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THE OVERLOOKED DAISY CHAIN PROBLEM IN SALMAN

FRANKLIN A. GEVURTZ*

Abstract: In *Salman v. United States*, the Supreme Court granted certiorari to resolve a conflict with *United States v. Newman* as to when corporate insiders receive sufficient personal benefit from making gifts of inside information to make the tip and consequent trade illegal. This Essay explores an overlooked aspect of these cases, the “daisy chain problem,” which involves how the personal benefit element for illegal tipping applies to the subsequent tips that occur when the recipient of information from the corporate insider, in turn, passes the information on to others. This daisy chain problem could potentially distinguish the facts of *Salman* and *Newman* and thus deserves the attention of the Court and commentators.

INTRODUCTION

The Supreme Court recently heard oral arguments in *Salman v. United States*. The Court granted certiorari to resolve the clash between *Salman* and the U.S. Court of Appeals for the Second Circuit’s 2014 decision in *United States v. Newman* as to when corporate insiders receive sufficient personal benefit from making gifts of inside information to make the tip and consequent trade illegal. Interestingly, both *Salman* and *Newman* ignored another aspect of the personal benefit issue raised by the facts of both cases. This aspect, which I refer to as the “daisy chain problem,” involves how the personal benefit element for illegal tipping applies to the subsequent tips that occur when the recipient of information from the corporate insider, in turn, passes the information on to others. Because the daisy chain problem will become pressing after *Salman* unless the Court addresses it in its opinion, this problem is worth exploring.

I. UNDERSTANDING THE PROBLEM

For the most part, the prohibition on insider trading in the United States comes from opinions of the Supreme Court interpreting Section 10(b) of the...

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Securities Exchange Act of 1934 and Rule 10b–5 promulgated by the Securities and Exchange Commission. These opinions create a fairly elaborate set of rules governing when insider trading constitutes fraud in connection with the purchase or sale of a security, thereby violating Section 10(b) and Rule 10b–5. Essentially, corporate insiders cannot legally trade on material non-public information about the company for which they work, and persons cannot legally trade on information they misappropriate through the pretense that they could be trusted with such information. Critically for present purposes, in the 1983 case Dirks v. Securities and Exchange Commission, the Supreme Court held that insiders violate the law when they provide others with information upon which the insiders cannot legally trade (thereby becoming a “tipper”) and receive some personal benefit from providing the tip for the recipient’s trading. If the recipient of the information (the “tippee”) knows or should have known he or she received the information illegally, then the tippee also cannot legally trade.

Benefits the tipper might receive from tipping include money from selling the information, other inside information from swapping the information, or perhaps some reputational gain. Language in Dirks suggesting that the tipper can obtain a benefit from making a gift of information—based upon the rationale that this is equivalent to the tipper trading on the information and making a gift of the proceeds—created the issue in the case now before the Court in Salman and also in the Second Circuit’s decision in Newman. Yet, with all the focus in Salman and Newman on the benefit of making gifts, little attention has been given to the question of how Dirks’s “benefit of the tip” test applies to chains of tipping, as occurred in both Salman and Newman.

The facts in Salman illustrate the problem. Maher, the insider, tipped his brother, Michael, who, in turn, tipped his friend (and Maher’s brother-in-law), Salman. In order for Salman’s trades to be illegal, must Maher, in addition to benefiting from his original tips to Michael, also have benefited from Michael’s tips to Salman? Alternatively, is it sufficient that Michael benefited from his own tips to Salman, as long as Maher benefited from his tips to Michael? Or, given a benefit to Maher from his tips to Michael, is a benefit to either Maher or Michael from Michael’s tipping Salman even necessary?

