] The Second Circuit agreed.

First, the Second Circuit narrowly defined "personal benefit." The government must demonstrate the insider's personal benefit by showing that "the [insider] 'is in effect selling the information to its recipient for cash, reciprocal information, or other things of value for himself.'"[40] The government adduced evidence demonstrating a close relationship between Ray and Goyal, but the court held that a close relationship alone would not suffice.[41] Although the court stated "personal benefit is broadly defined to include not only pecuniary gain, but also . . . any reputational benefit that will translate into future earnings and the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend," this definition does not permit an inference of a personal benefit from a close relationship without further showing "an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[42]

Second, a remote tippee, such as Newman, must know about the *original* insider's personal benefit.[43] No matter how far down the chain, the Second Circuit judged *mens rea* based on the original "tip." Thus, the court held that "without establishing that the tippee knows of the personal benefit received by the insider in exchange for the disclosure, the Government cannot meet its burden of showing that the tippee knew of a breach."[44] The government did not produce any evidence showing that Newman knew that Ray, the insider, would

derive any benefit from Goyal, the original tippee.[45] Thus, Newman's sentence could not stand.[46]

Re-enter our friend, Bassam Salman. The Second Circuit handed down *Newman* while Salman awaited appeal. Salman surely thought that *Newman* provided a silver bullet for his own appeal. Alas, the Ninth Circuit wore body armor. The Ninth Circuit did not read "personal benefit" so narrowly. Recalling language in *Dirks* glossed over by the Second Circuit, the Ninth Circuit noted that a personal benefit "also exist[s] when an insider makes a gift of confidential information to a trading relative or friend."[47] The Ninth Circuit thus declined to follow *Newman* and held that a close relationship between the insider and original tippee *could* stand alone and satisfy the personal benefit requirement.[48]

Salman's argument faces serious challenges. The Ninth Circuit correctly followed the plain language in *Dirks*. The Supreme Court clearly contemplated comity gifts as a personal benefit.[49] Limiting a personal benefit to only pecuniary gain or quid pro quo exchanges undermines *Dirks*'s spirit. After all, the Court in *Dirks* established liability when an insider's tip violated the insider's duty of loyalty to the corporation. Thus, the Court focused not so much on measuring any tangible gain but rather on the motive underlying the original tip.

Furthermore, the Court's current composition cuts against Salman. Justices Ginsburg, Kennedy, and Breyer previously endorsed an expansive insider trading liability theory in *United States v. O'Hagan*.[50] Justice Sotomayor also recognized broad insider trading liability when she served as a judge on the Second Circuit.[51] These four justices already gridlock the Court. Given his prosecutorial background, Justice Alito could easily provide the fifth vote needed for a majority opinion expansively construing insider trading liability.[52]

Salman might place some hope in Justice Thomas, as Thomas dissented from the Court's holding in *O'Hagan*.[53] More recently, Justice Thomas joined Justice Scalia's concurring comment in a denial of certiorari from a Rule 10b-5 prosecution.[54] There, Justice Scalia posited two concerns with Rule 10b-5's continual expansion.[55] First, he noted a problem with separation-of-powers.[56] Legislatures define crimes, not the executive agencies and the courts.[57] Defining tippee liability through the common law might offend this notion.[58] As noted, Rule 10b-5 exists primarily as a "judicial oak which has grown from little more than a legislative acorn."[59] Second, Justice Scalia suggested Congress had inadequately defined criminal liability under the Securities Exchange Act of 1934.[60]

The Supreme Court's clumsy approach to an already-awkward statutory text needs to be clarified. *Salman* provides the Court an opportunity to prune the "judicial oak's" arthritic branches. After all, Salman represents the classic "bad actor." He schemed to use inside information toward his own advantage. Just because the original information exchange did not necessarily produce a pecuniary benefit to the corporate insider does not mean that Salman should walk away unscathed. The Court should devise a downstream "remote liability" test that effectively captures Salman's conduct. When doing so, however, the

Court should take Justice Scalia's concerns in *Whitman* seriously. A vague criminal sanction —created entirely by the judiciary and an administrative agency—poses serious constitutional deficiencies. Professor Richard Epstein has offered a simple solution: "[T]he sole violation that matters is the deliberate use or sharing of information contrary to the wish of the firm that has supplied it in the first place. These unauthorized uses should impose liability on the immediate recipient and any person who takes with knowledge of the illegal release."[61]

Justice Blackmun once dubbed the Second Circuit as the "justifiably esteemed panel . . . [and] 'Mother Court' in . . . [securities] law."[62] Yet the Second Circuit's opinion in *Newman* is seemingly at odds with the remote tippee liability described in *Dirks*. Furthermore, the Second Circuit's rule threatens market efficiency by weakening investor confidence in confidentiality. A tightened "personal benefit" requirement distracts from the main issue. Therefore, the Supreme Court should use *Salman v. United States* as a vehicle to clarify downstream remote tippee liability and just what constitutes a "personal benefit" under the *Dirks* standard.

[1]J.D. expected May 2017.

[2]Kelefa Sanneh, *Everyone Hates Martin Shkreli. Everyone is Missing the Point*, The New Yorker (Feb. 5, 2016), http://www.newyorker.com/culture/cultural-comment/everyone-hates-martin-shkreli-everyone-is-missing-the-point (quoting Congressman Elijah Cummings).

