

Congress, Not Federal Agencies, Make Criminal Laws

As the United States Supreme Court begins its new term next Monday, one of the first cases it will hear is *Salman v. United States*, a significant criminal case involving insider trading, one of the murkiest areas of criminal law.

In 2004, Bassam Salman, a grocery wholesaler, received valuable inside information from his brother-in-law-to-be Michael Kara, who, in turn, had received the information from his brother Maher Kara (Maher Kara married Salman's sister in 2005), an investment banker at Citigroup.

Although there was no allegation that Salman gave any money or goods to either Michael or Maher Kara, Salman was subsequently convicted of insider trading.

To obtain a conviction, prosecutors must prove that the insider (the tipper) received some personal benefit from the person to whom the information was given (the tippee). The *Salman* case asks whether strengthening a family bond by giving a "gift" of inside information to a relative is a legally sufficient benefit to the tipper to sustain the tippee's conviction for insider trading.

What Is Insider Trading?

There can be no crime without law, and only Congress can enact federal criminal law; the Supreme Court has reiterated these principles time and again. Yet there is no federal statute that clearly defines and prohibits the federal crime of insider trading.

The Securities Exchange Act of 1934 addresses one subspecies of the offense (the short-swing profit, a purchase and sale of stock within a six-month window by a "beneficial owner,

director, or officer,” driven by nonpublic information).

Other demarcations between legal and illegal trading have not come from Congress, but rather have come from the Securities and Exchange Commission and the judiciary.

There is a federal law (15 U.S.C. § 78j(b)) that outlaws “any manipulative or deceptive device or contrivance in contravention of such rules and regulations” promulgated by the SEC. SEC Rule 10b-5 prohibits fraudulent or deceitful practices “in connection with the purchase or sale of any security.” Other regulations purport to flesh out the details, but they are as clear as mud.

The Supreme Court has stepped in to demystify—in Congress’s stead—when insider trading is and is not a crime. In 1983, in *Dirks v. SEC*, the court held that insider trading by the recipient of nonpublic information is prohibited only when the corporate insider who discloses the information personally benefits from the disclosure and the recipient who trades on the information “knows or should know” that the disclosure constitutes a breach of the insider’s fiduciary duty to his corporation.

The court went on to state that “[a]bsent some personal gain, there has been no breach of duty to stockholders,” and therefore no crime has occurred. That leaves open the question of what exactly is and is not a personal gain or benefit to the tipper that will trigger liability. Although, the court said in dictum (a statement in a court opinion that is not necessary to resolve the legal issues in that particular case, and which, although perhaps persuasive, lacks the full force of binding precedent) in the *Dirks* case that one could be held liable “when an insider makes a gift of confidential information to a trading relative or friend.”

To clarify this concept, if an individual trades on information he innocently overhears from a CEO at a high

school track meet, there is no tippee liability for insider trading because the tipper unwittingly disclosed the information without receiving a personal benefit.

While that seems an unlikely venue to get stock tips, legendary football coach Barry Switzer once benefitted from that precise scenario and was cleared of wrongdoing.

On the other hand, the classic example of insider trading occurs when a corporate employee tips insider information to a friend who then trades on that information and splits the profits with the employee. Here, the tipper received a clear, monetary benefit in exchange for providing the illicit information.

Yet, cases are often not so cut-and-dry as to what amounts to a personal benefit. *Salman* is expected to have far-reaching consequences on the scope of liability, depending on what the Supreme Court decides constitutes a “personal benefit” to an insider.

In 2012, a federal district court judge in New York City, Jed Rakoff, long considered a leading authority in both criminal law and securities law, wrote an opinion affirming an insider trading conviction, in which he stated that “the benefit does not need to be financial or tangible in nature; it could include, for example, maintaining a useful networking contact, improving the reputation or power within the company, obtaining future financial benefits, *or just maintaining or furthering a friendship*” (emphasis added).

However, in 2014, in *U.S. v. Newman*, the 2nd U.S. Circuit Court of Appeals—which includes New York—held otherwise, proclaiming that the personal benefit requirement:

does not suggest that the Government may prove the receipt of a personal benefit by the mere fact of a friendship, particularly of a casual or social nature. If that were true, and the Government was allowed to meet its burden by

proving that two individuals were alumni of the same school or attended the same church, the personal benefit requirement would be a nullity.

Newman gave the personal benefit requirement its bite back by requiring proof of “an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.”

Under Newman, a tippee can no longer be held criminally liable for trading a tip received from a friend without there being a more tangible benefit passing to the tipper.

Ironically, the 9th Circuit’s opinion affirming Salman’s conviction was written by none other than Rakoff, who was sitting by designation on that court. That opinion effectively reinstituted the pre-Newman, loose personal benefit standard, which concludes that a tipper who has a friendship or familial relationship with a tippee need not receive any more tangible benefit for passing on the information in order to subject the tippee to criminal liability.

Supreme Implications

Now, it is up to the Supreme Court to put its stamp of approval on either the 2nd Circuit’s more tangible personal benefit standard or the 9th Circuit’s looser standard.

The court should be reluctant to adopt the 9th Circuit’s standard. First, this definition would give prosecutors incredibly broad power, enabling them to prosecute tippees, even remote tippees, based on an intangible and somewhat amorphous “benefit” (if it can be called that) to the tipper.

As stated in an amicus brief filed on behalf of businessman Mark Cuban—who knows a thing or two about insider trading lawsuits—“any tip to a friend or relative could suffice to jail the tipper irrespective of any receipt of concrete

benefit from the exchange" if the Supreme Court does not curtail the SEC's attempt to expand the reach of insider trading law through litigation.

More fundamentally, however, while this case does not present an opportunity to the court to re-examine *Dirks*, which seems to be settled law, the Supreme Court should not go one step further—however opprobrious the tipper's conduct was here, and it was—in criminalizing conduct that has not been clearly proscribed by Congress.

As stated above, the Supreme Court held as far back as 1812 in *United States v. Hudson and Goodwin*, and several times since then, that there are no federal common law offenses and that before someone can be punished as a criminal, his conduct must "plainly and unmistakably" run afoul of a federal criminal statute.

As the court has also stated, "because of the seriousness of criminal penalties, and because criminal punishment usually represents the moral condemnation of the community, legislatures, and not courts, should define criminal activity."

The court deviated from this sound reasoning in *Dirks*, a move that has seemingly been tolerated by Congress. The court should not compound its error by going one step further, even if it seems like a small step. If Congress wishes to criminalize insider trading or expand the scope of current criminal liability, it can and should do so.

The court should send a signal to Congress in the *Salman* case that it needs to take back its authority to define criminal conduct; to provide greater direction to the courts, the SEC, the Department of Justice, and the public about what is and is not permissible; and to alleviate the concerns of parties who may be engaging in lawful trading, but who nonetheless fear the government may think otherwise.

John G. Malcolm oversees The Heritage Foundation's work to increase understanding of the Constitution and the rule of law as director of the think tank's Edwin Meese III Center for Legal and Judicial Studies.

David Rosenthal is a visiting legal fellow in the Edwin Meese III Center for Legal and Judicial Studies at The Heritage Foundation.

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