IT'S ALL DERIVATIVE: INSIDER TRADING WITHOUT A PERSONAL BENEFIT

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INTRODUCTION

The Supreme Court recently weighed different interpretations of insider trading liability in *Salman v. United States*.[1] The first piece of this two-part series dealt with the arguments of the parties and the muddled case law.[2] Courts have struggled with conflicting interpretations of the "classical theory" of insider trading as stated in the seminal case of *Dirks v. SEC*.[3] The previous uncertainty in cases such as *Salman* comes from the following question: under what circumstances can a tippee (a person receiving confidential corporate information) be held liable for insider trading?[4] *Dirks* held that the test to trigger liability is whether the corporate insider will in some way personally benefit from his disclosure to the tippee.[5] It also held that liability derivatively extends to the tippee only if the tippee has reason to know that the information was disclosed in breach of a fiduciary duty.[6] The Court in *Salman*, by simply reaffirming *Dirks*, missed an opportunity to significantly clarify tippee liability. While *Salman* involved a close relationship between brothers-in-law, lower courts will continue struggling to define whether a more remote relationship is sufficient to satisfy *Dirks*' "personal benefit" test.[7]

This piece discusses tippee liability under *Dirks* and argues that the

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[1] Salman v. United States, 137 S. Ct. 420 (2016).

[2] Raphael Davidian, Tips with Benefits: Insider Trading at Oral Arguments in *Salman*, 54 AM. CRIM. L. REV. ONLINE 1 (Nov. 7, 2016), http://www.americancriminallawreview.com/aclronline/tips-benefits-insider-trading-oral-arguments-salman/.

[3] Dirks v. SEC, 463 U.S. 646 (1983).

[4] *See* United States v. Newman, 773 F.3d 438, 452 (2d Cir. 2014) (holding that an exchange for the confidential information must be "objective, consequential, and represent[] at least a potential gain of a pecuniary or similarly valuable nature."). *But see* United States v. Salman, 792 F.3d 1087, 1093 (9th Cir. 2015) (holding that a tipper's "close familial relationship" with the tippee, when providing confidential information, suffices for tippee liability).

[5] *Dirks*, 463 U.S. at 662 (holding that "the test is whether the insider personally will benefit, directly or indirectly, from his disclosure.").

[6] *Id.* at 660 (stating that, absent a breach by the insider, the duty does not derivatively extend to the tippee and, furthermore, liability extends only when "the tippee knows or should know" that the tipper breached his duty).

[7] *Id.* at 664 (stating that a juror can infer that the insider received a personal benefit when making "a gift of confidential information to a trading relative or friend.").

Court in *Salman* should have read *Dirks* through the lens of the subsequent case, *United States v. O'Hagan*, rather than repeat a similarly imprecise ruling. In doing so, the Court could have incorporated useful elements of the "misappropriation theory" of liability for tippees.

I. TIPPEE LIABILITY UNDER *DIRKS V. SEC*

The Court in *Salman* properly rejected both the Government's broad "lack of corporate purpose" test, which finds "personal benefit" any time that "corporate purpose" is lacking,[8] and Salman's narrow "pecuniary benefit" test, which requires a tangible benefit or potential for a financial benefit in order to find "personal benefit."[9] The Government's sweeping standard—as stated in its briefs[10]—would have given the Securities and Exchange Commission ("SEC") nearly unlimited discretion to prosecute even the most remote tippee by inferring personal benefit in almost every circumstance.[11] On the other hand, the Court could not have adopted Salman's proposed standard—which required that the insider actually benefit, mirroring the Second Circuit's requirement articulated in *United*

[8] Salman v. U.S., 137 S. Ct. 420, 426 (2016) (stating the Government's broad view under which "a tipper personally benefits whenever the tipper discloses confidential trading information for a noncorporate purpose."). The Government's "lack of corporate purpose" test would reinstate the rejected rule that the market requires equal information among all traders, and would extend liability to insiders that inadvertently disclosed the information or believed that it was already public. *See Dirks*, 463 U.S. at 662, 674 n.22.

