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## Ignorance Is Bliss: Should Lack of Personal Benefit Knowledge Immunize Insider Trading?

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# IGNORANCE IS BLISS: SHOULD LACK OF PERSONAL BENEFIT KNOWLEDGE IMMUNIZE INSIDER TRADING?

Laura Palk\*

*This article examines the controversial Second Circuit decision in United States v. Newman,<sup>1</sup> requiring that a tippee know that an insider received a personal benefit for his disclosure of material nonpublic information prior to holding a tippee liable for insider trading. The Newman court's decision caused controversy by allegedly narrowing the definition of what constitutes a personal benefit, contrary to the United States Securities and Exchange Commission's administrative stance, and narrowing how much information about the personal benefit a tippee must know to be held liable for insider trading. An examination of the scant legislative history surrounding insider trading, combined with a discussion of the methods of enforcement, the muddled case law, and the level of scienter required for liability, reveals the need for an updated view of the public policy behind insider trading and legislative intervention to resolve ambiguities in insider trading law.*

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1. 773 F.3d 438 (2d Cir. 2014), *cert. denied*, 136 S.Ct. 242 (2015).

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## INTRODUCTION

Imagine the following scenario:

*Jack, a physician, is at a Chamber of Commerce party. Jill, also at the party, owns a local stationery store and is married to a local restaurant franchise owner, John, whose business is publicly traded. Jack and Jill have known each other socially for 5 years, but do not consider themselves close friends. Jill tells Jack and others at the Chamber party that her husband's restaurant business is expanding and that she anticipates a huge announcement in the next month. Jack happens to see Jill the next day at her family's restaurant. She sees Jack and waves at him while she is on the telephone. Jack sits behind Jill and can overhear her conversation in which she exclaims that she is excited about the huge cost savings the new chief financial officer has been able to develop for them and that their quarterly earnings numbers will be better than expected. Jack calls his broker, Joe, and tells Joe what he heard. The broker asks his friend, Phil the analyst, to investigate the franchise company. Joe, Phil, and Jack open trading accounts in their children's names and trade on the restaurant's stock. Their gamble pays off as the restaurant announces a 5 percent increase in profits over analysts' prior predictions, enabling Joe, Phil, and Jack to earn \$100,000 in profits.*

*The United States Securities and Exchange Commission (SEC) investigates and determines insider trading occurred, seeking judgment in federal district court in New York against Jack, Jill, Joe, and Phil. The defendants move to dismiss the complaint for failure to allege any breach of fiduciary or similar duty, lack of publication of nonpublic material information, and lack of knowledge of the personal benefit to the tipper.*

This example exposes the discrepancies between insider trading philosophies and interpretations pre- and post-*Newman*. Historically, courts assumed a personal benefit to the tipper existed when the tipper and tippee had any affiliation. Courts summarily concluded that a personal benefit to the tipper existed without much discussion, but differed in their opinions regarding the level of knowledge the tippee must have about the extent of the personal benefit to the tipper. After *Newman*, the issue is whether the tippee's failure to determine where the information originated is sufficient to establish liability, or if the tippee must also know why the tipper provided the initial tip. According to *Newman*, the tippee must know why the initial tip was provided, that it was provided in breach of a duty of trust and confidence, and that it gave the tipper a meaningful personal benefit.<sup>2</sup> Whether other courts will agree with the Second Circuit is open to debate; however, the Second Circuit's influence in insider trading laws is significant. The SEC believes the decision to be contrary to its insider trading philosophies. This paper discusses the nuances of the

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2. *Id.* at 242.

*Newman* decision in comparison to a practical application and addresses the need for congressional intervention.

This article begins by reviewing the background and underlying philosophies of insider trading prohibitions in Section I. Insider trading philosophies vary between a belief that it promotes a true market price, and a belief that there should be informational parity among market participants. Section II addresses the creation of a federal common law for insider trading elements. Insider trading illegality has mainly been developed through case law and regulation.<sup>3</sup> Supreme Court jurisprudence provides some guidance for insider trading and is explored in Section III by discussing the three basic forms of insider trading: classical, tipper-tippee liability, and misappropriation theories. Section IV addresses the confusion in lower courts regarding the proof needed to show that the tipper received a personal benefit for a tip and that the tippee had knowledge of the benefit. This section also discusses the subtle nuances of scienter and the inconsistent judicial opinions surrounding it. The controversial ruling examining these issues in *United States v. Newman* is addressed in Section V along with its aftermath and its application to the hypothetical above, culminating in the approval of proposed legislation in Section VI. In these final two sections, this article explores the ramifications of the Second Circuit's analysis and how proposed legislation could clarify the controversial issues surrounding insider trading theories.

## I. INSIDER TRADING PHILOSOPHY AND LAWS

The illegality of insider trading is based on theories of fraud in connection with trading on material nonpublic information.<sup>4</sup> These theories were developed in response to market unrest due in part to lax financial market regulation. Though events over several decades contributed to financial market unrest, the strongest impetus for stock market reformation was the 1929 stock market crash.<sup>5</sup> Prior to 1934, there was little federal control over securities markets.<sup>6</sup> Blue Sky laws, enacted pursuant to individual state laws, provided a

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3. *Id.* at 445. See also 15 U.S.C. § 78p(b) (2012) (prohibiting an owner, director, or officer from profiting from the purchase or sale of an interest in the issuer in certain timeframes and instances). The SEC has no enforcement role in section 16(b) violations; only private investors may seek civil recourse against the wrongdoer. See *Foremost-McKesson, Inc. v. Provident Securities Co.*, 423 U.S. 232, 243 (1976).

4. See, e.g., 15 U.S.C. § 78(b); 17 C.F.R. § 240.10b5-2 (2012); Dodd Frank Wall Street Reform & Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376, 1737-39 (2010).

5. See Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 408 (1990) ("This view is correct at least in the sense that stock market legislation was inevitable once the public blamed the stock market crash for the Depression").

6. W. Taylor Marshall, Note, *Securities Law-The Securities Exchange Act of 1934-'Round and 'Round We Go: The Supreme Court Again Limits The Circumstances In which Federal Courts May Hold Secondary Actors Liable Under Section 10(b) and SEC Rule 10B-5*, 31 U. ARK. LITTLE ROCK L. REV. 197, 200 (2008). See generally *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 158 (2008) (holding that Rule 10b-5 only covers conduct prohibited by Section 10(b), which does

minimal level of investor protections.<sup>7</sup> Generally, Blue Sky laws required companies to provide the trading public with a prospectus, identifying how much interest in the company they were receiving, and why.<sup>8</sup> However, state regulatory enforcement of the Blue Sky laws was infrequent.<sup>9</sup> Today, federal law preempts many state law regulations regarding securities transactions, but states may bring enforcement actions for fraud in connection with securities, such as insider trading.<sup>10</sup>

The first of the three acts designed to prevent another market crash was the Securities Exchange Act of 1933 (the 1933 Act),<sup>11</sup> which requires corporations to register their securities and provide regular financial disclosures through securities offerings.<sup>12</sup> Next, the Securities Exchange Act of 1934 (the 1934 Act),<sup>13</sup> created the SEC, a federal agency designed to regulate and monitor exchanges, brokers, over-the-counter markets, and corporate financial disclosures through the trading of securities.<sup>14</sup> The third act was the Public Utility Holding Company Act of 1935, eliminating monopolies in the field of utility companies.<sup>15</sup> Additional statutes, such as The Trust Indenture Act of 1939<sup>16</sup> and the Investment Company Act of 1940,<sup>17</sup> were later enacted to assist the SEC's enforcement strategies. More recently, the Sarbanes-Oxley Act of 2002 requires national exchange companies to maintain independent audits of their financial practices and disclose adequate control procedures for financial reporting,<sup>18</sup> promotes transparency in financial practices, grants increased whistleblower protections, and increases the SEC's jurisdiction over securities markets and corporate governance historically left to state regulation.<sup>19</sup>

With respect to claims and elements of securities fraud, SEC Rule 10b-5 and Section 32(a) of the 1934 Act provide a basic framework.<sup>20</sup> Federal case

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not incorporate common-law fraud actions that may have been available before 1934); Richard H. Pildes, *Separation of Powers, Independent Agencies, and Financial Regulation: The Case of the Sarbanes-Oxley Act*, 5 N.Y.U. J. L. & BUS. 485, 494 (2009) (providing a survey of the growth of securities regulation in the 1930s).

7. 14 GUY P. LANDER, U.S. SECURITIES LAW FOR INTERNATIONAL FINANCIAL TRANSACTIONS AND CAPITAL MARKETS § 1:1 (2d ed. 2013); *see also* Hall v. Geiger-Jones Co., 242 U.S. 539 (1917).

8. Rick A. Fleming, *100 Years of Securities Law: Examining A Foundation Laid in The Kansas Blue Sky*, 50 WASH. L. J. 583, 604 (2011).

9. LANDER, *supra* note 7 at § 1:10.

10. *Id.*; *see also* THOMAS LEE HAZEN, FED. JUDICIAL CTR., FEDERAL SECURITIES LAW 25 (3d ed. 2011).

11. *Id.* §§ 77a-77z (2012).

12. *Id.* §§ 77f-77g.

13. *Id.* §§ 78a-78ll.

14. *Id.* §§ 78d, 78j.

15. *Id.* §§ 79a to 79z-6 (repealed (2005)).

16. *Id.* §§ 77aaa-77bbbb.

17. *Id.* §§ 80a-1 to 80a-64.

18. *Id.* § 7262.

19. *See id.* § 78j-1 (Supp. III 2003).

20. *Id.* § 78j-2(a) (permitting the SEC to promulgate rules "necessary or appropriate in the public interest or for the protection of investors").

law and federal regulation have determined the boundaries of insider trading prohibitions, and created a form of federal common law.<sup>21</sup> In essence, a corporate insider (i.e., an officer, director, employee, or affiliate) must disclose to the public the material nonpublic information in his possession relating to his corporation's securities, or refrain from trading based on the information.<sup>22</sup> Moreover, the SEC's administrative ruling in *Cady, Roberts and Co.* set a new tone for corporate law. It was designed to eliminate managers' temptation to take advantage of investors by interpreting Rule 10b-5 as requiring insiders to disclose to the market material facts prior to trading on it themselves.<sup>23</sup> But the executive and judicial systems are at odds with one another regarding the underlying theories of insider trading, with the SEC defining insider trading much more broadly than the federal courts.<sup>24</sup>

The SEC's broad interpretation of insider trading is based on the SEC's mission to promote confidence in the stock markets, and in large part, upon the English statutory prohibitions of insider trading and the need for full market disclosure.<sup>25</sup> The origins of insider trading prohibitions can be found in the State of New York's Martin Act, which created claims under antifraud theories and empowered the government to investigate and obtain injunctive relief.<sup>26</sup>

As noted by the SEC, its mission "is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."<sup>27</sup> Building on this philosophy, the SEC states, "[o]nly through the steady flow of timely, comprehensive, and accurate information can people make sound investment decisions."<sup>28</sup> Although this is a seemingly legitimate and well-intentioned mission and formulation of insider trading prohibitions, the SEC, courts, academics, and politicians debate the parameters and philosophical underpinnings of insider trading.<sup>29</sup> Not all legal scholars agree with the SEC's

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21. See, e.g., *Cady, Roberts & Co.*, Exchange Act Release No. 6668, 1961 WL 60638, at \*3 (Nov. 8, 1961) (overturning precedent which had held insider trading actionable as common-law fraud during SEC adjudication regarding a broker-dealer disciplinary proceeding); *Steginsky v. Xcelera Inc.*, 741 F.3d 365 (2d Cir. 2014) (holding the rules of insider trading apply even where stock is unregistered). See generally Tammy L. O'Leary & Timothy F. O'Leary, Comment, *The Insider Trading Sanctions Act of 1984: Did Congress and the SEC Go Home Too Early?* 19 U.C. DAVIS L. REV. 497 (1986) (surveying debate over defining insider trading).

22. See generally Thel, *supra* note 5, at 423 n.167.

23. *Cady*, 1961 WL 60638, at \*3.

24. William Shotzbarger, Note, *Business and Friendship Don't Mix: The Government's Expansion of Insider Trading Liability Under SEC Rule 10b5-2*, 65 SYRACUSE L. REV. 579, 600 (2015).

25. See Thomas C. Newkirk & Ira L. Brandriss, *Speech by SEC Staff: The Advantages of a Dual System: Parallel Streams of Civil and Criminal Enforcement of the U.S. Securities Laws*, SEC (Sept. 19, 1998), <https://www.sec.gov/news/speech/speecharchive/1998/spch222.htm> (discussing the Companies Act of 1929, 19 & 20 Geo. 5 (Eng.)). See generally Thel, *supra* note 5; 15 U.S.C. § 78w (1982 & Supp. V 1987).

26. Newkirk, *supra* note 25 (citing N.Y. GEN. BUS. LAW § 23-A (McKinney 1984)).

27. See *What We Do*, SEC, [www.sec.gov/about/whatwedo.shtml](http://www.sec.gov/about/whatwedo.shtml) (last modified June 10, 2013).

28. *Id.*

29. For a thorough discussion of the philosophical and economic debate behind the insider trading prohibition, see Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella*

view that insider trading prosecutions secure confidence in the marketplace.<sup>30</sup> Resolution of this lengthy debate is necessary to ensure market participants have adequate knowledge of what behavior violates the law. As the laws currently stand, a market participant might be found responsible in an SEC administrative proceeding,<sup>31</sup> and yet, be found not responsible in a court proceeding. This confusion requires congressional intervention.

## II. REGULATORY MECHANISMS

With respect to insider trading cases, there are three basic enforcement mechanisms—administrative, criminal, and civil—as well as the potential for a private right of action brought by injured traders. The SEC noted nearly a decade ago that its authority to regulate misconduct and proper trading behavior goes much deeper than its enforcement actions.<sup>32</sup> At its very core, the SEC has the power to supervise the entire securities industry, including the ability to set and regulate disclosure standards, decline to register securities of potential issuers, approve broker-dealer credentials, cease the trading of a stock, and inspect brokerage firms without notice.<sup>33</sup> Brokerage firms support the SEC's efforts through internal compliance programs.<sup>34</sup>

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*Restatement*, 70 CALIF. L. REV. 1 (1982). See also HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (Free Press 1966); Hsiu-Kwang Wu, *An Economist Looks at Section 16 of the Securities Exchange Act of 1934*, 68 COLUM. L. REV. 260 (1968) (explaining that insider trading is the best way to establish a “true” market price). *Contra* Roy A. Schotland, *Unsafe at Any Price: A Reply to Manne*, 53 VA. L. REV. 1425 (1967) (arguing the prohibition on insider trading without disclosure to the trading public ensures timely disclosure of relevant market information). For a comprehensive discussion of the issue, see Victor Brudney, *Insiders, Outsiders, and Informational Advantages under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979).

30. Compare MANNE, *supra* note 29, at 138-41 (arguing that some insider trading should be permissible, particularly in relation to executive compensations), with Henry G. Manne, *Insider Trading: Hayek, Virtual Markets, and the Dog that Did Not Bark*, 31 J. CORP. L. 167, 168 (2005) (quoting Walter Bagehot (pseud. for Jack L. Treynor), *The Only Game in Town*, FIN. ANALYSTS J., Mar.-Apr. 1971, at 12) (recognizing that insider trading can have a negative impact on the market in the long term as market makers will pass along costs associated with insider trading, similar to an “insider trading tax”). See also Thomas E. Copeland & Dan Galai, *Information Effects on the Bid-Ask Spread*, 38 J. FIN. 1457 (1983); Lawrence R. Glosten & Paul R. Milgrom, *Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders*, 14 J. FIN. ECON. 71 (1985); STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 593 (2002) (noting that insider trading laws incentivize managers to disclose information earlier than otherwise scheduled to avoid arguments regarding information being available to the trading public).

31. *But see* Bolan, Jr., Exchange Act Release No. 877, 2015 WL 5316569, at \*27-30 (Sept. 14, 2015) (confirming the Second Circuit's decision in *Newman*, specifically disagreeing with the holding in *United States v. Libera*, 989 F.2d 596 (2d Cir. 1993), and affirmatively requiring that the SEC prove a tippee know of the tipper's breach of a fiduciary duty and his receipt or anticipated receipt of a personal benefit based on the tip in both a classical and a misappropriation type of tipping liability case). This administrative ruling is on review to the SEC Commission which has indicated it wishes to expound upon the issue of personal benefits and knowledge elements. Ruggieri, Exchange Act Release No. 76614, 2015 WL 8519533 (Dec. 10, 2015).

32. See generally Thel, *supra* note 5.

33. See generally Thel *supra* note 5 (noting 15 U.S.C. §§ 77h(b), 78o(b), 78l(k), 77h(d), 78q(b) (1994). For a discussion on whether the SEC's imposition of disgorgement penalties and/or the federal court's granting of such relief is appropriate, see Russell G. Ryan, *The Equity Façade of SEC*

The SEC is an executive agency headquartered in Washington, DC, with five divisions (Corporate Finance,<sup>35</sup> Trading and Markets,<sup>36</sup> Investment Management,<sup>37</sup> Economic and Risk Analysis,<sup>38</sup> and Enforcement) and eleven regional offices.<sup>39</sup> The SEC administers securities law on two levels: through its governmental regulation and enforcement, and through industry self-regulation with SEC oversight.<sup>40</sup>

The Division of Enforcement recommends and acts as prosecutor in the investigation of securities laws violations, the commencement of civil actions in federal court,<sup>41</sup> and administrative proceedings<sup>42</sup> before an SEC

*Disgorgement*, 4 HARV. BUS. L. REV. ONLINE 1 (2013), <http://www.hblr.org/2013/11/the-equity-facade-of-sec-disgorgement>.

34. See 15 U.S.C. §§ 78f, 78o(b), 78s.

35. The Division of Corporate Finance governs corporations' compliance with investment disclosure requirements, provides administrative interpretations, and closely monitors accounting profession activities and the Financial Accounting Standards Board ("FASB"), resulting in the adoption of generally accepted accounting principles ("GAAP"). See *What We Do*, *supra* note 27.

36. The Division of Trading and Markets oversees the daily operations of the securities exchanges, firms, and self-regulatory organizations ("SROs"), including the Financial Industry Regulatory Authority ("FINRA"). *Id.* FINRA is a private corporation that acts as an SRO and is the successor entity to the National Association Securities Dealer ("NASD"), acting as an enforcement and regulatory body for the New York Stock Exchange ("NYSE"). *About FINRA*, FINANCIAL INDUSTRY REGULATORY AUTHORITY, [www.finra.org/about](http://www.finra.org/about) (last visited July 31, 2015). All firms that trade in securities not regulated by another SRO—e.g. Municipal Securities Rulemaking Board—are required to be members of FINRA. *Id.* FINRA audits its regulated institutions and identifies concerning issues. *Id.* FINRA licenses individuals and permits admission of firms to the securities industry, issues compliance rules, disciplines members, trains individuals, and examines industry professionals for admission as a broker-dealer. *Id.*

37. The Division of Investment Management oversees the regulation of the investment management industry, including mutual funds, their managers, analysts, and investment advisors. *What We Do*, *supra* note 27. It reviews investor adviser filings, and interprets laws and regulations for the public and the SEC's inspection/enforcement staff. *Id.*

38. The Division of Economic and Risk Analysis provides economic and data analysis furthering the SEC's mission, provides guidance for policy- and rule-making implementations, enforcement, and examination. *Id.*

39. Offices located in Atlanta, Boston, Chicago, Denver, Fort Worth, Los Angeles, Miami, New York City, Philadelphia, Salt Lake City, and San Francisco. *Id.*; *SEC Addresses: Headquarters and Regional Offices*, SEC, <http://www.sec.gov/contact/addresses.htm> (last modified Nov. 10, 2015).

