Rolex Watches, Undersized Fish, and Insider Trading?

Donna M. Nagy*

The Supreme Court’s concern with over-criminalization is the theme that connects the Rolex watch in McDonnell v. United States1 with the undersized fish in Yates v. United States.2 “Gifts” of a luxury watch and high-end designer clothing, along with multiple “loans” and the payment of the catering bill for his daughter’s wedding, were key parts of the evidence against former Virginia Governor Robert McDonnell, whose federal convictions for wire fraud and honest services fraud were recently vacated by a unanimous Supreme Court.3 The Court’s decision turned on whether McDonnell had engaged in quid pro quo exchanges for “official acts” within the meaning of the federal bribery statute.4 The Court deemed his acceptance of the gifts and loans to be “no doubt . . . distasteful” and perhaps “even worse than that.”5 But rather than “tawdry tales of Ferraris, Rolexes, and ball gowns” (along with the other quids received by the Governor and his wife), the Court was concerned with “the broader legal implications of the Government’s boundless interpretation” of the statute’s term “official act.”6 In the Court’s view, the quos that were granted to the couple’s benefactor (a pharmaceutical company’s CEO who had sought state-sponsored research studies) were not “concrete”7 or “specific and focused”8 enough to constitute “a decision or action” on a “question, matter, cause, suit, proceeding or controversy” brought before a public official.9 Instead, the quos merely involved “arranging meetings” between the CEO and other Virginia officials to discuss the company’s nutritional supplement, “hosting” events for the company at the Governor’s Mansion, and “contacting other government officials” concerning the research studies.9 The Court resolved the case by announcing a bright line rule that to fall within the federal crime of bribery, an official act “must involve a formal exercise of governmental power that is similar in nature to a lawsuit before a court, a determination before an


1 136 S.Ct. 2355 (2016).
3 McDonnell, 136 S.Ct. at 2362-64.
5 McDonnell, 136 S.Ct. at 2374.
6 Id. at 2375.
7 Id. at 2369.
8 Id. at 2371-72 (quoting 18 U.S.C. § 201(a)(3)). See also id. at 2368-69 (applying the interpretive canon noscitur a sociis, “a word is known by the company it keeps” and observing that it applied “that same approach” in Gustafson v. Alloyd Co., 513 U.S. 561 (1995)).
9 Id. at 2361.
agency, or a hearing before a committee.”\textsuperscript{10} Although the favors dispensed had yielded the McDonnells more than $175,000 in personal benefits, the Court foresaw the possibility of politically motivated prosecutions for \textit{de minus} exchanges and thus refused to broadly “construe a criminal statute on the assumption that the Government will ‘use it responsibly.’”\textsuperscript{11}

\textit{Yates v. United States}\textsuperscript{12} involved a captain’s failure to follow a federal inspector’s instruction to segregate possibly unlawfully-caught undersized fish from the rest of his catch until his ship returned to port. He instead had brazenly ordered one of his crew members to toss the evidence overboard. The captain was then charged with, and convicted for, violating the Sarbanes-Oxley Act provision that made it a crime for a person to knowingly alter, destroy, or conceal “any record, document or tangible object with the intent to impede, obstruct, or influence” a federal investigation.\textsuperscript{13} Interpreting the term “tangible object” to cover only “objects one can use to record or preserve information, not all objects in the physical world,” the Court vacated the captain’s conviction.\textsuperscript{14} As the plurality saw it, Congress had been concerned with the destruction of financial information, not the destruction of fish. But even if legislative history and other “traditional tools of statutory construction” had left some doubt as to the meaning of “tangible object,” the Court observed that the “rule of lenity” reinforced its conclusion that any “harsher alternative” should be a “clear and definite” choice made by Congress.\textsuperscript{15}

The Court’s current concern with federal prosecutorial overreaching dates back to its 2010 decision in \textit{Skilling v. United States}.\textsuperscript{16} Jeffrey Skilling had been convicted of, among other offenses, defrauding Enron and its shareholders of their “intangible right of his honest services” in violation of the federal wire and honest services fraud statutes.\textsuperscript{17} In vacating Skilling’s conviction for these frauds, the Court rejected the Government’s argument that the statutes extend to any scheme that involves an undisclosed conflict of interest. Instead, it read the proscription of fraudulent deprivations of honest services to criminalize only conduct involving bribes or kickbacks – offenses that implicate “seriously culpable conduct.”\textsuperscript{18} The Court reached this holding because there was “no doubt that Congress intended § 1346 to reach at least bribes and kickbacks,”