[9] *Salman*, 137 S. Ct. at 426 (stating Salman's narrow view under which a "tipper does not personally benefit unless the tipper's goal in disclosing inside information is to obtain money, property, or something of tangible value.").

[10] Brief for the United States at 27, *Salman*, 137 S. Ct. 420 (No. 15-628) (arguing that "*Dirks*'s personal-benefit test encompasses a gift to *any* person with the expectation that the information will be used for trading, not just to a 'trading relative or friend.'" (quoting *Dirks*, 463 U.S. at 664)).

[11] *See*, *e.g.*, SEC v. Blackwell, 291 F. Supp. 2d 673, 692 (S.D. Ohio 2003) ("A mere allegation that the insider has disclosed material non-public information is sufficient to create a legal inference that the insider intended to provide a gift to the recipient of the information, thereby establishing the personal benefit requirement."); SEC v. Blackman, No. 3:99-1072, 2000 WL 868770, at *9 (M.D. Tenn. 2000) ("[T]he mere fact of [a tipper's] disclosure of . . . information sufficiently alleges a gift by him . . . so as to satisfy the personal benefit requirement of *Dirks*."); SEC v. Rubin, No. 91 Civ. 6531 (MBM), 1993 WL 405428, at *5 (S.D.N.Y. Oct. 8, 1993) (fact that tippee was tipper's broker was sufficient to create inference of personal benefit "absent evidence of an identifiable proper motive to disclose the information in question"). At oral argument, the Deputy Solicitor General appeared to add a refinement to the "corporate purpose" test, namely breach of "duty of loyalty." Transcript of Oral Argument at 29, *Salman* , 137 S. Ct. 420 (No. 15-628). This potentially less-absolutist approach is instructive. The duty of loyalty, and concomitant breach by use for personal reasons, can be rightly read into *Dirks* and its progeny.

States v. Newman[12]—because "deception" and "manipulation" constitute insider trading, but do not necessarily require a pecuniary gain.[13] The Court's extensive discussion about "gifts of information" in *Dirks* also indicates that the Court contemplated situations not involving pecuniary gain to trigger liability.[14]

While some language in *Dirks* may support each of the parties' conclusions, the Court should have returned to the principles that predate its ill-fated attempt to circumscribe "personal benefit." These principles stand for the proposition that although a personal benefit may often accompany a breach of fiduciary duty, a finding of personal benefit should not be substituted wholesale for broader consideration of whether a breach of duty occurred. In short, courts should look to whether there is an existence of a duty rather than personal gain. It is true that the most common breach of duty is for personal gain, but it is not the only one.[15] *Dirks* appears, at times, to wrongly make personal benefit a necessary condition of a breach.[16] *Salman* merely reaffirms the language in *Dirks* that a personal benefit may be inferred when the tip is made to a trading relative or friend.[17] The difficulty with this reasoning is that shareholders are injured by the insider's misuse of nonpublic information in breach of his duty, regardless of whether the insider actually benefitted.[18] In addition, *Salman's* holding leaves open the question of just how close the relationship between the tipper and tippee must be.[19] This vagueness

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[12] United States v. Newman, 773 F.3d 438, 452 (2d Cir. 2014) (holding that such an exchange must be "objective, consequential, and represent[] at least a potential gain of a pecuniary or similarly valuable nature.")

[13] *Dirks* 463 U.S. at 654 (1983) ("There must also be 'manipulation or deception.'") (quoting Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 473). "In an inside-trading case this fraud derives from the 'inherent unfairness involved where one takes advantage' of 'information intended to be available only for a corporate purpose and not for the personal benefit of anyone.'" *Dirks*, 463 U.S. at 654. (quoting *In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933, 936 (1968)).

[14] *Dirks*, 463 U.S. at 664.

