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# A RULE OF CONSTRUCTION FOR THE PERSONAL BENEFIT REQUIREMENT IN TIPPING CASES

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## INTRODUCTION

An essential element of an insider trading case based on a tipping violation is proof that the insider personally benefited from the disclosure to the tippee. The meaning of the personal benefit requirement has been controversial and led to differing interpretations in the courts of appeals that the Supreme Court partially resolved in Salman v. United States.[1] That case dealt with a tip from an insider to his brother, who traded and tipped Salman,

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[1] Salman v. United States, 137 S. Ct. 420 (2016). The Ninth Circuit's decision in *Salman*, 792 F.3d 1087 (9th Cir. 2015), had rejected the Second Circuit's interpretation of the personal benefit requirement in United States v. Newman, 773 F.3d 438 (2d Cir. 2014), cert. denied, 136 S. Ct. 242 (mem.) (2015).

who also traded, and the Court decided it by re-affirming passages from the Court's original tipping decision, Dirks v. SEC.[2] Those passages suggested that an insider benefits personally when giving a gift of confidential information to a trading relative.[3]

This essay began as a proposed interpretive approach to the question about the meaning of the personal benefit requirement raised in Salman. It was made publicly available during the briefing for that case and before the Court issued its decision. The purpose of the essay was not to recommend how the Court should define personal benefit and instead was to suggest that the Court should apply a rule of construction to the personal benefit element that narrows the scope of potential liability. The Court has now decided Salman and held that an insider receives a personal benefit when making a gift of information to a family member, but other questions about the scope of the personal benefit requirement remain. For example, if the gift concept also applies to an insider's disclosure to a friend, how close a friend must the tippee be? What kind of personal benefit justifies insider trading liability in situations not addressed by gifts to family or friends, such as those raised by the Second Circuit in the Newman case?[4]

As a result, the narrowing rule of construction outlined in this essay remains useful. A narrow interpretation would be

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

[3] *Salman*, 137 S. Ct. at 427-28. The Second Circuit decision in *Newman*, see note 1 supra, did not involve a tip from an insider to a family member or close friend. One tip was from an insider to a long-time business acquaintance, and a second tip was from an insider to a person the insider met at church and socialized with occasionally. The tips then went through one or more other persons to hedge fund portfolio managers who traded. *Newman*, 773 F.3d at 442, 443, 452.

[4] *See supra* note 3. *Newman* said an inference of personal benefit from a personal relationship between a tipper and tippee is not permissible unless the government proves "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." *Newman*, 773 F.3d at 452.

appropriate because the tipping violation is a judicially implied claim under Section 10(b) of the Exchange Act and Rule 10b-5, and the Supreme Court's precedents for the judicially implied private right of action under Section 10(b) have stressed the need for limiting constructions.

The remainder of this essay covers four points. First, it identifies the role of the personal benefit requirement in tipping cases. Next, it describes the Supreme Court precedent applying a cautious and restrained approach to interpretations of judicially implied claims under Section 10(b) and Rule 10b-5. Third, it explains that the tipping violation is a claim the Supreme Court implied from Section 10(b) and Rule 10b-5 and that a narrow construction of the personal benefit element would be appropriate even though the government, and not a private party, brought Salman. A narrow interpretation would be needed whether the tipping case is a criminal prosecution, SEC civil enforcement proceeding, or private civil action. Finally, it discusses the effect of insider trading legislation and concludes that the reasons for a limiting interpretation remain.

## I. THE PERSONAL BENEFIT REQUIREMENT

A tipping violation is a form of insider trading, and insider trading is a form of fraud prohibited by the general anti-fraud provisions of the federal securities laws, such as Rule 10b-5. The personal benefit requirement in a tipping case derives from a feature of insider trading violations.

Insider trading occurs when a person buys or sells a security while aware of nonpublic information significant to the price of a security and when that person has a duty to the source of the information, such as an employer, to keep the information confidential and use it solely for the source's purposes. The person violates this duty and commits securities fraud when he uses the information to make a personal profit through a securities trade without publicly disclosing the information and before the information otherwise becomes public.[5]

Tipping can occur when the insider discloses confidential, price-sensitive information to a third party who then trades on the information before the information becomes public. The essential predicate for a tipping violation is whether the insider's disclosure of confidential information to a tippee was a breach of the insider's fiduciary duty of confidentiality.[6] Whether a disclosure is a breach of duty depends on the purpose of the disclosure, and "the test is whether the insider personally will benefit, directly or indirectly, from his disclosure."[7] The need for proof of the tipper's personal benefit was the connection of the fraudulent act in a standard insider trading case to a tipping violation, because without a breach of the tipper's duty of confidentiality and disclosure, as evidenced by a personal benefit, there can be no fraud or deceit.[8]

