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Introduction

On October 5, when the U.S. Supreme Court hears Salman v. United States, it will focus on the role of the “personal benefit” test in insider trading law for the first time since the test was established in the now iconic 1983 case Dirks v. SEC. Dirks reaffirmed the principle that trading on the basis of material nonpublic information is not a crime unless it involves a breach of a duty of trust and confidence to the owner of the information being traded. The Court in Dirks went on to establish the important principle, recently fortified in the notable Second Circuit case United States v. Newman, that a tipper has committed no breach of fiduciary duty unless he receives a personal benefit in exchange for the disclosure.

This Essay maintains that the SEC has persistently sought to minimize the role of the personal benefit test in insider trading law, thereby stretching the limits of its delegated power under securities law. It also contends that the SEC categorically rejects the theory, embraced by the Supreme Court and the Second Circuit in Newman and reflected in the personal benefit test, that tipping by insiders is sometimes not just benign, but also decidedly curative for capital market imperfections.

1. October Term 2016, SUP. CT. OF THE U.S., https://www.supremecourt.gov/oral_arguments/calendars/MonthlyArgumentCalOctober2016.html (last visited Aug. 12, 2016). Salman is an appeal from the Ninth Circuit’s decision in United States v. Salman, 792 F.3d 1087 (9th Cir. 2015), cert. granted, 136 S. Ct. 899 (2016). In that case, the Ninth Circuit held that to establish tippee liability in insider trading cases, it is sufficient for the government to show that there was a close family relationship between the tipper and the tippee. Id. at 1094.


3. Id. at 657-58.


5. Dirks, 463 U.S. at 662; Newman, 773 F.3d at 446.
I. Background on the Law and Economics of Insider Trading

Inside information is the same as other forms of intellectual property in that it is susceptible to theft by unscrupulous agents. Applying the law of insider trading is a process of determining who owns a particular piece of information and then protecting that property right from pilfering by others. Determining who owns a piece of information in this context is quite easy. The owner of information about a company is the person or firm who creates the information, just as the owner of a patent is the person who invented the gadget or process receiving the patent.

The government, however, does not limit itself to prosecuting only those who steal information from the companies to which it belongs. The government also seeks to regulate and/or forbid any trading on this information before it is public, regardless of how the trader obtained the information in the first place. For example, the SEC has promulgated a rule requiring any company that makes a tender offer for the shares of another firm to disclose publicly all sorts of information about itself and its plans simultaneously with making the bid. Such a rule ignores the bidding firm’s property rights in its information for no reason other than that the SEC thinks requiring disclosure is somehow “fairer.”

At the moment, the battle between the executive and the judicial branches over the contours of insider trading law is focused on a single question: whether it is ever, under any circumstances, permissible for a corporate insider (tipper) to pass along confidential information to an outsider (tippee). Based on the positions that they have taken in litigation, the SEC and the Justice Department believe that providing insider tips of material, nonpublic


7. See id. (explaining goals of insider trading law).

8. U.S. CONST. art. I, § 8 (“Congress shall have Power ... [t]o promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries....” See generally Henry E. Smith, Intellectual Property as Property: Delineating Entitlements in Information, 116 YALE L.J., 1742, 1799-817 (2007) (explaining certain differences between the more tort-like copyright regime and the more property-like patent law regime).


10. In this context, the term “fairness” is defined as eliminating any asymmetries of information between a trader and her counterparty. See Newman, 773 F.3d at 448-49 (“Although the Government might like the law to be different, nothing in the law requires a symmetry of information in the nation’s securities markets.”).
information to people who trade on that information constitutes civil or criminal fraud unless it is first disclosed. The Supreme Court and lower federal courts, in contrast, believe that there are several contexts in which insiders legally can pass along insider information because doing so furthers a legitimate corporate purpose.

Suppose, for example, that an insider is working in a company mired in fraud and illegal activities. Unable to get the authorities or press interested or involved, the insider passes along his concerns to a securities analyst who does his own investigation, verifies the fraud, and, putting his money where his mouth is, sells stock in the fraudulent firm. This simultaneously drives the company’s share price down and notifies the market that something is amiss in the company. The SEC would brand the trader in this hypothetical a fraudster and seek to sanction her. It might even ask the Department of Justice to bring criminal charges against the trader and or the person who provided the tip to the trader. The Supreme Court, on the other hand, reasoning that having securities analysts ferret out fraud is a good thing that should be encouraged, rejected the SEC’s contention that the tipper in a case similar to this hypothetical committed fraud in Dirks.