[15] "[The insider] would have a duty not to take a position adverse to [the shareholders], not to take secret profits at their expense, not to misrepresent facts to them, and in general to place their interests ahead of his own." *Dirks*, 463 U.S. at 674 n.4 (Blackmun, J., dissenting) (quoting *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961)).

[16] *Dirks*, 463 U.S. at 668 (Blackmun, J., dissenting) ("The [personal benefit test] employed in this case engrafts a special motivational requirement on the fiduciary duty.").

[17] Salman v. U.S., 137 S. Ct. 420, 427 (2016) (holding that a personal benefit "'also exists when an insider makes a gift of confidential information to a trading relative or friend.'" (quoting *Dirks*, 463 U.S. at 664)).

[18] *Dirks*, 463 U.S. at 673–74 (Blackmun, J., dissenting) ("The fact that the insider himself does not benefit from the breach does not eradicate the shareholder's injury."). "Although [the] general motive to expose the [company] fraud was laudable, the means he chose were not." *Id.* at 677.

[19] *Salman*, 137 S. Ct. at 427 (instructing lower courts to "focus on objective criteria, i.e., whether the insider receives a direct or indirect personal benefit from the

may result in arbitrary lower court decisions that can leave analysts and market participants uncertain of whether their research and trading activities will result in criminal prosecution.

Several prominent securities law scholars support this view that a personal benefit should not be the center of attention when discerning tippee liability.[20] According to these scholars, tippee liability should turn on whether the corporate information was disclosed in a disloyal manner.[21] As Professor Langevoort explains, tippees that act in good faith and without constructive notice of the tipper's disloyal disclosure would be protected under the second prong in *Dirks*.[22] Similarly, an inquiry about on whether a personal benefit is conveyed is unnecessary when the tippee has reason to know that the tipper breached a duty.[23]

II. *DIRKS* THROUGH THE LENS OF *O'HAGAN*

In *O'Hagan*, the Court complemented *Dirks* with an additional theory that finds liability for other disloyal actions of persons in fiduciary positions.[24] There, a lawyer who was advising the acquiring company in a tender offer misappropriated information about the upcoming merger by buying stock of the target company.[25] Despite the fact that the lawyer did not have a direct fiduciary duty to the target company, the Court found a breach of a duty of loyalty and confidentiality because the target was the source of the information.[26]

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disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings." (quoting *Dirks*, 463 U.S. at 663)).

[20] Zachary J. Gubler, A Unified Theory of Insider Trading Law, GEO. L. J. (forthcoming 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2832863; Donald C. Langevoort, Informational Cronyism, 69 STAN. L. REV. ONLINE 37 (2016); Donna M. Nagy, Beyond Dirks: Gratuitous Tipping and Insider Trading, 42 J. CORP. L. 1 (2016), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2665820.

[21] *See* Langevoort, *supra* note 20, at 40 (arguing that "[a]ny disloyalty should suffice, so long as the tippee is in a position to understand that the disloyalty motivated the tip."); Nagy, *supra* note 20, at 61–66.

[22] Langevoort, *supra* note 20, at 40 ("providing protection to tippees who act in good faith should be left mainly to the awareness requirement, the second step in the *Dirks* test.").

[23] *Id.* at 44 (stating that it would be helpful if the Court could clarify the required state of mind for liability, "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.").

[24] United States v. O'Hagan, 521 U.S. 642, 652 (1997) ("The two theories are complementary, each addressing efforts to capitalize on nonpublic information through the purchase or sale of securities.").

