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Why Insider Benefit Is Irrelevant To Criminal Insider Trading

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For the past two and a half years, practicing lawyers and commentators alike have spilled oceans of ink analyzing what kind of insider benefit — as opposed to merely a breach of confidentiality — and what level of tippee knowledge of such benefit are sufficient to establish liability for insider trading. This flood of motion practice and academic analysis followed the Second Circuit's December 2014 ruling in United States v. Newman,[1] in which the court ruled that not only is an insider's personal benefit an essential liability element, but such benefit must also be "objective, consequential, and represent[] at least a potential gain of a pecuniary or similarly valuable nature."[2]

At least for downstream traders, the debate over the nature of the requisite insider benefit has proceeded unabated even since the U.S. Supreme Court's Dec. 6, 2016, ruling in Salman v. United States,[3] in which, not surprisingly, the court concluded that an actionable personal benefit inheres in the mere exchange of confidential information between family members.[4] The Salman court declined to address, and indeed invited further lower court proceedings regarding, what kind of personal benefit is required when an insider and tippee are not related.

But what has been largely ignored by most practitioners, academics and the legal press, however, is that in criminal insider trading cases (in which the stakes are plainly higher than in civil or administrative enforcement proceedings), the U.S. Department of Justice is legally empowered to avoid issues of insider benefit and trader knowledge of such benefit entirely. Federal prosecutors may do so simply by charging insider trading under 18 U.S.C. § 1348, the Sarbanes-Oxley era criminal securities fraud statute, or 18 U.S.C. §§ 1341 and 1343, the federal mail and wire fraud statutes, rather than, per tradition, Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5.

The DOJ's arguably easier path to liability under Sections 1341, 1343 and 1348 has important ramifications. Invocation of these statutes sidesteps decades of common law underlying Section 10(b) and Rule 10b-5. Further, it likely forecloses numerous defense arguments commonly raised in insider trading prosecutions, including what constitutes an actionable breach of fiduciary duty, the legal source of that duty, whether the confidential information was in fact material or nonpublic, and the extent to which the information factored into the trading decision (i.e., whether it was the sole consideration, a primary driver, or at least a factor).

Moreover, these statutes merely require proof of the defendant's knowing participation in a scheme or artifice to defraud, defined in most federal appellate jurisdictions as simply any plan or course of action intended to deceive someone out of money or property, which courts have construed to include a company's confidential information. And the scheme to defraud forming the linchpin of such a prosecution need only involve a breach of confidentiality and some deceptive conduct towards the issuer, as opposed to a breach of confidentiality accompanied by a personal benefit to the tipping insider, as required by Section 10(b) and Rule 10b-5.

Because the malleability of these statutes affords federal prosecutors broad latitude to attach criminal penalties to trading activity that is beyond the reach of Rule 10b-5, practitioners should take note. Criminal and securities enforcement defense lawyers who fail to advise their individual clients of their potential Section 1341, 1343 and 1348 exposure in insider trading investigations do them a disservice, as do practitioners who advise their corporate clients on securities trading and compliance programs without considering the broader criminal ambit of these statutes.

The Traditional Framework: Exchange Act Section 10(b) and SEC Rule 10b-5

Tipping liability flows from the notion that a public company insider cannot help an outsider take advantage of a breach that the insider is barred from exploiting directly. As the U.S. Supreme Court noted with respect to Section 10(b) more than 30 years ago in Dirks v. U.S. Securities and Exchange Commission: "[I]nsiders [are] forbidden by their fiduciary relationship [to the company and its shareholders] from personally using undisclosed corporate information to their advantage, [and] ... they may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain."[5] Further, gifting confidential information to a "trading relative or friend" is no different than a corporate insider trading on the information himself: "The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient."[6] A tippee's insider trading liability under Section 10(b) stems from his knowing participation (albeit derivatively) in the insider's breach of fiduciary duty, which is defined by reference to the personal benefit the insider received for divulging confidential corporate information.