40. *What We Do*, *supra* note 27.

41. See Brian Lewis et al., *Securities Fraud*, 52 AM. CRIM. L. REV. 1567, 1628 (2015). Congress's enactment of the Insider Trading Sanctions Act of 1984 ("ITSA"), 15 U.S.C. § 78u-1, and the amendments to the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA"), 15 U.S.C. § 78t-1, granted the SEC authority to seek civil penalties up to three times the illegal profits, or losses avoided, in federal court. The Securities Enforcement Remedies and Penny Stock Reform Act of 1990, 15 U.S.C. § 78u, gave the SEC the ability to seek monetary penalties against anyone for any violation of the federal securities laws and granted the SEC additional administrative powers. More recently, the Dodd-Frank Act authorized the SEC to impose civil penalties for insider trading cases in administrative proceedings. 15 U.S.C. § 78u-2(a)(2). Arguably, these remedies mimic criminal sanctions and are punitive in nature; however, the SEC argues, and the courts generally agree, the remedies are designed to deter behavior. see also *Gabelli v. SEC*, 133 S.Ct. 1216, 1223 (2013) (acknowledging administrative SEC proceedings may impose severe sanctions and penalties); *Hudson v. United States*, 522 U.S. 93 (1997); *Kenneth Mann, Punitive Civil Sanctions: The Middleground Between Criminal and Civil Law*, 101 YALE L.J. 1795, 1851 (1992).

42. See Lewis et al. *supra* note 41 at 1626-1628.

administrative law judge (ALJ).<sup>43</sup> The Division also assists criminal law enforcement agencies such as the Department of Justice prosecute securities violations.<sup>44</sup> Cumulative remedies are permissible in the prosecution of SEC cases,<sup>45</sup> and do not necessarily raise double jeopardy concerns.<sup>46</sup>

Originally, the SEC was limited in its internal administrative process to prosecuting claims against regulated entities, such as investment advisers, and broker-dealers.<sup>47</sup> However, the Dodd-Frank Act broadened the SEC's power to bring administrative actions against unregulated entities and individuals, giving it the ability to do internally what it historically had to do in the federal court system.<sup>48</sup> The SEC has discretion to determine the forum in which it wishes to litigate a matter.<sup>49</sup> Courts and academia grapple with this discretionary power, as well as the breadth of the available monetary and other civil penalties.<sup>50</sup>

Recently, the SEC advised interested parties the methods it uses to determine which forum it will utilize in any given proceeding.<sup>51</sup> When the SEC refers a matter to its administrative process, there is no right to a jury trial and no right to object to the SEC's choice of venue.<sup>52</sup> The proceedings allow only

43. *What We Do*, *supra* note 27.

44. *Id.* Section 32 of the Exchange Act makes it a crime to willfully violate any provision of the 1934 Act or rule, including Rule 10b-5. 15 U.S.C. § 78ff(a). The U.S. Department of Justice ("DOJ"), as well as the SEC, can pursue an insider trading violation. *See* SEC v. Dresser Industries, Inc., 628 F.2d 1368, 1376 (D.C. Cir. 1980). The DOJ also may pursue charges of conspiracy, mail and wire fraud, false statements to investigators, and perjury. David E. Austin, Comment, "In God We Trust": *The Cultural and Social Impact of Affinity Fraud in the African American American Church*, 4 U. MD. L. J. RACE, RELIGION, GENDER & CLASS 365, 386 (2004). These charges do not require proof of the insider trading elements. *See generally* Allyson Poulos et al., *Securities Fraud*, 50 AM. CRIM. L. REV. 1479, 1488-89 (2013). Criminal actions are prosecuted under section 32(a) of the Securities and Exchange Act of 1934 and require willfulness, e.g. intentional, or deliberate behavior. *Id.* Whereas, the scienter required for civil actions by the SEC under section 10(b) and 10b-5 is an "intent to deceive, manipulate, or defraud." *Id.*; *see also id.* at 1489 n.47 (examining a majority of cases upholding the theory of recklessness as satisfying scienter in civil cases).

45. *See* Lewis et al. *supra* note 41, at 1628.

46. *See, e.g.*, Standard Sanitary Mfg. Co. v. United States, 226 U.S. 20, 52 (1912) (cited in *Dresser Industries, Inc.*, 628 F.2d at 1374); *see also* Kornman v. SEC, 592 F.3d 173, 188 (D.C. Cir. 2010); *accord* Jones v. SEC, 115 F.3d 1173, 1182-83 (4th Cir. 1997). *See generally* Andrew Z. Glickman, Note, *Civil Sanctions and the Double Jeopardy Clause: Applying the Multiple Punishment Doctrine to Parallel Proceedings After United States v. Halper*, 76 VA. L. REV. 1251, 1252 (1990); Mann, *supra* note 41, at 1822.

47. Lewis et al., *supra* note 41.

48. Lewis et al., *supra* note 41.

49. *See* SEC, DIVISION OF ENFORCEMENT APPROACH TO FORUM SELECTION IN CONTESTED ACTION, <http://www.sec.gov/divisions/enforce/enforcement-approach-forum-selection-contested-actions.pdf> (last visited July 31, 2015); *see also* CTR. FOR CAPITAL MKTS, EXAMINING U.S. SECURITIES AND EXCHANGE COMMISSION ENFORCEMENT: RECOMMENDATIONS ON CURRENT PROCESSES AND PRACTICES (July 2015), [http://www.centerforcapitalmarkets.com/wp-content/uploads/2015/07/021882\\_SEC\\_Reform\\_FIN1.pdf](http://www.centerforcapitalmarkets.com/wp-content/uploads/2015/07/021882_SEC_Reform_FIN1.pdf).

50. *See generally supra* notes 29-30, 41.

51. *See generally supra* notes 29-30, 41.

52. *See* Daniel P. Dwyer, *The Policies, Procedural Rules and Other Considerations Governing Administrative Investigations by and Proceedings before the United States Securities and Exchange Commission*, ABA, [apps.americanbar.org/buslaw/committees/CL996000pub/newsletter/201504/fa\\_2.pdf](https://apps.americanbar.org/buslaw/committees/CL996000pub/newsletter/201504/fa_2.pdf)

limited discovery and permit the admission of hearsay evidence.<sup>53</sup> Constitutional challenges surrounding the SEC's use of its administrative process are prevalent, and some courts find the issues may have merit.<sup>54</sup> Appeals of an ALJ's decision are made to the full SEC Commission—the very entity that initially approves the filing of the charges—for a de novo review.<sup>55</sup> After exhausting this avenue, a party may appeal to the Court of Appeals for the District of Columbia, or the circuit in which the respondent resides or has its principal place of business.<sup>56</sup> The ability of the SEC to choose its forum,

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(last visited July 31, 2015); *see also* Tull v. United States, 481 U.S. 412 (1987) (holding defendants have right to a jury trial where government seeks injunction and civil penalties under Clean Water Act).

53. Dwyer, *supra* note 52, at 16-18; *see also* Arouh, Exchange Act Release No. 62898, 2010 WL 3554584 (Sept. 13, 2010) (admitting hearsay evidence).

54. *See* Bennett v. SEC, No. PWG-15-3325, 2015 WL 9183445, at \*7-8 (D. Md. Dec. 17, 2015) (discussing split of opinion between courts regarding whether federal courts have jurisdiction to hear these particular challenges to constitutionality of SEC proceedings prior to a final decision and determining it did not have jurisdiction, as the claims “were not wholly collateral to the administrative proceedings”); *see also* Gupta v. SEC, 796 F. Supp. 2d 503 (S.D.N.Y. 2011) (finding the initiation of administrative proceedings was a violation of equal protection as this was the only case of its type regarding expert network investigations that had not been brought in district court), *called into doubt* by Jarksey v. SEC, 803 F.3d 9, 23 (D.C. Cir. 2015) (finding administrative proceedings do not violate a defendant's constitutional rights). The SEC dismissed Gupta's administrative proceeding and filed a civil action in district court. Gupta was later criminally convicted. *Compare* United States v. Gupta, 925 F. Supp. 2d 581 (S.D.N.Y. 2013), *with* Altman v. SEC, 768 F. Supp. 2d 554 (S.D.N.Y. 2011) (dismissing constitutional procedural challenge to SEC administrative proceeding as party could challenge on appeal after the conclusion of the SEC proceedings), *and* Chau v. SEC, 72 F. Supp. 3d 417 (S.D.N.Y. 2014) (distinguishing *Gupta* and holding ability to appeal from SEC administrative proceeding precludes subject matter jurisdiction even though it was a constitutional challenge). *But see* Duka v. SEC, 2015 WL 5547463 and 2015 WL 5579880 (S.D.N.Y. 2015) (staying proceedings pending outcome of constitutional challenge to facial validity of SEC proceeding's based on ALJ appointments); *see generally* Bebo v. SEC, No. 15-15-C-3, 2015 WL 905349, at \*4 (E.D. Wis. 2015) (citing Landry v. F.D.I.C., 204 F.3d 1125, 1134 (D.C. Cir. 2000) (rejecting Article II challenge to the appointment of F.D.I.C. ALJs as they are not “inferior officers” because they simply recommend sanctions and decisions)). Pending challenges to the SEC and its administrative process continue. *See SEC Says it Will Appeal Hill v. SEC Decision, Seek to Stay the Case, and Try to Prevent Discovery*, SEC DIARY (June 16, 2015), <http://www.securitiesdiary.com/2015/06/16/sec-says-it-will-appeal-hill-v-sec-decision-seek-to-stay-the-case-and-try-to-prevent-discovery>; *Division of Enforcement Continues to Refuse to Comply with SEC Orders in Timbervest Case*, SEC DIARY (July 2, 2015) <http://www.securitiesdiary.com/2015/07/02/division-of-enforcement-continues-to-refuse-to-comply-with-sec-orders-in-timbervest-case>; *see also* Tilton et al. v. SEC, No. 15-02472, 2015 WL 4006165 (S.D.N.Y. Jun 30, 2015) (denying preliminary injunction against the SEC based on lack of probability of success on issue of unconstitutionality of ALJ appointments); Hill v. SEC, Civil Action No. 1:15-CV-1801-LMM, 2015 WL 4307088 (N.D. Ga. June 8, 2015) (granting preliminary injunction for plaintiffs on substantial likelihood of success regarding unconstitutionality of ALJ appointments and SEC appealing to Eleventh Circuit regarding district judge's denial of SEC's request to stay the injunction).

55. *Office of Administrative Law Judges*, SEC (last modified Oct. 22, 2015), <http://www.sec.gov/alj>; *see also Rules of Practice and Rules on Fair Fund and Disgorgement Plans*, SEC (last modified Mar. 2006), <http://www.sec.gov/about/rulesprac2006.pdf>.

56. *See* 15 U.S.C. §§ 77i, 78y(a)(1), 80a-42, 80b-13 (2012). Federal courts are instructed to defer to the SEC's rulings on appeal regarding findings of fact. *Id.* Courts uphold an ALJ's findings if there is substantial evidence to support the findings. *Id.* Substantial evidence is “such relevant evidence as a reasonable mind might accept as adequate to support a conclusion.” *Richardson v. Perales*, 402 U.S. 389, 401 (1971). With respect to conclusions of law, courts may only set them aside if they are “[a]rbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.” 5 U.S.C. § 706(2)(A). Courts review issues surrounding the choice of SEC penalties for an abuse of discretion—e.g., “if the remedy chosen is unwarranted in law or is without justification in fact.” *Am. Power & Light Co. v. SEC*, 329 U.S. 90, 112-13 (1946). Regarding the SEC's interpretation of its regulations, courts

combined with its broader interpretation of insider trading laws relative to the federal court system, raises significant procedural fairness concerns and signifies the need for congressional clarity.

### III. IDENTIFYING INSIDER TRADING

Insider trading laws' framework first became apparent in an SEC enforcement action, *Cady, Roberts & Co.*<sup>57</sup> In 1968, the Second Circuit Court of Appeals in *SEC v. Texas Gulf Sulphur Co.*<sup>58</sup> relied on *Cady, Roberts & Co.*, and found that insider trading prohibitions were designed to ensure all traders have "equal access to material information."<sup>59</sup> In practice, this means that an insider either must disclose the material information to the trading public, or, if the insider's fiduciary duty precludes the disclosure, must refrain from trading.<sup>60</sup> It took the United States Supreme Court nearly two decades after *Cady, Roberts & Co.* to espouse its insider trading views in *Chiarella v. United States*.<sup>61</sup>

#### A. Supreme Court Jurisprudence

There are three basic theories for insider trading actions: *classical*, *tipper-tippee liability*, and *misappropriation*. First, the classical insider trading case is based on the insider's duty not to use material, nonpublic information for his trading advantage based on his fiduciary relationship with the company or its shareholders.<sup>62</sup> The second type of liability exists when an insider breaches his fiduciary duty by tipping another (the tippee), and the tippee trades on the material nonpublic information, knowing the *tipper* has breached his fiduciary duty for his personal benefit.<sup>63</sup> Third, the misappropriation theory imposes liability on those who breach a duty of trust and confidence they owe to the

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examine whether the interpretation is unreasonable or plainly erroneous. See *SEC v. Zandford*, 535 U.S. 813, 820 (2002). In addition to the SEC filing a civil or administrative action, investors may seek civil damages in federal court in a private right of action. Investors have an implied and expressed right of action under 10(b) for insider trading. *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 361 (1991) (quoting H.R. REP. NO. 100-910, at 7 (1988) ("Congress adopted [Section] 20A as one of 'a variety of measures designed to provide greater deterrence, detection and punishment of violations of insider trading'")); 15 U.S.C. § 78t-1(b)(4). The aggrieved party must have "trad[ed] contemporaneously with the insider," generally within 3-4 days, and disgorgement of profits can only be granted once to the SEC or to the plaintiff. See *Wilson v. Comtech Telecomm. Corp.*, 648 F.2d 88, 94 (2d Cir. 1981). For a thorough discussion of the scope, reach, and jurisdictional limitations of the 1933 and 1934 Acts and exclusive/concurrent jurisdiction, see *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983). See also *HAZEN*, *supra* note 10, at 11-18.

57. Exchange Act Release No. 6668, 1961 WL 60638 (Nov. 8, 1961).

58. 401 F.2d 833 (2d Cir. 1968).

59. *Id.* at 848.

60. See *Dirks v. SEC*, 463 U.S. 646, 653 (1983).

61. 445 U.S. 222 (1980).

62. See, e.g., *Cady*, 1961 WL 60638, at \*1; *Chiarella*, 445 U.S. at 227.

63. See, e.g., *Dirks*, 463 U.S. at 659 (explaining that the tippee is derivatively liable for the breach, and the tipper is liable for the tipper's role as well as for the tippee's trades).

source of the material nonpublic information, rather than to the corporation itself, and then trade on the information.<sup>64</sup>

### 1. Classical Theory

The basic, or classic, insider trading case involves an insider who obtains material nonpublic information through his relationship with a company, and in breach of his duty, trades on this information to his unfair advantage. The nuances of this concept arose out of a financial printing employee, Chiarella, guessing the identities of acquisition targets from the information he handled for the company hired by the acquiring company.<sup>65</sup> The information Chiarella handled did not contain the names of the target companies, but he determined their identities and traded on the information.<sup>66</sup> To determine whether his criminal conviction should stand, the Supreme Court examined the language and legislative history of Section 10(b).<sup>67</sup>

The issue surrounding a Section 10(b) violation is whether there is a relationship affording access to information that is restricted to a corporate purpose, and whether it would be unfair to allow the insider to take advantage of that information by trading without prior disclosure.<sup>68</sup> The Supreme Court noted that the duty is analogous to the common law theories of misrepresentation and reliance related to fraud.<sup>69</sup> The Court found the duty to disclose does not lie in the mere possession of material nonpublic information.<sup>70</sup> This duty, and thus, a failure to disclose, only exists when there is a “fiduciary or other similar relation of trust and confidence.”<sup>71</sup> Where the purchaser has no duty to the prospective seller because he is neither an insider nor a fiduciary, there is no duty to disclose.<sup>72</sup>

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64. 15 U.S.C. § 78j(b) (2012); *United States v. O’Hagan*, 521 U.S. 642, 652 (1997) (holding the violation is based on deception to the source of the information).

65. *Chiarella*, 445 U.S. at 224.

66. Chiarella had entered a consent decree with the SEC, agreeing to return his profits, and was criminally convicted for seventeen counts of violating Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. *Id.* at 225.

67. *Id.* at 226 (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (holding that Section 10(b) does not address whether **silence**, rather than a duty to disclose, is considered a manipulative or deceptive device—a necessary element for a 10(b) violation; instead, the Court held the scope of Rule 10b-5 cannot exceed power Congress granted the SEC under Section 10(b)); *see also* *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 173 (1994) (explaining that private 10b-5 challenges are impermissible where conduct is not prohibited by “the text of the statute”).

68. *See Cady, Roberts & Co.*, Exchange Act Release No. 6668, 1961 WL 60638 (Nov. 8, 1961). In a classical insider trading case, disclosure to the corporation that you intend to trade does not alleviate the breach as it would not eliminate the harm to the trading public. Rather, there are times when an insider’s fiduciary duty to retain confidences would preclude such a disclosure; thus, the duty converts into a duty to abstain from trading. *See generally*, *SEC v. Obus*, 693 F.3d 276, 285 (2d Cir. 2012).

69. *Chiarella*, 445 U.S. at 227-28.

70. *Id.*

71. *Id.* at 228.

72. *Id.* at 229-31. Chiarella was not an employee, officer, or director of the acquiring or target companies. *Id.* Absent a fiduciary relationship, there is no duty to the entire trading public. *Id.*

The Court noted the SEC had been pursuing claims based on a party's possession of material nonpublic information, believing all market participants owe a duty to one another to not trade upon information that is not widely available to all market participants—where there is no *parity of information*.<sup>73</sup> The Supreme Court denounced the parity-of-information philosophy espoused by the SEC, finding the SEC's interpretation was much broader than the 1934 Act permits.<sup>74</sup>

Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak. We hold that a duty to disclose under [Section] 10(b) does not arise from the mere possession of nonpublic market information. The contrary result is without support in the legislative history of [Section] 10(b), and would be inconsistent with the careful plan that Congress has enacted for regulation of the securities markets. *Cf. Santa Fe Industries, Inv. v. Green*, 430 U.S. at 479.<sup>75</sup>

In this regard, the Supreme Court ruled Chiarella owed no fiduciary duty to the injured traders, and as a result, committed no fraud.<sup>76</sup> The Supreme Court stated that *Chiarella* fell under the classical insider trading theory,<sup>77</sup> and left much open for future cases, including a misappropriation theory creating an insider trading violation.<sup>78</sup>

## 2. Tipper-Tippee Liability

Even after the Supreme Court clarified all market participants need not have equal access to all available information, the SEC continued to pursue claims on this basis. In 1983, the Supreme Court examined whether an insider, or temporary insider, could be held accountable for tipping others who trade when the tipper does not trade for himself and does not breach a duty to the corporation.<sup>79</sup> In *Dirks v. SEC*, the Supreme Court confirmed that there is no general duty to refrain from trading merely because one has access to material nonpublic information.<sup>80</sup> The Court found that antifraud provisions do not

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73. *Id.* at 233.

