THE REVIEW OF
SECURITIES & COMMODITIES REGULATION
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 50 No. 19 November 8, 2017

THE IMPACT OF *SALMAN V. UNITED STATES* ON DOWNSTREAM TIPPEE PROSECUTIONS

In Salman v. United States*, the Supreme Court held that a tipper receives a personal benefit sufficient to establish illegal insider trading when the tipper makes a gift of confidential information to a trading relative or friend.* Salman *did not address, however, the question of what level of knowledge a downstream tippee must possess of the personal benefit the tipper received in order to be held liable for insider trading. The authors address how district courts have analyzed the question of what downstream tippees must know to be held liable for insider trading after* Salman *and* Salman*'s continued impact on this question going forward.*

By Brian A. Jacobs and Priya Raghavan *

In *Salman v. United States*,[1] the Supreme Court held that a tipper receives a "personal benefit" sufficient to be guilty of illegal insider trading when the tipper makes a gift of confidential information to a trading relative or friend. *Salman* explained that "[i]n such situations, the tipper benefits personally because giving a gift of trading information is the same thing as trading by the tipper followed by a gift of the proceeds."[2] *Salman* thus abrogated the Second Circuit's holding in *United States v. Newman*[3] that a personal benefit can be found only where the relationship between the tipper and tippee is "meaningfully close," and the exchange generates potential pecuniary or similar gain for the tipper. Following *Salman*, numerous commentators analyzed open questions that remained, including the extent to which *Newman*'s requirement that tippers and tippees have a "meaningfully close personal relationship" survived *Salman*, if at all.[4] Then, in *United States v.*

[1] 137 S. Ct. 420 (2016).

[2] *Id.* at 428.

[3] 773 F.3d 438, 452 (2d Cir. 2014).

[4] McBride, Scott B., Salman v. United States *and its Impact on Insider Trading Enforcement*, The Review of Securities and

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RSCR Publications LLC Published 22 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $1,197 per year in U.S., Canada, and Mexico; $1,262 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call (937) 387-0473 or visit our website at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@gmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail sarah.s.himmelfarb@gmail.com. To submit a manuscript for publication contact Ms. Himmelfarb. ISSN: 0884-2426.

Martoma,[5] a divided panel of the Second Circuit held that "*Salman* fundamentally altered the analysis underlying *Newman*'s 'meaningfully close personal relationship' requirement such that the 'meaningfully close personal relationship' requirement is no longer good law."[6]

In this article, we limit our analysis to a specific issue that remains unclear in the wake of *Newman*, *Salman*, and *Martoma*: the impact of these cases on the question of what level of knowledge of the benefit *downstream* tippees must possess to be guilty of insider trading. In *Newman*, in a secondary holding that was not at issue in *Salman* or *Martoma*, the Second Circuit reaffirmed the principle that a tippee is guilty of insider trading only where the "tippee knew of the tipper's breach; that is, he knew the information was confidential and divulged for personal benefit."[7] Although neither *Salman* nor *Martoma* expressly addressed this "knowledge of the benefit" requirement, their holdings with respect to what constitutes a benefit in the first place necessarily impact the level of knowledge that downstream tippees must be found to possess.

Just as *Salman* makes plain that a personal benefit may be inferred when a tipper makes a gift of confidential information in the context of a family or friend relationship, so too *Salman* may mean that — at least in cases involving such a relationship — the *downstream* tippee needs only to have knowledge of the nature of that relationship to have "knowledge of the benefit" sufficient to be found guilty of insider trading. By the same token, in cases that do not involve a family or friend relationship between the original tipper and tippee, the requirement that a downstream tippee have knowledge of the benefit may be more challenging for the government to satisfy. *Martoma* further complicates this question by emphasizing that a personal benefit only lies where "the insider discloses inside information 'with the expectation that [the recipient] would trade on it.'"[8] Thus, following *Martoma*, the government will likely need to show that a downstream tippee had knowledge that the original tipper expected the recipient of inside information to trade on it in order for the downstream tippee to be guilty of insider trading. In this article we review some of the initial cases that have addressed these issues and discuss the challenges for prosecutors and defendants going forward.