\begin{itemize}
  \item[10] Id. at 2372.
  \item[11] Id. at 2372-73.
  \item[12] 135 S. Ct. 1074 (2015)
  \item[13] Id. at 1078 (quoting 18 U.S.C. § 1519).
  \item[14] Id. at 1081.
  \item[15] Id. at 1088 (stating that “[a]pplication of the rule of lenity ensures that criminal statutes will provide fair warning concerning conduct rendered illegal and strikes the appropriate balance between the legislature, the prosecutor, and the court in defining criminal liability” (quoting Liparota v. United States, 471 U.S. 419, 427 434 (1985)).
  \item[16] 130 S. Ct. 2896 (2010).
  \item[17] Id. at 2908 (observing that 18 U.S.C. §§ 1341 and 1343 criminalize the use of the mails and wires in furtherance of “any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises” and that the honest-services statute, § 1346, defines “the term ‘scheme or artifice to defraud’ ” in these provisions to include “a scheme or artifice to deprive another of the intangible right of honest services”).
  \item[18] Id. at 2933 (internal quotes omitted).
\end{itemize}
whereas interpreting “the statute to proscribe a wider range of offensive conduct . . . would raise the due process concerns underlying the vagueness doctrine.” 19 The Court thus concluded that “[i]f Congress desires to go further, . . . it must speak more clearly than it has.” 20

The defendant in *Salman v. United States* 21 is clearly hoping that the Court’s inclination in *McDonnell, Yates,* and *Skilling* to interpret federal criminal statutes narrowly will bode well for him in the October 2016 term, when the Court reviews the Ninth Circuit’s decision that affirmed his conviction and three-year prison sentence for insider trading in violation of Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder. The case involved trading tips that an investment banker shared with his older brother, who traded securities on the basis of confidential merger and acquisition-related information. 22 The older brother also passed the tips on to the defendant, Bassam Salman (a close friend who later became an in-law), who traded as well. In his appeal to the Ninth Circuit, Salman invoked the Second Circuit’s restrictive interpretation of the type of “personal benefit” that would satisfy the test for tipper-tippee liability that the Court set out in its 1983 decision in *Dirks v. SEC.* 23 That is, the defendant argued that the evidence resulting in his guilty verdict was insufficient because the investment banker did not share the tips with his brother in exchange for a personal benefit that was “‘objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.’” 24 The Ninth Circuit, however, affirmed the defendant’s conviction, declining to follow *United States v. Newman* to the extent the Second Circuit’s ruling requires proof of a tangible benefit. 25 The court emphasized that where evidence of an informational gift exists, it would create a troubling loophole to interpret *Dirks* as also requiring a tangible benefit. Reading *Dirks* in that manner would facilitate insider trading by permitting insiders to argue that they asked “for no tangible compensation in return.” 26 The Ninth Circuit therefore concluded that “[p]roof that the insider disclosed material nonpublic information with the intent to benefit a trading relative or friend is sufficient to establish the breach of fiduciary duty element of insider trading.” 27

But the defendant in *Salman* also reads *Skilling* – and will almost certainly read *McDonnell* – as direct support for his view that trading on a stock tip cannot constitute securities fraud unless the tip was exchanged for money or some type of other tangible gain. Indeed, Salman extracts from *Skilling* a command purportedly grounded in constitutional due process that federal “fraud

---

19 Id. at 2931.
20 Id. at 2906 (quoting McNally v. United States, 483 U.S. 350, 360 (1987)).
22 792 F.3d. 1087, 1089-90 (9th Cir. 2015).
25 Id. at 1093.
26 Id. at 1094.
27 Id.
offenses require a showing that the fraudster acted to obtain money or property.”

Salman can also be expected to seize upon McDonnell’s demand for “officials acts” that are “concrete” and “specific and focused” as a means of ensuring that federal prosecutions for bribery involve explicit quos as well as quids. As Salman sees it, the “intangible, emotional ‘benefit’ that one might receive by providing a ‘gift’ of inside information” to a brother, or “psychic benefits such as ‘friendship’ or the ‘approbation’ of others,” are too indeterminate to “make tipping by a corporate insider, or trading on that insider’s tip, criminal securities fraud.”

But the Supreme Court should reject Salman’s attempt to re-categorize his fraudulent insider trading as a type of collateral punishment for someone else’s betrayal of honesty, loyalty, and other fiduciary obligations. State laws provide corporations and shareholders with private remedies to recover disgorgement or damages from corporate officials like Skilling who have been unjustly enriched through undisclosed conflicts of interest. And public officials like McDonnell who accept gifts in exchange for political favors can be voted out of office, impeached, or dismissed from their appointed positions. Although federal criminal prosecutions for both types of fiduciary breaches would provide additional deterrence against such corruption, for good or for ill, the Supreme Court has concluded that, absent more explicit instructions from Congress, federal law should not be on the vanguard of ensuring that public and private officials act with the honesty and loyalty that fiduciary law demands.

Insider traders like Salman are not being punished under the federal securities laws because of their involvement in, or their enrichment from, secret corruption that deprives sources of material nonpublic information of a fiduciary’s honest services. Rather, as the Court emphasized in United States v. O’Hagan, the prohibition of insider trading under the misappropriation theory is directed at conduct that “undermines the integrity of, and investor confidence in, the securities markets.” Although it is a breach of loyalty that triggers the Rule 10b-5 disclosure obligation to the source of the information, the fiduciary’s fraud on the source “simultaneously harms members of the investing public.” Thus, as the Court recently emphasized in Chadbourne & Parke LLP v. Troice, the insider trader’s “victims [are] members of the investing public” harmed by the defendant’s gaining of an ‘advantageous market position’ through insider trading.