The Newman and Salman Decisions

In its December 2014 Newman decision, the Second Circuit modified the insider benefit and trader knowledge of insider benefit elements of Section 10(b) in two significant respects. First, it held that, for the tippee to be criminally culpable, the government must prove not only that the tippee knew that the information on which he relied was disclosed in breach of a duty of confidentiality, but also that the tippee knew that the tipper had obtained a personal benefit in exchange for the tip. In other words, it is no longer enough to prove that the tippee knew that he or she had received material nonpublic information from a company insider who was not permitted to disclose the information; it must also prove that the tippee knew that the insider received some personal benefit in return for the tip.

Second, the Second Circuit held that where no tangible quid pro quo changes hands and prosecutors seek to prove personal benefit based on friendship between the tipper and the tippee (i.e., the intangible benefit that one receives from giving a gift to a friend or relative), the government may not do so based on "the mere fact of a friendship, particularly of a casual or social nature."[7] Instead, there must be "proof of a meaningfully close personal relationship" between the tipper and the tippee that generates a consequential exchange, which according to Newman must be pecuniary or quasi-pecuniary in nature.[8]

After substantial DOJ outcry that Newman had rendered insider trading convictions far more difficult to obtain in all but the most direct and obvious insider trading schemes (and, indeed, following DOJ's abandonment of several significant insider trading convictions due to lack of conformity with Newman), the Supreme Court took up a Ninth Circuit decision that rejected the Newman court's personal benefit test. In Salman v. United States, the Supreme Court reaffirmed the long-standing principle that a mere gift of confidential information to a trading relative or friend, absent any other quid pro quo to the tipper, is alone sufficient to trigger liability.[9]

Salman did not completely settle the debate over Newman, however. For example, the Salman court declined to address whether a tipper's intent to gift inside information to someone with whom the tipper had no pre-existing relationship (but perhaps hoped to develop) could be sufficient. And because the tipper-tippee relationship at issue in Salman was familial, the case arguably does not resolve the question of which nonfamilial relationships along a social continuum — from merely casual or social acquaintances, to professional colleagues or counterparts, to strong, lifelong friends — might be sufficient for a jury to infer personal benefit.

Enter 18 U.S.C. §§ 1341, 1343 and 1348

These and other questions are largely irrelevant in criminal cases, however, because of 18 U.S.C. §§ 1341, 1343 and 1348. While prosecutors have experience bringing insider trading charges under the federal mail and wire fraud statutes, they have not frequently used Section 1348 in such cases. Congress enacted Section 1348 as part of the Sarbanes-Oxley Act of 2002. The relevant legislative history indicates that Congress intended for Section 1348 to function as a broad, omnibus securities fraud statute patterned after the federal mail, wire, and bank fraud statutes. To that end, the drafters of Section 1348 intended for it to usurp the "awkward and heightened burdens on the prosecution of criminal securities fraud cases" under the Exchange Act.[10] Accordingly, and in contrast to Section 10(b) and Rule 10b-5, Section 1348 simply requires proof of (1) a scheme or artifice to defraud; (2) fraudulent intent; and (3) a nexus with a security.[11]

Application of Section 1348 to Insider Trading Cases

Seizing on this broad statutory language and the legislative history of Section 1348, federal prosecutors in several recent criminal insider trading cases have successfully argued that the traditional elements of Section 10(b) and Rule 10b-5 do not apply to Section 1348, avoiding questions of fiduciary breach, personal benefit, and a trader's knowledge of such benefit altogether. Indeed, post-Newman, all five federal judges known to have squarely addressed whether Newman reads on Section 1348 have endorsed the government's view that it does not.[12]

Prosecutors in such cases have relied instead on the principles set out in Carpenter v. United States[13] and its progeny, which merely require the government to prove that the tippee induced or participated in an insider's scheme to defraud his employer through the misappropriation of confidential information — i.e., the employer's property — in some deceptive or fraudulent manner to facilitate illicit trades. In other words, the gravamen of a Section 1341, 1343, or 1348 insider trading case is insider deception, rather than benefit, which lends itself to far greater malleability than is available under traditional Rule 10b-5 constraints.

