

NOTHING NEW, MAN!—THE SECOND CIRCUIT’S CLARIFICATION OF INSIDER TRADING LIABILITY IN *UNITED STATES v. NEWMAN* COMES AT A CRITICAL JUNCTURE IN THE EVOLUTION OF INSIDER TRADING

Abstract: On December 10, 2014, in *United States v. Newman*, the U.S. Court of Appeals for the Second Circuit clarified what is required for remote tippees to be liable in insider trading cases. The government has argued that the *Newman* decision is unprecedented and will make it far more difficult to prosecute insider trading defendants. This Note argues that the *Newman* decision is consistent with precedent and the principles of criminal law and comes at a critical juncture where the SEC’s prosecutorial tactics do not square with the common law. Importantly, *Newman* reins in prosecutorial overreaching aimed at those who are least culpable and will hopefully shift the government’s focus to the crux of the problem: corporate insiders who tip material, nonpublic information for a personal benefit.

INTRODUCTION

Imagine this: you manage a successful hedge fund.¹ You employ analysts who conduct market research to help you accurately price securities.² The information these analysts generate affects your business judgment about in which securities to invest your fund’s assets.³ Now, one of your analysts comes to you with a “tip” on XYZ Company’s performance prior to its earnings announcement for the quarter.⁴ The company’s earnings are actually lower than

¹ See *United States v. Newman (Newman I)*, 773 F.3d 438, 442 (2d Cir. 2014), *cert. denied*, *United States v. Newman (Newman II)*, 136 S. Ct. 242 (2015) (mem.).

² See Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023, 1025 (1990) (noting the role of investment analysts to discover information about securities and make recommendations); Marron C. Doherty, Note, *Regulating Channel Checks: Clarifying the Legality of Supply-Chain Research*, 8 BROOK. J. CORP. FIN. & COM. L. 470, 470 (2014) (discussing the practice of channel-checking by investment analysts).

³ See Langevoort, *supra* note 2, at 1026 (discussing the relationship between investment funds and the investment analysts they employ); Doherty, *supra* note 2, at 477 (discussing how market professionals collect and analyze all available information about companies to make investment decisions).

⁴ See *Newman I*, 773 F.3d at 443 (describing how analysts passed information they learned from company insiders to hedge fund portfolio managers Newman and Chiasson).

the market expects.⁵ Do you trade on this information without asking questions?⁶ After all, you hired the analyst for exactly this reason—to get information so that you can accurately price securities and make informed investment decisions.⁷ Do you simply not trade on the information from this otherwise trustworthy source merely because it may have been obtained improperly and thus constitutes insider trading?⁸ Do you ask where he got this nonpublic information?⁹ Do you have a duty to ask?¹⁰

You ask because you do not want to trade on the information unless it is from a reliable source.¹¹ Your analyst divulges that he received the tip from an analyst at AAA, another hedge fund.¹² When pressed further you find out the following: the analyst at AAA received the information from an analyst at XXX and the analyst at XXX received the information from an employee of XYZ company.¹³ You are four degrees removed from the alleged source of in-

⁵ *Id.* (discussing the situation where analysts received information from corporate insiders disclosing company earnings numbers before they were publicly released in quarterly earnings announcements).

⁶ *See id.* at 454 (describing how analysts routinely confirm their financial modeling assumptions with company investor relations departments).

⁷ *See* Ronald J. Colombo, *Buy, Sell, or Hold? Analyst Fraud from Economic and Natural Law Perspectives*, 73 BROOK. L. REV. 91, 95 (2007) (detailing how analyst recommendations shape investor decisions); Doherty, *supra* note 2, at 477 (discussing how market professionals use their superior resources to provide a window into a company's "inner workings" so that they may accurately value the company to determine whether or not to invest).

⁸ *See* United States v. O'Hagan, 521 U.S. 642, 665 (1997) (holding that a breach of fiduciary duty to a source of information caused by secretly converting the source's information for personal gain constitutes a fraud in violation of securities law); Dirks v. SEC, 463 U.S. 646, 660 (1983) (holding that "a tippee assumes a fiduciary duty not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach"); United States v. Chiarella, 445 U.S. 222, 228 (1980) (holding that a duty to disclose or abstain from trading arises only from a specific fiduciary or similar relationship of trust and confidence); *Newman I*, 773 F.3d at 442 (holding that for a tippee to be liable, he or she must know both (1) that an insider disclosed confidential information and (2) that the insider did so in exchange for a personal benefit).

⁹ *See Newman I*, 773 F.3d at 454 (noting that hedge fund analysts routinely use financial modeling to estimate metrics such as revenue and that internal relations departments tell the analysts whether the assumptions in their models are "too high or too low" or in the "ball park").

¹⁰ *See id.* at 450 (noting that the defendants could be liable if they deliberately avoided learning that the information came from corporate insiders).

¹¹ *See id.* (noting that company investor relations departments routinely disclose financial information to gain favor with potential investors). *But see* Manuel Utset, *Fraudulent Corporate Signals, Conduct as Securities Fraud*, 54 B.C. L. REV. 645, 651 (2013) (noting that a corporate insider may selectively disclose certain information not to benefit the company, but instead to signal certain information to investors for his or her own benefit).

¹² *See* Brief for Defendant-Appellant Anthony Chiasson at 9, *Newman I*, 773 F.3d 438 (No. 13-1917), 2013 WL 4497030 (noting that defendant Chiasson received the inside information from co-defendant Newman's analyst at Diamondback Capital).

¹³ *See Newman I*, 773 F.3d at 443 (discussing the details of the two tipping chains at issue).

formation.¹⁴ You do not know the source of information, his or her position within XYZ, nor why he or she divulged this information.¹⁵ From your experience, you understand that it is industry practice for companies to selectively disclose such information to analysts prior to quarterly earnings releases.¹⁶ Remembering the game of telephone from elementary school you ask yourself: “Should I really trade on this information or is it merely a rumor at this point?”¹⁷

You decide to trade on the tip and, because it turned out to be accurate, you realize a substantial gain on your investment.¹⁸ At first, you are happy, your clients are happy, and you get to keep your job, but then you are indicted for securities fraud in violation of section 10(b) of the Securities Exchange Act (“Exchange Act”) and U.S. Securities and Exchange Commission (“SEC”) Rule 10b-5.¹⁹ You are tried and convicted by a jury of your peers.²⁰ You are sentenced to six years in prison, you must disgorge the profits from the trade, and you must pay a multi-million dollar penalty.²¹ How do you feel? Is this outcome fair? Oh, by the way, the employee tipper at XYZ who started the chain was never prosecuted.²² How do you feel now?

¹⁴ See *id.* (acknowledging that defendants Newman and Chiasson were three and four degrees removed, respectively, from the source of inside information in one tipping chain and four degrees removed from the source of inside information in the other tipping chain).

¹⁵ See *id.* (noting that there was no evidence that either defendant was aware of the source of the inside information).

¹⁶ See *id.* at 454 (finding that the evidence established that company investor relations personnel routinely leak earnings data in advance of quarterly earnings announcements).

¹⁷ See *id.* at 443 (highlighting how far removed the defendant traders were from the source of information).

¹⁸ See *id.* (noting that defendants Newman and Chiasson earned approximately \$4 million and \$68 million, respectively, in profits for their funds on the trades).

¹⁹ See *id.* (discussing the charges against Newman and Chiasson). Newman and Chiasson were charged with securities fraud in violation of section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. *Id.* Section 10(b) of the Securities Exchange Act of 1934 makes it unlawful for any person to use a manipulative or deceptive device in connection with the purchase or sale of a public security. 15 U.S.C. § 78j(b) (2012). Section 10(b)(5) also delegates to the SEC the power to promulgate rules to protect investors from such deceptive practices. *Id.* Pursuant to section 10(b)’s rulemaking power, the SEC has adopted Rule 10b-5, which provides:

It shall be unlawful for any person, directly or indirectly . . . (a) [t]o employ any device, scheme, or artifice to defraud [or] . . . (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5 (2015).

²⁰ See *Newman I*, 773 F.3d at 444–45 (returning a jury verdict of guilty on all counts).

²¹ See *id.* (discussing the prison sentencing, fines, and assessments levied against Newman and Chiasson).

²² See *id.* at 443 (noting that one of the insider tipplers has yet to be charged criminally for insider trading, while the other insider tipper has yet to be charged administratively, civilly, or criminally).

The above hypothetical is derived from the facts of *United States v. Newman*, an insider trading case decided by the U.S. Court of Appeals for the Second Circuit in 2014.²³ The *Newman* decision, which helps clarify the insider trading landscape, comes at a critical juncture where the SEC plans to bring more insider trading cases in-house.²⁴ Some have criticized the *Newman* decision, arguing that it unfairly limits the SEC's power to pursue insider trading cases and gives traders a roadmap by which to commit securities fraud.²⁵

This Note argues that *Newman* properly limited the SEC's expansion of insider trading liability and that the SEC should reevaluate its prosecutorial tactics in light of *Newman*.²⁶ Part I of this Note discusses the development of insider trading law and the requirements for insider trading liability.²⁷ Part II details the arguments for both sides and the ultimate decision by the Second Circuit in *United States v. Newman*.²⁸ Finally, Part III argues that the Second Circuit's decision in *Newman* is consistent with precedent and the principles of criminal law.²⁹ Part III also explains why it is important to rein in the SEC's prosecutorial overreach and why the government should shift its focus to insider-tippers who are the crux of the problem.³⁰

²³ See *id.* at 455 (vacating the convictions of defendants Newman and Chiasson and remanding to the district court to dismiss the indictment with prejudice). The government petitioned for a rehearing but the Second Circuit denied it. See Petition of the United States of America for Rehearing and Rehearing En Banc at 2–3, *Newman I*, 773 F.3d 438 (No. 13-1837(L)), 2015 WL 1064423. The government also petitioned the U.S. Supreme Court for certiorari, but the Court denied it without comment. See *Newman II*, 136 S. Ct. at 242.

²⁴ See Ed Beeson, *SEC Retooling Insider Trading Tactics After Newman*, LAW360 (Nov. 4, 2015, 10:36 PM), <http://www.law360.com/articles/723289/sec-retooling-insider-trading-tactics-after-newman> [<https://perma.cc/K892-596S>] (noting how prosecutors have had to redirect their attention to meet the *Newman* evidentiary standards); Joel Cohen et al., *SEC Plans to Play Insider-Trading Cases on Home Court*, NAT'L L.J., Sept. 16, 2014, at 1–2, <http://www.gibsondunn.com/publications/Documents/CohenDunningHarris-SECPlansToPlayInsiderTradingCases.pdf> [<https://perma.cc/Y8V9-YJ76>] (discussing the implications of bringing insider trading cases as administrative proceedings within the SEC); Stephanie Russell-Kraft, *SEC Admin Judge Will Apply Newman to Insider Trading Case*, LAW360 (Feb. 11, 2015, 7:18 PM), <http://www.law360.com/articles/620709/sec-admin-judge-will-apply-newman-to-insider-trading-case> [<https://perma.cc/L8U2-FSDL>] (quoting an SEC administrative law judge who said he would apply the *Newman* reasoning in an administrative proceeding before him).

²⁵ See Petition of the United States of America for Rehearing and Rehearing En Banc, *supra* note 23, at 22 (noting that *Newman* “threatens the integrity of the securities markets”); Alan Lieberman, *Major Developments in SEC Enforcement*, in NEW DEVELOPMENTS IN SECURITIES LITIGATION 1, 7 (2015 ed.), 2015 WL 2407608, at *6 (noting that *Newman* may have signaled a “seismic shift” in the enforcement of insider trading laws).

²⁶ See *infra* notes 31–214 and accompanying text.

²⁷ See *infra* notes 31–110 and accompanying text.

²⁸ See *infra* notes 111–146 and accompanying text.

²⁹ See *infra* notes 147–176 and accompanying text.

³⁰ See *infra* notes 177–214 and accompanying text.

I. A BRIEF OVERVIEW OF THE CURRENT STATE OF INSIDER TRADING LAW

Insider trading liability is a convoluted area of law that has developed through judicial interpretation of federal statutes and SEC regulations.³¹ Section A of this Part reviews the statutory basis and rationales of insider trading law rooted in section 10(b) of the Securities and Exchange Act of 1934.³² Section B explains the current state of insider trading law premised on a breach of a fiduciary duty constituting a fraud.³³ Finally, section C briefly discusses two additional elements required for insider trading liability: materiality and scienter.³⁴

A. The Basis and Rationales of Insider Trading Law

Generally speaking, insider trading is unlawfully trading securities based on material nonpublic information.³⁵ Nevertheless, federal securities statutes do not explicitly prohibit insider trading.³⁶ Rather, the law of insider trading has developed primarily through the common law of securities fraud, interpretations of § 10(b) of the Exchange Act and SEC Rule 10b-5 promulgated thereunder.³⁷ Rule 10b-5 makes it unlawful for any person to engage in fraudulent behavior in connection with the purchase or sale of securities.³⁸

The purpose of the Securities Act of 1933 (“Securities Act”) and the Exchange Act was to deter fraud and promote investor confidence in the securities markets.³⁹ Congress intended regulations promulgated under the Exchange

³¹ See *O’Hagan*, 521 U.S. at 650–52 (analyzing whether the misappropriation theory of insider trading is consistent with the text and purpose of section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder by the SEC); Ted Kamman & Rory T. Hood, *With the Spotlight on the Financial Crisis, Regulatory Loopholes, and Hedge Funds, How Should Hedge Funds Comply with the Insider Trading Laws?*, 2009 COLUM. BUS. L. REV. 357, 363 (discussing the convoluted history and common law evolution of insider trading law).

³² See *infra* notes 35–57 and accompanying text.

³³ See *infra* notes 58–99 and accompanying text.

³⁴ See *infra* notes 100–110 and accompanying text.

³⁵ See C. EDWARD FLETCHER, MATERIALS ON THE LAW OF INSIDER TRADING 3 (1991) (“[Insider trading] is probably best defined, to the extent any definition is adequate, as ‘the purchase or sale of securities on the basis of material, non-public information.’”); *Insider Trading*, BLACK’S LAW DICTIONARY (10th ed. 2014).

³⁶ See 15 U.S.C. § 78j(b) (prohibiting fraud but not specifically insider trading); 17 C.F.R. § 240.10b-5 (same).

³⁷ See Jimmy Fokas & Yulia Fradkin, *2nd Circuit Slams the Door on ‘Soft Benefit’ Insider Trading; Will Congress Pry It Back Open?*, 21 WESTLAW J. SEC. LIT. & REG., no. 2, May 28, 2015, at *1, *1 (noting that insider trading law has been shaped by decades of judge-made precedent); Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1322 (2009) (noting that insider trading law is essentially judge-made).

³⁸ 17 C.F.R. § 240.10b-5 (making it unlawful for any person to engage in conduct that “would operate as a fraud or deceit upon any person in connection with the purchase or sale of a security”).