Apart from exposing fraud and other illegality, corporate insiders promote a variety of legitimate corporate purposes by leaking information to securities analysts. For example, in Newman, a case involving tips by corporate insiders who were casual acquaintances of financial analysts who passed the tips along to hedge fund traders, the defendants established that it was common for

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11. See Newman, 773 F.3d at 447 (“By selectively parsing this dictum, the Government seeks to revive the absolute bar on tippee trading that the Supreme Court explicitly rejected in Dirks.”). In Dirks, the SEC's litigation position “differ[ed] little from the view that [the Supreme Court] rejected as inconsistent with congressional intent in Chiarella,” which was that “[a]nyone—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose.” Dirks v. SEC, 463 U.S. 646, 656 (1983) (quoting United States v. Chiarella, 588 F.2d 1358, 1365 (2d Cir. 1978)). The SEC “maintain[ed] that anyone who knowingly receive[d] nonpublic material information from an insider ha[d] a fiduciary duty to disclose before trading.” Id.

12. For example, in Newman, the court quoted United States v. Chestman for the proposition that “[t]he policy rationale [for prohibiting insider trading] stops well short of prohibiting all trading on material nonpublic information. Efficient capital markets depend on the protection of property rights in information. However, they also require that persons who acquire and act on information about companies be able to profit from the information they generate . . . .” 773 F.3d at 449 (second alteration in original) (quoting United States v. Chestman, 947 F.2d 551, 578 (2d Cir. 1991) (Winter, J., concurring)). In Dirks, ferreting out fraud was considered a valid corporate purpose.

13. See Dirks, 463 U.S. at 650-52.

14. Id. at 650-52, 667.

15. 773 F.3d at 451-54.
insiders at Dell to disclose "confidential quarterly financial information arguably similar to the inside information disclosed by [the Dell defendants] to establish relationships with financial firms who might be in a position to buy Dell's stock."16 Convincing investors to buy a company's stock is a legitimate goal for a company official and a legitimate reason to provide tips, in other words.

In Dirks, the Court established the personal benefit test as the tool to distinguish wrongful insider trading that should be outlawed from insider trading that is rightful because it reveals fraud or makes markets more efficient.17 The personal benefit that makes a trade illegal can take the form of a briefcase full of cash clandestinely passed from tippee to tipper. It also can take the form of a gift to a family member or close friend, as the Court made clear in Dirks.18

In light of the language in Dirks that "a gift of confidential information to a trading relative" satisfies the Court's personal benefit test,19 the decision in Salman that a bank employee who was found to have given his brother confidential information—knowing that his brother would trade on that information—was therefore guilty of committing insider trading,20 was unremarkable and straightforward.

Indeed, the sheer banality of Salman leaves one to wonder why the Supreme Court agreed to hear the case at all. It is likely that the Court will be urged to go even further and loosen—or worse, eliminate—the requirement that prosecutors show that people accused of insider trading either provided personal benefits or were family members of the tipper.21

16. Id. at 454-55.

17. 463 U.S at 661-64. Determining whether a tip is consistent with the tipper's fiduciary duties, and thus consistent with the law ("good"), depends on whether the insider's "tip" constituted a breach of the insider's fiduciary duty. This, in turn, depends largely on whether the insider receives something as a result of the disclosure. Absent an improper purpose, there is no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach by the tipper. Id.

18. Id. at 664 (holding that a violation of the law occurs "when an insider makes a gift of confidential information to a trading relative or friend").

19. Id.

20. 792 F.3d 1087, 1092 (9th Cir. 2015).

II. The Personal Benefit Test and Tippee Liability

The SEC rejects the personal benefit test because it rejects the premise on which it is based, which is that tipping by insiders in certain contexts is benign, and sometimes even decidedly curative for capital market imperfections. If, as the SEC has indicated, no valid social goal such as increased efficiency or less fraud could be attained by decriminalizing some tipping and trading, then it would make sense to ban all such activity. In other words, if all insider trading is wrongful, there is no justification for the personal benefit test, which seeks to distinguish wrongful insider trading from rightful insider trading. Only if at least some trading is salutary and beneficial is there a need for a legal test—the personal benefit test—to allow traders and courts to distinguish between permissible and impermissible insider trading.22

The SEC has long maintained that no insider trading on the basis of tips is permissible because “anyone who knowingly receives nonpublic material information from an insider has a fiduciary duty to disclose before trading.”23 According to the SEC, regardless of whether a tipper has received a personal benefit, or whether property rights and market efficiency were enhanced or diminished by the tipping and trading, the tipper breached her fiduciary duty.