I. INSIDER TRADING LAW: *DIRKS*, *NEWMAN*, AND *SALMAN*

Prior to *Salman*, the Supreme Court addressed insider trading liability in *Dirks v. S.E.C.*, and set forth the test for when an insider's disclosure of information constitutes a breach of a fiduciary duty sufficient to give rise to insider trading liability: whether a breach occurs depends on "whether the insider personally will benefit, directly or indirectly, from his disclosure."[9] The Court explained that such a breach of duty occurs where it can be inferred that 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."[10] The Court gave a few examples of situations that could justify such an inference, including where the relationship between the insider and the recipient suggests a quid pro quo, or where the insider makes a gift of confidential information to a trading relative or friend. The Court also made clear in *Dirks* that a tippee can assume a fiduciary duty to the shareholders of a corporation not to trade on material

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Commodities Regulation, May 24, 2017; Antonia M. Apps, *The Significance of '*U.S. v. Blaszczak*' for Insider Trading Prosecutions*, New York Law Journal, June 8, 2017 (*available at* http://www.newyorklawjournal.com/id=1202789094446/The-Significance-of-US-v-Blaszczak-for-Insider-Trading-Prosecutions).

[5] No. 14-3599, --- F.3d ----, 2017 WL 3611518 (2d Cir. August 23, 2017).

[6] *Id.* at *7.

[7] *Newman*, 773 F.3d at 450.

[8] 2017 WL 3611518, at *8 (quoting *Salman*, 137 S. Ct. at 428) (alterations in *Martoma*).

[9] *Dirks v. S.E.C.*, 463 U.S. 646, 662 (1983).

[10] *Id*. at 663.

nonpublic information only where the tippee "knows or should know that there has been a breach."[11]

More than 20 years later, the Second Circuit interpreted and expounded on the *Dirks* test in *United States v. Newman*, in which defendants Todd Newman and Anthony Chiasson appealed their convictions for insider trading. In *Newman*, the defendants allegedly received inside information when company insiders tipped information to analysts, who relayed the information to other analysts, who provided the information to the defendants.

In construing *Dirks*, *Newman* made two significant holdings. First, the Second Circuit held that, to the extent that *Dirks* suggested that a personal benefit could be inferred from a personal relationship between a tipper and tippee, such an inference is impermissible in the absence of "proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[12] The Second Circuit concluded that although the government had established that the tippers and tippees were friends, the scant evidence of "meaningfully close" relationships or any potential gain of a pecuniary or similarly valuable nature was insufficient to permit the inference of a personal benefit to the tippers.

Second, the Second Circuit also held, following *Dirks*, that a tippee could be found liable for insider trading only where the "tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit,"[13] and still used that information to trade. The court explained that, in addition to the lack of personal benefit to the tippers, tippees Newman and Chiasson were unaware of any personal benefit to the tippers, and were unaware that the information originated with corporate insiders; therefore, they did not assume the fiduciary duties of the tippers and did not commit the crime of insider trading.

Following *Newman*, the Supreme Court addressed the issue of insider trading in *Salman v. United States*. *Salman* came up from the Ninth Circuit, where that court declined to follow the Second Circuit's holding in *Newman* that an insider providing information to a trading relative must have a meaningfully close relationship and the potential for pecuniary gain. The Supreme Court agreed with the Ninth Circuit, and held that simply making a gift of confidential information to a trading relative satisfied the personal benefit requirement, in abrogation of *Newman.*[14]