³⁹ John A. MacKerron, *The Price Integrity Cause of Action Under Rule 10b-5: Limiting and Expanding the Use of the Fraud on the Market Theory*, 69 OR. L. REV. 177, 179 (1990) (discussing how

Act to protect investors against insider manipulation of stock prices by imposing reporting requirements on companies that list their stock on national securities exchanges.⁴⁰ These reporting requirements sought to make it difficult for companies to manipulate the public's perception of their financial state and facilitate investors' ability to interpret the required financial information distributed by the company.⁴¹

Insider trading is perhaps the most emblematic, yet misunderstood, white-collar crime.⁴² There are two competing policy rationales for why the United States has disclosure requirements and holds individuals liable for trading on material nonpublic information.⁴³ The first is the fairness or "parity of information" rationale, which has been backed by the SEC from the inception of Rule 10b-5 to its more recent regulations.⁴⁴ The second is the duty rationale that is premised on an efficient market theory, which has been expressly adopted by the U.S. Supreme Court.⁴⁵

the legislative history to the Securities Act and Exchange Act indicates that protection of individual investors and restoration of confidence in the securities markets were Congress's primary concerns); Michelle N. Comeau, Comment, *The Hidden Contradiction Within Insider Trading Regulation*, 53 UCLA L. REV. 1275, 1283 (referencing the U.S. Supreme Court cases that outline the purpose of the Securities Act and the Exchange Act).

⁴⁰ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) (discussing how the Exchange Act was intended to protect investors against manipulation of stock prices through regulation and the imposition of regular reporting requirements).

⁴¹ *See id.* (discussing the rationale behind the Securities Act); Comeau, *supra* note 39, at 1283 (discussing how reporting requirements would increase investor confidence in the securities markets).

⁴² *See* Kip Schlegel et al., *Are White-Collar Crimes Overcriminalized? Some Evidence on the Use of Criminal Sanctions Against Securities Violators*, 28 W. ST. U. L. REV. 117, 126–27 (2001) (noting the notoriety associated with the prosecution of insider trading cases on Wall Street during the 1980s); Neil V. Shah, Note, *Section 20a and the Struggle for Coherence, Meaning, and Fundamental Fairness in the Express Right of Action for Contemporaneous Insider Trading Liability*, 61 RUTGERS L. REV. 791, 797–98 (2009) (highlighting prominent insider trading cases in the 1980s involving notorious high-profile defendants such as Dennis Levine, Michael Milken, and Ivan Boesky, who served as the inspiration for Gordon Gecko in the movie "Wall Street").

⁴³ *Compare Chiarella*, 445 U.S. at 232 (acknowledging the fairness rationale), with William O. Fisher, *Does the Efficient Market Theory Help Us Do Justice in a Time of Madness?*, 54 EMORY L.J. 843, 854 (2005) (discussing the efficient market theory).

⁴⁴ *See* Regulation FD, 17 C.F.R. §§ 243.100–.103 (2015) (requiring simultaneous public disclosure of information any time an insider discloses material, nonpublic information); *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912–13 (1961) (adopting the fairness rationale).

⁴⁵ *See Dirks*, 463 U.S. at 660 (holding that because there is no general duty to the market generally, "a tippee assumes a fiduciary duty not to trade on material nonpublic information only when the insider has breached his fiduciary duty to shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach"). Both of these rationales are intended to promote investor confidence in the securities market, albeit for different reasons. *See* Comeau, *supra* note 39, at 1280 (describing investor confidence as a general conviction that investors trust the stock market enough to purchase securities). Investor confidence includes trust of intermediaries and institutional mechanisms, as well as the regulatory system in place to ensure the integrity of capital markets. *Id.* at 1280–81.

The fairness rationale is based on the premise that federal securities laws should create a system that provides equal access to information in the securities market, a parity of information, which is necessary for investors to make reasoned and intelligent investment decisions.⁴⁶ According to this rationale, using information not generally available to the market to trade in securities is fraudulent because it gives corporate insiders with access to information an unfair advantage over less informed shareholders or other buyers and sellers of securities.⁴⁷ Investors would be discouraged from participating in the securities market because they would have no way of knowing whether they were at an unfair disadvantage.⁴⁸ Under this fairness rationale, insider trading is undesirable because it is fundamentally unfair to those investors lacking the same access to information as insiders.⁴⁹ The uninformed investor is harmed to the extent he or she would have made a different investment decision had he or she had access to the same inside information.⁵⁰ The SEC has utilized this rationale to persuade courts to expand the law of insider trading.⁵¹

⁴⁶ *Chiarella*, 445 U.S. at 232 (discussing the appellate court's decision, which rested on the fairness rationale that federal securities laws have "created a system providing equal access to information necessary for reasoned and intelligent investment decisions"); Kathleen Coles, *The Dilemma of the Remote Tippee*, 41 GONZ. L. REV. 181, 189 (2006) (discussing the parity of information rationale employed by the SEC in insider trading cases).

⁴⁷ *Chiarella*, 445 U.S. at 232 ("The use by anyone of material information not generally available is fraudulent, [the fairness theory] suggests, because such information gives certain buyers or sellers an unfair advantage over less informed buyers and sellers."); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (stating that Rule 10b-5 is based on the policy that all investors should have "relatively equal access to material information").

⁴⁸ See *Texas Gulf Sulphur Co.*, 401 F.2d at 851–52 (stating that the purpose behind section 10(b) and the promulgation of Rule 10b-5 is that all investors should have equal access to the rewards of participating in the securities market and be subject to identical market risks); Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 339–40 (1979) (discussing how preventing informational advantages in the market has been proffered as a rationale for parity-of-information).

⁴⁹ See *Texas Gulf Sulphur Co.*, 401 F.2d at 852 (noting the inequalities based upon access to information). The European Union has adopted this rationale for its own securities fraud legislation. Stephen J. Crimmins, *Insider Trading: Where Is the Line?*, 2013 COLUM. BUS. L. REV. 330, 358 (describing how the European Union has fully embraced the parity-of-information approach); James B. Stewart, *Delving into the Morass of Insider Trading*, N.Y. TIMES (Dec. 19, 2014), http://www.nytimes.com/2014/12/20/business/the-insider-trading-morass.html?_r=0 (quoting Professor Marco Ventoruzzo as stating, "The European approach, by contrast, is much simpler 'If you have material, inside information, you can't trade on it, period' . . ."). Congress, however, has not adopted this parity-of-information rule. *Chiarella*, 445 U.S. at 233.

⁵⁰ See Joel Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1115 (1985) (discussing the harm caused by the informational disadvantage); Comeau, *supra* note 39, at 1281 (same).

⁵¹ See *United States v. Carpenter*, 791 F.2d 1024, 1034 (2d Cir. 1986) (holding defendants liable for insider trading under the misappropriation theory because in their role as newspaper employees they had access to confidential information regarding companies in advance of publications disseminated to the public at large), *aff'd*, 484 U.S. 19 (1987); *Texas Gulf Sulphur Co.*, 401 F.2d at 848 (holding that anyone in possession of material inside information must disclose it to the investing public or

Whereas parity-of-information is easy to understand and plays to the public's sense of fairness, the efficient market rationale is more abstract and suggests fewer restrictions on insider trading.⁵² The efficient market rationale promotes investor confidence in the securities market by assuming that a security's price promptly reacts to new and unexpected information.⁵³ Under this rationale, trading based on nonpublic, material information contributes to efficient stock market pricing because information relevant to a stock's value becomes embedded in stock prices more quickly than if the public had to wait until such information was disclosed.⁵⁴ Additionally, the efforts of market professionals, such as analysts, help bring security prices in line with the underlying value of the asset.⁵⁵ The profits made by these market professionals are therefore an appropriate re-

abstain from trading on that information); *In re Blyth & Co.*, 43 S.E.C. 1037, 1040 (1969) (sanctioning broker-dealer for trading on the basis of non-public information he obtained from a Federal Reserve Bank employee); Coles, *supra* note 46, at 189–90 (noting that by promoting the general fairness rationale, prosecutors were able to expand the law of insider trading until the Court decisively ruled in *Chiarella*).

⁵² See Eric Engle, *Insider Trading: Incoherent in Theory, Inefficient in Practice*, 32 OKLA. CITY U. L. REV. 37, 61 (2007) (arguing that although insider trading looks unfair it is a good thing because it renders the markets more efficient); Comeau, *supra* note 39, at 1301 (“[I]nvestor protection has a great deal of populist appeal, while the promotion of efficient markets appears . . . at best . . . coldly technocratic, and at worst, anti-populist—we’re siding with Wall Street against Main Street.”).

⁵³ See Fisher, *supra* note 43, at 854 (discussing the efficient market theory that courts employ in securities litigation). A market can achieve “mechanical efficiency” if it promptly responds to information, without having “value efficiency” in which it generates prices reflecting the actual economic values of securities calculated by risk and expected returns. *Id.* at 852–53; see also Daniel R. Fischel, *Efficient Capital Markets, the Crash, and the Fraud on the Market Theory*, 74 CORNELL L. REV. 907, 914 (1989) (noting that the best model for ascertaining the true value of a publicly-traded firm's assets is looking at the prices of its securities).

⁵⁴ See Engle, *supra* note 52, at 61 (arguing that insider trading creates a more efficient market); Roberta S. Karmel, *Outsider Trading on Confidential Information—A Breach in Search of a Duty*, 20 CARDOZO L. REV. 83, 110–11 (1998) (discussing the academic debate on whether insider trading contributes to, or undermines, market efficiency). Those who think insider trading makes markets inefficient argue, among other things, that (1) allowing insider trading encourages insiders to manipulate corporate decision-making and withhold relevant information from the market, and (2) the information companies make available to analysts does not reflect all the information upon which insiders are trading, thereby preventing accurate valuation and pricing of stocks. See Karmel, *supra*, at 110–11.

⁵⁵ See *In re Verifone Sec. Litig.*, 784 F. Supp. 1471, 1479 (N.D. Cal. 1992) (noting that efforts by market professionals push the price of securities towards a value that reflects all publicly available information), *aff'd*, 11 F.3d 865 (9th Cir. 1993); Jay W. Eisenhofer et al., *Securities Fraud, Stock Price Valuation, and Loss Causation: Toward a Corporate Finance-Based Theory of Loss Causation*, 59 BUS. LAW. 1419, 1421 (2004) (noting that corporate finance theory holds that a stock's price reflects the market's estimation of the company's future discounted cash flows); Jonathan R. Macey et al., *Lessons from Financial Economics: Materiality, Reliance, and Extending the Reach of Basic v. Levinson*, 77 VA. L. REV. 1017, 1022 (1991) (arguing that stock price is a good estimate of investment value because it is equal to the present value of the expected discounted cash flows from the stock to its owners).

ward for their labor.⁵⁶ As discussed further below, under this rationale then, insider trading is undesirable only to the extent it benefits a corporate insider to the detriment of the company's shareholders or source of information.⁵⁷

*B. Insider Trading Law Premised on Duty, Not Premised on
Equal Access to Information in the Market*

Importantly, the U.S. Supreme Court has explicitly stated that not all securities trading on the basis of material, nonpublic information constitutes fraud in violation of section 10(b) and Rule 10b-5.⁵⁸ The Court has repeatedly found that liability for insider trading cannot be based on the notion that the antifraud provisions of the Exchange Act and Rule 10b-5 require equal information among all traders in the securities market.⁵⁹ In 1983, in *Dirks v. SEC*, the Court noted the adverse effect such a broad rule would have on market analysts, whose role is necessary to the preservation of a healthy market.⁶⁰ Instead, the Court, through its three insider trading opinions, has built its jurisprudence

⁵⁶ See *United States v. Chestman*, 947 F.2d 551, 578 (2d Cir. 1991) (Winter, J., concurring) (“Efficient capital markets depend on the protection of property rights in information. However, they also require that persons who acquire and act on information about companies be able to profit from the information they generate”); Karmel, *supra* note 56, at 110. If market professionals had to wait to trade until after disclosure to the public, it would be too late to reap any reward from their labor. See *Chestman*, 947 F.2d at 578 (noting that efficient markets require that those who generate information are able to profit from it as long as it does not amount to theft). Additionally, if certain investors believe it is worthwhile to seek out valuable market information, investing considerable time and effort to “beat the market” with better research, those efforts enhance market efficiency. *Id.*; Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 BUS. LAW. 1, 4–5 (1982) (noting that market professionals who have a competitive advantage in obtaining and interpreting relevant information have an incentive to do so and take actions that will affect the market price).

⁵⁷ See *O’Hagan*, 521 U.S. at 665 (holding that a breach of fiduciary duty to a source of information by secretly converting the source’s information for personal gain constitutes a fraud in violation of securities law); *Dirks*, 463 U.S. at 660 (holding that “a tippee assumes a fiduciary duty not to trade on material nonpublic information only when the insider has breached his fiduciary duty to shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach”).

⁵⁸ *Dirks*, 463 U.S. at 666 n.27 (emphasizing that there is no general duty to forgo market transactions based on material, nonpublic information because such a broad duty to the market would “depart radically from the established doctrine that duty arises from a specific relationship between two parties”).

⁵⁹ *Id.* at 657; *Chiarella*, 445 U.S. at 235 (holding that a duty to disclose under section 10(b) does not arise from the mere possession of nonpublic market information and noting that a contrary result would be inconsistent with the “careful plan that Congress has enacted for regulation of the securities markets”).

⁶⁰ *Dirks*, 463 U.S. at 658 (“Imposing a duty to disclose . . . solely because a person knowingly receives . . . information from an insider . . . could have an inhibiting influence on . . . market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market.”). Market analysts “ferret out and analyze information” by questioning corporate insiders to establish a basis for the market price and underlying value of a corporation’s securities. *Id.* at 658–59.

on the idea that only certain individuals have a duty to either disclose inside information or abstain from trading on it.⁶¹

As it stands today, insider trading liability stems from a breach of fiduciary duty constituting a fraud under Rule 10b-5.⁶² Subsection 1 discusses the development of the classical theory of insider trading.⁶³ Subsection 2 explores the U.S. Supreme Court's express adoption of the misappropriation theory of insider trading in *United States v. O'Hagan*.⁶⁴ Subsection 3 examines how tippees and tippees of material, nonpublic information can be liable under either theory of insider trading.⁶⁵

1. Classical Theory

Under the classical theory of insider trading liability, a corporate insider commits fraud under section 10(b) and Rule 10b-5 when he or she trades in the securities of the corporation on the basis of material, nonpublic information.⁶⁶ Trading on such information without disclosing it breaches a fiduciary duty owed to the shareholders of the corporation.⁶⁷ The existence of the fiduciary relationship gives rise to a duty to disclose or abstain from trading so as to prevent the corporate insider from taking unfair advantage of the uninformed stockholders.⁶⁸

⁶¹ See *O'Hagan*, 521 U.S. at 665 (holding that a breach of fiduciary duty to a source of information by secretly converting the source's information for personal gain constitutes a fraud in violation of securities law); *Dirks*, 463 U.S. at 660; *Chiarella*, 445 U.S. at 228 (holding that a duty to disclose or abstain from trading arises only from a specific fiduciary or similar relationship of trust and confidence).