[25] *Id.*

[26] *Id.* at 652–53 ("[T]he misappropriation theory outlaws trading on the basis of nonpublic information by a corporate 'outsider' in breach of a duty owed not to a trading party, but to the source of the information.). "Under [the misappropriation] theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds

The Court emphasized the motivating principle behind the rules at issue: to "protect the integrity of the securities market [against those] who have access to confidential information" and can misappropriate it.[27] At oral argument in *Salman*, Justice Kagan emphasized the importance of preserving the integrity of the securities markets and cautioned the Court against deviating from a thirty-year-old precedent absent any legislative action.[28] However, elements of the more recently articulated misappropriation theory in *O'Hagan* could have been applied to *Salman*, thereby establishing a more perspicuous rule of law—consistent with both legislative intent and judicial precedent.

The "misappropriation theory" articulated in *O'Hagan* applies §10(b) of the Exchange Act and the holding in *Dirks* to traders who have no direct fiduciary duty to the corporation.[29] The Court, under this well-established precedent, should be able to hold a tippee liable under the theory that the tippee inherits the insider's duty to the source of the confidential information, if he has reason to know that it was disclosed without consent of the corporation.[30]

III. APPLICATION OF DERIVATIVE LIABILITY TO REMOTE TIPPEES IN *SALMAN* AND BEYOND

The Court in *Salman* was not presented with the issue of whether a personal benefit is necessary under both the classical and the misappropriation theory, or just the former.[31] This crucial distinction, however, may be the missing piece to the vexing framework of tippee liability in insider-trading law.[32] While the Court in the future may look to analyze insider-trading cases solely under either the "classical theory" or the "misappropriation theory," both are instructive.[33] *Dirks*, in

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the principal of the exclusive use of that information.") *Id.* at 652.

[27] *Id.* at 653.

[28] Transcript of Oral Argument, *supra* note 11, at 21.

[29] *O'Hagan*, 521 U.S. at 653 ("The misappropriation theory is thus designed to "protec[t] the integrity of the securities markets against abuses by 'outsiders' to a corporation who have access to confidential information that will affect th[e] corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders." (quoting Brief for United States at 14, *U.S. v. O'Hagan*, 1997 WL 86306 (U.S.) (No. 96-842) (alteration in original))).

[30] *Id.* at 652–53.

[31] *Salman*, 137 S. Ct. 420, 429 n.2 (2016) (stating that since "[t]he parties do not dispute that *Dirks*'s personal-benefit analysis applies in both classical and misappropriation cases, [the Court] will proceed on the assumption that it does.").

[32] *See* SEC v. Obus, 693 F.3d 276, 285–88 (2d Cir. 2012) (holding that *Dirks'* personal benefit test also applies to the misappropriation theory. *But see* SEC v. Payton, 97 F. Supp. 3d 558, 562 (S.D.N.Y. 2015) (discussing whether the Second Circuit's interpretation in *Newman*—that a personal benefit inquiry is required under the misappropriation theory—was dicta, but ultimately deciding it was binding).

[33] United States v. O'Hagan, 521 U.S. 642, 653–54 (1997) ("The two theories are

applying the classical theory, noted that when an insider tipper has a fiduciary duty to the corporation and its shareholders, a tippee will "assume[] [the] fiduciary duty" of the insider.[34] Under the misappropriation theory, a remote tippee should likewise be able to inherit and violate a fiduciary duty when entrusted with material, nonpublic information knowing that it was disclosed without consent of the source of the information.[35]

The company's confidential information is property to which the company has a right to exclusive use,[36] and a tipper effectively has a fiduciary duty to the company because he is acting as a trustee of that information.[37] When the tipper misappropriates the confidential information by secretly disclosing it to a tippee, and the tippee has reason to know that it was disclosed in breach of the tipper's fiduciary duty to the source of the information, the tippee should inherit the tipper's duty.[38] The classical theory is consistent with this notion that a duty can be derivative so long as the tippee has reason to know that the information was disclosed without permission from the source of the information.[39] Hence, a chain of fiduciary duty could accompany the chain of information disclosure under both theories.