Thus, a tipper's receipt of a personal benefit in exchange for a disclosure of confidential information was the initial premise of the tipping violation recognized by the Court in *Dirks*.[9] *Dirks* went on to discuss the personal benefit requirement,[10] and it is that discussion that caused the lower courts to reach divergent

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[5] The Supreme Court developed these rules for a classical insider, such as a director or employee of the company whose securities are traded, in Chiarella v. United States, 445 U.S. 222 (1980). The Court widened the prohibition to cover "misappropriation" cases in United States v. O'Hagan, 521 U.S. 642 (1997). Those occur when a person who is not a company insider learns confidential information material to the price of the company's securities from a source other than the company, such as a person who plans to make a large investment in the company's stock.

[6] Dirks v. SEC, 463 U.S. 646, 660-61 (1983).

[7] *Id.* at 662.

[8] *Id.* at 659.

[9] *Newman*, 773 F.3d at 449 ("*Dirks* clearly defines a breach of fiduciary duty as a breach of the duty of confidentiality in exchange for a personal benefit.")

[10] *Dirks*, 463 U.S. at 663-64.

interpretations.[11] Rather than propose any single meaning for the personal benefit element, the purpose of this essay is to explain that the Supreme Court's Rule 10b-5 precedents require the courts to consider the meaning of personal benefit with an interpretive guide that limits liability.

## II. PRECEDENTS FOR A NARROW CONSTRUCTION OF JUDICIALLY IMPLIED CLAIMS UNDER SECTION 10(B)

In a series of decisions construing Section 10(b) and Rule 10b-5 after the courts had implied a private right of action, the Supreme Court expressed concern with the relentless broadening of the application of the Rule. Section 10(b) of the Exchange Act authorizes SEC rules to prohibit manipulative and deceptive devices used in connection with the purchase or sale of a security, and Rule 10b-5 is the general provision implementing the section. Over time, the Court formulated a rule of narrow construction to check expansion of the Rule. Three examples are *Blue Chip Stamps*,[12] *Stoneridge*,[13] and *Janus*.[14]

In *Blue Chip Stamps*, the plaintiffs alleged that a company violated Rule 10b-5 by offering securities using material misstatements that caused them not to buy the securities. The Court held that a plaintiff must be a purchaser or seller to bring a private Rule 10b-5 claim, expressing concern with "the inexorable broadening of the class of plaintiff who may sue in this area of the law."[15] The Court gave a list of reasons for limiting the class of

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[11] *See*, *e.g.*, *Newman*, 773 F.3d at 452-53 (discussing other court decisions on personal benefit).
[12] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).
[13] Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008).
[14] Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct. 2296 (2011).
[15] *Blue Chip Stamps*, 421 U.S. at 747-48.

private plaintiffs. Some related to the nature of private litigation,[16] but one reason for the limitation was the absence of a statute explicitly creating the private claim: "We are dealing with a private cause of action which has been judicially found to exist, and which will have to be judicially delimited one way or another unless and until Congress addresses the question."[17]

In *Stoneridge*, the Court limited the reliance element of a private Rule 10b-5 claim. Suppliers to a publicly reporting company allegedly engaged in deceptive transactions to help the company issue false financial statements. The Court held that private plaintiffs could not be said to have relied on the conduct of the suppliers and could not maintain the action.[18] Justice Kennedy's opinion explained that the Court needed to limit the construction of the reliance element of a private Rule 10b-5 claim because the courts implied the claim: "Concerns with the judicial creation of a private cause of action caution against its expansion."[19] One concern was the need to respect the separation of powers and the role of Congress: "The decision to extend the cause of action is for Congress, not for us."[20] Expansion of the implied right of action under Section 10(b) and Rule 10b-5 also risked intrusion into areas governed by state law:

> Were the implied cause of action to be extended to the practices described here, however, there would be a risk that the federal power would be used to invite litigation

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[16] *Id.* at 739 ("There has been widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."), 739-46.
[17] *Id.* at 749.
[18] *Stoneridge*, 552 U.S. at 166-67.
[19] *Id.* at 165.
[20] *Id.* at 164-65.