⁶² See *Newman I*, 773 F.3d at 449 (noting that the U.S. Supreme Court had previously established that insider trading liability is based on breaches of fiduciary duty, not on informational asymmetries); *Chestman*, 947 F.2d at 578 (noting that the rationale behind insider trading law stops "well short" of prohibiting all trading on material nonpublic information).

⁶³ See *infra* notes 66–82 and accompanying text.

⁶⁴ See *infra* notes 83–88 and accompanying text.

⁶⁵ See *infra* notes 89–99 and accompanying text.

⁶⁶ *O'Hagan*, 521 U.S. at 651–52. A corporate "insider" is not limited to officers or directors of a corporation, as the definition also applies to temporary insiders like attorneys, accountants, or consultants who temporarily become fiduciaries of the corporation. *Dirks*, 463 U.S. at 655 n.14.

⁶⁷ *O'Hagan*, 521 U.S. at 652 ("Trading on such information qualifies as a 'deceptive device' . . . because 'a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders . . .'" (quoting *Chiarella*, 445 U.S. at 228)).

⁶⁸ *Chiarella*, 445 U.S. at 228–29. Shareholders are harmed when an insider uses the material, nonpublic information to trade in the securities of the corporation to the extent that the information would have caused shareholders to seek trades of their securities had they been privy to the same information. *Dirks*, 463 U.S. at 673 n.8 (Blackmun, J., dissenting) (noting the harm to the shareholders).

The SEC established the “disclose or abstain” rule that epitomizes insider trading law in 1961, in *In re Cady, Roberts & Co.*⁶⁹ In that case, the SEC set forth the elements for establishing a Rule 10b-5 violation: (1) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (2) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure.⁷⁰ Based on the fairness rationale, judicial and regulatory decisions following *In re Cady* expanded the duty to disclose or abstain into a broad duty to all participants in the market.⁷¹

The U.S. Supreme Court, however, decisively reined in this disclosure duty in 1980 in *Chiarella v. United States*.⁷² In *Chiarella*, the Court held that a duty to disclose or abstain from trading arises only from a specific fiduciary or similar relationship of trust and confidence.⁷³ The defendant obtained nonpublic information about upcoming mergers through his job as a “markup man” for a financial printer.⁷⁴ He was convicted for purchasing stock in the target companies of the mergers and selling them immediately after the takeover bids were made public.⁷⁵ To the Court, the Rule 10b-5 duty to disclose prior to trading sought to ensure that corporate insiders, who have an obligation to place the shareholder’s welfare before their own, would not benefit personally through fraudulent use of material, nonpublic information.⁷⁶ Because it found

⁶⁹ *In re Cady, Roberts*, 40 S.E.C. at 911 (noting that an affirmative duty to disclose material information has been traditionally imposed on corporate “insiders,” particularly officers, directors, or controlling stockholders).

⁷⁰ *Id.* (“[I]nsiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal Failure to make disclosure in these circumstances constitutes a violation of the anti-fraud provisions.”). In this case, directors of a public company decided to reduce the amount of a dividend to shareholders. *Id.* at 909. After the decision was made, one of the directors informed a broker who avoided a significant loss by selling shares of the company’s stock before the news went public. *Id.* The SEC held that the director violated Rule 10b-5. *Id.* at 911.

⁷¹ See *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 238 (2d Cir. 1974) (holding that defendants breached a duty to disclose or abstain from trading owed to all persons who purchased the relevant stock in the open market without knowledge of the material inside information possessed by defendants); *Texas Gulf Sulphur Co.*, 401 F.2d at 848 (explaining that Rule 10b-5 “is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to information”).

⁷² *Chiarella*, 445 U.S. at 228–30 (premising liability on a breach of fiduciary duty).

⁷³ *Id.* at 228–30, 232 (finding that “[n]o duty could arise from petitioner’s relationship with the sellers of the target company’s securities, for petitioner had no prior dealings with them”).

⁷⁴ *Id.* at 224.

⁷⁵ *Id.* at 224–25.

⁷⁶ *Id.* at 230. The Court reversed because the jury instructions erroneously stated that defendant was liable for fraud if he “did not disclose . . . material non-public information in connection with the purchases of stock.” *Id.* at 236. The Court refused to decide whether an insider owes such a fiduciary duty to disclose or abstain to both sellers and buyers of securities, the latter of whom are not shareholders at the time of the transaction. *Id.* at 235–36.

that the defendant had no duty to the target company's shareholders, the Court reversed his conviction.⁷⁷

Three years later in 1983, in *Dirks v. SEC*, the Court again found that individuals have no duty to disclose or abstain from trading unless they are a corporation's agent, a fiduciary, or a person in whom the sellers of securities have placed their trust or confidence.⁷⁸ The Court followed *Chiarella* and continued to refuse to recognize a general duty between all participants in market transactions to forgo actions based on material, nonpublic information.⁷⁹ At the same time, the Court in *Dirks* recognized that there were circumstances where corporate outsiders could become temporary insiders owing a fiduciary duty to shareholders.⁸⁰ Thus, under the classical theory, a corporate "insider" is not limited to officers or directors of a corporation, but also to temporary insiders — those who temporarily become fiduciaries of the corporation, such as attorneys, accountants or consultants.⁸¹ In sum, to be liable under the classical theory of insider trading, a defendant must be an insider, temporary insider, or tippee of an insider or temporary insider of the traded corporation.⁸²

2. Misappropriation Theory

Whereas the classical theory targets a corporate insider's breach of duty to shareholders, the misappropriation theory of insider trading targets a corporate outsider's breach of duty to a source of information.⁸³ Under the misappropriation theory, an individual commits fraud under section 10(b) and Rule

⁷⁷ *Id.*

⁷⁸ *Dirks*, 463 U.S. at 654–55 (acknowledging that the Court's opinion in *Chiarella* left unclear how a tippee could acquire the duty to disclose or refrain from trading on inside information if he or she owed no fiduciary duty like the insider-tipper).

⁷⁹ *Id.* ("Not to require such a fiduciary relationship . . . would 'depar[t] radically from the established doctrine that duty arises from a specific relationship between two parties' and would amount to 'recognizing a general duty between all participants in [the] market . . .'" (quoting *Chiarella*, 445 U.S. at 230)).

⁸⁰ *Id.* at 655 n.14 (highlighting that the basis for recognizing a fiduciary duty is that the insider enters into a special confidential relationship to conduct business for the enterprise and is given access to information for that exclusive purpose).

⁸¹ *Id.* ("Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders.") In *Chiarella*, the Court never reached the question of whether *Chiarella* was a "temporary insider" with respect to the acquiring and target companies in his role as a markup man. *Chiarella*, 445 U.S. at 230.

⁸² *Dirks*, 463 U.S. at 655 n.14 (recognizing that temporary insiders have a duty to disclose or abstain from trading); *Chiarella*, 445 U.S. at 230 (holding that a duty to disclose or abstain from trading arises only from a fiduciary relationship).

⁸³ *O'Hagan*, 521 U.S. at 652 (explaining that under the misappropriation theory, a fiduciary's undisclosed use of its principal's information to personally benefit in the trade of securities constitutes a breach of a duty of loyalty and confidentiality and defrauds the principal corporation of the exclusive use of that information).

10b-5 when he or she misappropriates material, nonpublic information for securities trading purposes, in breach of a duty owed to the source of the information.⁸⁴

The U.S. Supreme Court adopted the misappropriation theory in *United States v. O'Hagan* in 1997.⁸⁵ In *O'Hagan*, the Court held the misappropriation theory was consistent with securities fraud under section 10(b), and upheld the conviction of an attorney who misappropriated material, nonpublic information from his law firm and its client.⁸⁶ As the Court noted, breaching a fiduciary duty to a source of information by secretly converting the source's information for personal gain while feigning loyalty to the source constitutes a fraud.⁸⁷ The misappropriation theory thus extends insider trading law to prevent corporate "outsiders" who have access to a corporation's confidential information, but no fiduciary duty to the corporation or its shareholders, from trading on the basis of that information.⁸⁸

⁸⁴ *Id.* (observing that a fiduciary who feigns loyalty to his or her principal while secretly converting the principal's information for personal gain defrauds the principal).

⁸⁵ *Id.* at 650 (holding that criminal liability under section 10(b) may be predicated on the misappropriation theory). The *O'Hagan* Court stated that its prior holding in *Chiarella* did not provide that a fiduciary relationship was the *only* special relationship between two parties giving rise to liability under section 10(b) and Rule 10b-5. *Id.* at 661.

⁸⁶ *Id.* at 665 (adopting the misappropriation theory as both consistent with section 10(b) and Court precedent). The Court held that the misappropriation theory satisfies section 10(b)'s requirement that the deceptive use of information be "in connection with the purchase or sale of a security" even though the deceptive act happens before and independent of any securities trading. *Id.* at 655-56. The defendant was a partner in a law firm that represented Grand Metropolitan PLC ("Grand Met"). *Id.* at 647. Grand Met retained the firm to represent it regarding a potential tender offer for stock in the Pillsbury Company ("Pillsbury"). *Id.* Although defendant himself did no work for Grand Met, he used Grand Met's material, nonpublic information to trade on the Pillsbury stock, making a profit of more than \$4.3 million. *Id.*

⁸⁷ *Id.* at 655 (recognizing that because the deception essential to the misappropriation theory involves feigning loyalty to the principal, there is no deception and no violation of section 10(b) if the fiduciary discloses to the principal that he or she plans to trade on the nonpublic information).

⁸⁸ *Id.* at 653. Additionally, the SEC promulgated Rule 10b5-2, which extended the misappropriation theory by stating that people engage in fiduciary duties to sources of information whenever they agree to maintain information in confidence. 17 C.F.R. § 240.10b5-2 (2015). A duty of confidence is not the same as a fiduciary duty, and someone can breach a duty of confidentiality without breaching his or her fiduciary duties. Ryan M. Davis, Note, *Trimming the "Judicial Oak": Rule 10b5-2(b)(1), Confidentiality Agreements, and the Proper Scope of Insider Trading Liability*, 63 VAND. L. REV. 1469, 1486 (2010) (discussing the implications of Rule 10b5-2). This rule, however, provides that a duty of confidentiality alone can satisfy the duty requirement, thus expanding the scope of insider trading law to capture any relationship covered by a confidentiality agreement. *Id.*

3. Tipper and Tippee: Derivative of Classical and Misappropriation Theories of Liability

Individuals do not have to trade on material, nonpublic information to be liable under either theory of insider trading.⁸⁹ Individuals also violate Rule 10b-5 when they communicate or “tip” the information for an improper purpose, regardless of whether they trade on the information themselves.⁹⁰ Tippees also may be liable for violating Rule 10b-5 if they trade on the material, nonpublic information or tip another person.⁹¹ Tipper-tippee chains are common in insider trading cases, and the SEC frequently brings cases against remote tippees who may be many degrees removed from the initial tipper.⁹²

But if the tipper’s duty to disclose or abstain from trading arises from a duty owed either to shareholders (classical theory) or a source of information (misappropriation theory), from where does a tippee’s duty stem?⁹³ In *Dirks*, the Court answered this question, holding that a tippee assumes a fiduciary duty to the shareholders not to trade on material, nonpublic information only when (1) the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and (2) the tippee knows or should know that there has been a breach.⁹⁴ The Court found that a tippee’s duty to disclose information or abstain from trading is derivative from that of an insider’s duty.⁹⁵ In recognizing this derivative duty, the Court noted that those who know-

⁸⁹ *Dirks*, 463 U.S. at 659 (“Not only are insiders forbidden . . . from personally using undisclosed corporate information . . . but they also may not give such information to an outsider for the same improper purpose . . .”). See generally 15 U.S.C. § 78t(b) (2012) (making it unlawful to do indirectly (i.e., by way of another person) any act made unlawful by federal securities laws).

⁹⁰ *Dirks*, 463 U.S. at 659.

⁹¹ *Id.* (noting that in *Chiarella*, the Court viewed a tippee’s obligation arising from his or her role as a “participant after the fact in the insider’s breach of a fiduciary duty”). A tippee can become a tipper by tipping information to someone else who trades on the material, nonpublic information. See *Newman I*, 773 F.3d at 446 (discussing how insider trading liability is not confined to those who trade but also to those who disclose to someone else who trades on the information).

⁹² See *Newman I*, 773 F.3d at 442 (involving a tipping chain); *SEC v. Obus*, 693 F.3d 276, 288 (2d Cir. 2012) (same); *United States v. Rajaratnam*, 802 F. Supp. 2d 491, 499 (S.D.N.Y. 2011) (involving a channel check tipping chain).

⁹³ See *O’Hagan*, 521 U.S. at 652 (applying the misappropriation theory); *Dirks*, 463 U.S. at 654 (applying the classical theory).

⁹⁴ *Dirks*, 463 U.S. at 660 (applying this standard in a classical theory case); see *Obus*, 693 F.3d at 285–86 (applying the *Dirks* tippee liability standard in a misappropriation case). In this case, a securities analyst received material, nonpublic information from an insider of Equity Funding of America (“Equity Funding”) that the corporation was overstating its assets. *Dirks*, 463 U.S. at 648–49. The insider tipped the analyst so that the analyst could expose the fraud. *Id.* at 649–50. The analyst confirmed the fraud and discussed the information he had obtained through his investigation with clients and investors, some of whom sold their shares of Equity Funding thereby avoiding losses when the fraud became public and stock prices dropped. *Id.* The SEC and U.S. Court of Appeals for the District of Columbia found that the analyst violated insider trading laws under Rule 10b-5. *Id.* at 650–52.

⁹⁵ *Dirks*, 463 U.S. at 659 (noting that tipping is viewed properly only as a means of indirectly violating the *Cady, Roberts* disclose or abstain from trading rule).

ingly participate with a fiduciary in such a breach are “as forbidden” from the improper purpose of exploiting the information for their personal gain.⁹⁶

The Court went on to hold that whether a disclosure by the tipper is a breach of a duty, thereby implicating the tippee’s derivative liability, depends on the purpose of the disclosure.⁹⁷ Observing that not all disclosures or “tips” of confidential corporate information violate the duty insiders owe to shareholders, the Court stated that the test for whether an insider breached his or her duty was “whether the insider personally will benefit, directly or indirectly, from the disclosure.”⁹⁸ Without such a legal limitation, the Court noted, market participants would be at the mercy of the SEC’s litigation strategy.⁹⁹

C. Materiality and Scienter

To be held liable for insider trading, two additional elements must be established: materiality and scienter.¹⁰⁰ According to the U.S. Supreme Court, a fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.¹⁰¹ Therefore, a fact is material under section 10(b) and Rule 10b-5 if there is a substantial likelihood that the disclosure of the fact would be viewed by a reasonable investor as having significantly altered the “total mix” of information made available.¹⁰² The materiality standard is extraordinarily broad and potentially encompasses a

⁹⁶ *Id.* (explaining how a contrary rule would “open up opportunities for devious dealings in the name of others that the trustee could not conduct in his own”).

⁹⁷ *Id.* at 662 (recognizing that the purpose of the securities laws was to eliminate the “use of inside information for personal advantage”).

