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Federal Courts Lack Authority to Decide Insider Trading Criminal Cases

The federal courts since the 1960s have imposed criminal sanctions for insider trading violations without a statute defining the prohibited conduct. They have done so based on a statute that authorizes criminal sanctions for violations of rules promulgated by the Securities and Exchange Commission and an SEC regulation that prohibits, without defining, conduct we have come generally to call "insider trading." Yet, in 1812 the U.S. Supreme Court held, in *United States v. Hudson*, 11 U.S. (7 Cranch) 32 (1812), that federal courts lack constitutional authority to define criminal conduct and decide common-law criminal cases. It is time for the federal courts to adhere to *Hudson* and get out of the business of enforcing an administrative agency's rule as a crime. It is also time for Congress to perform its constitutional function, if it wishes to have continued criminal enforcement, and enact an insider trading statute.

On May 9, 2017, the U.S. Court of Appeals for the Second Circuit heard further argument in the case of Mathew Martoma, serving a nine-year sentence for insider trading. One of the issues that the court will consider is how much, if any, of its 2014 *Newman* personal-benefit standard (773 F.3d 438 (2d Cir. 2014)), a required element for insider trading conviction, survives the Supreme Court's 2016 ruling in *Salman* (137 S. Ct. 420 (2016)). That is an important issue. In deciding the *Martoma* appeal, the Court of Appeals may also want to consider the more fundamental issue of whether it even has the constitutional authority to decide an insider trading criminal case.

Background

In 1942, the SEC promulgated Rule 10b-5 to prohibit insider trading. The Rule neither mentions insider trading, much less defines the precise conduct (among the variety of insider trading acts) that is deemed wrongful. It adopts the language of §17(a) of the Securities Act of 1933, but places its authority on §10(b) of the Securities Exchange Act of 1934, a broad delegation to an agency without any statutory standards to guide its conduct. In structuring

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as it did Rule 10b-5, the SEC avoided the constraints imposed by Congress on §17(a) while benefiting from the unconstrained delegated authority of §10(b). Congress has never enacted a law defining insider trading and making the defined conduct a crime. Indeed, it has expressly declined even to define insider trading. As Louis Loss and Joel Seligman have said of this doctrine, "it is difficult to think of another instance in the entire corpus juris in which the interaction of the legislature, administrative rulemaking, and judicial processes has produced so much from so little."[1]

With the acquiescence of Congress, and the statutory authority to enforce properly promulgated SEC regulations as crimes, the federal courts have enforced Rule 10b-5 with criminal sanctions by defining the elements of criminal insider trading. The courts have announced those elements in case-by-case adjudications, the typical common law methodology. Virtually all would agree that insider trading is a common-law crime. As defined by federal courts, the personal-benefit element of that crime has wreaked havoc in insider trading criminal cases. In 1983, the Supreme Court held in *Dirks v. SEC*, 463 U.S. 646 (1983), that a violation requires a corporate tipper-insider to breach a fiduciary duty by disclosing confidential information to a tippee-outsider, that disclosure must have been f*or a personal benefit to the tipper*, and the tippee who trades based on the information must have had knowledge of both the breach of duty by, and the personal benefit to, the tipper. Moreover, the court stated that where tipper and tippee are "trading relative or friend," it is sufficient that the tipper gave such information as a "gift" knowing the tippee will use it to trade. From 1983 to 2014, the lower federal courts have struggled to make sense of the precise nature and contours of the personal-benefit element announced in *Dirks*.[2]

On Dec. 10, 2014, the federal Court of Appeals in New York reversed the convictions in the *Newman* case and announced a stricter standard of tipper personal benefit than that promulgated in *Dirks*. To uphold the convictions, the government must prove, the court held, that the tipper and tippees (some of whom were three or four levels removed from the tipper) had (1) a "meaningfully close personal relationship," (2) that "generates an exchange that is objective, consequential," and (3) that the exchange yielded "a potential gain of a pecuniary or similarly valuable nature." The Supreme Court declined the government's request to hear the *Newman* case.

On July 6, 2015, U.S. Court of Appeals for the Ninth Circuit affirmed the insider trading conviction of Bassam Salman using the *Dirks* standard. There, declining to follow *Newman* in a case involving close relatives by blood and marriage, the court ruled that it was enough to convict Salman that the tipper-insider was his brother-in-law who had made a "gift" of confidential inside information to his older brother, who then passed the information to Salman. The tipper knew that his brother would (and indeed intended that he) use the information to trade, and Salman knew that the tipper was the younger brother. The younger brother was not aware that his older brother would share the information with Salman, but Salman knew of the brothers' close relationship. The evidence revealed no tangible benefit to the younger brother other than his desire to appease his older brother's incessant demands for inside information and to "help him" and fulfill "whatever needs he had." Salman was sentenced to three years. *United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015) (Rakoff, J., sitting by designation).