74. *Id.* at 233-34 (citing *Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979)).

75. *Chiarella*, 445 U.S. at 234-35.

76. *Id.* at 232.

77. *O'Hagan*, 521 U.S. at 652-53.

78. Justice Burger's dissent proposed the misappropriation theory of liability: "[a]ny time information is acquired by mere an illegal act it would seem that there should be a duty to disclose that information." *Chiarella*, 455 U.S. at 240; *see also* *SEC v. Cherif*, 933 F.2d 403, 408 (2d Cir. 1991) (describing *Chiarella* as the basis for the "classical" theory of insider trading). In response to *Chiarella*, within the context of a tender offer, the SEC adopted Rule 14e-3(a). *See O'Hagan*, 521 U.S. at 645. Rule 14e-3(a) holds a trader liable for trading on the basis of advance information pertaining to an unannounced tender offer by anyone other than the tender offeror. *Id.*; 17 C.F.R. § 240.14e-3(a) (2012).

79. *Dirks v. SEC*, 463 U.S. 646 (1983).

80. *Id.* at 654.

require “equal information among all traders.”<sup>81</sup> Instead, the duty to disclose or abstain arises from the relationship between the parties themselves.<sup>82</sup>

With respect to *Dirks*, the Supreme Court found he was not an insider and had not acquired a fiduciary or other similar duty to Equity Funding, a company that sold life insurance and mutual funds.<sup>83</sup> Rather, *Dirks* was an officer of a broker-dealer firm that specialized in analyzing insurance companies and their securities for institutional investors.<sup>84</sup> Ronald Secrist, a former officer of Equity Funding, told *Dirks* that Equity Funding’s assets had been fraudulently and significantly overstated.<sup>85</sup> Secrist, who intended for *Dirks* to confirm the misdeeds and disclose the information to the marketplace, also told regulatory agencies of the fraud, but they failed to take any action.<sup>86</sup> *Dirks* investigated and then advised a reporter for the Wall Street Journal, asking him to publish a story based on the information, but the reporter declined.<sup>87</sup> *Dirks* also advised the clients of his firm; they traded on the information and avoided significant losses, but *Dirks* did not trade on the information, and his firm did not own any securities in Equity Funding.<sup>88</sup> When Equity Funding’s share price dropped dramatically, the SEC halted trading and investigated the matter, including *Dirks*’s role.<sup>89</sup> The Court determined *Dirks* violated SEC Rule 10b-5 because, as a tippee in possession of material corporate information he knew was confidential, and knew or should have known came from an insider, he failed to disclose or abstain from trading.<sup>90</sup>

Other individuals besides corporate insiders can be obligated to disclose or abstain if the following elements are present: (1) there is a relationship granting access to corporate purpose information and (2) unfairness in enabling an insider to take advantage of the information.<sup>91</sup> However, not all breaches of fiduciary duties are prohibited by Rule 10b-5.<sup>92</sup> Rather, the additional element of “manipulation or deception” must exist.<sup>93</sup> There are times when corporate outsiders, such as accountants, lawyers, consultants, and other individuals not

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81. *Id.* at 657.

82. *Id.*

83. *Id.* at 649.

84. *Id.*

85. *Dirks*, 463 U.S. at 649.

86. *Id.*

87. *Id.* Initially, the reporter, William Blundell, declined to publish because of defamation concerns, but once the SEC pursued charges against Equity Funding, Blundell published an article crediting *Dirks* for the information. *Id.* at 649-50. *Dirks* also advised the clients of his firm; they traded on the information and avoided significant losses. *Id.* *Dirks* did not trade on the information, and his firm did not own any securities in Equity Funding. *Id.*

88. *Id.* at 649.

89. *Id.*

90. *Id.* at 651.

91. *Dirks*, 463 U.S. at 653.

92. *Id.* at 654.

93. *Id.* (citing *Santa Fe Indus. v. Green*, 430 U.S. 462, 472 (1977)).

employed by the corporation, become temporary insiders through the services they provide.<sup>94</sup> When they become temporary insiders, they acquire a fiduciary duty, and in essence, become a potential tipper.<sup>95</sup>

The relevant issue is the actual purpose of the disclosure. For example, making the sort of “secret profits” proscribed by *Cady, Roberts & Co.*,<sup>96</sup> and “whether the insider personally will benefit, directly or indirectly, from his disclosure [is the true focus]. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.”<sup>97</sup> The Supreme Court noted that insiders who discuss matters with analysts, like *Dirks*, do not necessarily breach any fiduciary duty because there is a possibility the information is not material, or is already in the marketplace, or fills in the gaps of existing financial modeling.<sup>98</sup> Market analysts provide a recognized benefit to the trading public.<sup>99</sup> Analysts often talk with corporate insiders and create a financial model based on industry projections, earnings calls, market sentiment, and market research. As such, they are predicting the status of the corporation without relying substantially on the insider’s information and whether its share price will likely increase or decrease.<sup>100</sup> The analyst then educates the marketplace through market letters and advice to clients.<sup>101</sup> If an analyst receives material nonpublic information through these discussions, he cannot then trade on the information if it was provided in breach of the insider’s fiduciary duty to the corporation.<sup>102</sup>

The focus, noted by the Supreme Court, should be on “policing insiders and what they do . . . rather than on the policing information *per se* and its possession.”<sup>103</sup> The SEC often proves an improper purpose through “objective criteria, *i.e.*, whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings.”<sup>104</sup> The *Dirks* holding that has provided the most fodder, evaluated in Section V below, is the following statement about an inference of personal advantage:

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94. *Id.* at 655, 655 n.14.

95. *Id.*

96. *Id.* at 654.

97. *Dirks*, 463 U.S. at 662.

98. Some of these conversations have been curtailed through the SEC’s rule on selective disclosure Regulation FD, 17 C.F.R. § 243.100 (2012) (prohibiting selective disclosure of nonpublic information to analysts and other outsiders and requiring timely disclosure when it occurs); *see also Dirks*, 463 U.S. at 658-59, 658 n.17; *accord SEC v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226, 1231 (S.D.N.Y. 1976).

99. *Dirks*, 463 U.S. at 658 n.17, 659.

100. *Id.*

101. *Id.*

102. *Id.*

103. *Id.* at 663 (“As we noted in *Chiarella*, “[t]he tippee’s obligation has been viewed as arising from his role as a participant after the fact in the insider’s breach of a fiduciary duty.”).

104. *Dirks*, 463 U.S. at 663.

[T]here may be a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient. The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend. The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.<sup>105</sup>

Here, the majority found the tip to Dirks was provided to expose fraud previously unpunished by authorities.<sup>106</sup> Neither Secrist nor Dirks, nor the other insiders traded on the information. Accordingly, the reason for the tip was not for the personal gain of the tipper or the tippee,<sup>107</sup> but for the purpose of publishing relevant information of fraud.<sup>108</sup> Because the purpose was appropriate, the Supreme Court determined that not all disclosures of material nonpublic information by insiders are necessarily breaches of fiduciary duty, and courts will not hold a tippee accountable if the tipper is not accountable.<sup>109</sup>

### 3. *Misappropriation Theory*

It was nearly two decades after *Chiarella* before the Supreme Court addressed the idea of a misappropriation theory of insider trading in the criminal action *United States v. O'Hagan*.<sup>110</sup> In *O'Hagan*, the defendant was a lawyer in a firm hired to assist the firm's client in acquiring Pillsbury.<sup>111</sup> The firm had not assigned O'Hagan to the project, thus he was not a corporate insider or temporary insider, but he gathered information through inferences he made while working at the firm.<sup>112</sup> Upon learning of the likely acquisition, O'Hagan traded on the information.<sup>113</sup> The Supreme Court held that a

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105. *Id.* at 664.

106. *Id.* at 664-67.

107. *Id.*

108. *Id.*

109. Dissenting, Justices Blackmun, Brennan, and Marshall took issue with the limitations on insider trading and the need to demonstrate the insider acted for personal gain. *Dirks*, 463 U.S. at 667-69 (Blackmun J., dissenting). They contended that a breach of confidentiality is sufficient to create liability under general theories of trust and fiduciary obligations, and because he disclosed the information to individuals who could profit, this was the breach of fiduciary obligation upon which insider trading violations should rest. *Id.* at 677-78.

110. 521 U.S. 642 (1997).

111. *Id.* at 647.

112. *Id.*

113. *Id.*

company's confidential information is the property of the company and its undisclosed misappropriation by O'Hagan is a violation of a fiduciary duty to the source of the information, his firm, constituting fraud and a form of embezzlement.<sup>114</sup>

A misappropriation theory captures those instances where an *outsider* is in possession of material nonpublic information and breaches a duty of trust and confidence to the one who entrusted him with the information by trading on it for the outsider's personal gain.<sup>115</sup> Because O'Hagan owed a duty of trust and confidence to his law firm, and in turn to its client, he misappropriated the information for his personal use, depriving the company of its right to exclusive use of its property.<sup>116</sup> The deprivation, combined with pretending fidelity to the *source* of the information, constitutes the "deceptive device" necessary to establish a violation of Section 10(b). The breach of fiduciary duty to the firm by itself is insufficient to establish the type of fraud necessary for a Section 10(b) violation; trading on the misappropriated information is also required.<sup>117</sup> The marketplace contains some informational inequities, but it is the taking advantage of an informational disparity, like misappropriation through trickery as opposed to research and analysis, that is prohibited.<sup>118</sup>

The case law and regulations thus far evidence that courts often define what does not constitute insider trading, and the SEC then issues regulations to counter judicial interpretation.

#### IV. PERSONAL BENEFITS AND THE MISAPPROPRIATION THEORY IN TIPPER-TIPPEE LIABILITY CASES

One of the most controversial elements of insider trading violations for tipper-tippee liability is the issue of a tipper's receipt of a personal benefit in exchange for the tip, and the knowledge level of the tippee, particularly a remote tippee, of the personal benefit to the tipper based on the disclosure. This

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114. *Id.* at 654.

115. *O'Hagan*, 521 U.S. at 655.

116. *Id.* at 653-54 (citing *Carpenter v. United States*, 484 U.S. 19 (1987) (holding confidential information is a company's property to which it is entitled to exclusive use)).

117. This does not preclude other causes of action based on conversion, embezzlement, interference with business relations, breach of duty of loyalty, etc. *See generally id.*

118. *Id.* at 658-59. In a misappropriation case, disclosure to the source of the information eliminates fraud for § 10b-5 violations. *Id.* at 655. *O'Hagan* confirmed that SEC Rule 14e-3's prohibition in trading on tender offer information was valid. *Id.* at 673-74. Certain relationships are deemed to create a fiduciary-like duty, including spouse, parent, child, or sibling, and anyone who has "a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality." 17 C.F.R. § 240.10b5-2(b)(2) (2012). Case law can also dictate when duties of confidentiality exist. *See United States v. McGee*, 763 F.3d 304 (3d Cir. 2014) (holding SEC did not exceed its authority in defining relationships other than fiduciary relationships that rise to the level of "a duty to disclose or abstain from trading on material nonpublic information"); *see also* 17 C.F.R. § 240.10b5-2 (Preliminary Note).

section examines this issue and discusses whether a personal benefit is an element of the misappropriation theory of insider trading with respect to tipper-tippee liability cases. As discussed below, courts agree that for a classical theory tipper-tippee liability case, the tippee must know the tipper will receive a personal benefit from the tip in order for the tippee to be liable. The intellectual dispute is whether, in a misappropriation theory tipper-tippee liability case, the tippee likewise must know the tipper will personally benefit from the disclosure.

Because of the location of the Second Circuit, its rulings have substantial weight in insider trading cases.<sup>119</sup> Accordingly, one must examine Second Circuit precedent in this light. One such example is the case of *Obus* which articulated the standard for general tipper and tippee liability in the civil, tipping liability case.<sup>120</sup> The Second Circuit indicated that for a tipper to be liable, he must have had “a duty to keep material nonpublic information confidential,” he must have either intentionally or recklessly disclosed the information to a tippee “who could use the information in connection with securities trading,” and he must have “received a personal benefit from the tip.”<sup>121</sup>

A tipper can be held liable for his trades as well as the trades of his tippees.<sup>122</sup> Moreover, a tippee’s liability is derivative of the tipper’s breach.<sup>123</sup> Insiders or outsiders with a duty to disclose or abstain, but who disclose information to a tippee, create liability for the tippee if the tippee trades.<sup>124</sup> Because the tippee’s liability is derivative, the government must prove that the tipper breached a duty to the shareholders, and that the tippee knew, or should have known, there was a breach.<sup>125</sup> For the tippee to be found liable, the *Obus* court required the tipper to have “breached a duty by tipping confidential information” which “the tippee knew or had reason to know” had been gathered through the tipper’s breach and the tippee traded or further tipped the information to another for the tippee’s own benefit all the while in “knowing possession of the material nonpublic information.”<sup>126</sup>

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119. See generally *Petition of the United States of America for Rehearing & Rehearing En Banc, United States v. Newman*, Nos. 13-1837(L), 13-1917(Con), 2015 WL 1954058 (2d Cir. Jan. 23, 2015); *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 32 (D.C. Cir. 1987) (recognizing the Second Circuit’s preeminence in securities laws).

120. *SEC v. Obus*, 693 F.3d 276, 289 (2d Cir. 2012).

121. *Id.*

122. See *id.* at 285; see also *SEC v. Clark*, 915 F.2d 439, 454 (9th Cir. 1990).

123. *O’Hagan*, 521 U.S. at 663 (citing *Dirks v. SEC*, 463 U.S. 646, 667 (1983)).

124. *Dirks*, 463 U.S. at 659.

125. *Id.*; see also *Obus*, 693 F.3d at 285.

126. As stated in *Obus*:

To be held liable, a tipper must (1) tip (2) material non-public information (3) in breach of a fiduciary duty of confidentiality owed to shareholders (classical theory) or the source of the information (misappropriation theory) (4) for personal benefit to the tipper. The requisite scienter corresponds to the first three of these elements. First, the tipper must tip deliberately or recklessly, not through negligence.

Tipper-tippee liability can create a sequence of insider trading liability in the form of tipping chains. Tipping chains occur when information is transferred from a tipper to a tippee and then the tippee tips a third party, becoming a secondary tipper himself. According to the Second Circuit in *Obus*, a tipping chain requires that

[t]he first tippee must both know or have reason to know that the information was obtained and transmitted through a breach and intentionally or recklessly tip the information further for her own benefit. The final tippee must both know or have reason to know that the information was obtained through a breach and trade while in knowing possession of the information. Chain tippee liability may also result from conscious avoidance.<sup>127</sup>

The most straightforward type of tipping liability occurs in the classical theory tipping case. Liability arises when the insider provides material nonpublic information to another, and the insider receives a personal benefit for providing that information.<sup>128</sup> If this has occurred, the tipper is liable.<sup>129</sup> The tippee is likewise liable if he knows of the personal benefit to the tipper.<sup>130</sup> There is no need for the tippee to know all of the details of the benefit, only that something was provided to the tipper in return for the information.<sup>131</sup> Whether

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Second, the tipper must know that the information that is the subject of the tip is non-public and is material for securities trading purposes or act with reckless disregard of the nature of the information. Third, the tipper must know (or be reckless in not knowing) that to disseminate the information would violate a fiduciary duty. While the tipper need not have specific knowledge of the legal nature of a breach of fiduciary duty, he must understand that tipping the information would be violating a confidence.

693 F.3d at 286. *See also* United States v. Rajaratnam, 802 F. Supp. 2d 491, 498 (S.D.N.Y. 2011) (finding tippee must know of each element, including the personal benefit to the tipper and tipper's breach of fiduciary duty to be criminally liable). *See generally* SEC v. Warde, 151 F.3d 42, 47 (2d Cir. 1998). For a thorough discussion of the level of scienter required and the confusion over courts' interpretations, see Kelly Strader, (*Re*)*Conceptualizing Insider Trading*, 80 BROOK. L. REV. 1419 (2015).

127. *Obus*, 693 F.3d at 288-89 (finding sufficient evidence to send issue to a jury to determine whether the insider breached a fiduciary duty by asking his friend—an analyst at a firm that was the target's largest shareholder—due diligence questions). The friend, in turn, advised his boss, enabling the firm to trade on the information. The Second Circuit found the insider provided the information for his personal benefit by making a gift to a friend he had known since college, knowing the friend would trade upon the information. Further, the tip from the friend to his boss reflected evidence of tipping for his own personal benefit, i.e. “currying favor,” with his boss. Upon remand, jury acquitted all of the defendants. *Obus*, Exchange Act Release No. 06 CIVIL 3150 (GBD), 2014 WL 3533575 (June 2, 2014).

128. *See* United States v. Whitman, 904 F. Supp. 2d 363, 370 (S.D.N.Y. 2012), *aff'd*, 555 F. App'x. 98 (2d Cir. 2014), *cert. denied*, 135 S.Ct. 352 (2014), and *post-conviction relief denied* by 111 F. Supp. 3d 439 (2015). *Cf.* Randall v. Rational Software Corp., 34 F. App'x. 301 (9th Cir. 2002) (dismissing class action for failure to allege that corporate insider received a personal benefit by tipping a particular market analyst with material nonpublic information about lower than expected earnings, which he revealed to his clients who then traded on the information, and failed to allege that the analyst knew or should have known the insider's revelation was a breach of fiduciary duty).

129. *See Obus*, 693 F.3d at 288.

130. *Id.*

131. *Id.* *See also* United States v. Falcone, 257 F.3d 226, 234 (2d Cir. 2001) (Sotomayor, J.) (finding the misappropriation of pre-release information merely requires a tipper breach a duty to the

a tipper or insider personally benefits from the tip is a question of fact.<sup>132</sup> The personal benefit to the insider is a necessary element of tippee liability because, in its absence, the insider has not breached any duty.<sup>133</sup> The tippee's knowledge of an actual breach by the tipper is critical for tippee liability as evidenced by the Supreme Court in *Dirks*,<sup>134</sup> and explained by the Southern District of New York in *Whitman*, where the court said,

[I]f the only way to know whether the tipper is violating the law is to know whether the tipper is anticipating something in return for the unauthorized disclosure, then the tippee must have knowledge that such self-dealing occurred, for, without such a knowledge requirement, the tippee does not know if there has been an "improper" disclosure of insider information.<sup>135</sup>

The *Newman* decision notwithstanding,<sup>136</sup> it is unclear whether, unlike the classical theory of tipper-tippee liability, the misappropriation theory requires that the tipper/misappropriator intend to benefit from his tip.<sup>137</sup> There is a divergence of opinion in the courts. Those courts that do not require the tipper to intend to benefit argue there is no benefit requirement because the

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owner of the information and the tippee know that the tipper had breached the duty, i.e., defendant knew where the information came from and knew he was paying for the information even though the tipper did not trade himself. Justice Sotomayor's discussion in this case provides potential insight into how she might rule should this issue be presented to the Supreme Court in the future.); *United States v. Libera*, 989 F.2d 596, 600 (2d Cir. 1993) (holding information was misappropriated from Business Week), *superseded by regulation* as noted in *United States v. McGee*, 763 F.3d 304, 312-19 (providing detailed explanation of duty rising to the level of a breach, and the validity of Rule 10b5-2).