⁹⁸ *Id.* (“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.”). The Court noted the typical scenario where an insider discloses nonpublic information without deriving any personal benefit from it or breaching his or her fiduciary duty. *Id.* The Court acknowledged that such a question of fact would not always be easy for courts to apply, but recognized the importance in having a “guiding principle for those whose daily activities must be limited and instructed by the SEC’s insider trading rules.” *Id.* at 664.

⁹⁹ *Id.* at 664 n.24 (noting that the rule supported by the SEC would have no limiting principle, and without legal limitations, market participants would be forced into the hazardous position of having to rely on the reasonableness of the SEC’s enforcement tactics and litigation strategy).

¹⁰⁰ See *Newman I*, 773 F.3d at 447 (discussing the elements of insider trading liability).

¹⁰¹ *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (stating that the materiality standard requires a showing of a substantial likelihood that, under all the circumstances, the information would effect the deliberations of the reasonable shareholder); see *Dirks*, 463 U.S. at 660 (holding that an insider will be liable under Rule 10b-5 for insider trading only where he or she fails to disclose material nonpublic information before trading on it).

¹⁰² *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 45–46 (2011) (holding that it was possible that a reasonable investor would have viewed a report linking the drug Zicam with anosmia (loss of smell) as significantly altering the total mix of information available when making an investment decision); *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988) (expressly adopting the *TSC Industries* standard of materiality for section 10(b)).

great deal of information that would have no effect on the value of a company or the pricing of its securities.¹⁰³

Liability for insider trading also requires proof of scienter, which is defined as “a mental state embracing intent to deceive, manipulate, or defraud.”¹⁰⁴ To determine scienter in insider trading, courts focus on objective criteria, such as whether the insider receives a personal benefit from the disclosure through a pecuniary gain or a reputational benefit that will translate into future earnings.¹⁰⁵ Under the Exchange Act, there is no criminal liability for insider trading unless the defendant acts “willfully.”¹⁰⁶ Willfulness requires the defendant to know he or she was acting wrongfully under the securities laws.¹⁰⁷ Under the common law, this knowledge requirement (*mens rea*) is a necessary element in every crime and requires that the defendant knew the facts that made his or her willful conduct illegal.¹⁰⁸ The Second Circuit has recognized that there should be a high *mens rea* standard for criminal liability,

¹⁰³ Richard C. Sauer, *The Erosion of the Materiality Standard in the Enforcement of the Federal Securities Laws*, 62 BUS. LAW. 317, 318 (2007) (discussing the implications of the expansive materiality standard in light of new disclosure mandates); see Joan MacLeod Heminway, *Materiality Guidance in the Context of Insider Trading: A Call for Action*, 52 AM. U. L. REV. 1131, 1138 (2003) (discussing the complexities of trying to apply the ambiguous materiality standard for transaction planners, litigants, government agencies, and courts).

¹⁰⁴ *Dirks*, 463 U.S. at 663 n.23 (“Scienter . . . is an independent element of a Rule 10b-5 violation.”); *Hochfelder*, 425 U.S. at 201 (holding that the relevant legislative history of the Exchange Act supports the Court’s conclusion that section 10(b) was targeted at practices involving some element of scienter, not merely negligence); *Newman I*, 773 F.3d at 447 (stating that liability for insider trading also requires proof that the defendant acted with scienter). Negligently disclosing material, nonpublic information is not enough. *Hochfelder*, 425 U.S. at 194 n.12.

¹⁰⁵ *Dirks*, 463 U.S. at 663. The theory behind this requirement is that the insider, by giving out information selectively, is in effect selling the information for cash, reciprocal information, or other value. *Id.*; Brudney, *supra* note 48, at 348. Thus, in *Dirks*, the Court held that the tipplers did not breach their duty to shareholders because they received no personal gain for their disclosure of material, nonpublic information—they merely wanted to expose the fraud. *Dirks*, 463 U.S. at 666–67 (noting that the tipplers received no monetary or reciprocal personal benefit for revealing Equity Funding’s inside information, but rather were motivated by the desire to expose the fraud). As such, *Dirks*, a tippee who also tipped to others, was not liable for a derivative breach because he could not have been a “participant after the fact” in the insiders’ breach of fiduciary duty; they and he lacked the requisite scienter to deceive, manipulate or defraud. *Id.* at 665.

¹⁰⁶ 15 U.S.C. § 78ff(a) (2012); *O’Hagan*, 521 U.S. at 665 (noting that Congress intended the willfulness standard to provide a “sturdy safeguard[]” in insider trading cases).

¹⁰⁷ *O’Hagan*, 521 U.S. at 665–66 (recognizing that two safeguards Congress implemented regarding scienter are (1) the government must prove that a person “willfully” violated a provision and (2) he or she must have knowledge of the rule); *Dirks*, 463 U.S. at 663 n.23 (noting that scienter requires an intentional or willful mindset, not merely that an insider’s conduct results in harm to investors).

¹⁰⁸ *Staples v. United States*, 511 U.S. 600, 605 (1994) (explaining that *mens rea*, which requires that a defendant knows the facts that make his or her conduct illegal, is a necessary element in every crime); *Newman I*, 773 F.3d at 450 (noting that *mens rea* is a required element in criminal insider trading case).

especially in remote tippee cases.¹⁰⁹ The U.S. Supreme Court has not settled the dispute whether recklessness satisfies section 10(b)'s scienter requirement in civil cases, however lower courts have embraced and applied a recklessness standard.¹¹⁰

II. WHAT'S THE ISSUE? *NEWMAN* FOCUSES ON THE KNOWLEDGE REQUIREMENT FOR REMOTE TIPPEE LIABILITY

In 2014, in *United States v. Newman*, the Second Circuit Court of Appeals held that defendant tippees did not have the requisite scienter to be convicted of insider trading.¹¹¹ Section A of this Part provides an overview of *Newman* and presents the arguments for both sides.¹¹² Section B highlights the Second Circuit's holding in *Newman*.¹¹³ Finally, section C discusses how the Second Circuit also circumscribed what constitutes a personal benefit under insider trading law.¹¹⁴

A. *United States v. Newman: Arguments for Both Sides*

In *United States v. Newman*, defendants Todd Newman and Anthony Chiasson were hedge fund managers for Diamondback Capital and Level Global Investors, respectively.¹¹⁵ Both Newman and Chiasson traded on non-public information about Dell and NVIDIA that Newman's analyst at Diamondback provided to them.¹¹⁶ Newman and Chiasson were three or four degrees removed from the insider tipplers at Dell and NVIDIA.¹¹⁷ As such, nei-

¹⁰⁹ *United States v. Kaiser*, 609 F.3d 556, 569 (2d Cir. 2010) ("Unlike securities fraud, insider trading does not necessarily involve deception, and it is easy to imagine an insider trader who receives a tip and is unaware that his conduct was illegal and therefore wrongful.")

¹¹⁰ *Obus*, 693 F.3d at 286 (noting that the U.S. Supreme Court has yet to decide whether recklessness satisfies section 10(b) for civil cases, but that the Second Circuit has recognized a recklessness standard).

¹¹¹ See *United States v. Newman (Newman I)*, 773 F.3d 438, 442 (2d Cir. 2014), *cert. denied*, *United States v. Newman (Newman II)*, 136 S. Ct. 242 (2015) (mem.).

¹¹² See *infra* notes 115–127 and accompanying text.

¹¹³ See *infra* notes 128–127 and accompanying text.

¹¹⁴ See *infra* notes 134–146 and accompanying text.

¹¹⁵ Brief for the United States of America at 3, *Newman I*, 773 F.3d 438 (No. 13-1917), 2013 WL 6163307.

¹¹⁶ *Newman I*, 773 F.3d at 443.

¹¹⁷ *Id.* (discussing a brief summary of the two tipping chains at issue). At issue in *Newman* were two tipping chains: Dell and NVIDIA. *Id.* With respect to Dell, the tipping chain was as follows: Rob Ray, who worked in Dell's investor relations department (insider-tipper) gave information about Dell's earnings to Sandy Goyal, an analyst at Neuberger Berman, who in turn gave the information to Diamondback analyst Jesse Tortora, who relayed the information to Newman as well as Level Global analyst Sam Adondakis, who ultimately provided the information to Chiasson. *Id.* With respect to the NVIDIA tipping chain: Chris Choi, a member of NVIDIA's finance unit, tipped information to Hyung Lim, a former executive at Broadcom Corp. and Altera, who in turn passed the information to Danny

ther Newman nor Chiasson knew the insider tippers at Dell or NVIDIA, nor why they divulged this information.¹¹⁸ Regardless, both men were indicted and convicted of insider trading in the U.S. District Court for the Southern District of New York.¹¹⁹

The main issue on appeal was whether a remote tippee could be guilty of insider trading if he or she does not know that the corporate insider disclosed information in exchange for a personal benefit.¹²⁰ The government argued that the insiders at Dell and NVIDIA breached their duties of confidentiality by tipping material, nonpublic information to others who tipped or traded on the basis of that information.¹²¹ Under tipper-tippee liability, Newman and Chiasson, as tippees, would be derivatively liable if they knew that such a breach occurred.¹²² The district court instructed the jury that the defendant tippees could be liable if they knew the inside information was disclosed by the insiders in breach of a fiduciary duty of trust and confidence.¹²³ The jury found that

Kuo, an analyst at Whittier Trust, who circulated the information to his group of analyst friends including Tortora and Adondakis, who informed Newman and Chiasson, respectively. *Id.*

¹¹⁸ *Id.* (noting that there was no evidence that either Newman or Chiasson, who were several steps removed from the corporate insiders, was aware of the source of the inside information); Brief for Defendant-Appellant Anthony Chiasson, *supra* note 12, at 1.

¹¹⁹ *Newman I*, 773 F.3d at 444–45.

¹²⁰ *Id.* at 442 (stating that the issue on appeal was whether the district court erred in failing to instruct the jury that it must find that a tippee knew that the insider disclosed confidential information in exchange for a personal benefit); Brief for Defendant-Appellant Anthony Chiasson, *supra* note 12, at 3 (arguing that absent knowledge that a tipper exchanged inside information for personal gain, defendants did not engage in conduct in violation of section 10(b) or Rule 10b-5).

¹²¹ See Brief for the United States of America, *supra* note 115, at 17–27. The government’s argument falls within the classical theory of insider trading. See *id.* at 55 (arguing that the defendants’ attempts to distinguish precedent based on misappropriation theory inappropriate because the same analysis applies to this classical theory case).

¹²² Compare *id.* at 35 (arguing that all the government had to establish was that the defendants traded on material, nonpublic information they knew insiders had disclosed in violation of a duty of confidentiality), with *Dirks*, 463 U.S. at 660 (holding that a tippee assumes a fiduciary duty to the shareholders of a corporation only when the insider has breached his or her fiduciary duty to the shareholders and the tippee knows or should know that there has been a breach).

¹²³ *Newman I*, 773 F.3d at 444; Brief for the United States of America, *supra* note 115, at 36–37. Specifically, the district court instructed the jury that the defendants could be held liable if all of the following elements were met:

(1) the tippers had a fiduciary duty or other relationship of trust and confidence with their employers such that they were entrusted with material, nonpublic information with the reasonable expectation that they would keep it confidential and not use it for personal benefit; (2) the tippers intentionally breached that duty by disclosing material, nonpublic information for their own benefit; (3) the tippers received a personal benefit from the tips; (4) *the defendant tippees knew the inside information was disclosed by the insiders in breach of a duty of trust and confidence*; and (5) the defendant tippees participated in the insider trading scheme knowingly, willfully, and with specific intent to defraud.

Brief for the United States of America, *supra* note 115, at 36–37 (emphasis added).

the government had proven this element and both men were found guilty of insider trading.¹²⁴

Newman and Chiasson appealed, arguing that this jury instruction was erroneous.¹²⁵ They asserted that, under *Dirks*, they could be liable only if they knew that the tipper disclosed the information for a personal benefit, and because neither knew the tippers, they could not be liable for insider trading.¹²⁶ They urged that it is the personal benefit element that turns the breach of fiduciary duty into a fraudulent activity prohibited by section 10(b) of the Exchange Act and Rule 10b-5.¹²⁷

B. The Holding: Tippees Must Know of the Personal Benefit Derived by the Insider Tipper to Be Liable

In its pivotal decision, the Second Circuit panel agreed with defendants' argument that the Government must prove that the tippee knew both (1) that an insider disclosed confidential information and (2) that he or she did so in exchange for a personal benefit.¹²⁸ The court was clear: the exchange of confidential information for a personal benefit is not separate from an insider's breach of his or her fiduciary duty; it is the breach that triggers liability for securities fraud under Rule 10b-5.¹²⁹ Thus, the Second Circuit held that the jury instructions were erroneous because they failed to instruct the jurors on this essential element, specifically that Newman and Chiasson must have known of the personal benefit received by the insiders in exchange for the disclosure of material nonpublic information.¹³⁰

¹²⁴ *Newman I*, 773 F.3d at 444. The district court sentenced Newman to fifty-four months of imprisonment followed by one year of supervised release, required Newman to forfeit \$737,724 from the fraudulent trades, and imposed a \$1,000,000 fine. *Id.* The district court sentenced Chiasson to seventy-eight months of imprisonment followed by one year of supervised release, required Chiasson to forfeit \$1,382,217, and imposed a \$5,000,000 fine. *Id.* at 444–45. Both Newman and Chiasson were granted bail pending appeal. Brief for the United States of America, *supra* note 115, at 3.

¹²⁵ Brief for Defendant-Appellant Anthony Chiasson, *supra* note 12, at 2; Brief of Defendant-Appellant Todd Newman at 3, *Newman I*, 773 F.3d 438 (No. 13-1917), 2013 WL 6827040.

¹²⁶ *Dirks*, 463 U.S. at 660 (holding that the test is whether the insider personally will benefit from his or her disclosure); Brief for Defendant-Appellant Anthony Chiasson, *supra* note 125, at 2 (arguing that it is not a crime to trade on information, even if Chiasson knew it was coming from insiders because he did not know why they divulged the information); Brief of Defendant-Appellant Todd Newman, *supra* note 125, at 2 (noting that the government did not even try to prove that Newman had such knowledge).

¹²⁷ Brief of Defendant-Appellant Todd Newman, *supra* note 125, at 26 (arguing that the key fact that distinguishes legal from illegal activity is a personal benefit to the insider).

¹²⁸ *Newman I*, 773 F.3d at 442.

¹²⁹ *Id.* at 447–48 (“*Dirks* counsels us that the exchange of confidential information for personal benefit is not separate from an insider’s fiduciary breach; it is the fiduciary breach that triggers liability for securities fraud under Rule 10b-5.”).