> beyond the immediate sphere of securities litigation and in areas already governed by functioning and effective state-law guarantees. Our precedents counsel against this extension.[21]

The Court's apprehension about expansions of liability under Rule 10b-5 has not been limited to elements of the private claim that the SEC or federal criminal prosecutors do not need to prove. In *Janus*, the Court held that an investment adviser to an investment fund did not have primary Rule 10b-5 liability for statements under the ultimate control of the fund.[22] That limitation on the reach of primary liability for a false statement under Rule 10b-5 applies in both government and private claims, yet a reason given for the limitation was the judicially created private right of action. The Court began its analysis by observing that "we are mindful that we must give 'narrow dimensions . . . to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law.'"[23] It later repeated: "Our holding also accords with the narrow scope that we must give the implied private right of action."[24]

The Court's concern with judicially implied claims resulted in narrowing constructions in other situations. In *Virginia Bankshares*, the Court refused to expand the class of plaintiffs entitled to bring an implied private action under Section 14 for a proxy violation.[25] In *Central Bank*, the Court refused to extend the implied private

[21] *Id*. at 161.
[22] *Janus*, 131 S. Ct. at 2305.
[23] *Id*. at 2302 (quoting *Stoneridge*, 552 U.S. at 167) (ellipsis in original).
[24] *Id*. at 2303.
[25] Va. Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1102-08 (1991).

right under Section 10(b) to claims against aiders and abettors.[26] The cases show that a restrictive interpretation is appropriate "when the Court has previously found that the statute in question provides an implied right of action and a party attempts to expand the class of persons or the conduct to which the recognized action applies."[27]

Time and again, the Supreme Court has expressed reservations about efforts to extend the reach of the private right of action implied by the courts under Section 10(b) and Rule 10b-5 and has applied a restricting and limiting rule of construction. Expansive interpretations should be left to Congress, which can better take competing interests into account, especially when an expansion would displace state law and other remedies.

## III. TIPPING AS A JUDICIALLY IMPLIED CLAIM

The tipping violation is a claim implied by the courts from Section 10(b) and Rule 10b-5 and should be subject to the same narrowing rule of construction that the Court has applied to the implied private right of action under Section 10(b). The insider trading claim for tipping is a judicially implied cause of action because the connection to Section 10(b) and Rule 10b-5 is so remote.

At the time of *Dirks*, no act of Congress expressly prohibited insider trading or tipping in securities transactions. The legal foundation for both prohibitions was Rule 10b-5, which is the general anti-fraud regulation the SEC issued under the authority of Section 10(b) of the Exchange Act. That remains true today. Congress has not passed legislation describing the elements of or

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[26] Cent. Bank of Denver, NA v. First Interstate Bank of Denver, NA, 511 U.S. 164 (1994).

[27] Jackson v. Birmingham Bd. of Educ., 544 U.S. 167, 193 (2005) (Thomas, J., dissenting).

defining insider trading or tipping as a violation, although some post-*Dirks* statutes do refer to insider trading law. The "fact remains that there is no statutory definition to precisely identify which types of insider trading are permissible and which are not."[28]

Insider trading and tipping violations are creations of the courts and were initially based on an aggressive position from the SEC in a settled enforcement case. The Supreme Court recognized the insider trading violation in *Chiarella*, where the Court considered whether a defendant engaged in a "manipulative or deceptive device" within the meaning of Section 10(b) and Rule 10b-5 when he traded with material nonpublic information but was silent when purchasing the securities.[29] The Court acknowledged that "neither the legislative history nor the statute itself affords specific guidance for the resolution of this case."[30] It then concluded that a person's silence amounted to fraud proscribed by Section 10(b) when the person had a duty to disclose arising from a relationship of trust and confidence between parties to a transaction.[31] The Court's approach was based on parts of the SEC's opinion in the settled enforcement case *Cady, Roberts & Co*.[32]

The Court recognized tipping as a fraud violation under Section 10(b) and Rule 10b-5 in *Dirks*. The case concerned a person who

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[28] 4 THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 345 (6th ed. 2009).
[29] *Chiarella*, 445 U.S. at 226.
[30] *Id.*
[31] *Id.* at 230. *See also* Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153 (1972).
[32] *Chiarella*, 445 U.S. at 226-29. The reasoning in *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), was aggressive because neither Section 10(b) nor Rule 10b-5 expressly reached an omission based on a duty to disclose, the Commission issued its opinion in a settled case, and the facts involved tipping, an insider's disclosure at a time he had reason to believe the information was already public, and sales of securities to persons who were not shareholders in the relevant company.

received material nonpublic information from an insider and who had no duty to disclose before trading the security.[33] The legal question was how such an outsider acquired a duty not to trade on the inside information.[34] The Court constructed the violation as an extension of *Chiarella* on policies and laws other than Section 10(b) or Rule 10b-5[35] and fabricated elements of the violation to examine both the tipper and the tippee. A "tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information … when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach."[36] As already mentioned, the test for a breach of duty was "whether the insider personally will benefit, directly or indirectly, from his disclosure."[37]