132. See, e.g., *SEC v. Maxwell*, 341 F. Supp. 2d 941, 947 (2004) (holding evidence insufficient of intent to benefit his barber).

133. *Whitman*, 904 F. Supp. 2d at 370. In addressing this tippee knowledge element in a request to vacate his conviction and sentence based on *Newman*, the Southern District of New York indicated there was ample evidence that Whitman knew the insiders from whom he was receiving his information were not only breaching their fiduciary duties, but were doing so in expectation of some benefit even though he did not know exactly what that benefit would be. *United States v. Whitman*, 115 F. Supp. 3d 439, 446 (S.D.N.Y. 2015) (denying motion to vacate sentence).

134. *Dirks v. SEC*, 463 U.S. 646, at 659 (1983).

135. *Whitman*, 904 F. Supp. 2d at 371. In the Second Circuit's denial of Whitman's post-conviction relief, it noted it had, "yet to decide whether a remote tippee must know that the original tipper received a personal benefit in return for revealing inside information." *United States v. Whitman*, 555 F. Appx. 98 (2d Cir. 2014) (comparing *United States v. Rajaratnam*, 802 F. Supp. 2d 491, 499 (S.D.N.Y. 2011), which required such tippee knowledge with *United States v. Newman*, No. 12 Cr. 121(RJS), 2013 WL 1943342 (S.D.N.Y. May 7, 2013), which only required the tippee to know a duty had been breached). An issue that it squarely addressed with respect to the classical theory tipping liability case on appeal in *United States v. Newman*, 773 F.3d 438, 445 (2d Cir. 2014).

136. *Newman*, 773 F.3d at 445 (using a classical theory of tipping liability requiring tippee's knowledge of the personal benefit in the Second Circuit); see discussion *infra* Section V; see also case cited *supra* note 31.

137. See *SEC v. Sargent*, 229 F.3d 68, 77 (1st Cir. 2000) (recognizing a conflict in cases regarding whether a benefit is required in a misappropriation case and declining to resolve the conflict as there was sufficient evidence of personal benefit, e.g. personal friends, referred clients to one another, and the tipper attempted to resolve a financial dispute between the tippee and the tipper's family and friends).

underlying liability for misappropriation is the misuse of stolen property.<sup>138</sup> Specifically, in these courts there is no requirement the tipper know the tip will lead to the tippee actually trading on the information.<sup>139</sup> The tipper's liability rests on the misappropriation of the information itself.<sup>140</sup> Further, in these courts, in cases that involve tippee liability in the misappropriation context, the tipper need only breach a duty and the tippee know the breach has occurred.<sup>141</sup> Notably, "the tippee's knowledge that disclosure of the inside information was unauthorized is sufficient for liability in a misappropriation case."<sup>142</sup>

However, the Eleventh Circuit disagrees with this analysis and holds that the tippee's knowledge of a personal benefit to the tipper based on the disclosure of the information to the tippee is a necessary element in *both* a misappropriation and a classical tipper-tippee liability case.<sup>143</sup> The court found that because Rule 10b-5 prohibits *fraud*, the receipt or intent to receive a personal benefit is a necessary element—without it, it is simply embezzlement.<sup>144</sup> This rationale is clearly based not only on knowingly

138. See, e.g., *United States v. Libera*, 989 F.2d 596, 600 (2d Cir. 1993); accord *United States v. Chestman*, 947 F.2d 551, 564 (2d Cir. 1991); *United States v. Carpenter*, 791 F.2d 1024, 1027 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987) (arguing the only fraud that need be proven in a misappropriation case is the trading on stolen information and the tipper need not know that revelation of the information will lead to trading). *But see Newman*, 773 F.3d at 451.

139. *Libera*, 989 F.2d at 600.

140. *Id.*

141. *United States v. Whitman*, 904 F. Supp. 2d 363, 370-71 (S.D.N.Y. 2012) (finding tippee knowledge of the personal benefit required in a classical theory case and distinguishing *Libera*, 989 F.2d at 600, *United States v. Mylett*, 97 F.3d 663, 668 (2d Cir. 1996), and *United States v. Falcone*, 257 F.3d 226, 239 (2d Cir. 2001), as they were based on the misappropriation theory); see also *SEC v. Willis*, 777 F. Supp. 1165, 1172, 1172 n.7 (S.D.N.Y. 1991) (holding tippee liable based solely on knowledge psychiatrist-tipper misappropriated information from his client); *SEC v. Musella*, 748 F. Supp. 1028, 1038, 1038 n.4 (S.D.N.Y. 1989) (holding government need not prove the initial tipper received a personal benefit to hold a secondary tippee liable who knew he was trading on misappropriated information as part of an insider trading scheme).

142. *Whitman*, 904 F. Supp. 2d at 370.

143. See *SEC v. Yun*, 327 F.3d 1263, 1276 (11th Cir. 2003) (citing *United States v. O'Hagan*, 521 U.S. 642, 652 (1997), for the proposition that insider trading law requires a synthesis between the classical and misappropriation theories); see also *State Teachers Ret. Bd. v. Fluor Corp.*, 592 F. Supp. 592, 594 (S.D.N.Y. 1984).

144. See RESTATEMENT (THIRD) OF AGENCY § 8:02 (2006) (*Material Benefit Arising Out of Position* provides: "An agent has a duty not to acquire a material benefit from a third party in connection with transactions conducted or other action taken on behalf of the principal or otherwise through the agent's use of the agent's position."); *id.* § 8:05 (*Use of Principal's Property; Use of Confidential Information* states: "An agent has a duty (1) not to use property of the principal for the agent's own purposes or those of a third party; and (2) not to use or communicate confidential information of the principal for the agent's own purposes or those of a third party."); RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1977) (*Liability for Nondisclosure* indicates: "One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated, matters known to him that the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them."); see also *SEC v. Cuban*, 634 F. Supp. 2d 713, 724-26 (N.D. Tex. 2009), *rev'd*, 620 F.3d 551 (5th Cir. 2010), *acq. in result* No. 3:08-CV-2050-D, 2013 WL 6019461 (N.D. Tex. 2013). *But see SEC v. Nothorn*, 598 F. Supp. 2d 167, 176 (D. Mass. 2009). See generally Alison Grey Anderson, *Fraud, Fiduciaries, and Insider Trading*, 10 HOFSTRA L. REV. 341 (1982). Rule 10b-5 is modeled after the federal mail fraud statute, 18 U.S.C. § 1341 (2012). Robert A. Prentice, *Scheme Liability: Does It Have a Future After Stoneridge?* 2009 WISC. L. REV. 351, 361 nn.54-56, 365 n.77

possessing material nonpublic information, but on trading or tipping that information knowing that it was obtained through a breach of fiduciary duty or a breach of a duty of confidentiality.<sup>145</sup> Recall that not all disclosures are in breach of a fiduciary duty where there is no personal gain, and it is the element of a personal gain that creates the fraudulent element necessary for an insider trading violation.<sup>146</sup>

The Eleventh Circuit declines to require different liability standards for a tippee in a misappropriation case versus a tippee in a classical theory case because under either theory the tippee knows he is in receipt of material nonpublic information in violation of a breach of duty and yet trades upon that information.<sup>147</sup> It is this knowledge and use of the misappropriated information that creates liability in a misappropriation case. The Eleventh Circuit noted a tippee's liability is based on the same elements under either the misappropriation or the classical theory regardless of whether the tipper is an insider or an outsider, saying, "the only way to taint a tippee with liability for insider trading is to find a co-venture with the fiduciary and that co-venture exists only if the tipper intends to benefit."<sup>148</sup>

Legal scholars contend courts' incorporation of a personal benefit requirement into a misappropriation type of tipping case, and the knowledge thereof, diminishes the goals of insider trading laws.<sup>149</sup> Arguably, a tippee could pretend ignorance about who, what, where, and how a tip came to them. This pretense could hinder the SEC's ability to pursue valid insider trading cases because of a matter of semantics.<sup>150</sup> However, a court's elimination of the requirement that a tippee know the tipper is receiving a personal benefit in exchange for the disclosure for insider trading cases would do judicially what

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(2009) (noting that Rule 10b-5 tracks the language of Section 17(a) of the Securities Act of 1933, which tracks the federal mail fraud statute).

145. See *Yun*, 327 F.3d at 1276.

146. See *Dirks v. United States*, 463 U.S. 646, 659 (1983).

147. *Yun*, 327 F.3d at 1276; see also *SEC v. Big Apple Consulting USA, Inc.*, 783 F.3d 786, 801-02 (11th Cir. 2015) (finding jury instructions for a Section 20(e) violation of aiding and abetting in a civil misappropriation case must have an intent to benefit, but deliberate ignorance satisfies this element for either a civil or a criminal case).

148. *Yun*, 327 F.3d at 1276-77 (noting outsiders must "have intended to benefit" from their tip to be liable), *enforced on remand*, SEC Obtains Jury Verdict, Exchange Act Release No. 18805, 2004 WL 1765352 (July 28, 2004) (noting that on re-trial, a jury entered judgment against defendants for insider trading and ordered disgorgement and civil penalties). See *United States v. O'Hagan*, 521 U.S. 642, 659 (1997).

149. See generally David T. Cohen, Note, *Old Rule, New Theory: Revising the Personal Benefit Requirement for Tipper/Tippee Liability Under the Misappropriation Theory of Insider Trading*, 47 B.C. L. REV. 547 (2006) (explaining insider trading laws are designed to protect the investing public and requiring a personal benefit in misappropriation tipping cases eliminates the ability to pursue egregious claims.); Donald C. Langevoort, "Fine Distinctions" in *the Contemporary Law of Insider Trading*, 2013 COLUM. BUS. L. REV. 429, 460-62 (2013).

150. See generally Cohen, *supra* note 149.

the SEC is not authorized to do by regulation.<sup>151</sup> In this regard, clarity in the regulations would resolve this confusion and articulate for the trading public the type of activity that is prohibited: trading with knowledge the information was obtained inappropriately, or trading with knowledge the information was obtained in exchange for some personal benefit of the disclosing party.

Even within the SEC's administrative process there is confusion surrounding the personal benefit requirements, and legislation should be enacted to resolve the continued disagreements over the relevant elements of insider trading, including whether a tippee must know of the existence of a personal benefit in either a classical or misappropriation theory case.<sup>152</sup> In the absence of such legislation, the Second Circuit's rationale appears to be the most supported by the underlying Supreme Court case law and the legislative history of the 1934 Act. If a parity of information is the desired standard in light of market abuses and the concern over market manipulation to the public detriment, then legislation making this purpose clear is needed.

V. SECOND CIRCUIT'S LIMITING OF PERSONAL BENEFITS IN *UNITED STATES V. NEWMAN*

The need for congressional intervention is evidenced by the Second Circuit's controversial ruling in *United States v. Newman*.<sup>153</sup> The case discusses the parameters of what constitutes a personal benefit to the tipper sufficient to establish his liability, and the extent of a tippee's knowledge of the personal benefit to the tipper sufficient to establish tippee liability. The Second Circuit chastised the SEC's aggressive stance in prosecuting remote tippees and determined judicial interpretation to clarify the parameters of an insider trading liability case was needed. Some see the ruling as consistent with precedent, while others see it as groundbreaking.<sup>154</sup> Although the *Newman* decision

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151. The SEC can only regulate pursuant to the authority granted to it under the 1934 Act, and authority is limited to regulations defining a manipulative device. See *O'Hagan*, 521 U.S. at 651; *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 173-74 (1994); *Ernst & Ernst Hochfelder*, 425 U.S. 185, 197 (1976).

152. See Ruggieri, Exchange Act Release No. 76614, 2015 WL 8519533 (Dec. 10, 2015) (SEC Commission agreeing to review an administrative law judge's ruling that *Newman* limits the SEC's prosecutions and requires specific evidence of a personal benefit and the knowledge thereof for liability in tipping cases).

153. 773 F.3d 438 (2d Cir. 2014), *cert. denied*, 136 S.Ct. 242 (2015). The SEC also pursued Chiasson and Newman in a federal civil suit for the same allegations. *SEC v. Adondakis et al.*, No. 12 CIV. 0409, 2013 WL 1814914 (S.D.N.Y. Apr. 30, 2013). After the criminal action was finalized, the defendants moved for summary judgment in their civil suit which the SEC did not oppose. Kurt Orzeck, *SEC's Insider Trading Suit Against Newman Draws to Close*, LAW 360 (OCT. 21, 2015, 11:38 PM), [HTTP://www.law360.com/articles/717411/sec-s-insider-trading-suit-against-newman-draws-to-close](http://www.law360.com/articles/717411/sec-s-insider-trading-suit-against-newman-draws-to-close).

154. Compare Pete Brush, *Defense Bar Backs 2nd Circ. Newman Insider Trading Reversal*, LAW 360 (Feb. 20, 2015, 4:35 PM), <http://www.law360.com/articles/623627/defense-bar-backs-2nd-circ-newman-insider-trading-reversal>, with Litigation Practice Group Schiff Hardin, *Second Circuit Rebuffs DOJ and SEC in Denying Rehearing in Newman Insider Trading Cases*, NAT'L LAW REVIEW (Apr. 6,

attempts to clarify the interpretation of insider trading law, it has left much for courts and legal scholars to debate.

#### A. Case Summary

Two analysts for separate hedge funds, Todd Newman and his co-defendant, Anthony Chiasson, were charged with insider trading as remote tippees in *United States v. Newman* for two separate tips each made.<sup>155</sup> Rob Ray, a Dell employee in its investor relations department, allegedly tipped inside information about Dell's earnings to Sandy Goyal (the Dell tip), an analyst at Neuberger Berman.<sup>156</sup> Goyal then tipped the Dell Tip to an analyst with Newman's firm, Jesse Tortora.<sup>157</sup> Tortora then told his supervisor, Newman, as well as an analyst with Chiasson's firm, Sam Adondakis about the Dell tip.<sup>158</sup> Adondakis relayed the Dell tip to his supervisor, Chiasson.<sup>159</sup> Regarding the second tip (the NVIDIA tip), Chris Choi, in NVIDIA's finance department, tipped inside information to his church friend, Hyung Lim. Lim then told an analyst at Whittier Trust, Danny Kuo about the NVIDIA tip, who then told several analysts, including Tortora and Adondakis. Again, Tortora and Adondakis shared the NVIDIA tip with their supervisors, Newman and Chiasson.<sup>160</sup>

The government charged Newman and Chiasson with insider trading based on the misappropriation theory.<sup>161</sup> Initially, the jury convicted Newman and Chiasson.<sup>162</sup> On appeal to the Second Circuit, Newman challenged the government's failure to show the initial tips were made for a personal benefit to the initial tipper.<sup>163</sup> Based on the instructions to the jury, the evidence allegedly

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2015), [www.natlawreview.com/article/second-circuit-rebuffs-doj-and-sec-denying-rehearing-newman-insider-trading-case](http://www.natlawreview.com/article/second-circuit-rebuffs-doj-and-sec-denying-rehearing-newman-insider-trading-case).

155. *Newman*, 773 F.3d at 442.

156. *Id.* at 443.

157. *Id.*

158. *Id.*

159. *Id.* at 443-44.

160. *Newman*, 773 F.3d at 443.

161. *Id.* Although the government charged Newman and Chiasson with insider trading based on the misappropriation theory, the appellate court found it interesting the government had yet to charge the original tipplers, Ray and Choi, with criminal insider trading, but had selected tippees to prosecute three and four levels removed from the initial tip to prosecute. *Id.*; see Choi, Exchange Act Release No. 72494, 2014 WL 2915938 (June 27, 2014) (settling with the SEC for passing on insider information to friend, Lim, who told his friend, Kuo, who told Tortora, Adondakis, and Jo Horvath); SEC v. Adondakis, No. 12 CV 409(HB), 2012 WL 10817377 (S.D.N.Y. May 21, 2012); Adondakis, Enforcement Proceedings, 2013 WL 1931367 (May 9, 2013) (pleading guilty to securities fraud and conspiracy to commit securities fraud); Tortora, Enforcement Proceedings, 2013 WL 1931369 (May 9, 2013) (pleading guilty to securities fraud and conspiracy to commit securities fraud); SEC v. Lim, No. 12-CV-06707 (S.D.N.Y. Sept. 4, 2012). Although not an issue in the case, the selective prosecution could raise equal protection arguments as noted *supra* note 54.

162. *Newman*, 773 F.3d at 442.

163. *Id.* at 444.

failed to demonstrate that the tippees knew about the insiders' breach of a fiduciary duty or whether the tippers received a personal benefit.<sup>164</sup>

In *Newman*, the Second Circuit addressed both the classical and misappropriation theories of insider trading. Despite the SEC's repeated attempts to prosecute cases anytime a person trades on inside information, the court confirmed that, legislatively, insider trading is only prohibited when it is deceptive or fraudulent.<sup>165</sup> Liability, especially criminal liability, is not supported when there is simply trading on material nonpublic information.<sup>166</sup> There must be a breach of a duty of confidentiality or its equivalent to support an insider trading violation.<sup>167</sup> For the insider, this would be trading on the information in breach of his fiduciary duty, or providing the information to another in exchange for a personal benefit.<sup>168</sup>

At issue in *Newman* was the extent of the tippees' requisite knowledge.<sup>169</sup> The government argued that a tippee need only know, or was reckless in not knowing, that the tipper breached a duty of confidentiality.<sup>170</sup> The tippee need not know whether the tipper received a personal benefit from the breach.<sup>171</sup> Regarding the personal benefit and tippers' intent, the jury instruction read:

Now, if you find that Mr. Ray and/or Mr. Choi had a fiduciary or other relationship of trust and confidence with their employers, then you must next consider whether the [G]overnment has proven beyond a reasonable doubt that they intentionally breached a duty of trust and confidence by disclosing material[,] nonpublic information for their own benefit.<sup>172</sup>

Regarding the scope of the tippees' knowledge, the instruction read:

To meet its burden, the [G]overnment must also prove beyond a reasonable doubt that the defendant you are considering knew that the material nonpublic information had been disclosed by the insider in breach of a duty of trust and confidence. The mere receipt of material nonpublic information by a defendant, and even trading on that information, is not sufficient; he must have known that it was originally disclosed by the insider in violation of a duty of confidentiality.<sup>173</sup>

The government supported its argument by citing *Dirks* for the proposition that a tippee need only know the tipper breached "a duty," not that there was

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164. *Id.*

165. *Id.* at 446.

166. *Id.* at 448.

167. *Id.* at 449.

168. *Newman*, 773 F.3d at 449.

169. *Id.* at 447-49.

170. *Id.* at 447.

171. *Id.*

172. *Id.* at 444.