¹³⁰ *Id.* at 442. The *Newman* Court also held that the evidence against Newman and Chiasson was insufficient to sustain a guilty verdict for two reasons: (1) “the Government’s evidence of any person-

The court also expressly rejected the government's argument that because Newman and Chiasson were sophisticated traders, they must have known, or deliberately avoided knowing, that the information originated from a breach of a fiduciary duty by a corporate insider who received some kind of personal benefit for such a disclosure.¹³¹ Indeed the court found that defendants had established facts that negated such an inference against them.¹³² The Second Circuit recognized that disclosures of information for reasons other than benefiting the tipper are routine in the securities markets and do not violate insider trading law.¹³³

C. The Second Circuit Circumscribes What Constitutes a Personal Benefit

The Second Circuit panel went a step further and held that the government also failed to prove beyond a reasonable doubt that the insiders received

al benefit received by the alleged insiders was insufficient to establish the tipper liability from which defendants' purported tippee liability would derive," and (2) "the Government presented no evidence that Newman and Chiasson knew that they were trading on information obtained from insiders in violation of those insiders' fiduciary duties." *Id.* Importantly, the Second Circuit stated that this element for tipping liability applies equally to both the classical and misappropriation theories of insider trading. *Id.* at 446.

¹³¹ *Id.* at 454 ("The Government argues that . . . Newman and Chiasson must have known, or deliberately avoided knowing, that the information originated with corporate insiders, and that those insiders disclosed the information in exchange for a personal benefit. We disagree.").

¹³² *Newman I*, 773 F.3d at 454–55. Importantly, the *Newman* Court found the defendants established the following facts:

[A]nalyt[s] at hedge funds routinely estimate metrics such as revenue, gross margin, operating margin, and earnings per share through legitimate financial modeling using publicly available information and educated assumptions about industry and company trends. . . . [A]nalyt[s] routinely solicited information from companies in order to check assumptions in their models in advance of earnings announcements. . . . [I]nvestor relations departments routinely assisted analysts with developing their models. . . . [A]nd Dell's investor relations personnel routinely "leaked" earnings data in advance of quarterly earnings.

Id.

¹³³ *Id.* at 448–49, 454–55 ("Although the Government might like the law to be different, nothing in the law requires a symmetry of information in the nation's securities markets."). The reasons for selective disclosures are numerous, and necessary in maintaining an efficient market. Brief for Defendant-Appellant Anthony Chiasson, *supra* note 12, at 46–47 (citing Stephen J. Choi, *Selective Disclosures in the Public Capital Markets*, 35 U.C. DAVIS L. REV. 533, 543–48 (2002)) ("Insiders routinely provide nonpublic information to market participants for myriad reasons—to curry favor with large shareholders, to entice significant investors, to 'condition' the market in advance of unexpected earnings results, to bolster their credibility with certain analysts, to provide 'comfort' about investment theses, and other reasons."); Scott Russell, Note, *Regulation Fair Disclosure: The Death of the Efficient Capital Market Hypothesis and the Birth of Herd Behavior*, 82 B.U. L. REV. 527, 550 (2002) (noting that analysts interpret and relay the information in a way that individual investors can understand and use to assess the value of securities and make informed investment decisions); see *supra* notes 52–56 and accompanying text (discussing the important role that market insiders, such as analysts, have on a mechanically- and value-efficient market).

a personal benefit for providing material nonpublic information.¹³⁴ In so doing, the court circumscribed what constitutes a “personal benefit” under insider trading law, limiting it to a quid-pro-quo type of relationship.¹³⁵ The court held that a personal benefit cannot be merely inferred from a personal relationship between tipper and tippee, but rather that such an inference is only permissible if the government proves that there was a “meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of pecuniary or similarly valuable nature.”¹³⁶

The government filed for a petition for rehearing on both the scienter requirement and what constitutes a personal benefit, but the Second Circuit denied it.¹³⁷ The U.S. Supreme Court also denied the government’s petition for certiorari without comment.¹³⁸

Since *Newman*, however, the Court has granted certiorari to a U.S. Court of Appeals for the Ninth Circuit case to clarify the question about what consti-

¹³⁴ *Newman I*, 773 F.3d at 451–52 (stating that the circumstantial evidence relied upon by the government was insufficient to warrant an inference that the insiders received any personal benefit in exchange for their tips). As to the Dell tipping chain, tipper Ray and tippee Goyal were alumni of the same school and it was shown that Goyal provided some career advice and assistance to Ray. *Id.* at 452. As to the NVIDIA tipping chain, tipper Choi and tippee Lim were “family friends” who attended the same church and occasionally socialized together. *Id.* The *Newman* Court held that providing evidence that a tipper and tippee are family friends or acquaintances is not sufficient to prove that the tippers derived some benefit from tipping. *Id.*

¹³⁵ *Id.* (“While our case law at times emphasizes language from *Dirks* indicating that the tipper’s gain need not be *immediately* pecuniary, it does not erode the fundamental insight that, in order to form the basis for a fraudulent breach, the personal benefit received in exchange for confidential information must be of some consequence.”).

¹³⁶ *Id.* In so holding, the *Newman* Court acknowledged the Second Circuit’s prior acceptance of a permissive definition of personal benefit. *United States v. Jiau*, 734 F.3d 147, 153 (2d Cir. 2013) (holding that a personal benefit is broadly defined to include (1) a “pecuniary gain,” (2) any “reputational benefit that will translate into future earnings,” and (3) any benefit from a gift of information to a relative or friend). But, the Second Circuit qualified this permissive standard, recognizing that if the government merely had to show some sort of friendly relationship between the tipper and tippee to prove a personal benefit, the personal benefit requirement would be a nullity. *Newman I*, 773 F.3d at 452 (holding that the government did not prove beyond a reasonable doubt that tippers received a personal benefit).

¹³⁷ Petition of the United States of America for Rehearing and Rehearing En Banc, *supra* note 23, at 2–3 (arguing that this refined definition of personal benefit could produce extreme and unwanted results, which will “dramatically limit the Government’s ability to prosecute some of the most common, culpable, and market threatening forms of insider trading”). In particular, prosecutors expressed concern about situations where a parent passes on a confidential stock tip to a child without receiving anything but the child’s love and affection, or the corporate executive who whispers to a golf buddy about upcoming deals. Matthew Goldstein & Ben Protess, *U.S. Attorney Preet Bharara Challenges Insider Trading Ruling*, N.Y. TIMES: DEALBOOK (Jan 23, 2015), <http://dealbook.nytimes.com/2015/01/23/u-s-attorney-preet-bharara-to-challenge-insider-trading-ruling/> (discussing prosecutors’ view that the *Newman* decision could produce extreme and unwanted results).

¹³⁸ *Newman II*, 136 S. Ct. at 242. Interestingly, the government sought certiorari only on the personal benefit requirement, effectively conceding the knowledge requirement. Petition for Writ of Certiorari at 15–34, *Newman II*, 136 S. Ct. 242 (No. 15-137); Jonathan D. Schmidt et al., *What Newman Means for the Market*, 21 WESTLAW J. SEC. LIT. & REG., no. 12, Oct. 15, 2015, at *1, *5.

tutes a personal benefit.¹³⁹ In *Salman v. United States*, the Ninth Circuit held that a personal benefit need not be a tangible, pecuniary benefit but instead can be a benefit one would obtain from simply making a gift of information to a close relative or friend.¹⁴⁰ Although some commentators have said that the Court will be settling a circuit split on this issue, others believe that the facts of *Newman* and *Salman* are distinguishable and the two sister circuits are not diametrically opposed.¹⁴¹ As such, *Newman* still provides the correct framework for determining remote tippee liability in insider trading cases.¹⁴²

The Second Circuit's decision in *Newman* reins in the expansion of insider trading law that has dominated since *Dirks*.¹⁴³ The scienter requirement makes it tougher for the government to sustain a case against remote tippees because the government must prove that a remote tippee knew of a personal

¹³⁹ *United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015), cert. granted in part, 136 S. Ct. 899 (2016) (mem.); Petition for Writ of Certiorari at i, *Salman*, 792 F.3d 1087 (No. 15-628), 2015 WL 7180648 (asking the Court to answer whether a personal benefit to an insider requires proof of "an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary of similarly valuable nature," or whether it is sufficient to show that the insider and tippee shared a close family relationship).

¹⁴⁰ *Salman*, 792 F.3d at 1093–94 (declining to follow *Newman* to the extent it can be read to require the personal benefit received by the tipper to be tangible). In *Salman*, the insider-tipper, Mahar Kara, regularly disclosed confidential information he received from his investment banking job to his older brother, Michael. *Id.* at 1089. The defendant *Salman*, the brother-in-law and friend of Mahar and Michael, successfully traded on information he received from Michael, knowing full well that the information came from Mahar as the insider-tipper. *Id.* *Salman* argued that he did not know of the personal benefit Mahar received for disclosing the information to Michael, and that evidence of a family relationship alone is insufficient to prove that the insider-tipper received a benefit. *Id.* at 1093. The Ninth Circuit held that the government presented sufficient evidence that Mahar disclosed the information as a gift intended to benefit Michael. *Id.* at 1094.

¹⁴¹ Compare *Newman I*, 773 F.3d at 443 (dealing with remote tippees in the securities industry who were four degrees removed from the source of information, who did not know the insider-tipper, the first-degree tippee, or the relationship between the two), with *Salman*, 792 F.3d at 1093–94 (dealing with a second-degree tippee who was a family member of both the insider-tipper and the first-degree tippee, and who knew the personal benefit derived by the insider-tipper for disclosing the information). See generally Matt Levine, *Justices Will Know Insider Trading When They See It*, BLOOMBERGVIEW (Jan. 19, 2016, 5:48 PM), <http://www.bloombergvew.com/articles/2016-01-19/justices-will-know-insider-trading-when-they-see-it> [<https://perma.cc/A7PH-J2E9>] (noting that both appeals courts have drawn lines in sensible, unsurprising ways based on the differences between the two cases).

¹⁴² See *Newman I*, 773 F.3d at 450 (setting out the elements the government must prove beyond a reasonable doubt in order to sustain an insider trading conviction); Levine, *supra* note 141 (arguing that if the U.S. Supreme Court does more than simply affirm and clarify the appeals court decisions in *Salman*, it will likely narrow insider trading law, which is consistent with *Newman*).

¹⁴³ See *Newman I*, 773 F.3d at 455 (clarifying the knowledge requirement and circumscribing the personal benefit requirement); Schmidt et al., *supra* note 138, at *6 (discussing how *Newman* makes it more difficult for the government to bring cases against remote tippees especially when evidence of a personal benefit and knowledge of that benefit is thin); Tebsy Paul, Comment, *Friends with Benefits: Analyzing the Implications of United States v. Newman for the Future of Insider Trading*, 5 AM. U. BUS. L. REV. 109, 112 (2015) (noting how *Newman* put an end to the government's "recent crusade" against insider trading in which the government has stretched precedent through "scant evidence").

benefit to an insider—something a tippee multiple degrees removed from the insider-tipper will not likely know.¹⁴⁴ Additionally, the standard for what constitutes a personal benefit also makes it harder for the government to sustain a case against a remote tippee because the government relies heavily on circumstantial evidence to prove its case.¹⁴⁵ The government can no longer simply infer a personal benefit from a relationship between tipper and tippee; the government must prove this element beyond a reasonable doubt.¹⁴⁶

III. THE IMPLICATIONS OF *NEWMAN*: CONSISTENT WITH PRECEDENT, CRITICAL FOR FUTURE REMOTE TIPPEE INSIDER TRADING DEFENDANTS

The Second Circuit's opinion in *United States v. Newman* stays true to the duty-based theory of liability upon which insider trading law and an efficient market theory rests.¹⁴⁷ Additionally, the *Newman* decision prevents the government from prosecutorial over-reaching in the future.¹⁴⁸ Section A of this Part

¹⁴⁴ See 3 ALAN R. BROMBERG & LEWIS D. LOWEFELS, BROMBERG & LOWEFELS ON SECURITIES FRAUD § 6:315.90 (2d ed. 2015) (noting that the government will be less likely to target remote tippees in future cases); DIXIE L. JOHNSON & MATTHEW B. HANSON, KING & SPALDING, CLIENT ALERT: POST-*NEWMAN* REALITY: INVESTIGATIONS INVOLVING UNWITTING 'TIPS' TO CLOSE FRIENDS AND RELATIVES WILL CONTINUE 5 (2015), <http://www.kslaw.com/imageserver/kspublic/library/publication/ca100815.pdf> [<https://perma.cc/M8YN-DCEW>] (noting that *Newman* will undoubtedly change prosecutors' calculations for investigations involving tipping chains among business colleagues). In 2015, in response to the *Newman* decision, three bills aimed at defining and even outlawing insider trading were introduced in Congress. Insider Trading Prohibition Act, H.R. 1625, 114th Cong. (2015); Stop Illegal Insider Trading Act, S. 702, 114th Cong. (2015); Ban Insider Trading Act of 2015, H.R. 1097, 114th Cong. (2015); see Fokas & Fradkin, *supra* note 37, at *3 (noting how each bill is aimed at overruling *Newman* and removing the personal benefit requirement).

¹⁴⁵ See BROMBERG & LOWEFELS, *supra* note 144, § 6:315.90 (noting how the government will have to work harder to produce such evidence); Yin Wilczek, *SEC to Pursue More Insider Trading Cases in Administrative Forum, Director Says*, BLOOMBERG BNA (June 13, 2014), <http://www.bna.com/sec-pursue-insider-n17179891282/> [<https://perma.cc/JX39-Q7AZ>] (noting how insider trading cases usually turn on circumstantial evidence).

¹⁴⁶ See *Newman*, 773 F.3d at 452 (refusing to make the inference of a personal benefit based solely on circumstantial evidence of a relationship between tipper and tippee); Gina LaMonica, *Second Circuit Narrows Scope of Remote Tippee Liability in Landmark Insider Trading Decision*, WHITE COLLAR BRIEFLY (Dec. 10, 2014), <http://www.whitecollarbriely.com/2014/12/10/second-circuit-narrows-scope-of-remote-tippee-liability-in-landmark-insider-trading-decision/> [<https://perma.cc/SY2A-MXVS>] (noting how the *Newman* decision "raise[s] the bar" for the government's burden of proof in remote tippee cases).

¹⁴⁷ See *United States v. O'Hagan*, 521 U.S. 642, 665 (1997) (holding that liability is based on breach of duty to a source of information); *Dirks v. SEC*, 463 U.S. 646, 660 (1983) (holding that liability is based on breach of a fiduciary duty); *United States v. Chiarella*, 445 U.S. 222, 228 (1980) (same); *United States v. Newman (Newman I)*, 773 F.3d 438, 442 (2d Cir. 2014) (same), *cert. denied*, *United States v. Newman (Newman II)*, 136 S. Ct. 242 (2015) (mem.); see also Coles, *supra* note 46, at 211 (arguing that the adoption of the misappropriation theory and lower courts' expansive application of the personal benefit and tippee knowledge requirement have led to the de facto demise of *Dirks* as a predictable framework for analyzing tippee liability).