In sharp contrast, the Supreme Court distinguished illegal trading from legal trading with great precision over thirty years ago in two now-iconic cases: Chiarella v. United States24 and Dirks v. SEC.25 Chiarella held that an element of the crime of insider trading is the breach of a duty of trust and confidence toward the owner of the information being traded.26 Dirks held that sharing corporate information is not a crime unless it involves a breach of such a duty.27

The Supreme Court in Dirks and the Second Circuit in Newman explicitly recognized that analysts and other researchers play a vital role in maintaining properly functioning and efficient capital markets28 and that there are valid reasons, consistent with the interests of shareholders, why corporate insiders should disclose material, nonpublic information to stock market analysts and

22. Dirks, 463 U.S. at 654 (holding that it is impermissible to trade on “information intended to be available only for a corporate purpose and not for the personal benefit of anyone” (quoting Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933, 936 (1968)).
23. Dirks, 463 U.S. at 656.
27. 463 U.S. at 657-60.
other capital market participants in advance of its general release to the public.\textsuperscript{29}

The SEC has shown, with its promulgation of Regulation FD\textsuperscript{30} and in its litigation theory in \textit{Chiarella} and \textit{Dirks},\textsuperscript{31} that it rejects the premise that tipping should be decriminalized in certain contexts. Gomes, Gorton, and Madureira show that Regulation FD increased the costs to companies of producing information, which, in turn, negatively affected the asset prices of smaller companies.\textsuperscript{32} As a result of Regulation FD, smaller companies tend to have less analyst coverage,\textsuperscript{33} as analysts are less inclined to cover existing companies, and companies that had analyst coverage when Regulation FD was promulgated often lost such coverage and have experienced significant increases in their costs of capital.\textsuperscript{34}

With Regulation FD the SEC made illegal conduct that had been explicitly condoned by the Supreme Court seventeen years earlier in \textit{Dirks} when it noted that what analysts do is “ferret out and analyze information,”\textsuperscript{35} and that “this often is done by meeting with and questioning corporate officers and others who are insiders.”\textsuperscript{36} But for the fact that the SEC did not promulgate Regulation FD until October 23, 2000,\textsuperscript{37} seventeen years after \textit{Dirks},\textsuperscript{38} the

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29. \textit{Dirks}, 463 U.S. at 658 ("Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts.").


31. \textit{Dirks}, 463 U.S. at 656 (noting that in \textit{Chiarella}, the SEC maintained that “[a]nyone… who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose” (quoting United States v. \textit{Chiarella}, 588 F.2d 1358, 1365 (2d Cir. 1978), rev’d, 445 U.S. 222 (1980)), and observing that “[h]ere [in \textit{Dirks}, the SEC maintains that anyone who knowingly receives nonpublic material information from an insider has a fiduciary duty to disclose before trading].”


33. \textit{Id.} at 315.

34. \textit{Id.} at 315, 323-25.


36. \textit{Id.} at 658.


38. \textit{Dirks} v. \textit{SEC} was decided on July 1, 1983. 463 U.S. at 646.
\end{flushleft}
Supreme Court might have been arguing specifically against Regulation FD in Dirks when it noted that “[i]t is the nature of this type of information [i.e., information conveyed while ‘meeting with and questioning corporate officers and others who are insiders’] and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation’s stockholders or the public generally.”

In the Court’s world of law, selective disclosure can benefit investors and capital markets by ferreting out fraud—as it did in Dirks—or by encouraging investor monitoring and moving capital market prices to reflect more accurately underlying corporate values—as it did in Newman.

Selective disclosure, however, can also undermine the integrity of capital markets where insiders use undisclosed corporate information to their personal advantage, without concern for the interests of the company to which such information belongs. In these situations, “[t]he need for a ban on some tippee trading is clear.”

Because the SEC does not distinguish between situations in which tipping is done for valid corporate purposes and those in which tipping is done for venal purposes, the SEC has never found a reason to distinguish between the contexts in which tipping is appropriate and those in which it is not. In contrast, because of its more nuanced and sophisticated view of the role of insider tips to analysts, the Supreme Court in Dirks was compelled to craft the personal benefit test to distinguish benign from malignant tipping.