173. *Id.*

knowledge of a personal benefit to the tipper.<sup>174</sup> Although case law does not specifically state the tippee must have knowledge of a personal benefit to the tipper in conjunction with knowledge of a breach of a duty, such an element is necessarily subsumed within whether a duty is breached in the first place.<sup>175</sup>

The court found the breach of fiduciary duty to be one of “confidentiality in exchange for a personal benefit” and the element of what a tippee must know includes knowledge that a duty is breached.<sup>176</sup> There are times where a tippee may know the insider should not reveal information, and yet no breach of duty has occurred (for example, whistleblowing, or revealing market information that is not material or is already in the marketplace).<sup>177</sup> It is this element identified by *Dirks* that instills a need for the tippee to know it was a breach, and to do so, he must know the tip was provided for a personal benefit.<sup>178</sup>

Thus, *Newman* established that the standard for tippee liability in the Second Circuit, at least in criminal cases involving the classical theory, is as follows:

(1) the corporate insider was entrusted with a fiduciary duty; (2) the corporate insider breached his fiduciary duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit; (3) the tippee knew of the tipper’s breach, that is, he knew the information was confidential and divulged for personal benefit; and (4) the tippee still used that information to trade in a security or tip another individual for personal benefit.<sup>179</sup>

The knowledge required of the tippee in a criminal case includes knowing the tipper breached his duty and personally benefitted from it.<sup>180</sup> For criminal violations, only “willful” behavior suffices.<sup>181</sup> As the Court acknowledged, “it

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174. *Newman*, 773 F.3d at 444.

175. *Id.* at 447-48.

176. *Id.* at 449.

177. *Id.* at 450. *See also Dirks v. SEC*, 463 U.S. 646, 662 (1983); *SEC v. Payton*, 97 F. Supp. 3d 558, 564 (S.D.N.Y. 2015).

178. *Newman* examined other cases addressing the issue and with one exception found they supported a theory that the tippee’s knowledge includes knowledge of the breach of a duty of confidentiality combined with a knowledge of a personal benefit to the initial tipper. 773 F.3d at 449-50; *see also United States v. Jiau*, 734 F.3d 147 (2d Cir. 2013) (finding the defendant and the insiders had a scheme to pay for inside information, implicating personal benefit and knowledge thereof by tippees); *United States v. Falcone*, 257 F.3d 226, 235 (2d Cir. 2011) (holding criminal liability was warranted where ultimate tippee knew of financial scheme between initial tipper and secondary tipper); *SEC v. Warde*, 151 F.3d 42, 48-49 (2d Cir. 1998) (holding discussions between tipper and tippee regarding how to profit from the information provided inference of breach and its knowledge in a civil action); *United States v. Mylett*, 97 F.3d 663, 668 (2d Cir. 1996) (finding the information came directly from tipper friend and tippee was aware of the benefit to the friend).

179. *Newman*, 773 F.3d at 450.

180. *Id.* at 448-50.

181. *Id.* at 450 (citing *United States v. Temple*, 447 F.3d 130, 137 (2d Cir. 2006)) (“[w]illful” repeatedly has been defined in the criminal context as intentional, purposeful, and voluntary, as distinguished from accidental or negligent”).

is easy to imagine a . . . trader who receives a tip and is unaware that his conduct was illegal and therefore wrongful.”<sup>182</sup>

Next, the court discussed the personal benefit element, quoting *Dirks* and saying, “there is no breach unless the tipper ‘is in effect selling the information to its recipient for cash, reciprocal information, or other things of value for himself. . . .’”<sup>183</sup> When examining the circumstantial evidence and whether it created an inference that these particular defendants had knowledge of a personal benefit, the court found it lacking.<sup>184</sup> Regarding the Dell tips, Goyal and Ray were not “‘close’ friends.”<sup>185</sup> They were acquainted for years from business school, had worked together at Dell, and discussed career advice.<sup>186</sup> However, the evidence reflected that much of this advice occurred prior to any tip.<sup>187</sup> With respect to Lim and Choi, the court found they were merely family friends, church acquaintances, and occasionally socialized together.<sup>188</sup> There were no pecuniary exchanges between them, and Lim did not trade the NVIDIA stock during the relevant time period, which undermined the theory that Choi provided the tips as a gift to Lim.<sup>189</sup> While the government asserted that friendship is a sufficient demonstration of a personal benefit, the appellate court disagreed, saying that if this is sufficient “‘practically anything would qualify.’”<sup>190</sup>

The issue trial courts will confront is the interpretation of friendship under *Dirks* as explained by *Newman*.<sup>191</sup> Discussing its recent holding in *Jiau*, the *Newman* court recognized that personal benefit is broadly defined and can include things other than pecuniary gain, such as a “reputational benefit that will translate into future earnings and the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend.”<sup>192</sup> However, the *Newman* court did limit the definition of personal benefit to something more than the “mere fact of a friendship, particularly of a casual or social nature.”<sup>193</sup> Notably, the *Newman* court found *Dirks*’s inference of a

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182. *Id.* (quoting *United States v. Kaiser*, 609 F.3d 556, 569 (2d Cir. 2010)). This leaves open the question of whether this same knowledge requirement exists in a civil or administrative proceeding.

183. *Id.* (citation omitted). Note the phrase “or other things of value for himself.” What constitutes “other things of value” will likely create judicial interpretive inconsistencies.

184. *Id.* at 451.

185. *Newman*, 773 F.3d at 452.

186. *Id.* at 452-53

187. *Id.*

188. *Id.*

189. *Id.*

190. *Id.* at 452.

191. *Newman*, 773 F.3d at 452; *see also* *SEC v. Payton*, 97 F. Supp. 3d 558, 563-64 (S.D.N.Y. 2015).

192. *Newman*, 773 F.3d at 452 (quoting *United States v. Jiau*, 734 F.3d 147, 153 (2d Cir. 2013), where two insiders tipped an intermediary, who established a trading scheme with two tippees, and the court found personal benefit existed based on access to investment club, reciprocity of information, and some monetary exchanges between some of the trading partners).

193. *Id.*

personal benefit from a personal relationship requires proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.”<sup>194</sup> There must be a “*quid pro quo* from the latter, or an intention to benefit the [latter].”<sup>195</sup>

The *Newman* court explained that precedent requires the personal benefit to be “of some consequence” even though it is not “*immediately* pecuniary.”<sup>196</sup> Something more than mere friendship must exist.<sup>197</sup> The Court cited with approval its holding, as well as other circuits’ holdings, that the relevant test is a meaningful personal benefit based on a friendship where there is the existence of a this for that relationship.<sup>198</sup>

Finally, the court concluded that neither *Newman* nor *Chiasson* knew who the initial tippees were nor whether any personal benefit was received.<sup>199</sup> The intermediate tippees, *Adondakis* and *Tortora*, did not know who the initial insiders were or whether they had received personal benefits.<sup>200</sup> They testified that the information was general financial information commonly confirmed by corporations and could have been extrapolated through standard analysts’ financial modeling.<sup>201</sup>

After *Newman*, the fact two people know one another and one of them provides the other with material nonpublic information upon which the recipient trades is insufficient in and of itself to establish insider trading liability. This concept is in line with Supreme Court precedent.<sup>202</sup> It clarifies for courts that the government cannot charge tippees with insider trading where they have a limited acquaintanceship with a tipper, and nothing more (e.g. no intimate relationship, familial relationship, business development relationship,

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194. *Id.*

195. *Id.*

196. *Id.*

197. *Id.*

198. *Newman*, 773 F.3d at 452 (first citing *United States v. Jiau*, 734 F.3d 147, 152-53 (2d Cir. 2013) (holding personal benefit arose out of friendship combined with providing access to an investment club where profitable information could be garnered); then citing *SEC v. Yun*, 327 F.3d 1263, 1280 (11th Cir. 2003) (“finding evidence of personal benefit where tipper and tippee worked closely together in real estate deals and commonly split commissions on various real estate transactions”); and then citing *SEC v. Sargent*, 229 F.3d 68, 77 (1st Cir. 2000) (“finding evidence of personal benefit when the tipper passed information to a friend who referred others to the tipper for dental work”).

199. *Id.* at 453. *But see* *SEC v. Obus*, 693 F.3d 276, 289 (2d Cir. 2012) (citing *SEC v. Musella*, 678 F. Supp. 1060, 1063 (S.D.N.Y. 1988), where the defendants “did not ask [about the source of information] because they did not want to know.”). The *Newman* Court seemed to discount the conscious avoidance inference based on the type of information at issue, e.g. commonly found in public knowledge and analyst modeling. 773 F.3d at 454. It is interesting to note that they were market experts and could have simply asked where the information originated and yet did not.

200. *Newman*, 773 F.3d at 453-54.

201. *Id.* at 454. The information was far from specific and was within the range of the financial modeling they had already conducted on these companies, negating the inference that there had been a leak or a breach.

202. *See, e.g., Dirks v. SEC*, 463 U.S. 646, 653 (1983).

or financial ties).<sup>203</sup> Requiring that the tippee know of the tipper's breach of fiduciary duty in addition to knowing that the tipper received a personal benefit eliminates those charges based solely on an insider trading claim through mere possession of confidential information.<sup>204</sup>

### *B. Newman's Aftermath*

In the aftermath of the *Newman* decision, the SEC vehemently objected in its Petition for Rehearing to what it termed was a “break[] with Supreme Court and Second Circuit precedent, [a] conflict[] with the decisions of other circuits, and [a] threat[] [to] the effective enforcement of the securities laws.”<sup>205</sup> It appears that the SEC's concerns may be premature.<sup>206</sup> After *Newman*, numerous defendants in a variety of insider trading cases (civil, criminal, and administrative) have argued they are not liable under the lack of personal benefit standard.<sup>207</sup> They have not always been successful.<sup>208</sup> Moving forward, the SEC must either charge defendants under different regulations, or properly allege the personal benefit and knowledge elements under Rule 10b-5.

Contrary to the SEC's allegation, the Second Circuit's recent decision in *Newman* is consistent with prior case law and rulings in other jurisdictions. Thirty years ago, the court in *State Teachers Retirement Board v. Fluor*

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203. See, e.g., *SEC v. Payton*, 97 F. Supp. 3d 558, 563-64 (S.D.N.Y. 2015); *United States v. Riley*, 90 F. Supp. 3d 176, 190-91 (S.D.N.Y. 2015); *SEC v. Zeringue*, No. 3:15-CV-00405, 2015 WL 992752 (W.D. La. Mar. 6, 2015). Cf. *SEC v. Sabrdaran*, No. 14-cv-04825-JSC, 2015 WL 901352 (N.D. Cal. Mar. 2, 2015); Brief of Division of Enforcement, Bolan, Jr., No. 3-16178 (June 12, 2015); Bolan, Jr., Admin. Proc. Exchange Act Release No. 2309, 2015 SEC LEXIS 523 (ALJ Feb. 12, 2015); *supra* notes 31, 136.

204. See e.g., *Payton*, 97 F. Supp. 3d at 563-64.

205. Petition of the United States of America for Rehearing and Rehearing En Banc, *United States v. Newman*, Nos. 13-1837(L), 13-1917(CON), 2015 WL 1954058 (2d Cir. Jan. 23, 2015), 2015 WL 1064423, at \*1. The court subsequently denied the petition, and SEC's petition for writ of was also denied. *United States v. Newman*, 136 S.Ct. 242 (2015).

206. See *United States v. Conradt*, No. 12 Cr. 887(ALC), 2015 WL 480419 (S.D.N.Y. Jan. 22, 2015) (vacation of the guilty pleas notwithstanding). But see *SEC v. Conradt*, 309 F.R.D. 186 (S.D.N.Y. 2015) (presiding over the case, Judge Rakoff noted vacation of guilty pleas, but denied defendants' motion to set aside their consent decrees with the SEC in its civil action, stating that *Newman* did not diverge from insider trading law precedent and declined to interfere with the consent decree). See also *United States v. Whitman*, 115 F. Supp. 3d 439 (S.D.N.Y. 2015) (presiding over the case, Judge Rakoff denied post-conviction relief, despite *Newman*'s holding in a related case, *United States v. Whitman*, 904 F. Supp. 2d 363, 368 (2012)).

207. See Brief for the United States of America, *United States v. Martoma*, No. 14-3599, 2015 WL 2147900 (2d Cir. May 4, 2015) (noting the defendants arguing the issue of what constitutes a personal benefit should be re-examined despite payments to physician insider who provided information on viability of trial drug); Appellant's Reply Brief Concerning *United States v. Newman*, *United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015) (No. 14-10204), 2015 WL 2165460, *rejected by id.* at 1092 (sitting by designation and writing the opinion, Judge Rakoff—Senior District Judge for the U.S. District Court of New York—rejected defendant's argument that *Newman* requires reversal of his conviction because the tip to the tipper's brother is not a personal benefit standing alone and there is no evidence defendant knew of a personal benefit as a secondary tippee; finding instead that if *Newman* requires a pecuniary gain rather than a gift between familial relations, it exceeds Supreme Court precedent).

208. See, e.g., *Martoma*, 2015 WL 2147900.

*Corporation* held liability “necessitates tippee knowledge of each *element*, including the personal benefit, of the tipper’s breach.”<sup>209</sup> *Fluor*’s decision was supported by *Dirks* which held that “derivative liability can attach only if the tippee recognizes that the relationship between tipper and tippee is such that the tippee has effectively become a participant after the fact in the insider’s breach.”<sup>210</sup> “Consequently, unless the tippee knew or had reason to know that the tipper had satisfied the elements of tipper liability, the tippee cannot be said to be a knowing participant in the tipper’s breach.”<sup>211</sup>

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209. 592 F. Supp. 592, 594 (S.D.N.Y. 1984). A tipper is responsible for the tippee’s trades. *See* SEC v. Tome, 638 F. Supp. 596, 617 (S.D.N.Y. 1986).

210. *Fluor*, 592 F. Supp. at 594-95 (internal quotation marks omitted).

211. *Id.* at 595. When items of monetary value or sharing of profits exist in a case, it is easy to demonstrate the tipper expected to, or did, receive a personal benefit. *See, e.g.*, *United States v. Evans*, 486 F.3d 315, 324 (7th Cir. 2007) (finding analyst and tippee-college friend spoke frequently and traded on information relevant to tippee’s bank established liability for tippee even though tipper was acquitted); *SEC v. Rocklage*, 470 F.3d 1, 7-8 (1st Cir. 2006) (holding wife who had prior trading agreement with her brother misappropriated information from her husband even though she disclosed her intent to trade because the disclosure was not helpful to the trading public); *SEC v. McGinnis*, No. 13-CV-1047(AVC), 2013 WL 6500268, at \*4 (D. Conn. Dec. 11, 2013) (holding allegations of internet access to nonpublic information and trading scheme with longtime friend in advance of earnings reports sufficient to support a misappropriation theory); *SEC v. Sekhri*, 333 F. Supp. 2d 222, 229 (S.D.N.Y. 2004) (finding tipper received profits from tipping his trading friends); *SEC v. Thrasher*, 152 F. Supp. 2d 291, 304-05 (S.D.N.Y. 2001) (holding that there is no need to prove remote tippee definitively knew how the initial breach occurred when evidence of trading profits exists), *superseded by statute*, FED. R. CIV. P. 56, *as recognized in* *Isovolta, Inc. v. Protrans Int’l, Inc.*, 780 F. Supp. 2d 776, 779 (S.D. Ind. 2011). The trickier cases are those involving a tip as a “gift” or where disclosed in exchange for the tipper’s “reputational benefit.” *See, e.g.*, *SEC v. Drescher*, No. 99 CIV. 1418(SAS), 1999 WL 946864, at \*4 (S.D.N.Y. Oct. 19, 1999) (denying motion to dismiss as SEC alleged strong inference of fraudulent intent, including conscious misbehavior or recklessness by telling close friends enough information they were able to guess the target, and they had a subjective belief that there was a breach). *But see* *SEC v. Palermo*, No. 99CIV 10067(AGS), 2001 WL 1160612, at \*1 (S.D.N.Y. Oct. 2, 2001) (finding no need to show tipper intended to benefit, only that he intended to benefit tippee and tippee knew the information came from an insider); *SEC v. Lund*, 570 F. Supp. 1397, 1402 (C.D. Cal. 1983) (holding president of company not an illegal tipper because his disclosure was within scope of his authority to obtain financing for a joint venture, but tippee liable as court found him to be a temporary insider). Historically, cases have been lenient in defining “gifts” and “reputational benefits” so long as there is some evidence the benefit flowed back to the tipper that can be inferred from the closeness of the relationship between the tipper and the tippee. *See, e.g.*, *SEC v. Clark*, 915 F.2d 439, 454 (9th Cir. 1990) (noting a lack of legislative history surrounding insider trading prohibitions, and denying motion to dismiss, stating “(1) enriching a friend, or relative; or (2) tipping others with the expectation of reciprocity” is a violation of the misappropriation theory); *SEC v. Breed*, No. 01 CIV.7798(CSH)(AJP), 2004 WL 909170, at \*1 (S.D.N.Y. 2004) (holding secondary tippee liable where he received the tip from a friend who had received the tip from an insider/attorney and tippee knew it was material nonpublic information); *SEC v. Blackwell*, 291 F. Supp. 2d 673, 692 (S.D. Ohio 2003) (finding under a classical theory trading case, defendant liable as the tip was a gift to his close trading friends and relatives and he received indirect pecuniary benefits through his family and trust funds). Gifts to friends or relatives have been held to be sufficient, where these friends and relatives were known to trade. *See, e.g.*, *Salman*, 792 F.3d at 1092 (finding if *Newman* requires a pecuniary gain rather than simply a gift between familial relations, it exceeds Supreme Court precedent); *SEC v. Warde*, 151 F.3d 42, 47-48 (2d Cir. 1998) (finding defendant good friends and evidence of sharing investment information); *United States v. Cusimano*, 123 F.3d 83, 87-89 (2d Cir. 1997) (involving a trading scheme between tippees); *SEC v. Maio*, 51 F.3d 623, 633 (7th Cir. 1995) (holding tipping was one of many favors from their friendship); *SEC v. Falbo*, 14 F. Supp. 2d 508, 526 (S.D.N.Y. 1998) (satisfying a gift to tippee as the personal benefit, where contract electrician for the company overheard conversations and confirmed information through insider-wife then tipped his trading partner); *SEC v. Downe*, 969 F. Supp. 149, 154-55 (S.D.N.Y. 1997) (detailing closeness of friendship from the *Warde* case, and evidence that information was shared between them as a form of

Since *Newman*, courts have held the SEC need only prove, at least in civil actions, that defendant-tippees either knew, or were reckless in not knowing, about the personal benefit to the tipper surrounding the original tip.<sup>212</sup> Combining the scienter requirement with the requirement that the tippee know of a personal benefit to the tipper means that the SEC must prove the tippee “knew or should have known that the information he traded on was divulged by the tipper for personal benefit.”<sup>213</sup> The issue of whether *Newman*’s interpretation of the personal benefit standard is more onerous than the one articulated by the Supreme Court in *Dirks* remains an open question.<sup>214</sup> But if

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quid pro quo); SEC v. Farrell, No. 95-CV-6133T, 1996 WL 788367, at \*10 (W.D.N.Y. Nov. 6, 1996) (finding insider of bank who tipped friends to trade was liable for their trades and the trades of their sub-tippees); SEC v. Singer, 786 F. Supp. 1158, 1161 (S.D.N.Y.1992) (finding where tippee had business and personal relationship with member of company’s board of directors). Even those instances where direct evidence of trading schemes is not present, but there is evidence of a tip without a proper motive for it, cases found sufficient evidence. *See, e.g.*, SEC v. Yun, 327 F.3d 1263, 1274 (11th Cir. 2003) (holding wife and her work colleague who shared an office and real estate profits were liable for insider trading under the misappropriation theory based on their *quid pro quo* relationship; husband was not liable as the tipper because he disclosed the information in relation to a discussion about the division of their assets); SEC v. Sargent, 229 F.3d 68, 77 (1st Cir. 2000) (holding desire to reconcile financial dispute between a third party friend and dentist with whom tipper was friendly was sufficient); Lewis v. Walston & Co., 487 F.2d 617, 622 (5th Cir. 1973) (holding analysts can return the tipper’s favor by encouraging investments in the company); SEC v. Kornman, 391 F. Supp. 2d 477, 489 (N.D. Tex. 2005) (finding attorney learned confidential information during discussions with tax clients regarding prospective business relationship); SEC v. Blackman, No. 3:99-1072, 2000 WL 868770, at \*1 (M.D. Tenn. May 26, 2000) (finding that a broker’s experience and timing of his trades demonstrated he knew or was in reckless disregard of not knowing the information was nonpublic information); SEC v. Rubin, No. 91 CIV. 6531(MBM), 1993 WL 405428, at \*5 (S.D.N.Y. Oct. 8, 1993) (finding tip by customer to broker with no proper motive was sufficient to establish a personal benefit under *Dirks*); Burlington Indus., v. Edelman, 666 F. Supp. 799, 811 (M.D.N.C. 1987) (finding sufficient evidence where tip was given in return for management position).