¹⁴⁸ See *Newman I*, 773 F.3d at 442; James Fanto, *Financial Professionals Face Heightened SEC Insider Trading Enforcement: Line-Drawing Issues and the Compliance Response*, in ASPATORE

argues that the Second Circuit decision in *Newman* is consistent with U.S. Supreme Court and Second Circuit precedent, as well as fundamental principles of criminal law.¹⁴⁹ Section B explains the importance *Newman* has on reining in prosecutorial overreaching by the government in insider trading cases. Section B further argues that the government should focus its aim on prosecuting insider-tippers rather than trying to expand insider trading law to capture remote tippees.¹⁵⁰

A. *The Second Circuit's Decision in Newman Is Consistent with Precedent and the Principles of Criminal Law*

Although categorized by the government as a drastic departure from established insider trading law, the Second Circuit's decision in *Newman* is actually consistent with the U.S. Supreme Court's precedent set in *Chiarella* and *Dirks*.¹⁵¹ Section 10(b) of the Exchange Act and Rule 10b-5 forbid securities fraud, not breaches of fiduciary duty.¹⁵² In *Dirks*, the Court was clear that whether disclosure of confidential information in breach of a fiduciary duty constituted fraud was contingent on the purpose of the disclosure.¹⁵³ To constitute fraud in violation of Rule 10b-5, the insider must personally benefit, either directly or indirectly, from the disclosure of material, nonpublic information.¹⁵⁴ Therefore, as the Second Circuit in *Newman* recognized, receiving a personal benefit from a breach of fiduciary duty (disclosing material, nonpublic information) is what makes the breach a fraud under Rule 10b-5.¹⁵⁵ Following the U.S. Supreme Court's logic, the Second Circuit held that a tippee could not be

SPECIAL REPORT: SEC ENFORCEMENT OF INSIDER TRADING REGULATIONS: AN IMMEDIATE LOOK AT RECENT SEC INVESTIGATIONS INTO ALLEGED INSIDER TRADING ACTIVITY 5 (2011) (discussing how the SEC's prosecution tactics expand the boundaries of insider trading liability).

¹⁴⁹ See *infra* notes 151–176 and accompanying text.

¹⁵⁰ See *infra* notes 177–214 and accompanying text.

¹⁵¹ Petition of the United States of America for Rehearing and Rehearing En Banc, *supra* note 23, at 1 (claiming that the *Newman* decision breaks with U.S. Supreme Court and Second Circuit precedent); cf. *Dirks*, 463 U.S. at 659; *Chiarella*, 445 U.S. at 230 n.12 (characterizing tippee liability as arising from tippee's role after the fact in the insider's breach of duty).

¹⁵² 15 U.S.C. § 78j(b) (2012); Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5 (2015); see *supra* note 19 (discussing statutory basis for insider trading law).

¹⁵³ See *Dirks*, 463 U.S. at 654 (stating the principle that in insider trading cases fraud derives from the use of information for a personal benefit rather than for a corporate purpose, which is the sole intended use of such information). The *Dirks* Court also states that insiders “may not give such [inside] information to an outsider for the *same* improper purpose of exploiting the information for their *personal gain*.” *Id.* at 659 (emphasis added).

¹⁵⁴ *Id.* at 662 (“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.”).

¹⁵⁵ *Newman I*, 773 F.3d at 447–48 (“[T]he exchange of confidential information for personal benefit is not separate from an insider's fiduciary breach; it is the fiduciary breach . . .”).

held liable under 10b-5 unless he or she knew that the insider received a personal benefit for disclosing the information.¹⁵⁶

Additionally, the Second Circuit's standard for what constitutes a personal benefit can hardly be seen as a drastic departure from precedent.¹⁵⁷ Although *Newman* did not turn on whether there was a personal benefit to the insider-tippers, the court clarified that to prove a personal benefit to an insider-tipper the government must at the very least show evidence of an intention to benefit the tippee.¹⁵⁸ In so holding, the court recognized that the standard for what constitutes a personal benefit is permissive but not without limits, and it is the government's burden to prove beyond a reasonable doubt that there was in fact a personal benefit of some consequence to the insider-tipper.¹⁵⁹ This limiting principle is especially important when the government pursues remote tippees like *Newman* and *Chiasson*, because the government should not be allowed to infer that a remote tippee should have known that a personal benefit was conferred on an insider-tipper solely because he or she had a relationship with the first-degree tippee.¹⁶⁰ This position is consistent with *Dirks* as well as prior Second Circuit precedent.¹⁶¹

¹⁵⁶ *Id.* The government's argument, that a tippee only needed to know that the tipper breached his or her fiduciary duty to be criminally liable, was premised on ambiguous language in *Dirks* and dicta in other Second Circuit decisions post-*Dirks* about the tippee knowledge requirement. *Id.* Selectively citing from *Dirks*, without acknowledging the personal benefit test as part-and-parcel with its holding, the government argued that a tippee only needs to know that a tipper disclosed information in breach of his or her duty of confidentiality. *Id.* at 448. The Second Circuit flatly rejected this argument while also slamming the government for its "doctrinal novelty" in not only this case, but its other recent insider trading prosecutions. *Id.*

¹⁵⁷ See *Dirks* 463 U.S. at 664 (noting the objective criteria for determining personal benefit as a pecuniary gain or reputational benefit that will translate into future earnings); *Newman I*, 773 F.3d at 452 (noting that the personal benefit element would be a nullity if all the government had to prove was that two individuals were alumni of the same school or attended the same church); Petition of the United States of America for Rehearing and Rehearing En Banc, *supra* note 23, at 1 (arguing the *Newman* decision is a drastic departure from precedent).

¹⁵⁸ See *Newman I*, 773 F.3d at 452 (requiring evidence of a quid-pro-quo relationship between tipper and tippee or an intention to benefit the tippee).

¹⁵⁹ *Id.* (discussing the permissive personal benefit standard previously adopted by the Second Circuit but stating that it has important limits).

¹⁶⁰ *Id.* In *Newman*, the government argued that, as sophisticated traders, *Newman* and *Chiasson* must have known that the information originated with corporate insiders and that those insiders disclosed the information in exchange for a personal benefit. *Id.* at 443–44. Refusing to make such a leap in the context of a securities industry case, the Second Circuit clarified that a personal benefit cannot be inferred merely from a personal relationship between two people—the government has the burden to prove it. *Id.* at 452. Under *Newman*, such an inference would also be impermissible on the facts of *Salman*, which involved less remote tippees. *United States v. Salman*, 792 F.3d 1087, 1093–94 (9th Cir. 2015), *cert. granted in part*, 136 S. Ct. 899 (2016) (mem.). The government still has the burden to prove establish that there was a personal benefit and that a tippee knew of the personal benefit, which is something the government could do in *Salman* because it provided evidence that the remote tippee knew the insider tipped a family member to benefit that family member with private gains. See *id.*

¹⁶¹ See *Dirks*, 463 U.S. at 664 (defining a personal benefit with objective criteria); *Newman I*, 773 F.3d at 452 (holding that a personal benefit must be of some consequences); *United States v. Jiau*, 734

Moreover, the Second Circuit easily distinguished prior Second Circuit decisions on which the government's novel argument rested.¹⁶² In these earlier cases, the tippee either directly participated in the tipper's breach and therefore clearly knew of the tipper's personal benefit, or was explicitly apprised of the tipper's personal gain by an intermediary tippee.¹⁶³ Therefore, the tippee's knowledge of the tipper's personal benefit was never in question in these cases, and the Second Circuit's cursory recitation of the elements for tippee liability did not serve as a basis for extending criminal liability for remote tippees.¹⁶⁴ As the Second Circuit made clear, no precedent supported finding Newman and Chiasson liable.¹⁶⁵

The Second Circuit's *Newman* decision also comports with two fundamental principles of criminal law: giving fair notice of what is illegal, and protecting against arbitrary enforcement of the law.¹⁶⁶ The Second Circuit's decision pro-

F.3d 147, 153 (2d Cir. 2013), (holding that a personal benefit is broadly defined to include the benefit one would receive from the gift of information to a relative or friend).

¹⁶² *Newman I*, 773 F.3d at 448–49 (noting that the law does not require a parity of information in the securities markets).

¹⁶³ *Id.*; *Jiau*, 734 F.3d at 153 (tippee received information directly from insider-tipper in exchange for personal benefits such as meals, gifts of inside information regarding other securities, and an invitation to join an investment club); *United States v. Falcone*, 257 F.3d 226, 235 (2d Cir. 2001) (tippee paid insider-tipper \$200 for pre-release copies of a news publication containing material, confidential information); *S.E.C. v. Warde*, 151 F.3d 42, 48 (2d Cir. 1998) (tippee received information directly from insider-tipper and thus clearly knew of the personal benefit to tipper for disclosing the material nonpublic information); *United States v. Mylett*, 97 F.3d 663, 668 (2d Cir. 1996) (same).

¹⁶⁴ *Newman I*, 773 F.3d at 448. The elements of criminal liability for insider trading are as follows:

- (1) the insider-tippers . . . were entrusted the duty to protect confidential information,
- which (2) they breached by disclosing [the information] to their tippee . . . who (3) knew of [the tippers'] duty and (4) still used the information to trade a security or further tip the information for [the tippee's] benefit, and finally (5) the insider-tippers benefited in some way from the disclosure.

Jiau, 734 F.3d at 152–53.

¹⁶⁵ *Newman I*, 773 F.3d at 448. (“We note that the Government has not cited, nor have we found, a single case in which tippees as remote as Newman and Chiasson have been held criminally liable for insider trading.”). The *Newman* Court also came down hard on the district court judge who adopted the government's novel extension of tippee liability by approving of the erroneous jury instructions. *Id.* at 449 (“In reaching [our] conclusion, we join every other district court to our knowledge—apart from Judge Sullivan—that has confronted this question.”).

¹⁶⁶ See Paul H. Robinson, *Fair Notice and Fair Adjudication: Two Kinds of Legality*, 154 U. PA. L. REV. 335, 336–37 (2005) (discussing the doctrines comprising the legality principle). Essentially, the legality principle holds that criminal liability and punishment can only be based on prior legislative enactment prohibiting conduct that is expressed with adequate precision and clarity). *Id.* The legality principle requires giving fair notice of what conduct is illegal. See *McBoyle v. United States*, 283 U.S. 23, 27 (1931) (reversing a conviction for transporting a stolen airplane across state lines because defendant did not have fair notice that the statutory definition of “motor vehicle” included an airplane); Robinson, *supra*, at 340 (noting that fair notice is especially important in criminal law, where a defendant's life and liberty are often at stake). This principle puts a premium on individual autonomy and allows people to make choices about their behavior that is in line with the law. See Robin-

vides market participants with notice of what is fraudulent activity in violation of Rule 10b-5, specifically, that tippees must have knowledge that an insider-tipper received a personal benefit in exchange for inside information.¹⁶⁷ Moreover, the *Newman* decision comports with the Exchange Act that provides that there is no criminal liability unless the defendant acts “willfully.”¹⁶⁸ Tippee knowledge of an insider’s personal benefit is critical because otherwise, a remote tippee’s liability would depend on facts beyond his or her knowledge or control.¹⁶⁹

The government has argued that giving notice of what is illegal may actually encourage loophole behavior because it clarifies what someone can get away with without actually breaking the law.¹⁷⁰ Thus, in insider trading cases, the government has argued it needs to maintain a degree of flexibility to deal with new

son, *supra*, at 343 n.25 (discussing how it is fair for people to know what the law is and to be able to conform their conduct accordingly); *see also* 15 U.S.C. § 78ff(a) (2012) (requiring “willfulness” for criminal liability); *O’Hagan*, 521 U.S. at 665 (recognizing the willfulness standard as necessary safeguard in insider trading cases).

¹⁶⁷ *Newman I*, 773 F.3d at 450. The court explained,

Our conclusion also comports with well-settled principles of substantive criminal law. As the Supreme Court explained in *Staples v. United States*, under the common law, *mens rea*, which requires that the defendant know the facts that make his conduct illegal, is a necessary element in every crime. Such a requirement is particularly appropriate in insider trading cases where we have acknowledged “it is easy to imagine a . . . trader who receives a tip and is unaware that his conduct was illegal and therefore wrongful.”

Id. (alteration in original) (citation omitted) (quoting *United States v. Kaiser*, 609 F.3d 556, 569 (2d Cir. 2010)); *see* J. Kelly Strader, *(Re)conceptualizing Insider Trading*, 80 BROOK. L. REV. 1419, 1440 (2015) (noting that *Newman* “goes a long way towards clarifying” the mens rea required for tippees in insider trading cases).

¹⁶⁸ 15 U.S.C. § 78ff(a). This also comports with the prior U.S. Supreme Court holding that tippees are not as culpable as insider-tippers. *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 313 (1985) (“In the context of insider trading, we do not believe that a person whose liability is solely derivative can be said to be as culpable as one whose breach of duty gave rise to that liability in the first place.”).

¹⁶⁹ Brief for Defendant-Appellant Anthony Chiasson, *supra* note 12, at 29 (noting that the contrary rule argued for by the government would make no sense and would be inconsistent with fundamental mens rea principles and express “willfulness” standard of the Exchange Act). Indeed, under the government’s argued approach, an investor’s ordinarily lawful activity could become fraudulent based on facts entirely outside of his or her control. *Id.* For example, an investor may lawfully trade in securities of an issuer based on material nonpublic information routinely leaked by the issuer. *Id.* If it turns out, however, that the disclosure the investor received from the issuer was motivated by the issuer insider’s expectation of a personal benefit, a fact completely unknown to the investor, the investor could nonetheless be imprisoned for trading. *Id.* To be liable, the investor would only have to be aware that the tipper’s disclosure violated some duty of confidentiality. *Id.* at 30.

¹⁷⁰ Petition of the United States of America for Rehearing and Rehearing En Banc, *supra* note 23, at 24 (arguing that the *Newman* decision provides a “virtual roadmap for savvy hedge-fund managers and other traders to insulate themselves from tippee liability by knowingly placing themselves at the end of a chain of inside information and avoiding learning the details about the sources of obviously confidential and improperly disclosed information”); *see also* Comeau, *supra* note 39, at 1299 (stating that the SEC’s policy is to keep the scope of insider trading liability as broad as possible to avoid setting out a “roadmap to fraud”).

schemes, so as not to provide a “roadmap” for committing securities fraud.¹⁷¹ When an individual’s liberty is at stake, however, as with criminal insider trading cases, the need for a clear standard for liability outweighs the government’s interest in being able to extend its prosecutorial range.¹⁷²

A second bedrock principle of criminal law is that there shall be no retroactive judicial enlargement of criminal law.¹⁷³ But, since *Dirks*, the government has attempted to extend the scope of insider trading law to cover remote tippees who do not know whether an insider received a personal benefit, thereby retroactively enlarging what is forbidden under criminal law.¹⁷⁴ The SEC’s recent prosecutorial tactics, targeting remote tippees using novel theories of liability, shows how vague laws such as section 10(b) and Rule 10b-5 can be enforced arbitrarily.¹⁷⁵ The *Newman* decision sets essential limits on the government’s power to

¹⁷¹ See Petition of the United States of America for Rehearing and Rehearing En Banc, *supra* note 23, at 24 (noting how tippees could insulate themselves from liability by consciously avoiding knowing the details behind the disclosure of information by the insider tipper). This also appears to be the reason why Congress has been reluctant to pass legislation expressly defining the contours of insider trading liability. See Peter J. Henning, *Insider Trading Case Could Push Congress to Define a Murky World*, N.Y. TIMES: DEALBOOK (Feb. 23, 2015), http://www.nytimes.com/2015/02/24/business/dealbook/insider-trading-case-could-push-congress-to-define-a-murky-world.html?emc=edit_dlb_kam_20150224&nl=business&nid=70754771 (noting that the congressional “cure,” or legislation, could be worse than the “disease” or common law of insider trading as it stands today).