O'Hagan—in laying out the motivation for the misappropriation theory—emphasizes that the justification for this theory is protection of the securities market as a whole.[40] This principle underlies the SEC's jurisdictional mandate in § 10(b) of the Exchange Act of 1934.[41] The

complementary . . . . The classical theory targets a corporate insider's breach of duty to [the corporation and its] shareholders . . . the misappropriation theory outlaws trading on the basis of nonpublic information by a corporate 'outsider' in breach of a duty owed not to a trading party, but to the source of the information.").

[34] *Dirks*, 463 U.S. at 660 ("Thus, a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information . . . .").

[35] *O'Hagan*, 521 U.S. at 655 (stating that "the deception essential to the misappropriation theory involves feigning fidelity to the source of information . . . .").

[36] *Id.* at 654 (stating that "a company's confidential information . . . qualifies as property to which the company has a right of exclusive use.").

[37] *Id.* at 654 (stating that "'a trustee may not use the property that [has] been entrusted [to] him'" unless the source of the information consents (quoting Transcript of Oral Arg. at 12, *O'Hagan,* 521 U.S. 642 (No. 96-842).

[38] *Id.* at 656 (noting that a misappropriator "deceives the source of the information and simultaneously harms members of the investing public").

[39] *Id.* at 663 (stating that "*Dirks* thus presents no suggestion that a person who gains nonpublic information through misappropriation in breach of a fiduciary duty escapes []liability when, without alerting the source, he trades on the information.").

[40] *Id.* at 658 ("[I]nvestors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law."). *Id.* at 657 ("The Exchange Act was enacted in part 'to insure the maintenance of fair and honest markets.").

[41] Under this analysis, a remote tippee could be guilty of, "us[ing] . . . [a] manipulative or deceptive device" in contravention of S.E.C. rules designed for the "protection of investors." 15 U.S.C. § 78j(b).

Court's decision, on the other hand, leaves open the question of how close the relationship between the tipper and tippee must be.[42] Under a derivative liability approach, no analysis of familial relationships or attenuated "personal benefit" is necessary.

In *Salman*, the initial tipper—Maher—misappropriated confidential information that belonged to the corporation he was representing by disclosing it to the tippee—his brother Michael. Michael, knowing that Maher had disclosed the information in breach of his fiduciary duty of confidentiality became derivatively liable once he traded on the information. Michael consequently relayed the information to Salman—the ultimate remote tippee—who likewise inherited a fiduciary duty to the corporation because he knew or should have known that Maher disclosed it in breach of his duty. It is imperative that the Court's analysis focus on whether the insider and remote tippee breached their fiduciary duty of confidentiality, instead of attempting to characterize the relationship between the tipper and tippee. The Court should have extended this approach to remote tippee cases, and held the tippee derivatively liable, presuming that he had reason to know that the information was disclosed in breach of a fiduciary duty.[43] Salman, knowing that the information came from Maher,[44] should be held liable because he inherited Maher's fiduciary duty of confidentiality to the source of information.[45] His disloyal actions violated a core purpose of the Exchange Act—to protect investors in the securities market.[46]

[42] Salman v. United States, 137 S. Ct. 420, 427 (2016) (instructing "courts to 'focus on objective criteria'" (quoting Dirks v. SEC, 463 U.S. 663 (1983))). However, focusing on the relationships between the tipper, tippee, and remote tippee would remove the more significant inquiry of whether a fiduciary duty subsequent to the initial tipper's exists, since liability would continue to pass as long as the tip continues to be disclosed between people holding a close enough relationship.

[43]Dirks v. SEC, 463 U.S. 646, 660 (1983) ("Tippee assumes a fiduciary duty . . . not to trade on material nonpublic information only when the insider has breached his fiduciary duty . . . by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.").

[44] Brief for Petitioner at 9, *Salman*, 137 S. Ct. 420.(No. 15-628).

[45] Brief for the United States, *supra* note 10, at 7. ("Petitioner also knew that Maher's disclosures were illicit . . . and offered to shred the papers.").

[46] 15 U.S.C. § 78j(b).