212. *See, e.g.*, SEC v. Jafar, No. 13-CV-4645 (JPO), 2015 WL 3604228, at \*4 (S.D.N.Y. June 8, 2015) (citing SEC v. Payton, 97 F. Supp. 3d 558, 564 (S.D.N.Y. 2015) (holding recklessness is “in heedless disregard of the probable consequences”)) (denying reconsideration of a motion to dismiss an amended complaint because the SEC only needs to allege in a civil case that tippees were reckless in not knowing of the tip or the personal benefit). For a discussion regarding whether Judge Rakoff’s attempt to distinguish between civil and criminal insider trading cases is misguided, see THOMAS O. GORMAN, *The Impact of Newman on SEC Enforcement: Part V*, SEC ACTIONS (June 3, 2015), <http://www.secactions.com/the-impact-of-newman-on-sec-enforcement-part-v>. There are concerns over the SEC’s next course of action, i.e., whether it entails utilizing the less formal administrative process, or the district court system to establish a split among the circuits on the issue of personal benefit. *Id.*

213. *Jafar*, 2015 WL 3604228, at \*4. There is a distinction in the nature of the knowledge requirement. With respect to knowledge of a breach of fiduciary duty, all that is required is the tippee know or should have known of the breach, similar to a negligence standard. Whereas, with respect to all other elements of tippee liability, the standard is the tippee acted intentionally for criminal cases, and recklessly for civil cases in trading on the information. *See* SEC v. Obus, 693 F.3d 276, 286-88 (2d Cir. 2012); Strader, *supra* note 126 (discussing courts’ confusion over scienter requirements in insider trading cases).

214. *Jafar*, 2015 WL 3604228, at \*5. With respect to tipper liability, however, the SEC takes an extremely broad view of the terms “friend” and “reputational benefit” as evidenced by one of its administrative hearings in which a tip to a casual office acquaintance was sufficient to satisfy the personal benefit element through the tipper’s alleged receipt of “personal satisfaction.” *See, e.g.*, McGhee v. Joutas, 908 F. Supp. 566, 575 (N.D. Ill. 1995) (finding enough to overcome a summary judgment motion for plaintiff-seller to show, in the face of allegations that buyer never received communications of material nonpublic information as tippee, that insider and buyer had significant personal and business relations); Lohmann, Exchange Act Release No. 48092, 2003 WL 21468604, at

the identity of the tipper and the existence of a personal benefit are only known to the defendant tippee and the tipper, the complaint can withstand dismissal if it alleges sufficient facts to create an inference of insider trading.<sup>215</sup>

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\*4 (June 26, 2003) (holding investment adviser tipped co-worker, new to the business, about future merger and received the benefit of “personal satisfaction of his generosity and the admiration” envisioned by *Dirks*). The ALJ assumed a benefit existed where there was an absence of legitimate reason for the initial tip. *See Maio*, 51 F.3d at 632; *Blackman*, 2000 WL 868770, at \*8; *Drescher*, 1999 WL 946864, at \*4; *Rubin*, 1993 WL 405428, at \*5. These broad allegations do not always withstand judicial scrutiny, and can involve attenuated relationships, or significant issues of whether the tipper knew the revelation of the information was a breach of fiduciary duty. *See, e.g.*, *SEC v. Monarch Fund*, 608 F.2d 938, 943 (2d Cir. 1979) (holding insufficient evidence for insider trading where an analyst contacted corporate outsiders and insiders to discuss the refinancing of a company in which he was invested and received some generic information); *SEC v. Rorech*, 720 F. Supp. 2d 367, 414-15 (S.D.N.Y. 2010) (holding no violation for insider trading because defendants had a purely professional working relationship, were not friends, and the information was not confidential and generally available in the market; tipper believed he was doing his job as a salesman providing his opinion to a potential purchaser); *SEC v. Maxwell*, 341 F. Supp. 2d 941, 948-49 (S.D. Ohio 2004) (holding disclosure to barber involved no reputational benefit and thus no liability for the barber’s trades). *But see SEC v. Sabrdaran*, No. 14-cv-04825-JSC, 2015 WL 901352, at \*16 (N.D. Cal. Mar. 2, 2015) (holding tipper liable for hairdresser’s trades even though the hairdresser would not be held liable in light of his lack of knowledge of any personal benefit). With respect to a tippee’s liability associated with a tipper’s tip, it is less complicated to demonstrate a personal benefit when the source of the tip is known, but it is not necessarily required. *See United States v. Goffer*, 721 F.3d 113, 124-25 (2d Cir. 2013) (holding that to convict the defendant of securities fraud, the government need not prove that the defendant knew the identity or the nature of the source of the tip as long as he knew that the information was illegally obtained); *SEC v. All Know Holdings, Ltd.*, 949 F. Supp. 2d 814, 823-24 (N.D. Ill. 2013) (holding no liability in an unidentified tipping case, where defendants did not “know or should they have known that there had been a breach”). Generally, at least the source of the information and an apparent breach is identified even if the specific person is not. *Compare SEC v. Tang*, No. C-09-05146 JCS, 2012 WL 10522, at \*1 (N.D. Cal. Jan. 3, 2012) (involving defendant who was employee of private equity fund with access to inside information), *and SEC v. Hollier*, No. 6:09-CV-0928, 2011 WL 201451, at \*1 (W.D. La. Jan. 18, 2011) (involving tippee who received tips from member of company’s board of directors), *with Wise v. Kidder Peabody & Co.*, 596 F. Supp. 1391, 1395 (D. Del. 1984) (involving a situation where no initial breach of an insider’s duty of disclosure to shareholders had been shown, a remote tippee who had not violated securities laws could not be barred from recovery in a private suit by applying the *in pari delicto* defense), *and SEC v. Platt*, 565 F. Supp. 1244, 1257-58 (W.D. Okla. 1983) (holding no tippee liability where information was not improperly disclosed by insider). The identity of the source of the information can be relevant in determining whether other elements of insider trading exist. *Compare SEC v. Mayhew*, 121 F.3d 44, 51 (2d Cir. 1997) (involving neighbors who exercised together), *SEC v. Kirch*, 263 F. Supp. 2d 1144, 1150 (N.D. Ill. 2003) (finding a member of an executive officers’ club misappropriated the information by trading as the club had expectation of confidentiality), *and SEC v. Singer*, 786 F. Supp. 1158, 1170 (S.D.N.Y. 1992) (involving close personal relationship, dinners, common vacations), *with United States v. Cassese*, 273 F. Supp. 2d 481, 487 (S.D.N.Y. 2003) (involving no close relationship between competitors), *and United States v. Kim*, 184 F. Supp. 2d 1006, 1011 (N.D. Cal. 2002) (involving no fiduciary relationship between two members of a business club even though policies entailed confidentiality). Overhearing a conversation may not create any duty. *See, e.g.*, *SEC v. Switzer*, 590 F. Supp. 756, 767 (W.D. Okla. 1984) (holding no tipper/tippee liability where tipper did not realize tippee overheard conversation between tipper and his wife). *But see Falbo*, 14 F. Supp. 2d at 526 (denying motion as tippee knew information came from eavesdropping). Other times, it can. *See, e.g., Yun*, 327 F.3d at 1280. *But see SEC v. Schvacho*, 991 F. Supp. 2d 1284, 1302 (N.D. Ga. 2014) (holding defendant may have overheard private information but evidence did not support the theory).

215. *Jafar*, 2015 WL 3604228, at \*5. The SEC has the right to discover this information and allow a jury to base its determination on circumstantial evidence. The *Jafar* facts alleged to provide circumstantial evidence of significant, risky, and well-timed trades on companies about whom a journalist of the Canadian Financial Post was writing, and the paper’s belief that confidential information had been leaked. *Id.* at \*6.

With respect to misappropriation cases since *Newman*, trial courts have confirmed there must be a personal benefit to the tipper along with the tippee's knowledge of a personal benefit to establish liability.<sup>216</sup> Specifically, trial courts note that it is unclear whether *Newman*'s quid pro quo relationship requirements conflict with the definitions of friendship in *Dirks*.<sup>217</sup> Interestingly, at least one ALJ has followed the Second Circuit's personal benefit test in an administrative proceeding, contrary to critics' concerns that the SEC would simply turn to its administrative proceedings to avoid the personal benefit issue.<sup>218</sup> Accordingly, at least in criminal actions, the government must ensure the personal benefit element is alleged to survive potential dismissals in the Second Circuit.<sup>219</sup> Courts will likely apply the element in civil cases as well.

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216. See, e.g., *Payton*, 97 F. Supp. 3d at 564-65 (denying a motion to dismiss because remote tippees knew of original tipper's personal and financial relationship with an insider/roommate combined with the remote tippees' hiding their trades, providing inference of scienter); *SEC v. One or More Unknown Traders in the Sec. of Onyx Pharm., Inc.*, No. 13-CV-4645 (JPO), 2014 WL 5026153 (S.D.N.Y. 2014) (holding it "impractical to require plaintiffs to allege the[] details with particularity" where tips and tippers are only known to the tipper and tippee themselves). *But see* Complaint, *SEC v. Andrade*, No. 15-231 S, 2016 WL 199423 (D.R.I. Jan. 15, 2016) (alleging the insider tip is an illicit gift for all of the years of friendship and other business ventures, and they knew he had no legitimate reason for tipping them); *United States v. McPhail*, No. 14-10201-DJC, 2015 WL 2226249, at \*3 (D. Mass. May 12, 2015) (explaining that the personal benefit requirement is not always necessary in a misappropriation case where the original tipper was an unknowing participant in the disclosure of the material nonpublic information the tippee need not know whether the original source intended to receive a personal benefit); *SEC v. Gray*, Exchange Act Release No. 23189, 2015 WL 501238 (Feb. 5, 2015) (involving research analysts engaged in insider trading ring, but with respect to one tippee, there was no allegation of knowledge of personal benefit).

217. Compare Complaint, *SEC v. Kanodia*, No. 15-cv-00479 (D. Conn. Apr. 2, 2015) (involving close friends who traded on information one obtained from his wife who was general counsel to an acquiring company), *United States v. Riley*, 90 F. Supp. 3d 176, 189-90 (S.D.N.Y. 2015) (holding it was not clear error for the jury instructions to include a statement that personal benefit includes the maintenance or furtherance of a friendship where the acquaintances appear to have both a personal and a professional relationship and the tipper was relying on the tippee for career advice in furtherance of his career), and *SEC v. Zeringue*, No. 3:15-CV-00405, 2015 WL 992752 (W.D. La. Mar. 6, 2015) (stating closeness of a brother-in-law relationship and the secondary tippee's knowledge of the closeness is an open question), with *Sabrdaran*, 2015 WL 901352, at \*11 (denying motion to dismiss and holding personal benefit exists as there were financial benefits between tipper and original tippee, but not with respect to the secondary tippees, a pharmacist and a hairdresser; however, the original tippers can be liable for remote tippees' trades even if the tippees cannot based on their lack of knowledge).

218. Brief of Division of Enforcement, *Bolan, Jr.*, No. 3-16178 (June 12, 2015); *Bolan, Jr.*, Admin. Proc. Exchange Act Release No. 2309, 2015 SEC LEXIS 523 (ALJ Feb. 12, 2015) (finding that SEC must establish a personal benefit for allegedly tipping material nonpublic information, finding *Newman*'s personal benefit requirement applicable even in a misappropriation theory tipping case, and requiring the SEC to provide an offer of proof as to the inference of a personal benefit based on the close personal relationship). The SEC later offered evidence that *Bolan* tipped his close friend *Ruggieri* to obtain an accelerated promotion and annual raise. Thereafter, *Bolan* settled the matter. See *Bolan Jr.*, Exchange Act Release No. 9795, 2015 WL 3413279 (May 28, 2015). *Ruggieri*'s case is ongoing. See *supra* note 31.

219. *United States v. Conradt*, No. 12 Cr. 887(ALC), 2015 WL 480419 (S.D.N.Y. Jan. 22, 2015). For related criminal actions, see *United States v. Payton*, No. 4:13-CV-55-BO, 2014 WL 407575 (E.D.N.C. Feb. 3, 2014), and *SEC v. Conradt*, 947 F. Supp. 2d 406 (S.D.N.Y. 2013). See also *The New Insider Trading Landscape: United States v. Newman and Its Impact on Pending Insider Trading Prosecutions*, BUCHANAN, INGERSOLL & ROONEY, PC (Mar. 3, 2015), <http://www.bipc.com/the-new->

The personal benefit, even under pre-*Newman* precedent, must flow back to the tipper.<sup>220</sup> The focus, although often blurred by the breadth of relationships, has been whether the tip appears to be *because* of a friendship and whether the gift is in continuation or repayment of the favors provided to one another.<sup>221</sup> Cases focus specifically on the issue of whether the tippee knew the information was misappropriated and traded nevertheless.<sup>222</sup>

## VI. IMPLICATIONS OF *NEWMAN* AND THE NEED FOR LEGISLATIVE REFORM

Recall Jack, Jill, and the other cast of characters from the example in the introduction. The outcome of the motion to dismiss in this example hinges upon the applicable standards in determining what constitutes a personal benefit to the tipper and what the tippee needs to know about the personal benefit to the tipper in order to be found liable. Comparing the proof requirements for stating a claim under existing law as clarified by *Newman*, to the proof requirements under proposed legislation reveals potentially differing results and demonstrates the need for legislative clarity for market participants.

### *A. Stating a Claim for Relief after Newman*

To properly state a claim in federal district court, the SEC, DOJ, or private plaintiff must articulate facts in sufficient detail to achieve the pleading standards of *Ashcroft v. Iqbal*<sup>223</sup> and *Bell Atlantic Corp. v. Twombly*.<sup>224</sup> Federal Rule of Civil Procedure 8(a)(2) requires a pleading to contain a “short and plain statement of the claim showing that the pleader is entitled to relief” in sufficient detail to enable the defendant to have “fair notice of what the . . . claim is and the grounds upon which it rests.” Courts do not assess the likelihood of success on the allegations, but should assume the allegations are true and determine whether they state a claim for relief.<sup>225</sup> As with many cases in litigation, the defendants in our example move to have the case dismissed under Rule 12(b)(6) for “failure to state a claim upon which relief may be granted.” To survive a motion to dismiss, the complaint need not contain “detailed factual allegations,” but must contain more than legal conclusions and factual speculation.<sup>226</sup>

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insider-trading-landscape-united-states-v-newman-and-its-impact-on-pending-insider-trading-prosecutions-03-03-2015/ (discussing potential impact of the *Newman* decision).

220. *See supra* notes 135, 178, 211.

221. *Supra* notes 178, 211.

222. *See supra* note 216.

223. 556 U.S. 662, 677-78 (2009).

224. 550 U.S. 544, 555 (2007).

225. *Iqbal*, 556 U.S. at 678.

226. *Id.*; *see also* *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007) (discussing pleading requirements for private rights of actions in insider trading cases).

Because insider trading involves fraud, there are heightened pleading standards under Federal Rule of Civil Procedure 9(b).<sup>227</sup> Rule 9(b) allows allegations of the defendant's state of mind to be articulated in general terms.<sup>228</sup> Fraud, on the other hand, must be stated "with particularity."<sup>229</sup> Rule 9 is more demanding than Rule 8, and courts must read them together.<sup>230</sup> To properly state a claim for fraud, a plaintiff must allege who made the misrepresentation, when it was made, where it was made, the content, and the basis.<sup>231</sup>

Often insider trading is apparent, and yet the plaintiff may not know the details of the transaction.<sup>232</sup> Only the wrongdoers may know the tips and tipplers, making it impractical to require plaintiffs to allege the details of a claim with particularity.<sup>233</sup> For these reasons, courts relax the Rule 9(b) pleading standards to allow a plaintiff to state facts implying the content and circumstances of the tip.<sup>234</sup> The relaxation of the standards relates to those instances where the necessary elements are only within the defendants' knowledge.<sup>235</sup> In such instances, the plaintiffs must allege facts supporting the belief that the information surrounding the tip is limited to the defendants' knowledge.<sup>236</sup>

The elements asserted for either a misappropriation theory or a classical theory of insider trading are similar, with one exception: the level of scienter required.<sup>237</sup> The Supreme Court held that scienter is an important element for a Section 10(b) violation, but left the definition of scienter open for judicial interpretation.<sup>238</sup> Courts base liability for insider trading on "knowing or

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227. See *SEC v. One or More Unknown Traders in the Sec. of Onyx Pharm., Inc.*, 296 F.R.D. 241, 247 (S.D.N.Y. 2013).

228. *Id.*

229. *Id.*

230. *Id.*; see also FED. R. CIV. P. 9(b) ("Fraud or Mistake; Conditions of Mind. In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a person's mind may be alleged generally.")

231. See *One or More Unknown Traders*, 296 F.R.D. at 248.

232. *Id.*

233. *Id.*

234. *Id.* (citing *SEC v. Alexander*, 160 F. Supp. 2d 642, 649 (S.D.N.Y. 2001)); see also *Stevens v. O'Brien Envtl. Energy, Inc.*, No. CIV. A. 94-4577, 1999 WL 310550, at \*5 (E.D. Pa. May 10, 1999) (denying motion to dismiss and using a relaxed pleading standard as it would be nearly impossible to allege the factual circumstances of the tip or the tipper's identity, but sufficient facts existed inferring the existence of insider trading).

235. *One or More Unknown Traders*, 296 F.R.D. at 248.

236. *Id.*

237. *United States v. O'Hagan*, 521 U.S. 642, 666-67 (1997); *Aaron v. SEC*, 446 U.S. 680, 691 (1980) (holding the scienter requirement for private 10(b) actions is equally required in an SEC enforcement action).

238. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193, 193 n.12 (1976). Because Section 17(a) of the 1934 Act lacks a scienter requirement, it has been suggested as a tool for insider trading prosecutions and civil injunctions in tipper-tippee situations. See *SEC v. Svoboda*, 409 F. Supp. 2d 331, 342 (S.D.N.Y. 2006). For a thorough discussion of courts' insertion of a negligence standard where "willful blindness" should be the appropriate element, see Strader, *supra* note 126 (recommending a revision to courts' jury instructions eliminating confusion over the "know or should know" and "reckless" elements

intentional conduct.”<sup>239</sup> Unfortunately, the Supreme Court has not yet determined whether recklessness satisfies Section 10(b)’s scienter requirement for criminal actions.<sup>240</sup> Regarding civil actions, the Second Circuit, noting that ten other circuits have agreed, held that scienter “may be established through a showing of reckless disregard for the truth, that is, conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care.”<sup>241</sup> Scienter can be demonstrated through circumstantial evidence and must be rebutted by clear evidence that the tipper believed the disclosure was not of any “significance.”<sup>242</sup> Circumstantial evidence is often demonstrated through well-timed trades that take advantage of material nonpublic information, are out of the defendants’ ordinary trading patterns, and involve significant telephone or text messages between the defendants around significant events.<sup>243</sup>

The *Obus* court attempted to clarify the scienter standard for insider trading tipping liability, but created confusion in the process.<sup>244</sup> The *Obus* decision held that if the tipper discloses the information intentionally or recklessly to a person he knew or should have known would trade, the tipper has the requisite scienter.<sup>245</sup> For a tippee’s liability, if the tippee knew or should have known (a negligence standard) that the tipper breached his fiduciary duty or duty of trust and confidence, then the tippee has the requisite scienter if he trades intentionally or recklessly.<sup>246</sup> Willful blindness can satisfy the intentional element (i.e., a defendant takes deliberate measures to evade learning or

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in insider trading cases and reflecting the requirement that insider trading requires intentional behavior as it is a form of fraud).

239. *Ernst*, 425 U.S. at 196-97.

240. *Id.* at 193, 193 n.12; *see also* *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1323-24 (2011).

241. *SEC v. Obus*, 693 F.3d 276, 286 (2d Cir. 2012). *See also* *SEC v. U.S. Envtl. Inc.*, 155 F.3d 107, 111 (2d Cir. 1998) (noting eleven circuits hold recklessness can be sufficient); *One or More Unknown Traders*, 296 F.R.D. at 249; *accord* *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1023-24 (6th Cir. 1979); *SEC v. Blavin*, 557 F. Supp. 1304, 1313 (E.D. Mich. 1983).

242. *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 165 (2d Cir. 1980) (noting that analysts may be able to piece together “seemingly inconsequential data” into a model that actually reveals the nonpublic information, which places the corporate insider and analyst tippee in a precarious position), *superseded by statute*, 15 U.S.C. § 78bb(a)(1) (2012), *as recognized in* *Actigon AG v. China N. E. Petroleum Holdings Ltd.*, 692 F.3d 34, 38 (2d Cir. 2012).

243. *See* *SEC v. McGee*, 895 F. Supp. 2d 669, 683-84 (E.D. Pa. 2012) (“Circumstantial evidence probative of scienter includes the sophistication of the tippee, the temporal proximity of communications between the tippee and the insider . . . and trades atypical to the tippee’s investment patterns”); *see also* *Gildan Activewear, Inc.*, 636 F. Supp. 2d 261, 272 (S.D.N.Y. 2009) (relying on *Elam v. Neidorff*, 544 F.3d 921, 928 (8th Cir. 2008) (holding that trades made pursuant to a 10b-5 plan can raise an inference that the trades were not suspicious)).

244. *Obus*, 693 F.3d at 288. For discussion of the confusion, *see* Allison M. Vissichelli, Note, *Intent to Reconcile: SEC v. Obus: The Second Circuit’s Edification of the Tippee Scienter Standard*, 62 AM. U.L. REV. 763, 775 (2013).

245. *Obus*, 693 F.3d at 288; *see also* *Langevoort*, *supra* note 149.

246. *Obus*, 693 F.3d at 286. The insertion of the “knew or should have known” language is the phrase analogous to a negligence standard, and has been the source of some confusion. Vissichelli, *supra* note 244, at 775.

confirming the facts supporting the violation).<sup>247</sup> Another term for willful blindness is “conscious avoidance,” which has been found to support scienter in criminal cases (i.e., “defendant was aware of a high probability of the fact in dispute and consciously avoided confirming that fact”).<sup>248</sup> Thus, *Obus* conflated a recklessness standard of liability with simple negligence in the context of tipper and tippee liability.

As discussed, there is some controversy over what a tippee must know to be found liable. Courts consistently hold the tippee must know, or should have known, that the information in question was obtained through a breach of a duty.<sup>249</sup> The issue is whether that includes knowing the tipper committed the breach, or tipped for the tipper’s personal benefit. Historically, simply alleging a gift to a friend or relative satisfied this element.<sup>250</sup> *Newman* arguably narrows who qualifies as a friend or what satisfies the personal benefit requirement.<sup>251</sup> However, language in *Newman* suggests that the scope of “personal benefit” extends beyond pecuniary gains, and also encompasses something of a

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247. *Global-Tech Appliances, Inc. v. SEB S.A.*, 131 S. Ct. 2060, 2070-71 (2011) (“While the Courts of Appeals articulate the doctrine of willful blindness in slightly different ways, all appear to agree on two basic requirements: (1) the defendant must subjectively believe that there is a high probability that a fact exists and (2) the defendant must take deliberate actions to avoid learning of that fact. We think these requirements give willful blindness an appropriately limited scope that surpasses recklessness and negligence. Under this formulation, a willfully blind defendant is one who takes deliberate actions to avoid confirming a high probability of wrongdoing and who can almost be said to have actually known the critical facts.”); *see also* GLANVILLE L. WILLIAMS, CRIMINAL LAW: THE GENERAL PART 159 (2d ed. 1961) (“A court can properly find willful blindness only where it can almost be said that the defendant actually knew”). *Compare* MODEL PENAL CODE § 2.02(2)(c) (1985) (a reckless defendant is one who “consciously disregards a substantial and unjustified risk” of such wrongdoing), *with id.* § 2.02(2)(d) (a negligent defendant is one who should have known of a similar risk but, in fact, did not).

248. *United States v. Goffer*, 721 F.3d 113, 127 (2d Cir. 2013) (quoting *United States v. Svoboda*, 347 F.3d 471, 480 (2d Cir. 2003)); *see also* *United States v. Whitman*, 904 F. Supp. 2d 363, 372 (S.D.N.Y. 2012) (“[W]here appropriate (as here), the Government is entitled to a ‘willful blindness’ or ‘conscious avoidance’ instruction to the jury on the issue of such knowledge [regarding whether the tipper were receiving actual or anticipated benefits].”); *SEC v. Kelly*, 545 F. Supp. 2d 808, 811-12 (N.D. Ill. 2008) (holding that failure to investigate is a deliberate act and fraudulent); *United States v. Berger*, 188 F. Supp. 2d 307, 329 (S.D.N.Y. 2002) (holding that deliberate indifference can suffice for scienter).

249. *Dirks v. SEC*, 463 U.S. 646, 653 (1983).

250. *See supra* note 178 and accompanying text.

251. The relationship must be a “meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.” *United States v. Newman*, 773 F.3d 438, 452 (2d Cir. 2014). Nonetheless, Judge Rakoff—Senior District Judge of the U.S. District Court for the Southern District of New York—finds that *Newman* does not alter precedent in this area, and to the extent that it does, is erroneous. *United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015); *SEC v. Conrad*, 309 F.R.D. 186 (S.D.N.Y. 2015); *United States v. Whitman*, 115 F. Supp. 3d 439 (S.D.N.Y. 2015). *See also* *United States v. Melvin*, No. 3:14-cr-00022-TCB, 2015 WL 7077258, at \*15-16 (N.D. Ga. Nov. 10, 2015) (distinguishing *Newman* and indicating personal benefits can be much more broadly interpreted than that described by the Second Circuit in *Newman*); *SEC v. McGinnis*, No. 5:14-cv-6, 2015 WL 5643186, at \*19-20 (D. Vt. Sept. 23, 2015) (denying defendant’s motion for summary judgment as material disputed facts regarding existence of personal benefits between trading partners existed); *SEC v. Holley*, No. 11-0205 (DEA), 2015 WL 5554788, at \*5 (D.N.J. Sept. 21, 2015) (holding personal benefit existed where evidence defendant provided tips to his companion and cousin to benefit them even though defendant did not personally benefit).

“similarly valuable nature,” including “an intention to benefit the [tippee].”<sup>252</sup> These phrases could provide the government with the latitude to bring allegations involving a longtime friend or family member. In such cases, demonstrating the value to a tipper of a long-time friendship or family member—and thereby evidencing the tipper’s desire to give that person a gift—may not be difficult. A gift can provide something of a “similarly valuable nature” (e.g. love, personal favors, emotional support) even if an insider tips a friend or family member who is of a lower social, economic, or business stature than the tipper.<sup>253</sup> The existence or lack of a personal benefit is a question of fact.<sup>254</sup>

Next, to properly plead a claim, the substance of the tip must be material. The relevant issue is not whether the information is accurate, but whether investors are “accurately inform[ed].”<sup>255</sup> Materiality is commonly defined as information that is “reasonably certain to have a substantial effect on the market price of the security.”<sup>256</sup> The Supreme Court clarified the definition:

What the standard [of materiality] does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.<sup>257</sup>

Often, materiality is proven through circumstantial evidence.<sup>258</sup> Information that confirms market rumors and comes from an insider can hold substantial weight of materiality.<sup>259</sup> Whether information is material is both a question of

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252. *Newman*, 773 F.3d at 452.

253. *See id.*

254. *Dirks*, 463 U.S. at 664.

255. *McMahan & Co. v. Warehouse Entm’t, Inc.*, 900 F.2d 576, 579 (2d Cir. 1990).

256. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968); *see also TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

257. *TSC Indus.*, at 449.

258. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 390 n.30 (1983).

259. *United States v. Contorinis*, 692 F.3d 136, 144 (2d Cir. 2012); *SEC v. Mayhew*, 121 F.3d 44, 50-52 (2d Cir. 1997) (finding a tip that a company was seeking an investment partner was deemed material because the information came from an insider, despite that the potential partner was not identified and no further details about the merger were provided); *United States v. Whitman*, 904 F.Supp.2d 363, 367 (S.D.N.Y. 2012). *But see Garcia v. Cordova*, 930 F.2d 826, 830 (10th Cir. 1991) (characterizing information based on subjective analysis or extrapolation as “soft information,” as opposed to “objectively verifiable information,” and, as such, too speculative and unreliable to be considered material and subject to disclosure requirements). *Cf. Brady v. UBS Fin. Servs., Inc.*, No. 10-CV-284-SPF-FHM, 2013 WL 1309250, at \*24 (N.D. Okla. Mar. 26, 2013) (distinguishing *Garcia* and finding the information was material and verifiable).

law and fact.<sup>260</sup> The fact aspect is the amount of weight an investor would have attributed to the fact.<sup>261</sup>

In addition to being material, the information must be nonpublic to violate insider trading prohibitions.<sup>262</sup> The Second Circuit explained nonpublic information as follows:

Information becomes public when disclosed “to achieve a broad dissemination to the investing public generally and without favoring any special person or group,” or when, although known only by a few persons, their trading on it “has caused the information to be fully impounded into the price of the particular stock.” Moreover, “[t]o constitute non-public information under the act, information must be specific and more private than general rumor.”<sup>263</sup>

The concerning aspect of this seemingly innocuous element is that disclosure could be inadvertent or unintentional and could inhibit a financial analyst’s valid attempts at modeling and prediction.<sup>264</sup> The SEC has carved out exceptions for valid analyst research, as analysts frequently have access to both public and nonpublic information.<sup>265</sup> The nonpublic information may be facially immaterial.<sup>266</sup> Nonetheless, if the analyst can piece together a theory that accurately predicts a company’s trading viability based on both the public and nonpublic information, he places himself and the unwitting tipper in a potential predicament.<sup>267</sup>

To state a valid claim for tipper-tippee liability in a civil insider trading action, the SEC must establish that either an insider tipped material nonpublic information in breach of his fiduciary duty to his corporation or its shareholders, or that the insider or outsider-tipper tipped material nonpublic

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260. *Whitman*, 904 F. Supp. 2d at 367.

261. See generally, Bradley J. Bondi & Steven D. Lofchie, Practitioner Note, *The Law of Insider Trading: Legal Theories, Common Defenses, and Best Practices for Ensuring Compliance*, 8 N.Y.U. J. L. & BUS. 151, 179-85 (2011).

262. See *United States v. Libera*, 989 F.2d 596, 601 (2d Cir. 1993).

263. *Mayhew*, 121 F.3d at 50 (quoting *Dirks v. SEC*, 463 U.S. 646, 653 n.12 (1983), *Libera*, 989 F.2d at 601, and *United States v. Mylett*, 97 F.3d 663, 666 (2d Cir. 1996)).

264. Many analysts and arbitrageurs, for example, receive information through speculation and rumor. *United States v. Teicher*, 987 F.2d 112, 121 (2d Cir. 1993) (upholding circumstantial evidence conviction for arbitrageur who had possession of material nonpublic information rendering it difficult to argue he did not trade on information); *United States v. Victor Teicher & Co., L.P.*, No. 88 CR. 796 (CSH), 1990 WL 29697, at \*2 n.5 (S.D.N.Y. Mar. 9, 1990) (holding trading on common market rumors “is at the core of” arbitrage).

265. See Bondi, *supra* note 260, at 177.

266. See *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 166-167 (2d Cir. 1980) (citing *SEC v. Bausch & Lomb*, 565 F.2d 8, 9 (2d Cir. 1977) (“The corporate officer dealing with financial analysts inevitably finds himself in a precarious position, which we have analogized to ‘a fencing match conducted on a tightrope.’”)).

267. *Id.* Thereafter, Regulation FD (Fair Disclosure) was issued allowing utilization of companies’ websites to distribute information to the public if it is “reasonably designed to provide broad, non-exclusionary distribution of the information to the public.”*Id.* at 171-79 (providing a thorough discussion of nonpublic information).

information in breach of his duty of trust and confidence to the source of the information. The duty need not be a fiduciary one per se, but a fiduciary-like relationship.<sup>268</sup> Fiduciary duties under the misappropriation theory are found in a variety of contexts: husband and wife, attorney and client, physician and patient.<sup>269</sup> Explicitly agreeing to keep information confidential creates a fiduciary relationship that otherwise would not exist.<sup>270</sup> Moreover, overhearing a friend discussing material nonpublic information could also impose a duty on the recipient not to trade.<sup>271</sup> Case law has spoken to issues of “recognized duty,” “fiduciary or other similar relation,” “agency or other fiduciary relationship,” a “duty of loyalty and confidentiality,” and a “a duty of trust and confidence.”<sup>272</sup> Examining the history of the parties’ relationship and whether it was one of sharing confidences is necessary to assess whether a duty exists.<sup>273</sup> At times, individuals who are not a corporation’s insiders take on temporary

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268. *United States v. McGee*, 763 F.3d 304, 316 (3d Cir. 2014) (finding a duty of trust and confidence to exist between Alcoholics Anonymous attendees). *See generally* Stephen J. Crimmins, *Insider Trading: Where is the Line?*, 2013 COLUM. BUS. L. REV. 330 (providing a thorough discussion of duties).

269. *Supra* notes 132, 189, 196.

270. *United States v. Falcone*, 257 F.3d 226, 234 (2d Cir. 2001) (involving relationship of trust and confidence).

271. *See SEC v. Schvacho*, 991 F. Supp. 2d 1284, 1299-300 (N.D. Ga. 2014) (dismissing the action as there was no evidence that the defendant’s trades were different, or that he overheard the insider’s conversation, even though he potentially had access to it); *Scammell*, Investment Advisers Act Release No. IA-3961, 2014 WL 5493265 (Oct. 29, 2014) (involving misappropriated information from girlfriend, possibly by overhearing her conversations); *see also SEC v. Switzer*, 590 F. Supp. 2d 756, 766 (W.D. Okla. 1984) (holding husband advising wife of travel plans because of work on an acquisition being accidentally overheard does not create liability for the accidental tipper or the tippee, as disclosure was not for improper purpose and tippee did not misappropriate information).

272. *United States v. O’Hagan*, 521 U.S. 642, 652-70 (1997). *See also* discussion *infra* note 271.

273. *E.g.*, *SEC v. Cuban*, 620 F.3d 551, 558 (5th Cir. 2010) (finding no duty where unilateral statement asking person to keep information confidential); *United States v. Kim*, 184 F. Supp. 2d 1006, 1011 (N.D. Cal. 2002) (finding being part of a social club that expected confidentiality was insufficient to create a duty of trust and confidence). *Cf. SEC v. Talbot*, 530 F.3d 1085, 1096 (9th Cir. 2008) (holding director of acquiring company owed duty to potential target not to trade); *United States v. Corbin*, 729 F. Supp. 2d 607, 616-17 (S.D.N.Y. 2010) (recognizing the codification of court analysis regarding confidentiality agreements and spousal relationships); *SEC v. Rocklage*, 470 F.3d 1, 7 (1st Cir. 2006) (finding fiduciary relationship between spouses prior to SEC regulations); *SEC v. Kornman*, 391 F. Supp. 2d 477, 485 (N.D. Tex. 2005) (holding duty created by attorney seeking prospective clients); *SEC v. Kirch*, 263 F. Supp. 2d 1144, 1151 (N.D. Ill. 2003) (holding software executive group had expressed requirements of confidentiality creating a duty); *SEC v. Seibald*, No. 95 CIV.2081(LLS), 1997 WL 605114, at \*1 (S.D.N.Y. Sept. 30, 1997) (involving tipped friends pre-publication information contained within his own analyst reports); *SEC v. Cherif*, 933 F.2d 403, 408 (2d Cir. 1991) (explaining that a fiduciary-like duty arises during employment and can continue upon separation); *SEC v. Dorozhko*, 574 F.3d 42, 50 (2d Cir. 2009) (holding that a computer hacker qualifies as using a deceptive device to gain inside information); *SEC v. Nothorn*, 598 F. Supp. 2d 167 (D. Mass. 2009) (holding that an analyst breached a duty of trust and confidence as he tipped information learned at a United States Treasury Department briefing after signing confidentiality agreement); *McGee*, 763 F.3d at 308-09 (involving misappropriated information learned from another member of Alcoholics Anonymous used to tip others); *Scammell*, 2014 WL 5493265 (involving misappropriated information from girlfriend who was working on an acquisition and he may have overheard her discussions).

insider qualities through their affiliation with the entity (e.g., accountants, lawyers, and bankers).<sup>274</sup>

Finally, the Second Circuit held that if nonpublic information played *any* role in the trade, it is considered knowing possession and is illegal insider trading.<sup>275</sup> Other courts, including the Seventh and Eleventh Circuits, have determined that the material nonpublic information must have actually caused the person to trade.<sup>276</sup> This discrepancy continues to provide defense counsel with arguments in those courts within the Seventh and Eleventh circuits. However, the well-accepted view is that in a civil case, possession of the material, nonpublic information at the time of the trade is sufficient to infer actual use of that information for illegal insider trading.<sup>277</sup>

### *B. Application of Insider Trading Elements*

Had the SEC applied these standards to our initial hypothetical, they likely would have successfully pursued claims against all of the parties involved in federal district court. The factual allegations of a complaint under pre-*Newman* standards might have looked something like this:

1. At all relevant times, Jill was an insider of the restaurant franchise.
2. Alternatively, Jill had a relationship of trust and confidence with her husband, the corporate insider, John.
3. John disclosed material nonpublic information to Jill about the sales and profit increase of the franchise as well as the expectation

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274. See *Seibald*, 1997 WL 605114, at \*8 (denying motion for summary judgment where analyst was a temporary insider in receipt of information of potential mergers and tipped defendants regarding the timing of his research reports before they were published and the reports had the ability to move the markets); *SEC v. Moran*, 922 F. Supp. 867 (S.D.N.Y. 1996) (involving analyst of financial brokerage firm who tipped his father of an upcoming merger he learned about in his capacity working for the acquiring company); *State Teachers Ret. Bd. v. Fluor Corp.*, 576 F. Supp. 1116, 1120 (S.D.N.Y. 1983) (declining to dismiss action against Fluor Corp for the tips of one of its employees because he could have been providing the tip on behalf of himself and his corporation's interests); *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 167 (2d Cir. 1980) (holding tip to a favored few analysts furthered a corporate interest, but breached a duty).