In some instances, it will not matter who, if anyone, must benefit from the subsequent tips and trades in a daisy chain of tipping in order for the subsequent tips and trades to be illegal. For example, suppose a corporate insider,

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Steve, sells inside corporate information to a stock analyst, Dirk. Steve understands that Dirk will not trade himself, but will instead provide the information to Dirk’s clients for them to trade (in exchange for which Dirk will gain the continued patronage of his clients). In this example, both Steve and Dirk clearly benefit from Dirk’s tip to Dirk’s clients, and this benefit was contemplated when Steve tipped Dirk. Steve benefits from Dirk’s tip to Dirk’s clients because Dirk would not have paid Steve for the information without the plan (of which Steve was aware) to pass the information on to his clients. Dirk benefits by the continued patronage of his clients. Hence, Dirk’s tip to his clients is illegal and, if the clients are aware of Steve and Dirk’s dealings, their trades are illegal too. Indeed, any other result would drive a huge hole through the middle of the insider trading prohibition, since insiders could then simply sell information to parties who will not trade, but will instead sell the information to other parties who will.

To see where problems arise, compare the following example. Valerie, a CEO, gives her lover, a politician named Francois, valuable inside information about her company as a gift to celebrate the seventh anniversary of their relationship. Unknown to Valerie, Francois has started a fling with Julie. Francois passes on the information as a gift to Julie, who trades on it. Let us assume that the gift of information from Valerie to Francois meets the personal benefit test for Valerie, and that the gift of information from Francois to Julie provides a personal benefit for Francois. It is difficult to imagine that Valerie—even if she is as open-minded about such things as the French—perceives any benefit from Francois’ tip to Julie, or that part of the value of the gift she intended to bestow on Francois was the value he would obtain from giving the information to another woman. Hence, in this example, it matters to whom (if anyone) there must be a personal benefit from the subsequent tip. If it is just the intermediate tippee/tipper (Francois), then Francois’ tip and Julie’s trade (if she is aware of the source of the information) are illegal. If the personal benefit must accrue only to the original insider/tipper (Valerie), then Francois’ tip and Julie’s trade are legal.

If the rule is that the benefit of the subsequent tips must flow back to the original tipper in order to be illegal, then the complexity of the prosecution in a case like Salman multiplies, even if the Supreme Court holds that gifts benefit the giver regardless of whether they are offered as part of a quid pro quo. Putting aside the happenstance that Salman is Maher’s brother-in-law, how do Michael’s gifts of information to his friend Salman benefit Maher, who intended simply to provide a gift to Michael? Perhaps part of the value of the gift Maher intended to bestow upon Michael is the ability to benefit by giving the information to others for trading. Yet, how can this be established? Should we rely on Maher’s testimony?
Moreover, if the rule is that the benefit of each subsequent tip must flow back to the original insider/tipper, does this mean that the original insider/tipper must have contemplated this benefit when he or she provided the original tip, or is it sufficient that the subsequent tip objectively benefits the original tipper? Suppose, for example, that Maher sold the inside information to an arbitrager named Boesky, who turned around and sold the information to a trader named Milken, who traded on it. One can argue that Maher personally benefited from Boesky’s subsequent sale of the information for Milken’s trading. After all, Boesky’s willingness to pay for the information depends upon his ability to profit from its trading value, and he profits from the trading value—thereby dictating how much he is willing to pay—by either trading on the information himself or by selling the information for another to trade. Still, if Maher did not know that Boesky planned to sell the information, one might argue that, whatever the objective benefit Maher received from Boesky’s sale of the information, this was not part of the contemplated benefit that made Maher’s tip illegal. Of course, a rule that demands the original insider/tipper have contemplated the subsequent tips not only compounds the complexity of the prosecution, but also can tempt the intermediate tippee/tipper (Boesky in this example) to mislead the original insider/tipper by saying that the tippee plans to trade, not tip. After all, if Boesky does not trade, then he is not liable for trading, and if the tip to Milken is legal because Maher did not realize it would occur, then Boesky is not liable for the tip.