What makes Salman’s insider trading a federal crime under Section 10(b) and Rule 10b-5 is the injury to investors that results from the deception experienced by the source of the material nonpublic information. State law provides such sources of information with multiple remedies for the breaches of loyalty and honesty that they have suffered. But promoting investor confidence

---

28 See Brief for Petitioner, Salman v. United States, 2016 2732058 at *56 (filed May 6, 2016).

29 Id. at *3.

30 Id. at *57.


32 Id. at 656.

33 Chadbourne & Park LLP v. Troice, 134 S.Ct. 1058 (2014) (quoting O’Hagan, 521 U.S. at 656) (emphasis added). See also id. at 1069 (depicting O’Hagan as a case that “concerned a false statement (or the like) that was ‘material’ to another individual’s decision to ‘purchase or sell’ a statutorily defined ‘security’”).
and protecting the integrity of securities markets are uniquely federal interests. And Congress has placed the Securities and Exchange Commission in charge of safeguarding those important interests, with willful violations of the federal securities laws subject as well to prosecution by the Department of Justice. Concerns about reading into the honest services fraud statute a sweeping all-purpose ban on fiduciary misconduct are therefore inapposite to Section 10(b) and Rule 10b-5, which prohibit not all instance of “feigning fidelity,” but only “feigning fidelity” that occurs in connection with entrusted information that will be used for securities trading.

The Court should also reject Salman’s ahistorical assertion that “Congress did not intend for § 10(b) to be an anti-insider trading rule.”34 To be sure, when the Supreme Court decided Chiarella v. United States35 and Dirks36 in the early 1980s, it did so against a statutory backdrop that expressly addressed, through Section 16(b) of the Exchange Act, only a single narrow type of insider trading—namely, the “vicious practices” of directors, officers, and controlling shareholders who used their positions with the corporation to “acquire and profit [from] information not available to others” by purchasing and selling the corporation’s stock within a six-month timespan.36 Although Chiarella and Dirks37’s classical theory construed Section 10(b) and Rule 10b-5 to reach instances of insider trading that were not subject to Section 16(b)’s “short-swing profit” provision, the Court acted cautiously in refusing to adopt the broader interpretation that the government had urged “absent some explicit evidence of congressional intent.”37

But the Court in Salman now has explicit evidence that Congress intends for Rule 10b-5 to be the principal mechanism for prohibiting insider trading and tipping, and that Congress intends for Rule 10b-5, in the context of such insider trading cases, to be interpreted as broadly and flexibly as the text of Section 10(b) will allow. Congress’s clear intent can be drawn from the legislative history surrounding the many insider-trading related provisions that were added to the Exchange Act as part of the Insider Trading Sanctions Act of 1984 (“ITSA”),38 the Insider Trading and Securities Fraud Enforcement Act of 1988 (“ITSFEA”),39 and the Stop Trading on Congressional Knowledge (STOCK) Act of 2012.40 Congress’s intent is also now reflected in the explicit text of Exchange Act Sections 21(g) and (h), which expressly reference “the insider trading prohibitions arising under the securities laws, including Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder.”41 These legislative developments likewise confirm Congress’s unequivocal endorsement of a misappropriation theory of insider trading and an expansive interpretation of what constitutes a personal benefit under Dirks. Thus, while the federal prohibitions of insider

34 Petitioner’s Brief, supra note __, at 20.
37 Chiarella, 445 U.S. at 233.
41 15 U.S.C. §§ 78u-1(g) and (h).
trading and tipping may derive their lineage from judicially implied claims, Congress has since ratified those claims many times over.42

The constitutional principle of separation of powers prohibits courts from “imposing criminal punishment beyond what Congress in fact has enacted by a valid law.”43 But that very same principle prohibits the judiciary, as the Second Circuit did in \textit{Newman}, from insulating defendants from the criminal consequences of conduct that Congress clearly and repeatedly has encompassed within the insider trading prohibitions arising under Section 10(b) and Rule 10b-5. Thus, in contrast to the Rolex watches, undersized fish, and undisclosed conflicts at issue in \textit{McDonnell}, \textit{Yates}, and \textit{Skilling}, insider trading based on an investment banker’s gratuitous tips to his brother falls squarely within the law that Congress enacted and has charged the SEC and DOJ with enforcing.

\footnotesize
\begin{itemize}
    \item[42] See Jill E. Fisch. \textit{Federal Securities Fraud Litigation as a Lawmaking Partnership}, 93 WASH. U. L. REV. 453, 476 (depicting “the development of the legal prohibition on insider trading” as “[p]erhaps the most compelling example of the lawmaking partnership” between Congress and the Supreme Court).
\end{itemize}