[3]*Id.*

[4]*Id.*

[5]*Id.*

[6]Press Release, Sec. & Exch. Comm'n, SEC Charges Martin Shkreli with Fraud (Dec. 17, 2015), https://www.sec.gov/news/pressrelease/2015-282.html.

[7]Ultimately, the government charged Martha Stewart with obstruction of justice rather than insider trading under Rule 10b-5. *Corporations and Society: Developments in the Law*, 117 Harv. L. Rev. 2169, 2178–79 (2004).

[8]Insider trading cases typically feature two parties: an insider and a tippee. The insider possesses pertinent undisclosed public information because of his or her proximity to a corporate entity. The insider leaks this information to a tippee. The tippee, in turn, trades on this nonpublic information. However, "remote tippees" enter the picture when the original tippee subsequently becomes a tipper and informs someone else. Thus, a "remote tippee" represents someone outside the original information exchange who nonetheless receives that information in a chain of tipping.

[9]15 U.S.C. § 78(j) (2016) ("It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails . . . to use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary . . . .").

[10]17 C.F.R. § 240.10b-5 ("It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails . . . (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to 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.").

[11]An apocryphal tale recounts Rule 10b-5's origins. Rule 10b-5 emerged when Securities and Exchange Commission members gathered around a table, passed the proposed Rule language around, and then tossed the note on the table in approval. After some silence, Commissioner Sumner Pike simply said: "Well, we are against fraud, aren't we?" Francisco A. Loayza, *The Remote Tippee Dilemma: Resolving Tippee Liability More Than Thirty Years After Dirks v. SEC*, 56 Cal. W. L. Rev. 109, 115 (2015).

[12]*Id.*

[13]Blue Chips Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975).

[14]Steve Thel, *Taking Section 10(b) Seriously: Criminal Enforcement of SEC Rules*, 2014 Colum. Bus. L. Rev. 1, 2 (2014) (quoting 7 Louis Loss, Joel Seligman & Troy Paredes, Securities Regulation 498 (4th ed. 2006)).

[15]Adam Liptak, *Supreme Court Will Hear a California Insider Trading Case*, N.Y. Times (Jan. 19, 2016), http://www.nytimes.com/2016/01/20/business/supreme-court-agrees-to-hear-insider-trading-case.html?_r=0.

[16]United States v. Salman, 792 F.3d 1087, 1088 (9th Cir. 2015).

[17]*Id.* at 1089.

[18]*Id.*

[19]*Id.*

[20]*Id.* at 1088.

[21]*Id.* at 1090.

[22]773 F.3d 438, 443 (2d Cir. 2014).

[23]Salman v. United States, 136 S. Ct. 899 (2016).

[24]Amy Howe, *Supreme Court Releases Calendar for October Sitting*, SCOTUSBlog (Jul. 14, 2016,
3:42 PM), http://www.scotusblog.com/2016/07/supreme-court-releases-calendar-for-october-sitting/.

[25]436 U.S. 646 (1984).

[26]*Id.* at 648–49.

[27]*Id.* at 649.

[28]*Id.*

[29]*Id.* at 650.

[30]*Id.* at 651 (citations omitted).

[31]*Id.* at 658. The Court reaffirmed an earlier holding in *Chiarella v. United States*: "A duty [to disclose] arises from the relationship between parties . . . and not merely from one's

ability to acquire information because of his position in the market." *Id.* (quoting Chiarella v. United States, 445 U.S. 222, 231–32 n.14 (1980)).

[32] *Id.* at 661.

[33] *Id.* at 663.

[34] United States v. Newman, 773 F.3d 438, 443 (2d Cir. 2014).

[35] *Id.*

[36] *Id.*

[37] *Id.*

[38] *Id.* at 444.

[39] *Id.*

[40] *Id.* at 450 (quoting Dirks v. SEC, 436 U.S. 646, 664 (1984)).

[41] *Id.* at 452.

[42] *Id.*

[43] *Id.* at 447–48.

[44] *Id.* at 448.

[45] *Id.*

[46] *Id.*

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

[48] *Id.* at 1093.

[49] Dirks v. SEC, 436 U.S. 646, 664 (1984) (finding a personal benefit when "an insider makes a gift of confidential information to a trading relative or friend").

[50] 521 U.S. 642 (1997).

[51] United States v. Falcone, 257 F.3d 226 (2d Cir. 2001).

[52] One commentator has called Rule 10b-5 the vehicle whereby federal courts started "facilitating pro-prosecutorial efforts against insider trading." Michael H. Dessent, *Joe Six-Pack, United States v. O'Hagan, and Private Securities Litigation Reform: A Line Must Be Drawn*, 40 Ariz. L. Rev. 1137, 1142 (1998).

[53] *O'Hagan*, 521 U.S. at 680 (Thomas, J., concurring in the judgment in part and dissenting in part).

[54] Whitman v. United States, 135 S. Ct. 352 (2014).

[55] *Id.*

[56] *Id.* at 353.

[57] *Id.*

[58] *Id.*

[59] Blue Chips Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975).

[60] *Whitman*, 135 S. Ct. at 354.

[61] Richard Epstein, *Returning to Common Law Principles of Insider Trading after United States v. Newman*, 125 Yale L. J. 1482, 1530 (2016) (describing a constructive trust theory of insider trading).

[62] *Blue Chips Stamps*, 421 U.S. at 762 (Blackmun, J., dissenting).

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