¹⁷² See Robinson, *supra* note 166, at 340 (noting the imperative for fair notice in criminal law, where a defendant’s life and liberty hang in the balance); Michael Faure et al., *The Regulator’s Dilemma: Caught Between the Need for Flexibility & the Demands of Foreseeability. Reassessing the Lex Certa Principle*, 24 ALB. L.J. SCI. & TECH. 283, 289 (2014) (discussing the dilemma inherent in regulations that impose criminal sanctions that need to be flexible enough to cover unforeseeable target behavior while maintaining legal certainty required by the legality principles); see also *Newman I*, 773 F.3d at 451 (noting that few events in life are more important than an individual’s criminal conviction).

¹⁷³ See U.S. CONST. art. I, § 9, cl. 3 (“No . . . ex post facto Law shall be passed.”); *id.* § 10, cl. 1 (“No State shall . . . pass any . . . ex post facto Law”); Robinson, *supra* note 166, at 353 (noting that ex post facto judicial action altering a penal rule retrospectively offends the legality principle just as an ex post facto criminal law). The rationale for prohibiting retroactive judicial enlargement of statutory language is also grounded on notions of fair notice and constitutional due process. See Robinson, *supra* note 166, at 354–55 (noting that the primary rationale behind the prohibition of judicial interpretation is fair notice required by the due process clause).

¹⁷⁴ See *Newman I*, 773 F.3d at 448 (holding that defendants could not be liable for insider trading because no evidence was presented to show that they knew the source of the information or why he disclosed that information); *cf.* SEC v. Musella, 678 F. Supp. 1060, 1063 (S.D.N.Y. 1988) (holding two New York police officers liable for trading on tips even though they did not know the identity of the insider-tippers nor whether they received a personal benefit because they “should have known that fiduciary duties were being breached with respect to confidential, non-public information”).

¹⁷⁵ See *Newman I*, 773 F.3d at 448 (criticizing the doctrinal novelty of the government’s recent insider trading prosecutions targeted at remote tippees many levels removed from corporate insiders); Doherty, *supra* note 2, at 489 (arguing that the broad definition of materiality is ripe for judicial or regulatory enlargement constituting ex post facto lawmaking); see also Schmidt et al., *supra* note 138, at *6 (arguing that the biggest takeaway from *Newman* is not that the narrowing of the knowledge or personal benefit requirements will have any affect on market professionals’ behavior, but rather that the requirement to show these will place substantive limits on prosecutors and regulators).

bring insider trading claims, articulating clearer standards for insider trading liability that comport with these basic principles of criminal law.¹⁷⁶

*B. Reining in the SEC's Expansion of Insider Trading Law
Is a Good Thing . . . Really!*

Insider trading, to some extent, is inevitable under an efficient market theory.¹⁷⁷ Unless Congress expressly adopts a parity-of-information approach through legislation, this is the theory upon which the common law of insider trading rests.¹⁷⁸ The *Newman* decision clarifies the area of remote tippee liability, which has cast a shadow over the securities markets since *Dirks*.¹⁷⁹ Subsection 1 discusses the importance of the *Newman* decision with the advent of the SEC bringing more cases in-house.¹⁸⁰ Subsection 2 argues that the SEC should focus on prosecuting insider-tippers rather than downstream tippees.¹⁸¹

¹⁷⁶ See *Newman I*, 773 F.3d at 450 (holding that for a tippee defendant to be liable he or she must know of a personal benefit to the insider tipper that is of some consequence); see also *Dirks*, 463 U.S. at 664 n.24 (“Without legal limitations, market participants are forced to rely on the reasonableness of the SEC’s litigation strategy, but that can be hazardous, as the facts of this case make plain.”); Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 247–48 (1991) (discussing how many insider trading defendants are receiving prison sentences even though the government’s prosecutions present judicial issues of first impression, implicating obvious due process concerns). Since the *Newman* decision, fourteen of more than ninety insider trading convictions have been set aside. Neil Weinberg & Patricia Hurtado, *Gordon and Bud Did It. Did You? Insider Trading Gets a Rethink*, BLOOMBERG BUS. (Feb. 16, 2016), <http://www.bloomberg.com/news/articles/2016-02-16/gordon-and-bud-did-it-did-you-insider-trading-gets-a-rethink> [<https://perma.cc/B4JZ-PV5H>].

¹⁷⁷ See Engle, *supra* note 52, at 67 (discussing how information is inevitably asymmetric and therefore, to some extent, nonpublic).

¹⁷⁸ See *O’Hagan*, 521 U.S. at 665 (holding that liability is based on breach of duty to a source of information); *Dirks*, 463 U.S. at 660 (holding that liability is based on a breach of a fiduciary or similar duty); *Chiarella*, 445 U.S. at 228 (same); cf. Council Directive 2003/6, 2003 O.J. (L 96) 16 (EC) (adopting a definition and prohibiting insider trading in the European Union); Edward Greene & Olivia Schmid, *Duty-Free Insider Trading?*, 2013 COLUM. BUS. L. REV. 369, 372 (noting that the Market Abuse Directive, the codification of the prohibition on trading on material, nonpublic information in the European Union, is premised on a parity-of-information approach).

¹⁷⁹ See *Newman I*, 773 F.3d at 450 (stating that to sustain an insider trading conviction against a tippee, the government must prove (1) the corporate insider had a fiduciary duty; (2) the corporate insider breached his or her fiduciary duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit; (3) the tippee 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).

¹⁸⁰ See *infra* notes 182–193 and accompanying text.

¹⁸¹ See *infra* notes 194–214 and accompanying text.

1. Reining in the Expanse of Government Overreach Is Increasingly Important as the SEC Brings More Cases In-House

Federal courts are indispensable in preventing the SEC from pushing its own unprecedented agenda in expanding the scope of insider trading law.¹⁸² In fiscal years 2014 and 2015, the SEC ramped up its prosecution, bringing eighty and eight-seven cases based on insider trading law, respectively.¹⁸³ Prior to the 2010 Dodd-Frank Act, the SEC could only bring administrative enforcement actions if a respondent was a regulated entity or an individual employed by one.¹⁸⁴ Now, Dodd-Frank permits the SEC unbridled discretion whether to prosecute cases before its own administrative law judges (“ALJs”), rather than Article III judges.¹⁸⁵ The SEC has made it perfectly clear that it will use its discretion to prosecute inside trading cases in an advantageous forum, but it has failed to articulate guidelines for how it would choose the forum.¹⁸⁶ An advantageous forum for the SEC unavoidably means that the forum will have certain disadvantages for an insider trading defendant.¹⁸⁷

¹⁸² See Fanto, *supra* note 148 (“[C]ourts will . . . always insist upon a showing of a violation of a duty, refusing to accept that an insider trading arises simply from the possession of material inside information.”); Jacquelyn Lamb, *Judge Rakoff Warns About SEC’s Move to More Administrative Proceedings*, SEC TODAY (Nov. 5, 2014), http://www.dailyreportingsuite.com/securities/news/judge_rakoff_warns_about_sec_s_move_to_more_administrative_proceedings [https://perma.cc/CF4C-9EG5] (highlighting concerns about allowing administrative law judges (“ALJs”) to make insider trading law); see also Press Release, Sec. & Exch. Comm’n, SEC Announces Enforcement Results for FY 2015 (Oct. 22, 2015), <https://www.sec.gov/news/pressrelease/2015-245.html> [https://perma.cc/Y4QJ-PFAM] [hereinafter SEC Press Release] (providing SEC enforcement statistics for fiscal years 2014 and 2015).

¹⁸³ SEC Press Release, *supra* note 182; David A. Wilson, *Coming to an Administrative Law Judge Near You: Insider-Trading Cases*, 29 WESTLAW J. DEL. CORP., no. 11, Dec. 9, 2014, at *1 (noting that these figures show no signs of slowing down).

¹⁸⁴ Wilson, *supra* note 183, at *1 (discussing how under prior law, broker-dealers, investment advisors, or anyone employed by either, was considered a regulated entity).

¹⁸⁵ See *id.* (noting that respondents have no say in the matter).

¹⁸⁶ See Cohen, *supra* note 24 (noting that Andrew Ceresney, the head of the SEC’s Division of Enforcement, announced that the SEC planned to bring more future insider trading cases as administrative proceedings); Jean Eaglesham, *SEC Is Steering More Trials to Judges It Appoints*, WALL STREET J. (Oct. 21, 2014), <http://www.wsj.com/articles/sec-is-steering-more-trials-to-judges-it-appoints-1413849590> (quoting Kara Brockmeyer, head of the SEC’s anti-foreign-corruption unit, who stated that bringing insider trading cases as administrative proceedings is the “new normal”). This serves to compound the existing problems presented by SEC’s tactic of shopping for judges who are more likely to rule favorably on the SEC’s insider trading prosecutions. See *Newman I*, 773 F.3d at 450 n.5 (implying that prosecutors steered the case to U.S. District Court Judge Sullivan); Fanto, *supra* note 148 (noting how the SEC strategically brings cases before friendly courts to establish the precedent it wants).

¹⁸⁷ See Cohen, *supra* note 24 (discussing the decided advantages the SEC would enjoy if it brought insider trading cases as administrative proceedings); Brian Mahoney, *SEC Could Bring More Insider Trading Cases In-House*, LAW360 (Jun. 11, 2014) <http://www.law360.com/articles/547183/sec-could-bring-more-insider-trading-cases-in-house> [https://perma.cc/KMT2-BXKH] (noting that Andrew Ceresney, head of the SEC’s Division of Enforcement, admitted that even threatening in-house proceedings gives the SEC a “leg-up” in negotiating settlements).

Allowing SEC administrative law judges to make the law on insider trading in closed-door administrative proceedings is a dangerous shift in the development of securities fraud law.¹⁸⁸ Indeed, there have already been constitutional due process challenges by respondents in these cases brought before the ALJs.¹⁸⁹ The advantages for the SEC bringing civil insider trading cases in-house are numerous, and clear from the fact that in fiscal year 2013, the SEC won 100% of its administrative proceedings compared to only 60% of its trials before federal judges.¹⁹⁰

With these concerns in mind, the *Newman* decision puts a decisive limit on how ALJs can rule in remote tippee cases.¹⁹¹ Even if the government brings civil

¹⁸⁸ See Lamb, *supra* note 182 (discussing how some argue that a move to administrative proceedings hinders the balanced development of the securities laws). Although there are limits, federal judges must be highly deferential to rulings by ALJs under the *Chevron* doctrine. See *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842–44 (1984) (holding that a court may not substitute its own construction of a statutory provision for an administrative agency’s reasonable interpretation).

¹⁸⁹ *Chau v. SEC*, No. 14-CV-1903 LAK, 2014 WL 6984236, at *14 (S.D.N.Y. Dec. 11, 2014) (granting SEC’s motion to dismiss Plaintiff’s due process and equal protection claim for court’s lack of jurisdiction without addressing constitutional arguments); *Gupta v. SEC*, 796 F. Supp. 2d 503, 513 (S.D.N.Y. 2011) (allowing a constitutional equal protection argument for selective prosecution to go forward); Complaint for Declaratory and Injunctive Relief at 2, *Duka v. SEC*, No. 15-cv-357 (S.D.N.Y. Jan. 16, 2015) (arguing that SEC administrative proceedings are unconstitutional because they violate Article II of the Constitution); Complaint for Declaratory and Injunctive Relief and Demand for Jury Trial at 1, *Peixoto v. SEC*, No. 14-cv-08364-WHP (S.D.N.Y. Oct. 20, 2014) (arguing the SEC administrative proceeding violated plaintiff’s constitutional due process and equal protection rights); Complaint for Declaratory and Injunctive Relief and Demand for Jury Trial at 2, *Stilwell et al. v. SEC*, No. 14-cv-07931-KBF (S.D.N.Y. Oct. 1, 2014) (arguing that SEC administrative proceedings violate Article III of the Constitution). One major argument is that if the SEC prosecutes a factually-related group, it cannot prosecute part of the group in court and the other part administratively without violating the Equal Protection Clause. See generally Bennett Rawicki, *The Dodd-Frank Act and SEC Enforcement—The Significant Expansion and Remaining Limitations on the SEC’s Enforcement Scope and Arsenal*, 41 SEC. REG. L.J. 35 (2013) (discussing how the SEC will likely be limited going forward by selective-prosecution claims when it attempts to prosecute a factually related group of insider trading defendants). The same selective-prosecution argument could be made that all defendants charged with insider trading are similarly situated, and therefore the government cannot bring an administrative proceeding against one and a federal court case against another without violating the equal protection clause. *Id.*

¹⁹⁰ See Lamb, *supra* note 182 (noting this disparity in outcomes); see also Wilson, *supra* note 183, at *1 (noting the better record the SEC has in ALJ proceedings). First, the timeline of an administrative proceeding is substantially shorter than in a federal court case. Wilson, *supra* note 183, at *1–2. Second, discovery is limited. *Id.* Third, standards for admissibility of evidence are lower than in federal courts, and hearsay is allowed. *Id.* at *2. Fourth, there is no jury. *Id.* And, fifth, a respondent has a right to appeal, but must first exhaust his or her administrative remedies by appealing to the SEC (which authorized the prosecution of the case in the first instance) before seeking appeal to a federal appeals court. *Id.*

¹⁹¹ Kenneth A. Bamberger, *Provisional Precedent: Protecting Flexibility in Administrative Policymaking*, 77 N.Y.U. L. REV. 1272, 1274 (2002) (noting that under the rule of stare decisis, when a court interprets a statute before an agency, the judicial interpretation becomes binding precedent on the agency); Matthew Diller & Nancy Morawetz, *Intracircuit Nonacquiescence and the Breakdown of the Rule of Law: A Response to Estreicher and Revesz*, 99 YALE L.J. 801, 828 (1990) (discussing how

cases in-house, prosecutors must still prove that a remote tippee knew that the tipper received a personal benefit to be liable.¹⁹² The irony is that the SEC's role is to enforce regulations that make financial markets more transparent and fair, yet by bringing civil cases in-house based on the advantages and likelihood of success, the agency is engaging in arbitrary and opaque behavior that undermines the legitimacy of the agency and enforcement process.¹⁹³

2. Shifting Its Aim: Why the SEC Should Target Insider-Tippers

By setting a definitive threshold for remote tippee liability, the *Newman* decision may ultimately persuade the SEC to pursue a different litigation strategy aimed at the crux of the information problem: insider-tippers.¹⁹⁴ This is hardly a novel idea, yet the SEC has a history of pursuing downstream tippees who trade on confidential information while failing to prosecute tipper-insiders whose breach of duty commences the tipping chain.¹⁹⁵ The crux of the problem is the fraudulent disclosure of the information in the first instance, in breach of a duty owed to shareholders or source of information.¹⁹⁶

the system of judicial review depends upon oversight by federal courts, and how federal courts create binding precedent on ALJs).

