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Friends and Benefits: US Supreme Court clarifies how insider trading liability under US law differs from UK law

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In December of last year, the US Supreme Court issued its first insider trading decision in more than two decades, in *Salman v United States*. The decision reinforced the single most important difference between insider trading in the UK and in the US: that the US offence includes a somewhat formal breach of fiduciary duty element.

Salman reiterated that in a case involving a "tip" of inside information, the breach of fiduciary duty requirement means that the tipper must have received some personal benefit from the tippee. The Supreme Court relaxed this personal benefit requirement solely in non-commercial circumstances where the tipper and tippee are either friends or family. Thus, in a tipping case in the United States, the government cannot convict a person for trading on inside information in a commercial context unless it can prove either that the trader (or some other tippee) provided the tipper with some benefit in exchange for the information, or that the tipper and tippee had a familial or friendly relationship that could itself constitute a sort of benefit. Because the English regime does not require the prosecution to prove a breach of fiduciary duty or a personal benefit to the tipper, or the ultimate trader's knowledge that the tipper breached his fiduciary duty by receiving a personal benefit, market participants who trade on potentially non-public information in the UK are at somewhat greater risk of prosecution than in the US. On the other hand, the English regime has a much broader definition of what information qualifies as public, meaning that market participants in the UK have greater latitude to trade on information that has not been formally disclosed by the issuer, but may nevertheless be available to a diligent investor. As a result of these two key distinctions, conduct that is illegal in one jurisdiction may be legal in the other.

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Background legal rules in the UK and the US

In the UK, under the Criminal Justice Act 1993 (CJA), "inside information" is defined as information which: (1) relates to particular securities or a particular issuer(s); (2) is specific or precise; (3) has not been made public; and (4) if it were made public, would likely have a significant effect on the price of any securities. This last component of the definition is the English regime's equivalent to the US requirement of "materiality".

Pursuant to the CJA, "An individual who has information as an insider is guilty of insider dealing if, [in specified circumstances], he deals in securities that are price-affected securities in relation to the information." Further, "An individual who has information as an insider is also guilty of insider dealing if (a) he encourages another person to deal in securities that are (whether or not the other knows it) price-affected securities in relation to the information, knowing or having reasonable cause to believe that the dealing would take place in [specified circumstances]; or (b) he discloses the information, otherwise in the proper performance of the functions of his employment, office or profession, to another person." The specified circumstances are "that the acquisition or disposal in question occurs on a regulated market, or that the person dealing relies on a professional intermediary or is himself acting as a professional intermediary".

In the US, section 10(b) of the Securities Exchange Act of 1934 prohibits "any manipulative or deceptive device or contrivance" used "in connection with the purchase or sale of any security." Although this general antifraud provision does not specifically mention insider trading, the courts have developed two theories of insider trading. Under the classical theory, corporate insiders such as a company's employees, lawyers or bankers violate US insider trading laws if they trade on the basis of material, non-public information in breach of their fiduciary duty not to exploit the company's information for their personal advantage. Under the misappropriation theory, even corporate outsiders, who have no fiduciary duty to the company itself, can violate US insider trading laws if they misappropriate confidential information for trading purposes, in breach of a duty of trust or confidence owed to some other source of the information, such as their employer or client.

Under either theory, the non-public information must be material. Information is material for the purpose of US law if it might reasonably be expected to affect the market value of the securities or influence investor decisions to buy, sell, or hold securities. Materiality determinations are inherently fact-intensive and there are no bright-line rules. Thus, section 10(b), as interpreted by the courts, prohibits the same type of activity proscribed by the UK's dealing and disclosing offences.

Under US law, persons bound by a duty of trust or confidence not to trade on inside information are also forbidden from tipping inside information to others for trading. A tippee who receives inside information with the knowledge that its disclosure breached the tipper's duty acquires that duty and may be liable for any undisclosed trading on the information. Tippee liability hinges on whether the tipper's disclosure breaches a fiduciary duty, which occurs when the tipper discloses the information for a personal benefit. Historically, this personal benefit requirement was construed loosely to include mere reputational benefits associated with a tipper's gift of inside information. In 2014, however, the Second Circuit decided *United States v Newman*, which significantly tightened the personal benefit requirement to require a "potential gain of a pecuniary or similarly valuable nature".

Salman v United States: breach of fiduciary duty or personal benefit requirement

In *Salman v United States*, the US Supreme Court considered a variant of the question decided by a lower court in *Newman* – whether a tipper must receive money or some other pecuniary benefit to meet the "personal benefit" requirement. But in Salman, the tipper and the tippees, including Salman himself, were all part of the same extended family. Relying on *Newman*, Salman argued that he could not be held derivatively liable as a tippee because the tipper (his brother-in-law) did not personally receive money or property in exchange for the tips and thus did not personally benefit from them.