Salman, however, did not involve the question — raised in *Newman* — relating to the level of knowledge a downstream tippee must have of the personal benefit conferred on the original tipper. The Supreme Court expressly noted in *Salman* that the case did not implicate the "knowledge of the benefit" issue.[15] It also noted the government's apparent acceptance of the general rule that in order to establish tippee liability, the government must prove that the "tippee knew that the tipper disclosed the information for a personal benefit and that the tipper expected trading to ensue."[16] At oral argument in *Salman*, the government even explained the difficulties this rule presented in cases involving downstream tippees: "We need to be able to show that the tippee, perhaps at the end of the chain will be more difficult than the ones earlier in the chain, had knowledge that the information originated in a circumstance in which there was a breach of fiduciary duty for personal benefit."[17] Even though *Salman* did not expressly address the question of "knowledge of the benefit," *Salman* nevertheless has important implications for how this question must be analyzed.

II. TIPPEE KNOWLEDGE OF PERSONAL BENEFIT AFTER *SALMAN* (BUT BEFORE *MARTOMA*)

Although one of *Newman*'s key holdings — that tippee culpability requires knowledge that the tipper provided inside information for a personal benefit — was left largely untouched by the Supreme Court and ceded by the government, *Salman*'s holding defining "personal benefit" nonetheless has important consequences for downstream tippee liability. Post-*Salman*, where a downstream tippee is aware of a family or friend relationship between the original tipper and tippee, that awareness is arguably alone sufficient to show that the downstream tippee possessed knowledge of the benefit — and some recent district court decisions have followed this logic.

[11] *Id*. at 664.

[12] *Newman*, 773 F.3d at 452.

[13] *Id.* at 450.

[14] *Salman*, 137 S. Ct. at 428-29.

[15] *See United States v. Bray*, 853 F.3d 18, 28 n.6 (1st Cir. 2017) (noting that the Supreme Court expressly declined to address what level or type of knowledge a criminal tippee must have regarding a tipper's receipt of a personal benefit).

[16] *Salman*, 137 S. Ct. at 427.

[17] Transcript of Oral Argument at 36, *Salman v. U.S.*, 137 S. Ct. 420 (2016) (No. 15-628).

In *Rajaratnam v. United States*,[18] a post-conviction challenge to Raj Rajaratnam's conviction for insider trading, United States District Judge Loretta A. Preska, in the Southern District of New York, addressed this issue, applying the post-*Salman* definition of personal benefit to a second-level tippee. Rajaratnam moved to vacate his conviction, arguing that there was no evidence that he knew of any personal benefit to corporate insiders in exchange for the confidential information they provided to intermediate tippees. Judge Preska disagreed, explaining that, in light of *Salman*, because all the information received by the petitioner was transferred between trading relatives or friends, "the mere transfer of information [was] sufficient to constitute a benefit."[19] Thus, for the government to prove that petitioner Rajaratnam had knowledge of the tippers' breaches, which, as *Newman* confirmed, requires knowledge that the information was confidential *and* that it was divulged for a personal benefit, it need only show that Rajaratnam had knowledge that the tipper divulged confidential information in the context of a friend or family relationship between the tipper and the intermediate tippee. Judge Preska held with respect to certain tipping chains that, because Rajaratnam conceded that he knew the tipper had provided confidential information to the intermediate tippee because of their "close friendship," Rajaratnam had the requisite knowledge of the personal benefit provided to the tipper.

In *Rajaratnam*, Judge Preska went even further with respect to a count addressing a separate tipping chain, explaining that even where a tipper provided confidential information to an intermediate tippee with whom the tipper had a "close relationship," and the intermediate tippee actually provided the tipper with potential pecuniary benefits including introductions and recommendations to certain technology companies, the government did not have to prove that the petitioner knew about these potential pecuniary benefits. Judge Preska explained that, in light of *Salman*, the mere provision of inside information is sufficient to establish the requisite personal benefit where there was a close relationship between the tipper and intermediate tippee. Accordingly, the petitioner's knowledge of the exchange of nonpublic information in the context of a "close relationship" between the tipper and intermediate tippee was enough to establish the defendant's knowledge of a personal benefit to the tipper, regardless of his level of knowledge of the potential pecuniary benefits actually provided.