275. See, e.g., *United States v. Rajaratnam*, 719 F.3d 139, 158 (2d Cir. 2013); *United States v. Royer*, 549 F.3d 886, 899 (2d Cir. 2008).

276. *SEC v. Lipson*, 278 F.3d 656, 660 (7th Cir. 2002) (finding inference of use through unusual trading); *SEC v. Adler*, 137 F.3d 1325, 1337 (11th Cir. 1998); see also *SEC v. Truong*, 98 F. Supp. 2d 1086 (N.D. Cal. 2000); *SEC v. Anton*, No. 06-2274, 2009 WL 1109324 (E.D. Pa. Apr. 23, 2009); *Langevoort*, *supra* note 149, at 439, 439 n.36 (noting that *Adler* courts still follow the theory even after Rule 10b-5's adoption, but that the *Teischer* courts appear to have regulatory support).

277. See *United States v. Smith*, 155 F.3d 1051, 1069, 1069 n.27 (9th Cir. 1998); *United States v. Dombrowski*, No. 14 CR 41, 2014 WL 3454320 (N.D. Ill. July 15, 2014); *United States v. Causey*, No. H-04-025-SS, 2005 WL 3560632, at \*4, \*5 (S.D. Tex. Dec. 29, 2005) (discussing the "use" and not the "possession" standard in the criminal context, but finding it seemingly irrelevant in light of the evidence supporting both); Bryan C. Smith, Comment, *Possession Versus Use: Reconciling the Letter and the Spirit of Insider Trading Regulation Under Rule 10b-5*, 35 CAL. W. L. REV. 371 (1999). But see *Elam v. Neidorff*, 544 F.3d 921 (8th Cir. 2008) (finding failure to establish scienter with respect to defendant's trades under Rule 10b5-1 plan).

- of a corporate expansion. As her spouse, John expected Jill to maintain this information in trust and confidence.
4. Jill tipped material, nonpublic information to several acquaintances in violation of her duty as a corporate insider, and, alternatively, in breach of her duty of trust and confidence to her spouse.
  5. Jill knowingly or recklessly tipped the individuals in attendance at the Chamber of Commerce event.
  6. Information received from Jill carries a higher degree of credibility in light of her relationship with the owner of the business. The Chamber of Commerce attendees knew of her relationship to the corporation and knew it was in breach of a duty of trust and confidence.
  7. Jill knowingly or recklessly confirmed the material nonpublic information by allowing Jack to hear a conversation regarding the specifics of the corporation's increase in profits and expansion.
  8. Jack was in receipt of material nonpublic information that he knew or should have known Jill provided in breach of her fiduciary duty to the company or duty of trust and confidence to her husband and Jack violated Rule 10b-5 by trading on the information himself and by tipping Joe and Phil.
  9. Upon information and belief, Jack, Joe, and Phil hid their trades knowing the trades to be in violation of insider trading laws.
  10. Joe traded on information knowing it to be material nonpublic information received in breach of a fiduciary or similar duty.
  11. Phil traded on information knowing it to be material nonpublic information received in breach of a fiduciary or similar duty.

As discussed above, pre-*Newman*, the SEC needed simply to allege the information was a gift to a friend or trading partner. It was seemingly irrelevant that Jack, or the others, were distant acquaintances of Jill. Jill's disclosure without a proper purpose would have been sufficient to establish that it was a gift of information to someone she knew. Courts would have assumed a personal benefit. Likewise, Jack's knowledge of a breach would have been assumed by his trading and hiding the trades. His disclosure to Joe and Phil would have qualified as a gift to a trading relative or partner and in anticipation of furthering their trading scheme. Even if Phil had reached the same conclusion through his research and investigation, because he knew of the information through a nonpublic source, trading on the information would have been a violation.<sup>278</sup>

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278. Compare *United States v. Newman*, 773 F.3d 438, 452 (2d Cir. 2014) (finding analyst not liable where no reason to know information was nonpublic), *SEC v. One or More Unknown Traders in the Sec. of Onyx Pharm., Inc.*, 296 F.R.D. 241, 250 (S.D.N.Y. 2013) (finding allegations insufficient where identity of tipper unknown), and *Elkind*, 635 F.2d. at 167 (finding fact that earnings report would

Post-*Newman*, the relevant issue is whether Jill benefitted from her statement, or was simply careless or reckless in making it. If she was merely careless, did the tippees know of a personal benefit to her? If not, is she liable for tipping even if the tippees cannot be held liable for trading on the information? To properly state a claim in the Second Circuit, the plaintiff must establish scienter and personal benefit in more detail. For example, additional factual allegations like the following might be required post-*Newman*:

1. To raise her social standing in town and to further increase the profitability of her husband's business, Jill disclosed information to those individuals she believed could promote the family's business by eating at their restaurants, recommending their restaurants, and buying stock in the restaurants to increase profitability.
2. To further the trading scheme, Jack confided in Joe and Phil in order to conceal the evidence of their illegal trades, and to jointly profit.
3. Jack personally benefitted by increasing his credibility in the business community in anticipation of receiving more patients.
4. Joe personally benefitted by increasing his market reputation as a knowledgeable broker.
5. Phil likewise personally benefitted by increasing his market reputation as a credible analyst.
6. Phil's investigation and analysis of the restaurant was a sham in an effort to further the trading scheme based on misappropriated information.
7. Joe, Jack, and Phil all knew, or were reckless in not knowing, that Jill had breached her fiduciary duty to the company or to her husband in an effort to further advance the profitability of the family business and her social and economic standing in the community.

Arguably, Jill's initial tip was not material in nature. She did not specify what the exciting news was. Her statements could have been viewed as pure speculation and insufficient to qualify as material information.<sup>279</sup> However, because of her relationship with an insider, others would view her as having

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be forthcoming was not a material tip), *with Moore*, Exchange Act Release No. 22674, 2013 WL 1646915 (Apr. 16, 2013) (discussed by Joanna B. Apolinsky, *The Boundaries of Fraud Under the Insider Trading Rules*, 13 FLA. ST. U. BUS. REV. 1, 4 n.16 (2014) (noting that Moore was able to deduce the material information by artfully observing activity of relevant corporate insiders)). *See also* SEC v. Tang, No. C-09-05146 JCS, 2012 WL 10522, at \*1 (N.D. Cal. Jan. 3, 2012) (denying summary judgment for defendants, where corporate insider provided noncommittal answers to analyst's questions, but analyst was able to combine the answers with public information to trade on the belief the earnings report would show a decline).

279. *TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

relevant nonpublic information.<sup>280</sup> The information that Jack overheard was clearly material. Whether Jill was reckless in having the conversation in front of Jack would be a question of fact for a jury.<sup>281</sup> The issue would focus on what, if any, personal benefit Jill received, or intended to receive, by allowing Jack to overhear the conversation.

Whether Jack or the other Chamber attendees would be considered friends would likewise be a question of fact.<sup>282</sup> Pre-*Newman*, acquaintances were considered friends.<sup>283</sup> Post-*Newman*, there must be something more than being acquainted with someone to satisfy the requirement.<sup>284</sup> Specifically, there must be some relationship combined with something of value.<sup>285</sup>

As demonstrated by the hypothetical above, it seems incongruous and certainly unfair to allow someone to take inside information they receive and trade upon it simply because the plaintiff cannot demonstrate the initial tipper anticipated a personal benefit. It is also inappropriate to shield an individual from liability for disclosing information in a negligent or reckless manner simply because they did so for no apparent reason other than an inability to maintain secrecy. However, concern over the need to show something of value for liability to attach could be premature. The *Newman* court specifically recognized that a personal benefit can be based not only on something “pecuniary” but also on something of a “similarly valuable nature.”<sup>286</sup> What is

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280. Materiality is a fact-specific analysis and depends on the weight a reasonable investor attributes to the information. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968); *SEC v. Mayhew*, 121 F.3d 44, 50-51 (2d Cir. 1997) (finding tipper’s direct statements can be more credible than other reports in the marketplace, especially where the statement is made by the insider); accord *United States v. Mylett*, 97 F.3d 663, 667 (2d Cir. 1996).

281. See, e.g., *SEC v. Dunn*, No. 2:09-CV-2213 JCM (LRL), 2011 WL 2623509, at \*2 (D. Nev. June 30, 2011). Insiders have a duty not to disclose material nonpublic information. *SEC v. Bausch & Lomb Inc.*, 565 F.2d 8, 15 (2d Cir. 1977).

282. *State Teachers Ret. Bd. v. Fluor Corp.*, 576 F. Supp. 1116, 1116-20 (S.D.N.Y. 1983).

283. See *SEC v. Khan*, Exchange Act Release No. 23022, 2014 WL 2704318 (June 13, 2014). A friend is “1. a person whom one knows well and is fond of; close acquaintance; 2. a person on the same side in a struggle; ally; 3. a supporter or sympathizer; 4. something thought of as like a friend.” *Friend*, WEBSTER’S NEW WORLD DICTIONARY CONCISE EDITION 2D (1977).

284. The relationship must be a “meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.” *United States v. Newman*, 773 F.3d 438, 452 (2d Cir. 2014). According to the Webster’s New World Dictionary Concise Edition 2d “*Objective*” is: “of or having to do with a known or perceived object that is not merely in the mind; . . . real; while “*Consequential*” means: “[i]mportant.” WEBSTER’S NEW WORLD DICTIONARY CONCISE EDITION 2D (1977). The term pecuniary is defined as: “. . . involving money.” *Pecuniary*, WEBSTER’S NEW WORLD DICTIONARY CONCISE EDITION 2D (1977). *Newman* cited with approval the *Jiau* court, which required evidence of “a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the [latter].” *Newman*, 773 F.3d at 452 (quoting *United States v. Jiau*, 734 F.3d 147, 153 (2d Cir. 2013)). Black’s Law Dictionary has defined the phrase “*quid pro quo*” as: “[w]hat for what; something for something. Used in the law for the giving one valuable thing for another. It is nothing more than the mutual consideration which passes between the parties to a contract, and which renders it valid and binding.” *Quid pro quo*, A LAW DICTIONARY (2d ed. 1910).

285. *Newman*, 773 F.3d at 452.

286. *Id.*

sufficient to constitute a “similarly valuable nature” will likely be left for a jury’s or ALJ’s determination and a vast discrepancy among courts and administrative panels may arise. Therefore, legislative intervention is needed.

### *C. The Need for Congressional Intervention*

An analysis of Jack and Jill’s hypothetical situation demonstrates these inconsistencies. If a court were to read the *Newman* decision as it currently stands, all parties in the hypothetical likely would not be found responsible for illegal insider trading. However, if a court or ALJ were to utilize a pre-*Newman* standard, all of the parties likely would be found responsible. This appears to suggest some interest in revision of the insider trading laws. Legislative history indicates that insider trading laws, among other securities regulations, were specifically left broad in nature to allow for flexible application meted out through an executive rulemaking agency.<sup>287</sup> Courts interpret limitations on the SEC’s rulemaking power in two basic fashions: (1) regulations must address only intentional, or possibly reckless, behavior, and (2) only behavior involving a form of deceit, through nondisclosure, qualifies.<sup>288</sup> Arguably, the fundamental purpose of the 1934 Act was to bar “misconduct involving deception, misrepresentation, or nondisclosure” and “support full disclosure.”<sup>289</sup>

However, recent legislative proposals seem to contradict the Supreme Court’s limitation on insider trading and support a theory of parity of information.<sup>290</sup> Certainly, a bright-line test of no trading while in possession of material nonpublic information would guide those in the marketplace. The most thorough of the current proposals is Congressman Himes’s bill entitled “The Insider Trading Prohibition Act.”<sup>291</sup> The proposal prohibits trades “while in possession of material, nonpublic information relating to such security . . . if such person knows, or recklessly disregards, that such information has been obtained wrongfully, or that such . . . [trade] would constitute a wrongful use of such information,”<sup>292</sup> and prohibits wrongfully communicating,

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287. See generally Thel, *supra* note 5.

288. *Id.* at 386.

289. *Id.* at 388.

290. See Ban Insider Trading Act of 2015, H.R. 1173, 114th Cong. (2015) (Rep. Stephen Lynch) (focusing on definition of “materiality”); Stop Illegal Insider Trading Act, S. 702, 114th Cong. § 2(d)(1)(A) (2015) (Senators Jack Reed and Bob Menendez) (prohibiting trading “on the basis of material information that the person knows or has reason to know is not publicly available,” regardless of any breach of fiduciary duty).

291. Mr. Himes, a Representative from Connecticut, criticizes the *Newman* decision and the “restrictive and amorphous case law currently governing insider trading prosecutions” and the overwhelming need to have a definitive prohibition on insider trading to eliminate the inconsistent application of these laws. *Himes Statement on U.S. Court of Appeals for the Second Circuit’s Decision on Insider Trading*, CONGRESSMAN JIM HIMES (Apr. 3, 2015), <https://himes.house.gov/press-release/himes-statement-us-court-appeals-second-circuit%E2%80%99s-decision-insider-trading>.

292. Insider Trading Prohibition Act, H.R. 1625 § 16A(a) (2015) (current status as of March 25, 2015: referred to the House Committee on Financial Services).

material, nonpublic information relating to such security . . . to any other person if— (1) the other person—(A) purchases, sells, or causes the purchase or sale of, any security . . . to which such communication relates; or (B) communicates the information to another person who makes or causes such a purchase, sale, or entry while in possession of such information; and (2) such a purchase, sale, or entry while in possession of such information is reasonably foreseeable.<sup>293</sup>

The level of scienter required under the proposal eliminates the need to know of a personal benefit to the tipper. Rather, wrongful trading occurs when:

the information has been obtained by, or its communication or use would constitute, directly or indirectly—(A) theft, bribery, misrepresentation, or espionage (through electronic or other means); (B) a violation of any Federal law protecting computer data or the intellectual property or privacy of computer users; or (C) conversion, misappropriation, or other unauthorized and deceptive taking of such information, or a breach of any fiduciary duty or any other personal or other relationship of trust and confidence.<sup>294</sup>

The person need only be aware or be in reckless disregard of knowing that the information was “wrongfully obtained or communicated.”<sup>295</sup> For clarity, the theory of willful blindness should be incorporated into the scienter requirements for any insider trading violations.<sup>296</sup>

The proposal disaffirms the *Newman* decision’s requirement that a tippee know that the tipper received a personal benefit. Additionally, unlike the Eleventh and Seventh Circuits’ holdings, there would be no need to prove the actual use of the information in the trade. Mere possession at the time of the trade would suffice. For tipper-tippee liability under the proposed legislation, the tip must be wrongful (i.e., theft, misrepresentation, bribery, espionage, or the violation of other federal law). Where the disclosure does not constitute theft, bribery, or misrepresentation, it does not violate the statute *unless* it qualifies as a form of conversion, misappropriation, or other unauthorized and deceptive taking, or breach of fiduciary duty, personal duty, or relationship of trust and confidence.

If a person overhears a conversation involving a discussion of material nonpublic information, no liability would exist if he were unaware of whom the person was making the disclosure or whether the revelation was wrongful. To the extent there is a desire to broaden the scope of liability, the proposal should include language prohibiting the disclosure of information without a legitimate corporate purpose to another who trades upon the information. At a minimum,

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293. *Id.* § 16A(b).

294. *Id.* § 16(A)(c)(1).

295. *Id.* § 16(A)(c)(2).

296. *See* Strader, *supra* note 129, 1449.

Congress should engage in a thorough and thoughtful discussion regarding the philosophy behind the proposed prohibitions so that future decisions have the benefit of a clear policy upon which to base their decisions.

The parity of information analysis, the public policy goals of the SEC, and enforcement efforts in the United Kingdom and the European Union encourage a broader prohibition on insider trading.<sup>297</sup> Having a parity of information standard alleviates any inconsistencies in determining whether one is in a fiduciary or similar relationship, whether one receives or intended to receive a personal benefit, and the motive behind the disclosure. A consistent application of the rule will result in prohibiting individuals from capitalizing on material, nonpublic information.

In our hypothetical above, all individuals either knew or should have known that the information was material and nonpublic, and yet traded on it to their advantage. The proposed legislation would eliminate the argument surrounding whether a duty or personal benefit exists. Redefining the prohibitions would also eliminate the inconsistencies that arise between federal district courts and administrative proceedings, reducing forum shopping. Market participants would have little difficulty in understanding they are violating the law if they trade on information they know or were willfully blind to knowing was gained inappropriately or from an insider prior to full market disclosure. Although this definition creates a parity of information theory of liability, it leaves little to no room for confusion.

#### CONCLUSION

This paper addresses the discrepancy between the courts' and the SEC's philosophies of insider trading, and explores how subtle nuances in definitions of seemingly straightforward words could lead to uncertainty in the marketplace. Insider trading has been fraught with disputes over when the SEC should pursue cases. Because of the scant legislative history and divergent judicial and executive views on the illegality of insider trading, much confusion has arisen in this area of the law. Market participants should be given clear guidance on what activity will violate insider trading laws irrespective of the forum in which they are pursued. Congress seemingly sides with the SEC's broad interpretation and informational parity rather than a judicial construction in certain circuits that narrowly defines the elements of insider trading. To

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297. Congress has similar prohibitions for trading on nonpublic information learned during their congressional dealings for their personal benefit. *See* 15 U.S.C. § 78u-1(h)(1) (2012). Additionally, the United Kingdom's insider trading prohibitions for tipping liability simply require a showing the tipper realized receipt of material nonpublic information and traded upon it. *See* Financial Services and Markets Act 2000, c. 8, § 118(2) (Eng.), [http://www.legislation.gov.uk/ukpga/2000/8/pdfs/ukpga\\_20000008\\_en.pdf](http://www.legislation.gov.uk/ukpga/2000/8/pdfs/ukpga_20000008_en.pdf); *see also* *United States v. Whitman*, 904 F. Supp. 2d 363, 367 n.1 (S.D.N.Y. 2012) (noting the differences between U.S. securities laws and the European Union).

ensure clarity and uniformity, Congress should promulgate clear legislation with detailed discussions to assist in future judicial interpretations and SEC prosecutions. Legislation should carefully articulate the level of scienter required by all parties to a trading transaction to avoid future confusion between negligence and criminal standards.