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Fishy insider trading in Salman

By Neill May

Logic is a scarce commodity. This should not be surprising. Cracks appear when articles are published indicating that 90 per cent of drivers think they are above average even when confronted by that anomaly. The same thought occurs when bank studies show that more than a third of Canadians are counting on lottery winnings to fund their retirement. What is most illogical, I suppose, is any expectation of logic. All of this by way of a segue to the state of insider trading law in the United States in the wake of the recent U.S. Supreme Court decision in *Salman v. U.S.*, which is a useful contrast to illustrate how our own system works.

Since the 1983 U.S. Supreme Court decision in *Dirks v. SEC*, insider trading in the U.S. has turned on the "personal benefit" test: Insider trading occurs where an insider discloses information to someone who trades and the insider "receives a direct or indirect personal benefit from the disclosure." This fits most people's intuitive understanding of insider trading — cheating the system by earning personal profit or advantage by trading (or informing others who trade) on the basis of information not disclosed to the market. The Gordon Gekko model.

But there are other frameworks for sharing of information not publicly disclosed to which this framework fits more awkwardly. Most obviously, if institutional or other deep-pocketed investors get access to issuers that is not generally available to the public, and through that access get information that has not been publicly disclosed, and trade on it, has there been insider trading? The executive who discloses information to a hedge fund can be said to be acting in the best interests of the issuer by cultivating relationships with "serious investors." More to the point, she is not obviously personally benefiting but may be said to be doing her job.

A U.S. appellate-level decision post-*Dirks* (*United States v. Newman*) confirmed that this type of communication does not indicate a "personal benefit." The U.S. Supreme Court waded into insider trading for the first time since *Dirks* in the *Salman* case. The facts of the case, and the conclusion, are unremarkable: Salman, a grocer, knowingly traded on confidential information that came from his brother-in-law, an investment banker at Citigroup, reaping more than US$1.5 million in illicit profits, and his conviction was upheld. At its core, the case confirms the principle from the earlier cases: If there is personal benefit (which is inferred when there is a relationship between the discloser and the disclosee), then there is insider trading.

That appears to be the law in the U.S., namely that misuse of corporate information is insider trading but an issuer's disclosures of non-public information to certain (but not all) investors may not be. It does not conform with everyone's expectations of the law — apparently during argument one of the U.S. Supreme Court judges interrupted to (incorrectly) state that conversations between issuers and analysts were prohibited by regulation — but the "personal benefit" framework endures intact.

The Canadian law of insider trading is different. Most fundamentally, "personal benefit" is not a relevant element of the analysis. With exceptions, any trading or disclosure by issuers, insiders and/or certain other parties of material, non-public information about the issuer is in breach of our insider trading rules. This begs the difficult question of how to determine when information is "material," a vexing question about which I've previously written. Issuers and their principals engaging in these disclosures must conclude that the information so vigorously sought by advisors, institutions and others is merely "important" for their analyses but falls short of "material."

On both sides of the border, markets rely on research, disclosure and analysis to encourage efficiency. Information is not limited to what issuers disclose in their legally required filings. Financial industry experts ask probing questions, sometimes in calls to which access is universally available and other times privately. The experts undertake analysis of the disclosures made, perhaps impose some discipline on the issuers from their presence, and through the advice they render to their clients, hopefully assist in informed pricing of securities. It appears that in Canada the rules are more restrictive in terms of what disclosures can be legally made in those contexts.

The strain on logic, at grave risk of oversimplification, is that if an issuer has material non-public information then disclosure of that information by an executive to a family member or friend that trades is impermissible, but disclosure of that same information by an executive in a meeting with a hedge fund that trades in the issuer's securities is not. Not that any of this analysis would have saved Salman, who was, on the facts, poached (baked, cooked and fried are also good words here, for those with interests in the law and tastes for salmon).

I think the best way to sum up the view that bilateral disclosures often result in some kind of profit (even if you can't see the personal benefit) is expressed in Steven Wright's observation: "If it's a penny for your thoughts and you put in your two cents worth, then someone, somewhere is making a penny." CL

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