In *United States v. Adcox*, United States District Judge S. Maurice Hicks, Jr., in the Western District of Louisiana, employed an analysis similar to Judge Preska's.[20] In *Adcox*, Judge Hicks held that the indictment sufficiently alleged that the downstream tippee defendant committed the crime of securities fraud where it included allegations that this defendant knew the tipper provided the intermediate tippee, and the tipper's friend and brother-in-law, with nonpublic information and knew that there was a "connection" between the tipper and intermediate tippee.

In *United States v. Goffer*,[21] United States District Judge Richard J. Sullivan, in the Southern District of New York — who had been the trial judge in *Newman* — followed similar reasoning when addressing tippee petitioners Goffer's and Kimelman's motions to vacate their insider trading convictions. Although in this case the corporate insider tipper received a pecuniary benefit from the intermediate tippee — specifically, bags of cash — Judge Sullivan made clear that Kimelman "need only have known or consciously avoided knowing the fact that Goffer's sources were receiving *any* benefit that qualifies under *Dirks*."[22] Judge Sullivan made note of the fact that *Salman*'s holding was relevant to the determination of a downstream tippee's knowledge of a personal benefit to the tipper because "*Salman*'s reaffirmation of *Dirks* makes clear . . . that something as minimal as a gift of confidential information to a trading friend can satisfy the personal benefit requirement."[23] Judge Sullivan then clarified that *Newman* requires only that the government prove that the downstream tippee knew that the tipper received "*a* personal benefit," not "the *specific* personal benefit actually received by the insider."[24] Judge Sullivan explained that even though Kimelman may not have known that bags of cash were being provided to the tipper, Kimelman's knowledge of "any benefit that qualifies under *Dirks*," including the benefit received from simply having given a gift to a trading friend, was sufficient to preclude a finding of

[18] 15 Civ. 5325 (LAP), 2017 WL 887027 (S.D.N.Y. March 3, 2017).

[19] *Id*. at *4.

[20] No. 15-00036, 2017 WL 2489998 (W.D. La June 7, 2017).

[21] No. 10-cr-56 (RJS), 2017 WL 203229 (S.D.N.Y. Jan 17, 2017).

[22] *Id.* at *17 (emphasis added).

[23] *Id*. at *16.

[24] *Id.* at *16-17 (emphasis in original).

actual innocence, and the trial record amply supported an inference that Kimelman had such knowledge.[25]

Both *Rajaratnam* and *Goffer* thus suggest that where a friend or family relationship exists between the tipper and the intermediate tippee — even where a pecuniary benefit or potential pecuniary benefit was actually provided to the tipper — the government need only prove that the downstream tippee had knowledge of the exchange of nonpublic information in the context of such a relationship.

III. THE SECOND CIRCUIT'S DECISION IN *MARTOMA*

Recently, in *United States v. Martoma*,[26] the Second Circuit held that in light of *Salman*, *Newman*'s "meaningfully close personal relationship" requirement was no longer good law. The Second Circuit explained that *Dirks* and *Salman* do not support a categorical rule that an insider can never benefit personally from gifting inside information to people other than "meaningfully close" friends or family members, especially because the justification for construing a gift as involving a personal benefit is that "the tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient."[27]

To illustrate this point, the Second Circuit provided the example of a corporate insider giving a tip of inside information to his doorman, in lieu of a cash end-of-year gift, with instructions to trade on the information and consider the proceeds of the trade to be his end-of-year gift, and explained that while there is no meaningfully close personal relationship between the tipper and the tippee in this example, it is clearly an illustration of prohibited insider trading. *Martoma* thus held that a tipper "personally benefits from a disclosure of inside information whenever the information was disclosed with the expectation that the recipient would trade on it, . . . and the disclosure 'resemble[s] trading by the insider followed by a gift of the profits to the recipient, . . . whether or not there was a meaningfully close personal relationship between the tipper and tippee."[28]