Analysis

The "tension," to use the Supreme Court's word, between the rulings in *Newman* and in *Salman* resulted in a court ruling affirming Salman's conviction on Dec. 6, 2016. Justice Samuel Alito, writing for a unanimous 8-0 court, ruled, narrowly, that the *Salman* decision was consistent, and the *Newman* ruling inconsistent, with the court's decision in

Dirks. The court reaffirmed and announced as a rule of law a standard from *Dirks* that might, with some plausibility, have been viewed as dictum. The tipper and tippee in *Dirks* were neither family members nor close friends. Unlike *Dirks*, however, the legality of a "gift" of inside information to a family member was squarely presented in *Salman*. The court there disapproved (at least in cases involving family members) the *Newman* element of a benefit to the tipper of a "pecuniary or similarly valuable nature." Justice Alito, however, did not define the nature of the personal benefit to the tipper-insider necessary for criminal conviction in "trading relative cases" or in other cases. If, in the Supreme Court's view, the *Newman* ruling was too rigorous in requiring the government to prove a pecuniary or other similar personal benefit when close family members are involved, the *Salman* decision failed to define the nature of the personal benefit required for conviction even when trading relatives are charged. Understandably, given the facts of *Salman*, the court did not address the issue of what is meant by a "meaningfully close personal relationship" in cases not involving family members. More troubling, however, since even family members may not be close, the court gave no indication of how close must the family relationship be to support conviction. Hence, the need for further consideration of the Martoma conviction by the Second Circuit after the *Salman* ruling. As between casual "friends" or professional acquaintances, as in *Martoma*, how close must the relationship be to sustain a conviction? And if a pecuniary benefit is not required, what exactly must the prosecution prove beyond a psychological benefit, presuming that by itself is insufficient? Unless changed by congressional legislation, lower courts will therefore continue to grapple with these "difficult" problems. See *United States v. Bray*, 853 F.3d at 25 n. 5 (*Newman's* "meaningfully close personal relationship" survives *Salman's* ruling and conviction is affirmed based on facts showing "close" relationship).[3]

The federal courts, however, should not have to struggle in case after case to define the nature of the personal benefit, the closeness of the relationship between tipper and tippee, and the precise level of knowledge a tippee must be shown to possess sufficient for criminal conviction. They must do so now only because we lack a statute defining the elements of the insider trading crime. More important, members of the financial services sector, and legal advisors, should not have to guess on what is necessary for compliance on pain of conviction if mistaken. The fate of Matthew Martoma, the SAC Capital Advisors manager now serving his sentence, may depend on a judicial declaration, after his conviction, of the closeness of his relationship to his tipper, if the Second Circuit concludes that that aspect of its *Newman* personal-benefit element survived the *Salman* decision. We should all be deeply troubled by such a legal development. We should all know, before prosecution and conviction, the legal rules regarding insider trading. In the words of the English philosopher, J. R. Lucas, "It is a great enhancement of liberty to have all the laws written down explicitly and not locked up in the hearts of judges, no matter how just." J. R. LUCAS, ON JUSTICE 143 (1980). We should all be deeply concerned that for decades the federal courts have been adjudicating criminal insider trading cases under common-law rules and sending people to jail for substantial periods for a crime Congress has decided not to define.

On Nov. 10, 2014, in *Whitman v. United States*, 135 S. Ct. 352, 354 (2014) (Scalia, J., respecting the denial of certiorari), a criminal insider trading case that the Supreme Court declined to hear, the late Justice Antonin Scalia, joined by Justice Clarence Thomas, issued a statement that the court in an appropriate future case may want to reconsider the doctrine of giving deference to an administrative agency like the SEC construing a statute with civil and criminal sanctions.[4] The Scalia and Thomas *Whitman* statement also reaffirmed the principle that it is a legislative, not a judicial or administrative, function to define conduct as criminal. A judicial ruling invalidating the insider trading doctrine on constitutional or even statutory grounds may be all that Congress needs to pass a statute.

Endnotes

1. LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3485 (3d ed. 1991) (quoted in Carlyle H. Dauenhauer, "Justice in Equity: *Newman* and Egalitarian Reconciliation for Insider-Trading Theory," 12 RUTGERS BUS. L. REV. 41, 84 n. 132.

2. There is some disagreement about whether the personal-benefit element, announced in "classical" theory insider cases, also applies in "misappropriation" cases, the second (and more often utilized) of the two theories used for insider trading cases. See *United States v. Bray*, 853 F.3d 18, 24 n. 4 (1st Cir. 2017). Associate Justice David H. Souter (Ret.) participated in the decision of this case.

3. The Court of Appeals in Bray concluded that "[w]e need not determine, for instance, how 'close' a tipper-tippee relationship must be before a jury can infer a gift-based personal benefit." Id. at 26. Insider trading criminal doctrine also requires proof of the tippee's knowledge of the benefit to the tipper. Although that issue was not implicated in *Salman*, it too is likely to be fertile ground for future litigation in insider criminal cases. What exactly must be proven as the tippee's knowledge of the benefit to obtain a conviction?

4. Justice Neil Gorsuch is likely to share this view. See *Gutierrez-Brizuela v. Lynch*, 834 F.3d 1142, 1149 (10th Cir. 2016) (Gorsuch, J., concurring).

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