¹⁹² See *Newman I*, 773 F.3d at 450 (summarizing all of the elements the government is required to prove in an insider trading conviction against a tippee); Bamberger, *supra* note 191, at 1274 (discussing how an agency's ability to construe an ambiguous statutory provision is foreclosed when a court resolves the ambiguity first).

¹⁹³ See Wilson, *supra* note 183, at *4 (noting this irony and arguing that the SEC's arbitrary and opaque prosecution tactics are directly in conflict with the goals of fairness and transparency conferred on the agency by Congress); Eric Hammesfahr, *Ceresney Defends Use of SEC Judges*, CQ ROLL CALL: WASH. SEC. ENFORCEMENT & LIT. BRIEFING (Nov. 25, 2014), 2014 WL 6675018 (noting "efficiency" as the SEC's rationale for choosing to file in an administrative forum). Efficiency, however, should never trump constitutional due process. See Wilson, *supra* note 183, at *3-4 (noting that increased efficiency is a point of contention); Hammesfahr, *supra* (same).

¹⁹⁴ See *Newman I*, 773 F.3d at 450 (holding that for remote tippees to be liable they must know of a personal benefit of some consequence that is conferred on the insider-tipper for the disclosure of inside information); Coles, *supra* note 46, at 226-27 (highlighting how insiders are in the best position to control disclosure and prevent manipulation of corporate actions). In fact, Japan's prohibition on insider trading is limited to those who receive nonpublic information directly from a party related to a corporation and does not extend liability to remote tippees. Franklin A. Gevurtz, *The Globalization of Insider Trading Prohibitions*, 15 TRANSNAT'L LAW. 63, 83 (2002) (comparing Japan's insider trading law with that of the United States, European Union, and Australia).

¹⁹⁵ See Coles, *supra* note 46, at 226 (discussing the view that there should be liability for tipping, but not for receiving, nonpublic information); Fisch, *supra* note 176, at 247-48 (proposing regulation of insider trading by holding insider-tippers responsible for the economic consequences of tippee trading). In *Newman*, the government only civilly charged one of the insider-tippers while completely failing to bring claims against the other. 773 F.3d at 443-44. The *Newman* Court made its displeasure of this prosecutorial tactic known when it called the SEC out in its opinion for such discretionary decisions. *Id.*

¹⁹⁶ See *O'Hagan*, 521 U.S. at 665 (holding that liability is based on breach of duty to a source of information); *Dirks*, 463 U.S. at 660 (holding that liability is based on a breach of a fiduciary or similar duty); *Chiarella*, 445 U.S. at 228 (same); see also Fisch, *supra* note 176, at 249 (arguing that the tipper should bear the penalty for insider trading because he or she is responsible for protecting the

So why has the SEC tried so hard to expand insider trading liability to pursue remote tippees when in some cases it fails to prosecute the insider-tippers at all?¹⁹⁷ The answer is twofold: leverage and fear.¹⁹⁸ The government leverages insider-tippers to provide evidence to convict tippees further down the line.¹⁹⁹ Additionally, the government has leveraged the expansive, vague state of insider trading law to settle cases with individual defendants and corporations who would rather not challenge the resources of the federal government and the stigma that comes along with insider trading charges.²⁰⁰ The government can merely threaten administrative proceedings and extract a settlement from respondents.²⁰¹ Such tactics led to the SEC recording \$4.16 billion in disgorgements and penalties in fiscal year 2014.²⁰² Prosecuting remote tip-

interests of the issuer or source of information). Indeed, as Commissioner Smith of the SEC stated in *Investors Management Co.*, one of the earliest insider trading cases: “It is important in [insider trading] case[s] to focus on policing insiders and what they do . . . rather than on policing information *per se* and its possession . . .” *Dirks*, 463 U.S. at 662–63 (quoting *In re Investors Mgmt. Co., Inc.*, 44 S.E.C. 633, 651 (1971)). Additionally, it is important to note that Congress enacted the Insider Trading Sanctions Act of 1984, which imposes civil penalties on nontrading tippers, because tippers are “most directly culpable in a violation”; thus, “[a]bsent the tipper’s misconduct, the tippee’s trading would not occur.” H.R. REP. NO. 98-355, at 9 (1984).

¹⁹⁷ See *Newman I*, 773 F.3d at 443–44 (noting that the government failed to prosecute the one of the insider tippers altogether, while only bringing civil charges against the other insider tipper).

¹⁹⁸ See *Dirks*, at 664 n.24 (highlighting the hazardous position when someone has to rely on the SEC’s enforcement tactics and litigation strategy in a murky area of law); J. Kelly Strader, *White Collar Crime and Punishment: Reflections on Michael, Martha, and Milberg Weiss*, 15 GEO. MASON L. REV. 45, 79 (2007) (discussing prosecutorial leverage in the context of the Martha Stewart case). Essentially, the government can prosecute a case under a novel theory of liability that has a harsh sentencing range under the U.S. Sentencing Guidelines to force a plea bargain. See Strader, *supra*, at 65 (asking whether the government should be able to “cherry pick” its theory to force a plea).

¹⁹⁹ Ellen C. Brotman & Erin C. Dougherty, *Blue Collar Tactics in White Collar Cases*, THE CHAMPION, Sept. 2011, at 16, 20, http://www.mmwr.com/Uploads/FileManager/blue_collar_brotman.pdf [<https://perma.cc/DB8E-6BZM>] (discussing the various prosecutorial tactics employed by the SEC in insider trading cases such as confidential informants, whistleblowers, and cooperating witnesses). The SEC can submit witness immunity requests to the Department of Justice, and will even provide monetary rewards to cooperating individuals and companies in securities fraud investigations. *Id.* (quoting U.S. District Court Judge Lewis Kaplan of the Southern District of New York addressing a cooperating witness: “Our criminal justice system works in part because of bargaining with people like yourself. It isn’t pretty. . . . You happen to have the goods and get the goods on them. And so, frankly, in the words of the street, you get to walk.”).

²⁰⁰ See Michael J. Metzger, Note, *Treble Damages, Deterrence, and Their Relation to Substantive Law: Ramifications of the Insider Trading Sanctions Act of 1984*, 20 VAL. U. L. REV. 575, 612 (1986) (discussing how the government can extort a settlement from a defendant due to the uncertainty in insider trading law coupled with severe monetary penalties and the stigma of a conviction). *But see* Patrick Craine & Lashon Kell, *Prosecuting Insider Trading: Recent Developments and Novel Approaches*, 59 THE ADVOC., Summer 2012, at 45, 46, <http://www.urbanlawoffices.com/Articles/UrbanArticle.pdf> [<https://perma.cc/578A-J4JB>] (noting that the SEC’s use of increasingly novel theories of insider trading has led more defendants to elect to litigate their cases rather than settle).

²⁰¹ See Mahoney, *supra* note 187 (noting that the vast majority of insider trading cases settle).

²⁰² A \$4.16 Billion Haul and a Year of ‘Firsts’ for SEC, 21 MONEY MANAGER’S COMPLIANCE GUIDE, no. 5, Nov. 2014, at 7, 7. The SEC’s fiscal year ended in September 2014, two months before the *Newman* decision. See SEC Press Release, *supra* note 182.

pees against whom the government has the weakest case for the sake of general deterrence can hardly be approved as an appropriate rationale for destroying people's lives and livelihoods.²⁰³ As the Court in *Dirks* aptly warned, without guiding principles market participants are subject to the mercy of the government's litigation strategy.²⁰⁴

Newman should force the SEC to focus on those individuals who disclose confidential information in breach of a duty, which hurts shareholders or a source of the information, rather than those individuals who are three or four degrees removed down the tipping chain.²⁰⁵ The U.S. Supreme Court has made clear that any liability on the part of the tippee is derived from the breach of duty to either the shareholders of a corporation or source of information.²⁰⁶ By focusing its prosecution strategy on insider-tippers, the government will deter insiders at the outset from disclosing confidential information in breach of their fiduciary duty.²⁰⁷

²⁰³ See Goldstein & Protess, *supra* note 137 (questioning whether U.S. Attorney Bharara's eighty-plus insider trading convictions will stand post-*Newman*). In November 2010, the FBI raided Level Global and Diamondback Capital Management. Julia LaRoche, *Ex-Level Global Employee: We'll Never Get Our Reputations Back*, BUS. INSIDER (Dec. 10, 2014, 1:46 PM), <http://www.businessinsider.com/level-global-reputations-destroyed-2014-12> [<https://perma.cc/7Y4H-NBXC>]. David Ganek, Co-Founder of Level Global, was never charged with any wrongdoing, yet the FBI raids led to the complete shut down of Level Global because investors demanded their money back. *Id.* Mr. Ganek released a statement after the *Newman* decisions stating: "For the dozens of my high-integrity colleagues at Level Global who lost their jobs and their reputations because the F.B.I. improperly raided our firm in this now-discredited fishing expedition, today's legal vindication is a reminder how prosecutorial recklessness has a real impact on real people." *Id.* Diamondback Capital also was forced to shut down operations in 2012 due to investor redemptions as a result of the FBI probes. *Id.* Mr. Ganek has sued the government for violating his constitutional rights in conjunction with the FBI raids. Complaint at 36–41, *Ganek v. Leibowitz*, No. 15-cv-1446, (S.D.N.Y. Feb. 26, 2015), *available at* <https://securitiesdiary.files.wordpress.com/2014/11/complaint-filed-against-sdny-prosecutors-ganek-v-leibowitz-et-al.pdf> [<https://perma.cc/5MBD-ARTB>] (bringing claims against the government for violation of Mr. Ganek's Fourth and Fifth Amendment rights).

²⁰⁴ See *Dirks*, 463 U.S. at 664 n.24 (noting the hazards of market participants having to rely on the SEC's litigation strategy).

²⁰⁵ See *Newman I*, 773 F.3d at 448 (criticizing the SEC's practice of prosecuting remote tippees under novel theories of insider trading).

²⁰⁶ See *O'Hagan*, 521 U.S. at 665 (holding that liability is based on breach of duty to a source of information); *Dirks*, 463 U.S. at 660 (holding that liability is based on a breach of a fiduciary or similar duty); *Chiarella*, 445 U.S. at 228 (same).

²⁰⁷ See *Berner*, 472 U.S. at 316 (noting that even if, as the government advances, the purpose of the law is to restrict the use of all material inside information until it is disclosed to the investment public, the most effective means of carrying out that policy is to "nip in the bud" the source of the information, the tipper, by discouraging him or her from unlawfully disclosing inside information (quoting *Nathanson v. Weis, Voisin, Cannon, Inc.*, 325 F. Supp. 50, 57–58 (S.D.N.Y. 1971))); Fisch, *supra* note 176, at 249–50 (arguing that imposing substantial liability on tippees should adequately nip in the bud the practice of unlawfully tipping).

Even with the tougher *Newman* standard, the SEC has still been able to successfully prosecute insider trading cases against remote tippees.²⁰⁸ In fiscal year 2015, the SEC recorded \$4.2 billion in disgorgements and penalties, indicating that *Newman* has not had the extreme results that the government warned about.²⁰⁹ Although the Ninth Circuit's decision in *Salman* is cited for the proposition that the *Newman* standard was too restrictive, it is actually a good example of how the *Newman* decision still allows the government to successfully pursue criminal cases against less remote tippees.²¹⁰ Even if the U.S. Supreme Court in *Salman* disagrees with the Ninth Circuit's expansive view of what constitutes a personal benefit, the Court will likely hold that the government still provided sufficient evidence to sustain the conviction against the remote tippee.²¹¹ This is because the remote tippee was only two degrees removed from the insider-tipper and knew both the insider-tipper and the first-degree tippee.²¹² Additionally, the government presented sufficient evidence that the insider-tipper disclosed the information for the purpose of benefitting the tippee, not merely that the tipper and tippee were in a close familial relationship, and that the remote tippee knew this.²¹³ As such, the *Newman* framework allows the government to prosecute those who are most culpable: insider-tippers and less remote tippees who know of the personal benefit received by the insider-tippers for disclosure of material, nonpublic information.²¹⁴

²⁰⁸ See *Salman*, 792 F.3d at 1094 (affirming the district court's conviction of a second-degree tippee); Mary Jo White, Keynote Speech at the 43rd Annual Securities Regulation Institute, A Conversation with Chair Mary Jo White (Jan. 26, 2016), <https://www.sec.gov/news/speech/securities-regulation-institute-keynote-white.html> [<https://perma.cc/N7AH-GC64>] (stating that *Newman* has had less of an impact than commentators have suggested).

²⁰⁹ See Petition of the United States of America for Rehearing and Rehearing En Banc, *supra* note 23, at 2–3 (arguing that *Newman* would “dramatically limit” and “threaten” the government's ability to enforce insider trading); SEC Press Release, *supra* note 182 (providing SEC enforcement statistics for fiscal years 2014 and 2015).

²¹⁰ See *Salman*, 792 F.3d at 1094 (noting that the jury had more than enough facts to infer that the insider disclosed information for a personal benefit); BROMBERG & LOWEFELS, *supra* note 144, § 6:315.90 (arguing that the government could have won its case in *Newman* if it just presented evidence that the intermediate tippees had passed along information about the tipper's personal benefit to the defendants).

²¹¹ See *Salman*, 792 F.3d at 1094 (affirming conviction of second-degree tippee); *Newman I*, 773 F.3d at 448 (holding that a personal benefit must be of some consequence, which would include a *quid pro quo* type of relationship or an intention to benefit the tippee). Less remote tippees are in a better position to know of a personal benefit conferred on the insider-tipper for the “gift” of confidential information. See *Salman*, 792 F.3d at 1094 (affirming conviction of second-degree tippee).

²¹² See *Salman*, 792 F.3d at 1089 (emphasizing the close relationship between tippee and insider tipper).

²¹³ See *id.* at 1094 (noting that the government presented direct evidence that the insider-tipper received a benefit and the remote-tippee defendant knew of that benefit).

²¹⁴ See *Newman I*, 773 F.3d at 450 (limiting remote tippee liability to those who actually know of a personal benefit of some consequence received by an insider-tipper for disclosing material nonpublic information).

CONCLUSION

The law of insider trading remains largely convoluted, especially with attempts by the SEC to expand the boundaries of the law with novel prosecution strategies against remote tippees. Absent intervention from Congress, federal courts continue to play a crucial role in circumscribing this increasingly expansive area of law. The *Newman* decision, which clarifies remote tippee liability, comes at a critical juncture where the SEC's prosecutorial tactics do not square with the common law. The *Newman* decision stays true to the U.S. Supreme Court's holding that liability for insider trading must stem from a breach of a fiduciary duty, either to shareholders of a corporation or a source of information. Importantly, *Newman* reins in prosecutorial over-reaching aimed at those who are least culpable and will hopefully shift the government's focus to the crux of the problem, namely corporate insiders who exchange material, nonpublic information for a personal benefit.

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