The result of *Dirks* was far more legislative than the normal outcome of a court using traditional tools of statutory or regulatory construction to determine the meaning of a law. *Dirks* authorized a claim against an entirely new category of defendants, that is, strangers to a company who did not have a duty to keep information confidential or make any disclosure. The tipping violation was a new theory of liability with new elements of proof for conduct different from an insider's trade. The Court suggested that a tipping claim resembled a theory of secondary liability for a participant after the fact in the insider's breach of duty,[38] but that characterization smacks of the aiding and abetting claim the Court

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[33] *Dirks*, 463 U.S. at 649, 655.
[34] *Id*. at 655, 660.
[35] *Id*. at 659-60.
[36] *Id*. at 660.
[37] *Id*. at 662. *See supra* notes 11-14 and accompanying text.
[38] *Dirks*, 463 U.S. at 659; *see also Chiarella*, 445 U.S. at 230 n.12.

refused to accept in *Central Bank*.[39] *Dirks* purported to be a natural extension of *Chiarella*, which was supposedly rooted in the general anti-fraud law of Section 10(b) and Rule 10b-5, but *Chiarella* itself was a significant expansion, and *Dirks* was a complete invention of the Supreme Court with only a distant tie to Section 10(b) and Rule 10b-5.

In fashioning the insider trading and tipping claims, the Court did not limit their availability to the SEC or criminal prosecutors. The claims are also available to private parties through the private right of action implied under Section 10(b) and Rule 10b-5. A private party who trades directly with an insider or tippee may assert such a claim.[40] Therefore the Court's reasons for narrowly construing the scope of the private right of action implied under Section 10(b) apply to any interpretation of the insider trading or tipping violations. The availability of private insider trading actions implied under Section 10(b) adds to the need for the Court's narrowing rule of construction of the personal benefit element but is not a prerequisite because the concern is with judicial extensions of legal claims that are not securely attached to statutory language and that could overshadow existing state law remedies.[41]

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[39] *See supra* note 32 and accompanying text.

[40] *See* Fujisawa Pharm. Co. v. Kapoor, 115 F.3d 1332, 1337 (7th Cir. 1997) (plaintiff had direct insider trading claim under Rule 10b-5 against defendant, but the statute of limitations barred the claim; the plaintiff could not assert a statutory claim as a contemporaneous trader when it had a direct claim). A contemporaneous open-market trader has a statutory private right of action against an insider or tippee, *see infra* note 43 and accompanying text, but the statute expressly preserves the implied private right of action. 15 U.S.C. § 78t-1(d).

[41] *See* Leocal v. Ashcroft, 543 U.S. 1, 11 n.8 (2004) (when a statute has both criminal and noncriminal applications, it must be interpreted consistently whether encountered in a criminal or noncriminal context).

## IV. EFFECT OF INSIDER TRADING LEGISLATION AFTER *DIRKS*

After *Dirks*, Congress added several provisions to the Exchange Act that referred to insider trading violations, but the existence of those provisions does not alter the fundamental truth that insider trading law, and tipping law in particular, are creations and creatures of the courts. No language added by Congress provides any details or guidance about the terms or elements of an insider trading violation, exceptions, or defenses; the enactments do nothing more than refer generally to insider trading precedents or to a securities violation by a person in possession of material, nonpublic information.

In 1984, Congress added a section to the Exchange Act, now Section 21A, that authorizes the imposition of a civil monetary penalty in an SEC case in federal court against a person who violated the Exchange Act by buying or selling a security "while in possession of material, nonpublic information" or by communicating such information.[42] In 1988, Congress used similar language in Section 20A, which grants a private right of action to a person who bought or sold the same security contemporaneously with an inside trader.[43] Both Sections 21A and 20A use the

[42] Pub. L. No. 98-376, § 2, 98 Stat. 1264 (1984) (now codified at 15 U.S.C. § 78u-1). Section 21A(a)(1) permits a district court to impose a civil penalty on any person who "violated any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security or security-based swap agreement while in possession of material, nonpublic information in, or has violated any such provision by communicating such information in connection with" certain securities transactions.