II. EXISTING AUTHORITY

Interestingly, there is not much authority on the question of who (if anyone) must benefit from the subsequent tips in order for remote tipping and trading to be illegal. Dirks v. Securities and Exchange Commission involved a tipping chain in which Dirks, a stock analyst, was both a tippee who received information from a corporate whistleblower, and a tipper, passing the information on to Dirks’s clients to use in trading (from which Dirks benefited in commissions and reputation).\(^7\) Dirks’s benefit, however, was irrelevant to the Supreme Court given the lack of benefit to the whistleblower in passing the inside information to Dirks—thereby never forcing the Court to consider who, if anyone, needed to benefit from Dirks’s further tipping the information he received from the insider.

In 2014, the U.S. Court of Appeals for the Second Circuit in United States v. Newman, similarly did not address what, if any, benefit was required for the middle tips in the daisy chains involved in that case.\(^8\) The court found that the

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\(^7\) See Dirks, 463 U.S. at 648–52.

insiders at the beginnings of the chains did not benefit from the initial tips, and, in any event, there was no proof that the prosecuted traders at the end of the chains were aware of the circumstances at the beginning of the chains. By contrast, the U.S. Court of Appeals for the Ninth Circuit’s decision to uphold the district court’s conviction in *Salman v. United States* should have called for someone to address the issue outlined earlier in this Essay as to whether Maher or Michael must benefit from Michael’s tips to Salman in order for Salman’s trading to be illegal.

A few federal court decisions address the question, with conflicting results. In 2011, in *Securities and Exchange Commission v. Obus*, the Second Circuit ruled that, in addition to the insider benefiting from the initial tip, the intermediate tipper/tippee must benefit from making the subsequent tip in order for the subsequent tippee to be liable for trading. In other words, it adopted the chain of individual benefits approach. By contrast, in 1984, the U.S. District Court for the Eastern District of Michigan in *Schick v. Steiger* found no illegal trading by a subsequent tippee when there was no allegation that the insider intended the intermediate tippee/tipper to disclose the inside information to other traders. It also found that the insider did not gain personally from the intermediate tipper/tippee’s further disclosure—thereby indicating that the benefit of subsequent tips must flow back to the original insider/tipper.

Commentators have generally avoided taking a position on the topic; I confess that even my own treatise on corporation law contents itself with simply identifying the issue. The two leading treatises on insider trading contain brief discussions, though these too ultimately leave the topic as an open question.

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9 See *id.*


11 See *SEC v. Obus*, 693 F.3d 276, 293 (2d Cir. 2011).

12 See *id.*


14 See *id.*

15 See FRANKLIN A. GEVURTZ, CORPORATION LAW 622 (2d ed. 2010).

III. RESOLVING THE ISSUE

So what should the rule be? To answer this question, it is necessary to understand the rationale behind the Court’s requirement from Dirks v. Securities and Exchange Commission that the insider must receive a benefit from making the tip in order for tipping and trading upon the tip to be illegal. This rationale is most definitely not that the law should limit disparity in information among stock traders in order to maintain some notion of integrity in the market. If that were the goal, the law would prohibit trading based on tips traceable to an insider regardless of whether the insider received a benefit from making the tip. This is the law in Europe, but the Supreme Court rejected this approach in Dirks.\(^\text{17}\) Instead, Dirks’s tipper/tippee liability rule is simply a necessary (but limited) patch designed to prevent the prohibition on corporate insiders profiting by trading on inside information from turning into the hollow letter it would become if insiders could still profit by passing on the information for others to use in trading. In other words, if the law seeks to prohibit certain persons from profiting by trading on inside information, then the law must prevent such persons from profiting by passing on the information for another person’s trading. This prevents people who hold insider information from doing indirectly what they cannot do directly.

Based upon this rationale, we can quickly dismiss the idea that no further benefit is necessary to make subsequent tips and trades illegal as long as the original tip benefited the insider and subsequent tippees are aware of the originally tainted source of the information. This would create the sort of tainted fruit approach to inside information that the Supreme Court rejected in Dirks. True, in this instance, unlike Dirks, the taint arises from the insider’s original sin of tipping for personal benefit. Still, it is difficult to see how a subsequent tip constitutes part of the insider’s effort to obtain profits from another person’s trading, when that tip does not produce even an indirect benefit for the insider. Nor is the subsequent tip part of an effort by the intermediate tippee/tipper to profit from information that the intermediate tippee/tipper cannot legally use for trading, when the intermediate tippee/tipper does not receive a benefit from making the subsequent tip. Hence, imposing liability when the subsequent tip does not produce some benefit from passing on information for trading—for instance, because the intermediate tipper/tippee was just gossiping—is contrary to the Dirks rationale for tipper/tippee liability.