Martoma did not expressly discuss downstream tippee liability. But *Martoma*'s laserlike focus on the precise definition of the personal benefit a tipper receives from giving a gift of inside information — "the imputed pecuniary benefit of having effectively profited from the trade oneself and given the proceeds as a cash gift"[29] — could have a substantial impact on the prosecutions of downstream tippees. The post-*Salman* but pre-*Martoma* district court cases discussed above — *Rajaratnam* and *Goffer* — found that a downstream tippee's mere knowledge of a friend or family relationship between the first-level tipper and tippee sufficed to prove the downstream tippee's knowledge of the benefit received by the tipper. Following *Martoma*, however, lower courts may well find that knowledge of a family or friend relationship is not alone sufficient, and instead require that downstream tippees be shown to know that the original tipper disclosed inside information with the "expectation that the recipient would trade on it" in order to find that the downstream tippee possessed knowledge of the benefit.

IV. CONCLUSION

Notwithstanding the fact that *Newman*'s "meaningfully close personal relationship" holding has now been twice overruled — implicitly by *Salman*, and expressly by *Martoma* — *Newman*'s "knowledge of the benefit" requirement remains good law and will continue to impact downstream tippee cases going forward. The combination of *Salman* and *Martoma* leaves some uncertainty as to what kind of proof will suffice to show knowledge of the benefit on the part of a downstream tippee being prosecuted for insider trading, but a few points are clear. First, in the wake of *Newman*, *Salman*, and *Martoma*, the strongest cases against downstream tippees will be those in which the government is able to show both that the downstream tippee was aware of a friend or family relationship between the first-level tipper and tippee (such as the family relationship in *Salman*), *and* that the downstream tippee knew that the first-level tipper passed inside information with the expectation that the first-level tippee would trade on it, resembling a trade by the tipper followed by a gift of profits to the first-level tippee (as *Martoma* makes clear is required). Second, by contrast, the government will face increased litigation risk in those cases where there is no family or friend relationship between the top level tipper and tippee, notwithstanding the fact that *Martoma* makes clear that liability can exist in such cases. Third, even in cases involving a family or friend relationship, the government will still face increased litigation risk

[25] *Id*. at *17.

[26] 2017 WL 3611518.

[27] *Id*. at *7 (quoting *Dirks*, 463 U.S. at 664) (internal alterations and quotation marks omitted).

[28] *Id*. at *8 (internal quotation marks omitted).

[29] *Id.* at *9.

where it attempts to rely on a downstream tippee's knowledge of the family or friend relationship between the first-level tipper and tippee *alone* to establish knowledge of the benefit — notwithstanding the favorable precedents discussed above — without any further evidence that the downstream tippee knew the original tipper passed information with the expectation that the first-level tippee would trade.[30] And of course, the government faces substantial risk in those cases where the downstream tippee is many steps removed from the original tipper and tippee, and may not know them at all. ■

[30] The limits of the application of *Newman*'s holding regarding downstream tippee knowledge will likely be further tested in *United States v. Blaszczak*, 17 Cr. 308 (DLC) (S.D.N.Y. May 24, 2017) and *S.E.C. v. Blaszczak*, 17-cv-03919, 2017 WL 2266005 (S.D.N.Y. May 24, 2017), where the indictment and SEC complaint seemingly allege only that the downstream tippees should have known that the first-level tippee was friendly with the tipper. *See* Apps, *supra* note 3. *See also* Ronak V. Patel and Toby M. Galloway, *Tippee Insider Trading after* Newman *and* Salman*: Why Knowledge Is Not Always Your Friend*, White Collar Crime Committee Newsletter, Jan 2017 (*available at* https://www.americanbar.org/content/dam/aba/publications/criminaljustice/2017/wccn2017_Patel.authcheckdam.pdf) (noting that more remote tippees may be shielded from criminal liability unless the government has evidence that those tippees knew of the relationship between the insider and first-level tippee friend).