The US Supreme Court disagreed, holding that a gift of confidential information to a "trading relative or friend" is sufficient to constitute a personal benefit. In these situations, the Court explained that the tipper personally benefits because giving a gift of trading information to a trading relative is the same thing as trading by the tipper followed by a gift of the proceeds.

In contrast, under English law there is no requirement for prosecutors to prove that inside information is obtained or disclosed in violation of a fiduciary duty or for a personal benefit. It is enough that an insider carries out a prohibited act (dealing, encouraging or disclosing) while in possession of inside information. This approach can be seen as taking closer account of commercial reality, as it recognises that insiders may give inside information even to individuals who are not friends or family, without receiving a tangible personal benefit in return. The English regime also avoids the need for prosecutors to prove that a tipper received a personal benefit, or that a tippee knew that the tipper had received a personal benefit. This requirement can be difficult to prove, particularly when the information is transmitted through multiple tippers and tippees, such that the person who ultimately trades on the information knows nothing about the original tipper/source.

That said, under English law a person is an insider only if he knows that the information in his possession is inside information and he knows that he has the information from an inside source. In practice, this knowledge requirement is often difficult for prosecutors to establish.

Non-public information

The other most significant discrepancy between US and English law is that English law has a significantly looser definition of when information is deemed public. Information is non-public for the purpose of US law if it has not been disseminated in a manner making it available to investors generally. Information does not become public until it is disseminated in a manner calculated to reach the securities marketplace through recognised channels of distribution, and public investors have had a reasonable period of time to react to the information. Recognised channels of distribution include annual reports, prospectuses, press releases, marketing materials, and publication of information in prominent financial publications.

By contrast, the CJA permits information to be deemed public in a variety of circumstances that involve less extensive disclosure than under US law, including where the information: (a) is published in accordance with the rules of a regulated market for the purposes of informing investors and their professional advisers; (b) is contained in records which are open to public inspection by virtue of an enactment; (c) can be readily acquired by those likely to deal in any securities to which the information relates or of an issuer to which the information relates; and (d) is derived from information which has been made public. Furthermore, under English law information may be deemed public even if it: (a) can be acquired only by persons exercising diligence or expertise; (b) is communicated to a section of the public only; (c) can be acquired by observation only; (d) is communicated only on payment of a fee; and (e) is only published outside the UK.

English law's broader view of when information may be deemed to have been made public is arguably more grounded in marketplace reality. For example, channel checking (third-party research into a company's business by obtaining information from distribution channels of the company) has been a hot topic in the US for a number of years. US regulators have investigated whether such activity could amount to insider trading, and this issue remains a grey area under US law. Under English law, and absent knowledge on the part of the recipient that the information was confidential or inside information, information obtained by these means would likely be classified as public information.

Affirmative defence – individual would have traded anyway

Another difference between US and English law on insider trading relates to an available affirmative defence. In the UK, a defendant will not be found guilty of insider trading if he can prove that he would have undertaken the same trades (or encouraged another to do so) even if he had not been in possession of the inside information.

This type of defence is not available under US law. In the US – at least in a case brought by the SEC rather than the US Department of Justice (DOJ) – if a trader was aware of material, non-public information, then he could not trade on that information, even if he can prove that would have traded anyway. Instead, under SEC Rule 10b5-1, a trader can escape liability for insider trading if he can show that, *before* becoming aware of the information, he had some sort of binding contract or plan to trade the security.

Someone in the securities business likely would view the UK's affirmative defence as more in line with commercial realities, as the US rule can prevent a person from trading even if they received information by accident and was already planning to make a particular trade. But in practice the two regimes may not be so different on this point: Even in the UK, a defendant would need to adduce compelling corroborative evidence to show that he had a firm intention, prior to the date on which he obtained the inside information, to purchase the same type and amount of securities actually purchased.

Penalties

The penalties and likely approach of the prosecuting authorities in the US and UK in cases of insider trading are markedly different. In the US, several individuals have been sentenced in high-profile insider trading cases to prison terms of nine to 12 years in the last decade. In contrast, in the UK the longest prison sentence to date for an insider trading violation was four-and-a-half years. The UK has also lagged behind the US in terms of the number of successful prosecutions for insider trading, largely due to the more robust investigation techniques used in the US and the greater resources of the DOJ. While the UK's Financial Conduct Authority (FCA) appears to have made headway in this respect in the years following the financial crisis, the UK is still considerably behind the US.

Conclusion

Market participants and compliance officers must be sensitive to these key differences between US and English law, which can be outcome determinative in situations that frequently arise in the marketplace.