Notably, under Sections 1341, 1343 and 1348, the confidential information at issue need not necessarily rise to the level of being considered material nonpublic information, potentially avoiding a commonly

raised insider trading defense. Instead, the information need only constitute confidential business information, typically defined by courts to include confidential information that has commercial value, that could give the company's competitors a commercial advantage, that would harm the company's reputation if it was disclosed, or that could be used by others for profit.[14]

Further, although deceptive or fraudulent conduct is required to establish the scheme or artifice to defraud element of Sections 1341, 1343 or 1348, this element could likely be established by showing that the insider deceived his or her employer into believing that he or she was abiding by company confidentiality policies while the insider was instead trading or tipping; i.e., where the insider periodically signed company confidentiality policies or otherwise falsely acknowledged and agreed to abide by such policies in proximity to the illicit trading or tipping, and the tippee knew or consciously avoided knowledge of the insider's deception by virtue of his or her experience in the corporate world, where such policies are now ubiquitous. The scheme or artifice to defraud element may thus be a relatively low bar to conviction.

Takeaways

This shift in the use of Section 1348 in criminal insider trading cases has been met largely with silence, perhaps because the Newman-Salman debate makes for a better story. It is also possible that the use of Section 1348 is viewed as a passing fad, akin to the brief popularity of wire and mail fraud insider trading charges in the 1980s, that will fade into the background in light of calls for the enactment of a dedicated insider trading statute.

But regardless of whether this shift is fleeting or permanent (and it is highly unlikely that Section 1348 would be abrogated even if Congress enacts a stand-alone insider trading provision), Section 1348 undoubtedly covers a broader array of misconduct than Rule 10b-5. Companies and investment firms are thus well-advised to review and revise their insider trading compliance and confidentiality policies to address the broader reach of Sections 1341, 1343 and 1348, and individual traders who find themselves in the regulatory crosshairs need to include such charges in any analysis of their potential exposure. Further, corporate insider trading victims may also want to reconsider criminal referrals and the potential availability of restitution for such trading even if traditional Rule 10b-5 elements may not be apparent, and where the facts instead point to theft and deception as the core of the offense.

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[1] 773 F.3d 438 (2d Cir. 2014).

[2] Id. at 452.

[3] 137 S. Ct. 420 (2016).

[4] Id. at 427-28.

[5] 463 U.S. 646, 658 (1983).

[6] Id. at 664.

[7]773 F.3d at 452.

[8] Id.

[9] 137 S. Ct. 420, 427-28 (2016).

[10] The Corporate And Criminal Fraud Accountability Act Of 2002, S. Rep. 107-146, at *6 (May 6, 2002); see also Legislative History Of Title VIII Of HR 2673: The Sarbanes-Oxley Act Of 2002, 148 Cong. Rec. S7418-01, *S7418 , 2002 WL 1731002 (July 26, 2002) ("The provision would supplement the patchwork of existing technical securities law violations with a more general and less technical provision, with elements and intent requirements comparable to current bank fraud and health care fraud statutes.").

[11] United States v. Mahaffy, 693 F.3d 113, 125 (2d Cir. 2012).

[12] United States v. Slawson, No. l:14-CR-00186-RWS, 2014 U.S. Dist. LEXIS 159931, 2014 WL 5804191, at *6 (N.D. Ga. Nov. 7, 2014) ("This court declines to impose on the charges set forth in the indictment the requirement to plead elements of offenses not charged in the indictment in light of the lack of binding or persuasive legal authority imposing same"), adopted by, 2014 U.S. Dist. LEXIS 170479, 2014 WL 6990307 (N.D. Ga. Dec. 10, 2014); see also Docket No. 77, Order Den. Mot. Recons., at 2 (July 27, 2015); United States v. Melvin et al., 143 F. Supp. 3d 1354, 1375 (N.D. Ga. 2015) ("In this action, the Government brought criminal charges under § 1348, and therefore it must allege the elements of that offense, no more and no less"); United States v. DeCinces et al., No. 8:12-CR-269-AG (C.D. Cal. Jan. 23, 2015) (Docket No. 312, Minute Order Den. Mot. Dismiss).

[13] 484 U.S. 19 (1987).

[14] See Belt v. United States, 868 F.2d 1208, 1213-14 (11th Cir. 1989); United States v. Poirier, 321 F.3d 1024, 1030 (11th Cir. 2003); United States v. Grossman, 843 F.2d 78, 86 (2d Cir. 1988).

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