The personal benefit test is an expression of the view that the receipt by a tippee of a personal benefit in exchange for her tip obviates the defense that the tip was for a valid corporate purpose. As a corollary, the personal benefit test is also an expression of the view that if a tipper did not receive a personal benefit in exchange for the information, one should infer that the tip was provided for a valid corporate purpose. The personal benefit test bars trading by some insiders that appears to be socially beneficial. For example, it would be socially beneficial for an insider to reveal that his company has committed accounting

39. Id. at 659.
40. Id. at 651-52 (noting that the SEC “recognized... that Dirks ‘played an important role in bringing [Equity Funding’s] massive fraud to light’” (quoting 21 SEC Docket at 1412)).
41. United States v. Newman, 773 F.3d 438, 449 (2d Cir. 2014), cert. denied, 136 S. Ct. 242 (2015) (“Efficient capital markets depend on the protection of property rights in information. However, they also require that persons who acquire and act on information about companies be able to profit from the information they generate....” (quoting United States v. Chestman, 947 F.2d 551, 578 (2d Cir. 1991) (Winter, J., concurring))).
42. Dirks, 463 U.S. at 659.
43. Id. at 663-64 (articulating the personal benefit test).
44. Id. (“Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.”).
fraud, but, under current doctrine, if the insider receives cash in exchange for this tip, his tipping is criminal under the personal benefit test.

III. Salman and Judicial Confusion

In Salman, Maher Kara, who worked in the Citigroup healthcare investment banking group, tipped his older brother Mounir ("Michael") Kara, who had become increasingly "more brazen and more persistent in his requests for inside information." In the midst of these conversations between brothers, Maher Kara, the tipping brother, became engaged to the sister of one Bassam Salman, who got to know the family and became close friends with his future brother-in-law, Michael Kara. Michael began giving the information he got from his brother Maher to Salman, who traded on it in an account held in the name of yet another relative. So, Maher Kara tipped his brother Michael, who tipped Maher's future brother-in-law Salman.

In his defense at trial, Salman argued that evidence of a friendship or familial relationship between tipper and tippee standing alone is insufficient to demonstrate that the tipper received a benefit absent evidence that the tipper received a "personal benefit." This argument is clearly wrong as a matter of law because the Supreme Court explicitly held in Dirks that a gift to a relative satisfies the personal benefit test. As Judge Rakoff observed, a "personal benefit is broadly defined to include not only pecuniary gain, but also, inter alia, . . . the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend." The presence of the familial relationship in Salman and the absence of such a relationship in Newman not only makes these cases easily reconcilable, it—along with the absence of a consequential personal benefit in Salman—explains why both cases were correctly decided.

45. United States v. Salman, 792 F.3d 1087, 1088-89 (9th Cir. 2015), cert. granted, 136 S. Ct. 899 (2016).
46. Id.
47. Id. at 1093. In Salman, Michael Kara, the tippee, in turn, tipped the defendant, Salman, but the court did not confront the issue decided in United States v. Newman of whether the government must prove that such a remote tippee had knowledge of the personal benefit that the insider tipper received for disclosing inside information to the tipper. 773 F.3d 438, 450 (2d Cir. 2014), cert. denied, 136 S. Ct. 242 (2015). This is because the jury in Salman "was instructed that it had to find that Salman 'knew that Maher Kara personally benefitted in some way, directly or indirectly, from the disclosure of the allegedly inside information to Mounir ("Michael") Kara." 792 F.3d at 1091 n.2.
48. 463 U.S. at 664 (holding that a violation of the law occurs "when an insider makes a gift of confidential information to a trading relative or friend").
49. Salman, 792 F.3d at 1093-94 (alteration in original) (quoting Newman, 773 F.3d at 452).
Conclusion

The inconsistencies that exist in the law of insider trading are not inconsistencies among the federal courts, but are instead inconsistencies between the executive branch and the judiciary. Both sides agree that insider tippers receiving a personal benefit in exchange for providing material, nonpublic information to a tippee is and should be illegal. The disagreement lies in the opposing views about the legality of trading on a tip that is provided by a tipper for no personal benefit, especially where the tip is made for a legitimate business purposes, such as to disclose fraud or correct imperfections in the market’s pricing process. The government views such trading as illegal, while the federal courts do not.

There is no reason for insider trading in general or the personal benefit test in particular to be on the Supreme Court’s agenda this term. *Salman* and *Newman* are entirely consistent. The case that the Court will hear in October, *Salman*, breaks no new ground and presents no issues that are either novel or complex.

More generally the law of insider trading is very clear and very sensible over a wide range of issues, notwithstanding the SEC and the Department of Justice’s arguments to the contrary. The government’s objection to the status quo as reflected in *Dirks* and *Newman* is not to the ambiguity of these decisions but rather to the restraints they impose on the government’s power and prosecutorial discretion. Indeed, while it might have been best if the Court had never granted certiorari in *Salman*, the Court can use its opinion in the case to emphasize that the law of insider trading as it stands protects property rights in information, promotes market efficiency, and protects costly and valuable research by stock market analysts. The Court’s current approach is not only good law, it is also sound policy and economics.