[43] Pub. L. No. 100–704, § 5, 102 Stat. 4680 (1988) (codified at 15 U.S.C. § 78t-1). Section 20A(a) provides: "Any person who violates any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information shall be liable in an action in any court of competent jurisdiction to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased (where such violation is based on a sale of

substantive Section 10(b) law developed by the courts as the predicate for the private claim and the fines in an SEC case. The statutes do not define an insider trading or tipping violation. Commentators noted that, with Section 21A, Congress provided penalties for insider trading "without having to define precisely the conduct that is subject to sanction"[44] and, with Section 20A, established a private right of action for insider trading "without specifically defining the insider trading offense."[45] Two more recent statutes and the SEC also rely on judicially developed insider trading law.[46]

The statutes show some ratification by Congress of the judicially developed insider trading claims, but they do not counter

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securities) or sold (where such violation is based on a purchase of securities) securities of the same class." Private plaintiffs bring cases under Section 20A. *See, e.g.*, City of Edinburgh Council v. Pfizer, Inc., 754 F.3d 159 (3d Cir. 2014).

[44] DONNA M. NAGY ET AL., SECURITIES LITIGATION AND ENFORCEMENT 541 (3d ed. 2012).

[45] *Id.* at 543; *see also* 4 THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 402 (6th ed. 2009) (in 1984 and 1988, "the attempt to legislatively define insider trading was dropped and the statute was enacted without any such definition").

[46] In 2000, Congress extended "judicial precedents … that prohibit fraud, manipulation, or insider trading" to security-based swaps. Pub. L. No. 106-554, § 303(d), 114 Stat. 2763A-454 (2000) (adding second paragraph to section 10(b) of the Exchange Act). In 2012, a new statute provided that officials and employees of the federal government have a relationship of trust and confidence with the federal government and the citizens of the United States "for purposes of the insider trading prohibitions arising under this Act, including section 10(b) and Rule 10b-5." STOCK Act, Pub. L. No. 112-105, §§ 4(b)(2), 9(b)(2), 126 Stat. 292, 297 (2012) (adding Section 21A(g)-(h), 15 U.S.C. § 78u-1(g)-(h)).

The SEC summarized the main features of insider trading law in a rule, Rule 10b5-1(a), but included a preliminary note stating that the "law of insider trading is … defined by judicial opinions construing Rule 10b-5, and Rule 10b5-1 does not modify the scope of insider trading law" other than the meaning of a securities transaction "on the basis of" material nonpublic information. 17 C.F.R. § 240.10b5-1.

the reasons that the Supreme Court should apply a narrow rule of construction to specific aspects of those claims. The statutes validating insider trading proscriptions added no detail to the substantive elements of the violations. When a component of an insider trading or tipping claim is susceptible to reasonable doubt or dispute, such as the personal benefit requirement, the Supreme Court or a lower court must resolve the issue without help from the statutes. In the provisions, Congress accepted the judicial positions existing at the time with all of the gaps and ambiguities that those positions had and did not provide the kind of meaningful guidance that would relieve the courts of the need to exercise restraint and caution when further interpreting a judicially implied claim.

As a result, both of the Court's main reasons for narrowly construing aspects of a judicially implied claim apply to the elaboration of the personal benefit element of a tipping violation. Congress has not spelled out an insider trading or tipping violation, and various state law and other remedies apply to deter insider trading and tipping.[47]

## CONCLUSION

*Salman* resolved some but left open other questions about the meaning of the personal benefit test that is part of the tipping

[47] State law remedies are available. *See* STEPHEN M. BAINBRIDGE, INSIDER TRADING LAW AND POLICY 16-24, 53 (2014). Broker-dealers and investment advisers must establish, maintain, and enforce written policies and procedures to prevent the misuse of material, non-public information. 15 U.S.C. §§ 78*o*(g), 80b-4a. Companies typically have internal policies and procedures to prevent insider trading or unauthorized disclosures of information. *See, e.g.*, Alan M. Weinberger, *Preventing Insider Trading Violations: A Survey of Corporate Compliance Programs*, 18 SEC. REG. L.J. 180, 186 (1990); *see also Chiarella*, 445 U.S. at 246 (Blackmun, J., dissenting) (Chiarella's employer warned that his actions were improper and forbidden). An employer may discipline or discharge an employee for a violation of the policies.

violation of the insider trading laws. The tipping violation is a claim the Court implied under Section 10(b) and Rule 10b-5, and, as a result, the personal benefit question involves law that is distant from a congressional statute. Many issues about the personal benefit element call on a court to interpret the earlier Supreme Court decisions on tipping claims (*Dirks* and *Salman*), which interpreted a prior decision (*Chiarella*), which interpreted and applied an SEC rule (Rule 10b-5), which was derived from a general anti-fraud statute in the Securities Exchange Act (Section 10(b)). The courts therefore should adhere to Supreme Court precedents and narrowly construe the personal benefit test and other essential elements of the tipping violation to limit liability.