On the other hand, tempting as it might be for the Supreme Court to cut back on the prospects for remote tipping liability by holding that the benefit of

subsequent tips must flow back to the original insider/tipper, the Court should reject such an approach. Instead, the better rule is that a chain of independent benefits—beginning with the insider’s benefit from the original tip and extending through each subsequent tippee/tipper’s benefit from passing on the information—should be sufficient to establish the illegality of the subsequent tips. There are two rationales for this conclusion.

The first rationale is pragmatic. As illustrated by *Salman v. United States* and *United States v. Newman*, determining whether the original insider/tipper received a sufficient personal benefit in the initial tip is already often difficult enough without vastly complicating the problem by trying to decide when subsequent tipping benefits the original tipper. As illustrated by the examples discussed above, matters become impossibly speculative if courts must find that the benefit of later tips flowed back to the original tipper, especially if this requires that the original insider somehow contemplated this benefit at the time of the initial tip.

Beyond pragmatics, there is principle, which in this instance points in the same direction. Specifically, looking at whether each intermediate tippee/tipper benefited from his or her tip, rather than demanding that the benefit of later tips flow all the way back to the original insider/tipper, carries out the underlying policy behind tipper/tippee liability, which, as explained above, is to prevent parties from doing indirectly what would be illegal for them to do directly (profiting from trading on inside information). Among the persons who cannot legally trade are tippees (if they know or should have known of their tipper’s breach), because they face liability as an accessory to an insider’s breach if they trade. In other words, tipper/tippee liability does not merely preclude the insider from profiting by passing on information for another’s trading in exchange for some personal benefit, it also holds that the knowing tippee cannot profit from trading on the information. Following the purpose for tipper/tippee liability set out above, if the knowing tippee cannot legally profit from trading, the knowing tippee should not be able to profit by passing along the information for another’s trading in exchange for some personal benefit.

Rest assured, however, that looking to the intermediate tippee/tipper’s benefit in each step of the daisy chain, rather than insisting that the benefit of subsequent tips flow all the way back to the original insider/tipper, should not create overly broad liability. This is because, under this theory, the prosecutor must prove not only that each tippee/tipper along the chain gained a personal benefit from passing on the tip, but also that each tippee along the chain knew or should have known that he or she illegally received information. This would include requiring the prosecutor to show that tippee/tipper knew or should have known that each prior tippee along the chain received a benefit and had the requisite knowledge to make that tippee’s tip illegal. Establishing that level
of proof should be manageable in compact chains, such as in *Salman*, but becomes problematic in attenuated chains as in *Newman*.

In fact, one might worry that insiders will seek to exploit this proof problem with a scheme of information laundering (like money laundering, but only with inside information) in which they sell inside information to tippees, who will sell the information to subsequent tippees until the final buyer can plausibly hide behind the difficulty of proving the requisite knowledge of illegality up the entire chain. To avoid this, the option to prove the illegality of subsequent tips based upon the initial insider/tipper having anticipated his or her indirect benefit from the subsequent tips should remain a viable theory as well. In other words, either theory of benefit from the daisy chain should be acceptable.

**CONCLUSION**

While the parties, courts, and commentators in *Salman v. United States* and *United States v. Newman* have been preoccupied by evaluating when giving the gift of inside information benefits the giver, an overlooked issue in these cases involves how the personal benefit element for illegal tipping applies to the subsequent tips that occur when the recipient of information from the corporate insider, in turn, passes the information on to others. This aspect, which I refer to as the “daisy chain problem,” might actually distinguish the facts of *Salman* and *Newman* and deserves critical attention.

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